A Business Split-Dollar Life Insurance Plan

Since salary alone is often not enough,
what steps can your business take to retain your key employees?

Prepared for:

Brought to you by:

MRW FINANCIAL BROKERAGE

Life Insurance, Annuities and Long-Term Care

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What Is a Business Split-Dollar Life Insurance Plan?

A business split-dollar life insurance plan is not a type of insurance policy but rather, when used by a business, is an arrangement that allocates life insurance policy benefits and, in some cases, premium costs between an **employer** and a valued **employee**.

In a typical business split-dollar life insurance plan, an **employer** assists one or more selected **employees** to purchase needed life insurance protection by paying all or a portion of the premiums, the total of which the **employer** will ultimately recover from the policy benefits.

As a result of this premium and benefit sharing arrangement, the **employee** receives valuable life insurance protection at a reduced out-of-pocket cost, while the **employer** eventually recovers its share of the premium costs from the policy's cash value or death benefit.

Types of Split-Dollar Life Insurance Plans

A business split-dollar life insurance plan is an arrangement under which an **employer** and a valued **employee** agree to share, or split, the premiums and benefits of a life insurance policy. How the policy benefits are allocated determines the type of split-dollar arrangement in effect:

Equity Split-Dollar Plan

In an equity split-dollar arrangement, the **employee** receives an interest in the policy's cash value (equity) that is disproportionate to the **employee's** share of the premium payments, while the **employer** pays more of the premium cost. Typically, the party paying less (the **employee**) also receives the benefit of current life insurance protection.

Non-Equity Split-Dollar Plan

In a non-equity split-dollar arrangement, the **employer** typically provides the **employee** with current life insurance protection, but the **employee** has no interest in the policy's cash value.

Since the objective of a business split-dollar life insurance plan is to provide a valued **employee** with life insurance policy benefits at a reduced out-of-pocket cost, the tax treatment of the split-dollar arrangement must also be taken into account.

Tax Treatment of Split-Dollar Life Insurance Plans

There are two mutually exclusive regimes which determine how a split-dollar life insurance plan will be taxed. The **ownership of the life insurance policy on the employee's life** is the primary determinate as to which of these tax regimes will apply to the split-dollar plan:

Economic Benefit Regime (Endorsement Split-Dollar Plan)

The **employer** owns the life insurance contract, advances money to pay the premiums and provides economic benefits to the **employee** by allowing the **employee** to name a beneficiary for the policy's death benefit by means of an endorsement to the life insurance contract.

The **employee** is then taxed on the value of the economic benefits received in each taxable year.

The endorsement method allows the policy's cash value to be carried as a business asset and borrowed for business purposes (withdrawals and loans will reduce the policy's death benefit and cash value available for use).

Loan Regime (Collateral Assignment Split-Dollar Plan)

The **employee** owns the life insurance contract, names a personal beneficiary and assigns the policy as collateral to the **employer**, in return for the **employer's** premium payments. At the **employee's** death, the **employer** receives a portion of the death benefit (usually equal to the total premiums it has paid) and the **employee's** beneficiary receives the balance. If the policy is surrendered, the **employer** receives back the total premiums it has paid, up to the policy's cash surrender value, and the **employee** receives any remaining cash surrender value.

The payment of premiums by the **employer** for a life insurance contract owned by the **employee** is treated as a series of loans to the **employee**. Unless the **employee** pays the **employer** market-rate interest on the loans, the **employee** is taxed each year on the difference between market-rate interest and the actual interest paid, if any.

Since the **employer's** premium contributions are considered loans to the **employee**, federal and state law should be checked to determine if there are any restrictions on corporate loans to employees, shareholders, officers, etc., before implementing a collateral assignment split-dollar plan. In addition, publicly-held corporations are strongly encouraged to consult their securities counsel on the potential impact of the Sarbanes-Oxley Act of 2002 on collateral assignment split-dollar plans.

A professional tax advisor should be consulted in the design and administration of a split-dollar life insurance plan in order to avoid unintended tax consequences.

The Traditional Split-Dollar Life Insurance Plan

In the traditional, or basic, version of the split-dollar life insurance plan, the **employer** agrees to pay the portion of the annual premium that is equal to the annual increase in the policy's cash value, with the **employee** paying the remainder of the premium. Since the annual increase in a life insurance policy's cash value generally becomes larger in each subsequent year, the **employee's** portion of the annual premium payment gradually diminishes over time.

For Example...

Year	Annual Premium	Annual Increase in Cash Value	Premium Paid by:	
			Employer	Employee
1	$2,000	$250	$250	$1,750
2	$2,000	$1,000	$1,000	$1,000
3	$2,000	$1,400	$1,400	$600
4	$2,000	$1,450	$1,450	$550
5	$2,000	$1,500	$1,500	$500

Depending on policy ownership, the **employee** either reports as income the value of the economic benefits received each taxable year (economic benefit tax regime), or the difference between market-rate interest and the actual interest paid by the **employee**, if any (loan tax regime).

In the event of the **employee's** death or policy surrender, the **employer** recovers the total premiums it has paid, with the balance of the proceeds going to the **employee's** personal beneficiary at death or to the **employee** at policy surrender.

Important Note: Any premiums contributed to an **endorsement** split-dollar plan (economic benefit tax regime) by the **employee** are considered income to the **employer**.

Premium Sharing Variations

In order to overcome the problem of the employee generally having to pay a large portion of the premiums in the early years, a number of premium sharing variations have been developed, including:

Employer Pay All Split-Dollar

The **employer** pays the entire premium. Depending on policy ownership, the **employee** either reports as income the value of the economic benefits received (economic benefit tax regime), or the difference between market-rate interest and the actual interest paid by the **employee**, if any (loan tax regime).

Level Outlay Split-Dollar *

The **employee's** premium contribution is a level amount for a specified period of time, with the **employer** paying the balance of the premium.

Economic Benefit Split-Dollar (Endorsement Plan Only) *

The **employee** pays the portion of the premium equal to that year's reportable economic benefit and the **employer** pays the balance. This approach eliminates the **employee's** out-of-pocket cost for the tax on the economic benefit.

Bonus Split-Dollar (Endorsement Plan Only) *

The **employer** bonuses the annual economic benefit to the **employee**. The **employee** then uses the bonus to pay the portion of the premium equal to that year's reportable economic benefit and the **employer** pays the balance of the premium. Assuming overall compensation is reasonable, the **employer** can deduct the bonused amount, which the **employee** must include in income. Another alternative is for the **employer** to bonus both the economic benefit and the tax on the bonus, resulting in no out-of-pocket cost to the **employee**.

Bonus Split-Dollar (Collateral Assignment Plan Only)

The **employer** bonuses to the **employee** an amount equal to the **employee's** tax liability on the market-rate interest imputed to the outstanding premium "loans." The **employee** then uses the bonus to pay his/her tax liability. Assuming overall compensation is reasonable, the **employer** can deduct the bonused amount, which the **employee** must include in income. Another alternative is for the **employer** to bonus both the tax liability on the imputed interest and the tax on the bonus, resulting in no out-of-pocket cost to the **employee**, assuming the employer is paying the full premium.

* **Important Note:** Any premiums contributed to an **endorsement** split-dollar plan (economic benefit tax regime) by the **employee** are considered income to the **employer**.

Split-Dollar Life Insurance Plan Features

To the Employer:

- The employer can select which employees will be covered by the plan and for what amounts.
- A business split-dollar life insurance plan requires no IRS approval.
- The employer can ultimately recover its premium outlays.
- A business split-dollar life insurance plan may help to retain valuable employees, since the benefit will be lost if the employee terminates employment.

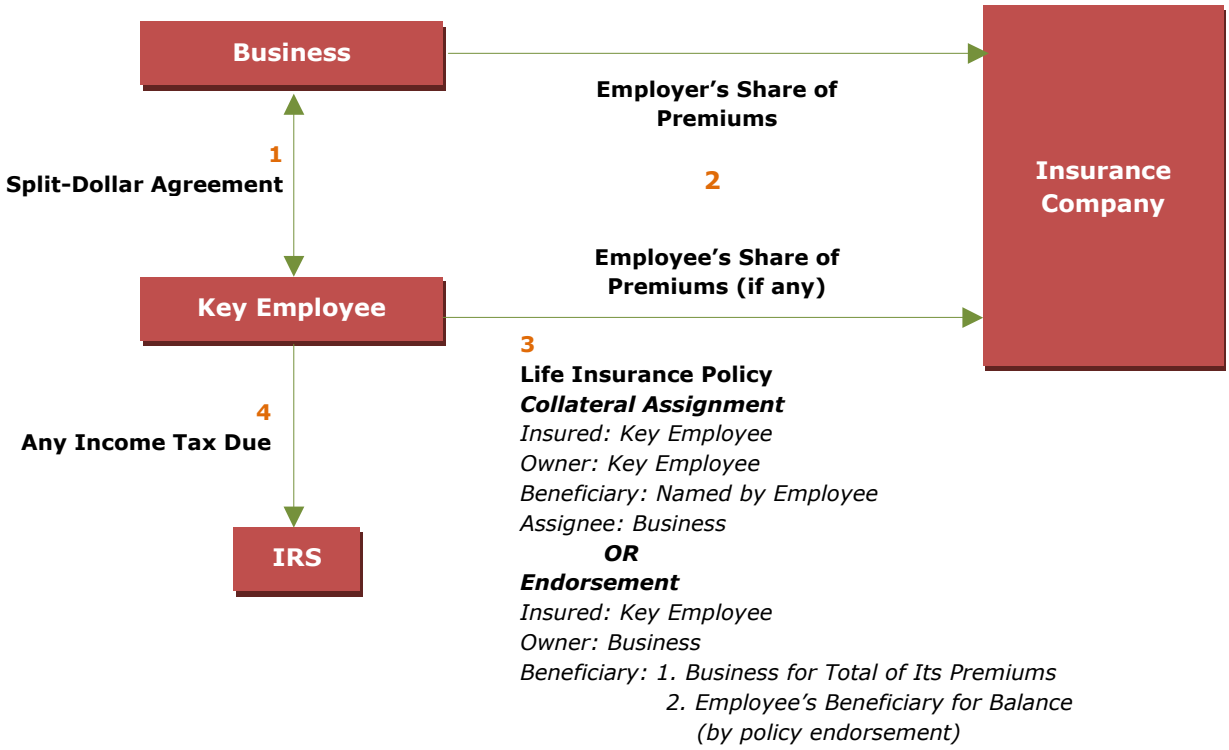
To the Employee:

- The employee receives valuable life insurance protection at reduced or no out-of-pocket cost.
- Personal funds that might otherwise be spent on life insurance become available for other purposes.
- The employee's personal beneficiary generally receives the death proceeds free of income tax.
- It may be possible to arrange the split-dollar life insurance plan so that death proceeds are not subject to estate tax.
- A split-dollar life insurance plan may be a cost-effective way for a shareholder-employee of a closely-held corporation to shift a portion of the cost of the owner's personal life insurance to the corporation, if the corporation is in a lower tax bracket than the shareholder-employee.

The Mechanics of a Business Split-Dollar Life Insurance Plan

The bottom line is that a split-dollar life insurance plan is an effective way to assist selected employees to purchase needed personal life insurance with business dollars that ultimately can be recovered.

Here's how a split-dollar life insurance plan could work *today*...



1. The business enters into a split-dollar agreement with each selected employee. The agreement spells out the rights and responsibilities of each party.

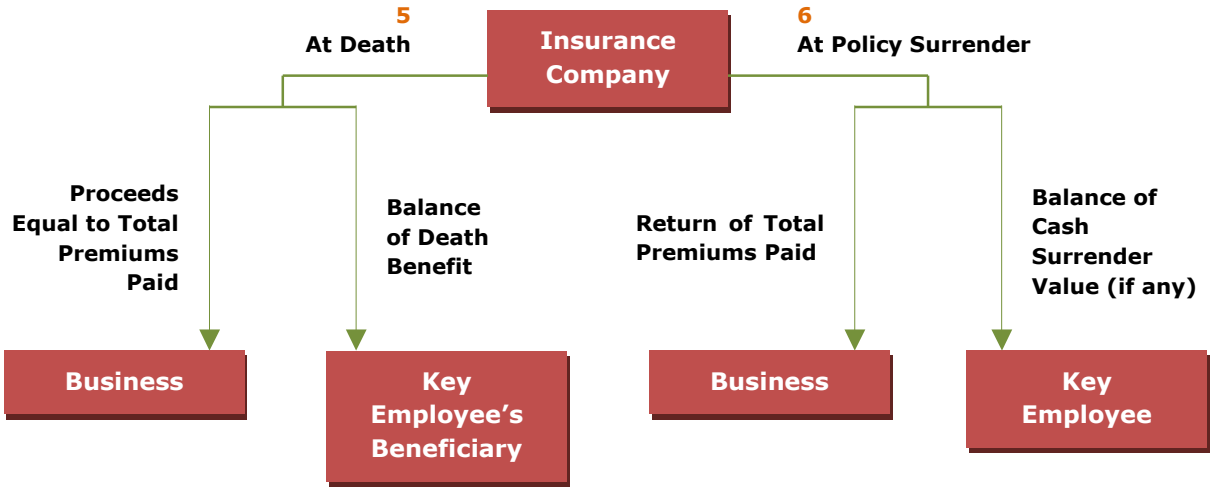
2. Based on the premium sharing arrangement, the business and employee each contribute a portion of the premium payments.

3. The ownership and beneficiary arrangements of the life insurance policy are determined by selection of the collateral assignment or endorsement method.

4. The employee may have to pay income tax on the economic benefit received (economic benefit tax regime) or on imputed interest on the employer's premium "loans" (loan tax regime).

The Mechanics of a Business Split-Dollar Life Insurance Plan

Here's how a split-dollar life insurance plan could work at the employee's death or policy surrender...



5. At the employee's death, the business is usually entitled to receive from the death benefit the total of the premiums it has paid, with the employee's beneficiary receiving the balance of the death benefit, generally on an income-tax-free basis. In an endorsement split-dollar plan, the employee must have either paid for the cost of the current life insurance protection or taken the value of the current life insurance protection into account as an economic benefit in order for his/her beneficiary to receive death proceeds free of income tax. Otherwise, the death proceeds are considered payable from the business to the employee's beneficiary and are taxable as income to the beneficiary.

6. If the policy is surrendered prior to the employee's death, the business is usually entitled to receive from the cash surrender value the total of the premiums it has paid, and the employee receives the balance, if any

Summary of Tax Results: Endorsement Split-Dollar

- **No portion of the premium** paid by either the business or the employee **is tax deductible.** Any bonuses paid by the business to the employee in connection with an endorsement split-dollar insurance plan, however, are tax deductible as a business expense, assuming that overall compensation is reasonable. The employee then must report the bonus amount as income.

- The **value of the economic benefit** received by the employee as a result of the employer participating in the plan is taxable to the employee, but may be reduced or eliminated by the employee's portion of the premium payment. See "Endorsement Split-Dollar Reportable Economic Benefit Worksheet" for more information on determining the value of the taxable economic benefit.

- Any **premiums contributed** to an endorsement split-dollar plan **by the employee** are considered **income to the employer.**

- If the business is a corporation, the policy's cash values may have **corporate alternative minimum tax implications.** Consult your professional tax advisor.

- Life insurance proceeds received by the business and the employee's beneficiary at the employee's death generally are not subject to federal income tax, **assuming that the employee either paid for the cost of the current life insurance protection or took the value of the current life insurance protection into account as an economic benefit provided by the employer to the employee.**

- **To the extent that the employee has neither paid for nor taken into account the cost of the current life insurance protection,** death benefit proceeds are considered paid to the policy owner (the employer), excluded from the employer's income, and then taxed when paid by the owner to the employee's beneficiary (whether paid to the beneficiary directly by the insurance company or not). If the employee is also a shareholder, the proceeds are considered a corporate distribution (dividend) to the shareholder. Otherwise, the proceeds are considered a taxable distribution for past services.

- The **death benefit** paid to the employee's beneficiary is **included in the deceased employee's estate** if he or she held any incidents of ownership. If policy ownership is transferred to a third party, such as the spouse, and the three-year rule is satisfied, the proceeds may be removed from the deceased employee's estate. A professional tax advisor should be consulted, particularly if the insured is a controlling shareholder of the corporation participating in the plan.

Reportable Economic Benefit Worksheet

(For Use with Endorsement Split-Dollar Life Insurance Plans)

An employee who is insured under an endorsement split-dollar life insurance arrangement put into effect or materially modified after September 17, 2003 is taxed under the economic benefit regime, meaning the employee receives an annual economic benefit that must be included in gross income for income tax purposes.

The value of the economic benefit that must be reported as income to the employee each year is determined as follows:

	Total Death Benefit (including the face amount of any paid-up additions) *	$_____
MINUS	Total Amount Payable to Policy Owner (Employer) (including any outstanding policy loans that offset amounts otherwise payable to the owner) *	-_____
MINUS	Any Portion of the Cash Value to Which the Employee Has Current Access (to the extent that such amount was not actually taken into account for a prior taxable year) *	-_____
EQUALS	Current Life Insurance Protection Provided to Employee	$_____
TIMES	Life Insurance Premium Factor Designated by the IRS (currently Table 2001)	X_____
EQUALS	Cost of Current Life Insurance Protection Provided to Employee	$_____
PLUS	Amount of Policy Cash Value to Which the Employee Has Current Access (to the extent that such amount was not actually taken into account for a prior taxable year) *	+_____
PLUS	Value of Any Other Economic Benefits Provided to the Employee (to the extent that such amount was not actually taken into account for a prior taxable year)	+_____
EQUALS	Total Value of Economic Benefits	$_____

** The amount of current life insurance protection and policy cash value are determined as of the last day of the employee's taxable year unless the parties agree to use the policy anniversary date.*

Summary of Tax Results: Collateral Assignment Split-Dollar

- **No portion of the premium** paid by either the business or the employee **is tax deductible.** Any bonuses paid by the business to the employee in connection with a collateral assignment split-dollar insurance plan, however, are tax deductible as a business expense, assuming that overall compensation is reasonable. The employee then must report the bonus amount as income.

- **Each premium amount** paid by the employer is treated as a **separate loan to the employee.** Unless the employee pays the employer market-rate interest on each loan, the **employee is taxed on the difference between market-rate interest and the actual interest paid,** if any.

- **If market-rate interest is not paid** on a split-dollar loan (i.e., the loan is a below-market loan), the **loan is recharacterized** as a loan with interest at the applicable Federal rate (AFR), coupled with an **imputed transfer of the interest amount from the employer to the employee,** which the employee must then report as **taxable income**. The rate used to determine the amount of foregone interest each year is the AFR at the time the loan is made.

- **Any interest paid** by the employee to the employer on a split-dollar loan generally is **not deductible** by the employee.

- **Life insurance proceeds** received by the employer and the employee's beneficiary at the employee's death generally **are not subject to federal income tax.**

- The **death benefit** paid to the employee's beneficiary is **included in the deceased employee's estate** if he or she held any incidents of ownership. If policy ownership is transferred to a third party, such as the spouse, and the three-year rule is satisfied, the proceeds may be removed from the deceased employee's estate. A professional tax advisor should be consulted, particularly if the insured is a controlling shareholder of the corporation participating in the plan.

A professional tax advisor should be consulted in the design and administration of a collateral assignment split-dollar plan in order to avoid unintended tax consequences.

Business Split-Dollar Life Insurance Plan Action Checklist

Now…

- ☐ Select the employee(s) to participate in the plan, as well as the insurance amounts, premium sharing methods and the ownership arrangements. A professional tax advisor should be consulted in the design of a split-dollar life insurance plan in order to avoid unintended tax consequences.
- ☐ Select the appropriate life insurance funding vehicle(s).
- ☐ Establish each participating employee's insurability.
- ☐ Arrange for payment of premiums.

Short-Term…

- ☐ Draft and execute a split-dollar agreement and a corporate resolution authorizing the plan, as appropriate.
- ☐ Review the issued policy(ies), verifying that policy ownership and beneficiary designations are correct and that an assignment form has been executed (collateral assignment plan only).
- ☐ Establish an administrative system to pay premiums when due and to determine and report taxable economic benefits (endorsement plan) or taxable imputed interest payments (collateral assignment plan).

Longer-Term…

- ☐ An annual review can help ensure that the plan remains current.
- ☐ Evaluate other employee benefit planning needs.

Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

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