



Endorsement Split Dollar

HEIRMARK

HEIRMARK.COM



ENDORSEMENT

Split Dollar

ENDORSEMENT SPLIT DOLLAR

Using business-owned life insurance to benefit key employees

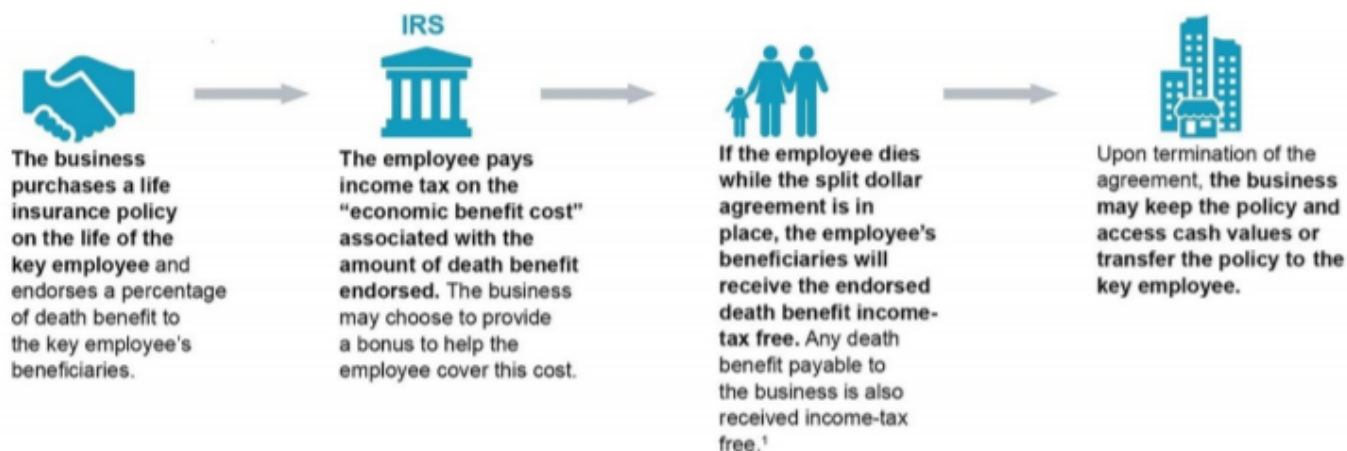
Like many business owners, you want to provide valuable incentives and benefits to recruit, reward and retain key employees. One compelling way to do this is through business-owned life insurance in an Endorsement Split Dollar arrangement, which offers several advantages, including:

- Encouraging key employee(s) to remain working for the business for the long-term,
- Protecting the business,
- Keeping control of the policy with the business, and
- Offering a solution that is easy to implement.

How does an Endorsement Split Dollar arrangement work?

The business owner controls the plan design in an Endorsement Split Dollar arrangement, including:

- Choosing which key employee(s) to offer this benefit;
- Owning and paying for a permanent life insurance policy on a key employee's life and sharing (aka "endorsing") the death benefit with the employee's beneficiaries. In return for endorsing the death benefit, an "economic benefit cost" is included in the employee's taxable income, ensuring the death benefit remains income-tax free;
- Determining how much death benefit to endorse to the key employee (the business can choose to endorse between 1-100% of the death benefit);
- Having full control and access to the policy's cash value; and
- Selecting the duration of the arrangement and the disposition of the policy upon plan termination, which typically occurs after a set number of years or when the employee leaves the business (e.g., at retirement).



1. The requirements of IRC sec 101(j), including notice and consent, must be met for the employer's portion of the death benefit to be received income tax free.



ENDORSEMENT

Split Dollar

ENDORSEMENT SPLIT DOLLAR

Why life insurance?

Permanent life insurance offers benefits to your business and a key employee in two key ways:

1. **Income Tax-Free Death Benefit** — Provides immediate financial protection to the key employee's loved ones; any death benefit that is not endorsed acts as "key person" coverage for the business.²
2. **Tax-Deferred Cash Value Growth, Which Can Be Accessed Income Tax- Free³** — Cash value can be used:
 - By the business to recover the premium cost or when additional cash is needed, and
 - By the key employee to provide supplemental income if the policy is transferred to the key employee upon plan termination

Why an Endorsement Split Dollar plan?

An Endorsement Split Dollar Plan can provide the following benefits:

For the business

- Motivates key employees to remain with the business
- Selects which key employees to include and can customize benefit for each
- Ability to access policy cash value
- Decides what to do with policy at plan termination (e.g., keep policy, access cash value, transfer)
- Can be implemented and administered at minimal cost

For the key employee

- Right to choose beneficiary for the endorsed death benefit
- Obtains life insurance protection at minimal cost while the plan is in effect
- Provides income-tax free death benefit to beneficiaries
- At employment termination, can access the policy cash value if the business transfers policy to key employee

² Life insurance death benefit proceeds are generally received income-tax free under IRC sec 101(a). There are a few exceptions, such as when the life policy has been transferred for valuable consideration or the requirements of sec 101(j) have not been complied with.

³ Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2. Cash value available for loans and withdrawals may be more or less than originally invested.

* Business should consult with its tax advisors to determine to what extent, if any, the rewards received by the employee through his/her engagement with the Vitality program must be reported by the business on the employee's W2.



ENDORSEMENT

Split Dollar

ENDORSEMENT SPLIT DOLLAR

What are the options at plan termination?

Your business has several options when the Endorsement Split Dollar plan terminates, including:

- Keeping the policy as an asset of the business,
- Transferring the policy to the key employee after accessing a portion of cash value to recoup costs, or
- Transferring the policy, along with all the cash value, to the key employee.

What are the income-tax considerations?

- Each year, the employee will be responsible for paying income tax on the “economic benefit cost” associated with the amount of death benefit endorsed. This cost is determined based on either IRS Table 2001-10 or carrier’s published rates for annual term insurance available to all standard risks. The business should work with legal counsel to determine which rate table to use.⁴
- The business may opt to make an additional taxable cash bonus to help the employee cover the tax associated with the economic benefit costs so that the employee has little or no out-of-pocket cost.
- The life insurance premiums are not tax deductible.
- If the policy is transferred to the employee, the fair market value of the policy will be treated as taxable income to the employee and tax deductible to the business.⁵ For illustration purposes, it is assumed that the fair market value of the policy at the time of transfer is the cash surrender value, less any withdrawals or loans the business takes from the policy.

Are there any other considerations?

- If the intention is to transfer the policy to the key employee in the future, consider customizing the policy to meet the employee’s financial goals (e.g., cash value growth to help with supplemental income, death benefit, etc.).
- The rules governing employer-owned insurance under IRC Sec 101(j), including obtaining Notice and Consent, must be followed to ensure any death benefit payable to the business is received income-tax free.
- If the policy will be transferred to the employee upon termination, the split dollar agreement should be drafted to avoid inclusion as a non-qualified deferred compensation arrangement under 409A.

4. IRS Notice 2002-8 provides that for split-dollar arrangements entered into after January 28, 2002, the Service will not consider an insurer’s published premium to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer’s normal distribution channel. John Hancock cannot guarantee that our One-Year Term product will satisfy any applicable IRS requirements as a substitute for the IRS Table 2001 rates. Each client should rely on their tax advisor to determine which rate to use in calculating economic benefit.

5. The employer’s tax savings will be reduced by tax owed on any gain in the policy. Fair market value may be approximated in this scenario by looking to applicable Treasury Regulations or similar IRS authority. See, e.g., Treasury Regulation §1.61-22(g)(2) and Revenue Procedure 2005-25. Employer’s tax counsel should determine the most appropriate method for valuation if the policy is transferred to the employee.



Disclosures

The example provided is not representative of all clients' experiences and are not indicative of any future performance or results. This is for informational purposes only.

This information has been taken from sources, which we believe to be reliable, but there is no guarantee as to its accuracy. This material is intended for informational purposes only and should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor or plan provider.