

Executive's Comparative Benefits

Are the benefits to the covered executive (either Arthur Lee or Robert Huntington) worth the \$60,000 loss in after tax income in years 1 through 5? To gauge this, we used the Equity Calculator located under the InsCalc tab in the InsMark Illustration System. For the calculations, we assumed that the executive does *not* make the voluntary compensation adjustment of \$100,000 a year for five years and, instead, invests the resulting \$60,000 in after tax income and draws down a spendable \$100,000 a year in retirement years. (Since Loan-Based Deferred Compensation is funded with variable universal life, we assumed the executive would invest the money in equities.)

Tables 1a (Pre-Retirement) and 1b (Post-Retirement) show the results. Assumptions for the equity account are: Capital Growth: 8.50%; Dividend: 1.50%; Management Fee: 1.00%; Annual Portfolio Turnover: 50% (Yes -- our equity calculator can include this feature); Capital Gains Taxes: 30% effective rate (i.e., 50% long term @ 20%; 50% short term @ 40%).

Table 1a (Executive's Comparative Benefits)

Pre-Retirement Values

Year	<u>Equity Account</u>	<u>Loan-Based Deferred Compensation</u>					
	(1) Executive's Annual Cost of the Comp. Adjustment (40% tax bracket)	(2) Executive's After Tax Retirement Income Cash Flow from Equity Acc't	(3) Illustrated Value of Executive's Equity Acc't	(4) Executive's After Tax Retirement Income Cash Flow from the Policy	(5) Executive's Share of Policy Accum. Value (net of loans due Employer)	(6) Executive's Share of Policy Cash Value (net of loans due Employer)	(7) Executive's Share of Policy Death Benefit (net of loans due Employer)
1	60,000	0	64,226	0	1,714	0	2,400,000
2	60,000	0	132,694	0	12,346	0	2,300,000
3	60,000	0	205,540	0	32,215	0	2,200,000
4	60,000	0	282,973	0	62,138	0	2,100,000
5	60,000	0	365,245	0	103,023	28,523	2,000,000
6	0	0	388,412	0	146,994	76,219	2,000,000
7	0	0	412,768	0	194,192	127,887	2,000,000
8	0	0	438,509	0	244,896	183,806	2,000,000
9	0	0	465,783	0	299,374	244,244	2,000,000
10	0	0	494,716	0	357,934	309,509	2,000,000
11	0	0	525,426	0	420,944	379,969	2,000,000
12	0	0	558,034	0	488,800	456,020	2,000,000
13	0	0	592,660	0	561,919	538,079	2,000,000
14	0	0	629,433	0	640,815	626,660	2,000,000
15	0	0	668,487	0	726,058	726,058	2,000,000
16	0	0	709,962	0	818,255	818,255	2,000,000
17	0	0	754,011	0	918,159	918,159	2,000,000
18	0	0	800,792	0	1,026,610	1,026,610	2,000,000
19	0	0	850,475	0	1,144,559	1,144,559	2,000,000
20	0	0	903,240	0	1,273,121	1,273,121	2,000,000

All values are illustrative only and may be higher or lower based on actual performance.

Source of Equity Data: Equity Calculator in the InsMark Illustration System.

Table 1b (Executive's Comparative Benefits)

Post-Retirement Values

Year	<u>Equity Account</u>		<u>Loan-Based Deferred Compensation</u>				
	(1) Executive's Annual Cost of the Comp. Adjustment (40% tax bracket)	(2) Executive's After Tax Retirement Income Cash Flow from Equity Acc't	(3) Illustrated Value of Executive's Equity Acc't	(4) Executive's After Tax Retirement Income Cash Flow from the Policy	(5) Executive's Share of Policy Accum. Value*	(6) Executive's Share of Policy Cash Value*	(7) Executive's Share of Policy Death Benefit*
21	0	100,000	851,900	100,000	1,262,158	1,262,158	1,893,975
22	0	100,000	797,253	100,000	1,250,844	1,250,844	1,781,615
23	0	100,000	739,138	100,000	1,239,457	1,239,457	1,662,513
24	0	100,000	677,359	100,000	1,228,421	1,228,421	1,536,266
25	0	100,000	611,698	100,000	1,217,694	1,217,694	1,508,130
26	0	100,000	541,918	100,000	1,205,326	1,205,326	1,497,032
27	0	100,000	467,760	100,000	1,191,695	1,191,695	1,462,282
28	0	100,000	388,951	100,000	1,176,862	1,176,862	1,421,721
29	0	100,000	305,200	100,000	1,160,958	1,160,958	1,375,071
30	0	100,000	216,197	100,000	1,144,197	1,144,197	1,322,092
31	0	100,000	121,613	100,000	1,126,909	1,126,909	1,262,604
32	0	100,000	21,098	100,000	1,107,183	1,107,183	1,251,952
33	0	20,733	0	100,000	1,084,665	1,084,665	1,238,974
34	0	0	0	100,000	1,058,955	1,058,955	1,223,283
35	0	0	0	100,000	1,029,591	1,029,591	1,204,433
36	0	0	0	100,000	996,048	996,048	1,181,915
37	0	0	0	100,000	957,716	957,716	1,155,130
38	0	0	0	100,000	913,902	913,902	1,123,397
39	0	0	0	100,000	863,806	863,806	1,085,925
40	0	0	0	100,000	806,518	806,518	1,041,807

*Loan to employer assumed repaid via policy withdrawal in year 21.

All values are illustrative only and may be higher or lower based on actual performance.

Source of Equity Data: Equity Calculator in the InsMark Illustration System.

As you can see, the equity account is no match for Loan-Based Deferred Compensation as it runs out of gas in year 33. The only way the equity account can last is to reduce the after tax cash flow taken from it to \$74,449 -- and then its value would be reduced to zero in year 40. Alternatively, the executive could reduce the after tax cash flow taken from the equity account to \$54,750 and closely match the policy's ending balance of \$806,776. That's an interesting cash flow number -- \$54,750 -- the best the equity account can do is produce 54.75% of the \$100,000 cash flow produced by the policy. Even if we raise the equity account's growth assumption to 12% growth and 0% dividend, the equity account falls short -- it can match the \$100,000 after tax cash flow in all years but comes up \$350,000 short in residual balance at the end of year 40. Also of significance, *the equity account has no life insurance death benefit*. If you factor in a premium for, say, 20-year level term insurance, Loan-Based Deferred Compensation looks even better. In the calculations we did to evaluate this, the equity account runs out of gas in year 30.

Adding Severance Benefits

If the executive is not a majority shareholder, one concern might be early termination of employment (voluntary or otherwise). If this were to occur before the life insurance policy is sufficiently seasoned, the amount of loan owed to the employer will not be covered by the policy's cash values.

This can be overcome by adding a severance benefit to the plan. In fact, the plan as constructed is so favorable to employers, it seems logical to add this benefit, and Table 1c below includes it. Column (1) reflects \$100,000 a year starting in year 21 (withdrawals to basis; loans thereafter). Shaded Columns (5) and (6) reflect the severance benefit in the same amount as the compensation reduction. The addition of a severance benefit should make this plan virtually irresistible to the executive.

Table 1c (Executive's Benefits Including Optional Severance)

Year	(1) Executive's After Tax <u>Cumulative</u> Retirement Income Cash Flow from the Policy	(2) Executive's Share of Policy Accum. Value (net of loans due Employer)	(3) Executive's Share of Policy Cash Value (net of loans due Employer)	(4) Executive's Share of Policy Death Benefit (net of loans due Employer)	(5) Executive's One-Time Severance Benefit	(6) Executive's One-Time After Tax Severance Benefit (40% tax bracket)
1	0	1,714	0	2,400,000	100,000	60,000
2	0	12,346	0	2,300,000	200,000	120,000
3	0	32,215	0	2,200,000	300,000	180,000
4	0	62,138	0	2,100,000	400,000	240,000
5	0	103,023	28,523	2,000,000	500,000	300,000
10	0	357,934	309,509	2,000,000	500,000	300,000
20	0	1,273,121	1,273,121	2,000,000	500,000	300,000
21	100,000	1,262,158	1,262,158	1,893,975	500,000	300,000
30	1,000,000	1,144,197	1,144,197	1,322,092	0	0
40	2,000,000	806,518	806,518	1,041,807	0	0

Values are illustrative only and may be higher or lower based on actual performance. Values in Columns 2, 3, and 4 in years 21 - 40 are net of a \$500,000 policy withdrawal illustrated in year 21 used to repay the loan to the employer.

Severance is presumed paid no later than year 21. Severance is conditional on a formal agreement between the parties. It is illustrated in years 1 - 21 in the event of employment termination for any reason -- including death. (Severance benefits for employees of tax exempt organizations must be handled differently due to IRC Section 457(f).)

Assuming the executive's one-time severance benefit of \$500,000 is paid at retirement, the resulting after tax amount of \$300,000 could, of course, be added to his retirement income. If distributions from the equity account alternative discussed on Pages 1 and 2 are increased to reflect the additional one-time payment of \$300,000, the equity account runs out of gas in year 27. Only if the other \$100,000 after tax withdrawals from the equity account are *reduced by \$70,000 to \$30,000* in each retirement year, will the equity account and the policy end up with similar residual values.

Assuming the compensation adjustment can be tolerated, with or without the severance feature, Loan-Based Deferred Compensation provides extraordinary financial leverage for this executive.