



Are **You** Getting the **Most** Out of Your **Business?**

Planning Strategies Plus Life Insurance
Can Help Power Your Business Makeover.

John W., 50, owns Totally Board, a surfboard maker that employs 12 people. He wants to retire in 15 years, but he has limited 401(k) accumulation and is unsure what his business might be worth. John's big worry is that he and his wife, Mary, 48, will not have enough income to retire anytime soon.



A **life insurance retirement plan** may help John supplement his retirement income.

See page 6.

A **one-way buy-sell** may help John sell his business to a key executive.

See page 24.

A **qualified combo plan** may help John catch up his retirement savings.

See page 10.

Is Your Business Poised for What Comes Next?

There is light at the end of the economic tunnel. The global economy is showing signs of life again. Potential is in the air. With investors slowly emerging from their hibernation and consumers weighing where to spend their increased savings, new business opportunities are popping up every day. Now's the time to be poised for what comes next.

Is Your Business Ready for a Makeover?

Business owners who continue to succeed are always seeking new opportunities to improve their financial position. Whether you're ready to hire or ready to retire, life insurance can provide you and your business with numerous ways to help improve your financial potential. Along with the security of a death benefit, life insurance may offer you peace of mind. Now's the time for a business makeover.

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Deborah R., 37, owns Your Momma's Kitchen, a growing nationwide food retailer that employs 130 people. She has a hard time hanging on to her workforce due to a lack of employee benefits. She's especially concerned about losing key executives. Deborah wonders what kind of plan she might put in place.



A **permanent benefit Section 79 plan** may help Deborah offer her employees retirement savings potential as well as other benefits for selected employees.

See page 13.

A **401(k) mirror voluntary deferral plan** may help Deborah offer executives tax-deferred retirement savings potential.

See page 18.

A **419(e) welfare benefit plan** may help Deborah offer employees postretirement medical benefits.

See page 14.

A **supplemental executive retirement plan** may help Deborah offer key executives supplemental retirement income potential.

See page 15.

A **controlled executive bonus plan** may help Deborah provide executives with life insurance and retirement income potential on a tax-deductible basis for her business.

See page 19.

Where Do You Want to Take Your Business?

What do you need to plan effectively for your future? For the future of your business? For the future of your executives? Where are you vulnerable? What risks are on the horizon? Consider the following questions and strategies as you start your business makeover. Each of these strategies features potential tax savings for you, your business, your heirs, and/or your employees, in addition to the security of a death benefit. Let's get started.

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Fernando V., 60, co-owns Simply Social Media, a marketing firm that employs 25 individuals, including two of his three children. Looking to retire in a few years, Fernando is concerned about the future ownership of the business, what will happen to his family's income if he were to die, and how to treat his children equitably if he decides to sell his portion to the two who work with him at the business.



A **one-way buy-sell** may help Fernando transition his business to a key executive if his children decide not to buy the business or only one of them decides to buy it.

See page 24.

A **family buy-sell arrangement** may help Fernando pass his portion of the business to his two children who work with him and also treat his other child equitably.

See page 23.



Life Insurance Retirement Plan

A life insurance retirement plan (LIRP) is a commonly used and easily implemented life insurance-based supplemental retirement income accumulation strategy. The life insurance policy serves the dual purpose of providing death benefit protection for a beneficiary chosen by the policyholder as well as the potential to provide supplemental retirement income through the policy's cash value. For individuals who cannot solely rely on their business or the government to provide retirement benefits, a LIRP offers a self-contained and independent alternative to help supplement retirement income.

How it works:

- The business owner purchases a personally owned cash value life insurance policy on his or her life.
- If the life insurance policy is properly structured, the cash value of the life insurance policy will grow tax-deferred.
- At the insured's retirement, he or she may take tax-free loans or withdrawals from the policy's cash value to supplement his or her retirement income.²
- At the insured's death, a beneficiary chosen by the insured will receive the life insurance policy's death benefit income tax-free.*

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Business-Financed Life Insurance

A business-financed life insurance arrangement is a way for a business owner to accumulate retirement income using the value of his or her business. A loan from the business to the business owner is used to purchase a life insurance policy.³ In many cases, a third-party lender provides the loan to the business owner. If structured properly, the life insurance policy can be accessed by the business owner as a source of supplemental retirement income.



How it works:

- The business gets a loan or a line of credit from a lender. As collateral for the loan, the business pledges a portion of assets (potentially including its accounts receivable). The lender may file a Uniform Commercial Code Financing Statement with the Secretary of State where the business is located that provides the lender a priority claim over other creditors for the accounts receivable pledged.^{1†}
- Over time, the business distributes the loan proceeds to the business owner as a loan.⁴ The business-provided loan will require the business owner to pay interest to the business and give the business a source of funds to pay the interest on its loan from the lender.
- The business owner uses the loan proceeds from the business to pay premiums on a personal life insurance policy. A portion of the policy cash value and death benefit may be assigned to the lender as secondary collateral for the loan.
- When the business owner retires, both loans are repaid and the collateral assignment is released from the policy. In many cases, the cash value of the life insurance policy is the primary source of funds for the repayment of the loans. The business owner may then use the policy cash value to supplement his or her retirement income through policy loans and withdrawals.
- Upon death of the business owner, the death benefit proceeds in excess of what is needed to repay the third-party lender (if the loan has not been repaid) are distributed to the beneficiaries income tax-free.*



Accounts Receivable Financing

An accounts receivable financing arrangement allows a business owner to use his or her business to accumulate retirement income. In this strategy, a business owner uses the business' accounts receivable as collateral for a personal loan (which also may protect these assets from unwanted creditors[†]) via a third-party lender. The business owner then uses the loan to pay the premiums for a life insurance policy, which may be pledged to the lender as secondary collateral for the loan. After the loan has been repaid, the business owner can access the cash value of the life insurance policy to supplement his or her retirement income.

How it works:

- The business owner receives a loan from a third-party lender.⁴
- The business pledges a portion of its accounts receivable as primary collateral for the loan. The lender may file a Uniform Commercial Code Financing Statement with the Secretary of State where the business is located, providing the lender a priority claim over other creditors for the accounts receivable pledged.
- The business owner pays interest on the loan as a nondeductible personal expense, although the business may pay the owner a taxable bonus to assist in paying the interest due on the loan.
- The business owner uses the borrowed money to purchase a life insurance policy, usually assigning a portion of the cash value and death benefit of the policy as secondary collateral for the loan. This additional security may permit the lender to increase the amount it is willing to lend or provide more favorable terms for the loan.
- When the business owner retires, the loan is repaid primarily using the business' outstanding accounts receivable.
- The business may receive a tax deduction for repaying the loan on behalf of the business owner for whom the loan repayment is considered taxable ordinary income.
- When the loan is repaid, the lender releases the assignment on the life insurance policy and the business owner may choose to use the policy cash value to supplement his or her retirement income through tax-free policy withdrawals and loans.²

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

† Business-Financed Life Insurance and Accounts Receivable Financing are retirement strategies using life insurance. When a business loan is formally secured by collateral (e.g. a Uniform Commercial Code Filing for personal property or a recorded property deed for real property) for a loan from a third-party lender, the assets securing the loan may be potentially protected from unsecured creditors.

Pacific Life is not affiliated with any third-party lenders.



Split-Funded Defined Benefit Plan

For business owners close to retirement and behind on retirement savings, a split-funded defined benefit plan is an effective method for catching up on their savings due to the age-weighted contributions allowed under the plan.

A split-funded defined benefit plan is a qualified plan designed to provide the participant with a stated benefit amount at retirement.⁵ Typically, when a defined benefit plan participant dies, the plan pays the beneficiaries the account balance. The account balance may be insufficient for the family's needs, but if life insurance is added to the defined benefit plan, the participant's beneficiaries receive the life insurance death benefit.⁶ Generally, a split-funded defined benefit plan will allow a business to make much larger contributions to the plan than it could make to a defined contribution plan (such as a 401(k) profit-sharing plan).

How it works:

- The business establishes a split-funded defined benefit plan and makes tax-deductible contributions to the plan to fund various investment choices and life insurance.
- A portion of the business' contribution 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 as taxable income each year.
- The split-funded defined benefit plan is the owner and beneficiary of the life insurance policy. Should the participant die prior to retirement, the life insurance death benefit is paid to the plan.
- Upon the participant's death, the split-funded defined benefit plan provides a survivor benefit to the heirs. This survivor benefit includes 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.*
- 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 surrender the life insurance policy, purchase the life insurance policy from the plan, or take the policy out of the plan as a taxable distribution.³ The participant will have basis in the policy equal to the cost of current life insurance he or she has incurred. This basis may reduce the value of the policy for the purposes of a distribution from the qualified plan.⁷ Once the life insurance policy is outside of the qualified plan, the insured can access the policy's available cash value to supplement his or her retirement income.



Qualified Combo Plan

A qualified combo plan is a retirement income accumulation strategy using life insurance that allows business owners to take advantage of the cross-testing provisions that exist for meeting the nondiscrimination requirements established for qualified plans.⁶ Business owners with more than 10 employees may find the qualified combo plan attractive because the split-funded benefit plan may be implemented in many cases primarily for the business owner.⁸

Business owners who already have 401(k) profit-sharing plans in place may be able to implement a split-funded defined benefit plan primarily for themselves and maintain the 401(k) profit-sharing plan for the remainder of their eligible employees. For business owners who do not have a qualified plan in place, the qualified combo plan may be a sensible alternative to offering a pure defined benefit plan since the investment risk for the 401(k) profit-sharing plan is born by the individual participants, whereas the investment risk for the defined benefit plan is born by the business.

How it works:

- The business establishes both a 401(k) profit-sharing plan (if one has not already been established) and a split-funded defined benefit plan, and makes tax-deductible contributions to both plans to fund the participant's retirement benefits.⁹
- Portions of the business' contributions to both plans are used to pay premiums on life insurance policies insuring the participants' lives.¹⁰
- Since the 401(k) profit-sharing plan or the split-funded defined benefit plan will be the owner and beneficiary of each life insurance policy, life insurance death benefits will be paid to the plan if a participant dies prior to retirement.
- If a participant dies before retirement, his or her heirs will receive a survivor benefit consisting of the vested retirement balance. In the case of an insured participant, 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 survivor benefit free from income taxes.* In the case of a profit-sharing plan participant, this survivor benefit generally will be limited to the amount of funds currently in the plan.
- Once a participant retires, he or she may begin receiving taxable retirement income benefits from the plan. At retirement, the participant may surrender the life insurance policy, purchase the life insurance policy from the plan, or take the policy out of the plan as a taxable distribution.¹¹ Once the life insurance policy is outside of the qualified plan, the insured can access the policy's cash value to supplement his or her retirement income.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).



Qualified Plans with Life Insurance

Qualified plans (specifically 401(k) profit-sharing plans) are an important part of nearly everyone's diversified retirement accumulation strategy. At the same time, life insurance can be an important part of a 401(k) profit-sharing plan. In this strategy, the participant (business owner and/or employee) directs the qualified plan to use a portion of his or her retirement balance to fund a life insurance policy on his or her life.¹² By placing the life insurance policy inside the qualified plan, the participant is able to use pre-tax dollars to pay the life insurance policy premiums.

This arrangement may allow the participant to pay larger policy premiums, resulting in a potentially larger death benefit than would be possible if the participant was forced to take a taxable withdrawal from the plan in order to purchase the policy.

How it works:

- The plan trustee, with the consent of the participant, uses qualified plan assets to purchase a life insurance policy on the participant.
- While the life insurance is in the qualified plan, the participant will incur a cost for the death benefit he or she is being provided. This cost will be imputed to the participant as taxable income.
- The qualified plan will be the owner and beneficiary of the policy and will receive the death benefit. The life insurance death benefit paid to the qualified plan will then pass on to the participant's heirs. A portion of the death benefit proceeds received by the heirs may be income tax-free.*
- At the participant's retirement, he or she may surrender the life insurance policy, purchase the life insurance policy from the plan, or take the policy out of the plan as a taxable distribution.¹¹ Once the life insurance policy is outside of the qualified plan, the participant can access the policy's cash value to supplement the qualified plan distributions for retirement income.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Stock Redemption

A stock redemption plan is a type of business continuation plan that in many cases is best suited for a business with four or more business owners.¹³ A stock redemption requires a business owner (or the business owner's estate) to sell all interest in the business and the business to buy it. A properly executed stock redemption arrangement may allow for continuity of management, a source of income for the decedent business owner's family, and a clear direction for future ownership of the business. Life insurance may be an ideal funding vehicle for a stock redemption plan.



How it works:

- The business and the shareholders enter into a stock redemption agreement requiring the business to purchase the shareholders' interests in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g. retirement, disability, death).
- The business will purchase a life insurance policy on each of the business owner's lives to fund the purchase obligation. The business will pay the premiums and will be the owner and beneficiary of the policy.¹³
- Upon a business owner's retirement (or other exit from the business during his or her lifetime), the business can use the policies' cash value to effectuate a lifetime buyout.¹⁴
- At the business owner's death, the business will receive the death benefit proceeds income tax-free.*
- The business will apply the death benefit proceeds toward the purchase of the decedent business owner's interest in the business from the decedent's estate.¹⁵



Permanent Benefit Section 79 Plan

The Treasury Regulations for Section 79 provide that group term life insurance may be combined with permanent benefits under specified circumstances, which allows the use of cash value life insurance policies. The employee's income, in addition to the cost of the value of any death benefit in excess of \$50,000, must include the cost of the permanent benefits reduced by the amount, if any, that the employee pays for the benefits.

Internal Revenue Code (IRC) Section 79 permits businesses to offer group life insurance to employees. In this strategy, which is ideal for C-Corporations,¹⁶ a business pays the premiums and is able to deduct the full amount, while the employees receive up to \$50,000 of death benefit income tax-free and are nominally taxed on the value of any excess death benefit plus the permanent benefit cost. The life insurance policy's cash value may be used as a source of supplemental retirement income by the participant.

How it works:

- The business establishes a group life plan under IRC Section 79 and allows an employee to choose between a taxable permanent benefit (cash value life insurance), regular term life insurance with a taxable economic benefit, or \$50,000 group term insurance with no taxable economic benefit. Each participating employee¹⁷ will choose the option that best fits his or her economic needs. If the permanent benefit option is chosen, the employee will own the life insurance policy and may continue the life insurance coverage after retirement.
- The employee may receive the first \$50,000 of death benefit coverage free of cost. For death benefit coverage in excess of \$50,000, the employee must include an annual cost (economic benefit cost) in his or her taxable income.¹⁸
- In addition to the annual death benefit coverage, a cash value policy may provide a permanent benefit to the employee, and the employee is annually taxed on the cost of the permanent benefit.⁶ The amount taxed to the employee may be less than the cash value policy premium paid and deducted by the business.
- The employee has the ability to access the policy cash values income tax-free for supplemental retirement income or other purposes.
- Upon the death of the employee, his or her named beneficiaries will receive the death benefit proceeds income tax-free.*

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

419(e) Welfare Benefit Plan

With the rising cost of medical care, a 419(e) welfare benefit plan that provides postretirement medical benefits can be a powerful incentive to employees for many businesses. A 419(e) welfare benefit plan may help alleviate the potentially large burden that medical care can have on an employee's retirement savings and provide life insurance death benefits to the employee's heirs.

How it works:

- The business establishes a 419(e) welfare benefit plan and makes potentially deductible contributions to the plan to fund various welfare benefits for its employees, such as postretirement medical and pre- and postretirement life insurance death benefits.
- The 419(e) plan purchases a life insurance policy on the life of the covered employee and is both the owner and beneficiary of the policy. The employee reports the current cost of life insurance in his or her taxable income each year and, if the plan provides current life insurance death benefit protection, the death benefit received by the 419(e) plan may be passed on to the employee's heirs income tax-free.*
- In retirement, if the covered employee incurs covered medical costs, the 419(e) plan either pays for these costs or reimburses the employee, who is not taxed on these benefits.





Supplemental Executive Retirement Plan

A supplemental executive retirement plan (SERP) is a business-sponsored non-qualified deferred compensation plan that, in most cases, is designed to provide an executive or executives with supplemental retirement income. This strategy is typically used to provide retirement benefits in addition to those provided by the business' 401(k) or other qualified retirement plan. Contributions to a SERP are made solely by the business. Through a formal written agreement, the business makes a promise to pay the benefits to the executive. The business may wish to place a vesting schedule on these benefits to encourage executives to remain with the company.

Some plans may allow for distributions while the executive is still employed and may even offer survivor benefits should the executive die before the SERP benefits have been fully distributed. There is no requirement that the business fund its SERP obligations; however, many businesses choose to purchase a life insurance policy to informally fund the SERP benefits. At the executive's retirement, or at another specified date, the business may access the life insurance policy's cash value to make the SERP distributions.

How it works:

- The business enters into an agreement with the executive promising to provide future income for the executive. The agreement explains the various distribution provisions (e.g. retirement, disability, death) and whether a vesting schedule will be applied to the promised benefit.¹⁹
- The business creates an accounting entry in its financial statements that represents the executive's account balance. The account balance will be considered a general asset of the business and will be fully subject to the claims of the business' creditors, but will not be currently taxed to the executive until paid.¹⁴
- The business may choose to informally fund the arrangement using a life insurance policy on the life of the executive.²⁰ The business is considered the owner and beneficiary of the policy, and the executive is the insured. The business pays the premiums of the life insurance policy. The premiums are a nondeductible expense for the business. The life insurance policy will provide the business with a death benefit and tax-deferred accumulation of the cash value, and will serve to informally fund the business' liability for the plan benefits.
- At the executive's retirement, or earlier if stipulated under the SERP agreement, the business begins paying the executive's SERP benefits. The business may fund these payments via tax-free distributions of the cash value accumulated within the life insurance policy.² The payments from the plan are taxable income for the executive and may be tax-deductible for the business.
- In the event of the executive's death, the business may receive the tax-free life insurance death benefit.* If the business has not completed the payments due to the executive under the terms of the agreement, the business may use the death benefit to pay the executive's heirs the remainder value.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

The Benefits Trio

The Benefits Trio is the combination of a split-funded defined benefit plan, a 401(k) profit-sharing plan, and a non-qualified deferred compensation plan. The addition of the non-qualified deferred compensation plan allows the business to provide retirement income benefits to executives not covered by the split-funded defined benefit plan (which primarily covers the business owner). This combination strategy that allows a business to provide retirement income benefits to every layer of its workforce.

Life insurance may be an important part of both the split-funded defined benefit plan and the 401(k) profit-sharing plan by providing death benefit protection to a beneficiary chosen by the participant. Additionally, the business could use a life insurance policy as the informal funding vehicle for the non-qualified deferred compensation plan.

How it works for qualified plans:

- The business establishes both a 401(k) profit-sharing plan (if one has not already been established) and a split-funded defined benefit plan, and makes deductible contributions to both plans to fund the participant's retirement benefits.²¹
- A portion of the business' contribution going to either the 401(k) profit-sharing plan and/or the split-funded defined benefit plan is used to pay premiums on a life insurance policy insuring the participant's life.⁶ While covered by current life insurance protection, the participant must report the current cost of life insurance protection as taxable income each year.
- Since the 401(k) profit-sharing plan and/or split-funded defined benefit plan will be the owner and beneficiary of the life insurance policy, the life insurance death benefit will be paid to the plan if the participant dies prior to retirement.
- If the participant dies before retirement, his or her heirs will receive a survivor benefit consisting of the vested retirement balance. For an insured participant, 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 survivor benefit free from income taxes.* In the case of a profit-sharing plan participant, this survivor benefit generally will be limited to the amount of funds currently in the plan.
- Once the participant retires, he or she may begin receiving taxable retirement benefits from the plan. At retirement, the participant may surrender the life insurance policy, purchase the life insurance policy from the plan, or take the policy out of the plan as a taxable distribution.⁵ The participant will have basis in the policy equal to the cost of current life insurance he or she has incurred. This basis may reduce the value of the policy for the purposes of a sale or distribution from the qualified plan.⁷ Once the life insurance policy is outside of the qualified plan, the insured can access the policy's available cash value to supplement his or her retirement income.

How it works for non-qualified deferred compensation plans^{††}

- The business enters into an agreement with the executive to provide future income for the executive that clearly explains the various distribution provisions (e.g. retirement, disability, death) and whether a vesting schedule will be applied to the promised benefit.
- The business creates an accounting entry in its financial statements which represents the executive's account balance.²⁰
- The business may choose to informally fund the arrangement using a life insurance policy.²² The business is considered the owner and beneficiary of the policy and the executive is the insured. The business pays the premiums of the life insurance policy. The premiums are a nondeductible expense for the business. The life insurance policy will provide the business with a death benefit and tax-deferred accumulation of the cash value and will serve to informally fund the business' liability for the plan benefits.
- At the executive's retirement, or earlier if stipulated under the SERP agreement, the business will start the payment of the executive's SERP benefits. The business may fund these payments via tax-free distributions of the cash value accumulated within the life insurance policy.¹ The payments from the plan will be taxable income for the executive and may be tax-deductible for the business.
- In the event of the executive's death, the business may receive the tax-free life insurance death benefit.* If the business has not completed the payments due to the executive under the terms of the agreement, the business may use the death benefit to pay the executive's heirs the remainder value.

^{††} Assuming the business implements a SERP¹⁹ for the benefit of the executives.



Voluntary Deferral Plan

A voluntary deferral plan is a business-sponsored, non-qualified retirement plan in which the business allows selected executives who have maximized their qualified plan deferrals to defer additional amounts of future income.²³ In return, the business agrees to provide supplemental retirement income to the executive. While most voluntary deferral plans are designed to provide retirement benefits, some plans may allow for distributions while the executive is still employed and may even offer survivor benefits should the executive die before the voluntary deferral benefit has been fully distributed.

There is no requirement that the business fund its voluntary deferral plan obligations; however, many businesses choose to purchase a life insurance policy to informally fund the voluntary deferral plan benefits. At the executive's retirement, or at another specified date, the business may access the life insurance policy's cash value to make the voluntary deferral plan distributions.

How it works:

- Through a written agreement, the executive elects to defer a portion of his or her compensation. In return, the business agrees to provide supplemental retirement income to the executive. The agreement will clearly explain the various distribution provisions (e.g. retirement, disability, death).²⁴
- The business creates an accounting entry in its financial statements that represents the executive's account balance. The business may or may not choose to informally fund the plan with an asset. If so, the asset will be funded through executive deferrals. Any asset used to informally fund the executive's account balance is a general asset of the business and is fully subject to the claims of the business' creditors. Contributions to the executive's account balance are the result of the executive's elective compensation deferrals, are nondeductible by the business, and are not currently taxed to the executive until they are paid.
- The business may choose to informally fund the arrangement using a life insurance policy.²⁷ The business is considered the owner and beneficiary of the policy, and the executive is the insured. The premiums will be a nondeductible expense for the business. The life insurance policy will provide the business with a death benefit and tax-deferred accumulation of the cash value and will serve to informally fund the business' liability for the plan benefits.
- At the executive's retirement, the business begins making payments from the executive's account balance according to the plan agreement. The business may fund these payments via a tax-free distribution of the cash value accumulated within the life insurance policy.² The payments from the plan will be taxable income for the executive and may be tax-deductible for the business.
- In the event of the executive's death, the business will receive the tax-free life insurance death benefit.* If the business has not completed the payments due to the executive under the terms of the agreement, the business may use the death benefit to pay the executive's heirs the remainder value.



401(k) Mirror Voluntary Deferral Plan

A 401(k) mirror plan is a great way to attract and hold on to key executives—especially those who may have already maximized their qualified plan contributions. In many respects, a 401(k) mirror is essentially a non-qualified version of a traditional 401(k) plan, allowing an executive to defer a portion of his or her pre-tax salary, usually with the promise of a company match on some or all of the deferral. Since it is a non-qualified plan, a 401(k) mirror is not subject to normal qualified plan limits²⁵ and may be offered to only a select group of executives as an additional incentive.

The business has the freedom to create a vesting schedule on the matched portion of the plan to encourage executives to stay with the company. Some plans may allow for distributions while the executive is still employed and may even offer survivor benefits should the executive die before the 401(k) mirror benefits have been fully distributed.

How it works:

- The executive agrees to defer future compensation in return for postretirement income, death benefits, or both. The business may also agree to provide contributions matching the executive's deferral.
- The business creates an accounting entry for the executive's account balance, which includes both the executive's deferrals and any matching contributions from the business (neither of which will be taxed to the executive until they are paid).
- The business may choose to informally fund the arrangement by purchasing an insurance policy on the life of the executive.²² The life insurance will provide the business with a death benefit and tax-deferred accumulation of the cash value to offset the expense of the plan benefits.
- When the executive retires, the business begins making payments from the account balance. These payments may be funded through tax-free distributions of the cash value accumulated within the life insurance policy.² Payments from the plan are taxable income for the executive and may be tax-deductible for the business.
- In the event of the executive's death, the business receives the tax-free life insurance death benefit.* If the business has not completed the payments due to the executive under the terms of the agreement, the business may use the death benefit to pay the executive's heirs the remainder due.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Executive Bonus

An executive bonus²⁶ using life insurance is a simple, flexible executive benefits planning strategy. It can be designed to provide an executive with significant benefits on a tax-deductible basis for the business. Similar to a life insurance retirement plan, an executive bonus can provide a business' key executives with a tool for accumulating retirement funds that is both portable and will enable them to take ownership of their own retirement planning.

How it works:

- The business resolves to provide an executive with a taxable bonus or a series of taxable bonuses.
- The executive uses the bonus payments to pay the premiums on a personally owned cash-value life insurance policy.²⁷ The bonuses paid to the executive may be grossed up to help offset the additional income taxes generated by the bonus, resulting in a reduced net cost to the executive.
- During the executive's lifetime, he or she may access the policy's cash value income tax-free for emergencies or other financial needs.²
- At the executive's death, the life insurance death benefit will be paid to the executive's heirs income tax-free.*



Controlled Executive Bonus

A controlled executive bonus²⁶ not only may provide selected executives with significant benefits such as life insurance death benefit protection and cash value accumulation for supplemental retirement income, it may also provide the business with a measure of control over the life insurance policy's cash value. The controlled executive bonus agreement and the policy direction form may allow the business to limit the executive's access to the policy cash value until he or she meets the terms of a vesting schedule.



How it works:

- 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.²⁸
- The executive uses the bonuses to purchase a personally owned life insurance policy. The executive will name the beneficiary of the policy's death benefit.
- A direction form is filed with the life insurance company stating that the exercise of any policy ownership rights (e.g. access to the policy cash value or the surrender of the policy) except for beneficiary designation requires the signature of both the executive and the business. A vesting schedule can be utilized to give the executive incremental access to the policy cash value.
- Once the executive vests or the direction form is removed from the policy, the executive may access the cash value of the life insurance policy tax-free through loans and withdrawals for emergencies as a source of supplemental retirement income or other financial needs.²
- At the executive's death, the life insurance death benefit proceeds may be paid to the executive's heirs income tax-free.*

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).



Cross Purchase

A cross-purchase arrangement requires departing business owners or the estates of deceased business owners to sell their interest in the business at an agreed price. This arrangement may allow for the continuity of management, a source of income for the decedent business owner's family, and a clear direction for future ownership of the business. Life insurance can be an ideal funding vehicle for the cross-purchase.

How it works:

- The business owners enter into a cross purchase agreement requiring them to purchase an exiting or decedent business owner's interest in the business upon a triggering event (e.g. retirement, disability, death).
- To fund their purchase, the business owners purchase life insurance policies on the lives of the other business owners, with the business owners as the owners and beneficiaries of the respective policies.
- Upon a business owner's exit, the remaining business owners can use the policies' cash value for a lifetime buyout.
- At the first business owner's death, the business owners receive the life insurance death benefit proceeds income tax-free* and apply the death benefit proceeds toward the purchase of the decedent business owner's interest in the business.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Insured Controlled Cross Purchase

An insured controlled cross-purchase arrangement is a type of business continuation plan that requires departing business owners or the estates of deceased business owners to sell their interest in the business at an agreed upon price utilizing life insurance policies that are owned by the insureds. This arrangement allows for the continuity of management, a source of income for the decedent business owner's family, and a clear direction for future ownership of the business.

How it works:

- The business owners enter into a binding buy-sell agreement for the purchase and sale of their business interest. Additionally, the business owners enter into private endorsement split-dollar agreements.
- Each business owner purchases a life insurance policy insuring his or her own life.
- Each business owner endorses a portion of the net amount at risk of his or her policy to the others.
- Depending on the split-dollar structure, the business owners may pay premiums equal to the reportable economic benefit on the portion of the death benefit endorsed to him or her, or merely pay income tax on that amount.
- Upon a business owner's retirement (or other departure from the business during his or her lifetime), the remaining business owners can use the policies' cash value for a lifetime buyout; or the split-dollar agreements may be terminated and the life insurance policies' cash value may be used as a source of retirement income.
- At the death of one of the owners, both the owner's estate and the surviving owners receive their portions of the policy death benefit income tax-free.*
- Under the terms of the buy-sell agreement, the living owners apply the death benefit proceeds toward the purchase of the decedent owner's interest in the business.





Family Buy-Sell

A family buy-sell is a cross purchase arrangement designed to address issues unique to family-run businesses. Through it, business owners can address the financial security of their spouses in case of the business owner's death and ensure that the family run business continues to be run by the family members who have kept it a successful operation.

How it works:

- The business owner and a family member enter into a cross purchase arrangement that requires the family member to purchase the business owner's interest in the business for an agreed upon price at the business owner's death.
- To fund the purchase, the family member purchases a life insurance policy on the life of the business owner. The business may provide the family member with a taxable bonus or a series of taxable bonuses to assist with the premium payments.
- At the business owner's death, the family member receives the death benefit proceeds income tax-free* and applies the death benefit proceeds toward the purchase of the business owner's interest in the business from business owner's spouse.

* 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 a business-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

One-Way Buy-Sell

The one-way buy-sell is designed for the sole owners of businesses who may find buy-sell planning difficult because of the lack of co-business owners to buy or take over the business should the business owner die or want to retire. Taking the place of the buyer in this design is a key executive to whom the existing business owner wishes to pass the business. The one-way buy-sell ensures the business transitions from the business owner to the key executive.

How it works:

- The business owner and the executive enter into a one-way cross purchase agreement that requires the executive to purchase the business owner's interest in the business for an agreed upon price at the business owner's death.
- To fund this purchase obligation, the executive purchases a life insurance policy on the life of the business owner. The executive pays the policy premiums and will be the policy beneficiary. To assist with the premium payments, the business may provide the key executive with a taxable bonus or a series of taxable bonuses.
- At the business owner's death, the executive receives the death benefit proceeds income tax-free.*
- The executive applies the death benefit proceeds toward the purchase of the business owner's interest in the business.



Endnotes

- 1 State law may provide life insurance and annuities with certain asset protection benefits. As a general rule, a debtor may not transfer property with the intent to avoid debt due to his creditors. The laws governing asset protection, however, are complex and the consequences of poor planning may be both civil and criminal penalties. Anyone contemplating an asset protection plan should not undertake such without the advice of legal counsel. The protection afforded to the business' accounts receivable through the filing of the form UCC-1 is affected by both federal and state law. The determination of what protection is afforded to those accounts receivable for both the business and the third party lender should be made solely by their legal counsel. The protection afforded to the accounts receivable through the filing of UCC-1 does not perfect the third-party lender's claim in that property if there has been a fraudulent conveyance of the accounts receivable pledged.
- 2 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. 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.
- 3 When a loan is used to purchase a variable life insurance policy, additional lending requirements under Regulation U (12 C.F.R. 220) and Regulation T (12 C.F.R. 221) must be met. Please contact your lender and/or your legal advisors for more information.
- 4 Split Dollar arrangements may be affected by the Sarbanes-Oxley Act of 2002 which prohibits personal loans by public companies to their directors and executive officers. Additionally, final split dollar regulations have been adopted by the IRS that may impact the taxation of split dollar arrangements entered into after September 17, 2003 in many circumstances. Please contact your tax and legal advisors for further guidance.
- 5 In 2011, the maximum benefit that may be provided by a defined benefit plan is \$195,000 per year.
- 6 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 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 non-discrimination 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.
- 7 The client's tax advisor must determine the value of the life insurance policy for a purchase or distribution from the plan.
- 8 The split-funded defined benefit plan may be required to provide de minimus benefits to the rank-and-file employees.
- 9 A qualified plan is subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). The qualified plan administrator will calculate the amounts that must be contributed to both the 401(k) profit-sharing and defined benefit plans without violating qualified plan non-discrimination rules.
- 10 While covered by current life insurance protection, each participant must report the current cost of life insurance protection as taxable income each year.
- 11 The participant will have basis in the policy equal to the cost of current life insurance he or she has incurred. This basis may reduce the value of the policy for the purposes of a sale or distribution from the qualified plan.
- 12 The amount of life insurance protection that may be offered in the qualified plan is limited by the incident death benefit rule.
- 13 In order to use life insurance as the informal funding vehicle for the plan, the insured should be a 5% or more shareholder, a director of the business, or a highly compensated employee as defined in either IRC Sec. 416(q) or IRC Sec. 105(h)(5). Prior to issuance of the life insurance policy, the business must provide written notice to the insured that it intends to be the owner and beneficiary of a life insurance policy on the insured's life and may choose to continue the coverage beyond the executive's employment. The business must also notify the insured as to the maximum amount of life insurance that could be purchased on the executive's life. The insured must give written consent to such life insurance coverage.
- 14 The business may continue to maintain death benefit coverage on the business owner even after a life-time buyout.
- 15 The remaining owners of a C-Corporation will not receive an increase in basis in the business. Deceased shareholder's estate may receive a step-up in basis in business interest within six months of death, which may reduce or eliminate capital gains exposure.
- 16 Because of the fringe benefit rules, more than 2% owners of pass-through entities (e.g. S-Corporation and LLCs) cannot participate in a Section 79 Plan.
- 17 Benefits must be offered to employees other than the business owner. Depending on the size of the business, it is possible that the benefits must be offered to all of the business' employees.
- 18 In order for the cost of the first \$50,000 of death benefit coverage to be excluded from income taxation for key employees and owners, the plan must meet non-discrimination rules with respect to eligibility and benefits. If the death benefit coverage exceeds \$50,000, the employee must include in income the value of the excess death benefit (economic benefit cost) as determined using the IRS Table I rates, which establishes uniform premiums based on 5-year age brackets.
- 19 Most SERPs are subject to the requirements of IRC Section 409A. Failure to meet the requirements of IRC Section 409A will result in substantial tax-penalties for the executive/participants.
- 20 The executive's SERP account balance will be subject to employment taxes (FICA and FUTA) when the plan is no longer subject to a substantial risk of forfeiture (i.e. vested).
- 21 The qualified plan administrator will calculate the amounts that must be contributed to both the 401(k) profit-sharing and defined benefit plans without violating qualified plan non-discrimination rules. A qualified plan is subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA).
- 22 Note that the life insurance policy is not the plan; it is merely an informal funding vehicle utilized by the business to accumulate the funds necessary to pay the benefits due under the plan. Prior to issuance of the life insurance policy, the business 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. The business must also notify the executive as to the maximum amount of life insurance that could be purchased on the executive's life. The executive must give written consent to such life insurance coverage. In order to use life insurance as the informal funding vehicle for the plan, the executive should be a 5% or more shareholder, a director of the business, or a highly compensated employee as defined in either IRC Sec. 416(q) or IRC Sec. 105(h)(5).
- 23 A Voluntary Deferral Plan is subject to the requirements of IRC Section 409A. Failure to meet the requirements of IRC Section 409A will result in substantial tax penalties for the executive/participant.
- 24 If the voluntary deferral plan provides a survivor benefit, the executive's voluntary deferral plan account balance will be included in his or her taxable estate. The executive's deferral into the voluntary deferral plan will be subject to employment taxes (FICA and FUTA).
- 25 A 401(k) Mirror is subject to the requirements of IRC Section 409A. Failure to meet the requirements of IRC Section 409A will result in substantial tax penalties for the executive/participant.
- 26 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.
- 27 Universal life insurance generally requires additional premium payments after the initial premium. If either no premiums are paid, or subsequent premiums are insufficient to continue coverage, it is possible that coverage will expire.
- 28 The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).



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