Business

SPLIT-DOLLAR LIFE INSURANCE: ENDORSEMENT METHOD

Presented for

Sample Company

Presented by

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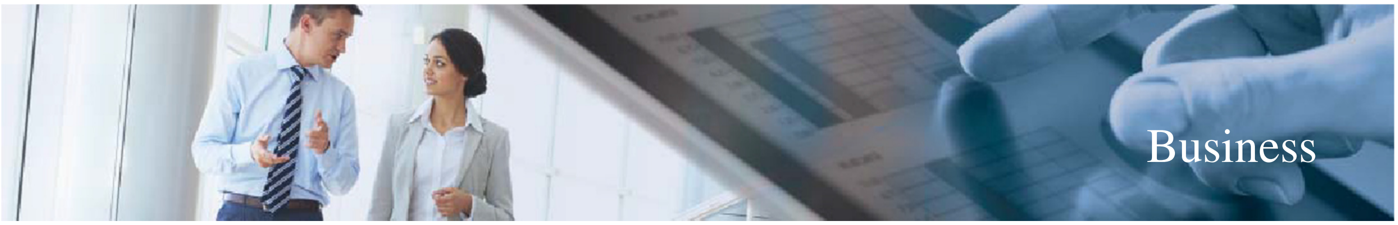


SPLIT-DOLLAR LIFE INSURANCE: ENDORSEMENT METHOD

The Concept…

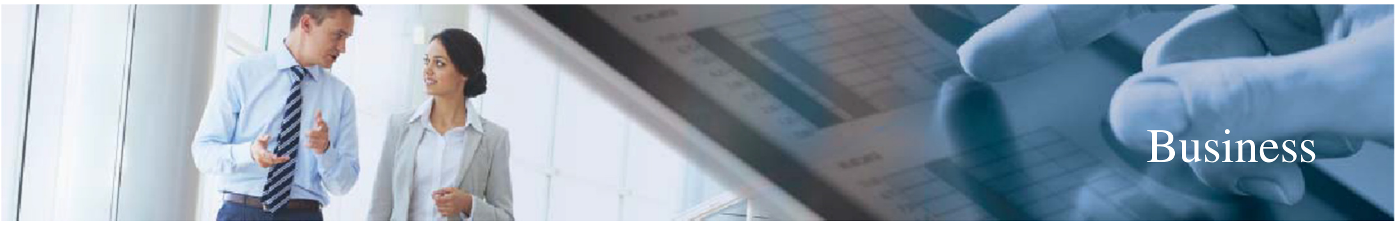
- Split-dollar is a method for purchasing life insurance in which premium payments or policy benefits—or both—are divided in a predetermined way. The split is often between a business and an employee, although sometimes between two individuals or between an individual and a trust.
- Premium payments and policy benefits are split in a manner that is specified in a split-dollar agreement.
- Split-dollar arrangements are designed to terminate at a specific future date, such as retirement or the death of the insured.

The Purpose…

- Split-dollar is a method—not a reason—for buying life insurance. A need for life insurance should exist before a split-dollar arrangement is implemented.
- In a business setting, the employer may need life insurance to provide a valuable fringe benefit to recruit or retain a key employee.
- For the employee, a split-dollar arrangement can provide life insurance protection for survivors at a lower current out-of-pocket cost than a personally purchased policy.

The Details…

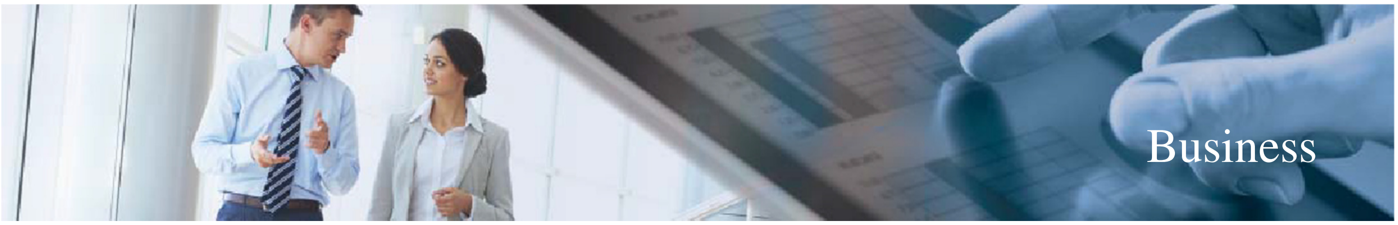
- The formal ownership of a life insurance policy in a split-dollar arrangement has important tax consequences under Treasury Department regulations. Split-dollar arrangements usually structure policy ownership in one of two ways: the endorsement method or the collateral assignment method.
- Under the endorsement method, the employer owns the policy and an agreement spells out the employee's rights to the policy.
- Typically, a split-dollar agreement gives the employee the right to name a personal beneficiary for the employee's share of the death proceeds as prescribed in the agreement between the parties.



- At the employee's death, life insurance proceeds are split between the employer and the employee's beneficiaries. The employer receives the amount dictated in the agreement (typically, a return of premiums only, a return of cash value only, or a return of the greater of the premiums paid or the cash value) and the employee's beneficiaries receive the remaining proceeds.
- "Equity split-dollar" is an arrangement in which the employer's share of the cash value and death benefit is limited to the aggregate net premiums paid. Any cash value in excess of the employer's premium payments inures to the benefit of the employee, giving the employee an equity interest in the cash value as well as providing current life insurance protection.
- In a "non-equity" arrangement, the employer provides the employee with current life insurance protection but no interest in the policy's cash value.
- In an "equity" arrangement, the employee enjoys additional economic benefits that are reflected in the taxation of the arrangement. Typically, equity will be taxed to the employee unless the premium payments are loans. If the loan does not provide for sufficient interest, the loan is a split-dollar loan, and the employee is taxed on the imputed interest at the applicable federal rate.

Tax Aspects…

- The final Treasury regulations issued in September 2003 clarified and altered the federal taxation of split-dollar arrangements. The regulations provide for two alternative tax regimes governing the taxation of split-dollar life insurance arrangements: the economic benefit regime and the loan regime.
- The two-regime approach applies to split-dollar arrangements entered into on and after September 18, 2003, and to pre-existing arrangements that are "materially modified" on or after that date.
- The regime that applies to a particular arrangement generally hinges, with some exceptions, on who owns the life insurance policy, which in turn depends on whether it was set up under the endorsement method or the collateral assignment method.
- The economic benefit regime generally applies to the endorsement method, where the employer owns the policy and the employee's rights are spelled out in the split-dollar agreement.



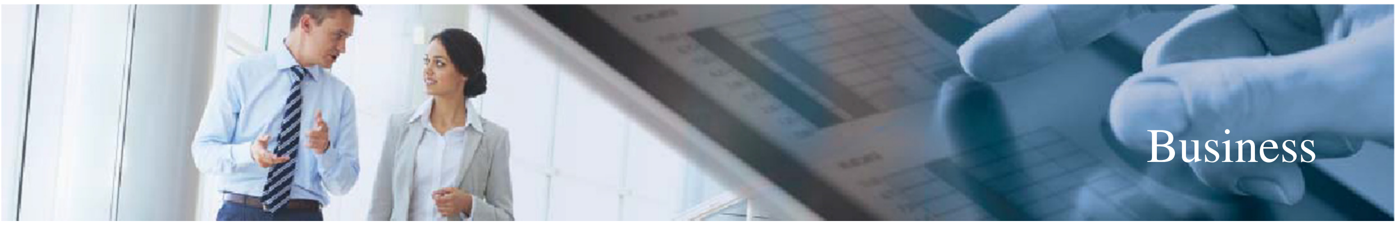
Special rule: The economic benefit regime applies regardless of who actually owns the policy if: (1) the split-dollar arrangement was entered into in an employer-employee context, or a gift context (often involving family members); and (2) the arrangement is a “non-equity” arrangement, which means that the non-owner employee has no interest in the policy’s cash value. **In other words, generally, the economic benefit regime applies to non-equity collateral assignment arrangements as well as endorsement arrangements.**

Economic Benefit Regime…

- Under the economic benefit regime, the policy’s owner is deemed to provide a taxable economic benefit to the other party to the arrangement.
- The economic benefit may consist only of the value of life insurance protection in a non-equity arrangement, or may consist of this and other economic benefits in an equity arrangement.
- All economic benefits must be accounted for fully and consistently by both the policy’s owner and the non-owner.
- Assuming the parties are an owner employer and non-owner employee, the employee reports as gross income the value of the economic benefits received, reduced by any amounts paid to the employer as reimbursement of economic benefit costs.
- Economic benefit costs paid by the employee to the employer are gross income to the employer.
- The economic benefit of life insurance protection is generally determined under IRS Table 2001.
- The death benefit received from an employer-owned policy at the death of an employee is not taxable. However, the death benefit becomes taxable when the employer fails to provide the employee with notice of the intention to buy life insurance on the employee and to secure the employee’s written consent for the purchase.

The Outcome…

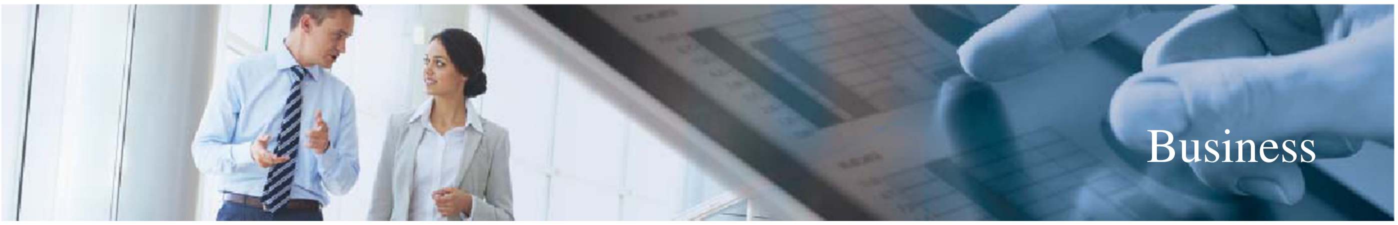
- Unless the employee or other insured dies while the split-dollar arrangement is in effect, the arrangement will eventually terminate as specified in the agreement between the parties (at the employee’s retirement, for example).
- Such a lifetime exit strategy from a split-dollar arrangement is known as a “rollout.”



- At rollout, the policy is transferred to the employee, who then repays the employer out of policy values or other assets.
- If the split-dollar agreement specifies a rollout (termination while the employee is living), this would likely make the arrangement subject to IRC §409A tax treatment as a form of deferred compensation.

The Bottom Line…

Along with other potential uses, a split-dollar arrangement can be an effective way for employers and key employees to cement a solid working relationship by providing life insurance coverage that gives additional financial security to employees and their families.



SUMMARY

What Is Split-Dollar Life Insurance?

A split-dollar arrangement is a method of purchasing life insurance in which the premium payments, policy benefits, or both are split between a business and an employee (or sometimes between two individuals or between an individual and a trust).

Split-dollar is a method of buying life insurance, not a reason for buying it. A need for life insurance should always exist before implementing a split-dollar arrangement.

What Is the Endorsement Method?

The ownership of a life insurance policy used to fund a split-dollar arrangement has important tax consequences under regulations issued by the Treasury Department.

Under the endorsement method, the employer owns the policy and an agreement spells out the employee's rights, typically including the right to name a beneficiary for the employee's share of the death proceeds.

At the employee's death, the life insurance proceeds are split between the parties. The employer typically receives a return of premiums only, a return of cash value only, or a return of the greater of the premiums paid or the cash value. The employee's beneficiaries receive the remaining proceeds.

A lifetime exit strategy from a split-dollar arrangement is known as a "rollout." The policy is transferred to the employee, who repays the employer out of policy values or other assets.

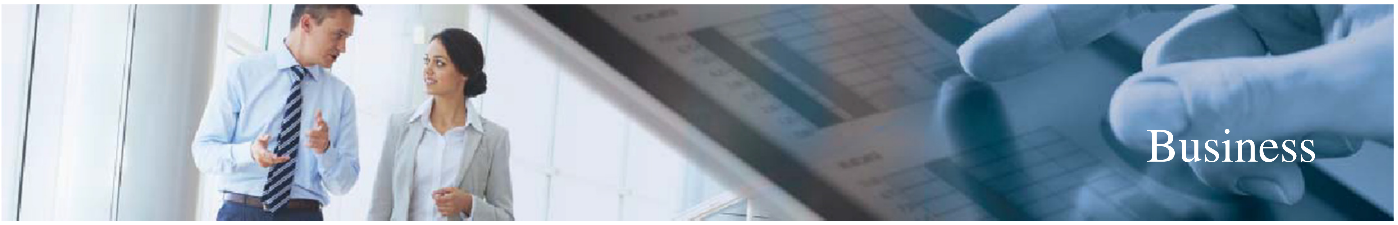
What Is Equity Split-Dollar?

"Equity split-dollar" is an arrangement in which the employer's share of the cash value and death benefit is limited to its aggregate net premiums paid. Any cash value in excess of the employer's premium payments inures to the benefit of the employee. Thus, the employee builds up an equity interest in the cash value while enjoying current life insurance protection.

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

How Are Split-Dollar Arrangements Taxed?

Two alternative tax regimes govern the federal income taxation of split-dollar life insurance arrangements: the economic benefit regime and the loan regime. Under the economic benefit regime—which generally applies to an endorsement method arrangement—the owner of the policy is deemed to provide taxable economic benefits to the other party.



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Both the owner and the non-owner must fully and consistently account for all economic benefits. Assuming the parties are an employer and an employee, the non-owner employee reports as gross income the value of the economic benefits received, reduced by any amounts paid to the owner employer as reimbursement of economic benefit costs.

Economic benefit costs paid by the employee are gross income to the employer and are not deductible by the employee. The economic benefit of life insurance protection is generally determined under IRS Table 2001.

A non-equity collateral assignment arrangement is taxed under the economic benefit regime—that is, the employee is taxed on the annual value of the death benefit payable to the beneficiaries, usually as measured by IRS Table 2001.

Some endorsement method split-dollar arrangements may fall within the reach of IRC §409A, which deals generally with deferred compensation arrangements. For example, if a split-dollar arrangement is to terminate at some point while the employee is living, and the policy will then be rolled out to the employee, this would probably make the arrangement subject to §409A tax treatment as a form of deferred compensation.

The death benefit received from an employer-owned policy at the death of an employee is not taxable. However, the death benefit becomes taxable if the employer fails to give the employee notice of the intention to buy life insurance on the employee and to obtain the employee's written consent for the purchase.

What Are the Advantages to the Employer?

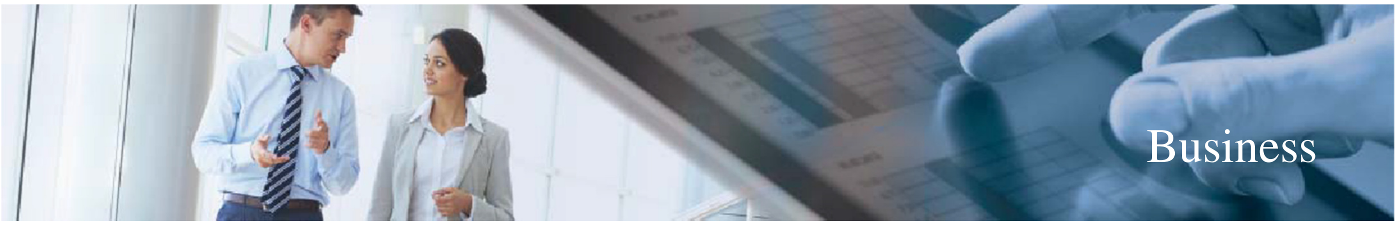
Split-dollar life insurance can be an effective method of attracting and retaining valuable key employees. The employer can be highly selective regarding which employees are covered. The employer may have access to the policy's cash value. A split-dollar arrangement does not need IRS pre-approval.

What Are the Advantages to the Employee?

Split-dollar life insurance can provide needed insurance protection for a key employee, possibly at a reduced current out-of-pocket cost. The arrangement can be combined with a cross-purchase buy-sell agreement to even out the current premium cost in the case of a wide age variance among the owners.

A Benefit to All Parties

A split-dollar arrangement is clearly an effective way for employers and key employees to cement a solid working relationship by providing life insurance protection that helps secure a mutually beneficial, long-term association.

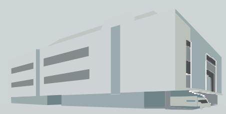


SPLIT-DOLLAR LIFE INSURANCE: ENDORSEMENT METHOD

1

An employer who wants to offer a fringe benefit to a key employee enters into a formal agreement to split the costs and benefits of a permanent life insurance policy.

EMPLOYER



2

After giving notice and obtaining consent, the employer purchases the policy and pays all premiums.

3

The employee gains an economic benefit through this arrangement. The amount of this benefit is included in gross income and is taxable.

EMPLOYEE

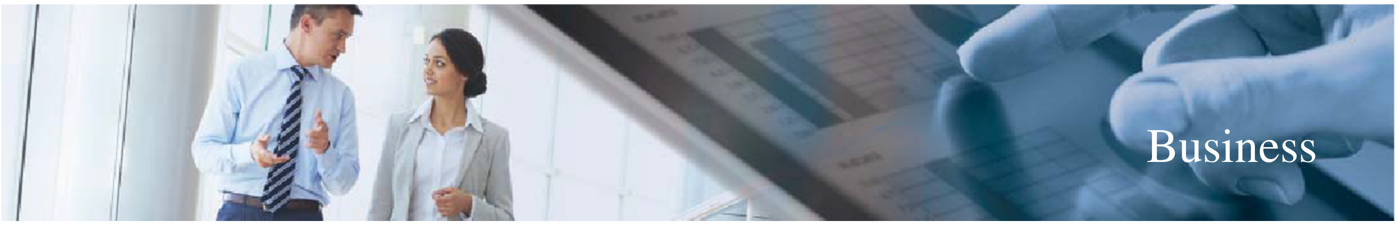
INSURANCE POLICY ON EMPLOYEE'S LIFE

4

At the employee's death (or the termination of the agreement), the employer recovers its total premiums or the cash value, depending on the terms of the agreement. Proceeds are tax free.

5

If the agreement terminates, the employer transfers the policy to the employee. If the employee dies, the employer pays out the balance of the death proceeds to the employee's beneficiary.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