Life-insurance–based strategies
to attract and retain key employees

Business Strategies

FOR THE CLOSELY HELD BUSINESS

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Prudential Financial

Growing and Protecting Your Wealth®

BUSINESS STRATEGIES
MAKING KEY DECISIONS

In today's competitive environment you know the challenge of attracting and retaining quality people who are needed for the continued success of your business. You recognize the current benefits that your business provides to both you and your family. But are you making the key decisions today that will ensure your business's future and the financial security of your family?

Perhaps its time to partner with your licensed financial professional who can help you fund arrangements that address such needs as:

- Retirement Income
- Executive Compensation
- Business Continuation

Thousands of entrepreneurs rely on the business funding strategies that Prudential has helped put into place. In conjunction with counsel from your attorney, accountant, and other advisors, we can do the same for you.

The material that follows provides a general overview of business strategies that might fit your business needs.

RETIREMENT SECURITY

Today, more and more small business owners are concerned about their future retirement lifestyle. And today's employees are very aware of the value retirement benefits add to their compensation package.

Prudential and its affiliated companies offer a broad spectrum of insurance and financial products to support employer sponsored tax-qualified and nonqualified retirement plans.

TAX-QUALIFIED RETIREMENT PLANS:[1] In general, tax-qualified plans enjoy a combination of income tax and asset protection benefits that are not available to other retirement arrangements. Your business is entitled to a current income tax deduction for the amounts contributed to the qualified plan, and your employees are not taxed on these amounts, nor on any investment earnings, until the benefits are actually received — generally at retirement. In addition, benefits are held by a separate trust that is beyond the reach of your business creditors, providing added security to participants that future benefits will be paid.

Tax-qualified retirement plans come in many forms:

Defined Benefit Plans: A defined benefit plan promises a predetermined retirement benefit to your employees, either in the form of a certain dollar amount or a specific percentage of compensation. Since you, as the employer, make the promise to pay a certain sum in the future, it is your business that assumes the risk of investment performance. The calculation of the amount of funds needed to pay the promised benefits is complex and requires the help of an actuary. The investments you choose to fund the plan are held by a trust for the benefit of your employees, and your employees have no voice in investment decisions.

While more complex to administer, a defined benefit plan may be a good choice for a small business with older, higher-paid employees who are owners or shareholders. Why? Because, when benefit formulas are based on recent compensation, older participants can accumulate sizable benefits in a short period of time.

Defined Contribution Plan: Unlike a defined benefit plan, each participant in a defined contribution plan has a separate account in the benefit trust. The actual retirement benefits received depend on how much was contributed by the participant during his/her working years; whether the employer added matching contributions; and the investment gains and earnings. In a defined contribution plan, the investment risk is shifted to the employees.

[1] See Prudential Financial's IFS-A075140 Comparison of Retirement Plan Alternatives for contribution limitations for the retirement plans discussed in this section.

Defined contribution plans have begun to dominate the qualified retirement market, as they shift the risk of investment performance away from the business; are more easily administered; and are easier for plan participants to understand.

The following is a discussion of some of the more common defined contribution plans:

- **Profit Sharing Plan:** Profit sharing plans are a popular choice among small business owners with fluctuating cash flow because they allow the business owner to decide how much (up to 25% of total compensation of participating employees with individual employee compensation for contribution purposes limited by tax law, indexed for inflation) or how little to contribute to the plan each year, depending on company performance. The employer may decide not to contribute in any given year, but overall there must be "substantial and recurring" employer contributions.

  Employers like its flexibility and employees are often more motivated when they share in company profits.

- **Money Purchase Plan:** A money purchase plan is a defined contribution plan in which the employer's contributions are mandatory and are usually based on a set percentage of each employee's compensation.

  Because the employer is obligated to make annual contributions, money purchase plans are more commonly seen in mid-size or larger corporations with stable year-to-year earnings.

- **401(k) Plan:** A 401(k) is a form of profit sharing plan that allows plan participants to save for retirement using pretax dollars. To encourage participation, employers may provide matching contributions. Employer contributions are deductible but are limited to no more than 25% of the total compensation of the participating employees with individual employee compensation for contribution purposes limited by tax law, indexed for inflation.

  401(k) plans are popular with both employers and employees because of their income tax advantages. Employers' contributions are deductible up to a prescribed limit and elective deferrals allow employees to use pretax dollars to accumulate funds that grow income-tax deferred until retirement.

- **Employee Stock Ownership Plan (ESOP):** An ESOP is a qualified defined contribution plan and is similar to a profit sharing plan. An ESOP is required by law to invest primarily in the stock of the sponsoring employer, essentially making the employees owners in the company. The employer benefits not only because of the ability to deduct contributions (within prescribed limits), but also because the ESOP can be used as a conduit for borrowing money from a bank or other lending institution for a variety of business purposes. In turn, employees share in the business value that they helped to build.

Other tax-qualified plans that are often seen in smaller businesses are:

- **SIMPLE Retirement Plan:** A SIMPLE plan is one of the easiest and most convenient methods for a small business to provide retirement income to owners and employees.

  A SIMPLE plan can be structured as a group of IRAs, or as a 401(k) plan. It can be implemented by any small business that has 100 or fewer employees and that does not maintain another tax-qualified retirement plan.

  Under the general rule, employers are required to either make matching contributions or nonelective contributions. If making matching contributions, the employer must match participating employees' contributions dollar-for-dollar up to 3% of compensation. To allow some limited flexibility, SIMPLE IRAs permit the employer's percentage match to be reduced to no lower than 1% in two out of five years. If the employer instead chooses to make nonelective contributions, the employer must make contributions for all eligible employees equal to 2% of each employee's compensation — whether or not the employee has chosen to make pretax deferrals.

  If a SIMPLE 401(k) is chosen, the employer generally must match the annual elective contribution of each employee in an amount not exceeding 3% of the employee's compensation.

  Setting up and administering a SIMPLE plan is fairly straightforward, inexpensive, and low-maintenance.

- **Simplified Employee Pension Plan (SEP):** A SEP is a simplified alternative to a profit sharing plan under which an employer makes contributions to IRAs of employees. Employee and employer contributions are subject to the same limitations as profit sharing plans.

  SEPs are ideal for small business owners and self-employed individuals as they are subject to less reporting and record-keeping requirements and cost significantly less to setup than other qualified plans. For employees, SEPs offer substantially higher contribution limits than regular IRAs, contributions are immediately fully vested, and the plan is portable.

SOME OTHER CONSIDERATIONS: The real appeal of tax-qualified retirement plans is their tax efficiency. For the employee, a qualified plan provides the opportunity for increased retirement savings through tax deferral on contributions and investment earnings, as well as rollover opportunities. For the employer, contributions are tax deductible, within limits, in the year they are made.

The trade-off for the tax advantages of qualified plans is strict adherence to tight legislative guidelines, such as:

- No discrimination — the qualified plan must cover all eligible employees
- Benefits cannot favor highly compensated employees
- Prescribed vesting schedules
- Limitations on employer and employee contributions
- Limitations on the compensation considered for plan contributions
- Limitations on the benefits distributed annually
- Penalty taxes on distributions prior to age 59½, unless an exception applies

In effect, the limits on benefits and contributions have created "reverse discrimination" in many qualified plans, as they fail to provide the same ratio of pre-retirement income to post-retirement income for high-income earners as they do for the rank-and-file workers. For this reason, many small business owners like you are looking for a solution to this retirement dilemma. One potential answer is the addition of nonqualified plans to the retirement strategies your business has in place.

In addition to retirement income, the amount needed to pay post-retirement health care expenses can be significant. Medical costs are escalating with such items as prescription medications, expensive new technology, and inflation contributing to significant and relentless increases. It is easy to see how one's retirement savings can disappear.

One solution is to set aside funds using tax-deductible business contributions to provide post-retirement health care and life insurance benefits under terms of a single employer welfare benefit plan.[2] For more information on single employer welfare benefit plans please see Prudential Financial's brochure IFS-A086952 — *A Tax Advantaged Plan Providing Post Retirement Health Care & Life Benefits*.[3]

EXECUTIVE COMPENSATION

NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS: Nonqualified deferred compensation arrangements have gained in popularity as companies have come to realize that the addition of a nonqualified benefit arrangement to a compensation package helps attract and retain key executives.

In its simplest form, a nonqualified deferred compensation arrangement is merely an unfunded, unsecured promise to pay a stated dollar amount at some point in the future.

Properly structured, a nonqualified plan allows an employee to defer the receipt of taxable wages or bonuses until some future year, when the employee may be in a lower income-tax bracket. Amounts (and any earnings) accrued under a nonqualified plan are not deductible by the employer until the year in which they are included in the employee's income and then only to the extent that these amounts represent reasonable compensation.

While nonqualified plans do not offer the same tax advantages as qualified plans, they are not subject to many of the restrictions imposed on tax-qualified plans. Therefore they can be extremely flexible.

Properly structured, nonqualified plans:

- Do not have to include all employees, but can be offered just to key executives
- May be individualized to meet the specific needs of a key executive

[2] Single employer welfare benefit plans are covered by 419 and 419A of the Internal Revenue Code.

[3] This document is provided for information and educational purposes only to an individual or entity that may be interested in the purchase of life insurance. It provides general information concerning the use of single employer welfare benefit plans to provide post-retirement health and life insurance benefits ("Concept"). Prudential will only act in the capacity of a product provider with regard to the Concept and will not provide the Concept to you. You must obtain the Concept from an individual or entity that is independent of Prudential and who has responsibility for implementing the Concept. Prudential shall not have any involvement, not even as a product provider only, with regard to multi-employer 419A(f)(6) plans. Additionally, Prudential will not provide tax or legal advice and has not endorsed or promoted the use of the Concept nor how a life insurance policy is used within the framework of the Concept. If you desire to use the Concept and purchase life insurance from Prudential, you must also engage the services of your own legal counsel. When you purchase a life insurance policy from us, we will require that you sign a Disclosure Letter that acknowledges that you have discussed the Concept with your independent legal counsel and obtained advice related to the Concept's risks and benefits.

- Can be designed to replace deferrals lost to qualified plan limitations
- Require no complicated government testing or reporting
- Are not subject to the early retirement penalty tax

This flexibility has manifested itself in a wide array of plan designs and funding arrangements. Traditional nonqualified deferred compensation arrangements are generally structured in one of three ways:

Deferred Compensation Arrangement: Under a traditional deferred compensation arrangement, the participating executive elects to defer receipt of compensation earned until some time in the future. A formula in the plan document determines how the deferred sums will be credited with earnings during the deferral period. A variation of a pure deferral occurs when,as an incentive, the employer matches the executive's deferral according to a predetermined formula. These types of arrangements are often referred to as "mirror plans" or "401(k) look-alikes."

Supplemental Executive Retirement Plan (SERP): Under a SERP, a business agrees to make defined contributions or provide defined future benefits for the employee with no change in the employee's current compensation. A SERP acts as "golden handcuffs," tying the participant to the business, since benefits are subject to forfeiture if specified conditions are not met.

Death Benefit Only (DBO) Plan: A death benefit only plan provides supplemental survivor income benefits for a selected employee's beneficiaries should the employee die prior to retirement. Benefits are generally deductible by the business as paid and taxable as ordinary income to an executive's beneficiaries as received.

The Benefit Obligation: While a nonqualified compensation arrangement cannot be funded without causing current taxation to the employee, the prudent employer sets aside funds as benefits accrue to provide for future cash flow needs and to increase the participant's confidence that the "promise to pay" will be honored.

The majority of traditional nonqualified plans are informally funded using corporate-owned life insurance on consenting participants. Policies may be designed to make use of cash values to pay liabilities as they become due; or benefits may be paid out of current company earnings with reimbursement through income-tax-free death benefit proceeds.[4]

[4] Death benefit proceeds are generally received income tax free under IRC § 101(a). Loans and withdrawals cause a reduction in cash values and death benefits, may affect guarantees against lapse, and may have tax consequences.

OTHER NONQUALIFIED EXECUTIVE BENEFIT ARRANGEMENTS: In addition to establishing plans that can help provide retirement security, you may want to offer additional benefits for executives that you consider key to your operation. Each of the following life insurance arrangements can be an invaluable benefit for a key executive who has a need for death benefit protection.

Executive Bonus Arrangement: An executive bonus arrangement is simple, easy to administer, and can be used to provide life and/or disability insurance benefits to key executives.

Executive Bonus Arrangement Using Life Insurance: The employee usually applies for and owns the policy, naming family members or heirs as beneficiaries. Premiums paid by the business are treated as additional compensation to the employee and, where reasonable, are deductible by the business. Additional dollars are often added to the bonus to cover any income taxes so that the arrangement results in no out-of-pocket cost for the employee.

If the executive should die, income-tax-free policy death benefits are payable to his/her named beneficiaries; or where needed, the accumulated cash value can be used to supplement retirement needs.[5]

While executive bonus arrangements are valuable when the business needs a tax deduction, their weak point is that they have little value as "golden handcuffs." In situations where it is important to tie the executive to the business, an employer might want to take the bonus arrangement a step further by structuring it as a restrictive executive bonus arrangement (REBA).

Similar to a traditional bonus plan, in a REBA, the employee owns the policy while the employer pays the premium cost. However, the employee's ability to exercise many policy rights is limited through the use of a restrictive endorsement placed on the underlying policy. The restrictive endorsement acts as "golden handcuffs" as it remains in effect until the employee meets the terms negotiated in a separate employment contract.

[5] A policy's cash values may consist of both guaranteed and non-guaranteed elements. Non-guaranteed cash values will reflect actual policy earnings and expense deductions, both of which can be expected to change over time. Life insurance policy cash values are accessed through withdrawals and/or policy loans. In general, loans are not taxable, but withdrawals are taxable to the extent they exceed basis in the contract. Unpaid loans and/or withdrawals cause a reduction in policy cash values and death benefits and may affect any policy guarantees against lapse. Loans outstanding at policy lapse or surrender prior to the death of the insured will cause immediate taxation to the extent of gain in the contract. For policies that are Modified Endowment Contracts, loans and withdrawals will be taxed to the extent of policy earnings and there may be an additional 10% federal income tax penalty for loans and withdrawals prior to age 59½.

Executive Bonus Arrangement Using Disability Income: Similar to the life insurance plan described previously, under a disability bonus plan, the employer bonuses compensation to a selected employee who uses the bonus to pay the premium on a disability policy owned by the employee.

The bonus is taxable as compensation to the employee when received and is deductible by the business when the amount is reasonable. If policy benefits are later paid to the employee, they are received income-tax-free.[6]

Group Term Carve-Out: The group term carve-out concept enables an employer to provide permanent life insurance to an executive on a selected basis without having to comply with the nondiscriminatory provision normally affecting standard group life coverage. Under this arrangement, selected executives are excluded or "carved-out" of the employer's group life insurance plan for death benefit amounts over $50,000. Individual permanent life insurance contracts are substituted — policies that can accumulate cash values during the employee's working years that can later be used to enhance retirement income.[7] Permanent policies can also eliminate a common problem with group term insurance: decreasing or disappearing coverage at an executive's retirement.

Split Dollar Arrangement:[8] A split dollar arrangement is essentially a technique where an employer and an employee agree to share the premium, death benefit, and cash value in a permanent life insurance policy.

There are a number of variations of split dollar arrangements. In all of them, the payment of premiums makes it easier for the executive to obtain coverage. For the business, a split dollar arrangement allows for cost recovery and effectively functions as golden handcuffs because the employee is obligated to repay the business for the amount of premiums advanced.

The tax treatment of a split dollar arrangement is complex and generally depends on the ownership of the life insurance policy. Where the business owns the policy, the executive is taxed on the "economic benefit." Where the executive or a third-party owns the policy, the premiums paid by the business are treated as a series of loans.

[6] IRC § 104(a)(3)

[7] A policy's cash values may consist of both guaranteed and non-guaranteed elements. Non-guaranteed cash values will reflect actual policy earnings and expense deductions, both of which can be expected to change over time. Life insurance policy cash values are accessed through withdrawals and/or policy loans. In general, loans are not taxable, but withdrawals are taxable to the extent they exceed basis in the contract. Unpaid loans and/or withdrawals cause a reduction in policy cash values and death benefits and may affect any policy guarantees against lapse. Loans outstanding at policy lapse or surrender prior to the death of the insured will cause immediate taxation to the extent of gain in the contract. For policies that are Modified Endowment Contracts, loans and withdrawals will be taxed to the extent of policy earnings and there may be an additional 10% federal income tax penalty for loans and withdrawals prior to age 59½.

[8] The Sarbanes-Oxley Act makes it a crime for publicly traded companies to, directly or indirectly, enter into a loan with certain directors and executive officers. It is unclear whether the Act applies to split dollar arrangements. Clients should contact their tax or legal advisors for the most recent developments.

BUSINESS CONTINUATION

Many small, family held businesses fail to survive beyond the first generation because the owners neglected to build and fund solutions for the disposition of their business at their death, disability, or retirement. Have you thought about your business's future? The place to start is the buy-sell agreement.

A Buy-Sell Agreement: Drafted by your attorney, the buy-sell agreement assures a market for your business should you die, become disabled, or leave the business. It does this by predetermining the business price, identifying the future buyer(s), and creating a legal obligation between you, the business owner, and the buyer(s). While the buy-sell agreement creates a contractual obligation for you to sell and the purchaser to buy, its successful completion requires that the needed funds be in place when a triggering event occurs.

There are a number of ways to structure and fund a buy-sell agreement. Life and disability insurance policies,[9] when structured properly, can provide the confidence that, no matter how soon the triggering event occurs, funds will be available to complete the plan.

Key Employee Protection: You may depend on the talents, managerial skills, and experience of a key employee. If that key employee is lost because of a disability or death, the financial loss to your business can be devastating. Creditors may become nervous about continuing to extend credit. The goodwill that you have worked so hard to establish may be diminished by a change in management. You can protect your business from such a loss through the use of life or disability insurance.[9]

Life insurance proceeds or disability income benefits will be paid to the business to be used to help meet debt obligations, offset lost sales, or cover the expenses associated with recruiting, hiring, and training a replacement for the key person.

[9] Availability varies by carrier and state.

INVEST TIME TODAY TO PLAN FOR TOMORROW

Finding time to manage your company's strategic vision isn't easy. But it's best not to put it off. The key decisions you make today will have an impact on your company's performance, your employees' morale, and your executives' loyalty.

Your licensed financial professional is prepared to work with you and your advisors to create the programs that are best for your company, your employees and executives, your family, and you.

Prudential Financial companies serve individual and institutional customers worldwide and include The Prudential Insurance Company of America, one of the largest life insurance companies in the United States. We offer a variety of products and services — including a full range of solutions to help meet your business needs for sound business insurance planning and protection.

NOTES:

INSURANCE MARKETPLACE STANDARDS ASSOCIATION

Membership promotes ethical market conduct for individual life insurance, long-term care and annuities.

Life insurance policies contain exclusions, limitations, reductions of benefits, and terms for keeping them in force. Your licensed financial professional can provide you with costs and complete details.

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