Nationwide®
is on your side

The Advanced Consulting Group

White paper

Death benefits: low-cost and cost recovered

Anne L. Meagher, JD, CLU®, ChFC®
Director, Advanced Consulting Group

Case study

ACME is an old, well-established company that offers a number of benefits to its key employees. Because many of the key employees are now young and haven't been with the company for a long time, ACME is looking into what types of benefits will be valued by both experienced and newer employees while keeping the company's costs to a minimum. ACME does not want to establish costly benefits for employees who may not be there for the long haul.

ACME's financial advisor suggested the company consider either a Death Benefit Only Plan or an Endorsement Split Dollar Life Insurance Plan. Both arrangements pay a death benefit to an employee's beneficiary provided the employee dies while employed. In addition, both can be structured to provide ACME with tax-free death benefits, thereby mitigating against the financial loss of losing a key employee.

Let's look at the differences and similarities between the two arrangements.

Economic benefit regime (endorsement) split dollar

In an endorsement split dollar life insurance arrangement, the company owns and is the beneficiary of a life insurance policy insuring one or more key employees. The company endorses a portion of the death benefit to each employee, who then designates a beneficiary to receive that portion of the policy death benefit directly from the insurance company. The arrangement ends when the employee terminates employment with the company. When the employee terminates employment, the company may keep the policy in force until the former employee dies, or it may change insureds (if the contract allows that), or it can surrender the policy and receive payment of the cash surrender value.

The employee receives an "economic benefit" from the company's endorsement of the death benefit. The value of this economic benefit is considered compensation and included in the employee's taxable income and is deductible by the employer. In addition, both the employer and the employee will pay Social Security and Medicare (FICA) taxes on this additional compensation.

Upon the employee's death, the company and the employee's beneficiary (assuming the employee is employed by the company) will receive the death benefit free of income tax. However, the death benefit paid to the beneficiary may be included in the employee's taxable estate.

Death benefit only plan

Typically, a death benefit only ("DBO") plan will provide a benefit to a key employee's beneficiary if the employee dies while employed by the company. The governing document will name the beneficiary, usually beginning with the employee's spouse, then to the employee's heirs if there is no spouse.[1]

Benefits paid to a beneficiary under a DBO plan will be subject to income tax to the beneficiary and tax deductible to the employer. The plan may pay a benefit in a lump sum or in installments for a certain number of years. For example, a plan may be structured to pay the beneficiary two times the employee's annual rate of pay as of the date of death for five years.

If the DBO plan does not permit the employee to designate or change the beneficiary, and the employee's estate is not a potential beneficiary, it is possible that the benefit will not be included in the employee's estate.

The employer will usually purchase life insurance on each participant in the plan and will receive the entire death benefit income tax-free. Just as in the endorsement split dollar arrangement, the employer may keep the policy until the death of the employee, even if the employee terminates employment many years prior to death. The employer may, in some cases, change the insured individual on the contract or may surrender it.

Compare endorsement split dollar arrangement to a DBO plan

	Endorsement Split Dollar	DBO plan
Advantages to the company		
• Receives income tax-free death benefit	✓	✓
• Deducts benefit payments made to beneficiaries		✓
• Little or no administration required		✓
Disadvantages to the company		
• Requires calculation of additional income to participants	✓	
• Generates additional compensation (the economic benefit) on which FICA taxes will be due	✓	
• Must obtain written consent from participants to be insured	✓	✓
• Life insurance premiums are not deductible	✓	✓
• May be an ERISA welfare benefit plan requiring some documentation	✓	✓
Advantages to the participants/beneficiaries		
• Participant designates (and can change) the beneficiary	✓	[2]
• Benefit is tax-free to the beneficiary	✓	
• No cost to participants		✓
• Benefit may be paid in installments ("salary continuation")		✓
Disadvantages to the participants/beneficiaries		
• Benefits may be included in participant's estate	✓	[3]
• Participants will have the economic benefit of the death benefit included in taxable income each year	✓	
• Participants may not be able to designate the beneficiary		✓[4]
• Benefits will be included in beneficiary's taxable income		✓

ACME's decision

After weighing both options, ACME decided to establish a DBO plan. Although the endorsement split dollar arrangement provides a tax-free death benefit to the beneficiary, ACME did not like the fact that it would have to pay FICA tax on the economic benefit assessed to the employees; employees would have imputed income on which they would have to pay tax; and the plan would require more work for its payroll department.

Although ACME opted for the DBO plan, other employers might view the choice differently. The endorsement split dollar plan allows employees to designate the beneficiary, and when death occurs, the insurance company pays the beneficiary directly. The employer does not have to provide the beneficiary with a Form 1099 for benefit payments or determine who is the beneficiary.

Each employer will need to analyze the pros and cons of each plan to determine which one fits better. Ultimately, each plan provides a cost-recovery benefit upon the death of an employee to the employer as well as a benefit to the employee's beneficiary.

Employer-owned life insurance products

Life insurance products specifically designed and institutionally-priced for the business market are often called corporate-owned life insurance, or COLI. These products generally have lower upfront loads, high early cash values and lower insurance costs than insurance products designed for the individual market. In addition, for groups with as few as 10 employees, some carriers, including Nationwide, offer guaranteed issue with no medical underwriting.

Insuring employees

Death benefits paid to an employer will not be taxed if notice and consent were obtained from the employee and any one of the following is true:

- The insured was an employee at any time during the 12-month period before death; or
- At the time the contract is issued, the insured is
    - A member of the board of directors;
    - A highly-compensated employee within the meaning of Code section 414(q);[5]
    - One of the 5 highest paid officers;
    - A shareholder who owns more than 10 percent in value of the stock of the employer;[6] or
    - Among the highest paid 35 percent of all employees.[7]

The employer's notice to the employee must state the maximum face amount for which the employee can be insured, that the employer (or policy owner) will be the beneficiary and that the coverage may continue after the insured is no longer employed by the employer.

Every taxpayer that owns one or more COLI policies issued after August 17, 2006 must file a Form 8925 with its tax return showing the number of employees insured at the end of the year; the total amount of insurance in force at the end of the year; and stating that each insured consented to the insurance.[8] Many third-party administrators of COLI will provide this data to employers at the end of the employer's fiscal year.

Summary

Employers are increasingly interested in finding low-cost benefits to help attract, retain and reward key employees. Both endorsement split dollar life insurance arrangements and DBO plans can provide attractive benefits for both employees and employers. The employer can recoup the cost of the arrangement, and they're both suitable for long-term employees as well as newer employees who may need more incentives to stay. Employees have the knowledge that their beneficiary will have some income to replace the income lost due to the employee's untimely death.

Nationwide®

NFM-18120AO (01/19)

[1] A DBO can also be structured so that the employee can designate his or her own beneficiary.

[2] See endnote 1.

[3] If the DBO permits the employee to designate the beneficiary, the benefit may be included in the employee's esate.

[4] See endnote 1

[5] A highly compensated employee is an employee who is a 5% owner at any time during the year or the preceding year or who earns $125,000 or more (2019). This amount is indexed and may change from year to year.

[6] Including stock owned due to the application of Code section 318 attribution rules.

[7] To determine the top 35%, "employer" means a controlled group under Code section 414(b) and (c).

[8] Code sec. 6039I.