Business Uses of Life and Health Insurance

This is intended as an introduction and summary of some of the more important uses of life and health insurance in the business context.

# Transferring Business Ownership

Life insurance is an ideal funding vehicle for business continuation agreements. It guarantees that cash will be available at an owner's death to purchase his or her interest in the business.

Purchase Money, Transition Fund, Liquidation

The death of a business owner, if it does not bring the liquidation and termination of the business itself, must result in a definite change in the ownership and management personnel—in the human factor behind the business. In those cases where there are co-owners or employees who desire to carry on the business, life insurance proceeds can give them the money to purchase the deceased's interest.

In other cases, where the new business manager will be the child or other member of the decedent's family, through inheritance, life insurance proceeds can pay the estate's debts, costs and taxes, and provide some financial "operating room" during the transition period following death.

On the other hand, the best thing for all concerned may be an orderly liquidation of the business. Here, again, life insurance proceeds can be helpful. They can offset the dollar loss that occurs when a business is liquidated at the death of an owner.

Insuring the Owners

To avoid the risk of having uninsurable owners, a business should act promptly, while its owners are still healthy, to secure the insurance. A waiver-of-premium rider, of course, is useful in the event the owner is disabled before his departure from the business. A guaranteed insurability rider will enable an impaired owner to obtain additional insurance, which is particularly beneficial if there is a buy-sell agreement with a periodically adjusted purchase price.

Business owners sometimes remark that buy-sell insurance is just too expensive. It is not the insurance that is expensive; it is the business interest that is expensive. Insurance is simply the least expensive and most intelligent way to carry out the purchase.

Business Uses of Life and Health Insurance

Forms of Buy-Sell Agreements: Entity vs. Cross Purchase Agreements

The term buy-sell agreement refers to a contractual arrangement for the purchase of the interest of a co-owner of a business upon his or her death, disability, retirement, or withdrawal from the business. Stock purchase agreements are useful when:

* There is a need to restrict the transfer of stock to undesirable third parties.
* There is a need to "guarantee" a market for stock that is otherwise illiquid in the event of death, disability or retirement.
* There is a desire to formalize "continuity" in the family business (rather than relying on revocable will provisions).

Such an arrangement generally takes the form of either an entity-purchase or a cross-purchase agreement. An entity agreement is one in which the entity—partnership, LLC, or corporation—purchases insurance on the lives of its owners to fund a purchase of a deceased owner's interest by the entity. A corporate entity agreement is usually called a stock redemption agreement.

A cross-purchase agreement is one in which the surviving co-owners purchase the decedent's interest; the entity itself is not directly involved. The owners obtain insurance upon one another to fund the eventual purchase of a deceased co-owner's interest.

Basic Income Tax Rules

There is no income tax deduction for premium payments on life insurance policies funding any type of buy-sell agreement. Code §§264(a)(1), 262, 265(a)(1), 162(a) Rev. Rul. 70-117, 1970-1, CB 30. Policy proceeds are ordinarily received income tax-free by the corporation (in a stock redemption plan) or by the surviving shareholder (in a cross-purchase agreement). Code §101(a). In all business continuation planning caution must be exercised to be sure the transfer for value rule is not violated and to avoid taxation of the policy proceeds under Code §101(j). Policy proceeds received by a C corporation may be subject to tax under the corporate alternative minimum tax.

Impact on Cost Basis

In a cross-purchase buy-sell agreement, there will normally be no taxable gain to the deceased shareholder's estate. At the deceased shareholder's death, his stock receives a step up in basis equal to its fair market value at the date of death. Code §1014. The amount the surviving shareholder pays the estate for the stock becomes his cost basis in the stock.

Business Uses of Life and Health Insurance

In a stock redemption buy-sell agreement, the policy proceeds become part of the general assets of the corporation, thereby increasing the book value of the stock of the survivors by an amount equal to the difference between the policy proceeds and the cash surrender value prior to death. The cost basis of the survivor's stock will not be increased.

In the case of an S corporation buy-sell agreement funded with life insurance the income tax treatment of redemption versus cross-purchase methods will tend to more closely even up, because the insurance proceeds increase basis (pro rata among the S corporation shareholders). For this purpose, the basis increase would be equal to the total proceeds minus cash value. There are still differences though. With a cross-purchase agreement, all basis increases are effectively allocated to the surviving shareholders, while in a stock redemption, it is pro rata among all stockholders (including the estate of the deceased stockholder). One possible way to avoid wasting some of the basis increase (i.e., the part that goes to the estate of a deceased shareholder) is to terminate the S Corporation's tax year under Code §1377(a)(2) at the first shareholders death and shift the basis adjustment attributable to the life insurance proceeds to the following taxable year (when the surviving shareholder does not have to share the basis increase with the deceased shareholder's estate). Note that a cross-purchase agreement avoids this whole problem to begin with.

Avoiding Dividend Treatment (i.e., "disappearing basis" in a C corporation stock redemption)

The general rule is that any payment by a corporation (other than an S corporation) to a shareholder will be treated as ordinary income (a dividend) rather than a capital transaction (sale or exchange), even if the payment is made to redeem stock. Code §301(a) Rev. Rul. 55-515, 1955 - 2 CB 222. If a payment is treated as a dividend, the entire amount will be taxed as ordinary income, with no recovery of basis. To avoid this treatment, there must be a qualifying redemption under Code §302 or Code §303.

Avoiding dividend treatment - Code §302. Where a redemption completely terminates the shareholder's interest in the corporation, (Code §302(b)(3)), is "substantially disproportionate" with respect to the shareholder, (Code §302(b)(2)), or is not equivalent to a dividend, (Code §302(b)(1)), the redemption will qualify for sale treatment (a capital transaction and not a dividend) under Code §302. These tests are sometimes difficult to meet in family-owned businesses because of attribution principles.

Business Uses of Life and Health Insurance

In order to qualify under Code §303, the value of the stock must exceed 35% of the adjusted gross estate. If the decedent has at least a 20% interest in two or more corporations, they can be aggregated to meet the 35% requirement. Note that the three year bring back rule (Code §2035) is retained for purposes of determining the estate's qualifications for a Code §303 redemption (i.e., gifts made within three years of death (that did not qualify for the gift tax annual exclusion) are brought back into the adjusted gross estate for purposes of Code §303 calculations).

Cross-Purchase Expedited by Use of Trust or Partnership

A departure from the usual practice of having shareholders purchase and maintain personal ownership of policies is to have the insurance purchased and maintained by a trust (or partnership), created at the time the cross-purchase agreement is entered into. This solution eliminates the problems of multiple shareholders holding individual policies on each other. The number of policies purchased can be limited to the number of shareholder participants. When using this technique caution must be exercised to be sure the transfer for value rule is not violated.

Another advantage is the avoidance of potentially touchy dealings between a bereaved spouse and the surviving co-owners: the trustee of the trust effects the settlement. The trustee (or managing partner), as possessor of both the stock and the policies, is legally bound to carry out the agreement promptly and, therefore, the possibility of a last minute change of heart on the part of heirs or survivor/owners is eliminated.

Split-Dollar Arrangement for Premium Payments

In cross-purchases, where differing ages and varying face amounts corresponding to majority and minority interests sometimes lead to disputes about inequities in premiums, a split-dollar agreement is sometimes suggested.

When using split-dollar in the buy-sell context beware of the transfer for value tax trap. The endorsement method generally should be avoided because it can cause transfer for value problems. When the corporation, as owner, transfers a right to the co-shareholder in consideration for services, this appears to be a transfer for value [I.R.C., §101(a)(2)]. Recall that a co-shareholder of the insured is not in the exempt group of transferees. The endorsement method can also cause estate tax problems for a sole or controlling shareholder.

Business Uses of Life and Health Insurance

There is some fear that the transfer for value rule can cause problems even with the collateral assignment method. Each co-shareholder would be paying the P.S. 58 or Table 2001 cost on the policy owned on the life of another co-shareholder, and this could be looked upon as some form of reciprocal transfer [Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961); see also Rev. Rul. 78-420, supra]. In addition the release of a collateral assignment can be construed as a transfer for value.

Disposition of Policies on Surviving Shareholders in Buy-Sell Agreements

An often neglected provision in buy-sell agreements is some arrangement for the disposition of the life insurance policies which the decedent had held on the lives of the surviving shareholders. In a typical cross-purchase plan the family of a deceased shareholder will own a policy on the surviving shareholder(s) which may contain a considerable amount of cash value.

The family will also have the cash from selling the deceased shareholder's interest in the business. The family has some options available, including:

1. Keeping the policy on the survivor;

2. Surrendering the contract and receiving the cash value;

3. Offering the contract to the surviving shareholder(s), who in the interim may have become uninsurable.

In order to deal with these policies in a reasonable and advantageous manner and avoid any future problems, arrangements for disposition of the policies can be written into the original buy-sell agreement. The agreement can be written so that in the event of a death, all policies are transferred to the surviving insured(s), or to a trust or partnership designed to hold the policies.

Advantages of the Insured Buy-Sell Agreement

The insured buy-sell agreement gives the purchaser an opportunity to advance-fund his obligation, rather than attempting to come up with the purchase money on short notice or set the money aside currently. Further, he is guaranteed that the purchase money is available when needed, regardless of how soon the owner dies. In effect, the purchase price is amortized over the owner's working years.

A valid buy-sell agreement can peg the value of a deceased owner's business interest for estate tax purposes. This generally allows the owner to plan his affairs around this fixed value without fear of a higher IRS value determination. However, such a value will

Business Uses of Life and Health Insurance

. not be conclusive for estate tax purposes unless it is essentially a bona fide arms-length transaction. When the buyer is a family member of the deceased seller special scrutiny is called for [See I.R.C. §2703].

The buy-sell agreement guarantees that there will be a market for the stock at death. Closely held stock is not readily marketable, and the owner's family could be left at the mercy of the surviving owners as to receiving a fair price, absent the agreement.

The agreement also assures the surviving owners that persons who are not active in the business (e.g., the heirs of the deceased and/or others to whom they might sell) will not become owners and interfere with the conduct of the enterprise.

While the insurance premiums are not deductible by the purchaser (whether entity or individual) the proceeds are typically received income tax-free.

# Key-Executive Indemnification

Key-executive insurance is designed to indemnify a business for the economic loss caused by the death of a key employee.

Small businesses are guided to success by a handful of key people. A "key executive" is an employee whose premature death or disability would cause an economic loss to the business, or whose continued presence is considered material to the success of the business.

It may be the person who is largely responsible for the credit the firm enjoys; it may be the person who develops the firm's product lines; it may be the firm's sales manager, whose activity constitutes much of the goodwill the firm enjoys. The death of a key person is bound to leave its mark upon the business. It may result in a pronounced interruption, if not a full termination, of business activity and a curtailment in the flow of profits.

To offset some or all of these losses, the firm could carry life insurance on its key people. This insurance, payable to the firm, would indemnify it against the loss of these key people.

Disability insurance also may be purchased to give key executive protection to a firm. This coverage is discussed briefly below.

Business Uses of Life and Health Insurance

# Business Health Insurance

Health insurance, as well as life insurance, has an important role in business. The more common uses are for Health Reimbursement Arrangements (HRAs), wage continuation plans, dismemberment plans, disability buyouts and key-executive disability indemnification. These subjects are discussed below.

Health Reimbursement Arrangements (HRAs)

A health reimbursement arrangement (HRA) must be funded solely by an employer. The contribution cannot be paid through a voluntary salary reduction agreement on the part of an employee. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period. An HRA may be offered with other health plans, including FSAs (Flexible Spending Arrangements). An employee covered by an HDHP (High Deductible Health Plan)and a health FSA or an HRA that pays or reimburses qualified medical expenses generally cannot make contributions to an HSA (Health Savings Account).

What are the benefits of an HRA?

* Contributions made by an employer can be excluded from the employees gross income.
* Reimbursements may be tax free if the employee paid qualified medical expenses.
* Any unused amounts in the HRA can be carried forward for reimbursements in later years.

Qualifying for an HRA

Self-employed persons (i.e., unincorporated business owners) are not eligible for an HRA .

HRAs are employer-established benefit plans. These may be offered in conjunction with other employer-provided health benefits. Employers have complete flexibility to offer various combinations of benefits in designing their plan. An employee does not have to be covered under any other health care plan to participate. Certain limitations may apply to highly compensated employee participants.

Business Uses of Life and Health Insurance

Contributions to an HRA

HRAs are funded solely through employer contributions and may not be funded through employee salary deferrals under a cafeteria plan. These contributions are not included in the employee's income. Employee's pay no federal income taxes or employment taxes on employer contributions to the HRA.

Amount of Contribution

There is no limit on the amount of money an employer can contribute to the accounts. Additionally, the maximum reimbursement amount credited under the HRA in the future may be increased or decreased by amounts not previously used. See Balance in an HRA, below.

Distributions from an HRA

Generally, distributions from an HRA must be paid to reimburse an employee for qualified medical expenses incurred. The expense must have been incurred on or after the date of enrollment in the HRA.

Employer provided debit cards, credit cards, and stored value cards can be used to reimburse participants in an HRA. If the use of these cards meets certain substantiation methods, the employee may not have to provide additional information to the HRA. For information on these methods, see Revenue Ruling 2003-43 I.R.B. 2003-21, Notice 2006-69, 2006-31 I.R.B. 107, and Notice 2007-2, 2007-2 I.R.B. 254.

If any distribution is, or can be, made for other than the reimbursement of qualified medical expenses, any distribution (including reimbursement of qualified medical expenses) made in the current tax year is included in gross income. For example, if an unused reimbursement is payable to an employee in cash at the end of the year, or upon termination of his or her employment, any distribution from the HRA is included in the employee's income. This also applies if any unused amount upon death is payable in cash to the employee's beneficiary or estate, or if the HRA provides an option for an employee to transfer any unused reimbursement at the end of the year to a retirement plan. See Qualified HSA Distribution, below.

If the plan permits amounts to be paid as medical benefits to a designated beneficiary (other than the employee's spouse or dependents), any distribution from the HRA is included in income. However, if, before August 15, 2006, the plan contains such a provision, this rule only applies to plan years beginning after December 31, 2008.

Business Uses of Life and Health Insurance

Reimbursements under an HRA can be made to the following persons.

1 - Current and former employees.

2 - Spouses and dependents of those employees.

3 - Any person an employee could have claimed as a dependent on their return except that:

* The person filed a joint return,
* The person had gross income of $3,500 or more, or
* The employee, or their spouse if filing jointly, could be claimed as a dependent on someone else's return.

4 - Spouses and dependents of deceased employees.

For this purpose, a child of parents that are divorced, separated, or living apart for the last 6 months of the calendar year is treated as the dependent of both parents whether or not the custodial parent releases the claim to the child's exemption.

Qualified Medical Expenses

Qualified medical expenses are those specified in the plan that would generally qualify for the medical and dental expenses deduction. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for HRA purposes. Under HRA rules qualified medical expenses include:

* Amounts paid for health insurance premiums.
* Amounts paid for long-term care coverage.
* Amounts that are not covered under another health plan.

An employee covered under both an HRA and a health FSA cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the distribution from the HRA. Notice 2002-45, Part V, I.R.B. 2002-28.

Business Uses of Life and Health Insurance

Qualified Health Savings Account (HSA) Distribution

This is a distribution from an HRA that is transferred to an HSA. The distribution must not be more than the lesser of the balance in the HRA on:

* September 21, 2006, or
* The date of the distribution.

An employee not covered by an HRA on September 21, 2006, cannot elect to make a qualified HSA distribution from the HRA.  The following conditions must be met to make a qualified HSA distribution.

* The plan must have been amended to allow these distributions.
* Th employee must elect to make the rollover.
* The year-end balance in the HRA must be frozen.
* The funds must be transferred within 2½ months after the end of the HRA's plan year and result in a zero balance in the HRA.
* The distribution must be contributed directly to the HSA trustee by the employer.

Only one qualified HSA distribution is allowed for each HRA.  Notice 2007-22, 2007-10 I.R.B. 670. The employee must remain remain an eligible individual for HSA purposes during the testing period, or the distribution is included in his or her income and is subject to a 10% additional tax.

Balance in an HRA

Amounts that remain at the end of the year can generally be carried over to the next year. An employer is not permitted to refund any part of the balance to an employee. These amounts may never be used for anything but reimbursements for qualified medical expenses. See Qualified HSA Distribution, above.

Wage Continuation Plans

Wage (or salary) continuation plans are designed to compensate an employee during a period in which he or she is absent from work due to illness or injury. Such plans may be insured or uninsured.

Business Uses of Life and Health Insurance

If insured, the employer may deduct its premiums if the disability income benefits are paid directly to employees. If the disability benefits are paid to the employer (and then on to the employee), the employer may not deduct its premiums but it receives the benefits tax-free. In any event, the employer's premiums are not taxed to the employee. When an employee receives benefits, he is usually fully taxed upon them since they are a salary replacement [I.R.C. §105(a)].

Unincorporated business owners may not participate in wage continuation plans on the tax-favored basis described above. They may purchase personal disability insurance with nondeductible premiums and receive tax-free benefits. And they may, of course, cover their employees under a wage continuation plan. Shareholder-employees are permitted to participate in a wage continuation plan, provided the plan is for employees and not just for shareholders.

Section 105(c) Plans

Section 105(c) plans are designed to compensate an employee for the permanent loss (or loss of use) of a member or function of the body, or a permanent disfigurement. Thus, the benefits under such a plan are determined by the nature of the injury, not the period during which the employee is absent from work.

The employer's premiums in an insured §105(c) plan are deductible and are not taxed to employees. The benefits are completely tax-free to the employees.

The restrictions mentioned previously with respect to unincorporated owners and shareholder-employees also apply here.

Disability Buyouts

Partners and stockholders in small enterprises commonly provide for eventual retirement and death of principals. The happenstance of disability of a key figure in the business raises even more complex issues. While death and retirement are final and predictable occurrences, disability engenders some unique problems. Usually, no one knows how long the period of disablement may last. Two major items to be considered are (1) the potential loss of income by the employee or partner and (2) the effect on the capital investment of the disabled key person and his/her associate or associates in the venture.

A sick-pay plan funded by a conventional disability policy is a simple, basic solution for lost income. However, this solution may only address part of the problem. If the

Business Uses of Life and Health Insurance

disability persists for more than a year or so, the indications are that it will be a permanent situation In fact, the odds are that anyone disabled for two years or more is likely to be unable to return to an active working life. This brings on a completely new set of problems that can deeply affect the future of the business enterprise.

For example, in a two-person partnership the remaining healthy partner may be forced to continue the sole operation of the business. When the partnership was originally formed, there were two individuals who could pool their talents to effectively perform the duties involved in the day-to-day operations of the company. They also had certain long-term goals in mind for the enterprise. Undoubtedly, after operating in this "temporary" situation, the remaining partner must begin to think about a replacement.

The ailing partner, being removed from the daily activities of the business, must also begin to feel that the working partner is becoming progressively less receptive about his or her opinions and ideas about running the company. Although the disabled partner is receiving an income, probably the maximum that the insurance would cover, the return on his or her capital investment is a question that will arise. The situation might eventually occur that others (especially if there is a replacement partner) would be running the business, financed at least in part with the disabled partner's money. All these constraints on the successful continuation of the business could not help but extract a price. In fact, a study by the Small Business Administration (SBA) has revealed that the preponderance of small business failures are caused by the poor health of an owner.

The alternative to such a situation is to create an effective plan incorporating an agreement for a buyout of a disabled owner's share of the business. Since life insurance will not solve this problem, what other solutions can be worked out? The business could set up a contingency reserve fund in advance, or if this is not practical, perhaps installment payments might be an option.

Insurers, recognizing the need for a product to meet this situation, have responded. Disability policies are available which not only provide traditional forms of income replacement, but will provide a capital sum to indemnify an owner for a financial interest in his or her company. Like conventional forms of business life insurance, the benefit is based on the value of the business interest and the terms of the buyout agreement. Disability buyout arrangements are discussed in general terms below.

Business Uses of Life and Health Insurance

Designing the Disability Buyout Agreement

In general, disability buyout agreements cover two potential phases. The first phase sets forth the intent to purchase disability insurance on the lives of the business owners. Depending on the resources available in the company reserve, the stockholder/employee will begin to receive policy benefits after a 30 to 60 day waiting period or longer. The firm will provide salary continuation payments during the insurance waiting period. When the policy takes effect, the company can reduce its payroll expenditure and be spared the full or, at least, part of the financial burden, depending on the level of income replacement contracted for from the insurance company.

The next part of the agreement deals with the eventuality of prolonged disability. One approach is simply to wait out the disability period. Since long-term disability often results in death, the life insurance buyout arrangement would then be operative. However, this is not a practical solution, since the time elapsed under uncertain conditions could be ruinous for the business.

The other option is to effect a mandatory buyout. The company or remaining active owners buy out the full interest of the disabled principal for a previously agreed upon price. Ownership is immediately transferred, just as it would have been in the case of death. A provision may be inserted in the agreement for the principal's possible recovery; in which case, the disabled participant might be able to buy back his or her business interest.

Income Tax Consequences

Providing that the disability income replacement insurance is part of a sick-pay plan for employees (without regard to their status as stockholders), premiums are deductible to a corporation, and premium amounts are not includible in income of the insured's. Disability payments may be includible in income. In sole proprietorships, partnerships or S corporations, premiums are not deductible by the company, but benefits are received on a tax-free basis.

For the disability buyout insurance mentioned above, premiums are not deductible, whether paid by the corporation, partners or individual. Accordingly, premium amounts are not taxable income and benefits are received tax-free. Buyout payments are deemed a capital transaction and as such, not deductible. Amounts received by the payee under the agreement are taxed to the extent that they exceed the recipient's basis in the interest being bought out.

Business Uses of Life and Health Insurance

The agreement may be written with the option of extending the buyout payments over a number of years. If this is the case, any gain will be taxed over the period of years, rather than a single year, applying the installment method. Thus, similar to the principal of annuity taxation, the payments each year would be a combination of tax-free return of principal and taxable capital gain and interest.

Disability Buyout Products

The DBO (Disability Buy Out) insurance contract chosen should incorporate the flexibility needed for individual situations. Generally there will be two types of payment methods available: lump-sum and installment payments. For premium and tax considerations, the installment method is often favored.

The installment payment plan is less costly than the lump-sum payment, plus the tax is spread out as payments are received. There is usually a "presumptive disability" provision, i.e., a provision that if the insured's disability continues beyond some selected waiting period, say six months, the disability will be considered permanent and benefits will continue to be paid, even if recovery later occurs. A customary buyout stipulation provides that if the insured recovers before the presumptive disability time limit expires, a buy back into the firm will be allowed by the participant's refunding of the payments that have been received.

Policies available differ in their terms. Some offer a lump partial "down payment" with installments to follow. Packages can be designed so that the total value of the buyout will be paid over a stated period of time. Waiting periods are customarily offered at 12, 18 and 24 months, with benefit payments stretching out over 24, 36 or 60 months. Business overhead expense policies can be issued to provide disability payments during the waiting period for the DBO policy. Definitions of disability will also vary with different products, and these provisions should also be examined closely when purchase is contemplated.

Although planning authorities and the SBA and other groups have cautioned business owners for many years about the problems that disability can bring to a business, this area is still very much overlooked in business planning. Most attorneys do not adequately provide for this potential problem in buyout agreements and most business principals do not fund for this eventuality.

Business Uses of Life and Health Insurance

Living Benefits Rider Application to Disability Business Insurance

The living benefits rider, an innovative addition to life insurance contracts, has been hailed as one of the most creative product developments in life insurance history. This rider, as generally constructed, pays a lump-sum benefit upon the occurrence of any of several debilitating health conditions, such as Alzheimer's disease, strokes, heart attacks, cancer and other similar conditions. While this product was welcomed by the general public, its significance for business applications is now becoming apparent. In particular, there may be wide application for use of this type of coverage in connection with buy-sell agreements.

For example, even if conventional disability insurance is purchased to bolster the provisions of a buy-sell agreement, there are some problems that remain unattended. One consideration is that in keeping the cost down, there is usually a long elimination period, as much as one or two years. A living benefit provision can provide a lump-sum payment to help close the waiting period gap or provide a substantial down payment for the corporation to purchase the disabled owner's interest. Generally, such payments are made upon the diagnosis of the adverse medical condition; therefore, actual disability need not be proven in order to receive benefits, as would be the case with conventional disability insurance. It is not suggested, however, that the living benefits rider is a less costly substitute for disability income insurance, only that the addition is a valuable supplement to such a plan.

Applications in Key Person Insurance

The addition of living benefits to life insurance is a valuable option when covering a key executive. When such an employee becomes the victim of a debilitating illness, the corporation loses the services of that individual for an extended period. Even upon return to the job, the executive may not function at full strength for a time. A lump-sum cash benefit payout from a rider can help solve many problems for the business in the interim. The executive can be temporarily replaced and still receive his or her accustomed income. If circumstances arise preventing the key person's return to the business, insurance proceeds can be used to provide early retirement payments to the executive. In any event, the cash provided by the policy allows the business time to look into options for short-term or long-term solutions to the problem of the disabled employee.

Key-Executive Disability Indemnification

The disability of a key executive can harm a business economically just as his death can. The employer can compensate for this loss by purchasing key-executive disability

 Business Uses of Life and Health Insurance

# insurance. The premiums for such insurance are nondeductible but the benefits are received tax-free.

# Executive Compensation

Businesses commonly use life insurance products as an incentive compensation device to attract and retain executives. The three principal uses of life insurance in this regard are in deferred compensation plans, split-dollar plans and employee death benefit plans.

Deferred Compensation

There are many circumstances in which various forms of deferred compensation, which do not meet the restrictive criteria for a "qualified plan" may, nonetheless, be quite useful. Such arrangements are referred to as "non-qualified" deferred compensation; essentially a contractual arrangement binding the employer to pay benefits in the future. Although non-qualified plans have long been used by employers, the restrictions placed on qualified plans by a string of successive tax acts and Department of Labor requirements under ERISA, have made non-qualified plans increasingly important. Since life insurance fits neatly into a deferred compensation plan, the promotion and sale of deferred compensation arrangements is a natural activity for the financial advisor.

Nonqualified deferred compensation can be advantageous to both the employer and the employee. The employer may be interested in persuading an individual to join, or stay with, the firm. An employee may be interested in reducing his current tax liability and in providing some additional retirement security for himself. In either case, life insurance and annuity products can fund the employer's obligation, formally or informally, to provide a promised future benefit.

The structure of the arrangement has important tax and regulatory ramifications.

Split-Dollar

In split-dollar plans, life insurance is an integral part of the compensation scheme. The employer and employee share in the purchase of insurance on the employee's life, and divide the proceeds at his death. Thus, the employee obtains substantial protection at a low out-of-pocket cost to him or her. In some plans, the employee's only cost is the income tax attributable to the value of the pure insurance protection that the employer's

Business Uses of Life and Health Insurance

premium payments confer upon him (determined under the P.S. 58 or Table 2001 rates or some cases the insurer's published term rates).

Employee Death Benefit Plans

Sometimes an employer will pay a death benefit to the survivors of an employee that is not part of any deferred compensation, split-dollar, group life or qualified retirement plan. These benefits are sometimes called "death benefit only" ("DBO") plans, "survivor's income benefit" ("SIB") plans or "naked death benefit" plans. Life insurance is an obvious funding vehicle for such a plan.

# Qualified Retirement Plans

Many qualified pension and profit-sharing plans utilize insurance and annuity products as funding vehicles.

# Group Life Insurance

Group life insurance plans may be funded with a master group contract, or with a group of individual policies.

Group life insurance, like qualified retirement plans, is on the perimeter of "business insurance." While it does involve insurance purchased by a business, most insurance companies have separate group departments to handle group products.