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## **Life Insurance for Closely Held Businesses**

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Martin J. Satinsky, CPA/PFS, JD, LL.M. of Isdamer & Company, Bala Cynwyd, PA has spoken frequently at AICPA PFP technical conferences. This year, in his presentation, "Life Insurance for Closely Held Businesses," he focused on four areas: (1) tax treatment of corporate owned life insurance, (2) uses of life insurance for closely held businesses, (3) how much life insurance is enough and (4) what type of insurance is appropriate.

### **Tools and Techniques for Using Life Insurance**

Life insurance is a useful tool in many financial planning situations including those involving closely held businesses. Insurance companies and agents think of it as a product, but from a financial planning standpoint, it is a tool with one priority: to help the client accomplish his or her goals. The planner therefore needs to understand how various insurance products can help meet client's goals and objectives.

Life insurance is often critical for funding buy-sell agreements, which take several forms based on the parties to the contract:

- *Stock redemption* (also called entity purchase). The business purchases the business interest upon the triggering event at a price based on a predetermined formula. With respect to the insurance, the corporation would be the applicant, owner, beneficiary and premium payer.
- *Cross purchase*. The remaining business owners buy the business interest upon the triggering event at a price based on predetermined formula. With respect to any insurance, the shareholders would be the applicants, owners, beneficiaries and premium payers.
- *"Wait and See."* Under this flexible approach, the business entity is given the first option to purchase stock. At this stage, the "wait and see" takes the form of a stock redemption plan. To the extent that option is not exercised in a timely manner, the remaining shareholders are given the option to purchase the stock. At this stage, the buy-sell is in the form of a cross purchase plan.

Another important use for life insurance is key employee insurance for a client at risk of losing a key employee. This policy would provide the resources to replace, if possible, a key employee.

Most life insurance written is for employee benefits such as group term life insurance. Another type of employee benefit insurance is a Section 162 plan, which is also called a salary increase, executive bonus, executive life insurance or selective pension plan. Under this arrangement, an employer pays the premium on a permanent life insurance policy that insures and is owned by one or more selected employees.

Another employee benefit, usually for highly compensated employees, is split dollar insurance, which is an arrangement for splitting the interests in an insurance contract. The splitting and sharing can be of premium outlay, death benefits, cash values, dividends and ownership. In the typical split dollar approach, the employer pays the annual premium equal to the increase in the policy's cash value (or net premium, if lower). The employee pays the balance, if any. Other split dollar arrangements are reverse split dollar, P.S. 58

Offset Plan, employee-pay-all arrangement, and level premium plan.

A Death Benefit Only (DBO) plan is often called a survivor's income benefit plan, which is logically used for life insurance. As its name implies, a DBO plan provides only death benefits and makes no promises or payments to the employee during lifetime.

### **Tax Treatment**

Satinsky touched on the tax treatment of corporate owned life insurance. Under IRC Section 101, death benefit proceeds of a life insurance policy are exempt from income tax. Section 7702 defines life insurance. Satinsky said, "If it looks like life insurance and smells like life insurance, it probably is life insurance."

In a term policy, you terminate the premiums and the policy is no longer in force. In a cash value policy, cash value increases attributed to investment income are not usually taxable as long as the policy remains in force. If the policy is surrendered for cash before the insured's death, there is a potential for taxable gains. Any excess of the proceeds received upon surrender over the policy owner's basis is taxed as ordinary income. Basis in the policy is the premiums actually paid less the dividends received and tax free withdrawals. Proceeds equal the cash received at surrender plus any outstanding loans "paid off" at surrender. In a typical mutual insurance company, the policy holder will receive a dividend, which is not taxable because it really is a return of capital or premium.

Over time, the cash can build up to such a degree that if the policy is in force, depending on the level of premiums to be paid and how well the cash value has been performing (based on the earnings rate), it is very possible to get cash back because the cash value will exceed the premiums. This is the advantage of using insurance as a retirement planning vehicle. Withdrawals of cash values without surrender means you are pulling cash out but not terminating the policy, as with a variable universal product. You can take

distributions not just loans. You can also put excess premiums in. Withdrawals are on a cost recovery basis so no income is taxable until you have gotten your basis back.

### **MECs**

Satinsky also covered the special rules for modified endowment contracts (MECs) under IRC Section 7702A. These rules are intended to limit the perceived abuses of life insurance contracts designed to take advantage of the tax free build-up of cash values. They are aimed at the single-premium and short-pay life insurance policies. Satinsky cautioned that the rules are complex and most insurance agents do not understand how a MEC works.

The typical MEC is usually a single premium whole life policy. For example, the client puts \$100,000 of cash in at once to buy the policy. The cash builds up inside the policy on a tax free or tax deferred basis. It would be tax free when it ends up as part of the death benefit or tax deferred if the client withdraws cash from the policy.

People put huge amounts of cash into these policies, which meet all the provisions of section 7702 from an actuarial definition and an at-risk definition and so forth. Those funds build up on a tax free basis, the owners figuring that they could either let the cash values be added to the face amount of the policy and build up huge amounts of death benefits or use it as a basis for loans for cash flow during retirement.

The IRS eventually said this was not an insurance vehicle but an investment wrapped inside an insurance product. Consequently, they created the MEC rules, which require that any distributions or withdrawals before death be taxed on an interest-first basis, not a cost-recovery basis. The first dollar received is out of income in excess of basis. In addition, distributions taken from a MEC before age 59½ are deemed to be premature and subject to a 10% penalty.

Clients should be aware that it's difficult to escape MEC issues. Borrowing against the policy using the MEC as collateral is considered a withdrawal resulting in taxable income. Clients can fall into MEC traps unexpectedly. Consider, for example, a client who agrees to pay premiums of \$10,000 per year over 5 years. The agent thinks this shouldn't be a MEC issue because the client is buying a variable universal product and funds are invested in the stock market, which has performed exceptionally well. The client is still paying in the same premiums. Suddenly, the cash value exceeds what would qualify the client from being within the exceptions to avoid MEC issues.

This example illustrates what Satinsky calls the need to manage the life insurance product like other investments. The insurance agent might not catch this issue. An agent looks at how the policy is structured and makes the sale. But before you know it you can have a client with a MEC and all the negative treatments affecting withdrawals from the policy. The death benefits are fine, but the client was looking for the policy to fund a deferred compensation program. Suddenly, the great plan falls apart because the investments did exceptionally well but nobody warned the client to watch out about the levels of premiums paid.

### **The Planner's Role**

Whose responsibility is it to watch the policy for possible MEC issues? The agent is not responsible unless the client has retained him or her on a fee basis to manage the policy. Agents are sales people. The client can retain an insurance consultant, an accountant, a financial planner, or an attorney to monitor this for the employer, who purchased the policy. The person who purchased the policy is responsible and most at risk.

The above example will be in the back of your head whenever you see a short-pay policy proposal, Satinsky said. Typically, you will see an insurance illustration once—at the time the policy is issued. The illustration is part of the marketing materials. If you are representing a client in the life insurance area, you should be getting, probably annually, what is called an in-force ledger or an in-force illustration. This is an illustration similar to the original one, based on the cash values and current assumptions at the time the illustration is ordered. This will allow you to see how the policy is performing. Time shows the truth: MEC issues should pop out at that time. You may get an annual report on the policy from the insurance company, which will give you other information but may not be enough to determine whether there is a MEC problem.

At the time of the initial sale, insurance companies generally, for liability purposes, will indicate that you may have a MEC issue. Since future in-force illustrations are cranked out of the same software, you will have the same kind of disclosure on whether you have a MEC problem.

There is no way out once the contract becomes a MEC. If you make a Section 1035 contract exchange from one policy with a MEC taint to another, that exchange does not remove the taint.

You can buy a new policy, but any universal policy within certain ranges has the possibility of adjusting the death benefit and letting the MEC policy die, which means it is used only for its death benefit. The client would let the cash values that build up pay the premiums until the cash values are gone. The client enters into another policy that is a separate policy totally for cash value build-up.

The insurance company reports that it is a MEC to the IRS and issues a 1099 to the policyholder, when there is reportable income.

### **Other Tax Issues**

Space doesn't permit more detailed discussion of the great amount of guidance that Satinsky offered in his session. He also covered, for example, transfer for value rules under IRC Section 101 (a)(2) and estate tax treatments. Readers would do well to listen to Satinsky's session on audiotape (see the list on this page). Satinsky believes that planners can provide world-class service to their clients by becoming aware of the many nuances of life insurance and thereby preparing themselves to provide guidance on this investment by the client as they would for the client's other financial concerns and assets.

For questions about life insurance planning for the closely held business, contact [Msatinsky@isdanerllc.com](mailto:Msatinsky@isdanerllc.com)

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