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Split Dollar Life Insurance, Including Nonqualified Deferred Compensation Plans

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What is it?

In general

A split dollar life insurance arrangement, or SDA, is an agreement between an employer and an employee to split the premium payments and the benefits (e.g., cash value, death proceeds, and possibly the dividends) of a life insurance policy on the employee's life. For an employer, split dollar life insurance arrangements offer a way to attract, motivate, and retain key employees. They also provide a source of cash to fund nonqualified deferred compensation plans for them. For an employee, an SDA offers partially subsidized life insurance.

When can you use it?

An employer can use a split dollar life insurance arrangement for the following purposes:

- To attract, motivate, and retain key employees
- To fund nonqualified deferred compensation plans for key employees
- To provide life insurance for a key employee in an amount that the employee might not be able to afford
- To fund stock purchase agreements
- To fund severance benefits

How does it work?

Cash value method

In the classic split dollar arrangement (called the cash value method), the employer pays the portion of the premium that equals the annual increase in the cash value of the policy, and the employee pays the balance. When the annual increase in the cash value of the policy equals or exceeds the net premium (the gross premium less the dividends), the employer pays the entire amount. The employer benefits from this approach because it ensures that the cash value of the policy is always sufficient to reimburse the cash outlay. For more information on split dollar plans in general, refer to Business Insurance: Split Dollar Life Insurance.

Split dollar arrangements usually take one of two forms. In the endorsement form, the employer is formally designated as the owner of the insurance contract and endorses the contract to specify the portion of the insurance proceeds payable to the employee's beneficiary. In the collateral assignment form, the employee is formally designated as the owner of the contract, and the employer's premium advances are secured by a collateral assignment of the policy.

Caution: The Sarbanes-Oxley Act of 2002 makes it a criminal offense for a public company to lend money to its executives or directors. This may prohibit the use of the collateral assignment form in these companies.

Split dollar life insurance is an important part of the compensation package of many key employees. In a typical split dollar arrangement, the employer funds all or part of the cost of providing an employee with life insurance protection and then recoups that cost by sharing in the insurance proceeds at the employee's death. Split dollar

arrangements have also come into wide use in gift and estate planning.

Nonqualified deferred compensation plans

A split dollar arrangement can also operate as an informal funding device for an employer's nonqualified deferred compensation plan. Split dollar life insurance allows an employer to fund benefits payable under a NQDC plan with the proceeds the employer receives from the split dollar life insurance policy. While there are a number of variations, one way an employer can accomplish this is by establishing an unfunded NQDC plan to provide employees with a promised level of deferred compensation benefits. The employer then purchases a life insurance policy on the employees' lives. The premiums may be split between the employees and the employer in any way desired. Typically the employees are entitled to a death benefit from the policy equal to some multiple of compensation, for example 3 times pay. The face amount of the policy, however, is usually greater than that amount. Each year, your employer credits employees' NQDC plan accounts with an amount specified in the plan. When distribution is scheduled to occur, the employer pays the NQDC plan benefits from his or her general assets. Upon an employee's death, the employee's beneficiary receives the promised level of death benefits from the life insurance policy, and the employer receives the balance of the policy proceeds. The life insurance benefits are tax-free. By informally funding a NQDC plan with split dollar life insurance, employees can receive death benefit protection under the life insurance policy along with deferred compensation under the NQDC plan, and the employer can recoup all or part of the cost of providing these benefits.

Caution: Informal funding of a NQDC plan with split dollar life insurance may only be possible using the endorsement method. In a collateral assignment split dollar arrangement taxed under the loan regime, the employer's premium payments will not be treated as a split dollar loan if the owner does not intend full repayment. An example in the preamble of the regulations provides that if a separate agreement is entered into that the employer will make a future transfer to the employee sufficient to pay off the loan, the arrangement will not be treated as a split dollar loan. This suggests that if the employee and employer want their arrangement to be treated as a split dollar loan, they cannot enter into a separate deferred compensation agreement that will provide the employee with a future benefit sufficient to pay off the loan amount. The regulations as written do not clearly back up this assertion from the preamble.

Strengths

Low-cost benefit for key employees

A split dollar arrangement provides a low-cost mechanism for an employer to recruit and retain desirable employees. With an SDA, an employee can purchase life insurance at a cost lower than he or she could obtain outside the arrangement, or can purchase more life insurance for the same amount of money. Most split dollar arrangements allow an employee to purchase the policy from the employer at retirement, which enables the employee to continue the policy at rates that were set when he or she was younger. Some employers provide pay increases or bonuses to help employees fund their share of the premiums, while other employers loan their employees the funds at low or no interest. For more information, see Interest-Free and Below-Market Loans.

Fully secured cash outlay

The employer's cash outlay is usually fully secured. At the employee's death or termination of employment, the employer is reimbursed from the policy's cash value for the cost of the premiums.

Can be limited to selected employees

An employer can selectively offer a SDA to key employees without having to offer it to all employees, since split dollar arrangements are exempt from the Employee Retirement Income Security Act (ERISA) nondiscrimination rules.

Flexible plan designs

Because split dollar arrangements can be designed in a variety of ways, they can be customized to meet employer and employee objectives.

Tradeoffs

Arrangement must remain in effect for a long period

The SDA must remain in effect for a reasonably long period (e.g., 10 to 20 years) so the policy cash values rise to a level sufficient to maximize the arrangement's benefit.

Arrangement may be terminated at age 65

The arrangement may generally end when the employee reaches age 65, since the employee's taxable cost may rise sharply after age 65.

Tax considerations

Effective as of September 17, 2003 are two mutually exclusive regimes for taxing split dollar life insurance arrangements: the economic benefit regime and the loan regime. Both the owner and the non-owner are required to fully and consistently account for all amounts under a split dollar agreement under either the economic benefit regime or the loan regime.

Under the economic benefit regime, the owner of the life insurance contract is treated as transferring economic benefits to the non-owner. This regime generally governs the taxation of compensatory arrangements in which the employee is not the owner of the contract (e.g., endorsement split dollar arrangements). For more information, see Endorsement Split Dollar Method.

Under the loan regime, the non-owner is treated as lending premium payments to the owner. The loan regime generally governs the taxation of collateral assignment split dollar arrangements (e.g., arrangements in which the employee is designated as the owner of the contract and the employer (non-owner) pays all or a portion of the premiums). For more information, see Collateral Assignment Split Dollar Method.

No direct tax benefit to employer

In most cases, an employer receives no direct tax benefit. Since an employer is either a direct or indirect beneficiary of a life insurance policy underlying an SDA, the employer's share of the premiums is not tax deductible. If the arrangement is taxed under the economic benefit regime, the IRS even disallows a deduction for the portion of the employer's contribution that results in taxable income to the employee. If the arrangement is taxed under the loan regime, the employer is entitled to a tax deduction for any compensatory bonus paid to the employee to offset any interest paid by the employee. However, the employer must include these interest payments in its taxable income for the year.

Employee recognizes taxable income

If the arrangement is structured as an SDA taxed under the economic benefit regime, the employee must pay income taxes each year on the value of the economic benefits provided by the insurance policy underlying the arrangement (less any premiums paid by the employee). The economic benefits may include:

- The cost of current life insurance protection provided to the employee
- The amount (if any) of policy cash value to which the employee has current access (that has not been taken into account in a prior taxable year)
- The value of any other economic benefits (not taken into account in a prior taxable year) provided by the employer to the employee

If the arrangement is structured as an SDA taxed under the loan regime, the employer is considered to be lending to the employee the funds to make the premium payments on the life insurance policy. If the employee is

paying little or no interest on these loans to the employer, then the below market loan rules apply, and the employee must pay tax annually on the imputed interest on the loans.

For more information, see Taxation of Split Dollar Arrangements.

Death benefits received by surviving family members are exempt from income tax

Generally, death benefit proceeds attributable to life insurance protection offered under an SDA are excludable from the income of the employee's beneficiary to the extent that the employee has either paid for the coverage or taken its economic value into account.

Estate tax considerations

If death benefits are payable to an employee's estate, the proceeds are includable in the employee's gross estate for federal estate tax purposes. Similarly, these proceeds are includable in the employee's gross estate when they are payable to a beneficiary and the employee possesses incidence of ownership in the policy at the time of death. In general, an employee has incidents of ownership if he or she has the power to change the beneficiary or has access to the economic benefits of the policy.

The death benefit is not includable in the employee's gross estate if the employee had no incidents of ownership.

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