Creative Uses of Life Insurance for the Business Owner

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Life insurance as a concept has changed very little over the years. Simply stated, a large number of premium paying entities make installment payments to assure dollars will be available for the minority that suffer a premature death. However, the product of life insurance has been evolving since its inception. Besides providing insurance protection and a death benefit, the product has become a financial tool to accomplish many objectives. Some of the uses of the product for business owners are quite creative and very exciting.

One use of life insurance that has grown in popularity is as a non-qualified retirement supplement. The concept is fairly simple: a business owner can put away as much as he/she wants after-tax to supplement his or her retirement. Furthermore, he/she can do this without government intervention and can actually decide who will participate. Life insurance as the funding vehicle has some tax advantages not available to most other products. First, the growth in cash value is tax-deferred, which enables the dollars to increase more quickly. Secondly, according to current tax law, the cash value can be extracted from the policy without taxation if you use withdrawals and loans. Since all of the dollars people receive from their <u>qualified</u> retirement plans are taxable, these non-taxable distributions are quite attractive. This use has become more prevalent over the last decade due to the product evolution that allows policyholders to direct their premium payments into subaccounts that invest in equities, bonds and real estate. The ability to provide a pre-retirement death benefit while participating in the market through the use of variable life insurance has elevated this financial and insurance tool. One should remember, however, that the subaccount values will fluctuate depending on market conditions and may be worth more or less than their original cost.

With today's tight labor market one of the major concerns of many business owners is attracting and retaining key employees. One way an employer can differentiate itself from competitors is by offering creative benefits beyond the usual health, dental, vision insurance and 401(k) plans. Some form of deferred compensation is an attractive benefit. Deferred compensation can take many forms depending on the objective, but the ultimate goal is normally to provide compensation, over and above the formal retirement plan, to a select group of management. Since deferred compensation – in order to maintain its tax benefits – must be **"**unfunded**",** life insurance is increasingly being used as an informal funding method.

It works like this. The business owner promises an executive an additional income in retirement. The company books the future liability. A life insurance policy is purchased by the corporation on the lives of each participant and is the beneficiary. In some cases the cash value will be used to pay out the deferred benefits, but you need time to make this work. In many cases the benefits are paid to the participants out of cash flow and the life insurance death benefit becomes a cost recovery vehicle for the corporation.

As is the case with any concept or product, it will not fit every situation. This is true for non-qualified deferred compensation as it is for a “Fully Insured Defined Benefit Plan”. The seed for the use of life insurance in a qualified plan was planted in 1987 with the enactment of OBRA ’87. This legislation placed such severe restrictions on Defined Benefit plans that many employers abandoned these plans. Briefly, OBRA ’87 altered funding requirements in Defined Benefit plans so that smaller deductions, more chance for penalties and increased risk of attack on plan assumptions, became the new benchmark of these plans. Since it was primarily the funding requirements that caused the problem the idea began to emerge to utilize a plan that was exempt from these requirements. Thus, the Fully Insured Defined Benefit plan was born.

A plan qualifies under 412(i) if:

- all plan benefits are funded and guaranteed by individual level premium insurance company contracts;
- no rights in the contract may be subject to a security interest or loan at any time during the plan year. Loans may be made after the policy is distributed;
- contract must provide for level annual, or more frequent, premium payments over a period ending no later than normal retirement age of the plan participant;
- the benefits provided under each plan must be equal to the benefits provided under each contract at normal retirement age and must be guaranteed by an insurance carrier.

Some of the reasons this type of plan is so attractive include:

- no quarterly contribution requirement
- no penalty for reversion of excess assets
- no enrolled actuary need be involved since Schedule B is not filed
- plan assumptions shouldn’t be attacked since the assumptions are mandated to be the guarantees in the insurance company contracts
- much larger contributions (deductions) are available
- more cash is generated at retirement
- benefits are guaranteed by the insurance company.

Although the 412(i) Fully Insured Defined Benefit plan has a narrow appeal – primarily to small firms with an income and age disparity between the owner and other employees – in the right situation it is a very effective use of an insurance contract.

Business owners have been using life insurance to fund buy-out agreements since buy-outs came into existence. Obviously, in the event of a premature death, life insurance proceeds provide either the corporation or the shareholders with tax-free cash to purchase the stock of the deceased. The agreements along with adequate funding assure that the business will be able to continue with no unwanted owners or outside involvement. A problem arises when the owners survive and desire to exit the business. If cash value life insurance was used for funding, it is a challenge to somehow transfer the policies to the respective insured without violating the “transfer for value” rules leading to unwanted tax issues. However, there is an interesting solution to this dilemma being offered by a few major life insurance companies. Without getting overly technical, the life policies used to fund a buy-out are structured on a split ownership basis. The death benefit (pure term) portion is owned by the corporation (entity buy-sell) or by the “other” shareholder (cross purchase), but the cash value portion is owned by the insured. In the event of a premature death the death benefit is paid and the exchange of stock for cash takes place. The policy or policies that remain can be surrendered for their cash values and avoid any tax issues since the cash value is owned by the insured. The ability to structure a life policy on a split ownership basis creates tremendous flexibility and for the first time allows the policies being used to fund a buy-out agreement to legitimately serve a secondary purpose of supplemental retirement.

As the life insurance product continues to evolve its use as a unique financial tool continues to gain wider acceptance. In addition to the risk management features of the product its tax advantages and accumulation potential have allowed for more and more creative applications. Life insurance is no longer a subject to be avoided but, rather, an essential part of the business owner’s planning process.