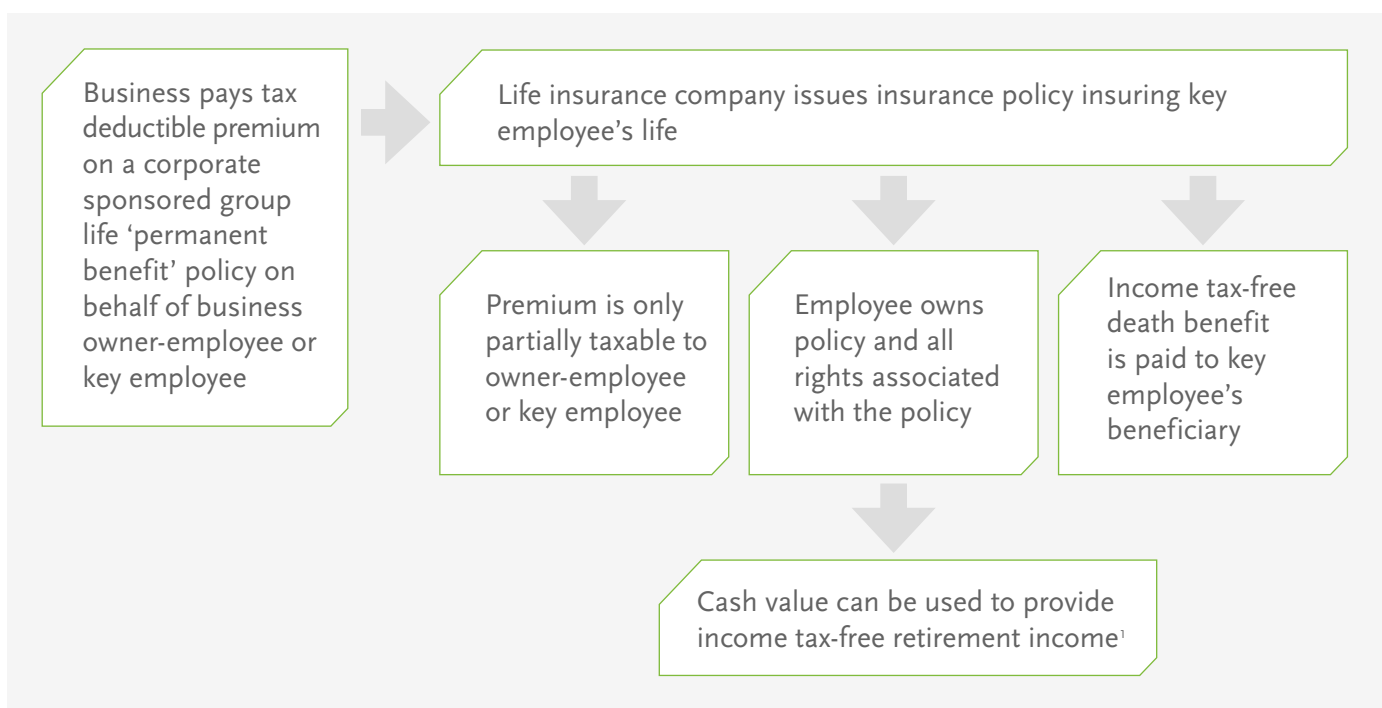


## Section 79 'Permanent' Life Insurance

Your business success depends on the expertise of a few key employees...

How can you provide life insurance as a benefit to business owners and their employees in a tax advantaged way?




### The advantages of this strategy:

- Business contributions are tax deductible.
- Cash value grows tax-deferred.
- Provides income-tax free stream of income for insured employee.<sup>1</sup>
- Death benefits are paid income tax-free to named beneficiaries.

Experience Life™

<sup>1</sup> Policy loans and withdrawals reduce the policy's cash value & death benefits and may result in a taxable event. Withdrawals up to the basis paid into the contract and loans thereafter will not create an immediate taxable event, but substantial tax ramifications could result upon contract lapse or surrender. Surrender charges may reduce the policy's cash value in early years.



When the ongoing success of your business depends on the skills, knowledge, and expertise of a few key employees...

**A Section 79 ‘Permanent Benefit’ Plan can help keep them committed to your company.**

Here’s how it works:

- The business adopts a group life insurance plan. The employee elects type and amount of benefit.
- There is generally minimum funding for rank and file employees who typically select only \$50,000 of group term coverage under the plan.
- Your company pays a tax-deductible premium on the life insurance policy for the employee(s).
- The employee recognizes a reduced economic benefit as taxable income, and owns the policy outright.
- At retirement, the key employee can access policy values to supplement retirement income.<sup>1</sup>
- At death, the life insurance policy pays an income-tax free benefit to the employee’s beneficiaries.

**Permanent life insurance:**

- Provides an income-tax free death benefit at death.
- Accumulation of policy cash values is tax-deferred.
- Can provide income tax-free retirement income via policy loans and withdrawals.<sup>1</sup>
- The policy cash values are not subject to the company’s creditors, liability or litigation issues.
- In some states, the policy may also be creditor-proof.

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National Life Home Office: One National Life Drive, Montpelier, Vermont 05604 • (888) 297-3990 • [www.nationallife.com](http://www.nationallife.com)  
LSW Home Office: 1300 West Mockingbird Lane, Dallas, Texas 75247 • (800) 579-2878 • [www.lifeofsouthwest.com](http://www.lifeofsouthwest.com)

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## Section 79

### It's More Than Group Term Insurance

By Peter M. Weinbaum, JD. CLU, ChFC

Mention Internal Revenue Code Section 79 to most business owners and advisors and typically they will think “group term insurance.” Now that is changing. Ironically, recent IRS pronouncements that *removed* some of the tax benefits of Section 79 may have increased awareness of its potential as a planning strategy.

#### Technical Issues

Under a nondiscriminatory Section 79 plan, employees can receive up to \$50,000 of term life insurance income tax-free. Employers may provide employees term life insurance in excess of \$50,000, so long as they report the value of the excess coverage on the employee's W-2 as compensation. The value of the excess term coverage is determined under Table I of the Treasury Regulations, which sets forth uniform premiums computed on the basis of 5-year age brackets. So long as the employer is not directly or indirectly a beneficiary of the insurance and the compensation is deemed “reasonable,” employer contributions to the plan should be tax deductible.

The regulations under Section 79 also permit these plans to provide **permanent benefits**, defined as “an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy.” The formula for valuing permanent benefits is set forth in the regulations, and is based on such factors as the age of the employee and the type of insurance contract used. **Only specially designed life insurance contracts will produce favorable tax results under this formula.**

Section 79(d) contains nondiscrimination rules as to eligibility and benefits. Certain types of employees can be excluded from consideration based on such factors as union membership, length of service, and whether they work part-time or seasonally.

A plan is non-discriminatory as to **benefits** if “the type and amount of benefits available under the plan do not discriminate in favor of participants who are key employees.” A well-designed plan requires that all eligible participants be offered the option to elect the same **type** of benefits offered to key employees (e.g., permanent benefits). Such a plan also requires that all employees be offered a non-discriminatory **amount** of benefits; generally this requirement is satisfied by offering all employees life insurance in an amount that represents a uniform percentage or multiple of W-2 compensation.

Because the options that involve coverage in excess of \$50,000 of term insurance will result in an increase in an employee's income tax liability, employees are permitted to decline coverage in excess of \$50,000. Consequently, rank and file employees typically elect the free (to them) \$50,000 of group term life insurance and waive their right to higher amounts of insurance or permanent benefits.

Employees who do elect to receive permanent benefits must include the value of the permanent benefits in their gross income, reduced by any amounts they contribute from their own funds for the permanent benefits. Additional rules apply when the plan covers fewer than 10 employees.

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## Entity Types

Although a Section 79 plan can be used to benefit non-owner employees in any type of entity, **owner-employees can participate only if they are employed by a C corporation**. Depending on the tax situation, an owner of an S-Corporation, partnership, LLC, or sole proprietorship may elect to add a C corporation into the business model. Owners who receive W-2 compensation from the C corporation may participate in the plan, along with non-owner employees of both entities.

## Plan Features

A Section 79 plan that includes permanent benefits has several important characteristics:

- Corporate contributions to the plan are tax deductible in virtually all cases
- Only a portion (generally 60-65%) of these amounts is includible in the participant's income
- Because participants who elect permanent benefits own cash value life insurance policies personally, the rules governing employer-owned life insurance do not apply, and there is no need for a "rollout" upon plan termination
- The plan and the underlying contract are designed to be fully funded in five years
- The usual tax characteristics of cash value life insurance apply to these contracts
  - Policy cash values accumulate tax-deferred
  - Death benefits are generally received income tax-free
  - Once the plan is terminated and the life insurance cash values have had time to accumulate, the participant can take policy loans as a source of tax-free income, as long as the contract is kept in force
- Administrative fees are modest, as is the typical cost for rank and file employees

## Life Insurance Need is Critical

Although initial interest in a Section 79 plan is often driven by tax considerations, the core of the strategy is a need for life insurance. Life insurance contracts purchased under Section 79 can be used to address a variety of planning and protection needs:

- **Income replacement/capital needs for survivors.** The participant names beneficiaries just as he or she would in the case of other personally owned insurance.
- **Supplementary retirement income.** The participant can take loans from the policy as described above to supplement other sources of retirement income. The death benefit can supplement retirement income for a surviving spouse.
- **Charitable giving.** If income from the contract is not needed for retirement, it can be used to make tax deductible charitable gifts.\*
- **Cross-purchase buy-sell funding.** Each participant can use withdrawals or loans from the personally owned contract to help fund a lifetime buyout.\* Because policies are at least initially owned by the respective insureds, death benefits should be used for buy-sell purposes only if transfer for value issues can be avoided. Otherwise, cross-owned term insurance may be more appropriate to cover death contingencies.
- **Estate tax planning.** The participant can transfer the contract to an irrevocable trust immediately after issue. The participant must include in income the value of the life insurance protection and the permanent benefit. The initial transfer to the trust is treated as a gift of the entire premium. In years 2 through 5, the participant is treated as making gifts of the amounts includible in income. The 3-year rule applies from the date the contract is transferred to the trust.

Section 79 plans are not for every business, but for those closely held businesses and professional practices where there's a fit they provide an exciting, tax-advantaged opportunity for both owners and their key employees.

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\* Policy loans will reduce the policy's cash value and death benefit and may result in a taxable event if the contract is surrendered or allowed to lapse.

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*Peter M. Weinbaum, JD. CLU, ChFC  
Vice President – Advanced Business & Estate Planning  
National Life Group, Montpelier, VT*

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