Wolters Kluwer
Journal of Deferred Compensation
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Frederick, MD 21704

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JOURNAL OF DEFERRED COMPENSATION

VOLUME 22 NUMBER 2 • WINTER 2017

9900600840

JOURNAL OF DEFERRED COMPENSATION

Nonqualified Plans and Executive Compensation

Editor: Bruce J. McNeil, Esq.

VOLUME 22, NUMBER 2
WINTER 2017

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- TO BE OR NOT TO BE A DEFERRED COMPENSATION PLAN
  Bruce J. McNeil

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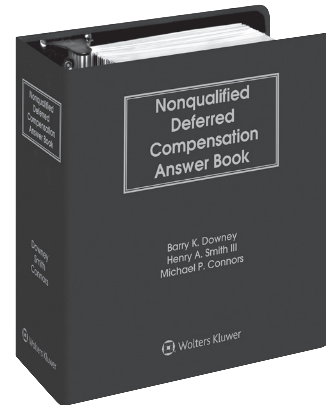

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Solutions to Split-Dollar Increasing Term Costs

Part two of a two-part series

RYAN EVANS AND LEE NUNN

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This article is Part Two of a two-part series on postretirement economic benefit regime split-dollar, which is a life insurance arrangement for executives. Part One describes the issues that participants and their employers face in these arrangements. Part Two describes what employers that still sponsor these arrangements can do to address these issues. Part Two assumes that the reader has either read part one or understands split-dollar and the motivation to identify a practical alternative.

SCOPE OF DISCUSSION

Although split-dollar takes many shapes and forms, this two-part series addresses postretirement arrangements taxed under the economic benefit regime until death. The economic benefit regime is characterized by annual term costs, which are either imputed as wages or contributed by the retiree or a third party such as an irrevocable life insurance trust (ILIT). These term costs can reach cripplingly high levels late in life. Sometimes these high term costs were anticipated by participants and

their employers. More frequently, incurring these high term costs at advanced ages is the result of worse than expected policy performance, which has extended the duration of the arrangement far beyond what was envisioned when the policies were issued.

Recap of Split-Dollar Challenges

As described in Part One, split-dollar participants and their employers face numerous challenges. Term rates increase at every age. The availability of relatively affordable carrier term rates can disappear after certain ages or the rate table can disappear entirely, such as when the carrier discontinues the sale of the term product. Some term products fail to meet the criteria of the Internal Revenue Service (IRS). Policies with large face amounts are often second-to-die split-dollar arrangements, which experience dramatic increases in term costs after the first death. Imputed term costs generally require FICA withholding, which necessitates a withholding source or a gross-up. Gross-ups can create new challenges in the form of IRC Section 409A compliance, which complicates attempts to settle. In addition, high term costs can create gift tax issues when rights to the benefit have been assigned to an ILIT for estate tax planning purposes. Finally, US GAAP now requires benefit obligations for most postretirement split-dollar arrangements even where no additional premiums will be paid.

Solutions Are Situation Specific

No single solution solves every situation. For example, term rates vary. When relatively favorable carrier rates meet IRS criteria, term costs may be manageable, especially when coverage amounts are modest. Other arrangements may be required to use the less favorable uniform Table 2001 term rates, which become unaffordable at older ages on high death benefits. Participants' priorities vary. Whereas older participants often focus on their beneficiaries' receiving these death proceeds income tax-free, younger participants may focus more on the many years of future out-of-pocket costs. A gross-up reduces these employee out-of-pocket costs but can create 409A issues when employers create a legally binding right to the gross-up. Employer perspectives vary. Whereas some employers consider themselves paternalistic and bound by a moral obligation to provide an expected benefit, other employers focus on their unilateral right to terminate the plan without compensating participants. Plan documents vary. Some arrangements restrict the employer's ability to amend the plan unilaterally, and unanimous written consent from participants is often impractical. Elective solutions are possible but create additional complexity. Finally, size matters. Some solutions require economies of scale, whereas other solutions are appropriate for only a

handful of participants. The accounting issues related to these solutions should be discussed with the actuary who values the benefit obligation.

EIGHT SOLUTIONS

Here are eight solutions that employers might consider, either individually or in combination.

1. Pare benefit down to legally binding right
2. Communicate the future
3. Convert to death benefit only (DBO)
4. Cash settlement
5. Release of policies
6. Large case solution
7. Small case solution
8. Do nothing

Solution One: Pare Benefit Down to Legally Binding Right

Collect plan documents and communication materials to determine the legally binding rights of participants. These are benefits that cannot be terminated unilaterally by the employer. For example, a gross-up for taxes on imputed term costs may have been communicated as a year-to-year arrangement and not a legally binding right. Communication materials that clearly state that payment of a gross-up in one year does not imply any right to a gross-up in a future year help prevent the creation of a legally binding right. Discontinuing a gross-up to which participants have become accustomed forces participants to come out-of-pocket for taxes on the imputed income. As a result, some participants will forfeit the benefit voluntarily to avoid the taxes. In some cases, the entire split-dollar benefit is a year-to-year arrangement. However, participants may have the right to purchase policies on their lives for the cash surrender value at plan termination.

Because accounting guidance requires the accrual of expected benefits, including benefits that have been provided in the past and for which participants have no legally binding right,[1] a benefit liability can exceed the legal obligation to pay benefits. However, actuarial assumptions include the probability of payment,[2] which should reflect forfeitures. Discontinuing a gross-up to which participants have no legally binding right is a change of assumption that directly results in a gain. An indirect result of discontinuing the gross-up is a higher rate of expected forfeitures, which increases the gain. Because many plans delay the recognition of gains and losses, employers should discuss accounting for postretirement benefits with their actuary.

In spite of the potential savings, many employers are not comfortable reducing benefits that participants have come to expect regardless of the employer's right to terminate such benefits.

> Example One: Able Corporation has promised a postretirement split-dollar benefit of $600,000 for Adam, who is now 80 years old, and issues a Form W-2 with $32,736 of imputed term cost. Able Corporation estimates that Adam's tax rate is 40% and provides Adam with a cash gross-up payment of $21,824 to pay the taxes on both the imputed income and the cash payment. Able Corporation's split-dollar communication materials have always emphasized that participants have no legally binding right to a gross-up, and Able Corporation decides to discontinue the gross-up. Able Corporation informs Adam that he will be responsible for paying taxes on next year's imputed income of $36,306, which reflects IRS Table 2001 on Adam's increased age. Adam grumbles but doesn't want to pay $14,422 in taxes. Instead, Adam withdraws from the plan and has no further benefit.

Solution Two: Communicate the Future

Provide participants with projections of their imputed income, taxes on that imputed income, and the future accumulation of those taxes with interest. Armed with this information, participants can decide whether the future taxes exceed the value of the benefit. For example, a participant in poor health may be more likely to rationalize the tax cost than a healthy participant. Effectively communicating future participant costs may increase expected forfeitures and reduce the benefit obligation.

However, employers that communicate projections of imputed income to encourage voluntary cancellation of insurance coverage should consider the effect of a future settlement on participants who withdraw from the plan voluntarily. In other words, a participant who requests cancellation of life insurance coverage after seeing a projection of imputed income may feel mistreated if an employer pays lump sums to remaining participants to settle the benefit at a later time. To avoid hard feelings and even ERISA claims, an employer might either communicate the possibility of a future settlement or consider extending any future settlement offer to participants who will have voluntarily withdrawn from the plan.

> Example Two: Big Corporation has promised a postretirement split-dollar benefit of $600,000 for Brian, who

is now 80 years old, and issues a Form W-2 with $32,736 of imputed term cost. Brian has noticed that the imputed term costs increase every year and wonders about future increases. Brian requests a projection of his imputed income. The projection shows over $600,000 of future imputed income by age 91. While Brian can rationalize paying taxes of over $240,000 to provide his beneficiaries with $600,000 of income tax-free death proceeds, he believes he will live even beyond age 91. Also, he wonders how his family will react to a Form W-2 with $137,010 of imputed income when he is age 95, when he may have lost his decision making abilities. Becoming more and more skeptical that he or his family will continue coverage until his death, Brian requests cancellation of coverage and now wishes he had done so earlier.

Solution Three: Convert to DBO

Convert the split-dollar benefit to a death benefit only (DBO) arrangement, which is a cash payment from the employer to the participant's beneficiary at the participant's death. A primary advantage of a DBO over split-dollar is the tax advantage to the employer. In spite of the split-dollar term costs imputed as taxable wages, the employer receives no deduction when it is a beneficiary of even a small portion of the death proceeds. The employer generally does receive a tax deduction for gross-up payments because a gross-up is a separate tax transaction in the form of cash wages. Unlike split-dollar premiums paid by the employer or split-dollar death benefits paid to the participant's beneficiary, the DBO payment is deductible to the employer and income taxable to the beneficiary. Employers can finance DBO arrangements with corporate owned life insurance (COLI), but financing is not required.

Another advantage is FICA taxation. Unlike split-dollar imputed income, DBO payments are not subject to FICA. Most important, DBO arrangements create no imputed income during the participant's lifetime, and beneficiaries have the cash to pay the income taxes at the participant's death.

DBO arrangements do have disadvantages. Participants who care about estate taxation should know that DBO arrangements are almost always includible in an estate for estate tax purposes. Likewise, a DBO will not provide a solution for employers that want to shed postretirement benefit liabilities completely. Accruing a deferred tax asset provides immediate recognition of the future tax savings attributable to the current benefit obligation, but a benefit obligation remains. Furthermore, the transition from split-dollar to a DBO can create issues. Participants

who expect to die prematurely may prefer the tax-free death proceeds of the split-dollar arrangement in spite of the imputed income during their lives.

> Example Three: Car Corporation has promised a postretirement split-dollar benefit of $600,000 for Charlie, who is now 80 years old, and issues a Form W-2 with $32,736 of imputed term cost. Charlie requests a projection of his imputed income, which shows over $600,000 of future imputed income by age 91. Charlie contacts Cindy, Car's Director of Compensation and Benefits, who promises to give the issue some thought. Cindy offers to allow Charlie to exchange his $600,000 split-dollar benefit for a $600,000 DBO benefit in order to avoid any additional imputed income. The exchange allows Car Corporation a tax deduction at Charlie's death, immediate access to the cash value of the life insurance policy, and relief from any ongoing premium requirements. Charlie welcomes the relief from the imputed income but starts to worry about the 40% reduction in the after-tax benefit to his beneficiaries after he learns that Car will issue a Form 1099-MISC for the $600,000. Charlie ponders his dilemma and seeks the advice of his financial advisor, who jokes that the choice is easy if Charlie knows when he will die. Continue the split-dollar arrange if death is sooner, but exchange the split-dollar for DBO benefit if death is later.

Converting a split-dollar benefit to an equal amount of DBO benefit has no effect on the benefit obligation to the extent that expected forfeitures are the same. The effect on net income is generally positive because of the immediate recognition of a deferred tax asset to reflect the deductible nature of the benefit.

A grossed-up DBO may be a solution to the erosion of the benefit from taxes.

> Example Four: Charlie's advisor turns serious and points out that Car can deduct the DBO payment, whereas the split-dollar arrangement provides no deduction. Car can pay a deductible death benefit of $1,000,000 for approximately the same after-tax cost as allowing Charlie's beneficiary to receive $600,000 of the policy death benefit. Car's retention of the $600,000 in tax-free death proceeds otherwise payable to Charlie's beneficiaries can finance most of

> the after-tax cost of the $1,000,000 DBO benefit. Although the liability increases from the actuarial present value of $600,000 to the actuarial present value of $1,000,000, Car recognizes a deferred tax asset equal to 35% of the liability. The $600,000 increase in the tax-free insurance policy death proceeds payable to Car finances most of the $650,000 after-tax benefit expense. Charlie schedules a phone with Cindy to request exchanging his $600,000 split-dollar benefit for a $1,000,000 DBO benefit.

The increase in the obligation results in prior service cost, which is amortized over average future service or life expectancy depending on the circumstances. This amortization of prior service cost increases the benefit expense (and reduces pre-tax earnings), but the immediate recognition of the deferred tax asset generally creates an immediate accounting gain.

A gradual erosion of the gross-up component can allow the employer to share in the income tax and FICA tax savings.

> Example Five: Cindy listens to Charlie and promises to give the proposal some thought. Cindy understands the advantages to Charlie and his beneficiaries of exchanging the $600,000 split-dollar benefit for the $1,000,000 DBO benefit: Charlie has no more imputed income, and the beneficiaries receive the same after-tax benefit. What troubles her is that the advantages are one-sided and rely on Car's future corporate tax position. Her analysis shows that Charlie would probably exchange a $600,000 split-dollar benefit for a DBO benefit of an equal amount if Charlie knew he would live to age 95. Cindy proposes a gradual reduction of the DBO benefit from $1,000,000 at age 80 to $600,000 at age 95. Charlie accepts the exchange after realizing that he would have spent over $400,000 in taxes on imputed income by the time he reaches age 95.

Solution Four: Cash Settlement

Pay participants a lump sum in cash to settle the benefit obligation. Although the lump sum is fully taxable as supplemental wages, many participants prefer the taxable lump sum during lifetime over the split-dollar arrangement. Split-dollar agreements that prohibit employers from modifying or terminating the plan require a settlement amount that is mutually agreeable: high enough for the employee to accept the offer and low enough for the employer to make the offer. Arrangements

that do allow unilateral termination may require a settlement amount at least equal to the actuarial present value of the benefit. The deductible nature of the cash payment allows employers to offer a somewhat higher amount than they might otherwise offer, but not always enough to satisfy participants in poor health who were counting on the income tax-free benefit payable to their heirs.

> Example Six: Doll Corporation sponsors a postretirement split-dollar arrangement reflected on its books as $12 million benefit obligation. The arrangement allows Doll to terminate the plan as long as participants receive the actuarial value of their benefit. Because the absence of lifetime benefits exempts the arrangement from IRC § 409A, no 12-month delay from plan termination to payout is required. Doll settles the arrangement for $12 million by paying each participant his or her share of the obligation and saves $4.8 million in taxes.

Cash settlement may involve a combination of a curtailment and settlement for accounting purposes. Announcement cash settlement triggers immediate recognition of a tax benefit through net income as a result of the expected tax deduction. Settlement of the benefit requires recognition of any accumulated losses (or gains) in accumulated other comprehensive income through net income. The ultimate effect of the cash settlement on net income also depends on the settlement amount relative to the benefit obligation. Employers that have not fully accrued the value of the split-dollar benefit obligation may be reluctant to absorb the expense of settling the arrangement. This reluctance may be more of a reflection on current accounting than on the economics of settlement.

Solution Five: Release of Policies

Pay participants a combination of cash and cash surrender value of life insurance to settle the benefit obligation. Solution Five is similar to Solution Four but substitutes cash surrender value of the split-dollar life insurance policy on the life for a portion of the settlement amount. The transfer of the life insurance policies appeals to some participants who are in poor health, because their beneficiaries benefit from the entire death proceeds, which often exceed the split-dollar death benefit. Other participants who are in poor health may have preferred to continue paying taxes on imputed term costs.

The primary disadvantage of distributing the policies as part of the settlement is increased administrative cost. For example, some policies could have cash values that exceed the settlement amount for a

particular participant. This necessitates a distribution from the policy to trim the excess cash value. Because the cash value provides a withholding source for income taxes, the cash value transferred to the participant should not exceed the lump sum net of required withholding.

> Example Seven: David is one of the split-dollar participants at Doll Corporation in example six. He has been diagnosed with cancer and does not expect to survive the next year. He will receive $400,000 in settlement of his $600,000 split-dollar benefit. Payroll withholding at 40% on the $400,000 is $160,000, so his net pay will be the remaining $240,000. The universal life policy on his life has cash value of $700,000 and a total death benefit of $1,000,000. Doll withdraws $460,000 from the policy, which reduces the cash value to $240,000 and the death benefit to $540,000. Doll transfers the $240,000 of cash value to David in lieu of cash. When David dies several months later, his beneficiary receives the $540,000 of income tax-free death proceeds. The $540,000 is less than his former split-dollar benefit, but more than the $240,000 of net pay. The value of the life insurance policy in this context is its cash value, regardless of the obvious additional value of the death benefit.

Many participants, particularly those in good health, will surrender the policies. Surrender triggers a Form 1099-R to an individual policy owner from the insurance company to report the gain in the policy. Insurance carriers generally track tax basis and gain completely independently of any split-dollar arrangement and often refuse to update tax basis to reflect taxation of the cash value reported on a Form W-2. This reported gain often duplicates a portion of the wages reported by the employer on Form W-2. The transfer of cash value is a form of wages, and Form W-2 is the correct form to report wages, even to retirees. Although an explanation of the duplicate reporting on both Form W-2 and Form 1099-R is straightforward, surrendering employer owned policies and paying cash to participants is the easier method for employees who want just cash.

> Example Eight: Diane is another split-dollar participant at Doll Corporation. Coincidentally, Diane is the same age as David, earned the same compensation, and was covered for the same amount by an identical life insurance policy. However, Diane enjoys excellent health. After the ownership of the policy is transferred to her, she immediately

> surrenders the policy for its $240,000 cash value. The insurance company issues a Form 1099-R to report a taxable gain of $240,000. The following January Diane receives a Form W-2 from Doll reporting $400,000 of supplemental wages and $160,000 of withholding. Diane's tax advisor, Danny, understands that the $240,000 reported on Form 1099-R is not taxable income, because Diane's tax basis equaled the $240,000 reported as part of Box 1 on her Form W-2. Danny asks the insurance company to correct Diane's tax basis and the Form 1099-R, but the insurance refuses. Danny provides a written explanation of the transaction with Diane's return. In retrospect, Danny wishes that Doll Corporation had paid Diane cash.

Employer taxation follows the rules of Internal Revenue Code Section 83, Property Transferred in Connection with the Performance of Services. The employer receives a tax deduction for the amount of gross income reported to the employee and pays tax on any gain in the policy.

> Example Nine: The identical universal life policies owned by Doll on David and Diane each had a death benefit of $1 million and cash value of $700,000. Doll's tax basis in each policy was $425,000. When Doll withdrew the $460,000 from cash value, it realized a $35,000 taxable gain (withdrawal proceeds in excess of basis). Doll had no basis in the remaining $240,000 of cash value. When Doll included the $240,000 of cash value in taxable wages, it deducted a compensation expense of $240,000 and reported an additional $240,000 gain realized on transfer of the policy.

Solution Six: Large Case Solution

Purchase a guaranteed single premium, guaranteed issue, no cash value, group life product. This is a product designed to allow employers to transfer liabilities for postretirement group term life to an insurance company. A single premium guarantees that the death benefit will be paid (subject to the insurer's solvency) but provides no cash value. The lack of cash value prevents healthy participants from surrendering the coverage for cash, and allows guaranteed issue of negotiated coverage amounts. Death benefit patterns can be customized to replicate the pattern of the split-dollar coverage (e.g., multiples of final pay and step downs of coverage at certain attained ages). The guaranteed nature of the pricing generally causes the premium to be slightly higher than the accounting liability.

The premium is taxed as supplemental wages, which are generally deductible for the employer and taxable to the participants. The participant taxation differs from the traditional context of this product, which is broad based coverage of less than $50,000 per retiree provided on a tax-free basis. Employers must request an allocation of the single premium by participant using unisex mortality and allocating all fixed costs included in the premium. Federal law requires allocation of the premium on a unisex basis in spite of the fact that the premium was priced based on the gender of the insureds.

Like any solution, there are pros and cons. Besides offering continued life insurance coverage to participants, the advantages of this solution include settlement of the benefit obligation and the creation of an income tax deduction. The tax deduction allows the employer to gross-up the benefit in order to indemnify participants for the tax cost. The primary disadvantage is that the specialized nature of the product and guaranteed issue formulas limit this solution to larger arrangements (i.e., multiple lives and a multi-million dollar single premium).

> Example Ten: Elephant Corporation sponsors a frozen split-dollar arrangement for 200 retirees that its actuaries have valued at $48 million for accounting purposes. Elephant will receive no tax deduction on the current arrangement and has therefore not recorded a deferred tax asset. A life insurance carrier has priced a guaranteed single premium for the arrangement at $60 million. Elephant decides to settle the arrangement by paying the $60 million single premium and another $20 million in cash to provide a withholding source for FICA taxes and income taxes. The entire $80 million settlement cost is deductible and creates tax savings of $32 million. Although the after-tax cost of $48 million equals the existing accounting liability, the curtailment and settlement cause $10 million in prior service cost and losses to be recognized through net income. Although the 25% allowance for taxes ($20 million gross-up divided by $80 million in taxable wages) does not fully indemnify participants for taxes, most participants are relieved to avoid the taxes on future imputed income amounts.

Solution Seven: Small Case Solution

Not every split dollar arrangement involves scores of participants and multi-million dollar single premiums. Settle these arrangements on healthy participants with single premium, no cash value, individual life

products subject to medical underwriting. The concept is the same as the large case solution above, but medical underwriting limits this solution to healthy participants.

> Example Eleven: Famous Corporation sponsors a frozen split-dollar arrangement for five retirees that its actuaries have valued at $1.2 million for accounting purposes. Famous Corporation will receive no tax deduction on the current arrangement and has therefore not recorded a deferred tax asset. A life insurance carrier has priced five guaranteed universal life policies with death benefits equal to the split-dollar death benefits for a total premium of $1.5 million. Famous Corporation decides to settle the arrangement by paying the $1.5 million single premium and another $500K in cash to provide a withholding source for FICA taxes and income taxes. The entire $2 million settlement cost is deductible and creates tax savings of $800K. Although the 25% allowance for taxes ($500K gross-up divided by $2 million in taxable wages) does not fully indemnify participants for taxes, the participants are relieved to avoid the taxes on future imputed income amounts.

Solution Eight: Switch to Loan Regime Taxation

Smaller arrangements with unhealthy participants require even greater creativity. Consider switching to taxation of the arrangement under the loan regime. The split-dollar loan is the amount that the employer will claim against the cash value and death benefits. Although a detailed discussion of the loan regime is beyond the scope of this discussion, a few points are worth mentioning. Making this amount at least equal to the cash value will avoid taxation of the cash value to the participant, but may also reduce the participant's remaining death benefit to an unacceptably low level. Policies with low levels of cash value may allow higher participant death benefits, but may require significant future premiums that will increase the split-dollar loan and thus reduce the participant death benefit. Split-dollar loans payable at death allow participants to lock in today's relatively low interest rates, but require an interest rate that is based on the life expectancy of the insured (the long-term applicable federal rate for participants with a life expectancy greater than nine years). Employers and split-dollar participants should discuss the effects of loan taxation with their insurance advisors, tax advisors, and auditors. Taxation under the loan regime does not generally result in accounting for the benefit as a loan when the arrangement is non-recourse.

Solution Nine: Do Nothing

Sometimes doing nothing is the most practical approach by process of elimination. A participant with a short life expectancy often views the status quo as the best scenario because future taxes are minimal compared to the tax-free benefit received by his or her beneficiaries. However, status quo may be the most practical approach even for participants who are unhappy about potential taxes on imputed income. Participants often understand their potential tax outlays; they just aren't happy about it. Estate tax concerns eliminate death benefit only solutions. Accounting concerns prohibit settlement. The arrangement is too small for a guaranteed issue offer on new insurance, and the participants' health is too poor for medical underwriting. Any existing life insurance may not be workable in the context of a settlement. The employer and participants agree on the problem of escalating imputed income amounts, but not on whose problem it is. Participants may have a legally binding right to a gross-up subject to 409A, and any settlement of the gross-up would necessitate the settlement of all 409A reimbursement arrangements. These are just a few of the obstacles to solving the problem of increasing term costs. Furthermore, any solution requires analysis and implementation. Competing priorities can permanently delay even the most workable solution.

Elective Arrangements

Split-dollar solutions are not limited to the nine solutions above. For example, solutions can be used in combination, and employers may want to offer a specific combination of solutions on an elective basis. For example, an employer may want to offer participants a choice between status quo and a DBO arrangement. Elective arrangements reduce ERISA claims because participants choose the option most appropriate for their circumstances. For example, a participant in poor health who is presented the choice between the status quo and a DBO arrangement may choose the status quo. Forcing that participant to accept a DBO without a gross-up may cause an ERISA claim for the reduction in the after-tax benefit. The downside of elective arrangements is cost of more extensive communication with participants to explain the pros and cons of each option. Furthermore, an elective arrangement may not eliminate the entire obligation, which may be a primary objective.

409A Issues

Split-dollar arrangements subject to IRC Section 409A face additional hurdles in designing a solution. Fortunately, many split-dollar arrangements are exempt from IRC Section 409A because they provide

no benefits during the lifetime of the participant, because participants have no legally binding right to a benefit, or because they are grandfathered. The most common lifetime benefits are gross-up arrangements tied to split-dollar arrangements or participant rights to cash surrender value (i.e., equity split-dollar). However, gross-up arrangements are not subject to IRC Section 409A when the employer has clearly communicated its right to terminate the gross-up unilaterally. When participants do have a legally binding right to a gross-up but vested in all future gross-ups before January 1, 2005, the arrangement is grandfathered under the IRC Section 409A rules.

Split-dollar arrangements that do fall within the scope of IRC Section 409A must follow specific rules in any "termination and liquidation" of benefits. These rules include the aggregation of all 409A arrangements within each of nine categories benefit arrangements. Two of these categories are "in-kind benefits or reimbursement of expenses" and "split-dollar" arrangements. A gross-up arrangement tied to a split-dollar arrangement comprises two separate 409A categories, even though the gross-up appears to be fundamentally tied to the split-dollar arrangement. The 409A guidance on tax gross-up payments includes the statement "Nothing in this paragraph (i)(1)(v) otherwise alters the application of Section 409A to the underlying compensation arrangement or other arrangement that results in the taxes subject to the right to the tax gross-up payment."[3] Understanding the effect of terminating a split-dollar arrangement (not otherwise subject to 409A because it provides no lifetime benefits) on the related 409A gross-up arrangement requires a careful reading of the plan documents.

Bankruptcy and change of control events offer relief from the general rules on termination and liquidation. For example, an employer can elect to terminate and liquidate all 409A reimbursement and split-dollar arrangements benefitting participants who experienced the change of control as early as 30 days before the event or as late as 12 months after the event. Then the employer has up to another 12 months from the election to pay the benefits. This timing theoretically allows employers to pay all benefits as early as 30 days before the event or as late as 24 months after the event. Employers that miss the 12-month deadline to elect termination must follow the general rules for termination and liquidation.

The general rules on termination and liquidation of any arrangement subject to IRC Section 409A start with the requirement that the planned acceleration of benefits is not "proximate to a downturn in the financial health of the service recipient." Although the IRS has not issued any formal guidance on the meaning of this term, most advisors agree that this means that the benefits are expected to be paid if the

arrangement were not terminated and liquidated. The second requirement is that all benefits within the applicable 409A category (e.g., reimbursement arrangements and split-dollar arrangements) across the entire controlled group must be terminated and liquidated. Retention of a single split-dollar arrangement within the controlled group causes an IRC Section 409A failure. The difference between this aggregation rule and the aggregation rule upon change of control is that employers can limit termination and liquidation to the participants who experienced the change of control. For example, an employer can continue its reimbursement of country club dues to its CEO after it has terminated and liquidated all 409A gross-up arrangements inherited in an acquisition. The general rule requires the termination and liquidation of all arrangements within that 409A category (or categories) across the controlled group. In other words, electing to terminate an inherited gross-up arrangement after the 12-month change in control deadline requires the termination of its reimbursement of country club dues to its CEO. The aggregation rules make 409A termination and liquidation both nonelective and universal across the controlled group.

> Example Twelve: Generous Corporation provides gross-ups to its split-dollar participants to indemnify them for taxes on imputed term costs and to provide a withholding source for FICA taxes. Participants have a legally binding right to the gross-ups, which were not vested before January 1, 2005. As Generous Corporation analyzes its ability to terminate and liquidate all split dollar arrangements, it learns that the retired CEO's employment agreement includes the stipulation that Generous Corporation will continue both the retired CEO's split-dollar arrangement and the gross-up until his death. Generous Corporation contacts the retired CEO to present a settlement offer, but the CEO refuses. The retired CEO's refusal of the settlement offer prevents Generous Corporation from terminating and liquidating any split-dollar arrangement that is subject to IRC Section 409A.

Under the general rules for termination and liquidation, the employer makes an irrevocable election to terminate all such arrangements across the controlled group. During the next 12 months, only scheduled benefits are paid. No sooner than 12 months after the election, but no later than 24 months after the election, the employer pays all liquidating benefits. The employer does not adopt a 409A within these categories until three years after the election.

Disposition of Policies

Unless the life insurance policies are transferred to the participants, any settlement of a split-dollar arrangement will leave the employer with life insurance policies no longer connected to a benefit plan. Although surrender is an obvious option, some employers may prefer to hold the policies until death to avoid the income tax on the gain on surrender. To the degree that the policies are not modified endowment contacts and have basis available for withdrawal, withdrawing this basis can provide a source of cash without causing taxation. Policy loans may allow sources of cash without taxable income. Policies continued as corporate owned life insurance (COLI) generally should be optimized to eliminate excess death benefit in order to maximize cash value growth. Employers that retain policies from terminated split-dollar arrangements should discuss the effect of the transfer for value tax rules on the taxation of death benefits with their tax counsel.

SUMMARY

Postretirement split-dollar arrangements taxed under the economic benefit regime face significant challenges. Solutions are available, but the right mix of solutions depends on the employer's objectives and the specific situation. Taking the time and expense to identify the right set of solutions can benefit both the employer and participants.

NOTES

1. ASC 715-60-15-9.
2. ASC 715-60-35-73e.
3. Treas. Reg. § 1.409A-3(i)(1)(v).