



WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Death Benefit Only Plans – Not Dead Yet.

MARKET TREND: As income tax rates rise, death benefit only plans can be an appealing way to attract or retain selected key employees.

SYNOPSIS: As the name implies, death benefit only plans generally provide death benefits to a current employee's surviving beneficiaries. These plans typically are: (1) subject to less complex tax rules and ERISA regulations than other nonqualified deferred compensation plans that provide lifetime benefits to the employee and (2) can be relatively easily and informally funded using life insurance.

TAKE AWAYS: Death benefit only plans may make sense for employers looking to attract and retain younger talent whose commitment to the company is untested, as key employee carve-outs from group-term life insurance programs, or as an alternative to split-dollar life insurance plans where premium or economic benefit costs to the employee may not make economic sense. The employee should not be subject to income tax on the value of the current life insurance protection and, with proper structuring, should not incur estate taxes on the death benefit paid to his or her beneficiaries (although they will pay income tax on those benefits). The employer generally cannot take a current deduction for the life insurance premiums but should receive the death benefits without income tax (if it complies with employer-owned life insurance ("EOLI") tax rules) and should be able to deduct the payments made to the surviving beneficiaries.

RELATED REPORTS: 12-23; 11-16; 11-11; 10-56; 10-43; 07-108; 07-91; 05-04; 03-72; 02-99; 00-72; 95-50.

Death benefit only ("DBO") plans can offer a simple and flexible option for providing benefits to attract or retain key employees. Life insurance also can provide a fairly easy method to informally fund these plans, but requires careful initial structuring to comply with various tax and reporting restrictions.

DBO BASICS

A DBO plan provides specified death benefits to an employee's surviving beneficiaries (likely the surviving spouse or children), if the employee was employed by the sponsoring business at death. These plans generally do not require employee contributions and are not constrained by participation limits applicable to other types of nonqualified deferred plans. However, DBO plans cannot provide disability, severance, retirement or any other lifetime employee benefits commonly associated with other nonqualified deferred compensation plans.

WHEN DBOs MAY MAKE SENSE

Despite some of the restrictions placed on benefits provided by DBO plans, they may be appealing in the following situations:

- For employers looking to attract and retain younger talent whose commitment to the company is untested. A DBO plan is far simpler to implement and administer than other nonqualified plans, so the employer incurs fewer costs and hassles to provide benefits to an employee that could leave.
- As executive carve-out from group-term life insurance programs.
- As an alternative to a split-dollar life insurance plan, particularly if the premium or economic benefit cost to the employee would not make economic sense.

ROLE OF LIFE INSURANCE

Life insurance is commonly used to support financing for a DBO plan, with the sponsoring employer purchasing one or more life insurance policies on the participants. The employer has flexibility in setting the coverage amount, such that the policies' death benefits can match the expected survivor benefits or be set at an amount sufficient to cover both the cost of the survivor benefits and the amount needed to effectively reimburse the company for its premiums.

GENERAL TAX AND FLEXIBILITY CONSIDERATIONS

Tax. While the tax implications of DBO plans are discussed in more detail below, with a proper structure, death benefits paid from a DBO plan to an employee's beneficiaries can be excluded from the employee's estate. When informally financed with life insurance, the value of the current life insurance protection provided to the employee is not taxed to him or her as income during life (unlike split-dollar insurance arrangements, in which the employee generally will be taxed on the annual imputed interest income or economic benefit costs). The life insurance death benefits, when paid to the employer, also generally are not subject to income tax (assuming compliance with EOLI requirements, as noted below). Although the employer cannot take current deductions for the payment of life insurance premiums, it can deduct payments of benefits to the employee's beneficiaries and also structure the policy death benefits so that it recovers its premiums costs.

Flexibility. In addition, a DBO plan is not considered a "qualified plan" under the Code or ERISA.¹ Consequently, as a nonqualified plan, an employer's DBO plan does not need to follow certain nondiscrimination rules, which means the company has flexibility in choosing which

employees are covered by the plan and can limit participants to a select group. In addition, a company can offer multiple DBO plans with different terms in order to provide distinct benefits to various key employees.

TAX IMPLICATIONS

Income Tax

Employee. A properly constructed DBO should not generate taxable income to the employee during his or her life. Further, since DBO plans do not provide the employee with lifetime benefits either during employment or at retirement, they generally qualify for the death benefit only exemption from application of the complex and restrictive Internal Revenue Code (“Code”) § 409A tax rules for nonqualified deferred compensation plans.

Employer. As noted, the sponsoring company cannot take current deductions for premium payments on life insurance covering participating employees, but, assuming EOLI compliance, it should receive the policy death benefits without income tax. C corporations, however, may fall within the corporate alternative minimum tax (AMT) regime as a result of receipt of life insurance proceeds.² This possibility should be reviewed and the tax outcomes modeled for C corporations considering DBO plans. If the corporate AMT will apply, the corporation could consider grossing up the policy death benefits to cover the anticipated AMT liability.

The company typically can take an income tax deduction for benefits paid under the DBO plan, provided those payments are deemed to constitute ordinary and necessary business expenses (i.e., the DBO payments represent reasonable compensation for the employee’s services).³

Beneficiaries. Survivor benefits paid to the employee’s beneficiaries are treated and subjected to income tax based on either the “income in respect of a decedent” rules under Code §691 or the annuity rules under Code §72. The recipient does not receive a basis step-up in the proceeds.

Estate Tax

Generally, DBO plan benefits likely will be taxable in a deceased employee’s estate if: (1) the employee has any rights to direct or change the plan or policy terms, including the ability to name or change the designated survivor beneficiaries; and (2) the employee is entitled to lifetime post-retirement benefits provided under another nonqualified plan sponsored by the same employer.⁴

Thus, DBO plan participants that also participate in a company’s other nonqualified plans could run the risk of estate tax exposure with regard to the DBO plan. The DBO plan also should irrevocably specify the eligible survivor beneficiaries, rather than allowing individual employees to make the selection. The plan should reference the eligible beneficiaries by type or class (e.g., surviving spouse, or if none, then surviving descendants, etc.), not by names and allow payments of benefits only to the eligible, surviving beneficiaries. Further, the plan beneficiaries should be persons whose receipt of benefits will not result in estate tax inclusion for the deceased employee (as would payment to the employee’s estate or the employee’s revocable trust).

Note that estate tax exposure also can arise if a DBO participant effectively controls the plan or any life insurance policies held by the plan. For example, an insurance-financed DBO plan set

up for a participant who is an employee but also more than a 50% shareholder of a company could result in estate tax inclusion of the DBO benefits because the participant, as a controlling shareholder, can change the plan terms and/or force the plan to make withdrawals from or surrender the life insurance policy. Thus, DBO plans likely are not good vehicles for controlling shareholders.

To the extent any DBO proceeds are included in a deceased employee's estate, the beneficiary may be able to take an income tax deduction for estate tax paid attributable to the plan benefit.⁵ **Gift Tax.** DBO plans should not result in a taxable gift from the employee to his beneficiaries.⁶

INSURANCE-FINANCED CONSIDERATIONS

Policy Owner/Beneficiary. The employer will be both the owner and beneficiary of the policies and will be responsible for paying all premiums. Generally, the employer holds the policy and should receive the death benefits as part of its general assets. The employer should not provide the employee directly or indirectly with any rights or interest in the policy or the actual policy proceeds.

EOLI Compliance. Policies purchased by a company to support a DBO plan generally will constitute EOLI, which will subject the policy death benefits to income tax under Code § 101(j) and will require information reporting with regard to the policies under Code § 6039I. ***To qualify for an exception to EOLI income taxation, the employer must notify and obtain consent from the insured employee before the purchase of the life insurance coverage.*** See *Washington Report No. 12-24* for a discussion of EOLI and the specific notice and consent requirements.

IRS Target: Insurance-Financed "419 Plans"

While DBO plans offer structuring flexibility, the IRS has targeted insurance-financed "welfare benefit plans"⁷ under Code §§ 419 and 419A (including those providing only death benefits), which purport to allow employers to take current income tax deductions for plan contributions used to pay life insurance premiums. Within strict limits, Code §§ 419 and 419A do allow employers to deduct contributions to welfare benefit plans for the year made. As discussed in *Washington Reports Nos. 95-50, 03-45, 07-91 and 07-109*, however, existing IRS guidance and Tax Court decisions have held that these 419 plans generally do not provide the purported tax deduction benefits to the payment of life insurance premiums. The IRS also has specifically targeted some of these plans as "listed transactions," potentially requiring the involved advisors and taxpayers to comply with additional reporting and disclosure requirements.

Thus, given the above, any DBO plan structure that claims to offer tax deductions related to the payment of life insurance premiums should be approached with caution and carefully analyzed to determine the basis and legitimacy for deductibility. Life insurance premiums are rarely deductible, even if owned for business purposes, when the taxpayer is directly or indirectly a policy beneficiary,⁸ and the IRS is highly sensitive to these issues.

DOCUMENTATION

When creating a DBO plan, the sponsoring employer should document the plan provisions in a written agreement with the participating employee(s). Although DBO plans can be structured with a variety of terms, at a minimum, the plan agreement should specify the following:

- **Who:** The beneficiaries entitled to receive plan payments (*e.g.*, surviving spouse or children). Note that, for the estate tax reasons noted above, the employee should not be allowed to choose or change the beneficiaries specified by the plan.
- **When:** The timing of plan payments (such as lump-sum or annual installments over a set period) and requirements that must first be met before payments will begin (*e.g.*, the employee must be employed by the business at the time of death and leave survivors who fall into the plan’s eligible class of beneficiaries).
- **What & How:** The amount of death benefits that will be paid and the formula which will be used to calculate that amount (*e.g.*, final salary, average salary over specified number of years, multiples of \$X for each year of service, etc.).

The plan’s implementing documentation also should state that the plan is unfunded, such that the plan payments will come from the general assets of the company, which are subject to the claims of the company’s general creditors.

TAKE AWAYS

- DBO plans may make sense for employers looking to attract and retain younger talent whose commitment to the company is untested, as executive carve-outs from group-term life insurance programs, or as an alternative to split-dollar life insurance plans where premium or economic benefit costs to the employee may not make economic sense.
- The employee should not be subject to income tax on the value of the current life insurance protection and, with proper structuring, should not incur estate taxes on the death benefit paid to his or her beneficiaries (although they will pay income tax on those benefits).
- The employer generally cannot take a current deduction for the life insurance premiums but should receive the death benefits without income tax (if it complies with EOLI tax rules) and should be able to deduct the payments made to the surviving beneficiaries.

NOTES

¹ Note that DBO plans may constitute “welfare benefit plans” for ERISA purposes and thus be subject to ERISA’s reporting and disclosure requirements, fiduciary requirements and administration and enforcement provisions, unless an exemption applies. DBO plans that benefit a small group of employees or are structured as “top-hat” plans may qualify for an exemption to many of these ERISA requirements.

² Application of corporate AMT in any given tax year is the result of many factors, of which corporate owned life insurance is just one.

³ See Code § 162.

⁴ See Treas. Reg. § 20.2039-1(b)(2) (Ex. 6); *Schelberg Est. v. Commissioner*, 612 F.2d 25 (2d Cir. 1979). Note that qualified plans and disability benefits are excluded from this analysis.

⁵ See Code § 691, governing income in respect of a decedent.

⁶ See *DiMarco Est v. Commissioner*, 87 T.C. 653 (1986), *acq.*, 1990-2 C.B. 1.

⁷ There is a distinction in the term “welfare benefit plan” as applied for purposes of the Code versus application under ERISA (see footnote 3 below).

⁸ See Code § 264(a)(1).

DISCLAIMER

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WRM #15-08 was written by Greenberg Traurig, LLP

Jonathan M. Forster
Martin Kalb
Richard A. Sirius
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012