It's All About the Business

Planning Strategies Integrated with Life Insurance to Help a Business Owner Accomplish Retirement, Business and Estate Planning Goals.

PACIFIC LIFE

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1. Introduction

3. Step Planning Process

4 Step 1
6 Step 2
8 Step 3

11. Planning Strategies

12 Cross-Purchase Buy-Sell
13 Defined Benefit Buy-Out
14 Employee Stock Ownership Plan (ESOP)
15 Entity Purchase Buy-Sell (a.k.a. Stock Redemption)
16 Estate Liquidity Planning Using an Entity Redemption
18 Executive Bonus
19 Insured Controlled Cross-Purchase
20 Irrevocable Life Insurance Trust (ILIT)
21 Key Person Life Insurance
22 Life Insurance for Risk Protection (LIRP)
23 Nonqualified Deferred Compensation (NQDC)
26 One-Way Buy-Sell
27 Personally-Owned Life Insurance
28 Restricted Executive Bonus
30 SERP Buy-Out
31 Split Dollar (Endorsement)
32 Split Dollar (Loan Regime)
33 Split-Funded Defined Benefit Plan
35 Split Premium Bonus Arrangement
37 Wait-and-See Buy-Sell

<table>
<tr><td colspan="2">Investment and Insurance Products: Not a Deposit</td><td colspan="2">Not Insured by any Federal Government Agency</td></tr>
<tr><td colspan="2">Not FDIC Insured</td><td>No Bank Guarantee</td><td>May Lose Value</td></tr>
</table>

Ignoring Important Issues Involving Your Business Won't Make Them Go Away

Have you avoided planning because you don't want to face certain issues involving your business? It's easy not to think about challenging issues such as retiring, transitioning to a lesser role in your business, or facing your own mortality. But putting off planning and ignoring these issues will not give you peace of mind.

- How can I ensure my business will continue to thrive when I'm not around?
- How do I successfully transition the ownership of the business?
- How can I enjoy a comfortable retirement?
- How will the business provide for my family if something should happen to me?
- How do I treat my children fairly?
- How can I leave a legacy to my children?

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What could happen if you don't take action?

Your business and your legacy may not survive your death.

- 75% of small business owners do NOT have a succession plan in place[1] and only about a third of family-owned businesses are transferred successfully to the next generation.[2]

Your business may not be able to sufficiently provide for your family after your death.

You may not have sufficient retirement income if you are counting on your business to be the primary source of that income.

- According to the Exit Planning Institute, up to 80% of businesses will never sell.[3]

You may not be able to treat your non-business children fairly.

The value of your business may decline if you are unable to retain key people critical to its success.

- More than 50% of all organizations globally have difficulty retaining some of their most valued employee groups.[4]

Imagine using your business to help you accomplish your goals for retirement, perpetuating a family business, or successfully transitioning it to your key employees...

1 "75% of Small Businesses Don't Have Succession Plan: Two groups to help with planning," Mackenzie Hoeferlin, available at https://www.daytondailynews.com/news/75-of-small-businesses-dont-have-succession-plan-two-groups-to-help-with-planning/4K7IHJ6CZBBM (February 21, 2021).
2 "Do Most Family Businesses Really Fail by the Third Generation?," Justin Baron and Rob Lachenauer, available at https://hbr.org/2021/07/do-most-family-businesses-really-fail-by-the-third-generation (July 19, 2021).
3 "Warning: Your Business is Not a Retirement Fund!," Just Goodbread, available at https://www.kiplinger.com/business/small-business/entrepreneurship/603901/warning-your-business-is-not-a-retirement-fund (December 11, 2021).
4 "20 Surprising Employee Retention Statistics You Need to Know," George Dickson, available at https://blog.bonus.ly/10-surprising-employee-retention-statistics-you-need-to-know (September 22, 2021).

3 Steps to Turn Your Concerns Into a Plan for Success

How You and Your Life Insurance Producer Can Work Together

1 **Identify Your Top Planning Concerns** Identify your top planning concerns by answering a few questions. Then, prioritize your top concern. Discuss your concerns and goals with your life insurance producer.

2 **Identify and Implement the Strategies that Best Fit Your Situation** Work closely with your tax and legal advisors to determine which strategies will help address your concerns and move you closer to your goals.

3 **Fund Your Planning Strategies** Funding each strategy can be critical to its successful implementation. You may have several options for funding. You should consider all of the options and choose the method that best suits your situation. During this final phase of the planning process, you should work closely with your life insurance producer.

Identify Your Top Planning Concerns

Answer the following questions below in Section 1 to identify your top planning concerns. Then, in Section 2, prioritize your top concerns. Once you have prioritized your top concerns, then locate your top concern in step 2 in order to determine which strategy may best addresses it.

STEP 1

SECTION 1

Answer the following questions below to help identify your areas of concern

I. Protecting the Business Against the Loss of Key Employee(s)

a. Are there any individuals including yourself whose loss (if the individual voluntarily left or died) would pose a significant financial hardship to the business? ○ Yes ○ No
   - If yes, has your business taken any steps to protect itself financially in the event of the death of one of these key employees ○ Yes ○ No
   - If yes, has your business implemented strategies that are having a meaningful impact on retaining your key employee(s)? ○ Yes ○ No

II. Business Succession

a. Do you currently have a formal plan in place? ○ Yes ○ No
   - If yes, does it reflect your current goals regarding how you would ideally like to exit your business? ○ Yes ○ No

III. Retirement Planning

a. Do you have adequate retirement assets other than the business so that you're not so reliant on the business as your sole source of retirement income? ○ Yes ○ No

IV. Estate Planning

a. Is your estate large enough that you may be subject to federal or state estate taxes upon your death? ○ Yes ○ No
   - If yes, do you have adequate liquidity so that estate taxes do not adversely impact your ability to pass on your business to your heirs? ○ Yes ○ No

b. Do you have non-business heirs that you want to ensure are treated fairly as part of your estate plan? ○ Yes ○ No
   - If yes, do you have adequate non-business assets to accomplish your goal of treating them fairly? ○ Yes ○ No

c. Is your business the primary source of financial support for your family? ○ Yes ○ No
   - If yes, if something were to unexpectedly happen to you, do you feel confident that your family will be provided for? ○ Yes ○ No

SECTION 2

Listed below are the potential planning concerns covered in the questions above.
Using the chart below, identify your area of top planning concerns. In column 1, please indicate which areas of concerns you checked "No." In column 2, check the one you feel is your primary need.

Potential Areas of Concern	Check if a "No" Response	Top Concern?
I. Business is Protected Against the Loss of Key Employees • Business is protected against the death of a key employee		
• Business has implemented a plan to retain key employee(s)		
II. Business Succession • I have a plan in place that reflects current goals to transfer or transition the business		
III. Retirement Planning • I have adequate retirement assets		
IV. Estate Planning • I have adequate liquidity to pay for estate taxes		
• I have non-business assets to treat non-business heirs fairly		
• My family will be adequately provided for in the event of my death		

Based on the checked box(es), locate your primary area of concern and then, proceed to Step 2 and use the chart that applies to your primary area of concern.

STEP 2

Consider the Strategies that Address Your Top Concern Identified in the Chart from Section 2

Primary Area of Concern is Business Succession

Does this describe you?	Strategies to Consider
My business has multiple owners, and we would like to sell our interests to each other.	*Entity Purchase Buy-Sell (p. 15)* *Cross-Purchase Buy-Sell (p. 12)*
My business has multiple owners, and we would like to sell our interests to each other, but we also have a need for supplemental retirement income.	*Insured Controlled Cross-Purchase (p. 19)*
My business has multiple owners, and we would like to sell our interests to each other, but we want flexibility as to how the purchase is ultimately handled.	*Wait-and-See Buy-Sell (p. 37)*
My business has multiple owners and I want to sell my interest to one or more co-owners, but there is no mutual intent to sell on their part.	*One-Way Buy-Sell (p. 26)* *Entity Purchase Buy-Sell (p. 15)*
My business has multiple owners and I want to sell my interest to one or more co-owners, but there is no mutual intent to sell on their part. I want flexibility as to how the purchase is ultimately handled.	*Wait-and-See Buy-Sell (p. 37)*
I want to sell my business interest to a non-owner, such as a key employee, family member or third party.	*Defined Benefit Buy-Out (p.13)* *SERP Buy-Out (p.30)* *One-Way Buy-Sell (p. 26)*
My business is a C-Corp or S-Corp. I have no readily available successor or buyer of my business interest and would consider having the business become employee-owned.	*Employee Stock Ownership Plan[5] (p. 14)*

5 Limited to C and S-Corporations

Primary Area of Concern is Protecting the Business Against the Loss of a Key Employee

Does this describe you?	Strategies to Consider
I want to preserve the value of my business and keep it thriving for many years by incentivizing my key employees to remain with the business.	*Executive Bonus (p.18)* *Split Premium Bonus Arrangement (p.35)* *Restricted Executive Bonus (p. 28)* *Nonqualified Deferred Compensation (p. 23)* *Split Dollar (Endorsement) (p.31)* *Split Dollar (Loan Regime) (p.32)*
I want to protect my business in the event of the premature death of one or more key executives.	*Key Person Life Insurance (p. 21)*

Primary Area of Concern is Retirement Planning

Does this describe you?	Strategies to Consider
My business currently has an existing qualified retirement plan with matching contributions. My business does not currently offer a qualified retirement plan but I have a small business with relatively few non-owner employees.	*Split-Funded Defined Benefit Plan (p. 33)*
My business employs more than a few employees and does not currently offer a qualified retirement plan.	*Life Insurance for Risk Protection (p. 22)*

Primary Area of Concern is Estate Planning

Does this describe you?	Strategies to Consider
I want my estate to have sufficient liquidity so that estate taxes[6] and other costs do not adversely impact the business or my succession or exit plan.	*Estate Liquidity Planning Using an Entity Redemption (p. 16)* *Irrevocable Life Insurance Trust (p. 20)*
I want my family to be taken care of upon my death without being dependent upon the continued success or disposition of the business.	*Irrevocable Life Insurance Trust (p. 20)* *Personally-Owned Life Insurance (p. 27)*
I want to ensure that any non-business heirs are treated fairly.	*Irrevocable Life Insurance Trust (p. 20)* *Personally-Owned Life Insurance (p. 27)* *Estate Liquidity Planning Using an Entity Redemption (p.16)*

6 [According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).]

Fund Your Planning Strategies

There are many different ways to fund your planning strategies. For example, depending on the strategy, you may be able to fund them by using current cash flow from the business, obtaining a business loan, or setting aside a sinking fund. In many cases, however, cash value life insurance may be the most flexible way to fund your various planning strategies. Use the following grid to find examples of how life insurance may address the concerns you identified earlier.

STEP 3

What are your concerns?	How Life Insurance Can Help
I want to sell my business eventually. • How can I successfully sell my interest in the business during my lifetime or at death to a family member, co-owner, third party or employee(s)?	• Death benefit can provide funds to purchase your business interest at death. Cash value acts as a tax-deferred sinking fund for purposes of purchasing your business interest during your lifetime.
My business is highly dependent upon one or more key employees. • How can I ensure the continued success of my business throughout the transition process? • How can I make sure my business continues to succeed if I lose a key employee?	• Cash value can be used to informally fund an executive benefit plan to help you retain key employees essential to the continued success of your business. • Death benefit can provide funds to help your business recover from the death of a key employee. • Death benefit can provide funds to pay off business debt that may otherwise be called, and to ensure that the business is more financially secure.
I want to make sure I have a comfortable retirement. • How can I secure a retirement that is less dependent on the continued success of the business and/or the disposition of my interest in the business?	• Cash value can provide a potential source of supplemental retirement income so that you and your family are not as dependent upon the business for retirement income. • Death benefit can address a short-fall in retirement income for a surviving spouse should you die prematurely.
I want to provide financially for my family and protect my business in the event of my death. • How can I provide for my family independent of the continued success of the business? • How do I treat my non-business heirs fairly? • How do I make sure that estate taxes do not adversely impact the business?	• Death benefit can provide funds for your family so that they aren't dependent upon the continued success of the business after your death. • Death benefit can provide funds to treat children not involved in the family business fairly. • Death benefit can provide funds to pay estate taxes[7] to make sure your business doesn't need to be sold and that it passes intact to your children.

7 [According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011)]

Why choose cash value life insurance to fund your planning strategies?

Cash value life insurance not only offers considerable flexibility as to its potential uses, but it is also a tax-efficient asset. It offers the following combination of features not available with other types of assets:

1. Tax-free death benefit payable to the life insurance policy's named beneficiary.[8]
2. Tax-deferred treatment of any increase in cash value.
3. Tax-free distributions from the cash surrender value.[9]

Life insurance is subject to underwriting and approval of the application and will incur monthly policy charges. In general, additional premium is required to continue coverage of the policy. Policy may lapse if premium is insufficient to continue coverage.

Buy-Sell Funding

A common misconception is that term life insurance should be used because it provides the lowest cost way to provide funds in the event of a business owner's death. The use of term life insurance may be short-sighted, however, because the more likely scenario is that a business owner will sell the business during his or her lifetime. Term life insurance does not provide any funding for a lifetime sale because it has no cash value.

Cash value life insurance, on the other hand, provides funds in the event of the business owner's death and acts as a tax-deferred vehicle for purposes of a lifetime buyout. If the business owner leaves the business due to retirement, disability, etc., the owner of the policy has income tax-free[10] access to the policy's available cash surrender value in order to effectuate a lifetime buy-out.

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 For federal income tax purposes, 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.

10 See note 9.

Now is the time to start planning.
Take control of your future.

Integrated business succession & exit planning
Advanced planning strategies using cash value life insurance

Cross-Purchase Buy-Sell

WHAT IS IT? A cross-purchase arrangement is a type of business continuation plan best suited for a business with few business owners. The cross-purchase arrangement requires departing business owners or the estates of decedent business owners to sell their interest in the business to the remaining business owners at an agreed upon price. The agreement can apply to one or more of the existing business owners (i.e., it can apply only to those owners that choose to participate). A properly structured cross-purchase arrangement allows for continuity of management, a source of income for the business owner and his or her family, and a clear direction for future ownership of the business.

HOW DOES IT WORK? Working with their legal, tax, and financial professionals,[11] the participating business owners enter into a cross-purchase agreement. The agreement will require the participating business owners to purchase other participating business owners' interests in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g., death, disability, or retirement). The participating business owners will purchase a cash value life insurance policy on each of the other participating business owners' lives in order to fund the purchase obligation(s). Each participating business owner will pay the premiums and will be the beneficiary of the respective policies. At the first business owner's death or departure from the business, the other participating business owners will use the life insurance death benefit proceeds or the available cash surrender value to purchase the decedent or departing business owner's interest.

CONSIDERATIONS:

- Purchasing business owners may receive an increase in basis equal to purchase price of their interest in the business.
- Cash value of life insurance owned on co-owner(s)' lives may be included in decedent business owner's estate
- May require a large number of life insurance policies depending on the number of business owners participating. Total number of policies needed = (number of participating business owners) x (number of participating business owners - 1).

11 In order to sell life insurance, a financial professional must be a properly licensed and appointed life insurance producer.

Defined Benefit Buy-Out

WHAT IS IT? A defined benefit buy-out is a combination of a one-way buy-sell in conjunction with a defined benefit plan to provide a business owner with the desired amount of funds that he or she needs to retire from the business. This strategy may work well in situations where a business owner would like to sell the business to a key employee or family member. The challenge in these instances, however, is when the buy-outs are solely structured as installment buy-outs. The more needed from the business, the more financial stress placed on the business – which means, the more likely the business will fail. If the business fails, the business owner's desire to ensure the business succeeds may be dashed and his/her retirement income needs are jeopardized. Therefore, rather than just relying on the one way buy-sell arrangement, combining it with a defined benefit plan may reduce the future cash flow burden on the business and also help provide a more stable and predictable income stream for the business owner.

HOW DOES IT WORK? Working with their legal, tax and financial professionals,[12] a business owner establishes a one-way buy-sell plan funded with a life insurance policy and combines it with a defined benefit plan. The starting point, however, is to figure out the amount of funds the business owner needs to retire comfortably. Once the business owner makes this assessment, a defined benefit plan is established to provide a lump-sum amount of the portion of the desired total while the remaining portion needed by the business owner is sold to a key employee or family member on an installment basis. This will allow a business owner to help fund his/her retirement benefit during his/her pre-retirement years and lessen the installment buyout cash flow burden on the business after he or she retires. Not only does this better prepare the business owner for retirement, but the contributions the business makes to the defined benefit plan are generally tax-deductible to the business. An added feature of a defined benefit plan is that the assets inside the plan are protected from the owner's or the business's creditors under the Employee Retirement Income Security Act of 1974 (ERISA).

Whether a business owner funds his/her retirement with a defined benefit plan or a one-way buy-sell with life insurance, the source of money is coming from the same place- the business. Therefore, with a defined benefit plan in place, a business owner may prepare and achieve their retirement goals while also ensuring the business successfully transitions to a key employer or family member.

12 In order to sell life insurance, a financial professional must be a properly licensed and appointed life insurance producer.

Employee Stock Ownership Plan (ESOP)

WHAT IS IT? ESOPs are a special type of qualified profit-sharing plan that invest primarily in employer securities. If an S or C-Corporation owner doesn't have an heir, co-owner, or outside buyer interested in taking over the business, or wants the business to end up being employee-owned, an ESOP can be an effective vehicle for creating a source of funds to purchase the owner's interest in the company. Not only does the ESOP create a buyer for the business owner's stock, but a C-Corporation business owner (but not an S-Corporation owner) can use the sale proceeds to purchase "qualified replacement property" and defer taxation on the sale of the stock to the ESOP. This allows a C-Corporation owner to sell part or all of the business to the ESOP without immediate taxation and use the proceeds to diversify his or her assets through the purchase of qualified securities.

HOW DOES IT WORK? Working with its legal, tax and financial professionals,[13] the business has a feasibility study conducted to determine whether an ESOP plan makes sense for the company. Assuming that an ESOP plan is feasible, the company sets up and makes tax-deductible contributions to a qualified plan. All full-time employees with a year or more of service are normally included. The company contributes cash to buy existing shares from a business owner who desires to sell his or her stock. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Once the stock is in the ESOP, it is then allocated to accounts for individual employees on a non-discriminatory basis, and it vests over time. When employees leave the company, they receive their vested ESOP shares, which the company generally is required to buy back at an appraised fair market value.

Cash value life insurance owned by the company is oftentimes used to informally "fund" the company's repurchase obligation. Policy cash values can accumulate tax-deferred and can potentially be accessed income tax-free[14] for annual stock repurchases. In addition, any death benefit proceeds paid may be received by the company income tax-free,[15] and can create an immediate source of funds to repurchase stock in the event of an untimely death of a major participant or shareholder.

13 See note 11.
14 See note 9.
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).

Entity Purchase Buy-Sell (a.k.a. Stock Redemption)

WHAT IS IT? An entity purchase plan is a type of business continuation plan that may be best suited for a business with three or more business owners. The entity purchase plan requires the business to purchase a departing or deceased business owner's interest in the business at an agreed upon price. The agreement can apply to one or more of the existing owners (i.e., it can apply only to those owners that choose to participate). A properly structured entity purchase plan may allow for continuity of management, a source of income for the business owner or his or her family, and a clear direction for the future ownership of the business.

HOW DOES IT WORK? Working with their legal, tax, and financial professionals,[16] the business and the business owners enter into an entity purchase agreement. The agreement will require the business to purchase the participating business owners' interests in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g., death, disability, retirement). The business will purchase a cash value life insurance policy on each of the participating business owner's lives in order to fund the purchase obligation. The business will pay the premiums and be the owner and beneficiary of the policies. At the business owner's death or departure from the business, the business will use the death benefit proceeds or the available cash surrender value to purchase the business owner's interest.

16 In order to sell life insurance, a financial professional must be a properly licensed and appointed life insurance producer.

Estate Liquidity Planning Using an Entity Redemption

WHAT IS IT? One of the more common ways to address the challenge of estate liquidity is through an irrevocable life insurance trust (ILIT). When an individual's gifting capacity poses a problem, however, one alternative is to purchase life insurance inside a business (using business dollars) to help provide estate liquidity to pay for state/federal estate taxes and other estate settlement costs and treat non-business heirs fairly. For business owners who have the majority of their net-worth in their business, this strategy provides estate tax liquidity using life insurance without the use of an ILIT and potentially without direct or indirect estate inclusion.

- No Direct Estate Inclusion: While a personally owned policy is included in your estate,[17] a life insurance policy owned by and for the benefit of your business should not be directly included in your estate.[18] This is because the incidents of ownership of the policy are not attributed to the business owner. What is included in the estate is the pro rata share of the business. This may or may not reflect the value of the life insurance proceeds received by the business.
- No Indirect Estate Inclusion: Two Federal Courts have ruled that when the business owns life insurance that is intended to fulfill an obligation under a valid buy-sell agreement, those life insurance proceeds should not be added to the value of the business when calculating its fair market value.[19] To that end, the life insurance proceeds paid to the business may be offset by an obligation to pay those proceeds to an individual's estate in an entity buy-out.[20] As one Court noted, this approach is "consistent with common sense."[21]

17 IRC Sec. 2042
18 Estate of Knipp v. Comm'r, 25 TC 153 (1955), acq. in result, 1959-1 CB 4; Rev. Rul. 83-147, 1983-2 CB 158.
19 See Estate of Blount v. Comm'r, 428 F.3d 1338 (11th Cir. 2005); see also Estate of Cartwright v. Comm'r, 183 F.3d 1034 (9th Cir. 1999). "[T]he insurance proceeds are not the kind of ordinary non-operating asset that should be included in the value of [the business] under the treasury regulations. . . . the insurance proceeds are offset dollar-for-dollar by [the business'] obligation to satisfy its [buy sell] contract with the decedent's estate. . . To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a [buy sell] liability strains credulity and defies any sensible construct of fair market value." Id. at 1346.
20 Id.
21 Estate of Cartwright v. Comm'r, 183 F.3d 1034 (9th Cir. 1999). "The [Tax] Court, however, properly determined that [the business' life] insurance policy would not necessarily affect what a willing buyer would pay for the firm's stock because it was offset dollar-for-dollar by [the business'] obligation to pay out the entirety of the policy benefits to Cartwright's estate." Id.
22 In other to preserve the tax-free nature of the death benefit proceeds, the requirements of IRC Section 101(j) must be met prior to the issuance of the life insurance policy. The business must provide written notice it intends to buy life insurance on the life of the business owner. The notice must state that the business will be the beneficiary of the policy and may remain so even after the insured no longer is employed by the business. Additionally, the notice must state the maximum amount of life insurance that he business will own of the life of the insured. After the notice is provided, the insured must provide written consent to the business to purchase the life insurance.
23 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).

HOW DOES IT WORK? Working with your business' legal, tax and financial advisors, determine the amount of life insurance needed to pay federal and/or state estate taxes or to provide funds to equalize with non-business heirs. Once that is determined, working with your legal advisor, a special purpose entity redemption agreement is entered into which requires the business to redeem a portion of the business equal to the amount of life insurance proceeds at death. This potentially creates an off-setting liability so that the life insurance doesn't increase the value of the business, thus causing unintentional adverse estate tax consequences. To fund the purchase obligation, the business purchases a life insurance policy on the business owner's life (or the life of the business owner and his/her spouse).[22] The business pays the policy premiums and is the policy beneficiary. At death, the business receives the life insurance death benefit potentially income tax-free.[23] The business uses the death benefit proceeds to purchase part or all of the interest in the business from the estate. The executor of the estate may use the cash from the redemption proceeds to pay federal and/or state estate taxes and other estate settlement costs or to equalize with non-business heirs.

Executive Bonus

WHAT IS IT? An executive bonus using life insurance is a flexible executive benefits planning alternative to split-dollar and nonqualified deferred compensation plans. It's a strategy that an employer can implement that may provide the executive a way to fund an individually-owned life insurance policy with the additional life insurance death benefit protection and cash value accumulation for supplemental retirement income that he or she may need.

HOW DOES IT WORK? The business enters into an agreement with the executive to assist with the purchase of a life insurance policy through a series of taxable bonuses. The bonuses are potentially tax-deductible for the business.[24] The executive will use the bonuses to purchase an individually-owned cash value life insurance policy. The executive will name a personal beneficiary for the policy's death benefit. The executive may access the available cash surrender value of the life insurance policy tax-free through loans and withdrawals for emergencies or other financial needs.[25] Keep in mind that the cash value accumulates without current taxation to the policy owner. At the executive's death, the life insurance death benefit proceeds may be paid to the executive's heirs income tax-free.[26]

CONSIDERATIONS:

- Generally provides an income tax-free death benefit to executive's family
- Bonuses may be tax-deductible for the business
- Employer cannot recover its cost
- Design is simple and a third-party administrator is generally not required
- The benefits provided can be custom tailored for each executive

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

25 Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits. For federal income tax purposes, 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.

26 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).

Insured Controlled Cross-Purchase

WHAT IS IT? An insured controlled cross-purchase arrangement is a way for business owners to fund their buy-sell agreement and simultaneously accumulate cash for their future supplemental retirement income needs.

HOW DOES IT WORK? Working with their tax, legal, and financial advisors,[27] the partners will enter into a cross purchase buy-sell agreement. The insured purchases a life insurance policy on his or her own life and names the beneficiary (e.g., a family member) of the policy for an amount equal to at least the policy's cash value. The insured enters into a private endorsement split-dollar agreement with the business partner. As part of the split-dollar arrangement the insured then endorses a portion or all of the death benefit in excess of the cash value of the policy to his or her business partner.[28] The endorsee/business partner pays a reportable economic benefit (REB) cost for the death benefit amount endorsed. If the insured dies, the beneficiary named by the insured receives the insured's portion of the death benefit. The remainder will be paid to the insured's business partner. The business partner may use these funds to purchase the decedent's interest in the business under the terms of the buy-sell agreement. If the partners outlive the need for the buy-sell agreement, they may release the endorsements and terminate the split-dollar agreements. The insureds may then access their life insurance policy's available cash value through tax-free loans and withdrawals[29] for emergencies or supplemental retirement income needs.

CONSIDERATIONS:

- The insured retains control over his or her own policy, including any available cash value
- There is no need to swap policies if the buy-sell agreement is terminated
- The purchasing partner may receive a step-up in basis in the partnership interest they acquire
- If the buy-sell is no longer needed, the parties may terminate the split-dollar agreements and continue to own policies on their own lives
- Both the insured and the endorsee must be partners in a valid partnership to avoid violating the transfer-for-value rule

27 In order to sell life insurance a financial advisor must be a properly licensed and appointed life insurance producer.
28 Both the insured and the endorsee must be partners in a valid partnership to avoid violating the transfer-for-value rule. Whether an entity is a valid partnership for purposes of the transfer-for-value rule will be based upon the federal tax rules rather than state partnership law.
29 For federal income tax purposes, 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.

Irrevocable Life Insurance Trust (ILIT)

WHAT IS IT? To the extent that the business owner needs life insurance and has an estate size that is subject to potential estate taxation,[30] it may be prudent to have the life insurance owned outside the business owner's estate. An ILIT is an estate planning tool that is commonly used to accomplish this goal. It is designed to be the owner and beneficiary of a life insurance policy or policies. A properly drafted ILIT removes the life insurance policies from the insured's gross estate and thus avoids subjecting the proceeds to estate taxation. Additionally, because the ILIT is also the beneficiary of the life insurance policy, the terms of the ILIT determine how the death benefit proceeds will be distributed. A possible alternative to an ILIT is to have an adult child or children own the life insurance.

HOW DOES IT WORK? With the assistance of an attorney, the business owner establishes an ILIT to be the owner and beneficiary of a life insurance policy insuring the business owner's life or the lives of the business owner and his or her spouse. The business owner gifts cash to the ILIT in order for the trustee[31] of the ILIT to pay life insurance premiums. Whether or not these transfers are subject to gift tax depends on the business owner's ability to make annual exclusion gifts and/or to use his or her lifetime gift tax exemption.[32] If structured properly, the life insurance death benefit proceeds will be excluded from the business owner's taxable estate and, as a result, will not be subject to estate tax.

After the business owner's death, the life insurance death benefit proceeds can be used by the trustee of the ILIT to purchase assets from or lend money to the business owner's estate in order to provide the estate with the liquidity necessary to pay any estate tax due. It is important to remember that an ILIT is irrevocable and the business owner will not be able to change its terms after the ILIT has been established.

CONSIDERATIONS:

- Death benefit should be paid income tax-free[33] and estate tax-free to ILIT beneficiaries.
- ILIT trustee can use the life insurance death benefit proceeds to purchase assets from or lend money to the business owner's estate to provide estate tax liquidity.

30 See note 6.
31 The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.
32 See note 6.
33 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).

Key Person Life Insurance

WHAT IS IT? The success of a business may hinge on the ideas and leadership provided by a key executive. Depending on the executive's role, the business is at risk of losing large amounts of revenue in the event of the executive's death. Given this potential risk, it may be prudent to implement a strategy that may assist a business in the event of the key executive's sudden or unexpected death. Implementing such a "fall-back" strategy may ensure that the business is prepared to address not only the loss of income to the business attributable to that key executive's unique skills and abilities but also the need to expend substantial amounts of cash to recruit and train a replacement executive. Purchasing cash value life insurance on the life of a key executive may provide the business with the type of financial security it needs to address the loss of the key executive.

HOW DOES IT WORK? The business purchases a life insurance policy on the life of a key executive. The business, prior to issuance of the life insurance policy, must provide written notice to the executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment.[34] The business must also notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage. The business pays all of the premiums and retains all ownership rights to the policy. If cash value life insurance is utilized, the cash value of the policy will accumulate in a tax-advantaged manner. If the key executive dies while the life insurance policy is in-force, the business will receive the policy death benefit proceeds income tax-free.[35] The business may use the death benefit proceeds or available cash surrender value to sustain operations following the key executive's death.

34 In order for death proceeds payable after the executive's employment to be tax-free, the executive should be a 5% or more owner, a director, or a highly compensated employee as defined under IRC Sec. 101(j).

35 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).

Life Insurance for Risk Protection (LIRP)

WHAT IS IT? Life Insurance for Risk Protection (LIRP) is a strategy using cash value life insurance. The life insurance provides death benefit protection and acts as a potential supplemental retirement income strategy. LIRP is designed as a cash accumulation vehicle and may complement a Roth IRA.[*] In the event a client does not meet the eligibility requirements of a Roth IRA or the contribution limits are too low, a LIRP may be a Roth IRA alternative or supplement. Similarly, a LIRP is characterized by the following: (1) premiums are paid with after-tax dollars, (2) any increase in cash value is tax-deferred and (3) income can be distributed tax-free from the policy.[36] Unlike a Roth IRA, assuming the policy complies with IRC Sec. 7702 and is not a Modified Endowment Contract, there is no IRS limit on the amount of premium that can be paid. In addition, the pre-retirement death benefit may address any shortfall in retirement income for a surviving spouse. It should be noted that mortality costs are deducted from the cash value of the policy, so a LIRP makes the most sense where there is a need for the life insurance death benefit.

HOW DOES IT WORK? The business owner will purchase and personally own a cash value life insurance policy on his or her own life. If the life insurance policy is properly structured, any cash value in the life insurance policy will grow tax-deferred. At the business owner's retirement, he or she may take tax-free loans or withdrawals[34] from the policy's available cash surrender value to supplement retirement income. At the business owner's death, the beneficiaries will receive the life insurance policy's death benefit proceeds income tax-free.[37]

Life insurance is subject to underwriting, approval of the application, and will incur monthly policy charges. In general, additional premium is required to continue coverage of the policy. Policy may lapse if premium is insufficient to continue coverage.

* IRA stands for Individual Retirement Account.

36 See note 9.

37 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).

Nonqualified Deferred Compensation (NQDC)[38]

WHAT IS IT? A nonqualified deferred compensation (NQDC) plan[38] can provide attractive supplemental retirement benefits to executives who have maximized their qualified plan options. It can be an effective method for a business to attract and retain key executives. NQDC plans are made up of employee before-tax salary deferrals, business contributions, or both. The business may informally fund the promised benefit with any asset it deems appropriate, including cash value life insurance. Alternatively, the business may choose not to informally fund the benefit at all and can pay the promised benefits out of future cash flows. Participating key employees of for-profit business entities are not income taxed until they receive their benefits.

There are several types of NQDC plans available, depending on the source of money, asset administration, size of business, and structure of expected retirement benefit. The following are three of the most popular types of NQDC plans:

1. A Supplemental Executive Retirement Plan (SERP) is comprised solely of business contributions. SERPs can be either defined contribution or defined benefit in design. In a defined contribution SERP, the business informally funds the agreement with a pre-determined annual contribution and the executive's retirement benefit is equal to whatever the account balance is at retirement. In a defined benefit SERP, the business is obligated to provide a pre-determined or "defined" retirement benefit to the executive upon retirement or another specified date. SERPs typically include a vesting schedule to encourage executives to remain with the company.

2. A Voluntary Deferral Plan uses solely executive deferrals. Because they rely on salary reduction, Voluntary Deferral Plans are generally structured as defined contribution plans. Their benefits can be determined by using a hypothetical growth factor or indexed to an investment asset. This type of plan cannot contain a vesting schedule because the executive is vested immediately on all of his or her contributions.

3. A 401(k) Overlay/Mirror Plan typically is a hybrid of a defined contribution SERP and a Voluntary Deferral Plan. Typically, the executive is given the option to defer salary and bonus amounts, and the business will make a matching contribution. The 401(k) Overlay/Mirror Plan usually involves a vesting schedule for employer contributions to encourage the executive to remain with the company.

Nonqualified Deferred Compensation continued on next page.

38 Employers who establish nonqualified deferred compensation plans that contain amounts earned or vested after December 31, 2004 must comply with IRC Sec. 409A. If a nonqualified deferred compensation plan fails to meet IRC Sec. 409A's requirements, then all compensation deferred under the plan that is subject to IRC Sec. 409A for the current tax year and all preceding tax years is includible in the participants' income in the current tax year (with a 20 percent tax penalty and potential interest) to the extent that the amounts are not subject to a substantial risk of forfeiture and not previously included in the participants' gross income.

Nonqualified Deferred Compensation (NQDC) (continued)

Cash value life insurance can serve as an attractive informal funding option for the business because the policy's cash values may accumulate without any current taxation to the business. Additionally, the business may access the policy's available cash surrender values on a tax-free basis[39] in order to pay the promised benefits to the executive. Finally, life insurance policy death benefit proceeds are received by the business income tax-free.[40] Businesses may use this death benefit as a cost recovery feature to partially or wholly offset the costs of sponsoring the plan and/or to provide a pre-retirement death benefit to the executive's heirs.

As compared to the Restricted Executive Bonus (see p. 28), the NQDC arrangement funded with employer contributions has the advantage of providing much stronger "golden handcuffs" on the executive via the inclusion of a vesting schedule within the agreement.

CONSIDERATIONS:

- May provide "golden handcuffs" if business places vesting schedule on the benefits.
- NQDC plan must be offered only to "top hat" group (select group of management or highly compensated employees).
- May allow executive to accumulate retirement income in excess of what can be accumulated in a qualified plan.
- Subject to IRC Sec. 409A requirements.
- Executive's salary deferrals are pre-tax contributions to the plan.
- NQDC plans do not allow an up front tax deduction for the business' contributions to the plan.
- Cash value life insurance can serve as an informal funding vehicle. However, the life insurance must remain subject to the business' creditors at all times.
- Cash value life insurance may help provide cost recovery to business.

39 See note 9.

40 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).

HOW DOES IT WORK? With the help of an attorney, the business enters into a NQDC agreement with the executive(s), whereby the business or the executive(s) or both agree to make contributions to the plan. The agreement will detail the various distribution provisions (i.e., upon death, retirement, etc.) and whether a vesting schedule will be applied to the promised benefit. The executive's account balance will be considered a general asset of the business and subject to the business' creditors. Assuming the arrangement is structured properly, the deferrals and/or business' contributions will not be taxed to the executive until benefits are paid (assuming the business is a for-profit entity).

If the business chooses to informally fund the NQDC plan with life insurance, the business, prior to issuance of the life insurance policy, must provide written notice to each executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment.[41] Also, the business must notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage. The policy may provide the business with tax-deferred growth of the policy's cash value, and a death benefit payable to the business which may be used to pay survivor benefits to the executive's heirs.

At the executive's retirement, or earlier if stipulated under the agreement, the business will begin payment of the promised NQDC benefits. The business may access the life insurance policy's available cash surrender value to help provide the benefit payment. Keep in mind that the retirement benefit is not directly tied to the life insurance policy cash value. The policy's cash value may be greater than or less than the promised benefit. In the event of the executive's death, if stipulated under the agreement, the business may use the tax-free death benefit proceeds[42] to pay a survivor benefit to the executive's heirs.

41 The insured executive should be a 5% or more owner, a director, or a highly compensated employee as defined under both IRC sec. 101(j) and DOL Reg. Sec. 2520.104-23.

42 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).

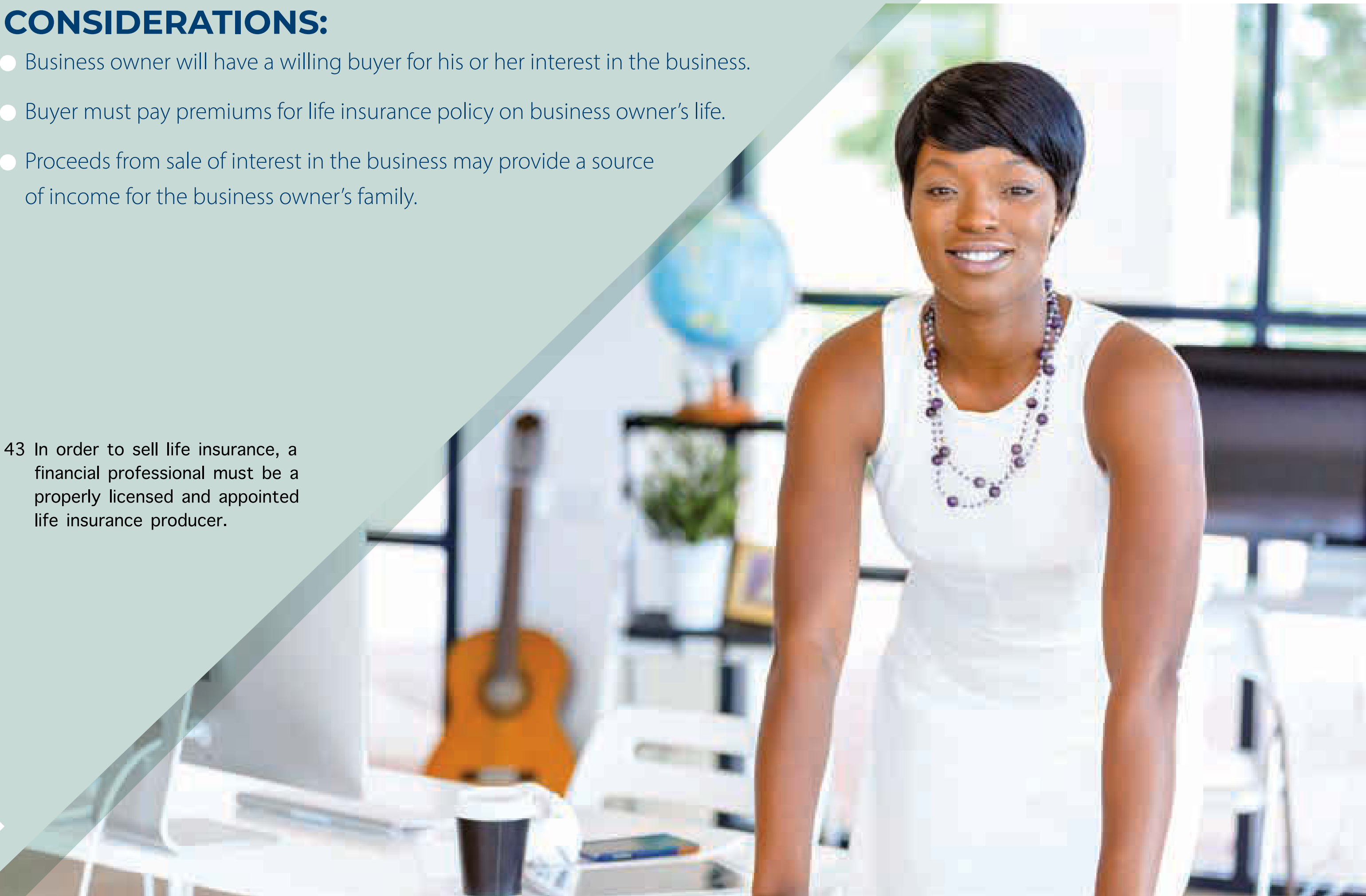
One-Way Buy-Sell

WHAT IS IT? The one-way buy-sell arrangement is designed either for (1) an owner of a business who wants to sell to someone who does not currently have an ownership interest or (2) an owner of a business who wants to arrange for the sale of his or her business interest to one or more co-owners who have no reciprocal intent to sell. The buyer in this design may be a key executive, a family member or third-party to whom the business owner wants to transfer the business. The one-way buy-sell ensures that the business owner can sell his or her business interest to an appropriate buyer.

HOW DOES IT WORK? Working with their legal, tax and financial professionals,[43] the business owner and the buyer enter into a one-way buy-sell agreement. The agreement will require the buyer to purchase the business owner's interest in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g., death, disability, retirement). The buyer will purchase a cash value life insurance policy on the business owner's life in order to fund the purchase obligation. The buyer will pay the premiums and will be the beneficiary of the policy. The business may provide the buyer (typically, if the buyer is a key executive) with a taxable bonus or a series of taxable bonuses in order to assist with the premium payments. At the business owner's death or departure from the business, the buyer uses the death benefit proceeds or available cash surrender value to purchase the business owner's interest.

CONSIDERATIONS:

- Business owner will have a willing buyer for his or her interest in the business.
- Buyer must pay premiums for life insurance policy on business owner's life.
- Proceeds from sale of interest in the business may provide a source of income for the business owner's family.



43 In order to sell life insurance, a financial professional must be a properly licensed and appointed life insurance producer.

Personally-Owned Life Insurance

WHAT IS IT? To the extent that a business owner needs life insurance but does not expect to have any estate tax liability[44] with respect to the life insurance policy, it may be prudent to own the life insurance personally. The personally-owned life insurance policy serves the dual purpose of providing death benefit protection for the designated beneficiaries as well as providing potentially income tax-free access[45] to the policy's available cash surrender value for supplemental income purposes, if needed. Note that if the inclusion of the life insurance policy in the estate becomes problematic, the policy owner can always gift the policy out of the estate at that time.[46]

HOW DOES IT WORK? The business owner will purchase and personally own a cash value life insurance policy on his or her own life, on the spouse's life, or both. If the life insurance policy is properly structured, any increase in the policy's cash value will be tax-deferred. The business owner, as owner of the policy, may take tax-free loans or withdrawals from the policy's cash surrender value to provide for any personal or business needs. At the business owner's death, his or her designated beneficiaries will receive the life insurance policy's death benefit proceeds income tax-free.[47] These funds are available to provide estate liquidity and/or to ensure that non-business heirs are treated fairly.

44 See note 7.
45 See note 9.
46 15 Pursuant to IRC Sec. 2035, the death benefit proceeds will still be includible in the insured policyowner's taxable estate if the insured dies within 3 years of gifting the policy out of the estate.
47 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).

Restricted Executive Bonus

WHAT IS IT? A Restricted Executive Bonus is a strategy that allows an executive to use business-provided dollars to fund an individually-owned life insurance policy.[48] A Restricted Executive Bonus may provide selected executives with significant benefits such as life insurance death benefit protection and cash value accumulation for supplemental retirement income, as well as provide the business with a measure of control over the life insurance policy's cash value. The Restricted Executive Bonus agreement and the policy's direction form allow the business to limit the executive's access to the policy's cash surrender value until he or she meets the terms of a restricted access schedule.

As compared to nonqualified deferred compensation (see p. 23), the Restricted Executive Bonus has the advantage of providing an immediate tax deduction of the bonus amounts paid to executives. The design may provide the business with a measure of control over its executives via a restricted access schedule as part of the agreement. Also, the life insurance is owned by the executive rather than the business; therefore, it is not subject to the business' creditors.

HOW DOES IT WORK? The business enters into an agreement with the executive to assist with the purchase of a life insurance policy through a series of taxable bonuses. The bonuses are potentially tax-deductible for the business.[49] The executive will use the bonuses to purchase an individually-owned cash value life insurance policy. The executive will name a personal beneficiary for the policy's death benefit. The business will file a direction form with the life insurance company. The direction form states that the exercise of any policy ownership rights (e.g., access to the policy cash surrender value or surrender of the policy) except for beneficiary designation requires the signatures of both the employer and the executive. A restricted access schedule can be utilized to give the executive incremental access to the policy's cash surrender value. Once the access is no longer restricted, the executive may access the available cash surrender value of the life insurance policy tax-free through loans and withdrawals for emergencies or other financial needs.[50] Keep in mind that the cash value accumulates without current taxation to the policy owner. At the executive's death, the life insurance death benefit proceeds may be paid to the executive's heir's income tax-free.[51]

48 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.

49 The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a). 12 See note 8.

50 For federal income tax purposes, 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.

51 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).

CONSIDERATIONS:

- Bonuses may be tax-deductible for the business, so strategy may be most advantageous for high tax-bracket C-Corporations.
- May provide "golden handcuffs" to help business attract and retain key executives.
- Business can control executive's access to the policy's cash value.
- Generally provides an income tax-free death benefit[51] to executive's family.
- Business does not have any beneficial interest in either the cash value or the death benefit, and will not recover its bonus outlays in the event the key executive leaves the business.

SERP Buy-Out

WHAT IS IT? A SERP buy out is both an executive retention strategy and a business transition strategy. The SERP, a type of nonqualified deferred compensation plan, serves as the executive retention vehicle by incentivizing and rewarding a non-owner key executive to stay and grow the business to eventually purchase it upon the owner's departure.

HOW DOES IT WORK? With the help of a non-qualified plan administrator and the business' legal and tax advisors, the business sets up a SERP arrangement[52] in conjunction with a one-way buy-sell arrangement. The one-way buy-sell arrangement obligates the business owner to sell and the key executive to buy the business upon a triggering event such as retirement, disability, or death of the business owner. It generally requires a significant down payment, followed by installment payments over a period of years. The SERP payment may provide the key executive the money to provide the down payment towards the purchase of the business, and is generally designed to pay out a lump-sum benefit to the key executive at a set point in time (i.e., the planned retirement date of the business owner).

To fund the SERP buyout, the business purchases a cash value life insurance policy (as an informal funding vehicle for the SERP) on the key executive.[53] To protect against the premature death of a business owner, the key executive may purchase a term policy on the business owner's life, which is intended to provide pre-retirement coverage, as well as post-retirement coverage throughout the length of the installment term.

53 SERP is a type of non-qualified deferred compensation, subject to ERISA (Employee Retirement Income Security Act of 1974) and IRC Section 409A compliance. Please consult with you 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.

54 Please note that life insurance purchased by a business on one of its executive will reduce the executive's total life insurance capacity. This reduction in total insurance capacity may reduce or eliminate the executive's ability to purchase additional life insurance for the executive's personal needs. Life insurance is subjection to underwriting and approval of the application and will incur monthly policy charges.

Split Dollar (Endorsement)

WHAT IS IT? Endorsement Split-Dollar is a type of executive benefit intended to retain key executives. Many top executives need additional personal life insurance protection. Endorsement Split-Dollar is a strategy that is intended to assist key executives to meet pre-retirement life insurance death benefit needs.

HOW DOES IT WORK? The employer purchases a life insurance policy insuring the executive. Prior to the issuance of the life insurance policy, the employer must provide written notice to the executive that it intends to continue the coverage beyond the executive's employment. The employer must also notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage. As a policyowner, the employer has the right to exercise all policy rights and nonforfeiture privileges, including the right to borrow or withdraw against the policy's cash value and the employer retains the right to change the beneficiary for its portion of the death benefit. Through an agreement, the employer "endorses," or grants to the executive, the right to designate the beneficiary part of or the entire death benefit in excess of the cash value. In the event of the executive's death, the employer will receive a death benefit at least equal to the cash value while the executive's heirs will receive the executive's portion of the death benefit income tax-free.[54]

There are generally two premium options with an endorsement split-dollar arrangement:

1. The executive will pay premiums equal to the Reportable Economic Benefit (REB) on his or her portion of the death benefit and the employer will pay the remainder of the premiums.[55]

2. The employer will pay all premiums due. The executive will pay no premiums but the REB on his or her portion of the death benefit will be taxable to the executive.

UTILIZING AS PART OF A "WAIT AND SEE KEY EMPLOYEE PLAN"

Although endorsement split dollar by itself just provides a pre-retirement death benefit to the insured key employee, it can be used as part of a broader "wait and see key employee plan" that enables the employer to wait until the key employee terminates employment to decide what to do with the policy. This potentially provides the key employee with valuable post-retirement benefits. Upon the key employee's termination of employment, the employer has several options:

1. If the key employee is departing on good terms, the employer can decide to make a discretionary bonus of the policy to the insured. The key employee would pay tax on the fair market value of the policy and the employer may receive an income tax deduction. Thereafter, the key employee will be required to pay any future premiums due, but will no longer need to pay the REB amounts.

2. The employer could choose to retain the policy as an asset of the business and keep it in force until the policy matures upon the death of the insured, at which time it could collect any death proceeds.

3. The employer could choose to surrender the policy for its cash surrender value, and recoup some, if not all, of its cumulative premiums paid.

54 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).

55 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 state 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.

Split Dollar (Loan Regime)

WHAT IS IT? A Split-Dollar Loan Regime arrangement is a type of executive benefit intended to retain key executives. It is a loan agreement between an employer and an executive to purchase needed life insurance for death benefit and supplemental retirement income.[56] Using the loan regime method, a portion or all of the premium payments would be paid by the employer, with the executive owning the life insurance policy and the policy cash value and death benefit being split between the parties as provided in the agreement in order to repay the employer its premium loans.

HOW DOES IT WORK? Working with their legal, tax and financial professionals:

- The employer and executive enter into a written loan agreement. The loan can be structured as either a term loan (which has a set date or event for repayment), or a demand loan (which allows the sponsoring business to demand repayment of the loan at any time).
- The executive purchases a personally-owned cash value life insurance policy and pays the premiums via the loans from the employer.
- The executive collaterally assigns an interest in both the cash value and death benefit of the life insurance policy equal to the loan balance to the employer as collateral for the loan. While the loan arrangement is in place, the executive does not have access to the portion of the cash value used to collateralize the loan.
- The executive must account for the appropriate interest cost for the loan on an annual basis.[57]
- The executive is able to access the cash value of the policy in excess of the loan balance. For example, if the cash value of the policy is $750,000 and the loan balance is $500,000, the executive would have access to $250,000 through tax-free policy loans and withdrawals.[58]

At some point as defined in the agreement (such as retirement, disability, or death), the arrangement terminates. The employer is repaid its interest from the policy cash value or death benefit (if applicable). If the executive is alive, he or she can access the remaining cash value through policy loans and withdrawals. If the executive is deceased, the named beneficiaries receive the remainder of the life insurance death benefit.

56 Split-Dollar loan regime may not be appropriate for publicly traded companies. The anti-loan provision that was part of the Sarbanes-Oxley Act prohibits these types of arrangements for certain executives in publicly-traded companies.

57 The amount of loan interest charged and whether the loan interest is paid annually to the sponsoring business, or, imputed in the executive's income will depend on the type and duration of the loan. The business' tax advisor should make the determination regarding how the interest will be accounted for annually.

58 For federal income tax purposes, 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.

Split-Funded Defined Benefit Plan

WHAT IS IT? A defined benefit (DB) plan is a qualified plan designed to provide the participant with a stated benefit at retirement.[59] Generally, in the case of older participants, a DB plan will allow a business to make much larger contributions to the plan than it could make to a defined contribution plan (e.g., a 401(k)-profit-sharing plan). A split-funded DB plan is simply a DB plan that is funded with both securities and life insurance. Including an incidental amount of life insurance in the plan not only allows the participant to meet his or her life insurance needs using pre-tax dollars, but also increases the annual deductible contribution without reducing the retirement income benefit.[60]

For business owners closer to retirement and behind on their retirement savings, a split-funded defined benefit plan can be an effective method for catching-up on their saving due to the age-weighted contributions allowed under the plan. However, non-discrimination rules apply to DB plans, just like any other type of qualified plan. Therefore, there may be considerable expense involved to the business for other employees that have to be included. As a result, a split-funded DB plan may be more appropriate for (1) small businesses that have relatively few non-owner employees or (2) businesses that already maintain a defined contribution qualified plan and are already incurring much of the employee expense.

Split-Funded Defined Benefit Plan continued on next page.

59 In 2022, the maximum benefit that may be provided by a defined benefit plan is $245,000 per year.
60 It is important to emphasize that the amount of plan contribution that can be allocated to the life insurance premium and the amount of death benefit proceeds that can be paid out in the event of death are limited under the "incidental death benefit" rules for qualified plans. Additionally, the use of life insurance in a qualified plan must meet certain nondiscrimination rules. Participants are urged to discuss these limitations and rules with a qualified plan third-party administrator (TPA) before placing life insurance inside a qualified plan. Experienced qualified plan TPAs can assist participants in selecting an appropriate plan design, as well as offer help, together with the plan's legal and tax advisors, in navigating the myriad of qualified plan rules and regulations to achieve specific objectives

Split-Funded Defined Benefit Plan (continued)

HOW DOES IT WORK? With the help of a qualified plan administrator and the business' legal and tax advisors, the business will establish a split-funded DB plan and make tax-deductible contributions to the plan. A portion of the business' contributions will be used to pay premiums on a life insurance policy insuring the participant's life. The plan will be the owner and beneficiary of the life insurance policy. While covered by current life insurance protection, the participant must report the current cost of life insurance protection (generally measured by the Table 2001 term rates) as taxable income each year.

If the participant dies prior to retirement, the life insurance death benefit will be paid to the plan. Upon the participant's death, the split-funded DB plan will provide a survivor benefit to the participant's heirs. This survivor benefit will include the life insurance death benefit received by the plan. If the participant included the cost of current life insurance protection in his or her income, the heirs will receive a portion of the life insurance death benefit free from income taxes.[61] If the participant retires prior to death, he or she may begin receiving taxable retirement income benefits from the plan. At retirement, the participant may (1) have the plan surrender the life insurance policy, (2) purchase the life insurance policy from the plan, or (3) take the policy out of the plan as a taxable distribution.[62]

CONSIDERATIONS:

- May be funded in part with life insurance, subject to certain limitations.
- Current cost of life insurance protection may be less than full premiums.
- May provide income tax-free[63] survivor benefit to executive's heirs.

61 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).

62 Pursuant to Revenue Procedure 2005-25, the client's tax advisor must determine the value of the life insurance policy for a purchase or distribution from the plan. Please consult with the plan administrator regarding what options are available for the life insurance policy at retirement.

63 See note 61.

Split Premium Bonus Arrangement

WHAT IS IT? A split premium bonus arrangement is a flexible and more cost-effective solution than the traditional executive bonus arrangement. It's a way to attract and retain top talent while controlling employee costs. Like an executive bonus arrangement, participating employees can provide their families with financial protection should they die prematurely. As policyowners, they may access the policy's available cash value through potentially income tax-free loans and withdrawals[64] for supplemental retirement income or for other financial needs. At death, the life insurance death benefit proceeds will be paid to his or her named beneficiaries income tax-free.[65]

Employees who have exhausted their qualified plan and/or individual retirement plan contributions may find this strategy especially attractive, as it offers them a way to save more for retirement. In addition, for business owners who do not offer a qualified retirement plan, this arrangement may be an attractive option.

Split Premium Bonus Arrangement continued on next page.

64 For federal income tax purposes, 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.

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Split Premium Bonus Arrangement (continued)

HOW DOES IT WORK? If an executive is either unable to participate in a qualified plan and/or traditional or Roth individual retirement account (IRA), or has exhausted his/her qualified plan and/or traditional or Roth IRA contributions, a split premium bonus arrangement may be a way to better prepare an executive for retirement. Before implementing a split premium bonus arrangement, however, figure out an executive's life insurance death benefit and supplemental retirement income needs beyond what the company offers. An executive may have an objection regarding a policy's various charges that may be associated with the purchase of life insurance, which may include, but are not limited to, administrative charges,[66] cost of insurance charges,[67] and optional additional benefits charges (if any).[68] By paying a portion of the policy charges which in turn may allow for an employee's portion of the premium to build cash value more effectively, the employer may overcome this objection.

Once both parties decide to move forward, the business enters into an agreement with the executive to assist with the purchase of a life insurance policy. The business has the flexibility to determine how much premium to pay and for how long, but will generally pay a portion of the premium intended to mitigate the annual cost of insurance each year that the insured remains employed with the business. The remaining portion of each life insurance policy premium is paid by the participating employee and is generally equal to the amount that he or she wants to set aside annually to save for retirement. The business' portion of the premium will be tax-deductible to the business and treated as a taxable bonus to the key employee.[69] The business may provide the employee with an additional bonus amount designed to offset the taxes he/she owes.

66 Administrative charges are generally intended to reimburse the life insurance company for the expenses associated with the administration and maintenance of the life insurance policy. These may include various items such as sales and marketing expenses and general overhead costs that are incurred by the life insurance company.

67 Cost of insurance charges (sometimes referred to as mortality charges) are charges that are levied by the life insurance company for the life insurance policy offered. Please note that these charges will typically increase over time as the insured ages.

68 Additional benefits charges generally refer to the cost of additional optional life insurance policy features, such as riders. Riders will likely incur additional charges and are subject to availability, restrictions and limitations. When considering a rider, request a policy illustration from your life insurance producer to determine the rider's impact (if an) on your life insurance policy.

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

Wait-and-See Buy-Sell

WHAT IS IT? The wait-and-see buy-sell arrangement allows business owners to postpone the choice between an entity purchase and a cross-purchase buy-sell until the death or departure of a business owner. This arrangement requires that both the business and the business owners agree to purchase a decedent or departing business owner's interest in the business at an agreed upon or determinable price. A properly structured wait-and-see buy-sell arrangement allows for continuity of management, a source of income for the business owner or his or her family, and a clear direction for future ownership of the business.

HOW DOES IT WORK? Working with their legal, tax and financial professionals,[70] the participating co-business owners enter into a wait-and-see buy-sell agreement. The agreement will require the business and the participating business owners to purchase a decedent or departing business owner's interest in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g., death, disability or retirement). Typically, the agreement grants the business the first right of refusal to purchase the decedent or departing business owner's interest in the business, and a second option to the remaining participating business owners to purchase any portion of the business interest not purchased by the business. The participating business owners purchase cash value life insurance on the lives of the other participating business owners. The policy owners will pay the premiums and will be the beneficiary of the respective policies.

At the first business owner's death or departure from the business, the business decides whether to exercise the entity purchase option. If the entity purchase option is exercised, the participating business owners contribute funds (from death benefit proceeds or the cash surrender value) to the business in exchange for an increase in basis equal to their contributions. The business then purchases all or a portion of the decedent or departing business owner's interest in the business. If the business waives the right to exercise the entity purchase option (or purchases only a portion of the business owner's interest), then the cross purchase option may be exercised. The participating business owners use the death benefit proceeds or the cash surrender value to purchase all or a portion of the decedent or departing business owner's interest. The business must purchase any portion of the business interest not yet purchased, funded with capital contributions from the remaining business owners.

70 In order to sell life insurance, a financial professional must be a properly licensed and appointed life insurance producer.

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Life insurance is subject to underwriting and approval of the application and may incur monthly policy charges.

Pacific Life does not provide qualified plan administrative services or investment advice, and does not act in a fiduciary capacity for any plan.

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