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Split-Dollar Life Insurance—Endorsement Method

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SPLIT-DOLLAR LIFE INSURANCE—ENDORSEMENT METHOD

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.



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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.

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.



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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.



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