It's All About the Business

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

AD-OC-775B

TABLE OF CONTENTS

1: Introduction

3: 3 Step Planning Process

- 4: Step 1
- 6: Step 2
- 8: Step 3

11: Planning Strategies

- 12: Restricted Executive Bonus
- 14: Cross-Purchase Buy-Sell
- 15: Employee Stock Ownership Plan (ESOP)
- 16: Entity Purchase Buy-Sell (a.k.a. Stock Redemption)
- 17: Irrevocable Life Insurance Trust (ILIT)
- 18: Key Person Life Insurance
- 19: Life Insurance Retirement Plan (LIRP)
- 20: Nonqualified Deferred Compensation (NQDC)
- 23: One-Way Buy-Sell
- 24: Permanent Benefit Section 79 Plan
- 25: Personally-Owned Life Insurance
- 26: Split-Funded Defined Benefit Plan
- 28: Wait-and-See Buy-Sell

29: Endnotes

Insurance products are issued by Pacific Life Insurance Company in all states except New York, and in New York by Pacific Life & Annuity Company. Product availability and features may vary by state.

Investment and Insurance Products: Not a Deposit — Not FDIC Insured — Not Insured by any Federal Government Agency — No Bank Guarantee — May Lose Value

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

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

How can I ensure my business will continue to thrive when I'm not around?

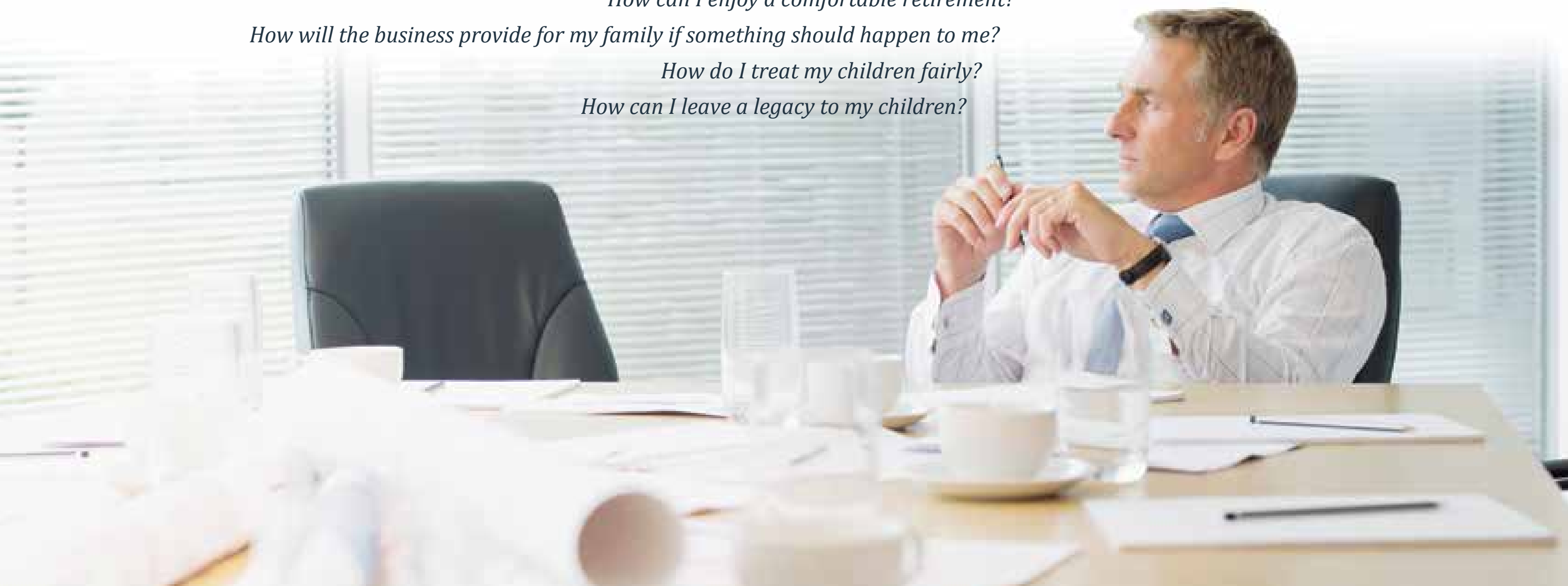
How do I successfully transition the ownership of the business?

How can I enjoy a comfortable retirement?

How will the business provide for my family if something should happen to me?

How do I treat my children fairly?

How can I leave a legacy to my children?



This material is not intended to be used, nor can it be used by any taxpayer, for the purpose of avoiding U.S. federal, state or local tax penalties. This material is written to support the promotion or marketing of the transaction(s) or matter(s) addressed by this material. Pacific Life, its distributors and their respective representatives do not provide tax, accounting or legal advice. Any taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

What could happen if you don't take action?

Your business and your legacy may not survive your death.

Only between **10-20% of small business owners** have a succession plan in place[1] and less than **30% of family-owned businesses** are transferred successfully to the next generation.[2]

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

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

2/3 of investors between age 21 and 50 doubt they will have enough money for retirement[3]; 64% of Gen X & Gen Y investors expect retirement income will come from non-retirement accounts; and 1/3 of small business owners do not have a personal or business sponsored retirement[4]

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

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

Only **27% of businesses** proactively manage retention of key employees through funded programs.[4]

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

See relevant endnotes on page 29.

3 Steps to Turn Your Concerns Into a Plan for Success

How You and Your Life Insurance Producer Can Work Together

STEP 1 **Identify and Prioritize Your Concerns** Discuss your concerns and goals with your life insurance producer. Together you can locate your concerns on the chart on the following pages. The chart connects concerns with planning strategies that might help. Each planning strategy is described on the corresponding page. Pay special attention to any considerations. These are items you may want to discuss with your tax and legal advisors as well as your life insurance producer.

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

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

STEP1

Identify and Prioritize Your Concerns

Use the following grid to find the concerns that most closely match your own. Then, note the respective planning areas that may help resolve those concerns. Finally, prioritize the concerns and the respective planning areas on which you need to focus.

What are your concerns?	Planning Areas That Address Your Concerns
I want to sell my business eventually. • How can I successfully sell my interest in the business during my lifetime or at death to a family member, co-owner, third party or employee(s)?	*Business Continuation Planning Strategies* *(Refer to grid in Step 2 on following pages)*
My business is highly dependent upon one or more key employees. • How can I ensure the continued success of my business throughout the transition process? • How can I make sure my business continues to succeed if I lose a key employee?	*Executive Benefit Planning Strategies* *(Refer to grid in Step 2 on following pages)*
I want to make sure I have a comfortable retirement. • How can I secure a retirement that is less dependent on the continued success of the business and/or the disposition of my interest in the business?	*Retirement Planning Strategies* *(Refer to grid in Step 2 on following pages)*
I want to provide financially for my family and protect my business in the event of my death. • How can I provide for my family independent of the continued success of the business? • How do I treat my non-business heirs fairly? • How do I make sure that estate taxes do not adversely impact the business?	*Estate Planning Strategies* *(Refer to grid in Step 2 on following pages)*

Identify and Implement the Strategies that Best Fit Your Situation

Business Continuation Planning Strategies

Does this describe you?	Strategies to Consider
My business has multiple owners, and we would like to sell our interests to each other.	*Entity Purchase Buy-Sell (p. 16)* *Cross-Purchase Buy-Sell (p. 14)*
My business has multiple owners, and we would like to sell our interests to each other, but we want flexibility as to how the purchase is ultimately handled.	*Wait-and-See Buy-Sell (p. 28)*
My business has multiple owners and I want to sell my interest to one or more co-owners, but there is no mutual intent to sell on their part.	*One-Way Buy-Sell (p. 23)* *Entity Purchase Buy-Sell (p. 16)*
My business has multiple owners and I want to sell my interest to one or more co-owners, but there is no mutual intent to sell on their part. I want flexibility as to how the purchase is ultimately handled.	*Wait-and-See Buy-Sell (p. 28)*
I want to sell my business interest to a non-owner, such as a key employee, family member or third party.	*One-Way Buy-Sell (p. 23)*
I have no readily available successor or buyer of my business interest and would consider having the business become employee-owned.	*Employee Stock Ownership Plan* (p. 15)*

* *Limited to C and S-Corporations*

Executive Benefits Planning Strategies

Does this describe you?	Strategies to Consider
I want to preserve the value of my business and keep it thriving for many years by incentivizing my key employees to remain with the business.	*Restricted Executive Bonus (p. 12)* *Nonqualified Deferred Compensation (p. 20)*
I want to protect my business in the event of the premature death of one or more key executives.	*Key Person Life Insurance (p. 18)*

Retirement Planning Strategies

Does this describe you?	Strategies to Consider
My business is a C-Corporation.	*Permanent Benefit Section 79 Plan (p. 24)* *Split-Funded Defined Benefit Plan (p. 26)* *Life Insurance Retirement Plan (p. 19)*
My business is a pass-through entity (e.g., S-Corporation, limited liability company, or partnership).	*Split-Funded Defined Benefit Plan (p. 26)* *Life Insurance Retirement Plan (p. 19)*

Estate Planning Strategies

Does this describe you?	Strategies to Consider
I want my estate to have sufficient liquidity so that estate taxes[5] and other costs do not adversely impact the business or my succession or exit plan.	*Irrevocable Life Insurance Trust (p. 17)*
I want my family to be taken care of upon my death without being dependent upon the continued success or disposition of the business.	*Irrevocable Life Insurance Trust (p. 17)* *Personally-Owned Life Insurance (p. 25)*
I want to ensure that any non-business heirs are treated fairly.	*Irrevocable Life Insurance Trust (p. 17)* *Personally-Owned Life Insurance (p. 25)*

STEP3

Fund Your Planning Strategies

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

What are your concerns?	How Life Insurance Can Help
I want to sell my business eventually. • How can I successfully sell my interest in the business during my lifetime or at death to a family member, co-owner, third party or employee(s)?	• *Death benefit provides funds to purchase your business interest at death. Cash value acts as a tax-deferred sinking fund for purposes of purchasing your business interest during your lifetime.*
My business is highly dependent upon one or more key employees. • How can I ensure the continued success of my business throughout the transition process? • How can I make sure my business continues to succeed if I lose a key employee?	• *Cash value can be used to informally fund an executive benefit plan to help you retain key employees essential to the continued success of your business.* • *Death benefit provides funds to help your business recover from the death of a key employee.* • *Death benefit provides funds to pay off business debt that may otherwise be called, and to ensure that the business is more financially secure.*
I want to make sure I have a comfortable retirement. • How can I secure a retirement that is less dependent on the continued success of the business and/or the disposition of my interest in the business?	• *Cash value can provide a potential source of supplemental retirement income so that you and your family are not as dependent upon the business for retirement income.* • *Death benefit can address a short-fall in retirement income for a surviving spouse should you die prematurely.*
I want to provide financially for my family and protect my business in the event of my death. • How can I provide for my family independent of the continued success of the business? • How do I treat my non-business heirs fairly? • How do I make sure that estate taxes do not adversely impact the business?	• *Death benefit provides funds for your family so that they aren't dependent upon the continued success of the business after your death.* • *Death benefit provides funds to treat children not involved in the family business fairly.* • *Death benefit provides funds to pay estate taxes[5] to make sure your business doesn't need to be sold and that it passes intact to your children.*

See relevant endnotes on page 29.

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

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

1. Tax-deferred treatment of any increase in cash value.
2. Tax-free distributions from the cash surrender value.[6]
3. Tax-free death benefit payable to the life insurance policy's named beneficiary.*

Buy-Sell Funding

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

Cash value life insurance, on the other hand, provides funds in the event of the business owner's death and acts as a tax-deferred sinking fund for purposes of a lifetime buyout. If the business owner leaves the business due to retirement, disability, etc., the owner of the policy has income tax-free[6] access to the policy's available cash surrender value in order to effectuate a lifetime buy-out.

See relevant endnotes on page 29.

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

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

Integrated Business Succession & Exit Planning

Restricted Executive Bonus

WHAT IS IT? A Restricted Executive Bonus is a strategy that allows an executive to use business-provided dollars to fund an individually-owned life insurance policy.[7] A Restricted Executive Bonus may provide selected executives with significant benefits such as life insurance death benefit protection and cash value accumulation for supplemental retirement income, as well as provide the business with a measure of control over the life insurance policy's cash value. The Restricted Executive Bonus agreement and the policy's direction form allow the business to limit the executive's access to the policy's cash surrender value until he or she meets the terms of a restricted access schedule.

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

CONSIDERATIONS:

- Bonuses may be tax-deductible for the business, so strategy may be most advantageous for high tax-bracket C-Corporations.
- May provide "golden handcuffs" to help business attract and retain key executives.
- Business can control executive's access to the policy's cash value.
- Generally provides an income tax-free death benefit* to executive's family.

See relevant endnotes on page 29.

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

HOW DOES IT WORK? Working with an attorney, the business enters into a written 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.[8] The executive will use the bonuses to purchase an individually-owned cash value life insurance policy. The executive will name a personal beneficiary for the policy's death benefit. The business will file a direction form with the life insurance company. The direction form states that the exercise of any policy ownership rights (e.g., access to the policy cash surrender value or surrender of the policy) except for beneficiary designation requires the signatures of both you (the employer) and the executive. A restricted access schedule can be utilized to give the executive incremental access to the policy's cash surrender value. Once the access is no longer restricted, the executive may access the available cash surrender value of the life insurance policy tax-free through loans and withdrawals for emergencies or other financial needs.[6] Keep in mind that the cash value accumulates without current taxation to the policy owner. At the executive's death, the life insurance death benefit proceeds may be paid to the executive's heirs income tax-free.*

Cross-Purchase Buy-Sell

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

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

CONSIDERATIONS:

- Purchasing business owners may receive an increase in basis equal to purchase price of their interest in the business.
- Cash value of life insurance owned on co-owner's lives may be included in decedent business owner's estate.

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

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

Cash value life insurance owned by the company is oftentimes used to informally "fund" the company's repurchase obligation. Policy cash values can accumulate tax-deferred and can potentially be accessed income tax-free[6] for annual stock repurchases. In addition, any death benefit proceeds paid may be received by the company income tax-free,[*] and can create an immediate source of funds for stock repurchase in the event of an untimely death of a major participant or shareholder.

See relevant endnotes on page 29.

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

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

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

HOW DOES IT WORK? Working with their legal, tax and financial advisors, the business and the business owners enter into an entity purchase agreement. The agreement will require the business to purchase the participating business owners' interests in the business for an agreed upon or determinable price upon the occurrence of a triggering event (e.g., death, disability, retirement). The business will purchase a cash value life insurance policy on each of the participating business owner's lives in order to fund the purchase obligation.[9] The business will pay the premiums and be the owner and beneficiary of the policies. At the business owner's death or departure from the business, the business will use the death benefit proceeds or the available cash surrender value to purchase the business owner's interest.

WHAT IS IT? To the extent that the business owner needs life insurance and has an estate size that is subject to potential estate taxation,[5] it may be prudent to have the life insurance owned outside the business owner's estate. An ILIT is an estate planning tool that is commonly used to accomplish this goal. It is designed to be the owner and beneficiary of a life insurance policy or policies. A properly drafted ILIT removes the life insurance policies from the insured's gross estate and thus avoids subjecting the proceeds to estate taxation. Additionally, because the ILIT is also the beneficiary of the life insurance policy, the terms of the ILIT determine how the death benefit proceeds will be distributed. A possible alternative to an ILIT is to have an adult child or children own the life insurance.

HOW DOES IT WORK? With the assistance of an attorney, the business owner establishes an ILIT to be the owner and beneficiary of a life insurance policy insuring the business owner's life or the lives of the business owner and his or her spouse. The business owner gifts cash to the ILIT in order for the trustee[10] of the ILIT to pay life insurance premiums. Whether or not these transfers are subject to gift tax depends on the business owner's ability to make annual exclusion gifts and/or to use his or her lifetime gift tax exemption.[5] If structured properly, the life insurance death benefit proceeds will be excluded from the business owner's taxable estate and, as a result, will not be subject to estate tax.

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

CONSIDERATIONS:

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

See relevant endnotes on page 29.

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

Key Person Life Insurance

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

HOW DOES IT WORK? The business purchases a life insurance policy on the life of a key executive. The business, prior to issuance of the life insurance policy, must provide written notice to the executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment.[11] The business must also notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage. The business pays all of the premiums and retains all ownership rights to the policy. If cash value life insurance is utilized, the cash value of the policy will accumulate in a tax-advantaged manner. If the key executive dies while the life insurance policy is in-force, the business will receive the policy death benefit proceeds income tax-free.* The business may use the death benefit proceeds or available cash surrender value to sustain operations following the key executive's death.

See relevant endnotes on page 29.

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

Life Insurance Retirement Plan (LIRP)

WHAT IS IT? A Life Insurance Retirement Plan (LIRP) is a strategy using life insurance. The life insurance provides death benefit protection while acting as a supplemental retirement income strategy with the use of cash value life insurance. LIRP is designed as a cash accumulation vehicle and may complement a Roth IRA. In the event a client does not meet the eligibility requirements of a Roth IRA or the contribution limits are too low, a LIRP may be a Roth IRA alternative or supplement. Similarly, LIRP is characterized by the following: (1) premiums are paid with after-tax dollars, (2) any increase in cash value is tax-deferred and (3) income can be distributed tax-free from the policy.[6] Unlike a Roth IRA, assuming the policy complies with IRC Sec. 7702 and is not a Modified Endowment Contract, there is no IRS limit on the amount of premium that can be paid. In addition, the pre-retirement death benefit may address any shortfall in retirement income for a surviving spouse. It should be noted that mortality costs are deducted from the cash value of the policy, so LIRP makes the most sense where there is a need for the life insurance death benefit.

HOW DOES IT WORK? The business owner will purchase and personally own a cash value life insurance policy on his or her own life. If the life insurance policy is properly structured, any cash value in the life insurance policy will grow tax-deferred. At the business owner's retirement, he or she may take tax-free loans or withdrawals[6] from the policy's available cash surrender value to supplement retirement income. At the business owner's death, the beneficiaries will receive the life insurance policy's death benefit proceeds income tax-free.*

Nonqualified Deferred Compensation (NQDC)[12]

WHAT IS IT? A nonqualified deferred compensation (NQDC) plan[7] can provide attractive supplemental retirement benefits to executives who have maximized their qualified plan options. It can be an effective method for a business to attract and retain key executives. NQDC plans are made up of employee before-tax salary deferrals, business contributions, or both. The business may informally fund the promised benefit with any asset it deems appropriate, including life insurance. Alternatively, the business may choose not to informally fund the benefit at all and can pay the promised benefits out of future cash flows. Participating key employees are not generally income taxed until they receive their benefits.

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

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

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

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

See relevant endnotes on page 29.

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

Cash value life insurance can serve as an attractive informal funding option for the business because the policy's cash values may accumulate without any current taxation to the business. Additionally, the business may access the policy's available cash surrender values on a tax-free basis[6] in order to pay the promised benefits to the executive. Finally, life insurance policy death benefit proceeds are received by the business income tax-free.* Businesses may use this death benefit as a cost recovery feature to partially or wholly offset the costs of sponsoring the plan and/or to provide a pre-retirement death benefit to the executive's heirs.

As compared to the Restricted Executive Bonus, the NQDC arrangement has the advantage of providing much stronger "golden handcuffs" on the executive via the inclusion of a vesting schedule within the agreement. Note, however, that NQDC plans do not allow an up-front tax deduction for the business' contributions to the plan. Also, if life insurance or other asset is chosen to informally fund the benefit, this asset must remain subject to the business' creditors at all times.

CONSIDERATIONS:

- May provide "golden handcuffs" if business places vesting schedule on the benefits.
- NQDC plan must be offered only to "top hat" group (select group of management or highly compensated employees).
- May allow executive to accumulate retirement income in excess of what can be accumulated in a qualified plan.
- Subject to IRC Sec. 409A requirements.
- Executive's salary deferrals are pre-tax contributions to the plan.
- Cash value life insurance can serve as an informal funding vehicle.
- Cash value life insurance may help provide cost recovery to business.

Nonqualified Deferred Compensation continued on next page.

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

If the business chooses to informally fund the NQDC plan with life insurance, the business, prior to issuance of the life insurance policy, must provide written notice to each executive that it intends to be the owner and beneficiary of a life insurance policy on the executive's life and may choose to continue the coverage beyond the executive's employment.[13] Also, the business must notify the executive as to the maximum amount of life insurance that could be placed on the executive's life. The executive must give written consent to such life insurance coverage. The policy may provide the business with tax-deferred growth of the policy's cash value, and a death benefit payable to the business which may be used to pay survivor benefits to the executive's heirs.

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

See relevant endnotes on page 29.

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

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

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

CONSIDERATIONS:

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

Permanent Benefit Section 79 Plan

WHAT IS IT? IRC Section 79 permits businesses to offer group life insurance to employees. The employer pays the premiums and is able to deduct the full amount. The employee receives up to $50,000 of death benefit proceeds income tax-free* and is taxed on the cost to provide any excess death benefit. 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 individually owned cash value life insurance policies. Employees who choose permanent benefits, in addition to the cost to provide any death benefit in excess of $50,000, must include as income the cost of the permanent benefits.[14] The formula used to determine the cost of the permanent benefits may result in the participants being taxed on less than 100% of the permanent policy premium.

If two-percent or more owners of a business want to participate, the business will need to be a C-Corporation or an LLC taxed as a C-Corporation. Two-percent or more owners of pass-through entities are not eligible because they are not considered to be employees.

HOW DOES IT WORK? The business, working with its attorneys, tax advisors and third-party administrator (TPA), will establish a group life plan under IRC Section 79 and allow an employee to choose among the following options:

- $50,000 group term insurance with no taxable economic benefit.
- Supplemental term life insurance in excess of $50,000 with a taxable economic benefit.
- A taxable permanent benefit (cash value life insurance).

Each participating employee will choose the option that best fits his or her economic needs. Employees electing permanent benefits will own an individually-owned cash value life insurance policy. These employees can use the cash value policy as a potential source of tax-free[6] supplemental retirement income.

CONSIDERATIONS:

- Business must be a C-Corporation or an LLC taxed as a C-Corporation.
- May provide significant benefits to business owner and employees.
- Premium payments are tax-deductible for business.
- Amount taxable to participant may be significantly less than full premiums paid.

See relevant endnotes on page 29.

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

WHAT IS IT? To the extent that a business owner needs life insurance but does not expect to have any estate tax liability[5] with respect to the life insurance policy, it may be prudent to own the life insurance personally. The personally-owned life insurance policy serves the dual purpose of providing death benefit protection for the designated beneficiaries as well as providing potentially income tax-free access[6] to the policy's available cash surrender value for supplemental income purposes, if needed. Note that if the inclusion of the life insurance policy in the estate becomes problematic, the policy owner can always gift the policy out of the estate at that time.[15]

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

Split-Funded Defined Benefit Plan

WHAT IS IT? A defined benefit (DB) plan is a qualified plan designed to provide the participant with a stated benefit at retirement.[16] Generally, in the case of older participants, a DB plan will allow a business to make much larger contributions to the plan than it could make to a defined contribution plan (e.g., a 401(k) profit-sharing plan). A split-funded DB plan is simply a DB plan that is funded with both securities and life insurance. Including an incidental amount of life insurance in the plan not only allows the participant to meet his or her life insurance needs using pre-tax dollars, but also increases the annual deductible contribution without reducing the retirement income benefit.[17]

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

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

If the participant dies prior to retirement, the life insurance death benefit will be paid to the plan. Upon the participant's death, the split-funded DB plan will provide a survivor benefit to the participant's heirs. This survivor benefit will include the life insurance death benefit received by the plan. If the participant included the cost of current life insurance protection in his or her income, the heirs will receive a portion of the life insurance death benefit free from income taxes.* If the participant retires prior to death, he or she may begin receiving taxable retirement income benefits from the plan. At retirement, the participant may (1) have the plan surrender the life insurance policy, (2) purchase the life insurance policy from the plan, or (3) take the policy out of the plan as a taxable distribution.[18]

CONSIDERATIONS:

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

See relevant endnotes on page 29.

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

Wait-and-See Buy-Sell

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

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

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

Endnotes

1 *The Succession Planning Group, "Business Owner Succession Planning for Death, Divorce or Disability, available at http://www.thesuccessionplanninggroup.com/articles/item/33-succession-plan-death-divorce-disability?tmpl=component&print=1 (last visited March 25, 2013).*

2 *Tannette Johnson-Elie, "Succession Planning for Small Business Owners." Market Wire (February 7, 2013).*

3 *Gen X and Y Investors Worry Retirement Savings Won't Be Enough," Michael S. Fischer, AdvisorOne, March 9, 2012.*

4 *Many Small-Business owners aren't prepared for Retirement," Laura Petrecca, USA Today, March 1, 2012.*

5 *According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).*

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

7 *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.*

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

9 *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). However, death proceeds from an employer-owned policy are taxable unless the policy qualifies for an exception under IRC Sec. 101(j). Prior to the issuance of the life insurance policy, the employer must provide written notice to the employee that it intends to be the owner and beneficiary of a life insurance policy on the employee's life and may choose to continue the coverage beyond the employee's employment. The employer must also notify the employee as to the maximum amount of life insurance that could be placed on the employee's life. The employee must give written consent to such life insurance coverage.*

10 *The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.*

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

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

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

14 *Taxable income to participants in a Sec. 79 Permanent Benefit plan is comprised of two parts: (1) the life insurance benefit; and (2) the permanent benefit. Calculation of taxable income is not performed by Pacific Life, and is not a part of any sales material or illustration prepared by Pacific Life. Taxable income calculations are typically performed by independent third party administrators based on their understanding of the Sec. 79 regulations. Pacific Life makes no representation as to the appropriateness of these taxable income calculations. You should obtain whatever advice you deem necessary and appropriate from your independent tax and legal counsel as to the reasonableness of those calculations performed by such third parties.*

15 *Pursuant to IRC Sec. 2035, the death benefit proceeds will still be includible in the insured policyowner's taxable estate if the insured dies within 3 years of gifting the policy out of the estate.*

16 *In 2013, the maximum benefit that may be provided by a defined benefit plan is $205,000 per year.*

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

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

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

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

Pacific Life refers to Pacific Life Insurance Company and its affiliates, including Pacific Life & Annuity Company. Insurance products are issued by Pacific Life Insurance Company in all states except New York and in New York by Pacific Life & Annuity Company. Product availability and features may vary by state. Each insurance company is solely responsible for the financial obligations accruing under the products it issues. Insurance products and their guarantees, including optional benefits and any fixed subaccount crediting rates, are backed by the financial strength and claims-paying ability of the issuing insurance company, but they do not protect the value of the variable investment options. Look to the strength of the life insurance company with regard to such guarantees as these guarantees are not backed by the broker-dealer, insurance agency or their affiliates from which products are purchased. Neither these entities nor their representatives make any representation or assurance regarding the claims-paying ability of the life insurance company. Variable insurance products are distributed by **Pacific Select Distributors, Inc.,** (member FINRA & SIPC), a subsidiary of Pacific Life Insurance Company, and an affiliate of Pacific Life & Annuity Company, and are available through licensed third-party broker-dealers.

Please Note: This brochure is designed to provide introductory information in regard to the subject matter covered. Neither Pacific Life nor its representatives offer legal or tax advice.

Consult your attorney or tax advisor for complete up-to-date information concerning federal and state tax laws in this area.

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

____
Life Insurance Producer's Name

____
State Insurance License Number
(or affix your business card)

AD-OC-775B

15-30022-02 6/13