Working Paper on the Tax Benefits of Insurance Planning for Small Business Owners

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When it comes to putting aside funds for retirement, owners should first consider “qualified” retirement plans. Qualified plans such as a 401k plan, a defined benefit plan or a cash balance plan may be an attractive pre-tax solution for any owner. The contribution is deductible and not currently taxed to the owner. However, owners often avoid implementing these plans because of low employee participation and burdensome compliance requirements. Further, these are tax-deferred plans, not tax-free plans. The trade-off for a current tax deferral is paying ordinary income tax on the accumulated amounts during retirement. In essence, a qualified plan is a box the owner can fill up with deductions. Once the box is full and the owner still desires to save money, it may be time to see what other benefits are available. To provide additional savings or to avoid many of complexities of qualified plans, many business owners use non-deductible (also called non-qualified) plans in place of or in addition to a qualified plan.

Most contributions to non-qualified plans are placed in an “over-funded” life insurance policy to allow the funds to grow tax-free and be accessed tax-free. When a policy is designed to have the smallest death benefit allowable under the tax code, the internal fees will be minimized allowing the majority of premiums to go into the cash value. The most efficient policy in terms of cash value growth has the maximum premium paid for the minimum death benefit. Under this structure the internal costs have the lowest drag on cash value growth. The policy cash value can grow tax-deferred and through policy loans, the gains can be accessed tax free. This type of policy has tax features similar to a Roth IRA[[1]](#footnote-1) – without the income limitations or contribution restrictions. The strategy can be simple and inexpensive to administer. Additionally, life insurance can “mirror” the benefits of a qualified plan without the same costs, participation requirements, and limitations of a qualified plan. Beyond the lifetime tax benefits, life insurance is favored for its “self-completing” nature that provides a death benefit above the cash value if the insured dies before retirement.

One of the most basic principles of life insurance income taxation is that in the absence of a Modified Endowment Contract (MEC) status, distributions to the owner of a cash value life insurance can provide an income tax-free stream of income at retirement up to certain limits.  The reason for the income tax-free treatment is that (a) the premiums are paid with after tax funds, and (b) a “basis first” treatment is specifically provided for under the Internal Revenue Code. In addition to the ability to withdrawal basis before gain in a life insurance policy, owners have the option to receive policy loans, also free of income tax, provided the policy is not a MEC.  The reason for this treatment is that a loan, by definition, is subject to a repayment requirement and accrues interest. However, the availability to receive policy loans without triggering income tax can be an attractive benefit as well as an income tax trap.  If policy loans and interest accumulate to the point that the policy no longer has sufficient cash value to sustain the loans and support a death benefit, the policy can lapse, or the owner can be forced to surrender it.  If this happens, the entire gain in the policy is taxed as ordinary income. There have been recent improvements in policy features to prevent this occurrence.

***A short history of tax-deductible life insurance schemes***

Congress has granted numerous benefits to life insurance policies, such as tax-free growth of the cash value[[2]](#footnote-2), tax-free access to the cash value, and a tax-free death benefit. As a general rule, life insurance premiums are not deductible and one needs to be careful when using tax-deducted funds to pay premiums on life insurance policies.[[3]](#footnote-3)

The IRS has historically frowned upon (and many times combated[[4]](#footnote-4)) arrangements that create a tax-deductible premium payment where no deduction would exist but for that arrangement. Why is that? Because the combination of an immediate tax deduction, future tax-free growth, future tax-free income, and a future tax-free death benefit would create the perfect tax shelter. The funds would completely escape taxation. However, by choosing how and when to pay income tax, many owners are finding benefits in using over-funded life insurance policies.

To be clear, have there been arrangements that purport to create tax-deductible premiums that avoid IRS scrutiny for a period of time? Absolutely. However ultimately, those participants have experienced unfavorable results, litigation and/or tax penalties. For the business owner who has a need for life insurance or long-term care protection, are there current and future tax benefits to purchasing insurance with business dollars? Absolutely.

***Small Business Owner Wealth Accumulation Planning using Life Insurance***

The life insurance premiums in an “over-funded” policy are typically paid (1) by redeploying personal after-tax dollars[[5]](#footnote-5), (2) as part of a non-qualified “bonus” plan, or (3) as part of a non-qualified “split-dollar” plan.

***(1) Redeploying after-tax dollars***

When redeploying after-tax dollars to an over-funded life insurance policy, the tax advantages are found in the life insurance policy itself, rather than being based on a tax code provision for the plan. The owner will not get a current year income tax benefit. The tax benefit is a future benefit of tax-free cash value growth and tax-free distributions coming from the using life insurance to fund the plan, rather than an immediate benefit being based on a tax code provision.

Absent an additional wrapper, (such as a qualified retirement plan) life insurance is often purchased with after-tax dollars. Thereafter, all growth and distributions will typically be income tax free. The cash value can be borrowed out income tax free and the death benefit will be income tax free. If the policy is surrendered and the cash value is greater than the policy basis, the gain is taxed as ordinary income. If the policy is terminated by death of the insured, the investment income accrued after premium payments have been made is exempt from taxation.

***(2) Bonus Plan***

A Bonus Plan[[6]](#footnote-6) can be used in place of or as a compliment to an existing qualified retirement plan and it can be used with owners and/or employees of any type of business entity. It typically uses an over-funded life insurance policy to accumulate tax-deferred assets outside of the business, which can later provide tax-free income. This future tax-free income helps to offset the impact of future taxable income from an existing qualified retirement plan. More recently, business owners are also using bonus plans to fund “hybrid” long-term care policies.

**How a Bonus Plan Works**

1. The owner purchases and will be the owner of a cash value life insurance policy while the business pays the premium through a bonus. The premium payments will be deductible to the business under IRC § 162[[7]](#footnote-7) and taxed as ordinary income to the owner. The business can also provide the owner with a second amount to pay the income taxes incurred on the premium. This is referred to as a “double bonus” and can be used to eliminate any out-of-pocket expense for the owner. *Example: Suppose that the annual premium is $100,000, and the owner is in the 28% tax bracket. To pay the premium and the tax incurred on the bonus itself, the employer could bonus the executive $13,889 [$10,000 ÷ (1 - 0.28)]. The tax on $13,889 at 28% is $3,889, leaving $10,000 to pay the insurance premium.*
2. At retirement, the policy cash values are available on a tax-preferred basis to supplement the business owner’s retirement income and the policy death benefit will be paid income tax-free to the owner’s beneficiaries.

A Bonus Plan offers owners the following potential benefits:

* **Income Tax-Free Death Benefit** – Income tax-free death benefits help the business owner’s beneficiaries remain financially secure.
* **Tax-Deferred Growth** – No income tax is payable while money is accumulating inside the life insurance policy.
* **Tax-Free Income** – Provided the life insurance policy is not structured as a modified endowment contract (“MEC”), the business owner will be able to attain tax-free income through a combination of policy withdrawals and loans
* **No IRS Distribution Requirements or Penalties** – Distributions from the insurance policy can occur before age 59 1⁄2 without an IRS penalty and there are no required minimum distributions at age 70 1⁄2 or thereafter.

A bonus plan is ideal for owners of C-Corporations whose personal tax bracket is lower than the company’s income tax bracket. Consider an owner in the 28% personal bracket with a C-Corp in the 34% bracket. If an owner is considering how to pay a $10,000 life insurance premium, it makes sense to pay a lower personal tax of $2,800 than paying a corporate tax of $3,400[[8]](#footnote-8). This “tax leverage” is unique to C Corp owners. Unfortunately, for owners of “pass through” entities (such as an S Corp, LLC, Partnership, or Sole Proprietorship) there is no tax leverage in using a bonus plan because taxes are paid on all business income regardless of whether it is actually distributed.

Bonus Plan Benefits for S Corp Owners

As discussed above, S corp owners have to pay tax on the company's earnings even if they don't distribute the earnings to themselves. For this reason, non-qualified deferred compensation plans won't work for S corp owners. It makes no sense for them to defer taxes on their own wages and then pay income taxes on those same dollars as S corporation earnings.

A bonus plan however can be a tax-effective retirement and death benefit strategy. With this plan, the business pays for a personally owned insurance policy, funded at a high premium level. This would provide both death and retirement benefits on a tax-efficient basis. The premium on the policy is either taxed as compensation (W-2) or as an S corporation dividend (K-1). The advantage of characterizing the premium as a dividend is that it is not subject to employment taxes such as Medicare. Keep in mind, however, that if there are multiple owners, the premium must be part of the allocable share of dividends to all the owners. Either way, the S corp owner pays income tax on the premium.

**Advantages of a Bonus Plan for S Corp owners**

1-The plan offers income tax diversification. With a qualified plan, contributions are tax-deferred but taxable in full in the future. With the S corp bonus plan, using a permanent life insurance policy, the premium is taxed currently but avoids tax on growth in the future. It's like paying tax on the seed but not on the harvest.

2-The plan can be self-completing if life insurance is the chosen funding vehicle. Depending on the policy used, the premium may be waived in the event of disability. If the S corp owner retires, cash values may be available for retirement income. And, of course, when the owner dies, a death benefit would be paid.

3- The policy is an individually owned asset, unencumbered by the business

***Split Dollar***

A “split dollar” plan is not a type of life insurance policy. Split dollar is a method of allocating the costs and benefits of a life insurance policy to maximize tax advantages for the business and owner/employee. “Split dollar” refers to a broad array of arrangements where an employer and an employee split the dollars (premium dollars, cash value dollars, and death benefit dollars) in a life insurance policy.

An owner of a C-Corporations whose personal tax bracket is higher than the company’s income tax bracket is an ideal candidate for a loan regime split dollar plan. The fact of different income tax brackets for the corporation and its owners may play a big part in the selection of a split dollar plan.  When a corporation is in a lower income tax bracket than its owners, the corporation pays less in income taxes to net $1 of after-tax income than its owners.  As a result of that difference in taxation, every personal expense that can be paid with corporate dollars results in a savings, sometimes a very substantial savings.  This is the reduction in costs that causes the split dollar plan to be attractive to owners of C corporations.  In a sense, the corporate owner is turning a personal expense into a corporate expense and saving taxes in the process.

However, an S corporation owner receives no income tax benefit from a split-dollar agreement since any premiums paid for by the S corporation are paid with after-tax dollars because of the pass through nature of an S Corporation. An S corporation employee can enjoy the tax treatment given to C corporations.

Since the IRS issued new regulations in 2003, the planning has consolidated into two regimes, the economic benefit regime and the loan regime. The loan regime is the most prevalent for accumulation planning because of the current low interest rate environment and product enhancements.

The policy owner determines which regime applies. Loan regime applies when the employee owns the policy. The employee also names the beneficiary but collaterally assigns policy benefits to the employer as collateral for the employer’s premium advances under the arrangement.

In loan regime split dollar, the most common plan design is as follows:

Steps:

1. Business pays 100% of the annual premium into an over-funded life insurance policy. This policy is owned 100% by the business owner and the business owner assigns the policy to the business as collateral for repaying the premiums. All policy cash value and death benefit in excess of the loan balance belongs to the business owner.
2. Under the rules, the premium payments made by the business are treated as a loan to the executive. If the business charges and collects interest on the loan at the IRS-specified “applicable federal rate” (“AFR”) or higher, the executive has no taxable income during life or at death. If the business does not charge and collect interest on the loan, or charges less than the AFR, the shortfall is taxable as ordinary income to the executive each year.
3. The owner borrows from the policy to supplement retirement income.
4. The business is repaid its cumulative loan (aka policy premium payments) payments from the policy’s death benefit.

The split dollar agreement above is structured to terminate at death of the business owner. Another option is to terminate the agreement at a specific date (usually retirement). This is referred to as a “roll-out.” The amount due the business is its cumulative loan payments. This amount can be repaid from policy cash values, from outside funds, or forgiven as income to the owner. If re-paid or forgiven over a series of years, the termination is referred to as a “crawl-out.”

The employee is taxed on any forgiven loan principal or forgiven loan interest payments.

**S Corporation Use of Split Dollar Plans**



Due to the pass through nature of an S Corp, there is no *tax* advantage in a split dollar plan for shareholders in S corporations as there is in C corporations.  There may be other reasons for split dollar plan use in S corporations, however.

Shareholders in S corporations often find split dollar plans appropriate for funding a cross purchase agreement when the shareholders' ages differ.  The reason for split dollar use in such a case is fairly straightforward: it permits the shareholders to share the total premium burden equally.

We noted just above that the lack of a corporate tax bracket in an S corporation removes the tax motivation from the split dollar plan involving shareholders.  The same issue *does not* apply to other S corporation employees.  Instead, split dollar plans insuring employees in an S corporation that are not also shareholders enjoy the tax treatment given to C corporations.

***Qualified Plans partially funded with life insurance***

Defined benefit plans, split funded profit sharing plans and cash balance plans may invest some of the contributions to a life insurance policy. Employer contributions are determined according to an actuarial calculation, which takes into account an assumed growth rate. As such, plans that are funded with assets that have a low growth rate, such as life insurance cash values, require larger contributions. Larger contributions translate into larger income tax deductions.

Life insurance is a unique plan asset in that it is “self-completing.” Since the success of a retirement plan hinges the participant funding the plan until retirement, an early death of the participant will prevent full funding of the plan. A life insurance policy can provide an immediate lump sum to replace contributions that would have accumulated had the business owner survived. Additionally, a portion of the death benefit can be paid to beneficiaries income tax free.

1. *In a Roth IRA, the contributions are not tax deductible. With a Roth IRA, the interest or earnings on the account values are income tax free. Withdrawals from Roth IRAs are also income tax free if the account owner is at least age 59 ½ or older. The Roth IRA benefits are typically also income tax free to the beneficiaries.*  [↑](#footnote-ref-1)
2. *Often referred to as “internal build-up”*  [↑](#footnote-ref-2)
3. *Two notable exceptions to this general rule include: (1) proper contributions to a qualified retirement plan (which in turn can buy limited amounts of life insurance), and (2) a business deduction for interest on $50,000 used to purchase key man life insurance policies.[180]* [↑](#footnote-ref-3)
4. *The IRS has a long history of successfully attacking § 419 plans, § 412(e)(3) plans, and § 79 plans* [↑](#footnote-ref-4)
5. *Remember that by simply using the money to pay a life insurance premium does not in and of itself create a new tax deduction*  [↑](#footnote-ref-5)
6. *For an owner of a pass through entity, a bonus plan is identical to #1 above except contemplated before paying the income tax*  [↑](#footnote-ref-6)
7. *Assuming the business owner’s total compensation is reasonable under IRC § 162* [↑](#footnote-ref-7)
8. *For owners with a lower corporate tax rate than personal tax rate, a split dollar plan is a better alternative. This is discussed in a later section.* [↑](#footnote-ref-8)