

An Overview of Business Insurance

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1.0 Forms of Buy/Sell Agreements

After completing this course, you should be able to:

- Identify the forms of business ownership and business disposition.
- Describe buy/sell agreements.
- Define business valuation and buy/sell funding options.
- Explain the key executive's value to a business and recognize key executives.
- Describe the problems that arise due to the loss of a key executive and to define key executive insurance.
- Explain how key executive insurance works and how a key executive is valued.
- Describe selective benefit plans, including executive bonus and split dollar concepts.
- Understand split dollar ownership.
- Describe split dollar taxation, types of split dollar plans and split dollar uses.
- Describe the deferred compensation plan and plan mechanics.
- Understand deferred compensation plan taxation and the funding of deferred compensation benefits.
- Define tax leveraging and explain how it affects deferred compensation plans.
- Describe qualified plans, contribution and benefit limits and plan types.
- Explain Social Security integration, vesting, plan investments and advantages of using life insurance.
- Understand TDAs, IRAs, and SIMPLEs and describe retirement benefits and taxation.

1.1 Introduction to An Overview of Business Insurance

Welcome to An Overview of Business Insurance.

In this course we will cover the forms under which a business may organize the various ways that life insurance is used to solve problems of the business owner and the types of plans that a business may put into place to attract and keep key employees.

Lesson 1 of this course will cover the principal forms of business organizations: sole proprietorships, partnerships and corporations.

You will learn the pros and cons of each form of business organization as well as how each is affected by retirement, disability and death of the business owner or owners.

This lesson will also introduce buy/sell agreements and how funds are accumulated to make these agreements work for business owners.

Lesson 2 discusses key executives.

We'll be taking a detailed look at what can happen to a business when a key executive dies or terminates employment.

You'll learn how the business places a value on the key executive and how a key executive insurance plan works.

Lesson 3 will introduce you to the concept of selective benefit plans and how they are used to attract and keep valuable employees.

You will learn what executive bonus and split dollar insurance plans are and how they are advantageous to both the employer and the employee.

We will give you an overview of the types of split dollar plans which you will have the option of exploring in more depth.

Lesson 4 continues our discussion of selective benefit plans. This lesson will cover the concept of deferred compensation and salary continuation plans. These plans are also used to attract and retain valuable employees.

You'll learn how these plans can be informally funded with life insurance so that the cost of the plan to an employer can be kept to a minimum.

In our final lesson in this course on business insurance we focus on qualified retirement plans. The key terms associated with pension plans will be defined and the two broad types of qualified plans will be discussed.

You will learn some of the rules associated with these plans and will have the option to look at some of them in depth.

You will also learn why employers adopt pension and profit-sharing plans for the benefit of their employees.

When you have completed this section on business insurance, you should have a good general understanding of how a business uses various types of plans to:

- Protect itself against loss of valuable employees
- Attract and retain key executives
- Pass on the business at death, disability or retirement
- Provide retirement benefits to all employees

As you proceed through the lessons, you will be given the opportunity in various selected locations to look at a topic in more detail.

Choose the desired topic from the menu. After you have completed the topic, you will be returned to the menu from which you can select other topics or continue on with the lesson.

Let's continue on to Lesson 1.

1.2 Introduction

The owner of a small business typically spends a lifetime creating, running and managing a successful business. That same owner, however, usually spends little or no time planning for the future, when the business will be sold or passed on to others.

When a business owner retires voluntarily or becomes disabled or dies, a well-planned transition will often mean the difference between continued financial success or failure, for both the business and the owner and his or her family.

Lesson Objectives

To assist you in better understanding the importance of planning for the disposition of a business and the role that life insurance and disability income insurance can play, this lesson has the following objectives:

- **Forms of Business Ownership:** to review the different forms of business ownership.
- **Business Disposition Options:** to describe the options available for the disposition of a business at the owner's death, retirement or disability.
- **Types of Buy/Sell Agreements:** to explain the different types of buy/sell agreements and how they operate.
- **Business Valuation:** to explore the various methods for valuing a business.
- **Buy/Sell Funding Options:** to describe and contrast the options for funding a buy/sell agreement.

1.3 Forms of Business Ownership

To understand the considerations that go into planning for the disposition of a business at the owner's death, retirement or disability, you must first understand the various forms of business ownership.

There are three basic forms of business ownership, each of which is affected differently by an owner's death, retirement or disability:

- Sole Proprietorship
- Partnership
- Corporation

Sole Proprietorship

The most common and simplest form of business operation is the **sole proprietorship**, which can be defined as **one person** operating a business for profit.

The size of the business is unimportant. The sole proprietor may be the only one working the business, or there may be many employees.

There is no separate legal or tax entity involved in a sole proprietorship. All of the assets used in the operation of the business are **personal assets of the owner**, and all business debts or liabilities are the **owner's personal responsibility**. All profits and losses from the business are included on the owner's personal tax return.

When a sole proprietor dies, all the business assets are part of his or her estate and are passed to the heirs by will. In the absence of a will, the business assets are passed according to the laws of intestacy, those state laws directing the distribution of assets when no will exists.

Partnership

Another form of conducting business is the partnership—an association of two or more persons to carry on a business for profit as co-owners.

While not required, a written partnership agreement is advisable. This agreement stipulates how the partners will share in the profits and losses and the financial contribution each partner will make. Partners need not share in the profits and losses equally, nor is it necessary for each partner to make a financial contribution to the partnership.

A partnership can engage in any type of business, including professional partnerships in medicine, law or accounting.

The partnership is not a separate taxable entity. Each partner is taxed personally on his or her share of partnership income or losses and is personally responsible for partnership debts.

A partner's business interest is included in his or her estate at death. In the absence of a written buy/sell agreement, a partner's financial interest passes by will or intestacy and the partnership is automatically dissolved. A well-planned transition will provide for the buyout of the partner's interest.

Corporation

A **corporation** is an entity authorized and created under state law to carry on a business. It has a **separate legal and tax existence**.

Ownership in a corporation is represented by shares of stock. Each shareholder or stockholder (interchangeable terms) is issued the number of shares of stock that correspond to his or her ownership interest in the business. Since these shares are transferable, it is generally easier to transfer a share of stock than it is to divide the ownership of assets in a partnership.

There are two classifications of corporations:

- A **public corporation** makes its stock available for purchase by the general public. As a general rule, its stockholders are not involved in the active management of the business.
- A **close corporation** is wholly or principally owned by one or more individuals who are usually actively engaged in the management of the business. Since it is not listed on an exchange, the stock of a close corporation is not readily marketable. This is often a family-run business.

A corporation is a separate legal entity, with an unlimited life. Unlike a sole proprietor or partner, corporate stockholders are not personally responsible for business debts and the corporation's existence is not terminated by the death of a shareholder. In the absence of a written agreement, the shares are passed by will or intestacy and are included in the deceased's estate.

The corporation is also a separate tax entity. Its earnings are taxed separately at a corporate tax rate. While this allows for tax-advantaged employee benefits, it also means that any dividends are first taxed at the corporate tax rate and then again to the shareholders when distributed.

Dividends are classified, based on meeting certain criteria, as either ordinary or qualified. Ordinary dividends are taxed at ordinary income tax rates; however, qualified dividends are taxed at the same favorable rates that apply to long-term capital gain. This long-term capital gains treatment reduces the negative impact of the double taxation with respect to qualified dividends. This rule has not always been the case and future legislation could restore the old rule that taxed all dividends as ordinary income.

There are two special forms of corporations:

- The **S corporation** is treated as a corporation for non-tax purposes, while its income gains and losses are passed through to the shareholders and taxed or deducted at personal income tax rates, similar to a partnership.
- The **professional corporation** is limited to certain professions, such as medicine, law, accounting, etc. Only persons licensed by the state in the same profession are allowed to own an interest in a professional corporation.

Another form of business ownership is the **limited liability company**, which, depending on the state in which it is established, may simply be called an LLC, or, if appropriate, an LLP (limited liability partnership) or PLLP (professional limited liability partnership). This business form offers many of the benefits offered under the S corporation business organization. Establishing an LLC, LLP or PLLP, however, is generally less complicated than establishing an S corporation. The needs of an LLC to plan for voluntary or involuntary withdrawal of an owner are generally similar to those of a partnership.

The form of business that is NOT dissolved at an owner's death is:

- A. A partnership. **[Your answer is incorrect. A partnership does dissolve at an owner's death.]**
- B. A corporation. **[Your answer is correct. A corporation is NOT dissolved at an owner's death.]**
- C. A sole proprietorship. **[Your answer is incorrect. A sole proprietorship does dissolve at an owner's death.]**
- D. All of the above. **[Your answer is incorrect. There is a better response to this question.]**

1.4 Business Disposition Options

At some point, every business owner will withdraw from the business either voluntarily or involuntarily, due to:

- retirement;
- disability; or
- death.

Let's review the options available to each form of business ownership.

1.5 Business Disposition Options at Retirement

The following is a review of options a business has to dispose of a business at retirement, depending on the type of business organization.

Sole Proprietor

Option	Problem
Liquidate the business assets.	A forced sale may result in the sole proprietor's heirs receiving just pennies on the dollar.
Have someone in the family carry on the business in the form of a new sole proprietorship.	There must be a qualified family member to establish the business as a new sole proprietorship, and the owner may need to receive some proceeds from the sale.
Sell the business assets.	There must be a qualified and interested buyer for the business assets at a mutually agreed upon price.

Partner

A partner has the same three options as a sole proprietor.

Option	Problem
Liquidate the partnership interest.	Difficult, if not impossible, to dispose of only a partial interest in assets.
Reconstitute the partnership with	There must be a qualified family member or outsider interested in joining the newly formed

one or more new partners.	partnership; the other partners must approve the new partner's entry; having a partnership agreement in place may provide additional options for transitioning when a partner leaves under various reasons: death , disability, retirement

Corporation

The shareholder-employees (individuals actively engaged in the business) in a corporation have three options, but being owners of a corporation puts them in a somewhat different position.

Option	Problem
Liquidate the business.	Can only be done by a majority stockholder or the majority vote of a group of minority stockholders whose aggregate holdings constitute a majority of the corporations stock.
Retain the shares in the family.	In whose hands and at what price to the economic viability of the business?
Sell the shares.	In a close corporation, there is a very limited market for the sale of stock.

Corporation

In reality, shares of stock in a public corporation are readily marketable. As a result, our discussion will focus on planning for the disposition of stock in a close corporation.

Each form of business ownership presents its own special set of problems for disposal of the business interest at retirement.

The solution is to create a market for the business interest prior to retirement through the use of a properly drafted buy/sell agreement.

All shareholders individually have the option of liquidating a corporation at retirement.

- A. True [Your answer is incorrect. This is not a true statement.]
 B. False [Your answer is correct. All shareholders do not have the option individually of liquidating a corporation at retirement.]

1.6 Business Disposition Options at Disability

The options for the disposition of a business interest at the owner's disability do not differ greatly from those at retirement, but the disposition need is usually much greater.

Unless a key employee can carry on the business, the sole proprietor's income will stop. With a partner or shareholder-employee, the other owners can carry on the business, but have to decide whether to continue the disabled owner's salary, in what amount and for how long. Unless there is a prior agreement, they are under no obligation to do so.

Again, a buy/sell agreement that provides for a sale in the event of disability can be the solution!

1.7 Business Disposition Options at Death

When a sole proprietor dies, all of the business assets become part of his or her estate and are subject to the personal and business creditors of the estate. The options available all raise certain concerns:

Liquidate	Executor Operates Until Sold	Sell to Key Employee
<ul style="list-style-type: none"> Family income stops. Business value lost. Enough cash for debts and taxes. 	<ul style="list-style-type: none"> Time to run it if work undertaken needs to be completed? Ability to run it? Creditors want payment. 	<ul style="list-style-type: none"> At what price? Does employee have the cash?

	<ul style="list-style-type: none"> • Price for the business assets? • Sold to whom? 	
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When a partner dies, the surviving partners must choose between:

- Liquidating the business; or
- Reorganizing the business.

A liquidation of the partnership will probably bring less than the real value of the business. A reorganization of the business—the remaining partners can sell out to the heirs, buy out the heirs or take the heirs in as new partners— raises a variety of concerns. Reconstituting the partnership or purchase of a deceased partner's interest must be permitted under an existing agreement; absent an agreement to that effect; otherwise the partnership must be dissolved.

Liquidate	Reorganize		
	With Heirs	Buy out Heirs	Sell to Heirs
<ul style="list-style-type: none"> • Family income lost. • Surviving partners lose jobs. • Business value lost. • Creditors demand payment. • Enough cash for debts and taxes. 	<ul style="list-style-type: none"> • Are heirs capable? • Will they fit in? • What share of profits? • What income? 	<ul style="list-style-type: none"> • At what price? • Terms of payment? • Cash available? 	<ul style="list-style-type: none"> • At what price? • Terms of payment? • Cash available? • Are heirs capable? • Partners jobless.

When one of several stockholders of a close corporation dies, the surviving stockholders must choose one of the following alternatives if no prior written agreement exists for the sale of the business interest:

- Buy out the heirs.
- Take the heirs into the business, either as inactive co-owners or active co-owners.
- Take an outsider into the business who has purchased the decedent's stock.
- Sell to the heirs.
- Join with the heirs to liquidate the business.
- Join with the heirs to sell to a third party.

Again, each of these options raises potential problems.

IF THE SURVIVING SHAREHOLDERS:			
Buy Out Heirs	Sell to Heirs	Take Heirs In	Liquidate or Sell
<ul style="list-style-type: none"> • At what price? • Enough cash? • Terms of payment? • Value of stock for estate taxes? 	<ul style="list-style-type: none"> • Are heirs capable? • At what price? • Do heirs have cash? • Surviving owners lose jobs. 	<ul style="list-style-type: none"> • Are heirs capable? • Inactive or active? • Can all get along? 	<ul style="list-style-type: none"> • Business value lost. • Survivors lose jobs. • Sell at what price? • To whom?

The death of a sole proprietor, partner, LLC member or stockholder in a close corporation presents major problems for the heirs and any surviving owners. These problems arise not so much from the legal aspects, but from the more practical business aspects of disposing of a business interest.

Without prior planning, everyone stands to lose. In the next section, we'll explore a planning technique that provides for the orderly transfer of a business interest at the owner's retirement, disability or death.

Unless otherwise provided in a partnership agreement, the surviving partners must choose between _____ the business and reorganizing it.

- A. Liquidating **[Your answer is correct. Unless otherwise provided in a partnership agreement, the surviving partners must choose between liquidating the business and reorganizing it.]**
- B. Renaming **[Your answer is incorrect. Unless otherwise provided in a partnership agreement, the surviving partners do not choose between renaming the business and reorganizing it.]**
- C. Retooling **[Your answer is incorrect. Unless otherwise provided in a partnership agreement, the surviving partners do not choose between retooling the business and reorganizing it.]**
- D. Leveraging **[Your answer is incorrect. Unless otherwise provided in a partnership agreement, the surviving partners do not choose between leveraging the business and reorganizing it.]**

1.8 The Solution—A Buy/Sell Agreement

The problems that arise at the retirement, disability or death of a business owner can be avoided with a written buy/sell agreement, which:

- Allows the remaining owners to retain control of the business.
- Ensures business continuity.
- Creates a guaranteed market for the business interest.
- Establishes the price of an owner's business interest.
- Pegs the value of the business interest for estate tax purposes.
- Provides liquidity to the deceased owner's estate.

A buy/sell agreement is the most efficient way to provide for the orderly transfer of an ownership interest.

In most instances, the value of a business interest represents the most valuable asset of the business owner.

At retirement or disability, the owner must look to this asset to continue providing a stream of income.

At the business owner's death, the family looks to the business interest to provide income as well as funds to settle the estate costs.

The remaining owners, on the other hand, want the security of knowing they will retain control of the business. They also need the profits that the business generates in order to retain customers and continue business operations.

The end result is that there may be an inherent conflict between the needs of a business owner or his or her family at retirement, disability or death and the needs of the business. A buy/sell agreement can resolve this conflict.

After a question, let's review the three types of buy/sell agreements.

A buy/sell agreement:

- A. Can be a verbal agreement. **[Your answer is incorrect. A buy/sell agreement cannot be a verbal agreement.]**
- B. Creates a guaranteed market for the business interest. **[Your answer is correct. A buy/sell agreement creates a guaranteed market for the business interest.]**
- C. Cannot establish the price of an owner's business interest. **[Your answer is incorrect. A buy/sell agreement can establish the price of an owner's business interest.]**
- D. Hinders business continuity. **[Your answer is incorrect. A buy/sell agreement does not hinder business continuity.]**

1.9 The Entity Purchase Buy/Sell Agreement

The entity itself is the purchaser of the business interest. The owners of a partnership or corporation enter into an entity purchase buy/sell agreement with the business (the entity). The business agrees to buy and the owners agree to sell their business interest at death or withdrawal. If the agreement is funded with life insurance to provide the necessary cash, the business is the owner and beneficiary of each policy. The premiums paid are not tax deductible.

In a corporation, an entity purchase agreement is known as a stock redemption agreement because the stock representing the deceased or withdrawing owner's interest is redeemed by the corporation.

For example, A, B and C each own 33 1/3 percent of a corporation and enter into a stock redemption agreement with the corporation. Each owner's stock is valued at \$100,000, so the corporation purchases a \$100,000 life insurance policy on each owner.

Owner B dies and the corporation purchases his stock from his estate, using the \$100,000 in life insurance proceeds. This stock is then retired as treasury stock, increasing the value of the remaining owner's shares proportionately.

Corporations have another form of stock redemption agreement under which the corporation redeems only a portion of the stock at an owner's death.

1.10 The Section 303 Stock Redemption

The Section 303 redemption is an estate planning tool used to provide liquidity to the estate. It allows the corporation to purchase enough stock from a deceased shareholder's estate to pay for the funeral expenses, administration costs, and state and federal estate and death taxes. When all the requirements are met, the sale is taxed as a capital transaction rather than as a dividend distribution, the normal tax treatment for a partial redemption.

Section 303 is most often used when the owner is a sole shareholder or a co-shareholder who wants a family member to continue in the business. The shares of stock not redeemed can then be willed or sold to a family member.

If a stock redemption is funded with life insurance, the corporation is the owner and _____ of each policy.

- A. Issuer **[Your answer is incorrect. If a stock redemption is funded with life insurance, the corporation is not the owner and issuer of each policy.]**
- B. Payee **[Your answer is incorrect. If a stock redemption is funded with life insurance, the corporation is not the owner and payee of each policy.]**
- C. Entity **[Your answer is incorrect. If a stock redemption is funded with life insurance, the corporation is not the owner and entity of each policy.]**
- D. Beneficiary **[Your answer is correct. If a stock redemption is funded with life insurance, the corporation is the owner and beneficiary of each policy.]**

1.11 The Cross Purchase Buy/Sell Agreement

A cross purchase agreement allows the partners or shareholders to buy the deceased or withdrawing owner's interest. The business is not a party to the agreement. If the agreement is funded with life insurance, each owner is the owner and beneficiary of a policy on the other owners' lives in an amount equal to a proportional share of the other owners' interest.

The number of policies needed to fund a cross purchase agreement is equal to $N \times (N-1)$, with N being the number of partners or shareholders. Thus, if there are three partners or shareholders, six policies must be purchased.

$$3 \times (3 - 1) = 6$$

For example, A and B each own 30% and C owns the remaining 40% of a partnership valued at \$600,000. Each partner must purchase the following:

A owns policies on B and C for \$90,000 and \$120,000 respectively. B owns policies on A and C for the same amounts. C owns policies on A and B for \$90,000 each.

Partner A dies and Partners B and C purchase his business interest from his estate, thus increasing their ownership interests as follows:

Partner B now owns 30% + 15% or 45%

Partner C now owns 40% + 15% or 55%

A written purchase agreement can also be used to sell a sole proprietorship to a key employee, family member or outsider.

There are five owners of a corporation who enter into a cross purchase buy/sell agreement. The total number of life insurance policies needed to fund the agreement is equal to _____.

- A. 20 **[Your answer is correct. There are five owners of a corporation who enter into a cross purchase buy/sell agreement. The total number of life insurance policies needed to fund the agreement is equal to 20.]**
- B. 25 **[Your answer is incorrect. The total number of life insurance policies needed to fund the agreement is not 25.]**
- C. 30 **[Your answer is incorrect. The total number of life insurance policies needed to fund the agreement is not 30.]**
- D. None of the above **[Your answer is incorrect. The total number of life insurance policies needed to fund the agreement is one of the options above.]**

1.12 Entity Purchase vs. Cross Purchase Agreements

Once business owners have recognized the need for a buy/sell agreement, they must decide which type of agreement best fits the needs of the business involved. This decision is based on factors such as:

- Life insurance considerations.
- Income taxation of the proceeds on a subsequent sale of the purchased interest.

- Relationship of the parties involved.

A detailed discussion of these factors is beyond the scope of this course. The following, however, will serve to summarize the considerations involved.

Entity Purchase		Cross Purchase
<ul style="list-style-type: none"> • purchaser is entity • entity is owner and beneficiary of life insurance • only one policy per owner • premiums paid by entity not tax deductible • insurance proceeds received income tax-free • no change in cost basis of business interest for surviving owners 	OR	<ul style="list-style-type: none"> • purchaser is individual • individuals are owners and beneficiaries of life insurance • possibly a large number of policies; formula is $N(N-1)$ • premiums paid by individuals not tax deductible • insurance proceeds received income tax-free • cost basis of business interest of surviving owners increased by value of shares purchased

Since each business owner's situation is different, it is not possible to recommend one form of buy/sell agreement over the other. Instead, each business owner must consult with his or her attorney and accountant to determine which agreement best fits the owner's situation.

Premiums paid for life insurance to fund both entity purchase and cross purchase agreements are NOT tax deductible.

- A. True **[Your answer is correct. Premiums paid for life insurance to fund both entity purchase and cross purchase agreements are NOT tax deductible.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

1.13 Business Valuation

Imagine for a moment that you own 50% of a close corporation and are entering into a buy/sell agreement with the other 50% owner.

If you retire, die or become disabled, you want to receive the highest possible price for your share of the business. On the other hand, if the other owner retires, dies or becomes disabled, it is natural that you'd want to pay the smallest price possible for his or her share of the business.

Since this inherent conflict exists, a buy/sell agreement must decide on a method for fixing the price of the business interest at the time the agreement is drawn.

The IRS dictates that all business transfers of ownership must reflect fair market value—the price that a willing seller can get a willing buyer to pay for the business.

If the requirements for a valid buy/sell agreement are met, the IRS has indicated that it will accept the value of the business interest set in the buy/sell agreement for estate tax purposes. Otherwise, the IRS may challenge the value and even impose a gift tax on the difference between fair market value and the sale price.

The requirements for a valid buy/sell agreement are:

- The deceased owner's estate must be obligated to sell.
- The obligation to sell must be binding upon the seller during lifetime as well as upon death.
- In a lifetime sale, the purchaser is not required to buy but must be given an option to buy before anyone else.
- The purchase price must either be fixed, be determined according to a formula or the method for fixing the price must be established in the agreement.
- The agreement must be negotiated as an "arm's-length" business deal.
- The purchase price cannot be higher in a lifetime sale than a sale at death.

In order for a buy/sell agreement to be binding for federal estate tax purposes, it must meet all of the following requirements EXCEPT: (Refer to Sec. 1.13, p. 17)

- A. The estate must be obligated to sell **[Your answer is incorrect. In order for a buy/sell agreement to be binding for federal estate tax purposes the estate must be obligated to sell.]**

- B. The obligation to sell is mandatory during lifetime as well as at death **[Your answer is incorrect. In order for a buy/sell agreement to be binding for federal estate tax purposes, the obligation to sell is mandatory during lifetime as well as at death.]**
- C. The method for determining the purchase can be determined at the time of sale **[Your answer is correct. In order for a buy/sell agreement to be binding for federal estate tax purposes, it must meet all of the requirements EXCEPT the method for determining the purchase can be determined at the time of sale.]**
- D. The agreement must be an arm's-length business transaction **[Your answer is incorrect. In order for a buy/sell agreement to be binding for federal estate tax purposes, the agreement must be an arm's-length business transaction.]**

1.14 Business Valuation Methods

There are four different methods of determining the value of a closely held business:

1. **Agreed Value:** a price is fixed when the agreement is written.
2. **Appraised Value:** the value is determined by appraisal at the time of sale.
3. **Book Value:** total business assets minus total business liabilities.
4. **Formula Value:** one of three formulas used to establish value at the time of sale.

Agreed Value

The owners fix a price for the business when the agreement is drawn. This price must reflect the fair market value of the business at the time the agreement is drawn. While this method is simple, it does not reflect changes in the business value over the years unless periodically reviewed and changed.

Example:

The owners of Southern Manufacturing Corp. agree that the business is worth \$750,000 at the time the buy/sell agreement is written.

Appraised Value

The owners agree that the value will be determined by appraisal at the time of a sale. To solve potential conflicts, the agreement should address the selection of an appraiser and the standards to be used for valuing assets. A general solution is the use of three appraisers, one selected by the buyer, one by the seller and the other selected by agreement of both buyer and seller (or by the two other appraisers). While costly, this approach can resolve conflicts that may arise.

Example:

Appraiser A sets Southern Manufacturing's value at \$800,000, Appraiser B at \$1,000,000 and Appraiser C at \$750,000. The value of the business will then be the average of the three appraisals, or \$850,000.

Book Value

This is equal to a company's net worth and is determined by subtracting business liabilities from business assets. A company's book value frequently does not reflect the fair market value of a business. Assets are carried at their original cost when some, such as real estate, may have appreciated in value. In addition, book value does not reflect the intangible assets of a business, known as goodwill. This includes such factors as name recognition, effective management and customer satisfaction.

Example:**SOUTHERN MANUFACTURING**

Total Assets \$950,000

Total Liabilities -300,000

Book Value \$650,000

Formula Value

The value of a business for buy/sell purposes can be determined at the time of sale by a formula method of valuation. The formula chosen is described in the agreement. The three most common methods of formula valuation are:

1. Straight Capitalization
2. Capitalization of Earnings
3. Years Purchase

Straight Capitalization - Determines the value of a business based on its earnings. Straight capitalization averages the adjusted annual earnings of a business (business earnings adjusted for such factors as excess salaries paid to owners, interest-free loans and extraordinary gains or losses) over a specific period of time, usually five years. The adjusted average annual earnings are then divided by a selected capitalization rate (the rate of return an investor expects to earn on an investment).

Example:

Adjusted average annual earnings ÷ Capitalization rate = Business value

\$85,000 ÷ .12 = \$708.333

Capitalization of Earnings - The adjusted average annual earnings are first determined. The book value is then multiplied by a capitalization rate, 8% - 14% for example, to determine the portion of business income representing a return on capital. This is subtracted from the adjusted average annual earnings, resulting in excess earnings attributable to goodwill. The excess earnings are then multiplied by a goodwill capitalization rate (5 in this example) to produce the capitalized value of goodwill. The total of capitalized goodwill and book value produces the value of the business.

Capitalization of Earnings Example:

Adjusted Average Annual Earnings	\$ 85,000
Less 10% Book Value Return	<u>- 65,000</u>
Equals Annual Excess Earnings Attributed to Goodwill	\$ 20,000
Times Capitalization Factor for Goodwill	<u>× 5</u>
Equals Capitalized Value of Goodwill	\$ 100,000
Plus Book Value	<u>+ 650,000</u>
Equals Total Value	\$ 750,000

Years Purchase - A variation on capitalization of earnings, this formula also uses adjusted average annual earnings and a more conservative return on book value investment, such as 6%. This method assumes that the value of goodwill will not extend to a purchaser for more than five years. It also discounts the goodwill figure to account for the fact that the purchaser is paying for an asset today, which would be worth more in the future if it were invested at a guaranteed interest rate. The total value is equal to the discounted value of goodwill plus book value.

Years Purchase Example:

Adjusted Average Annual Earnings	\$ 85,000
Less 6% Book Value Return	<u>- 39,000</u>
Equals Annual Excess Earnings Attributed to Goodwill	\$ 46,000

Times Years Goodwill Assumed to Last	<u> </u> × 5
Equals Capitalized Goodwill	\$ 230,000
Capitalized Goodwill Discounted at 15% for 5 Years	\$ 130,508
Plus Book Value	<u>\$ 650,000</u>
Equals Total Value	\$ 780,508

In the book value method, business value is determined by subtracting business liabilities from business _____.

- A. Debts **[Your answer is incorrect. In the book value method, business value is not determined by subtracting business liabilities from business debts.]**
- B. Assets **[Your answer is correct. In the book value method, business value is determined by subtracting business liabilities from business assets.]**
- C. Net worth **[Your answer is incorrect. In the book value method, business value is not determined by subtracting business liabilities from business net worth.]**
- D. Current income **[Your answer is incorrect. In the book value method, business value is not determined by subtracting business liabilities from business current income.]**

1.15 Buy/Sell Funding Options

A buy/sell agreement will not succeed, no matter how well it is written, unless there are funds available to purchase the business interest at the owner's retirement, death or disability.

There are only four ways that a buy/sell agreement can be funded:

1. Current Earnings
2. Borrowed Funds
3. Sinking Fund
4. Insurance Proceeds

Let's review each.

Current Earnings

One of the ways to generate funds needed to purchase the business interest under the terms of the buy-sell agreement is to use current earnings. In reality, using current earnings means not funding the agreement at all, but simply relying upon future revenue to pay off the seller. Even if the current business earnings are sufficient to make the necessary payments under the buy-sell agreement, the cash drain needed to make the payments could substantially impair the ability of the business to survive.

Funding with current earnings is costly. Each dollar paid for the business interest is a nondeductible after-tax dollar. A corporation in a 34% combined state and federal tax bracket must earn \$1.52 in order to pay \$1.00.

$$\$1.52 \times .34 = 52¢ \text{ tax}$$

$$\$1.52 - 52¢ \text{ tax} = \$1.00 \text{ after taxes}$$

Borrowed Funds

The buyer could borrow the funds from a third party, such as a bank. The disadvantage is that the total amount paid for the business is a great deal more than the purchase price, depending on interest and duration of the loan. For example, for a corporation to borrow \$100,000 at 12% for 10 years, the total cost is \$176,984. In addition, the buyer's earnings must be sufficient to make the loan payments.

If a sale occurs during one's lifetime, due to retirement for example, the retiring owner may agree to finance the sale through installment payments over a stated number of years. This is a common approach to a lifetime sale of a business interest.

Sinking Fund

Deposits are made to a sinking fund on a consistent basis with after-tax dollars in an attempt to meet the obligation created by the agreement. The problem is that it may take years to build the needed funds, and the death or disability of an owner cannot be predicted.

This is a viable solution for funding for death or disability only when an owner is uninsurable. A sinking fund is, however, a common approach to funding for a sale at retirement because it is a predictable event.

Insurance Proceeds

Few business planners question the advisability of funding buy/sell agreements with life insurance. The guarantee of insurance proceeds when death or disability occurs cannot be duplicated.

Life insurance guarantees the necessary dollars will be available exactly when needed, at an owner's death. The death proceeds are received income tax-free, allowing the purchase of the business interest with premiums instead of full purchase price.

In the event of disability, the agreement can be funded with disability insurance, using the definition of disability in the policy to define disability in the agreement. Two types of disability insurance are available:

- **Disability Buyout Policy** - pays the purchase price in the event of an owner's disability.
- **Disability Income Policy** - continues the owner's income during a disability, until a buyout occurs or beyond that point.

The only way to guarantee that the money will be available to fund a buy/sell agreement at an owner's death or disability is through insurance.

- A. True **[Your answer is correct. The only way to guarantee that the money will be available to fund a buy/sell agreement at an owner's death or disability is through insurance.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

LESSON PRACTICE TEST ONE

An association of two or more persons who carry on a business for profit is known as a _____.

- A. Sole proprietorship **[Your answer is incorrect. An association of two or more persons who carry on a business for profit is not known as a sole proprietorship.]**
- B. Sub-corporation **[Your answer is incorrect. An association of two or more persons who carry on a business for profit is not known as a sub-corporation.]**
- C. Private entrepreneurship **[Your answer is incorrect. An association of two or more persons who carry on a business for profit is not known as a private entrepreneurship.]**
- D. Partnership **[Your answer is correct. An association of two or more persons who carry on a business for profit is known as a partnership.]**

Any type of business can organize as a professional corporation.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Not just any type of business can organize as a professional corporation.]**

From a practical point of view, a partnership has which of the following options available at retirement of a partner?

- I. Dissolve the partnership and pay the retiring partner their share of the partnership assets.
 - II. Purchase the retiring partner's interest.
 - III. Give partnership interest to a family member.
 - IV. Sell to an outsider whom the other partner(s) will accept as a new partner.
- A. I and II only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. I, II and IV only **[Your answer is correct. From a practical point of view, a partner has these two options available at his or her retirement: Sell interest to the remaining partner(s) or sell to an outsider whom the other partner(s) will accept as a new partner.]**
 - C. III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

In the absence of a prior agreement, if a partner or shareholder-employee becomes disabled, the other owners must make which of the following decisions?

- A. How much of the disabled owner's salary to continue. **[Your answer is only partially correct. There is a better response to this question.]**
- B. Whether to continue the disabled owner's salary. **[Your answer is only partially correct. There is a better response to this question.]**
- C. How long to continue the disabled owner's salary. **[Your answer is only partially correct. There is a better response to this question.]**
- D. All of the above **[Your answer is correct. In the absence of a prior agreement, if a partner or shareholder-employee becomes disabled, the other owners must decide how much of the disabled owner's**

salary to continue, whether to continue the disabled owner's salary, and how long to continue the disabled owner's salary.]

When a sole proprietor dies, the business assets are subject to the claims of business creditors only.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[When a sole proprietor dies, the business assets are not subject to the claims of business creditors only.]**

A _____ agreement allows the remaining owners to retain control of the business.

- A. Renewability **[Your answer is incorrect. A renewability agreement does not allow the remaining owners to retain control of the business.]**
- B. Buy/sell **[Your answer is correct. A buy/sell agreement allows the remaining owners to retain control of the business.]**
- C. Settlement **[Your answer is incorrect. A settlement agreement does not allow the remaining owners to retain control of the business.]**
- D. Reorganization **[Your answer is incorrect. A reorganization agreement does not allow the remaining owners to retain control of the business.]**

A Section 303 stock redemption allows the corporation to purchase enough stock from a deceased shareholder's estate to pay for the funeral expenses, administration costs, and state and federal estate and death taxes.

- A. True **[Your answer is correct. A Section 303 stock redemption allows the corporation to purchase enough stock from a deceased shareholder's estate to pay for the funeral expenses, administration costs, and state and federal estate and death taxes.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

A owns 40% and B owns 60% of a partnership valued at \$500,000. They enter into a cross purchase agreement. Which of the following life insurance policies must A purchase on B to fully fund the agreement?

- A. \$500,000 **[Your answer is incorrect. A must not purchase a \$500,000 life insurance policy on B to fully fund the agreement.]**
- B. \$300,000 **[Your answer is correct. A must purchase a \$300,000 life insurance policy on B to fully fund the agreement.]**
- C. \$200,000 **[Your answer is incorrect. A must not purchase a \$200,000 life insurance policy on B to fully fund the agreement.]**

- D. None of the above **[Your answer is incorrect. One of the above options is accurate.]**

In a(n)_____ purchase agreement, the individuals are the owners and beneficiaries of the life insurance policies.

- A. Entity **[Your answer is incorrect. In an entity purchase agreement, the individuals are not the owners and beneficiaries of the life insurance policies.]**
- B. Cross **[Your answer is correct. In a cross purchase agreement, the individuals are the owners and beneficiaries of the life insurance policies].**
- C. Section 303 **[Your answer is incorrect. In a Section 303 purchase agreement, the individuals are not the owners and beneficiaries of the life insurance policies.]**
- D. Return **[Your answer is incorrect. In a return purchase agreement, the individuals are not the owners and beneficiaries of the life insurance policies.]**

If the requirements for a valid buy/sell agreement are met, the IRS will accept the value set by the agreement for _____ tax purposes.

- A. Gift **[Your answer is incorrect. If the requirements for a valid buy/sell agreement are met, the IRS will not accept the value set by the agreement for gift tax purposes.]**
- B. Income **[Your answer is incorrect. If the requirements for a valid buy/sell agreement are met, the IRS will not accept the value set by the agreement for income tax purposes.]**
- C. State **[Your answer is incorrect. If the requirements for a valid buy/sell agreement are met, the IRS will not accept the value set by the agreement for State tax purposes.]**
- D. Estate **[Your answer is correct. If the requirements for a valid buy/sell agreement are met, the IRS will accept the value set by the agreement for estate tax purposes.]**

Which of the following ways of funding a buy/sell agreement is essentially equal to no funding?

- A. Sinking fund **[Your answer is incorrect. Using a sinking fund as a way of funding a buy/sell agreement is not essentially equal to no funding.]**
- B. Insurance proceeds **[Your answer is incorrect. Using insurance proceeds as a way of funding a buy/sell agreement is not essentially equal to no funding.]**

- C. Current earnings [**Your answer is correct. Using current earnings as a way of funding a buy/sell agreement is essentially equal to no funding.**]
- D. Borrowed funds [**Your answer is incorrect. Using borrowed funds as a way of funding a buy/sell agreement is not essentially equal to no funding.**]

2.0 Key Executive Insurance

2.1 Introduction

In the previous lesson, we talked about how businesses are organized and how sole proprietors, partners and stockholders handle the disposition of their businesses. We also talked about how the business can best survive upon retirement, death or disability of one of the owners.

In this lesson, we will focus on the health of a business as it relates to the key employees who are employed by it. These key employees are oftentimes the owners, but may also be other employees who make a significant contribution of their talent to the business.

Lesson Objectives

This lesson will:

- **Introduce the Key Executive:** introduce you to key executives and why they are important to a company.
- **Show What Happens at Loss of Key Executive:** show you what can happen to a company when a key executive dies, retires or leaves employment for another job.
- **Introduce Key Executive Insurance:** introduce you to key executive insurance and its importance to a company.
- **Detail Policy and Valuation:** detail how the key executive policy works and how a value is placed on a key executive.

Let's begin.

2.2 The Business—Success or Failure?

The first, capital investment, is useless without the second, key executives. It is the talent and skill of the management team that forges capital investment and labor into a profitable business enterprise.

Without an able management team, the capital investment is worth little more than its resale value.

Successful businesses today realize that profits are made by people and not by machines.

Since the success or failure of a business rests almost entirely with its key executives, two important business planning needs arise:

- To retain key executives
- To indemnify the business in the event of the death of a key executive

A business can lose a key executive to death just as quickly and unexpectedly as to termination of employment, and the blow can be a devastating one in either case.

The success or failure of a small- or medium-sized business can hinge on the abilities of just a few key executives, usually owners and their key management employees.

Remove one of these key players and business success can quickly turn to business failure, unless the business has taken steps to offset the economic loss that will result from the death of a key executive.

The profits of a business arise principally from which of the following?

- I. Experience and abilities of the management team
 - II. Labor
 - III. Capital investment
 - IV. luck
- A. II and III only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. I and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - C. I and III only **[Your answer is correct. The profits of a business arise principally from experience and abilities of the management team and capital investment.]**
 - D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

2.3 The Key Executive

You might be wondering why an executive is considered KEY to a business. Let's look at a case study to see why certain executives are key to a business' survival.

Case Study

Western Manufacturing Corporation

Western manufactures a specialized line of machinery for the packaging industry. There are 10 executives, four of whom are considered *key*:

Fred Forrest - President

Craig Wood - V.P. Research & Development

Carl Le Grasse - V.P. Manufacturing

Doris Green - V.P. Sales

Fred Forrest, President

Fred has been President of Western for the past five years. Formerly, he was a senior vice president with one of Western's leading competitors.

Prior to Fred joining the company, any profit that was made by Western was simply deposited into a regular savings account in the local bank. The account paid 5% interest on Western's money.

Fred knows a great deal about the packaging business and the companies that are in the business. Because of this knowledge, he has been able to make a number of good investments which have paid a return of 10% and higher on Western's money. This has substantially increased the assets of Western.

He has also been able to double the profits the company has made each year since he started with Western.

Is Fred a key executive? You bet!

Craig Wood, V.P. Research & Development

Craig has been instrumental in developing some very sophisticated equipment. Although Western sells standard packaging equipment, Craig spends most of his time researching and developing customized equipment for two of Western's largest customers, AAA Packaging and Foremost Foods.

Craig has designed and manufactured equipment for both customers that cut their costs of packaging in half.

Craig has also developed some new standard machinery that is the fastest and most cost effective in the industry.

Many companies have tried to win him away from Western, but he is a loyal, long-term employee.

Is Craig key to Western's business? He sure is!

Carl Le Grasse, V.P. Manufacturing

Carl has been an employee of Western for one year and is in charge of the manufacturing end of the business. In this short period of time, he has improved the manufacturing process so much that Western is able to ship machinery to customers one to two months sooner than before.

His sweeping changes have made Western the most responsive manufacturer of packaging in the industry.

Is Carl a key executive? He sure is!

Doris Green, V.P. Sales

Doris is the leading salesperson at Western. Of the 10 people on the sales staff, Doris is directly responsible for one half of the sales.

AAA and Foremost are two of her customers. She predicts her total sales this year will be in excess of \$15,000,000. None of her customers will let anyone else handle their accounts because she always delivers exactly what they want, on time, and at the best price.

Is Doris key to the health of Western Manufacturing? Absolutely!

Based on the case study you just completed, which of the following would be the best indicator for a key person?

- A. The person has a positive influence on the dollars flowing into the company. **[Your answer is correct. Based on the case study you just completed, the best indicator for a key person is the person who has a positive influence on the dollars flowing into the company.]**
- B. The person has been employed by the company for many years. **[Your answer is incorrect. Being employed by the company for many years is not the best indicator for a key person.]**

- C. The person is considered an all-around "nice guy" by the employees. **[Being known as an all-around “nice guy” by employees is not the best indicator for a key person.]**
- D. The person draws a large salary. **[Your answer is incorrect. Drawing the largest salary is not the best indicator for a key person.]**

2.4 Who Replaces the Key Executive?

- If remaining key executives fill in, do their jobs suffer?
- If a new executive is found, how long until he or she is up to speed?
- Did the key executive have special talents that are difficult to replace?
- Will profitability be affected by the loss?
- Will creditors worry that the business may fail?

If Western were to lose any of their four key people, the corporation would be in trouble.

- Who would design the new products?
- Who would run the company?
- Who would manufacture the products?
- Who would bring in the \$15,000,000 of sales?

A key executive generally doesn't contribute to profitability.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. A key employee generally contributes to profitability.]**

2.5 Death of a Key Executive

Let's take another look at Western Manufacturing.

Fred Forrest died very suddenly of a heart attack last month. Western had not prepared for this eventuality and is now having problems.

Fred had been instrumental in arranging for a \$5,000,000 credit line with the local bank. Now that he is gone, the bank has notified Western that the credit line will be cut back considerably.

Because of this cut, Western may have to stop development of a major new product.

A number of employees in the development department are starting to quietly look around for new positions.

Western had to pay an executive search firm \$50,000 to find them a new president. Phil Fox has started on the job and is just beginning to learn what Western is all about.

Until Phil can get up to speed, one of Western's outside accountants has taken over the job of managing the investments. Phil has been so busy that he hasn't even looked at them yet.

As a result of that, Western has lost money because some of the securities should have been sold last week.

Western's big customers have decided to wait before placing new orders, just to make sure that Western is still capable of doing business.

Without those big orders, Western is going to suffer a loss of earnings for the first time in five years.

Fred's family is also having problems that are affecting Western. Since most of Fred's assets consisted of stock in Western Manufacturing, the family has no income.

Western has had to continue Fred's salary so that the family will be able to live. With decreasing sales, falling profits and a new president's salary to pay, they won't be able to continue this for too long.

We could go on and on with this, but you should see the picture of turmoil occurring within Western because of Fred's untimely death.

At the death of a key executive of a small corporation, which of the following could happen to the business?

- A. Employees could be afraid for their jobs. **[Your answer is only partially correct. There is a better response to this question.]**

- B. Interim managers could be overloaded with work. **[Your answer is only partially correct. There is a better response to this question.]**
- C. The bank could cancel the company credit line. **[Your answer is only partially correct. There is a better response to this question.]**
- D. All of the above **[Your answer is correct. At the death of a key executive of a small corporation employees could be afraid for their jobs, interim managers could be overloaded with work, and the bank could cancel the company credit line.]**

2.6 Key Executive Insurance

A solution to this dilemma is for a business to purchase a life insurance policy on the life of each key executive, the proceeds of which would be payable to the business in the event of the key executive's death.

Key executive insurance guarantees that the business will receive tax-free dollars just when they're needed most – at the death of a key executive.

A well-managed company wouldn't think of not insuring its property against loss, and yet life insurance on key executives may be a far more vital need. Consider that:

- Statistics tell us that the odds of the death of a key executive are far greater than the odds of a fire loss.
- Death is always a complete loss while property may be a partial loss.
- Replaced property is likely to be newer and more efficient; a key executive's replacement may not.

This cash can be used to:

- Help offset the loss of profits resulting from the key executive's death.
- Recruit and train a replacement.
- Assure creditors that the business remains a safe credit risk.
- Assure customers of the soundness of the business.
- Assure employees that their jobs will not be lost through a business failure.
- Pay a tax-deductible death benefit to the executive's family.

In addition, the mere existence of life insurance on the key executive can provide numerous benefits to the business itself, even if the key executive lives to retirement.

Creditors will be impressed by the fiscal responsibility demonstrated by a business that insures its most important assets—its key executives.

Key executive life insurance can be used as collateral to secure a loan since it can guarantee repayment in the event of the borrower's death.

If a permanent form of cash value insurance is purchased to cover the key employee, the policy's cash value can be borrowed in the event of a business opportunity or emergency.

Finally, if the key executive does live until retirement, the key executive insurance policy can be an excellent way of providing a retirement benefit.

The business might wish to pay a retirement benefit to the executive, keeping the insurance policy in force and collecting the death benefit at the executive's later death; or the business could cash surrender the policy to provide a retirement benefit to the executive.

One of the benefits of a key executive insurance policy is that the business can _____ in the event of an emergency or business opportunity.

- A. Borrow the policy's cash value **[Your answer is correct. One of the benefits of a key executive insurance policy is that the business can borrow the policy's cash value in the event of an emergency or business opportunity.]**
- B. Borrow the policy's face amount **[Your answer is incorrect. One of the benefits of a key executive insurance policy is not that the business can borrow the policy's face amount in the event of an emergency or business opportunity.]**
- C. Change the name of the insured **[Your answer is incorrect. One of the benefits of a key executive insurance policy is not that the business can change the name of the insured in the event of an emergency or business opportunity.]**
- D. Change the beneficiary **[Your answer is incorrect. One of the benefits of a key executive insurance policy is not that the business can change the beneficiary in the event of an emergency or business opportunity.]**

2.7 The Key Executive Retires

Let's assume for a minute that Western Manufacturing had purchased key executive insurance policies on the lives of all four key executives and none of them have died.

Since Craig is the oldest, let's further assume he is going to retire this month. Western has decided to pay Craig a retirement benefit of \$20,000 per year for 10 years.

Since Craig's \$500,000 life insurance policy has \$200,000 of cash value, they have decided to cash in the policy and pay the \$20,000 each year from the cash surrender value. If Western had enough cash to pay the retirement benefit from current income, they could keep the policy in force and collect the \$500,000 proceeds at Craig's eventual death.

A financially more-attractive approach might be to have the company maintain the policy in force and take tax-free withdrawals up to the policy's cost basis. (This strategy assumes, of course, that the policy is one that permits withdrawals.) When withdrawals are taken up to the amount of basis, the company can then begin taking loans from the cash value. The net result is that all of the cash value funds accessed by the company would be received without tax.

When Craig does die, Western would receive any remaining death benefits tax-free and could, thereby, recover its cost for both the life insurance premiums and the retirement benefits paid to Craig.

As a result, a single key executive insurance policy can serve to indemnify the business in the event of the executive's death prior to retirement, or provide a retirement benefit if the executive lives.

If the key executive retires, the business must cash in the policy.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. If the key executive retires, the business does not have to cash in the policy.]**

2.8 Key Executive Terminates

What happens when a key executive terminates employment?

Let's suppose that Carl Le Grasse decided voluntarily to leave Western Manufacturing because he wants to go on to bigger and better things.

Western has purchased a \$500,000 life insurance policy on Carl's life. When he terminates employment, Western has several choices.

The life insurance policy can be kept in force until Carl's subsequent death when Western will collect the \$500,000 death proceeds.

Western can cash in the policy for its cash surrender value and use the money to offset the cost of recruiting and training a new executive to replace Carl.

Western can sell the policy to Carl for the amount of the accumulated cash value. Western chooses to cash surrender the policy and uses the money to pay an executive search fee. They will keep the remainder of the money in reserve in case there are any unpleasant financial consequences to Carl's termination of employment.

When a key executive terminates employment, which of the following is an option for the company with regard to key executive life insurance?

- I. Keep the policy in force
 - II. Surrender the policy for its cash value
 - III. Sell the policy to the employee
 - IV. Collect the death proceeds immediately
- A. I and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. I, II and III only **[Your answer is correct. When a key executive terminates employment, the options are to keep the policy in force, surrender the policy for its cash value, or sell the policy to the employee.]**
 - C. II and III only **[Your answer is only partially correct. There is a better response to this question.]**
 - D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

2.9 How the Policy Works

Key executive insurance is one of the simplest business planning tools available.

The business is the owner, premium payer and beneficiary of an insurance policy on the life of each key executive. The premiums are not tax deductible and the business must have an insurable interest in the life of the key executive at the time the policy is purchased.

This means the business will suffer a tangible loss if that executive should die while employed by the business, a loss that can be offset by the receipt of the tax-free death benefit.

As long as the life insurance policy is issued in this standard manner—the business as owner, premium payer and beneficiary—there are no adverse tax consequences to the employee.

That's all well and good, but how does the business go about putting a value on the key executive in the first place?

Under the standard key executive life insurance policy, the business is the owner, the premium payer and the _____.

- A. Insurer [Your answer is incorrect. Under the standard key executive life insurance policy, the business is not the owner, the premium payer and insurer.]
- B. Lender [Your answer is incorrect. Under the standard key executive life insurance policy, the business is not the owner, the premium payer and lender.]
- C. Beneficiary [Your answer is correct. Under the standard key executive life insurance policy, the business is the owner, the premium payer and the beneficiary.]
- D. Underwriter [Your answer is incorrect. Under the standard key executive life insurance policy, the business is not the owner, the premium payer and underwriter.]

2.10 The Value of a Key Executive

If a piece of property is being insured, it is a fairly simple matter to determine its value for replacement purposes. The same cannot be said for determining the monetary value of a key executive to a business.

As a result, several different methods are used to value key executives: multiple of current salary, contribution to profits and business life value. Each of these methods is a valid method to use.

Key Executive Valuation Methods

- **The Multiple of Current Salary Method** simply multiplies the current salary by anything from 5 to 15 times.
- **The Contribution to Profits Method** uses a formula to determine what portion of the business profits is attributable to that executive.
- **The Business Life Value Method** bases the value on the potential loss of company earnings if the executive were to die while employed.

Multiple of Current Salary Method

This method insures the key executive for a multiple of his or her salary, usually from 5 to 15 times annual salary.

Example:

Executive B is currently earning \$75,000 per year and the corporation decides that she is worth five times her salary to the business. An insurance policy is purchased for \$375,000.

A variation of the multiple of salary method uses a multiple of the key executive's "excess" salary, with "excess" being defined as the difference between the key executive's salary and what would be paid to a replacement that is performing the routine duties of the key executive. This excess is multiplied by the number of years estimated to recruit and fully train a replacement.

Example:

Executive B is currently earning \$75,000 per year, but it is estimated that a replacement to perform her routine duties could be paid \$50,000 and that it would take four years to recruit and fully train a replacement for her. As a result, a key executive life insurance policy of \$100,000 is purchased ($\$75,000 - \$50,000 \times 4$ years).

Contribution to Profits Method

Each key executive's contribution to net profits is estimated and then multiplied by the number of years it will take to recruit and train a replacement. The most scientific of the methods, this approach subtracts a return on book value from actual average profits. The difference is capitalized by a multiple, such as 5, resulting in a figure attributed directly to the efforts of the key executives.

Example:

Z Corporation has a book value of \$750,000 with an average after-tax profit of \$90,000 and two key executives. Executive C contributes 60% and Executive D contributes 40%.

Average After-Tax Profits	\$ 90,000
Minus Book Value at 5% ($\$750,000 \times .05$)	<u>- 37,500</u>
Equals Key Executive Contribution	\$ 52,500
Capitalized by 5	<u>× 5</u>

Equals	\$262,500
Executive C attributed value ($\$262,500 \times 60\%$)	\$157,500
Executive D attributed value ($\$262,500 \times 40\%$)	\$105,000

Business Life Value Method

This method is a variation of the method sometimes used to place a financial value on a person. The business estimates its potential annual loss in earnings if the key executive were to die today, multiplies that amount by the number of working years the executive has left and then discounts the total by a reasonable interest rate to arrive at the present value of that future earnings loss.

Example:

The M Corporation estimates its loss of earnings if Executive E were to die today at \$20,000 a year. At age 50, Executive E has 15 working years left. The total of \$300,000 ($\$20,000 \times 15$ years) is then discounted, in this case by 10%, giving a present value of Executive E's business life value of \$71,820.

Summary

Any estimate of a key executive's worth is, to a certain extent, an arbitrary assumption by the business.

In the final analysis, the most important thing to remember is that key executives contribute toward a company's profits and their deaths will cause a loss.

A reasonable amount of insurance, determined by an honest appraisal of the key executive's worth, places the business in the position of indemnifying itself for that loss.

The Multiple of Current _____ Method simply multiplies by a factor from 5 to 15 times.

- A. Profits **[Your answer is incorrect. The Multiple of Current Profits Method does not simply multiply by a factor from 5 to 15 times.]**
- B. Assets **[Your answer is incorrect. The Multiple of Current Assets Method does not simply multiply by a factor from 5 to 15 times.]**
- C. Salary **[Your answer is correct. The Multiple of Current Salary Method simply multiplies by a factor from 5 to 15 times.]**

- D. None of the above **[Your answer is incorrect. The correct answer is provided in the options above.]**

2.11 IRC Section 101(j)

Section 101(j) of the Internal Revenue Code (IRC) specifies the rules under which employer-owned life insurance policies, including key person insurance, could retain the advantage of providing tax-free benefits when the employee dies.

The details of this Code Section and the regulations under it are beyond the scope of this course, but it's important to know at least the following:

- This code section outlines four “safe harbors” for purchasing life insurance on an employee, that is, situations in which such a purchase will provide tax-free death benefits;
- A notice must be provided to employees *before* insurance coverage is purchased on them, informing them of the employer's intent and requesting their consent to the purchase; and
- Annual employer reporting to the IRS of specified information on the life insurance purchased on employees is required.

Not adhering to these requirements can create unnecessary and unwanted problems when a key employee dies.

LESSON PRACTICE TEST TWO

If a surviving executive has to take over the duties of a deceased executive, chances are his or her own job would suffer.

- A. True **[Your answer is correct. If a surviving executive has to take over the duties of a deceased executive, chances are his or her own job would suffer.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

The cash received at a key executive's death from a key executive life insurance policy can be used to do which of the following?

- I. Help offset the loss of profits
- II. Recruit and train a replacement
- III. Assure creditors, customers and employees of the soundness of the business
- IV. Pay a tax-deductible death benefit to the executive's family

- A. I and II only **[Your answer is only partially correct. There is a better response to this question.]**
- B. I, II and IV only **[Your answer is only partially correct. There is a better response to this question.]**
- C. I, II and III only **[Your answer is only partially correct. There is a better response to this question.]**
- D. I, II, III and IV **[Your answer is correct. The cash received at a key executive's death from a key executive life insurance policy can be used to help offset the loss of profits, recruit and train a replacement, assure creditors, customers and employees of the soundness of the business, and pay a tax-deductible death benefit to the executive's family].**

If a business has a key executive insurance policy on the life of a retiring executive, it must pay out a retirement benefit from the cash value of the policy.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. If a business has a key executive insurance policy on the life of a retiring executive, it is not required to pay out a retirement benefit from the cash value of the policy.]**

Under the standard key executive life insurance arrangement, the business is the _____, premium payer and beneficiary of the policy.

- A. Lender **[Your answer is incorrect. Under the standard key executive life insurance arrangement, the business is not the lender, premium payer and beneficiary of the policy.]**
- B. Underwriter **[Your answer is incorrect. Under the standard key executive life insurance arrangement, the business is not the underwriter, premium payer and beneficiary of the policy.]**
- C. Seller **[Your answer is incorrect. Under the standard key executive life insurance arrangement, the business is not the seller, premium payer and beneficiary of the policy.]**
- D. Owner **[Your answer is correct. Under the standard key executive life insurance arrangement, the business is the owner, premium payer and beneficiary of the policy.]**

Which of the following best describes the taxation of a standard key executive life insurance plan?

- A. The premium is tax deductible and the death benefit is tax-free. **[Your answer is incorrect. This does not best describe the taxation of a standard key executive life insurance plan.]**
- B. The premiums are not tax deductible, but the death benefits are received tax-free. **[Your answer is correct. This statement best describes the taxation of a standard key executive life insurance plan.]**
- C. While the key executive is taxed on the premiums, the business receives the death benefit tax-free. **[Your answer is incorrect. This does not best describe the taxation of a standard key executive life insurance plan.]**
- D. Both the premiums and death benefit are taxed to the executive. **[Your answer is incorrect. This does not best describe the taxation of a standard key executive life insurance plan.]**

Which is an acceptable method to use in valuing a key executive?

- A. Multiple of Current Salary **[Your answer is only partially correct. There is a better response to this question.]**
- B. Contribution to Profits **[Your answer is only partially correct. There is a better response to this question.]**
- C. Business Life Value **[Your answer is only partially correct. There is a better response to this question.]**
- D. All of the above **[Your answer is correct. Multiple of Current Salary, Contribution to Profits, and Business Life Value are all acceptable methods to use in valuing a key executive.]**

The _____ Method insures the key executive based on the loss of company earnings if the executive were to die while employed.

- A. Multiple of Current Salary **[Your answer is incorrect. The Multiple of Current Salary Method does not insure the key executive based on the loss of company earnings if the executive were to die while employed.]**
- B. Business Life Value **[Your answer is correct. The Business Life Value Method insures the key executive based on the loss of company earnings if the executive were to die while employed.]**
- C. Contribution to Profits **[Your answer is incorrect. The Contribution to Profits Method does not insure the key executive based on the loss of company earnings if the executive were to die while employed.]**
- D. Appraisal Value **[Your answer is incorrect. The Appraisal Value Method does not insure the key executive based on the loss of company earnings if the executive were to die while employed.]**

3.0 Split Dollar

3.1 Introduction

The key to the success of any business lies in the experience and ability of its management team. People make profits, not machines.

The loss to a business, however, can be sudden and great when a key executive terminates employment. It can be even greater if that executive goes to work for a competitor.

This lesson includes:

- **Introduction to Selective Benefit Plans:** introducing you to the concept of selective benefit plans in general.
- **Split Dollar Concept:** describing split dollar, a specific type of selective benefit plan.
- **Split Dollar Taxation:** explaining how split dollar plans are taxed.
- **Split Dollar Plans:** exploring the various types of split dollar plans and their uses.

Let's begin.

3.2 Introduction to Selective Benefit Plans

There are two basic forms of employee benefit, or fringe benefit, plans designed to provide benefits to the employees of a business. The two classifications are generally based on how these plans are taxed.

1. **Qualified or formal plans** are those for which the employer can deduct the contributions it makes to the plan. These payments are generally excluded from the employees' income.
2. **Nonqualified plans** are those in which the employer's contributions are either taxable to the employees or nondeductible by the employer.

In return for the favorable tax treatment afforded **qualified plans**, the plan must basically include all full-time employees who have worked for the employer for a certain amount of time.

In other words, in order to receive tax benefits, the plan cannot discriminate in favor of certain key employees.

Two examples of qualified plans are pension plans and group term life insurance.

The benefits provided by these qualified plans are the basic benefits that most employees have come to expect. As a result, they do not provide a key employee with any extra incentive to remain with an employer.

An employer without these basic benefits would have difficulty hiring and retaining employees in general, much less key executives. On the other hand, a key executive could expect basically these same basic benefits from the employer or from a competitor.

What, then, is the answer for a business that needs to attract and retain key executives?

The answer for many employers is to offer a special package of benefits to key executives only. These **selective benefit plans** are **nonqualified**, so the employer may not be able to deduct its contributions to the plan. Tax consequences to the employee vary, and the employer may discriminate in favor of highly compensated employees.

Since different selective benefits can be offered to different key executives, these plans can be tailored to the unique needs of a business to attract and retain key executives. Key executives, in turn, are less likely to be able to obtain these same benefits from another employer.

One of the most popular selective benefit plans is split dollar. **Split dollar** uses business dollars to help key executives purchase needed personal life insurance.

A qualified plan can be designed so that it discriminates in favor of selected key executives.

- A. True [Your answer is incorrect. This is not a true statement.]
- B. False [Your answer is correct. A qualified plan cannot be designed so that it discriminates in favor of selected key executives.]

3.3 The Split Dollar Concept

Split dollar is a method of **sharing** the costs and benefits of a **permanent** life insurance policy between two or more persons or entities. The permanent policy may be **any** traditional plan of insurance, such as whole life insurance, or may be a flexible premium policy, such as universal life or variable universal life.

The purpose of split dollar is to bring together a party that has a need for life insurance with a party who has the funds and desire to pay the premiums. The parties involved can be individuals, such as a parent and child or, most frequently, an employer and employee. One of the parties will always be an individual insured.

The parties to a split dollar arrangement must share an insurable interest, as among relatives, business partners, and employers and key employees.

Since a major use of split dollar is to provide life insurance for key employees and owner-employees of a business, we'll refer to the two parties involved as **employer (ER)** and **employee (EE)**.

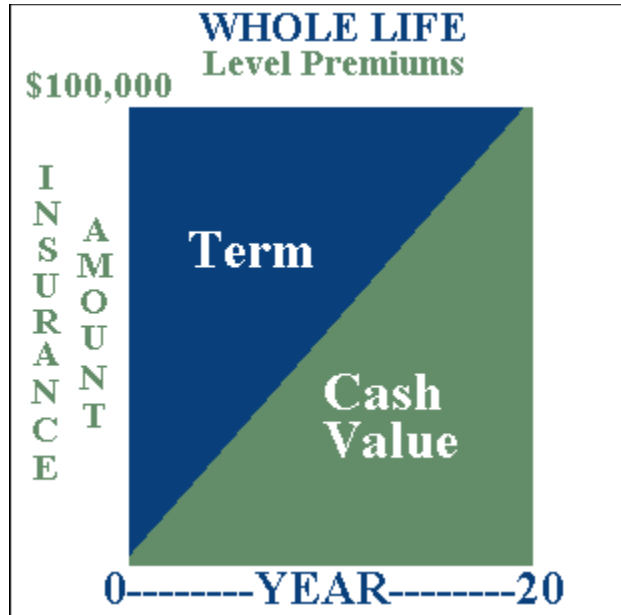
Insurable Interest

- A valid stake in the life of an insured.
- Can be based on love and affection or a business interest.

In a traditional split dollar arrangement, participants share a permanent life insurance policy, which is split into two separate elements:

- The **cash value**, which is owned by the **employer**
- The **term** or risk element, which is owned by the insured **employee**

As cash value—the employer's death benefit—increases, the risk element—the employee's death benefit—decreases. This problem is addressed in different ways, depending on the type of permanent policy used.



Let's suppose that Northern Manufacturing Co. has a key executive it wants to reward and retain for the business.

This key executive has a growing family and a need for a large amount of personal life insurance, more life insurance than the key executive can afford to purchase.

Split dollar may well be the answer. The employer has the funds to pay premiums and the desire to reward and retain the key executive. The key executive has the need for life insurance.

Under a traditional split dollar arrangement, the employer pays the portion of the premium equal to the annual increase in the policy's total cash value, and the employee pays any balance of the premium. At the employee's death, the employer recovers an amount equal to its total premiums paid, or the total cash value, and the employee's beneficiary receives the balance of the death proceeds—the term element.

As the years go by, the total premiums paid by the employer increase. Consequently, the death benefit payable to the employer **increases** while the key executive death benefit **decreases**.

Since any permanent life insurance contract can be used in a split dollar arrangement, there are different approaches to overcoming this problem and keeping the employee's death benefit essentially level.

In order to maintain a level employee death benefit:

Nonparticipating Contracts - For an extra premium, a one-year term (OYT) rider equal to the policy's increasing cash value can maintain a level employee death benefit.

Participating Contracts - Use dividends to maintain a level employee death benefit. Preferred dividend options for this purpose are paid-up additions and OYT insurance equal to the cash value.

Flexible Premium Contracts - Use death benefit option to maintain a level employee death benefit. Under Option B or 2 in a universal life policy, the death benefit equals the increasing cash value plus the initial specified amount. Certain flexible premium contracts offer an Option C or 3, under which the death benefit equals the initial specified amount plus the cumulative premiums paid.

In a split dollar arrangement, a permanent life insurance contract is split between an employer and an insured employee.

- A. True **[Your answer is correct. In a split dollar arrangement, a permanent life insurance contract is split between an employer and an insured employee.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

3.4 Split Dollar Ownership

There are three different methods of sharing the ownership and benefits of a life insurance policy under a split dollar contract:

- **Endorsement method**
- **Collateral assignment method**
- **Joint ownership method**

Let's briefly review each.

Endorsement Method:

- Employer is the owner, applicant and premium payer.
- Employer generally owns cash value.
- Employer's death benefit equals the greater of total premiums paid or the cash value.
- Employee has the right to name a beneficiary for the risk portion.

- Employer pays premiums directly to the insurance company.

Collateral Assignment Method:

- Employee is owner and applicant.
- Employee assigns policy to employer as security for employer's premium advances.
- Employer's death benefit equals total employer premiums paid; employee's beneficiary receives the balance.
- Employer advances some or all of premium to employee who pays the insurance company.

Joint Ownership Method:

- Employer and employee apply for policy and own specific policy rights and benefits.
- Employer generally owns cash value to the extent of its premiums.
- Employee owns risk portion and balance of cash value.
- Accomplished by instructions on application usually accompanied by a special assignment form creating split ownership.
- Premiums are paid directly to the insurance company by both parties.

The method of split dollar ownership selected depends primarily on:

Tax Consequences - The income tax treatment and estate tax consequences may depend upon the policy's ownership arrangement that is selected.

Security and Control - The employer who wants the most security for its premiums paid or to exercise the most control over the life insurance policy will select the endorsement method.

In an endorsement split dollar plan:

- A. The employer is owner of the policy. **[Your answer is correct. In an endorsement split dollar plan, the employer is owner of the policy.]**
- B. The employee is owner of the policy. **[Your answer is incorrect. In an endorsement split dollar plan, the employee is not the owner of the policy.]**
- C. The employer and employee both own the policy. **[Your answer is incorrect. In an endorsement split dollar plan, the employer and employee do not both own the policy.]**
- D. The insurance company owns the policy. **[Your answer is incorrect. In an endorsement split dollar plan, the insurance company does not own the policy.]**

3.5 Split Dollar Taxation

The **income tax** consequences of a split dollar arrangement are as follows:

- **Premiums** paid by the employer for life insurance under a split dollar plan are **not** tax deductible to the employer. Any premiums paid by the employee are made with after-tax dollars.
- In the case of traditional split dollar insurance, the employee is treated as receiving an “**economic benefit**,” i.e., life insurance protection, the value of which is subject to income tax.
- **Death benefits** are received by the employer and the employee's beneficiary on an income tax-free basis.

Over half a century ago, the IRS laid down the basic ground rules for taxing split dollar life insurance. Then, in a 1964 revenue ruling, the IRS concluded that all economic benefits conferred on an employee under a split dollar insurance policy are taxable to the employee. With the traditional split dollar policies, the economic benefit equals only the value of the current pure insurance protection the employee receives, since the cash value buildup accrues to the employer. This amount, less any portion of the premium the employee pays, is taxable to him or her.

The IRS position has been that an employee enjoys a current life insurance protection benefit under a split dollar plan that, in addition to cash benefits like salary and bonuses, can and should be valued. This amount should be included in gross income for income tax purposes each year. The IRS began tinkering with the long-standing split dollar rules. In a series of notices and rulings, the IRS changed the rules for valuing the economic benefit an employee receives in a split dollar arrangement. The IRS guidance culminated in 2003 with the issuance of comprehensive regulations governing the taxation of split dollar life insurance.

The regulations have no significant effect on the way traditional split dollar insurance is taxed; the regulations retain the long-standing basic valuation methods for the economic benefit the employee receives. However, the same cannot be said about three variations on split dollar insurance: (1) reverse split dollar insurance (2) equity split dollar insurance, and (3) private split dollar insurance. These three variations have been adversely affected by the IRS.

The regulations apply only to split dollar life insurance arrangements entered into after September 17, 2003 or to split dollar life insurance arrangements entered into on or before September 17, 2003 that are materially modified after September 17, 2003.

The earlier notices and rulings continue to apply to preexisting arrangements that have not been materially modified. This earlier guidance provides certain transition and “grandfather” rules that are beyond the scope of this lesson.

For the first time, the regulations defined precisely what split dollar insurance is for tax purposes. The regulations state that a life insurance arrangement (other than a tax-free, employer-provided group term insurance plan) will be treated as split dollar insurance if:

- The arrangement is between an owner of the life insurance contract and a non-owner;
- Either party to the arrangement pays all or part of the premiums;
- One of the parties paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums; and
- The recovery of the premiums is made from, or secured by, the proceeds of the policy.

According to the IRS, this definition is intended to apply broadly. For example, it will cover an arrangement under which the non-owner of a contract provides funds directly to the owner of the contract and the owner uses the funds to pay premiums as long as the non-owner is entitled to recover all or a portion of the funds from the death benefits. In addition, the amount to be recovered by the party paying the premiums need not be determined by reference to the amount of those premiums.

A special rule applies in the case of split dollar arrangements between employers and employees and corporations and shareholders. Under this special rule, a split dollar life insurance arrangement also includes any arrangement between an owner and a non-owner of a life insurance contract if:

- The employer or corporation pays, directly or indirectly, all or any portion of the premiums, and
- The beneficiary of the death benefit is either designated by the employee or shareholder or is a person whom the employee or shareholder would reasonably be expected to name as beneficiary.

With traditional split dollar life insurance, the economic benefit the employee receives equals the annual increases in the policy cash value. (Refer to Sec. 3.5, p. 48)

A. True **[Your answer is incorrect. This is not a true statement.]**

- B. False [Your answer is correct. With traditional split dollar life insurance, the economic benefit the employee receives does not equal the annual increases in the policy cash value.]

3.6 The Economic Benefit

As we mentioned earlier, the tax treatment of traditional split dollar insurance arrangements has its roots in a 1964 revenue ruling [Rev. Rule 64-328]. In that ruling, the IRS stated that the taxable economic benefit that an employee receives equals the value of the death benefit coverage provided by the employer, based on the cost of OYT insurance. The ruling specified that the value of the death benefit coverage could be determined using the IRS's P.S. 58 table based on the attained age of the employee.

The P.S. 58 rates are shown below:

**P.S. 58 Rates per \$1,000
of OYT Insurance**

Age	Premium	Age	Premium
15	\$ 1.27	49	\$ 8.53
16	1.38	50	9.22
17	1.48	51	9.97
18	1.52	52	10.79
19	1.56	53	11.69
20	1.61	54	12.67
21	1.67	55	13.74
22	1.73	56	14.91
23	1.79	57	16.18
24	1.86	58	17.56
25	1.93	59	19.08
26	2.02	60	20.73
27	2.11	61	22.53
28	2.20	62	24.50
29	2.31	63	26.63
30	2.43	64	28.98

31	2.57	65	31.51
32	2.70	66	34.28
33	2.86	67	37.31
34	3.02	68	40.59
35	3.21	69	44.17
36	3.41	70	48.06
37	3.63	71	52.29
38	3.87	72	56.89
39	4.14	73	61.89
40	4.42	74	67.33
41	4.73	75	73.23
42	5.07	76	79.63
43	5.44	77	86.57
44	5.85	78	94.09
45	6.30	79	102.23
46	6.78	80	111.04
47	7.32	81	120.57
48	7.89		

The IRS subsequently ruled that if the life insurance company's published one-year rates for standard risks were lower than the P.S. 58 rates, the insurer's rates could be used to value the death benefit coverage provided to the employee [Rev. Rul. 66-110].

In either case, once the value of the death benefit coverage for the employee is calculated, the employee-paid portion of the annual premium is subtracted to arrive at the amount taxable to the employee.

In 2001, the IRS announced a change in the valuation rules for split dollar arrangements. The IRS concluded that the P.S. 58 rates, which are based on mortality tables originally published in 1946, no longer reflected the fair market value of the current life insurance protection. Since the rates were found to be too high, use of those rates to value the cost of current life insurance protection resulted in excess tax to the employee. To remedy this problem, the IRS introduced a new table—Table 2001—with materially lower rates than the P.S. 58 table. (Although, rates for term insurance continue to change, Table 2001 remains the current table for this purpose. Remember that the change from P.S. 58 to Table 2001 took 43 years.)

The Table 2001 rates are shown below:

Table 2001 Interim Tables of One-Year Term Premiums for \$1,000 of Life Insurance Protection

Age	Premium	Age	Premium	Age	Premium	Age	Premium
0	\$.70	25	\$.71	50	\$ 2.30	75	\$ 33.05
1	.41	26	.73	51	2.52	76	36.33
2	.27	27	.76	52	2.81	77	40.17
3	.19	28	.80	53	3.20	78	44.33
4	.13	29	.83	54	3.65	79	49.23
5	.13	30	.87	55	4.15	80	54.56
6	.14	31	.90	56	4.68	81	60.51
7	.15	32	.93	57	5.20	82	66.74
8	.16	33	.96	58	5.66	83	73.07
9	.16	34	.98	59	6.06	84	80.35
10	.16	35	.99	60	6.51	85	88.76
11	.19	36	1.01	61	7.11	86	99.16
12	.24	37	1.04	62	7.96	87	110.40
13	.28	38	1.06	63	9.08	88	121.85
14	.33	39	1.07	64	10.41	89	133.40
15	.38	40	1.10	65	11.90	90	144.30
16	.52	41	1.13	66	13.51	91	155.80
17	.57	42	1.20	67	15.20	92	168.75
18	.59	43	1.29	68	16.92	93	186.44
19	.61	44	1.40	69	18.70	94	206.70
20	.62	45	1.53	70	20.62	95	228.35
21	.62	46	1.67	71	22.72	96	250.01
22	.64	47	1.83	72	25.07	97	265.09
23	.66	48	1.98	73	27.57	98	270.11
24	.68	49	2.13	74	30.18	99	281.05

In 2001, the IRS replaced the P.S. 58 rates with the Table 2001 rates because:

- I. The P.S. 58 rates no longer reflect the cost of current life insurance protection.
- II. The P.S. 58 rates produced an excess tax on employees.
- III. The P.S. 58 rates were too low.

- A. I and II only **[Your answer is correct. In 2001, the IRS replaced the P.S. 58 rates with the Table 2001 rate because the P.S. 58 rates no longer reflect the cost of current life insurance protection, and the P.S. 58 rates produced an excess tax on employees.]**
- B. II and III only **[Your answer is only partially correct. There is a better response to this question.]**
- C. I and III only **[Your answer is only partially correct. There is a better response to this question.]**
- D. I, II and III **[Your answer is only partially correct. There is a better response to this question.]**

Under the final IRS regulations, employees with traditional split dollar arrangements continue to be taxed on the economic benefit they receive. As before, the taxable economic benefit to the employee equals the value of the current life insurance protection provided by the employer (death benefit less cash value) in excess of the employee's premium payments.

The regulations provide that the cost of current life insurance protection equals the amount of the current life insurance protection multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin. The published guidance uses Table 2001. Subject to an anti-abuse rule, current life insurance protection is determined on the last day of the non-owner's taxable year unless the parties agree to use the policy anniversary date

In the alternative, the regulations continue to permit the economic benefit to be determined using the insurer's published rates. However, the regulations impose the following conditions:

- The insurer generally makes the availability of such rates known to persons who apply for term insurance; and
- The insurer regularly sells term insurance at those rates to individuals who apply for coverage through normal distribution channels.

Now, let's turn our attention to the calculation of the amount of the taxable economic benefit in a traditional split dollar insurance policy.

We will begin with valuing the term insurance benefit.

First Element—Term Insurance Cost

Age	Table 2001 Rates	Insurance Company Hypothetical ART Rate
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35	\$.99	\$.61
40	1.10	.97
45	1.53	1.14
50	2.30	1.82
55	4.15	2.46
60	6.51	5.01

First Element—Term Insurance Cost

Term Insurance Cost Calculation

Step I: To the original face amount of the policy, add the face amount of any paid-up additions (PUA).

Original face + face of PUA = total face amount
\$100,000 + \$15,500 = \$115,500

Step II: From Step I, deduct the total cash value to determine employee's term portion.

Step I total - total CV = employee's term amount
\$115,500 - \$12,872 = \$102,628

Step III: Select the lower of Table 2001 rates or the issuing company's annual renewable term (ART) rates for insured's current age.

Table 2001 rate = \$1.53 per \$1,000
ART rate = \$1.14 per \$1,000

Step IV: Multiply the employee's term amount per thousand (Step II) by the Table 2001 or ART rate (Step III).

Employee's term amount ÷ 1,000 × ART rate =Term

Cost
 $\$102,628 \div 1,000 = \$102.628 \times 1.14 = \$117$

We now have the first element—term insurance cost.

1. Table 2001 cost \$117				
PLUS	LESS	3. Employee premiums	EQUALS	The Economic Benefit
2. Dividends paid in cash or used to buy OYT				

Now let's review the second element—dividends.

Second Element—Dividends

1. Table 2001 cost \$117
PLUS
2. Dividends paid in cash or used to buy OYT \$0

The IRS has ruled that dividends **paid in cash** to the employee or used to purchase **OYT coverage** under a split dollar plan owned by the employer are taxable as ordinary income as part of the economic benefit formula.

This element does not apply to non-par life policies, which do not pay dividends. With respect to universal life policies, no rulings or cases have addressed this issue. Thus, to be conservative, the same rules that apply to traditional life policies should apply.

Third Element—Employee Premiums

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LESS	3. Employee premiums

Subtract any annual premium paid by the employee.

In the third and final element, any annual premium paid by the **employee** is deducted. The first two elements represent the taxable value of the economic benefits the employee is receiving. If, however, the employee is contributing to the purchase of the benefits by paying a portion of the premium, the employee's premium is deducted from the taxable value.

The Benefit

1. Table 2001 cost \$117				
PLUS	LESS	3. Employee premiums \$58	EQUALS	The Economic Benefit \$59
2. Dividends paid in cash or used to buy OYT \$0				

The economic benefit amount is reported on the employee's annual income report Form W-2. The employee will pay federal, state and local income taxes on this amount. Let's assume that the employee in our example is in a 25% tax bracket, resulting in a total **after-tax** cost to the employee of:

\$59.00	Taxable Economic benefit
× .25	Tax bracket
\$ 14.25	Income tax

<u>+ 58.00</u>	Employee premium
\$ 72.25	Total after-tax cost

The amount is significantly less than if the employee had purchased the same insurance personally.

With a traditional split-dollar insurance policy, the value of the economic benefit received by an employee is subject to ordinary income tax.

- A. True **[Your answer is correct. The economic benefit amount is reported on the employee's annual income report Form W-2. The employee will pay federal, state and local income taxes on this amount.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

3.7 Split Dollar Tax Considerations

In the design of a split dollar plan, the income tax brackets of the employer and employee are an important consideration. Since the objective is generally to provide insurance for the employee at the lowest possible cost to both parties, the split dollar plan selected should spend dollars from the lowest tax bracket and claim tax deductions for dollars from the highest tax bracket.

Let's look at an example of how taxes impact the employer and employee, who are in 34% and 25% tax brackets respectively.

- \$1,000 of salary paid to an employee will cost the employer \$660, since salary is a deductible expense. The employee pays \$250 in income taxes.
- \$1,000 of corporate earnings will cost the employer \$340 in corporate income taxes.
- \$1,000 of nondeductible insurance premium paid by an employer costs \$1,515, since the employer must earn \$1,515 to pay \$1,000.
- \$1,000 in economic benefit costs the employee \$250 in taxes.
- \$1,000 of insurance premium paid by an employee costs \$1,333, since the employee must earn \$1,333 to pay \$1,000.

Keep these income tax considerations in mind as we review the various types of split dollar plans.

In designing a split dollar plan, the objective is generally to spend dollars from the highest tax bracket and claim tax deductions for dollars from the lowest tax bracket.

- A. True [Your answer is incorrect. This is not a true statement.]
- B. False [Your answer is correct. In designing a split dollar plan, the objective is not to spend dollars from the highest tax bracket and claim tax deductions for dollars from the lowest tax bracket.]

3.8 Types of Split Dollar Plans

The **original traditional split dollar plan** was a separation of employer and employee interests, which closely follows the allocation of the term, and cash value elements of a permanent life insurance contract.

Other forms of split dollar have been developed to meet specialized business and personal needs and/or to minimize the combined cost to the employer and employee or to limit the employee's cost.

We'll briefly review some of these split dollar variations. Then we will take a detailed look at three split-dollar variations that have been adversely affected by the IRS: equity split dollar plans, reverse split dollar plans, and private split-dollar plans.

Year	Annual Increase in CV	Annual Premium Paid	
		Employer	Employee
1	\$ 0	\$ 0	\$1,500
2	715	715	785
3	1,388	1,388	112
4	1,428	1,428	72
5	1,465	1,465	35
10	1,648	1,500	0
20	1,813	1,500	0

In a **traditional split dollar plan** the employer pays the portion of the life insurance premium equal to the annual increase in the policy's cash value, and the employee pays any balance. This generally results in high premiums for the employee in the early years.

Year	Annual Increase in CV	Annual Premium Paid	
		Employer	Employee
1	\$ 0	\$ 0	\$1,500
2	715	715	785
3	1,388	1,388	112
4	1,428	1,428	72
5	1,465	1,465	35
10	1,648	1,500	0
20	1,813	1,500	0

The death benefit payable to the employer in traditional split dollar is an amount equal to the total cash value of the policy or the total premiums paid, whichever is greater. The employee's beneficiary then receives the balance of the death benefit.

Year	Annual Increase in CV	Annual Premium Paid	
		Employer	Employee
1	\$1,500	\$1,250	\$250
2	1,500	1,250	250
3	1,500	1,250	250
4	1,500	1,250	250
5	1,500	1,250	250
10	1,500	1,250	250
20	1,500	1,500	0

To overcome the disadvantage of the high premiums for the employee in the early years, the **level outlay split dollar plan** was developed. This approach **averages** the total employee premiums that will be paid over a stipulated period, such as 10 years. While the employer's premium in the early years is increased, the employer's total outlay remains the same over the stipulated period.

Year	Annual Increase in CV	Annual Premium Paid	
		Employer	Employee
1	\$1,500	\$1,250	\$250
2	1,500	1,250	250
3	1,500	1,250	250
4	1,500	1,250	250
5	1,500	1,250	250

10	1,500	1,250	250
20	1,500	1,500	0

The employer's death benefit remains equal to the greater of the employer's premiums paid or the total cash value.

In order to minimize the employee's after-tax cost, an **employer pay all split dollar plan** can be used. The employer pays the full premium each year, and the employee pays the income tax on the economic benefit annually.

The employer's death benefit is equal to the greater of total premiums paid or total cash value, and the employee's beneficiary receives the balance.

Equity Split Dollar Plans

Equity split dollar plans are different from the arrangements previously discussed in that they offer employees more than simply pure life insurance protection. With an equity plan, policy cash value is also transferred to the employee.

The employer's death benefit and interest in the cash value is limited to the total employer premiums paid. The balance of the death benefit is paid to the employee's beneficiary, and the balance of the cash value belongs to the employee. This latter feature has made equity split dollar plans very attractive to employees.

The IRS says that providing access to the cash value, over and above pure insurance protection, is separately taxable. How it is taxed is more complicated.

For example, Section 83, which closely mirrors the IRS Technical Advice Memorandum (TAM) 9604001, governs the transfer of property from an employer to an employee. The employee generally owes tax when he or she receives the property, or if restrictions are imposed, when the restrictions lapse. If an equity split dollar arrangement involves the transfer of property from an employer to an employee (i.e., the endorsement method), Section 83 – or TAM 9604001 – will come into play.

On the other hand, an equity split dollar arrangement may be structured as the purchase of life insurance by the employee with the proceeds of loans from the employer (i.e., collateral assignment method). In this situation, Section 7872 of the Internal Revenue Code controls.

Code Section 7872 deals with interest-free or low-interest loans between certain parties, including employers and employees. For example, if an employer lends

money to an employee at no interest, Section 7872 imputes an interest charge to the loan. The employer is treated as paying the employee an amount equal to the imputed interest, which the employee then pays back to the employer as interest on the loan. The employee has compensation income equal to the imputed interest. The employer has a corresponding compensation deduction offset by the imputed interest income received from the employee.

The final IRS regulations reflect this dichotomy. Under prior rules, all equity split dollar plans were taxed the same way that traditional split dollar plans were taxed. Employees had to include in income the value of the economic benefit they received. But under the final regulations, equity split dollar plans entered into after September 17, 2003 are taxed under one of two mutually exclusive regimes: the economic benefit regime and the loan regime. If the employer is the owner of the life insurance contract (i.e., an endorsement arrangement), the tax consequences will be determined under the economic benefit regime. If the employee is the owner (i.e., a collateral assignment arrangement), the tax is determined under the loan regime.

If an equity split dollar arrangement involves the transfer of property from an employer to an employee, then it is taxed under a loan regime.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. If an equity split dollar arrangement involves the transfer of property from an employer to an employee, it not is taxed under a loan regime.]**

Equity Split Dollar Plans Endorsement Method

Now let's take a closer look at the two taxing regimes for equity split dollar arrangements: endorsement method; and collateral assignment method.

Endorsement method: If the economic benefit regime applies, the value of the economic benefits provided by the employer to the employee for a taxable year equals not only the cost of any current life insurance protection provided to the employee, but also the amount of policy cash value to which the employee has "current access" (to the extent that such amount was not actually taken into account for a prior taxable year).

The employee has current access to any portion of the policy cash value to which he or she has a current or future right and that currently is directly or indirectly accessible by the employee, inaccessible to the employer, or inaccessible to the employer's general creditors. The policy cash value, like the amount of current

life insurance protection, is determined as of the last day of the employee's taxable year, unless the parties agree to use the policy anniversary date.

The IRS says that "access" is to be construed broadly and includes any direct or indirect right of the employee to obtain, use, or realize potential economic value from the policy cash value. Thus, for example, an employee has current access to a policy's cash value if he or she can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy. Similarly, the employee has current access if he or she can anticipate, assign, pledge, or encumber the cash value or if the cash value is available to the employee's creditors by attachment, garnishment, or levy.

The policy's cash value will be considered inaccessible to the employer if the employer does not have the full rights to policy cash value normally held by an owner of a life insurance contract. The policy's cash value will be considered inaccessible to the employer's general creditors if, under the terms of the arrangement or by operation of law, the creditors cannot, for any reason, effectively reach the full policy cash value in the event of the employer's bankruptcy.

Example: In year 1, Acme Corp. and Vincent Ricardo enter into the equity split dollar life insurance arrangement. Under this arrangement, Acme pays all of the premiums on the life insurance contract until the termination of the arrangement or Ricardo's death. The arrangement also provides that, upon termination of the arrangement or Ricardo's death, Acme is entitled to receive the lesser of the aggregate premiums paid or the policy's cash value. At the same time, Ricardo (or his beneficiary) is entitled to receive any remaining amounts.

Under the terms of the arrangement and applicable state law, the policy's cash value is fully accessible by Acme and Acme's creditors. However, Ricardo has the right to borrow or withdraw the portion of the policy's cash value exceeding the amount payable to Acme upon termination of the arrangement or Acme's death. To fund the arrangement, Acme purchases a life insurance contract with constant death benefit protection equal to \$1,500,000.

As of December 31 of year 1, the policy cash value equals \$55,000 and Acme has paid \$60,000 of premiums on the life insurance contract. As of December 31 of year 2, the policy's cash value equals \$140,000 and Acme has paid aggregate premiums of \$120,000 on the life insurance contract. As of December 31 of year 3, the policy cash value equals \$240,000 and Acme has paid \$180,000 of premiums on the life insurance contract.

For year 1, Ricardo receives \$0 of the policy's cash value (excess of \$55,000 cash value over \$55,000 payable to Acme). Ricardo does, however, receive current life insurance protection of \$1,445,000 (\$1,500,000 minus \$55,000 payable to Acme). Thus, Ricardo includes in gross income for year 1 the cost of

\$1,445,000 of current life insurance protection (determined under Table 2001 or by using the insurer's ART rate).

For year 2, Ricardo receives \$20,000 of cash value (\$140,000 cash value minus \$120,000 payable to Acme). For year 2, Ricardo is also provided with current life insurance protection of \$1,360,000 (\$1,500,000 minus the sum of \$120,000 payable to Acme and the aggregate of \$20,000 of cash value that Ricardo actually includes in income from year 1[\$0] and from year 2 [\$20,000]). Thus, Ricardo includes in gross income for year 2 the sum of \$20,000 of cash value and the cost of \$1,360,000 of current life insurance protection.

For year 3, Ricardo receives \$40,000 of cash value (\$240,000 cash value minus the sum of \$180,000 payable to Acme and the \$20,000 of aggregate cash value that Ricardo included in income in year 2). For year 3, Ricardo is also provided current life insurance protection of \$1,260,000 (\$1,500,000 minus the sum of \$180,000 payable to Acme and \$60,000 of aggregate cash value included in income in year 1 [\$0], year 2 [\$20,000], and year 3). Thus, Ricardo includes in income for year 3 the sum of \$40,000 of cash value (having already included in income and paid income tax on the \$20,000 attributable to him from year 2) and the cost of \$1,260,000 of current life insurance protection.

Collateral Assignment Method

Collateral assignment method: If the split dollar arrangement is established under the collateral assignment method, the premiums advanced by the employer are generally treated in one of two ways under the IRS regulations. The treatment depends on whether or not the insured is obligated to repay the premiums advanced under the split dollar arrangement. If employer-advanced premiums are not subject to repayment upon plan termination, the full value of the annual employer-advanced premium must be included in the employee's gross income for income tax purposes.

If the employee is required to repay the premium payments made, the premiums paid by the employer are considered a series of loans on which sufficient interest is expected to be charged. If sufficient interest is charged, the employer and the employee generally take the interest into account under the original issue discount (OID) rules of the Internal Revenue Code. This means that the employer includes the OID in income as it accrues on the basis of the loan's yield to maturity.

If the employee-policy owner:

- Is not charged interest; or
- Is charged interest at a rate that is less than the "applicable federal rate,"

then the employee is treated as having received a **below-market loan**.

Applicable federal rates are interest rates issued monthly by the IRS for various tax purposes and generally reflect market interest rate trends.

If the employee has received a below-market loan, the transaction is recast as a two-step transaction for tax purposes: (1) the interest that was not paid (but should have been paid) is deemed to be additional compensation paid to the employee and (2) an interest payment is deemed to be made from the employee to the employer. In other words, additional income is imputed to the employee equal to the interest that should have been due and was not paid. The "economic benefit" the employee receives has no impact when the premium payments are treated as loans.

Under the economic benefit regime for equity split dollar arrangements, the employee pays tax only on the value of the current life insurance protection.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Under the economic benefit regime for equity split dollar arrangements, the employee does not pay tax only on the value of the current life insurance protection.]**

Reverse Split Dollar

Reverse split dollar is another type of equity-transfer arrangement. Although not widely utilized, you should be at least familiar with it.

The rationale underlying the design of a reverse split dollar plan relied on two aspects. The first is the well-established concept that the costs and benefits of a cash value life insurance policy can be shared. The second is that the cost associated with the term insurance protection provided under the plan is calculated under favorable IRS-approved rules.

Under a reverse split dollar arrangement, a key employee applies for and owns a cash value life insurance policy. The employee then assigns the entire death benefit to the employer to use as key person insurance for a fixed number of years. The employer "chooses" (remember, this is an equity transfer strategy) to calculate its annual term insurance premium payment based on the highest permitted OYT insurance rates.

Usually, the employer would choose to "prepay" premiums over a shorter period than it and the employee intended the reverse split dollar plan agreement to remain in effect.

The intended result of this design was to allow an employer to pay very high premiums to generate high policy cash values that would be available to the insured key employee for later use when the agreement terminated. Growth in policy cash value was construed as simply appreciation, like capital appreciation of stock, since the employee had retained all ownership rights to policy cash value from inception of the plan. The employer had not transferred any taxable value to the employee, but had simply paid an allowable price—albeit the highest possible price—for the term insurance benefit.

The IRS issued a notice in 2002 effectively ending this practice of overpaying the cost of OYT insurance. Under the notice, Table 2001 and the insurer's ART rate can be used only when valuing the current insurance protection one party provides to another. They cannot be used to value the cost of current insurance protection a party provides to itself. In other words, if excessive term insurance premium payments result in an effective transfer of cash value from an employer to an employee, the tax on the transfer cannot be avoided by using Table 2001 or the insurer's ART rate as justification.

A reverse split dollar plan is different from the basic, "employer pay all" and equity split dollar plans in that the term insurance protection provided under the split dollar arrangement is enjoyed by the:

- A. Employee. **[Your answer is incorrect. A reverse split dollar plan is not different from the basic "employer pay all" and equity split dollar plans in that the term insurance protection provided under the split dollar arrangement is enjoyed by the employee.]**
- B. Employer. **[Your answer is correct. A reverse split dollar plan is different from the basic "employer pay all" and equity split dollar plans in that the term insurance protection provided under the split dollar arrangement is enjoyed by the employer.]**
- C. Beneficiary. **[Your answer is incorrect. A reverse split dollar plan is not different from the basic "employer pay all" and equity split dollar plans in that the term insurance protection provided under the split dollar arrangement is enjoyed by the beneficiary.]**
- D. IRS. **[Your answer is incorrect. A reverse split dollar plan is not different from the basic "employer pay all" and equity split dollar plans in that the term insurance protection provided under the split dollar arrangement is enjoyed by the IRS.]**

Private Split Dollar

A development in split dollar plan design is the use of private split dollar, which was established for high net worth couples who wanted to accomplish two goals

using life insurance: first, to **minimize their estate tax liabilities**, and second, to **maintain access to policy cash values to enhance retirement income**. The plan achieves these goals by establishing a split dollar agreement, not between an employer and employee, but between the trust and one of the spouses.

Although a great deal has been written about the benefits of private split dollar plans, like reverse split dollar plans, they have not been widely used. Nevertheless, it is important to know the basic structure of a private split dollar plan.

An example will help. Let's look at how Bill and Sally Carstairs, both of whom are age 45, set up a typical private split dollar plan for themselves.

First, Bill and Sally establish an irrevocable trust, the provisions of which allow the trustee to apply for a cash value life insurance policy on Bill's life. Second, Sally enters into a private split dollar agreement with the trust, under which Sally and the trust will split policy benefits and premiums. Sally's interest in policy cash value or death benefits is limited to the value of the premium payments she makes. The trust owns any excess cash value or proceeds. Ideally, Sally will pay premiums with her own funds. If she has none, or not enough, her husband Bill will give her a gift of cash to make her premium payments.

The trust will pay an annual premium equal to the term cost (i.e., the economic benefit amount) attributable to the death benefit to which it is entitled. Bill will make annual gifts to the trust to provide funds to pay these premiums. Premium payments continue for a fixed number of years, usually until retirement, at which time Sally can begin to recoup her after-tax premium payments by making cash withdrawals or by taking policy loans against her cash value ownership interest, depending on the type of policy used to insure Bill. When Bill dies, Sally or her heirs will receive proceeds equal to the remaining value of her un-recouped cash value interest as a tax-free death benefit, with the remainder of the proceeds being paid into the trust.

The benefits suggested by this arrangement can be substantial:

- Sally can recoup her after-tax premiums to supplement her and Bill's retirement income;
- Any of Sally's un-recouped premiums will be paid to her or her heirs as tax-free life insurance proceeds at Bill's death;
- The life insurance policy in the trust will not be included in either of their estates for estate tax purposes; and
- The trustee of the trust can be given the discretion to use policy proceeds paid to the trust to help meet Sally and Bill's estate settlement costs.

Under the final split dollar regulations, private split dollar plans are governed by the same economic benefit and loan regimes that apply to equity split dollar arrangements. As a result, there may be significant gift tax consequences.

If, in the example above, the trust is the owner of the policy, and a reasonable person would expect that Sally (or her estate) would recover her premium payments, those payments are treated as loans from Sally to the trust. If insufficient interest is charged and the below-market loan rules apply, Sally will be treated as making gifts to the trust equal to the foregone interest. If, on the other hand, Sally is treated as the owner of the policy, she will be treated as making a gift to the trust equal to the economic benefit.

Adapting to Changing Circumstances

A split dollar insurance arrangement that is viable today may not be so in the future. For example, at some point, the employee may no longer desire to have a split dollar arrangement with his or her employer. Or the employee may eventually find the premium payments burdensome. Or, because the taxable economic benefit increases with age, the employee may find the tax to be a financial strain. There are several ways to deal with a change in circumstances.

If the employee is no longer satisfied with the split dollar arrangement, the arrangement may be terminated and the policy **"rolled out"** to the employee, who then owns it outright. The employer is generally repaid by a policy loan or cash withdrawal. The employee, however, may put off repayment by executing a demand note held by the employer for an amount equal to the employer's premium outlay. Such a loan would be subject to the IRS rules on below-market loans.

If the premium payments become burdensome for the employee, the employer can pay a bonus to the employee. The employee uses this **single bonus** to pay his or her share of the premium, with the employer still paying the balance of the premium.

The employer is able to deduct the **bonus** portion that it pays, while the employee must pay taxes on the amount of the bonus.

A net after-tax cost of zero for the employee can be achieved with a **double bonus** plan. The employer pays the employee a bonus equal to his or her premium payments **plus** the tax the employee must pay on the bonus.

For example, if an employee in a 25% tax bracket has a \$423 premium payment, the employer would pay a bonus of \$564 (\$423 premium payment plus \$141 for taxes due on the \$564).

The amount of the bonus can be determined using the following formula:

Bonus = Premium Payment/1 - Applicable Tax Rate

When an employer pays an employee a bonus plus the tax the employee owes on the bonus, which type of split dollar plan is this?

- A. Single bonus plan **[Your answer is incorrect. When an employer pays an employee a bonus plus the tax the employee owes on the bonus, it is not a single bonus plan.]**
- B. Level premium plan **[Your answer is incorrect. When an employer pays an employee a bonus plus the tax the employee owes on the bonus, it is not a level premium plan.]**
- C. Double bonus plan **[Your answer is incorrect. When an employer pays an employee a bonus plus the tax the employee owes on the bonus, it is not a double bonus plan.]**
- D. Equity split dollar plan **[Your answer is correct. When an employer pays an employee a bonus plus the tax the employee owes on the bonus, it is an equity split dollar plan.]**

The Crawl-Out Strategy

When a participating, or dividend paying, whole life insurance policy has been used to fund a split dollar plan, then a variation on the "rollout" approach, called a "crawl-out," may be available to address an employee's financial burden.

Here is a typical crawl-out situation: XYZ Corporation enters into a split dollar agreement with its employee, Gary, when he is 40 years old. XYZ intends for the split dollar agreement to be in force until Gary retires at age 65. A participating whole life policy is chosen to fund the plan.

At this point, XYZ Corporation must choose an approach to use potential policy dividends to manage the premium payments.

XYZ might choose to accelerate premium payments over fewer years than it intends the agreement to remain in force, for example, for ten years only. This strategy calls for higher premiums, with the excess over annual required premium going to purchase paid-up additions, which themselves have a guaranteed cash value and the potential to generate additional dividends.

XYZ might also choose to pay required premiums only, using dividends to reduce its obligation, thereby limiting its policy interest. When dividends exceed the premium, the excess may be paid in cash to XYZ to further reduce its interest or used to purchase paid-up additions, to generate additional dividends and guaranteed cash value for later rollout under a reduced obligation. However dividends are used, limiting or partially repaying the corporation's premiums prior

to retirement makes it easier for Gary to terminate the agreement and regain total ownership of the policy.

A split dollar plan that uses a "crawl-out" strategy must be funded with a:

- A. Participating whole life policy. **[Your answer is correct. A split dollar plan that uses a "crawl-out" strategy must be funded with a participating whole life policy.]**
- B. Traditional ordinary whole life policy. **[Your answer is incorrect. A split dollar plan that uses a "crawl-out" strategy is not funded with a traditional ordinary whole life policy.]**
- C. Variable whole life policy. **[Your answer is incorrect. A split dollar plan that uses a "crawl-out" strategy is not funded with a variable whole life policy.]**
- D. Interest sensitive whole life policy. **[Your answer is incorrect. A split dollar plan that uses a "crawl-out" strategy is not funded with an interest sensitive whole life policy.]**

Traditional Split Dollar

The Split:

Premiums - Employer pays the portion of the annual premium equal to the annual increase in the policy's cash value, and the employee pays the balance.

Cash Value - Owned by the employer.

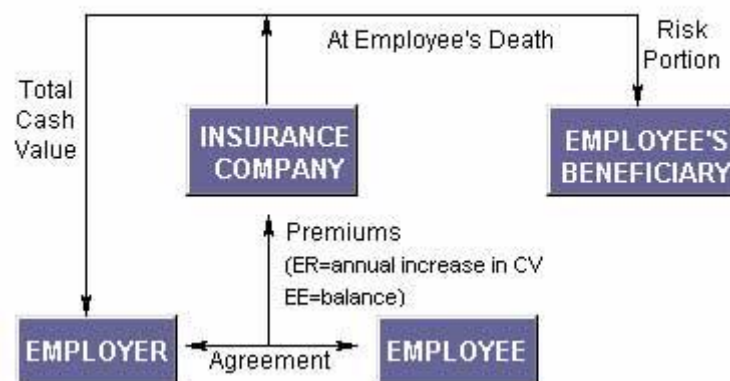
Death Benefit - Employer receives the greater of the cash value or total premiums paid; employee's beneficiary receives the balance.

Advantage - The employer's premium payments are fully secured by the policy's cash value.

Disadvantage - The employee has a high premium cost in the early years.

In-Depth Study Traditional Split Dollar

IN ACTION



Illustrated

\$100,000 Whole Life
First annual premium

Male at 35

Dividends buy OYT insurance
Balance of dividends reduce premiums

Annual Premium less Div.	Annual Premium Paid		Annual Increase in CV	Year	Total CV		Death Benefit	
	ER	EE			ER	EE	ER	EE
1,665	0	1,665	0	1	0	0	0	100,000
1,528	715	813	715	2	715	0	715	100,000
1,482	1,388	94	1,388	3	2,103	0	2,103	100,000
1,403	1,403	0	1,428	4	3,531	0	3,531	100,000
1,325	1,325	0	1,465	5	4,996	0	4,996	100,000
1,244	1,244	0	1,503	6	6,499	0	6,499	100,000
915	915	0	1,648	10	12,872	0	12,872	100,000
73	73	0	1,813	20	30,007	0	30,007	100,000

Level Premium Split Dollar

The Split:

Premiums - Employee pays a level premium for a stipulated period, such as 10 years. The level premium paid is equal to what the employee would have paid for

10 years under the basic split dollar plan divided by 10. The employer pays the balance of the premium.

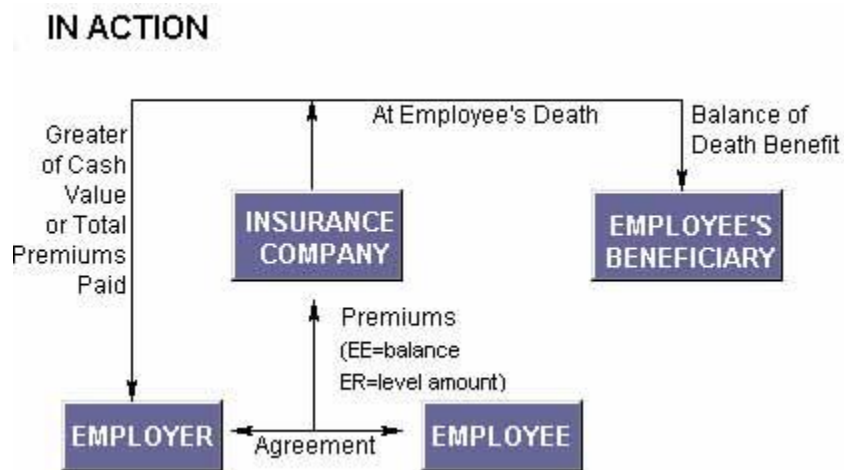
Cash Value - Owned by the employer.

Death Benefit - Employer receives the greater of the cash value or total premiums paid; employee's beneficiary receives the balance.

Advantage - Levels out the EE's premium payments; also has the effect of lowering the reportable economic benefit over the stipulated period.

Disadvantage - Increases ER's premiums in early years, but not total outlay over the stipulated period; exposes ER to some risk of loss if plan is terminated in early years.

In-Depth Study Level Premium Split Dollar



Illustrated

\$100,000 Whole Life First annual premium \$1,665			Male at 35		
Dividends buy OYT insurance Balance of dividends reduce premiums			Total ER Premiums=\$14,638 Total EE Premiums= 2,572		
Annual Premium less Div.	Annual Premium Paid	Annual Increase in CV	Year	Total CV	Death Benefit

	ER	EE			ER	EE	ER	EE
1,665	1,408	257	0	1	0	0	1,408	98,592
1,528	1,271	257	715	2	715	0	2,679	98,036
1,482	1,225	257	1,388	3	2,103	0	3,904	99,199
1,403	1,146	257	1,428	4	3,531	0	5,050	99,481
1,325	1,067	257	1,465	5	4,996	0	6,117	98,789
1,244	987	257	1,503	6	6,499	0	7,104	99,395
915	658	257	1,648	10	12,872	0	12,872	100,000
73	73	0	1,813	20	30,007	0	30,007	100,000

Employer Pay All Split Dollar

The Split:

Premiums - The employer pays the entire premium.

Cash Value - Owned by the employer.

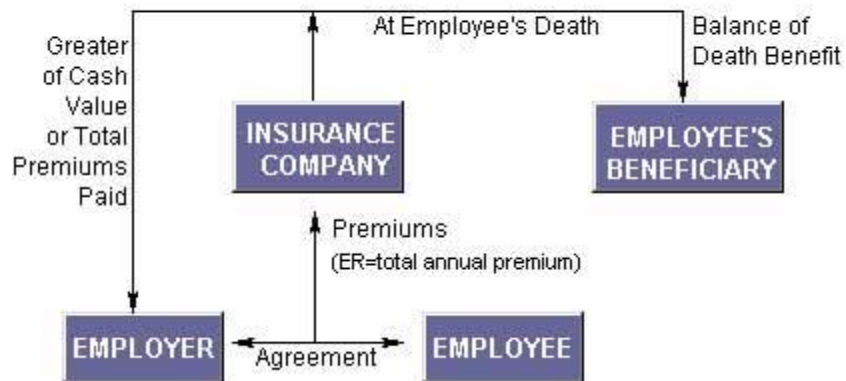
Death Benefit - Employer receives greater of total premiums paid or the cash value; employee's beneficiary receives the balance.

Advantage - Limits employee's after-tax cost to tax on economic benefit; simple to administer.

Disadvantage - Combined employer and employee costs are increased; if plan is terminated, employer could receive less than total premiums paid.

Employer Pay All Split Dollar

IN ACTION



Employee Pay All Split Dollar

Illustrated

\$100,000 Whole Life First annual premium \$1,665			Male at 35		
Dividends buy OYT insurance Balance of dividends reduce premiums					
Year	Employer Premium	+	Employee After-Tax Cost of Economic Benefit	=	ER Pay All Combined Cost
1	\$1,665		\$89		\$1,754
2	1,528		94		1,622
3	1,482		99		1,581
4	1,403		106		1,509
5	1,325		114		1,439
6	1,244		122		1,366
10	915		168		1,083
20	73		179		252

Private Split Dollar

The Split:

Premiums - Split between a spouse and an irrevocable trust, with the trust paying the economic benefit cost of death benefit to which it is entitled and the spouse paying the remainder of the annual premium.

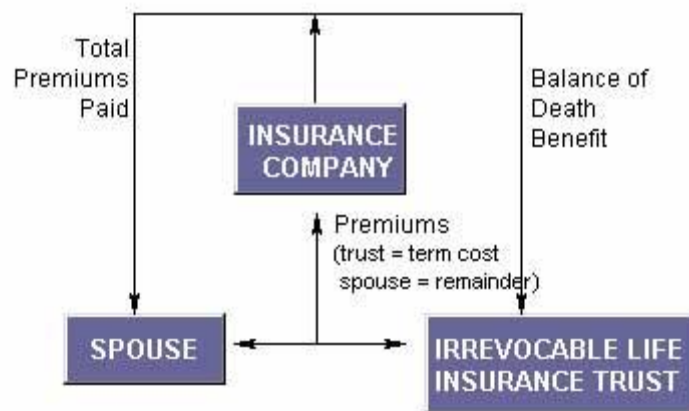
Cash Value - Owned by the spouse.

Death Benefit - Spouse receives a death benefit equal to the greater of premium payments made or total accumulated cash value; the trust receives the remainder of proceeds.

Advantage - Removal of the trust's death benefit interest from the estates of both spouses, while allowing the spouse who is party to the split dollar arrangement to have access to accumulated cash value.

Disadvantage - The cash value interest of the spouse who is party to the split dollar arrangement will be included in his or her estate if he or she predeceases the insured, non-party spouse. The gift tax treatment of the plan must be consistent with the principles governing split dollar plans under the final IRS regulations. In addition, the trust cannot use Table 2001 or the insurer's ART to determine the value of the term insurance portion of the premium payments it makes.

IN ACTION



Split Dollar/Nonqualified Deferred Compensation Plan

Often an employer will combine a split dollar plan with a nonqualified deferred compensation agreement to offer an employee an additional incentive to remain

loyal through retirement. Under this approach, each part of the plan will offer the employee a different benefit. The split dollar plan is designed principally, if not solely, to provide the employee with pre-retirement death protection. The nonqualified deferred compensation plan is usually designed to provide the employee with fixed post-retirement income benefits if he or she lives to retirement, or a fixed income benefit to his or her survivors in the event of death before retirement.

This approach offers a number of planning advantages.

- Neither the employer nor the employee needs to worry about employee taxation of cash values under a combined plan. All policy cash value belongs to the employer. The employee enjoys only pre-retirement death protection.
- The employer can offer the employee a second incentive to remain loyal until retirement: supplemental retirement income payments.
- The employee won't need to effect a rollout under the split dollar plan.
- An employee who maintains the life insurance policy that funded the split dollar agreement as personal insurance in retirement will find the nonqualified deferred compensation plan benefits a ready source of cash from which to make ongoing premium payments.

3.9 Split Dollar Uses

The uses of split dollar are as varied as the types of split dollar plans. For the business owner, split dollar can provide funds for family income needs, estate liquidity and buy/sell agreements, as well as offer an attractive fringe benefit to recruit or retain key employees. For the high net worth couple it was thought to provide—and may still provide—retirement income and estate planning benefits.

A split dollar agreement can be established and provides a tax benefit between a:

- Corporation and key employee.
- Corporation and shareholder/employee.
- Partnership and key employee.
- Sole proprietor and key employee.
- Spouse and an irrevocable trust.

The parties to a split dollar agreement need to be **separate** tax entities for there to be a tax benefit from the plan. As an example, a corporate owner can enter into a split dollar agreement with his or her own corporation. Split dollar, however, provides no tax benefits for an owner and his or her sole proprietorship, or for a partner and his or her partnership. Because there is no separate tax

entity, the owner's personal and business dollars are one and the same. Similarly, a husband or wife can enter into a split dollar agreement with an irrevocable life insurance trust in the hope of obtaining some benefit, but not with each other.

When the business relationship is between an employing corporation or partnership and a key employee, split dollar offers an attractive way to recruit and retain valuable key employees.

The business can pick and choose to whom it wishes to offer a split dollar plan. Furthermore, the plan is easy to install and has no elaborate government reporting requirements. In addition, the business can choose to further reward key employees by using the cash value from the life insurance policy in the split dollar plan to pay them an additional retirement benefit.

LESSON PRACTICE TEST THREE

Split dollar is a special type of life insurance contract.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Split dollar is not a special type of life insurance contract.]**

Which of the following life insurance contracts would be a suitable choice for a split dollar agreement?

- I. Nonparticipating permanent insurance
 - II. Participating term insurance
 - III. Flexible premium insurance
 - IV. Participating permanent insurance
- A. I, II and IV only **[Your answer is only partially correct. There is a better answer to this question.]**
 - B. I and IV only **[Your answer is only partially correct. There is a better answer to this question.]**
 - C. I, III and IV only **[Your answer is correct. Suitable life insurance contracts for a split dollar agreement are nonparticipating permanent insurance, flexible premium insurance and participating permanent insurance.]**
 - D. I, II, III and IV **[Your answer is only partially correct. There is a better answer to this question.]**

The dividend options most commonly used in a split dollar plan are PUA and the OYT dividend option.

- A. True **[Your answer is correct. The dividend options most commonly used in a split dollar plan are PUAs and the OYT dividend option.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

In the collateral assignment method, the employer:

- A. Is the owner. **[Your answer is incorrect. In the collateral assignment method, the employer is not the owner.]**
- B. Is the applicant. **[Your answer is incorrect. In the collateral assignment method, the employer is not the applicant.]**
- C. Advances some or all of the premium. **[Your answer is correct. In the collateral assignment method, the employer advances some or all of the premium.]**
- D. Assigns the policy. **[Your answer is incorrect. In the collateral assignment method, the employer does not assign the policy.]**

Premiums paid for a split dollar plan are tax deductible by the employer and taxable income to the employee.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Premiums paid for a split dollar plan are not tax deductible by the employer and taxable income to the employee.]**

A primary disadvantage of the traditional split dollar plan is that the employee must generally pay high premiums in the early years.

- A. True **[Your answer is correct. A primary disadvantage of the traditional split dollar plan is that the employee must generally pay high premiums in the early years.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

In which of the following cases does split dollar provide no tax benefit?

- A. A corporate owner enters into a split dollar agreement with his/her corporation for estate liquidity purposes. **[Your answer is incorrect. If a corporate owner enters into a split dollar agreement with his/her corporation for estate liquidity purposes, a tax benefit would be provided.]**

- B. A partner enters into a split dollar agreement with his/her partnership to fund a buy/sell agreement. **[Your answer is correct. If a partner enters into a split dollar agreement with his/her partnership to fund a buy/sell agreement, there is no tax benefit.]**
- C. A sole proprietor offers a split dollar plan to a key employee. **[Your answer is incorrect. If a sole proprietor offers a split dollar plan to a key employee, a tax benefit would be provided.]**
- D. All of the above **[Your answer is incorrect. Only one of the replies above is correct.]**

Under a reverse split dollar plan, the death benefit that is assigned to the employer is characterized as:

- A. Key person coverage. **[Your answer is correct. Under a reverse split dollar plan, the death benefit that is assigned to the employer is characterized as key person coverage.]**
- B. Creditor insurance. **[Your answer is incorrect. Under a reverse split dollar plan, the death benefit that is assigned to the employer is not characterized as creditor insurance.]**
- C. Nonqualified deferred compensation. **[Your answer is incorrect. Under a reverse split dollar plan, the death benefit that is assigned to the employer is not characterized as nonqualified deferred compensation.]**
- D. Supplemental life insurance coverage. **[Your answer is incorrect. Under a reverse split dollar plan, the death benefit that is assigned to the employer is not characterized as supplemental life insurance coverage.]**

Reverse split dollar insurance was originally designed to provide which of the following benefits to either the employer or the employee?

- I. Supplemental retirement income
 - II. Key employee insurance protection
 - III. Additional pre-retirement employee compensation
 - IV. Cost-free post-retirement death benefit
- A. I, II and III only **[Your answer is correct. Reverse split dollar insurance was originally designed to provide supplemental retirement income, key employee insurance protection, and additional pre-retirement employee compensation to either the employer or the employee.]**
 - B. I, III and IV only **[Your answer is only partially correct. There is a better answer to this question.]**
 - C. I, II and IV only **[Your answer is only partially correct. There is a better answer to this question.]**

- D. II, III and IV only **[Your answer is only partially correct. There is a better answer to this question.]**

Private split dollar is a split dollar arrangement generally between:

- I. A spouse.
 - II. An irrevocable trust.
 - III. An employer.
 - IV. A third-party representative of dependent children.
- A. I and II only **[Your answer is correct. Private split dollar is a split dollar arrangement generally between a spouse and an irrevocable trust.]**
 - B. II and III only **[Your answer is only partially correct. There is a better answer to this question.]**
 - C. I and III only **[Your answer is only partially correct. There is a better answer to this question.]**
 - D. II and IV only **[Your answer is only partially correct. There is a better answer to this question.]**

A split dollar crawl-out is possible with which of the following life insurance policies?

- A. Universal life **[Your answer is incorrect. A split dollar crawl-out is not possible with a universal life policy.]**
- B. Variable life **[Your answer is incorrect. A split dollar crawl-out is not possible with a variable life policy.]**
- C. Participation whole life **[Your answer is correct. A split dollar crawl-out is possible with a participation whole life policy.]**
- D. Interest sensitive whole life **[Your answer is incorrect. A split dollar crawl-out is not possible with an interest sensitive whole life policy.]**

Use of a split dollar and a nonqualified deferred compensation plan in combination offers planning advantages to:

- I. The employer.
 - II. The employee.
 - III. The employer's factors.
 - IV. The employee's heirs.
- A. I and III only **[Your answer is only partially correct. There is a better answer to this question.]**
 - B. I and II only **[Your answer is correct. Use of a split dollar and a nonqualified deferred compensation plan in combination offers planning advantages to the employer and the employee.]**
 - C. II and IV only **[Your answer is only partially correct. There is a better answer to this question.]**

D. II and III only **[Your answer is only partially correct. There is a better answer to this question.]**

4.0: Deferred Compensation

4.1 Introduction

Employers, today more than ever, need to be able to attract, motivate and retain key employees, but without incurring substantial increased costs. As a result, the design of the business' employee benefit program is critical to the success of the business.

Since qualified pension and profit-sharing plans do not allow an employer to discriminate in favor of selected key employees, those that the employer normally wants to favor, many employers turn to nonqualified **deferred compensation plans**. These plans require no government approval and can be arranged exclusively for the benefit of top management.

Lesson Objectives

This lesson will assist you in developing a better understanding of how a business can use deferred compensation.

- **The Deferred Compensation Plan - What and How:** understand what a deferred compensation plan is and how it works
- **Types of Deferred Compensation:** understand the two types of deferred compensation plans and how each is funded.
- **The Deferred Compensation Plan Taxation:** understand the taxation issues of a deferred compensation plan to the corporation and the executive.
- **Role of Life Insurance:** understand the role of life insurance in providing deferred compensation benefits.

Let's get started.

4.2 What Is a Deferred Compensation Plan?

A deferred compensation plan is:

A contractual agreement → Between a corporation and one or more of its key executives (members of a select group of management or highly

compensated employees) → Where the corporation promises to pay benefits in the event of retirement, disability and/or death.

The deferred compensation plan is outlined in a compensation agreement between the employer and the executive. This contract describes:

- The benefits to be provided; and
- The requirements the executive must meet in order to receive those benefits.

Unlike qualified retirement plans, deferred compensation plans can discriminate and include only selected key executives.

In addition to being able to select the executives covered by the plan, the employer can also provide different benefits for different key executives. These benefits can include:

- Retirement benefits;
- Death benefits;
- Disability benefits; or
- Any combination of the above.

When the benefits are being provided with employer dollars, the deferred compensation agreement usually contains certain requirements that the executive must meet in order to receive the benefits. Most frequently this is a requirement that the executive does not terminate employment prior to retirement.

For this reason, deferred compensation plans are frequently referred to as "**golden handcuffs**." The key executive who is considering terminating employment must take into account the loss of valuable benefits.

Summary

Employer	Executive
Needs to be able to attract, motivate and retain key executives without incurring substantial increased costs.	Is concerned about providing: 1. family security in the event of his or her death or disability prior to retirement.

	2. adequate retirement income to maintain living standards.
SOLUTION?	
A Deferred Compensation Plan!	

Employees to be covered by a deferred compensation plan are selected by the:

- A. IRS. **[Your answer is incorrect. Employees to be covered by a deferred compensation plan are not selected by the IRS.]**
- B. Employer. **[Your answer is correct. Employees to be covered by a deferred compensation plan are selected by the employer.]**
- C. Employees. **[Your answer is incorrect. Employees to be covered by a deferred compensation plan are not selected by the employees.]**
- D. None of the above. **[Your answer is incorrect. One of the options provided is correct.]**

4.3 Types of Deferred Compensation Plans

Originally, deferred compensation was a deferral of a portion of the executive's current salary, or of a salary increase or bonus, until the executive's retirement or death prior to retirement. At that time, the corporation then paid those accumulated amounts to the executive or his/her heirs.

This traditional approach to deferred compensation is known as a **salary reduction plan**.

By deferring a portion of current income (which would otherwise be currently taxed if not deferred), a higher tax bracket executive can have the entire amount invested for his or her retirement, resulting in a higher retirement income than would be available if the executive were to invest after-tax dollars.

The cost to the corporation is equal to the loss of the income tax deduction that could have been taken if the amount deferred had been paid as salary.

Salary Reduction Example

Harry T., who is in a 33% tax bracket, decides to allocate \$15,000 of his income for retirement purposes.

- **With a Salary Reduction Plan** - The full \$15,000 can be invested to provide retirement income.
- **Without a Salary Reduction Plan** - \$4,950 of the \$15,000 must be paid in taxes, leaving only \$10,050 for Harry to invest for retirement.

As a practical matter, the traditional **salary reduction** approach to deferred compensation is most often used today with:

- Tax exempt or other zero tax bracket employers where there is no business tax deduction involved; or
- Tax-paying employers who establish salary reduction plans as an accommodation to higher tax bracket executives who want to defer a portion of current income.

A corporation is more likely to attract and retain top-flight talent with the second type of deferred compensation plan, where the executive does not defer any current income. Instead, the benefits are fully paid for by the corporation and are over and above those provided by other company-sponsored benefit programs.

This incentive approach to deferred compensation is known as a salary continuation plan. In addition to providing important benefits, a **salary continuation plan** also provides the executive with more spendable income, income that he or she might otherwise have to spend to provide these same benefits.

Summary

Two Forms of Deferred Compensation Plans	
Traditional Approach (Salary Reduction)	Incentive Approach (Salary Continuation)
Where the executive actually defers a portion of his/her current income.	Where the corporation fully pays for the benefits which are over and above those provided by other company-sponsored plans.

In a salary reduction deferred compensation plan, the executive pays for his or her benefits through a deferral of current income.

- A. True [Your answer is correct. In a salary reduction deferred compensation plan, the executive pays for his or her own benefits through a deferral of current income.]
- B. False [Your answer is incorrect. This is not a false statement.]

4.4 Deferred Compensation Plan Mechanics

We've seen that a deferred compensation plan is an agreement between a corporation and one or more of its key executives, whereby the corporation promises to pay specified benefits at the time of a specific future event, such as retirement and death and/or disability prior to retirement. These benefits are paid in addition to any other employer-provided benefits. The executive, in return, must meet certain employment conditions in order to receive the benefits.

In order to put a deferred compensation plan into action, the corporation and the selected executives must answer a number of questions. We'll briefly review each.

Since the employer loses its income tax deduction on the deferred amount, the salary reduction approach is most commonly found in tax exempt or other zero bracket employers.

The salary continuation approach is most commonly used in tax-paying corporations that have recognized the need to invest in the human resources so vital to business success.

The types of benefits provided can be broken into two categories:

1. **Retirement Benefits** - A stipulated amount to be paid in annual installments at a specified retirement age.
2. **Pre-Retirement Benefits** - A stipulated annual amount to be paid to the executive and/or his/her family in the event of the executive's disability and/or death prior to retirement.

Plans almost always contain retirement benefits. The executive selects pre-retirement benefits in a salary reduction plan and by the corporation in a salary continuation plan. For example:

Executive A	Executive B	Executive C
-------------	-------------	-------------

<ul style="list-style-type: none"> • Retirement Benefit • Pre-Retirement Death Benefit 	<ul style="list-style-type: none"> • Retirement Benefit Only 	<ul style="list-style-type: none"> • Retirement Benefit • Pre-Retirement Death Benefit • Pre-Retirement Disability Benefit
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From the corporation's viewpoint, the decision on which benefits to include is based on the competitiveness of its existing benefit program, the needs of the executives it wants to retain and its ability to pay. The executive is generally interested in receiving a benefit package that is both well-rounded and as lucrative as possible.

The benefit formula, which can be custom designed for each executive, consists of the **amount** of the benefit and **how long** it will be payable. The **benefit amount** can be determined in two ways:

1. **Defined Benefit** - The amount of benefit to be paid is specified as a flat amount (\$20,000 per year) or as a percentage (50% of final salary); most commonly used in salary continuation plans.
2. **Defined Contribution** - The annual contribution to be made to the plan, expressed as a flat amount (\$4,000 per year) or as a percentage (5% of salary). The benefit amount will then depend on the funds accumulated. Most commonly used in salary reduction plans.

For example:

Executive A	Executive B	Executive C
Retirement Benefit = amount provided by annual contribution of 10% of year's commissions.	Retirement Benefit = 50% of final year's salary.	Retirement Benefit = \$30,000 per year.
Pre-Retirement Death Benefit = amount available from accumulated		Pre-Retirement Death Benefit = \$30,000 per year.

annual contributions.		
		Pre-Retirement Disability Benefit = \$30,000 per year.

The second part of the benefit formula—the period of time for which benefits will be payable—can be for any period of time, ranging from a one-time lump-sum payment to payments for life.

Most commonly, benefits are payable for a stated number of years, such as 10 years, although 15 and even 20 years are not uncommon. The benefit period can vary for each benefit provided.

In a **defined benefit plan**, the longer the benefit period, the more costly the plan because a larger total benefit will be payable. In a **defined contribution plan**, the longer the benefit period, the smaller the annual benefit.

Let's complete our example:

Executive A	Executive B	Executive C
Retirement Benefit = amount provided by annual contribution of 10% of year's commissions, payable for life	Retirement Benefit = 50% of final year's salary for 15 years.	Retirement Benefit = \$30,000 per year for 10 years.
Pre-Retirement Death Benefit = amount available from accumulated annual contributions, payable over 10 years.		Pre-Retirement Death Benefit = \$30,000 per year for 10 years.
		Pre-Retirement Disability Benefit = \$30,000 per year for 10 years.

Finally, a decision must be made as to whether the plan will be funded or unfunded.

A **funded** plan is one in which the employer establishes a trust or escrow fund to satisfy its future obligations to the executives. Unless the rights of the executive to the assets in a funded plan are subject to substantial risk of forfeiture and nontransferable, the executive will be currently taxed on the employer's contributions.

In an **unfunded** plan, the executive receives only the employer's unsecured promise to pay the benefits. No separate assets are set aside and the executive is not taxed until the benefits are actually received.

A form of unfunded plan is the **informally funded plan** where the employer purchases a life insurance policy to provide cash to meet its future obligations. The policy is applied for, owned by and paid for by the corporation, which is also its beneficiary.

As a result, the policy is considered an asset of the employer, carried on its balance sheet and available to creditors, so the payment of premiums does not generate taxable income to the employee.

Informally funded deferred compensation plans are not required to include forfeiture provisions as a means to keep plan contributions from becoming treated as currently taxable income to the employee. However, many employers choose to include such provisions as a means of reducing the likelihood that a key executive will terminate.

For example, if an executive knows that his deferred compensation agreement has a provision stating that all plan benefits are forfeited should he terminate his employment prior to retirement except for death, he is much less likely to leave his employer.

Summary

Plan	Forfeiture Provisions?	Tax Consequences
Funded	Yes/substantial	No taxation until benefits received.
Funded	No	Executive taxed on contributions as made.
Unfunded	Yes or No	No taxation until benefits received.
Informally Funded	Yes or No	No taxation until benefits received.

A deferred compensation plan in which the employer agrees to fully pay for a retirement benefit of \$15,000 per year for 10 years is a:

- A. Defined contribution salary reduction plan. **[Your answer is incorrect. A deferred compensation plan in which the employer agrees to fully pay for a retirement benefit of \$15,000 per year for 10 years is not a defined contribution salary reduction plan.]**
- B. Defined contribution salary continuation plan. **[Your answer is incorrect. A deferred compensation plan in which the employer agrees to fully pay for a retirement benefit of \$15,000 per year for 10 years is not a defined contribution salary continuation plan.]**
- C. Defined benefit salary reduction plan. **[Your answer is incorrect. A deferred compensation plan in which the employer agrees to fully pay for a retirement benefit of \$15,000 per year for 10 years is not a defined benefit salary reduction plan.]**
- D. Defined benefit salary continuation plan. **[Your answer is correct. A deferred compensation plan in which the employer agrees to fully pay for a retirement benefit of \$15,000 per year for 10 years is a defined benefit salary continuation plan.]**

4.5 Deferred Compensation Plan Taxation

When properly arranged, a deferred compensation plan presents these tax consequences:

To the Corporation	To the Executive
<ul style="list-style-type: none"> Contributions to the plan are not income tax deductible. All benefits are income tax deductible when paid to the employee. Earnings on any sinking fund established to pay future benefits are taxed to the corporation. Internal growth of permanent life insurance purchased to pay future benefits is not currently taxed. 	<ul style="list-style-type: none"> Contributions to the plan are not subject to current income taxation. Benefits are included in income as received.

In order to accomplish a primary objective of deferring current taxation to the executive, the plan must be properly arranged so that:

- The **constructive receipt doctrine** will not arise if the executive and corporation enter into the deferred compensation agreement before the performance of services that generate the income to be deferred; and
- The **economic benefit doctrine** does not arise.

In order to avoid the **economic benefit doctrine**, the plan must either be:

1. **Unfunded**, so that the executive has no control over the income and no rights to the benefits other than that of a creditor; or
2. **Funded**, with the executive's rights nontransferable and subject to a substantial risk of forfeiture.

Summary

In a properly designed deferred compensation plan, a deduction by the corporation generates taxable income to the executive. Looked at another way, if the corporation can't deduct it, the executive isn't taxed on it.

Federal Income Tax Results	Income Tax Deductible by Corporation?	Taxable Income to Executive?
CONTRIBUTIONS to the plan	No	No
BENEFITS from the plan	Yes	Yes

If a corporation is obligated to pay a \$25,000 retirement benefit for 10 years, the total cost to the corporation is \$250,000. Its net, or actual cost, however, is the total benefit of \$250,000 less the tax savings from the corporation's tax deduction. For example:

Corporate Tax Bracket	Corporate Net Cost
15%	\$212,500
25%	\$187,500
34%	\$165,000

Which of the following are the federal income tax rules of a properly designed deferred compensation plan?

- I. Contributions to the plan are tax deductible by the corporation.
 - II. Contributions to the plan are not taxable income to the executive.
 - III. Benefits are income tax deductible by the corporation when paid.
 - IV. Benefits from the plan are not taxable income to the executive.
- A. I and II only **[Your answer is only partially correct. There is a better answer to this question.]**
- B. III and IV only **[Your answer is only partially correct. There is a better answer to this question.]**
- C. II and III only **[Your answer is correct. The federal income tax rules of a properly designed deferred compensation plan are (II) contributions to the plan are not taxable income to the executive and (III) benefits are income tax deductible by the corporation when paid.]**
- D. I, II, III and IV **[Your answer is only partially correct. There is a better answer to this question.]**

Retirement Benefits

The corporation is entitled to a federal income tax deduction for retirement benefits paid from a deferred compensation plan. The executive must report the retirement benefits as taxable income in the year received.



Pre-Retirement Death Benefits

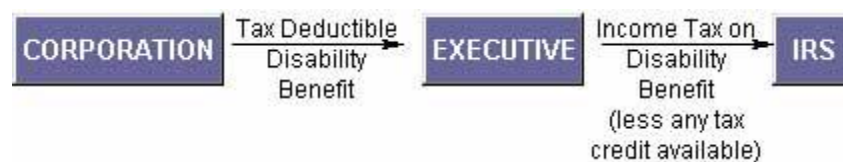
The corporation is entitled to a federal income tax deduction for pre-retirement death benefits paid from a deferred compensation plan. The executive's family/beneficiary must report the death benefit as taxable income in the year received.



Pre-Retirement Disability Benefits

The corporation is entitled to a federal income tax deduction for pre-retirement disability benefits paid from a deferred compensation plan. The executive must report the disability benefit as taxable income in the year received, but may be able to reduce the actual tax payable by a tax credit available to totally and permanently disabled employees under age 65.

While the calculation of this tax credit is beyond the scope of this lesson, it may serve to reduce income tax payable by the disabled executive.



4.6 Securing Nonqualified Deferred Compensation Plan Benefits

Before we move on to nonqualified deferred compensation plan funding methods, let's discuss several issues raised by the plan design elements.

An unfunded nonqualified deferred compensation plan offers a participant an entirely naked promise of payment. No assets are set aside to meet future benefit payment obligations, and all assets of the employer-sponsor are subject to the claims of its general creditors. Assets segregated under a funded plan also remain under the employer's control. A change of mind on the part of existing management or a change of management resulting from a company sale or merger might stop the employer-sponsor from making benefit payments to participating employees when they retire.

4.7 Key Employee Benefit Protection

A number of strategies effective to varying degrees have been developed to address the possibility that benefit payments under a nonqualified deferred compensation plan might not be paid, including:

- Building a vesting schedule into the plan

- Obtaining a surety bond
- Engaging a third-party guarantor
- Use of either a Rabbi or Secular Trust

Vesting

Building a vesting schedule into a nonqualified deferred compensation plan can add some payment security to the arrangement. Under a vesting schedule, the key employee becomes entitled to an increasingly larger percentage of promised benefits rather than having to fulfill an employment obligation that might run for 10 or more years before securing any benefit entitlement at all.

Vesting will not, however, guarantee an employer-sponsor will have the funds necessary to meet benefit obligations when they are due, nor does the vesting schedule neutralize the plan's substantial risk of forfeiture provision.

Surety Bonds

Sometimes it is important to provide key employees with a substantially greater degree of surety that benefits will be paid when due.

One way to do this is with a surety bond, a promise from an insurance company that it will step in to pay the promised benefits due the key employee in the event the employer-sponsor reneges on its promise to pay. To avoid application of the Constructive Receipt and Economic Benefit Doctrines with this strategy, premiums for the surety bond must be paid by the key employee with his or her own funds.

Premiums for a surety bond must be paid by the:

- Key employee. **[Your answer is correct. Premiums for a surety bond must be paid by the key employee.]**
- Employer-sponsor. **[Your answer is incorrect. Premiums for a surety bond are not paid by the employer-sponsor.]**
- Insurance company **[Your answer is incorrect. Premiums for a surety bond are not paid by the insurance company.]**
- All of the above **[Your answer is incorrect. Only one of the options above is the correct response.]**

Third-Party Guarantor

Another way a key employee can obtain some benefit payment surety is through a third-party guarantee of benefit payments. Generally, in this strategy, a

substantially larger, better-capitalized parent company guarantees the promise its less financially stable subsidiary has made to a key employee.

Still, another way for a key employee to obtain some surety that nonqualified deferred compensation benefits will be paid is for the plan to utilize either a Rabbi or a Secular Trust.

Rabbi Trust

A Rabbi Trust derives its name from a nonqualified deferred compensation plan involving a trust set up by the Board of Directors of a synagogue for its current Rabbi. When a Rabbi Trust is used, the employer-sponsor makes regular deposits into the trust for the sole purpose of funding its future benefit obligation.

While funds deposited in the trust remain the assets of the employer-sponsor, and thus remain accessible to the creditors of the employer, benefits payable under the plan will be protected under certain circumstances.

Rabbi Trust

The principal circumstances under which benefit payments will be protected under a Rabbi Trust are:

- Change of heart on the part of the employer-sponsor
- Change of management

A Rabbi Trust may only be used in nonqualified deferred compensation plans established by religious entities, such as churches and synagogues.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. A Rabbi Trust is not limited to use in nonqualified deferred compensation plans established by religious entities, such as churches and synagogues.]**

Secular Trust

A Secular Trust is used to actually guarantee nonqualified deferred compensation benefit payments under special circumstances.

Like a Rabbi Trust, assets deposited into a Secular Trust remain in the trust solely for the purpose of paying future plan benefit obligations. However, while a plan using a Rabbi Trust is arranged to keep trust deposits from being taxable to

participants, Secular Trust contributions are taxable to key employee-participants in the year they are made.

Key employees participate in a plan using a Secular Trust for at least two reasons: their employer is a potential candidate for a future bankruptcy proceeding, or is exposed to potential large liability suits.

The employer offers executives access to the plan because their loyalty and expertise are most needed during times of financial strain or high exposure to legal liability. Key employees commit to an at-risk employer because promised benefits can be fully guaranteed through the Secular Trust.

A key employee would consider entering into a nonqualified deferred compensation agreement involving a Secular Trust if:

- A. The promised payments were substantial enough. **[Your answer is incorrect. A key employee would not consider entering into a nonqualified deferred compensation agreement involving a Secular Trust if the promised payments were substantial enough.]**
- B. The key employee was relatively close to retirement age. **[Your answer is incorrect. A key employee would not consider entering into a nonqualified deferred compensation agreement involving a Secular Trust if the key employee was relatively close to retirement age.]**
- C. The key employee was concerned that the employer might be a good candidate for a future bankruptcy proceeding. **[Your answer is correct. A key employee would consider entering into a nonqualified deferred compensation agreement involving a Secular Trust if the key employee was concerned that the employer might be a good candidate for a future bankruptcy proceeding.]**
- D. The key employee was concerned that the employer might be sold. **[Your answer is incorrect. A key employee would not consider entering into a nonqualified deferred compensation agreement involving a Secular Trust if the key employee was concerned that the employer might be sold.]**

4.8 Funding the Deferred Compensation Benefits

Once decisions have been reached on what benefits the plan will provide and whether it will utilize the salary reduction or salary continuation approach, the corporation must determine how it will pay for those benefits.

Because of the complexities and potential adverse tax consequences of funded plans, our review of the funding alternatives will be limited to informally funded

plans where the executive receives only the employer's unsecured promise to pay the benefits.

This approach poses problems for both the executive and the corporation.

The **executive** will want some assurance that dollars will be available to pay the promised benefits, especially in a salary reduction plan where current salary is actually being deferred. Otherwise, the plan's potential to attract and retain key executives is diminished.

Without provisions to fund the future liability created when benefits become payable, the **corporation** could suffer severe cash flow problems in paying benefits from current earnings.

There are two problems with the sinking fund approach:

1. If a pre-retirement death benefit is payable, there is no assurance that sufficient funds will have been accumulated to pay the promised benefit.
2. Since the sinking fund remains an asset of the corporation, its earnings are subject to taxation at the corporation's income tax rate, thus eroding the overall rate of return.

There is only one funding vehicle available that can guarantee that funds will be available to pay benefits exactly when they are needed.

The purchase of a permanent life insurance policy **guarantees** that funds will be available in the event of:

- **Death** - The life insurance proceeds can be used to pay a pre-retirement death benefit.
- **Disability** - If the policy is issued with the waiver of premium benefit, the corporation can use the waived premium to pay a pre-retirement disability benefit.
- **Retirement** - The policy's cash value can be used to pay the retirement benefit, or the policy can be kept in force, with the corporation paying the retirement benefit from current earnings and eventually collecting the death benefit.

In addition to providing funds exactly when they are needed, permanent life insurance offers several tax benefits that the other funding alternatives do not offer.

- Earnings inside the permanent insurance contract are not taxed.
- All insurance death proceeds paid to the corporation are received income tax-free by the corporation.

These income tax advantages, plus the corporation's ability to deduct all benefit payments, combine to produce tax leveraging that enables the corporation to eventually recover all of its costs of participating in the program.

When funding deferred compensation benefits, there may NOT be sufficient money in a _____ to pay the promised pre-retirement death benefit.

- A. Sinking fund **[Your answer is correct. When funding deferred compensation benefits, there may NOT be sufficient money in a sinking fund to pay the promised pre-retirement death benefit.]**
- B. Money market **[Your answer is incorrect. When funding deferred compensation benefits, there may be sufficient money in a money market to pay the promised pre-retirement death benefit.]**
- C. Key employee **[Your answer is incorrect. When funding deferred compensation benefits, there may be sufficient money in a key employee to pay the promised pre-retirement death benefit.]**
- D. Salary deferral **[Your answer is incorrect. When funding deferred compensation benefits, there may be sufficient money in a salary deferral to pay the promised pre-retirement death benefit.]**

4.9 Tax Leveraging

Tax leveraging is the ability to combine the receipt of **income tax-free proceeds** with the payment of **tax-deductible benefits**.

Since the corporation can deduct benefit payments, it can afford to pay a higher benefit than it receives tax-free from the life insurance policy. The higher the corporation's income tax rate, the lower the effective, or actual, cost of the benefits to the corporation and the higher the benefit the corporation can afford to pay.

Let's look at an example.

For every \$1,000 of tax-free proceeds that a corporation receives, it can pay out benefits of:

Corporate Tax Bracket	Maximum "No Cost" Benefit
15%	\$1,176
25%	\$1,333

34%	\$1,515
-----	---------

If, for example, a corporation in a 34% tax bracket pays out \$1,515 in benefits, it can deduct the \$1,515, saving \$515 in taxes. The cost is thus reduced to \$1,000, the amount it received from the life insurance.

Continuing our same example, the maximum "no cost" benefit is calculated as follows:

Executive Benefit		=		IP/(1-TAX RATE)	
	=	$\frac{\$1,000}{1-.34}$	=	$\frac{\$1,000}{.66}$	= \$1,515

The tax leveraging concept applies only if the policy is retained until the death of the executive.

If the policy is cash surrendered, the proceeds are subject to income tax to the extent they exceed the total net premiums paid by the corporation. For example:

\$100,000 Cash Surrender Value
- 75,000 Total Net Premium Paid
 \$ 25,000 Taxable to Corporation

With the tax leveraging available through a deferred compensation plan, a corporation in the 25% tax bracket can pay out a \$1,250 maximum "no cost" benefit for every \$1,000 of death proceeds it receives.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. With the tax leveraging available through a deferred compensation plan, a corporation in the 25% tax bracket cannot pay out a \$1,250 maximum "no cost" benefit for every \$1,000 of death proceeds it receives.]**

4.10 The Deferred Compensation Plan in Action

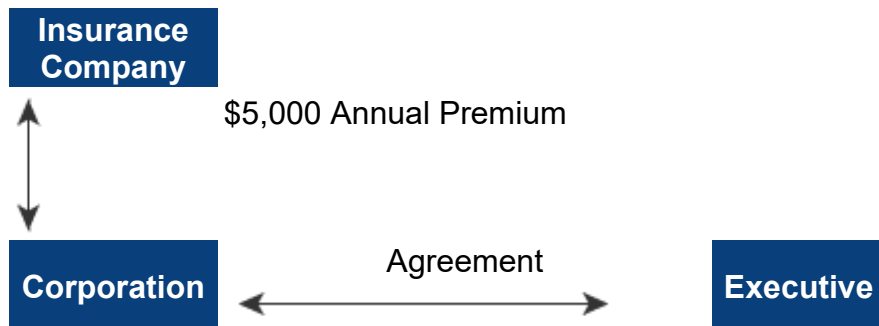
Let's conclude by taking a look at a deferred compensation plan in action.

Fred M. is a valued key executive with Southern Manufacturing, a corporation in the 34% tax bracket. Fred and his employer enter into the following deferred compensation agreement.

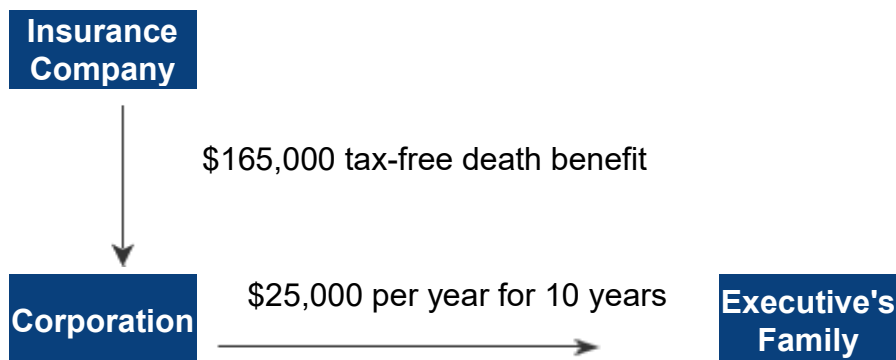


- Salary continuation plan
- Retirement benefit of \$25,000 per year for 10 years
- Pre-retirement death benefit of \$25,000/year for 10 years
- Pre-retirement disability benefit of \$7,575 per year

Southern Manufacturing decides to fund its obligations to Fred with a permanent life insurance policy.

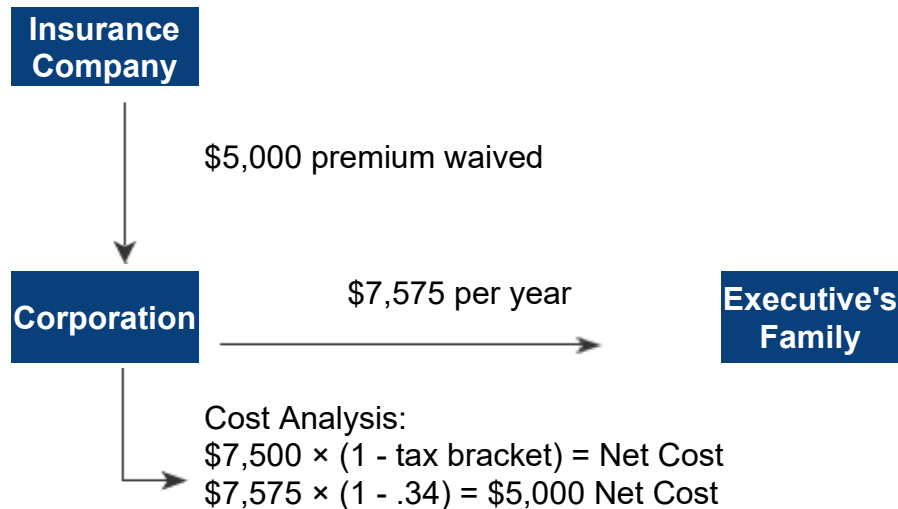


If Fred dies prior to retirement:



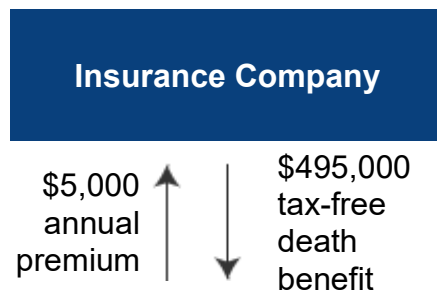
Cost Analysis:
 $\$25,000 \times 10 \text{ years} = \$250,000 \text{ Total Cost}$
 $\$250,000 \times (1 - \text{tax bracket}) = \text{Net Cost}$
 $\$250,000 \times (1 - .34) = \$165,000 \text{ Net Cost}$

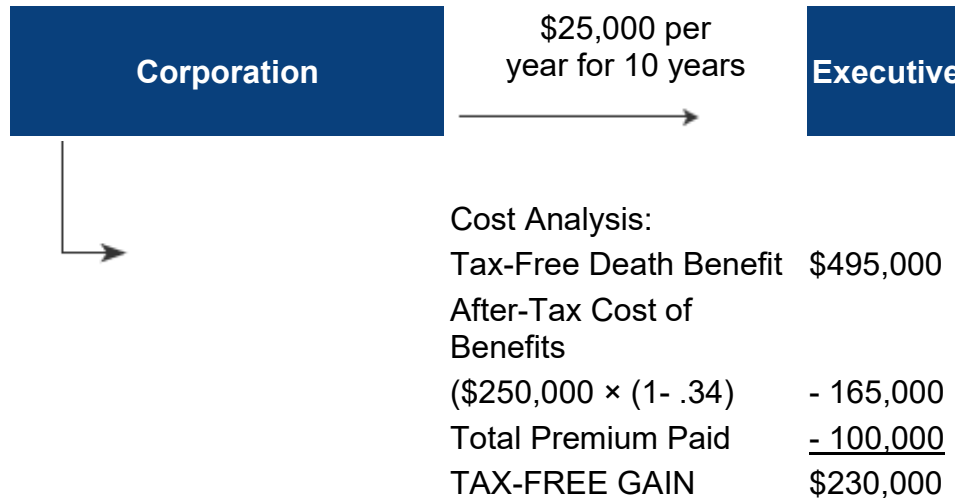
If Fred becomes disabled prior to retirement:



At Fred's retirement, Southern Manufacturing has three options:

1. It can cash surrender the policy, pay taxes on any gain and use the net proceeds to pay Fred's retirement benefit.
2. It can put the policy on reduced paid-up status and pay Fred's benefit from current earnings, including the \$5,000 previously used to pay the premium. At Fred's eventual death, Southern Manufacturing will receive the policy's reduced paid-up death benefit tax-free.
3. Southern Manufacturing can keep the policy in force and pay the retirement benefit and premium out of current earnings, eventually receiving the full death benefit, including paid-up additions, tax-free.





If a corporation's cash flow enables it to elect this option, it is the most attractive from a pure financial gain standpoint.

If Southern Manufacturing chose a life insurance policy that permits withdrawals, such as a universal life insurance policy, it has a fourth option for providing Fred's retirement income.

At Fred's retirement, it can cease premium payments and begin making cash value withdrawals in an amount sufficient to pay Fred's annual benefit. Since Southern Manufacturing is in a 34 percent tax bracket, it needs only \$15,840 each year to pay the deductible \$25,000 benefit. (The other \$9,160 is "paid for" by reduced taxes.) The entire \$100,000 of total premium that the corporation paid for the policy can be recovered tax-free through these withdrawals. So Southern Manufacturing can pay for Fred's benefit for 6.3 years solely from tax-free withdrawals. [$\$100,000 \div \$15,840 = 6.3$]

When Southern Manufacturing has withdrawn its entire cost basis in the policy, it could begin taking cash value loans from the policy to fund the remaining 3.7 years of Fred's benefit. These cash value loans are not considered distributions and are also received tax-free. When Fred dies, the remaining death benefits—depleted, of course, by withdrawals and loans—are paid to Southern Manufacturing tax-free.

When this withdrawal/loan strategy is employed, it is important that the life insurance policy never be surrendered or allowed to lapse. If the policy is subsequently terminated through surrender or lapse, the tax-free cash value loans are considered distributions, and the policy owner may have a significant income tax liability without sufficient remaining cash value to offset the liability.

If the corporation elects to keep the permanent policy in force at the executive's retirement, both the retirement benefits and the premiums must be paid from _____ earnings.

- A. Net **[Your answer is incorrect. If the corporation elects to keep the permanent policy in force at the executive's retirement, the retirement benefits and the premiums are not paid from net earnings.]**
- B. Gross **[Your answer is incorrect. If the corporation elects to keep the permanent policy in force at the executive's retirement, the retirement benefits and the premiums are not paid from gross earnings.]**
- C. Current **[Your answer is correct. If the corporation elects to keep the permanent policy in force at the executive's retirement, both the retirement benefits and the premiums are paid from current earnings.]**
- D. Deferred **[Your answer is incorrect. If the corporation elects to keep the permanent policy in force at the executive's retirement, the retirement benefits and the premiums are not paid from deferred earnings.]**

4.11 Split Dollar/Nonqualified Deferred Compensation Plan

Often a nonqualified deferred compensation plan will be established in combination with a split dollar arrangement. Together, the two plans offer an employee strong pre- and post-retirement incentives for an employee to remain loyal. The split dollar plan provides the employee with low-cost pre-retirement death protection. The nonqualified deferred compensation plan promises the employee fixed post-retirement income benefits if he or she lives to retirement, or a fixed income benefit to his or her survivors in the event of premature death. In tandem, the plans offer the employer a way to recoup nondeductible (tax-free on return) premium payments to provide the employee's (tax deductible) deferred compensation benefits.

This approach also offers a number of additional planning advantages.

- Neither the employer nor the employee have to worry about the final IRS split-dollar regulations which would tax the transfer of an interest in a policy's cash value from an employer to an employee. All policy cash value belongs to the employer the whole time the split dollar arrangement remains in effect.
- The split dollar plan provides the employer with readily available funds to pay the employee's deferred compensation benefit.
- The employee won't need to effect a rollout under the split dollar plan.

- An employee who maintains the life insurance policy that funded the split dollar agreement as personal insurance in retirement will find the nonqualified deferred compensation plan benefits a ready source of cash from which to make ongoing premium payments.

Under a split dollar/nonqualified deferred compensation combination plan, the benefit payable under the split dollar portion of the plan is limited to post-retirement supplemental income payments.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Under a split dollar/nonqualified compensation combination plan the benefit payable under the split dollar portion of the plan is not limited to post-retirement supplemental income payments.]**

A Word of Warning About Code Sec. 409A

The benefits available from this kind of planning are important and far ranging in their effects on both the company offering an employee this kind of planning opportunity and the employees and their family. Care, however, has to be taken with the formalities of the plan and the implementation.

Section 409A of the Internal Revenue Code controls the management of deferred compensation planning. Ignoring the requirements of Sec. 409A could have dire consequences for both the employee and the employer sponsoring the plan.

Section 409A makes clear that the plan document has to clearly state that only certain specific events may trigger payout of the employee's plan benefits, and that payment of those benefits has to be made within a specified time that was also stated in the plan. Plans are further specifically prohibited from accelerating the payment of benefits. Further still, 409A affirms that the election to defer income had to be made in the calendar year prior to the year in which the income would be earned, as did the election of payment type and timing.

If the 409A requirements are not met, the danger is that the deferred compensation that was directed into the plan to avoid immediate income taxation would become immediately income taxable, but not just at ordinary income tax rates: at ordinary income tax rates *plus* a 20% tax penalty.

While the principal burden of mismanaging the plan would fall on the employee, the employer has an obligation to report any 409A failures, which may then result in penalties for the employer as well.

LESSON PRACTICE TEST 4

All of the following benefits can be made available through a deferred compensation plan EXCEPT:

- A. Disability benefits **[Your answer is incorrect. This benefit can be made available through a deferred compensation plan.]**
- B. Major medical benefits **[Your answer is correct. Major medical benefits cannot be made available through a deferred compensation plan.]**
- C. Death benefits **[Your answer is incorrect. This benefit can be made available through a deferred compensation plan.]**
- D. Retirement benefits **[Your answer is incorrect. This benefit can be made available through a deferred compensation plan.]**

Under a typical deferred compensation plan, a key executive must be employed by the corporation at the time deferred compensation benefits become payable.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Under a typical deferred compensation plan, a key executive need not be employed by the corporation at the time deferred compensation benefits become payable.]**

When a corporation wants to attract and retain key executives, it is more likely to offer a(n) _____ deferred compensation plan.

- A. Salary continuation **[Your answer is correct. When a corporation wants to attract and retain key executives, it is more likely to offer a salary continuation deferred compensation plan.]**
- B. Salary reduction **[Your answer is incorrect. When a corporation wants to attract and retain key executives, it is not likely to offer a salary reduction deferred compensation plan.]**
- C. Level premium **[Your answer is incorrect. When a corporation wants to attract and retain key executives, it is not likely to offer a level premium deferred compensation plan.]**
- D. Employer pay all **[Your answer is incorrect. When a corporation wants to attract and retain key executives, it is not likely to offer an employer pay all deferred compensation plan.]**

The deferred compensation plan benefit formula consists of which of the following?

- I. Amount of benefit to be paid.
- II. Which benefits are to be provided.
- III. Whether the plan is funded or unfunded.
- IV. How long benefits will be payable.

- A. I, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
- B. I and IV only **[Your answer is correct. The deferred compensation plan benefit formula consists of the amount of benefit to be paid and how long benefits will be payable.]**
- C. I and II only **[Your answer is only partially correct. There is a better response to this question.]**
- D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

A life insurance policy purchased as part of an informally funded plan is applied for, owned by, and paid for by the corporation.

- A. True **[Your answer is correct. A life insurance policy purchased as part of an informally funded plan is applied for, owned by, and paid for by the corporation.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

There is no danger of the constructive receipt doctrine arising when the executive and corporation enter into a deferred compensation agreement in December to defer income earned during that calendar year.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. There is a danger of the constructive receipt doctrine arising when the executive and corporation enter into a deferred compensation agreement in December to defer income earned during that calendar year.]**

The use of permanent life insurance to fund a deferred compensation plan offers which of the following advantages?

- I. Tax-deferred accumulation of earnings.
 - II. Tax-free death benefit.
 - III. Tax-deductible premiums.
 - IV. Guarantee that funds will be available when needed.
- A. I, II and IV only **[Your answer is correct. Advantages to the use of permanent life insurance to fund a deferred compensation plan are tax-deferred accumulation of earnings, a tax-free death benefit, and a guarantee funds will be available when needed.]**
 - B. I and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - C. II, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**

- D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

Through the use of tax leveraging, a corporation can, at no cost, pay out deferred compensation benefits in excess of the tax-free proceeds it receives from a life insurance policy.

- A. True **[Your answer is correct. Through the use of tax leveraging, a corporation can, at no cost, pay out deferred compensation benefits in excess of the tax-free proceeds it receives from a life insurance policy.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

At an executive's retirement, the corporation can:

- I. Cash surrender the policy.
- II. Put it on reduced paid-up status.
- III. Keep it by continuing to pay the premiums.
- IV. Transfer the policy to another executive.
- A. I and II only **[Your answer is only partially correct. There is a better response to this question.]**
- B. I and IV only **[Your answer is only partially correct. There is a better response to this question.]**
- C. I, II and III only **[Your answer is correct. At an executive's retirement, the corporation can cash surrender the policy, put it on reduced paid-up status or keep it by continuing to pay the premiums.]**
- D. III and IV only **[Your answer is only partially correct. There is a better response to this question.]**

Deferred compensation plans may be preferable to pension and profit-sharing plans because of which of the following reasons?

- I. They are tax-qualified plans
- II. They can discriminate in favor of key employees
- III. They require no government approval
- IV. They can be arranged exclusively for the benefit of top management
- A. I, II and III only **[Your answer is only partially correct. There is a better response to this question.]**
- B. I, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
- C. II, III and IV only **[Your answer is correct. Deferred compensation plans may be preferable to pension and profit-sharing plans because they can discriminate in favor of key employees, require no**

government approval, and can be arranged exclusively for the benefit of top management.]

- D. I, II and IV only **[Your answer is only partially correct. There is a better response to this question.]**

With an informally funded plan:

- A. There is no distinct funding mechanism. **[Your answer is incorrect. With an informally funded plan, there is a distinct funding mechanism.]**
- B. The plan is funded by the employee. **[Your answer is incorrect. With an informally funded plan, the plan is not funded by the employee.]**
- C. The employers may purchase a life insurance policy to fund future obligations. **[Your answer is correct. With an informally funded plan the employers may purchase a life insurance policy to fund future obligations.]**
- D. The employer borrows money to fund future obligations. **[Your answer is incorrect. With an informally funded plan, the employer does not borrow money to fund future obligations.]**

A typical third-party guarantor for a company's nonqualified deferred compensation plan would be:

- A. A local credit union. **[Your answer is incorrect. A typical third-party guarantor for a company's nonqualified deferred compensation plan would not be the local credit union.]**
- B. The employer-sponsor's parent company. **[Your answer is correct. A typical third-party guarantor for a company's nonqualified deferred compensation plan would be the employer-sponsor's parent company.]**
- C. A commercial lending institution. **[Your answer is incorrect. A typical third-party guarantor for a company's nonqualified deferred compensation plan would not be a commercial lending institution.]**
- D. The employer-sponsor's minimally capitalized sister company. **[Your answer is incorrect. A typical third-party guarantor for a company's nonqualified deferred compensation plan would not be the employer-sponsor's minimally capitalized sister company.]**

Key employees would consider participation in a nonqualified deferred compensation plan with their employer, even though it is a likely candidate for a future bankruptcy proceeding, if the company's plan included a:

- A. Pension and profit-sharing plan. **[Your answer is incorrect. Key employees would consider participation in a nonqualified deferred**

- compensation plan with their employer, even though it is a likely candidate for a future bankruptcy proceeding, but not if the company's plan included a pension and profit-sharing plan.]
- B. Rabbi Trust. **[Your answer is incorrect. Key employees would consider participation in a nonqualified deferred compensation plan with their employer, even though it is a likely candidate for a future bankruptcy proceeding, but not if the company's plan included a Rabbi Trust.]**
 - C. Bankruptcy and legal liability waiver. **[Your answer is incorrect. Key employees would consider participation in a nonqualified deferred compensation plan with their employer, even though it is a likely candidate for a future bankruptcy proceeding, but not if the company's plan included a bankruptcy and legal liability waiver.]**
 - D. Secular Trust. **[Your answer is correct. Key employees would consider participation in a nonqualified deferred compensation plan with their employer, even though it is a likely candidate for a future bankruptcy proceeding, if the company's plan included a Secular Trust.]**

A benefit to an employer of combining split dollar and nonqualified deferred compensation plans includes:

- I. Tax-deductible split dollar premium payments.
 - II. Tax-deductible nonqualified deferred compensation payments.
 - III. Tax-free return of split dollar premium payments.
 - IV. Freedom from concern over the finding in TAM 9604001.
- A. I, II and III only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. I, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - C. II, III and IV only **[Your answer is correct. The benefits to an employer of combining split dollar and nonqualified deferred compensation plans include tax-deductible nonqualified deferred compensation payments, tax-free return of split dollar premium payments, and freedom from concern over the findings in TAM 9604001.]**
 - D. I, II and IV only **[Your answer is only partially correct. There is a better response to this question.]**

5.0 Qualified Retirement Plans

5.1 Introduction

All of us require money to live and to maintain our desired lifestyles. There are only two sources of that money: from our personal efforts, like a salary, or from money at work for us which provides a stream of income.

At retirement, that first source of income ceases and we must rely solely on the second source, money at work. For many of us, at least a portion of our retirement income is in the form of pension payments made from a qualified plan.

Some form of qualified plan is available to almost every working American. We will review these plans in this lesson.

Please note that the increases in the cash value in an annuity policy or a cash value life insurance policy are normally tax-deferred, so these products offer no additional tax advantages as funding options in a tax-qualified plan and, therefore, may not be suitable.

Note: Before we get started, you should understand that this lesson will not provide an in-depth review of all the technical issues surrounding qualified plans. Rather, it is intended to familiarize you with the operation of qualified plans in general.

Lesson Objectives

- **Qualified Plan Types, Structure, Taxation and Eligibility:** understand the various types of qualified plans, how they are structured and taxed and who is eligible for them.
- **Role of Life Insurance:** recognize the role of life insurance in qualified plans.
- **Pension Payments and Taxation:** understand how pension benefits can be paid and the tax implications of each option.

5.2 What Is a "Qualified" Plan?

Very simply, a qualified plan is one that, in return for meeting specific requirements, provides a range of tax advantages. These tax advantages include:

- Income exclusions or tax deductions for contributions to the plan.

- Tax-deferred accumulation of the earnings on plan contributions.
- No taxation of plan participants until benefits are actually received.
- Ability to spread out the taxation of benefits over a period of time.

For our purposes, we are going to divide qualified plans into two broad categories:

1. The plans established by a business for the benefit of its employees.
2. The plans established and paid for by individuals for their own benefit.

In a qualified plan, contributions to the plan are:

- A. Not taxed. **[Your answer is incorrect. In a qualified plan, contributions to the plan are taxed.]**
- B. Not tax deductible. **[Your answer is incorrect. In a qualified plan, contributions to the plan are tax deductible.]**
- C. Not allowed. **[Your answer is incorrect. In a qualified plan, contributions to the plan are allowed.]**
- D. Tax deductible or excludable from income. **[Your answer is correct. In a qualified plan, contributions to the plan are tax deductible or excludable from income.]**

5.3 Employer-Sponsored Qualified Plans

An employer-sponsored qualified plan is established by an employer for the benefit of its employees. Contributions to the plan may be made by the employer, by the employee or by both, depending on the type of plan. There are three broad categories of employer-sponsored qualified plans:

- **Corporate plans**, qualified plans established by corporations for their employees.
- **Qualified Plans** established by sole proprietorships and partnerships for the benefit of the self-employed individuals and any employees (once commonly known as Keogh Plans).
- **403(b) plans, also known as tax-deferred annuities**, established by nonprofit organizations and public schools for their employees.

While the tax advantages of a qualified plan are attractive, there are a number of non-tax reasons for an employer to establish a qualified plan to:

- Attract and retain key employees until retirement
- Increase productivity and employee morale
- Provide a cost-efficient and humane way to retire older employees

- Personally benefit the business owner

Let's review the general qualification requirements for all employer-sponsored pension plans.

To receive the intended tax advantages, a pension plan must be a qualified plan, meeting specific rules and regulations established by Congress. In its regulation of pension plans, Congress generally intends that pensions be conservatively invested, relatively secure and widely available to employees on a nondiscriminatory basis.

A pension plan must provide a definite, written document setting forth procedures for:

1. Establishing a method of funding the plan.
2. Allocating responsibilities for administering the plan.
3. Establishing procedures for amending the plan.
4. Specifying the basis on which payments are made to and distributions made from the plan.
5. Meeting qualification requirements such as vesting, nondiscrimination, etc.

In addition, a pension plan:

1. Must be established by the employer for the exclusive benefit of the employees.
2. Must be communicated in writing to all employees.
3. Cannot discriminate in favor of highly compensated employees, which includes officers and shareholders.
4. Must be a written plan.

5.4 Qualification Requirements

Since Congress intends pension benefits to be widely available, it prohibits discrimination in favor of highly compensated employees. In general, a highly compensated employee is any employee who:

- Was a 5% or greater owner; or
- Received compensation in excess of an annually specified level and,
- If the employer elects to apply this rule, was in the top paid 20% of employees for the prior year.

For example:

Employee	Highly Compensated?
Receives a salary of \$130,000	Yes
Is paid \$90,000 but 25% of employees earn more	No
Owens 75% of the business	Yes
Is a vice president earning \$115,000	Yes

A shareholder who is NOT an employee of the corporation can participate in the corporation's pension plan.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. A shareholder who is an employee of the corporation can participate in the corporation's pension plan.]**

5.5 Employee Participation Requirements

To be qualified, a pension plan must meet the following employee participation requirements:

1. The plan may not exclude, on the basis of age or service requirements, any full-time employees who:
 - a. Have attained age 21 and
 - b. Have completed one year of service (or two years of service if the plan allows immediate 100% vesting).
2. Seasonal or part-time employees working less than 1,000 hours per year can be excluded.
3. Union employees, if covered under a similar plan or if retirement benefits are part of a collective bargaining agreement, and non-resident aliens who receive no U.S. income can be excluded.

In addition to nondiscrimination in benefits and contributions, a plan must satisfy specific coverage requirements in order to be qualified. A plan must satisfy the ratio percentage test or the average benefit percentage test.

1. **Ratio percentage test:** The percentage of non-highly compensated employees receiving benefits under the plan is divided by the percentage

of highly compensated employees benefiting under the plan. The resulting percentage must be at least 70%.

2. **Average benefit percentage test:** The average benefit percentage of non-highly compensated employees must be at least 70 percent of the average benefit percentage for highly compensated employees.

These tests and safe harbor provisions are beyond the scope of this course.

Generally, the IRS permits classifications based on:

1. Age.
2. Years of service.
3. Salaried versus hourly employees.
4. Union versus non-union employees.

The final determination as to whether or not a plan will be considered to be qualified always revolves around the fact that a plan must not discriminate in favor of the highly compensated.

Under the coverage requirements, a plan must satisfy either the ratio percentage test or the _____ percentage test.

- A. Level [**Your answer is incorrect. Under the coverage requirements, a plan must satisfy the ratio percentage test but not the level percentage test.**]
- B. Average benefit [**Your answer is correct. Under the coverage requirements, a plan must satisfy either the ratio percentage test or the average benefit percentage test.**]
- C. Basic [**Your answer is incorrect. Under the coverage requirements, a plan must satisfy the ratio percentage test but not the basic percentage test.**]
- D. Overall benefit [**Your answer is incorrect. Under the coverage requirements, a plan must satisfy the ratio percentage test but not the overall benefit percentage test.**]

5.6 Types of Qualified Plans

In general, all qualified plans can be classified in one of two ways: defined contribution or defined benefit.

In a **defined contribution plan**, the annual contribution to the plan is generally a fixed amount or percentage of participant compensation. An individual account is provided for each participant, and the participant receives whatever benefit can

be purchased by the funds accumulated in the account at retirement. Thus, a defined contribution plan is any plan in which the final benefit cannot be predetermined. It will depend on the amount of the contribution and the length of plan participation, as well as investment gains, losses and expenses.

In a **defined benefit plan**, the amount of an employee's retirement benefit, or a formula to determine the benefit amount, is set in advance. The contributions needed to provide the benefits are then actuarially determined.

The amount of the contribution will depend on such factors as the size of the benefit, the years to retirement and the assumed rate of return. For example, the higher the rate of return assumed, the lower the initial contribution.

Summary

The two general types of qualified plans are:

Defined Contribution	Defined Benefit
Individual account	Benefit specified
Contributions fixed or determinable	Definitely determinable
Benefit equals account value	Based on years of service and compensation
Account value: contributions, participation, incomes, gains and losses	

In a defined _____ plan, the employee's benefit is NOT fixed or definitely determinable.

- A. Benefit [Your answer is incorrect. In a defined benefit plan, the employee's benefit is fixed or definitely determinable.]
- B. Premium [Your answer is incorrect. In a defined premium plan, the employee's benefit is fixed or definitely determinable.]
- C. Payout [Your answer is incorrect. In a defined payout plan, the employee's benefit is fixed or definitely determinable.]
- D. Contribution [Your answer is correct. In a defined contribution plan, the employee's benefit is NOT fixed or definitely determinable.]

5.7 Contribution and Benefit Limits

In order for a retirement plan to be qualified, it must be structured so that benefits or contributions will not exceed certain limits.

The benefit and contribution limits change each year based on cost-of-living adjustments.

Certain plans may require employee contributions as a condition of participating in the plan, but only to the extent that they are not considered burdensome to lower-paid employees. As a general rule, required contributions are not considered burdensome if they do not exceed 6% of an employee's salary.

In addition, a plan can allow non-deductible voluntary employee contributions, as long as they do not exceed the maximum allowable contribution percentage and are not required as a condition of employment or plan participation.

Employer contributions to a defined contribution plan:

- A. May be anything the employer wishes. **[Your answer is incorrect. Employer contributions to a defined contribution plan may not be anything the employer wishes.]**
- B. Are set by the employee. **[Your answer is incorrect. Employer contributions to a defined contribution plan are not set by the employee.]**
- C. Are limited. **[Your answer is correct. Employer contributions to a defined contribution plan are limited to the maximum contribution percentage for the current year.]**
- D. Are not allowed. **[Your answer is incorrect. Employer contributions to a defined contribution plan are allowed.]**

5.8 Qualified Plan Types

A **defined contribution plan** can be designed in two ways: as a money purchase plan or as a profit-sharing plan.

1. In a **money purchase plan**, the contributions are not based on the employer's profits, but on a flat dollar amount or a fixed percentage of the annual participating employee payroll, a very common method. The benefit received is dependent on the amount of contributions and length of time the contributions have to increase in value until paid at retirement.
2. In a **profit-sharing plan**, employees are allowed to participate in the corporation's profits. Unlike a money purchase plan, however, the business is not required to make an annual contribution and can change

its contribution from year-to-year (within deductible limits), or make no contribution at all, if it so chooses. Notwithstanding this flexibility, over time contributions to the plan must be "substantial and recurring" if the plan is to avoid disqualification.

An employer can have both a money purchase and a profit-sharing plan.

Other combinations of plans exist, which include 401(k) plans, thrift plans and stock bonus plans, among others. A detailed review of these plans is beyond the scope of this lesson, but a summary follows.

A **401(k) plan** is a retirement savings plan with a qualified cash or deferred compensation arrangement. An employee may elect to defer taxation on a limited portion of salary by permitting the employer to contribute it to a 401(k) plan.

A **thrift plan** is a defined contribution plan that combines a savings plan and a retirement plan. Employees contribute pretax amounts to the plan, usually by salary deduction. Employers will often match or partially match the employee's contribution and the plans allow withdrawals and loans by participants.

A **stock bonus** plan is a qualified plan that invests in company stock and distributes the retirement benefits in company stock. Although contributions are not necessarily dependent on profits, allocations and distributions of stock are subject to profit-sharing plan requirements.

In a **defined benefit plan**, the amount of an employee's retirement benefit is fixed in advance and the annual contributions are based on accumulating the funds needed to provide this predetermined benefit. Since younger employees have a longer period of time for deposits to be made on their behalf, the employer's annual contributions to fund their benefits are generally smaller than those required for an older employee.

The proper formula for determining an employee's retirement benefit is the most critical factor in a defined benefit plan.

The **target benefit plans** are a cross between a defined contribution and defined benefit plan, although technically a defined contribution plan.

The retirement benefit and annual contribution required to provide it are calculated as in a defined benefit plan. It then functions as a defined contribution plan in that the same annual contribution is made each year and the benefit ultimately paid depends on investment results. In other words, the retirement benefit is a "target" and not a guarantee.

A qualified plan in which the employer is NOT required to make annual contributions is a _____ plan.

- A. Profit-sharing **[Your answer is correct. A qualified plan in which the employer is NOT required to make annual contributions is a profit-sharing plan; however, contributions still must be made to the plan, and must be "substantial and recurring" if the plan is to avoid disqualification.]**
- B. Corporate option **[Your answer is incorrect. A qualified plan in which the employer is required to make annual contributions is a corporate option plan.]**
- C. Voluntary contribution **[Your answer is incorrect. A qualified plan in which the employer is required to make annual contributions is a voluntary contribution plan.]**
- D. Combination **[Your answer is incorrect. A qualified plan in which the employer is required to make annual contributions is a combination plan.]**

Money Purchase Plan

Contributions to a money purchase plan are based on a predetermined and definite formula and are allocated to each participating employee's account. Amounts cannot exceed the lesser of a percentage of compensation or a flat dollar amount, based on a maximum compensation limit. Any forfeiture can be used to reduce employer contributions or be reallocated to accounts of remaining participants. Forfeitures are amounts of money that have been forfeited by plan participants who have left employment before being entitled to the money contributed to the plan on their behalf.

Benefits depend on the amount of the contributions, any forfeitures, and length of time contributions have to increase in value until paid at retirement.

Suitability:

- Favors younger employees who have more time for their funds to accumulate and increase in value.
- Appropriate when the employer wants fixed, determinable contributions.
- If the turnover rate is high, an employer can use plan forfeitures to reduce its contributions.

For example:

Employee	Age	Salary	Yrs. to Retire	Annual Contribution	Accumulated Amounts at Retirement*
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Billy	30	\$60,000	35	\$6,000	\$569,000
Willy	50	\$60,000	15	\$6,000	\$136,000
* Based on an average 5% rate of return.					

Traditional Profit-Sharing Plan

The contribution formula for a profit-sharing plan can be based on a:

1. Flat percentage of profits; such as 10%.
2. Percentage of profits above a minimum amount; such as 10% of profits exceeding \$25,000.
3. Percentage of profits based on an increasing scale; such as 5% of the first \$25,000, plus 10% of the next \$50,000, 15% of profits in excess of \$75,000, etc.
4. A discretionary amount determined annually by the Board of Directors.

The plan must provide a definite written, predetermined formula for allocating contributions among participants. The allocation formula can be based on an employee's income up to a predetermined limit, length of service, or a combination of these factors. Forfeitures must be reallocated to each participant's account. A maximum of 25% of compensation of all employees in the plan can be contributed and deducted in any one year. However, the IRS also prescribes a maximum annual amount of an employee's compensation that can be taken into account for this purpose, and this amount tends to increase each year.

Benefits depend on the amount of the contributions, any forfeitures, and length of time they have to increase in value until paid. Based on the written plan formula for distributions, they may be made after a fixed number of years, at a stated age, or in the event of death, disability, retirement, or termination of employment.

Suitability:

- Attractive to an employer who wants to offer employees a production incentive.
- Allows a company to skip contributions (may be particularly suitable for young companies with unstable profits).
- Favors younger employees who have more time for their funds to accumulate and increase in value.

For example:

Spinning Wheel Corp. provides profit-sharing contributions equal to 15% compensation (up to the allowable annual limit).

The contributions for four of its employees are as follows:

Employee	Salary	Annual Contribution
A	\$150,000	\$22,500
B	\$100,000	\$15,000
C	\$75,000	\$11,250
D	\$25,000	\$3,750
Totals	\$350,000	\$52,500

Age-Weighted, Comparability-Based and Integrated Profit Sharing Plans

Along with traditional profit sharing plans, there are profit sharing plans that calculate contribution allocations other than by fixed percentages of participants' compensation. While traditional profit sharing plans tend to favor younger employees, who have more time to accumulate retirement benefits, age-weighted and comparability profit sharing plans are designed to shift as much of an employer's annual contribution as possible to older, higher-paid plan participants.

Integrated profit sharing plans are designed to take into account participants' anticipated Social Security benefits in calculating their contribution allocations. This profit sharing approach also favors older, more highly compensated plan participants, and especially those who are earning salaries above the annual Social Security taxable earnings base.

While it is beyond the scope of this course to provide more detail about these plans, it is important to know they exist and that profit sharing plans can, to a substantial degree, be customized for each business entity considering establishing one.

Defined Benefit Plan

Using mortality and interest assumptions, the contribution to a defined benefit plan is the amount needed to provide the predetermined retirement benefit.

A predetermined amount or formula, up to the lesser of a maximum dollar amount which changes periodically or 100% of the employee's average compensation for the highest three consecutive years, is used to calculate each plan participant's benefit. The IRS also prescribes a maximum annual amount of compensation that can be taken into account for this purpose.

Suitability:

- Favors the higher-paid older employees who require larger contributions to make up for lost time.
- Attractive when the key employees or shareholder-employees of small- and medium-sized corporations are older.
- The selection of the benefit formula is critical to proper plan design.

The formula that an employer will decide upon for a plan being established will be one that addresses some basic retirement planning questions:

What do you want to do? Who do you want to do it for? What do you want to spend? Answers to these questions will guide the creation of the plan's benefit formula.

For example:

I. Flat Amount Formula = \$250 per Month			
Employee	Salary	Years of Service	Monthly Retirement Benefit
A	\$45,000	20	\$250
B	\$21,000	1	\$250

II. Flat Amount per Year of Service Formula = \$25 per Month per Year of Service			
Employee	Salary	Years of Service	Monthly Retirement Benefit
A	\$45,000	20	\$500
B	\$21,000	1	\$25

III. Flat Percentage of Earnings Formula = 24% of Earnings			
Employee	Salary	Years of Service	Monthly Retirement Benefit
A	\$45,000	20	\$900
B	\$21,000	1	\$420

IV. Unit Benefit Formula = 2% of Annual Compensation for Each Year of Future Service, 1% for Each Year of Past Service			
Employee	Salary	Years of Service	Monthly Retirement Benefit

		Past	Future	
A	\$45,000	20	25	\$2,625
B	\$21,000	1	25	\$893

Comparison

Employee A's Benefit	Formula	Employee B's Benefit
\$250	Flat Amount	\$250
\$500	Flat Amount/Year of Service	\$25
\$900	Flat Percentage of Earnings	\$420
\$2,625	Unit Benefit	\$893

Target Benefit Plan

Contributions to a target benefit plan are fixed and based on the annual contribution needed to provide a "target" retirement benefit at an assumed rate of return.

The benefits are whatever the amount available in the employee's account will provide; may be higher or lower than the "target" benefit and based upon actual return on the money invested.

Suitability:

- Favors older employees since the calculation of the annual contribution is based on the employee's age, as in a defined benefit plan.
- Employer's contributions are required.
- Earnings above the assumed rate of return increase employee's benefit rather than decrease the employer's contributions, as in a defined benefit plan.

Target Benefit = 35% of Compensation Annual Contributions Based on 6½% Rate of Return								
Employee	Age	Monthly Salary	Target Benefit	Annual Contributions	Results at Retirement			
					6.5% Return		10% Return	
					Cash	Benefit	Cash	Benefit
A	55	\$5,500	\$1,925	\$16,341	\$234,850	\$1,925	\$286,467	\$2,348

If the money invested in the plan were to earn 10% instead of 6½%, Employee A would receive \$2,348 per month at retirement instead of \$1,925.

5.9 Social Security Integration

Through their contributions to Social Security, employers are helping to provide their employees with a retirement benefit. Since Social Security contributions by both the employer and employee are "capped" at the taxable earnings base and retirement benefits are limited to a maximum covered earnings base, Social Security tends to discriminate against higher-paid employees.

Integration—also known as "permitted disparity"—allows the private plan to become an extension of Social Security, allowing the employer to take into account its contributions to Social Security when designing the private plan. The result is that the private plan costs less and the two plans combined help to offset the discrimination against the higher-paid employees.

Defined Contribution

The excess contribution percentage in a defined contribution plan may not exceed the percentage contributed on the amount of salary up to the taxable earnings base or integration level by more than the lesser of:

1. The base contribution percentage; or
2. That amount of the tax attributable to old age insurance tax (not including disability insurance) at the beginning of the plan year or 5.7%, whichever is greater. When this percent becomes greater than 5.7%, the IRS will issue a "timely publication."

For example, a plan providing for a contribution of 10% of base compensation up to the integration level and 15.7% of excess compensation would be allowed because the difference between the base and excess percentages is 5.7%, which meets criterion number 2. If the base contribution percentage were 3%, then the excess contribution percentage would be limited to 6% under criterion number 1.

According to the formula, 8.72% of base compensation up to the integration level and 14.42% of excess compensation would be allowed under IRS rules.

- A. True **[Your answer is correct. The formula: 8.72% of base compensation up to the integration level and 14.42% of excess compensation would be allowed under IRS rules because the difference is the allowable maximum of 5.7%.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

Defined Benefit

Integration of a defined benefit plan considers the benefit that will be received from Social Security at retirement. The excess benefit percentage may not exceed the base benefit percentage by more than the maximum excess allowance. This limitation is designed to moderate the permitted disparity between the benefits payable to higher- and lower-paid participants.

The maximum excess allowance is the lesser of:

- The base percentage; or
- A formula that multiplies a percentage times years of service.

The maximum excess allowance formula is calculated by multiplying $\frac{3}{4}$ of 1% (.0075 or .75%) times the years of service with a maximum of 35 years of service. Therefore, the maximum excess allowance based on 35 years of service would be $.75\% \times 35 = 26.25\%$.

Let's look at the maximum excess allowance for several employees.

Employee	Years of Service	Calculation of Maximum Excess Allowance
A	10	$.75\% \times 10 = 7.5\%$
B	30	$.75\% \times 30 = 22.5\%$
C	40	$.75\% \times 40 = 26.25\%$

The integration level can be determined several ways. The most common to determine an integration level is to use a table (the covered compensation table), which averages the taxable earnings base. An individual's covered compensation depends on a person's year of birth and the year for which the calculation is made. Another variation is to use a dollar amount not greater than the taxable earnings base. If this method is used, the $\frac{3}{4}$ of 1% must be reduced. Other variations can be elected, but may also require changes in the maximum excess allowance formula if they do not meet the safe harbor guidelines.

The maximum excess allowance is calculated based on years of service times $\frac{3}{4}$ of 1 percent.

- A. True **(Your answer is correct. The maximum excess allowance formula is calculated by multiplying $\frac{3}{4}$ of 1% (.0075 or .75%) times the years of service with a maximum of 35 years of service.)**
- B. False **(Your answer is incorrect. This is not a false statement.)**

Defined Benefit Offset

An alternate method of defined benefit plan integration is by offset. In defined benefit offset plans, the employee's accrued benefit may be reduced (offset) to account for Social Security retirement benefits.

Only a defined benefit plan may use the offset method of plan integration.

In effect, Social Security integration allows an employer to design a qualified plan that favors higher-paid employees in order to offset the effect of Social Security discrimination.

- A. True **[Your answer is correct. In effect, Social Security integration allows an employer to design a qualified plan that favors higher-paid employees in order to offset the effect of Social Security discrimination.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

5.10 Vesting

A qualified plan must either vest a participant's benefit in the plan immediately or on a deferred basis generally within the limits to one of two minimum vesting schedules.

It should be noted that an employee must be 100% vested in his or her voluntary contributions at all times. Vesting in employer contributions—other than employer matching contributions—can be immediate or granted over a period of time, according to one of the two minimum vesting schedules:

- 5-year cliff vesting
- graded vesting from 3 to 6 years

Under the **5-year vesting schedule**, a participant must be 100% vested at the end of five years of service.

This is frequently referred to as "cliff" vesting, because if an employee terminates employment with less than five years of service, he or she has no right to the employer-provided plan benefits. With five years of service that employee becomes 100% vested.

Using the **graded vesting schedule**, the employee is gradually vested, beginning with specific percentages in year three and becoming 100% vested after seven years of service. The minimum graded vesting schedule is:

Years of Service	Compensation
3	20%
4	40%
5	60%
6	80%
7	100%

It should be noted that an employer could adopt a more liberal graded vesting schedule. For example, 20% per year after one year of service, resulting in 100% vesting after five years of service.

When a qualified plan calls for **employer matching contributions**, such as is often found in 401(k) plans, the minimum vesting requirements for those matching contributions are somewhat accelerated when compared to other employer contributions.

Similar to the minimum vesting requirements that apply to other employer contributions, vesting of **employer matching contributions** may be immediate or granted over a period of time according to one of two minimum vesting schedules:

- 3-year cliff vesting; or
- graded vesting from 2 to 6 years.

Under the 3-year cliff vesting schedule, a participant must be 100% vested in employer matching contributions at the end of three years of service, although the plan is not required to vest employer matching contributions, even partially, before the end of three years.

Under the graded vesting schedule for employer matching contributions, the minimum vesting schedule is as follows:

Years of Service	Vesting Percentage
2	20%
3	40%

4	60%
5	80%
6	100%

In regulating qualified plans, Congress has always sought to eliminate discrimination whereby a plan primarily benefits a certain prohibited group known as key employees. A plan that is considered **top-heavy**—primarily benefiting key employees—must provide vesting at a more rapid rate.

In simple terms, a plan is considered top-heavy if over 60% of the accrued benefits are allocated to key employees.

If a plan is top-heavy, it must provide vesting of all employer contributions at a more rapid rate, according to one of two minimum vesting schedules:

1. 3-year vesting—a participant must be 100% vested after three years of service.
2. 6-year graded vesting—a participant must be 20% vested after two years of service, increasing 20% per year until reaching 100% vesting after six years of service.

In a top-heavy plan, each non-key employee must also receive stipulated minimum contributions or benefits.

Which of the following vesting schedules is a minimum vesting schedule known as "cliff" vesting?

- A. 100% vesting after five years of service **[Your answer is correct. One hundred percent vesting after five years of service is known as "cliff" vesting.]**
- B. 20% vesting per year after four years of service, resulting in 100% vesting after eight years **[Your answer is incorrect. Twenty percent vesting per year after four years of service, resulting in 100% vesting after eight years is not known as "cliff" vesting.]**
- C. 25% vesting per year after four years of service, resulting in 100% vesting after seven years **[Your answer is incorrect. Twenty-five percent vesting per year after four years of service, resulting in 100% vesting after seven years is not known as "cliff" vesting.]**
- D. 100% vesting after six years of service **[Your answer is incorrect. One hundred percent vesting after six years of service is not known as "cliff" vesting.]**

5.11 Pension Plan Investments

Pension plan funds can be invested in any type of investment, such as common stocks, bonds, mutual funds and life insurance.

The person or entity that is responsible for operating the plan is called the **fiduciary**. A fiduciary must:

- Invest prudently.
- Act solely in the interest of participants.
- Avoid prohibited transactions.

The fiduciary that pursues an aggressive investment policy can be held personally liable for any losses to the plan due to the volatility of these investments.

Since the fiduciary must act solely in the interest of plan participants and their beneficiaries, any action taken by the fiduciary, which is contrary to that interest, is prohibited. As a result, specific transactions between the plan and a party-in-interest are prohibited transactions.

A party-in-interest can be a fiduciary, employer, owner, a person providing services to the plan and members of their families, as well as an employee organization whose members are covered by the plan.

5.12 Life Insurance in a Qualified Plan

Life insurance can be part of a qualified plan, so long as it is incidental to the primary objective of providing retirement benefits. The portion of the premium that provides current life insurance protection is taxable income to the insured employee.

For the employer in a small business, life insurance in the plan can be an attractive proposition, particularly if there is a need for insurance coverage that would have required after-tax, personal dollars to fulfill.

There are many advantages to including life insurance in a qualified plan. Life insurance:

- May be purchased with tax-deductible dollars.
- Offers a number of guarantees, which may include guaranteed interest rates on cash values and guaranteed annuity purchase price rates at retirement.

- May be less costly than similar coverage purchased outside the qualified plan if the tax to the employee (calculated on special IRS table rates or the insurance company's own term rates) would be lower than paying the full insurance premium. In addition, if the employer is also the employee, his or her deduction as employer may be greater than the tax cost he or she pays as an employee.
- Provides permanent coverage to a retiree while group insurance terminates at retirement.
- Provides life insurance coverage for participants who might otherwise be unable to purchase it personally.
- Can be purchased by a profit-sharing plan to cover key persons.
- If a plan participant dies before retiring, the net amount at risk in any life insurance on the participant will be paid out of the plan tax-free,

Since a qualified plan must have as its primary objective the payment of retirement benefits, death benefits can only be provided as long as they are incidental to this primary objective. There are tests a plan must meet to prove that the life insurance death benefit is incidental.

- **Defined Contribution and Defined Benefit Plans** - The premium for a level amount whole life policy must be less than 50% of the aggregate of employer contributions on a participant's behalf. For a term or universal life policy, the premium must be less than 25% of the employer's annual contribution on a participant's behalf.
- **Defined Benefit Plan Safe Harbor** - The death benefit cannot exceed 100 times the monthly benefit at retirement.

For example:

A \$4,000 pension contribution is made to a defined contribution pension plan on employee A's behalf. The maximum premium for life insurance that is to be included in the plan is:

- Whole Life - \$1,999
- Term or Universal Life - \$999

Employee B is entitled to a monthly retirement benefit of \$500 from a defined benefit plan. The safe harbor death benefit for insurance included in the plan is \$50,000.

Since life insurance is a current benefit to plan participants, the IRS imposes income tax on the economic value of the pure death benefit provided under a qualified plan. The amount included in a participant's gross income for tax purposes generally is calculated using rates specified in a special IRS table. In the past, the rates used for these calculations were called P.S. 58 rates.

However, for most plans the P.S. 58 rates have been replaced by Table 2001 rates.

The tax cost is calculated by subtracting the policy's cash value from its face amount and multiplying the difference by the applicable rate. The tax cost is generally lower than the actual premium costs for the insurance.

Which of the following are advantages of including life insurance in a qualified plan?

- I. It may offer a guaranteed rate of return.
 - II. It may be purchased with tax-deductible dollars.
 - III. It may be continued after retirement.
 - IV. It may guarantee annuity purchase rates at retirement.
- A. I, II and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. II, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - C. I, II and III only **[Your answer is only partially correct. There is a better response to this question.]**
 - D. I, II, III and IV **[Your answer is correct. Options I, II, III and IV are all advantages of including life insurance in a qualified plan.]**

5.13 403(b) Plans

Section 403(b) plans, also known as tax-deferred annuities (TDAs) are qualified plans established by nonprofit organizations and public schools for the benefit of their employees. They have the following tax advantages:

- Contributions to a TDA are excluded from a participant's gross taxable income.
- Earnings in a TDA accumulate tax-free until distribution.
- Both the earnings in a TDA and any previously excluded contributions are taxable upon distribution.

Since the employer sponsoring a 403(b) plan is not a tax paying entity, there are no tax advantages for the employer.

There are two types of TDA plans:

1. **Salary Reduction Only** - The employer makes no additional contributions to the plan; instead, the employee's salary is reduced, with the amount of the salary reduction contributed by the employer to a TDA. The employee is then taxed on his or her net income.

2. **Additional Employer Contribution** - The employer makes additional contributions to a TDA on behalf of the employee. These contributions are not included in the employee's taxable income and may be made whether or not the employee also contributes to the plan through salary reduction.

As qualified plans, TDAs are subject to eligibility and minimum participation requirements, similar to those reviewed earlier in this lesson.

TDAs are considered **defined contribution plans**.

If the TDA is a pure **salary reduction plan**, as many are, the employee can elect to reduce his or her salary up to a maximum amount annually. There is, however, a special lifetime catch-up provision that allows certain employees to exceed the regular elective deferral limit.

The two primary TDA plan requirements are:

1. The plan must be in writing.
2. The employer must remit the TDA contributions to either an annuity contract or to a custodial account, which has a wide variety of investment options, such as mutual funds, stocks, bonds, etc.

In addition, the employee's rights to his or her salary reduction contributions to a TDA must be nontransferable and nonforfeitable (or 100% vested). Additional employer contributions can be subjected to delayed vesting similar to the delayed vesting schedules applicable to other qualified plans.

TDAs are available to employees of _____ organizations and public schools.

- A. Corporate **[Your answer is incorrect. TDAs are not available to employees of corporate organizations and public schools.]**
- B. Government-related **[Your answer is incorrect. TDAs are not available to employees of government-related organizations and public schools.]**
- C. Nonprofit **[Your answer is correct. TDAs are available to employees of nonprofit organizations and public schools.]**
- D. Education-related **[Your answer is incorrect. TDAs are not able to employees of education-related organizations and public schools.]**

5.14 Traditional Individual Retirement Accounts (IRAs)

Up to this point, we've concentrated on qualified plans made available by an employer to its employees. There is, however, a personal retirement plan known

as a traditional individual retirement account, or traditional IRA, that offers these tax advantages:

- Income tax-deductible contributions within specified limits
- Tax-deferred accumulation of savings
- 100% immediate vesting
- Ability to transfer qualified funds with no current tax liability
- Restricted withdrawals prior to age 59½ in order to encourage savings

Note: The earnings in an IRA and any previously untaxed contributions are taxable upon distribution.

The lesser of 100% of compensation or the applicable IRA contribution limit can be **contributed** to a traditional IRA each year. The full amount can be **deducted** from gross income as long as the contributor is not an active participant in an employer's qualified plan.

The applicable IRA contribution limit for 2025 is \$7,000.

If a single employee is an active participant in an employer's pension plan, a traditional IRA contribution can still be made up to the specified limits. It will be fully deductible, partially deductible or nondeductible, depending on the employee's adjusted gross income. The deduction is gradually phased out as adjusted gross income increases, until finally no deduction is available. A non-working spouse of an individual who is a participant in an employer's pension plan can make a full tax-deductible contribution to a traditional IRA as long as the couple's adjusted gross income does not exceed certain inflation-adjusted IRS-established limits.

In addition to their regular IRA contributions, individuals who are age 50 and older are permitted to make **catch-up** contributions to their IRAs. These catch-up contributions may be either to a traditional IRA or a Roth IRA.

An additional \$1,000 catch-up contribution is allowed for individuals age 50 or older (bringing their total to \$8,000)

Whether contributions are fully deductible, partially deductible or nondeductible, all money contributed to an IRA grows income tax-deferred.

A simplified employee pension plan (SEP) is a type of traditional IRA that can accept contributions from an employer, although the employee owns the SEP account funds.

The employer can contribute up to a maximum amount each year. The employer can deduct its contributions, and the employees enjoy the tax advantages of a traditional IRA.

While a SEP has eligibility and participation requirements similar to other pension plans, it can be much easier for the small employer to administer.

IRA contributions in excess of the regular limits for individuals age 50 or older are catch-up contributions.

A. True **[Your answer is correct. In addition to their regular IRA contributions, individuals who are age 50 and older are permitted to make catch-up contributions to their IRAs. These catch-up contributions may be either to a traditional IRA or a Roth IRA.]**

B. False **[Your answer is incorrect. This is not a false statement.]**

5.15 SIMPLE Accounts

The Small Business Job Protection Act of 1996 added another IRA plan known as a **SIMPLE** (Savings Incentive Match Plan for Employees). Contributions to a SIMPLE plan can only be made through a qualified salary reduction arrangement under which:

1. Amounts contributed are expressed as a percentage of compensation and may not exceed the applicable limit on elective deferrals;
2. The employer makes contributions according to a formula; and
3. The employer does not maintain any other qualified plans.

A company must have had no more than 100 employees; and any employee who has earned \$5,000 in any two previous years and is expected to earn \$5,000 in the current year can participate in the plan.

The applicable limit on elective deferrals to SIMPLE IRAs and SIMPLE 401(k) plans for 2024 is \$16,000.

In addition to regular SIMPLE elective deferrals, individuals who are age 50 and older are permitted to make salary reduction **catch-up** contributions to their SIMPLE plans above the regular elective deferral limits. The catch-up contribution amount for 2024 is \$3,000.

A SIMPLE can be established in one of two ways:

1. In the form of an IRA for each employee
2. In the form of a 401(k) plan

Neither type of SIMPLE is subject to nondiscrimination or top-heavy rules.

Contributions to a SIMPLE account are generally not taxable until withdrawn. Contributions to a SIMPLE account set up as an IRA are not subject to the same dollar limits as IRAs.

Contributions must be fully vested. Premature distributions from a SIMPLE IRA are subject to a 25% penalty during the first two years of participation. Thereafter, the penalty is 10%.

What is the penalty for a premature distribution from a SIMPLE IRA in year two?

- A. 10% **[Your answer is incorrect. The penalty for a premature distribution from a SIMPLE IRA in year two is not 10 percent.]**
- B. 25% **[Your answer is correct. The penalty for a premature distribution from a SIMPLE IRA in year two is 25 percent.]**
- C. 6% **[Your answer is incorrect. The penalty for a premature distribution from a SIMPLE IRA in year two is not six percent.]**
- D. 15% **[Your answer is incorrect. The penalty for a premature distribution from a SIMPLE IRA in year two is not 15 percent.]**

5.16 The Roth IRA

By and large, the Roth IRA is designed to extend a tax-advantaged retirement program to a broader range of wage earners than can take advantage of the tax deductibility of traditional IRA contributions.

The tax advantage provided with the Roth IRA, though, is not a front-end advantage as tax-deductibility of contributions is with the traditional IRA. It is a

back-end advantage: the ability to take qualified distributions from the Roth IRA on a tax-free basis.

Contributions to a Roth IRA are made with after-tax dollars, are nondeductible and can be made up to the applicable IRA contribution limit. The Roth IRA contribution limits are reduced by any amount an individual contributes to a traditional IRA. Contributions can be continued even past age 70½. In addition, traditional IRA minimum distribution rules do not apply to Roth IRA account balances. The maximum contribution limit in 2025 is \$7,000.

Access to the Roth IRA (2024 figures) is phased out for single taxpayers with Adjusted Gross Incomes between \$146,000 and \$161,000 and for married taxpayers with Adjusted Gross Incomes between \$230,000 and \$240,000. These income limits are not dependent on participation by the taxpayer in a qualified plan. They apply to everyone. This is in contrast to the income limit on traditional IRAs, which only applies if a taxpayer is a participant in a qualified plan. Traditional IRA rules apply to Roth IRAs except where expressly changed.

For distributions from a Roth IRA to be totally tax-free, rather than merely tax-deferred, they must be either “qualified distributions” or distributions taken from the Roth IRA after age 59½ at a time that the Roth IRA has been in existence for at least five years. These distributions will be completely tax free anytime they are taken after these requirements are met. Distributions from a Roth IRA or spousal Roth IRA made during the initial five years the Roth IRA is in existence may be considered “qualified distributions” and be excluded from gross income if they are:

- Made on or after the individual reaches age 59½;
- Made after the death of the individual;
- Attributable to the individual's being disabled; or
- Made as a special purpose distribution.

Traditional IRA owners may convert them to a Roth IRA. This involves paying regular income tax on the balance (other than nondeductible contributions in the account), but the 10% early withdrawal penalty does not apply to these rollovers. As a Roth IRA, qualifying withdrawals will not be taxed. The decision to do this conversion depends on the individual's current tax bracket, the time until withdrawals are expected, and the tax bracket expected at the time of withdrawal.

We've spent most of this lesson discussing how qualified plans are designed and funded and the rules that come into play. Since the major purpose of these plans is to provide retirement benefits, we need to turn our attention now to how and when that happens.

5.17 Retirement Benefits

Generally, distributions made before age 59½, except in specific circumstances such as death or disability, are subject to a penalty tax of 10% of the premature distribution. In addition, distributions, other than Roth IRA distributions, must begin by April 1st following the year in which the participant attains age 73 or, if the individual remains employed and is not a 5% owner of the entity employing him/her, no later than in the year of actual retirement. Note, however, that distributions from a traditional IRA, a SEP or a SIMPLE plan, must begin no later than April 1 of the calendar year following the calendar year in which the IRA owner turns 73 regardless of whether the participant remains employed. Any part of the required distribution that is not actually distributed is subject to a 50% penalty tax. (For many years prior to 2020, the age was 70½. The age was briefly raised to 72 and is now 73. It is scheduled to be 75 in 2033.)

An employer's qualified plan must provide that, unless the participant elects otherwise, benefits will begin within 60 days after the latest of:

1. Age 65 or the plan's normal retirement age, whichever is earlier.
2. The 10th year of plan participation.
3. The year of termination of service.

In no event can the participant elect to defer distributions beyond April 1st of the year following attainment of age 73 or the year of actual retirement. As previously noted, participants in traditional IRAs, SEPs and SIMPLE plans cannot defer distributions beyond age 73. Roth IRAs are not subject to this requirement.

For example:

Ted, age 60, begins participating in his employer's pension plan which has a normal retirement age of 65. Ted's benefits can be delayed until he has accumulated 12 years of plan participation at age 73.

Retirement benefits are generally paid out from an employer's plan as a lump-sum distribution or as periodic payments.

Taxes are not paid until benefits from a qualified plan are ultimately distributed. At that time, the employee must pay income taxes on the benefits received.

There are no tax consequences for the employer. Since contributions to the plan were tax deductible, the employer does not receive a tax deduction for benefits paid.

Let's review the participant's taxation for both periodic payments and a lump-sum distribution.

If the employee has no cost basis, the full amount of each periodic payment will be taxed as ordinary income.

An employee's cost basis is equal to:

- The total of any non-deductible employee contributions; plus
- The total of any annual insurance costs (from a special IRS table) included in the employee's income.

If the employee has a cost basis, then an **exclusion ratio** must be calculated.

The exclusion ratio produces the percentage of each periodic payment that can be excluded from gross income. It is calculated by dividing the cost basis by the total expected periodic payments. Once the cost basis is recovered, the employee must pay income tax on the full amount of each periodic payment.

5.18 Taxation of Lump-Sum Distributions

To be considered a lump-sum distribution, it must:

1. Be made in one taxable year;
2. Constitute the employee's entire balance; and
3. Be payable on account of the employee's death, attainment of age 59½ or separation from service.

After subtracting the employee's cost basis, the balance of the lump-sum distribution will be subject to income taxation in the year it is received.

An individual who receives Required Minimum Distributions (RMDs) that must be distributed during a particular year are not eligible for rollover treatment.

IRA rollovers of pension distributions are subject to all the restrictions and benefits of regular IRAs.

The employer can tax deduct benefit payments to a participant from a qualified plan and the participant must pay taxes on these benefits as received.

A. True **[Your answer is incorrect. This is not a true statement.]**

- B. False **[Your answer is correct. The employer cannot tax deduct benefit payments to a participant from a qualified plan and the participant must pay taxes on these benefits as received.]**

LESSON PRACTICE TEST FIVE

All of the following are tax advantages of an employer-sponsored qualified plan EXCEPT:

- A. Tax-deductible contributions **[Your answer is incorrect. Tax-deductible contributions are a tax advantage of an employer-sponsored qualified plan.]**
- B. Tax-deferred growth of plan contributions **[Your answer is incorrect. Tax-deferred growth of plan contributions is a tax advantage of an employer-sponsored qualified plan.]**
- C. No current taxation of plan participants **[Your answer is incorrect. No current taxation of plan participants is a tax advantage of an employer-sponsored qualified plan.]**
- D. Tax-free pension benefits **[Your answer is correct. A tax advantage of an employer-sponsored qualified plan would not be tax-free pension benefits.]**

Employer-sponsored qualified plans can be established by corporations, sole proprietorships and partnerships, and by _____ organizations and public schools.

- A. Government **[Your answer is incorrect. Employer-sponsored qualified plans cannot be established by corporations, sole proprietorships and partnerships, and by government organizations and public schools.]**
- B. Nonprofit **[Your answer is correct. Employer-sponsored qualified plans can be established by corporations, sole proprietorships and partnerships, and by nonprofit organizations and public schools.]**
- C. For profit **[Your answer is incorrect. Employer-sponsored qualified plans cannot be established by corporations, sole proprietorships and partnerships, and by for-profit organizations and public schools.]**
- D. Government-approved **[Your answer is incorrect. Employer-sponsored qualified plans cannot be established by corporations, sole proprietorships and partnerships, and by government-approved organizations and public schools.]**

Which of the following employees must be considered highly compensated employees?

- I. An officer of the company who is paid 40% of the defined benefit limit.
- II. A 10% shareholder-employee who earns \$30,000 per year.
- III. An employee earning \$75,000 per year who is not in the top paid group of employees.
- IV. An employee not in the top paid 20%, earning \$50,000 per year.
 - A. I and II only **[Your answer is only partially correct. There is a better response to this question.]**
 - B. II only **[Your answer is correct. A 10 percent shareholder-employee who earns \$30,000 must be considered a highly compensated employee.]**
 - C. II, III and IV only **[Your answer is only partially correct. There is a better response to this question.]**
 - D. I, II, III and IV **[Your answer is only partially correct. There is a better response to this question.]**

A pension plan with a graded vesting schedule can require a maximum of one year of service for an employee to be eligible to participate.

- A. True **[Your answer is correct. A pension plan with a graded vesting schedule can require a maximum of one year of service for an employee to be eligible to participate.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**

There are two general types of pension plans, defined contribution plans and defined _____ plans.

- A. Premium **[Your answer is incorrect. There are two general types of pension plans, but they are not defined contribution plans and defined premium plans.]**
- B. Payout **[Your answer is incorrect. There are two general types of pension plans, but they are not defined contribution plans and defined payout plans.]**
- C. Investment **[Your answer is incorrect. There are two general types of pension plans, but they are not defined contribution plans and defined investment plans.]**
- D. Benefit **[Your answer is correct. There are two general types of pension plans, defined contribution plans and defined benefit plans.]**

As a general rule, required employee contributions will NOT be considered burdensome if they do not exceed 20% of the employee's salary.

- A. True **[Your answer is incorrect. This is not a true statement.]**

- B. False **[Your answer is correct. As a general rule, required employee contributions will not be considered burdensome if they do not exceed 6% of the employee's salary.]**

A qualified plan which fixes in advance a retirement benefit of \$25 per month for each year of service is a:

- A. Money purchase plan. **[Your answer is incorrect. A qualified plan which fixes in advance a retirement benefit of \$25 per month for each year of service is not a money purchase plan.]**
- B. Defined contribution plan. **[Your answer is incorrect. A qualified plan which fixes in advance a retirement benefit of \$25 per month for each year of service is not a defined contribution plan.]**
- C. Profit-sharing plan. **[Your answer is incorrect. A qualified plan which fixes in advance a retirement benefit of \$25 per month for each year of service is not a profit-sharing plan.]**
- D. Defined benefit plan. **[Your answer is correct. A qualified plan which fixes in advance a retirement benefit of \$25 per month for each year of service is a defined benefit plan.]**

Vesting is the employee's forfeitable right to benefits in a retirement plan.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. Vesting is not the employee's forfeitable right to benefits in a retirement plan.]**

A plan that primarily benefits _____ employees is considered a top-heavy plan.

- A. Lower-level **[Your answer is incorrect. A plan that primarily benefits lower-level employees is not considered a top-heavy plan.]**
- B. Middle management **[Your answer is incorrect. A plan that primarily benefits middle management employees is not considered a top-heavy plan.]**
- C. Key **[Your answer is correct. A plan that primarily benefits key employees is considered a top-heavy plan.]**
- D. Older **[Your answer is incorrect. A plan that primarily benefits older employees is not considered a top-heavy plan.]**

A fiduciary that pursues a very aggressive investment policy can be held personally liable for any losses to the plan assets.

- A. True **[Your answer is correct. A fiduciary that pursues a very aggressive investment policy can be held personally liable for any losses to the plan assets.]**

- B. False **[Your answer is incorrect. This is not a false statement.]**

Whole life insurance purchased in a defined contribution plan must be incidental; that is, the cost must be less than _____% of the employer's contribution for the participant.

- A. 40 **[Your answer is incorrect. Whole life insurance purchased in a defined contribution plan must be incidental, that is, the cost is not less than 40% of the employer's contribution for the participant, is not a true statement.]**
- B. 50 **[Your answer is correct. Whole life insurance purchased in a defined contribution plan must be incidental, that is, the cost must be less than 50% of the employer's contribution for the participant.]**
- C. 60 **[Your answer is incorrect. Whole life insurance purchased in a defined contribution plan must be incidental, that is, the cost is not less than 60% of the employer's contribution for the participant is not a true statement.]**
- D. 65 **[Your answer is incorrect. Whole life insurance purchased in a defined contribution plan must be incidental, that is, the cost is not less than 65% of the employer's contribution for the participant is not a true statement.]**

All of the following statements concerning TDAs are correct EXCEPT:

- A. TDAs can be either defined contribution or defined benefit plans. **[Your answer is correct. TDAs cannot be either defined contribution or defined benefit plans.]**
- B. TDAs must be in writing. **[Your answer is incorrect. TDAs must be in writing.]**
- C. The employee must be 100% vested immediately. **[Your answer is incorrect. The employee must be 100% vested immediately.]**
- D. The employer must remit the TDA contributions. **[Your answer is incorrect. The employer must remit the TDA contributions.]**

An employee who is an active participant in an employer's pension plan cannot contribute to a traditional IRA.

- A. True **[Your answer is incorrect. This is not a true statement.]**
- B. False **[Your answer is correct. An employee who is an active participant in an employer's pension plan can contribute to a traditional IRA.]**

Harold has just retired from the Ajax Buggywhip Corporation. He will receive \$2,000 per month from the Ajax retirement plan. Harold has made no

contributions to the plan and has had no annual insurance costs through the years. How much retirement income will Harold be taxed on each year?

- A. \$12,000 **[Your answer is incorrect. Harold will not be taxed on \$12,000 retirement income each year.]**
- B. \$2,000 **[Your answer is incorrect. Harold will not be taxed on \$2,000 retirement income each year.]**
- C. \$22,000 **[Your answer is incorrect. Harold will not be taxed on \$22,000 retirement income each year.]**
- D. \$24,000 **[Your answer is correct. Harold will be taxed on \$24,000 retirement income each year.]**

SIMPLEs established as 401(k) plans are NOT subject to nondiscrimination or top-heavy rules.

- A. True **[Your answer is correct. SIMPLEs established as 401(k) plans are NOT subject to nondiscrimination or top-heavy rules.]**
- B. False **[Your answer is incorrect. This is not a false statement.]**