Key Person, Split Dollar & Deferred Compensation Combination

Three Needs One Policy Presentation

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Does the business identify with the following?

♦ The business relies on one or more executives for generating the bulk of the revenue or for acquiring most of the new customers; or

♦ Business loans cannot be negotiated without the personal guarantee of one or more of the business owners; or

♦ The management of the business rests in the hands of a few key executives; and

♦ The death of a key executive would have a devastating effect on the operation of the business.

If so, you may want to consider purchasing key person life insurance coverage on your key executives. And, if

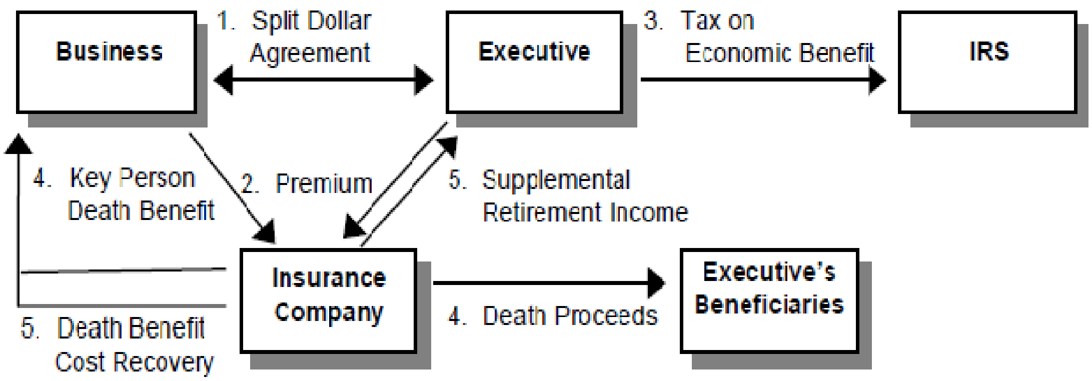
♦ the key executive also has a need for pre-retirement personal life insurance coverage, and post-retirement supplemental income; and

♦ the business has the cash flow and desires to provide an incentive which will help to retain the executive to the business

Consider combining the purchase of key person coverage with a split dollar and deferred compensation arrangement.

Key Person, Split Dollar & Deferred Compensation Combination

Structure of Key Person, Split Dollar & Deferred Compensation Combination



1. Business and executive enter into an endorsement split dollar agreement. The face amount of the policy is split with the key executive receiving the amount needed for personal coverage and the business receiving the balance for key person coverage.

2. Business and executive pay premiums on the policy using the key executive's life according to the terms of the split dollar agreement.

3. Executive pays tax on reportable economic benefit. [1]

4. If during the term of the split-dollar, the key executive dies, the executive's beneficiaries recover their share of the coverage from the death benefit as provided in the agreement, which is generally income tax-free under IRC § 101(a). The business receives the balance of the death proceeds that helps protect against losses it may suffer as a result of the executive's death.

5. At the key executive's retirement the business accesses the policy values on a non-Modified Endowment Contract (MEC) policy on a tax-favored basis to pay tax deductible deferred compensation income to the executive. [2] Once the executive has received the entire deferred compensation the split dollar agreement is terminated. The balance of the death benefit helps the business to recover its cost reducing its overall costs.

[1] The economic benefit is calculated using either the rules in Notice 2002-8 or the rules in other IRS guidance, as applicable.

[2] Withdrawals and loans will cause a reduction in death benefit and policy values, may affect any guarantee against lapse and may have tax consequences

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Benefits to the Executive:

♦ The key executive receives pre-retirement life insurance protection at a lower out-of-pocket cost than on an individual basis.

♦ The executive is protected against future uninsurability through the split dollar plan. Should he/she find that a need for death benefit continues after retirement, the executive can negotiate with the employer to have the policy “rolled out” through purchase or bonus.

♦ The executive receives post-retirement supplemental income as provided under the deferred compensation agreement provided by the employer.

♦ Unlike qualified plans, no federal income tax penalties are imposed on deferred compensation benefits paid before age 59 ½.

Benefits to the Business:

♦ Provides an incentive for executive retention through an attractive benefit backed by a binding agreement.

♦ Completely selective, the split-dollar and deferred compensation benefits can be offered only to those key executives chosen at the discretion of the business, thereby contributing to increased loyalty.

♦ The employer has “golden handcuffs” as the executive must sacrifice valuable benefits if he leaves the employer.

♦ The key person’s insurance coverage helps the business to protect itself from the losses it may suffer as a result of a key executive’s death.

♦ Provides a flexible program that is not encumbered by ERISA or nondiscrimination requirements.

♦ Business costs and benefits may be varied among the selective executives, allowing for individually designed incentive programs that meet the needs of both the business and the executive.

♦ The employer gains cost efficiency because one policy is used to cover several benefit needs. In addition, the arrangement can be structured to enable recovery of the employer’s cost at the insured’s death resulting in lower overall costs.

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Tax Considerations:

- No IRS approval is required for the arrangement; however, the deferred compensation arrangement must be filed with the Department of Labor within 120 days of plan inception.

- Employer contributions to the SERP plan cannot be deducted for income tax purposes until they are included in the participating executive's income (subject to tests for reasonableness).

- With a properly structured nonqualified plan, the executive pays no current income tax on income deferred, or on any additional employer contributions or credited earnings, until the benefits are actually or constructively received.[3]

- Premiums paid to purchase the life insurance on the executive's life are not tax deductible by the business.

- The arrangement is generally structured as an endorsement split dollar. Each year the endorsement split dollar arrangement is in effect the executive/taxpayer must report income equal to the "economic benefit" received less any amount the executive has contributed. The value of the economic benefit depends on the date the split dollar arrangement is entered into, the type of insurance policy (single life or survivorship coverage) and whether the arrangement is an equity or non-equity.[4]

- Life insurance policy loans are generally not taxable and withdrawals are generally not taxable to the extent they are a return of cost basis; however, withdrawals that cause a reduction in death benefit in the first 15 years of the policy may be subject to taxation. In addition, for policies that are MECs, distributions (including loans) are taxable to the extent of income in the contract, and an additional 10% federal income tax penalty may apply. If a policy lapses or is surrendered with an outstanding loan prior to the death of the insured, there is taxable income to the extent of income in the contract. Of course withdrawals and loans will reduce policy cash values and death benefit and may affect any guarantee against policy lapse.

- The death benefit received under the split dollar arrangement is generally income tax-free under IRC § 101(a), while any survivor benefits payable to the executive's heirs under the SERP plan are taxed to the heirs as ordinary income.

[3] Income deferred by an employee is 100% vested and would be subject to FICA in the year the services are performed. Employer matching contributions would be subject to FICA taxes in the year they vest.
[4] The economic benefit is calculated using either the rules in Notice 2002-8 or the rules in other IRS guidance, as applicable.

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♦ If the business is a C corporation subject to alternative minimum tax (AMT), life insurance death proceeds and annual increases in policy cash values may impact the calculation of adjusted current earnings.[5]

♦ Care must be taken when establishing a deferred compensation plan in conjunction with a split dollar agreement in order to avoid the split dollar agreement being viewed as a dedicated pre-funding of the deferred compensation agreement (raising the possibility that the employee could be currently taxed on the value of such pre-funding amount). Therefore, this arrangement should only be established pursuant to the counsel of the legal and tax advisors of the business and the executive.

♦ The Sarbanes-Oxley Act makes it a crime for publicly-traded companies to, directly or indirectly, enter into a loan with certain directors and officers. It is unclear whether the Act applies to split dollar arrangements. Clients should consult their tax advisors for the most recent developments

[5] Corporate AMT for “small corporations” has effectively been repealed. Small corporations are defined as having average gross receipts of $7.5 ml ($5 ml for initial qualification) for the three previous tax years ending before the year in question