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Life Insurance: Business Applications

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What is business life insurance?

Life insurance is an important part of a business. It may be used as a funding mechanism for your buy-sell agreement and as business interruption insurance to pay the business for interruptions caused by the death of key employees. Probably the most important role life insurance plays in your business is that of protecting the owner, employees, and family members. Life insurance may be used to insure key executives, to transfer ownership of a business interest, and to provide employee benefits. It may also be used in split dollar arrangements, executive bonus plans, qualified pension plans, and nonqualified deferred compensation plans.

Funding your buy-sell agreement with life insurance

The general function of life insurance is to create a sum of money payable at the death of the insured in order to replace the economic loss resulting from the person's death. When used to fund your buy-sell agreement, life insurance will create a sum of money at your death that will be used to buy your business interest from your family or estate.

Using life insurance in a buy-sell agreement requires all the procedures involved in buying personal life insurance. An application must be completed, including a completed medical history, and life insurance underwriting procedures must take place. You can use life insurance funding if you are one of the parties specified in a buy-sell agreement to purchase all or part of the business interest held by another buy-sell participant at the other person's death. This obligation provides an insurable interest, one of the requirements for an insurance company to issue a policy. For life insurance funding to work with your buy-sell agreement, you must be able to get life insurance, which often involves a physical examination. If you are in poor health, you might be considered uninsurable by insurance companies. If this applies to you, see Alternatives for the Uninsurable for some optional funding methods. Even if some of the parties are uninsurable, you can still use insurance to fund your buy-sell agreement, but you will need to structure alternate financing for the uninsurable shareholders.

Life insurance as an employee benefit

Life insurance can play a major role in the area of employee benefits. Such benefits may be limited to key employees or they may be offered to all full-time employees. Employee benefits can take the form of death benefit only plans that provide a death benefit for an employee's spouse or family. Life insurance policies can also be used to fund pension, profit-sharing, or deferred compensation plans. If an employee is interested in a large amount of personal life insurance but wants the business to buy the life insurance, a split dollar plan can be considered. Group life insurance is yet another form of employee benefit contract. It can be bought as group term life insurance or as group permanent life insurance and may be provided for a group of employees.

Life insurance coverage on a key employee

Key employee insurance is designed to help protect a business from the financial losses that may occur when a key employee dies. A key employee may be an owner of a business or a nonowner of the business. The key employee usually has special skills that, if unavailable, would harm the business if the employee died, resigned, or became disabled.

Typically, the business will buy life insurance on the life of the key employee. Since the business will be the owner and beneficiary of the life insurance policy, the business would pay the insurance company directly. At the death of the key employee, the insurance company will pay the death benefit directly to the business. These death proceeds are generally not subject to income tax. However, life insurance proceeds received by C corporations could cause the corporation to be subject to the alternative minimum tax (AMT) or increase the corporation's AMT liability. The death proceeds from the key employee life insurance policy may be used in a number of ways. The business may seek out a replacement for the key employee, may replace lost profits, or fund a partial stock redemption agreement. The death proceeds may also be used to make payments to the survivors of the key employee. If the business is sold, the business may want to fund a full stock redemption.

Life insurance in qualified retirement plans

Life insurance may be used to fund a qualified retirement plan. It may be used to finance or accumulate the funds necessary to guarantee the benefits that will be provided by the plan. Life insurance provides security and may be an important part of funding a retirement plan, assuring that the funds will be there when needed. For example, life insurance provides a benefit for the employee now if retirement is near. The cash values may be used to supplement the plan, and life insurance death proceeds may be used in the event of the employee's death to pay an income stream to the employee's survivors.

Since employers tend to look for ways to reduce taxes, immediate tax savings may result because contributions to these plans are usually deductible expenses and nontaxable to the employee. In addition, with creative design, the employers may have an advantage because these types of plans can shelter the income of owner-employees of profitable companies from taxation.

Life insurance used to fund split dollar arrangements

A split dollar life insurance arrangement, or SDA, is a method by which an employer and an employee share premium payments for a life insurance policy on the employee's life. It can be a win-win situation for both--providing the employer with a low-cost benefit to attract and retain desirable employees and enabling the employee to procure more insurance than he or she otherwise could afford (thereby providing more security for the employee and his or her family).

Split dollar arrangements usually take one of two forms. In the endorsement form, the employer is formally designated as the owner of the insurance contract and endorses the contract to specify the portion of the insurance proceeds payable to the employee's beneficiary. In the collateral assignment form, the employee is formally designated as the owner of the contract, and the employer's premium advances are secured by a collateral assignment of the policy.

> **Caution:** The Sarbanes-Oxley Act of 2002 makes it a criminal offense for a public company to lend money to its executives or directors. This may prohibit the use of the collateral assignment form in these companies.

Split dollar life insurance is an important part of the compensation package of many key employees. In a typical split dollar arrangement, the employer funds all or part of the cost of providing an employee with life insurance protection and then recoups the cost by sharing in the insurance proceeds at the employee's death. Split dollar arrangements have also come into wide use in gift and estate planning.

Under IRS regulations, effective September 17, 2003, there are two mutually exclusive regimes for taxing split dollar life insurance arrangements: the economic benefit regime and the loan regime. Both the owner and the non-owner are required to fully and consistently account for all amounts under a split dollar arrangement under either the economic benefit regime or the loan regime.

Under the economic benefit regime, the owner of the life insurance contract is treated as transferring economic benefits to the non-owner. This regime generally governs the taxation of compensatory arrangements in which the employee is not the owner of the contract (e.g., endorsement split dollar arrangements).

Under the loan regime, the non-owner is treated as lending premium payments to the owner. The loan regime generally governs the taxation of collateral assignment split dollar arrangements (e.g., arrangements in which the employee is designated as the owner of the contract and the employer (non-owner) pays all or a portion of the premiums).

Effects of life insurance on the valuation of stock

If a corporation owns life insurance and the insured dies, then the death proceeds become part of the general assets of the corporation and the value of the stock owned by each surviving shareholder will be increased by an amount proportionate to his or her interest. This increase in value can have unintended consequences.

Life insurance proceeds and the alternative minimum tax

As a general rule, death benefits from a life insurance policy are exempt from income tax. However, when a shareholder dies and the death benefit is paid to a C corporation, the corporation's exposure to the alternative minimum tax (AMT) is increased to the extent that the death benefit exceeds the corporation's basis in the policy.

The AMT is a complicated tax calculation that is intended to eliminate the potential for taxpayers to report large financial accounting profits while reporting little taxable income for federal income tax purposes, thus, paying little or no tax. The AMT is essentially a separate system of taxation with its own rules and tax computation methods. It requires the taxpayer to perform a set of calculations that may result in reclaiming some of the tax breaks otherwise available to taxpayers. The AMT amount is compared to the tax liability computed using the regular income tax calculation. If the AMT amount is higher than the regular tax amount on income, the AMT becomes the tax amount due.

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