Harmony Wealth Strategies
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Harmony Wealth Strategies
BUILDING AND SAFEGUARDING YOUR FINANCIAL WORLD

Business Use of Life Insurance: Corporate-Owned Life Insurance

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What is it?

Corporate-owned life insurance (COLI) is a type of policy that corporation/employer, can own on the life of one or more of its employees. In addition to owning the policy, the corporation is also the policy's beneficiary. As the policyowner, the corporation pays the premiums, and as the policy's beneficiary, the corporation retains the rights to the policy's benefits, including both the cash value buildup and the death benefit. Other than being named as the insured, the employee has no financial interest in the policy.

When can you use it?

To fund nonqualified deferred compensation (NQDC) plans

COLI is commonly used to fund nonqualified deferred compensation (NQDC) plans . When it is used in this way, the corporation can borrow against the accumulated cash value of the policy. The borrowed funds can be used to pay the COLI premiums or to fund the NQDC plan. The corporation can also draw against the accumulated cash value to pay distributions under the NQDC plan. Use of a COLI doesn't need to bear any relationship to the actual financial loss the corporation might experience from the covered employee's death.

How does it work?

As the employer, the corporation both owns and is the beneficiary of a COLI policy. The corporation is entitled to all the benefits under the policy, including both the cash-value buildup and the death benefit. The employee has no financial interest in the policy other than being named as the insured.

Typically, cash value life insurance is purchased on an individual employee and the corporation pays the premiums. When properly structured, the cash value that accumulates in the policy is not subject to tax. The corporation can borrow against the policy, using the funds to pay the premiums or to fund an NQDC plan.

Strengths

Informs employees of a source of funding for the corporation's NQDC obligations

When a COLI policy is used to fund an NQDC plan, it informs employees that their benefits may be protected from the demands on the corporation's cash flow.

Provides cash to fund corporate NQDC obligations

COLI also provides for the availability of funds to meet corporate obligations under an NQDC plan. This can reduce or eliminate the financial strain on the corporation when it is time for a distribution to occur.

Tradeoffs

It's important to carefully evaluate an insurance company's financial stability and earnings' history before purchasing COLI.

An insurer's financial difficulties can leave the corporation without cash to pay benefits

If a COLI policy is the corporation's only source of funds to meet its NQDC obligations and the insurance company experiences severe financial difficulties, the corporation may not be able to access the policy's cash value to pay the benefits.

Poor financial projections can leave the policy without sufficient cash value to pay plan benefits

If there is a disparity between the policy's actual earnings and the estimated earnings that were projected when the policy was issued, there may be insufficient cash value to pay the benefits when due.

Tax considerations

Deduction for deferred compensation

The corporation can generally deduct amounts paid to an employee under an NQDC plan that is funded by a COLI. The deduction can be claimed in the year the amounts are included in the employee's income.

Caution: *A COLI policy may sometimes be treated as a* modified endowment contract (MEC) *. If a COLI qualifies as a MEC, it's not eligible for some of the income tax benefits relating to withdrawals and loans that non-MEC life insurance contracts usually receive. For this reason, modified endowment contracts should be avoided when possible.*

Deduction for premiums

Life insurance premiums paid on a COLI policy can't be deducted when the corporation is a direct beneficiary.

Deduction for loan interest

If the corporation borrows against the accumulated cash value in a COLI, the loan interest may be deductible if meet certain conditions are met. For example, if the corporation has paid four of the first seven years' premiums without borrowing against the policy, the interest paid on later loans is deductible to a certain extent. However, for policies purchased after June 20, 1986, no deduction is allowed for interest on policy loans, except for interest on policy loans up to $50,000 per insured individual for policies covering a limited number of the employer's key employees (including certain officers and owners of the business). Thus, the corporation can purchase COLI policies with respect to a limited number of key employees and deduct the interest on policy loans of up to $50,000 per key employee; but otherwise no interest deduction is allowed with respect to any other COLI policy loan.

Treatment of cash value buildup

A COLI's cash value buildup is generally tax free, as long as the cash value is allowed to accumulate within the contract.

Treatment of policy withdrawals and loan proceeds

- Withdrawals--The IRS treats withdrawals of the accumulated cash value as a nontaxable recovery of investment in the contract. (This is calculated as the premiums paid less the dividends and prior cash distributions.) However, the IRS treats withdrawals that exceed the investment in the contract as income to the corporation.
- Loans--The IRS doesn't treat loans as distributions under the policy, so they're not subject to taxation.

Alternative minimum tax (AMT)

If you're a corporate employer, a COLI policy's accumulated cash value and death benefit are among the factors that may subject you to the alternative minimum tax (AMT).

Treatment of policy death benefit

Generally, the death benefit of COLI life insurance in which the corporation is both the policy owner and beneficiary is received tax free. However, for insurance contracts entered into after August 17, 2006, the corporation must meet certain notice and other requirements according to IRC Sec. 101(j) for the insurance death benefit to be received tax free.

IMPORTANT DISCLOSURES

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