LIFE INSURANCE PLANNING FOR CLOSELY-HELD BUSINESS

BY

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INTRODUCTION

The uses for life insurance by and in relation to a closely-held business are myriad. The purpose behind the life insurance planning for the closely-held business will determine a number of variables, including: what kind of policy will be purchased; how and by whom will the life insurance policy be owned; how and by whom will the policy premiums be paid; and how will the funds derived from the use of the insurance, whether policy proceeds or cash value, be used? This article discusses several of the most common purposes for closely-held life insurance planning and the various issues that arise in each context.

PURPOSES FOR THE LIFE INSURANCE

The first and most important question to be asked when considering the use of life insurance for a closely held business is, why is the insurance needed? What purpose does it serve for the business? Several of the most common purposes for life insurance planning in the closely-held business context are described below.

Key Person Insurance.

A very common use for life insurance in the business context is to protect the company from the loss of a key employee. In many instances, much of the value in a business is tied directly to its key employees. To help combat the difficulty that arises due to the loss of a key person, a closely-held business will often purchase life insurance on its essential personnel. The policy is owned by the company and the company is the beneficiary of the proceeds derived from the life insurance coverage.

In some instances, a company might buy some form of whole or "permanent" life policy for key person coverage, but most commonly a term policy is selected in this context. The reason for this is the relatively low cost for a term policy compared to a cash value bearing policy. The coverage is desired to help with the company's business challenges by providing cash to help fund operations during the transition period following the employee's unanticipated death, not necessarily to provide for a planned cash need in the future, so the lower expense of the term policy usually outweighs the accretion of cash value that would be part of a permanent policy.

The expense of policy premium payments should be anticipated and planned for by the company. IRC Section 264 denies a deduction for the company's payment of the premiums, so after tax dollars must be used to pay for the policy. This negative factor is somewhat ameliorated by the fact that the policy proceeds should be received by the company tax-free pursuant to IRC Section 101(a), as long as it doesn't run afoul of IRC Section 101(j).

Key person policy arrangements are usually fairly simple. The company pays the policy premiums out of operating cash flow, owns the policy and is the beneficiary. For that reason, it can be a trap for the unwary. Although IRC Section

101(j) applies to all employer owned life insurance plans, and should be complied with in all applicable cases, specifically the deferred compensation and redemption arrangements discussed below, the certainty that its requirements must be met under the traditional key person insurance plan makes it very important to consider in all such cases.

SECTION 101(j)

Section 101(j) will probably impact more closely-held business life insurance arrangements than any other topic in this article, and provides the most immediate danger to the businesses involved. Its concepts are straight forward but far-reaching, so every planner who advises business clients on life insurance arrangements should be familiar with its terms.

Since the enactment of the Pension Protection Act of 2006 ("PPA"), employer-owner life insurance contracts issued after August 17, 2006, for whatever purpose, will be subject to a denial of the Section 101(a) exclusion of death benefits (in excess of the employer's basis in the policy) unless it meets fairly restrictive conditions *before the policy is issued*. If the provisions of Section 101(j) are not complied with before the issuance of the policy, the proceeds are forever tainted and will only be received tax free if the policy is surrendered and a new one issued in a compliant manner.

To avoid the inclusion rule of Section 101(j) if the proceeds are paid to the employer, the insurance policy must be issued on a director, officer, highly compensated individual (which includes an individual who owned 5% or more of the company in the preceding 12 months, was paid at least $95,000 (adjusted for inflation) in the preceding year, is one of the five highest paid officers of the company or among the highest paid 35% of all employees) or an individual who was an employee during the 12 months before his or her death. In addition, the following notice and consent requirements must be met before the issuance of the contract. The employee:

- Is notified in writing that the employer intends to insure her life and the maximum face amount for which the employee could be insured at the time the contract was issued;
- Employee provides written consent to be insured and that the coverage may continue after the insured terminates employment; and
- Is informed in writing that the applicable policyholder will be a beneficiary upon employee's death.

Even if the issuance of the policy to the employer antedates the adoption of the PPA in 2006, the contract might still fall within the scope of Section 101(j) if there is a material modification of the insurance contract, such as a significant increase in death benefit that results in treating the modified contract as a newly issued policy.

There is an important estate and succession planning exception available under Section 101(j)(2)(B) for amounts paid to family members, trusts for their benefit and the estate of the insured, or to redeem an ownership interest of the insured from one of those parties. These policies would be owned by the employer, but the proceeds would either be paid to the family member, trust or estate directly as the named beneficiary of the policy, or the proceeds would be used by the company to purchase the ownership interest of the insured. There is little to no guidance available on this issue, so it is probably prudent to mandate the use of the proceeds to redeem the ownership interest in a buy-sell agreement executed by the business owner at the time the policy is issued to the company in order to avoid any possibility of subjecting the proceeds to taxation under Section 101(j). The notice and consent requirements still must be met to qualify for this estate planning exception.

Section 101(j) has recently become even more relevant to employers because the regulations for IRC 6039I, which requires annual reporting for employer owned life insurance, have been made final. Under IRC 6039I, an employer must annually file with the IRS for all tax years ending after November 13, 2007 (for policies subject to IRC 101(j)) a report that lists:

1) the number of employees employed by the company;

2) the number of employees insured by the company;

3) the total amount of employee life insurance in force at the end of the year;

4) the name, address and TIN of the company and the type of business it is in;

5) a representation that the company has the valid consent of all insured employees.

With all requirements of Section 101(j) satisfied, a planner is able to focus on some of the more complicated issues that arise in life insurance planning beyond key-person insurance for businesses and business owners.

<u>Deferred Compensation</u>.

Life insurance can play a very important role in the funding of non-qualified deferred compensation plans for closely-held businesses. The fact that the growth inside a permanent life insurance policy (such as whole, universal or variable life) is not subject to income taxation until it is withdrawn, and even then in most instances the policy owner will be allowed to first withdraw basis before recognizing any gain on the policy growth, make it a very appealing tool to provide the ultimate funding for the deferred compensation plan.

Under a typical life insurance funded non-qualified deferred compensation arrangement, the company agrees to put aside funds each year by purchasing a life insurance policy on the employee and paying the policy premiums each year. The employee is entitled to the payment of funds on a fixed schedule at some point in the future, usually retirement at a set age, disability or death. When the employee reaches retirement age, the company begins to withdraw funds from the policy to pay the amount owed under the deferred compensation agreement. If the employee dies while the policy is still in existence, then the death benefit proceeds are used to pay the remaining obligation to the employee. If there is death benefit in excess of the amount owed the employee, it will be retained by the company for its own use.

Because the purpose for purchasing the life insurance is to fund an obligation from the company to the employee, in most deferred compensation arrangements the company will own the policy and will be the beneficiary for the proceeds. Because the company is the owner and beneficiary of the policy, there should be no income tax implications for the employee before the deferred compensation payments begin. The terms of IRC Section 409A must be complied with to ensure there is no current taxation to the employee. A discussion of that Code section is beyond the scope of this article, but a traditional deferred compensation arrangement under which the employee has no right to access the policy cash value until the stated date or events come to pass, and does not have the ability to accelerate the payment of the benefits, should comply with Section 409A.

If some portion of the death benefit is payable to the employee's estate or at the employee's direction, other than as payment of the deferred compensation amount, the employee will be subject to tax on the value of the life insurance coverage provided to him or her each year. This concept will be discussed in the section below concerning split dollar life insurance funding.

Redemption / Buy-Sell Arrangements.

As described above, both key person and deferred compensation arrangements involve the company owning the life insurance policy and being the beneficiary of the proceeds. In both cases, the purpose is to fund certain discrete needs of the company and payment of its obligations. Key person insurance has a more general purpose of paying for operating expenses, while deferred compensation life insurance is used to fund employee benefit / compensation obligations. In contrast, life insurance in a redemption / buy-sell arrangement is often owned by the employer, and it is the beneficiary, but the purpose is to retire the ownership interest of a dead, disabled or retiring owner.

When a company and an owner have entered into a redemption or buy-sell agreement, it is typical for the company (or in some cases, other owners, as discussed below) to bear the obligation of paying for the ownership interest when the owner retires from employment or dies while owning the business interest. Because the payments are made only for the ownership interest in the company, with no real asset received in return for the funds, these arrangements can create a considerable financial strain on a company. To help alleviate this strain, the company will often purchase life insurance on the life of the owner.

When the owner retires from the company, he or she usually receives payment for the ownership interest over a period of time and plans for the delayed receipt of some portion of the purchase price for the ownership interest. It is possible that the life insurance, if it had any cash value, may be used to fund some portion of the purchase price, or that the transfer of the policy to the retired owner will satisfy some of the amount owed. That said, the main purpose of the life insurance to provide a large lump sum that may be used to fund the buy-out of the ownership interest from a deceased owner's estate. This allows the company to continue to operate, free of any debt to the deceased owner, and makes the administration of the estate much simpler, because it will have cash rather than a closely-held business interest.

<u>Cross Purchase Buy-Sell Arrangements</u>.

An alternative to the company owning the life insurance is to structure they buy-sell agreement so that the co-owners of the business each own life insurance on the life of the other owner(s). This is commonly referred to as a "cross-purchase" arrangement. The concept is that if one of the co-owners dies, then the other owners will receive the death benefit from the life insurance on the deceased owner and will use those funds to buy the deceased owner's business interest from his or her estate. The ownership percentages of the remaining owners should mirror those they would have under the traditional redemption agreement discussed above. There are a couple of very distinct differences between the traditional and cross-purchase arrangements, however.

First is the treatment of the premium payments if the company pays them all. If the company owns the policy, the premium payments are not deductible, but are not income to any of the business owners. If the business owners also own the policies, then the premium amount paid each year by the company will be treated as compensation or a distribution (whatever form that takes and tax implications it may have) to the owner. The recognition of income without the receipt of cash to pay the tax liability must be considered and planned for. In some instances this concern can be addressed with a split dollar agreement, as discussed below.

Another important distinction between the two buy-sell methods is what happens to the basis in the ownership interest of the remaining owners. In a cross-purchase arrangement, the other owners receive the life insurance proceeds tax free, then use the funds to purchase the deceased owner's interest. By purchasing the interest for themselves, the remaining owners' basis in the purchased interest is equal to the amount paid. In a traditional redemption arrangement, the company pays for the deceased owner's interest and the other owners at worst, as in a C-corporation, receive no basis benefit and at best are entitled to their proportionate share of basis increase they receive as members of a partnership or LLC, or as an S-corporation shareholder. The portion of the proceeds allocable to the deceased owner's share is wasted, because the estate already has a step up in basis due to the owner's death.

The negative result described above can be avoided in the case of a cash method pass through entity with good buy-sell agreement planning. When an owner of a pass through entity dies, the company can issue a note to the owner's estate in return for a redemption of all the decedent's interest in the business. The company then closes its books and starts a new year for accounting purposes. When the life insurance proceeds come into the company, the remaining members will receive their full, proportionate basis increases. The funds are then used to pay off the note held by the estate. Again, this technique only works for a cash method, pass through entity. We have received a private letter ruling in the context of an S –corporation, PLR 200409010, that ruled the proceeds accrue at the time of the shareholder's death, so it isn't possible to close the company's books in time to benefit the other shareholders.

The following language is an example of how the use of life insurance to purchase a deceased owner's interest works, taken from a buy-sell agreement (in the corporate context). The language contemplates a cascading obligation to purchase the shareholder's shares, first by the company, then the remaining shareholders.

> If the Corporation or purchasing Shareholders owns insurance on the life of a deceased Shareholder for the purpose [expressed in writing] of funding the purchase of his or her Shares upon the Shareholder's death, or payable on the disability of a disabled Shareholder whose Shares are purchased, the proceeds shall be applied against the purchase price at closing if the insurance proceeds are less than the purchase price. If the insurance proceeds exceed the purchase price, the entire purchase price shall be paid at closing. The Corporation or purchasing Shareholders shall file the necessary proofs of death and collect the proceeds of any policies of insurance outstanding on the life of the deceased Shareholder or on the disability of the disabled Shareholder. The decedent's personal representative shall apply for and obtain any necessary court approval or confirmation of the sale of the decedent's Shares under this Agreement.

It is important that a purchase price for the shares is determined independently from the amount of insurance available. The determination of the purchase price should state explicitly whether the life insurance proceeds are to be included in valuing the company. If they are not, it should be stated as such or the company runs the risk of argument from the estate of the owner that the proceeds are included in valuing the interest and the owner runs the risk that the IRS will make that argument for valuation of the interest in the estate. In certain instances the agreement may be binding on the estate, such as a defined value, but not for tax purposes so the estate can be whipsawed by receiving a set amount but owing tax on a higher value attributable to the interest for tax purposes.

Estate Liquidity.

The purposes for the use of life insurance by closely-held businesses discussed so far have been concerned with providing funding to the business for payment of its obligations or for its benefit. Even the cross-purchase arrangement, where the company does not own the policies or receive the funds, is for the direct benefit of the company, so it doesn't itself have to redeem a deceased owners interest. The last purpose discussed in this article also benefits the company, but does so indirectly. This purpose is to provide liquidity to an owner's estate so it doesn't have to sell or liquidate the ownership interest. By owning life insurance outside of the company, the business owner's estate will have additional liquidity to pay estate taxes and ideally avoid the necessity of disposing of the business interest to meet its tax obligations.

Using life insurance proceeds to purchase the ownership of an ongoing business also can serve the purpose of providing continuity of the enterprise. If there is a source of funds that may be relied upon to purchase all of a decedent's ownership interest, the dispersal of the ownership interest among any number of heirs may be avoided by facilitating the purchase of the entire interest by a trust for the family's benefit. This allows for centralized ownership that benefits all the intended beneficiaries without running the risk of individual members of the family attempting to sell their interests to outsiders or to die with the interests and subject the company to the same routine as was encountered in the first place.

Providing liquidity for an estate, other than in the context of a buy-sell arrangement, typically entails the ownership of a life insurance policy outside the company, either by the owner or preferably by a life insurance trust to keep the life insurance proceeds out of the owner's taxable estate. The company may pay the premiums directly to the insurer on behalf of the owner, pay the premiums to the owner and let him or her make the payments to the insurer. In either case, the premium amount will be compensation or a distribution to the business owner and a subsequent gift to the trust, unless an alternate funding mechanism, such as a split dollar agreement, is used.

SPLIT DOLLAR LIFE INSURANCE FUNDING

Reams of articles concerning split dollar life insurance funding have been published since the issuance of final regulations governing these arrangements were published on September 17, 2003 (the "Regulations"). A full discussion on all the vagaries of split dollar financing becomes increasingly involved, but the basics of split dollar funding for closely-held business life insurance planning is too important to ignore. To review how split dollar funding works:

<u>Split Dollar Defined</u>.

The Regulations under IRC §61 define split dollar insurance arrangements. Once defined as a split dollar arrangement, the taxation of the arrangement is determined under IRC §61 or §7872. The definition of what constitutes a split dollar arrangement is quite broad:

> A split dollar life insurance arrangement is *any arrangement* between an owner and a non-owner of a life insurance contract that satisfies the following criteria:
>
> (i) Either party to the arrangement pays directly or indirectly all or a portion of the premiums on the life insurance contract including a payment by means of a loan to the other party that is secured by the insurance contracts;
>
> (ii) At least one of the parties to the arrangement paying premium under the paragraph above is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group term insurance plan described in Section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in §1.79-0). Reg. §1.61-22(b)(1).

The definition also includes compensatory arrangements, such as the deferred compensation arrangement discussed above, where the employer or service recipient pays directly or indirectly all the portion of the premiums and the beneficiary is designated by the employee or service provider, or is a person that would be reasonably expected to be designated as the beneficiary. Also, if the employee or service provider has an interest in the cash value of the policy, it is a split dollar arrangement that is covered by the Regulations.

Taxation of the Arrangement.

In its simplest form, split dollar planning can be illustrated by the attached exhibits titled "Economic Benefit Regime" and "Interest-Free Loan Regime." The determination of which regime applies to the split dollar agreement in question is decided based on which party is deemed to own the policy. Under the split dollar Regulations, if the deemed owner of the policy is the employee (or a trust established by the employee), §7872 governing below market loans will control the relationship. The employee or donee will receive a benefit measured by the current cost of the foregone interest.

If, on the other hand, the employer owns the policy, the old economic benefit regime will apply and the benefit for the employee will be measured by the annual term cost of the life insurance protection provided. The person named as the policy owner is generally considered as the owner of the contract. Having such a simple standard is deceptive, for its application can be extraordinarily complex.

One such complexity is illustrated by the Regulations, which provide an exception for the simple ownership test of identifying the owner in the contract. Even if the employee or donee is listed as the owner on the policy, if the employee's benefit is limited to only annual death benefit coverage (the entire cash value is pledged to the employer), the employer will be *deemed* the owner.

This deemed ownership rule effectively provides an election for the parties. They can treat the arrangement as debt controlled by §7872, or they can elect to treat the arrangement under the economic benefit regime. They should consider which method provides better results and for how long. If the insured is young or the policy is a second-to-die policy with low term costs, they would typically chose economic benefit treatment and structure the agreement to provide the greater of premiums paid or cash value would be paid to the employer or donor at termination of the agreement. If the parties elected economic benefit treatment and subsequently terminated the split dollar arrangement, there should be no taxable transfer of property, and with all the cash value paid to the employer, no economic gain is reportable by the employee.

Economic Benefit Regime.

In the case of the economic benefit regime, the taxation of the arrangement is dependent on whether the agreement is structured as equity or non-equity. If the arrangement is non-equity (the employer is entitled to a return of the *greater* of the premiums advanced or the cash value) then the employee is responsible for the payment each year of only the annual term cost of the insurance, and is taxed on that amount as compensation or a distribution from the company if the company pays the entire premium. If the arrangement is an endorsement, equity agreement (the employer owns the policy and is entitled to a return of the *lesser* of premiums advanced or the cash value) then the employee will be taxed each year on the value of the annual term cost plus any increase in the cash value of the policy. The rules governing how to calculate the amount of excess cash value is taxable to the employee are more complicated but there are several helpful examples in the Regulations.

Split Dollar Loans.

In contrast to the economic benefit rules, the loan regime for the taxation of split dollar agreements treats the arrangement as a loan between the parties that is governed by the general tax rules for debt instruments, including the original issue discount rules of IRC §§1271-1275, if the note carries sufficient interest. If the split dollar loan is a below-market loan, as will typically be the case, then its treatment will be governed by IRC §7872 and Reg. §1.7872-15. As noted previously, treatment of a split dollar arrangement under the loan regime is mutually exclusive with taxation under the economic benefit regime.

The Regulations are concerned predominantly with measuring adequate interest, the waiver of interest, indirect payments of interest, and other similar concepts. While it is necessary to define these cases, the vast majority of split dollar loans are—and will be—either completely interest free or, much less often, provide for adequate interest. If no interest is charged, the majority of the Reg. §1.7872-15 rules are inapplicable, beyond determining the amount and timing of the forgone interest charge. If adequate interest in charged, the rules do not apply at all.

Similarly, it is very rare to come across a pure term split dollar loan in practice. In the context of employment, the employer almost always will require that the continuance of the agreement is dependent on the employee's continued employment or be terminated upon the employee's death, both of which are subject to the hybrid term loan rules.

In the context of split dollar loans, §1.7872-15(a)(2) treats the non-owner of the policy as the lender, while the owner is considered the borrower. It further provides that a payment made pursuant to a split dollar arrangement will be considered a loan for Federal tax purposes if the following three requirements are met:

1) The payment is made either directly or indirectly by the non-owner to the policy owner (including a payment by the non-owner directly to the insurance company on behalf of the owner);

2) The payment is a loan under general principals of Federal tax law or, if not, then a reasonable person would expect the payment to be repaid in full to the non-owner (either with or without interest); and

3) The repayment is to be made from, or is secured by, either the death benefit proceeds or the cash surrender value of the policy.

Section 7872 and the Regulations mandate that the foregone interest under an interest-free or below-market loan from the employer will be treated as compensation paid to the employee and then repaid to the employer as an interest payment, causing the employer to recognize income equal to that amount. The employer would have an offsetting deduction under §162 for the compensation deemed paid to the employee. The foregone interest is the amount of interest that would be owed if the appropriate AFR for the type of loan in question was used, less the actual amount of interest charged.

The decision whether to arrange the split dollar agreement as "private," i.e. between the business owner and the life insurance trust, or to have the company serve as the funding party for the business owner's benefit (as an employment or owner perk) depends on a variety of factors. One reason to consider using the company as the funding party is that it avoids the necessity of paying the owner compensation so he or she can pay the premiums, which may have income tax consequences to the owner. Another potential advantage to having the company advance the premiums is that the funds received back by the company when the arrangement is terminated will be just another asset of the business and the ownership interest of the insured owner may be eligible for a discount from its gross value for estate and gift tax purposes.

LIFE SETTLEMENTS

An area of life insurance planning for closely-held businesses that has come to be much more relevant in recent years is the market for life settlements. The settlement of a life insurance policy is essentially the sale of the policy on the secondary market rather than the surrender of the policy back to the insurer for its cash value. This market has developed dramatically over the last several years, and while it has seen some abuse and received some negative publicity, in its truest form, it can be a highly beneficial market for a closely-held business that owns an existing life insurance policy that is no longer needed.

If a business owns a life insurance policy on the life of either a current or former owner or employee (with their consent), and that policy is no longer needed and is not pledged under any form of agreement to the insured (such as in the case of a deferred compensation or buy-sell arrangement), the company may wish to investigate the value of that policy on the secondary market. The company may find that an investor will pay more for the policy than the insurance company will give it based on the policy's cash value. In fact, depending on the circumstances, in some instances an investor will pay cash for even a term policy that has no cash value itself. If the company were to stop paying premiums on that policy, it would disappear, but in this circumstance, the company might be able to actually see a return on the value of that policy without having any further obligation to maintain the policy.

The option to sell an existing policy on the secondary market is contingent on a number of factors. Among them are: the health of the insured currently compared to how it was at the time the policy was issued; how long the policy has been in existence; whether the policy was purchased for legitimate business reasons, as opposed to being purchased with the intention of selling it on the secondary market; and a number of other issues. The ideal policy is one that has been in effect for a substantial period of time, is no longer needed by the company and that insures an elderly individual. This may very well be the case for an owner/employee who was with the company for a long time but has since retired. Particularly if the policy was purchased as a key-person policy and the company is not obligated to use the proceeds for any form of payment to the insured or his or her estate, then it may be an ideal situation to look into the possibility of selling the policy and using the cash received for other purposes.

CONCLUSION

Each of the topics discussed in this article could be the subject of a full-blown, detailed analysis. Life insurance can be an excellent tool for the use of estate and business planners as long as the planner is aware of the many different issues concerning the taxation of the business, the owners or employees and the trusts and estates of the individuals involved. Without due care, there are many potentially negative repercussions for the use of life insurance in this kind of planning. With a full understanding of the rules and the appropriate circumstances under which to use the techniques at our disposal, life insurance planning for the closely-held business can be among the most beneficial uses of the client's resources.

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