A Fringe Benefit Primer for the Closely Held C Corporation (Part II)

Mark P. Altieri, J.D., LL.M., CPA
Associate Professor of Accounting
Kent State University
Kent, OH

This two-part article surveys basic techniques for selectively compensating key employees of closely held C corporations on a tax-favored basis. Part II discusses group-term life insurance, split-dollar life insurance and nonqualified deferred compensation.

In many circumstances, key employees of closely held C corporations can be compensated with salary and other benefits not granted proportionately or equivalently to other employees. Part I of this article, in the October 2004 issue, examined salaries and bonuses, interest-free loans and health and disability insurance. Part II, below, discusses the characteristics, advantages and disadvantages of group-term life insurance, split-dollar life insurance and nonqualified deferred compensation.

Group-Term Life Insurance

Employers and key employees should normally consider group-term life insurance as an insurance option, because the premiums are generally fully deductible by the employer and partially or fully excludible by the employee. Although the employer's premium is deductible if reasonable, Sec. 79(a) excludes the cost of the first $50,000 of group-term coverage from an employee's gross income. The cost of insurance over $50,000 is taxed to the benefited employees under the so-called Table I rates in Regs. Sec. 1.79-3(d)(2). The imputed Table I cost is also extended to a retired employee. However, if a covered employee is disabled within the meaning of Sec. 72(m)(7), it is not imputed to him or her for post-termination coverage, under Sec. 72(b)(1).

The Sec. 79 imputed income provisions are extremely favorable to a benefited employee, because (except for a discriminatory group-term plan, discussed below) the maximum imputed income to a retiree over age 70 equals that imputed to a 70-year-old employee. This is often less than the actual premium spent by a company for the retired employee's benefit.

The proceeds payable on an insured's death under a group-term life insurance plan are excluded from a beneficiary's gross income under Sec. 101(a). Additionally, group-term insurance is individually owned. Thus, if a particular contract can be assigned under state law and the insured employee retains no incidents of ownership under Sec. 2042, the death proceeds may be excluded from his or her gross estate, as well.

Plan Requirements

The requirements for structuring a group-term life insurance plan are found in the Sec. 79 regulations. To qualify under Regs. Sec. 1.79-0, coverage must be through a term insurance policy (or policies) and must be purchased for a group of common-law employees. Generally, under Regs. Sec. 1.79-0 and -1(a)(2), the covered group must include all employees; if fewer than all employees are covered, the group's *membership* must be determined solely on the basis of age, marital status or factors related to employment. For groups of 10 or more covered employees, Regs. Sec. 1.79-19(a)(4) requires membership to be conditioned on the nature of duties, the compensation level, the length of service or other employment-related factors.

Editor's note: Mr. Altieri is Special Tax Counsel to the law firm of Wickens, Herzer, Panza, Cook & Batista, Avon, OH.

Under Regs. Sec. 1.79-1(c), groups of fewer than 10 employees must include all employees, with the exception of (1) part-time employees (i.e., those whose customary work week does not exceed 20 hours or five months in a calendar year), (2) employees with less than six months of employment and (3) employees who have attained age 65. There can be no individual evidence of insurability other than a medical questionnaire that does not require a physical examination.

Nondiscrimination Rules

A group-term plan that does not meet Sec. 79(d)'s nondiscrimination standards, but otherwise meets the general requirements of group-term life insurance just noted, retains few tax advantages for a key employee. Sec. 79(d)(1) requires a key employee covered under a discriminatory group-term life insurance plan to include in income the *full* premium spent by the employee for his or her coverage under the plan. Thus, a key employee under a discriminatory plan cannot exclude the cost of the first $50,000 of coverage. Also, he or she cannot use the generally favorable Table I rates for determining the economic benefit provided through the group-term coverage.

To comply with Sec. 79(d) nondiscrimination requirements, a group-term plan must meet one of the following minimum participation rules (generally similar to those for qualified retirement plans):

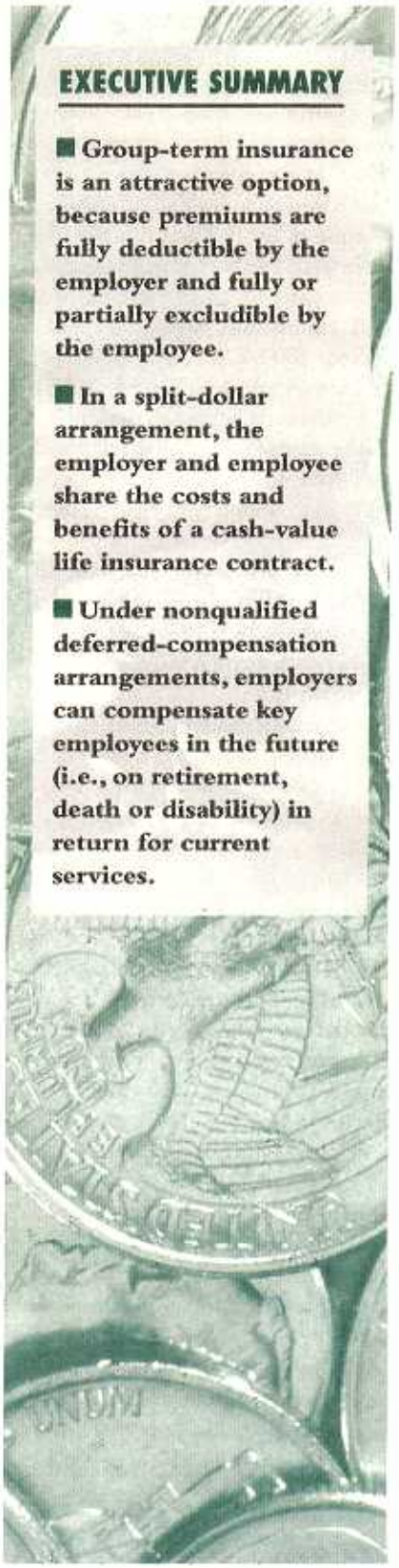
- The plan must benefit at least 70% of all employees;
- Not more than 15% of all participants can be key employees;
- The plan must benefit a classification (determined by the Service) that does not discriminate in favor of key employees; or
- The plan must be part of a cafeteria plan that meets Sec. 125 requirements.

Sec. 79(d) also requires the plan not to discriminate in amount or type of available benefits; although, under Sec. 79(d)(5), the amount of insurance can bear a uniform relationship to compensation (e.g., coverage may equal one times salary and bonus).[28]

Thus, a corporation can establish a nondiscriminatory group-term life insurance plan for key employees that provides them with coverage in excess of that of nonkey employees, provided the coverage is proportionate to compensation paid to all covered employees. Additionally, under either a discriminatory or nondiscriminatory plan, a key employee may exclude all imputed cost under a group-term life insurance plan provided to him or her after disability. Lastly, if the group-term plan is nondiscriminatory, the Table I imputed cost to a covered retired employee will never exceed that applicable to a 70-year-old employee. If group-term coverage is provided to a retired key employee through a discriminatory group-term plan, such coverage will be included in that employee's income. Thus, a company that wants to offer key employees post-retirement coverage will have to maintain a nondiscriminatory group-term plan.

Split-Dollar Arrangements

In addition to, or as an alternative to, group-term life insurance, an employer can establish life insurance protection on a selective basis for key employees through a split-dollar arrangement, and share in financing the policy. In a split-dollar arrangement, an employer and employee contractually share the cost and the benefits of a cash-value life insurance contract.[29] Generally, when the arrangement terminates, the death proceeds (if the employee has died) or the contract's cash value (if the



EXECUTIVE SUMMARY

- **Group-term insurance is an attractive option, because premiums are fully deductible by the employer and fully or partially excludible by the employee.**
- **In a split-dollar arrangement, the employer and employee share the costs and benefits of a cash-value life insurance contract.**
- **Under nonqualified deferred-compensation arrangements, employers can compensate key employees in the future (i.e., on retirement, death or disability) in return for current services.**

[28] An example of discriminatory types of group-term coverage would be funding retired life reserve group-term insurance for key employees (which would provide a fund for post-retirement premiums), while providing only pre-retirement group-term coverage for nonkey employees.

[29] See Rev. Rul. 64-328, 1964-2 CB 11.

For more information about this article, contact Prof. Altieri at maltieri@bsa3.kent.edu.

insured is living) are divided so as to reimburse the company for its gross investment.

Traditional split-dollar arrangements embodied an interest-free element, as the company was generally not reimbursed for the time value of its money. While Rev. Rul. 64-328[30] held that a split-dollar arrangement is not akin to an interest-free loan, that ruling was later modified by Notice 2002-8.[31]

New regulations,[32] in essence, force the parties to acknowledge the substance of the split-dollar relationship and have caused a major stir in the insurance industry. Prior authority (which remains in effect for pre-Sept. 17, 2003 arrangements) had often allowed taxpayers to whipsaw the government by relying on the IRS's and Treasury's own rulings and other promulgations.

Generally, under the regulations, the parties can elect between two methods for characterizing a split-dollar arrangement.

Loan method: Under this method, an employee is treated as the contract owner and the employer's premium payments are loans to the employee; the tax consequences are determined under Sec. 7872. Under Regs. Sec. 1.7872-15(e)(4), interest is imputed if the present value of the amount the employer will be repaid from the policy is less than the loan amount. As was discussed in Part I of this article,[33] a below-market-rate loan from an employer to an employee may not be overly tax detrimental if the loan is compensatory and has been properly documented as such. At first blush, it might appear that interest paid on loans from personally owned life insurance policies would be nondeductible personal interest expense. However, it is arguable that such a loan purchases property held for investment and, thus, is deductible under Sec. 163(d).[34] In this situation, when employer advances have been characterized as loans, the employer has no ownership in the policy other than as collateral for the loan principal. Unlike the next scenario, no additional economic benefits are imputed to the employee because the employee is the contract's owner.

Employer-owner method: Under this method, the arrangement is for services and the employer's interest in the policy is as an owner (or there is no cash value—just death protection—and the employer is deemed the owner).[35] The employee reports the economic benefit of the current life insurance protection (the difference between the policy's face amount and the company's interest in the cash value) as income. Prior to Notice 2001-10,[36] this was computed by referring to the "P.S. 58" cost found in the standard table of premium rates located in Rev. Rul. 55-747,[37] or the insurer's one-year term-insurance premium for standard health risks, if lower.[38] For tax years ending after Jan. 9, 2001, Notice 2001-10 (now Table 2001 of Notice 2002-8) directs taxpayers to use the premium rate table provided therein in lieu of P.S. 58 costs. The Notice 2001-10 rate table is based on the Table I amounts noted above under "Group-Term Life Insurance." However, it eliminates the five-year age brackets and imposes extensions for ages below 25 and above 70.

Problems may develop if a company attempts to formally fund a deferred-compensation plan.

Planning: Under traditional split-dollar arrangements and the current employer-owner method, it is a poor idea to have a company pay the entire premium in any one year in which a split-dollar arrangement is maintained, regardless of the policy's cash-value increase for that year. Sec. 264(a) will deny the company any deduction, while the P.S. 58/Table 2001 cost will be imputed to the employee. This situation can be avoided by having the employee pay a portion of the premium. To the extent the employee pays the part of the premium equal to the P.S. 58/Table 2001 cost had he or she not contributed to the premium payment, the employee will have no imputed income.[39] In this circumstance, a bonus paid to the employee to fund his or her portion of the premium payment might be an appropriate tool. As long as it is reasonable and unrestricted as to use, the bonus should be deductible by the company under Sec. 162(a).

The real value of a split-dollar arrangement lies in a company's ability to help a key employee buy permanent life insurance and maintain it in force while it incurs the acquisition costs and front-end load charges (agent commission). A split-dollar arrangement should generally be

[30] Id.

[31] Notice 2002-8, 2002-1 CB 398, revoking Notice 2001-10, 2001-1 CB 459; see Regs. Secs. 1.61-2(d)(2)(ii)(A) and -22; 1.83-6(a)(5); 1.301-1(a); and 1.7872-15.

[32] See TD 9092 (9/11/03).

[33] See the discussion of "Interest-Free Loans" in Altieri, "A Fringe Benefit Primer for the Closely Held C Corporation (Part 1)," 35 *The Tax Adviser* 624 (October 2004).

[34] There appears to be no authority on this issue. If such authority exists, investment interest expense is deductible to the extent of a taxpayer's net investment income for the year.

[35] See Regs. Sec. 1.61-22(c)(1).

[36] See Notice 2001-10, note 31 supra.

[37] Rev. Rul. 55-747, 1955-2 CB 228. Rev. Rul. 64-328, note 29 supra, also cites this table.

[38] Rev. Rul. 66-110, 1966-1 CB 12.

[39] See note 37, supra.

viewed as temporary. The loan expense under the loan method or the P.S. 58/Table 2001 cost under the employer-owned method will increase annually and will not level off or cease at the employee's retirement or disability (as does group-term coverage). Because of the continuous cost increase, maintaining a split-dollar arrangement until an employee's death is generally not a good idea.

The solution is to terminate the company's interest in the contract. Under the loan method, an employee has owned the contract since inception. The employer's contribution is deemed an employee loan subject to Sec. 7872; hence, the "buy out" is merely a loan repayment. After a traditional whole-life insurance contract from a high-dividend-paying mutual company has been maintained for eight or nine years, the employee may be in a position to borrow the cash value to repay the loan. If the employee meets Sec. 264(d)'s interest deductibility rules,[40] and the interest is Sec. 163(d) investment interest expense,[41] the employee should be able to deduct interest expense on the borrowed funds.

Under the employer-owner method, the employer is not making a loan to the employee. Thus, the value of the insurance protection (i.e., the P.S. 58/Table 2001 cost) is imputed to the benefited employee as compensation. Under this method, the employee does not own the contract's cash value. Thus, under the regulations, on receiving an ownership interest in the cash value, the cash surrender value is taxable compensation to the employee under Sec. 83 and deductible by the employer, if reasonable.

Once the company's interest in the contract has terminated, the employee has to pay the full premium (with after-tax dollars). If the contract has good cash-value accumulations, the employee can often minimize out-of-pocket cost. The employee may withdraw or borrow the needed cash value to help pay that year's premium. Policy dividends and cash-value withdrawals on partial surrender are generally tax free.[42] Additional amounts may be borrowed.

Although interest paid[43] on the policy's borrowed cash value may be deductible under Sec. 163(d), the deduction would be unavailable under Sec. 264(a)(3) if the employee systematically borrows from the cash-value policy, unless one of the exceptions in Sec. 264(d) applies. Under the "four out of seven" exception, the employee can deduct interest if at least four of the first seven annual policy premiums are paid without directly or indirectly borrowing to maintain the contract.[44] All cash-value amounts borrowed are then netted against the coverage's face amount when the employee dies, with the net death benefit received tax free by beneficiaries under Sec. 101(a). This technique provides a low-cost policy, partially maintained by possible tax-deductible debt.

Nonqualified Deferred Compensation

Broadly defined, a nonqualified deferred-compensation plan is any arrangement in which an employee or independent contractor agrees to be paid in whole or part in the future for services to be rendered currently.[45] Under certain circumstances, deferred income due to be paid can again be deferred without the employee constructively receiving the income.[46]

Nonqualified deferred-compensation arrangements may be (and usually are) structured on a completely discriminatory basis.[47] Under a typical nonqualified defined-benefit deferred-compensation plan, a company promises to pay a key employee on retirement, disability or death, 50% of his or her average annual compensation for the five years preceding the year in which the triggering event occurs. Payments may be structured to continue for the employee's life, and thereafter, for the life of his or her surviving spouse.

Under Sec. 404(a)(5), the company can deduct the deferred-compensation payment (subject, of course, to the Sec. 162 reasonable compensation limits) in the tax year in which the employee recognizes income from the arrangement. Because the recipient is almost always a cash-basis taxpayer, Sec. 404(a)(5) effectively puts the company on a cash basis for purposes of deducting such payments.

The advisability of a nonqualified deferred-compensation arrangement between a closely held corporation and its sole or controlling owner/employee is sometimes questioned by tax practitioners. The company's deferred obligation lowers its ostensible net value, so if an employee sells his or her stock on retirement, he or she would theoretically receive less for it. This could result in possible capital gain being converted into ordinary income. On the other hand, the company will get a compensation deduction for the payments, which may compensate for the higher tax on the owner/employee.

[40] Under Sec. 264(d), at least four of the last seven premium payments must have been made without borrowing the cash surrender value.

[41] See the text at note 38, supra.

[42] See Sec. 72(e)(5) and Regs. Sec. 1.72-11(b).

[43] The policyholder, if a cash-basis taxpayer, must actually pay the interest element on the cash-value borrowings to obtain a Sec. 163(a) interest deduction. The insurance company cannot simply deduct the interest cost from additional cash-value borrowings; see *Henry P. Keith*, 139 F2d 596 (2d Cir. 1944) and Rev. Rul. 73-482, 1973-2 CB 44.

[44] The years in which the company had an interest in the policy will be counted in the seven-year period; see Rev. Rul. 71-309, 1971-2 CB 168.

[45] See Rev. Rul. 60-31, 1960-1 CB 174, and Rev. Proc. 71-19, 1971-1 CB 698.

[46] See *George C. Martin*, 96 TC 814 (1991); *Olmsted Inc. Life Agency*, 304 F2d 16 (8th Cir. 1962); *Howard Veit*, 8 TC 809 (1947); and *James F. Oates*, 207 F2d 711 (7th Cir. 1953).

[47] Problems develop under the Employee Retirement Income Security Act of 1974 (ERISA) if this benefit is provided to nonhighly compensated employees.

Rather than avoiding using a deferred-compensation arrangement with a key employee or delaying its implementation until close to the employee's retirement,[48] the company could set up an arrangement at an early and convenient time. If, later, the need for retirement income can be provided on a more tax-effective basis through a stock sale, the deferred-compensation arrangement can be abrogated by the parties' mutual agreement, without discharge of debt income being attributed to the company.[49]

Unfunded plans: The tax effects of a deferred-compensation plan depend on whether the arrangement is "funded" or "unfunded." An unfunded plan is one in which an employee has only the company's unsecured contractual promise to pay the deferred compensation in the future. The employee's legal rights under the contract are those of a general, rather than a secured, creditor. An employee's rights under the arrangement should not be assignable and the plan should state that the payments are payable only from the employer's general assets.[50] Also, the plan must provide deferred compensation only to a "select group of management or highly compensated employees"[51]; otherwise, ERISA requires that the plan be formally funded,[52] which would cause negative tax results, as detailed below.

The company's obligation can be informally funded through a life insurance contract. The policy must be the sole property of the company, however, and must be a general asset subject to creditors' claims.[53] If the employer owns the policy until the employee's death, the life insurance proceeds will generally be tax free to the company under Sec. 101(a)[54]; the payments will be fully deductible to the company when paid. Hence, if a company is in a 34% marginal tax bracket (disregarding the time value of money), it could pay as benefits

Key employees may exclude the imputed cost of group-term life insurance provided after a disability.

152% of the amount it receives under the life insurance contract, and still break even after taxes.[55]

Another well-known type of informal funding device is a Rabbi Trust. This name resulted from the first favorable IRS letter ruling[56] in this area, which involved deferred compensation for a rabbi. A Rabbi Trust provides the employee with additional security that he or she will receive benefits in the event of a hostile change in management, without accelerating employee taxation. The employer contributes to an irrevocable trust to provide deferred-compensation payments. Although the employer's contributions to the trust are generally irrevocable, the assets placed in the trust must remain subject to the claims of the employer's general creditors. If the employee has no ownership rights in the trust assets, the same favorable tax treatment for the employee outlined above results. Additionally, the Department of Labor (DOL) will not deem such a plan to be funded for ERISA purposes if the employer's contributions are not currently taxable to the employee for income tax purposes.[57] The IRS has provided a model Rabbi Trust form.[58] Case law has affirmed these government-established parameters.[59]

Funded plans: Problems may develop if a company attempts to formally fund a deferred-compensation plan. A funded plan is one in which the company sets aside funds (in a nonqualified trust, custodial account or escrow arrangement) to make future deferred-compensation payments. The funds are either beyond the reach of the company's general creditors or the employee has a direct or secured interest. The employee would recognize compensation income equal to the value of his or her interest in the trust or fund in the first tax year in which his or her interest becomes vested within

[48] A limited period between the execution of the deferred-compensation arrangement and the employee's retirement will make it more difficult for the company and the employee to argue that the payments are reasonable compensation for services to be rendered. Also, the IRS will not rule on a factual situation involving deferred compensation for past services rendered; see Rev. Proc. 71-19, note 45 supra, and Rev. Proc. 92-65, 1992-2 CB 428. Pending legislation addresses this issue, as well as others affecting nonqualified deferred compensation; see HR 4520.

[49] See S. Rep't No. 96-1035, 96th Cong., 2d Sess. (1980).

[50] Otherwise, the employee could be deemed in receipt of a taxable cash equivalent or economic benefit.

[51] See ERISA Section 301.

[52] It is unclear whether ERISA would apply to a deferred-compensation arrangement covering only one key employee, because the statutory language affording the exemption is stated only in the plural; see Altieri, "Non-qualified Compensation Agreements and ERISA," 55 *Ohio CPA Journal* 42 (1996).

[53] See Rev. Rul. 72-25, 1972-1 CB 127.

[54] A C corporation subject to the alternative minimum tax would want to plan for a possible positive adjusted current earnings adjustment attributable to an influx of regular income-tax-free life insurance proceeds.

[55] Sec. 264(a) will prevent the company from deducting its premium costs while maintaining the contract, however.

[56] See IRS Letter Ruling 8113017 (12/30/80).

[57] See GCM 39230 (5/7/84); IRS Letter Rulings 9242007 (7/16/92), 9214035 (12/30/91) and 9210013 (12/5/91); DOL Advisory Opinion Letters 94-31A (9/9/94) and 92-13A (5/19/92); and DOL Letter to the IRS dated 12/13/85.

[58] See Rev. Proc. 92-64, 1992-2 CB 422; see also Rev. Proc. 92-65, 1992-2 CB 428, as to related constructive-receipt issues when using a trust arrangement.

[59] See *McAllister v. Resolution Trust Corp.*, 201 F3d 570 (5th Cir. 2000), and *Goodman v. Resolution Trust Corp.*, 7 F3d 1123 (4th Cir. 1993).

the meaning of Sec. 83 (i.e., the first year in which such interest is not subject to a substantial risk of forfeiture or is transferable free of that risk).[60] Under Regs. Sec. 1.402(b)-1(c), subsequent payments to an employee would be taxed as though he or she were receiving annuity payments, with the amounts previously includible in his or her gross income serving as basis. As with an unfunded deferred-compensation arrangement, the company's deduction (assuming reasonableness) may be taken in the year in which the employee recognizes taxable income from the arrangement.

Payments to beneficiaries: If deferred-compensation payments are continued to a surviving spouse or a nonspouse beneficiary after the key employee's death, the present value of such payments is includible in the employee's gross estate under Sec. 2039(a) and Regs. Sec. 20.2039-1(b). If left to the surviving spouse, the marital deduction will be available. In any case, the payments will be taxed to the employee's beneficiary as income in respect of a decedent; the payments will be ordinary income to the beneficiary, with a possible deduction allowed under Sec. 691(c) for estate taxes attributable to the inclusion of the survivor's payments in the employee's estate. If survivor payments are desired, the arrangement should be modified and the actuarial value of the survivor payments replaced by life insurance contracts; the proceeds would be received tax free by the beneficiary, under Sec. 101(a). As detailed above, the company may assist the employee in establishing and maintaining such life insurance coverage.

Conclusion

A number of techniques can selectively compensate key employees of a C corporation on a tax-favored basis. The ability to compensate these employees on a current, deferred or fringe benefit basis should always be considered and carefully evaluated. If an individual can benefit because of his or her role as a corporate key employee (rather than as an owner), the benefits can be provided with little or no tax cost and on a fully deductible basis.

TTA

[60] See Sec. 402(b) and Regs. Secs. 1.402(b)-1(a) and 1.83-3. The employee would have taxable income, even though he or she may have no cash available from the funding vehicle.