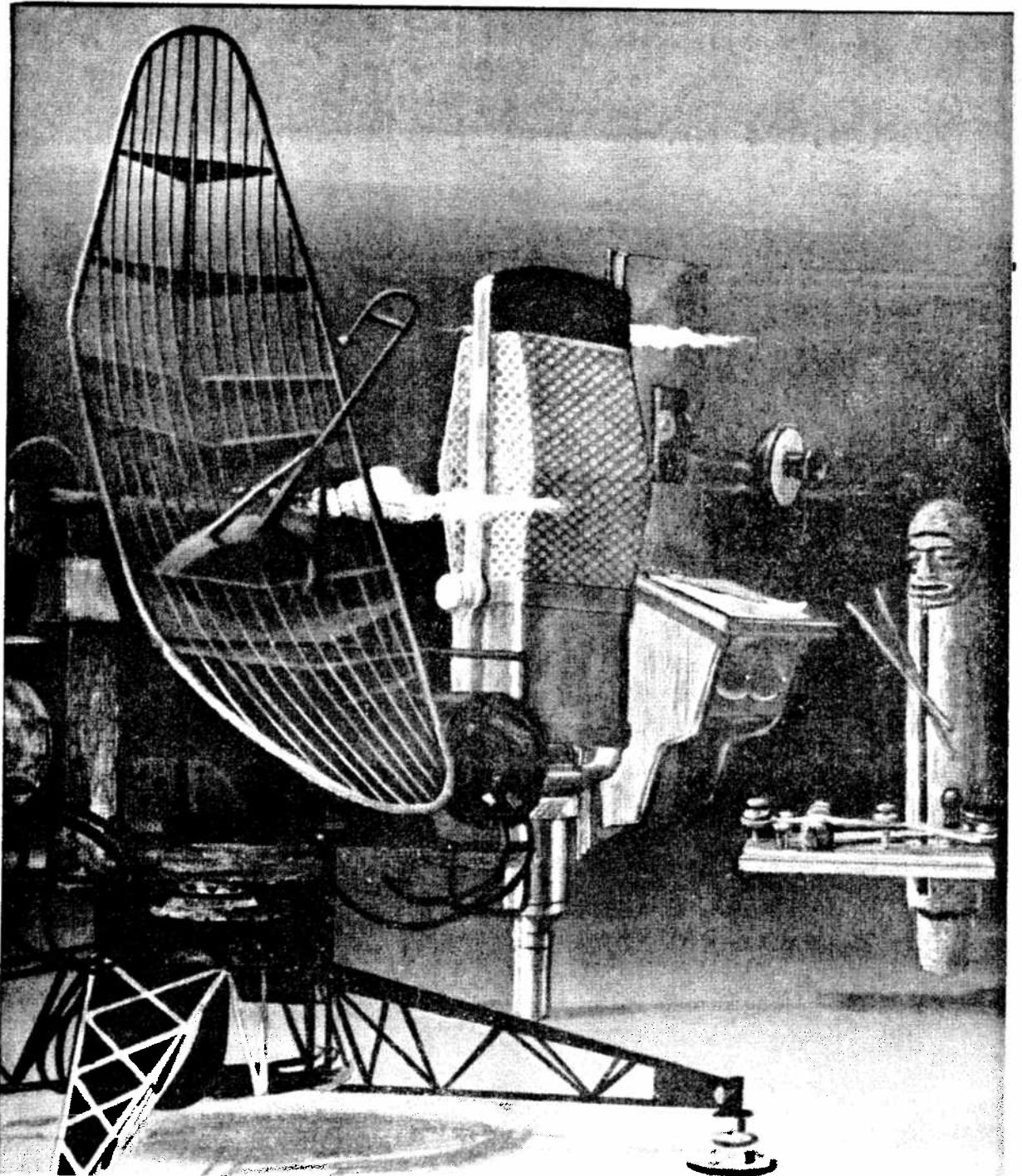


TRUSTS *and* ESTATES

FEBRUARY 1962



TECHNIQUE FOR DRAFTING WILLS
COMPENSATION FOR EXECUTIVES

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TRUSTS AND ESTATES is not to be considered as
expressing the views advocated in signed articles.

Cover Picture . . . Communication has been, after sustenance and safety, one of mankind's major concerns from the beginning. Ancient cave paintings in France, as well as elsewhere, indicate to anthropologists that these crude pictorial representations of man's primordial world even antedated development of a "formal" language, as such. Over countless centuries, he has gradually learned to make himself understood by his fellows, despite the multiplicity of tongues spoken around the world. Additionally, he has faced, and conquered in surprising degree, the problems of rapid communication over a distance, as depicted in the cover design. From relay stations using smoke signals or drumbeats or later by pigeons, horses or, for overseas messages, clipper ships, man's capabilities have spread into electrical media and its world-wide instantaneous contacts. Nor have we yet seen, in the opinion of Harold S. Osborne, the end of telecommunication marvels, as discussed at page 122.

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CORRESPONDENCE

Much Ado About M.D.?

"Marital Deduction Litigation." Mr. Harrison F. Durand's careful and searching article in the January 1962 issue of TRUSTS AND ESTATES, may, we think, be causing undue panic among the will draftsmen of the nation.

In a forceful sally against the marital deduction formula clause, Mr. Durand gives dramatic illustrations of the possible frustration of testamentary intent that may result from its use. He poses a situation in which the testator's intent is that his wife and son share equally in his entire estate. In such a situation Mr. Durand shows how the use of the formula clause may involve depriving the widow of any participation in the testamentary residue or cutting off the son without a penny.

Is it not true, however, that the problem posed exists only where there are beneficiaries in addition to the widow whose interests are to take effect upon the testator's death? In the most common situation, it is not a problem, i.e., where the testamentary residue is allocated between a marital share and a non-marital share, in both of which shares the widow has a lifetime income interest. In such a situation, the very worst that can happen (considering all possibilities with respect to the qualification or non-qualification of non-testamentary assets for the marital deduction) is that the marital share will contain *no* testamentary assets or *all* the testamentary assets. Most often the result will be somewhere in between. As a practical matter, this means merely that the amount of assets over which the wife has been given a power of appointment (usually testamentary) has been altered.

Mr. Durand's basic suggestion is to disqualify one-half of the non-testamentary assets and then use a non-formula residuary clause. To follow Mr. Durand's suggestion would seem to involve a danger more grisly than any of those to which he adverts, namely, underqualifying assets for the marital deduction. Mr. Durand's suggestion would be sounder, we think, if we could be certain, "ante mortem," that after disqualifying one-half of the non-testamentary assets, the balance of such assets would be treated by the Internal Revenue Service as qualifying. Without assurance on this point, which, of course, we can never have at the planning stage, the

(Continued on page 154)

COMPENSATION FOR EXECUTIVES



ARTHUR H. DAUMAN, C.L.U.

Life Member, Million Dollar Round Table;

Associate Manager, New York Lincoln Agency, Phoenix Mutual Life Insurance Co.

ONE OF THE GREATEST NEEDS OF THE corporate executive today is a means of compensation not subject to taxation — income or estate. The graduated income tax scale makes it difficult if not impossible for the executive to maintain a satisfactory standard of living and provide some degree of financial security for himself and his family at the same time. For the corporation faced with competitive hiring of executives, no longer are offers of increased taxable income an incentive to retain competent executives.

Creative thinking and the evolution of the modern life insurance contract now makes it possible for the corporation to provide economic security for its executives as well as their families in forms that give relief from the tax problem. At the same time these plans can result either in a profit to the corporation or a nominal cost to the corporation.

In musical terms, "Theme and Variations" can best describe the approach used in the following illustrations.

Basic Split Dollar

The basic Split Dollar concept has a number of variations to fill the needs of the corporation and the executive as

their circumstance require. These variations are interchangeable and can be adopted to meet the changing needs of both the corporation and the executive. Split Dollar is a true form of compensation since it permits the executive to provide economic security for his family at extremely nominal costs and thus releases spendable income for other purposes.

The basic Split Dollar plan shown in Illustration #1 is the standard plan under which the corporation advances the increase in cash value of the insurance contract each year and the employee pays the difference between the cash value and the net premium each year. The corporation at all times owns the cash value it has advanced and carries this as an asset on its books. In the event of the executive's death, the corporation receives this sum and the beneficiary of the executive receives the difference between it and the face amount of the policy.

Variation I

The evolution of the so-called fifth dividend option brought about a major change in the Split Dollar concept. By using a portion of the dividend each

year to purchase one year term insurance in the amount of the cash value, the death benefit payable to the executive's beneficiary becomes a level amount. The corporation still recoups the cash value advanced and the employee's beneficiary receives the full face amount of life insurance. The purchase of this term insurance results in a higher cost to the employee, but the end result is well worth the additional cost.

The reducing death benefit under the Split Dollar plan has long been criticized since in most instances the need for liquid assets increases as the executive accumulates an estate. The fifth dividend option, making possible the payment of a level death benefit, overcomes this objection.

Variation II

Many young and growing corporations have tremendous need for incentive plans to retain valuable executives but cannot afford to tie up corporate surplus needed for growth and expansion. Utilizing the same contract previously illustrated the corporation borrows 95% of the cash value instead of advancing all of it. The same result is achieved for the executive while the only cash outlay

Dividends and term insurance examples in all illustrations in this article are based on current dividend scale and term insurance rates — not guaranteed.

Illustration #1: BASIC SPLIT DOLLAR PLAN
\$100,000 — Age 40 — Annual Premium \$2,827

Year	EMPLOYER		EMPLOYEE	
	Advances	Receives	Pays	Receives
1	993	993	(1,834)*	99,007
2	2,251	3,244	327	96,756
3	2,276	5,520	247	94,480
4	2,298	7,818	169	92,182
5	2,319	10,137	91	89,863
10	2,106	20,591	33	79,409
15	1,883	31,144	0	68,856
20	1,636	41,533	0	58,467

*Payable by corporation as key-man insurance for first year.

Twenty Year Cost

Employer receives	....\$41,533	Employee pays	....\$ 1,593
Employer advances	.... 39,182	Average net cost	.... 80
Employer's gain	....\$ 2,351	(If first year cost is paid by employee, average is \$172.)	

Illustration #2 — VARIATION I: SPLIT DOLLAR PLAN
5th Dividend Option — Level Death Benefit
\$100,000 — Age 40 — Annual Premium \$2,827

Year	EMPLOYER		EMPLOYEE	
	Advances	Receives	Pays	Receives
1	993	993	(1,834)*	100,000
2	2,251	3,244	338	100,000
3	2,276	5,520	267	100,000
4	2,298	7,818	199	100,000
5	2,319	10,137	133	100,000
10	2,106	20,591	161	100,000
15	2,107	31,144	88	100,000
20	2,052	41,533	258	100,000

*Payable by corporation as key-man insurance for first year.

Twenty Year Cost

Employer advances	....\$41,533	Employee pays	....\$ 3,479
Employer receives	.... 41,533	Average net cost	.... 174
		(If first year cost is paid by employee, average is \$266.)	

ILLUSTRATION #3 — VARIATION II: CORPORATE SPLIT DOLLAR PLAN
(Borrowing Basis)

\$100,000 — Age 40 — Annual Premium \$2,827

Div. for Year	Amt. of Div. used for 1 yr. term ins.	Prem. less balance of div.	Cash Value End of Year	Corp. Borrowers (cancelable at death)	Total Corp. Loan	5% Cash Value (owned by Corp.)		Corporation Pays		Employee Pays	Payable to Employee's Benef.
						Ann.	Cum.	Interest at 5%	Total		
		2,827	993	943	943	50	50		50	(1,834)	99,057
249	11	2,589	3,244	2,138	3,081	113	163	47	160	338	100,000
304	20	2,543	5,520	2,163	5,244	113	276	154	267	267	100,000
360	30	2,497	7,818	2,183	7,427	115	391	262	377	199	100,000
417	42	2,452	10,137	2,203	9,630	116	507	371	487	133	100,000
476	128	2,267	20,591	2,001	19,561	105	1,030	878	983	161	100,000
535	312	2,195	31,144	2,001	29,586	106	1,558	1,379	1,485	88	100,000
594	674	2,310	41,533	1,950	39,456	102	2,077	1,875	1,977	258	100,000

*Payable by corporation as key-man insurance for first year.

TWENTY YEAR NET COST

Paid by Corporation			Paid by Employee		
Cash value	2,077	Total	3,479	<i>Net cost</i>	112
Value in excess of loan	2,077	Less 20th yr. dividend	1,237		
		Net cost	2,242		
Interest to end of 20th yr.	20,485				
Cost to corp. in 30% bracket	14,340				
Cost to corp. in 52% bracket	9,833				

ILLUSTRATION #4 — VARIATION III:
CORPORATE SPLIT DOLLAR PLAN

\$100,000 — Age 40 — Annual Premium \$2,827

Div. for Yr.	Net Premium	Cash Value End of Year	Corp. Borrowers	Total Corp. Loan	5% Cash Value (owned by Corp.)		Interest at 5%	Cost of Term Ins.	Total	Employee Pays	Payable to Employee's Benef.
					Ann.	Cum.					
	2,827	993	943	943	50	50			50	(1,834)	99,057
249	2,578	3,244	2,138	3,081	113	163	47	11	171	327	100,000
304	2,523	5,520	2,163	5,244	113	276	154	20	287	247	100,000
360	2,467	7,818	2,183	7,427	115	391	262	30	407	169	100,000
417	2,410	10,137	2,203	9,630	116	507	371	42	529	91	100,000
476	2,351	12,209	1,968	11,598	104	611	482	54	640	279	100,000
535	2,292	14,292	1,979	13,577	104	715	580	67	751	209	100,000
586	2,241	16,385	1,988	15,565	105	820	679	85	869	148	100,000
637	2,190	18,485	1,995	17,560	105	925	778	105	988	90	100,000
688	2,139	20,591	2,001	19,561	105	1,030	878	128	1,111	33	100,000
740	2,087	22,702	2,005	21,566	106	1,136	978	156	1,240	cr. 24	100,000
791	2,036	24,814	2,007	23,573	105	1,241	1,078	187	1,370	" 76	100,000
843	1,984	26,927	2,007	25,580	106	1,347	1,179	223	1,508	" 129	100,000
894	1,933	29,037	2,005	27,585	105	1,452	1,279	265	1,649	" 177	100,000
944	1,883	31,144	2,001	29,586	106	1,558	1,379	312	1,797	" 224	100,000
994	1,833	33,243	1,994	31,580	105	1,663	1,479	367	1,951	" 266	100,000
1,045	1,782	35,334	1,987	33,567	104	1,767	1,579	429	2,112	" 309	100,000
1,094	1,733	37,415	1,977	35,544	104	1,871	1,678	500	2,282	" 348	100,000
1,143	1,684	39,481	1,962	37,506	104	1,975	1,777	582	2,463	" 382	100,000
1,191	1,636	41,533	1,950	39,456	102	2,077	1,875	674	2,651	" 416	100,000

*Paid by corporation as key-man insurance for first year.
†Charged as additional compensation to employee.

TWENTY YEAR NET COST

Paid by corporation:		Paid by employee:	
Cash value	2,077	Net Premiums	758 cr.
Value in excess of loan	2,077	Plus 20th Year Dividend	1,237
		Gain by employee	1,995
Interest to end of 20th year	20,485		100
Cost of term insurance	4,237		
	24,722		
Cost in 30% bracket	14,340	Interest in 52% bracket	9,833
Cost of term insurance	4,237	Cost of term insurance	4,237
	18,577		\$14,070
	8,929		8,704

(Continued on next column)

by the corporation — in addition to the 5% of the cash value increase — is the annual interest* on the loan. Under the present law such interest is deductible. Thus, the corporation has the use of capital when it is badly needed at a very moderate cost.

As the corporation grows and reaches a point where working capital is no longer a problem, another problem often arises — accumulated surplus. In many instances this surplus may last only temporarily or future capital needs may make it undesirable to distribute such surplus as dividends.

Under these circumstances this form of Split Dollar policy becomes a valuable corporate asset. The corporation may repay the loans on the lives of its executives and retain the surplus since this is a permissible accumulation of surplus.** At a later date should such surplus be needed for business growth or expansion the money is readily available again at a nominal interest rate.

In the event that such capital needs do not arise the money will be available for funding deferred compensation contracts, as will be illustrated later.

Variation III

Since many corporations wish to provide the maximum benefit at minimum cost to their executives a further variation may be applied to the split dollar concept. Under this plan the corporation will pay the cost of the one year term insurance annually and permit the full dividend to be deducted from gross cost, thus giving the executive a lower dollar outlay. This payment by the corporation would probably be considered additional compensation to the executive and, therefore, taxable to him. However, since the amounts, particularly in the early years, are negligible, the amount of tax paid plus dollar outlay will still be less than the method outlined in variation II.

Variation IV

One of the most valuable uses of split dollar concept is the provision of tax-free dollars in the estate. Since the insured under the Split Dollar plan retains only one incident of ownership, i.e., the right to name his beneficiary, the irrevocable assignment of this right would remove this asset from his estate and make the proceeds available to his beneficiary without being subject to tax in his estate.

*Currently guaranteed in the insurance contract at 5% payable at the end of the year. This is equivalent to a bank interest rate of 4.78 discounted.

**Emeloid v. Comm., 189 F. 2d 230 (CA-3, 1951). Cf. Mountain States Steel Foundries v. Comm., 284 F. 2d 737 (CA-4, 1960).

This variation is of particular value to the executive with a growing estate and growing estate tax liability.

For the stockholder executive this form of compensation can be of more value than corporate owned life insurance for a Section 303 purchase. This plan will permit the family to retain the undiluted stock holding without effecting a sale to meet payment of estate taxes or administration costs.

Deferred Compensation

One of the amazing facts about deferred compensation from the corporate point of view is the possibility of profit to be derived from this very attractive "fringe benefit." Not only does the executive end up with more spendable dollars but the corporation will usually end up with a profit.

Using the above illustration of variations on the Split Dollar theme we would tie the Split Dollar program to a deferred compensation contract. The program would provide for a payment of \$10,000 per year for ten years to the executive upon his retirement, and in event of his death after retirement the balance of the ten years' payment would

be made to his beneficiary. Thus, \$100,000 would always be payable either to the executive or to his family.

Under the terms of the deferred compensation contract the executive would agree that upon his retirement or as soon as he starts to receive income under the terms of the deferred compensation contract, the beneficiary of the life insurance contract would automatically become the corporation. The corporation would either 1) make the payments to the executive out of surplus and retain the insurance in force until his death, or 2) make the payments out of the cash value accumulated under the Split Dollar plan.

Under the first method, illustration #5 shows the executive position and the corporation picture. In the illustration it is assumed that the corporation will pay the entire cost of maintaining the \$100,000 of insurance. Upon the executive's death, payments to his beneficiary would be made in ten annual installments of \$10,000 by the corporation.

Upon retirement, the corporation would make the annual payments out of

(Continued on page 154)

ILLUSTRATION #5: CORPORATE POSITION UNDER DEFERRED COMPENSATION PLAN		
<i>When corporation pays \$10,000 per year to executive or to his beneficiary, following is cost picture:</i>		
Payable to executive or beneficiary \$10,000 × 10 years	\$100,000	
Deductions allowed for such payment (52% bracket)....	52,000	
Net cost to corporation	48,000	
Amount required to pay \$48,000 discounted over 10 years at 4%	32,480	
<i>Corporation receives tax-free \$100,000 upon death of executive. Thus, in illustration of executive, age 40, following is cost picture:</i>		
Tax-free proceeds received	100,000	Split Dollar Plan 100,000
Total paid by corporation 20 years (after 52% tax credit)	13,909	11,667**
Total net cost of \$100,000 paid to executive or beneficiary by reason of death, disability or retirement	32,480	32,480
Net cost	46,389	44,147
Net Gain to Corporation if death occurs at end of 20 years	53,611	55,853
<i>Should executive live to expectancy (age 74)</i>		
Tax-free proceeds received by corporation	100,000	100,000
Total paid by Corporation for 34 years (after 52% tax credit) including \$10,000 to employee for 10 years..	69,053	67,047
Net Gain to Corporation	\$ 30,947	\$ 32,953

*Assuming all payments for insurance are made by employer, corporation is beneficiary and payments to family are made through corporation.

**Cost figures based upon illustration #3.

EXECUTIVE COMPENSATION

(Continued from page 110)

surplus and recoup the amount paid out plus the profit indicated upon the employee's death. It is assumed that the corporation will maintain the insurance on the executive's life, after his retirement, in order to eventually recoup its outlay upon his death.

If the executive wishes tax-free funds for his family in event of his death prior to retirement, he may enter into a Split Dollar agreement with the corporation under any of the aforementioned variations. Under this arrangement the corporation's outlay would be considerably reduced and the ensuing profit greater.

Under method 2, it is assumed that the corporation either will have had the opportunity to accumulate cash and repay the cash value borrowed over the years or will do so at retirement date in order to take advantage of the settlement options.

The insurance contract used in this illustration would have a cash value of \$51,471 at age 65. This cash value would provide a payment to the corporation of \$5,618[†] for a period of ten years.

[†]Guaranteed by insurance company based upon 2% interest assumption, excess interest would be paid annually by the company.

Using the above formula and the corporation as a vehicle to make the payments the executive could receive \$11,704[†] for 10 years, as calculated in the following table:

Paid by corporation	\$11,704
Tax credit at 52%	6,086
Net cost to corporation	\$ 5,618

The executive and the corporation could mutually agree to elect a lifetime income for a smaller amount based upon the cash value.

Summary

Corporations are in a position to provide a variety of non-taxable forms of compensation to their executives. Since the needs of corporations will vary as much as those of the individual executive, plans are available to meet both the variety of needs and the changing conditions of the corporation as well as the executive.

Use of the Split Dollar concept and the deferred compensation contract opens a wide field of possible variations at nominal cost or even a profit to the corporation.

Δ Δ Δ

NATIONAL TRUST SCHOOL SET FOR AUGUST 6-21

The third annual session of The National Trust School, will be held August 6-21 at Northwestern University, Evanston, Ill. During the first 9 days all students will take the same subjects. The second half of the session is devoted to specialized studies in Trust Administration and Trust New Business. Those who have taken the course in Trust Administration in the past may return for the special studies in Trust New Business and vice versa. Information may be obtained from the office of The National Trust School, American Bankers Association, 12 East 36 Street, New York 16.

Δ Δ Δ

CORRESPONDENCE

(Continued from page 99)

draftsman, following Mr. Durand's suggestion, exposes the Estate to what could be a painful tax bite.

Another disadvantage involved in the disqualification process, as Mr. Durand himself points out, is that it may involve the destruction of joint tenancies with the testator's wife and of tenancies by the entirety. Consideration of problems of local law and gift tax law aside, such a course introduces a problem which neither the lawyer nor the testator may be equipped to handle. Not every wife is sufficiently sophisticated to recognize that the surrender of her present one-half interest in the family home, for instance, will ultimately reap rewards for the deserving.

Joseph L. Hunter
A. Chester Safian

White Plains, New York

Δ Δ Δ

PENSION DIGEST

(Continued from page 144)

and actuaries] and polarizes the two professions to the detriment of employers, employees, the funding mediums involved (insured, trust-fund or combination), as well as of the respective professions and the general public." He goes on to urge that the Opinion's scope be narrowed" to recognize the pension actuary as a necessary technician with whom the lawyer in charge may team up and rely on."

• William W. Wolbach, president, Boston Safe Deposit and Trust Co., addressed the Corporate Fiduciaries Association of Boston February 20 on "Management of Closely-Held Corporations by Corporate Fiduciaries."

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