

Taking a Haircut

Section 79 plans used to look attractive for many small-office professionals. They now may be too close a shave. **By Rocco DeFrancesco**



ADVISERS WONDER HOW I FIND ALL the different plans I deal with (and the ones I refuse to deal with) on income tax reduction. The simple answer is that I get calls from several hundred physicians, professionals, and advisers after they read my articles in various journals. I've reviewed dozens of plans, so I am always a bit surprised when a new topic makes its way across my desk.

I hadn't heard of the Section 79 plan until a doctor in the Midwest asked me to review it for him. As it's devised, the plan has some nice aspects to it—before the proposed 412(i) regulations were

introduced, that is. These regulations, appear to put a damper on the financial benefits of the Section 79 plan.

If you look in the tax code under Section 79, you will see the basic outline for Section 79 plan benefits under the title "Group Term Life Insurance." These Section 79 plans are traditionally sold to companies as a way for them to provide additional benefits to their employees in the form of fairly inexpensive group term life insurance coverage.

But over the years, promoters discovered how to manipulate the tax code to make it more beneficial. That's what

has happened to the Section 79 plan. A Section 79 plan has several important benefits:

- It allows for a current tax deduction on contributions to the plan;
- It allows for tax-deferred growth;
- It provides for a flexible, unlimited funding window for key participants;
- Employee participation requires a minimal funding outlay;
- It does not have any minimum age requirements for withdrawing income (no early withdrawal penalties);
- It provides a non-taxable stream of income on demand; and
- Transfer of assets at the participant's death is income tax-free to heirs.

A Section 79 plan basically allows an employer to purchase life insurance on the employees (including the owners of the business) in a tax-deductible manner. In a typical arrangement, the key employees (the owners) will purchase a universal life (UL) insurance policy, while employees will opt for \$50,000 in term life insurance.

The plan's life insurance premiums are paid as a corporate deduction. If the life policy is a universal life policy, the key employee or owner will then have to recapture as income some portion of the deductible premium made by the employer. The \$50,000 term costs for employees should range from \$75 up to \$500 a year per employee, which is also deductible to the corporation. (Owners and the employees each have to recapture as income the Table 1 rates for the insurance each year.)

Who are the best candidates for Section 79 plans?

- Medical offices, law firms, or other professional firms with fewer than five principals and 40 employees. (If they have more than 40 employees, the term costs of insurance for the staff make the concept less viable.);

- Professionals who are looking for a way to purchase life insurance in a partially deductible manner for estate plans (although the life insurance is considered to be inside the client's estate for estate tax planning purposes); and

- Professionals looking for a plan that does not have upper-end funding limits.

There is no maximum amount of money the key employee or owner may deduct from the company for the purchase of the life insurance.

One main sales pitch for Section 79 plans is that the UL policies purchased have cash value in them. Plans are typically implemented for a five-year period. After that period is up, the owner then has a significant amount of money in a cash-building life policy, although the cash surrender value may be low at the end of the fifth year. Eventually, the key employees will be able to take income tax-free loans from their life insurance policies to use as supplemental retirement income, or the policies also can be used for estate planning purposes.

Various promoters of Section 79 plans used to claim that the UL policy bought for the business owner was about 70% deductible over the five-year funding window. That's not really true. In reality, however, the deductible amount is more in the first year and becomes the least deductible in year five.

Let's take a look at a sample plan (see "The Section 79 Math" below). To start, assume that Dr. Smith paid \$250,000 in premiums through the medical practice into his UL policy over five years. If the cost of the policy was 70% deductible, the out-of-pocket, after-tax cost to Dr. Smith would be \$180,000. He would feel good about the fact that he was able to fund a cash-building UL policy while saving \$70,000 of post-tax income in the

process (minus the minor term life costs for the employees and the recapture of the Table 1 costs of insurance).

This all sounds good, until you begin to consider the tax consequences of the recently proposed 412(i) regulations, which are intended to curb abuses in those defined benefit plans. As a by-product of the proposed regulations, the IRS intentionally or inadvertently (I'm not sure which) changed the valuation method for Section 79 UL policies.

In short, the new 412(i) regulations increase the value of the UL policy for tax calculation purposes that employees must recapture every year, whenever a company pays a premium into a UL policy. Without getting into the arcane specifics about exactly how the regulations changed the valuation method, just suffice it to say that the valuation experts that I've talked with figure that the Section 79 cash-building UL policy is now approximately 30% deductible instead of 70% deductible.

In our example, where Dr. Smith's corporation paid \$250,000 in premiums over a five-year period, the post-tax cost to Dr. Smith rises from \$180,000 to \$220,000. Similarly, everyone who uses the group's Section 79 plan must recapture a higher amount of premium each year as income when the corporation funds the policy. The end result is that Dr. Smith still saves \$30,000 in post-tax income over five years, but the savings is no longer quite so dramatic.

Financial advisers should also know that Section 79 plans have been around for many years in one form or another. In the past several years, a few marketing entities decided to market the plan as a deferred compensation plan rather than as the more traditional Section 79 plan, which revolves around the need for a death benefit.

I have done significant research on this topic and have talked with a variety of people whom I consider to be experts in this field. One thing is clear: there are sharp differences of opinion on how Section 79 plans should be set up and how aggressive they should be.

One major point of disagreement among the experts is whether it is possible to "levelize" the insurance cost over the life of the client. For example, the current mortality costs for a 48-year-old might be \$2,000 for X amount of insurance. The mortality costs for the exact same amount of insurance at the client's assumed age of death (let's say age 83) might be \$200,000.

Some promoters of Section 79 plans would say that you can average the mortality costs over the life expectancy of the client and then use that number to calculate the current deduction of insurance for the client. However, the conservative approach is not to levelize the mortality costs in this fashion and to use the actual costs of insurance when calculating the deductible cost of insurance in the year the premium is paid.

This is one of many issues that Section 79 marketers and advisers would debate. The plan remains an option for the right client to fund a tax-favorable, cash-building UL policy for supplemental retirement benefits or estate planning purposes. But the plans definitely have reduced financial viability now. **FP**

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The Section 79 Math

Dr. Smith runs a one-physician office with three employees. The cost for his practice to fund a Section 79 plan is as follows:

	Age	Salary	Death Benefit Purchased	Annual Cost of Term Insurance
Jan	50	\$35,000	\$50,000	\$150
Linda	40	\$30,000	\$50,000	\$100
Sally	35	\$25,000	\$50,000	\$75
Total				\$325
				Cost of UL Premium
Dr. Smith	40	\$500,000	\$1,000,000	\$50,000
Total annual cost for Dr. Smith and staff (annual):				\$50,325
Post-tax cost over five years for \$250,000 UL policy:				\$180,000

With 70% of the UL premium deductible, and Dr. Smith in the 40% income tax bracket, he has saved \$70,000 in out-of-pocket expense with the Section 79 plan under the old rules. The new regulations proposed for 412(i) plans indicate that Section 79 plans may only deduct 30% of UL premiums. In this example, the savings drop to \$30,000.—RD