SELECT PORTFOLIO MANAGEMENT, INC.
Integrated Wealth Management
A Registered Investment Advisor

White Paper:

Life Insurance as an Employee Benefit

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Life Insurance as an Employee Benefit

What is it?

In general

Life insurance is a method of providing funds payable to named beneficiaries upon the death of the insured. If you, the employer, offer your employees life insurance as a benefit, it most likely will be in the form of group life insurance. Group life insurance provides insurance for a group of employees through a contract that exists between you and the insurance company. Generally, group life insurance can be similar to the types of life insurance policies that are available on an individual basis, such as term, whole, and universal life. The actual group life insurance contract is issued to you rather than to each individual employee, and the contract, known as the master contract, provides coverage for the entire group. In lieu of having the master contract in hand, the insurance company issues each employee a certificate of insurance as proof of coverage. Although your employee is not a party to the master contract, he or she will be able to enforce his or her legal rights under the master contract as a third-party beneficiary.

> **Tip:** By paying a portion of the premium of a group life insurance policy, you can provide your employees with death benefit coverage at minimal cost to the individual employee.

> **Tip:** One of the major disadvantages of providing your employees with certain types of group life insurance is that the policy must comply with Section 79 of the Internal Revenue Code. All employer-sponsored employee benefit plans must comply with applicable nondiscriminatory requirements and rules. As an employer, you must comply with certain nondiscrimination requirements.

> **Tip:** A group life insurance plan qualifies as an Employee Retirement Income Security Act (ERISA) welfare benefit plan and is subject to the ERISA rules. For more information on ERISA, see Offering Employee Benefits.

> **Tip:** You can offer your employees the convenience of payroll deductions for the employee's share of the premiums.

> **Tip:** You can offer your employees a minimal amount of life insurance (e.g., one to two times an employee's annual salary) and allow employees to purchase optional amounts with low premiums.

> **Tip:** Since group life insurance is a contract between your company and the insurance company, you can terminate the plan at any time.

Term versus cash value life insurance

Generally, there are two types of insurance: term and cash value. Term insurance provides protection only and does not accumulate cash value that you can draw on in the future. As a result, term insurance requires minimal cash outlay in the beginning and requires no long-term commitments. On the other hand, if a life insurance policy accumulates cash value, any excess funds that your employee pays toward the permanent contract (the part of the premium that exceeds the cost of providing the death benefit) build up equity in the policy. Cash value life insurance provides your employees with protection besides building savings within the policy for their future use. Cash value can be a useful tool for an employee because it offers the opportunity to obtain a policy loan or the policy can be surrendered for cash value at date of surrender.

Group term life insurance

In general

Group term life insurance is a contract between your company and the insurance company that lasts for a specific period of time and provides death benefits on the life of your employee.

Group term life insurance carve-out plan

Under a group term life insurance carve-out plan, you remove certain highly compensated employees from the group term life insurance plan coverage and provide those employees with individual life insurance policies. These individual policies can includesplit dollar; death benefit only; or a Section 162 executive bonus plan.

Contributory or noncontributory

Under a group term life insurance policy, you, the employer, pay all or part of the premium. The amount of the premium that you pay depends on whether or not the policy is contributory or noncontributory. If a group term life insurance policy is contributory, you pay the majority of the premium, while your employee pays a small portion of the premium. If a policy is noncontributory, you pay the entire premium.

Group whole life insurance

In general

Under a group whole life insurance policy, the employee pays a fixed premium for the duration of his or her lifetime (ordinary life) or over a lesser period of time (limited pay life). While many variations of the group whole life insurance policy exist, it is mainly a mixture of both term and permanent insurance. Your employee's premium payment usually goes to the permanent insurance portion, while your payment goes to the term insurance portion. Group whole life insurance allows you to offer your employees employer-paid term insurance with the additional coverage of a permanent group life insurance plan.

> **Example(s):** Bill works for XYZ Company, which offers its employees a group whole life insurance policy. XYZ pays a portion of the premium that purchases the term life insurance, while the employee pays the premium for any permanent coverage. Bill can elect to receive only the term life insurance, with the premium being paid completely by XYZ. In addition, Bill can choose to have both term and permanent coverage; he will be personally responsible for that portion of the premium that purchases the permanent coverage.

Group universal life insurance

Under a group universal life insurance policy, your employee has the flexibility to pay premiums within the range of the minimum amount required to keep the policy in effect or the maximum amount allowed by the policy (fully fund). The minimum premium is usually not enough to accumulate a large amount of cash value. On the other hand, your employee can choose to fully fund the policy. If your employee fully funds the policy, he or she can cover the cost of keeping it in effect even while accumulating a large amount of cash value over time. If the employee cannot afford to spend much money on insurance premiums, he or she may want to pay the minimum premium. An employee who wants to limit his or her payments during retirement or to accumulate funds in the policy for future uses may want to pay more than the minimum premium.

Split dollar life insurance

In general

A split dollar life insurance arrangement, or SDA, is an agreement between you and your employee to share the costs and benefits of the life insurance policy on the life of the employee. An SDA is an agreement that concerns (at least in part) the premium payment (and eventual repayment) for the life insurance; it is not a type of policy.

Split dollar arrangements usually take one of two forms. In the endorsement form, the employer is formally designated as the owner of the insurance contract and endorses the contract to specify the portion of the insurance proceeds payable to the employee's beneficiary. In the collateral assignment form, the employee is formally designated as the owner of the contract, and the employer's premium advances are secured by a collateral assignment of the policy.

> **Caution:** The Sarbanes-Oxley Act of 2002 makes it a criminal offense for a public company to lend money to its executives or directors. This may prohibit the use of the collateral assignment form in these companies.

Split dollar life insurance is an important part of the compensation package of many key employees. In a typical split dollar arrangement, the employer funds all or part of the cost of providing an employee with life insurance protection and then recoups that cost either from the cash value of the policy or from the death benefit. Split dollar arrangements have also come into wide use in gift and estate planning.

Effective as of September 17, 2003 are two mutually exclusive regimes for taxing split dollar life insurance arrangements: the economic benefit regime and the loan regime. Both the owner and the non-owner are required to fully and consistently account for all amounts under a split dollar arrangement under either the economic benefit regime or the loan regime.

Under the economic benefit regime, the owner of the life insurance contract is treated as transferring economic benefits to the non-owner. This regime generally governs the taxation of compensatory arrangements in which the employee is not the owner of the contract (e.g., endorsement split dollar arrangements).

Under the loan regime, the non-owner is treated as lending premium payments to the owner. The loan regime generally governs the taxation of collateral assignment split dollar arrangements (e.g., arrangements in which the employee is designated as the owner of the contract and the employer (non-owner) pays all or a portion of the premiums).

Key employee life insurance

Key employee life insurance is a life insurance policy that insures the life of an employee whose death would cause significant economic loss to a business. Under this kind of life insurance policy, you purchase an insurance policy on the life of an employee. You become both the owner and the beneficiary for the policy and are responsible for paying the premiums. At your employee's death, the insurance company pays the death benefits to you. The proceeds are received tax free.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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