Executive Trifecta®

Tax Notes

Taxation When the Policy is Transferred to the Insured

(Also see “Other Tax Notes” on Pages 5 - 7 and “Suitability for Type and Size of Business” on Pages 7 - 8)

1. C Corporation (policy distributed as compensation):
If a C Corporation purchases a cash value life insurance policy on an executive, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Corporation later distributes the policy to the executive as compensation, the executive has taxable income to the extent of the policy’s fair market value -- which is generally approximated by the policy’s cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25). At the point of distribution, the Corporation must recognize any gain to the extent that the cash value of the policy exceeds the Corporation’s premium payments; however, the Corporation is entitled to a deduction under IRC Section 162 equal to the amount the executive includes in income.

Example when the policy is distributed to the insured executive as compensation (assume policy cash values are $200,000; cumulative premiums paid by the Corporation are $100,000): The Corporation has a tax deduction of $200,000 (the cash value) and taxable income of $100,000 (the gain) for a net deduction of $100,000. The executive has taxable income of $200,000 and basis in the policy of $200,000.

Note: The results should be the same if the insured executive is also a shareholder provided excess compensation is not an issue. Executive Trifecta can produce substantial cash values for a covered executive at the point the policy is transferred to the executive. On their own, such sums should not necessarily trigger excess compensation issues for a shareholder/executive because the agreement would likely cover many years of service.

Note: The results should be the same if multiple executives are insured regardless of whether the policies are all distributed in the same year or not.

2a. S Corporation (sole shareholder insured; policy distributed as K-1 distribution):
If an S Corporation purchases a cash value life insurance policy on a shareholder, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Corporation later distributes the policy to the insured shareholder as a K-1 distribution, any gain will be recognized to the Corporation as if the property were sold at fair market value -- which is generally approximated by the difference between the policy’s cost basis and its cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25) -- and any gain will pass through to the shareholder as ordinary income under the distribution rules (IRC Secs. 311(b) and 1366(a)(1)).

Example when the policy is distributed to the insured shareholder as K-1 distribution (assume policy cash values are $200,000; cumulative premiums paid by the Corporation are $100,000): The Corporation has taxable income of $100,000 which is passed through to the shareholder, and the shareholder has basis in the policy of $200,000.

2b. S Corporation (one of several shareholders insured; policy distributed as K-1 distribution):
If an S Corporation purchases a cash value life insurance policy on only one of several shareholders, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Corporation later distributes the policy to the insured shareholder, any gain will be recognized to the Corporation as if the property were sold at fair market value -- which is generally approximated by the difference between the policy's cost basis and its cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25) -- and each shareholder will have taxable income under the distribution rules to the extent of his or her pro-rata share of the gain from the policy being distributed (IRC Secs. 311(b) and 1366(a)(1)). S Corporation accounting can become extremely complex and should be done by a qualified professional.

Example when the policy is distributed to the insured shareholder as K-1 distribution (assume three shareholders have interests in the S Corporation of 50%, 30%, and 20%, respectively; policy cash values are $200,000; and cumulative premiums paid by the Corporation are $100,000): If the policy is distributed to the 50% shareholder, so that the distributions would remain proportionate, a distribution of $120,000 in cash or property would have to be made to the 30% shareholder and $80,000 in cash or property would have to be distributed to the 20% shareholder. The $100,000 taxable gain in the policy would also be divided proportionately. Thus, although each shareholder would receive value equal to his or her respective interest of $200,000, $120,000, and $80,000, each shareholder would recognize his or her proportionate gain from the policy of $50,000, $30,000, and $20,000.

2c. S Corporation (multiple shareholders insured; policies all distributed as K-1 distributions in the same year):
If an S Corporation purchases cash value life insurance policies on multiple shareholders, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Corporation distributes each policy to the respective insured shareholder as a K-1 distribution in the same year, each shareholder has taxable income to the extent of their proportionate share the combined gain from all policies being distributed. In the year of distribution, all shareholders are entitled to their proportionate share of a deduction based upon the distributed policies' combined fair market value -- which is generally approximated by the policies' combined cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25).

Example when the policies are distributed to the insured shareholders as K-1 distributions in the same year (assume three shareholders have interests in the S Corporation of 50%, 30%, and 20%, respectively; policy cash values of Policies 1, 2, and 3, are $200,000, $160,000, and $140,000, respectively; and cumulative premiums paid by the Corporation on Policies 1, 2, and 3 are $100,000, $80,000, and $60,000, respectively): If the policies are distributed to the three shareholders in the same year, then the combined gain in the policies ($260,000) will be taxed to each shareholder on a pro rata basis: $130,000 for the 50% shareholder, $78,000 for the 30% shareholder, and $52,000 for the 20% shareholder. To make the distribution proportionate, the policy with $140,000 of cash value would be distributed to the 20% shareholder without additional cash or property, the policy with $160,000 of cash value would be distributed to the 30% shareholder along with $50,000 cash (or property), and the policy with $200,000 of cash value would be distributed to the 50% shareholder along with $150,000 cash (or property).

Note: If the policies are distributed in different years, see 2b as it would apply to each shareholder.

Note: If all shareholders own an equal interest, consider establishing a common year of transfer and insuring all shareholders with policies that illustrate the identical cash value in that year.

Note: For multiple shareholders with differing interests, consider establishing a common year of transfer and insuring each shareholder with a policy that illustrates a cash value proportionate to his/her interest in that year.

2d. S Corporation (non-shareholder executive insured; policy distributed as compensation):
If an S Corporation purchases a cash value life insurance policy on a non-shareholder executive, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Corporation later distributes the policy to the insured executive as compensation, he or she has taxable income to the extent of the policy's fair market value -- which is generally approximated by the policy's cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25). In the year of policy distribution, all shareholders are entitled to a deduction equal to their proportionate share of the distributed policy's fair market value, and any gain will pass through to the shareholders pro rata as ordinary income under the distribution rules (IRC Secs. 311(b) and 1366(a)(1).

Example when the policy is distributed to the insured executive as compensation (assume policy cash values are $200,000; cumulative premiums paid by the Corporation are $100,000): All shareholders recognize their proportionate share of the $100,000 gain and share proportionately in a deduction of $200,000, and the insured non-shareholder executive has taxable income (compensation) of $200,000 and basis in the policy of $200,000.

3a. Limited Liability Company (sole member insured; policy distributed as K-1 distribution):
If a Limited Liability Company purchases a cash value life insurance policy on a sole member, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Company later distributes the policy to the insured member as a K-1 distribution, no gain or loss need be recognized by the Company on a distribution of property or money to a member (IRC Sec. 731(b)). Likewise, no gain or loss need be recognized by the member receiving the policy, regardless of whether the value of the policy is higher or lower than the member's adjusted basis in the member's interest in the Company (IRC Sec. 731(a)).

The basis of property (the policy in this case) distributed by the Company to a member, other than in liquidation of the member's interest, is its adjusted basis to the Company immediately before the distribution (which is the sum of the premiums paid by the Company less any withdrawals made by the Company prior to the distribution (IRS Rev. Proc. 2005-25)). The distributee member's basis in the property cannot exceed the adjusted basis of the member's interest in the Company reduced by any money distributed in the same transaction (IRC Sec. 732(a)).

Example when the policy is distributed to the insured member as a K-1 distribution: (assume policy cash values are $200,000; cumulative premiums paid by the Company are

$100,000): The member obtains the policy with no taxable gain, and his/her basis in the policy is $100,000. Because a Limited Liability Company is taxed as a Partnership, it has significant flexibility in how it accounts for assets in the Company, and the taxation of the policy distribution should be able to be arranged in this manner.

Note: Some states do not allow Limited Liability Companies with only one member.

3b. Limited Liability Company (multiple members insured):
Because a Limited Liability Company is taxed as a Partnership, it has significant flexibility in how it accounts for assets in the Company, and the taxation of each policy distribution for each member should be able to be arranged as indicated in 3a above.

3c. Limited Liability Company (non-member executive insured; policy distributed as compensation):
If a Limited Liability Company purchases a cash value life insurance policy on a non-member executive, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Company later distributes the policy to the executive as compensation, he or she has taxable income to the extent of the policy's fair market value -- which is generally approximated by the policy's cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25). In the year distributed, all members are entitled to their proportionate share of a deduction equal to the distributed policy's fair market value.

Example when the policy is distributed to the insured executive as compensation (assume policy cash values are $200,000; cumulative premiums paid by the Company are $100,000): All members proportionately recognize a gain of $100,000 and share proportionately in a deduction of $200,000, and the insured executive has taxable income of $200,000 and basis in the policy of $200,000.

4a. Partnership (one partner insured; policy distributed as K-1 distribution):
If a Partnership purchases a cash value life insurance policy on one of the partners, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Partnership later distributes the policy to the insured partner as a K-1 distribution, no gain or loss need be recognized by the Partnership on a distribution of property or money to a partner (IRC Sec. 731(b)). Likewise, no gain or loss need be recognized by the partner receiving the policy, regardless of whether the value of the policy is higher or lower than the partner's adjusted basis in the partner's interest in the Partnership (IRC Sec. 731(a)).

The basis of property (the policy in this case) distributed by the Partnership to a partner, other than in liquidation of the partner's interest, is its adjusted basis to the Partnership immediately before the distribution (which is the sum of the premiums paid by the Partnership less any withdrawals made by the Partnership prior to the distribution (IRS Rev. Proc. 2005-25)). The distributee partner's basis in the property cannot exceed the adjusted basis of the partner's interest in the Partnership reduced by any money distributed in the same transaction (IRC Sec. 732(a)).

Example when the policy is distributed to the insured partner as K-1 distribution (assume policy cash values are $200,000; cumulative premiums paid by the Partnership are $100,000): The partner obtains the policy with no taxable gain, and his/her basis in the policy is $100,000. A Partnership has significant flexibility in how it accounts for assets, and the taxation of each policy distribution for each partner should be able to be arranged in this manner.

4b. Partnership (multiple partners insured):
A Partnership has significant flexibility in how it accounts for assets in the Partnership, and the taxation of each policy distribution for each partner should be able to be arranged as indicated in 4a.

4c. Partnership (non-partner executive insured; policy distributed as compensation):
If a Partnership purchases a cash value life insurance policy on a non-partner executive, the premiums are not deductible (IRC Sec. 264(a)(1)). If the Partnership later distributes the policy to the executive as compensation, he or she has taxable income to the extent of the policy's fair market value -- which is generally approximated by the difference between the policy's cumulative premiums and its cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25)). In the year of distribution, all partners are entitled to their proportionate share of a deduction equal to the distributed policy's fair market value.

Example when the policy is distributed to the insured executive as compensation (assume policy cash values are $200,000; cumulative premiums paid by the Partnership are $100,000): All partners proportionately recognize a gain of $100,000 and share proportionately in a deduction of $200,000, and the insured executive has taxable income of $200,000 and basis in the policy of $200,000.

5. Tax Exempt Organization (policy distributed as compensation):
If a Tax Exempt Organization ("TEO") purchases a cash value life insurance policy on an executive and later distributes the policy to the executive as compensation, the executive has taxable income to the extent of the policy's fair market value -- which is generally approximated by the policy's cash value without reduction for surrender charges (IRS Rev. Proc. 2005-25). Due to its tax exempt status, the TEO neither recognizes gain nor deducts a loss on any aspect of the transaction.

Example when the policy is distributed to the insured executive as compensation (assume policy cash values are $200,000; cumulative premiums paid by the Tax Exempt Organization are $100,000): The executive has taxable income of $200,000 and basis in the policy of $200,000.

Other Tax Notes

1. Prior to the distribution of the policy to the insured participant, the entire death benefit of the policy funding an Executive Trifecta arrangement is payable to the business entity in order to provide it with funds to 1) indemnify the business against the loss of services of the insured participant and 2) informally fund the payment of a Survivor Income Benefit to the insured participant's family. The policy death benefit received should be income tax free to the business entity under IRC Section 101(a) provided that the appropriate notice and consent documents have been executed as required by IRC Section 101(j)(4) as well as the reporting requirements required by IRC Section 6039I.

The notice and consent requirements of IRC Sec. 101(j)(4) are met if, before the life insurance policy is issued, the employee:

- is notified in writing that the employer intends to insure the employee's life and the maximum face amount of the coverage at the time the coverage is issued;

- gives written consent to being insured under the contract and continuation of such coverage after the insured employee terminates employment; and
- is informed in writing that the employer will be a beneficiary of death proceeds from the policy.

With respect to IRC Section 6039I, in general, an employer that, after August 17, 2006, has one or more employer-owned life insurance contracts must file a return that shows for each year the policy is owned:

- the number of employees employed at the end of the year;
- the number of employees insured under employer-owned life insurance contracts at the end of the year;
- the total amount of insurance in force under such contracts at the end of the year;
- the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged; and
- that the employer has a valid consent for each insured employee (and, if applicable, the number of insured employees for who such consent was not obtained).

Record Keeping Requirement – Any employer (or other applicable policyholder) that owns one or more employer-owned life insurance contracts during the year must keep whatever records are necessary to determine whether the requirements of the IRC Sections 6039I and 101(j) are met.

The provisions of IRC Sections 101(j) and 6039I are effective for contracts issued or materially modified after August 17, 2006, except they do not apply to contracts exchanged under IRC Sec. 1035 for a contract issued prior to the effective date. However, if, as part of the exchange, the death benefit is materially increased or other material changes are made, the new contract will be subject to the new rules and not grandfathered. In the case of a master contract (within the meaning of IRC Sec. 264(f)(4)(E)), the addition of covered lives will be treated as a new contract only with respect to any additional covered lives.

Note: A specimen “Company-Owned Life Insurance - Notice and Consent Form” (as required by IRC Section 101(j)) and a specimen “Company-Owned Life Insurance - Annual Reporting Form” (as required by IRC Section 6039I) are in the Executive Trifecta document set and in the Special Files section of InsMark’s Documents On A Disk (Version 21.0 and higher).

2. Executive Trifecta falls under the purview of IRC Section 409A; however, provided the plan is properly documented and administered as outlined in Version 21.0 and higher of InsMark’s Documents On A Disk, there should be no adverse effects relative to Sec. 409A that should apply.

Executive Trifecta works because, even though it may fail the substantial risk of forfeiture test and be characterized as deferred compensation under IRC Section 409A, it meets the election and distribution requirements of Section 409A, thus allowing for deferral of income.

If the Department of Labor applies the Section 409A definition of substantial risk of forfeiture to a deferred bonus plan like Executive Trifecta, the plan should not be a funded plan for ERISA purposes as long as the plan participant is given an interest in the policy only after an acceptable triggering event under Section 409A has occurred.

Note: The Technical Preface in the Executive Trifecta section of specimen documents in Version 21.0 and higher of InsMark's Documents On A Disk has additional information regarding Section 409A.

Important Note: Legal and tax information regarding Section 409A is for general use only and may not be applicable to specific circumstances. Clients should consult their own legal, tax and accounting advisors to assist in the evaluation of any potential transaction or strategy.

3. Regardless of the business entity, the Survivor Income Benefit paid to an insured participant's family when the insured dies prior to distribution of the policy should be deductible by the business when paid (IRC Sec. 404(a)(5)) and taxable as ordinary income to the recipient(s). The survivor benefits are subject to tests of reasonable compensation (IRC Sec. 162).

Note regarding plans involving Shareholders of S Corporations, Members of Limited Liability Companies, and Partners of Partnerships: Legal and tax advisers may find it advantageous to treat the death benefit proceeds allocated for the survivor income benefit as a lump sum K-1 distribution.

4. After the policy is transferred to the insured executive, any subsequent death benefit payable to his/her beneficiaries should be income tax free under IRC Section 101(a).

5. After policy ownership is transferred to the insured executive, any withdrawals of cash values or dividends from the policy should be income tax free to the extent they do not exceed the insured's basis. Any policy loans should also be income tax free (provided the policy stays in force).

Suitability for Type and Size of Business

<u>Suitability for Type of Business</u>:

A C Corporation can retain its net profits as operating capital or merely to strengthen the balance sheet; however, a C Corporation is taxed at the corporate level on net profits. If net profits are then distributed as dividends, the shareholder(s) are again taxed. If all net after tax profits are distributed, there are no funds left to provide the Executive Trifecta for anyone, and it is unlikely that such a C Corporation can utilize Executive Trifecta unless the business also has significant liquid assets on its balance sheet.

The ideal C Corporation candidate for Executive Trifecta is one that retains a significant portion of net profits. (The ability to induce and retain key executives is certainly reason enough to do so.)

Note: A publicly-owned C Corporation can utilize Executive Trifecta very effectively. (Since it does not involve premium loans, it should be unaffected by the provisions of the Sarbanes-Oxley Act and the U. S. Treasury Department's Final Split Dollar Regulations issued in September 2003.)

A pass-through entity (S Corporation, Limited Liability Company, Partnership), like a C Corporation, can decide to retain its net profits as operating capital or merely to strengthen the balance sheet. However, all profits are considered as if they were distributed to shareholders, members, or partners, as the case may be, and are income taxable to those individuals. As a result, most pass-through entities distribute at least an amount of net profits to cover the income tax. If the remaining net profits are also distributed, there are no funds left to provide the Executive Trifecta for anyone unless the entity also has significant liquid assets on its balance sheet.

The ideal pass-through entity candidate for Executive Trifecta is one that retains a significant portion of net profits. (The ability to induce and retain key executives is certainly reason enough to do so.)

Tax Exempt Organizations with strong balance sheets are good candidates for Executive Trifecta arrangements for top executives.

<u>Suitability for Size of Business</u>:

With standard deferred compensation arrangements, there may be a concern that a business may not survive the death of its owner(s) resulting in an absence of the continuity of management needed to fulfill retirement income commitments.

The typical Executive Trifecta arrangement is funded over as few years as possible (five to ten years) after which the policy is transferred to the executive while cash values are low in order to minimize transfer taxation. The continuation of the business thereafter is irrelevant to the retirement cash flow benefits.

Continuity of management concerns can be avoided with the survivor income benefit associated with Executive Trifecta by scheduling the payment to the insured's family in a lump sum. (Legal and tax advisers may find it advantageous to treat the death benefit proceeds allocated for the survivor income benefit as a lump sum K-1 distribution for principals of S Corporations, Limited Liability Companies, and Partnerships.)

Important Note: This material is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.