Section 79
Permanent Benefit Plans

Producer Guide

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Understanding Section 79

Group Term Insurance Plans

Section 79 of the Internal Revenue Code permits employers to offer group life insurance coverage to their employees as a benefit of working for the business. Most group life insurance plans offer employees term life insurance coverage under a master policy which the employer purchases from the insurance company. Participating employees receive certificates of insurance coverage indicating the amount of life insurance coverage they have under the plan. The employee names a personal beneficiary to receive this death benefit.

Group term life insurance is a valuable source of protection for many participating employees. It is simple, affordable and for many it is their main source of life insurance protection. Unfortunately, group term life insurance has several disadvantages:

- Income taxes are due on the value of death benefits exceeding $50,000.
- Group term coverage ends upon retirement or termination of employment unless converted to individual coverage.
- Continuing the death benefit coverage after leaving can be expensive.
- The coverage doesn't provide potential supplemental income during retirement.

In general, group term life insurance is designed for the average employee. Many business owners and their key employees want life insurance coverage that provides more than a death benefit. They want life insurance coverage that offers protection that is portable so it can be continued after they leave the business or retire. They also want coverage that has the potential to provide supplemental income during retirement. In short, they would like to have cash value life insurance and they want to be able to use business dollars to pay the premiums. If their business is legally structured as a C corporation with taxable income, IRC section 79 may be able to help them out.

Cash Value Life Insurance in Group Life Plans

Section 79 permits a group term life insurance plan to provide "permanent benefits." "Permanent benefits" are defined as benefits under a life insurance policy with an "economic value extending beyond one policy year." Thus, cash value life insurance policies can be offered to employees participating in group life insurance plans if these conditions are satisfied:

1. The policy must provide a general death benefit excludable from a participating employee's income as life insurance under IRC section 101(a).
2. It must be provided to a group of employees as compensation for personal services performed by the employee.
3. The policy must be carried directly or indirectly by the employer. This requirement is met through a master policy or a group of individual policies if the employer pays the cost of coverage or arranges for payment by the employees through a single insurance company.
4. The amount of insurance provided must be computed under a formula that precludes individual selection. The formula can be based on age, years of service, compensation or position.

How a Section 79 Permanent Benefit Plan Works

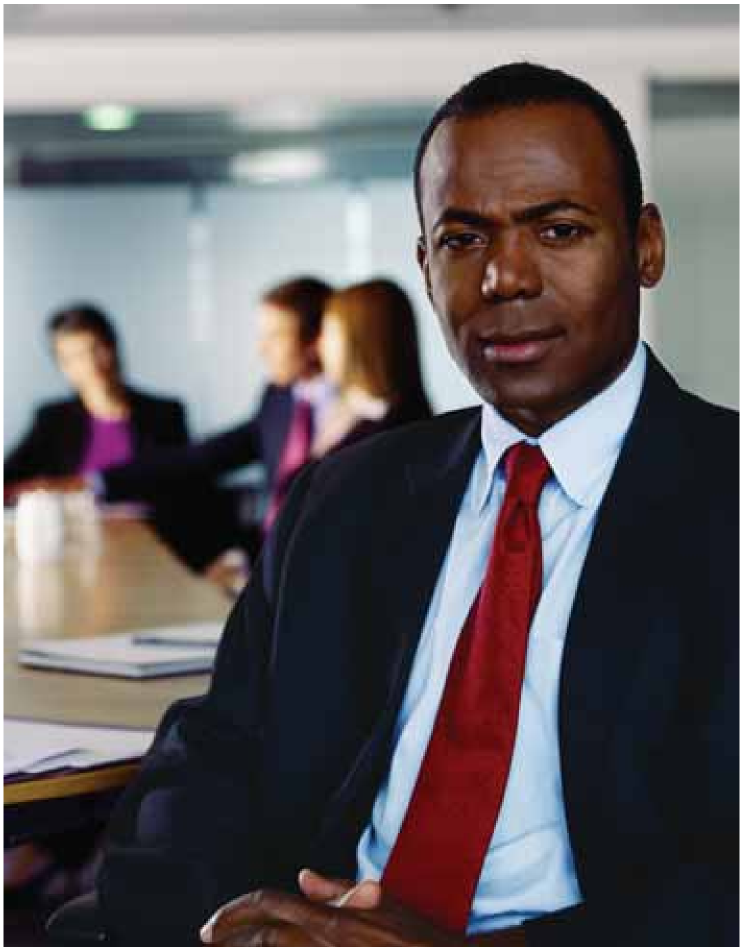
These are the steps for implementing a Section 79 permanent benefit plan:

1. The employer adopts a qualifying group life insurance plan.
2. Employees electing a permanent benefit under the plan apply for the policy.
3. The employer pays the policy premiums to the life insurance company.
4. The employee includes the cost of coverage in excess of $50,000 and the value of the permanent benefit in his/her income tax return.
5. If the employee retires or ceases to be an employee, he/she can continue to own the policy and pays premiums with personal dollars.
6. At the employee's death, income tax-free death benefits are paid to the policy beneficiary.*

*Proceeds from an insurance policy are generally income tax free and, if properly structured, may also be free from estate tax.

What Businesses Are Prospects?

Section 79 group permanent plans are primarily designed to benefit owner-employees and non-owner key employees. Any business can adopt a group permanent plan to benefit all employees, including non-owner employees. However, if an owner-employee is to participate in the plan, the business must be organized as a C corporation (but a group permanent plan may be disadvantageous for a C corporation if the corporation reports no taxable income). Independent contractors, partners in a partnership, members of an LLC (unless it has elected to be taxed as a C corporation), sole proprietors and owners of more than 2% of the stock of a subchapter S corporation are not permitted to receive any group life insurance benefits under Section 79.



Income Tax Consequences

To The Employer:

- Premiums paid are income tax deductible (to the extent compensation is reasonable under IRC Sec. 162 and to the extent the corporation has taxable income).

To Participating Employees:

- Coverage up to $50,000 is income tax free (for nondiscriminatory plans).
- Group term insurance coverage exceeding $50,000 is taxable under IRS Table 1 (for nondiscriminatory plans) – See Appendix.
- The cost of "permanent benefits" paid by the employer is taxable income.
- Policy cash values grow income tax deferred.
- Death benefits paid to the employee's beneficiary are generally income tax free.

Group Insurance Plans Can't Discriminate

To qualify for the tax benefits of a group life insurance, a permanent benefit plan must meet the non-discrimination rules of IRC Section 79. The plan can't unduly favor owners and key employees in the areas of eligibility and benefits. A key employee (IRC 79 (d)(6)) is an employee who, at any time during the employer's tax year was: (1) an officer of the employer having annual compensation greater than $160,000 (in 2010); (2) a more-than-5%-owner of the employer; or (3) a more-than-1%-owner having an annual compensation from the employer of more than $150,000. IRC Sec. 416(i).

Eligibility Discrimination

A plan is considered discriminatory in favor of key employees with respect to eligibility to participate unless: (1) it benefits at least 70% of all employees; or (2) at least 85% of the participants are not key employees; or (3) the plan benefits a class of employees found by the Secretary of the Treasury not to be discriminatory; or (4) if the plan is part of a cafeteria plan, the requirements for cafeteria plans are met. IRC Sec. 79 (d)(3)(A). Employees with less than three years of service, part-time and seasonal employees, employees excluded from the plan who are covered by a collective bargaining agreement (if group term life insurance was the subject of good faith bargaining), and certain nonresident aliens do not need to be counted. IRC Sec. 79(d)(3)(B).

Benefit Discrimination

The plan may not discriminate in favor of key employees in the amount of benefits it offers. This does not mean that all participating employees must be offered exactly the same amount of coverage. Section 79 sets discrimination standards based on the number of employees participating in the group insurance plan.

Groups of 10 or More Employees

All types of benefits available to key employee participants must also be made available to the other participants. IRC Sec. 79(d)(4). Benefits will not be discriminatory as long as the amount of insurance bears a uniform relationship to the total compensation of the employees, or to their basic or regular rate of compensation. IRC Sec. 79(d)(5).

Groups with Fewer than 10 Employees

Insurance for fewer than 10 employees may also qualify as group term life insurance if: (1) it is provided for all full-time employees; and (2) the amount of protection is computed either as a uniform percentage of compensation or on the basis of coverage brackets established by the insurer under which no bracket exceeds 2½ times the next lower bracket and the lowest bracket is at least 10% of the highest bracket. Eligibility and amount of coverage may be based on evidence of insurability but must be determined solely on the basis of a medical questionnaire completed by the employee. A physical examination cannot be required. Treas. Reg. §1.79-1 (c). Finally, additional medical information given voluntarily may not be used as the basis of a premium rate determination. Rev. Rul. 75-528, 1975-2 CB35.

For purposes of determining how many employees are provided insurance, all life insurance provided under policies carried by the employer is taken into account even if the policies are with different insurers. Treas. Reg. §1.79-1(c).

Advantages of a Section 79 Permanent Benefit Plan

Giving employees the option to use cash value life insurance for their coverage may add valuable flexibility to a group life insurance plan. This strategy has the potential to give participating employees coverage that can last beyond the date of their retirement or separation from service and the potential for supplemental retirement income.

For the Employer:

- Contributions to the plan are 100% income tax deductible (to the extent compensation is reasonable under IRC Sec. 162).
- A cost-efficient way to attract, retain and reward key employees.
- Minimal documentation and reporting requirements.

For the Employee:

- Income tax-free death benefits that are portable – The employee owns the policy and has the ability to continue it into retirement.
- The value of the first $50,000 of death benefit coverage is generally income tax free.
- Tax-deferred cash value accumulation – The cash values in these policies grow income tax deferred and potentially can be accessed through withdrawals and policy loans for supplemental retirement income. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse.
- Policy premiums are paid by the employer – The employee's cost is the income on the cost of the permanent benefits and the cost of coverage exceeding $50,000.

Disadvantages of a Section 79 Permanent Benefit Plan

There are some possible disadvantages to providing permanent benefits in group life insurance plans:

For the Employer:

- Non-discrimination rules for both eligibility and benefits must be satisfied.
- There are record keeping, actuarial and plan administration costs.
- Owners may only participate if they are employees and if the employer is a C corporation or an LLC that is taxed like a C corporation; if the corporation is a Subchapter S corporation, owner-employees may only participate if they don't own more than 2% of the stock.
- Depending on the number of employees electing permanent benefits, the employer's cost for the combined group term permanent benefit may be higher than those of providing ordinary group term benefits. Alternative programs allowing selectivity should also be considered.

For the Employee:

- Employees pay income taxes on both the cost of coverage exceeding $50,000 (under IRS Table 1) and the cost of the permanent benefit; this tax cost is measured in accordance with Section 79 and the regulations thereunder, and is typically less than the full amount of premium.*
- If the employee leaves the group, he/she may have to pay future premiums from personal dollars for the policy to stay in force.
- If the plan does not qualify as a group term life insurance plan, the premiums paid by the employer are includable in the insured employee's taxable income.

* Please consult with the plan administrator(s) responsible for calculating the taxable income of policy benefits.

Section 79 Group Life Insurance Design Alternatives

Employers can design their group life insurance plans to give participating employees more than one life insurance option. As long as each option is one that is permitted under Section 79 and its regulations, participating employees can select any option they wish. Options which may be offered are:

1. Group term life insurance up to $50,000.
2. Group term life insurance based on a multiple of salary – The employees can elect term life insurance coverage of one, two, three, four or five times their current salary. To the extent the amount of coverage elected exceeds $50,000, the employee recognizes additional taxable income based on the excess multiplied by the rate in IRS Table 1.
3. Cash value life insurance coverage based on a multiple of salary – The employees can elect to have their coverage provided through an individual cash value life insurance policy. This option has the highest potential cost to the employee. The cost is the income tax on both the Table 1 value of the coverage in excess of $50,000 and the cost of the permanent benefit.

When participating employees are given the ability to choose among these options, non-key employees often choose option 1 or option 2; they seldom choose option 3 because it has the highest out of pocket cost. Option 1 is attractive because it provides $50,000 of life insurance coverage that is essentially free to the employee. Option 2 is attractive because it allows employees to secure additional life insurance coverage by paying the income tax on the cost of coverage in excess of $50,000.

Key employees may also choose any option, but they often select option 3 for several reasons: (1) they are more likely to have the resources to pay the higher income tax cost; (2) they may see the higher income tax cost as being offset by the policy's portability and its potential to develop cash values that have the potential to provide supplemental retirement income; (3) sometimes the employer is willing to pay them a year-end bonus to assist in paying the income taxes.

An Alternative to Group Term Carve Out Plans

In the past many businesses have used a "carve-out" strategy as an alternative to group term life insurance. In this strategy owner-employees and selected key employees elect to limit their participation in the group term plan to the first $50,000 of life insurance coverage. The remainder of their death benefit is purchased through individual cash value life insurance policies. The business pays the premiums for these employees through a Section 162 Bonus Plan or a Split Dollar Plan. A Section 79 Permanent Benefit Plan offers different benefits.

Comparison to a Section 162 Bonus Plan – In this plan the employee pays income taxes on the entire premium. In a Permanent Benefit Section 79 Plan, the employee is taxed on the amount attributable to the employee's "deemed death benefit." This amount is typically less than the full amount of premium.*

* Please consult with the plan administrator(s) responsible for calculating the taxable income of policy benefits.

Comparison to a Split Dollar Plan – In this plan the employer's premium payments are not deductible, so its cost is higher to the employer. In addition, the employer retains control of the cash values. The employee can only use them after a "rollout" (transfer of the employer's interest to the employee) and this usually involves additional income tax costs. While the plan is in place the employee pays income taxes annually on the economic benefit value of the policy death benefit.

Employer Tax Reporting

The cost of the excess group term life insurance is not subject to withholding, but an employer who provides excess coverage must provide statements to the employees receiving such excess coverage. IRC Sec. 6052(a).

In addition, the employer is required to file an information return with the IRS indicating the number of its employees, the number of employees eligible to participate in the plan, the number of employees participating in the plan, the cost of the plan, and identifying the employer and the type of business which it is engaged. The employer must also report the number of highly compensated employees of the employer, the number of highly compensated employees eligible to participate in the plan and the number of such employees actually participating in the plan. IRC Sec. 6039D.

Conclusion

Section 79 Permanent Benefit Plans can be a valuable way for employees to acquire life insurance protection. They can help employees continue their life insurance coverage if they retire or leave the business and policy cash values have the potential to provide supplemental retirement income. They can be especially attractive to owner-employees of C corporations and they can be used to recruit, retain and reward non-owner key employees.

If you have questions about Section 79 Permanent Benefit Plans, call ING Life Sales Support at 866-ING-SELL (866-464-7355).

Appendix

To compute the cost of excess group term life insurance coverage, the rates in the table immediately below should be used. Treas. Reg. §1.79-3(d)(2).

Uniform Premiums for $1,000 of Group Term Life Insurance Protection*
Rates Applicable to Cost of Group-Term Life Insurance
Provided After June 30, 1999

5 Year Age Bracket	Cost per $1000 for One-Month Period
Under 25	$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	$1.27
70 and above	$2.06

*In using the above table, the age of the employee is his/her attained age on the last day of his taxable year.

Generally, any contribution toward group term life insurance (but not toward permanent benefits) made by the employee during the taxable year reduces, dollar for dollar, the amount that would otherwise be included in his/her gross income for term insurance.

The exemption for the first $50,000 is not available to “key employees” if the plan discriminates in their favor.

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141235 06/29/2010

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