Principal®

Economic benefit tax reporting for Endorsement Split Dollar Plans

Under a typical endorsement split dollar plan, the business is the owner of a life insurance policy that insures a key employee or business owner (the participant). The endorsement split dollar agreement provides the participant the right to name a beneficiary for a specified portion of the policy's death benefit, with any remainder of the death benefit being controlled by the business (which usually names itself as beneficiary for this non-endorsed portion).

The participant endorsee is deemed to receive an annual economic benefit based on the value of the endorsed death benefit. This value is based on three components:

- The amount of death benefit endorsed;
- The age of the insured; and
- The term rate table being used. Per IRS Notices 2001-10 and 2002-8, the parties can use either the government provided Table 2001, or an insurer's lower table if it meets certain criteria.

This annual economic benefit is generally reportable as income to the participant.[1] If the benefit is provided to a participant due to their status as an employee, then the participant is income taxed on the value of this benefit as compensation, but the policyowner/employer is not permitted a deduction for this amount.[2]

On rare occasion, the endorsee might avoid taxation by paying the value of this endorsed death benefit to the business – a "contributory" plan – and in such a case, the business is income taxed on those amounts received, just as a landlord is income taxed on rent received.[3]

Principal reports the economic benefit amount to the business

As part of our complimentary administrative services, Principal's Business Market Administration department calculates and reports economic benefit figures to the business via a summary annual report. These summary annual reports (which also provide other relevant policy information) are generally provided to the business each January in anticipation of the April tax reporting season. If a business prefers to receive these reports at some other time during the calendar year, that can be arranged upon request.

Tax reporting by the parties

Although Principal provides annual economic benefit amounts to the business, Principal does not tax report these figures to the IRS. Rather, it's the responsibility of the business to ensure appropriate tax reporting occurs for each of the key employees or business owners participating in the endorsement split dollar plan.

The split dollar regulations sensibly state that the tax effects of any split dollar plan depend upon the relationship between the parties involved.[4] Presumably, this should mean that:

- If the policyowner is a business endorsing death benefit to an individual due to that individual's role as an *employee*, the value of the economic benefit would be treated, and reported, as *compensation*.
- If a policyowner is a business endorsing death benefit to an individual due to that individual's role as an *owner of the business* (partner or shareholder), the value of the economic benefit would be treated, and reported, as a *distribution* or *dividend*.[5]

When it comes to tax reporting, federal government guidance about split dollar benefits provided to an *employee* are decently clear, but not as clear when the benefit is instead provided to someone due to their status as an *owner of the business*.

Endorsement to employee

When the policyowner is an employer endorsing death benefit to an employee, the employer should report the value of the economic death benefit for federal income tax purposes on a Form W-2, in Box 1 (wages, tips, and other compensation).[6] In line with this treatment of the value of the economic benefit being compensation to an employee, it seems the value would also be placed on the W-2 in:

- Box 3 with regard to Social Security Tax,
- Box 5 with regard to Medicare Tax, and
- Box 16 and 18 with regard to State and Local Tax (if applicable).

Endorsement to business owner

As indicated above, it is less clear how to report split dollar benefits to an individual due to his or her status as an owner of the business, such as a shareholder or partner. Some possible approaches include:

- The business could report the economic benefit on a Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc."
    - The instructions for 1099-R state that the "gross distribution" amount in Box 1 should include "premiums paid by a trustee or custodian for the cost of current life or other insurance protection." These instructions also state that the "taxable amount" in Box 2a should include the cost of "current life insurance protection" and that Code 9 should be placed in Box 7 to show this cost as the form of the distribution.
    - The 1099-R instructions do not, however, refer specifically to benefits under a *split dollar* arrangement (as do the W-2 instructions). The 1099-R instructions also refer to "trustee or custodian" providing life insurance benefits. Thus, some practitioners might interpret the 1099-R's cost of current life insurance provisions as referring not to split dollar plans, but instead to situations where life insurance coverage is provided to an employee by a policy owned in a qualified retirement plan as described in Treasury Regulation § 1.72-16.
- Alternatively, and in line with the split dollar regulations' directive that the *tax results* of split dollar plans are determined by the relationship between the parties, perhaps the *tax reporting* is simply determined by the parties' relationship as well. Under this view:
    - If a C corporation owns a policy and endorses death benefit to a shareholder, it seems reasonable to report the economic benefit as a dividend on a form 1099-DIV.
    - Along the same vein, if an S corporation endorses death benefit to a shareholder, it seems reasonable to report the economic benefit as a distribution on a Schedule K-1 of Form 1120-S.
    - And if a partnership endorses death benefit to a partner, it seems reasonable to report the economic benefit as a distribution on a Schedule K-1 of Form 1065.

Conclusion

As described above, Principal provides annual economic benefit amounts as a complimentary service to the business that sponsors the split dollar plan. But as can be discerned from the discussion above, tax law guidance is not entirely clear about how the business should in turn tax report split dollar benefits to the endorsee, especially when the endorsee is an owner of the business, such as a shareholder or partner. Ultimately, the parties involved in the split dollar plan will have to rely on their own legal and tax counsel when determining how to tax report the benefits that are provided.

[1] Treas. Reg. § 1.61-22(d)(2)(i) and (d)(6), Example 1. Additionally, per Treas. Reg. § 1.61-22(d)(2)(ii) and (2)(iii), the employee would also be income taxed on any cash value to which he or she has current access, and on any other economic benefits provided, but neither of these should exist in a well-written standard endorsement split dollar plan.

[2] Treas. Reg. § 1.61-22(f)(2)(ii).

[3] Treas. Reg. § 1.61-22(f)(2)(ii).

[4] Treasury Regulation Section 1.61-22(d)(1) states: "Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character." A distribution under IRC section 301 refers to distributions by a corporation "to a shareholder with respect to its stock," that is, due to ownership status rather than due to employee status.

[5] Given that no portion of the premium paid by the business is deductible, split dollar endorsement plans provided by *flow-through tax entities* (S corporations and partnerships) to their *owners* are very rare, as the endorsee owner would just be shifting the cost of paying for the policy to the business owners – including to the insured himself or herself – via the business. Furthermore, in S corporations, distributions must be made equally to all owners, proportionate to their relative percentages of ownership.

[6] The 2024 instructions to Form W-2 tell employers that Box 1 is to "[s]how the total taxable wages, tips, and other compensation that you paid to your employee during the year. . .. Include the following: . . . 17. Cost of current insurance protection under a compensatory split-dollar life insurance arrangement."

Principal®

principal.com