Employee benefit packages are increasingly viewed as an important form of compensation. The right mix of salary and other benefits can attract, and keep, top-quality employees.
Non-Qualified Fringe Benefit Planning

Non-qualified employee benefit plans are a way for a business to offer additional benefits to owner-employees and key employees, in addition to or in the absence of a qualified plan. Depending on the ownership arrangement and the intent of the employer and employee, these plans can be set up with just basic requirements or may need to comply with more complex governing rules.

This guide discusses several different types of Non-qualified Fringe Benefit Plans: Executive Bonus, Split Dollar, Deferred Compensation and Section 79 plans.
Executive Bonus Plan

An Executive Bonus Plan, also referred to as a Section 162 plan, allows an employer to provide personally owned life insurance as a fringe benefit for owners and select key employees. The employer chooses which employees it would like to include in the plan and how much of a bonus (or how much life insurance) each employee will receive. Participating employees apply for and own a life insurance policy on their life and name the beneficiary. The business pays the premiums and reports the amount paid as bonused compensation to the employee. As long as total compensation to the employee is reasonable, the premiums paid are tax-deductible to the business. Although the employee reports the bonused premium amount as taxable income, the employer may provide additional amounts (a double bonus) to the employee to offset the tax amount due.

If the benefit is for a non-owner employee, an executive bonus plan is appropriate for all business forms, including professional corporations, partnerships and LLC's. However, this type of plan does not offer any tax benefit for business owners if the business is an S-Corp, partnership or LLC.

Setting up the plan

Executive bonus plans provide a way for employers to supplement their fringe benefit package and provide an incentive that ties the employee to the company. The plan is not subject to non-discrimination requirements and does not require IRS approval, thereby providing greater flexibility for the business when deciding who to cover and how much coverage to provide. Although a formal agreement is not required, it is advisable to execute a corporate resolution and put the terms of the plan in writing.

An executive bonus plan can be ideal for the employee who needs additional life insurance protection and is willing to receive a bonus in the form of an insurance policy instead of a salary increase or cash bonus. Since many people need more life insurance than they can afford, employees often appreciate an employer’s help in buying the protection. Because the employee owns the policy, the plan is completely portable: if the employee leaves the company before retirement, the employer can simply discontinue paying the bonused premiums. The employee can take over premium payments and continue the policy.

Restrictive Endorsement

For an employer who wants to place a “golden handcuff” on the plan, a restrictive endorsement can be implemented. Under this type of arrangement, the employer and employee enter into a restrictive endorsement contract which limits the employee’s ability to exercise ownership rights in the policy without first obtaining the consent of the employer. The employer is not given any beneficial interest in the policy. Generally, the restrictive endorsement will remain in effect for a certain numbers of years or until the employee reaches a certain age.

Since Executive Bonus plans are not subject to non-discrimination rules, an employer can decide how he or she treats each employee under the plan. For example: Employee A has a young family and needs a large amount of life insurance. Employee A uses the bonus to buy a small amount of permanent coverage with a large term rider. Employee B is more interested in cash accumulation and uses the bonus to buy a policy that minimizes death benefit and maximizes cash value. Since each employee’s arrangement with the employer is confidential between the employer and the employee, the employer may also discriminate as to the benefit. In our example, Employee A may have a restrictive endorsement on the policy while Employee B not only does not have restrictive endorsement, the bonus Employee B receives is double the amount that Employee A receives. As discussed earlier, the “reasonable compensation” limits apply.
Permanent life insurance

One of the benefits of permanent life insurance is the tax-deferred growth of the cash value and the ability to access the cash value, during lifetime, through withdrawals and policy loans. Withdrawals and loans can be a source of supplemental retirement income for the insured. Policy cash value and the policy death benefit are both reduced by the amount of the withdrawal and loans, but as long as the policy stays in force withdrawals and loans are received tax free. Surrender charges may reduce the policy’s cash value in early years. Another lifetime benefit that life insurance offers is the ability to gain access to the death benefit through the use of optional riders if the insured becomes chronically or terminally ill. Called the Accelerated Benefits rider, this no additional cost rider allows the policy owner to gain access to the death benefit, on a discounted basis, if the insured is certified as either terminally or chronically ill. Policy cash value and the policy death benefit are both reduced if accelerated benefit payments are being paid. Riders are optional, and may not be available in all states. Receipt of Accelerated Benefits may be a taxable event and may affect the insured’s eligibility for public assistance programs.

Executive Bonus Plans

- Provides needed life insurance protection
- Employer decides who participates
- Employee controls the policy and pays the tax on the bonused premiums
- No IRS approval
- Easy to implement and administer
- Tax deductible premiums reduce the cost to employer
- Helps meet a variety of business and personal objectives
- Policy cash value grows tax-deferred and may be accessed through withdrawals or policy loans
- Death benefit is paid to the insured’s beneficiaries income tax-free*
- If bonus is paid directly to the insurance company, premiums are considered a “non-cash” fringe benefit for withholding purposes
- Premiums are reported as “other compensation” on W-2 and are subject to FICA and FUTA

* IRC § 101(a)(1). There are some exceptions to this rule. Please consult a qualified tax professional for advice concerning your individual situation.
Split Dollar Plans

Split dollar is a funding arrangement between two parties: premiums for a permanent cash value life insurance policy are paid by one entity / person in exchange for sharing the policy proceeds. Typically, the cash value or a portion of the death benefit is used to reimburse the premium paying party for its costs.

Who can set up a split dollar plan?
The most common use of split dollar is as an employee benefit. However, there are a variety of business or personal situations where a split dollar plan can work.

- Family members: parents or grandparents help a child or grandchild obtain needed life insurance protection.
- Business owners and key employee: business owner uses business dollars to help key employee fund the cost of a buy-out plan.
- Corporation and trust: business owner or professional wants to create estate liquidity by having their business or professional practice fund a life insurance policy in an irrevocable trust.

This section will focus on split dollar arrangements between an employer and an employee. Typically, the employer wants to provide a benefit to a key employee; under this arrangement, the employer pays the premium on a policy insuring the life of the employee, helping the employee obtain life insurance for survivor protection needs.

How does it work?
The employer and the employee enter into a written agreement that outlines the terms of the arrangement. Depending on the arrangement, either the employer or the employee applies for and is the owner of a policy insuring the life of the employee. The employer pays the entire premium (not a deductible expense) and the employee is taxed on the value of the life insurance protection he or she receives. The value of the life insurance protection is measured by rates from a government table or the insurance carrier’s lowest term rates. If the arrangement terminates during the lifetime of the insured, the business is entitled to the policy cash value. If the employee dies while the arrangement is in effect, the business receives the amount of the death benefit specified in the agreement. This amount is usually the aggregate premiums paid.

Plan structure

There are two basic methods for structuring the plan:

Collateral Assignment Method – The employee purchases a policy on his or her own life and the employee (or a trust established by the employee) is the owner of the policy. The employee collaterally assigns the policy to the employer in return for the employer’s promise to pay the premiums. At the employee’s death, the employer receives (from the death benefit) the sum of the premiums payments it made to the policy. The balance of the death benefit is paid to the employee’s designated beneficiaries.

Endorsement Method – The employer purchases and is the owner of the policy on the employee’s life. If there is a lifetime termination, the employer is entitled to the entire cash value. At the employee’s death, the arrangement can provide for a variety of death benefit splits, for example the employer receives the greater of the cash value or total contributions, or a fixed amount with the balance of the death benefit paid to the employee’s designated beneficiaries.

What happens when the arrangement terminates during the lifetime of the insured?
The arrangement is typically terminable by either party (employer or employee) with 30 days notice. Termination can result for many reasons, such as the employee’s retirement or if there is no more need for the business to pay premiums. In any case, there are several options available. With one option, the employer can simply surrender the policy and obtain the cash value and the employee receives nothing. Policy surrender may result in policy surrender charges and any value the employer receives in excess of the aggregate premiums paid, constitutes ordinary income to the employer.

Other options, listed below, are sometimes referred to as a policy “rollout.” These keep the policy in force, with all ownership interest maintained by the employee.

- The employee uses his or her own funds to pay the employer an amount equal to the cash value of the policy. The employer then transfers ownership of the contract to the employee (under the endorsement method) or releases the collateral assignment it holds on the policy.
• The employer reimburses itself by withdrawing or borrowing the cash value of the policy. In this case, any residual amount owed the employer is paid by the employee. The employee is the sole owner of the policy – one with a policy loan and ongoing premiums due.

• The employer transfers ownership of the policy or releases its collateral assignment and treats the cash value as bonus compensation to the employee. To the extent this represents “reasonable compensation”, it is fully deductible to the company under IRC Section 162. The employer can also choose to “gross up” the compensation with an additional amount to help the employee cover the income taxes due on the bonus of the policy value.

Other considerations

Employer owned life insurance

As discussed earlier, with an endorsement method split dollar plan, the employer is the owner of the policy insuring the life of the employee. Business owners entering into endorsement split dollar plans need to be aware of the requirements of IRC Section 101(j) and Section 6039I to ensure that the proceeds from any life insurance policy will be tax-free at the insured’s death. Under this code section, unless certain notification and consent requirements are met, and one of the listed exceptions applies, the death benefit amount (in excess of premiums paid) will be taxed as ordinary income to the beneficiary. Additionally, the employer is required to keep records and file annual reports to support compliance and enforcement of the law.

The arrangement

There are two components to a split dollar arrangement: the life insurance policy and the split dollar agreement.

Life insurance policy – while there could be a situation where term insurance is used, generally a policy issued with a split dollar arrangement is permanent coverage. The type of policy and the design will depend on the intent of the parties involved. For example, if an employee has a need for a level amount of death benefit in all years, universal life with an increasing death benefit (option B) will give the employee a level death benefit amount, while the employer is entitled to the cash value.

Split dollar agreement – the split dollar agreement is a legally binding contract and an attorney will need to be involved in executing the agreement. National Life will provide a specimen split dollar agreement to the attorney, if requested. Upon receipt of a completed split dollar checklist (cat. No. 63897), we will prepare a sample agreement for the attorney. There is no charge for this service.

Valuing and reporting the taxable income – in each split dollar arrangement, the employer pays the premium and the employee is entitled to a portion of the death benefit amount. For income tax purposes, the value or “economic benefit” of the death benefit the employee receives is measured by rates from a government table (Table 2001 rates) or the insurance carrier’s lowest term rates.

Periodic Reviews

As discussed, Split Dollar plans can be an attractive benefit, both from the employer and the employee standpoint, however, there are some points to consider with regard to keeping the agreement in place for a long period of time.

Increasing cost to employee – as stated earlier, the employee is taxed on the value of the life insurance protection he or she receives. The rate used to determine the value increases each year is based on age. There may be a point where the cost for the employee to maintain coverage is no longer advantageous and a “rollout” should be considered. We discussed ways to rollout – or transfer all policy rights to the employee – earlier in this booklet. Rollout options, as well as when the rollout should occur, should be reviewed occasionally as part of the overall financial objectives of the employer as well as the employee.
Deferred Compensation

A deferred compensation plan is an arrangement under which the employer agrees to provide the employee with a benefit at a future date. While the employer's deduction must wait until the benefits are actually paid, the employee does not recognize taxable income until the benefits are received. A deferred compensation plan does not need to meet coverage and contribution requirements of a qualified plan. However, there are specific rules that do not apply to Executive Bonus plans or Split Dollar plans, but must be followed with deferred compensation plans in order to achieve the objective of deferring an employee's taxable compensation. These plans must satisfy the following three requirements:

• The deferred compensation arrangement between the employer and the employee must be entered into before the compensation is earned by the employee.

• The deferred compensation cannot be available to the employee until a previously agreed upon future date or event.

• The amount of the deferred compensation cannot be secured (i.e. it must remain available to the employer’s creditors).

Who can set up a deferred compensation plan?

When the covered employee is not an owner, any business form is appropriate. Plans may also be established for non-employee independent contractors who provide services to the employer. However, when the employee to be covered is an owner, a C corporation is the preferred entity form, especially if the business is in a low tax bracket. A deferred compensation plan may not be appropriate for a sole proprietor or an owner of a business that is a pass through entity for income tax purposes (an S corporation or partnership).

State and local governments and nongovernmental tax-exempt organizations may set up deferred compensation arrangements, but these arrangements must comply with IRC Section 457. These plans include “eligible” 457(b) plans and “ineligible” 457(f) plans.

Deferred compensation plan designs

There are many variations of nonqualified deferred compensation plans, but all plans fall under one of the following broad categories:

• Salary Reduction – Sometimes referred to as a “pure deferred compensation plan,” the employee is given the option to defer the receipt of current compensation, bonuses or commissions each year, to be paid at a future date.

• Salary Continuation – The employer agrees to pay a certain amount of income to the employee for a designated term of years after retirement (or other stated event). The employer contributes additional amounts over and above the employee's salary (i.e., there is no corresponding reduction in the employee's present salary or bonuses).

While these plans may be established for the benefit of a single employee, Top Hat Plans (also known as Supplemental Executive Retirement Plans or SERPs) are plans maintained by an employer primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees. Unfunded Top Hat Plans do fall under ERISA, but because they are unfunded, the ERISA reporting and disclosure requirements can be satisfied simply by filing a brief statement with the Department of Labor (DOL) and providing copies of the plan documents to DOL upon request.

Unfunded vs. funded plans

In an unfunded deferred compensation arrangement, the employee only has the employer’s “mere promise to pay” the deferred compensation benefits in the future. The promise is not secured in any way. The employer may simply keep track of the benefit in a bookkeeping account, or it may invest in annuities, securities, or insurance arrangements to help fulfill its promise to pay the employee. Alternatively, the employer may establish an irrevocable “Rabbi” trust, which holds assets beyond the control of the employer, but subject to the claims of the employer's creditors if the employer becomes insolvent.
The employee is taxed only when those amounts are actually or constructively received. To obtain the benefit of income tax deferral, it is important that the amounts are not set aside from the employer’s creditors for the exclusive benefit of the employee. Additionally, unfunded plans are exempt from most ERISA requirements except certain disclosure and fiduciary requirements.

A funded arrangement exists when the employer sets aside assets from the claims of the employer’s creditors, for example in a trust or escrow account. These assets are generally identified as a source to which participants can look for the payment of their benefits. If the plan is funded, employer contributions are includible in an employee’s income in the year that the contributions are made. Furthermore, the funded plans will generally have to satisfy Title I of ERISA, which pertains to participation and vesting, funding, etc. Since the purpose of a deferred compensation arrangement is to allow benefits to be provided to only a few chosen employees (usually highly compensated, key individuals) and provide those employees with the ability to defer taxation until a later date, funded plans are inadvisable in most situations.

Use of permanent insurance

When there is a need for life insurance, permanent life insurance products are the preferred method for “informally funding” a deferred compensation plan. Policies owned by the employer must meet notification and consent requirements and fall under one of the listed exceptions of IRC §101(j) in order to avoid taxation on the policy proceeds.

Note that traditional investment products may also be used, particularly when the employee is uninsurable.

Application of IRC §409A

Section 409A of the Internal Revenue Code provides rules governing deferred compensation arrangements. More specifically, §409A provides that amounts deferred under these plans are currently includible in gross income (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income), unless certain requirements are satisfied.

- **Distributions:** A participant may receive a distribution of previously deferred compensation only upon the occurrence of one of six events: separation from service; the date the participant becomes disabled; death; a fixed time (or pursuant to a fixed scheduled) specified in the plan at the date of the deferral; change in the ownership or effective control of the corporation or assets of the corporation, to the extent provided in regulations; or the occurrence of an unforeseeable emergency.

- **Deferral Elections:** Participants must generally make deferral elections prior to the end of the preceding taxable year. However, in the first year in which a participant becomes eligible to participate in a plan, the participant may make an election within 30 days after the date of eligibility, but only with respect to services to be performed subsequent to the election. In the case of any performance-based compensation covering a period of at least 12 months, a participant must make an election no later than 6 months before the end of the covered period.

- **Changes in Time or Form of Payment:** Participants can elect to delay distributions or change the form of distributions from a plan as long as the plan requires the new election to be made at least 12 months in advance. In addition any election to delay a distribution must delay the distribution at least five years from the date of the new election (unless made on account of disability, death, or an unforeseeable emergency).
Penalties for Non-Compliance
IRC Section 409A also includes substantial penalties for failing to meet the statutory requirements when deferring compensation. Any violation of the above requirements results in retroactive constructive receipt, with the deferred compensation being taxable to the participant as of the time of the intended deferral. In addition to the normal income tax on the compensation, the participant must pay an additional 20% tax.

In general, §409A is effective with respect to amounts deferred in taxable years beginning after December 31, 2004. The deadline for strict compliance with the regulations, for the plan document and plan administration, was December 31st, 2008.

Section 409A is highly technical and complex. It is important that the deferred compensation agreement be drafted by an attorney who specializes in this type of planning.

- In order to allow employees to defer income tax until the amounts are received, these amounts must remain subject to the claims of the employer’s creditors in the event of insolvency (i.e., they must be unsecured). Therefore, benefits are not guaranteed.
- Premiums are not considered taxable income to the plan participants. Future payments are taxed as regular income when received.
- Unfunded plans are generally exempt from statutory limits on annual contributions and benefits, funding rules, qualified joint and survivor rules, and other provisions of ERISA that apply to qualified plans. No IRS approval of the plan is needed, although Top Hat plans require a form to be filed with the Department of Labor.
- Nearly all nonqualified deferred compensation plans are subject to new tax rules under §409A that impose election, distribution, and funding restrictions on these plans. Failure to comply with §409A may result in current taxation of deferrals and penalties.

1 Policy loans and withdrawals reduce the policy’s cash value and death benefit and may result in a taxable event. Surrender charges may reduce the policy’s cash value in early years.
2 IRC Sec. 409A(a)(2)(A) ; Prop. Treas. Reg. § 1.409A-3
3 IRC Sec. 409A(a)(4)(B)(i)
4 IRC Sec. 409A(a)(4)(B)(ii); Prop. Treas. Reg. § 1.409A-2
5 IRC Sec. 409A(a)(4)(B)(ii); Prop. Treas. Reg. § 1.409A-2(a)(7)
6 IRC Sec. 409A(a)(4)(C)(i); Prop. Treas. Reg. § 1.409A-2(b)
7 IRC Sec. 409A(a)(1)(A)(i).
Section 79 has been known for years as a way to provide term life insurance to groups of employees. A typical plan offers up to $50,000 of term life insurance to employees. So long as the employer is not directly or indirectly a beneficiary of the insurance, all employer contributions to the plan are currently deductible and the employee is not taxed on the first $50,000 of coverage. Employers are also permitted to provide additional amounts of term life insurance in excess of $50,000 to employees, the value of which is reported on the employee’s W-2 as additional compensation. The value of this excess amount is determined under Table I of the Treasury Regulations, which establishes uniform premiums based on 5-year age brackets.

Section 79 allows for permanent benefits to be provided as well, thus allowing the plan to be funded with cash value life insurance. When the permanent benefit is elected, the employee includes only a portion of each premium in income.

The formula for valuing the permanent benefit is set forth in the Regulations under Table I - Reg. §1.79-3(d)(2). Only specially designed permanent products generate favorable valuation.

### Tax Characteristics of Section 79 Permanent Benefit Plan

- 100% deductible to Employer under §162 as long as total compensation is reasonable
- Employee excludes value of up to $50,000 of pure insurance protection (IRS Table I Term Cost) from income
- Employee must include:
  - Value of Permanent Benefit
  - Value of Insurance protection > $50,000

Which means: Employee can typically exclude 35-40% of premium from current income

Group term insurance can be an ideal fringe benefit for rank and file employees. However, the business owner and key employees may be looking for life insurance coverage that provides benefits beyond the death benefit protection. Benefits such as:

- Portability at retirement or termination of employment to provide permanent protection
- Tax-deferred build up of policy cash value that can be accessed to supplement retirement income
- Lifetime access to policy values in the event of a chronic or terminal illness through the use of optional riders.

### Who are prospects for permanent group life plans?

Owner-employees of C corporations and non-owner key employees of any business entity are prospects for these plans. Section 79 does not allow owner-employees of the following entities to receive any group life insurance benefits:

- Partners of a partnership
- Members of an LLC (unless taxed as a C corporation)
- Sole proprietors
- Owners of more than 2% of the stock of an S corporation

If the owners of a pass-through entity believe sufficiently in the value of having a Section 79 plan, they may decide to work with their tax advisors to establish a new C corporation along side the pass-through entity. Typically the C corporation handles one or more functions of the enterprise, such as the management function, and the owners receive W-2 income as employees of the C corporation.
Non-discrimination rules

Section 79(d) does contain non-discrimination rules as to eligibility and benefits. Certain types of employees can be excluded from consideration, such as employees who are covered by a collective bargaining agreement, employees who have not completed three years of service, and part-time (not more than 20 hours per week) or seasonal (not more than 5 months per calendar year) employees. A plan is non-discriminatory as to benefits if “the type and amount of benefits available under the plan do not discriminate in favor of participants who are key employees.” A well-designed plan requires that all eligible participants be offered the option to elect the same type of benefits offered to key employees (e.g., permanent benefits). Such a plan will also require that all employees be offered a non-discriminatory amount of benefits, usually a uniform percentage or multiple of W-2 compensation.

Because the options available to eligible employees that involve coverage in excess of $50,000 of term insurance will result in an increase in the employee’s gross income – and generally an increase in the employee’s income tax liability – employees are permitted to decline coverage in excess of $50,000. In practice, nearly all rank and file employees will accept the free (to them) $50,000 of group term life insurance and waive their right to higher amounts of insurance or permanent benefits.

Section 79 Permanent Benefit Plan:

- All contributions to the plan are currently deductible to the business.
- Only a portion of the cost of insurance coverage is includible in the participant’s income.
- Plan assets (in the form of life insurance policy cash values) accumulate tax-deferred.
- Benefits paid to the employee’s beneficiaries at his or her death are received income tax-free.
- Once the plan is terminated, the participant may receive a tax-free income stream from the insurance policy to the extent of the policy’s cash value to supplement retirement income.

How Does the Section 79 plan work?

The employer, working with the plan administrator and financial professional, adopts a group life insurance plan. Employees elect the type and amount of benefits they wish to receive.

Participating employees apply for insurance coverage

The employer pays the insurance premiums and takes an income-tax deduction for the entire premium cost.

All employees electing insurance in excess of $50,000 must include the cost of that excess coverage in income. Employees electing permanent benefits must also include the value of those permanent benefits in income.

1 Policy loans and withdrawals reduce the policy’s cash value and death benefit and may result in a taxable event. Surrender charges may reduce the policy’s cash value in early years.

2. Riders are optional, may be available at additional cost, and may not be available in all states. Payment of Accelerated Benefits will reduce the Cash Value and Death Benefit otherwise payable under the policy. Receipt of Accelerated Benefits may be a taxable event and may affect your eligibility for public assistance programs. Please consult your personal tax advisor to determine the tax status of any benefits paid under this rider and with social service agencies concerning how receipt of such a payment will affect you, your spouse and your family’s eligibility for public assistance.

3. IRC § 101(a)(1). There are some exceptions to this rule. Please consult a qualified tax professional for advice concerning your individual situation.

4. Withdrawals up to the basis paid into the contract and loans thereafter will not create an immediate taxable event, but substantial tax ramifications could result upon contract lapse or surrender. Surrender charges may reduce the policy’s cash value in early years.
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