Executive Benefits/Non-qualified Plans in a High-Tax, Low-Interest Environment

*Construction Industry*

February 11, 2014

BOSTON | CHICAGO

www.pinnadefinancialconsultants.com
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David Hauptman
Managing Director
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57% US workers report < $25,000 household savings/investments

28% of Americans have no confidence they will have enough money to retire comfortably - highest in study's 23-year history

1 in 3 babies born today will live to 100!
CFOs were asked, “How, if at all, have your retirement plans changed in the last five years?” Their responses were:

- **I plan to spend fewer years working than I had intended five years ago**: 6%
- **I plan to spend more time working than I did five years ago**: 7%
- **I am more uncertain and cannot predict when I will retire**: 38%
- **Retirement plans are unchanged**: 49%

Source: PLANSPONSOR.com, “Executives May Be Rethinking Retirement.” February 21, 2013
The Need To Defer

85% INCOME REPLACEMENT GOAL
Source: Income Replacement Goal was derived from data provided in the 2008 Georgia State University/Aon Consulting Replacement Ratio Study.

Social Security

Final Income

$150,000

$250,000

$350,000

401(k)

Replaced at Retirement

% of Income

ASSUMPTIONS
• Age 45 retiring at 65, 20 years of retirement payout
• Max 401(k) contribution each year
• Assumed $17,500 in 2013; inflation rate thereafter (rounded to the nearest $500)
• Level 401(k) payout

6% RATE OF RETURN
ASSUMPTIONS

- 45 years old
- Plans to retire at 65
- $75K starting 401(k) balance
- Makes maximum annual contribution, including catch-up
- Earning 6%
- **4% annual salary growth**
Future of Retirement – The Numbers

- 1935 - Social Security ACT signed by FDR
- 17 Cents - First payment to Ernest Ackerman – lump sum
- 1965 - Medicare passed into law
- 64 – life expectancy in 1935
- 2024 – Medicare will run out of money
- 2033 - Social Security will run out of money
# The Changing Landscape of US Taxes

<table>
<thead>
<tr>
<th>TAX</th>
<th>2012</th>
<th>2013+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Federal Income Tax</td>
<td>35%</td>
<td>39.6%¹</td>
</tr>
<tr>
<td>Medicare Tax on Investment Income</td>
<td>0%</td>
<td>3.8%²</td>
</tr>
<tr>
<td>Capital Gains Tax</td>
<td>15%</td>
<td>20%¹</td>
</tr>
<tr>
<td>Dividends Tax</td>
<td>15%</td>
<td>20%¹</td>
</tr>
<tr>
<td>Social Security Payroll Tax</td>
<td>4.2%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Medicare Payroll Tax</td>
<td>1.45%</td>
<td>2.35%³</td>
</tr>
<tr>
<td>Top Gift and Estate Tax</td>
<td>35%</td>
<td>40%</td>
</tr>
<tr>
<td>Personal Exemption Phaseout</td>
<td>-</td>
<td>Reduced by 2% for each $2,500 exceeding threshold⁴</td>
</tr>
<tr>
<td>Itemized Deduction Limitations</td>
<td>-</td>
<td>Reduced by 3% of the amount exceeding threshold⁴</td>
</tr>
</tbody>
</table>

¹ Imposed on taxpayers with ordinary income exceeding $450,000 for joint filers ($400,000 for individuals)  
² Imposed on taxpayers with Adjusted Gross Income exceeding $250,000 for joint filers ($200,000 for individuals)  
³ Imposed on wages in excess of $250,000 for joint filers ($200,000 for individuals)  
⁴ Imposed on taxpayers with Adjusted Gross Income of $300,000 and above for joint filers, $275,000 for Heads of Household, $250,000 for Single filers and $150,000 for taxpayers Married Filing Separately – not to exceed 80%
Nonqualified Deferred Compensation Plans

Prevalence of NQ Plan Types by Ownership Classification

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>All Respondents (%)</th>
<th>Public (%)</th>
<th>Private (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NQDCP</td>
<td>90.8</td>
<td>91.3</td>
<td>89.7</td>
</tr>
<tr>
<td>Nonqualified defined benefit SERP</td>
<td>43.8</td>
<td>48.0</td>
<td>34.9</td>
</tr>
<tr>
<td>Phantom stock</td>
<td>6.0</td>
<td>6.1</td>
<td>5.8</td>
</tr>
<tr>
<td>Restricted stock/RSUs</td>
<td>43.4</td>
<td>60.9</td>
<td>41.5</td>
</tr>
<tr>
<td>Stock options</td>
<td>41.5</td>
<td>57.5</td>
<td>32.4</td>
</tr>
<tr>
<td>Incentive program</td>
<td>30.9</td>
<td>32.4</td>
<td>27.9</td>
</tr>
<tr>
<td>None</td>
<td>11.7</td>
<td>20.4</td>
<td>38.4</td>
</tr>
</tbody>
</table>

* Based on 2012 PLANSPONSOR Executive Benefits Survey.
## 401(k) versus NQDC

<table>
<thead>
<tr>
<th>Qualified Plan - 401(k)</th>
<th>NQDC</th>
</tr>
</thead>
<tbody>
<tr>
<td>• For all employees</td>
<td>• For the highly compensated</td>
</tr>
<tr>
<td>• Up to $17,500 for 2013</td>
<td>• No statutory max contribution</td>
</tr>
<tr>
<td>• $23,000 for those age 50 and over</td>
<td>• Up to 80% salary and</td>
</tr>
<tr>
<td></td>
<td>• 100% bonus earned</td>
</tr>
<tr>
<td>• Payout at 59½ without penalty</td>
<td>• Penalty-free payouts at any age, while still employed or after</td>
</tr>
<tr>
<td>• Investment options</td>
<td>• Investment crediting options</td>
</tr>
<tr>
<td>• Must be formally funded</td>
<td>• Cannot be formally funded</td>
</tr>
<tr>
<td>• Protected by ERISA</td>
<td>• Not constrained by ERISA’s participation, funding, vesting or fiduciary provisions</td>
</tr>
<tr>
<td></td>
<td>• Participants are general creditors of the company</td>
</tr>
</tbody>
</table>
# NQDC Pros and Cons

<table>
<thead>
<tr>
<th>Plan Advantages</th>
<th>Unique Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defer amounts in addition to a 401(k)</td>
<td>Bankruptcy or insolvency of Company (general creditor status)</td>
</tr>
<tr>
<td>Opportunity to accumulate additional amounts with compounded pre-tax savings</td>
<td>Investment risk (mitigate with 3%-4% fixed rate)</td>
</tr>
<tr>
<td>Reduce current income taxes (lower AGI)</td>
<td>No rollovers to IRA; not portable</td>
</tr>
<tr>
<td>Distribution and investment flexibility to plan for life events (payouts while still employed)</td>
<td>Future tax rates uncertain</td>
</tr>
<tr>
<td>Fixed rate 3%-4% (if funded with COLI)</td>
<td></td>
</tr>
<tr>
<td>Rabbi Trust segregates assets, protects against change of control</td>
<td></td>
</tr>
</tbody>
</table>
Plan AND operation must be compliant with 409A including:

- No distributions for 6 months following separation of service
- May not change deferral elections during the plan year
- No deferral realized gains from exercising stock options
- No use of trusts that place assets outside the reach of creditors
- Participants must have “substantial risk of forfeiture”
- No unscheduled withdrawals (except in the event of hardship)
- No acceleration of scheduled distributions

**PENALTIES**

*Fully taxable plus 20% additional tax plus retro interest*
Executive Benefits – Misconceptions

- I have to offer the plan to all employees
- It will impact my bonding capacity
- Owners will not be able to participate
- Too complex to include family members
- Plan is expensive to maintain
- Plan will not help me retain top performers
- Plan does not make sense if tax rates rise
Plan Design Levers to Achieve Goals

Plan features that will “Attract, Retain, Reward”

- Company match – extend 401(k) match to NQDC plan
- Pre-tax deferred retention/sign-on bonus
- Pre-tax performance bonus – company paid if performance criteria are met
- Ability to defer at least 75% of total compensation
- Eligibility beyond just the C-suite
- In-service distributions – elect payout as early as three years from deferral date
- Post-retirement distributions – distributions over as many as 10-20 years
- Investment lineup covers all market sectors including alternative investments
- Attractive fixed rate alternative 3%-4% plus death benefit (if COLI)
- Pre-retirement death benefit for participants
Non-qualified Plan Alternatives – 2 Choices

• **Defined contribution (DC)** - program where company may contribute annually:
  – Performance bonus based on meeting criteria
  – Sign-on bonus
  – Vesting from above provides retention element
  – Executives may reduce income by deferring pre-tax compensation
  – Tax deduction on contribution and earnings at distribution

• **Defined Benefit (DB)** - Supplemental Executive Retirement Program (SERP)
  – Tax deduction at distribution

• May offer pre-retirement death benefit for both DC and DB plan
Non-qualified Plan and Bonding Capacity

- Goal – offer non-qualified program without adverse “Bonding”
- Company may informally fund non-qualified program
  - Assets remain on company “books”
  - Unfunded liabilities adversely impact bonding
- Rabbi trust may result in lost bonding capacity since trustee owns assets
- Company must weigh bonding versus plan participant benefit security
  - Rabbi trust not prevalent in construction industry
Restricted Executive Bonus Arrangement

- IRS “Bonus 162” Program
- REBA -- impact on employer
  - Tax deductible to employer immediately
  - Helps attract and retain (vesting requirement)
  - May have adverse bonding impact
- REBA -- impact on executive
  - Pay tax now not later (employer may bonus the tax)
  - Asset grows tax free
    - May be fixed rate or market based
    - Tax free retirement income
    - Tax free death benefit
    - Estate enhancement planning opp
What are Informal Funding Options?

• No Funding
  – “Unfunded” plan
  – Potential benefit risk

• Taxable Securities
  – Range of investment alternatives — all market sectors and top managers
  – Most effective if company is not a tax payer; Net Operating Losses (NOLs) > longer than five years
  – Some tax and accounting limitations

• Life Insurance (COLI)
  – Range of investment alternatives — all market sectors and top managers
  – Most effective if company is “generally” a tax payer; NOLs < five years
  – Generally superior accounting treatment relative to taxable securities
  – Affords tax-deferred asset build-up and tax-free death benefit

• Hybrid (Taxable Securities & COLI)
  – Most effective when company currently not taxpayer; NOLs 3-10 years
Succession Planning

- Help future management/owners “buy out” current owners
- Allows executive or family member to “retire”/let go
- Avoid burdening next generation, “social security syndrome”
- Can be linked to buy sell or partnership agreements
- Offers security and sign of commitment to non family member executives
- Effective program ensures long term management loyalty
  - Attract and retain “right” talent long term
# Informal Funding Comparison

<table>
<thead>
<tr>
<th>Comparison</th>
<th>Taxable Investments</th>
<th>COLI *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large selection of available funds</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Simple to implement</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Can match 401(k) breadth of funds</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Quality investment choices and advisors that can provide valuable</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>diversification to existing 401(k) funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxation on investment, dividends, and interest</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Taxable event when changing allocation</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Tax due on any unrealized gains upon Plan withdrawal</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Tax-deferred investment income</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Annual expenses</td>
<td>Minimal</td>
<td>Initially higher; tax advantages outweigh insurance costs</td>
</tr>
<tr>
<td>Tax-free proceeds</td>
<td>No</td>
<td>Yes**</td>
</tr>
<tr>
<td>Cash accumulation tracks deferred compensation balances</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Eliminates taxes on investment income</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax-free access to cash to make benefit payments</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Can be accretive to corporate earnings</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Taxation of life insurance is subject to IRC sections 72, 101, 817, 7702 and 7702A and assume the taxpayer is not in AMT. Please consult your tax advisor for additional information.

**See Notes on Life Insurance and Notes on Life Insurance Distributions located at the back of this report for additional detail on when death proceeds are tax-free as well as other important information.
Informal Funding

Prevalence of Informal Funding Asset Types

- Corporate owned life insurance (COLI)
  - All Respondents: 45.5%
  - Rev > $1B: 43.7%
  - Rev < $1B: 44.3%

- Mutual funds/taxable securities (i.e., not inside of COLI)
  - All Respondents: 43.6%
  - Rev > $1B: 38.8%
  - Rev < $1B: 40.5%

- Company stock
  - All Respondents: 13.6%
  - Rev > $1B: 9.5%
  - Rev < $1B: 1.8%

- Cash
  - All Respondents: 33.0%
  - Rev > $1B: 20.0%
  - Rev < $1B: 28.5%

* Based on PLANSPONSOR Executive Benefits Survey.
Prevalence of COLI

Prevalence of COLI as a Funding Vehicle for Nonqualified Benefit Liabilities

2007 2008 2009 2010 2011 2012

All Public Private
COLI vs. Taxable Investment*

This chart incorporates hypothetical values that, while believed to be accurate, are not guaranteed nor are they a representation of past or future results. Actual results will vary. See Notes on Life Insurance located elsewhere in this report for additional detail.

The hypothetical taxable security values have been prepared to assist in analyzing informal funding alternatives. These values are not guaranteed nor are they a representation of past or future results. Investments in securities involve risks, including the possible loss of principal. When redeemed, shares may be worth more or less than their original value.

The preceding chart illustrates the effect of the income tax characteristics of life insurance on after-tax results by assuming, hypothetically, that each alternative generates the same pretax rate of return.

<table>
<thead>
<tr>
<th></th>
<th>Taxable Securities (50% Turnover)</th>
<th>Corporate-Owned Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax Return</td>
<td>7.00%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Impact of Income Tax</td>
<td>(2.70%)</td>
<td>0.00%</td>
</tr>
<tr>
<td>Impact of Insurance (Charges)/Gains</td>
<td>0.00%</td>
<td>(0.48%)</td>
</tr>
<tr>
<td>Life of Investment Net After-tax Return</td>
<td>4.30%</td>
<td>6.52%</td>
</tr>
</tbody>
</table>

SAVINGS USING COLI 2.22%

* Assumes capital gains tax rate and ordinary income tax rate is 40%
Case Study #1

Issues / Challenges

• No NQDC in place
• Failed discrimination testing – executives receive refunds
• Company considering adding safe harbor – large expense

Solutions

• Implemented NQDC “Wrap” plan – eliminate refunds from failed testing
• Includes company contributions tied to performance
• Fund plan with hybrid COLI and mutual funds
• Insurance acquired on key executives
  – Death benefit provided for both executives and ownership
• Improved ability to save for retirement – attract and retain
• Avoided expense of safe harbor plan
Case Study #2

Issues / Challenges
• 401(k) plan and NQDC with large 401(k) plan provider
• Little NQDC expertise and service – 409A violations
• Low plan participation – 14 out of 56 eligibles
• Significant tax cost from mutual fund taxable gains in Rabbi Trust

Solutions
• Converted to expert with both 401(k) and NQDC expertise
• Improved communication and education increased participation to 39 of 56
• Improved technology and administrative oversight and accountability
• Implement hybrid funding COLI and mutual funds
• Resulted in P&L pickup and reduced tax cost
• Added death benefit for executives
Case Study #3

Issues / Challenges

• 409A violations
• NQDC funded with “retail” COLI – insurance expenses > taxes
• Low plan participation – only 9 out of 38 eligible
• Money Market portfolio crediting close to 0%; no other fixed-rate choice
• Distributions limited to termination, no in-service

Solutions

• Exchanged to institutional insurance carrier; lower insurance charges
• Significant incremental P&L pick-up
• Added “while active” distributions and fixed rate crediting option
• Education initiatives increased participation to 31 out of 38 eligible
• Improved technology and administrative oversight and accountability
Why Implement a Plan?

No Current Nonqualified Plan in Place

- Low-cost method to deliver benefits
- Fill retirement savings gap
- Discrimination testing make-up – 401(k) “Wrap” plan
- Reduce current taxable income in new high tax rate environment
- Make-up for qualified plan limits
- Education/communication → Participation
- Succession planning
Currently Have Nonqualified Plan in Place

- Due diligence/Audit plan design and funding
- Identify plan strengths, weaknesses and actionable opportunities:
  - Is the plan compliant with current regulatory requirements?
  - Is this plan helping plan sponsors reach their goals?
  - Is this plan helping plan participants reach their goals?
  - Is the communications program driving enrollment?
  - Can the cost of the plan be reduced? What is the impact of an informal funding strategy and alternatives?
  - Is current funding vehicle most appropriate and competitive?
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• Be a leader in corporate citizenship.

Executive Benefits

• Clients range public and private mid-size companies to Fortune 1000
• Over $1B in nonqualified retirement assets under management
• David Hauptman, Partner and Managing Director
  ✓ Over 25 years experience
  ✓ Renowned for incisive plan assessments, executive education and optimal, compliant plan design solutions
Notes on Life Insurance

The charts and spreadsheets in this document incorporate hypothetical cash and death benefit values from sample variable life insurance contracts typical of the contracts available for sale today. The values are included for illustration purposes only and do not constitute an offer or a solicitation for the sale of any security or insurance product. Offers of securities may only be made by prospectus. The sources of the hypothetical values are computer-generated illustrations produced by software provided by the sample carriers. The computer-generated illustrations are not intended to be, and should not be relied upon as, either a representation of past performance or a prediction or forecast of future results. Rather, the purpose of the illustrations is to show how the performance of the contract's underlying investment accounts could affect the contract's cash and death benefit values in future years.

Copies of the computer-generated illustrations used in incorporating the hypothetical values are available upon request. The computer-generated illustrations also provide hypothetical values based on guaranteed maximum contract charges and on a zero percent rate of return applied to the contract's underlying investment accounts.

For additional and more detailed information about the life insurance contracts set forth in this report, ask to see the prospectus. Copies of the prospectus are available at the address listed at the front of this document. Please read it carefully before you invest.

Variable life insurance products are long term programs and may not be suitable for all investors. The acquisition of variable life insurance entails fees and charges and is subject to fluctuating values of the underlying investment options. Variable life insurance entails risks, including the possible loss of principal. Early withdrawals may trigger tax penalties. The death benefit coverage of variable life insurance is based on the claims-paying ability of the insurance company.

Values in “Alternative Investments’ After-Tax Results” Illustrations

Source of Variable Life Insurance Values – The “Alternative Investments’ After-Tax Results” illustrations incorporate hypothetical values from a variable life insurance contract based on the assumptions set forth in this report. The hypothetical values are not a prediction of future investment results. The contract is typical of those variable life products currently being marketed by life insurance companies to major corporations to informally fund nonqualified plans.

Ownership, Insurable Interest and Consent – The owner and beneficiary of the life insurance contract is illustrated as being the employer. Therefore, it is assumed that the employer has an insurable interest in the employee insured and that the employee has consented to the employer’s purchase of the contract.

Timing of Life Insurance Cash Flows – The illustration is based on the assumption that no loans or cash withdrawals will be taken from the life insurance contract during the insured’s life, but rather, that the investment return cash flows from the life insurance contract will be received as income tax-free death proceeds at the time of the insured’s death. If loans or cash withdrawals were to be taken from the life insurance contract prior to the insured’s death, the contract’s death benefit would be reduced (or eliminated), income tax might be due, and the contract’s rate of return would be lowered.

Net After-Tax Return Analysis – The illustrated net after-tax return for the life insurance contract is a calculated internal rate of return value based on (i) assumed cash outflows for premiums paid and (ii) assumed cash inflows for death proceeds received. The insurance expenses figure is solved for as the difference between the calculated net after-tax return and the assumed hypothetical pretax gross rate of return, net of money management expenses. The net after-tax return, being based on a life of contract analysis, does not represent either the actual growth of cash value each year or the actual incidence of insurance expenses each year.

“Trading” Versus “Available for Sale” – SFAS 115 outlines two approaches for the accounting of mutual funds. An alternative to the “Trading” method illustrated here is “Available for Sale”. Under the “Available for Sale” approach all realized gains flow through the earnings statement. Unrealized gains bypass the earnings statement and go to Shareholder Equity. Results under this approach are similar to the high turnover results under “Trading”. Accounting pronouncements are not 100% clear on which approach, if either, is always appropriate to reflect the accounting of mutual funds used within a rabbi trust. For more information, contact your accountant.
If a life insurance policy is deemed a Modified Endowment Contract (MEC) under IRC § 7702A, all distributions are generally taxed as income to the policyowner to the extent there is a gain in the policy. Distributions are treated first as gain (if any), then as cost basis. Distributions from a MEC may also be subject to an additional penalty tax of 10% on amounts includable in gross income.

Assuming a life insurance policy is not a MEC, withdrawals (but not loans) are generally taxed under the “cost recovery rule” and are taxable only to the extent the withdrawal exceeds the cost basis of the policy. However, during the first 15 policy years, some withdrawals may be taxed under the “gain first rule” as described in the recapture ceiling provisions of IRC § 7702(f)(7). If a loan is outstanding when a life insurance policy is surrendered or lapses, the loan is automatically repaid from the cash surrender value of the policy and generally results in taxable income to the extent the net surrender value plus the amount of the repaid loan exceeds the cost basis of the policy.