CAN LIFE INSURANCE BE PURCHASED INSIDE AN ESOP?

The short answer is "Yes." However, as with all matters involving corporate finance, employee benefits and the other issues which all converge in an ESOP decision, the well-thought out answer is often quite different. *It is better for any policies to be owned by the corporation rather than the ESOP trust in nearly all instances.*

If the ESOP owns the policies, there would be an advantage in:

1. Improved cash flows for the company if the ESOP has the additional cash to invest in the insurance, because of the immediate deductibility of the premiums.

2. Large ESOP accounts are funded for the stock repurchases in event of death.

The drawbacks to ESOP ownership of insurance are not insignificant:

1. Some fiduciary issues, for example: ESOP-owned insurance with death benefits or cash for key employees/shareholders could create a possible prohibited transaction.

2. Insurance death benefits paid to the ESOP cannot be used to retire ESOP debt (current law specifies ESOP loan repayments are to come from annual additions or dividends for that purpose; S corporation ESOPs can use K-1 distributions on unallocated shares to retire debt…the purchase of insurance with them is a gray area).

3. Why should a **tax-free death benefit** be paid to a **tax-exempt trust**?

4. Why should there be possible tax-exempt deferred cash value building up in a tax-exempt trust, when permanent insurance products are used?

5. A large cash infusion from a death benefit will generally repurchase stock <u>for the trust</u> or be paid out to departing participants, which increases the repurchase liability; it is probably better to have the flexibility of a death benefit coming to the balance sheet.

6. Ask this question: "Will the limit for annual contributions to the ESOP also allow payment of the premium(s)?"

7. Plan fiduciaries must consider the implications of possibly canceling a policy, when the death of an insured is a guaranteed benefit to the plan. (Would younger plan participants claim fiduciary malfeasance in the elimination of this benefit which would more than likely accrue to them?).

Corporately-owned insurance contracts can have numerous benefits:

1. The corporation can use any insurance proceeds or cash values to retire into treasury as little or as much of the stock as desired, adjusting the issued and outstanding shares - both the size of the ESOP and the future repurchase obligation in light of the financial posture of the company, the plan and shareholders.

2. The tax-free proceeds from the insurance policy to the company are more flexible than cash in the plan: they can be made tax-deductible contributions to the ESOP or loaned to the ESOP to the extent needed. In the case of a loan from an insurance benefit or cash values, the company can then make tax-deductible contributions to repay itself.

3. The premium(s) can be made tax-deductible through the contribution of newly issued shares to the plan, which can be adjusted as the shareholders desire in light of the tax benefits needed and the minimum dilution incurred. If NOL's or other factors mitigate the need for a tax-shelter, the company has control of the stock contribution and can choose to make no additional plan contribution.

4. The cash accumulations can be used to fund reasonable discriminatory key-executive benefit outside the ESOP…"golden handcuffs" to retain mission critical people for the benefit of the company and the ESOP participants.

    4.1. Important note: The "vesting" of such accumulated cash to key executives can be linked to the ability of these executives to retire ESOP debt or successfully fund ESOP stock repurchase obligations.

A potential drawback to the corporately owned insurance is:

1. A large tax-free death benefit paid to the corporation could increase the tax liability of the company through alternative minimum tax rules (the company should have its accountant review this and the possible impact on stock valuation).

In Short:

The significant constraints on trust-owned insurance and the flexibility of a company with insurance contracts on its balance sheet both argue strongly in favor of having the corporation own any policies.

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