RiverSource Insurance

Use life insurance to fund non-qualified benefits

As a small business owner, you need to meet a variety of needs such as:

- Buy-sell planning
- Key-person protection
- Personal disability protection
- Non-qualified retirement benefits

All these needs serve two fundamental goals of every business owner:

- Protecting the value you have created
- Leveraging that value to provide financial independence for retirement

One key tool may be to design benefits for key employees. These benefits come in two basic forms: qualified and non-qualified.

Qualified benefits include 401(k), profit sharing and pension plans. If these benefits are offered by you, as an employer, they generally must be offered to all full-time employees. Non-qualified benefits can be offered as a supplement or an alternative to qualified benefits and can be offered selectively – you may discriminate and offer such benefits to a few key employees.

The role of life insurance in non-qualified benefits

One of the goals of a non-qualified benefit arrangement is to provide employees a tax-advantaged means of accumulating for retirement. Qualified plans take advantage of the tax code to provide two stages of tax-free treatment for retirement savings. Section 401 of the Code (401(k) plans, profit sharing plans, etc.) allows pre-tax contributions to a plan followed by tax-free growth with plan distributions being fully taxable. On the other hand, IRC § 408A (Roth IRAs) allows after-tax contributions into a plan which allows tax-free growth and tax-free distributions. In either case, the plan participant achieves “two out of three” stages of tax-free treatment for retirement accumulation.

While the tax code creates some types of qualified accounts that can provide tax advantages, there is another section of the tax code related to a specific type of financial product that provides tax-advantaged treatment. IRC § 72(e) which governs the tax treatment of the cash value in permanent life insurance policies (i.e., whole life, universal life, variable universal life, and indexed universal life), allows for tax-deferred accumulation in a life insurance policy. Also, premiums paid into a permanent life insurance policy may be withdrawn up to the investment in the contract (a.k.a “basis”) income tax-free and gains may be borrowed income tax-free for non-modified endowment contract policies. By using a combination of withdrawals and loans, the owner of a life insurance policy may obtain tax-free growth and tax-free distributions of the policy’s cash value. This tax-advantaged treatment of policy cash values makes life insurance a potentially attractive tool for informally funding non-qualified benefits.

	Traditional 401(k)	Roth IRA	Life Insurance
Contribution:	Pre-tax	After-tax	After-tax
Growth:	Tax-deferred	Tax-deferred	Tax-deferred
Distribution:	Taxable	Tax-free*	Tax-free*

*Assumes certain conditions are met.

Three varieties of non-qualified benefits

There are a variety of non-qualified benefits that can be funded or informally funded using permanent life insurance from RiverSource Insurance. The type of arrangement will depend on several factors: (i) which party owns the life insurance, (ii) whether the benefit is funded by you or the employee, and (iii) whether you want “golden handcuffs” for the arrangement.

FIXED/VARIABLE LIFE INSURANCE
NOT A DEPOSIT • NOT FDIC INSURED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY • NOT BANK, CREDIT UNION OR SAVINGS & LOAN GUARANTEED • MAY LOSE VALUE

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If you are seeking tax deferral for the employee, then you can use a plan covered by IRC § 409A. These plans are referred to as non-qualified deferred compensation (NQDC) and can be informally funded with corporate-owned life insurance (COLI). In such cases, the life insurance policy is owned by the business and a benefit can be created through an employer Supplemental Executive Retirement Plan (SERP). These arrangements may require the use of a third-party administrator.

If you want to take immediate tax-deductions for funding a non-qualified benefit, or if the parties are looking for a simple arrangement, you may want to consider an executive bonus (sometimes referred to as a § 162 Bonus Plan). In these arrangements, the life insurance policy is owned by the employee and can also be funded by you (bonus arrangement) or the employee (TERI or tax-efficient retirement income).

There is a third type of plan design which involves split or shared interest in a life insurance policy. This arrangement is referred to as a split-dollar or split-dollar loan arrangement. It may be particularly attractive if you are seeking "golden handcuffs."

Accessing policy cash value through loans and surrenders may cause a permanent reduction of policy cash values and death benefit, and negate any guarantees against lapse. Surrender charges may apply to the policy and loans may be subject to interest charges. Although loans are generally not taxable, there may be tax consequences if the policy lapses, or is surrendered or exchanged with an outstanding loan. Taxable income could exceed the amount of proceeds actually available. Surrenders are generally taxable to the extent they exceed the remaining investment in the policy. If the policy is a modified endowment contract (MEC), pre-death distributions, including loans from the policy, are taxed on an income-first basis, and there may be a 10% federal income tax penalty for distributions of earnings prior to age 59-1/2.

Before you purchase life insurance, be sure to consider the policy's features, benefits and fees, and whether it is appropriate for you, based on your financial situation and objectives.

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