



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

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

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

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

Facts: Assume you have an employer who desires to provide a key executive pre-retirement death benefit of \$3,000,000 and post-retirement supplemental income of \$100,000 for twelve years. The employer likewise desires key executive indemnity of \$2,000,000 during the executive's employment and indemnity for out of pocket premium payments. The following is how the concept works ...

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: a non-equity endorsement split dollar agreement where the employer owns the policy and controls the total cash value as well as a nonqualified supplemental income arrangement (SERP).¹

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.

During the executive's working years, the employer pays the entire premium on the life insurance policy. The executive

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.

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reports, as taxable income, an amount equal to the economic benefit.²

Should the executive/key person die prior to retirement, under the split dollar agreement, both the executive's beneficiaries and the business receive income tax-free death benefit under IRC § 101(a). Thus, two needs are met as money is available to indemnify the business for the loss of a contributing executive, and the executive's heirs are assured of income tax-free death benefit if early death occurs.

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.³

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.

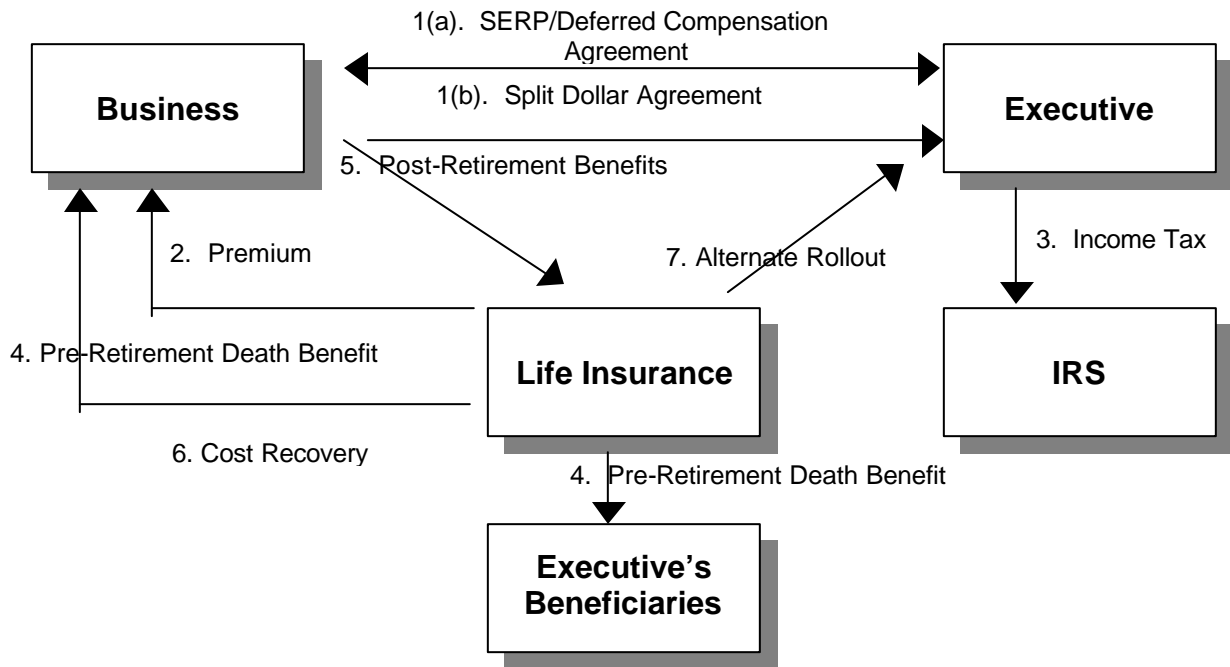
³ Of course, withdrawals and loans will reduce policy values and death benefit; may affect any guarantees against lapse; and may have tax consequences. A reduction in death benefit may cause the policy to become a Modified Endowment Contract (MEC). Distributions, including loans, from a MEC receive less 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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Prudential Financial

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) an endorsement split dollar agreement.

2. The business purchases a non-modified endowment contract (MEC) life insurance policy on the key person/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 indemnity for the premium.

3. Yearly, the executive and the business pay premiums on the policy according to the terms of the split dollar; and the executive reports any economic benefit as taxable income.⁴

If the Key Person/ Executive dies prior to retirement ...

4. Pursuant to the split dollar agreement, the business receives death benefit equal to the key person need; and

the executive's beneficiaries receive any remaining death benefit. Death benefit proceeds are generally income tax-free under IRC § 101(a).

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.⁵

7. Alternatively at retirement, where the executive has a continued need for death benefit, the executive can negotiate with the employer to have the policy "rolled out" through purchase or bonus.

⁴ 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.

⁵ Withdrawals and loans will reduce policy values and death benefit; may affect guarantee against lapse; and may have tax consequences.