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Modern Section 79 Plans

Tax beneficial retirement planning for business owners.

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Executive compensation planning opportunities for closely held businesses have been greatly curtailed during the past decade. Nonqualified and some “supercharged” pension plans used to offer a wide variety of customized supplemental plans to address reverse discrimination limitation endemic to traditional ERISA plans. These plans were mainly covered in my [previous article](#). Regulatory and legislative activity of the past 10 years all but decimated those planning opportunities either by outright prohibition on some or entwining others with unbearable rules and restrictions, even making some into “listed transactions” (419 plans and 412(i) plans). Split dollar plans used to be attractive in the context of retirement planning and provided a wide variety of supplemental income opportunities. Together with other types of non-qualified plans legislative and regulatory activism severely curtailed viability of those plans for most clients.

Unfortunately for the planning industry, “new and improved” often meant “more complicated and convoluted,” quite aggressive and often structurally and economically unsound.

Advisors and their clients generally want economically sound, straightforward, simple and effective strategies and ideas. One plan from the past that is going through a revival of sorts is the IRC Section 79 group term life plan.

The cost of these plans is 100-percent deductible to the corporation as an ordinary and necessary business expense under Section 162(a). However, a portion of the plan contribution must be reported as income by the participating employee. Due to certain recent changes in reporting requirements, the reportable portion has gone from 40 percent to 50 percent from 10 years to 15 years ago to a current 60 percent to 65 percent. Notwithstanding this increase, many advisors, CPAs and Employee Retirement Income Security Act (ERISA) attorneys find appreciable value in the planning opportunities presented by Section 79 Plans, particularly their ease of implementation, simplicity of design and absence of potentially harmful legislative complications.

Section 79 plans derive from the Internal Revenue Code’s section setting forth rules for employer-sponsored group life, health and medical insurance benefits. As it relates to life insurance, an employer may provide up to \$50,000 of group term life insurance for its employees without any cost to the employee (Section 79(a)(1)). The corporation will receive a tax deduction for the premiums paid and the employee does not report any income. If the benefit exceeds \$50,000, it is still fully deductible by the corporation, but the employee must pick up the Table I charge (Treas. Reg. Sec. 1.79-3(d)(2)) on excess death benefit every year the plan is in existence.

The attractiveness of the plan lies in the ability of the employer to provide inexpensive tax deductible fringe benefit at no cost to the employees. Employees also have the option to increase their benefits based on the plan formula and pick up corresponding taxable income and highly compensated key employees will find those benefits highly advantageous.

Those additional benefits may be funded with permanent or term insurance based on employees’ choice (Treas. Reg. Sec. 1.79-1(b) and Treas. Reg. Sec. 1.79-1(c)(5)). Based on the safe harbor valuation found in Rev. Proc. 2005-25, between 60-65% of premiums paid are taxable to the employee, while the corporation

deducts the full amount. The choice of policy is very important and actuarial review is highly recommended.

Clients are able to set up a plan to accumulate substantial, potentially larger than qualified plans, pools of tax-deferred assets that could be used up during their lifetime on a tax-free basis via policy loans under Sec. 72(e)(4)(A). In addition, clients acquire generally needed life insurance protection and may shelter assets from the claims of creditors. It is important to note that creditor protection laws are state specific, however proper advanced planning will accomplish desired results with respect to creditor protection issues. Anyone contemplating an asset protection plan should not undertake such without the advice of legal counsel.

Case Study

Dr. I.M. Surgeon, 49-years old, owns and operates several surgical centers through a "C" management corporation. His salary is around \$500,000. He considered but chose not to set up a defined benefit (DB) plan, because the cost of providing comparable benefits to his 30 full-time employees was far greater than any potential tax and accumulation benefits for him. Dr. Surgeon would like to supplement his existing 401(k)/profit-sharing plan and create additional current tax deductions.

The Section 79 Plan for Dr. Surgeon is based on his determination to set aside additional \$250,000 per year for himself for five years.

| Annual Year | Funding | Deductible Contribution by Corporation | W-2 Income to Executive | Net Cost in 40% Tax Bracket |
|---------------|---------|----------------------------------------|-------------------------|-----------------------------|
| 1 | 250,000 | 250,000 | 162,156 | 64,862 |
| 2 | 250,000 | 250,000 | 161,245 | 64,498 |
| 3 | 250,000 | 250,000 | 155,995 | 62,398 |
| 4 | 250,000 | 250,000 | 151,055 | 60,422 |
| 5 | 250,000 | <u>250,000</u> | <u>146,255</u> | <u>58,502</u> |
| Total: | | 1,250,000 | 776,706 | 310,682 |

The funding stops after the fifth year and the insurance policy continues to accumulate cash value until age 65 or other desired retirement date. The original death benefit is \$4,720,000; it is reduced after year seven to minimize insurance costs and maximize accumulations (not required).

Assuming retirement income starts at 65, the policy will provide:

| | |
|------------------------------------------------------------------------|---------------------------|
| Annual Income Tax-Free Retirement Distribution | 174,245 |
| Annual Taxable Equivalent | 290,408 |
| | 20 x Years (Age 65-84) |
| Total 20-Years Tax-Free Retirement Distributions | \$3,484,900 |
| Total 20-Years Taxable Equivalent | \$5,808,160 |
| – Taxable equivalent from a qualified plan in a 40-percent tax bracket | |

Over time, the policy's actual non-guaranteed elements and perhaps actual use of the policy's options are

likely to vary from the assumptions used in this chart. For these reasons, actual policy performance will either be more or less favorable than shown.

The benefits of the plan are easier to appreciate by comparison. Simplicity of design is comparable to an executive bonus plan, commonly known as Section 162 Bonus plan. The Section 79 Plan offers everything that a Section 162 Bonus plan offers and provides a client with about 35 percent to 40 percent of his bonus tax free. Additionally, there are no complications with transfer of interest in the policy, trust(s) creation and administration, vesting schedules and other lapsing restrictions.

Another and probably more effective way to illustrate the relative benefits of the Section 79 plan is to liken it to a **partially deductible Roth IRA**. A Roth IRA, simply put, is an “after-tax-contribution, tax-free-growth, tax-free-distribution” strategy. A Section 79 plan, by way of comparison, is a “partially-tax-deductible-contribution, tax-free-growth, tax-free-distribution.”

In effect, the plan allows your clients to capture the best of both qualified and nonqualified plans!

Conclusion

A Section 79 plan would benefit clients:

- For whom a Defined Benefits plan has little appeal due to “non-discrimination costs” and, thus, fail to address adequately their retirement needs
- Who have maxed out on their 401(k) contributions
- Who need and want additional corporate tax deductions
- Who operate as a C-Corporation

A Section 79 Plan cannot be established for an S-corporation because of the pass-through nature of the entity. As a result, IRC Sec. 264(a)(1) disallows a deduction for premiums paid on a life insurance policy by a taxpayer when that taxpayer is directly or indirectly a beneficiary of the policy. Thus, C-corporations are the only entities able to deduct the premiums paid on group term insurance on the life of an owner as an ordinary and necessary business expense under Section 162(a). Since many clients operate as “S” corporations, it may be possible to establish a second company, such as a management corporation, assuming that the general business structure allows for such an arrangement. Since the benefits of the Sec. 79 plan will be offered to all employees of both companies anyway, there should be no concern with affiliated service group status.

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