Rewarding Employees With Split-Dollar Life Insurance Program

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Many small business owners struggle to find affordable, easy and effective ways to reward and retain key employees. So-called endorsement split-dollar life is often a viable, yet little-known solution, that can be offered to select employees and does not require Internal Revenue Service or government oversight. While many attorneys and financial advisers are familiar with the uses of split-dollar insurance in the estate planning and wealth transfer arenas, it provides an ideal framework as an employee benefit.

Assume a business (the firm) has a highly compensated and valuable employee, age 40. Chances are the employee would benefit from and appreciate having an interest in a cash value life insurance policy insuring his or her life. Split-dollar is not a type of life insurance, but rather is a planning strategy wherein multiple parties have an interest in a life insurance policy. In the context of our example, an employer-pay-all endorsement split-dollar arrangement will obtain the desired result, which is to provide a current and a future benefit to the employee while assuring that the firm will ultimately be repaid for the cost of providing the benefit. The current benefit to the employee is that he or she will have the ability to endorse a portion of the death benefit of the policy insuring his or her life to the employee's beneficiaries (typically heirs or a trust for their benefit). The future benefit is that if the employee remains with the firm for the requisite amount of time, he or she can obtain ownership of the policy after the firm has been reimbursed what it paid in premium.

The initial step is for the firm and the employee to enter into a written document called the split-dollar agreement (the SDA). The firm pays the premium and owns the policy, which is designed primarily for cash accumulation, insuring the employee. Thus, the firm can maintain control over the policy and a portion of the cash value. The employee is provided notice of the policy and consents to the application and the policy's issuance. The policy is issued with beneficiary designations that note that the death benefit will be shared, or split, between the firm and the employee's beneficiary. In some instances, the firm will provide the insurance carrier with a split-dollar endorsement form so the carrier knows the parties' respective interests in the policy.

During the duration of the SDA (the term), which in our example would be 25 years (from the employee's current age of 40 to the employee's retirement age of 65), the employee is taxed on the value of the "economic benefit" he or she receives. The economic benefit is the term cost of the amount of the death benefit the employee is able to endorse to his or her beneficiaries. It is calculated using either the federal government's table, known as the 2001-10 rates, or the insurance carrier's alternative rates for term insurance. The below example will be illustrative. Frequently, the SDA is structured so that if the employee dies during the term of the agreement, the firm is repaid its premium from the proceeds and the balance is paid to the employee's beneficiary. Another way of structuring the SDA is to provide a so-called, key-man insurance element, wherein a greater portion of the death benefit will be paid to the firm so that it can use the money to help replace the deceased employee. For example, if the employee dies during the term, the death benefit can be split 50-50. Assuming the employee is still employed at the end of the term, the SDA terminates and the firm is reimbursed from the cash value the amount it paid in premium. The policy is then "paid" to the employee, who can access the cash as a retirement benefit or maintain the policy. The premium payments are not deductible to the firm, but it gets a deduction when the policy is paid to the employee. The employee, in turn, is taxed on the fair market value of the policy as ordinary income.

For our example, assume the firm applies for and pays the premiums on an equity index universal life policy insuring the employee. The policy has premiums of $25,000 per year, for 20 years, and assumes a 6.5 percent annual rate of return. The policy is designed for cash value appreciation, and has a low initial death benefit of $703,260. If the employee died during the first year, his or her beneficiaries would receive $678,260, which is the death benefit less the year one premium. The term cost for the economic benefit the employee receives for the first year is approximately $350. This is phantom income to the employee that must be reported by the firm. At the end of the term, at the assumed rates, the cash value would be $1.1 million (in reality, it will be more or less). After the firm is repaid the $500,000, the employee still receives the policy with a death benefit of about $1 million and cash value of about $660,000.

The "reward" element of this strategy is that the employee gets free insurance during his or her working years while the SDA is in force. Although the employee has to pick up the term cost of the death benefit he or she can endorse as income, it is a nominal amount (less than if the employee was paying for the coverage), and very often the employer will pay the employee a separate bonus that covers the tax liability of receiving the economic benefit.

The split-dollar strategy enables the employer to "retain" the employee because if the employee severs his or her employment during the term, the SDA terminates and the employee forfeits his or her interest in the policy. Thus, the firm has a golden handcuff on the employee because if the employee leaves, he or she loses a valuable benefit.

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