ADVANCED MARKETING
ACTIVATOR

JANUARY 2004

DEATH-BENEFIT-ONLY PLANS – 2004

WHAT IS A DBO PLAN?

A Death-Benefit-Only (DBO) plan is a legally binding agreement between an employer and one or more key employees.

Definition. It's called a "Death-Benefit-Only" or "Survivors Income Benefit" plan because no living benefits such as disability or retirement benefits of any kind are provided for the employee under the plan. The plan provides only death benefits and pays only if the selected employee dies while employed by the employer prior to a specified retirement date, and only if survived by a spouse or a beneficiary in a class designated by the employer.

The agreement. The employer agrees that, if the selected employee dies before retirement, it will pay a specified amount (or an amount determined by formula) to the employee's spouse, if living, or to another employer-designated class of beneficiary (such as children or dependent parents).

The formula. Sometimes the amount payable at the selected employee's death is a multiple of salary. An example would be a plan that promises to pay three (to five) times the employee's average base pay in the 3 years preceding death. More commonly, the death benefit is expressed as a fixed amount such as $50,000 or $100,000 a year for a specified number of years (often three, five, or ten years).

FACTORS INDICATING A DBO PLAN SHOULD BE CONSIDERED

Estate tax free income payments. A DBO plan can be used to provide literally hundreds of thousands of dollars of income to the family of an executive or other employee and – if the plan is arranged properly – every one of those dollars can be federal estate tax-free under current law. This potential for avoiding federal estate tax on massive amounts of income to selected employees' survivors extends

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

to any employee – including stockholder-employees, as long as they own 50 percent or less of the corporation's stock.

Means of attracting and retaining key employees. A DBO plan is one tool that should certainly be considered – apart from the incredible estate tax advantages – when additional income is desired for the survivors of any employee. This is an incredible way to attract and retain key employees.

Cost effective perquisite. The plan is particularly cost effective because, if a covered key employee terminates employment, the corporation can keep the policy in force by continuing to pay premiums, place the policy on extended term or reduced paid-up status, cash it in, or sell it to the employee.

Exceptional employer control & flexibility. A DBO is a nonqualified plan. That means there are no specific IRS or ERISA restrictions or limitations that must be followed. So an employer is completely free to choose (a) who will be covered by a DBO plan, (b) the terms of the plan, and (c) the benefit levels. Note that an employer can also vary these terms and benefit levels among covered individuals and, therefore, can have different DBO plans for different key employees. This makes the DBO plan an excellent "selective executive" fringe benefit.

DBO plan as a split-dollar alternative. A DBO plan is a very attractive alternative or supplement to a split-dollar arrangement and can have substantial advantages to both employer and employee. With proper funding, the DBO not only shows a lower "cost" than split dollar to the employer, it can result in an inevitable corporate gain! The employer could recover not only its cost and a return on its money in most cases, but also potentially realize a sizeable increase in surplus even after any possible corporate AMT. This would not occur in a split-dollar arrangement.

From the employee's viewpoint, a DBO plan provides a large amount of life insurance protection without any current cost. Under a split-dollar arrangement, the costs for current term life insurance increase rapidly after the insured reaches age 50, while there is no comparable yearly term cost or reportable income with a DBO plan.

DBO plan as "Golden Handcuffs." A DBO plan can be very flexible. At the employer's sole discretion, the plan can be "converted" to a nonqualified deferred compensation plan when the covered employee retires. In other words, the employer can arbitrarily choose to use some or all of the values in the underlying financing mechanism to turn a death-benefit-only plan into a nonqualified supplement retirement plan. This gives the employer a strong set of "golden handcuffs" to tie a young (or new) and potentially valuable employee to the firm.

DBO plan as a supplement to qualified plan. Given the additional survivor benefits payable under a DBO plan, it might be more feasible for an executive or employee to elect a "lump sum" or "life only" option under a qualified retirement plan, and still provide adequately for his or her survivors.

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

HOW DOES A DBO PLAN WORK?

Benny Factor, age 45, a widower with three minor children, is the comptroller of Going Places Fast Corporation (GPFC). He is truly a key employee in every sense of the term. In order to encourage Benny to give his utmost effort for GPFC, the corporation makes a legally binding promise (in an agreement with Benny) that, if he should die while employed by GPFC, it would pay his children a death benefit of $50,000 for 10 years.

In this example, GPFC could finance its obligation by purchasing a $500,000 life insurance policy on Benny's life. The policy would be owned by and payable to GPFC. If Benny should die, GPFC could use the income tax-free insurance proceeds to purchase $500,000 of tax-free municipal bonds. (AMT is ignored for simplicity but should be considered in an actual situation. However, remember that certain "small corporations" are no longer subject to AMT.)

For illustrative purposes, let us assume that GPFC is in a combined federal and state corporate tax bracket of 40 percent, and the tax-free bonds could earn 7 percent. The $35,000 ($500,000 x .07) tax-free income from the $500,000 worth of bonds would be $5,000 a year more than the after-tax cost of the promised payments. GPFC receives $35,000 each year income tax free, and pays out $50,000 a year to Benny's children. But the after-tax cost of each payment, at a 40 percent combined state and federal corporate tax bracket, is only $30,000. So the net result is $5,000 more of positive cash flow a year to GPFC. (Of course, the actual net return in today's market may be lower than 7 percent and the result may be break-even or a relatively modest annual net outlay by the corporation.)

At the end of the 10-year payout period, GPFC has $500,000 of bonds plus $50,000 ($5,000 x 10 years) and the after tax interest it has earned. This will probably be enough to reimburse the corporation for its entire premium outlay, the use of its money, any corporate AMT, and any administrative expenses it may have incurred. In some cases, it may also result in a net increase to corporate surplus.

WHAT ARE THE TAX IMPLICATIONS TO THE EMPLOYER?

No deduction for premiums. No deduction is allowed to the employer-corporation for its premium payments on the life insurance covering the insured employee. In fact, the policy should not be connected in any way to the employer's promise under the DBO plan, and should not be mentioned in the corporate resolution to adopt the plan, or in any agreement with the executive or employee. It should be purchased by the corporation on the selected key employee's life as key employee coverage. In other words, the employer should be named the owner, beneficiary and premium payor of the policy.

Proceeds generally income tax free. When the employer receives the life insurance proceeds at the employee's death, the entire amount will be income tax free.

However, the proceeds payable to a C corporation may be subject to potential alternative minimum tax. The calculation of AMT is complex and is intended to ensure that a C corporation pays either

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

the regular tax or the AMT (if higher). Note that the Taxpayer Relief Act of 1997 created a "small corporation" exemption from the AMT. In order to qualify for the exemption, a corporation must look to its three taxable years prior to the taxable year in question. The average gross receipts for this three-year period must not exceed $7.5 million. Also, the Jobs and Growth Tax Relief and Reconciliation Act of 2003 lowered the AMT from 20% to 15%.

Corporate-owned life insurance, per se, does not subject the corporation to the AMT; rather, it is only one of many factors that determine whether the corporation must pay the AMT. In a worst case scenario, 75 percent of the amount at risk (i.e., the difference between the death proceeds and the cash value) will be subject to the AMT at 15 percent (or 11.25% of total insurance proceeds). Typically, the receipt of death proceeds will generate little or no additional tax when the corporation has significant taxable income in the year of the insured's death.

But a "worst case" scenario can be anticipated by purchasing 113% of the "target" amount of life insurance – which will be sufficient to cover the potential AMT. For example, if the corporation needs $1,000,000 of key employee coverage, it could "gross up" the amount of insurance to $1,130,000 to account for the potential AMT. The maximum AMT would be $127,125 (or 11.25% of the total death benefit). [NOTE: The "gross up" amount of $1,130,000 is based on the "target" amount divided by 0.8875 (i.e., 1 minus 0.1125), rounded up to the nearest $10,000.]

Corporation's benefit payments deductible. When the corporation makes payments to the beneficiary (ies) it has designated (such as "spouse" or "children of a deceased employee covered under this plan"), those amounts are deductible when paid if – and to the extent – they represent reasonable compensation for services the employee rendered. A further requirement for deductibility is that the plan must serve a valid business (as opposed to a shareholder) purpose. This should be carefully documented in the corporate resolution adopting the DBO plan, and also in the agreement with the employee.

When benefit payments are made to the designated survivors, they are income taxable to those survivors as income in respect of a decedent under IRC Section 691 (discussed below) and deductible by the corporate employer – regardless of whether the corporation is a cash or accrual basis taxpayer.

WHAT ARE THE TAX IMPLICATIONS TO THE COVERED EMPLOYEE?

Income tax. While the employee is living and working, there should be no currently reportable income – even if the employer adequately (and informally) finances its obligation under the DBO plan with life insurance. This is because the employee has no actual receipt of any money, no constructive receipt (nothing is credited to the employee or his/her account, set apart for him/her, or otherwise made available to him/her), and receives no economic benefit of currently ascertainable value in money or money's worth set outside the corporation or the corporation's creditors' reach.

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

There is only the employer's promise that (1) if the employee dies, (2) while working for the corporation, and (3) if he or she is survived by the beneficiary the corporation has designated, a series of payments will be made.

Estate tax. Assuming a properly structured plan is established under which no benefits are promised or provided under any circumstances during the lifetime of the employee, and assuming the covered employee is a 50 percent or less shareholder, none of the promised payments under the plan should be includible in an employee's estate.

There is an additional advantage to non-majority employee shareholders who are covered under a DBO plan: Benefits payable under the plan should be considered a claim against the assets of the corporation. This corporate liability should reduce the overall value of the business and correspondingly the estate tax value of the decedent's stockholdings in the corporation and, therefore, further reduce estate tax liability.

Note: For specific information on how to properly structure a DBO Plan to avoid estate tax inclusion for the employee, please refer to the " Problems and Solutions" Section of this article beginning on page 7.

Gift tax implications. After losing a whole string of cases in the estate tax area – the IRS' most recent attacks on DBO plans involved gift tax issues. The IRS lost in the gift tax arena too (and has since acquiesced in result). The court held that no gift was made by the deceased employee to the recipient of the DBO payments from the corporation since the decedent (a) did not voluntarily participate in the plan, (b) had no personal right to select or change the beneficiaries, (c) could not unilaterally terminate coverage under the plan (except by terminating employment), and (d) could not change or directly affect the amount, form, or timing of the payments. There was no action by the covered employee that was considered an "act of transfer."

There were no adverse gift tax consequences even in a case where the covered employee was a controlling shareholder and chairman of the board of the corporation, and the board of directors had the power to terminate or amend the plan at any time. The court held that there was no completed gift for gift tax purposes, because the employee-shareholder could have defeated the transfer (i.e., he hadn't relinquished control over the annuity payments) by terminating his employment with the company before death, divorcing his wife, or terminating the plan.

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

WHAT ARE THE TAX IMPLICATIONS TO THE BENEFICIARY?

Payments taxable as received. Each payment received by the employee's survivor(s) from the corporation is treated as salary – unless payments are to some extent considered "unreasonable," or unless the beneficiary is a shareholder and the IRS could successfully assert that there was no business purpose for the plan and was instead a subterfuge for paying dividends. In that case, payments will be nondeductible by the corporation and taxable to the recipient as dividends. This dividend treatment may be eliminated if the client's counsel properly documents the business reason for the plan. So, in most cases the money received from the employer under a DBO plan is taxed in the beneficiary's income tax bracket at ordinary rates.

Technically, as noted above, the beneficiary reports each payment received as Section 691 income, that is, "income in respect of a decedent." This means the beneficiary could take an income tax deduction (from adjusted gross income) for any federal estate taxes generated by the inclusion (if there is inclusion – which will typically not be the case) of the employer-paid DBO benefits in the covered employee's estate.

FICA & FUTA. Payments made to the employee's survivors are exempt from federal income tax withholding, FICA, or FUTA.

WHAT ARE THE ERISA IMPLICATIONS?

Under ERISA (the Employee Retirement Income Security Act), a DBO plan is considered an employee welfare plan. (If the covered employees – or the covered employee and spouse – own 100 percent of the corporation and are the only employees under the DBO plan, it would not be considered an employee welfare benefit plan.)

Fortunately, since most DBOs cover only a select and relatively few management or highly paid employees, formal reporting and disclosure to the Department of Labor is generally not required. Even if the plan is not limited to those two groups, if there are less than 100 participants, the only reporting and disclosure required is that participants must be given a Summary Plan Description (SPD), and essentially a one-page letter to the Department of Labor explaining who is covered and the general terms of the plan.

A Department of Labor Advisory Opinion states that life insurance is not considered a "plan asset" for ERISA purposes and therefore a DBO plan will qualify for various exemptions from ERISA if the life insurance is (and should be):

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

(1) owned by and payable to the corporation,

(2) under total control of the corporation,

(3) subject to the claims of the corporation's creditors,

(4) not "set aside" for the benefit of any participant,

(5) not formally tied to the plan, and

(6) not represented to any participant or beneficiary as policy that would be used solely to provide plan benefits or represent security for the payment of benefits, or that plan benefits would be limited by the amount of the insurance proceeds received by the corporation.

TAX TRAPS AND PLANNING OPPORTUNITIES

1. Problem: If the agreement gives the employee any right to change the beneficiary, that power to designate who will enjoy the "transfer" (if there is one), will cause estate tax inclusion.

   Solution: The employer corporation should name the recipient of DBO payments. The agreement should spell out the class or classes of eligible beneficiaries. Generally, the beneficiaries are designated by family or marital relationship to the employee (i.e. spouse or child). The agreement should specifically deny the employee the right to name or change the payee, or to control or affect the timing or method of payment in any form or manner.

2. Problem: There may be estate tax inclusion if the beneficiary's right to receive the death benefit is conditioned on surviving the employee and the employee retains a right to direct the disposition of the payment. For example, where the death benefit is payable to the employee's spouse, but if the spouse does not survive the employee, the death benefit is then payable to the employee's estate, that reversionary interest (or the right to designate by will as to who gets the payments) may cause inclusion.

   Solution: The payee's right to receive DBO payments should not be made conditional on surviving the covered employee. The DBO agreement should give no rights (reversionary or otherwise) to the employee or the employee's estate to name or change the beneficiaries. The employer should specifically reserve the sole right to designate the class (or classes) of individuals who are payees, as well as stipulate the circumstances under which payments will be made under the DBO plan.

3. Problem: If the payee of DBO benefits is a revocable trust established by the employee, the employee's right to alter, amend, or revoke the transfer by changing the terms of the trust could cause inclusion for estate tax purposes.

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Solution: In some circumstances, a trust might be a useful recipient of DBO benefits since it could make income splitting possible. But the trust should be irrevocable and the employee should retain no meaningful or significant rights to change its terms – even as a trustee.

4. Problem: If the employee is a majority (more than 50 percent) shareholder, the IRS may claim that – by virtue of his or her voting control – there has been retention of the right to alter, amend, revoke, or terminate the agreement. This would cause inclusion of the present value of the post-death payments in the employee's estate.

   In an incredible (and in my opinion – not to be relied upon) IRS Technical Advice Memorandum, TAM 8701003, the Service held that the payments from a DBO plan would not be includible in a shareholder-employee's estate even though the decedent (a) was a majority shareholder, and (b) together with his wife, owned 100 percent of the corporation's outstanding stock! I strongly recommend that you look at this gift horse's mouth with caution. Since it looks too good to be true, it probably is.

   Solution: To be safe, if estate tax exclusion is the primary reason for, or objective of the plan, set up DBOs only for employees who own 50 percent or less of their corporation's stock. An irrevocable life insurance trust, perhaps funded with life insurance purchased through a Section 162 bonus plan or through a carefully structured non-equity collateral assignment split-dollar arrangement may be more appropriate for the controlling/majority shareholder employee.

5. Problem: If the employee has, through another employer-provided plan, post-retirement benefits, such as a nonqualified deferred compensation (NQDC) agreement that will pay a retirement benefit to him/her, the IRS will constructively link the DBO plan and the NQDC together and considered both as one. This linkage would cause the present value of the DBO payments to be treated for estate tax purposes as if it were a joint and survivor annuity. As a result, the present value of the amounts payable under the DBO to the survivors would be includible in the employee's estate.

   Solution: The DBO estate tax exclusion will only work where there are no other employer-sponsored nonqualified plans providing the employee payments which are (or could be considered) post-retirement or disability benefits.

   Note: At one time, you could safely have both a DBO plan and a qualified retirement plan; payments under both plans were federal estate tax free. Now that the pure life insurance death benefits under qualified plans are fully subject to estate tax and there is no longer estate tax exclusion for qualified pension proceeds, it is impossible to be sure the IRS will not attempt to link the two. But it's my opinion that the IRS will link only nonqualified retirement plan benefits to a DBO plan to

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

cause estate tax inclusion. So, the existence of a qualified pension or profit-sharing plan – per se – should not cause estate tax inclusion of DBO payments. But since the answer is uncertain, it is definitely an issue that should be researched and dealt with specifically by the client's counsel.

6. **Problem:** If the employer's obligation to pay a death benefit is financed with life insurance on the employee's life and the employee (through his/her stock ownership of the corporation) owned the policy or had veto rights over any change in the beneficiary, the IRS will probably attempt to include the policy proceeds because of the employee's incidents of ownership.

   Solution: As I've strongly suggested repeatedly, client's legal counsel should not connect the life insurance policy or other financing vehicle with the plan in any formal manner. Do not give the employee any rights or powers over the financing mechanism. If necessary, restrict his/her abilities (as shareholder) from exercising any ownership rights or privileges over corporate-owned policies under a DBO plan. Treat the policy as key employee coverage in form and operation.

CONCLUSIONS AND FINAL SUGGESTIONS

Benefit and retirement planning for employees in general, and executives in particular are more challenging than ever. Changes in qualified plan rules, harsh and complex distribution rules, final split-dollar regulations and the ever increasing taxation under current environment have made these benefit plans – although viable and in many cases appropriate planning tools nevertheless – more costly and difficult to administer. Taken as a whole, all of these factors enhance the appeal of the already impressive DBO plans as alternatives or supplemental benefits to attract, reward and retain key employees; as such, DBOs should be considered when designing a comprehensive executive benefit package.

This material is for internal use only and is provided courtesy of The Prudential Insurance Company of America. The discussion of planning techniques does not imply that a recommendation that a specific planning concept should be implemented. References to legal and tax considerations are made but are not meant to provide advice in this regard. Please remind clients that legal and tax advice, including the preparation of legal and tax documents, should come from an attorney and/or a tax advisor such as an accountant. These advisors can determine how best to utilize such product or technique.

Prudential Financial Planners can prepare financial plans incorporating many of the planning techniques discussed above. Financial Services Associates and producers can work as knowledgeable members of clients' professional teams to provide suitable products.

This author is not affiliated with Prudential and Prudential makes no representation as to the accuracy of the cites.

Prudential Financial and the Rock logo are registered service marks of The Prudential Insurance Company of America and its affiliates.

The Prudential Insurance Company of America
751 Broad Street
Newark, NJ 07102-3777

COPYRIGHT ©2004 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.