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Planning strategies for business owners

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OVERVIEW

Planning strategies featuring life insurance not only protect an owner's business investment but also provide the owner with a source of supplemental retirement income. Life insurance can be used to create powerful employee recruitment and retention incentives. It is frequently used to facilitate business continuity by funding buy-sell agreements, equalize estates for family wealth transfer, and provide funds to pay estate taxes. With appropriate income tax structuring, a business owner may use business assets to provide valuable fringe benefits to the business owner and key employees.

This white paper provides insight into these essential business strategies: business succession planning, protecting against the death of a key executive or owner, and executive benefit planning using life insurance for the owner and key executives. You'll find detailed information to assist you in helping your business owner clients achieve their goals.

SUCCESSION PLANNING AND BUY-SELL AGREEMENTS

One of the most important discussions to have with business owner clients is succession planning. Few family businesses ever make it beyond a second generation, often due to lack of planning. Apart from drafting a buy-sell agreement, there are a number of financial and psychological factors that have to be taken into account. These include decisions regarding:

- Which family members should be involved?
- How do you compensate nonactive family members?
- What events will trigger a stock purchase?
- What purchase or sale rights will arise upon the occurrence of a triggering event?
- How will the purchase price be determined?
- How will the purchase price be paid?

In structuring the agreement, due consideration must be given to the federal tax consequences of each potential alternative.

WHAT IS A BUY-SELL AGREEMENT?

It is a contract under which each business owner agrees to offer his or her interest for sale to the business, the other owners, or both on the occurrence of certain events such as the owner's retirement, receipt of an outside offer to buy, or death. A buy-sell includes a purchase price for the business interest, which is established as a fixed price per unit of interest, by formula, or by a required appraisal. The agreement may require the other parties to buy the offered interest or merely give them an option to buy.

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TYPES OF BUY-SELL AGREEMENTS

There are three forms of buy-sell agreements:

1. Redemption (or entity) agreements

A redemption agreement is a contract between each shareholder and the corporation (or between each partner/member and the business) by which the shareholders agree to sell the offered stock to the corporation (or the partners/members sell to the business).

2. Cross-purchase agreements

A cross-purchase agreement is a contract between or among the shareholders (or partners/members) by which each agrees to sell all or part of his or her equity interest to the others on the occurrence of certain specified events, such as retirement or death. The business is not necessarily a party to the agreement.

3. Hybrid agreements

A hybrid agreement is a contract among the business and the owners by which an owner offers his or her interest first to the business and then to the other owners. The business may be able to buy all or any part of the offered interest, and the owners buy whatever portion is left.

ADVANTAGES OF BUY-SELL AGREEMENTS

1. Establish rights for the owner and the business

A buy-sell agreement is an agreement among the owners of a business that fixes the owners' rights with respect to each other and with respect to the business enterprise. This agreement can be very important to the owners of a closely held business because it can:

- Restrict the transfer of stock to prevent ownership by undesirable parties. This is particularly important in family-owned enterprises, and it is often the paramount reason for using buy-sell agreements. If drafted correctly, such agreements can avoid involuntary transfers due to a divorce or separation, or the foreclosure by a creditor on pledged stock or partnership interests.
- Provide a ready market for the business interest in the event that one of the owners wants to sell his or her business interest. Thus, as a practical matter, the agreement can provide a framework for the owners to resolve a number of issues that might otherwise lead to conflict later.

2. Protect the owner's business investment

A buy-sell agreement creates a market for a business owner's interest, reducing or eliminating the liquidity problems of an estate's ownership of a block of closely held stock. The agreement provides a structure for cashing out the ownership interest of a shareholder who dies or becomes disabled. This can be significant in a situation where an owner's spouse and children have no familiarity with, or expertise in, running the business, yet depend on the income to pay living expenses and to fund anticipated future expenses such as college tuition.

It can also provide a vehicle for the business or the owners to purchase the interest of a deceased or disabled owner. For example, life insurance can be used to purchase the stock at a fair price that is fixed in advance by the agreement. This will ensure that the spouse and children of the shareholder receive adequate compensation for the business interest.

3. Provide tax advantages

Depending on the circumstances, when life insurance is used to purchase the interest of a deceased or disabled owner, the ownership of the policy can be structured so that the proceeds are not subject to federal estate tax in the estate of the deceased owner.

TAX CONSIDERATIONS

Income tax considerations

A. Redemption (or entity) agreements

Having a corporation redeem the stock of a departing shareholder can be very efficient and is a seemingly simple way to transfer ownership to the remaining shareholders. But the income tax rules for a corporate redemption buy-sell are very technical, and failure to comply with those rules can result in significant unexpected income taxes. The goal is to have the redemption treated as a sale of the stock.

Taxed as either a capital gain or a dividend

Under current tax law, the differential between whether capital gains treatment or dividend treatment relates to the taxation of the basis of the stock.

Dividend treatment: The full value may be taxable.

Capital gains treatment: Only the value above basis is taxable.

The rules of IRC Sec. 302(b), under which "sale or exchange" treatment may be obtained, are extremely complicated, and any redemption buy-sell agreement must be carefully designed to ensure that the redemption of a shareholder's stock will qualify for sale or exchange treatment.

A redemption will be treated as a sale or exchange of a shareholder's stock if it

1. Is not essentially equivalent to a dividend
2. Is substantially disproportionate
3. Completely terminates the shareholder's interest in the corporation, or
4. Is of the stock of a noncorporate shareholder in partial liquidation of the redeeming corporation

Top financial concerns of small-business owners

Source: Consumer Insights, "Small Business Owner Research," April 28, 2016.

Of these four categories, the substantially disproportionate and complete termination exceptions are the most useful in advance planning, since they operate with arithmetic precision.

THE VALUE OF LIFE INSURANCE

Absent a transfer for value, the life insurance policy proceeds intended to fund a redemption or cross-purchase buy-sell agreement should be received free of income taxes under IRC Sec. 101, as payments "by reason of the death of the insured."

This rule applies whether the beneficiary is:

- A corporation
- A partnership
- A co-owner of the insured's business

B. Cross-purchase agreements

Often considered the simplest form of buy-sell agreements, cross-purchase agreements raise the fewest income tax-planning problems. A shareholder or his or her estate merely sells the shares to the other shareholders at the price and terms set by the agreement.

Corporate cross-sell tax considerations

Because corporate stock is typically a capital asset, the gain on the sale is a capital gain regardless of the character of the corporation's underlying assets.

Exception: If the shareholder's estate sells the stock immediately following their death, there will be no gain, because under current income tax rules, the estate's income tax basis in the stock is its fair market value (FMV) on the date of death, which should be the sale price set by the agreement.

The buying shareholders increase their income tax basis in their total stock interests by the price they pay for the stock bought under the agreement, even if they pay for it with tax-free life insurance proceeds. This basis increase actually may be of only modest utility, since many shareholders retain closely held stock until death, when their estate receives a new basis.

Partnership cross-sell tax considerations

In a partnership cross-purchase buy-sell agreement, the lifetime or post-mortem sale of a partnership interest closes the partnership taxable year with respect to that partner, and the selling partner reports a distributive share of partnership profits and losses for the short taxable year. The selling partner also recognizes a gain or loss on the sale of the partnership interest. That gain or loss is equal to the difference between the purchase price and the partner's income tax basis in the partnership interest.

Such gain or loss is a capital gain or loss, except to the extent of the selling partner's share of the partnership's substantially appreciated inventory and unrealized receivables (so-called "hot assets"). To this extent, therefore, the character of the gain from the sale of a partnership depends in part on the underlying assets of the partnership, unlike the capital nature of all gain or loss on the sale of corporate stock.

The price set in a partnership cross-purchase buy-sell agreement should anticipate whatever ordinary income is likely to be recognized on a lifetime sale. A partner whose gain will probably be ordinary income will often want a higher purchase price to offset the increased tax cost.

Exception: The regulations, however, recognize the validity of an arm's-length agreement allocating the selling price between capital assets and hot assets on either an item-by-item basis or by reference to hot assets as a class.

C. Hybrid agreements

A hybrid buy-sell agreement is also known as a "wait and see" agreement. It is frequently used when there is concern that the business may be unable to purchase the interest of an owner, and the other owners become a secondary market for the interest of a retiring owner.

A compromise for tax efficiency

Often more important, a hybrid buy-sell agreement can be a good compromise between the use of business funds to redeem the interest and the use of owner funds to buy it when a redemption agreement is likely to create adverse income tax consequences.

In general, the hybrid agreement starts out as a cross-purchase agreement. However, the surviving owner may, after receiving life insurance proceeds, lend the proceeds to the business so that the business can accomplish a redemption type of transaction.

ESTATE TAX CONSIDERATIONS

One of the most appealing features of a properly prepared buy-sell agreement is that it can minimize, and in some cases eliminate, estate tax valuation problems. The theory behind this result is: If the decedent is contractually bound by the buy-sell agreement to sell their interest at a certain price, that price should constitute the estate tax value of the interest.

The buy-sell agreement must meet four requirements

Courts have essentially held that an agreement meeting four requirements will fix the value of closely held corporate stock for estate tax purposes.

Requirement 1: The estate must be obligated to sell the stock at the price set forth in the agreement.

While a mandatory buy-sell right will clearly satisfy this requirement, it is not the only way to meet this requirement. If the agreement bestows on the corporation (or the cross-purchasing stockholders) the right to call the stock of the estate, this too will meet the requirement.

Requirement 2: The agreement must place certain restrictions during life.

The agreement must prevent the transfer of stock during life for a price in excess of the stock's contractual purchase price upon death.

The purchase right will meet this requirement: If the right of first refusal grants the corporation (or the cross-purchasing stockholders) the right to purchase stock for a set price regardless of the transferee's offer price for the stock.

The requirement will not be met: If a right of first refusal requires that the stockholder/transferor offer the stock to the corporation (or the cross-purchasing stockholders) for purchase at a price equal to the offer received from the potential transferee.

Requirement 3: The agreement must either fix a price or set forth a mechanism for its determination, and the price must be fair and reasonable.

The purchase price must be:

1. Fixed in the agreement (e.g., $X per share), or determinable by reference to the agreement (e.g., book value, agreed value, or appraised value).
2. Reasonable and fair at the date of execution. Fairness is determined at the time the agreement is entered into, not at some later time (e.g., the date of death). The general rule is that if an agreement's price (or valuation approach) is fair and reasonable at the date of execution, subsequent events that diminish or eliminate that fairness will not cause the agreement to fail to satisfy this requirement.

Requirement 4: The agreement must be entered into for a valid business purpose.

- The agreement must allow current management to maintain control of the corporation and allow control of the corporation to be maintained within a family, having valid business purposes for entering into a buy-sell agreement.
- It must not be a device to pass the stock to the natural objects of the decedent's bounty. The possibility of a device is most likely present in an interfamily agreement.

The U.S. Court of Appeals for the Second Circuit has held that the value set by a stock redemption agreement was a bona fide business arrangement and not merely a testamentary device, even though the decedent intended for the agreement to pass assets to his family members free of the estate tax.

A stock redemption agreement is a testamentary device when it seeks to convey shares of stock to the decedent's family for less than adequate and full consideration. Here, the decedent conveyed an interest in his corporation to an employee who was not a family member in exchange for an agreement that the corporation would redeem sufficient shares of the decedent's stock to pay his estate taxes. At the time of the agreement, the decedent intended to run the corporation for many more years. The bona fide business purpose was demonstrated because the decedent believed that the best plan for the company was to leave the employee in control of the corporation.

The Statutory Material: Code Sec. 2703

Before 1987, the case law, regulations, and revenue rulings discussed above were the sole sources of authority as to the estate tax consequences of buy-sell agreements; there was no statutory material on point. In an attempt to battle perceived evils of estate freezing, as well as produce new revenue, Congress turned its attention to estate tax valuation issues with a vengeance in 1987. Congress enacted a whole new chapter to the Internal Revenue Code, Chapter 14. It consists of four sections, IRC 2701 through IRC 2704. These provisions became effective on October 9, 1990. One section, IRC 2703, impacts buy-sell agreements.

1. **IRC 2703 is intended to supplement:** It does not supplant the prior case law and administrative regulations and rulings in this area.
2. **With regard to nonfamily agreements:** It is merely the codification of pre-existing rules as to when a buy-sell agreement will fix a value of stock for estate tax purposes.
3. **IRC expressly limits its application to intra-family buy-sell agreements:** A family member is a lineal antecedent or lineal descendant of the business owner. Thus, it does not apply to siblings. The idea behind IRC 2703 is that a buy-sell agreement will be disregarded for estate and gift tax valuation purposes unless each of the following three requirements is met:

- The buy-sell agreement is a bona fide business arrangement.
- The buy-sell agreement is not a device to transfer property to members of the decedent's family for less than adequate and full consideration in money or money's worth.
- The terms of the buy-sell agreement are comparable to similar arrangements entered into by persons in an arm's length transaction.

Planning considerations

The third requirement is both new and problematic. First, it is difficult to determine if an intra-family buy-sell agreement is "comparable" to an arm's length buy-sell agreement. Buy-sell agreements are typically private documents, the terms of which are not public knowledge. In addition, each exercise in drafting an intra-family buy-sell agreement presents novel issues and concerns. Thus, in many instances, it is important to look at valuation formulas and practices within the particular industry involved with the agreement.

- Care should be taken when amending or modifying pre-October 9, 1990, buy-sell agreements.
- IRC does not apply to buy-sell agreements entered into before October 8, 1990, unless such an agreement is "substantially modified." Agreements executed before October 8, 1990, are grandfathered.

KEY EMPLOYEE COVERAGE

The death of an individual whose services are important to a business will almost always generate considerable losses and costs to the business. Some customers or clients with whom the deceased had a close relationship may not stay with the business, or they may be retained only after expenditures of substantial amounts of effort and money. When the death of a key person is unexpected or sudden, it also creates the significant expense of evaluating and ascertaining the status of works in progress, pending negotiations, and incomplete projects, as well as preparing other individuals within the business to assume responsibility. There also may be significant costs and commissions associated with searching for, finding, and hiring a successor. In the most dramatic situation, the death of a key person may create a void that cannot be competently filled, and the business may fail entirely, leaving life insurance as the only means of replacing the other investors' capital.

WHAT IS KEY EMPLOYEE COVERAGE?

It is one of the most important business uses of life insurance because it provides cash to help a business survive the expenses and losses caused by the death of a key employee.

WHICH BUSINESSES NEED KEY EMPLOYEE COVERAGE?

Key-person life insurance is usually owned by a business on the lives of its primary stockholders and partners. Losses on the death of a principal are particularly common (and severe) when the business involves the rendition of personal services, such as a professional corporation (a corporation of doctors, lawyers, or other licensed professionals) or any consulting firm. For such service businesses, the death of a principal can cause a precipitous drop in receipts and a dramatic increase in costs.

Planning considerations

For businesses not wholly devoted to the rendition of personal services, the decision whether to buy key-person life insurance, or how much to buy, depends on whether the loss of a particular individual will cause a financial hardship on the enterprise — not whether that individual has a proprietary interest in the enterprise.

The death of a key executive who owns little or no stock may force a corporation to spend months searching for a suitable replacement, during which time there may be significant lost profits and search costs. It is against these losses and costs that the enterprise needs to be protected by life insurance.

71% of firms claimed they were very dependent on one or two key employees, yet only 22% had key-person life insurance.

Source: Insurance Information Institute, "Life Insurance for Key Employees," http://www.iii.org/publications/insuring-your-business-small-business-owners-guide-to-insurance/specific-coverages/life-insurance-for-key-employees (accessed December 12, 2016)

A CASE FOR KEY EMPLOYEE COVERAGE: BASED ON A TRUE STORY

The co-founder of an on-demand private chef startup headquartered in San Francisco was also the CTO of the business. He was the genius who drove the organization with his unique technical skillset. He was struck by a car while taking a walk around the city.

His tragic death not only created an emotional drain on the startup's close-knit staff, but the loss of his unique talent took a toll on the organization. Even though other developers from the Bay Area stepped in to assist the company, it is no longer in business.*

*Stacy Cowley, "Regrouping After the Death of a Top Executive," *The New York Times*, http://www.nytimes.com/2016/03/24/business/smallbusiness/regrouping-after-the-death-of-a-key-executive.html?_r=0, March 23, 2016.

LIFE INSURANCE AS AN EXECUTIVE BENEFIT

More and more small businesses are using executive benefit plans to provide life, disability and health insurance to their owners and key employees. This highlights the fact that owners are opting for more cost-efficient ways to offer benefits to a select group of employees. In many cases, the executive benefit is intended to supplement qualified retirement plan benefits that are limited because of the participation and discrimination rules imposed on higher paid employees.

WHAT ARE THE TRENDS IN TODAY'S ECONOMIC ENVIRONMENT?

As economic recovery continues, an increasing number of small-business owners are saving for retirement. Because they rely heavily on personal investments for retirement funding, the popularity of supplemental executive retirement plans (SERPs) is on the rise. This trend is expected to continue.[1] Our improving economy is also creating a more competitive job market, and businesses face wage and benefit cost pressure to retain and attract top talent.[2]

[1]LIMRA, "Sizing Up Small-Business Owners," 2015.

[2]NFIB Small Business Economic Trends, January 2016.

TYPES OF PLANS

1. Executive bonus (Section 162 bonus) plans

   A Section 162 bonus plan is also known as an executive bonus plan. It involves the purchase of a life insurance policy on the life of an employer-selected key employee and the payment of premiums on that policy by the employer in the form of a bonus. The policy is owned from the beginning by the employee or by a third party such as an ILIT. The owner names the beneficiary of the policy and has all rights in the policy, and no incidents of ownership are shared with the employer.

2. Split-dollar life insurance plans

   A split-dollar life insurance arrangement is a technique by which two parties agree to share one or more of the following policy attributes: the premiums, death benefits, cash values, and/or policy ownership. There is an indeterminable number of permutations of split-dollar arrangements, and all of them use one party's outlay to reduce the costs imposed on another party.

3. Nonqualified deferred compensation (NQDC) arrangements

   NQDC arrangements involve an unsecured promise by an employer to pay deferred salary to an employee or independent contractor, or to their designated beneficiaries, at a fixed date or on a specified future event in return for services rendered currently by the employee. Typically, it provides benefits at an employee's death, disability or retirement.

ADVANTAGES OF EXECUTIVE BONUS (SECTION 162 BONUS) PLANS

A Section 162 plan provides four key advantages:

1. Selectivity

- The employer is free to choose who will be covered, the amount of employer-provided insurance premiums offered to each selected individual, and the terms and conditions of eligibility.
- There are no statutory or regulatory requirements regarding nondiscrimination in either eligibility or benefits.
- The employer is free to pick and choose with respect to almost every important plan decision without fear of intervention from the IRS or the Department of Labor.

2. Incentive to stay

- The plan is designed as an incentive for the employee not to leave the employer. It is sometimes called "golden handcuffs."
- The employer pays a bonus to the employee in the form of premiums sent directly to the insurer.

- In some cases, the employee may choose to enhance the retirement and death benefits under the plan by making a voluntary additional contribution to the premium.

3. Privacy

- A 162 plan can be private and no one other than covered employees need to be informed about the plan.
- A covered employee does not need to be told of the terms of other covered employees' benefits.

4. Flexibility

- Under a "restrictive endorsement" type of plan, the employer may place a restrictive endorsement on the policy for a period of time that allows the employee to change the beneficiary of the policy or to change the separate account elections for a variable policy, but nothing else. It restricts the employee's ability to make other policy changes; assignments of the policy as collateral; or have access to policy cash values via withdrawals, loans, partial or complete surrenders. The employer may decide to include a vesting-type schedule in the document granting the bonus, which would require the employee to repay some or the entire bonus if he or she leaves the employer before a stated period of time.
- There are no restrictions or taxes similar to those imposed on the termination of a qualified employee benefit plan.

TAX CONSIDERATIONS

The Section 162 plan is so named because the employer can deduct the amount of the bonus to the covered employee under IRC Section 162(a)(1), which relates to ordinary and necessary business expenses.

A compensation deduction for the business

Usually, premiums paid by an employer on life insurance are not deductible for income tax purposes, but because Section 162 plans require that the employer pay a cash bonus to the employee, payments under such plans are generally deductible as compensation, subject only to the limitation that they be part of a total package of compensation that is itself reasonable. The general nondeductibility rule of IRC 264 does not apply to a Section 162 plan, because the employer has no interest in the policy or its proceeds, even though it may actually pay the premiums. Legally, the policy is owned by the employee or his or her assignee.

- Premiums are deducted in the same manner as any other reasonable compensation, even if the employer derives an indirect benefit, such as the enhanced morale or increased efficiency of the employee.

TAXABLE AS ORDINARY COMPENSATION FOR THE EMPLOYEE

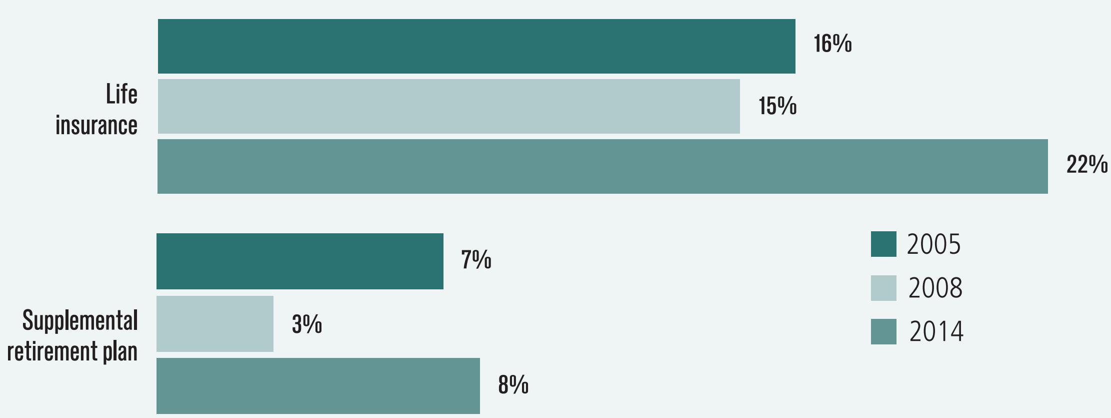
The entire premium paid by the employer under the plan is taxable to the insured employee as ordinary compensation income and reported on the employee's Form W-2.

- Each bonus payment under a plan is subject to FICA tax and to Federal Unemployment Tax Act (FUTA) tax.
- Employer premiums paid directly to the insurance company should be considered a noncash fringe benefit for withholding purposes.
- The premiums should be added to regular cash wages paid during the year, and the appropriate withholding adjustment should be made.

Section 162 plans are especially advantageous when the insured employee is in a relatively low income tax bracket, possibly because of substantial deductions for charitable contributions or investment losses.

Executive benefit plans: insurance and retirement

Executive life plans and SERPs are increasing in popularity.



Source: LIMRA, "Sizing Up Small-Business Owners — Product Ownership Trends," 2015.

PLANNING CONSIDERATIONS

The ideal candidate

It is a business in a relatively high combined income tax bracket that wants to provide fringe benefits to favored key employees in a lower income tax bracket. The plan may be chosen as part of a group carve-out to replace excess preretirement and postretirement, group term life insurance on selected executives. The employer's after-tax additional cost is merely the difference between the amount of premiums that would have been paid for the excess group term life insurance and the amount of premiums that are paid for the Section 162 plan, because both outlays are fully deductible.

ADVANTAGES OF SPLIT-DOLLAR PLANS

Because two parties share the premiums, these arrangements can often make the life insurance possible or easier to obtain, or provide an important fringe benefit that helps tie the insured to the employer.

ECONOMIC BENEFIT SPLIT-DOLLAR PLANS

The economic benefit regime applies to a split-dollar life insurance arrangement if the employer, service recipient, or donor is also the owner of the insurance contract. The economic benefit regime applies to a "nonequity" split-dollar life insurance arrangement if:

1. The arrangement is entered into in connection with the performance of services, and the employee or service provider does not own the life insurance contract, or
2. The arrangement is entered into between a donor and a donee (e.g., an irrevocable life insurance trust), and the donee does not own the contract.

A nonequity split-dollar arrangement is one in which one party provides the other with current life insurance protection, but no interest in the policy cash value.

Under the IRS rules, the parties can elect economic benefit treatment by using a type of collateral assignment split-dollar agreement. Although the employee technically owns the life insurance policy, the premium payor (i.e., the employer) is entitled at all times to the greater of cash value or premiums paid. All the employee receives under the agreement is death benefit protection.

TAX CONSIDERATIONS

The amount of the current life insurance protection provided to the nonowner for a taxable year (or any portion of a year, in the case of the first or last year of the arrangement), under a nonequity arrangement, is equal to the death benefit of the life insurance contract less the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement.

Nonowner taxability in a nonequity arrangement

Economic value of the pure term insurance coverage minus premiums contributed by the nonowner equals the taxable amount.

The value of the term component is done either under an IRS table (Table 2001) or under an insurer's term rates (if they are lower and they also meet a number of requirements).

Tax exposure increases over time

As an insured ages and the costs of providing term insurance coverage under a split-dollar arrangement increase, the employee's or nonowner's tax consequences increase as the term rates increase. At a certain point, it may become prohibitive for the employee to continue to pay his or her share of the economic benefit.

Rollout solution

An employer may respond to the employee's financial difficulty by transferring all of the employer's contractual rights to the employee or to a third-party owner of the term insurance portion, and making that party the sole owner. Such a transfer is known as a "rollout," and it can have significant financial and tax implications to all parties. In economic benefit plans, a rollout strategy must always be contemplated when the plan is presented.

The income tax consequences of a rollout of the policy, held under a split-dollar arrangement and taxed under the economic benefit regime, depend on the structure and terms of the arrangement. At the time of the rollout, the employee must take into account the value of the rolled-out policy.

1. The employee's taxable income from a rollout: It will be considered compensation since the insured owns no equity interest in the employer.
2. Taxable as a dividend: The income from a rollout could be taxed as a dividend if the insured employee is also a shareholder of the corporate employer; if the rollout is not part of reasonable, ordinary, and necessary compensation; and is a distribution of corporate earnings and profits.

Convert to a loan regime split-dollar plan

Another approach to rollouts is to have the employee or nonowner purchase the cash value in the policy for a note. In essence, you are converting to a loan regime split-dollar plan. The terms of the note will dictate the minimum required interest under the IRS AFR (Applicable Federal Rate) rules.

LOAN REGIME SPLIT-DOLLAR PLANS

In low interest environments, loan regime split-dollar becomes an extremely attractive fringe benefit.

- The employee or the employee's ILIT owns the policy.
- The employer's interest is established by a collateral assignment.
- The employer's interest is typically limited to the portion of the premiums paid by the employer.
- Any cash value in excess of split-dollar loan balance accrues tax-free to the employee.

The reverse mirror image of the economic benefit split-dollar plan

Rather than term rates, the employee reports the total interest on the loan as income. After the premiums cease, the loan amount will not go up. The interest will generally be fairly level thereafter, regardless of age.

TAX CONSIDERATIONS

Generally, a premium payment made according to a split-dollar arrangement is considered a split-dollar loan. The owner and nonowner are treated, respectively, as borrower and lender.

The loan regime applies if these conditions are met

1. The payment is made either directly or indirectly by the nonowner to the owner.
2. The payment is a loan under general principles of federal tax law, or if not a loan under general principles of federal tax law, a reasonable person would expect the payment to be repaid in full to the nonowner (whether with or without interest).
3. The repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value, or both.

A payment is not treated as a loan if the arrangement does not provide for repayment by the owner to the nonowner under an agreement of the parties.

Example: If a nonowner makes a payment to an owner purported to be a split-dollar loan *and* the nonowner and owner enter into a separate binding agreement providing that the nonowner will transfer to the owner an amount sufficient to repay the purported split-dollar loan, this may cause the initial payment not to be treated as a bona fide loan. This anti-abuse provision can also apply to a situation where the nonowner is entitled to repayment of some but not all of the payment. In this case, the nonowner is treated as having made two payments: one that is repayable and one that is not.

ANNUAL TEST FOR SUFFICIENT INTEREST

A split-dollar demand loan is tested in each calendar year in which it is outstanding to determine if it provides for sufficient interest.

Sufficient interest: A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate published by the IRS for the year.

Insufficient interest: A split-dollar demand loan that does not provide for sufficient interest is a below-market, split-dollar demand loan for that calendar year, and the amount of forgone interest is treated as having been transferred by the lender to the borrower and as retransferred as interest by the borrower to the lender.

The simplicity of a blended-rate approach

The regulations provide for a special "blended rate" of interest. This rate is issued every July and is the average demand rate of interest posted by the IRS for the previous year. The blended-rate approach saves arduous calculations because you simply have one outstanding loan balance. Otherwise under the IRS rules, each premium must be treated as a separate loan; each of which accrues interest under the appropriate short-term, mid-term or long-term AFR. In order to use the blended rate, the split-dollar loan has to be a "demand loan" under the IRS rules.

Blended approach:
(sum of net cumulative loan paid) × (the year's blended rate)

ADVANTAGES OF NQDC ARRANGEMENTS

An NQDC is used in lieu of a qualified retirement plan to avoid meeting the coverage and contribution requirements applicable to qualified pension and profit-sharing plans, and to maximize flexibility in coverage and benefits.

How it works

Typically, an employer adopts a board resolution authorizing the purchase of life insurance to indemnify the business for the costs it is likely to incur and the loss it is likely to realize at the death of the covered employee or independent contractor. In a second resolution, the company's board of directors authorizes it to enter into an agreement with the specified employee promising to make payments on fulfillment of conditions, such as employment until retirement age or death while employed by the company. An NQDC agreement is then signed by the authorized company officer and the covered employee. A rabbi trust may also be created, and a one-page ERISA notice will be sent to the DOL.

TAX CONSIDERATIONS

Because of the use of NQDC arrangements in situations where benefits were paid to top people just before the company went into bankruptcy, Congress enacted IRC 409A. The new legislation required the IRS to issue substantial regulations. Because of the complexity, many fewer NQDC plans are created, with more employers looking to loan regime split-dollar plans. IRC 409A (a)(2) substantially limits the situations under which an NQDC plan can make distributions to the covered employees without forfeiting favorable income tax treatment.

Distributions from an NQDC plan can be made only in the following situations

1. A separation from service (as determined by the Secretary)
2. Death
3. A specified time (or on a fixed schedule)
4. A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the corporation's assets (to the extent provided by the Secretary)
5. An unforeseeable emergency
6. If the participant becomes disabled

Haircut provisions

More than one of these payment dates and events may apply to the same NQDC plan, such as a plan that pays the participant deferred compensation on the earliest of reaching age 70, retiring, becoming disabled, or dying. These rules preclude provisions formerly included in some NQDC plans that allowed employees to withdraw amounts without restriction on the imposition of a small forfeiture (often less than 10 percent of the withdrawal). Such provisions, sometimes referred to as haircut provisions, provided substantial flexibility and protection for participants in an NQDC plan. Participants could withdraw their account balances if they believed that the corporation's financial safety was in doubt. These provisions are no longer permitted under IRC 409A. Likewise, some plans had "triggers" where benefits could be accelerated. These are now also prohibited.

Special rules for top heavy plans

Distributions on account of separation from service cannot be made to a key employee of a publicly traded corporation (a "specified employee") earlier than six months after the date of the separation from service or upon death. A key employee, for this purpose, is defined with reference to IRC 416, dealing with qualified plans. These are known as the Special Rules for Top Heavy Plans, and include either:

1. An officer of the employer with more than $130,000 (adjusted for inflation after 2002) of annual compensation
2. A five percent owner of the employer
3. A one percent owner of the employer with over $150,000 of annual compensation from the employer

Distributions taken at a specified time or fixed schedule

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral, rather than at some later date.

- A specified time means a specified date, rather than a specified event.
- Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time, unless the event is also a specific time certain (such as when the participant attains a specific age).

An unforeseeable emergency

The Internal Revenue Code defines an "unforeseeable emergency," for this purpose, as a severe financial hardship to the participant resulting from:

- An illness or accident of the participant, the participant's spouse, or a dependent (as defined in IRC 152) of the participant
- Loss of the participant's property due to casualty
- Other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the participant's control

For example, the regulations state that a payment due to unforeseeable circumstances might include:

1. The imminent foreclosure of or eviction from the service provider's primary residence
2. The need to pay for medical expenses, including nonrefundable deductibles, as well as for the costs of prescription drug medication
3. The need to pay for the funeral expenses of a spouse, a beneficiary or a dependent

On the other hand, the purchase of a home and the payment of college tuition are not unforeseeable emergencies. The regulations state that an unforeseeable emergency exists such that a distribution would be permitted if it is determined based on the relevant facts and circumstances of each case, but that such a distribution cannot be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets to the extent the liquidation of such assets would not cause severe financial hardship, or by cessation of deferrals under the plan.

The Code and the regulations state that a participant is considered disabled, for this purpose, if the participant is, by reason of any medically determinable physical or mental impairment, either:

1. Unable to engage in any substantial gainful activity, and the impairment can be expected to result in death or can be expected to last for a continuous period of not less than twelve months; or
2. Receiving income replacement benefits for a period of not

less than three months under an accident and health plan covering employees of the service provider's employer, and the impairment can be expected to result in death or to last for a period of not less than three months.

Disability

The regulations state that an arrangement can provide for payment upon any disability and need not provide for a payment upon all disabilities, as long as the determination of disability is made in accordance with these definitions.

An NQDC plan will not be entitled to favorable income tax treatment if it allows acceleration of distributions except as provided in the regulations. Generally, this rule prohibits any changes in the form of distribution that accelerates payments, though it does not preclude elections either:

- Between a fully taxable annuity contract and a lump-sum payment, or
- Between or among different forms of actuarially equivalent life annuity payments.

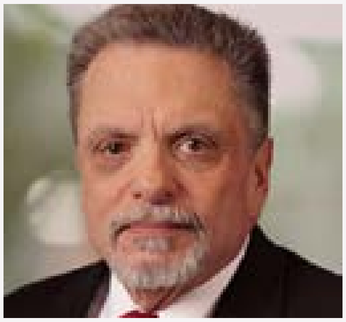
This limitation should not preclude a plan from providing a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution.

13 allowable situations for acceleration of distributions to a participant

The regulations permit acceleration of distributions to a participant in the following situations:

1. When it's necessary to fulfill a domestic relations order
2. To assure compliance with ethics agreements with the federal government, or with ethics or conflict-of-interest laws of any state, local, or foreign government
3. With respect to an IRC 457 deferred compensation plan for a state or local government or tax-exempt organization to the extent necessary to pay federal, state, local, and foreign income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the federal, state, local, and foreign income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includable by the service provider under IRC 457(f) at the time of the vesting
4. A mandatory lump-sum payment made under a plan or written amendment of deferred amounts, if all of the following:
    - The plan term or amendment is executed and effective before the payment.
    - Any required exercise of service-recipient discretion is evidenced in writing, no later than the date of such payment.
    - The payment results in the termination and liquidation of the entirety of the service provider's interest under the plan.
    - The payment is not greater than the applicable dollar amount under the qualified plan rules.
5. To pay the FICA tax, the federal, state, local, and foreign income tax withheld as a result of the payment of the FICA amount, and to pay the additional income tax at source on wages attributable to the pyramiding of such wages and taxes
6. Whenever the arrangement fails to meet the requirements of IRC 409A and the regulations thereunder causing income inclusion
7. The arrangement may permit a cancellation of a service provider's deferral election due to an unforeseeable emergency or a hardship distribution, as long as the deferral election is canceled, rather than postponed or otherwise delayed
8. If the right to the payment arises due to a termination of the arrangement under its terms, within 12 months of a corporate dissolution taxed under IRC 331, or certain change of control events, or pursuant to the service recipient's termination and liquidation of the plan
9. If the acceleration is made under a plan to prevent the occurrence of a nonallocation year for a tax-credit ESOP in the ESOP plan for the year next following the plan year in which such payment is made
10. To reflect payment of state, local, or foreign tax obligations arising from participation in the plan that apply to an amount deferred under the plan before the amount is paid or made available to the participant (the state, local, or foreign tax amount)
11. By cancellation of a service provider's deferral election, or a cancellation of such election, by the later of the end of the taxable year of the service provider or the fifteenth day of the third month following the date the service provider incurs a disability
12. As satisfaction for a debt of the service provider to the service recipient, incurred in the ordinary course of the service relationship between the service recipient and the service provider, if the entire amount of reduction in any of the service recipient's taxable years does not exceed $5,000, and the reduction is made at the same time and in the same amount as the debt otherwise would have been due and collected from the service provider
13. In settlement of a bona fide dispute as to a right to a payment

ABOUT THE AUTHOR



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