LIFE ADVANCED MARKETS

Key employee compensation strategies

Split-dollar life insurance arrangements

There are many reasons why employees may choose to dedicate their time, talents, and energy to your business. It could be the corporate culture, the challenges the job presents, the potential for advancement, or simply the people they'll work with. But employers who develop a compensation strategy that balances an employee's need for financial rewards with the business's need for high-performing, motivated, loyal employees should have a leg up on their competitors.

A split-dollar life insurance arrangement may be an effective way to accomplish these goals.

A split-dollar arrangement is an agreement between the employer and employee (insured) in which they split the rights and benefits of a life insurance policy's cash values and death benefit.

There are a number of different ways to design a split-dollar arrangement, but in general, each involves the employer paying all or a majority of the premiums and retaining a right to recover their premium outlays via policy cash values and death benefits. The employee receives the right to some portion of the death benefit and may receive the right to a portion of cash values (to be used for supplemental retirement income through policy loans or withdrawals[1]).

A split-dollar agreement may provide a number of tax advantages for the employee – such as minimal annual tax outlay when the premiums are paid; tax-deferred growth of policy accumulation values; income-tax-free loans from the policy; and a death benefit that is generally income-tax-free. While the employer contributions are not deductible, the employer typically does retain the right to receive all of their premium payments back.

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause unintended consequences, including lapse or taxable events. Please see full loan and withdrawal disclosure within this material for details.

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Two options for split-dollar arrangements

1 The Collateral Assignment Method

Basic design

The employee purchases a cash value life insurance policy covering their life – such as fixed index universal life insurance – and designates the beneficiary, typically their spouse and/or children. The employer pays the premiums and has the right to recover the business's total outlay from the employee, either from the policy's cash value during the insured's life or from the death benefits when the insured dies. The employer may also require these premiums be repaid by a certain point, typically upon the employee's retirement or termination of employment.

For tax purposes, the IRS will treat the arrangement as a loan from the employer to the employee. The policy is assigned to the employer as collateral to secure the "loan."

The amount of tax paid each year by the employee is measured by applying an interest rate to the total outstanding "loan" (the total premiums paid by the employer). This applicable interest rate is the annual blended rate provided by the Internal Revenue Service.[1] The following chart illustrates an example assuming a $20,000 annual employer contribution starting in the year 2014.

Example: Collateral assignment split-dollar – annual employee taxable income

Year	Blended annual rate	Annual premium paid by employer	Cumulative premium paid by employer	Annual taxable income to employee
2014	.28%	$20,000	$20,000	$56
2015	.45%	$20,000	$40,000	$180
2016	.73%	$20,000	$60,000	$438
2017	1.09%	$20,000	$80,000	$872
2018	2.03%	$20,000	$100,000	$2,030
2019	2.42%	$20,000	$120,000	$2,904
2020	.89%	$20,000	$140,000	$1,246
2021	.13%	$20,000	$160,000	$208
2022	1.40%	$20,000	$180,000	$2,520
2023	4.65%	$20,000	$200,000	$9,300
			$200,000	**$19,754**

[1] IRC §7872(e)(2)

Advantages	• In addition to providing the employee with a life insurance death benefit, collateral assignment split-dollar arrangements may be designed to provide the employee with supplemental retirement income via cash value policy loans or withdrawals[1] (when policy cash values exceed the premiums paid by the employer). • A collateral assignment split-dollar arrangement will have minimal impact on the employer's balance sheet and may become neutral as the policy cash values accumulate. A decrease in cash assets (i.e., premiums paid) is offset by an increase in accounts receivables. • The employer may select employees to participate without being subject to IRS or ERISA participation requirements. • The taxable income the employee must recognize annually will be substantially lower than the full premium amount paid by the employer, especially in the early years. • All death benefits received by the employee's designated beneficiaries are received income-tax-free.
Considerations	• The employer may not deduct the premium contributions. • The blended annual rate which is used to calculate the employee's taxable income fluctuates from year to year. • It is very important for the employer and employee to consider how the employee will repay the loan. The most common strategy is to use policy cash values to repay the obligation. The employee will continue to recognize taxable income until the loan is repaid. The employer may decide to forgive the loan at some point in time, which would cause the employee to recognize taxable income equal to the amount forgiven. The amount forgiven may also be deducted from the employer's taxable income as long as it is reasonable compensation.[2] • The employee may elect to have their irrevocable trust own the policy instead of owning the policy themselves. This may be done to accomplish estate planning goals by removing the policy's death benefit from their gross estate for estate tax purposes. If the employee's irrevocable trust is the owner, any amount recognized for income tax purposes will also be deemed a gift to the trust for gift tax purposes. The employee may apply their annual gift tax exclusion or their lifetime gift tax exemption to avoid paying gift taxes on such amounts. Each employee should work with their professional legal and tax advisors to determine the best option for them. • Section 402 of the Sarbanes-Oxley Act of 2002 prohibits public companies from making personal loans to any director or executive officer of the company on or after July 30, 2002. This may include collateral assignment split-dollar arrangements that are considered loans. • Even though the policy is not owned by the employer under a loan regime, under a collateral assignment split-dollar arrangement, IRC Sec. 101(j) does apply. The employee should sign a notice and consent form in order to assure all death benefits are received income-tax-free. • Under certain collateral assignment split-dollar arrangements, the plan may be required to comply with nonqualified deferred compensation guidelines under IRC §409A in order to avoid unexpected taxation and penalties. Parties to the arrangement should seek the advice of their professional legal and tax advisors.

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

[2] IRC §162(a)(1)

2 The Endorsement Method

Basic design

Under the endorsement split-dollar method, the employer purchases a cash value life insurance policy on the life of the key employee and names the employer as beneficiary. The employer endorses a portion of the death benefit to the employee, who then designates a beneficiary to receive their share of the death benefit. The employer retains the right to the greater of the policy's cash values or their premiums paid.

The amount of tax paid each year by the employee is measured by multiplying the employee's share of the death benefit by a rate per thousand as issued by the IRS (Table 2001 rate) based on the employee's age that year.[1] An example of the taxable income calculation is included in the chart below.

Example:
Endorsement method split-dollar – annual employee taxable income

Employee's age	Table 2001 rate per thousand of death benefit	Employee's share of death benefit	Annual taxable income to employee
30	.87	$1,000,000	$870
35	.99	$1,000,000	$990
40	1.10	$1,000,000	$1,100
45	1.53	$1,000,000	$1,530
50	2.30	$1,000,000	$2,300
55	4.15	$1,000,000	$4,150
60	6.51	$1,000,000	$6,510

Advantages

- An endorsement split-dollar arrangement has many of the same advantages listed above for collateral assignment split-dollar arrangements – i.e., life insurance death benefits for the employee; lower taxable income for the employee; tax-free death benefits; ability to select participating employees; and minimal to neutral impact on the employer's balance sheet.
- The employer retains access to the policy cash values which may used for business purposes when needed.
- When the employee terminates employment and the endorsement is removed, the employer may retain the policy and receive the death proceeds upon the death of the employee.

Considerations

- The employer may not deduct the premium contributions.
- The Table 2001 rates increase substantially at older ages, creating a cross-over point where the taxable income equals or exceeds the amount of annual premium paid by the employer.
- The employee may elect to name an irrevocable trust as the beneficiary to receive the employee's share of the death benefit. This may be done to accomplish estate planning goals, but since the endorsement method split-dollar is typically discontinued when the employee terminates employment, this may provide only a temporary solution. Each employee should work with professional legal and tax advisors to determine the best option for their situation.
- As employer-owned life insurance, the employee should sign a notice and consent form in order to assure all death benefits are received tax-free.[2]

[1] IRS Notice 2001-10

[2] IRC §101(j)

Summary

	1 Collateral assignment	2 Endorsement
Policy owner	Employee (or their trust)	Employer/business
Policy beneficiary	Named by employee	Employer/business
Premium payer	Employer (most or all)	Employer (all)
Employer's share of death benefit	Equal to premiums paid by employer	Equal to premiums paid by employer
Employee's share of cash values	Right to cash values in excess of employer premiums paid.*	None. Employer has all rights to cash values.
Measure of employee's taxable income	Loan Regime – Total employer premiums paid multiplied by IRS published annual blended rate.	Economic Benefit Regime – Employee's share of death benefit multiplied by IRS Table 2001 per thousand rate.
Primary benefit(s) for employee	Personal death benefit protection **AND** supplemental retirement income.	Personal death benefit protection.

*There is another version of collateral assignment split-dollar in which the employer retains the right to the **greater** of cash values or premiums paid. The version (non-equity collateral assignment) is not commonly used as a form of key employee compensation.

Considerations when using an FIUL split-dollar strategy:

- Employee must be insurable
- Life insurance requires health and financial underwriting
- Consult with your financial, tax, and legal professionals when exploring this strategy

FOR MORE INFORMATION on FIUL and split-dollar strategies, contact your financial professional.

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