ENDORSEMENT SPLIT SERP -
A VALUABLE NON-QUALIFIED BENEFIT

Traditional employers have historically compensated key employees through a combination of salary, bonuses, qualified benefits and stock option plans. In addition, many employers also use non-qualified benefit plans, such as split-dollar life insurance arrangements, to provide additional income and benefits to key employees beyond those that can be provided through traditional compensation strategies and qualified plans.

Not-for-profit entities have additional challenges in providing meaningful non-qualified benefits that can be offered to recruit and retain key employees. However, by combining two powerful non-qualified benefits – an endorsement split-dollar arrangement with the use of a supplemental executive retirement plan (SERP), a business or not-for-profit entity can offer its key employees important pre-retirement protection, and post retirement income.

Sometimes referred to as an endorsement split SERP, this technique allows employers a unique and cost effective way to offer customize benefits to fit the specific and changing needs of its key employees.

Summary of the Plan

An endorsement split-dollar arrangement is a plan in which a life insurance policy's premium, cash values, and death benefit are split between two parties, usually between an employer and an employee. This type of plan is frequently used by businesses and not-for-profit entities to provide an executive benefit in the form of pre-retirement insurance protection, and supplemental retirement income to encourage valuable employees to remain with the company.

When desired, this plan can be designed to provide the employer with key person insurance coverage to cover the cost of losing and replacing a valuable employee. Additionally, in many situations a cost recovery feature can also be included to allow the employer to recover its long-term cost of providing this benefit.

In 2003, the IRS published its final regulations with regards to split dollar arrangements providing specific guidance regarding the use of these plans. Today, a properly structured split dollar plan remains a viable and important planning approach to consider.

Advantages for the Key Employees

Under a split SERP arrangement, the employee receives an immediate benefit with the assurance that future retirement benefits are being addressed with the following advantages:

- Endorsement split dollar provides key executives with supplemental life insurance protection at minimal cost. If a key employee were to die prior to retirement, the endorsed death benefit is received by the named beneficiaries income tax free. Additionally, all out-of-pocket costs can be eliminated if the employer chooses to provide a "grossed-up" bonus that covers the entire employee's cost.
- Properly funded, this same life insurance policy is also an extremely tax efficient funding source to provide supplemental retirement income through policy withdrawals (up to cost basis) and policy loans.
- The key employee could choose to forego the supplemental retirement income benefit and obtain a significantly higher death benefit for his family members.
- This split dollar design is very flexible and can be custom designed to offer the following options at the executive's retirement:
    - The business can use the cash value for a supplemental executive retirement plan (SERP) for the employee in conjunction with, or as partial offset to, any existing deferred compensation plan.
    - The business can sell the policy for its fair market value to the employee.
    - Through the use of a bonus from the business, the life insurance policy can be transferred to the employee as a part of an overall compensation plan.
- From an estate planning perspective, the endorsement split dollar plan can be designed to permit each key employee's death benefit and supplemental retirement income benefits to avoid income and estate taxation at the death of the insured employee.
- When the employee is given the option to take ownership of the policy at retirement or when the plan is terminated, the employee gains assurance against future uninsurability.

Advantages for the Employer

Perhaps one of the strongest benefits for the employer is the tangible goodwill the split SERP plan fosters with key employees who feel they are receiving a benefit with both current and future value. Although promised future retirement benefits can act as "golden handcuffs," employees typically have a strong need for current life insurance protection for their families. By meeting this current need and addressing future retirement concerns, the employer creates a supportive environment that can reduce turnover costs. A summary of the advantages of implementing an endorsement split SERP arrangement include:

- Endorsement split dollar requires no IRS approval, and can provide selected executives with valuable pre-retirement death benefit protection and post-retirement supplemental income.
- The company retains full control over the policy, and has the right (subject to the terms of the agreement) to surrender the policy at any time for any reason or sell the same to the executive for its fair market value.

- An endorsement split dollar plan can be designed to have a minimal impact on charge-to-earnings and with long-term cost recovery.
- While premium payments are not deductible by the company, the supplemental executive retirement plan benefits are income-tax deductible assuming reasonable compensation.
- With the exception of the measure of the annual economic benefit, endorsement split-dollar life insurance arrangements are unaffected by Notice 2002-8 and the final regulations governing equity split-dollar life insurance arrangements.

How a Split SERP Works

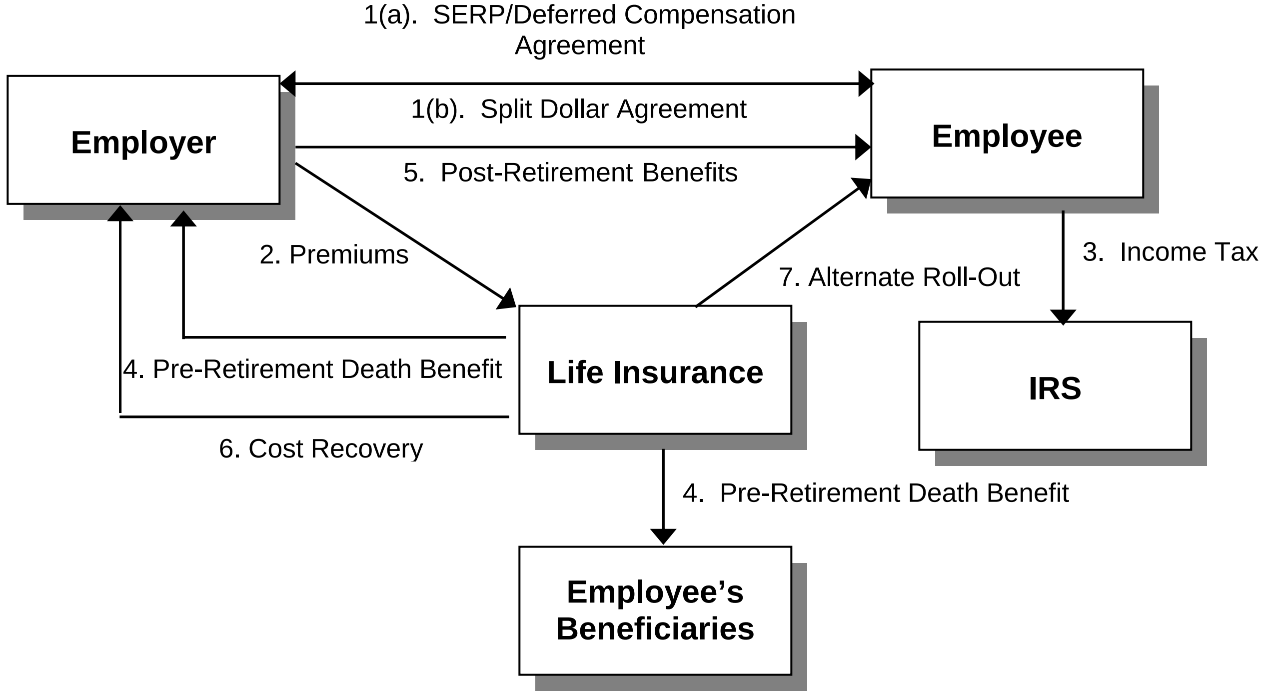
1. The employer and the employee enter into two separate and unrelated agreements: an endorsement split dollar plan and a supplemental executive retirement plan (SERP). The employer is the initial owner of the policy and has absolute control over the life insurance policy and its cash value.
2. During the employment years, the employer endorses to the employee the right to name the beneficiary for a large portion of the death benefit. If the executive dies during the pre-retirement years, the policy pays an income-tax-free death benefit to the employee's family. The employer retains the right to any remaining death benefit (usually for cost recovery purposes).
3. Retirement triggers termination of the split dollar agreement. The endorsement is cancelled, and all rights and benefits in the policy revert to the employer.
4. Generally, the employer pays the post-retirement income promised under the SERP plan using the policy values to fund the payouts. In the case of a not-for profit employer, a more efficient way to fund the post retirement income may be to simply transfer the life insurance policy to the employee, and let the employee use the policy to generate tax-free income from the policy (through cash value withdrawals to basis and policy loans).

Conclusion

Many companies struggle with the problem of how to control costs while still offering meaningful benefits that attract and retain key personnel. An endorsement split-dollar arrangement combined with a supplemental executive retirement plan (split SERP) can create a win-win situation for both the employer and its key employees.

With a split SERP, an employer can not only recruit key employees by offering immediate life insurance protection for the employee's family, but also bind key employees to the firm by creating a "golden handcuff" benefit that provides future supplemental retirement income.

The Endorsement Split SERP



1. The employer and the employee enter into two separate written agreements: (a) a SERP/deferred compensation agreement and (b) a split dollar agreement usually structured as a non-equity endorsement arrangement.
2. The employer purchases a life insurance policy on the employee's life.
3. Yearly, the employer pays premiums according to the terms of the split dollar agreement; and the employee reports any economic benefit as taxable income.[1]

If the Employee dies before retirement...

4. Pursuant to the split dollar agreement, the employer receives a small portion of the life insurance proceeds (which is generally income tax-free under IRC §101(a)), usually equal to the cumulative premiums paid; the employee's beneficiaries receive the remaining death benefit.

If the Employee lives to retirement …

5. Generally at retirement the split dollar agreement is terminated. The employer pays the employee the supplemental retirement benefits pursuant to the SERP agreement. If the employee dies during this payment period, any remaining payments are paid to the employee's beneficiaries.
6. Policy cash values may be accessed by the employer to help provide the promised supplemental retirement benefits or the plan costs can be recovered at the employee's death.[2]
7. Alternatively at retirement, where the executive has a continued need for death benefit, the executive can negotiate with the employer to have the policy "rolled out" through purchase or bonus.

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[1] The economic benefit in a non-equity endorsement arrangement is equal to the value of the life insurance protection. The value of the life insurance protection is calculated using either the rules in Notice 2002-8 or the rules in other IRS guidance, as applicable.
[2] Withdrawals and loans will reduce policy values and death benefit, may affect any guarantee against lapse and may have tax consequences.