PERMANENT BENEFIT GROUP-TERM LIFE INSURANCE PLAN UNDER IRC SECTION 79	Zermatt INSURANCE GROUP, INC

FREQUENTLY ASKED QUESTIONS

What is a Section 79 Plan?

Section 79 of the Internal Revenue Code ("IRC") allows a "C" Corporation to deduct the cost of life insurance premiums from income for federal tax purposes (provided the employer is not directly or indirectly a beneficiary of the policy).

A group-term life insurance plan may provide both term and permanent benefits.

Additionally, the policyowner(s) may, at a later date, take cash value distributions from the life insurance policy, potentially income tax free, and use those distributions as a source of supplemental retirement income.

Ultimately, death benefits pass to beneficiaries income tax free.

How long has the Section 79 been around and what are the tax risks?

Section 79 was added to the Code in 1954 and deals with group-term insurance. We are dealing with the permanent aspect of group-term. Tax risk is minimized because Zermatt Insurance Group, Inc. is using the Safe Harbor Fair Market Valuation provided in Rev. Proc. 2005-25.

How much coverage does it provide?

Under IRC Section 79, a corporation can provide up to $50,000 of group-term life insurance for an employee on a tax deductible basis with no increase in the employee's gross income. Any amount of group-term life insurance in excess of $50,000 is taxable to the employee and must be reported by the employer on the employee's W-2 as "other compensation" as described under IRC Section 6052. Any life insurance, which has a cash value, will also result in additional taxable income and must be reported by the employer on the employee's W-2.

How are benefits determined?

Coverage must be provided under a formula based on such factors as age, years of service, compensation, or position. The amount of insurance provided an employee must be computed under a formula which precludes discrimination.

What are the maximum benefits that can be offered by the plan?

Groups of Under 10: $2,750,000 of death benefit for Doctors and Dentists through age 60, $2,250,000 for all other professions through age 60, and $1,250,000 for ages 61-65.

Groups of Over 10: Death benefit not to exceed 10 times salary

Who is it for?

Only "employees" may participate. The term "employees" does not include self-employed individuals or 2% shareholders of an "S" Corporation, a Partnership or an LLC taxed as a Partnership. The Internal Revenue Service rules governing owner participation in your Section 79 Plan are as follows:

Type of Business	Participation Rules
"C" Corporation / LLC taxed as a "C" Corporation:	Owners who are employees may participate along with other employees who meet the Plan's eligibility requirements.
"S" Corporation / Partnership/LLP:	Employees may participate if they meet the Plan's eligibility requirements. This excludes 2% shareholders even if they are employees.**
Sole Proprietor:	May not participate.

*** Note: Ownership attribution rules provide that an individual is considered as owning the stock owned, directly or indirectly, by his or her spouse (other than a spouse who is legally separated from the individual under decree of divorce or separate maintenance), children, grandchildren, and parents.*

Why only "C" Corporations?

If you own more than 2% of a Pass-Thru Entity, you are not considered to be an employee of that entity; therefore, the cost for employee benefits for a greater than 2% owner would not be deductible.

Do I have to include my employees?

Yes. In order to enjoy the favorable treatment described, the plan must meet all non-discrimination requirements and benefit formula rules described in applicable Treasury Regulations. Section 79 Regs state that you must offer "like product" and term life insurance. Employees are offered an amount of death benefit determined by the group's formula.

Must the employer cover a certain minimum number of employees in its group? What are the nondiscrimination rules?

- **<u>Corporations with 10 employees or more</u>**
  - Must cover at least 10 employees;
  - Group must be comprised of 85% non-key employees or cover 70% of all full time employees;
  - Death benefit must be based on a formula that precludes individual selection and is related to employment status (years of service, income, job description, location, etc.), and
  - The penalty for a Plan's being discriminatory plan is that the entire death benefit will be imputed as taxable income to Key Employees (thus losing the $50,000 exclusion).

<u>Corporations with fewer than 10 employees</u>

- Coverage must be offered to all full time employees with 6 months or more of service;
- The amount of death benefit must be provided as a uniform multiple of income or a uniform death benefit amount or
- Provided using coverage brackets where the death benefit of the lowest bracket is at least 10% of the benefit of the highest bracket, and each bracket's benefit must be at 40% of the amount of the next higher bracket's benefit, and
- Underwriting must be based on a non-medical questionnaire only.

What about Key Employees?

Key employees are definitely eligible to participate. A Key Employee is an employee who at any time during the current plan year is any of the following:

- An Officer
- An Employee who earns more than $165,000 per year (for 2012),
- A 5% Owner, or

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- A 1% Owner who earns more than $150,000 per year.

<u>Controlled Groups and Affiliated Service Groups</u>

Two or more employers must be included under one Section 79 Plan if they are members of a "controlled group" or an "affiliated service group," as defined in the IRC and related regulations.

> **Note:** *The controlled group and affiliated service group rules are very complex. Please consult with a legal and/or tax advisor for more detailed information on the rules for controlled groups and affiliated service groups and how they may apply to your situation. In addition, if there are changes to your company's ownership structure after you have implemented your Section 79 Plan, please contact ZICO.*

> **Note-Leased Employees**:*The compliance tests described above are required to be conducted taking leased employees into account. A leased employee is a person who is not an employee and provides services to the company or any affiliate under an agreement with a leasing organization on a substantially fulltime basis for at least one year, under your primary direction or control. If you use the services of leased employees, you should consult with your legal and/or tax advisor regarding how you should treat the leased employees for compliance testing purposes.*

What if the employees don't want coverage with permanent benefits because of the tax consequences?

An employee can voluntarily reduce his amount of coverage so long as it is not below $50,000. The IRS has held that such voluntary reductions will not prevent the plan from qualifying under Section 79 as long as the amount of insurance available under the plan is based on a formula that is uniform as to compensation and as long as the company will not individually select employees to receive additional or reduced amounts of insurance. While this provision is not in the Regulations or the IRC, the IRS has indicated this to be true in private letter rulings. (PLR 97-01-027, PLR 93-19-026)

If non-highly compensated employees elect to reduce their coverage will it cause the plan to fail to meet the Section 79 requirements?

Insurance is considered to be "provided" to an employee whether or not the employee elects to receive it (unless the employee is required, as a condition to receiving the insurance, to contribute to the cost of benefits other than term life insurance. (Regs. Section 1.79-1(c)(5))

How are discrimination requirements under a Section 79 Plan affected by a plan that offers permanent benefits?

IRC Section 79(d) provides that if a group-term life insurance plan is discriminatory the exclusion under Section 79(a) of up to $50,000 of group-term coverage will not apply with respect to any key employee, thus ALL employer provided coverage would be includible in income. In addition, if a plan is discriminatory, the amount included in income would be the greater of the actual cost of employer provided life insurance coverage and the IRS Table I cost. (Section 79(d)(1)(B)). There is no indication in the Code or the Treasury Regulations that the amount includible in a key employee's income for the cost of permanent benefits is affected if the plan is discriminatory.

A plan is discriminatory, under Section 79(d), if it discriminates in favor of key employees as to eligibility to participate, or as to the type and amount of benefits available under the plan. In order to be considered nondiscriminatory, the plan must satisfy one of the following: benefit 70% or more of all employees; at least 85% of all employees who are participants are

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not key employees; the plan benefits a classification of employees judged by the IRS not to discriminate in favor of key employees; the plan is part of a cafeteria plan that meets the requirements of Section 125.

However, the amount of life insurance under the plan may bear a uniform relationship to total compensation or to base compensation.

Are the premiums paid taxed to the policyowner?

Under such a plan, corporate-paid premiums may only be partially taxable to the policyowner, and such amounts generally constitute additional compensation to the employee which must be reported.

How much is deductible by the corporation?

The corporation can deduct 100% of the premiums paid so long as compensation is considered reasonable and the general provisions of Section 79 are met, i.e. provides a general death benefit to a group of employees under a policy carried directly or indirectly by the employer where the amount of insurance provided is computed under a formula that precludes individual selection. The company cannot be a beneficiary of the policy.

> **Note-"S" Corporations:** *A deduction by the corporation will not be allowed for an "S" Corporation in relation to premiums paid on behalf of more than 2% shareholders.*

If a "C" Corporation is set up in order to be able to deduct benefits paid under a Section 79 Plan, how are employees of a related "S" Corporation or LLC affected?

Section 79 plans are subject to the affiliated service and control group rules of IRC Section 414, therefore the life insurance must be offered to employees of all companies in the controlled group.

How is the amount includible in an employee's income determined where the policy year and the tax year are different?

Where a policy year begins in one tax year of an employee and ends in another tax year, the cost of permanent benefits is allocated first to the employee's tax year in which the policy year begins by multiplying the cost of permanent benefits by the fraction of the premium for that policy year that is paid on or before the end of the tax year. The remaining cost of benefits is allocated to the next tax year of the employee. (Section 1.79-1(d)(6)).

How do I administer my plan?

Southwest Financial Group, Inc. provides complete third-party administration for you, with its team of well-qualified insurance professionals who have years of experience in providing benefits to companies like your own. The entire process is automated and is designed to be trouble free.

Is there an administration fee?

No, however there is a percentage of commission on the sale of life insurance policies to be shared with Southwest Financial Group, Inc.

How can a policy with permanent benefits qualify under Internal Revenue Code (IRC) Section 79?

Treasury Regulations (Regs.) Section 1.79-1(b) provides that group-term life insurance may be combined with permanent benefits under specified circumstances. Under Section 1.79-1(d) the employees' income must include the cost of these benefits reduced by the amount the employee pays for the benefits.

How is the cost of the permanent benefits calculated?

The cost of the permanent benefits is determined under a formula provided in the Section 79 Regulations that is based in part on

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the increase in the employee's deemed death benefit during the year. Revenue Procedure 2005-25 provides a safe harbor fair market valuation for use in determining permanent costs.

What if I have a good/bad year financially?

In bad years, you can skip or minimally fund the plan and make-up the missed contributions in subsequent years but not to exceed the total of 5 years normal funding.

When do I receive distributions from my plan?

Once you have decided to retire a benefit consultant will be available to help you determine the amount of annual distributions you can potentially withdraw tax-free from your insurance policy. The decision is solely yours as to when you begin receiving your distributions.

How do I get the money out of the life insurance policy income tax free?

Withdrawals and loans from the policy cash value. Borrowing rate from the policy is 0.25 and is not deductible so we don't bill you for the interest rates, rather it accumulates inside the policy and the outstanding policy loan is paid by some of the death benefit as long as the policy is in force at death.

How can I see how it could work for me?

Complete the attached census and answer the questionnaire. Check out our frequently asked questions on our website at www.zermattinsurance.com under the tab "Our Services", "Section 79 Plan." Call our office at 800-815-0129.

Are dividends under a policy with permanent benefits includible in employee's income?

Yes, all of the policy dividends actually or constructively received by an employee are includible in his income in those cases where the employer pays for the cost of all of the permanent benefits. (Section 1.79-1(d)(5)).

How does this affect other plans that I'm doing or considering?

Section 79 is a group-term concept and the life insurance policy is personally owed. Neither the funding amounts nor the tax-free policy distributions are affected by Qualified Plans, Non-Qualified Plans or Social Security Benefits.

Summary

A Section 79 Plan can be an effective tool for providing insurance on a tax-favored basis both prior to retirement, and at retirement.

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