

*John Hancock*

LIFE INSURANCE

# Planning Strategies at a Glance



**INSURANCE PRODUCTS:**

Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	

## TABLE OF CONTENTS

<b>Individual Planning Concepts</b>	<b>Page</b>
Invest in Your Life . . . . .	1
Life Insurance in Retirement Planning . . . . .	3
<b>Wealth Transfer Concepts</b>	
Annuity Maximization . . . . .	5
Charitable Remainder Trusts . . . . .	7
Gifting Analysis . . . . .	9
The Leveraged Credit Shelter Trust . . . . .	11
Private Financing . . . . .	13
Spousal Access Trust . . . . .	15
<b>Business Insurance Planning</b>	
Buy-Sell Plans . . . . .	17
Cross Endorsement Buy-Sell Arrangements . . . . .	19
<b>Executive Benefit Planning</b>	
Executive Bonus Plans . . . . .	21
Non-Qualified Deferred Compensation Plans . . . . .	23



# Invest In Your Life

Many people already own life insurance and are familiar with some of its uses. But most clients don't know all of the ways that life insurance can benefit them and their families.

## **LIFE INSURANCE PROVIDES NEEDED CASH AT YOUR DEATH**

Life insurance is an excellent way for a client to make sure his/her family has the money to meet its needs should anything unexpected happen. The liquidity provided by a life insurance death benefit can:

- Pay off a mortgage or other debt
- Replace lost salary income
- Pay estate, capital gains, and income taxes
- Equalize the inheritance between the heirs.

## **LIFE INSURANCE OFFERS A COMPETITIVE "RATE OF RETURN" ON THE PREMIUMS PAID**

Some clients believe that they do not need life insurance because they are in good health and their families could receive more if they invested the money elsewhere. However, has the client taken a look at the rate of return (ROR) life insurance offers?<sup>1</sup> It can be very competitive. For instance, a \$1,000,000 John Hancock Protection UL-G 09 policy on a female, Preferred Non Smoker, age 75 would have a guaranteed premium of \$29,359. At the client's life expectancy of 16 years, the rate of return on the death benefit of \$1,000,000 based on the cumulative premiums paid would be 8.26%.<sup>2</sup> Even if death does not occur until 4 years later, age 95, the rate of return would be 4.71%.

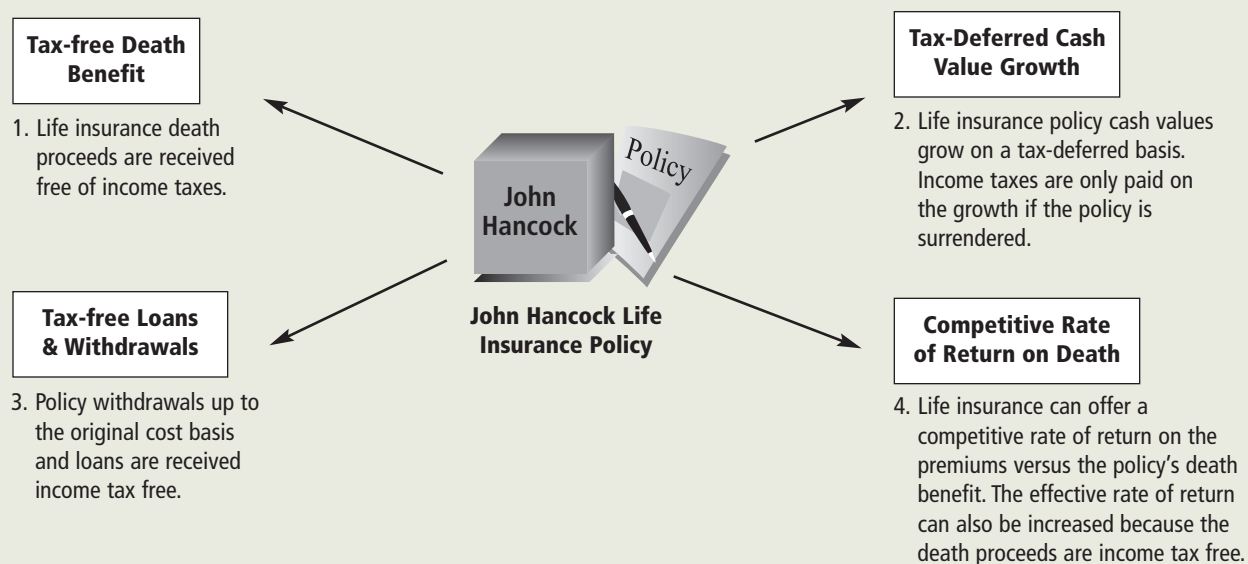
## **LIFE INSURANCE IS A TAX EFFICIENT VEHICLE**

There are many tax advantages associated with owning a life insurance policy. First, life insurance death proceeds are received by the heirs free of income taxes.<sup>3</sup> This means that the family may receive more money and a better return on the premium than if they had invested those dollars in a taxable asset. For instance, if the client in the example above had a tax bracket of 35%, the equivalent rate of return she would have had to earn in a taxable investment to equal the \$1,000,000 death benefit would have been 12.71%.

Second, life insurance policy cash values grow tax-deferred and can be accessed in a tax-favored manner. The policy owner will not be taxed on the growth in the policy's cash value unless the policy is surrendered. Furthermore, policy loans and withdrawals up to the total premium payments are received income-tax free.<sup>4</sup>

## LIFE INSURANCE CAN PROVIDE FOR “SELF-COMPLETION” OF FINANCIAL GOALS IN THE EVENT OF AN UNTIMELY DEATH

Most clients invest wisely and put away money to protect their families in the future. However, even the best investments need time for ongoing contributions and potential earnings growth. If something were to happen to a client along the way, his/her original plans may not come to fruition. The life insurance policy death benefit can facilitate “self-completion” of financial goals by providing the cash to compensate for the loss of planned contributions and earnings.



1. The rate of return (ROR) on death benefit is equivalent to an interest rate at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the net death benefit of the policy.
2. The data shown is taken from an illustration.
3. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. No legal, tax or accounting advice can be given by John Hancock, its agents, employees or registered representatives. Prospective purchasers should consult their professional tax advisor for details.
4. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than premiums paid.



# Life Insurance in Retirement Planning

For many successful people, protecting their families and planning for retirement may be some of the highest financial priorities. However, these clients may sometimes worry that there are not enough savings opportunities. 401(k)s and IRAs offer tax advantages, but are limited in the amount of money that can be contributed. What other financial tools offer tax-advantaged savings, can help supplement retirement income, and can provide death benefit protection all at the same time? Life insurance may be able to help.

## WHAT IS LIFE INSURANCE IN RETIREMENT PLANNING?

Life insurance can be a useful tool to supplement retirement planning efforts. During a client's working years, the life insurance policy death benefit can protect the family and replace income that would otherwise be lost should something happen to the client. At retirement, the client can then access any potential policy cash value via tax-favored loans and withdrawals.

## HOW DOES IT WORK?

The client will apply for a John Hancock universal life insurance policy on his/her life. The life insurance policy will provide a death benefit that will be received by the client's heirs income-tax free.<sup>1</sup> At retirement, the client may access any potential policy cash value to supplement his/her retirement income via tax-favored loans and withdrawals.

## BENEFITS

- Life insurance death benefit will be received by the heirs income-tax free.
- The life insurance policy cash value grows on a tax-deferred basis.
- As long as the policy is not designed as a Modified Endowment Contract (MEC), the client can take tax-free withdrawals up to basis and tax-free loans thereafter from the cash value.
- Withdrawals from insurance policies are not mandatory and may occur at any time or not at all, unlike distributions from qualified retirement plans which may be subject to an early withdrawal penalty at age 59½ and/or mandatory distributions at age 70½.

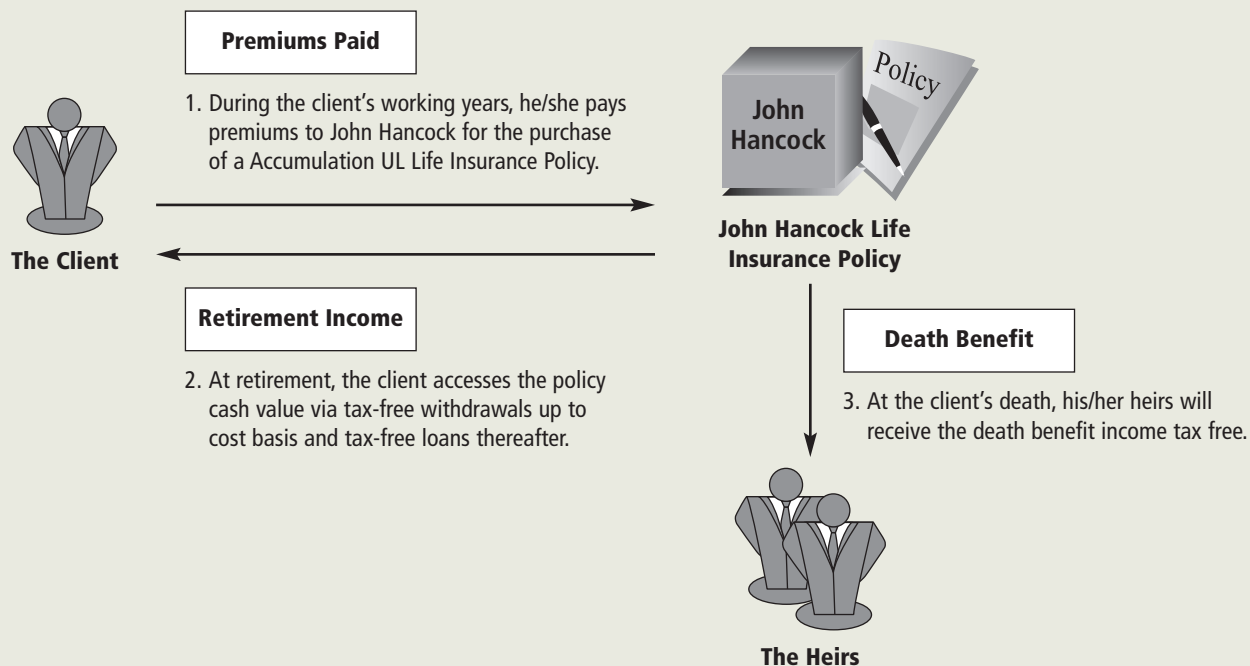
## CONSIDERATIONS

- Using life insurance to supplement retirement income is not tax-deductible.
- Care should be taken that the policy is not structured as a MEC. Policies classified as MECs may be subject to tax when a loan or withdrawal is made, and a federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. The policy cash value available for loans and withdrawals may be worth more or less than the original investment amount, depending on the performance of the policy crediting rate. Life insurance policies have surrender charges in the early policy years.
- Withdrawals and loans can reduce the policy death benefit and cash surrender value and may cause the policy to lapse. Lapse of a life insurance policy can cause the loss of the death benefit. Lapse of a life insurance policy with an outstanding loan may cause adverse income tax consequences.

## Comparison of Investment Alternatives

Feature	Life Insurance	Taxable Investments	Qualified Plan/ Traditional IRA	Roth IRA	Municipal Bonds
Tax-Favored Withdrawals	Yes	No	No	Yes	Yes
Tax-Deferred Accumulations	Yes	No	Yes	Yes	Yes
Tax-Free Death Benefit	Yes	None	None	None	None
Penalty Tax for Early Withdrawal	Maybe	No*	Yes	Yes	No
Contribution Limits	No	No	Yes	Yes	No
Cost of Insurance Charges	Yes	No*	No*	No	No
Market Risk	No	Yes	Yes	Yes	Yes

\*If the underlying investment is a deferred annuity, cost of insurance charges and/or withdrawal penalty may apply.



1. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. Please consult your professional tax advisor.



# Annuity Maximization

Many clients have worked hard to accumulate wealth and take care of their families, and like many investors, saved for retirement with tax-favored assets such as deferred annuities. Now that these clients are nearing retirement, they may realize that they have been more successful than they ever imagined and do not need additional retirement income. Instead, they would like to pass the annuities on to their heirs as a financial legacy. The problem is that while an annuity is an excellent vehicle for retirement planning, it is often a poor vehicle for wealth transfer. This is because at death, the annuity will be subject to a variety of taxes. How can a surplus deferred annuity be used to create a larger legacy? Wealth Transfer Planning with Deferred Annuities (Annuity Maximization) may be able to help.

## WHAT IS ANNUITY MAXIMIZATION?

Annuity Maximization is a way to move assets from a deferred annuity and use them to fund an Irrevocable Life Insurance Trust (ILIT).<sup>1</sup> This ILIT can then purchase life insurance on the client (and the client's spouse, if desired) and potentially increase the amount of money left to the heirs.

## HOW DOES IT WORK?

First, the client can create an income stream from the deferred annuity either by converting it to a Single Premium Immediate Annuity (SPIA approach), or by taking withdrawals as permitted under the annuity contract (withdrawals approach). Then, the client can create an ILIT and fund it with the after-tax annuity distribution, using annual exclusion gifts to avoid gift taxes. Finally, the ILIT will purchase a life insurance policy that will pass to the heirs at death, free of estate and income taxes.

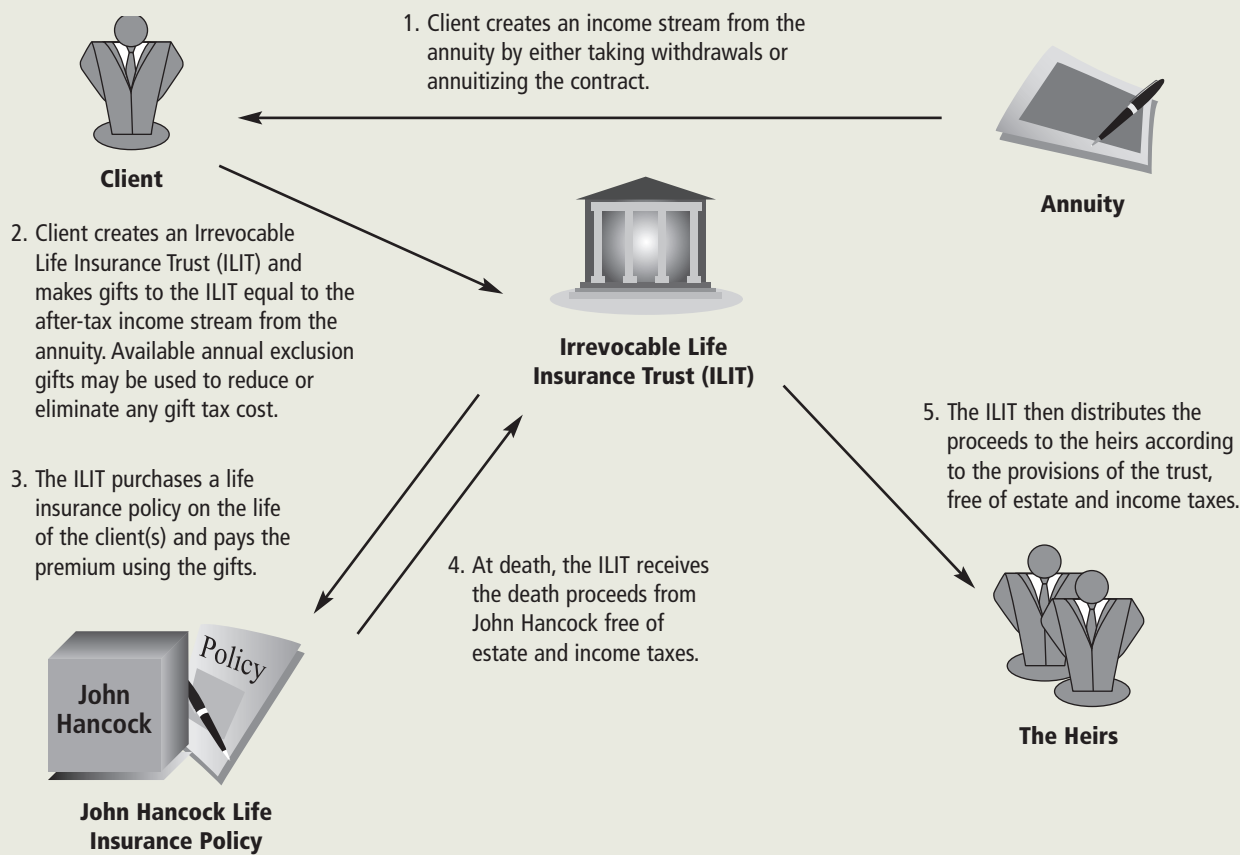
## BENEFITS

An Annuity Maximization approach can help:

- Reduce estate taxes
- Reduce income taxes in respect of a decedent
- Increase amount of money left for the heirs

## CONSIDERATIONS

- The SPIA approach generally creates a larger income stream, and one that is guaranteed for the life of the annuitant. A larger potential income stream means a larger potential death benefit for the heirs. However, once a deferred annuity is converted to a SPIA, the principal is gone and is not available in case of an emergency.
- The withdrawals approach is sometimes preferred because the client can retain access to the principal of the deferred annuity in case of an emergency. However, the income stream used with this approach is not guaranteed and is generally less than the SPIA, so less life insurance can be purchased. The withdrawals approach should not be used if the client is under age 59½ because he/she may then be subject to a 10% federal penalty tax.



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.



# Charitable Remainder Trusts

Making charitable gifts to a Charitable Remainder Trust (CRT)<sup>1</sup> can help clients to not only achieve their charitable objectives, but also to preserve their personal wealth. With a CRT, both the client and the charity benefit from the assets given away. Moreover, the asset transfer to the charity using a trust can be replaced at a discount for the family through the use of life insurance.

## HOW DOES IT WORK?

Instead of making a charitable gift directly to charity, the client can make a gift to a tax-exempt CRT to benefit a specifically named charity, or a specific cause.<sup>2</sup> A CRT can be set up for the client's lifetime, or for a period of years not to exceed 20, before the charity receives the balance of trust assets. In the meantime, the client will receive an income stream generated from the trust for the trust term. When an asset is transferred to a CRT, there is no capital gains tax on the appreciation. And, when the trust diversifies the asset, there is no tax as well, since the trust is tax-exempt.

If the trust is established as a Charitable Remainder Unitrust (CRUT), the income will be based on a stated percentage of the annual value of trust assets. The trust can also be established as a Charitable Remainder Annuity Trust (CRAT) in which the income payment is based on a fixed-dollar amount. In either case, the income paid to the client is taxable. A charitable income tax deduction may also be available at the time the client transfers the asset to the trust and is calculated based on the present value of the assets, net of the trust income to be paid.

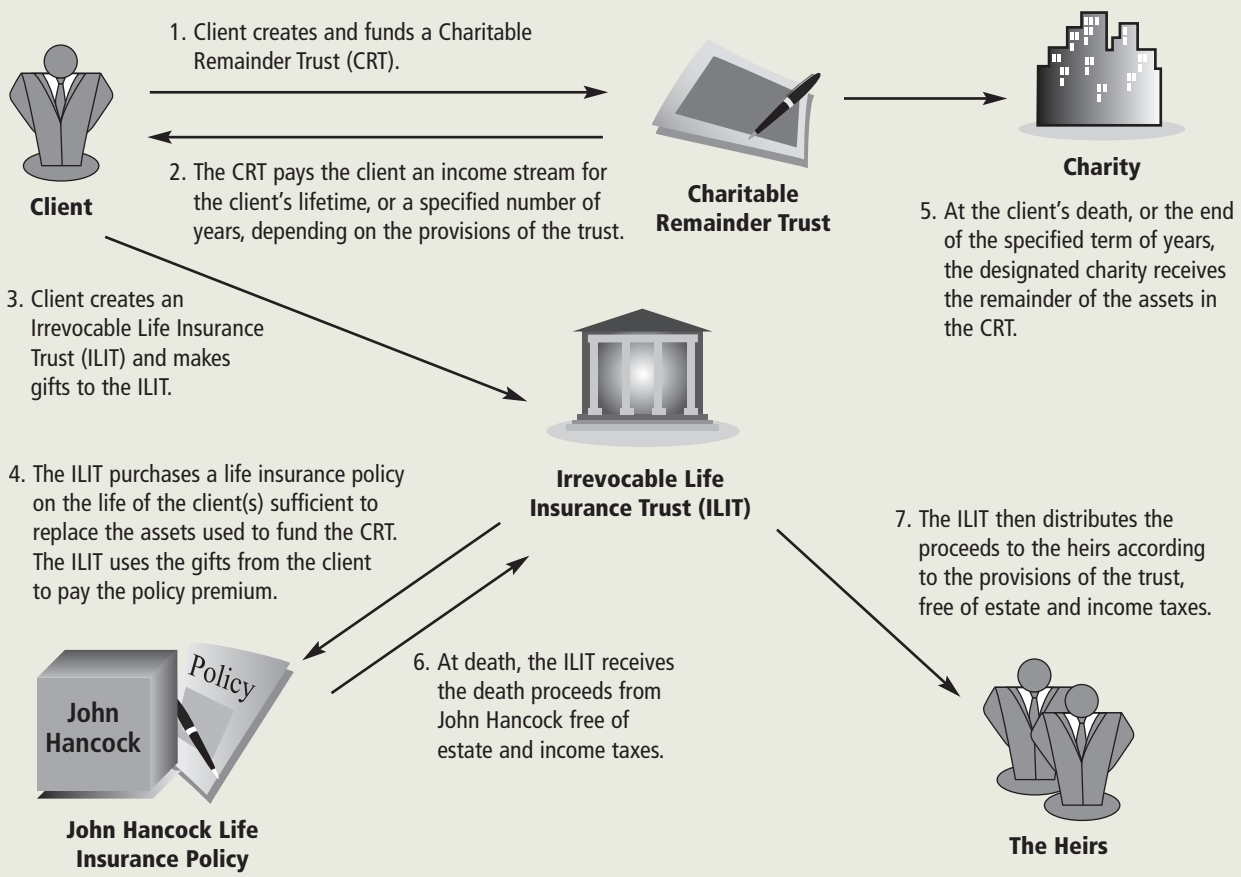
The asset given away to the charity can also be replaced for the heirs through the use of a Wealth Replacement Trust (WRT) funded with life insurance.

## BENEFITS

- Client will receive an income stream from the very asset given away. The trust is required to make the income payments, even if the payments must come from trust principal.
- Client may be eligible for a current income tax deduction for the present value of the CRT balance at the end of the trust term.<sup>3</sup>
- By giving a highly appreciated asset to the CRT, the client may avoid capital gain taxes that would otherwise have occurred if the asset were sold and reinvested.
- The client can replace the asset for his/her heirs at a "discount" by using a WRT funded with life insurance. The cost of replacing the gift for family members is the annual premiums on the life insurance policy and not the full value of the asset.

## CONSIDERATIONS

- Although the client may retain the income from the reinvested asset, the gift to the trust is irrevocable.
- The trust will incur administrative expenses, so a CRT may not be appropriate if small gifts are made.
- CRTs are subject to strict rules and limitations. In order to preserve the favorable tax treatment associated with making charitable gifts, certain rules and limitations apply. Generally, there are limits on the tax deductions allowed, the types of assets that can be transferred, the types of charities that may benefit, and the amount and types of contributions that can be made.



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. The Tax Relief and Health Care Act of 2006, which was signed into law by President Bush on December 20, 2006, includes a major change to the taxation of charitable remainder trusts (CRTs) which have unrelated business income (UBI), as defined in Section 512 of the tax code. The Act, which takes effect for tax years beginning after December 31, 2006, changes the penalty for CRTs that have unrelated business income. Instead of losing its tax-exempt status, a CRT that has unrelated business income will now be subject to a 100% excise tax on the unrelated business income. As a result of this legislation, Section 664 of the Internal Revenue Code has been amended. While the penalty is now less draconian than the loss of exempt status, it is still important for trustees of CRTs to minimize unrelated business income.
3. The income tax deduction is based on the grantor's Adjusted Gross Income (AGI) in the year that the gift is made, as well as the type of asset that is transferred to and the type of charity that will benefit from the trust. The value of the gift is calculated based on the 7520 rate, an IRS benchmark rate, the trust term and the trust income payments. See IRC §170(a); §664(e).



# Gifting Analysis

Many successful individuals have given a lot of thought to the question of how to provide for their loved ones “after I’m gone.” One of the best ways to provide for loved ones is to start preparing now. Lifetime Giving, also known as “Gifting Analysis,” can help reduce estate taxes, avoid probate, and when combined with life insurance, may also increase the amount passed to the heirs.

## WHAT IS LIFETIME GIVING?

Lifetime giving is a way to transfer money from the client’s estate to his/her heirs to reduce the size of the estate and the impact of potential estate taxes.

## HOW DOES IT WORK?

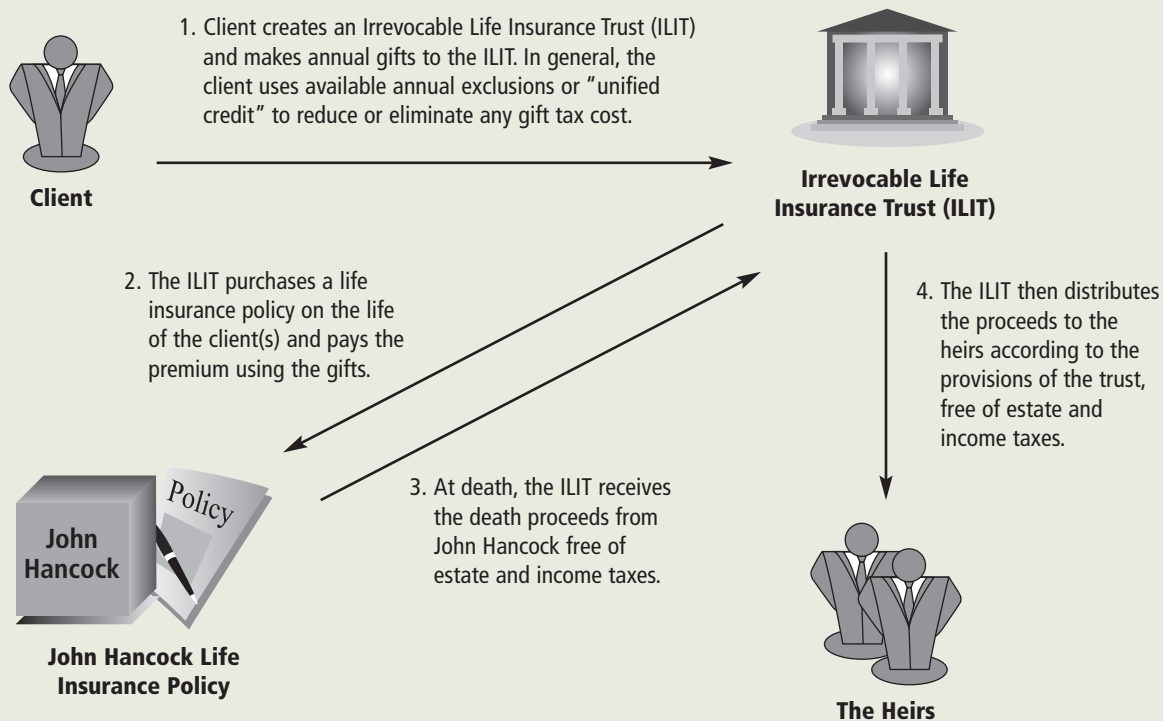
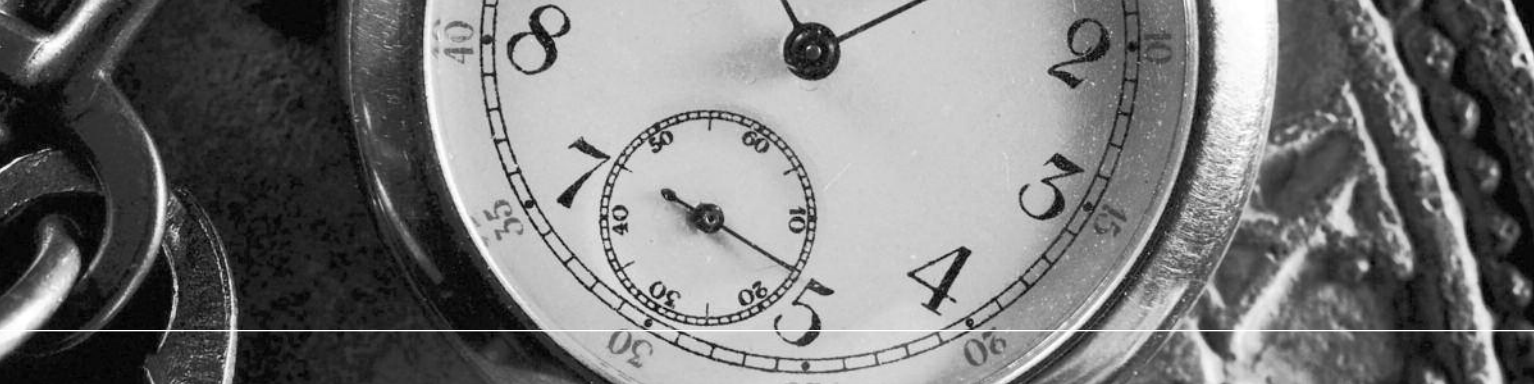
Every person is allowed to make annual gifts of up to \$13,000 per person each year without having to pay gift taxes. This type of gift is called an “annual exclusion gift,” and everyone can make as many annual exclusion gifts to as many people as desired in any given year, free of gift taxes. One very effective way to use annual exclusion gifts is to make lifetime gifts to an Irrevocable Life Insurance Trust (ILIT).<sup>1</sup> The ILIT can purchase a life insurance policy, which can be received by the trust free of estate and income taxes, potentially increasing the amount left for the heirs.

## BENEFITS

- Lifetime giving can help reduce the size of the estate and hence any potential estate taxes.
- Lifetime gifting can protect gifted assets from creditors, avoid probate for gifted assets, and protect the family’s privacy.<sup>2</sup>
- When gifts are used to purchase life insurance, lifetime giving may increase the amount of money left for the heirs.

## CONSIDERATIONS

- Transfers of assets to an ILIT are irrevocable, and once given, may only be used for the benefit of the trust beneficiaries.
- The desired life insurance policy premium may be higher than the available annual exclusion gifts.



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. Assuming the proposed initial gift was not a fraudulent conveyance meant to inhibit creditors.



# The Leveraged Credit Shelter Trust

Clients concerned about preserving assets for their heirs and minimizing gift and estate taxes may be looking for opportunities to transfer wealth more efficiently. An existing Credit Shelter Trust (CST)<sup>1</sup> is a gift tax-free way to fund a life insurance policy outside the taxable estate, leveraging the amount transferred to heirs.

## WHAT IS A CREDIT SHELTER TRUST?

A CST is an important part of most estate plans for married couples.<sup>2</sup> At the death of the first spouse, a specified amount of assets can be transferred to the trust, free of estate tax. The CST is typically designed to provide income and/or principal to a surviving spouse for life, as necessary for health, maintenance, education, and support. Alternatively and less frequently, a trust can be established and funded by each spouse during lifetime. Therefore, through proper planning, your estate tax bill can be minimized and deferred until the death of the surviving spouse.<sup>3</sup>

## HOW DOES THE LEVERAGED CREDIT SHELTER TRUST WORK?

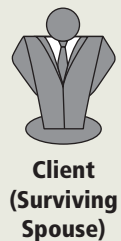
If you have a CST that is currently funded, and you are not taking income from it, the trust may purchase a life insurance policy on your life, significantly increasing its value for heirs. Since the assets are outside the taxable estate, the proceeds will not be subject to estate tax. And, no gift taxes apply to the premium, since the trust will fund the premium directly. Alternatively, if you and your spouse each have already established the trust and are currently funding the trust with tax-free gifts, you can leverage the trust assets with life insurance.

## BENEFITS

- The premiums are not subject to gift tax.
- Additional wealth can be transferred to heirs, both income and estate tax-free.
- The life insurance cash values grow tax-deferred, reducing the income tax burden on the trust.
- The life insurance proceeds are equivalent to a step-up in basis.

## CONSIDERATIONS

- The CST document or applicable state law must allow the trustee to purchase life insurance.
- In order for the life insurance proceeds to be excludable from the taxable estate, the insured must not be trustee and cannot hold a limited power of appointment over the trust. Also, the trust document or applicable state law must allow the trustee to purchase life insurance.



**Client  
(Surviving  
Spouse)**

1. The existing Credit Shelter Trust (CST) continues to pay the Client (a surviving spouse) income as provided for under the original trust provisions.



**Existing Credit  
Shelter Trust**

2. The CST then purchases a John Hancock life insurance policy on the life of the surviving spouse and pays the premium for the policy.



**John Hancock Life  
Insurance Policy**

3. At death, the CST receives the death proceeds from John Hancock free of estate and income taxes.

4. The CST then distributes not only the remaining trust principal to the heirs, but also the proceeds of the life insurance policy, potentially increasing the total amount left to the heirs.



**The Heirs**

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. As a result of the Economic Growth and Tax Relief and Reconciliation Act (EGTRRA) of 2001, the applicable exclusion amount (estate tax exemption) that is not subject to estate tax is \$3,500,000 for 2009 until the estate tax is repealed for one year in 2010. Thereafter, the applicable exclusion amount is \$1,000,000 per person. Amounts above the applicable exclusion are subject to estate tax. The lifetime applicable gift tax exclusion amount (gift tax exemption) that is not subject to federal gift tax is \$1,000,000 per person.
3. The couple must have assets titled in each other's individual names in order to take advantage of each of their estate tax applicable exemption amounts.



# Private Financing

Sometimes clients know that they need additional life insurance coverage, and have the means to pay for it. They understand that one of the best ways to purchase life insurance is in an Irrevocable Life Insurance Trust, so it will be outside of their estates and not subject to estate taxes.<sup>1</sup> However, they may not have enough annual exclusion gifts available to cover the full premium for the policy they wish to purchase without having to make taxable gifts. How can you get enough money into the ILIT to pay the premiums while reducing gift tax exposure? Private financing may be the solution.

## WHAT IS PRIVATE FINANCING?

Private Financing is an arrangement in which a client lends money to an Irrevocable Life Insurance Trust (ILIT) at the Applicable Federal Rate (AFR) so that the ILIT can purchase a life insurance policy on his/her life (including his/her spouse, if desired). Private Financing may reduce or eliminate gift taxes, as the loan interest, and not the premium, is considered the taxable gift.

## HOW DOES IT WORK?

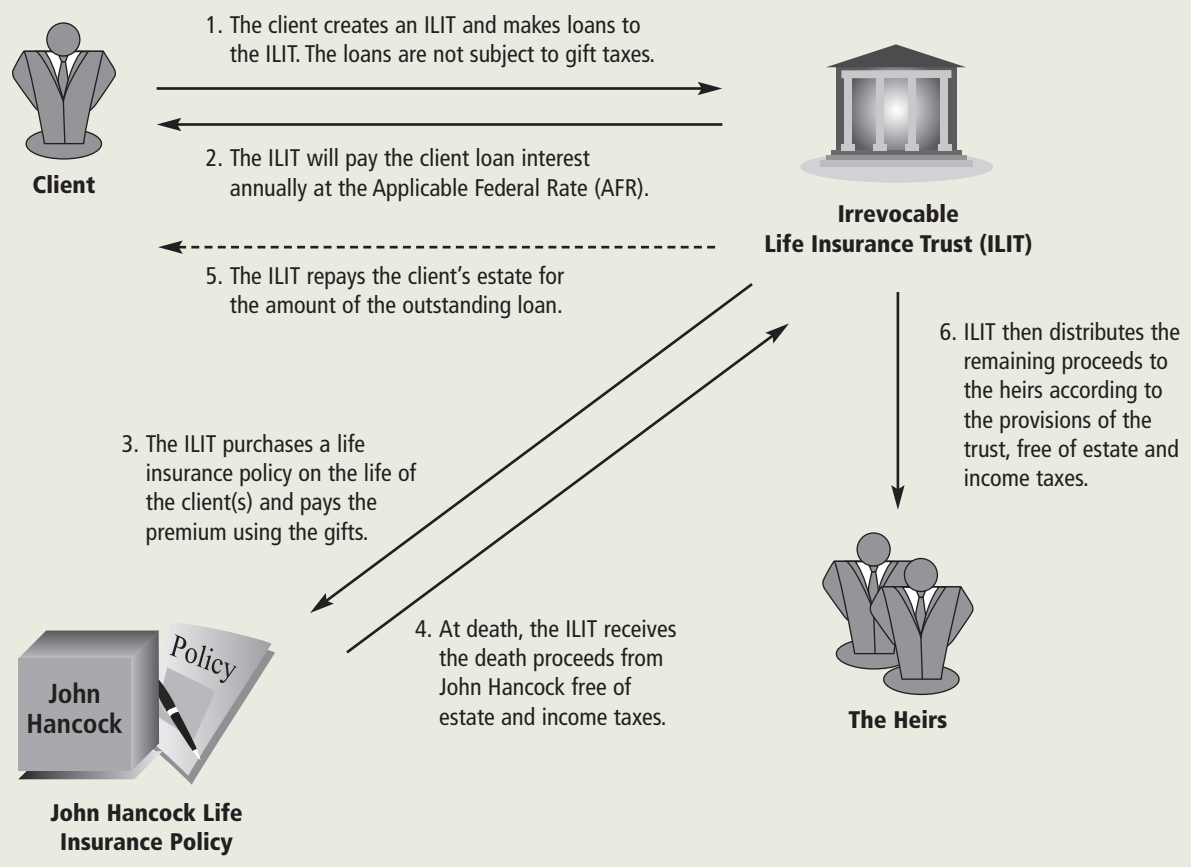
First, the client creates an ILIT which will apply for a life insurance policy on his/her life, or the lives of both spouses. Then, the client enters into a loan agreement with the trust where he/she will lend money to the trust to pay the premium. If desired, the lender could also be a Family Limited Partnership (FLP), Limited Liability Company (LLC), or another existing trust. The loan can be made annually or in an up-front lump sum to create a sinking fund (to cover future premium and interest payments) or to provide the trust funds to purchase an income-producing asset. The ILIT will owe the client loan interest based on the current AFR, which may either be paid annually or deferred and added to the total loan amount. The loan may be repaid from the policy proceeds at death, or earlier from the trust assets if desired.

## BENEFITS

- The gift tax costs may be eliminated or significantly reduced since the gift is only the loan interest and not the full premium.
- The heirs, in many cases, receive the loan repayment net of estate tax.
- Unlike a commercially financed loan, no approval by a third party is needed and the trust does not have to post collateral to secure the loan. There is also no risk of the loan being called by a third party lender.

## CONSIDERATIONS

- The client must have enough cash flow or liquid assets to pay the full premium or make a lump sum cash loan.
- The loan repayment may be subject to estate tax if the client is the lender.
- If an existing trust is the lender, it must pay income tax on the loan interest it receives from the ILIT.



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.



# Spousal Access Trusts

Married couples often create irrevocable life insurance trusts (ILITs) to replace income in the event of an untimely death, and to pay estate taxes and other expenses of estate administration.<sup>1</sup> ILITs have traditionally been an important vehicle for leveraging lifetime gifts with life insurance, and the trust will usually receive the life insurance death benefit free of income and estate taxes. However, a common complaint about ILITs is that both husband and wife lose the ability to access the life insurance policy's cash value during the insured's life. A Spousal Access Trust is a variation on a traditional ILIT that can provide flexibility and access for married clients who are buying a life insurance policy.

## WHAT IS A SPOUSAL ACCESS TRUST?

A Spousal Access Trust is a type of ILIT that enables the spouse of the trust grantor to receive distributions from the trust during his/her lifetime. A Spousal Access Trust names the spouse of the grantor, in addition to the children of the grantor, as trust beneficiaries. A Spousal Access Trust can be used with either a single life or a survivorship life insurance policy, and as long as the trust is drafted and administered correctly, it will also have the tax benefits of a traditional ILIT.

## HOW DOES IT WORK?

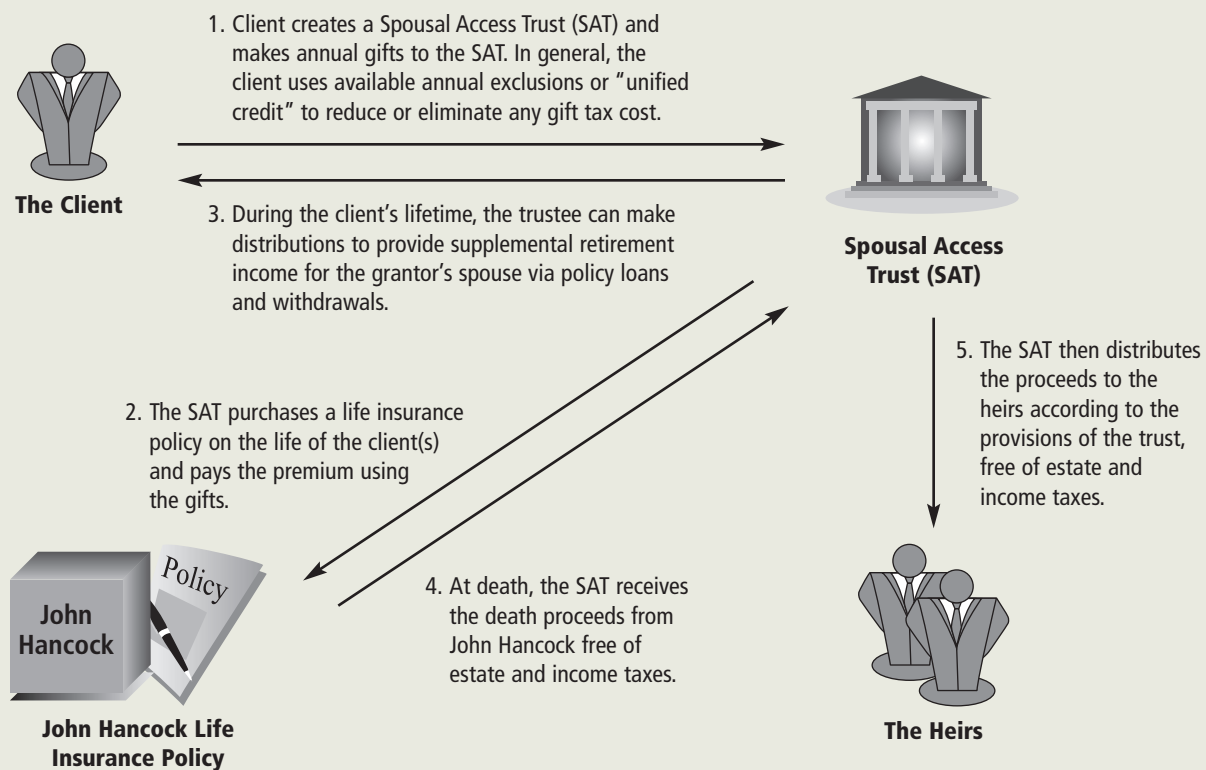
Every person is allowed to make annual exclusion gifts up to \$13,000 per person each year without having to pay gift taxes. A client can use the annual exclusion gifts to fund an ILIT for the benefit of his/her spouse and children. The trust will own the life insurance policy; the trust will receive the death benefit free of estate and income taxes, and the policy cash value will grow inside the trust on a tax-favored basis. The trust document will provide that distributions can be made to the spouse and children during the client's lifetime, usually for health, education, maintenance and support.<sup>2</sup>

## BENEFITS

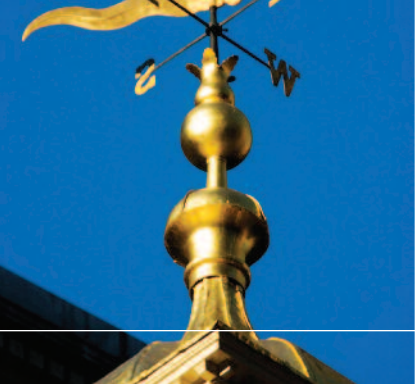
- The trust will receive the death benefit free from income and estate taxes.
- An irrevocable trust can protect assets from creditors and protect the family's privacy.<sup>3</sup>
- When gifts are used to purchase life insurance, lifetime giving can increase the amount of money left for the heirs.
- A Spousal Access Trust allows distributions to the grantor's spouse and children during his/her lifetime, allowing access to the policy cash value.
- The trustee can make distributions to provide supplemental retirement income for the grantor's spouse via policy loans and withdrawals.

## CONSIDERATIONS

- Transfers of assets to an ILIT are irrevocable, and may only be used for the benefit of the trust beneficiaries.
- Taking policy loans and withdrawals from a life insurance policy during the insured's lifetime can reduce the available death benefit.
- Withdrawals and loans from life insurance policies classified as modified endowment contracts may be subject to income tax, and may also be subject to a federal tax penalty if the withdrawal or loan is taken prior to age 59½.



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. See IRC Section 2041. To avoid giving the beneficiary spouse any incidents of ownership with a Survivorship Spousal Access Trust, the authority to make distributions to the surviving spouse may need to be limited to an independent trustee with absolute discretion. See PLR 200617008. Consult your tax advisors.
3. Assuming the proposed initial gift was not a fraudulent conveyance meant to inhibit creditors.



# Buy-Sell Plans

Most small business owners work very hard to make their companies successful. However, this dedication can turn into a double-edged sword. Small businesses can become so dependent on their owners that an unexpected death or disability can threaten the survival of the company. Even an expected event such as the retirement of an owner can cause difficulties, unless the proper planning has been done. In order for a business to succeed for generations, it needs to plan ahead for a change in ownership, whether due to retirement, unexpected death, or changes in the relationship of the owners. A key component of such a plan is a Buy-Sell Arrangement.

## WHAT IS A BUY-SELL ARRANGEMENT?

A Buy-Sell Arrangement is an agreement in which one party agrees to buy, and the other agrees to sell, business interest in the case of disability, retirement or death.

## HOW DOES IT WORK?

The two most common types of Buy-Sell Arrangement are Entity Purchase and Cross-Purchase. Each has its own advantages and disadvantages and can be structured to fit the needs of the business owners.

- **Entity Purchase Arrangement.** An Entity Purchase Plan, also known as a Stock Redemption Plan, works best with multiple partners. The business entity and business owners enter into an arrangement in which the business agrees to redeem the interest of a business owner upon his or her disability, retirement or death. The family will receive fair market value for the business and the other owners will not have to worry about a new family member joining the company or the shares being sold to a third party.

- **Cross-Purchase Arrangement.** A Cross-Purchase Arrangement is ideal for a small business with five or fewer owners. Each owner will purchase a life insurance policy on the others. It will provide the funds necessary to buy out the shares of the departing owner and the remaining owners are assured that a new family member will not join the business nor that the shares will be sold to a third party.

One of the best and most popular ways to fund a succession plan is with life insurance. It is cost effective and has several advantages. Life insurance grows tax deferred and the cash value may be taken out tax free up to the policy cost basis to fund a buyout. The income tax-free death benefit provides the source of cash flow needed upon the death of an owner for the business to survive.<sup>1</sup>

## BENEFITS

- Guarantees a buyer: A Buy-Sell Arrangement provides a guaranteed buyer upon the death, disability, or retirement of a business owner. The remaining owners are protected against the sale of a significant interest in the company to an unknown third party.
- Creates liquidity: At the death of one of the owners, his or her family may need cash for ordinary living expenses. The life insurance used to fund the Buy-Sell Arrangement will provide this liquidity.
- Sets a fair selling price: A business valuation strategy is determined while all partners are active and it can usually be negotiated on an arm's-length basis.
- Fixes the value: A Buy-Sell Arrangement negotiated at arm's length ordinarily sets the value for estate tax purposes.



## CONSIDERATIONS

- Clients should carefully consider the structure of the Buy-Sell Plan they choose to make sure it meets their needs.
- Buy-Sell Plans should be revisited on a regular basis to make sure that the current plan is still appropriate.
- The business should be re-valued on a regular basis to make sure the value set in the buy-sell plan stays accurate.

CROSS-PURCHASE BUY-SELL VS. ENTITY PURCHASE BUY-SELL ARRANGEMENTS		
	CROSS-PRUCHASE	ENTITY PURCHASE
<b>What is it?</b>	An arrangement in which each owner agrees to buy the business interest of another owner.	An arrangement between the business entity and individual owners.
<b>How does it work?</b>	Owners enter into a business continuation arrangement among themselves.	Business entity and each owner enter into a redemption arrangement.
<b>Funding Methods</b>	Life insurance, sinking fund, borrowed funds, installment purchase.	Life insurance, sinking fund, borrowed funds, installment purchase.
<b>Funding with Life Insurance</b>	Each owner purchases a life insurance policy on the others. For example, if there are three owners, then there will be six policies. [Formula: Owners X (owners-1)=number of policies]	Corporation buys a policy on the life of each owner. For example, if there are three owners, then there will be three policies.
<b>Who pays the life insurance premium?</b>	The owners pay the premiums. The premiums can be funded by the corporation through a bonus plan.	The business pays the premiums.
<b>Is life insurance subject to corporate creditors?</b>	No	Yes
<b>Alternative Minimum Tax</b>	No potential corporate alternative minimum tax (AMT) or accumulated earning tax.	For C corporation, the AMT and accumulated earnings tax may apply.
<b>Does life insurance increase the value of the business?</b>	No	Yes
<b>For whom does it work best?</b>	Businesses with five or fewer owners.	Businesses with several owners, as the business will only need to purchase one policy on each owner.
<b>Is there a step up in basis for the surviving owners?</b>	Yes	No

1. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than premiums paid.



# Cross Endorsement Buy-Sell Arrangements

Many closely held businesses do not make formal plans to transition the business in the event of the premature death or disability of a business owner, the lifetime transfer or sale of the business, the retirement of one of the key business owners, or a third-party sale of the business, such as a public offering of the company stock. Lack of planning can cause a business to fail because of the significant changes that are brought about due to one or more of these triggering events. A Cross Endorsement Buy-Sell Arrangement funded with a permanent life insurance policy, can help ensure that funds will be available to the client or his/her family to transfer the business efficiently when necessary according to a pre-determined plan.

## HOW DOES IT WORK?

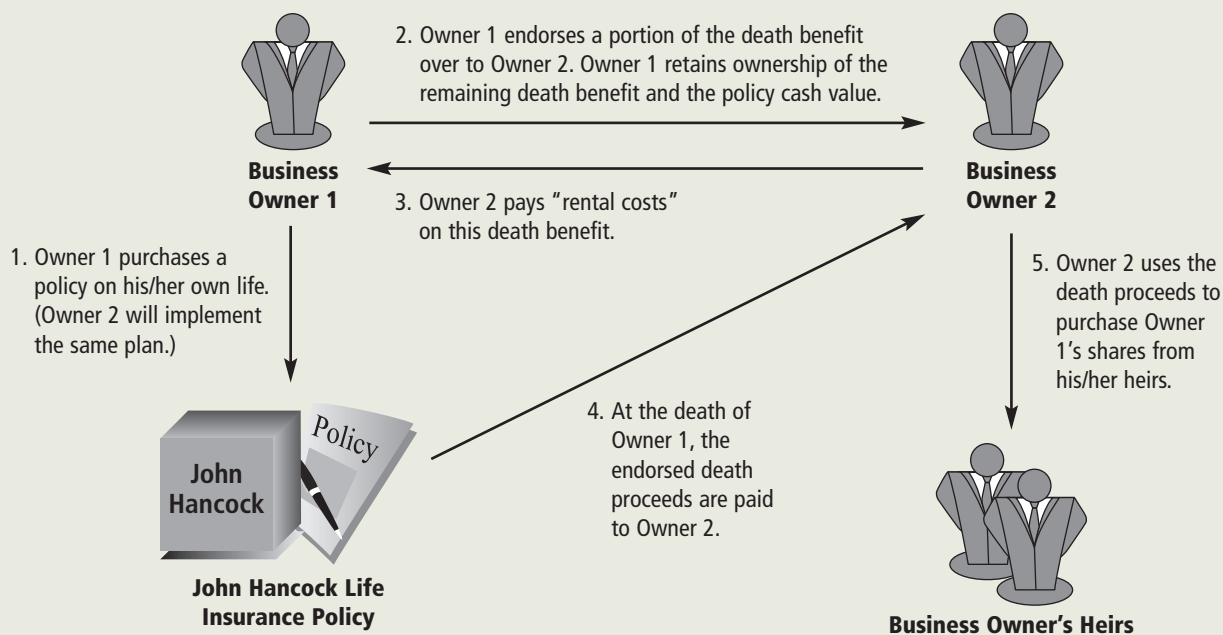
A business owner, or his/her Irrevocable Life Insurance Trust (ILIT),<sup>1</sup> purchases and owns a life insurance policy on his/her own life while each of the business partners (or their ILITs) does the same. The value of each policy will be based on each business owner's proportional interest in the business.<sup>2</sup> The arrangement is structured as an Endorsement Split-Dollar Plan so that each owner can endorse<sup>3</sup> a portion or all of the death benefit<sup>4</sup> to the others to satisfy his/her respective obligations under the Buy-Sell Agreement.<sup>5</sup> The value of the rental charge is based on the economic benefit cost of the death benefit which initially represents only a fraction of the premium. The economic benefit cost is measured annually using either a government or insurance company rate table that takes into account the owner's attained age as well as the amount of the death benefit being endorsed. When the Cross Endorsement Plan is terminated, the annual rental charge stops. While the Buy-Sell Plan is in place, the life insurance proceeds are to be paid to each surviving owner to fund the buy-sell obligation.<sup>6</sup> However, if the plan is terminated during lifetime, each owner can continue to own his/her own policy and can use the policy's potential cash values to supplement retirement income or to fund a buy-out of the business. Ultimately, each owner may retain the policy for estate liquidity purposes.<sup>7</sup>

## BENEFITS

- Establishes an agreement between the business owners on how to transfer the business.
- Provides the heirs with liquidity to transfer the business.
- Allows access to the policy's potential cash value accumulation.<sup>8</sup>
- Provides flexibility for changing needs.

## CONSIDERATIONS

- Cash flow is required to pay premiums.
- Economic benefit costs increase with age.
- Rental income may be taxable.<sup>9</sup>
- Access to the policy's potential cash values may lower the death benefit needed to satisfy the buy-sell obligation.<sup>10</sup>
- Final split-dollar regulations apply.
- Potential transfer-for-value.<sup>11</sup>



- Trusts should be drafted by an attorney familiar with such matters to take into account income and estate tax laws (including generation-skipping transfer taxes). Failure to do so could result in adverse tax treatment of trust assets.
- A qualified appraisal of the business should be completed.
- Each owner's legal advisor should determine if applicable state trust law permits the owner's ILIT to endorse death benefits to the other owners (or ILITs created by the other owners) as part of the Buy-Sell Arrangement to which the owner's ILIT is a party. Special provisions may have to be included in an owner's ILIT instrument to satisfy (or override) state trust law with respect to this issue. Clients should consult their tax advisors to discuss this issue.
- Each owner may desire to endorse one hundred percent (100%) of the death benefit to the other owners during the buy-sell period. The split-dollar final regulations are silent as to whether this is permissible. Clients should consult their tax advisors to discuss this issue.
- Please see the 2003 Final Split-Dollar Regulations for more information on the rules and taxation associated with an Endorsement Split-Dollar Plan.
- Although the life insurance proceeds are includible in the taxable estate when the policy is not owned by an ILIT, the estate receives a corresponding deduction for the liability associated with the Buy-Sell Plan.
- If the policy is not owned by a properly structured ILIT, the life insurance proceeds will be includible in the taxable estate for estate tax purposes.
- The parties to the Cross Endorsement Buy-Sell Arrangement may wish to restrict access to the policy's cash value to the extent that access does not impair the death benefit being endorsed. That is, loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income.
- Under the split-dollar final regulations, the economic benefit amounts received by each owner will be treated as rental income and taxed at ordinary income tax rates. In essence, the sum of all anticipated economic benefit amounts represents twice-taxed dollars. The present value of the combined income taxes on the sum of all anticipated economic benefits is essentially an option price the parties have agreed to at the outset to purchase the flexibility provided by the Cross Endorsement Buy-Sell Arrangement. Clients should consult their tax advisors to discuss this issue.
- Loans and withdrawals will reduce the death benefit and cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income.
- The owners may want to consider a partnership (if one does not already exist) between the owners (and/or ILITs created by the owners) to avoid any transfer for value issues with respect to the cross endorsements of the policy death benefits. Clients should consult their tax advisors to discuss this issue.



# Executive Bonus Plans

In today's increasingly competitive environment, it is getting harder for businesses to find an executive benefit plan to attract, retain, and reward talented executives. Qualified plans have preferential tax treatment, but employers must include all employees and reward everyone to the same degree, regardless of the benefit they bring to their company. Non-qualified plans are easier to administer and allow employers to reward key employees in a discriminatory fashion. However, they still require plan documents, ongoing administration, and face new regulation from Section 409A of the tax code. What type of plan is available that will reward the most productive employees in a way that is flexible, cost effective, and simple to administer?

## THE SOLUTION

Two plans may be able to help: the Executive Bonus Plan and the Restricted Bonus Endorsement Arrangement (REBA). Both of these plans are appealing to key employees, tax deductible to employers, and simple to implement and administer. In addition, the REBA can provide "golden handcuffs," an incentive for employees to stay with the company.

## EXECUTIVE BONUS PLANS

An Executive Bonus Plan (also known as a "162 Bonus Plan") is an arrangement in which the employer pays a bonus to a key executive by paying the annual premium on a life insurance policy for the executive. The executive will be the owner of the policy and have the right to name the beneficiaries of the policy. The executive will also own any potential policy cash value and be able to access it at retirement via tax-favored loans and withdrawals.<sup>1</sup>

## RESTRICTED BONUS ENDORSEMENT ARRANGEMENTS (REBAs)

A REBA is simply a more specialized form of an Executive Bonus Plan. As with the Executive Bonus Plan, the employer pays a bonus to an executive by paying the annual premium on a life insurance policy that the executive owns. However, with a REBA, a vesting schedule will be applied to the bonus and the executive's access to the cash value will be restricted until the executive vests fully. If the executive leaves before vesting, the unvested portion of the bonus must be paid back to the employer. If the executive stays until full vesting or retirement, the restricted endorsement is removed and the executive can access the policy cash value for any purpose, including supplemental retirement income.

## BENEFITS

For the employer, both the Executive Bonus Plan and the REBA provide a tax-deductible, discriminatory benefit plan that is simple to implement and inexpensive to administer. The Executive Bonus Plan offers an immediate income-tax deduction of the full bonus amount; the REBA provides a tax deduction as the employee vests in the bonus.<sup>2</sup> Additionally, the vesting schedule of the REBA creates "golden handcuffs" to provide an incentive for the executive to stay with the company.

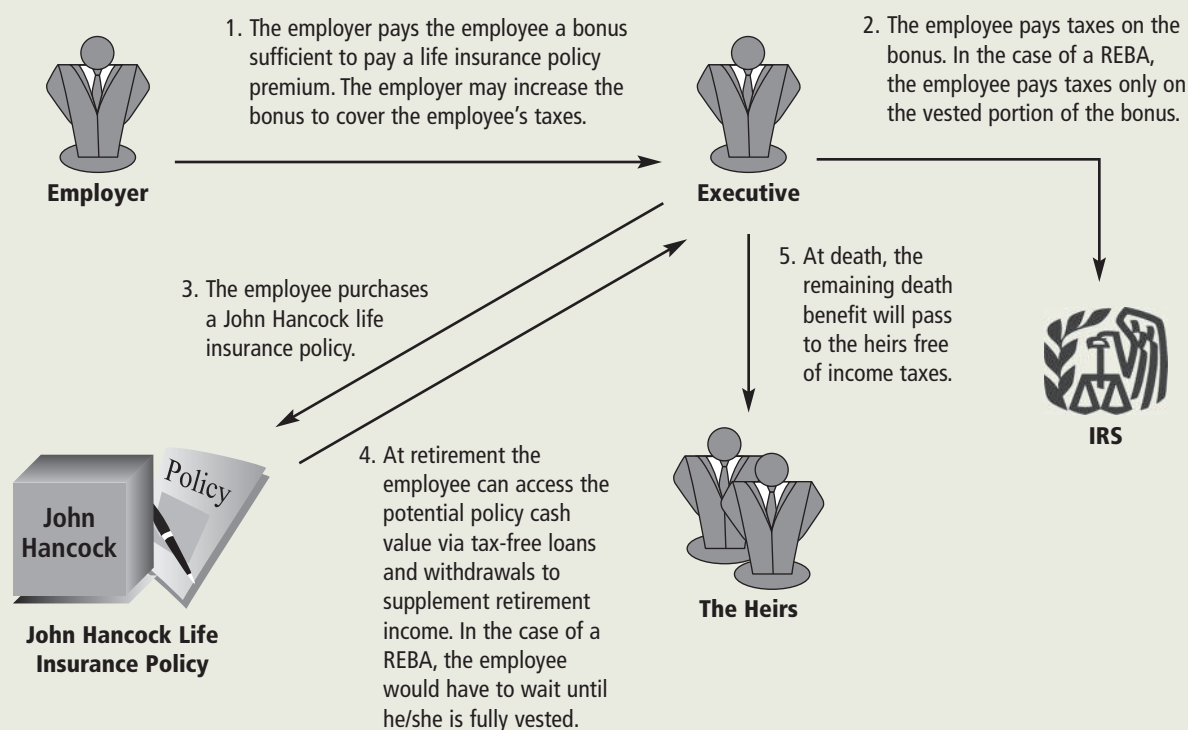
For the executive, both plans offer affordable life insurance protection and potential supplemental retirement income.



## CONSIDERATIONS

Executive Bonus Plans work better for business clients who would like an immediate income-tax deduction and do not care as much about creating “golden handcuffs.”

REBAs work better for business clients who care the most about creating “golden handcuffs,” and are willing to wait for the bonus to vest to take a tax deduction.



1. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.
2. The amount of the bonus that the employer is able to deduct is subject to reasonable compensation limits. A detailed discussion of this is beyond the scope of this document; clients should consult their tax advisors.



# Non-Qualified Deferred Compensation Plans

In today's increasingly competitive environment, even successful businesses can have difficulty in recruiting and retaining the best talent for their company. Qualified plan limitations and restrictions often make it difficult to reward the most valuable employees. How can you help your business clients recruit and reward outstanding talent? A Non-Qualified Deferred Compensation plan (NQDC) may be able to help. Two common NQDC plans are the Supplemental Executive Retirement Plan (SERP) and the Salary Deferral Plan.

## WHAT IS A NON-QUALIFIED DEFERRED COMPENSATION PLAN?

A NQDC plan is simply an agreement between an employer and a key executive, where the employer agrees to pay the executive an additional retirement benefit at a future point in time. In a Salary Deferral Plan, the executive defers current income which the employer promises to repay with interest in the future. In a SERP, the employer pays for the entire cost of the plan and specifies either an annual amount to contribute to the plan or a specific retirement benefit.

## HOW DOES IT WORK?

The employer first decides which key employees to include in the plan, and what benefit level to offer them. For a SERP, the employer may also impose a vesting schedule, reducing or eliminating the benefit if the employee leaves prior to fully vesting. For a Salary Deferral Plan, the employee is immediately vested in his/her own contributions but the employer can impose a vesting schedule on any matching contributions. Then, the employer and the employee enter into a SERP or a Salary Deferral agreement, where the employer promises to pay the benefits at retirement. In order to ensure that they will have the funds available to pay the retirement benefit and to recover their costs in the plan, the employer will purchase a John Hancock life insurance policy with the executive as the insured.<sup>1</sup> At retirement, the employer may access the potential policy cash value via loans and withdrawals to pay for the retirement benefit.<sup>2</sup>

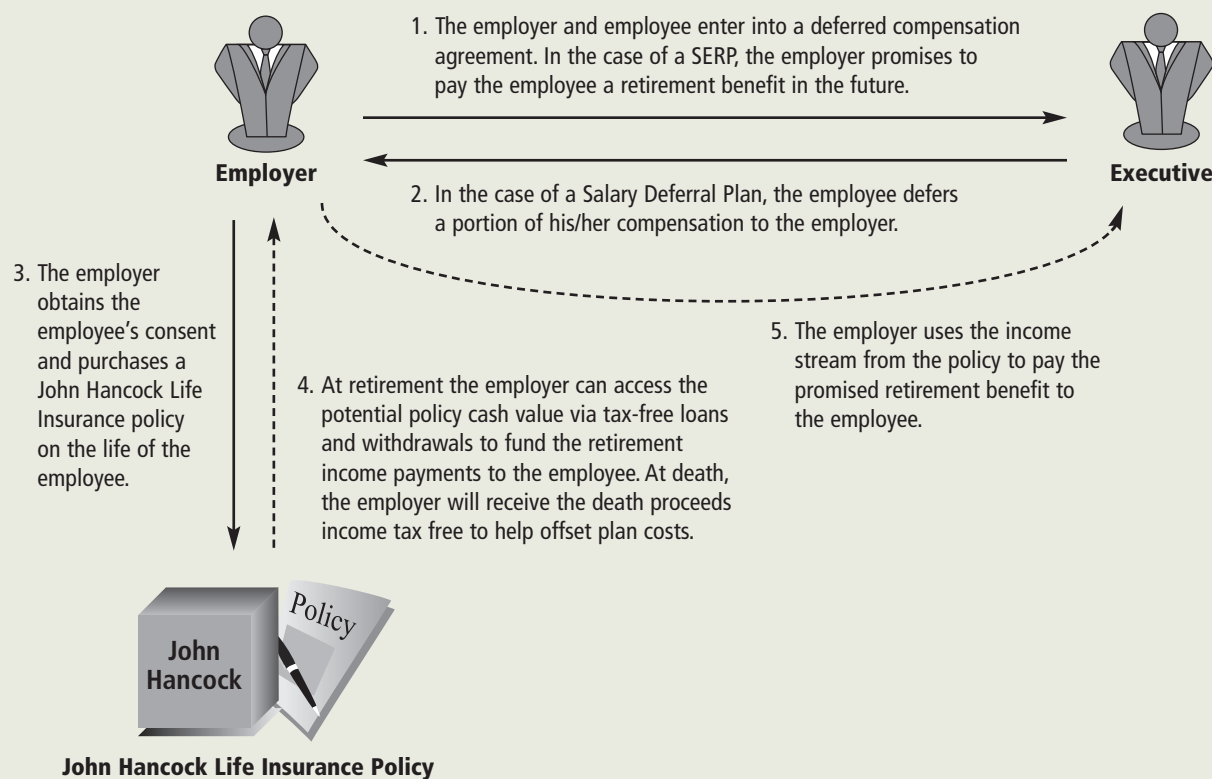
## BENEFITS

- The employer can choose to reward only a select group of employees, and give each employee a different benefit level.
- The employer can impose a vesting schedule, creating "golden handcuffs," an incentive for the Executive to stay with the company.
- The employer will receive a tax deduction when retirement benefits are paid.
- The employer can use the income tax free death benefit to recover plan costs.
- In the case of the SERP, the employee receives an additional retirement benefit and does not have to pay taxes on it until it is received.
- In the case of the Salary Deferral, the employee has an opportunity to defer additional income for retirement purposes.



## CONSIDERATIONS

- The employee must sign a “consent to insure” form.
- The employer may not deduct any plan contributions, including premiums spent on life insurance.
- The employer may only deduct the benefits when they are actually paid to the employee.
- The plan assets cannot be set aside in a trust to protect participants from company’s creditors. The assets must remain part of general assets of the corporation or they will become taxable to the executives.



1. Section 101(j) of the Internal Revenue Code imposes income tax on the death benefit of life insurance contracts owned by the employer of the life insured unless certain exceptions apply. All such exceptions include satisfaction of notice and consent requirements set forth in the section. Section 409A of the Internal Revenue Code imposes extensive substantive requirements on arrangements that purport to accomplish a deferral of income or the taxation of income. By its own provisions, failure to satisfy these requirements will result in the loss of deferral of recognition and taxation of the income.
2. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2009 John Hancock. All rights reserved.

