

Individual Disability Insurance

Highlights of Types of Business Organizations

Understanding business organization types is essential to help meet the disability insurance needs of your business owner clients. This understanding allows you to answer questions such as:

- What happens when an owner becomes disabled?
- Can business expenses be met and a replacement hired?
- How can disability solutions be structured to make the most “tax sense?”
- What happens to the business in the event of an owner’s permanent disability?
- What happens to the business in the event of a key employee’s total disability?

Below is an explanation of common types of businesses and the impact a disability could have on the business.

STRUCTURE	DESCRIPTION	IMPACT
Sole Proprietorships	The most common form of business, a sole proprietorship, has only one owner. As a result, the business could be in serious jeopardy if the owner becomes disabled. The owner needs to meet personal obligations, employee payroll and business expenses.	Liability: Full Profits/Taxes: Personal income Deductible Benefits: No Products: DI, OE
Partnerships/ Limited Liability Companies (LLC)	A partnership is an association of two or more people engaged in a for-profit business as co-owners. Though the disability risk is spread among more people, the loss of any could be significant. In addition, a disabled owner’s desire to continue drawing a pre-disability income could put a severe strain on the business.	Liability: Partnership – Full/LLC – Limited Profits/Taxes: Personal income Deductible Benefits: Yes, but must bonus premium to owner Products: DI, OE, DBO, KPR
C corporations	Though small in number, C corporations account for the majority of business receipts. Unlike sole proprietorships, partnerships and LLCs, C corporations are separate, taxable entities. Owners are considered shareholders with limited liability for the organization’s debts. Employee benefits are deductible to the corporation.	Liability: Limited Profits/Taxes: Corporate (dividends to shareholders taxed on personal level) Deductible Benefits: Yes Products: DI, OE, DBO, KPR
S corporations	S corporations are basically C corporations that are taxed like partnerships. They are separate legal entities that provide shareholders limited liability, yet business profits pass through to the shareholders’ tax returns.	Liability: Limited Profits/Taxes: Personal Income Deductible Benefits: Yes, but must bonus premium to owner Products: DI, OE, DBO, KPR

DI – Disability Income, OE – Overhead Expense, DBO – Disability Buy-Out, KPR – Key Person Replacement

Disability tax guide

POLICY OWNER	PREMIUM PAYER	BENEFITS PAYABLE TO (Loss Payee)	TAX RESULTS	
			PREMIUMS	BENEFITS
INDIVIDUAL DISABILITY INCOME INSURANCE				
Individual	Individual	Individual	Non-deductible (IRC § 213, 262 § 265)	Tax free (IRC § 104 (a)(3))
FORMAL SALARY CONTINUATION PLAN USING DISABILITY POLICIES				
Sole proprietor	Sole proprietor	Sole proprietor	Any form of business entity may establish a plan. However, since sole proprietors, partners and owners with greater than 2% interest in S corporations are not considered employees (IRC § 1372), they cannot participate in the plan. They can, however, establish a plan for their employees. On the other hand, owners of C corporations are considered owner employees and may participate in the plan.	N/A
Partner, LLC member	Partnership/LLC	Partner/LLC member		
S corporation owner (more than 2% ownership)	S corporation	S corporation owner		
C corporation owner/employee	C corporation	C corporation owner/employee	Deductible by employer (IRC § 162) and non-taxable to employee (IRC § 106)	Taxable (IRC § 105 (a)) with tax credit possible (IRC § 22)
Employee with no ownership	Any business entity	Employee		
Employee with no ownership	Any business entity shared by employer and employee	Employee	Employer share deductible to employer (IRC § 162) and non-taxable to employee (IRC § 106). Employee share non-deductible (IRC § 213).	Employer share taxable (IRC § 105(a)) with tax credit possible (IRC § 22). Employee share tax free (IRC 104(a)(3)).
EXECUTIVE BONUS PLAN USING DISABILITY POLICIES				
Sole proprietor	Sole proprietor	Sole proprietor	Non-deductible (IRC § 213, 262 & 265)	Tax free (IRC § 104(a)(3))
Partner/LLC member	Partnership/LLC	Partner/LLC member	Deductible by partnership; includible in income of partner as guaranteed payments (Rev. Rul. 91-26)	
S corporation owner (more than 2% ownership)	S corporation	S corporation owner	Deductible by S corporation; includible in W-2 income of shareholder/employee (Rev. Rul. 91-26)	
C corporation owner/employee	C corporation	C corporation owner/employee	Deductible by C corporation as regular compensation (IRC § 162); taxable as income to employee	
Employee with no ownership	Any entity	Employee	Deductible by business as regular compensation (IRC § 162); taxable as income to employee	
PREMIUM ONLY PLAN USING DISABILITY POLICIES				
Employee	Employee	Employee	Non-deductible by employer. However, premiums are paid by the employee with before-tax dollars, resulting in federal, state and FICA tax savings for the employee and FICA tax savings for the employer (IRC § 105(5)).	Taxable (IRC § 104(a)(3))
OVERHEAD EXPENSE INSURANCE				
Sole proprietor	Sole proprietor	Sole proprietor	Deductible (Rev. Rul. 55-264, 1955-1 C.B. 11)	Reportable as income (Rev. Rul. 55-264, 1955-1 C.B. 11). Although the benefits are taxable as income, the actual business expenses are deductible.
Partnership/LLC	Partnership/LLC	Partnership/LLC		
Corporation	Corporation	Corporation		
DISABILITY BUY-OUT AND KEY PERSON REPLACEMENT INSURANCE (NOTE: THE INSURED MAY NOT BE THE POLICYOWNER)				
Partnership/LLC	Partnership/LLC – Entity Purchase	Partnership/LLC	Non-deductible (IRC § 265; Rev. Rul. 66-262, 1966-2 C.B. 105)	Tax free (IRC § 104 (a)(3)); Rev. Rul 66-262, 1966-2 C.B. 105), IRC § 453* * For Disability Buy-Out only – The disabled owner is taxed only on the gain from the sale of the business. The gain may be considered an installment sale if at least one payment is to be received after the close of the tax year in which the sale was made. Consult a tax advisor for details.
Partner/LLC member	Partnership/LLC member – Cross Purchase	Partner/LLC member		
Corporation	Corporation – Entity Purchase	Corporation		
Individual shareholder	Individual shareholder – Cross Purchase	Individual shareholder		



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