Laws and Estates: Combining NQDC and Split Dollar

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Non-qualified deferred compensation (NQDC) plans offer tax advantages to both employers and employees, and are often used as golden handcuffs to bind a valued employee to a business. The specific term "nonqualified deferred compensation plan" encompasses not only plans where the employee actually defers his or her compensation, but also plans that provide for post-retirement salary continuation that's additional to the employee's normal retirement plan and fringe benefit compensation.

This latter type of plan is often called a SERP-a supplemental executive retirement plan. To avoid being subject to the ERISA requirements (i.e., participation, vesting and funding) most plans must follow, NQDC plans cover only a select group of management or highly compensated employees. These plans are sometimes referred to as ERISA "top hat" plans.

Such NQDC plans will usually provide for an employee's retirement benefits once he or she attains the normal retirement age as set forth in the plan. To illustrate, a plan could provide 10 years of retirement benefits that would start at age 60 for $50,000 per year.

Typically, the plan would also provide for survivor benefits if the employee dies prior to their normal retirement age. For example, should the employee die prior to attaining their normal retirement age, the plan might pay the surviving spouse $50,000 per year for 10 years.

An NQDC plan can also be structured to provide the employee with disability benefits should they become totally and permanently disabled prior to attaining their normal retirement age.

As long as the NQDC plan is unfunded, payments under the plan are not taxable to the employee until actually paid, presumably when the employee will be in a lower marginal income tax bracket. On the other hand, the employer does not receive an income tax deduction until the payments are made.

Employers often purchase cash value life insurance policies to fund NQDC plans on an informal basis. Such a policy can provide the necessary funds to pay retirement or death benefits under the plan. As long as the life policy used remains unrestricted as to its assets, and the employee has no interest in it, the value of the policy is not taxable to the employee. After the payments have been made, the policy becomes the property of the insurer.
the unrestricted asset of the employer, and the employee has no interest in the policy, the NQDC plan is considered unfunded.

Unlike a split dollar arrangement, the death benefit under an NQDC plan payable to an employee's family is subject both to income and estate taxes. Although the payments would be considered "income in respect of a decedent," so that the beneficiary would get an income tax deduction for a portion of the estate tax paid, the death benefit under a split dollar arrangement can be completely tax-free if structured properly.

A split dollar plan provides an income tax-free death benefit to an employee's family if the employee dies prior to their normal retirement age. And if the employee's irrevocable life insurance trust (ILIT) enters into the split dollar plan with the employer, the death benefit (in excess of the employer's interest in the policy) will also escape estate taxes at the death of the employee and their spouse. But although combining split dollar with an ILIT provides the employee's family with a tax-favored death benefit, doing so would fail to provide an employee with the kind of retirement benefit as would an NQDC plan.

How can an employee obtain the best of both worlds? The answer is to combine an NQDC plan with a split dollar plan, using a life insurance policy owned by the employee's ILIT.

Under the split dollar plan, the trustee of the ILIT obtains a life insurance policy on the life of the employee, naming the ILIT as the beneficiary. Each year the ILIT will pay (from gifts made to the ILIT by the employee) that portion of the premium equal to the lower of the P.S. 58 rates or the insurance company's "standard risk" one-year individual term rates. The employer pays the remaining balance of the premium. The employer may, if desired, also bonus to the employee sufficient funds to cover the gifts to the ILIT.

As part of the plan, the ILIT assigns to the employer (by a collateral assignment) the right to receive the total amount of premiums it has paid upon the death of the employee, or upon termination of the plan.

When used in combination with a split dollar plan, the NQDC plan would only provide for retirement and/or disability benefits, not death benefits. If the employee dies prior to normal retirement, the ILIT receives the death benefit income estate tax-free under the split dollar plan, and nothing is paid under the NQDC plan. If the employee retires after attaining his or her normal retirement age, the employer would pay the retirement benefits under the NQDC plan. Moreover, if the ILIT maintains the policy following the employee's retirement, the ILIT will also receive the death proceeds income and estate tax free upon the employee's eventual death.

Here's what typically happens when combining an NQDC plan with a split dollar plan. When the employee attains normal retirement age, the split dollar arrangement terminates and the employer is paid by the ILIT for its interest in the policy (i.e., the premiums paid or the cash surrender value of the policy). Once the employer is paid, the collateral assignment is canceled and the ILIT simply continues to own the policy. This is commonly referred to as a "roll-out." The amount paid to the employer can be used to finance the retirement benefits due...
amount paid to the employer can be used to finance the retirement benefits due under the NQDC plan.

However, if the ILIT may need to access the policy's cash values (either by withdrawals or policy loans) in order to pay back the employer, care must be taken in designing the policy. Otherwise, substantial premiums may be due after the roll-out in order to keep the policy in force.

A final consideration in combining an NQDC plan with a split dollar plan is whether such an arrangement results in a funded plan. If it does, then the NQDC plan component is not eligible for the ERISA top hat exemption.

With careful drafting, however, it should be possible to avoid having this arrangement treated as a funded NQDC plan. Here's how: The NQDC plan and the split dollar agreement should not refer to each other in any manner. In addition, the NQDC plan should specifically state that the employee has no rights in any of the employer's assets, and that the employee will be treated as an unsecured general creditor when seeking to enforce his or her rights under the plan. (See Miller v. Heller, 915 F.Supp. 651 [S.D.N.Y. 1996] for judicial authority for combining an NQDC plan and a split dollar plan [with one life insurance policy] without running afoul of the "no funding" requirement for top hat plans.)

When designing an NQDC plan, consideration should be given not only to the fringe benefit aspects of the plan, but also to the estate tax consequences to the employee. This is especially true when the employee is also an owner. Since death benefits under a NQDC plan are subject to both income and estate taxes, the employee may prefer to receive the death benefit portion of the program under a split dollar arrangement. While this adds complexity to the plan design, the tax savings to the employee will usually make it well worth the while. U

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