



Three Needs, One Policy: Key Person, Split Dollar & Deferred Compensation

When evaluating the needs of a business, one often identifies life insurance as an excellent financial tool to address three important needs:

- (1) Covering the loss to a business attributable to the death of a **key employee**
- (2) Motivating a key employee by providing life insurance at a very favorable cost through a **split dollar arrangement**
- (3) Retaining a key employee through a **deferred compensation or supplemental executive retirement plan (SERP)** to provide income at retirement.

All three needs can be met using a single life insurance policy.

Facts: Assume that an employer desires to provide a key executive preretirement death benefit of \$3,000,000 and postretirement supplemental income of \$100,000 for twelve years. The employer also is concerned about the financial loss that would be incurred if the executive should die during the period of his employment. Finally, the employer would also like to be reimbursed at the death of the employee for its premium expenditure.

Solution: The employer purchases a \$5,000,000 option "C" increasing death benefit life insurance policy structured to avoid classification as a modified endowment contract (MEC). Next, the employer and executive enter into two separate written agreements: (1) a non-equity endorsement split dollar agreement where the employer owns the policy and controls the total cash value and (2) a nonqualified supplemental executive retirement plan (SERP).⁵

Under the split dollar policy endorsement, the executive is given the right to designate the beneficiary for \$3,000,000 of policy death benefit, and the employer designates itself the beneficiary of the remaining death benefit.

¹ The Sarbanes-Oxley Act makes it a crime for publicly traded companies to directly or indirectly enter into a loan arrangement with certain directors and officers. It is unclear whether the Act applies to split dollar arrangements. Clients should consult their legal or tax advisors.

This training material has been prepared to assist our licensed financial professionals. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that Prudential is not rendering legal, accounting or tax advice. Such services should be provided by the client's own advisors.

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During the executive's working years, the employer pays the entire premium on the life insurance policy. The executive reports, as taxable income, an amount equal to the economic benefit.²

Should the executive/key person die before retirement while the split dollar agreement is in effect, both the executive's beneficiaries and the business receive income tax-free death benefits under IRC § 101(a).³ Thus, two needs are met: (1) money is available to indemnify the business for the loss of a contributing executive, and (2) money is available to the executive's heirs if death occurs before retirement.

At retirement, the split dollar agreement is terminated and the employer becomes the owner of the entire policy. At this time, if desired, the employer can adjust the policy death benefit to reflect reduced funding needs (i.e., the only remaining promise – the SERP benefits) and any plan costs.

During the retirement years, the employer pays the executive the SERP benefits as outlined in the deferred compensation agreement. Benefits can be paid from business cash flow or the employer may choose to access the cash values of the non-MEC policy on a tax-favored basis by taking policy withdrawals to basis, then loans.⁴

At the executive's death, the employer receives the policy death benefit to help recover the costs of the arrangement.

CHART ON THE CONCEPT ATTACHED

² The economic benefit in a non-equity endorsement split dollar arrangement is equal to the value of the life insurance protection calculated using either the rules in Notice 2002-8 or other IRS guidance where applicable.

³ For employer-owned contracts issued after August 17, 2006, death proceeds are subject to income tax. However, death proceeds can be received income tax-free where certain exceptions apply and specific employee notice and consent requirements are met prior to policy issue.

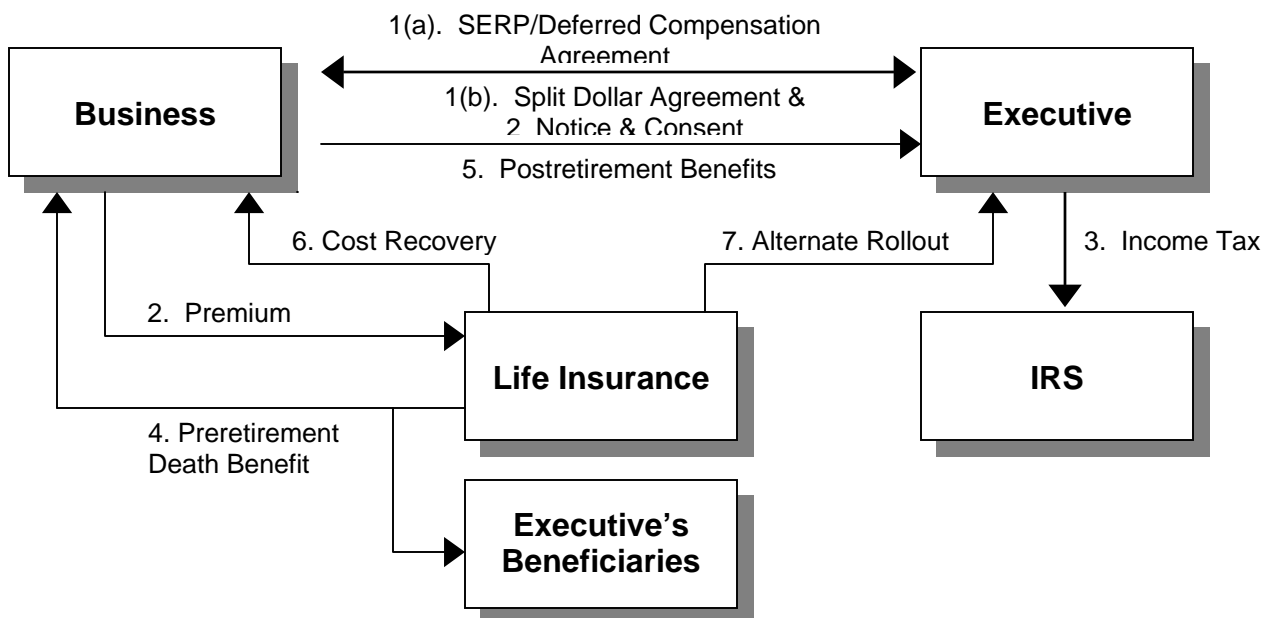
⁴ Withdrawals and loans will reduce policy values and death benefit, may affect any guarantees against lapse, and may have tax consequences. A reduction in death benefit may cause the policy to become a Modified Endowment Contract (MEC). Distributions, including loans, from a MEC receive less favorable tax treatment than policies that are not classified as MECs. This also applies to distributions made within two years prior to the policy becoming a MEC.

QUESTIONS? CALL ADVANCED MARKETING

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Key Person, Split Dollar & Deferred Compensation Combination



1. The executive and the business enter into two separate written agreements: (a) a SERP/deferred compensation agreement and (b) a non-equity endorsement split dollar agreement.
2. The business gives notice to the key executive that insurance will be purchased on the employee's life and receives consent from the employee.⁵ The business purchases a life insurance policy on the key executive's life. The face amount of the coverage is split with the executive's heirs receiving a fixed amount and the business receiving the balance for key person coverage and reimbursement of the premium.
3. The executive and the business pay premiums according to the terms of the split dollar agreement. The executive reports any economic benefit as taxable income.⁶

⁵ See footnote 3 on the previous page.

⁶ 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.

If the key person/executive dies prior to retirement ...

4. Pursuant to the split dollar agreement, the business and the key executive's beneficiaries receive their respective portions of the death benefit.

If the key person/executive lives to retirement ...

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

⁷ Withdrawals and loans will reduce policy values and death benefit, may affect guarantee against lapse, and may have tax consequences.