



Situation: Nonqualified Deferred Compensation (NQDC) plans are a flexible and strategic tool used by businesses to attract, retain, and reward key employees. Unlike qualified plans, NQDC arrangements are not subject to many of the strict contribution limits and nondiscrimination requirements imposed by ERISA. This allows employers to selectively offer enhanced retirement benefits to a targeted group of executives or highly compensated employees.

One common and effective method for informally funding these future obligations is through life insurance. However, there appears to be a great deal of confusion on how the death benefit paid to an executive's beneficiary is taxed when a plan is informally funded with life insurance. Part of the confusion may stem from the fact that there is more than one way the benefit can be taxed depending on the structure of the arrangement. This *Counselor's Corner* sheds light on the topic.

Solution: Before discussing how death benefit paid to an executive's beneficiary in a nonqualified deferred compensation arrangement is taxed it might be helpful to have a high-level understanding of how life insurance typically works in such a plan.

1. The business and the executive enter into a contract. The executive agrees to defer compensation in exchange for pre- and postretirement benefits. Technically, the benefit is nothing more than an employer promise that does not need to be backed by any assets. However, many businesses elect to purchase life insurance to help offset the business liability created by the plan.
2. The business gives notice to the executive that insurance will be purchased on the executive's life and receives consent from the executive.¹
3. The business purchases a life insurance policy on the executive's life. The employer is the owner, premium payer, and beneficiary of the policy.
4. Employer contributions and premiums paid to purchase life insurance cannot be deducted for income tax purposes. With a properly structured nonqualified plan, the executive pays no current income tax on income deferred, on any additional employer contributions, or on earnings credited to the account until the benefits are actually or constructively received.²
5. If the executive lives to retirement, the employer pays a retirement benefit that generally reflects the balance in the executive's bookkeeping account. This payment is deductible by the employer and is taxable as compensation to the executive. Policy cash values may be accessed by the business to provide retirement benefits.³ Or, the employer can pay the benefit from current earnings and recover the cost of the plan at the executive's death.
6. Alternatively, if the executive dies prior to retirement or before all payments have been received, many plans contain provisions that entitle the participant's name beneficiary to receive a survivor benefit. In this situation the policy pays the death benefit to the employer and the employer pays any survivor benefit described in the agreement to the executive's heirs.



It's the payment of the benefit in step 6 that has caused some tax confusion, both from an income and estate tax perspective. I will first explore the structures that can create different income tax consequences for the beneficiary followed by the structures that result in different estate tax results.

Income Taxation of Death Benefits Provided Under a Nonqualified Compensation Plan. First, it's necessary to begin with an understanding that the plan provisions should not be confused with the informal life insurance funding vehicle. When an employer purchases life insurance on the participant, death benefits will be paid to the business at the participant's death. The business will generally receive the death benefit from the life insurance policy income tax-free. However, this tax-exempt death benefit character is not passed on to the named beneficiary as a survivor benefit because the promised benefits are actually paid from the general assets of the business and not from the policy.

Survivor benefits paid by a nonqualified plan are generally taxable to the beneficiaries as "income in respect of a decedent" or "IRD" under IRC § 691(a). The payments represent amounts earned by the participant, but which were not includable in his/her taxable income before the year of death. There is no step-up in basis for IRD, so the beneficiary must pay tax on the benefits received in the same manner as the decedent/participant (i.e., as ordinary income). However, IRC § 691(c) allows an income tax deduction for the estate taxes attributable to the value of the IRD asset.

Split-SERP Alternative.

If an employee would rather have his/her beneficiaries receive pre-retirement survivor benefit as death benefit protection, a split dollar agreement can be the answer. With proper planning, this approach allows the employee's designated beneficiary to receive a death benefit income-tax free. This planning technique combines a split dollar arrangement with a nonqualified deferred compensation plan and is often referred to as a "Split-SERP."



In a Split-SERP, the executive and the business enter into two agreements, neither of which refers to the other: a SERP/deferred compensation agreement and a split dollar agreement, structured as a nonequity endorsement arrangement. The business purchases and owns a life insurance policy on the executive's life. Yearly, the executive reports any economic benefit from the split dollar agreement as taxable income.⁴ If the executive dies prior to retirement, under the terms of the split dollar agreement, the business receives a death benefit equal to the total cash value. The executive's beneficiaries receive the remaining death benefit, income tax-free.

Generally, the split dollar agreement terminates at retirement, and the business pays the executive the promised supplemental retirement benefits according to the terms of the SERP agreement. Policy cash values may be accessed by the business to help provide the promised supplemental retirement benefits or the plan costs can be recovered at the executive's death.⁵ If the executive dies during this payment period, any remaining payments are paid to the executive's beneficiaries and will be taxed as ordinary income.

Alternatively, if the executive has a greater need for death benefit at retirement, or insurability has become an issue, the executive can negotiate with the employer to have the policy "rolled out" through a purchase or bonus. By taking ownership of the policy, the employee's beneficiaries are now paid directly from the policy proceeds (i.e., they receive an income tax-free death benefit).



Estate Taxation of Death Benefits Provided Under a Nonqualified Compensation Plan. Death benefits promised under most nonqualified plans result in estate inclusion for the participant because the plan agreements contain provisions for lifetime benefits, which brings into play the application of IRC § 2039. Under IRC § 2039, the present value of a beneficiary's right to receive payments under a nonqualified deferred compensation plan after the employee's death is includible in the gross estate of the employee because the employee either was "entitled to receive, or actually was receiving payments that could not, or in fact did not, end before his or her death."

It is important to note that even if the death benefit is includible in the employee/participant's estate, no increased tax liability will result if the benefit qualifies for the marital deduction. If the surviving spouse (or a qualified marital trust) is the beneficiary of the DBO plan, then the decedent's estate will be entitled to a marital deduction from the gross estate for the full amount of the survivor's benefit that was included in the estate. The net effect on the taxable estate will be zero.

In addition to the marital deduction, an estate tax deduction is available for transfers to qualified charities. Thus, if an employee is charitably inclined, he or she can name a qualified charity as his or her designated beneficiary to receive the death benefits, and his or her estate should be entitled to a charitable deduction for the value of the death benefit. This arrangement can be especially beneficial because the charity may avoid paying income tax on the benefits received, whereas an individual receiving the same benefit would be required to include the benefit in his or her taxable income.

Split-SERP Alternative.

If the arrangement is structured as a combination deferred compensation and split dollar it's possible to have the death benefit received by the beneficiary income tax and estate tax free. With this alternative an irrevocable life insurance trust (ILIT) is established and the split dollar agreement is between the ILIT and the business. Assuming the insured/employee does not have an incident of ownership attributed to him/her from the ILIT or the business, the death proceeds paid to the ILIT should avoid estate tax.

In Summary. Nonqualified deferred compensation plans are a powerful tool to help retain and reward top level executives. Typically, the death benefit received by an employee's designated beneficiaries is subject to both income and estate tax. However, with proper planning it is possible for the employee's beneficiaries to receive the death benefit income and estate tax free.



¹For employer-owned life insurance policies issued after August 17, 2006, IRC § 101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally received income tax-free under IRC § 101(a). In a regular C corporation life insurance cash value and death benefit is subject to alternative minimum tax (AMT).

²Income deferred by an employee is 100% vested and is subject to FICA taxes in the year the services are performed. Employer contributions are subject to FICA taxes in the year they vest.

³Life insurance cash values are accessed through withdrawal and/or policy loans. Loans are generally not taxable. Withdrawals are taxable but only to the extent they exceed basis in the policy. Unpaid loans and/or withdrawals cause a reduction in policy cash values and death benefits and may affect any policy guarantees against lapse. Loans outstanding at policy lapse or termination, prior to the death of the insured, will cause immediate taxation to the extent of gain in the contract. For policies that are modified endowment contracts, distributions (including loans and withdrawals) will be taxed to the extent of policy earnings and the taxable amount may be subject to an additional 10% federal income tax penalty if taken prior to the contract owner attaining age 59½. Consult your tax advisor for advice regarding your particular situation.

⁴To receive the benefit income tax-free, the employee must either pay or report as taxable income an amount equal to the economic benefit. The economic benefit in a nonequity endorsement arrangement is equal to the value of the life insurance protection. The value of the life insurance protection is calculated using either the table 2001 rates or the rules in other IRS guidance, as applicable.

⁵Withdrawals and loans will reduce policy values and death benefit, may affect any guarantee against lapse, and may have tax consequences.

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