BUILDING A BETTER BUSINESS

FIELD GUIDE TO BUSINESS PLANNING USING LIFE INSURANCE

TRANSAMERICA®

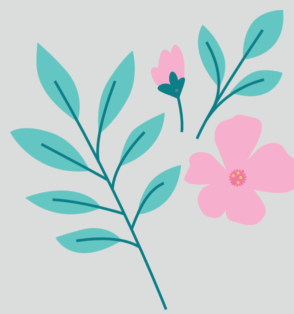
CONTENTS

THE IMPORTANT ROLE OF LIFE INSURANCE IN BUSINESS PLANNING

Transamerica is pleased to provide a consolidated reference guide on the role life insurance can play in your business. This guide is designed to give you actionable concepts and strategies to implement within your organization.

Many entrepreneurs and business owners may not understand how life insurance can play a critical role in their business's success during all stages of life. The reality is any business — no matter the size, structure, or length of establishment — may benefit from one or more of the strategies and concepts contained within this guide. A basic understanding of where life insurance can be leveraged in business planning may help you take care of the current and long-term sustainability of your business, as well as help potentially reduce taxes and be aware of common business planning pitfalls.

You are receiving a copy of this guide because your financial professional recognizes the importance of life insurance in business planning. We hope you find it a useful reference tool in helping you identify potential business planning issues and possible solutions.



Please note the information contained in the guide is not intended to constitute tax or legal advice. Always consult with your tax and legal professionals regarding your personal circumstances.

INTRODUCTION TO BUSINESS ENTITIES

The type of business entity you have established will determine what legal and tax implications will affect your business planning. The structure of your business is important because it will determine how the business operates, what liability the owner or owners have, how the business is taxed, and how expenses, benefits, and compensation are treated. To determine appropriate life insurance coverage amounts, premium dollars, and taxation when implementing these concepts and strategies, it is important to look at your business's financial statements.

SOLE PROPRIETORSHIPS

WHAT IT IS

A sole proprietorship is a business without a separate legal existence from its single owner.

The owner and the business are one and the same legal and tax-paying entity. Business property and assets are personal assets and property of the owner and all debts and liabilities are personal liabilities and debts of the owner. Sole proprietorships are the most common type of business, likely due to the simplicity of formation and the default classification for business with one owner. Many farms, stores, and professional practices adopt this type of business structure.

TAXATION

Since the sole proprietorship isn't a separate tax entity, it neither has to pay tax nor report tax. Therefore, it is not required to file a tax return. Instead, all tax reporting is filed by the owner on their personal tax return. The owner will report any profits or losses on Schedule C and file with Form 1040. All profits or losses are taxed at the owner's individual tax rate. A possible opportunity for a 199A (Qualified Business Income) Deduction is described later in this guide.

BUSINESS LIQUIDATION AFTER OWNER'S DEATH

Liquidation (worst case, no will): Once the proprietor passes away, the business assets and liabilities are part of the deceased's estate. Without a properly drafted will, the personal representative or executor may have no other option than to quickly sell the business assets to pay taxes, debts, or other expenses to settle the proprietor's estate. This could ultimately cost the beneficiaries if the assets are sold at lower than valued liquidation prices, and impact the income being produced by the business.

Continuing until a sale of the business can be executed (with a will): If the proprietor has a will, it can give broad authority to the executor to operate the business beyond a normal time needed for liquidation. This may not solve all the problems. The executor may not have the time or experience to run the day-to-day operations of the business. There may not be enough liquidity in the estate to pay the taxes and estate costs, which would force the sale of the business and assets.

BUSINESS LIFE AFTER OWNER'S DEATH

Keeping the business in the family: If the business has been established for years, there may be a family member who has the experience or desire to take over the ownership and management of the business. With a properly drafted will, the proprietor can simply bequeath the business assets to a family member.

Sale to an employee (using a buy-sell agreement): There may not be a family member who is able or willing to take over the business if the proprietor passes away. However, there may be an employee interested in taking over the business. A properly implemented buy-sell agreement can guarantee the orderly transfer of ownership. Buy-sell agreements are discussed in more detail later in this guide.

PARTNERSHIPS

WHAT IT IS

Under the Uniform Partnership Act (UPA), a partnership is "an association of two or more persons to carry on as co-owners of a business for profit."

Co-ownership and sharing of profits are the two key elements required to make a partnership. A partnership agreement can be entered into orally, but to avoid any misunderstanding, the partners should have a written partnership agreement. Every state, except Louisiana, models its partnership statute after the UPA or Revised Uniform Partnership Act. The UPA was enacted to help states govern the relationships between the partners as well as the relationships of the partners to third parties. The state statutes will be the default treatment for any partnership matters not specifically addressed in the partnership agreement.

TWO TYPES OF PARTNERSHIPS

General Partnership
All owners are general partners sharing in profits, losses, share in management, and subject to unlimited personal liability for the partnership. There are no limited partners in a general partnership.

Limited Partnership
A limited partnership has at least one general partner and at least one limited partner. Limited partners can contribute capital and share in profits, but are limited to liability for the partnership only up to the amount of their capital investment.

TAXATION

Similar to a sole proprietor, a partnership does not pay income tax. Dissimilar to a sole proprietor, a partnership is a separate tax entity from the partners and is required to file a tax return annually. Form 1065, "U.S. Return of Partnership Income," is completed by the partnership as an informational return. This form documents any deductions, income, and credits that are separate from the general income and deductions. Schedule K of Form 1065 is used to document the distributive shares, if any, of each of these separate items. Partners report items of profits, losses, deductions, and credits on Schedule E of their Form 1040. A possible opportunity for a 199A (Qualified Business Income) Deduction is described later in this guide.

BUSINESS LIFE AFTER PARTNER'S DEATH

Typically, the death of a general partner will dissolve the partnership agreement, while the death of a limited partner does not. Check state statutory law if it is not clearly written in the partnership agreement. When a general partner dies, the partnership is changed, causing dissolution and winding up of the partnership. Unless otherwise written in the partnership agreement, the surviving partners have two choices: liquidation (termination) or reorganization.

Liquidation (termination)
When a partner dies, that partner's share of the partnership passes to the intended beneficiaries. The heirs may need cash from the liquidation of the partnership to settle the deceased partner's estate, or they may not want or be able to take over the deceased's role in the business. This may cause a less than ideal liquidation sale at bargain prices.

Reorganization
With proper planning, a reorganization may prevent a liquidation of the partnership. There are typically four possible options between the deceased partner's heirs and the surviving partners:

- Heirs become partners
- Sell heir's interest to a third party
- Surviving partners sell their interest to the deceased partner's heirs
- The surviving partners buy the deceased partner's share from the heirs

A properly implemented buy-sell agreement between all the partners may provide for the orderly transfer of the deceased partner's share in the partnership and allow the partnership to continue. Buy-sell agreements are discussed in more detail later in this guide.

WHAT IT IS

An FLP is a business entity that serves a dual purpose as a financial planning tool. It can combine business succession planning, estate planning, tax planning, and business operational planning under one arrangement.

It is used most commonly when an individual owns real estate, a business, or a farm and wants to centralize management while reducing potential estate transfer tax to family members in the future.

Similar to a limited partnership, the FLP has general partners and limited partners. General partners have control over day-to-day operations of the business and have unlimited personal liability for the debts of the partnership, as well as personal liability for the negligence of the other partners. Limited partners are not involved in the operation of the business and their personal assets are shielded from partnership creditors. Limited partners' liability is limited to the amount of personal investment or shares in the partnership.

FAMILY LIMITED PARTNERSHIP (FLP)

HOW AN FLP WORKS – CASE STUDY

Jane and John are in their mid-40s and own some rental properties. Jane and John will be the general partners in the FLP. They have two children in their 20s (Jesse and Janice), who will be the limited partners in their FLP.

Jane and John reserve the name that the partnership will do business under with the secretary of state's office and file an application for a federal tax identification number (IRS Form SS-4). Then, Jane and John work with an experienced attorney, familiar with partnership agreements in their state, to prepare the partnership agreement, articles, and certificate of limited partnership. Those documents are then filed with the secretary of state's office. Once the limited partners have signed the acceptance, Jane and John make a capital contribution of their rental properties, currently valued at **$1,500,000.** The FLP is structured into units worth **$15,000** each, or 100 total units. Two of the units are general partnership units, and the rest are limited partnership units.

The FLP has now been established and funded with the rental properties. Jane and John may begin a gifting program giving the limited partnership units to Jesse and Janice. The IRS allows FLP units a valuation discount for minority interest and lack of marketability, we will assume the discount is 50%. This reduces the gift tax value of each unit in the FLP to **$7,500** instead of the **$15,000** fair market value. IRC Section 2513 allows a married couple to use gift-splitting, so Jane and John can gift a combined **$30,000** to each child each year by utilizing the full gift tax exclusion. This means Jane and John can gift each child four limited partnership units each year, or eight units per year to their two adult children.

This assumption implies the value of the units will stay the same or increase in the same proportion as indexed increases in the gift tax annual exclusion. In this case study, all 98 units of the limited partnership units will be completely transferred to the two adult children in 12 years without utilizing any of Jane and John's lifetime gift tax exemption amount.

NEED FOR LIFE INSURANCE IN FLPS

FLPs can be the owner of a life insurance policy, which can help create liquidity for an owner's estate upon their passing. You should consult your tax and/or legal professional before establishing these policies.

Further, there is a business insurance need for FLPs, just like any business entity. Business insurance needs include, but are not limited to:

- Key person life insurance
- Executive benefit strategies
- Business succession planning such as funding a buy-sell agreement among the partners

CORPORATIONS

WHAT THEY ARE

A corporation is created under state law and cannot legally exist without authorization from the state government.

Most states have a registration process to apply for incorporation. The steps set forth in the state corporation statutes must be completed before a corporation can begin doing business. Once a corporation is established, the shareholders purchase shares of equity in the corporation, which gives them the right to vote, elect the board of directors, attend shareholder meetings, receive dividends, inspect the books, and transfer shares freely unless restricted. After the shareholders elect the board of directors, it is their responsibility to appoint officers who will carry out the day-to-day management of the corporation.

HOW TO FORM A CORPORATION

First, an individual, called the incorporator, will work with an attorney familiar with that state's corporate statutes to draft a certificate of incorporation. The articles of incorporation will typically include:

1. The name of the corporation
2. The county where the principal office of the business will be located
3. The purpose for the formation of the corporation, which is typically to conduct any and all lawful business
4. The names and addresses of the incorporators and initial directors
5. Identify the number of shares of each share class that the corporation can issue and the par value, if any, of the shares
6. Identify how long the corporation will stay in existence, typically indefinitely

Once the articles of incorporation are drafted by the attorney and signed by the incorporators, they will file them with the state agency charged with accepting corporate registrations. It could be the secretary of state's office, but it may be a different agency. Unless a later date is requested, the corporation becomes effective when the articles are properly filed. At this point, the incorporators must take a few additional steps before the corporation becomes a functioning business:

- A meeting of the shareholders will be called to elect the board of directors of the corporation.
- The board of directors will typically use the meeting to elect officers and adopt the corporation's bylaws.
- The corporation will then need to obtain all necessary licenses and registrations to conduct the particular type of business it was created for. These may include state tax registration, specific occupational licenses, and municipal business licenses.

C CORPORATION

WHAT IT IS

A C corporation is an incorporated business that has chosen to be taxed for federal income tax purposes as a separate entity from its shareholders.

The shareholders are not liable for the debts and liabilities incurred by the corporation. The shareholder's liability is limited to the amount of capital investment in the corporation.

TAXATION

A C corporation is taxed at a different rate than individuals. In 2021, C corporations pay a flat 21% on taxable income. A corporation will determine its taxable income by subtracting the allowable deductions from gross income. Whether or not the corporation has income for a year, or owes tax, it must file a return annually using IRS Form 1120, "U.S. Corporation Income Tax Return."

DIVIDENDS AND SALARIES

C corporations are sometimes thought of as having certain earnings that are taxed twice. For example, dividends are taxed to the corporation when the income is earned and taxed again to the shareholder when paid out. Unlike salaries, dividends are not tax deductible to the corporation. This is why many refer to dividends from a corporation as being "double-taxed." Salaries, on the other hand, are deductible to the corporation as long as they are a reasonable amount. A corporation may decide to retain a certain level of earnings instead of paying them out as dividends or salaries.

ACCUMULATED EARNINGS TAX

If a corporation allows its earnings or profits to accumulate over a reasonable amount instead of paying out to the shareholders as dividends, they will be assessed a 20% accumulated earnings tax. If earnings are retained over **$150,000** for service corporations, or **$250,000** for business corporations, the accumulated earnings tax may apply if there is not a reasonable business purpose. This can be viewed as a penalty tax that is meant to encourage dividend distributions of unnecessary accumulations to the shareholders. One reasonable business purpose for accumulation over these thresholds is to fund 303 stock redemptions.

TAX ADVANTAGES OF C CORPORATIONS

1. Earnings can be accumulated for business purposes without current taxation to shareholders.
2. Reasonable salaries and bonuses for shareholder employees are deductible.
3. Tax-favored employee benefits, such as health insurance and group life insurance, can be provided to shareholder employees.

SUBCHAPTER S CORPORATION

WHAT IT IS

An S corporation is an incorporated entity that elects to be taxed under subchapter S of the Internal Revenue Code. Instead of paying corporate tax rates, it has similar tax characteristics to a partnership.

Both partnerships and S corporations pass through profits and losses to shareholders, who in turn pay taxes on their respective shares of the corporation's income at their individual income tax rates, even if the income is not distributed. An S corporation must meet several requirements, including:

- It must be domiciled in the U.S.
- It must have 100 or fewer shareholders. Lineal descendants of the same family can all be treated as one shareholder.
- None of the shareholders can be nonresident aliens.
- All shareholders must be individuals, estates, certain trusts, qualified retirement plans, and/or 501(a) charitable organizations.
- It can only issue one class of stock.

TAXATION

Even though the S corporation passes the tax liabilities through to the shareholders, it must file an annual tax return on IRS Form 1120-S, "U.S. Income Tax Return for an S Corporation." A possible opportunity for a 199A (Qualified Business Income) Deduction is described later in this guide.

TAX ADVANTAGES OF S CORPORATIONS

Avoids double taxation of dividends

Avoids the possibility for accumulated earnings tax

Net operating losses can reduce personal gross income

Possibility for 199A deduction of up to **20%**

(see page 11)

LIMITED LIABILITY COMPANY (LLC)

WHAT IT IS

An LLC is a hybrid entity that can join the limited liability of a corporation with the pass-through tax advantages of a partnership. LLCs are a relatively new form of entity and are the fastest growing form of business.

LLCs are authorized in all states and are the most flexible form of business entity. An LLC is formed through articles of organization being filed with the state. They typically include:

- The name of the LLC
- The nature of the LLC's business
- The name and address of the members and managers
- Whether it will be member-managed or manager-managed:
  - Member-managed LLCs usually have less members and those members are willing to be involved with day-to-day operations of the business
  - Manager-managed LLCs usually have a relatively large number of members and those members aren't willing to be involved with day-to-day operations of the business
- The name and address of the registered agent
- The principal office address
- An operating agreement is a legal document that outlines the ownership structure and member roles; not all states require this, but it is a good idea to have one

ADVANTAGES OF LLCS

All members have limited liability

Flexibility in operating and management structure

Asset protection from creditors in some states

No restrictions on members, like those of an S corporation

Tax treatment elected is typically pass-through allowing owners to be eligible for a 199A deduction

Some flexibility may allow allocating certain amounts of income or losses to individual members

TAXATION

For federal tax purposes, a multimember LLC is taxed as a partnership and a single-member LLC is taxed as a sole proprietorship, unless otherwise elected. An LLC can participate in the "check the box regulations" indicating it would like to be taxed as a corporation by filing IRS Form 8832, "Entity Classification Election." Furthermore, it may elect to be taxed as an S corporation, as long as the ownership restrictions are met, by filing IRS Form 2553, "Election by a Small Business Corporation." Even though the corporate taxation option is available for LLCs, they often elect to be taxed as partnerships. If the LLC is taxed as a sole proprietorship or partnership, there is a possible opportunity for a 199A (Qualified Business Income) Deduction. See the description on the next page.

IRC 199A – Qualified Business Income (QBI)

The Tax Cuts and Jobs Act of 2017 created a deduction for many owners of pass-through businesses, including some sole proprietorships. Owners can claim up to a **20%** deduction — although gradually phased out — when their taxable income is under a threshold amount (in 2023, $364,200 for married filing jointly, and $182,100 for all other filers). Generally, the deduction is not available to business owners in specified service trades or businesses (high-earning doctors, lawyers, accountants, etc.) due to these income thresholds, and has a number of other restrictions and exceptions. Business owners should discuss this possible deduction with a tax professional.

TAXABLE INCOME THRESHOLDS	QUALIFIED TRADE OR BUSINESS (QTB)	SPECIFIED SERVICE TRADE OR BUSINESS (SSTB)
Single: $0-$182,100 Married Filing Jointly: $0-$364,200	20% QBI deduction — up to 20% of taxable income	20% QBI deduction — up to 20% of taxable income
Single: $182,101-$232,100 Married Filing Jointly: $364,201-$464,200	Both deduction phase out and wage/capital limitation apply	Subject to deduction phase out
Single: $232,100 + Married Filing Jointly: $464,200 +	QBI Deduction is lesser of A or B: A: 20% of QBI, or B: The greater of: • 50% of W-2 wages, or • 25% of W-2 wages plus 2.5% of unadjusted basis of depreciable assets	No deduction

SUMMARY OF BUSINESS ENTITIES

TYPE OF BUSINESS	OWNERSHIP STRUCTURE	LIABILITY	TAXATION
Sole Proprietorship — The simplest form of business; the business doesn't have a separate legal existence from the owner	Unincorporated — Single owner and business are one and the same for legal and tax purposes	Owner has unlimited personal liability.	Owner reports profits and losses on Schedule C and files with Form 1040 on his/her individual tax return Potential 199A (Qualified Business Income) deduction of 20% depending on the specified trade or business and income phase out limits.
Partnership — Two or more owners (partners) who contribute to all aspects of the business and share in the profits and losses	Unincorporated — Two or more persons or entities	General partner has unlimited personal liability. Limited partner has liability to the total amount of investment in the partnership.	Partnership files a tax return. Form 1065 - U.S. Return of Partnership Income is used to show the total distributive share of each deduction, income, and credit on Schedule K. Then, Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., is used to enter each partner's share of each item (which is dependent on the terms of the partnership agreement) and is used for each partner in filing their individual tax return. Partners report profits, losses, deductions, and credits on Schedule E of their Form 1040 Pass-through profits and losses. Potential 199A (Qualified Business Income) deduction of 20% depending on the specified trade or business and income phase out limits.
C Corporation — A legally independent entity owned by shareholders	Incorporated — One or more persons or entities	Full asset protection. Owners/ shareholders have no personal liability.	A C corporation must file a tax return annually, even if it doesn't owe any tax or have any income. Income is reported on Form 1120. **Dividends** Double Taxation of Dividends: Corporation is taxed on profits at the entity level. Shareholders are taxed again on dividend distributions on Form 1099-DIV. Dividends paid to shareholders are not deductible by the corporation. **Compensation** C corporations can deduct a reasonable amount for salaries paid to officers and employees. **Accumulated Earnings Tax** There is a possibility of additional income tax for unreasonable amounts of earnings or profits not being distributed to shareholders.
S Corporation — A legally independent entity owned by shareholders	Incorporated — One or more (up to 100) U.S. citizen persons, estates, certain types of trusts, charitable organizations, and qualified retirement plans	Full asset protection. Owners/ shareholders have no personal liability.	Subchapter S corporations elect not to pay any corporate tax on their income. Instead, shareholders pay taxes on their respective shares of corporate income at their individual income tax rates, even if/ when income from the S corporation is not distributed to them. Even though it does not pay tax, the S corporation must file an annual tax return on Form 1120-S. Pass-through profits and losses. Potential 199A (Qualified Business Income) deduction of 20% depending on the specified trade or business and income phase out limits.
Limited Liability Company (LLC) — A hybrid entity that joins the limited liability of a corporation with the pass-through tax advantages of a partnership	Unincorporated — One or more persons or entities	Owner(s) have no personal liability.	Depends how the LLC is filed. An LLC can choose its federal tax classification as a Partnership (if two or more members), S corporation, C corporation, or Sole Proprietor (if single member). This election is made on Form 8832, Entity Classification Election. If established as a pass through for profits and losses, there is a potential 199A (Qualified Business Income) deduction of 20% depending on the specified trade or business and income phase out limits.
Family Limited Partnership — A unique limited partnership structure	Two or more family members or trusts for the primary benefit of family members (typically of different generations)	General partner has unlimited personal liability (usually older family member). Limited partner has no personal liability. Only liable to the total amount of investment in the partnership (usually second/third generation family member).	Same as Partnerships

BUSINESS-OWNED LIFE INSURANCE

(ALSO KNOWN AS EMPLOYER-OWNED LIFE INSURANCE (EOLI) OR COMPANY OR CORPORATE-OWNED LIFE INSURANCE (COLI))

Many business entities own life insurance to protect the business. From attracting and retaining key employees and top talent to safeguarding the business from potential negative financial impacts due to an unexpected death, there are several important reasons why a business may want to own life insurance on an employee, or past employee. Regardless of the business need for life insurance, there are requirements that need to be met for disclosure, consent, and reporting. Failure to abide by these requirements can result in death benefit proceeds being taxable to the employer.

EMPLOYER-OWNED LIFE INSURANCE

WHAT IT IS

A life insurance policy on an employee that is owned by the business and the business is also the beneficiary is called employer-owned life insurance. It is also commonly referred to as corporate or company-owned life insurance. The terms are interchangeable.

The Internal Revenue Code defines an EOLI contract as:

1. A policy owned by a person engaged in a trade or business under which that person or a related person[1] is directly or indirectly a beneficiary of the policy[2]; and
2. The policy insures an employee in the trade or business of the policy owner or a related person on the date the contract is issued.[3]

[1] A "related person" is a person who bears a certain relationship to the policy owner, or is engaged in trades or business with persons under common control with the policy owner – anyone related to the policyholder under the family or entity attribution rules of sec. 267(b) and sec. 707(b)(1). Sec. 101(j)(3)(B).

[2] IRC § 101(j)(3)(A)(i)

[3] IRC § 101(j)(3)(A)(ii)

TAXATION OF DEATH BENEFITS TO THE BUSINESS

When a business receives the death benefit from an EOLI policy, the IRS allows them to exclude from income the amount of premiums and amounts paid into the policy.[4] The remaining amount of the death benefit received is reported as income to the business. This is effective for contracts issued after August 17, 2006. However, there are some exceptions to this IRS inclusion rule, which could allow the entire death benefit proceeds to be free of income tax to the business, once the business satisfies the notice and consent requirements, and any one of the following:

1. Exception for a recent employee: The insured was an employee of the employer at any time during the 12-month period before the insured's death.[5]
2. Exception for a director or highly compensated employee or individual at the time the policy was issued. This would include:[6]
   - A director
   - A 5%-or-greater owner of the business at any time during the current year or the preceding year
   - A highly compensated employee or highly compensated individual with compensation of at least $130,000 for 2021 (adjusted annually for cost-of-living)
   - One of the five highest-paid officers
   - Among the highest-paid 35% of all employees
3. Exception for death proceeds paid to heirs: The death proceeds are paid to:[7]
   - A member of the insured's family, which includes brothers and sisters (also half-brothers and half-sisters), spouse, ancestors, and lineal descendants
   - Any individual who is the designated beneficiary of the insured under the contract (other than the employer)
   - A trust established for any family member or designated beneficiary, as just described
   - The estate of the insured
4. Exception for death benefit proceeds being used to purchase an equity interest in the business (employer) by any family member, beneficiary, trust, or estate.[8] This exception does have a deadline of the employer's tax return filing for the year in which the death benefit was received by the heirs in order to be used to purchase the equity interest in the business.

Planning point

Note that if the second exception is satisfied, the highly compensated employee would not need to be a current, or recent, employee of the business.

NOTICE AND CONSENT

The requirement for notice and consent is an important element for the business to be able to use any exception and avoid the income inclusion of the death benefit proceeds. There are three components to the notice and consent requirement that must be met before the policy is issued:

1. Notify the employee in writing that the employer intends to insure the employee's life. The notice must state the maximum face amount for which the employee could be insured at the time the policy is issued. The face amount must be either in dollars or as a multiple of salary.
2. Obtain the employee's written consent to being insured under the policy (including the possible continuance of the insurance after the insured terminates employment).
3. Inform the employee in writing that the employer will be directly or indirectly a beneficiary of any proceeds payable on the employee's death.

An inadvertent failure to satisfy the notice and consent requirements may be corrected under the following circumstances:[9]

1. The applicable policyholder (business/employer) made a good faith effort to satisfy those requirements, such as maintaining a formal system for providing notice and securing consents from new employees.
2. The failure was inadvertent.
3. The failure was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder (business/employer) in which the policy was issued. Because IRC §101(j)(4)(B) requires that the employee's consent be written, failure to obtain consent cannot be corrected after the insured employee has died.

A sample notice of consent is on the next page.

[4] IRC §101(j)(1)
[5] IRC §101(j)(2)(A)(i)
[6] IRC §101(j)(2)(A)(ii)
[7] IRC §101(j)(2)(B)(i)
[8] IRC §101(j)(2)(B)(ii)
[9] IRS Notice 2009-48, Q-13 & A-13

EMPLOYER INTENT TO INSURE EMPLOYEE'S LIFE

____ ("Employee") is being notified by

____ ("Employer") under Internal Revenue Code § 101 (j) that:

A. Employer intends to apply for insurance on Employee's life;

B. The maximum face amount at the time the policy is issued on the life of the Employee shall not exceed $ __________________ ; and

C. Employer shall be a direct or indirect beneficiary of life insurance proceeds payable upon death of Employee.

EMPLOYEE CONSENT TO BEING INSURED

Employee acknowledges receipt of this notice and agrees to:

A. Consent to being insured by Employer;

B. Consent to the policy being continued following any termination of employment with Employer; and

C. Consent to employer being a direct or indirect beneficiary of any life insurance proceeds payable.

______________________________ ______________________________

Employee **Date**

ANNUAL FILING REQUIREMENTS

Employers that own life insurance on their employees also must comply with the ongoing requirement outlined in IRC § 6039I, which requires an annual report of EOLI contracts. Reporting is accomplished by attaching IRS Form 8925 to the employer's income tax return for the year.

The employer must report the following to the IRS annually:

- The total number of employees under the employer at the end of the tax year
- The number of those employees insured under employer-owned life insurance contracts at the end of the tax year for policies issued after August 17, 2006
- The total amount of insurance in force at the end of the tax year under those contracts
- The name, address, and taxpayer identification number of the employer, and the type of business in which the employer is engaged
- Verification that the employer has a valid consent for each insured employee, or, if all required consents are not obtained, the number of insured employees for whom consent was not obtained

Employers are required to keep records that show the requirements of both IRC § 101(j) and 6039I are met for all applicable tax years by filing IRS Form 8925, "Report of Employer-Owned Life Insurance Contracts."

KEY EMPLOYEE LIFE INSURANCE

WHAT IS KEY EMPLOYEE LIFE INSURANCE?

Essentially, all businesses rely on employees for the success of the business. Some employees may provide a more critical role to contributing to the ongoing financial success of the business than others. The loss of one of these key employees could be detrimental to the business's continuation. To help protect against the loss of a key employee's contributions and expertise, a business can purchase insurance on the key employee's life.

This can be a form of EOLI and subject to the IRC § 101(j) guidelines. The employer retains all incidents of ownership, pays the premiums, and receives the death benefit proceeds as the beneficiary. The premiums are not tax deductible to the employer, but as long as IRS guidelines are met, the death benefit proceeds are received free of income tax. The strategy, not type of insurance policy, is a way for a business to hedge against the premature loss of a key employee. The negative impact of the unexpected death of a key employee can be offset by the death benefit proceeds provided by the life insurance policy. This allows the business to economically stay afloat and successfully transition from the loss until a replacement is found.

WHO MAY BE CONSIDERED A KEY EMPLOYEE?

A key employee could be viewed as anyone who provides for the ongoing financial success of the business in a critical way. Characteristics that could be used to identify key employees are:

- Employees with a specialized skill set or knowledge base that is critical for the success of the business; having to find a replacement may be time consuming to recruit and train and will typically require a higher salary level than non-key employees
- Employees in a sales capacity who have a large customer base and a high impact on generating sales for the business
- Employees who may be a source of capital and whose loss would damage the credit worthiness of the business

The purpose of key employee insurance is to help the business protect itself from the potential economic loss that could occur when a key employee passes away.

If proper planning is not completed, a business will typically see adverse consequences from losing a key employee:

1. A loss or interruption of leadership from losing an experienced manager of the business
2. A loss or interruption of sales generated from losing a talented sales employee
3. A loss in business may impact the ability to make credit payments, or obtain new lines of credit
4. Time and expense to recruit and train a new key employee
5. A loss of competitive position or goodwill in the marketplace
6. A loss or interruption of production or operations

The impact of these losses is more extreme for smaller businesses that rely on the contributions of a few critical employees. Identifying the key employees might not be as straightforward as one would think. The owner, officers, and directors could be considered key employees, but the important role of managerial employees is sometimes overlooked. To help identify possible key employees, consider the impact of having a top-tier sales member or manager missing a considerable amount of time at work.

ADVANTAGES OF KEY EMPLOYEE LIFE INSURANCE

Key employee life insurance helps a business plan for and protect against the uncertainty of losing a critical member of the team. Two major advantages of implementing key employee life insurance are:

1.

If the key employee dies, the employer receives the policy's death benefit to help meet the financial needs of the business and help carry the business through the gap of recruiting and training a new key employee.

Further, if the employer provided the notice and consent requirements under IRC § 101(j) guidelines as discussed in the EOLI section, the death benefit proceeds are received free of income tax.

2.

If cash value life insurance is used to fund the key employee policy, the business can access the cash value, through loans and withdrawals*, while the employee is still alive.

The employer should understand the impact withdrawals and loans will have on death benefits and taxation before accessing cash values.

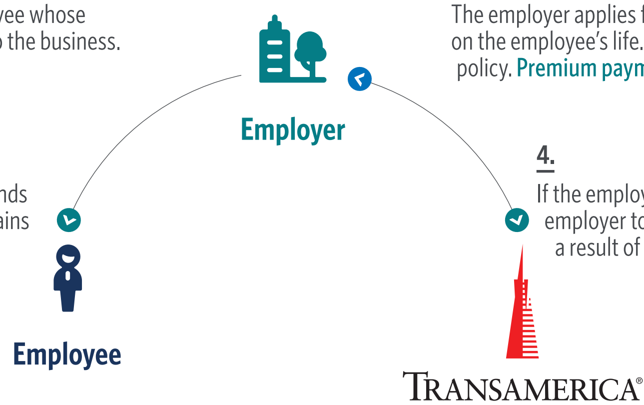
HOW KEY EMPLOYEE INSURANCE WORKS

The employer/business must:

- Give notice and receive consent to obtain the life insurance on the key employee per IRC § 101(j) guidelines
- Receive proper approval necessary to purchase the life insurance on the key employee. This will vary by type of business structure. For example, a corporation will need the board of directors to adopt a resolution permitting the purchase of the key employee policy.
- Apply for, own, and be the beneficiary of the insurance policy on the key employee's life. If the business does not retain complete ownership and the insured has any incidents of ownership, the death benefit proceeds will be included in the insured employee's estate for federal estate tax purposes.
- Pay all the premiums and abide by the reporting and recordkeeping requirements for EOLI policies
- Receive the death benefit proceeds at the employee's death

1.
The employer identifies a key employee whose death would result in financial loss to the business.

2.
The business gives notice that it intends to insure the employee's life and obtains the employee's written consent.



3.
The employer applies for, owns, and is the beneficiary of insurance on the employee's life. The employer pays the premiums on the policy. **Premium payments are not tax deductible.**

4.
If the employee dies, policy proceeds are paid to the employer to compensate the economic loss suffered as a result of the key person's death.

* Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

KEY EMPLOYEE VALUATION

Determining the value a key employee brings to your business may be the most difficult step in establishing a key employee life insurance strategy. The valuation may vary depending on the characteristics of the employee and the type of valuation method used. Many different techniques can be used to determine the value of the key employee. There are calculators available to assist in finding the right number. It can be as simple as a multiple of salary, or as complex as mathematical forecasting using several factors. Regardless of the method used, the value should not exceed a reasonable value of the key employee and should not be forecasted indefinitely. In this guide, we will discuss two: the contribution to profits method and the excess salary method.

Contribution to Profits Method

A business can take the following steps to determine a key employee's value using the contribution to profits method:

1. Establish the annual profits generated by the key employee
2. Multiply the annual profits that would be lost by the remaining estimated years until retirement
3. Multiply that number by the present value factor for $1 per year, using a reasonable rate of interest to discount future earnings

Case Study

Denise has been a salesperson for Pharmaceutical Manufacturers of America (PMA) for most of her career and is 10 years away from retirement. PMA estimates her loss would cause an average annual loss in profits of **$250,000.** This would equate to **$2,500,000** over her remaining 10 years of employment before retirement. PMA then discounts the **$2,500,000** using a 7% interest rate, which equates to **$1,750,000.** PMA will provide Denise with the proper notice and consent and apply for a **$1,750,000** face amount life insurance policy. If Denise dies, PMA would not suffer the economic loss from losing one of its top salespeople.

Excess Salary Method

A business can take the following steps to determine a key employee's value using the excess salary method.

1. Establish the difference in salary between the key employee and someone else who would perform the same duties
2. Multiply the difference by the number of years it would take to recruit, train, and grow the expertise the current key employee has

Case Study

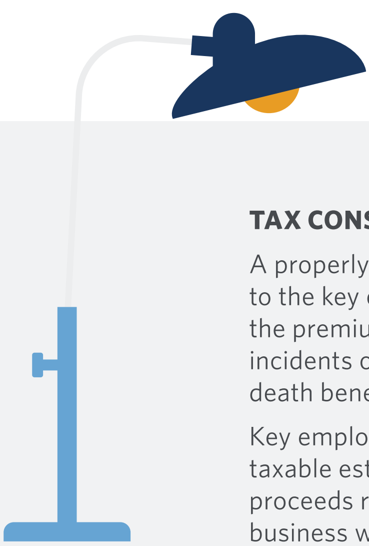
Frank has been a manager for PMA the majority of his career and has gained much needed expertise for the ongoing success of the business. His current salary is **$250,000,** which is more than others in his same position are paid elsewhere. PMA is willing to pay this extra amount to Frank because its success is based largely on Frank's expertise. Someone in a similar position elsewhere would be paid a salary of **$150,000.** If PMA hires a replacement for Frank, it would take the replacement five years to gain Frank's expertise. The difference in salary equals **$100,000** multiplied by the number of years to recruit, train, and grow the expertise of five years equals **$500,000.** PMA will provide Frank the proper notice and consent and apply for a **$500,000** face amount life insurance policy. If Frank dies, PMA would not suffer the economic loss from losing one of its top managers.

TAX CONSIDERATIONS FOR THE BUSINESS

Premiums
Under IRC § 264 guidelines, when a business is the beneficiary of a key employee life insurance policy, the premiums are not tax deductible. The business will have to determine how much it can afford to pay for premiums on the key employee life insurance policy. Either term or cash value life insurance can be used. Term will offer the appropriate coverage needed for the established time frame at a lower premium amount. While cash value will have a higher premium; it is typically the preferred option because it can provide additional benefits for the business. However, the health of the insured key employee also needs to be taken into consideration. If they are not able to obtain the best health rating for life insurance, the premiums will be higher.

Policy Loans
Similar to premiums, a business cannot deduct the interest paid or accrued on loans from life insurance policies that cover employees, or anyone financially interested in the business. Key employee policies are a limited exception. For purposes of discussing this exception, a key employee is defined as officers and 20% or greater owners of the business. There is a maximum number of key employees this exception will cover. The greater of five people, or the lesser of 5% of total officers or employees, or 20 individuals. This exception allows the business to take a deduction for policy loan interest to the extent that any one policy loan does not exceed $50,000, and interest paid for a month does not exceed the Moody's Composite Yield on Seasoned Corporate Bonds.

Death Benefit
As discussed in the prior section, EOLI, as long as IRC § 101(j) guidelines are met, the death benefit proceeds received by the business will be free of federal income tax.



TAX CONSIDERATIONS FOR THE KEY EMPLOYEE

A properly implemented key employee insurance arrangement will not result in any taxation to the key employee themselves. The business should hold all incidents of ownership, pay the premiums, and receive the death benefit proceeds. However, if the key employee has any incidents of ownership, such as the right to change the beneficiary or take a policy loan, the death benefit value is included in the key employee's taxable estate.

Key employee insurance covering a partner or controlling shareholder is not included in their taxable estate, but the value of the business will increase by the amount of death benefit proceeds received on their life, which will indirectly reflect in a proportional interest of the business when settling their estate.

EXECUTIVE BENEFITS

EXECUTIVE BONUS ARRANGEMENT

An executive bonus arrangement, also referred to as an IRC §162 arrangement, is a way for businesses to reward certain employees with a bonus to pay for their life insurance policy. The employer pays a bonus, either in cash or premium payments, to select employees under the arrangement on a personal life insurance policy of the employee. These types of arrangements can help businesses attract top talent as an additional benefit of employment to supplement their qualified plan and group term offerings. This is different from key employee life insurance, which protects the business from a premature loss of a key employee.

Once the arrangement is established, the employee applies for a personal permanent life insurance policy. The employee names someone other than the business as beneficiary. The employer will report the cash or premium payment bonus as additional compensation each year on the employee's W-2. Since this bonus is taxable to the employee, it is tax deductible to the business. A business may even offer a "double bonus" by paying a larger bonus to cover the income tax liability to the employee. The business may need to obtain a corporate resolution adopted by the board of directors to implement the arrangement.

Double Bonus Case Study

Enrique is a top executive at Technology Manufacturers of America (TMA) and was offered an executive bonus arrangement that included an additional bonus for his income tax liability. The double bonus includes his applicable ordinary income tax, payroll taxes, state tax, and local tax rates, which equate to 45%. Enrique's permanent life insurance policy premiums are **$13,750** a year. In order for TMA to determine the extra bonus needed to cover Enrique's tax liability, it would take **$13,750** annual premium divided by 0.55 (1 minus 0.45). The total executive bonus for Enrique each year would equal **$25,000.** This double bonus will cover the 45% tax Enrique will pay on the **$13,750** bonus he receives for him to pay his permanent life insurance policy.

Benefits to the Business

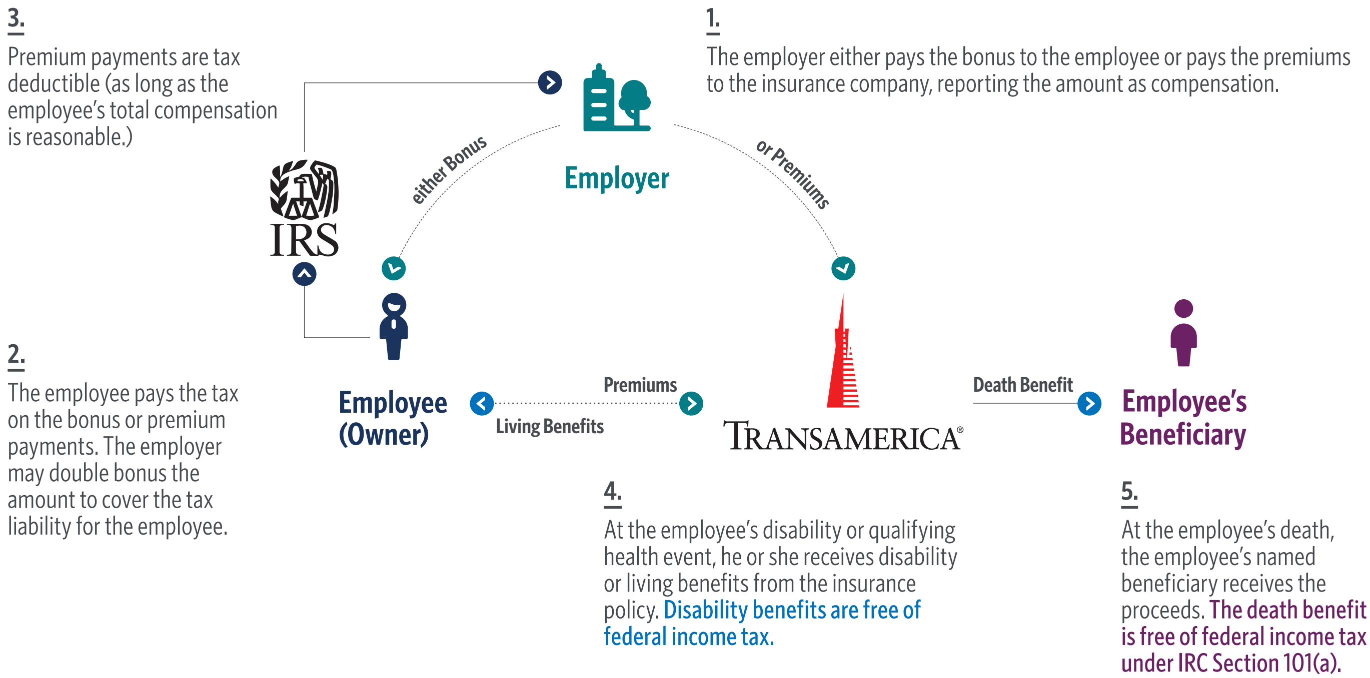
- Bonuses used to pay premiums are an ordinary and necessary business expense to the extent it is reasonable and will be tax deductible to the business under IRC §162.
- Because this is an arrangement between the business and the employee, the IRS does not need to preauthorize it or require disclosure and annual reporting.
- Because this is not a qualified plan, there are no annual administrative costas to the business, the bonus is handled through normal payroll services, and the business can select the employees to whom they offer this benefit.
- These kinds of arrangements can help the business recruit and maintain top talent in their industry.

Benefits to the Employee

- Since the employee is the owner of the life insurance policy and assuming premium payments are met, it will stay with them even if they leave the company.
- Double bonus arrangements cover the tax liability to the employee.
- Since the employee is the owner of the permanent life insurance policy, he or she has access to the cash value and can borrow* from the policy.
- The employee chooses the beneficiary, anyone other than the business, who receives the death benefit generally free of income tax.

* Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

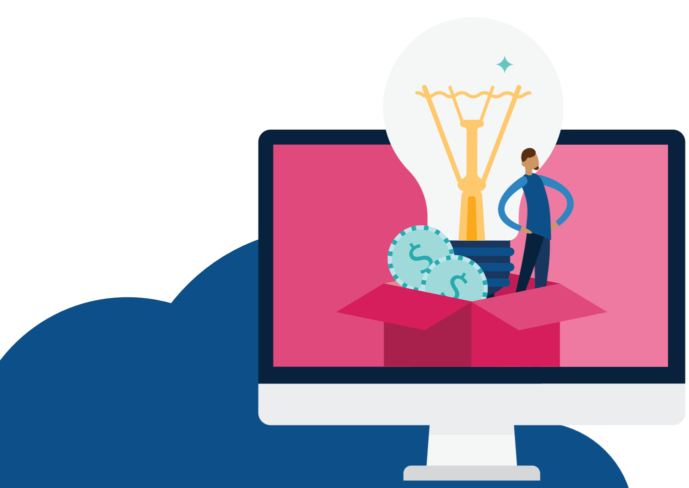
HOW EXECUTIVE BONUS ARRANGEMENTS WORK



1. The employer selects the employee(s) it wishes to benefit and pays annual premiums on a life insurance or disability policy, either directly or by way of a cash bonus to the employee.
2. The employee reports bonus or premium payments as additional compensation and pays taxes on that amount each year.
3. Premium payments are tax deductible to the employer as an ordinary business expense as long as the employee's total compensation is considered reasonable.
4. At the employee's disability or qualifying health event, he or she receives disability or living benefits from the insurance policy. Disability benefits are free of federal income tax. Living benefits (accelerated death benefits) are free of federal income tax in most instances.
5. At the employee's death, his or her beneficiary receives the death proceeds free of federal income taxes under IRC Section 101(a).

RESTRICTED EXECUTIVE BONUS ARRANGEMENT (REBA)

Some businesses may want to maintain more control over the executive bonus arrangement they enter into with an employee. A REBA establishes some limitations for the employee while they are still employed. The employee still owns the permanent life insurance policy and the business pays the bonus for the premiums. However, the difference is this type of policy contains a special endorsement, which requires the employee to obtain the employer's consent to borrow or withdraw cash value, surrender the policy, collaterally assign the policy for a loan, or change the ownership of the policy. This special endorsement does not give businesses any form of ownership, therefore still allowing them to deduct the bonus. The REBA will usually stipulate when these restrictions will be lifted. It could be upon retirement or disability, at a certain age, or once a waiver and release has been signed by the employer. Typically, the business will enter into a separate agreement with the employee that outlines what would happen if the employee terminates their employment with the business before retirement. It may require the employee to pay back all, or a portion of the bonuses received. Once the restricted period has ended, the business must send a written statement to the life insurance company to lift the special endorsement on the policy.



EXECUTIVE BONUS PLAN FACT FINDER

EMPLOYEE

Name ____________________

Annual Compensation $ __________ Federal Tax Rate (Including FICA) __________ State and Local Tax Rates __________

Company Ownership (if any) % ____________________

EMPLOYER

Name ____________________

Address ____________________

Entity Type: ◯ C Corporation ◯ S Corporation ◯ Partnership ◯ LLC, indicate tax treatment ◯ Other: __________

Federal Tax Rate __________ State and Local Tax Rate ____________________

Total Number of Employees ____________________

ILLUSTRATION

Product to Illustrate ____________________

Policy Assumptions: Current __________ Guaranteed ____________________

Insured's DOB __________ State of Policy Issue ____________________

Gender: ◯ Male ◯ Female

◯ Smoker ◯ Nonsmoker

Assumed Risk Classification: ◯ Select ◯ Preferred ◯ Standard ◯ Other __________

Death benefit $ __________ or minimum so as not to create a MEC __________

Death Benefit Option: Level ______ Increasing with cash value __________ Increasing switching to level __________

Plus-premium ____________________

Annual insurance premium $ ____________________

Years to pay premium __________ or to age __________

Maximize income from policy at insured's age ______ for __________ number of years __________

If premium is not known, indicate desired cash flow ____________________

Policy cash value at age 100 equal to: ____________________

Endowment at initial face __________ or keep in force until age 100 __________ or cash value equal to $ __________

PLAN DESIGN

Bonus Amount: Single ________ Double ________ Specified $ ________________________________

Pay Bonus Until: Retirement ______ Specified $ ________________________________

PRODUCER INFORMATION

Producer Name ____

Phone No. ____

Email Address ____

Date ____

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NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENT

Providing additional benefits to owner-employees, key executives, and other skilled and highly compensated employees is something all businesses must address to attract and retain top talent. The increasing regulation of qualified retirement plans and high costs to administer them has made nonqualified deferred compensation arrangements increasingly attractive for businesses and their employees. These arrangements allow the business to identify and select highly compensated employees or independent contractors to participate in creating financial security in retirement, upon death, or disability. The flexibility these benefits give the business are endless. A different benefit can be created for every employee to whom it offers this arrangement. Unlike qualified plans, nonqualified deferred compensation is not bound by contribution limits, vesting, nondiscrimination, top heavy rules, coverage requirements, or benefit accrual. Because of contribution limits, many high-income earners cap out the amount the IRS allows them to defer in qualified retirement plans and need other options for retirement income planning.

Provided Flexibility

- Nonqualified deferred compensation arrangements allow a business to be selective among "top-level" employees without concerns about government regulations like anti-discrimination rules or minimum funding requirements, which are required for qualified retirement plans.
- A business can provide different benefit levels for different employees.
- No government-mandated vesting rules apply.
- Deferred compensation can be customized to suit individual situations.
- Paperwork and administrative costs are kept to a minimum as compared to qualified plans.

Funded vs. Unfunded Arrangements

Unfunded nonqualified deferred compensation arrangements are when the business does not set aside or earmark specific funds to cover the contractual obligation. The business may or may not have a reserve established. If there is a reserve established, it is still considered an asset of the business and subject to claims from creditors of the business. The employee does not have any beneficial right to the reserve assets.

Funded nonqualified deferred compensation arrangements, on the other hand, do have specific funds set aside in a reserve to meet the future contractual obligation. These reserves are not part of the business's assets and therefore are not subject to the claims of creditors. However, a funded agreement means the deferred amounts are included in the employee's taxable income once there is no longer a substantial risk of forfeiture.

The employees may be concerned with the security of an unfunded arrangement and the possible tax inclusion of a funded arrangement. There is a solution that combines financial security while keeping tax deferral called a rabbi trust.

A rabbi trust is an irrevocable trust designed to hold the assets outside of the business or possible future successors. This offers the employees more security while still allowing the deferral of taxes. The IRS has provided guidance on rabbi trusts and even has issued a model rabbi trust agreement.[10] The trust does provide protection from the business accessing the reserves, but it does not fully protect the reserves from the general creditors of the business, if it goes bankrupt or insolvent. The IRS views this as a substantial risk of forfeiture and allows the reserved funds to remain tax deferred, because the employee does not have constructive receipt or an economic benefit to the funds.

[10] IRS Revenue Procedure 92-64

HOW IT WORKS

Life insurance can play a role in informally funding the unfunded deferred compensation arrangement without losing the ability to defer income tax. This benefits the business by creating a cost-effective way to pay the future benefits with little or no impact to future earnings.

STEPS:

1. Deferring Income

The employee defers a percentage of their pretax salary and/or bonus for a period of years. In return, at the retirement or death of the employee, the employer provides supplemental retirement income for the employee and their family.[11]

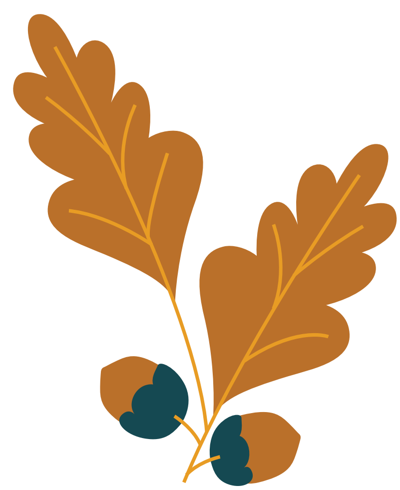
Since the deferred compensation benefits are an unsecured promise by the employer and are subject to the claims of the employer's creditors, the employee is not taxed until the income is distributed.

2. Purchasing Life Insurance

The employer purchases a permanent life insurance policy on the life of the executive, suitable to his or her risk tolerance, time horizon, and financial goals.

The employer is the owner of the policy and names itself as the beneficiary. The employee is the insured.

The policy may offer a death benefit free of income tax, grow tax-deferred, and may accumulate a tax–deferred cash value for the employer.[12] Premium payments are not deductible to the employer.



3. Receiving Income

When the employee retires or at another previously specified occurrence, he or she begins receiving the deferred salary from the employer, at which time the amount paid is deductible by the employer and taxable to the employee.

The employer can use the accumulated net cash value, through withdrawals or policy loans,* to fund the benefit payments.

4. Beneficiaries

In the event of the employee's death, the plan may provide that his or her beneficiaries receive either a taxable annual income or a taxable lump-sum death benefit, depending on plan design, funded by the policy proceeds received by the employer.

[11] These plans are subject to the requirements of IRC§ 409A and ERISA "Top Hat" limitations of 29 U.S.C. §§ 1021-1031 and 1131-1145.
[12] Notice and consent requirements and other provisions of IRC§ 101(j) must be met. Employer must also follow annual reporting requirements of IRC§ 6039I.
* Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

The Advantage

With the nonqualified deferred compensation plan, both the employer and employee benefit. Depending upon the design of the plan, here's how:

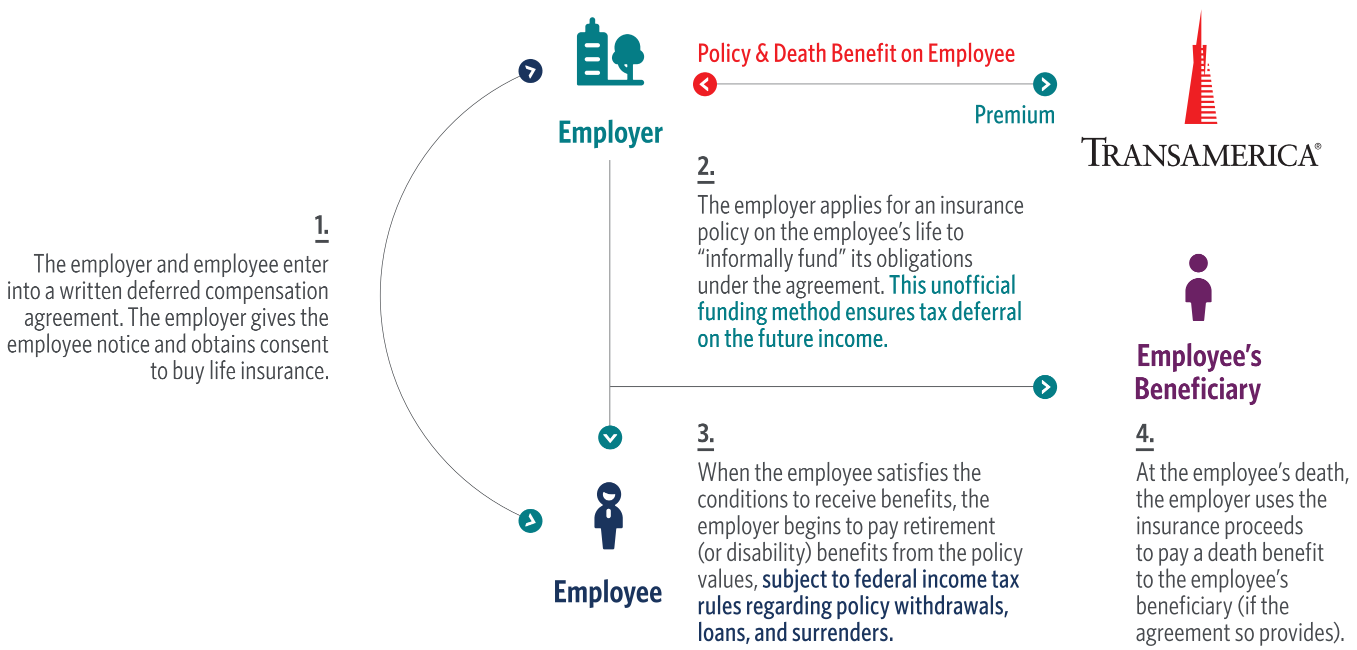
The Employee

- Reduces taxable income in deferral years
- Has customizable income deferral opportunities not subject to qualified plan limits
- Accumulates tax-deferred retirement benefits until distribution
- Can provide a preretirement survivor benefit

The Employer

- Has minimal legal requirements
- Controls the plan, owns the life insurance policy, and can include the cash value of the life insurance policy as an asset on the company's balance sheet
- Provides selected key employees with additional deferral opportunities different from those available to other employees
- Gains an attractive tool for recruiting, retaining, and rewarding talented executives by providing additional retirement income
- Receives an income tax deduction when benefits are paid out to the executive
- Enjoys greater flexibility in plan design
- Life insurance policy can provide for cost recovery with its benefit being free of income tax. However, the death benefit may be subject to the corporate Alternative Minimum Tax.

HOW A DEFERRED COMPENSATION ARRANGEMENT WORKS
(FUNDED WITH LIFE INSURANCE)



1. The employer and employee enter into a written deferred compensation agreement. The employer gives the employee notice and obtains consent to the life insurance.
2. The employer applies for an insurance policy on the employee's life to "informally fund" its obligations under the agreement.
3. When the employee satisfies the conditions to receive benefits, the employer begins to pay retirement (or disability) benefits from the policy values, subject to federal income tax rules regarding policy withdrawals, loans, and surrenders.
4. At the employee's death, the employer uses the insurance proceeds to pay a death benefit to the employee's beneficiary (if the arrangement so provides).

SECTION 457 DEFERRED COMPENSATION PLANS

Alternatives for State and Local Governments and Agencies and Tax-Exempt Organizations

Many tax-exempt organizations offer a combination of tax-deferred qualified and nonqualified retirement plans to stay competitive as employers.[13] Several types of these nonqualified deferred compensation plans are found under Internal Revenue Code Section 457. Section 457 plans sponsored by government employers have unique rules and benefits.

Eligible Section 457(b) Plans

In 2023, the law allows pretax contributions up to **$22,500** or up to 100% of “includible compensation,” whichever is less, to an eligible 457(b) plan.[14] It may also allow additional catch-up contributions or elective deferrals of **$7,500** by participants age 50 and older.

Amounts payable under an eligible plan are generally not subject to a vesting requirement and are paid to an employee or his or her family upon separation from service, retirement, or death. Generally, distributions must meet the minimum distribution requirements of qualified plans. Under certain circumstances, these amounts may be transferred from one eligible 457(b) plan to another.

Ineligible Section 457(f) Plans

Some tax-exempt organizations may also want to offer certain employees the ability to defer compensation in excess of the eligible amount through an ineligible plan (often called a Section 457(f) plan, pertaining to the Internal Revenue Code section). A 457(f) plan must be a “top hat” plan that covers only a select group of management or highly compensated employees. Also, the contributions and earnings must remain the property of the employer and are subject to the employer’s creditors.

Under an ineligible plan, employees may make tax-deferred contributions in excess of the eligible 457 limits as long as the amount of the deferred compensation is subject to a substantial risk of forfeiture. A substantial risk of forfeiture means that the employee must work for the tax-exempt organization until retirement, or a date specified in the agreement in order to receive benefits under the 457(f) plan. If he or she chooses to leave the organization or is involuntarily terminated before the date specified in the document, the deferrals, as well as their growth, may be forfeited and kept by the employer. In the first taxable year after the substantial risk of forfeiture has lapsed, the employee must include all of the account earnings up to the date of the lapse in his or her gross income. While this is also a salary deferral plan, the employer may increase the employee’s compensation — pay a bonus — to allow the employee to have enough income to comfortably defer a portion of his or her salary to the ineligible plan. Please note that the 457(f) plan must also meet the requirements of IRC § 409A, created by the American Jobs Creation Act of 2004.

[13] Plans of churches/synagogues/qualified church-controlled organizations as defined in the tax code are not subject to the Section 457 requirements and may be able to be more flexible in their design of deferred compensation plans.

[14] Includible compensation is currently taxable compensation and thus excludes employee contributions made to a 401(k) plan, SEP, SIMPLE retirement account, or a 403(b) plan, and other nontaxable amounts. If an employee contributes to one of these types of plans or accounts, his or her includible compensation will be lower than his or her actual income.

A Win-Win Situation

The state and local governments and agencies or tax-exempt organizations:

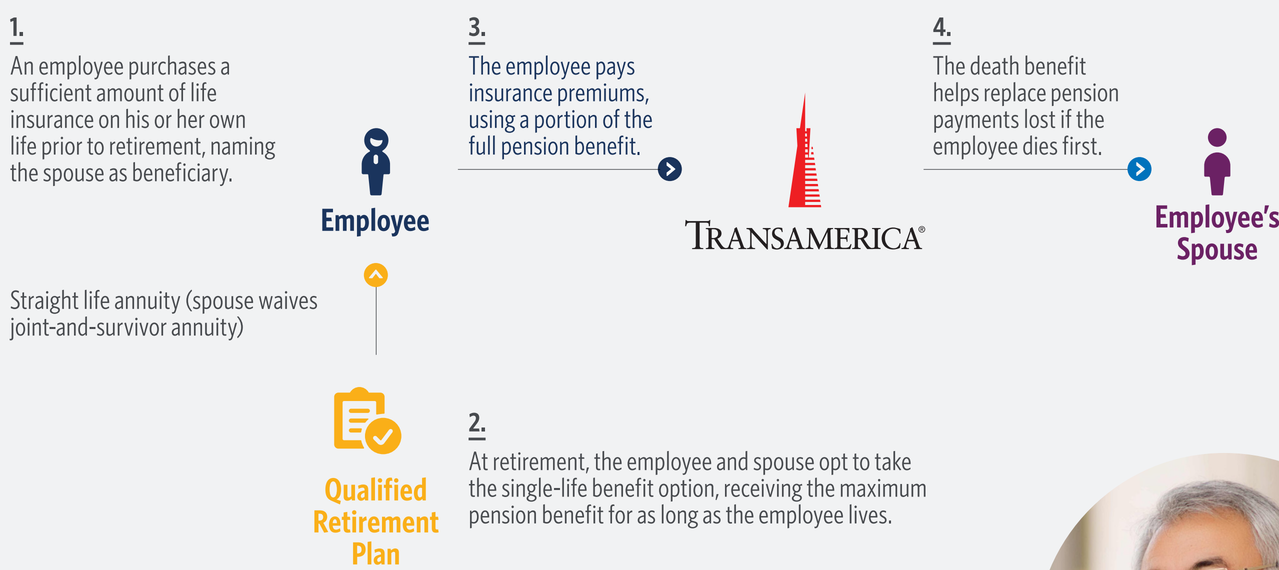
- Encourage long-term executive loyalty
- Provide selected employees with attractive benefits

The employee:

- Enjoys tax-deferred supplemental retirement savings
- Receives valuable taxable death benefit protection if they die while working for the organization

A nonqualified plan, such as an eligible Section 457(b) or ineligible Section 457(f) plan, is a staple of many employee compensation programs. State and local governments and agencies and tax-exempt organizations should be quick to embrace the flexibility these plans allow in providing long-term and performance-based benefits.

HOW PENSION INCOME SUPPLEMENTAL LIFE INSURANCE WORKS



1. An employee purchases a sufficient amount of life insurance on his or her own life prior to retirement, naming the spouse as beneficiary.
2. At retirement, the employee and spouse opt to take the single-life benefit option, receiving the maximum pension benefit for as long as the employee lives.
3. The employee pays insurance premiums, using a portion of the full pension benefit.
4. The death benefit helps replace pension payments lost if the employee dies first.

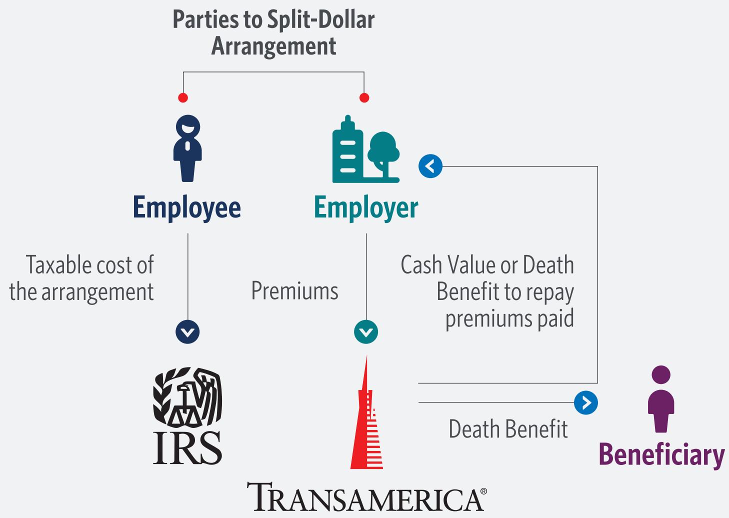
Life Insurance to Supplement a Qualified Retirement Plan

Many employees may want to add supplemental protection to their retirement assets. Employees that are granted a defined benefit pension plan may want to evaluate the payout options offered through the plan. One manner to evaluate these options is to consider the single life option with a portion purchasing a life insurance policy versus taking the survivor payout.

WHAT IT IS

Simply put, a split-dollar arrangement is an agreement between two or more parties wherein the owners and non-owners of a life insurance contract specify their obligations and benefits.

In a business setting, the parties to the arrangement are generally the employer and an employee.



Typically, an employee owns the policy and assigns it to the employer; though this differs under the endorsement structure explained later. The responsibility of premium payments rests with the employer, but these premiums are nondeductible. The tax burden for policies under a split-dollar arrangement falls to the employee, but at a rate that is generally less expensive than the employee purchasing permanent life insurance on their own. The details of specific arrangements vary, but generally the employer recovers the premiums paid upon the death of the employee. Other arrangements may have the employer receiving the cash value, a portion of the death benefit, or both in addition to repayment of the premiums. Again, all split-dollar arrangements are unique and can be tailored to the specific needs of both the employer and the employee. Any leftover death benefit, cash value, or combination of the two remaining after the arrangement's duty to repay the employer are then given to the employee's named beneficiaries on the policy.

Benefits of a Split-Dollar Arrangement

A split-dollar arrangement can be beneficial to all parties of the agreement. The benefits below are in addition to the split-dollar arrangement's relatively low administrative costs and ease of implementation.

When it comes to employees, there are two major benefits that come to mind:

- A split-dollar arrangement can assist employees in transferring wealth to future generations
- An agreement can provide the employee with a permanent life insurance policy at a reduced personal expense

An employer can also benefit from a split-dollar arrangement. Employer benefits include:

- Another way to add and retain talented employees
- The opportunity to recoup their cost of the policy via access to the policy's cash value, through loans or withdrawals*, or from the policy's death benefit
- Selectivity in participants unlike other plans that are required to be offered to all eligible employees

SPLIT-DOLLAR OWNERSHIP STRUCTURES

There are two essential ownership models for a policy created under a split-dollar arrangement: the endorsement method and the collateral assignment method. While there are more complex forms of ownership where there may be more than two owners, such as Irrevocable Life Insurance Trusts, and more, they still fall under either the endorsement or collateral assignment methods as described below.

Endorsement Method

Under the endorsement method, the business owns the life insurance policy and allows the employee participant to file an "endorsement" with the insurance company. Via this endorsement, the participant can name the beneficiary of the death benefit. How much of the death benefit they can endorse to their beneficiary is set forth in the split-dollar arrangement's contract between the employee and employer. The endorsement is a supplement to the original policy and with most insurance carriers is a relatively simple form. The employer pays the policy's premiums, and the employee pays the tax on the "economic benefit" they receive (discussed in more detail in the tax consequences section).

Upon the participant's death, the endorsed death benefit amount would be paid to the employee's named beneficiaries. Any remaining benefit would be paid to the employer to recover premiums paid, to finance a buyout of the employee's ownership interests, or to satisfy any number of possible terms defined in the split-dollar arrangement. Should the employee separate from service and terminate the arrangement, the company may either keep the policy and remove the former participant's endorsement or transfer the policy to the participant. If the policy is transferred to the ex-employee, the value of the policy would be treated as taxable income to the participant. If the employee does not want the policy, the company may access the cash value to recover any premiums paid.

Collateral Assignment Method

Unlike the endorsement method, a policy using the collateral assignment method is owned by the participant, not the employer. Aside from this detail, the arrangement itself is pretty much the same in that it outlines the responsibilities of each party, how the policies proceeds are to be divided upon death, and what happens should the arrangement terminate. The payment of premiums is the responsibility of the employer, while the employee reports the economic benefit for tax purposes.

Another difference between the methods is that rather than an endorsement being filed, the employee files a "collateral assignment" naming the company. Generally, this is a one- or two-page document that is filed to accompany the policy. The collateral assignment essentially prohibits the employee from transferring ownership of the policy, borrowing from the policy, or making material modifications to the policy without the consent of the collateral assignment designee who, in this case, is the business.

The methods are the same should the employee die wherein the company and beneficiaries receive the amounts agreed upon in the arrangement. Since the employee owns the policy and can take it with them, termination of the arrangement differs slightly because the company has been paying the premiums. The arrangement can either define repayment or forgiveness of the premium amount. In the case of forgiveness, the amount of debt forgiven would be included in the participant's income.

* Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

Tax Consequences of Split-Dollar Arrangements

An argument can be made that split-dollar arrangements are one of the most cost-effective benefit options that employers can provide to employees despite their lack of tax deductibility. The relatively low front-end administrative costs of drafting the arrangement and the ability to recover the costs of premiums via the policy's cash value or death benefit make split-dollar arrangements one of the more economical benefits that a business can provide to its most valued associates.

Given the only two certainties in life are death and taxes, the split-dollar arrangement is not without some tax liability. That liability falls on the participant and is based on the "economic benefit" received by the employee as determined using one of two methods. In the first method, illustrated below, the participant uses IRS Table 2001 to establish what the amount of economic benefit to include in their gross income. The illustration below assumes a $1.5 million policy wherein half of the death benefit goes to the participant's beneficiaries. As the illustration shows, the economic benefit increases as the employee ages. The reason for this will become a little clearer when we discuss the second method of determining the economic benefit.

		AMOUNT INCLUDED IN PARTICIPANT'S GROSS INCOME
PARTICIPANT'S AGE	PARTICIPANT'S DEATH BENEFIT	PER IRS TABLE 2001[15]
40	$750,000	$825.00
45	$750,000	$1,147.50
50	$750,000	$1,725.00
55	$750,000	$3,112.50
60	$750,000	$4,882.50
65	$750,000	$8,925.00

The second method for determining the participant's economic benefit is via the cost of a one-year term policy for the participant's benefit amount at their current age; at the end of the year, or on the anniversary date of the policy. Using the illustration above, a one-year term policy for $750,000 at age 45 may be significantly cheaper than Table 2001's implied economic benefit. The issue with this method is that the IRS requires that the term policy values used are regularly available and regularly sold in order to be used to ascertain economic benefit. Unfortunately, not many insurance providers offer one-year term policies with a regularity meeting these criteria. Depending on the insurer and available products, a tax professional should be consulted to determine the method used to establish the participant's tax liability on a split-dollar arrangement.

How to Implement a Split-Dollar Arrangement

An argument could be made that the implementation of a split-dollar arrangement is considerably easier than most employer-sponsored benefits due to its discriminatory nature and low administration costs. Both the employee and the employer should enlist attorneys to draft the agreement and outline the arrangement as it pertains to each party's responsibilities and benefits. These include, but are not limited to, the ownership structure of the policy, the division of the policy's benefits (both cash value and death benefit), premium payment responsibility, and what happens should the employee die or otherwise separate from service. Of course, all arrangements are unique and can be drawn up to meet the specific demands of virtually any situation. Ongoing administration of the arrangement is looked at as a cost to the business and a taxable benefit to the employee. Contact a tax professional to see how you would be impacted in your unique situation.

Once an arrangement has been defined, it is all a matter of finding a competitively priced insurance product that meets your needs.

[15] IRS Notice 2001-10

BUSINESS SUCCESSION

Like estate or retirement planning, business succession planning is something that most business owners, no matter how financially or professionally savvy, would rather put off indefinitely.

When business owners do not make any contingency plans to transfer the business in the event of retirement, disability, death, or other circumstance resulting in a separation from the business, negative consequences can arise for the owner, his or her loved ones, the remaining owners, employees, and the business itself. The death or disability of a principal owner of a closely held business can create serious financial problems for the estate, the business, and the survivors of the deceased. In fact, the most recent studies available show that a little more than 30% of all family-owned businesses survive into the second generation and only 12% into the third generation.[16] Certified professionals, such as engineers, attorneys, accountants, or financial professionals, have an even smaller pool of potential candidates because the successor would also need the correct credentials and certifications to take over the business. Thus, even if these individuals wanted to create a business succession plan, they may have to go through the process of locating a third-party buyer at a potential bargain price.

[16] "Solving Succession Problems in Family-Owned Businesses," Gallup, April 2019

WHAT IT IS

Having a buy-sell agreement in place can help business owners mitigate conflict and speed up the transition by creating a road map for the future of the business.

A buy-sell agreement is a legally binding contract that can be used with all types of businesses. It stipulates that upon a triggering event, such as the death, retirement, disability, or other withdrawal of a principal, his or her share of the business must be sold to the remaining partners or shareholders, or to the business itself. The remaining partners, shareholders, or the business itself agree to purchase the portion of the business owned by the deceased, retired, disabled, or withdrawing principal. The agreement helps to prepare for the owner's withdrawal from the company. For example, life insurance may be purchased to fund the agreement on the death or retirement of an owner.

KEY PROVISIONS OF A BUY-SELL AGREEMENT

The buy-sell agreement, regardless of form, must be drafted by an attorney and should specify certain key provisions. It is critical that the buy-sell agreement set out the intent of the parties in a manner that meets all legal requirements. The following information must be known for insurance planning and must be clearly explained in the buy-sell agreement:

Parties:
Who will be selling and who will be buying?

Must mandate sales and purchase:
The buy-sell agreement must state that it is mandatory for the seller to sell and for the buyer to buy the business interest.

What is to be purchased:
This differs with each business type. For instance, it could be partnership interests, membership interests, stock; or for a sole proprietorship, the business's assets.

Business valuation (price):
How much does the owner or the owner's estate get for his or her business interest and how much does the buyer have to pay for this business interest?

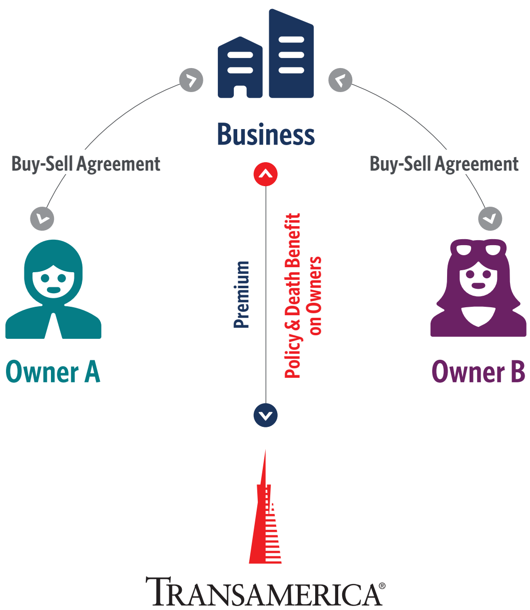
Timing of the sale:
For all parties involved, timing of the sale is critical.

Law:
Which state law(s) will apply?

Changes to the agreement:
A buy-sell agreement usually exists for a number of years. The process to update insurance coverage should be established.

Termination of the agreement:
There are valid reasons to terminate a buy-sell agreement, so having an exit provision can be useful.

ENTITY PURCHASE (STOCK REDEMPTION) BUY-SELL AGREEMENT



The entity purchase (stock redemption) buy-sell agreement is generally used with any business entity that has multiple owners who want to use the assets of the business to fund the agreement. The business is the purchaser, owner, premium payer, and beneficiary of life insurance policies on each owner's life. When an owner dies, the business receives the death benefit and uses the proceeds to purchase the business interest from the deceased owner's estate. The estate is paid the agreed-upon price, and the surviving business owners own the entire business.

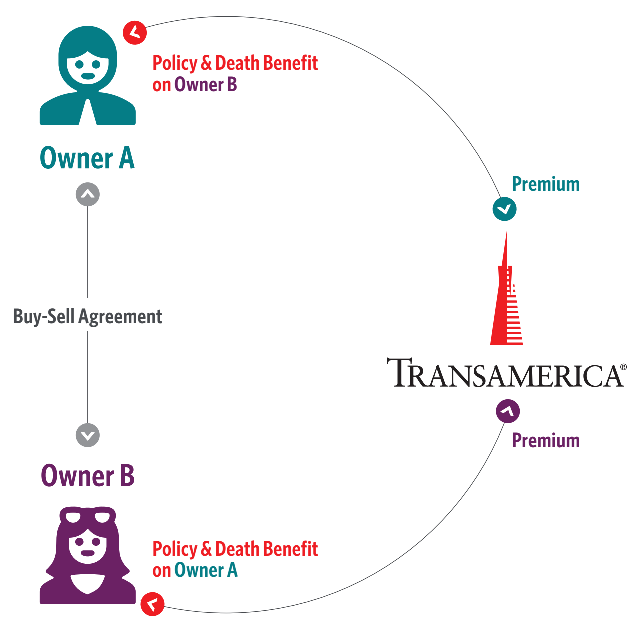
This is a form of EOLI, and the business will follow all notice and reporting requirements under IRC § 101(j) and IRC § 6039I. The business will show the life insurance policy cash value as a business asset. However, premiums paid by the business are not tax deductible. Entity purchase (stock redemption) buy-sell agreements may not be as advantageous for closely held businesses because family attribution rules may result in unforeseen tax consequences.

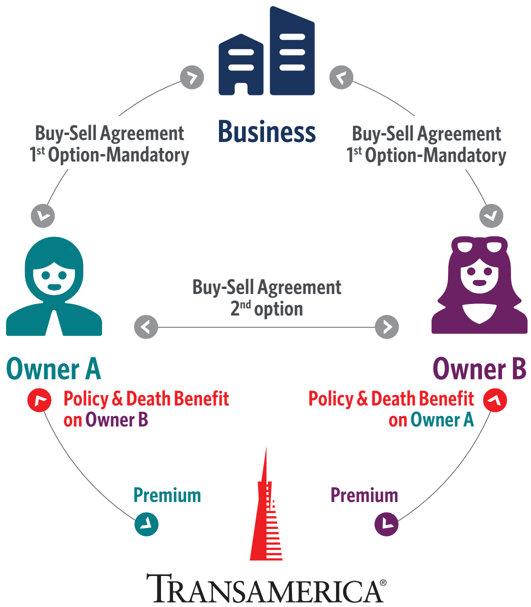
CROSS-PURCHASE BUY-SELL AGREEMENT

With this arrangement, each business owner purchases life and/or disability insurance on the other business owner(s). Each owner is the beneficiary of his or her respective policy(ies). The business is not part of the agreement. Upon the disability, death, or withdrawal of one owner, the remaining business owner(s) can use the policy proceeds or cash value to purchase their pro rata shares of the withdrawing owner's interest in the business.

In the case of sole owners, this agreement can be structured as a one-way agreement, where a buyer such as a key employee or third-party purchases a life insurance policy on the sole business owner.

At the owner's death or retirement, the buyer uses the policy proceeds or cash value to purchase the owner's entire business.





WAIT-AND-SEE BUY-SELL AGREEMENT

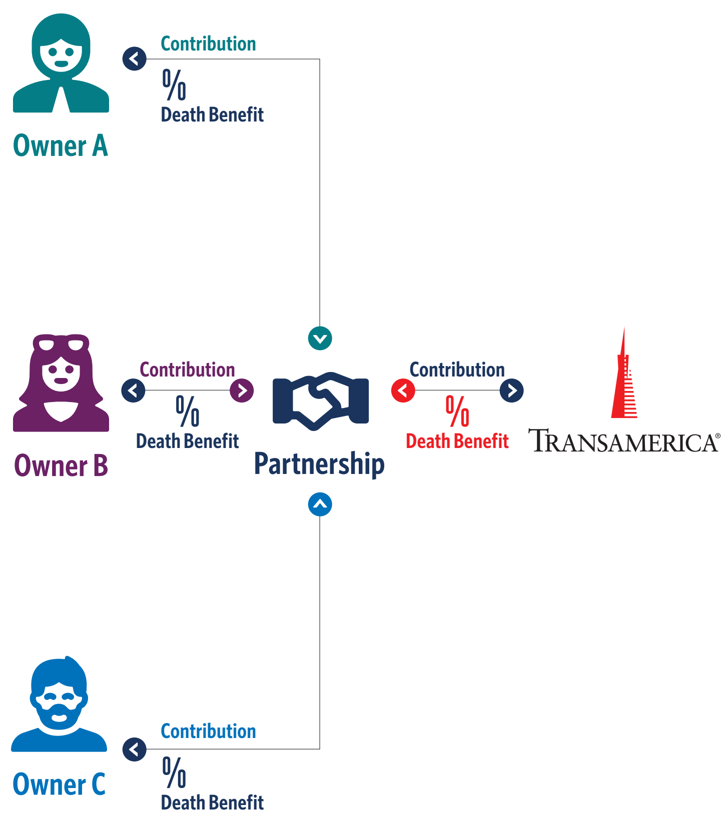
The primary advantage of the "wait-and-see" buy-sell agreement is its flexibility. Choosing between a cross-purchase and entity buy-sell agreement can be challenging because of the inability to predict the future and determine which plan will be better for all parties. The wait-and-see agreement can adjust to future tax law changes, fluctuating economic times, or owner uncertainty. The wait-and-see is a hybrid agreement containing language of both previously mentioned buy-sell agreements, which allows either the surviving principal(s) or the business itself to purchase the withdrawing owner's interest. The decision is not made until an owner actually withdraws from the business.

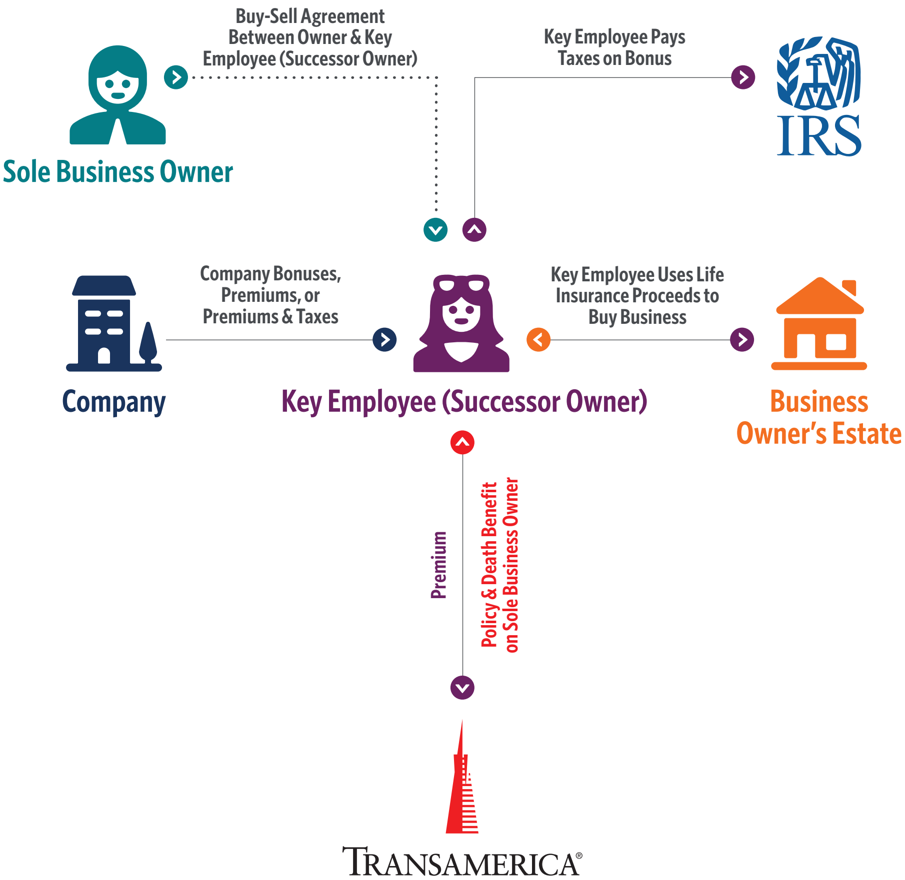
COMBINATION BUY-SELL AGREEMENT

The combination buy-sell is a nontraditional arrangement in which a general partnership is used to structure and fund a business buy-sell. This special arrangement combines the benefits of both a cross-purchase and entity purchase (stock redemption), while avoiding their negative aspects. With this arrangement — in addition to establishing a traditional buy-sell agreement for the business — the owners of the business establish a separate general partnership, which owns and names itself beneficiary of life insurance policies insuring the lives of the owners. The owners make contributions to the partnership to fund the payment of the premiums.

At the death of one of the owners, and according to the terms of the buy-sell, the death benefits can be:

- Distributed to the surviving owner(s)/ partner(s) to fund a cross-purchase-type buyout
- Lent by the surviving owners to the business to fund an entity purchase (stock redemption), or
- Used by the partnership to buy the deceased owner's interest



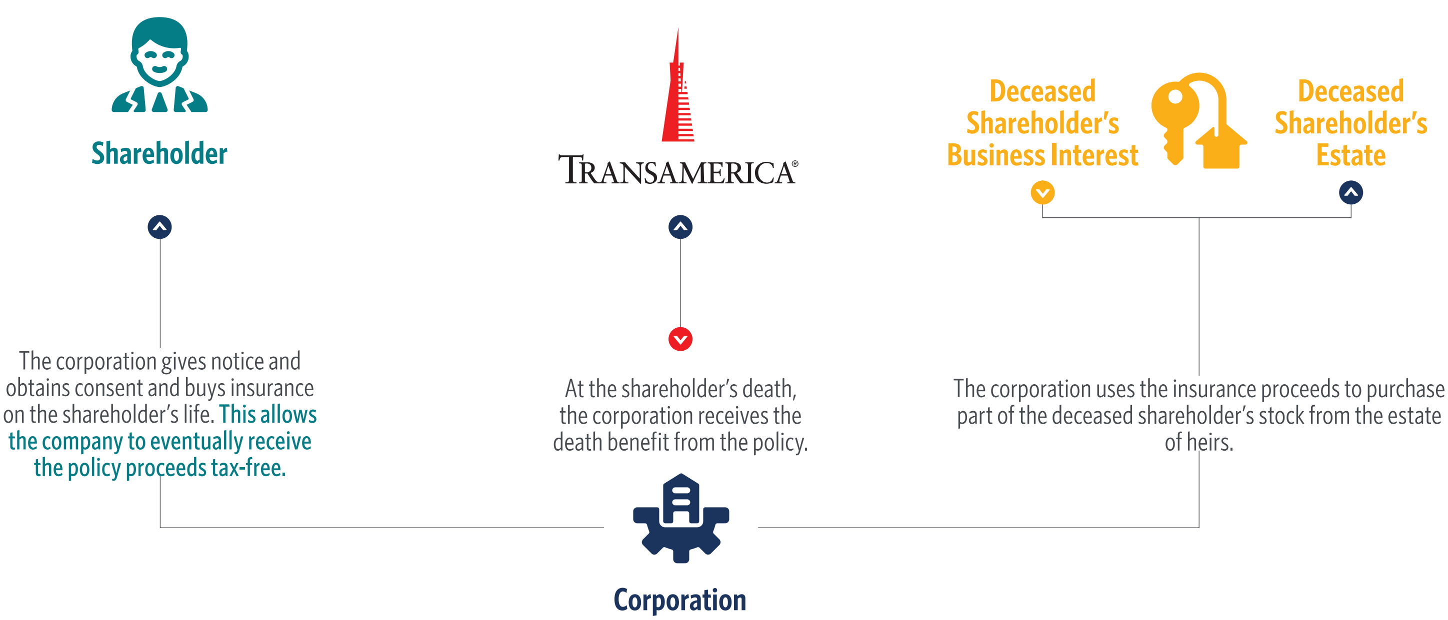


ONE-WAY BUY-SELL AGREEMENT

- This agreement is used for transferring a solely owned business to a successor owner (typically a key employee, friendly competitor, or relative).
- Successor owner purchases a life insurance policy on the life of the solely owned business owner's life and is the beneficiary of the policy.
- Upon the death or withdrawal of the sole business owner, the successor owner can use policy proceeds or cash value to purchase the business.
- The current business owner may agree to enter into a separate Executive Bonus Arrangement with the successor owner to cover the premium costs of the life insurance policy (optional).

SECTION 303 STOCK REDEMPTION

The 303 stock redemption is used for family corporations or closely held businesses, which the owner wishes to keep in the family. If the deceased owner's shares are valued at greater than 35% of the gross estate, IRC § 303 will allow his or her estate or heirs to sell to the closely held business enough stock to pay certain taxes and costs. The maximum amount of stock that may be sold to the business under IRC § 303 is limited to the total of state and federal estate taxes, costs of administrating the estate, and funeral expenses.



BUSINESS VALUATION

The most important component of a buy-sell agreement is the valuation of the business. The different ways to value a business are as unique as businesses themselves. A job aid for IRS valuation analysts states, "No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."[17] The IRS has provided guidance in *Revenue Ruling 59-60* for the eight factors involved in determining valuation of a closely held business:

1. The history of the company and the nature of the business
2. The economic environment in which the business will operate
3. The book value of the stock and the financial condition of the business
4. The earnings capacity
5. The dividend paying capacity
6. The existence of good will or other intangible values
7. The sale of the stock or size of the block of stock to be valued
8. The fair market value of publicly traded stock of comparable businesses

There are several methods to determining the purchase price in a buy-sell agreement. Only a properly structured buy-sell agreement will result in the purchase price being accepted by the IRS as the estate tax value of that business interest at an owner's death. The purchase price or formula used to determine the value should result in a fair market value at the triggering event for the buy-sell agreement.

Methods can be as simple as a fixed price, or a complex formula method. A buy-sell agreement could dictate that the business be valued by an appraiser at the time of the death of an owner. A combination of methods could also be used.

OPTIONS FOR FUNDING A BUY-SELL AGREEMENT

Having a buy-sell agreement in place is crucial for business owners who want to ensure a trouble-free transfer, as well as the continuing vitality of their businesses. There are four primary ways to fund a buy-sell agreement:

Pay Cash

This requires large sums of liquid assets that may not be readily available, particularly when an unforeseen event occurs. The business may have to liquidate their valuable personal or business assets at below-market value to quickly raise enough cash.

Borrow the Money

The loss of an owner or key person may significantly impact the credit rating of the business and its ability to borrow. Additionally, the business owners must pay principal plus interest. This could be a tremendous strain on the business budget.

Installment Sale

Under an installment plan, the remaining owners of the business make regular payments to a departed owner or a deceased owner's heirs in exchange for their share of the business. Deceased or departed owner/shareholder's family would receive compensation over time rather than a lump sum and may rely on continued success of the business to receive payment, which cannot be guaranteed.

Purchase a Life Insurance Policy

With a life insurance policy, money is available from the policy cash value or death benefit for the purchase of the business interest. This liquidity is available at the time it is needed without the need to raise funds by either selling the business or borrowing funds. Policy cash values grow tax deferred and death benefits are free of federal income tax.

[17] "Valuation of Non-Controlling Interests In Businesses Electing To Be Treated As S Corporations For Federal Tax Purposes – A Job Aid For IRS Valuation Analysts," Appendix A, Sec. 3.01, IRS, October 29, 2014

BUSINESS FACT FINDER
(EXECUTIVE BENEFITS, KEY EMPLOYEE, BUY-SELL AGREEMENTS)

Company Identification

Name ______________________ Address ______________________

City ______________ State __________ ZIP __________ Telephone __________

Entity Type ◯ Nonprofit ◯ C Corporation ◯ S Corporation ◯ Partnership ◯ Sole Proprietorship ◯ FLP ◯ LLC, indicate tax treatment

	BUSINESS OWNERS	AGE	SEX	SMOKER Y/N	% OF OWNERSHIP	TAX BRACKET	RELATIONSHIP TO OTHERS
1.							
2.							
3.							
4.							
5.							

EMPLOYEE BENEFITS

What employee benefit plans do you have and how are they funded?

Pension Plan ______________________ Profit-Sharing Plan ______________________

SEP ______________________ Group Health ______________________

Group Life ______________________ Group Disability ______________________

Other (Describe) ______________________

Are there any special benefit plans just for owners and key employees? If "yes," describe:

____

____

____

Do you plan to add anyone to the plan(s)? ______________ If "no," have you considered any? ______________

BUSINESS STABILITY

Do any owners have personal liability for business debts? ______________________

If "yes," are these debts covered by life insurance? ______________________

Are there key employees whose death or disability would jeopardize company profits? ______________________

____

What has been done to protect the business in the event of death or disability of one of these key employees? ______________

____

If key employees are insured, who are the insured? ______________________

____

If not insured, who should be? ______________ Is the insurance adequate today? ______________

BUSINESS CONTINUITY

What are the names and ages of any relatives or children who may enter the business?

In the event family members are too young or lack experience, who would run the business?

What have you done to guarantee that this person(s) will stay?

Do you have a Buy-Sell Agreement? (Y/ N)

What type? ◯ Entity Purchase (Stock Redemption) ◯ Cross-Purchase ◯ Wait-and-See ◯ Combination ◯ One-Way

If "yes," when was it last reviewed? Is it funded with life insurance?

If funded with insurance, when was the policy(ies) last reviewed?

How is the business value in the agreement determined?

If book value is unknown or out-of-date, provide book value of your business: $

Earnings & Growth: Average earnings—last five years $ Capitalization rate (reflects risk of business/industry) %

Years of goodwill (number of years that goodwill would last after owner's death, generally higher for service than manufacturing)

Return of tangible assets % Annual business growth rate %

Estimate value of the business $

Are there any other agreements concerning your business interest in existence?

If "yes," please explain:

Does your will contain any provision regarding the disposition or retention of your business interest?

Does your will direct or authorize your executor to retain or operate the business?

COMPANY PROFESSIONALS

Accountant Address

City State ZIP Code Telephone

Attorney Address

City State ZIP Code Telephone

Other (Banker, etc.) Address

City State ZIP Code Telephone

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