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Business Use of Life Insurance: Life Insurance in Qualified Plans

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What is it?

In general

Life insurance is one means for you, the employer, to finance an employer-sponsored retirement plan. As a source of funding, life insurance offers several advantages. It ensures that funds will be available to pay benefits at each employee's retirement when needed. Additionally, the policy's cash value can be used to supplement the qualified retirement plan's benefits. At the employee's death, the death proceeds will provide an income stream for the employee's survivors. However, there are many legal limitations to using life insurance to finance qualified retirement plans.

When can you use it?

As an employer, you can use life insurance to fund your company's qualified retirement plan, within the following legal limits:

In general

The purchase or availability of life insurance must be uniform and nondiscriminatory for all employees.

Defined contribution plans

Under a defined contribution plan, there is no limit to the face value of the policy. However, the percent of the total annual contribution that you can allocate to life insurance premiums varies with the type of policy.

- Term and universal life insurance--The amount you allocate to the premiums must be less than 25 percent of your total contribution to the qualified retirement plan
- Ordinary whole life insurance--The amount you allocate to the premiums must be less than 50 percent of your total contribution to the qualified retirement plan
- Combination insurance--All of the term or universal life premiums plus one-half of the ordinary whole life premiums must be less than 25 percent of your total contribution to the qualified retirement plan
- Profit-sharing plans--Profit-sharing plans are subject to the following special rule: You may completely invest company contributions accumulated in a profit-sharing plan for two years or more in life insurance

Defined benefit plans

Under a defined benefit plan, the following rules apply:

- Basic rule--The face value of the life insurance must be less than 100 times the expected monthly retirement benefit. For example, if a monthly retirement benefit of $1,000 were expected, the maximum allowable life insurance would be $100,000.
- Alternate rule--The total premiums for term or universal life insurance must be less than 33 1/3 percent of the assumed aggregate contributions that were made for the employee since he or she began participating in the plan. (The assumed aggregate contribution refers to a specific calculation distinct from the funding calculation.) For ordinary life insurance, the total premiums must be less than 66 2/3 percent of the assumed aggregate contributions.

Strengths

For employers

- If an employee's life insurance policy under a qualified retirement plan is paid up at retirement, he or she may be able to avoid converting from group to permanent insurance. This could save you a substantial cost if you carry an experience-rated group policy, since the experience rating typically changes when a policy is converted.
- If an employee dies under a defined benefit plan and the life insurance proceeds equal the entire pre-retirement death benefit, you can use the remaining equity assets to reduce your future contribution to the plan.

- You can achieve a favorable long-term cost for a defined benefit plan with participating whole life insurance if you use the dividends to reduce the premium.
- You may be able to make a larger contribution and take a larger deduction if you include ordinary life insurance in a defined benefit plan. This can help you avoid restrictions you might otherwise face on qualified retirement plan benefits and contributions.
- You can provide a current benefit to your younger employees who may favor the life insurance benefit over the long-term retirement benefit.

For employees

- By using life insurance in a qualified retirement plan, employees receive additional protection for their families if they die before they retire.
- Employees may save money, since they may need to buy less insurance outside the qualified retirement plan.
- A life insurance policy is portable. It can be moved to another plan if the employee changes employment and if the new plan accepts it.
- At retirement, an employee may be able to take a paid-up policy rather than incur the expense of converting his or her group insurance.
- With a waiver of premium option, an employee can forgo paying the premium if he or she becomes disabled.
- Employees who are otherwise uninsurable may be able to purchase insurance.
- Employees with high risk ratings (usually resulting from occupational hazards or poor health) don't need to pick up the higher cost. The company plan will cover it.
- Ordinary or universal life insurance policies can be used as annuities at retirement.

Tradeoffs

For employees

- Life insurance proceeds will increase the size of the employee's gross taxable estate, possibly resulting in estate taxes.
- Including life insurance within a qualified retirement plan essentially creates a tax shelter within a tax shelter. Since the buildup of life insurance cash values is already tax deferred, employees don't need to be included in a qualified retirement plan to get this advantage.

Tax considerations

For employers

- You can deduct life insurance premiums as part of your contribution to a qualified retirement plan.

For employees

- Most premiums for ordinary and universal life insurance are not taxable to employees yearly; however, each year the employeemust pay income taxes on the cost of current life insurance protection provided through the plan.
- Life insurance proceeds over the accumulated cash value are not subject to income tax.
- Life insurance proceeds will increase the size of the employee's gross taxable estate. If the beneficiary is the surviving spouse, this will not result in estate taxes due to the unlimited marital deduction. However, the surviving spouse's estate will be increased, possibly resulting in estate taxes when he or she dies.
- If the beneficiary is anyone other than the surviving spouse or a qualified charity, the proceeds may be subject to federal estate tax.

Tip: *Consider placing any additional life insurance in an* irrevocable life insurance trust (ILIT) *to keep the proceeds out of the estates of both spouses.*

IMPORTANT DISCLOSURES

Element Insurance Partners does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

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