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Death Benefit Only Plans: Taxation, Withholding, and Reporting Issues

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Financial institutions looking for a way to attract and retain top talent or to enhance employee benefits for important employees should consider establishing a death benefit only (DBO) plan. DBO plans – a type of nonqualified deferred compensation plan – are easy to implement and administer and will provide benefits to the beneficiaries of the covered employee if the employee was employed by the financial institution at the time of his or her death.

DBO Plans in a Nutshell

A DBO plan provides specified death benefits to one or more beneficiaries of a deceased employee, provided the employee was employed or retired from the sponsoring financial institution at the time of his or her death. Payments to beneficiaries can be made as a one-time lump sum or as periodic payments over a number of years. Typically the payment is calculated as a multiple or a percentage of the employee's annual salary.

Life insurance commonly is used to finance the payment of benefits, but is not required. The sponsoring employer purchases one or more life insurance policies on plan participants so that the death benefits can match the expected survivor benefits to be paid or be sufficient to cover both the survivor benefits and recover the employer-paid insurance premiums.

An employer's DBO plan should be in writing and clearly define who is entitled to benefits (surviving spouse or children), eligibility standards (for example, the decedent must have been an employee at the time of death), the timing of plan payments, and the amount of payments and how they are calculated (such as via final salary, average salary, and/or using a multiple for years of service).

Advantages of DBO Plans

Employers are attracted to DBO plans because they offer several advantages over other deferred compensation plans. DBO plans are easy to implement and administer, and no advance approval is required from the IRS or the Department of Labor. Because DBO plans aren't qualified plans, they don't need to follow the nondiscrimination rules that qualified plans must follow. The plans could be considered as an alternative to split-dollar life insurance plans when the premium or economic benefit cost to the employee is prohibitive. In addition, they provide a benefit post-death, rather than a benefit during the life of the employee.

Employer Tax Consequences

If an employer funds a DBO plan with life insurance, the premiums it pays are not tax deductible. When a covered employee dies and the death benefits are paid to the employer, the death benefits are tax-free provided the employer-owned life insurance requirements are met. These requirements include the employer notifying and obtaining consent from the insured employee before the purchase of the life insurance. Note, however, that the death benefits are required to be included in the calculation of the alternative minimum tax (AMT) and may be subject to tax if the AMT liability exceeds the regular tax liability. The employer can take a deduction for the payment of benefits to the beneficiaries provided that the payments represent reasonable compensation for the covered employee's services.

If the payments are made pursuant to an eligible DBO plan, the death benefit payments are exempt from *Federal Insurance Contributions Act* (FICA) and *Federal Unemployment Tax Act* (FUTA) taxes, so employers need not withhold for those taxes. The applicability of federal income tax withholding to the payments remains a gray area, though. IRC Section 3401(a), which defines wages for purposes of federal income tax withholding, does not contain a specific exception for death benefits as found in the FICA and FUTA provisions. The conservative approach for employers is to withhold for federal income tax purposes.

Employee and Beneficiary Tax Consequences

A properly structured DBO plan will not generate taxable income to the employee during his or her lifetime. For those individuals who are concerned about possible estate tax consequences, the value of the survivor benefit may be excluded from the employee's estate provided the employee's rights in the plan are limited. For example, the plan should specify the eligible beneficiaries by class or type (such as surviving spouse), instead of names, and allow payments of benefits only to the eligible beneficiaries. Furthermore, the employee should not control the plan or any life insurance policies held by the plan, and, as such, should not be allowed to change the plan terms or force the plan to surrender the life insurance policy.

The survivor benefits are taxed to the beneficiary as ordinary income in the year received.

Peace of Mind

A DBO plan can help attract and retain valuable employees without burdening an employer with complex benefit rules. Perhaps its greatest benefit is the confidence it provides to employees in knowing that their family has a source of income to help ease the financial blow when the employee dies. If properly structured, the value of the benefit avoids estate tax, further enhancing the value of DBO plans to certain employees.

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