# Business Uses of Life Insurance

Life insurance has long been considered an indispensable way of protecting individuals and their families from unavoidable risks, as well as preparing for future financial needs. Similarly, businesses face myriad financial risks and other more predictable needs that may be well addressed by life insurance. Life insurance proceeds can help a corporation through the period following the unexpected death of a particularly valuable employee. Owners of corporations also often use life insurance to fund the purchase and sale of their ownership interests to one another. The tax-favored nature of life insurance, together with the death benefit, make it an excellent way for a corporation to be prepared to meet its obligations under executive benefit plans as well.

Competition among employers to attract and retain talented executives is fierce in today's labor market-place. Increasingly, the difference is made by the benefits that the employer makes available. Life insurance can play a valuable role in executive benefits planning, as a benefit itself or as a means to funding another benefit. To illustrate, we will discuss briefly three ways that life insurance is often used to benefit a company's valuable executives.

## Non-qualified Deferred Compensation

Like everyone, highly compensated executives are interested in building the security of wealth sufficient to sustain their lifestyles throughout their retirement years. Traditional tax-favored retirement planning tools such as qualified plans (401(k)s, IRAs, 403(b)s, etc.), however, impose restrictive limitations on the amounts that a participant may contribute or the speed with which they may accumulate. Because of these limits, the higher your salary is, the harder it is to save enough for your retirement in a tax-favored qualified plan. Qualified plans bring with them broad appeal, and incentives to employers to keep them in place. Non-qualified deferred compensation plans ("NQDC"), however, are the remedy to the "reverse discrimination" problem.

Non-qualified plans, if properly structured, do not face the burdensome limitations or the onerous reporting requirements imposed by the tax code on qualified plans. The employer may hand pick those executives that are allowed to participate, and tailor the plan to the needs of these executives. Although NQDC can take any one of a host of varied structures, most such plans will be classified as "elective" plans (in which executives defer income that would otherwise be paid out as earned) or "nonelective" plans (in which the employer simply credits additional amounts to the executive's benefit amount). The executive and the company sign an agreement in which the company agrees to pay the executive the benefit over a number of years at some future time.

The company, of course, can choose to fund this future obligation in any number of ways, such as taxable investments, future cash flows, the lottery, etc. Life insurance on the life of the participant, with its tax-favored growth and death benefit, presents an excellent funding source for NQDC obligations. Here's how it might work: The company, XYZ and the participating executive, E, would execute a NQDC agreement under which XYZ agrees to pay E each year after her retirement for 15 years an amount equal to 75% of her last year's salary, but only if she's still employed by XYZ at retirement. XYZ buys a life insurance policy on E's life and pays a premium each year that will be calculated to pay the premium up to no later than E's retirement. If E is still with XYZ at retirement, each year thereafter XYZ makes withdrawals from the policy (up to basis, taking loans thereafter) to pay out its obligation under the NQDC agreement. Upon E's death, XYZ receives the death benefit free of income tax. E is gratified by the benefit that XYZ is providing her and is going to think long and hard before leaving XYZ before retirement.

## Executive Bonus Plans

Life insurance is not only an excellent funding source for a benefit plan; it can be the benefit itself that the executive values most. Sometimes referred to as a "162 Bonus" plan, the company can agree to pay directly the premium on an insurance policy that the executive (or the executive's trust) owns and controls. The owner of the policy (the executive or the trustee of the trust) can name the beneficiary of the policy, take withdrawals or loans from policy values, and generally exercise any and all rights in the policy as the owner. The executive must report the premium payments as taxable income in the year the payments are made, but often the employer will make an additional bonus payment to the executive in the amount of the income tax incurred because of the premium payment. The result is needed life insurance coverage with no out of pocket cost to the executive. All costs are deductible to the employer.

A very popular variation of the 162 Bonus Plan includes most of its features but adds a "golden handcuffs" inducement to the executive not to leave the company: the Restrictive Endorsement Bonus Arrangement ("REBA"). The REBA is exactly like a 162 Bonus Plan, but includes a restrictive endorsement that prevents the executive from exercising most rights in the policy until the endorsement is released by the company. In the bonus agreement, the company agrees to release the endorsement at some future time (in 10 years, at retirement, etc.). In return, the executive generally agrees to repay the company some or all of its costs if the executive leaves the company before that time.

## Split Dollar

One of the most popular executive bonus arrangements over the last half century has been, of course, the split dollar arrangement. Split dollar provides low cost life insurance protection (and can also be structured to provide access to cash values) to the executive, while providing cost recovery to the company. In such an arrangement, two parties agree to divide responsibility for the premium payments and the benefits of the values of a life insurance policy. In most scenarios, the executive recognizes as income only a small portion of the premium (equal to the cost of a term policy of the same amount). Upon termination of the agreement, whether at the death of the executive or before, the corporation will receive at least what it paid into the policy.

How a split dollar arrangement works depends first on who owns the policy. In an **Endorsement Split Dollar** arrangement, the company owns the life insurance policy and endorses to the executive the right to name the beneficiary. The executive reports the term cost of the death benefit as taxable income each year. Typically, upon retirement, the company gives the policy to the executive as a taxable bonus. On the other hand, in a **Collateral Assignment Split Dollar** arrangement, the executive (or the executive's trust) owns the policy and this owner assigns the policy values to the company as collateral to secure repayment of the company's outlay.

In January, the Internal Revenue Service issued IRS Notice 2002-8, which changed the measurement of the term cost of split dollar arrangements and promised to make sweeping changes to the way that split dollar may be structured in the future. A discussion of this notice is well beyond the scope of this article, but the reader may call Manulife Financial's Advanced Markets Group with any questions.

Life insurance can be as useful and effective a tool for a business as it traditionally has been for individuals and families. Whether insuring against risk of loss from the death of a key executive, providing tax-favored funding for buy-sell or executive benefit obligations, or being offered as a benefit itself, life insurance can be a valuable part of a company's financial planning.

For more information on business insurance please contact your local Manulife Financial Representative or call The Advanced Markets Group at 1-888-266-7498, option 3. In the next issue, Kevin will focus on Key Person Insurance and Business Succession Plans.

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