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Use Business Life Insurance for Tax Planning

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What is it?

Life insurance is an important feature of many business arrangements. Some of its more important uses are as follows:

- Funding buy-sell agreements
- Providing an employee benefit
- Insuring a key employee
- Guaranteeing a business loan

Using business life insurance for these purposes raises many tax issues and presents many tax-planning opportunities. It's important to plan carefully because the tax consequences can be significant enough to spell the difference between a business's success and failure. You should consult your tax advisor to determine which approach is best for you.

Funding a buy-sell agreement with life insurance

In general

Owners of a closely held corporation or partnership generally want to retain control over the stock or partnership interests to prevent ownership interests from falling into the hands of spouses of deceased partners, competitors, or other outsiders. A buy-sell agreement allows the owners of a closely held C or S corporation or a partnership to restrict the transfer of ownership interests. One of the major problems the parties to a buy-sell agreement face is how to obtain funds to purchase the stock or partnership interest of a deceased shareholder. Life insurance is a preferred method of funding a buy-sell agreement. However, life insurance funding can create significant potential tax problems.

Income tax considerations

- Deducting premiums--Premiums for life insurance that was purchased to fund a buy-sell agreement are not deductible
- Taxing death proceeds--Death proceeds of a life insurance policy are generally not subject to income tax, regardless of whether the beneficiary is a corporation, a partnership, or a co-owner

Caution: *If there is a transfer of a life insurance policy for value, serious tax consequences can result for the beneficiary upon receipt of the death proceeds. For more information, see below.*

Alternative minimum tax (AMT) considerations

Life insurance is not a perfect funding solution for a buy-sell agreement because a C corporation can be subject to the AMT on proceeds it receives even if it uses them to redeem a deceased shareholder's stock.

Tip: *This potential AMT problem does not affect S corporations or partnerships.*

Transfer-for-value considerations

If a life insurance policy is transferred for value, all or a portion of the death proceeds received by the beneficiaries may be subject to income tax as ordinary income. In the context of a buy-sell agreement, a transfer-for-value could leave the parties to the buy-sell agreement short of funds to buy back the stock.

One way to avoid this problem is to increase the amount of the insurance.

Caution: *The following situations can create possible transfer-for-value problems:*

- Using existing life insurance polices to fund a cross purchase buy-sell agreement
- Terminating a buy-sell agreement
- Using a trusteed buy-sell agreement in which one trust holds one policy per shareholder
- Using group term life insurance to fund a cross purchase buy-sell agreement

- Using endorsement split dollar life insurance to fund a buy-sell agreement

Life insurance as an employee benefit

Life insurance is a major component of many employee benefit packages. Many employees belong to group life insurance plans. Highly compensated employees can participate in carve-out plans that allow an employer to remove them from the group plan and structure individual policies that offer more attractive, customized life insurance benefits. Any employer planning to offer life insurance should consider the effects of the plan on current and future personal and corporate taxes.

Group term life insurance--income tax considerations

- Employers can deduct premiums for group term life insurance from income, as long as the employer is not a direct or indirect beneficiary of the coverage.
- Coverage on partners or sole proprietors is not deductible.
- An insured employee can exclude the premiums on the first $50,000 of coverage from his or her gross income. Premiums on coverage above $50,000 are subject to income tax. However, an insured employee is not taxed on premiums for coverage above $50,000 to the extent the employer is the beneficiary.
- Beneficiaries receive the death proceeds free of income tax.

For general information, see Group Life Insurance .

Executive bonus (Section 162) plans--income tax considerations

- Since executive bonus plans require an employer payout in the form of a bonus, employers can generally deduct the premiums as salary, if they are part of a reasonable compensation package
- The employee is taxed on the entire premium

Split dollar life insurance--income tax considerations

- In most cases, an employer receives no direct tax benefits from a split dollar life insurance plan. Employer-paid premiums are not tax deductible, since the employer is either a direct or indirect beneficiary.
- Depending on how the arrangement is structured, the employee may have to pay income taxes each year either on the value of the economic benefits provided by the employer through the life insurance protection underlying the arrangement or on any imputed interest under the below-market loan rules.
- Employees pay their share of premiums with after-tax dollars.

Death benefit only plans--income tax considerations

- Employers cannot deduct death-benefit-only premiums.
- Employees do not include premiums in their taxable income.
- At the employee's death, the company receives its share of the death benefits free of income tax, but the beneficiary may be subject to income tax on any death benefits received.

Nonqualified deferred compensation (NQDC) plans--income tax considerations

- The earnings from assets used to fund life insurance are tax deferred.
- The proceeds of life insurance policies used to fund NQDCs are free of income tax.
- Employers can generally deduct amounts paid to a participating employee or the employee's beneficiary, provided they are part of a reasonable compensation package.

Life insurance in qualified plans--income tax considerations

Employers can deduct life insurance premiums as part of the contribution to a qualified retirement plan.

Life insurance coverage on a key employee

In general

Key employee life insurance provides funds to help a business cover expenses and financial losses caused by the sudden or unexpected death of a key employee. If you are considering using a key employee life insurance policy, you should first understand the tax considerations and take them into account in your planning.

Income tax considerations

- Deducting premiums--You generally cannot deduct the cost of key employee life insurance premiums, because one of the following situations usually applies: You are directly or indirectly a beneficiary of the policy, you are a sole proprietor, or the IRS does not consider the premium an ordinary and necessary expense of doing business.
- Deducting loan interest--You cannot deduct interest paid on a loan secured by a key employee life insurance policy unless at least four of the first seven annual premiums are paid without taking out a loan against the policy. If so, the deduction is limited to interest on indebtedness not exceeding $50,000.
- Including proceeds in gross income--Key employee life insurance proceeds are generally not included in gross income, although a few exceptions apply. The specific exceptions are beyond the scope of this discussion. For more information, please consult additional resources.
- Effect of proceeds on other tax benefits--Although key employee life insurance proceeds are not included in a business's gross income, they can still affect the availability of other tax benefits. For instance, the IRS disallowed a long-term capital loss for a swine breeder because he was compensated by key employee insurance when he liquidated a partnership following the business's failure as a result of his partner's death.
- Effect of proceeds on corporate alternative minimum tax (AMT)--Although key employee life insurance proceeds are not included in a C corporation's gross income, they may be included in the tax benefits added to its ordinary taxable income to determine its AMT.
- Effect of policy changes on corporate taxable gains--Corporations must recognize a taxable gain when they change the insured in a key employee life insurance policy.

Business credit life insurance

In general

If a new or expanding business that is borrowing money does not have significant assets or the lender perceives that the business relies heavily on the talents of one or a few individuals, the lender will often require a borrower to guarantee the loan. Business credit life insurance guarantees repayment through a life insurance policy on the life of the owner or key employees. The use of a business credit life insurance policy creates a number of tax issues.

Income tax considerations

- Deducting premiums--Businesses cannot deduct premiums paid on business credit life insurance. Lenders, however, can deduct premiums as an ordinary and necessary business expense if the following conditions apply: The insured is not an officer or employee of the lender and does not have a financial interest in the lender; the lender is holding the policy as additional security for the loan; and the lender cannot recover the premiums from the borrower or borrow against the policy's cash values.
- Taxing proceeds--Proceeds that a lender receives in recovering the loan are treated as a return of collateral and not as tax-free insurance proceeds. Any portion of the proceeds received in lieu of interest is treated as taxable interest income. Usually, a lender's proceeds are limited to the amount of the outstanding loan. Any additional death proceeds that are paid to the insured's estate or other beneficiaries are not taxable to the lender.

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