Split dollar endorsement plans for employees

In brief

THE PLAN

A split dollar endorsement plan is a method of purchasing cash value life insurance where an employer provides a death benefit for an employee while retaining the policy's cash value.

Advantages

- To the employee:
  - Replace income lost at the employee's death.
  - Provide liquidity for payment of administrative expenses and estate taxes.
  - Plan can be customized to accommodate specific needs.
- To the employer:
  - Participation can be limited to a select group.
  - Employer can use it to recruit and retain key employees.
  - Employer can recover the cost of providing this benefit.
  - Employer has access to the policy's cash value.

The basics

- Employer owns the policy and endorses to the employee the right to name beneficiaries for all or a portion of the death benefit.
- Typically, the death benefit controlled by the employee is equal to the total death benefit minus the greater of the cash value or premiums paid by the employer.
- A separate written agreement and the policy endorsement establish the rights and obligations of the employer and the employee.

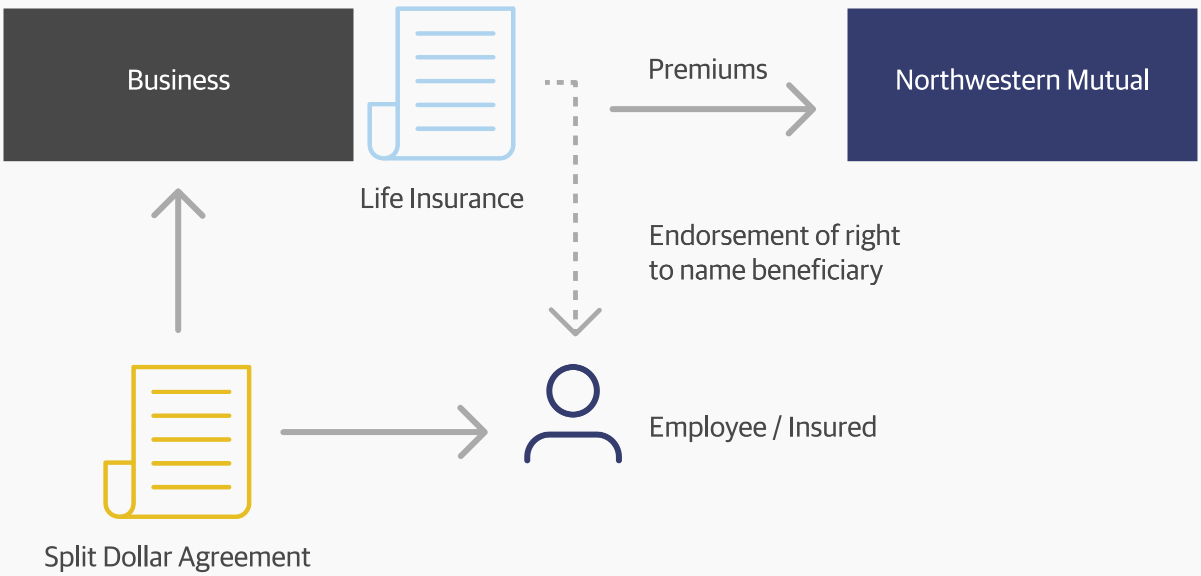
ERISA considerations

- A split dollar plan is generally considered a welfare benefit plan under the Employee Retirement Income Security Act (ERISA) because it provides benefits in the event of death. Accordingly, certain ERISA requirements could apply.
- Among other things, the application of ERISA means that there should be a written split dollar agreement (in addition to any endorsement on the policy). This split dollar agreement should be drafted by attorneys hired by the parties.

(REV 0921)

HOW DOES IT WORK?

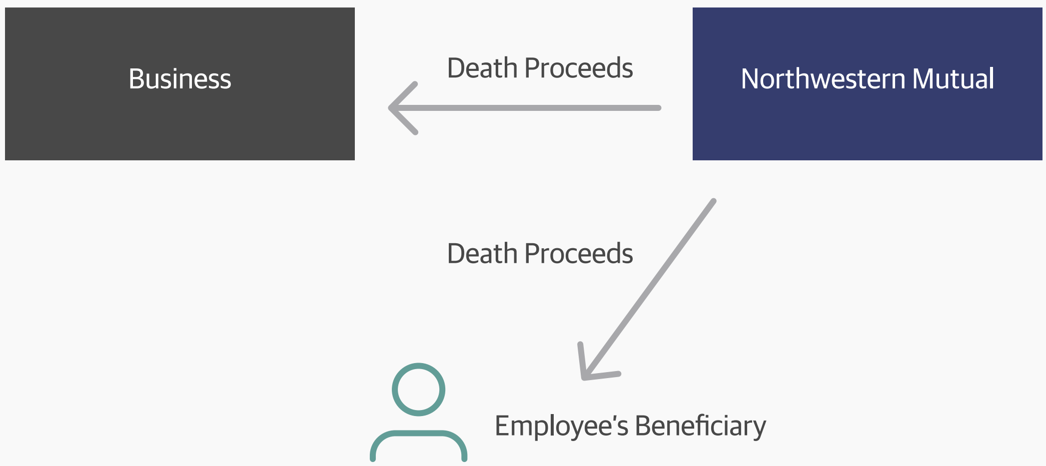
During employment



- Employer and employee enter into a written split dollar agreement.
- Employer owns the policy and pays the entire premium.
- Employer endorses to employee the right to name the beneficiary of a portion or all of the death benefit. This endorsement is filed with the insurance company.
- Each year, the employee includes in income (or pays the employer for) the value of the endorsed right to name the beneficiaries.
  - The value of the endorsed right is referred to as annual cost of insurance, value of insurance benefit, or value of economic benefit (VEB).
  - The VEB is based upon:
    - the amount of death benefit endorsed,
    - the age of the insured, and
    - the term rate table being used (the government's table, or the insurance company's lower table).

HOW DOES IT WORK?

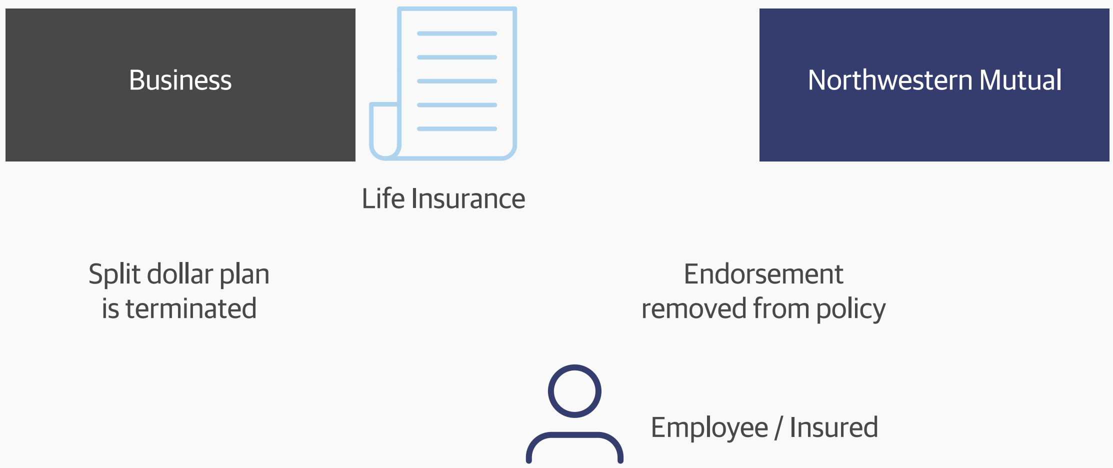
Plan termination at death



- The employer receives its portion of the death benefit income tax free.
- The employee's beneficiary receives the endorsed amount of death benefit income tax free.
- The split dollar agreement is terminated.

HOW DOES IT WORK?

Plan termination during the employee's life



- The split dollar agreement is terminated, and the endorsement is removed from the policy.
- Neither party owes money to the other, and the parties no longer account for the VEB.
- The employer retains ownership of the policy and keeps all its rights, including the right to name the beneficiary of all the death proceeds.
- After the split dollar endorsement plan terminates, the employer could:
  - surrender the policy;
  - use the policy to informally fund a nonqualified deferred compensation plan or a death benefit only plan;
  - use the policy for other business purposes (for example, key person coverage); or
  - transfer the policy to the employee as a discretionary bonus (in which case the employee would be income taxed on the fair market value of policy).

INCOME TAX CONSEQUENCES

To the employee

- The employee reports as income each year the VEB plus the value of any additional benefits (theoretically these could include policy dividends received by the employee in cash and any access to the cash value) minus any premiums contributed by the employee. Treas. Reg. § 1.61-22.
- When the only benefit provided is death benefit – which is true in virtually all split dollar endorsement plans – then the arrangement is *not* a deferred compensation plan and Internal Revenue Code (I.R.C.) § 409A does not apply. See Notice 2007-34, 2007-1 C.B. 996; and Treas. Reg. § 1.409A-1(a)(5).
- The VEB is based upon the lower of the government-provided Table 2001 rates or the Insurer's term rates. Notice 2002-8, 2002-1 C.B. 398.

To the employer

- Premium payments made by the employer are not deductible. The employer also is not permitted to deduct the VEB, even though it is included in the employee's income. See I.R.C. § 264(a)(1); and Treas. Reg. § 1.61-22(f)(2)(ii).
- If the employee contributes a portion of the premium or pays the VEB to the employer, the employer must report that amount as income. Treas. Reg. § 1.61-22(f)(2)(ii). This is one reason parties often prefer a non-contributory plan.

To beneficiary

- Death benefits received by the employer and the employee's beneficiary are generally income tax free.
- As for the transfer-for-value rule under I.R.C. § 101(a), the violation of which makes death benefit taxable, the endorsement is a transfer-for-value, but when the endorsement is made to the insured, it meets the "transfer to the insured" exception.

GIFT AND ESTATE TAX CONSEQUENCES

- At the employee's death, the death proceeds that are endorsed to the insured employee are generally included in the employee's estate under "incident of ownership" principles. I.R.C. § 2042.
- The portion of the death proceeds that remain with the employer might also be included in the insured's estate under the idea that an incident of ownership in any part of the policy places all the policy's death benefit in the insured's estate, but even if so, the proceeds paid to the employer might be deductible to the estate under I.R.C. § 2053 (claims against the estate or mortgaged property).
- When the insured is a majority stockholder (owning more than 50% of the combined voting power) of a corporation that owns the policy, the corporation's incident of ownership is imputed to the insured, causing the portion of death benefit that is endorsed outside the corporation to be included in the insured's estate, just as if the insured had owned the policy directly and endorsed death benefit elsewhere. Treas. Reg. § 20.2042-1(c)(6).
- If the insured employee irrevocably gives the endorsed right to another party (for example, to an irrevocable trust) and then lives for another three years, death proceeds controlled by the endorsement are generally not included in the insured employee's estate.
- If a split dollar plan exists between the employer and a third party who is connected to the employee (for example, the employee's irrevocable trust), the VEB is generally treated as being transferred twice each year:
  - from the employer to the employee, and subject to income tax; and
  - from the Employee to the irrevocable trust, and subject to gift tax.

This publication is not intended as legal or tax advice. This information was compiled by The Northwestern Mutual Life Insurance Company. It is intended solely for the information and education of Northwestern Mutual's financial representatives, their customers, and the legal and tax advisors of those customers. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its financial representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent legal, accounting, or tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

Copyright © 2021 by The Northwestern Mutual Life Insurance Company, Milwaukee, Wisconsin NorthwesternMutual.com

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities, and life insurance with long-term care benefits) and its subsidiaries

Advanced Planning, September 2021

(REV 0921)