The Competitive Edge

Attract, retain and reward top performers in your corporation

Executive Compensation
Strategies That Use
Life Insurance

PACIFIC LIFE

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Contents

This brochure provides you with an overview of different types of executive[1] compensation designs that use life insurance. Generally, the executive compensation design is first determined based on the needs of the company and its executives before any decisions about choosing a life insurance product are completed.

As a business owner, your success stems from the quality of your organization – from the people who make the daily decisions that keep your business thriving.

Irreplaceable Assets

One of the biggest threats facing your business today is the possibility that those key decision makers will move to a competitor. Not only is such an event a loss for your organization, it is a gain for your competition – a double loss, competitively. Therefore, it is essential that you put in place the proper arrangements that will ensure that your key players stay where they belong: with you.

1 "Executive" is defined as a 5% or more shareholder, a director of the business, or a highly compensated employee as defined in either IRS Sec. 416(q) or IRC Sec. 105(h)(5).

Muting the Siren's Song

Today, there are all kinds of temptations that threaten to lure your key executives away. For many the most appealing bait from your competitors could be the promise of financial security.

Having enough retirement income continues to be one of the top concerns of Americans.[2] This is especially the case with top income earners. Due to limits on contributions for qualified plans and social security benefits, high-income earners find that a diminishing percentage of their current compensation can be replaced at retirement through these two sources.

Compensation at Age 45	$50,000	$70,000	$100,000	$150,000	$200,000	$250,000
401(k) Plan Deposit at age 45[3]	$5,000	$7,000	$10,000	$15,000	$17,500	$17,500
Benefits at Age 67 from 401(k) Plan[4]	$17,148	$24,012	$34,307	$51,467	$60,046	$60,046
Benefits at Age 67 from Social Security[5]	$20,904	$25,692	$29,976	$32,592	$32,640	$32,640
Total Benefits	$38,052	$49,704	$64,283	$84,059	$92,686	92,686
Percent of Compensation Provided by Age 67	76.1%	71.1%	64.3%	56.0%	46.3%	37.1%

This leaves a gap in your executives' retirement savings that either you or your competitors can take advantage of. Here are some ways that you can address your key executives' concerns.

2 "Lack of Retirement Funds Is Americans' Biggest Financial Worry", E. Mendes, www.gallup.com (June 15, 2011)

3 The maximum contribution for 2014 is $17,500. However, if you will attain age 50 before the close of the plan year, you will also be eligible to defer an additional $5,500 as a catch-up contribution. In order to take advantage of the catch-up contribution election, you must first defer and contribute the full $17,500 of your pay during the plan year. This chart does not reflect the use of the catch-up provision. The maximum annual contribution may differ for other types of qualified plans.

4 Benefits from the 401(k) assume: (1) An individual age 45; (2) Contributions made for 22 yrs.; (3) Annual contribution increases at a rate of 2%; (4) 401(k) assets accumulate at 8% and payout is based on a single life annuity purchased at age 67.

5 Social Security benefits are based on the 2014 Quick Benefit Calculator at www.ssa.gov. Calculations assume: (1) An individual age 45 in 2014 will receive full Social Security benefits at age 67; (2) A worker's past earnings are based on the national average wage indexing series with a relative growth factor of 2%; (3) Current earnings stay the same until age 67 and are limited to the 2014 taxable maximum of $117,000.

The Competitive Edge – 3 Strategies

Recognizing the importance of your executives, we've highlighted 3 designs incorporating life insurance that can be your Competitive Edge in the struggle to attract and retain talented executives. They consist of Nonqualified Deferred Compensation, Executive Bonus Arrangements, and Split-Dollar Arrangements.

Simplicity & Deductibility
Executive Bonus

Control & Flexibility
Deferred Compensation (NQDC)

Affordability
Split-Dollar

The design you choose will depend on your priorities. To help, we've highlighted a feature of each type of design to distinguish them from one another. The design you choose may provide flexibility, simplicity, affordability, or a combination of these features.

Is flexibility as an employer a primary concern? Would you like to customize a compensation package for your key executives?

If you answered yes to these questions, a Nonqualified Deferred Compensation (NQDC) plan may be right for you. An NQDC plan may allow participants to systematically defer their compensation until retirement without the use of a qualified plan. To executives who have already maxed out contributions to their qualified plan, an NQDC plan can be an attractive alternative for accumulating supplemental retirement income.

In general, there are three types of NQDC plans: Voluntary Deferral Plans, Supplemental Executive Retirement Plans (SERPs), and 401(k) Mirror Plans.

Voluntary Deferral Plan

Comprised of Salary Deferrals; Allow Executives to Put More Away

SERP

Comprised of Employer Contributions; Opportunity to Utilize Vesting Schedule

401(k) Mirror

Combination of Salary Deferrals and Employer Contributions

Would you like to tailor-design a compensation package for your key executives?

Voluntary Deferral Plans offer a cost-effective method of helping your executives accumulate retirement income. By providing your executives with the option of deferring more of their salaries than is allowed under a qualified plan, a Voluntary Deferral Plan allows you to help your key executives save for retirement without having to make any additional employer contributions.

Supplemental Executive Retirement Plans (SERPs), on the other hand, allow you to make additional employer contributions to provide your executives with that extra incentive to stay. SERPs also allow you to implement vesting schedules that would require the executives to stay with your organization for a set number of years before they are entitled to any funds – a true golden handcuffs scenario.

Of course, you can always do a combination of a Voluntary Deferral Plan and a SERP through a **401(k) Mirror Plan.**

How Life Insurance Can Increase Your Competitive Edge

As an employer, you may informally fund the deferrals or promised benefits with any asset that you deem appropriate. Life insurance, however, provides an attractive informal funding option because the policy's cash value may accumulate without any current taxation to the business.[6] Additionally, you can access the life insurance policy's available cash values on a tax-free basis in order to help pay the promised benefits to the executive.[7] Finally, the life insurance death benefit proceeds that you receive at the executive's death will be free from income taxation.[8] You can use these proceeds as a cost-recovery feature to offset the original premium expense.

Company Benefits	Versus	Company Issues
Avoids most of the cost and ERISA requirements of qualified plans		Unless life insurance is used, earnings on contributions may be taxable to the company
Participation can be limited to executives without violating anti-discrimination rules		Contributions and deferrals to NQDC plan not deductible to company
Generally, benefits are deductible to company when paid to executive[9]		Complicated: 409A compliance; use of a third-party administrator recommended; written notice and consent must be provided to executive concerning life insurance purchase
Many design variations available, including cost-recovery		

Company Benefits vs. Issues

6 In accordance with existing and pending state insurable interest laws, an employer does not have an insurable interest in an employee unless certain conditions are met. Failure to satisfy state insurable interest requirements may result in disqualification of the policy as "life insurance" under IRC Section 7702, and also may, among other things, void the policy.

7 Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

Executive Benefits	Versus	Executive Issues
Allows executive to accumulate supplemental retirement income		Benefit is unsecured and remains general asset of company, reachable by creditors
Can provide executive with benefit proportional to total compensation		Benefits are subject to federal income tax when actually or constructively received
Earnings in plan grow tax-deferred		
Deferrals or company contributions not taxed to executive until distributed		

Executive Benefits vs. Issues

8 For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

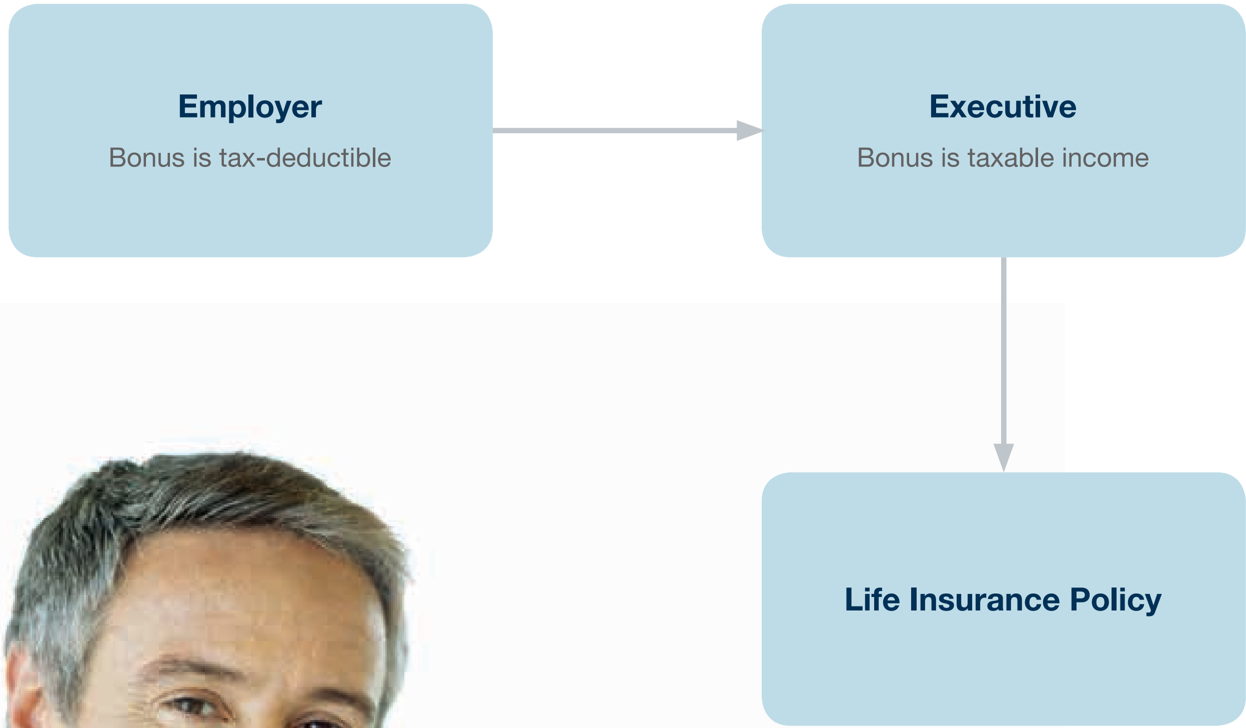
9 The deductibility of the distribution is subject to the reasonable compensation limits established by IRC Sec. 162(a).

Is simplicity in a benefits arrangement a priority for you? Would you prefer to avoid the hassle of complying with IRC Sec. 409A or of paying for the cost of a third-party administrator to keep your key executives?

If you answered yes to these questions, then an Executive Bonus arrangement may be right for you. An Executive Bonus arrangement involves paying the premiums, through a series of bonuses, for a personal life insurance policy that is owned by the executive.

Being Competitive Doesn't Mean Being Complicated

A basic Executive Bonus arrangement doesn't even require a separate agreement.[10] You can simply bonus the premiums to the executive or pay them directly to the insurance company. In both cases, however, the premium amounts will be taxable to the executive and tax-deductible for your business.[11]



10 Please consult with your employee benefits legal counsel as to whether this is an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and if so, whether any additional requirements are necessary to comply with ERISA.

11 The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).

If you wish to provide a stronger incentive for your executive to stay, there is the option of using a Restricted Executive Bonus arrangement instead. A Restricted Executive Bonus arrangement allows you to prevent the executive from accessing the cash value of his or her life insurance policy until the executive has remained with the organization for a set amount of time.

Employer

Bonus is tax-deductible

Executive

Bonus is taxable income

Life Insurance Policy

Access to Cash Value
Restricted by Employer

A Restricted Executive Bonus arrangement involves adding two additional documents to a basic Executive Bonus arrangement: an access agreement and a Restricted Executive Bonus form. The access agreement records the terms of the arrangement that you enter into with the executive and states how long the executive must remain with the organization in order to have access to the cash value of the life insurance policy. The Restricted Executive Bonus form prevents the executive from accessing the cash value of the policy without your signature.

Benefits for Company

- Simple to implement
- Bonuses may be tax-deductible

Benefits for Executive

- Life insurance policy is a portable benefit
- Life insurance cash value grows tax-deferred and can be accessed tax-free[7]
- Death benefits paid to beneficiary are received income-tax free[12]

Issues for Company

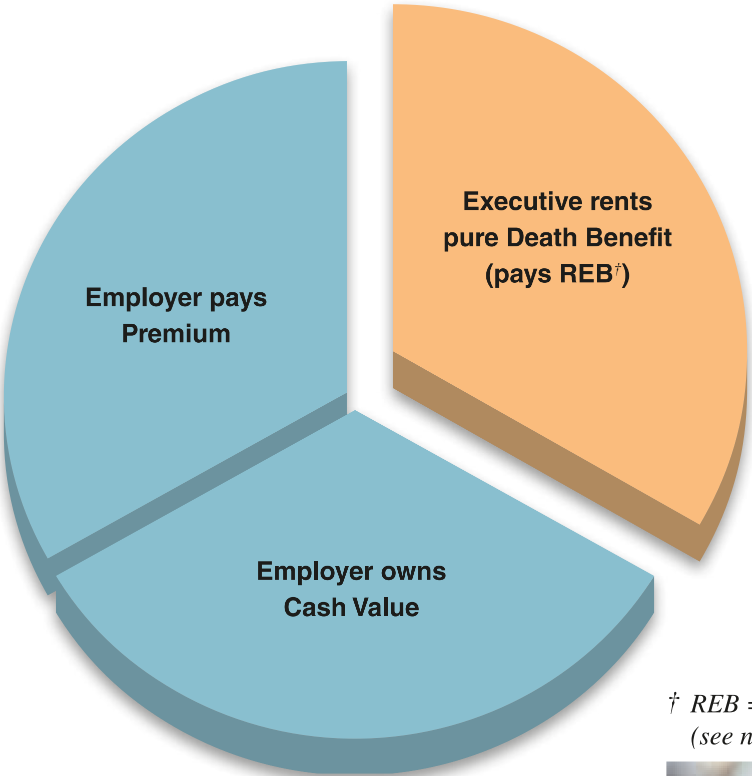
- Company cannot recover its costs

Issues for Executive

- Executive must recognize bonus payments as taxable income
- If the arrangement is terminated, policy may lapse unless executive pays premiums

Is affordability in a benefits arrangement a priority for you? Would you like to provide an attractive benefit for your key employees without committing the set amounts required under an NQDC plan or an Executive Bonus Arrangement?

If you answered yes to these questions then a split-dollar arrangement may be right for you.[13] A split-dollar arrangement is a method of sharing the benefits of a cash value life insurance policy. If you are an employer who either already owns key-person policies on your executives or are anticipating purchasing those policies, a split-dollar arrangement is a great way of offering death benefit protection to your executives at no extra cost to you.



† REB = Reportable Economic Benefit (see next page)

A split-dollar arrangement is a method of sharing the benefits of a cash value life insurance policy.

12 *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

13 *Split-dollar arrangements may be affected by the Sarbanes-Oxley Act of 2002 which prohibits personal loans by public companies to their directors and executive officers. Additionally, final split-dollar regulations have been adopted by the IRS that may impact the taxation of split-dollar arrangements entered into after September 17, 2003 in many circumstances. Please contact your tax and legal advisors for further guidance.*

Typically, in a split-dollar arrangement the employer either pays the bulk of the premium while the executive pays a small portion of the premium equal to the reportable economic benefit (REB), which is the term cost of the death benefit coverage.[14] Alternatively, the employer can pay the entire premium while the executive pays tax on the amount of the REB.

Since you as the employer will be the owner of a life insurance policy on the life of the executive, you must provide written notification that you intend to purchase the life insurance policy and the maximum amount of life insurance that you intend to purchase.

Benefits for Company

- Company owns life insurance policy and retains cash value[6]
- Cash value is general asset of company that can be accessed tax-free[7]

Issues for Company

- Premiums are not tax-deductible
- If executive pays REB,[14] that portion is taxable to company

Benefits for Executive

- Federal income tax-free death benefit protection[15]
- Can be used in conjunction with NQDC

Issues for Executive

- No basis for payment of REB
- REB becomes more expensive as executive ages

Conclusion

In the fight to retain your top performers, remember that you have tools at your disposal that can help provide a competitive edge. Whether you're looking for control and flexibility, simplicity and deductibility, or affordability in a benefit design, the Competitive Edge strategies using life insurance may provide the added incentives to keep your key executives with your organization, and keep your organization on top.

14 *Final Split-Dollar Regulations (Treas. Reg. Sec. 1.61-22(d)(3)(ii)) reserved the issue of the cost of current life insurance protection for future guidance. Until such guidance is issued, Notice 2002-8 states that taxpayers may continue to use the insurance carrier's published one year term rates or the Table 2001 rates for arrangements entered into prior to January 28, 2002. For arrangements entered into after that date, taxpayers are generally limited to the Table 2001 rates.*

15 *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

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Pacific Life Insurance Company
Newport Beach, CA
(800) 800-7681 • www.PacificLife.com

Pacific Life & Annuity Company
Newport Beach, CA
(888) 595-6996 • www.PacificLife.com

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