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Special Tax Considerations for the Business Use of Insurance

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What are special tax considerations for the business use of insurance?

Businesses use insurance for a variety of purposes: to fund buy-sell agreements, to fund retirement plans, as an employee benefit, to protect against the loss of key personnel, to protect buildings and property from casualty losses and other damage, and to protect against liability exposure. Insurance can be expensive, and financial considerations are certainly important. But if you want to purchase insurance protection for your business, you should become familiar with the tax implications of this coverage as well.

What are the income tax implications of using life insurance to fund a buy-sell agreement?

A buy-sell agreement is a contract used by some business owners to ensure that when one business owner dies, his (or her) business interest will be purchased by another party. (This other party is usually either another business owner or the business itself.) The death of a business owner can have a negative impact on the business as a whole; it can cause a strain for a company owing to the loss of talent, the disruption of the business, and the accompanying loss of revenue. Such an event could also cause the business temporary difficulty in acquiring loans or other funding. The use of life insurance funding in conjunction with the buy-sell agreement ensures that sufficient cash will be available to purchase the deceased owner's share of the business, eliminating the need to find financing at the time of the event. Typically, the insurance coverage is arranged so that your life is insured for an amount equal to the value of your ownership interest in the business. When you die, there should be enough cash from the policy proceeds for the beneficiary of the policy (either the other business owners or the business itself) to pay your estate the price agreed to in the buy-sell agreement for your share of the business.

It is important for you to be aware of the tax implications involved when you use life insurance to fund a buy-sell agreement.

Policy premiums are not deductible

In general, life insurance policy premiums are paid with after-tax dollars and do not represent a deductible expense. This applies regardless of who pays the premiums--the corporation, the shareholders, or a third party. Moreover, if stockholders in a corporation attempt to use company-paid group life insurance to fund the buy-sell agreement, the company may be denied a deduction for its premium payments. And if a corporation pays the premiums on life insurance to fund a buy-sell agreement between the individual shareholders (i.e., cross-purchase buy-sell agreement), the premium payments will be treated as dividends to the shareholders.

Proceeds are free of income tax

In general, proceeds received at the death of the insured are not subject to income tax for the named beneficiary. The notable exception to this rule occurs when a C corporation is named as beneficiary. The corporation could face an alternative minimum tax (AMT) liability when it receives the insurance proceeds.

What are the tax implications of using life insurance to fund retirement plans?

Businesses frequently use corporate-owned life insurance (COLI) to fund nonqualified retirement plans. Because the employer is the owner and beneficiary of the COLI policy, the employer retains all rights to the benefits under the policy, including the cash value buildup and the death proceeds. The policy insures the lives of one or more employees. Typically, the employer is permitted to borrow against the policy. These borrowed funds then may be used to pay the policy premiums and/or to fund nonqualified deferred compensation plans.

There are several tax implications:

No deduction allowed for premiums paid

No deduction is allowed to an employer with respect to the premiums paid on a COLI policy. This is because the employer is the direct beneficiary under the policy. (The general rule is that no deduction is allowed for premiums paid on any life insurance policy covering the life of any officer or employee of the employer, or of any person financially interested in any trade or business carried on by the employer, when the employer is directly or indirectly a beneficiary under the policy.)

Treatment of cash value buildup

The policy's cash value buildup is not taxed currently.

Treatment of withdrawals and loans

An employer's withdrawals of cash value under a life insurance policy generally are treated as a nontaxable recovery of investment in the contract (premiums paid minus dividends and prior cash distributions). However, withdrawals that exceed the employer's investment in the contract will be treated as income to the employer.

Tip: *Loans are not treated as distributions and therefore the loan proceeds are not included in the policy holder's income. (However, loan proceeds may be treated as distributions if the employer defaults on repayment of the loan or the policy loan is otherwise forgiven.)*

Deduction of interest paid on loans

If four of the first seven years' policy premiums have been paid without borrowing from the policy, interest paid on loans from the policy is deductible--to a certain extent. More particularly, the employer is allowed to deduct the interest on a loan of up to $50,000 from each COLI policy that it owns (assuming that each policy names a different employee as the insured).

What are the tax implications of using life insurance as an employee benefit?

A business can provide life insurance benefits to all permanent, full-time employees (group life) or only to managers and other key personnel (typically, split dollar life). Providing life insurance and other employee benefits is beneficial to businesses because goodwill is fostered among the employees and because tax deductions are possible for the business.

If they meet certain conditions, C corporations can provide employees with life insurance and deduct the premiums. Any death proceeds will be received tax free by the employees' beneficiaries. Note, however, that sole proprietors, partners, limited liability companies (LLCs), and S corporations don't qualify for the deduction. Death proceeds are limited to $50,000 for each employee. If greater coverage is provided, the cost is still deductible, but the excess cost is taxable as wages to the employees.

Split dollar life insurance policies are popular among employers who want to provide coverage to only a select group of key employees. Typically, the employer and the employee join together in purchasing an insurance policy on the life of the employee and enter into an agreement that requires them to split the cost of the premium and the policy's benefits (such as death proceeds). Split dollar policies typically carry the following tax ramifications:

No deduction for premiums paid

Because an employer is either an indirect or direct beneficiary under a split dollar policy, it is generally not entitled to a deduction for its share of the annual premiums.

Death benefits are tax free

Death benefits from a split dollar plan (both the employer's share and the employee's beneficiary's share) are generally not included in income.

Caution: *Watch out for "transfers for value" issues.*

Treatment of policy withdrawals

An employer's withdrawals of cash value under a life insurance policy generally are treated as a nontaxable recovery of investment in the contract (premiums paid minus dividends and prior cash distributions) to the extent that such withdrawals don't exceed the employer's basis in the policy. However, withdrawals that exceed the employer's investment in the contract will be treated as income to the employer.

What about protecting against the loss of key personnel?

Often, certain key employees are largely responsible for a firm's good credit, product line, or goodwill with customers. The death of such a key person is bound to leave its mark upon the business. To offset some or all of these losses, a business can carry life insurance on its key people . This insurance, payable to the business, indemnifies it against the loss of these important employees.

Tax ramifications follow the usual pattern:

No deduction for premiums

Generally, key employee life insurance premiums are not deductible as a business expense, since the firm is a direct or indirect beneficiary under the policy.

Taxation of proceeds

In general, life insurance proceeds received upon the death of a key employee are not subject to federal income taxation. (However, if the death proceeds are paid in installments, any interest element in the installment payments will be included in the income of the business.)

What about protection from casualty losses and from exposure to liabilities?

If a business suffers a loss (casualty or otherwise), to the extent that the business receives money or property as reimbursement for its loss that is less than the loss, the business realizes a deductible loss .

As for property and liability insurance, a business is allowed to deduct ordinary and necessary business expenses that have been properly paid. Therefore, premiums for property and liability insurance generally may be deducted by the business.

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