COMPANY SPONSORED Executive DEATH BENEFIT PLANS part 2

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We continue our examination of "Executive Death Benefit Plans" in this, the second of two articles. Here we will look at the remaining alternative plans:

Split Dollar Plans √
Executive Term Insurance √
Company Sponsored Supplemental Life √

For your reference, in our **previous article** on Executive Death Benefit Plans, the following plans were examined:

162 Executive Bonus
Executive Group Term Life
Executive DBO

This subject, death, might not be the most pleasant of topics, but it is, unfortunately, something that none of us can avoid. And, although it is virtually impossible to cast this discussion in an entertaining light, I will at least attempt to provide a perspective not seen previously.

Split Dollar ... a METHOD of Insuring:

Various forms of Split Dollar Life Insurance Programs have been in the mainstream of executive benefit for several decades, although several years ago this benefit had fallen out of popularity. Before we examine what happened, let's review what Split Dollar is and what it isn't.

Split Dollar Life Insurance is **not** a particular type of life insurance policy but rather, a method of funding or financing an individual life insurance policy.

Generally, a Split Dollar Program is established between an employee and his/her employer. The employer can be a for profit organization, such as a C Corporation, an S Corporation, a Partnership, or an LLC. Furthermore, a Split Dollar Program can be established between an employee of a not for profit organization such as a hospital or a charitable organization which is not in business to make a profit.

Structure of the Plan: The term "Split Dollar" provides an insight in to the structure of the Plan. In a Split Dollar Program, there are normally three elements of the life insurance policy that are “split.” First, the premium, second the cash value and third the death benefit - all three are split between the employer and the employee.

Before substantive changes were made to the prior methodologies about “who was entitled to what,” it was a very attractive arrangement, allowing substantial value to be allocated

to the employee. The prior arrangements, as formally structured are no longer allowed. However, all is not lost.

After several years of frustrating efforts to unearth some degree of value from what was a relatively simple and effective compensation device, a new type of Split Dollar Program has emerged. Several of the original components are still viable although the new structure is a bit more complicated than the previous structure.

A brief overview of the prior arrangement is necessary in order to appreciate what remains in the "new" Split Dollar program.

Example of the Former

Split Dollar Program

There were two major ingredients in the "former" Split Dollar Plan. The first ingredient was who got what. The second ingredient was how the values in the policy were split. You might ask, "Aren't those two issues one and the same?" The answer is, "Not necessarily."

The real value of the former arrangement primarily involved how the cash values were allocated (i.e., "split"). The IRS ultimately won the argument insisting the allocation of values was simply "too good to be true." The IRS determined that substantial value was being transferred to the policyholder **without being subject to taxation.**

To illustrate let's look at a simple example. Remember, there were three items that are being "split"- the premium, the death benefit, and the cash value. The IRS focused only on the cash value accruing in the policy. Typically, the premium was split according to a schedule of death benefits and the amount the employee was responsible for was equal to the cost of the life insurance that he/she was entitled to. This cost was often quite low making it very attractive to the participant.

Let's assume an executive age 45 is eligible for a Split Dollar Benefit of $2,000,000 which requires an annual premium of $25,000 payable for 20 years, or $500,000 total premiums. During the course of his/her career the participant is responsible for total premiums of $25,000 which represents the true cost of the death benefit while the company funds the balance of $475,000. At retirement the total value of the policy is assumed to be $1,000,000 and is split as follows; the company recovers their premium investment of $475,000 while the participant receives the balance of $525,000. Not a bad arrangement especially when there were no taxes paid on the value of $525,000, and the participant had the benefit of well over $1,000,000 of life insurance throughout the course of the plan. It was tantamount to providing an interest free loan to the participant. That cozy arrangement ultimately could not hold up to the scrutiny of the IRS and finally the IRS prevailed and required a major adjustment to the tidy arrangement.

New Split Dollar Program

Although the arrangement which is summarized above is no longer available, a new design has emerged which does offer a modified version of what had been an appealing arrangement.

The new arrangement has been dubbed a "Loan Regime Split Dollar Plan." It is beyond the scope of this article to analyze the full breath and value of this arrangement but it does involve establishing a loan account for each participant in the plan and, of course, this opens another can of worms as it relates to the top five executives of a public company because of the reporting and disclosure requirements. The other potentially troubling issue involves the interest rate itself. As long as rates are low, the design of such a plan could have some appeal. Its complexities however are off-putting to many companies.

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It may have more application in the Not-for-Profit space than the typical public marketplace, but again, it is beyond the scope of this article to engage in that review.

If you are interested in a deep dive into this concept, please click here for a thorough review of the subject.

Executive Term Insurance

In my view, the most important element of a successful executive death benefit plan will be the ability of the sponsor to secure a program that guarantees that the plan will be made available to all eligible employees without consideration to their health, either physical or financial. Executives today have no time for intrusive and exhaustive physical exams and personal financial disclosures to secure a company-paid-for life insurance plan.

Fortunately, there are several insurance companies that have recognized the opportunity to capture this emerging market and have developed attractive programs to satisfy this need.

The plans, however, will not be offered "carte blanche" without some minimal underwriting considerations. And generally, it must be a company sponsored and funded plan and not voluntary. Establishing this prerequisite reduces and essentially eliminates the most troubling issue an underwriter is horrified by: that being adverse selection.

The other underwriting considerations include the following limitations:

1. the amount of reasonable relationship the benefit must have to the current compensation earned.

2. there will likely be an age limit on the plan, thus eliminating older executives from participating and likely only available to executives/managers under age 70. Also, the plan is likely to require that only management and executives participate.

Limitations.....*continued*

3. negotiated formula (multiple of salary) will most likely be required to prevent access to the benefit certain executives otherwise could not secure.

4. in all likelihood, the payment of premiums would be funded by the company and not the individual executive.

5. although the policy could be shared or split between the executive and the company, it is generally assumed that the insured executive's spouse would be the beneficiary.

6. as the title suggests, the policy is a term variety and has no cash value and is also limited in duration most notably 5, 10 or 20 years.

7. the policy will provide the opportunity for either the company or the participant to convert the term policy to a universal life or other permanent form of insurance. In those circumstances the future premiums could be funded by either the individual participant or the company.

8. since the premiums are paid by the company, they are considered a deductible expense by the company and reportable income to the participant.

All in all, a properly designed Executive Term Insurance Plan could be a cost effective and valuable benefit to provide while not introducing a significant administrative or cost burden.

Company Supported

Supplemental Life Insurance

The last death benefit program I will discuss is referred to as a "Company Supported Supplemental Life Insurance" program. This type of program could take the form of any or all of the plans outlined above or could simply be a modified form of any or all of the previously examined programs. In other words, the company sponsoring the plan will only be limited by their imagination.

The design of this type of plan will most likely be based on answers to the following questions,

- What exactly is the company intending to accomplish?
- How will this program factor into the overall compensation strategic objectives of the company?
- What other investment vehicles are available to the company besides life insurance?
- Can the company incorporate various elements of the death benefit plans outlined to create a more robust overall program?

*press here to see our earlier article on **162 Bonus Plan***

For example, perhaps the most desirable option would be incorporating elements of the 162 Bonus Plan with the Split Dollar Program; or perhaps begin with an Executive Term Plan and then convert the policy to a permanent form under either a 162 Bonus or a Split Dollar Plan. Conversions of the term plan could be tied to either a company or to individual performance measures. The reward to the executive would be the opportunity provided the executive to accumulate cash value inside the policy which is also accruing on a tax deferred basis.

Summary

The opportunity allowing for some creative planning techniques is provided and allows the sponsoring organization to utilize a well understood and valuable benefit program to a greater extent than previously thought.

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