Executive Compensation Planning

Using Life Insurance

July 2012
MKTG-OC-786B
1 Hour CE

PACIFIC LIFE

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Contents

- Nuts and Bolts of Nonqualified Deferred Comp (NQDC)
- 401(k) Mirror Plan
- Restricted Executive Bonus
- Non-Equity Collateral Assignment Split-Dollar

NQDC - Why?

Qualified plans insufficient

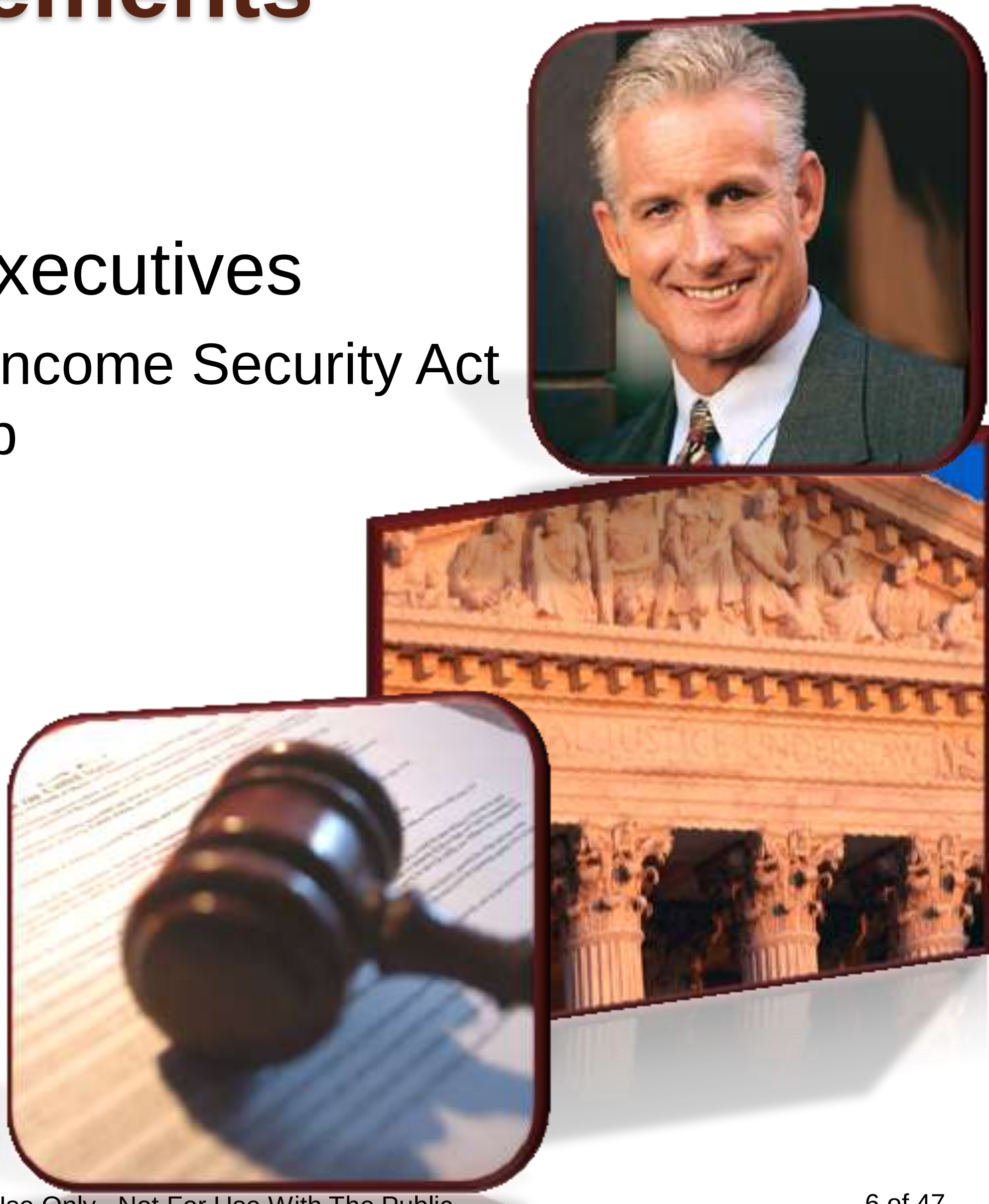
- “Maxed out”
- Too expensive

Need to attract and retain key-person

- “Golden handcuffs”

NQDC - Requirements

- Must be limited to executives
  - Employee Retirement Income Security Act (ERISA) Top-Hat Group
  - No ERISA
    - *Individual contract*
    - *Not a "Plan"*
    - *Business Owners*



NQDC - Requirements

- Plan assets must be reachable by the business' creditors
  - Unfunded: ERISA
  - Informally funded: Tax
- Vesting and substantial risk of forfeiture

IRC Section 409A

- Applies to many arrangements where income is earned in one tax year and payable in a subsequent tax year

- Limitations on distributions
  - Separation of service
  - Death
  - Disability
  - Change of control
  - Unforeseeable emergency
  - A specified date

Section 409A (cont.)

- IRC Section 409A (cont.)
  - Deferral elections
    - Must be made in the year prior to the year the compensation to be deferred is earned
      - Example: For a [2012] deferral, the election to defer must be made on or before December 31, [2011]
    - New plans or new participants – elections must be made within 30 days of eligibility
    - Performance-based compensation – 6 months prior to the end of the period earned

Section 409A (cont.)

- IRC Section 409A (cont.)
  - Eliminates aggressive planning techniques
    - Haircut provisions
    - Insolvency triggers
  - Penalties
    - Immediate taxation of deferrals
    - Interest at IRS underpayment rate +1%
    - 20% penalty

What has changed in NQDC since 409A?

- Answer - Not Much
- No more aggressive planning
  - Insolvency triggers
  - Haircut provisions
- Competent administration has become very important

Administration – Why is it important?*

409A
Compliance

- Limitations on distributions
- Elections to defer must be timely
- Penalties are stiff for non-compliance

Convenience

*Please note that Pacific Life does not administer nonqualified deferred compensation arrangements.

Administration – What do they do?

- Enrollment
- Receipt of elections
- Communication
- Calculation of benefits
- Payment of benefits

Three Types of NQDC Plans

Voluntary Deferral

- 100% executive deferrals

Supplemental Executive Retirement Plan (SERP)

- 100% business contributions

401(k) Mirror Voluntary Deferral Plan

- Combination of executive deferral and an employer match

Why Life Insurance?

- Policy Cash Value (CV) possible source of benefits
  - Tax-deferred accumulation
- Net Amount at Risk (NAR) for key-person/cost recovery and/or personal life insurance

IRC Section 101(j)

- Passed into law in 2006
- Makes death benefit taxable above basis unless certain exceptions and requirements are met
  - Who is the insured or why is the policy being purchased (exceptions)
  - Notice and consent (requirements)

IRC Section 101(j)

- Insured was an employee during 12-month period before death
- At the time the contract is issued, the insured is
  - A director, or
  - A highly compensated employee within the meaning of IRC Section 414(q), or
  - A highly compensated employee within the meaning of IRC Section 105(h)(5) (top 35% of all employees)
- Proceeds are paid to beneficiary of the insured (e.g. split-dollar) or are used for a buy-sell

IRC Section 101(j)

- Must provide the proposed insured with written notice of impending insurance contract. The notice must include:
  - That the employer will be the beneficiary
  - The employer may be the beneficiary after the executive leaves the employer
  - The maximum amount of insurance
- Must receive written consent from the insured
- Both notice and consent must happen *before* the policy is issued
- If notice and consent does not happen prior to issuance, the death benefit will be taxable
  - You can rarely remove the taint from that policy

The Bottom Line!

- Really important piece of law, but:
  - It does not curtail most traditional uses of Corporate-Owned Life Insurance (COLI):
    - NQDC
    - Key Person
    - Split-Dollar
    - Stock redemption
  - Insured in traditional COLI will almost always meet one of the exceptions
- Notice and consent are crucial

Measuring the Retirement Balance

For Defined Benefit:
- Fixed amount
- % of Income
- Plus Deduction

For Defined Contribution:
- Cash Surrender Value
- Adjusted Index
- Unrelated Index

Pass-through Entities

- NQDC generally not viable for owners of pass-through entities
- Alternative designs:
  - Executive Bonus
  - Restricted Executive Bonus
    - *ERISA concerns*

Uninsurable or Older Exec

- Alternate informal funding choice
- Aggregate funding
- Part treasury/part cash value
  - For example: Paying out the benefits first using company cash flow for the first 10 years, then accessing the cash value to pay out the benefits for years 11-15.

Vesting

Voluntary Deferral fully vested

All vested amounts still asset of business

No legal limits with SERP flexible vesting

Executive Taxation

- Contributions pre-tax to executive
- Premiums/contributions *not* deductible to business
- Benefit pay out deductible to business, taxable to executive
    - Can be installment or lump sum

Accounting

Accounting Principle Board (APB) 12/Financial Accounting Standards Board (FASB) 106 (most NQDC plans)

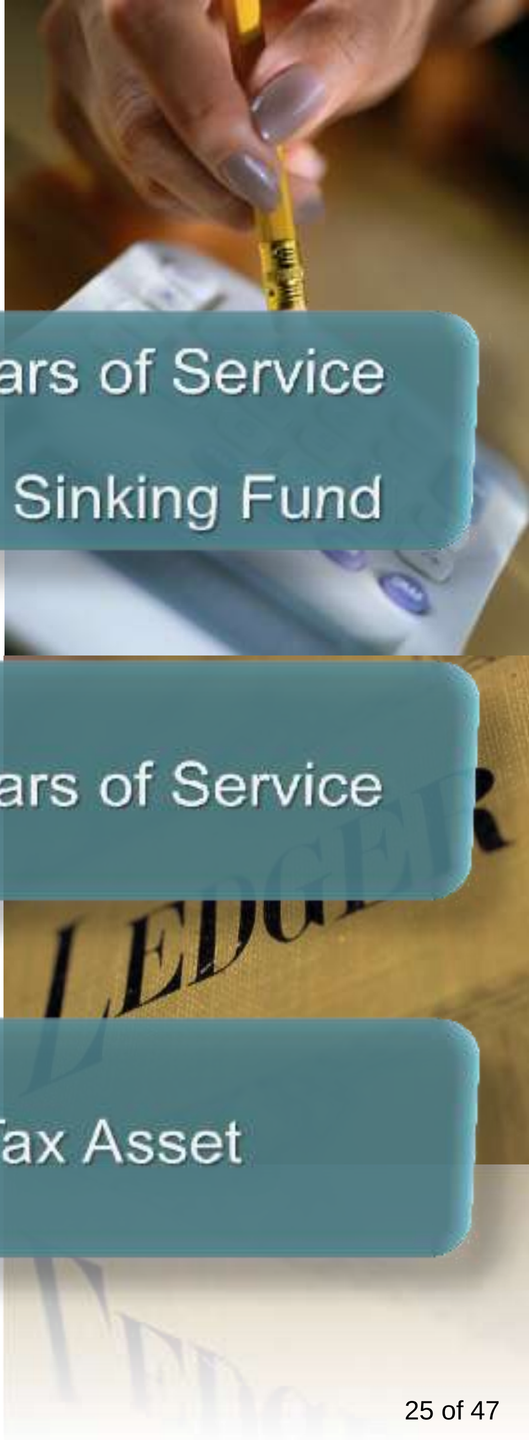
- Benefit/Years of Service
  or
  Strait-Line Sinking Fund

FASB 87 (pension equivalents)

- Benefit/Years of Service

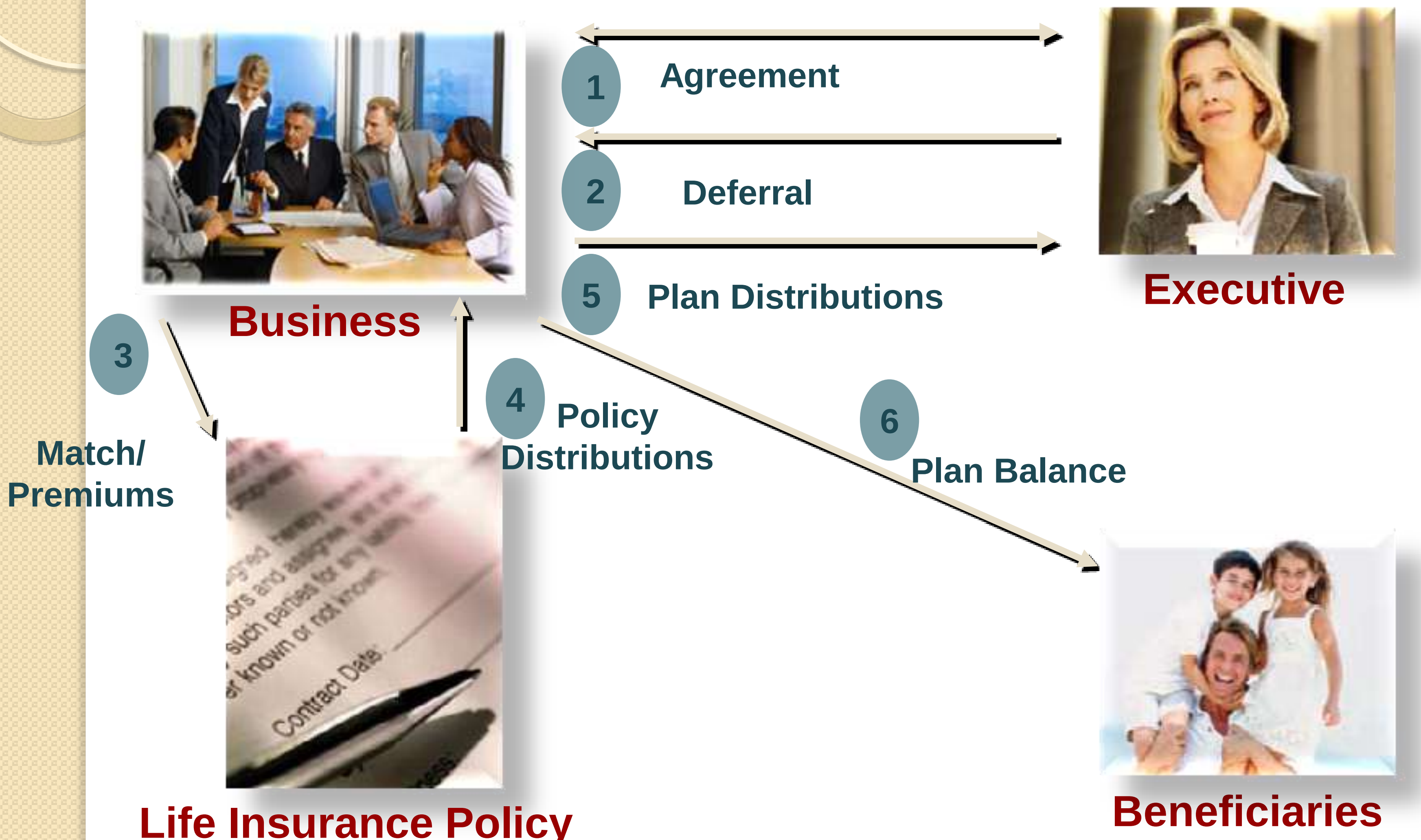
FASB 106 (taxation)

- Deferred Tax Asset



401(k) Mirror Voluntary Deferral Plan

401(k) Mirror Structure



Why Life Insurance?

- Tax-deferred growth
- Tax-free death benefit* to employer or executive’s heirs
- Tax-free distributions from cash value to employer**

*For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the “transfer- for- value rule”); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

** Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

Executive Summary: *Features*

Deferrals and match in excess of qualified plan and Individual Retirement Account (IRA) limits

Strict conditions for distribution, especially for unforeseeable emergencies, disability and change of control.

Retirement balance reachable by employer's creditors.

Executive Summary: *Taxation*

Deferrals and match pre-tax

Accumulation tax-deferred

Retirement balance distributions taxable

Through split-dollar, death benefit in excess of retirement balance tax-free*

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Employer Summary: *Features*

- Deferrals and match in excess of qualified plan limits
- Can limit to executives
- Retirement balance reachable by employer's creditors
- Vesting schedule on match
- Cost recovery from death benefit

Employer Summary: *Taxation*

- Deferrals and match taxable to employer
- If life insurance is used, accumulation not taxable (AMT may apply)
- Distributions deductible to employer
- Potential tax-free key person death benefit*

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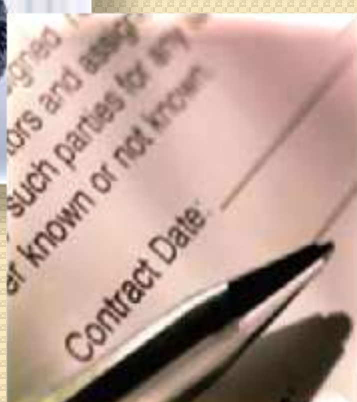
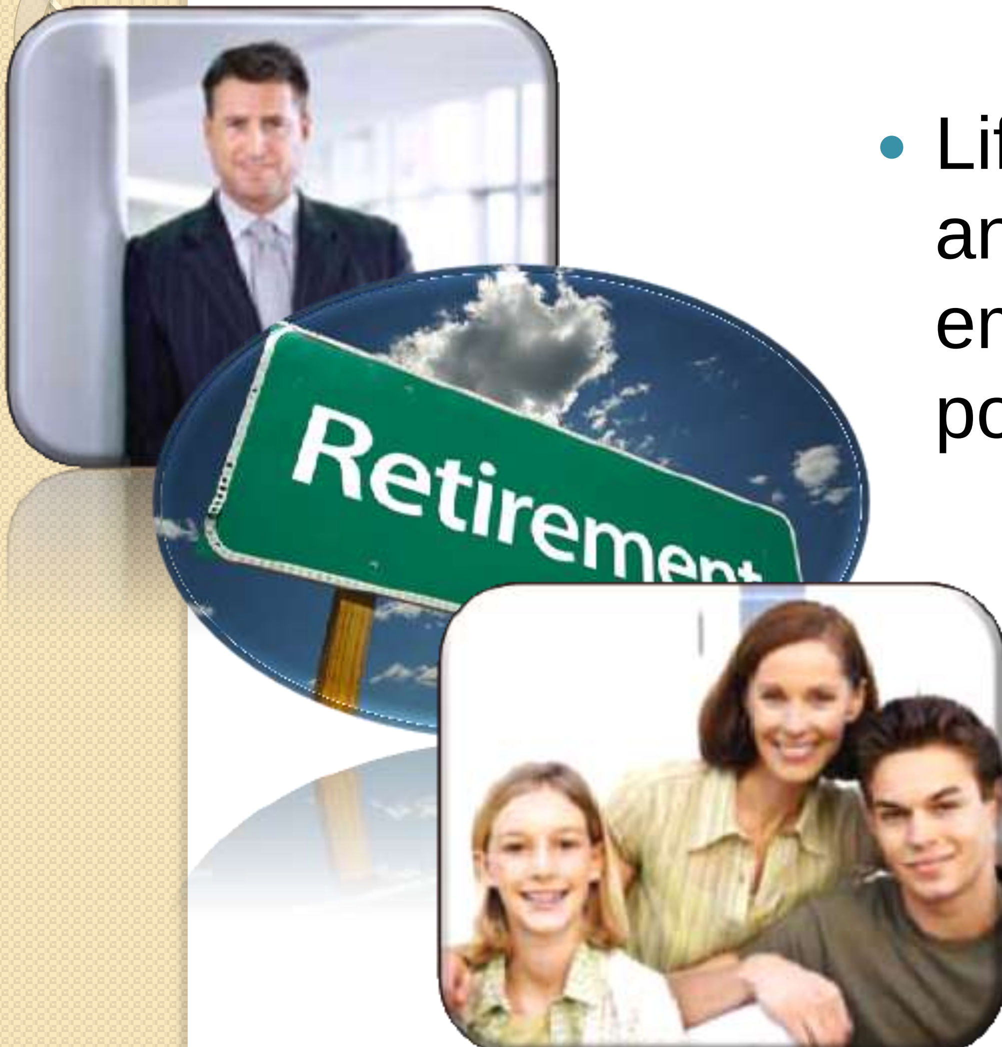
Restricted Executive Bonus



Employer’s Goal

- Provide attractive benefits with a “golden handcuff” to valued executive

Employee's Goal



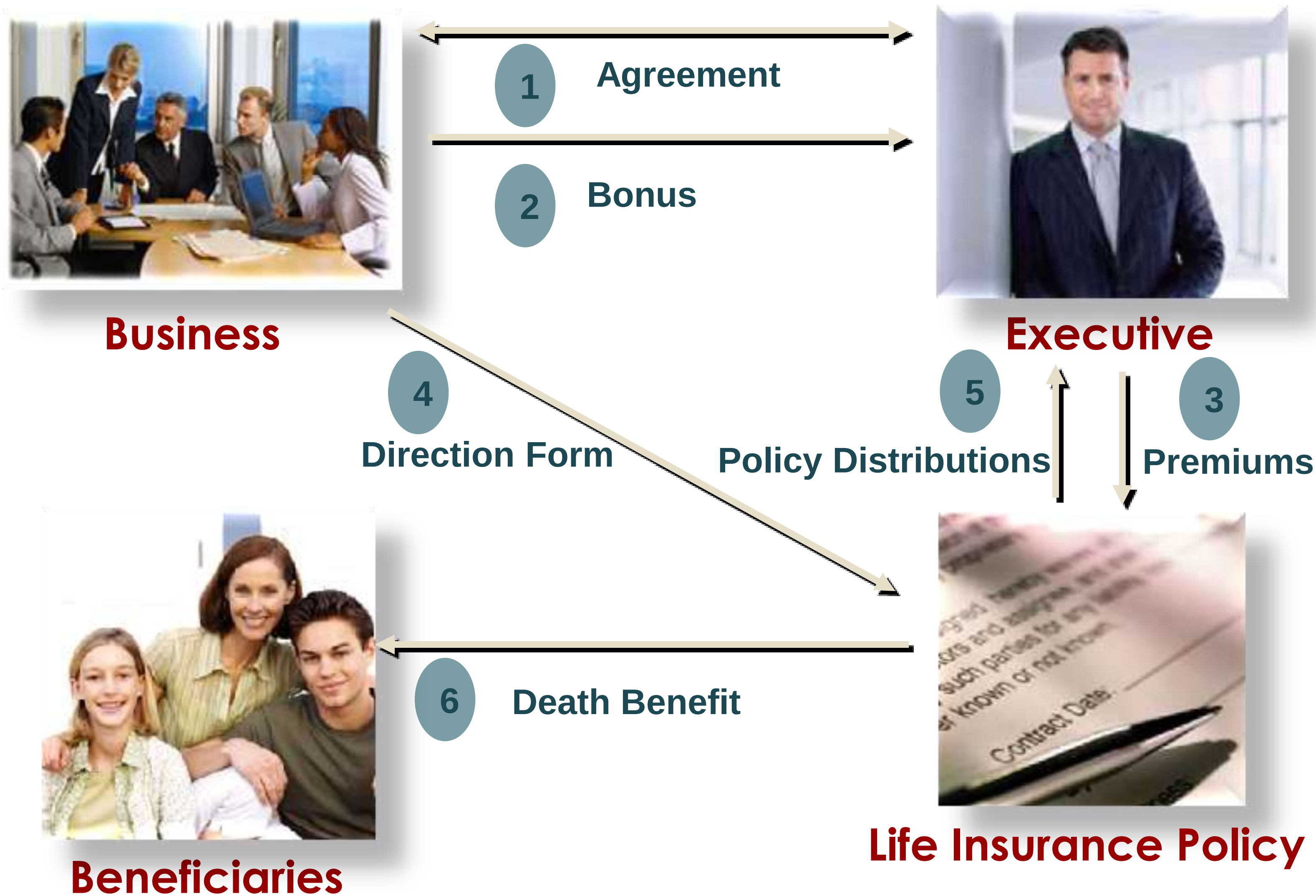
- Life insurance protection and accumulation for emergencies, education and possibly retirement.

Where to Use Restricted Executive Bonus

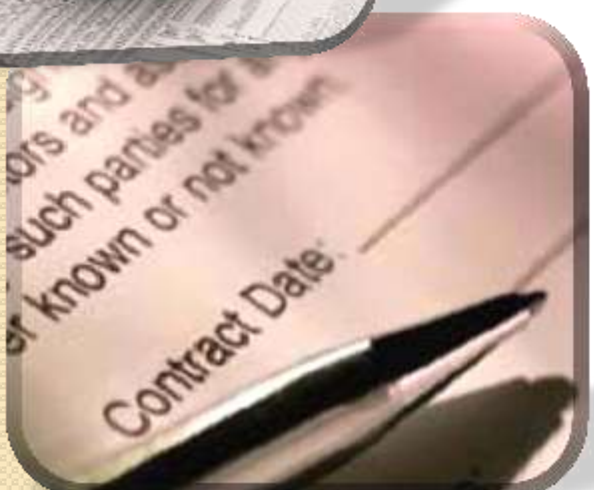
Key-executive, non-owners

S-Corps & partnerships, any pass-through organization or high-tax bracket C-Corp

Restricted Executive Bonus Structure



Benefits



- Bonus grossed-up to net premium after tax
- Death benefit for family protection
- Access to cash value for emergencies, education, home purchase and possibly retirement

Issues

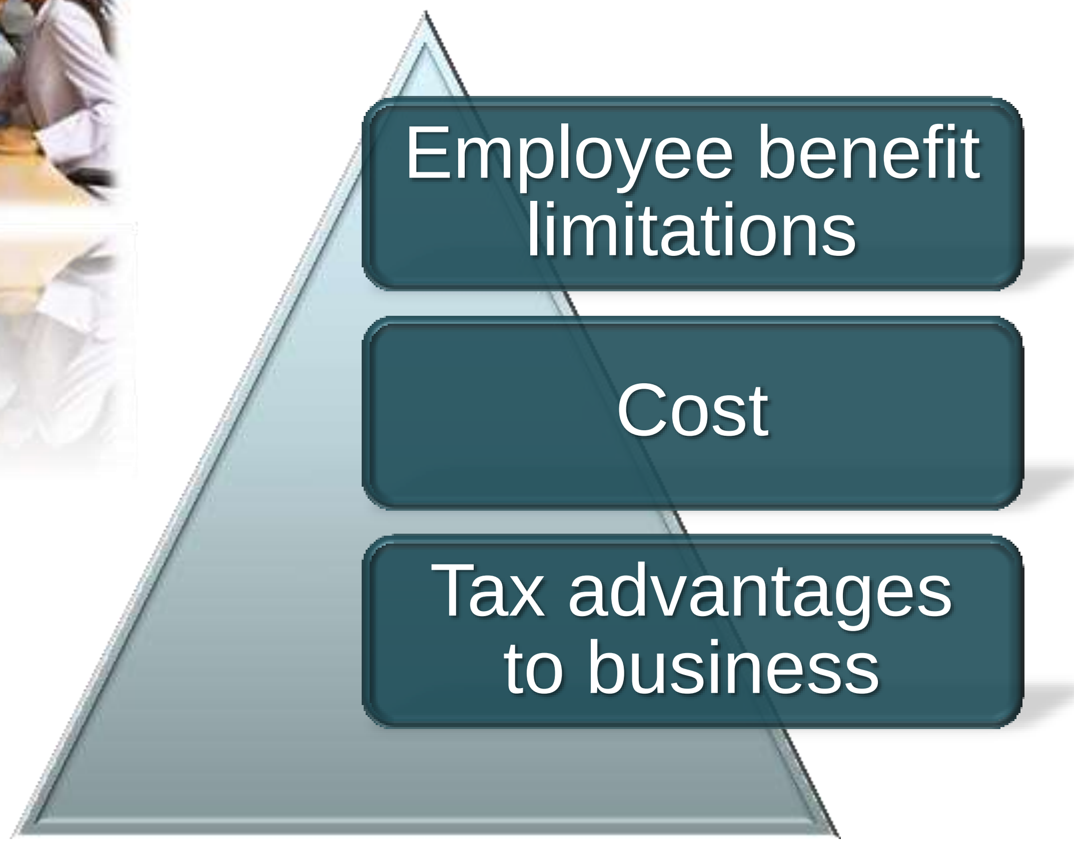
- No employer reimbursement
  - Consider employment contract
- ERISA – Consult with independent counsel regarding possible ERISA application

Non-Equity Collateral Assignment Split-Dollar

Providing for An Executive's Needs

- Pre and Post Retirement Life Insurance

Providing for Attractive Benefits

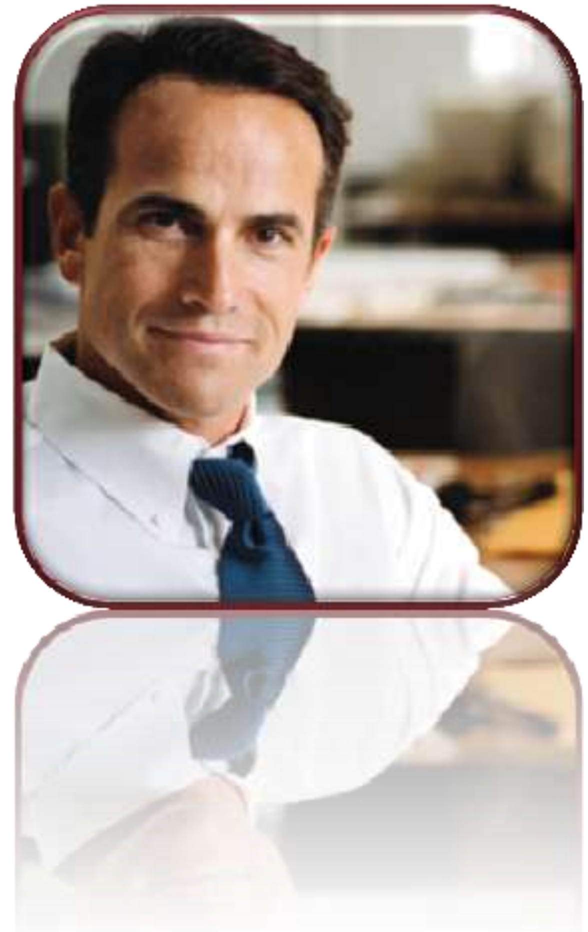


Non-Equity Collateral Assignment Split-Dollar Structure

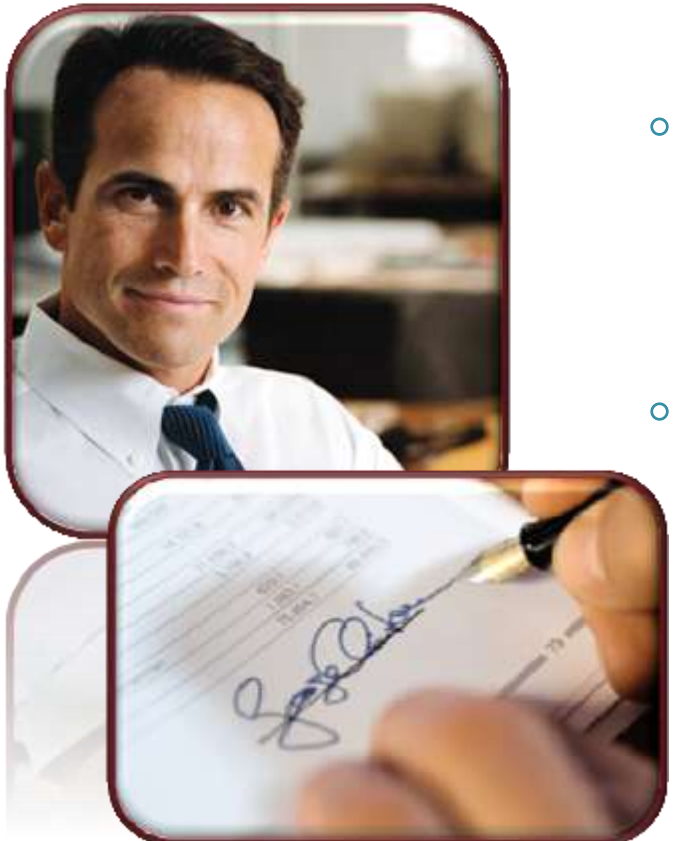
Executive Summary: *Features*

Collateral Assignment Split-Dollar

- Life insurance for pre and post retirement family protection
- Reduced cost



Executive Summary: *Taxation*



- REB (Table 2001 Rates or other approved rates) taxed to Executive
- Tax-free death benefit to Executive's heirs*

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Business Summary: *Features and Taxation*

- Premiums not deductible
- Interest secured through collateral assignment
- Can limit to Executive

Pacific Life

A Leader in Advanced Life Insurance Sales

- *Executive compensation*
- *Business continuation*
- *Employee benefits*
- *Individual retirement planning*
- *Estate planning*