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Employer Provided Life Insurance

As part of a comprehensive compensation package, many law firms provide key employees with life insurance coverage. Life insurance is an important benefit because it provides financial protection for the loss of income a family may suffer as the result of an employee's untimely death. The financial protection provided by life insurance can be particularly important in retaining highly compensated employees that are integral to the continued success of the firm. In deciding what life insurance benefit plan is best for a firm and its employees, a firm must consider whether to provide "Permanent" (also referred to as whole or universal life insurance) or "Term" life insurance. Whether or not a firm provides a qualified group term life insurance policy to all employees, it should consider obtaining permanent life insurance on key employees to help fund the benefits necessary to attract and retain these employees.

Differences between Permanent and Term Insurance: Asset v. Expense

Life insurance can either be purchased as term or permanent insurance. As its name suggests, term insurance provides coverage for a set premium over a given number of years as set forth in the policy purchased by the employer. Term insurance is often attractive because of the relatively low annual premiums. However, the premium paid on a term policy is a direct business expense for the employer that will never be recovered. Benefits provided under a term policy will only be paid if the employee dies during the coverage period and the benefits will be paid to the employee's designated beneficiary.

However, as an employee ages, renewing a term life insurance policy can become increasingly difficult if there is a change in the health status of the employee. Even if health and age considerations do not preclude the purchase of a term life insurance policy, the cost of coverage will increase commensurate with the age and health of the covered employee.

In contrast, permanent insurance provides guaranteed coverage for the life of the insured rather than for a set term of years. In addition, permanent insurance has a savings component that is tied to the life insurance coverage provided by the policy. As an additional benefit, the savings component of a permanent life insurance policy grows tax deferred. As a result, employer owned permanent insurance is an asset that increases the financial flexibility of the employer. For example, the cash value of permanent life insurance can be used to obtain financing for premium payments or to fund business operations. Depending on the interest rate tied to the financing of the permanent insurance, and the return on the cash value of the policies purchased by the employer, permanent insurance can represent a long-term growth asset on the books of the employer. The employer can then utilize the cash value of permanent life insurance to accomplish various business objectives as discussed below.

Potential Uses of Permanent Insurance

The savings component of employer owned permanent life insurance provides an asset with significant financial flexibility. The cash value of a policy can be used to:

- Provide death benefits to the designated beneficiaries of key employees;
- Provide retirement benefits to covered employees;
- Fund the buyout provisions of a buy-sell agreement;
- Provide an asset against which the employer can obtain business financing, including financing the permanent life insurance premiums.

Permanent life insurance allows an employer to build a financial asset to fund benefits for key employees on a tax deferred basis. Depending on the financing and structure of the permanent life insurance plan, the medium to long-term cost to the employer may be much lower than providing equivalent retirement and death benefits through other means.

There may be tremendous economic advantages for the employer in selecting a life insurance policy with substantial growth potential. Such a policy is typically structured as a universal life policy with growth based on one or more equity indices, such as the S & P 500, or a European or Asian market-based equity index. Even more advantages may be obtained if the policy premiums are financed through the use of a low interest rate limited recourse loan that may be available, whereby the policy itself serves as the primary collateral for the loan.

Income Tax Considerations

There are important differences in the income tax consequences of employer owned permanent life insurance and term insurance. Employer provided term life insurance is an employee benefit that is a deductible business expense for the employer. If term life insurance is provided through a group plan, the value of the first $50,000.00 in coverage is excludable from income by the covered employee. The value of coverage in excess of $50,000.00, as determined by the IRS, is taxable income to the covered employee and must be reported to the IRS. If term insurance is not provided through a group policy, the full value of the insurance provided by the employer is taxable income to the covered employee.

If the employer retains ownership of a permanent life insurance policy, the premiums are not currently deductible for income tax purposes. However, death benefits paid to the employer pursuant to a permanent life insurance policy would generally be received free of Federal income taxes.

Furthermore, if the employer is the beneficiary under a permanent life insurance policy, the covered employee is not subject to income taxes on the premiums paid by the employer. However, payments made to a deceased employee's beneficiaries would be subject to income taxation. The actual income tax consequences would depend on the nature of the payments to the beneficiaries. For example, payments made to beneficiaries based on services provided by a deceased employee would be taxed as ordinary income. Payments made with respect to the provisions of a buy-sell agreement may be taxed as ordinary income or capital gain depending on the terms of the agreement.

Flexibility of a Nonqualified Plan: ERISA Considerations

Employer owned permanent life insurance is geared toward providing additional benefits to key employees through a nonqualified employee benefit plan. As a nonqualified employee benefit plan, the employer does not get to deduct the expenses of the plan until benefits are actually paid to the employee. However, nonqualified plans avoid the participation requirements and many of the administrative burdens associated with qualified employee benefit plans under the Employee Retirement Income Security Act (ERISA). By structuring a "Top-Hat" plan that covers fifteen percent or less of all employees, the plan can avoid many of the costly burdens associated with ERISA compliance.[1] A Top-Hat plan is required to file a form with the Department of Labor regarding its existence, but is otherwise exempt from the annual reporting and participation requirements of qualified plans. Accordingly, a Top-Hat plan allows an employer to focus the provision of additional benefits available through permanent insurance to its most valuable employees.

Asset Protection

Under current tax law, there is a tension between asset protection and avoidance of current income taxation. If an employee is granted legal rights to the assets accumulated in a

[1] There is no bright line rule for how many employees can be covered by a "Top-Hat" benefit plan, but it is generally advisable to keep the number below fifteen percent (and perhaps below ten percent) of all employees.

nonqualified employee benefit plan which precludes access to those assets by the employer's creditors, the employee is deemed to have constructively received the assets and will be subject to current income taxation and the value of his or her interest in the plan, in this case the cash value of the permanent life insurance policies. Conversely, to avoid current taxation on assets accumulated in a nonqualified benefit plan, the assets must be available to satisfy the claims of an employer's creditors. As a result, permanent life insurance can provide an effective vehicle for setting aside funds to pay future employee benefits, but keeping the value of those policies on the books of the employer will defer income taxation to the employee until such time as the benefits are irrevocable set aside for, or paid to, the employee.

Conclusion

Permanent life insurance is a tax-advantaged method for providing additional retirement and life insurance benefits to a firm's most valuable employees. Permanent life insurance, particularly in light of favorable premium financing rates currently available, deserves serious consideration as part of any key employee benefit and retention program.