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The Advanced Consulting Group
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Advanced life marketing concepts

Simplifying financial planning techniques

When your clients have complex needs regarding the planning of their business, retirement or estate, you can count on Nationwide's **Advanced Consulting Group** to help you simplify these topics.

What's inside?

The following brochure was designed to provide a brief overview of some of the most commonly used financial planning strategies — including the benefits, tax considerations and steps necessary to put each plan in place.

Estate planning and wealth transfer

Business planning

Irrevocable life insurance trust (ILIT)

The concept

An irrevocable life insurance trust (or ILIT) is a form of irrevocable trust that is typically used to purchase life insurance while keeping the death proceeds outside of the insured grantor's gross estate.

Benefits

This technique enables the grantor to leverage their annual gift tax exclusion and/or lifetime gift tax applicable exclusion through the purchase of life insurance without causing the death proceeds to be included in the grantor's gross estate. Furthermore, the death proceeds may be used for estate liquidity, estate equalization, wealth replacement or other life insurance needs while being creditor protected.

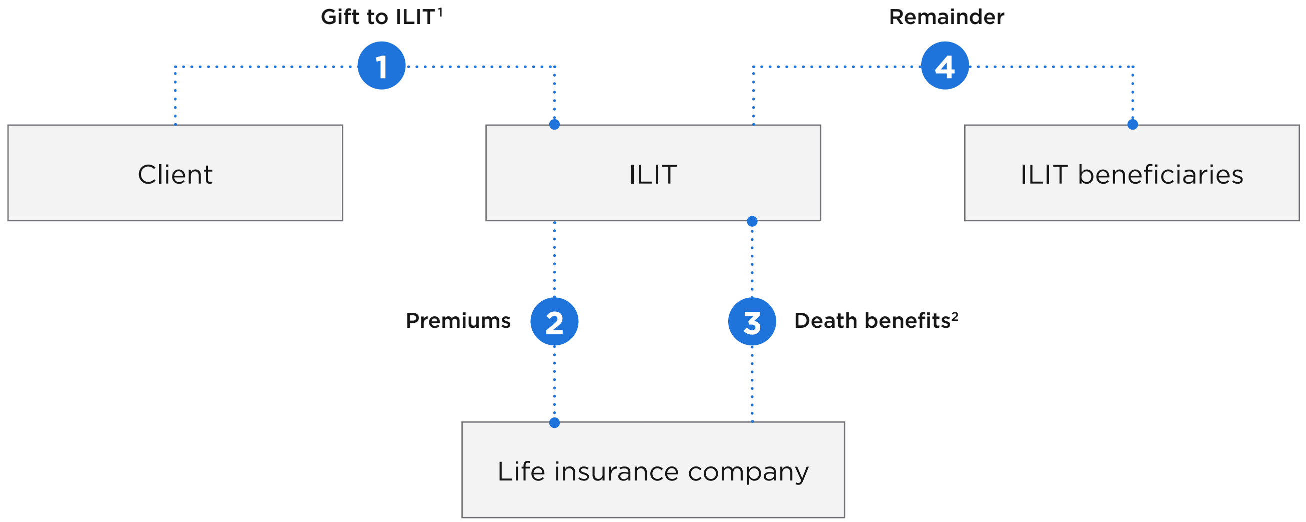
Tax considerations

- Crucial to keeping the death proceeds out of the grantor's estate is that the grantor not retain any right to modify, revoke or terminate the trust or have any incidents of ownership over the life insurance policy
- In addition, the grantor must neither be a trustee of the trust nor a beneficiary of the trust; this also means that the trust property must not be able to be used to meet the grantor's legal obligations
- The death proceeds are paid to the trust income and estate tax free

How it works

Steps

1. The grantor establishes an irrevocable trust under which the trustee is authorized to purchase life insurance on the life of the grantor
2. The grantor makes gifts to the trust using the grantor's annual gift tax exclusion and/or gift tax applicable exclusion
3. The trustee purchases insurance on the life of the grantor
4. Upon the grantor's death, the proceeds are received by the trustee and made available for application pursuant to the terms of the trust



[1] The trust language typically includes Crummey notice provisions that are designed to qualify gifts to the trust for the annual gift tax exclusion.

[2] If properly constructed, the ILIT may have access to cash values or accelerated death benefits during the grantor's life.

Annuity/IRA maximization

The concept

This is a technique for converting the value of a deferred annuity or IRA into a more tax-efficient legacy for heirs using an irrevocable life insurance trust (ILIT) and a life insurance policy.

Benefits

This concept can be used to effectively minimize income and estate taxes on an annuity or IRA that the owner does not want or need while maximizing the amount of wealth transferred to heirs.

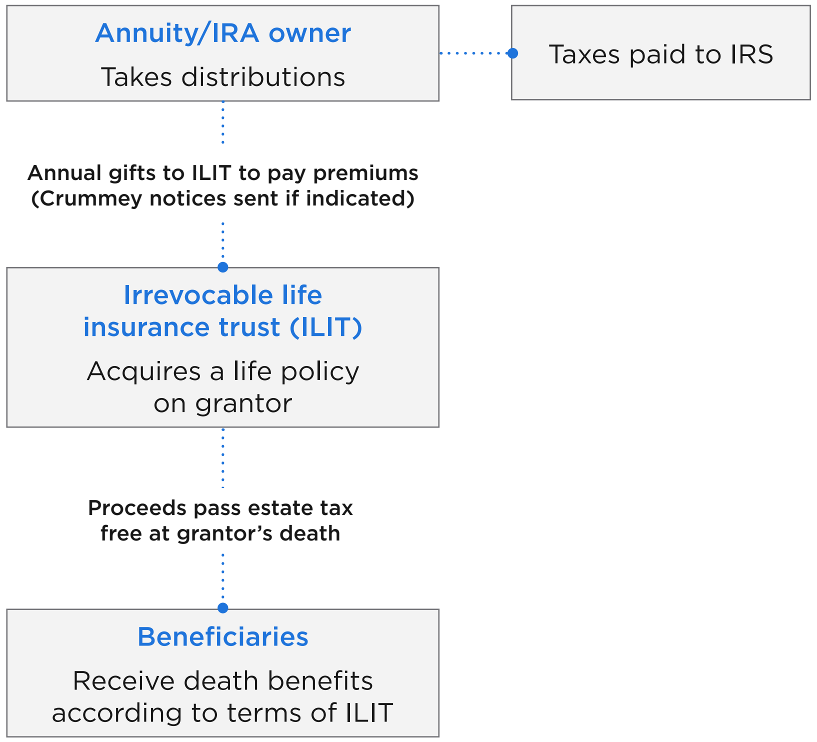
Tax considerations

- Annuities are included in the owner's gross estate and increase the owner's estate tax exposure
- They do not receive a "step-up" in basis at the owner's death for income tax purposes
- Annuity payments to the decedent's beneficiary are characterized as "income in respect of a decedent" and taxed as ordinary income

Steps

1. The owner takes distributions from the annuity or IRA and pays income taxes on the distributions
   - Annuity distributions may be subject to a surrender charge
   - A 10% early withdrawal federal tax penalty may be imposed, unless an exception applies
2. The owner establishes an ILIT
3. The owner gifts the after-tax distributions from the annuity/IRA to the ILIT
4. If the use of the annual gift tax exclusion is desirable, the trustee sends Crummey notices to ILIT beneficiaries
5. Using the gifted after-tax annuity distributions, the ILIT purchases, owns and is the beneficiary of a life insurance policy on the grantor
6. Upon the grantor's death, the trustee collects the death proceeds both income and estate tax free
7. The death proceeds are used to benefit trust beneficiaries, pursuant to the terms of the ILIT

How it works



Spousal lifetime access trust (SLAT)

The concept

A spousal lifetime access trust is simply an irrevocable life insurance trust (or ILIT) that allows the trustee to make distributions to the grantor's spouse and children during the grantor's lifetime, if needed.

Benefits

The death proceeds for this life insurance trust should be excluded from the grantor's gross estate. In addition, the trust assets should be protected from the creditors of the grantor, spouse and trust beneficiaries. Furthermore, the trustee can access policy cash values and distribute those amounts to the spouse and children, if needed. Finally, the policy's death proceeds may be used to provide estate liquidity.

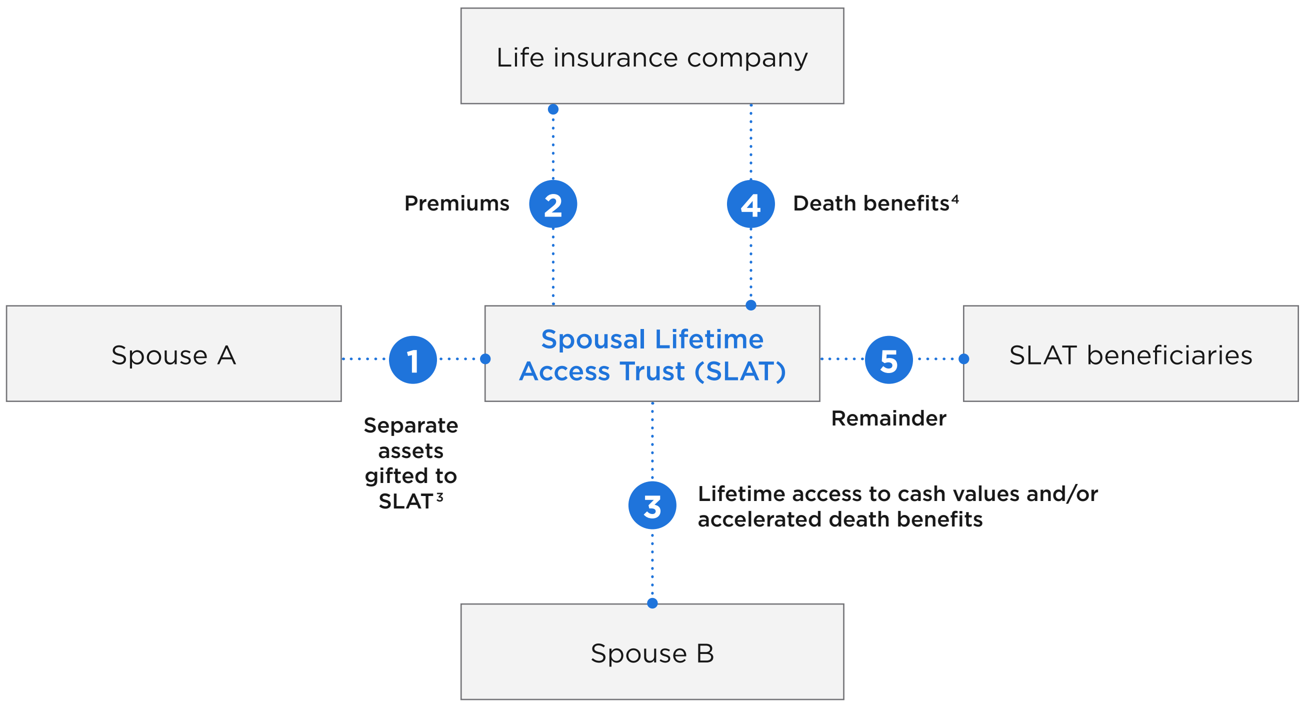
Tax considerations

- To keep the death proceeds out of the grantor's gross estate, the grantor should not retain any right to modify, revoke or terminate the trust or have any incidents of ownership over the life insurance policy
- The grantor must not be a trustee of the trust or a beneficiary of the trust; in the latter regard, the trust property must not be able to be used to satisfy the grantor's legal obligation to support their spouse or children
- The death proceeds are paid to the trust both income and estate tax free

Steps (see illustration on next page)

- The grantor establishes an irrevocable trust under which the trustee is authorized to purchase life insurance on the life of the grantor
- The grantor makes gifts of separate property to the trust using the grantor's annual gift tax exclusion and/or gift tax applicable exclusion
- The trustee purchases insurance on the life of the grantor
- Upon the grantor's death, the proceeds are received by the trustee and made available for application, pursuant to the terms of the trust

How it works



[3] The trust language typically includes Crummey notice provisions that are designed to qualify gifts to the trust for the annual gift tax exclusion.

[4] If properly constructed, the SLAT may have access to cash values or accelerated death benefits during the grantor's life.

Credit shelter/bypass trust

The concept

Married individuals with federal estate tax exposure often draft their will to include a credit shelter or bypass trust to utilize their estate-tax-applicable exclusion and shelter a corresponding amount of property from the estate tax. The trust typically provides for the surviving spouse during their life, with the remaining property going to the grantor's children at the surviving spouse's death.

Benefits

The purchase of life insurance leverages the amount of property going to the children. The life insurance also acts as a hedge, protecting against declines in the value of trust investments. Additionally, policy cash values may be accessed for the benefit of the surviving spouse and children, pursuant to the terms of the trust instrument.

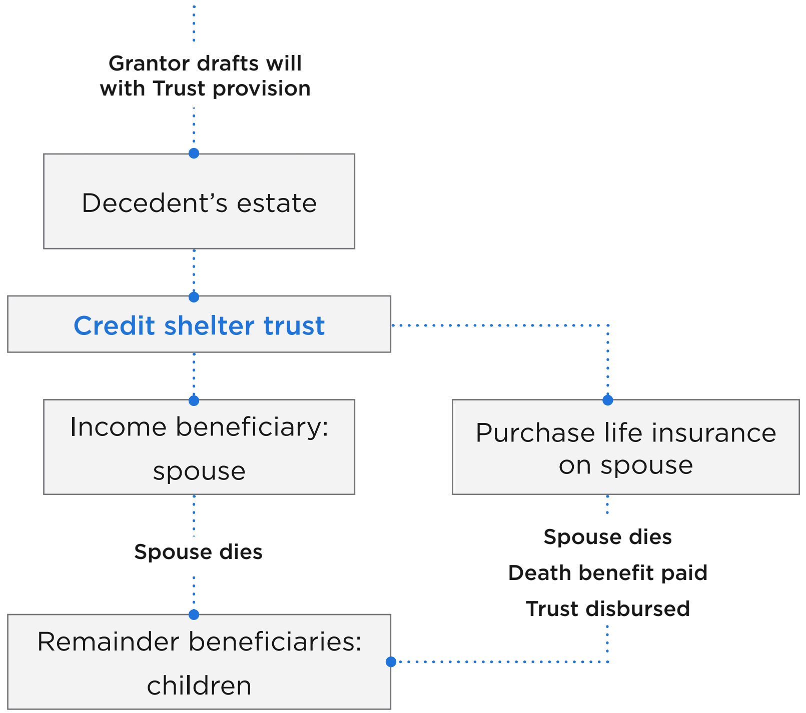
Tax considerations

- The surviving spouse acquires life insurance outside of the estate without having to apply their gift tax annual or applicable exclusion
- The life insurance cash values grow income tax free
- The death benefit is received by the trust both income and estate tax free
- The death proceeds are distributed to the children estate tax free

How it works

Steps

1. The grantor drafts their will with a credit shelter/bypass trust provision
2. Upon the grantor's death, the trust becomes funded with estate assets
3. The trustee purchases life insurance on the surviving spouse, naming the trust as the owner and beneficiary of the policy
4. The death benefit is paid to the trust both income and estate tax free
5. At the surviving spouse's death, the remaining trust assets, including the death proceeds, are paid to the children



Grantor retained annuity trust (GRAT)

The concept

A GRAT is an irrevocable trust to which the grantor transfers property in return for the right to receive an income stream for a certain period of years. At the end of the income period, the trust terminates and the residuary property in the trust passes to the trust's remainder beneficiary.

Benefits

This is a technique for passing highly appreciated or income-producing property to future generations at minimal or no gift-tax cost.

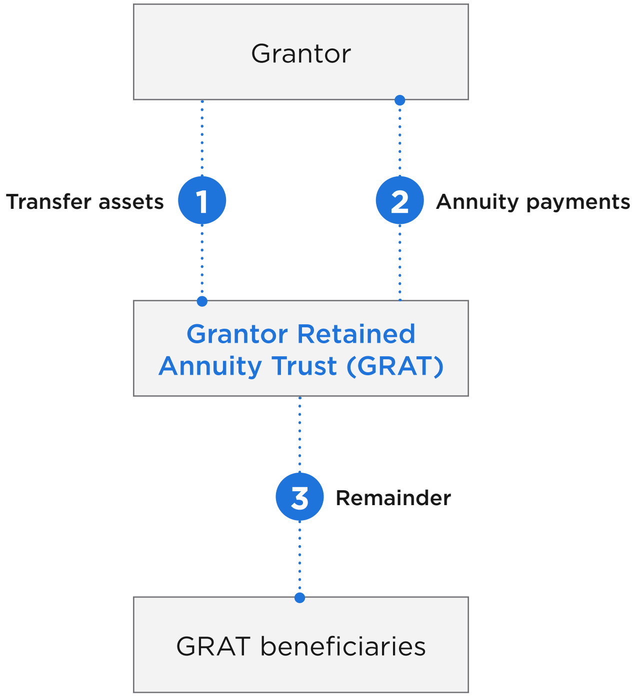
Tax considerations

- The remainder interest is a gift at the time that the trust is established
- The amount of the gift is determined by subtracting the present value of the grantor's income interest from the value of the assets transferred to the trust as of the transfer date
- If the value of the retained income interest equals the value of the assets transferred to the trust, the value of the gift is zero; this means that the transfer to the trust "freezes" the value of the assets in the grantor's estate by converting them into a fixed annuity interest payable to the grantor; the result is that all of the post-transfer appreciation on the transferred assets is removed from the grantor's estate
- The trust should be considered a grantor trust, with the result that the grantor pays the trust's income tax liability, meaning that the trust's assets grow income tax free for the benefit of the remainder beneficiary
- If the grantor does not survive the term of the trust, the trust property is included in the grantor's gross estate
- The grantor could purchase a term life insurance policy for the duration of the income period to cover any potential estate tax stems from the trust property being brought back into the grantor's estate

Steps

1. The grantor transfers highly appreciated or income-producing property to the trust in return for an income interest for a certain period of time
2. The trust makes income payments to the grantor for the duration of the trust
3. At the end of the grantor's income interest, the trust automatically terminates and the remaining trust assets go to the trust's remainder beneficiary

How it works



Installment sale to a grantor trust

The concept

This technique is used to transfer highly appreciated or income-producing property to future generations through an installment sale to a trust for their benefit, thereby avoiding gift taxes.

Benefits

This strategy freezes the value of the transferred assets in the grantor's estate by substituting an installment note for those assets that have been sold. In addition, no gain is recognized by the grantor on the sale of the assets.

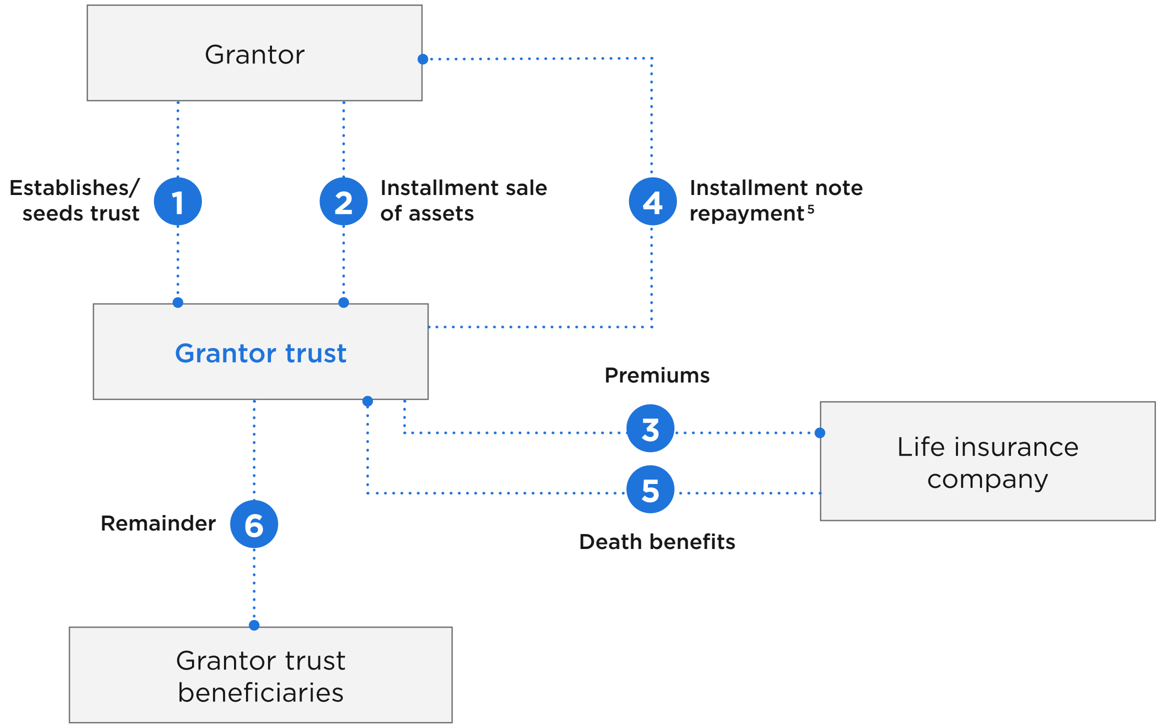
Tax considerations

- Because the trust is established as a grantor trust, no gain is recognized by the grantor on the sale of the assets to the trust
- Because the trust's income taxes are paid by the grantor, the assets grow inside the trust income tax free, and that can make a significant difference in the amount of wealth transferred to the trust beneficiaries
- The interest paid on the installment note is neither taxable nor deductible
- Because the transaction is a sale rather than a gift (except for the seed money), the grantor is not exposed to gift tax on the transfer of assets to the trust

Steps

- The grantor creates a grantor trust for family members and seeds the trust with a gift worth approximately 10% of the value of the assets to be sold to the trust
- The grantor sells assets to the trust for an interest-bearing installment note
- The trust pays off the installment notes using income from the gifted and purchased assets
- Because any unpaid installment notes will be included in the grantor's gross estate, the grantor should consider purchasing a term policy for the duration of the notes to cover any potential estate tax

How it works



[5] The note could be set up as a self-canceling installment note (SCIN), which, for an interest rate premium cost, would cancel future installments at the death of the grantor.

Estate equalization

The concept

This technique involves the use of life insurance to equalize inheritances from estates that might not distribute the decedent's wealth equitably to all heirs, as can occur in cases involving a closely held business or farming/ranching operation.

Benefits

This strategy enables a grantor to treat all of their heirs equitably in terms of each heir receiving a fair amount of wealth from the grantor at the grantor's death.

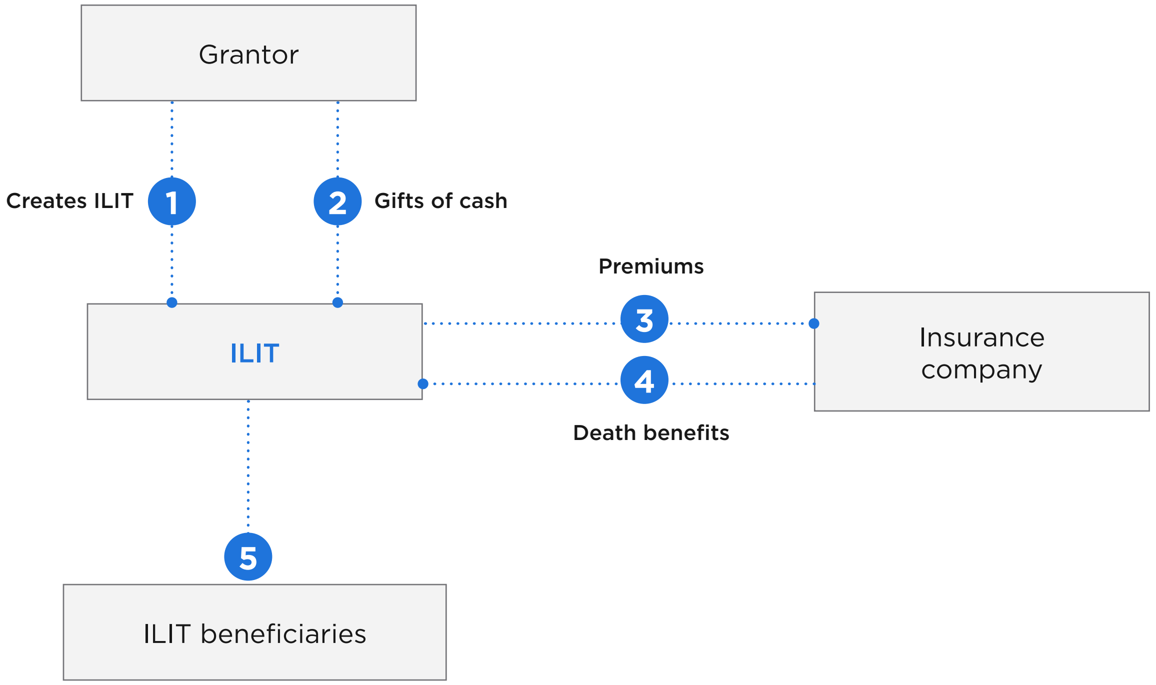
Tax considerations

- The grantor's premium payments are not deductible, but the death proceeds are received by the beneficiary income tax free
- If the grantor wants the life insurance proceeds to be excluded from their estate, the coverage may be purchased through an ILIT

Steps

- The grantor purchases, either individually or through an ILIT, life insurance coverage for the benefit of an heir or heirs to create equity in the overall distribution of the estate
- When the grantor dies, the death proceeds are paid income tax free to (or for the benefit of) the affected heirs

How it works



Charitable lead trust

The concept

A charitable lead trust, or CLT, is a split-interest irrevocable trust to which a donor can transfer property with the income, or lead interest, going to charity for a certain period of time and the remainder interest going to a noncharitable beneficiary, such as members of the donor's family.

Benefits

The donor can accomplish charitable objectives while leveraging transfers to noncharitable beneficiaries at minimal or no transfer-tax costs.

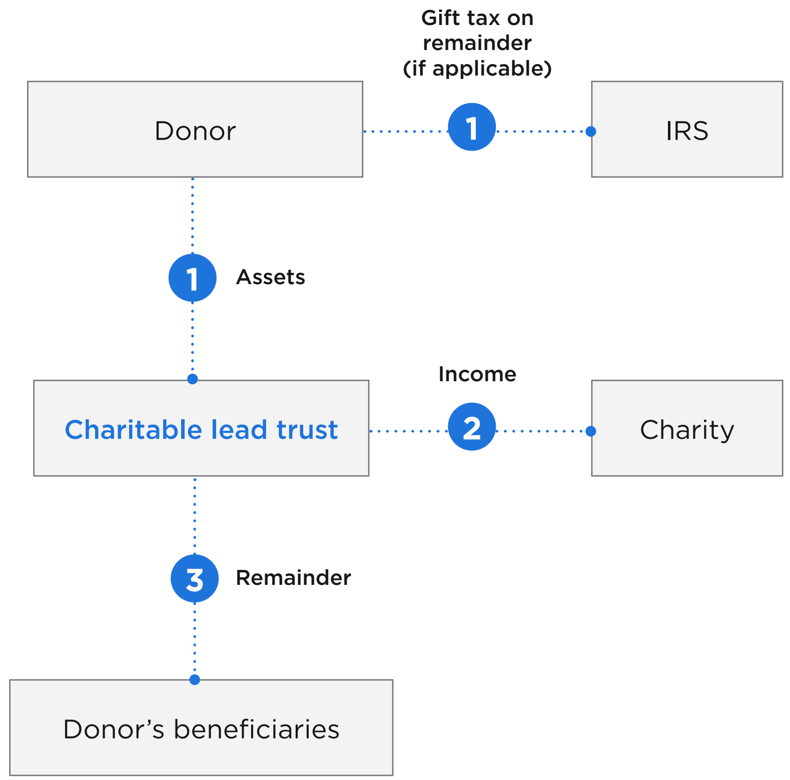
Tax considerations

- The value of the gift to the noncharitable remainder beneficiaries is determined at the time of the creation of the CLT by deducting the present value of the charity's income interest from the fair market value of the property transferred to the CLT
- This means that if the present value of the charity's income interest is structured to equal the fair market value of the property transferred to the CLT, the value of the remainder interest going to the noncharitable beneficiaries is zero for gift tax purposes

Steps

- The donor establishes a CLT and transfers property to it
- The CLT pays the charity its income interest
- The trustee of the CLT uses some of the trust's income to purchase life insurance on the donor, naming the CLT as owner and beneficiary; this makes up for the income interest having gone to charity
- Upon the donor's death, the trustee collects the death proceeds
- At the CLT's termination, the remainder interest — including the death proceeds — is paid to the noncharitable beneficiaries

How it works



Charitable remainder trust with wealth replacement

The concept

A charitable remainder trust, or CRT, is an irrevocable trust to which a donor can transfer appreciated property and retain a right to income, with the remainder interest going to charity, thus creating an immediate income tax deduction for the donor of the present value of the remainder interest donated.

Benefits

The donor can meet charitable objectives while possibly achieving a higher income stream with an offsetting tax deduction.

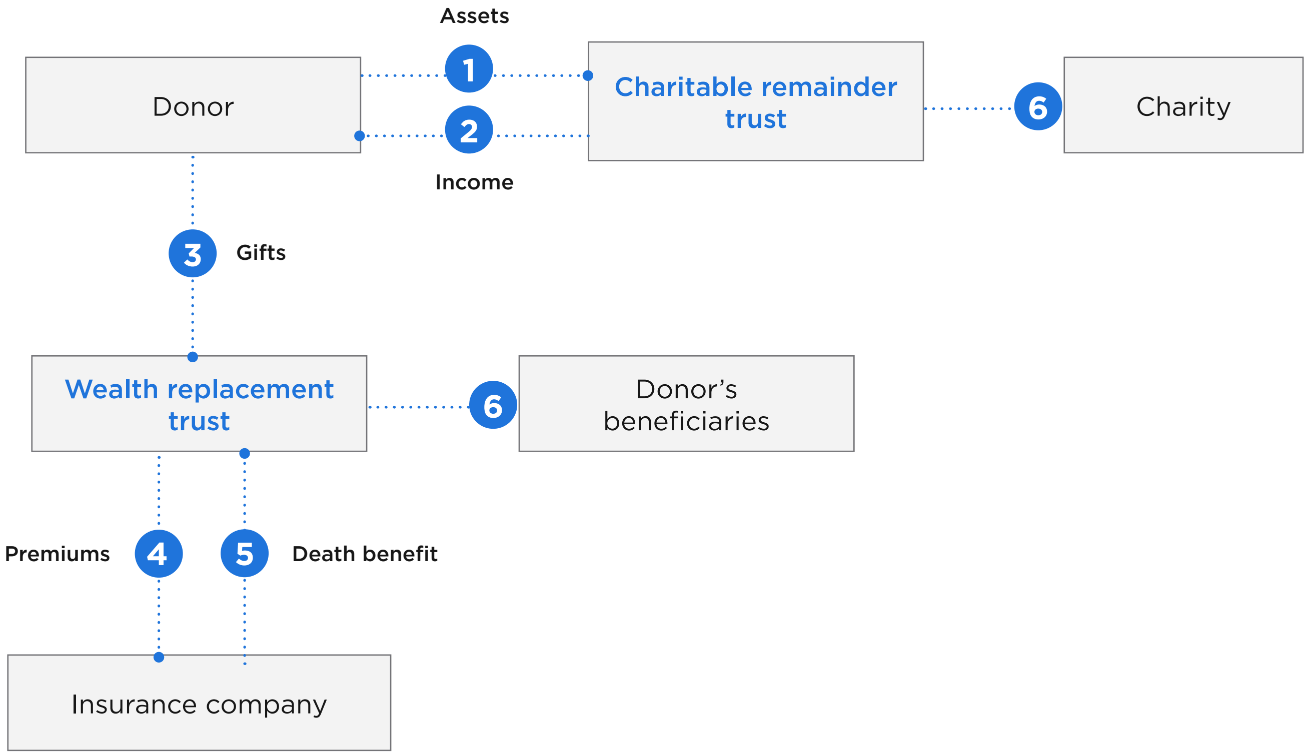
Tax considerations

- Because the CRT is tax exempt, it can sell the highly appreciated property contributed by the donor without incurring a taxable gain
- The donor gets an immediate income-tax deduction for the present value of the remainder interest
- The party receiving the CRT distributions will be taxed; the money is distributed in three layers: ordinary income, capital gains, then exempt income, if any

Steps

- The donor establishes a CRT and transfers appreciated property to the trust while retaining an income interest that may last for up to 20 years or the life of the donor or other beneficiaries
- The remainder to charity must be at least 10% of the fair market value of the property transferred to the trust
- The CRT makes payments to the income beneficiary at least annually
- The donor may establish an ILIT as a wealth replacement trust and fund it with some or all of the income received from the CRT and/or with the tax savings from the charitable deduction; this replaces for the donor's family the value of the remainder interest going to charity
- At the end of the income period, the CRT terminates and the remainder interest goes to the charity selected by the donor and designated in the CRT

How it works



Dynasty trust

The concept

A dynasty trust is an ILIT typically established to benefit multiple generations of the grantor's family as a form of family bank that can provide funds to future generations for educational, medical and other needs, such as to start a business or purchase a home.

Benefits

The use of life insurance to fund the ILIT leverages the amount of wealth benefiting future generations, because the policy premiums are relatively small as compared with the death benefit. In addition, as long as the funds remain in the trust, they are protected from the creditors of the grantor and trust beneficiaries.

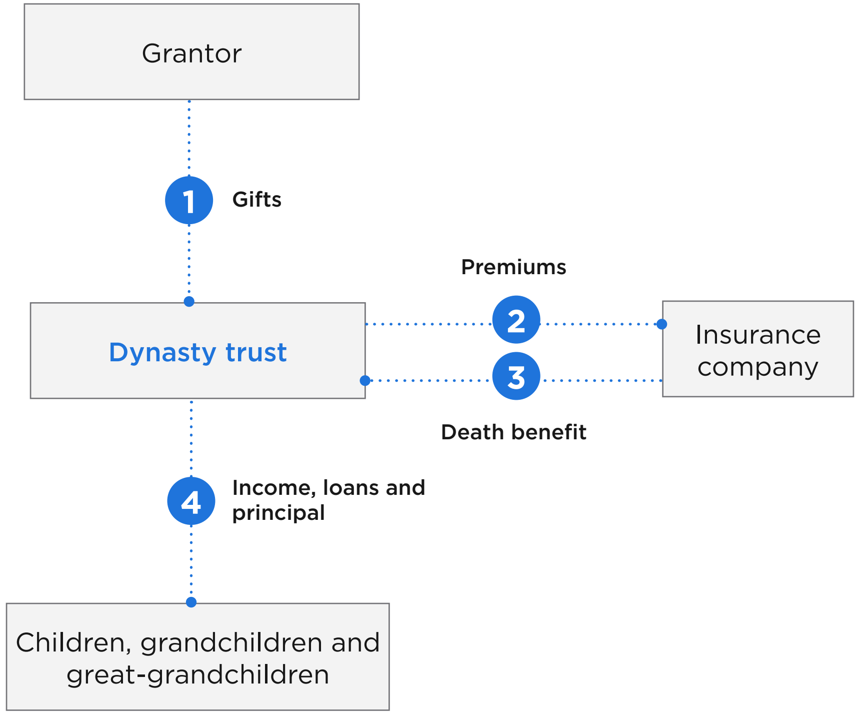
Tax considerations

- The grantor's generation-skipping transfer tax (GSTT) exemption is leveraged by applying it to the policy premiums as they are gifted to the trust, because the premiums are smaller than the death benefit
- The death benefit is paid to the trust both income and estate tax free
- If the trust is drafted with Crummey withdrawal rights, the gifts to the trust should qualify for the annual gift tax exclusion; in addition, the grantor may use their gift tax applicable exclusion to cover gifts in excess of the annual gift tax exclusion

Steps

- The grantor establishes an ILIT for the benefit of family members
- The grantor makes gifts to the ILIT, applying the grantor's annual gift tax exclusion and, if necessary, lifetime gift tax applicable exclusion
- The grantor applies his or her GSTT exclusion to gifts to the trust
- The trustee of the ILIT uses the gifts to purchase life insurance on the grantor
- Upon the grantor's death, the trustee collects the death proceeds — all income, estate and GSTT free
- The death proceeds serve as a form of family bank for as long as state law or the trust instrument permits

How it works



Premium financing

The concept

Premium financing is a way of acquiring needed life insurance with borrowed funds. The strategy typically involves a fair market loan arrangement between a commercial lender and an irrevocable life insurance trust, or ILIT, established by the prospective insured.

Benefits

This technique enables the grantor to acquire life insurance without having to make a gift of premium dollars to the trust. This means that the strategy is particularly useful when the amount of life insurance needed is so large that the premiums would exceed the grantor's annual gift tax exclusions and lifetime applicable gift tax exclusion, thereby exposing the grantor to taxable gifts. The approach is also helpful when the grantor needs life insurance but is temporarily illiquid and unable to contribute premium dollars to the trust. It may also be advantageous when the grantor has an investment portfolio that is liquid but he or she wants to maintain use of and control over the assets that would otherwise have to be liquidated to pay premiums.

Tax considerations

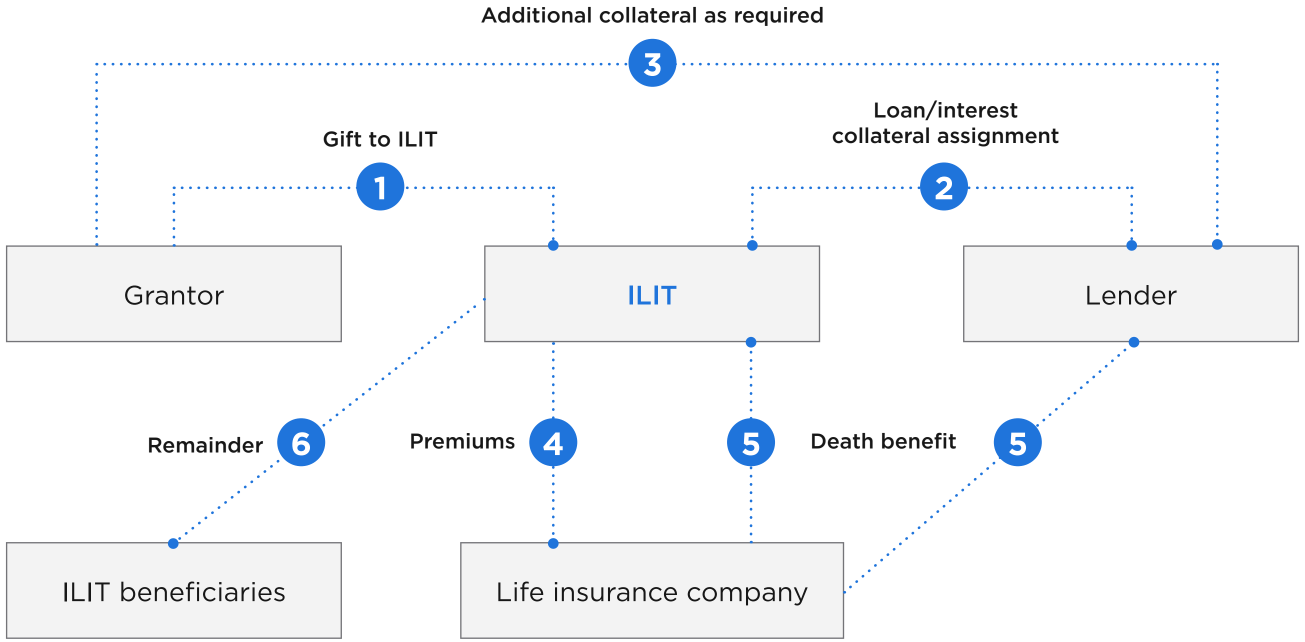
- The only gift to the trust by the grantor would be if the grantor chose or was required to pay all or a portion of the interest charges to the trust on the premium loans
- The death proceeds would be paid to the trust both income and estate tax free

Steps

- The grantor/insured creates an ILIT
- The ILIT borrows funds to pay the policy premiums and collaterally assigns the policy to the lender; the loan interest may be paid annually or deferred, depending on the terms of the loan and/or the restrictions of the life insurance carrier
- The grantor pledges additional assets to secure the loan
- At the grantor's death, the loan (if not previously repaid) is repaid from the death proceeds, and the remaining funds are distributed to the ILIT beneficiaries

Note that there are financial risks to the grantor that interest rates will rise; the lender might not renew the loan; or the policy may not perform as planned, requiring additional collateral to be pledged. Consequently, premium financing arrangements should be accompanied by an exit strategy and undertaken only by individuals or couples with substantial wealth.

How it works



Private split dollar financing

The concept

Private split dollar financing is often used in situations when there is a need for efficient planning for gift and estate taxes in moving assets from one generation to future generations. The typical case involves creation of a loan from an affluent family member to a trust in order to purchase a life insurance policy for the benefit of the trust beneficiaries. Because the transaction is structured as a loan, the potential for moving assets from one generation to the next in a tax-efficient manner may be enhanced.

Benefits

- The arrangement provides gift tax leverage because the gift that creates the death benefit is measured by the economic benefit of the death benefit protection rather than the premiums paid
- The death proceeds are received by the ILIT both income and estate tax free
- The death proceeds (net of the loan repayment) are available to provide estate liquidity or to meet other family objectives
- The ability to terminate the arrangement gives the family member providing the funding the ability to recover policy cash values if personal circumstances or objectives change

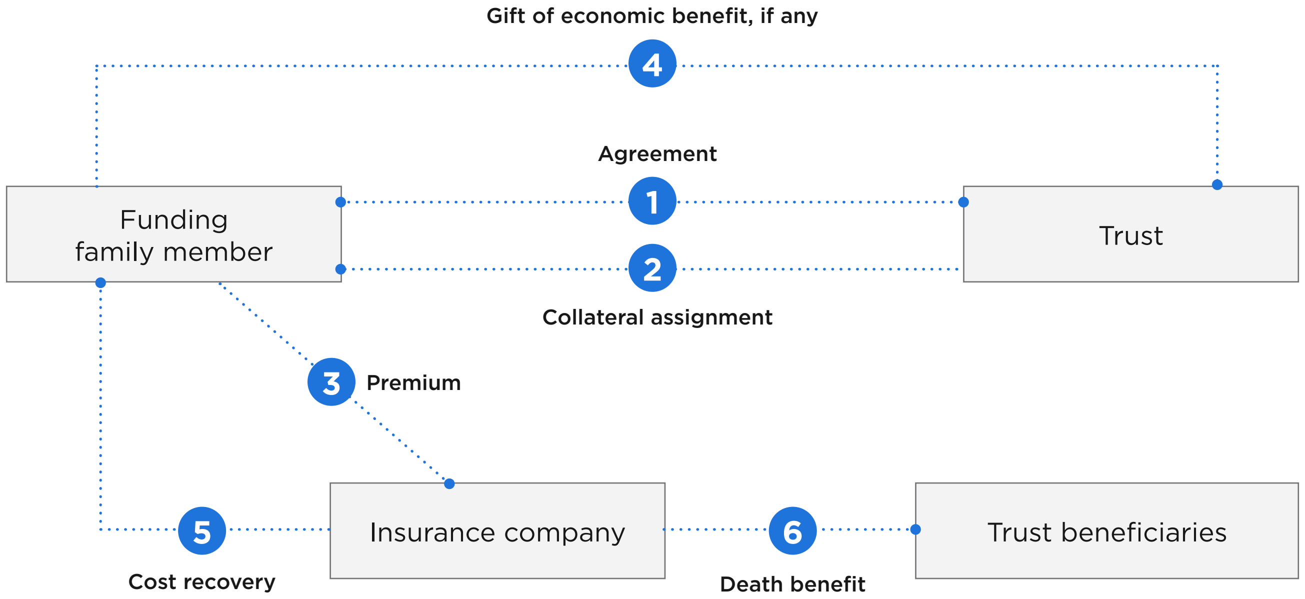
Tax considerations

IRS Notice 2002-8 and the associated final regulations permit the use of Table 2001 to calculate economic benefit values or alternatively the insurer's term rates if certain conditions are met.

Steps

- A trust is established to hold a life insurance policy to benefit future generations
- The trustee applies for a policy on the grantor's life (or potentially another's life) and enters into a private nonequity collateral assignment split dollar agreement with the family member providing the funding
- The trustee executes a collateral assignment in favor of the funding family member for the greater of the cash value of the policy or total premiums advanced
- The family member advances premium amounts to the insurance company and the economic benefit of the death benefit protection is treated as a gift to the trust
- Under the terms of the split dollar agreement and collateral assignment, the funding family member controls the access to the policy cash value
- If the agreement remains in place until the insured's death, the insurance company pays the death benefit to the trust, and the funding family member is reimbursed according to the terms of the split dollar agreement and the collateral assignment

How it works



Insurance-based income solution

The concept

Frequently, the best solution is the simplest solution. Whether you are a business owner, a highly compensated employee or just someone with a life insurance need and concerns about supplementing future cash flow, an insurance-based income solution gives you the opportunity to save more money for the future.

Benefits

An insurance-based income solution is a personally owned life insurance policy designed to maximize cash value and income while minimizing death benefit. If designed properly as a nonmodified endowment contract (non-MEC), the policy offers potential tax-deferred growth and tax-free income.

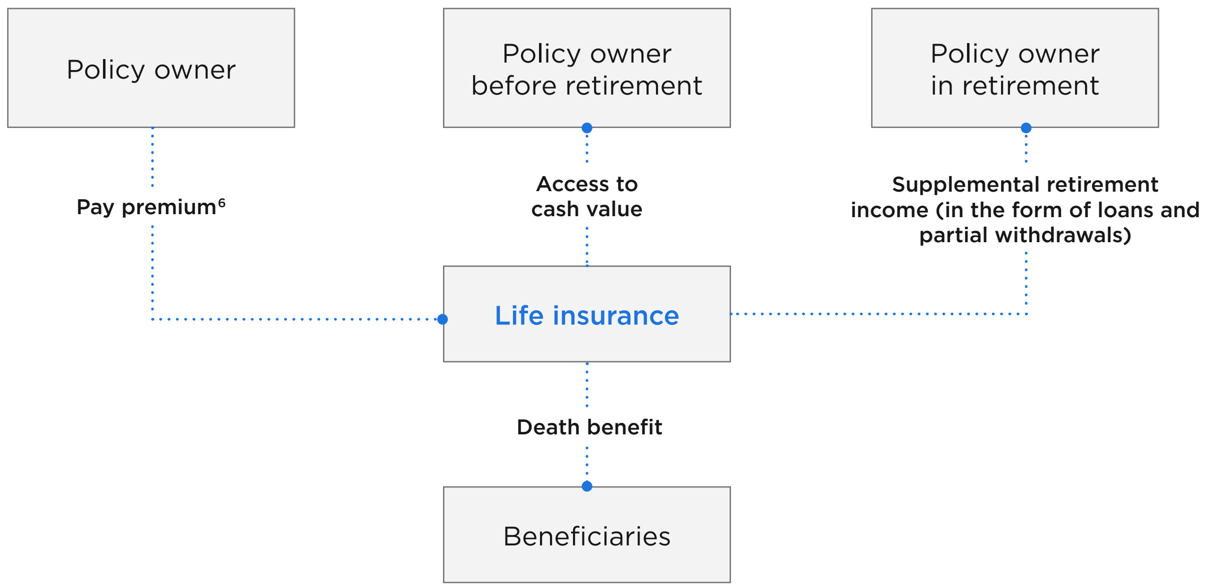
Tax considerations

- Tax-preferred cash flow can be obtained from the policy through withdrawals and loans (assuming the policy qualifies as a non-MEC)
- A MEC policy still has the benefits of tax-deferred growth and a tax-free death benefit, but lifetime distributions will be subject to income tax on gain and a 10% penalty on distributions of gain before age 59½
- Employees can defer additional after-tax money that can be accessed tax free when needed
- There are no withdrawal penalties before age 59½ (for non-MEC policies) and no required minimum distributions at age 72
- An insurance-based income solution lacks the contribution limits and regulatory rules associated with qualified retirement plans

Steps

- Purchase a non-MEC life policy on yourself
- Pay the regularly scheduled premiums on your policy
- Both prior to and at retirement, you have access to your policy's accumulated value through withdrawals and loans
- Upon your death, your beneficiaries receive the remaining death benefit

How it works



[6] The policy must stay in force until death proceeds become payable; otherwise, lapses or surrenders may result in adverse tax consequences.

Executive bonus arrangement (IRC 162 bonus)

The concept

An employer recruits and/or rewards employees by providing a bonus for the purpose of paying the premiums on a life insurance policy.

Benefits

This concept is the simplest type of employee benefit to establish and administer. It is an effective tool for recruiting and rewarding valued employees. Note that because the policy is completely portable for the employee, it does not serve as an effective tool for retaining employees. If more of a "golden handcuff" is preferred, a restricted executive bonus arrangement should be considered.

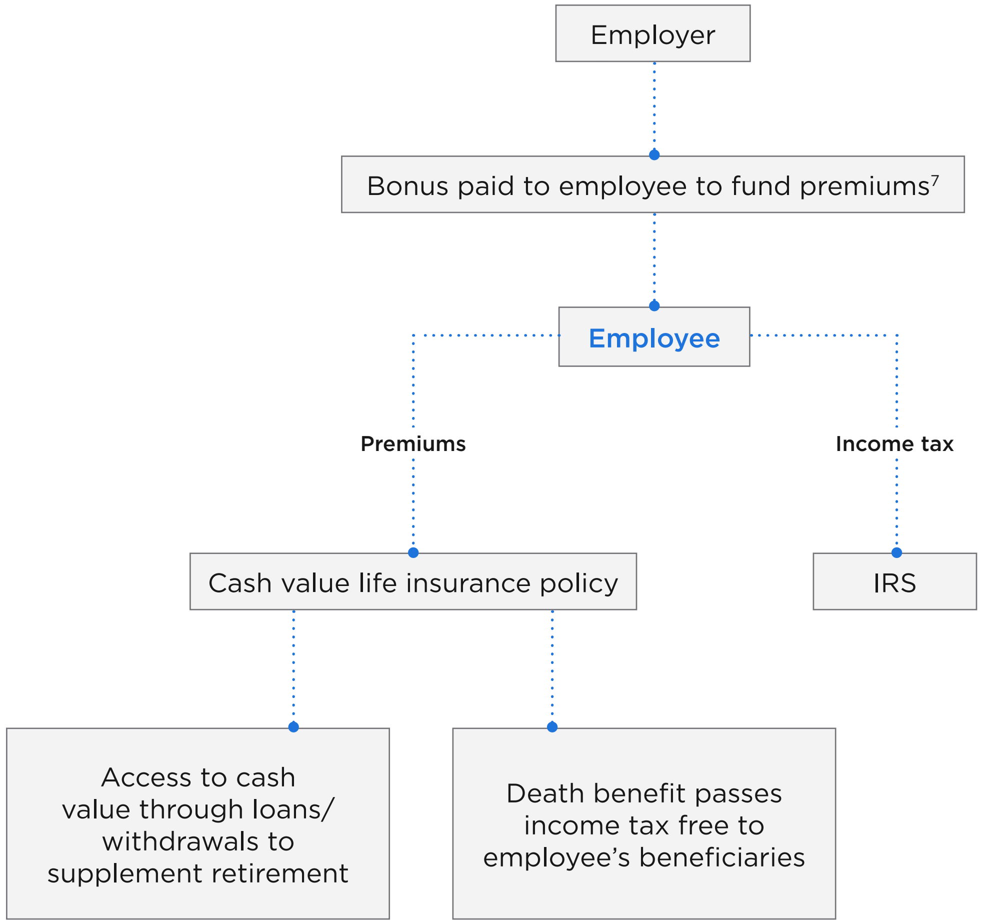
Tax considerations

- The employer's premium contributions are taxable as ordinary income to the employee and are deductible by the employer under IRC Section 162, provided that the total amount of compensation to the employee is "reasonable"
- The death proceeds are paid income tax free to the employee's beneficiary

Steps

- The employer agrees to pay the premiums on a life insurance policy purchased and owned by the employee
- The employee pays income tax on the additional income received either from additional bonus funds earmarked for this purpose or from other funds
- The employee has complete control of the policy, meaning that the employee can name and change the beneficiaries, take withdrawals from the policy and make loans against the policy

How it works



[7] It is considered a double or budget bonus if income tax due on the bonus is being accounted for.

Restricted executive bonus arrangement

The concept

Like an executive bonus arrangement, the employer pays the premiums on a life insurance policy purchased and owned by the employee as a form of employee benefit. The difference is that with this type of bonus plan, the employee's access to the policy's cash value is limited until a triggering event occurs, such as the passage of a certain period of time.

Benefits

This arrangement is an effective tool for recruiting, rewarding and retaining valued employees. Note that because the employee's access to the policy's cash value is limited until the passage of a triggering event, the policy acts as a form of "golden handcuff" for purposes of retaining the employee until the triggering event occurs. Except for the limit on access to the cash value, the policy is owned by and under the complete control of the employee.

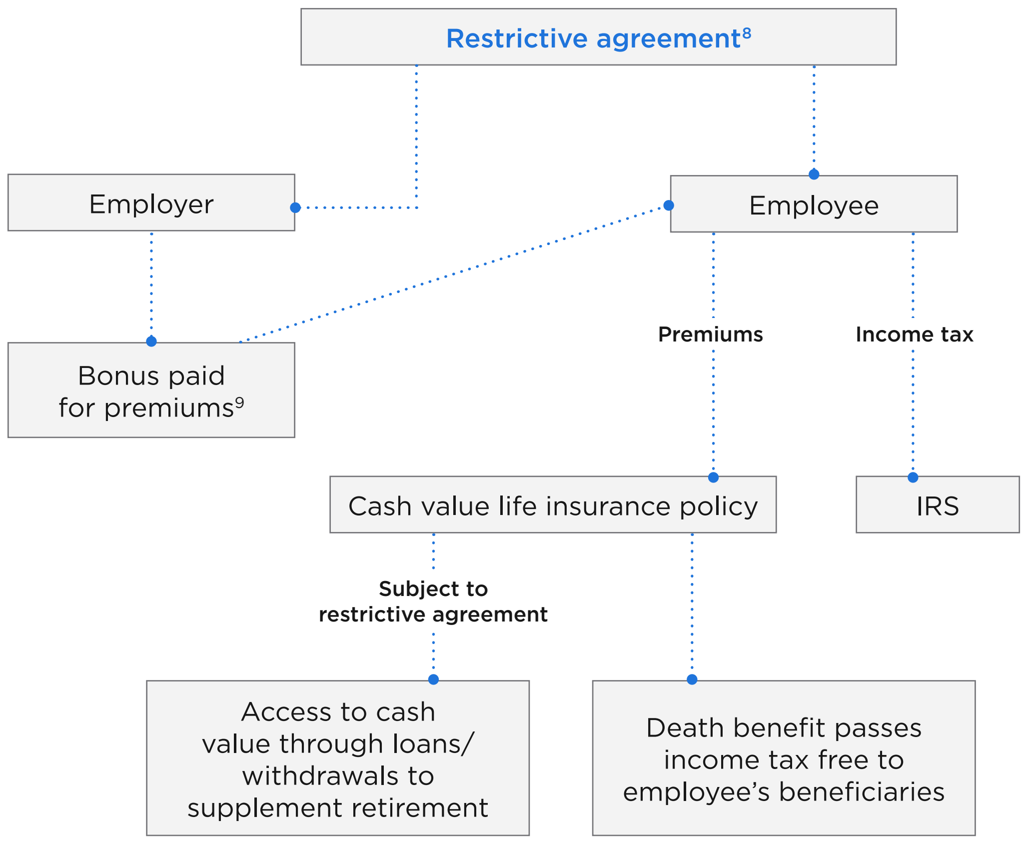
Tax considerations

- The employer's premium contributions are taxable as ordinary income to the employee at the time of the bonus, regardless of the restrictive agreement, and are deductible by the employer under IRC Section 162, provided that the total amount of compensation to the employee is "reasonable"
- The death proceeds are paid income tax free to the employee's beneficiary

Steps

- The employer agrees to pay the premiums on a life insurance policy purchased and owned by the employee
- The employer and employee create a separate written agreement under which the employee agrees not to access the policy's cash value through loans or withdrawals until the passage of a triggering event

How it works



[8] Restrictions on the policy's cash value commonly last until a specified date. Repayment obligations can remain at 100% until a specified date or can gradually decrease. The terms of the cash value restriction and the repayment obligation can be anything to which the employer and employee agree.

[9] It is considered a double or budget bonus if income tax due on the bonus is being accounted for by the employer.

Cross-purchase buy/sell arrangement

The concept

A cross-purchase buy/sell arrangement is an agreement in which the owners of a business draw up a contract among themselves promising that if one of them passes away, retires or becomes disabled, the remaining business owners will purchase the departing business owner's interest. To fund their purchase obligations, the business owners often purchase and own insurance policies on one another's lives.

Benefits

This arrangement provides the business owners with a ready market for their interests at a fair price. Funding a cross-purchase buy/sell arrangement with life insurance means that upon death, cash is available to immediately purchase the deceased business owner's interest. Additionally, if the purchase takes place while the business owner is alive, the policy's cash value may be used as a down payment, with the balance of the purchase price covered by installment notes.

Tax considerations

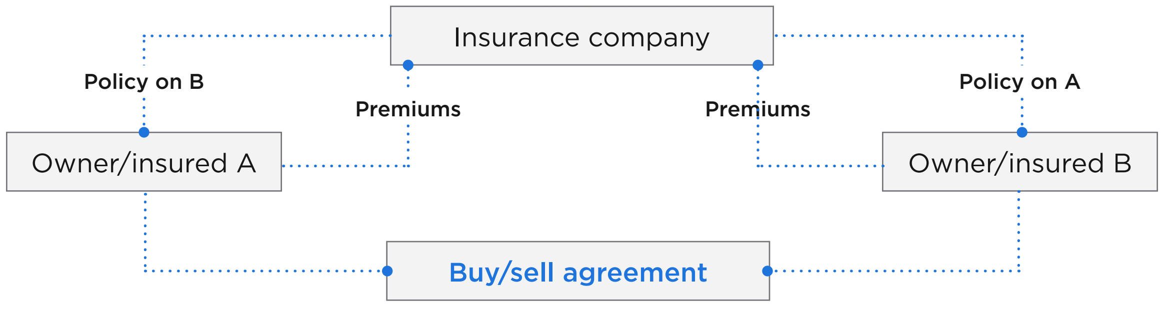
The purchasers of the departing business owner's interest will receive a step-up in basis for their acquired interest.

Steps

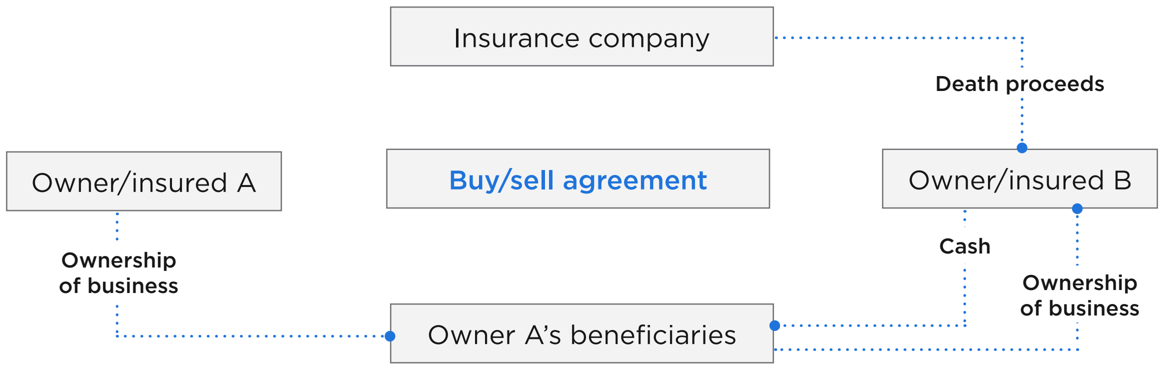
- The business owners enter into a written buy/sell agreement providing for the purchase and sale of a departing owner's interest upon their death, disability or retirement
- The owners purchase life insurance policies on each other's lives
- Upon an owner's death, disability or retirement, a sale of the departing owner's interest to the other owners takes place

How it works while employed

During life



Upon death of owner/insured A



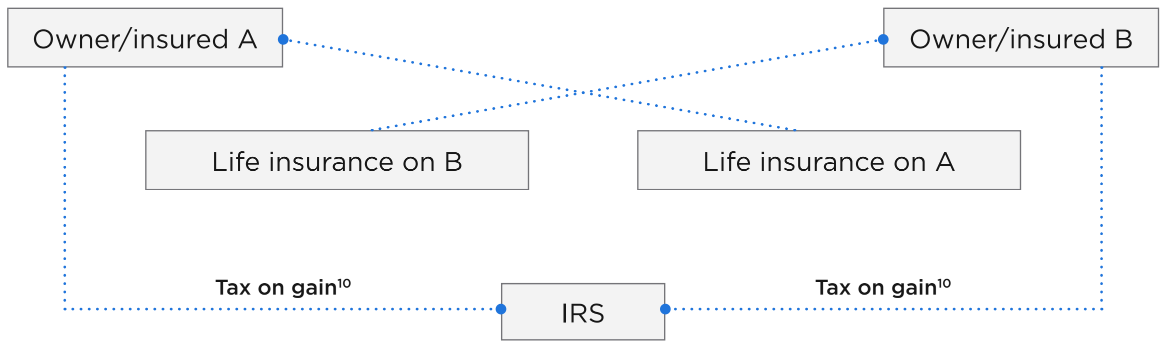
Cross-purchase buy/sell arrangement (continued)

Additional considerations

- Many times, the owners will retire and want to maintain the policies for personal use now that they're no longer needed for the cross-purchase agreement
- In these cases, the policies will be transferred to the insured; this transfer is a barter transaction and is taxable to the owners on the fair market value of the policy in excess of the basis
- The insured will now be the owner of the policy and will be able to access the policy's cash value during life
- The insured's beneficiaries will receive any remaining death benefit

How it works upon retirement

(assuming parties wish to continue their own policies)



[10] Generally, the fair market value of a policy is the greater of terminal reserve or the policy value. The gain, if any, in the policy is the excess of the fair market value over premiums paid, and it is taxed as ordinary income.

Entity-purchase buy/sell arrangement

The concept

An entity-purchase buy/sell arrangement is an agreement in which business owners contract with their business entity (whether a corporation, partnership or LLC) that upon the death, disability, separation of service or retirement of an owner, the entity will purchase that person's business interest. To fund the purchase obligations, the entity acquires a life insurance policy on each business owner's life.

Benefits

The business owners have a ready market for their interests at a fair price. Funding the entity-purchase buy/sell agreement with life insurance means that upon death, cash is available to immediately purchase the deceased business owner's interest. Additionally, if the purchase takes place during life, the policy's cash value may be used as a down payment, with the balance of the purchase price covered by installment notes.

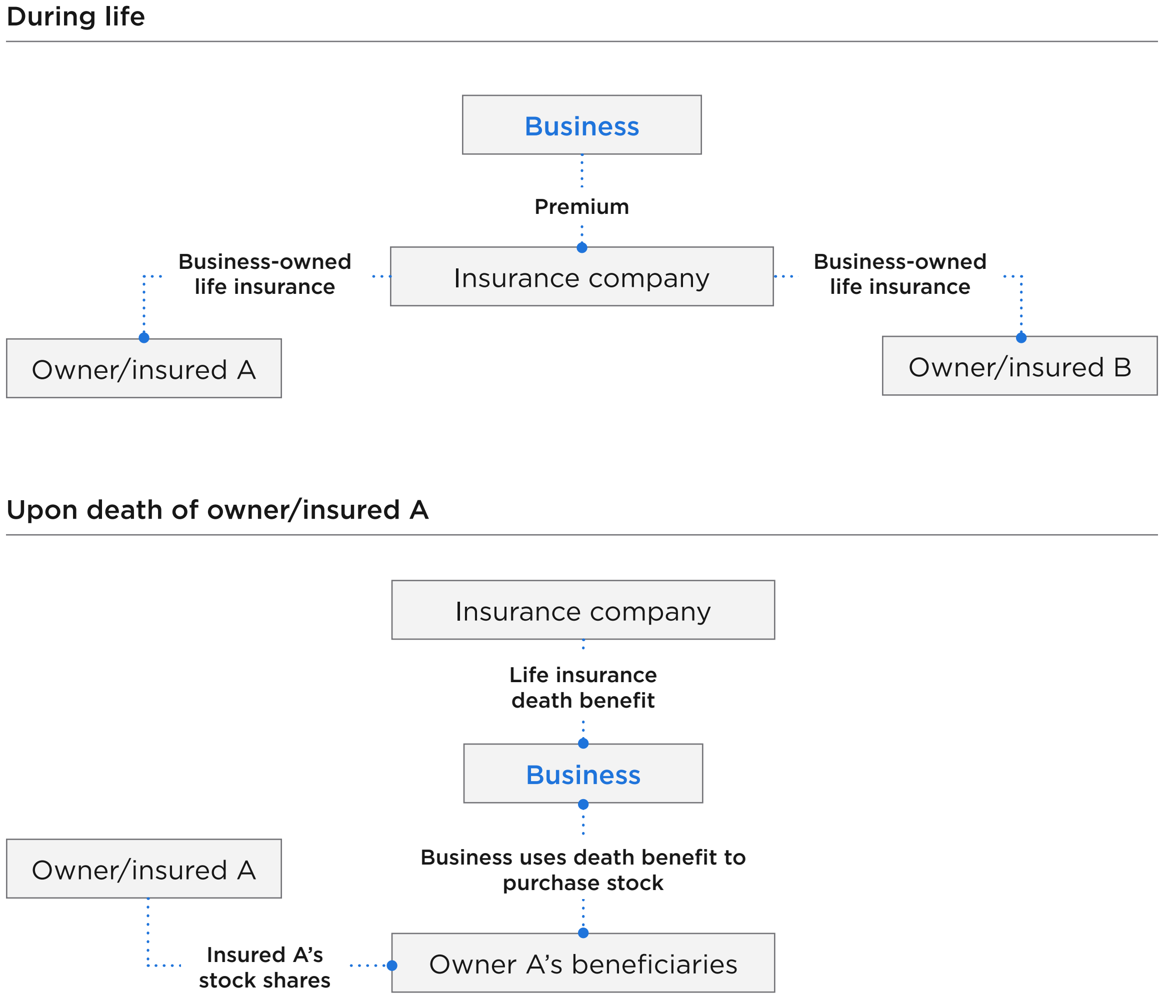
Tax considerations

The remaining business owners will not receive a step-up in basis on the purchase of a departing business owner's interest.

Steps

- The business owners enter into a written buy/sell agreement with the business entity, providing for the purchase and sale of a departing owner's interest upon their death, disability or retirement
- The business entity acquires insurance on each business owner's life to fund its purchase obligations
- Upon an owner's death, disability or retirement, a sale of the departing owner's interest to the entity takes place

How it works while employed



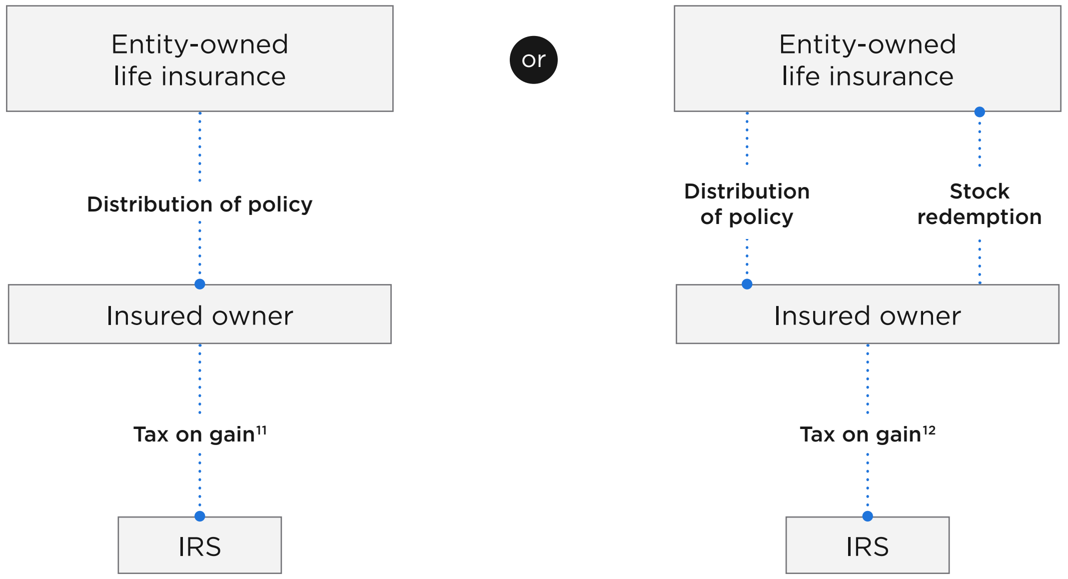
Entity-purchase buy/sell arrangement (continued)

Additional considerations

- Typically, when an owner retires, there would be a distribution (in part or in whole) of the life insurance policy (although it is possible for the business to retain the contract)
- If the life insurance policy is transferred to the business owner upon retirement, it's treated as additional income and is taxable as such at the owner's tax rate for the fair market value of the policy; the entity may be entitled to a deduction
- If the life insurance is distributed to the owner as a redemption of the owner's interest/shares in the company, it's taxable as a capital gain based on the fair market value of the policy
- The distribution of the policy, either as a retirement bonus or as partial payment for the retiree's stock, is a taxable disposition; if there is a gain in the contract, the corporation has to recognize the gain
- The insured will now be the owner of the policy and will be able to access the policy's cash value during life
- The insured's beneficiaries will receive any remaining death benefit

How it works upon retirement

(assuming parties wish to continue their own policies)



[11] If the life insurance policy is transferred to the business owner upon retirement, it is treated as additional income and is taxable as such at the owner's tax rate for the fair market value of the policy. The entity may be entitled to a deduction.

[12] If the life insurance is distributed to the owner as a redemption of the owner's interest/shares in the company, it is taxable as a capital gain to the owner based on the fair market value of the policy.

Employee stock ownership plan (ESOP)

The concept

An ESOP is a qualified defined contribution plan that invests primarily in the stock of a sponsoring corporation. These plans are commonly used to give retiring owners a way to cash out all or part of their holdings without selling the entire company. In addition, advantages are provided to employee participants; the shares they receive for engaging in the program are ultimately repurchased by the company at their fair market value. To prefund this repurchase obligation, the company may acquire cash value insurance on the lives of selected management personnel.

Benefits

- The natural consequence of initiating an ESOP is to create a market for company securities
- Provided that the ESOP owns 30% or more of company stock and the company is a C corporation, the owners selling their stock to the ESOP can defer taxation on their gains by reinvesting in the securities of other companies
- As employees have an ownership interest in the company, their productivity may increase

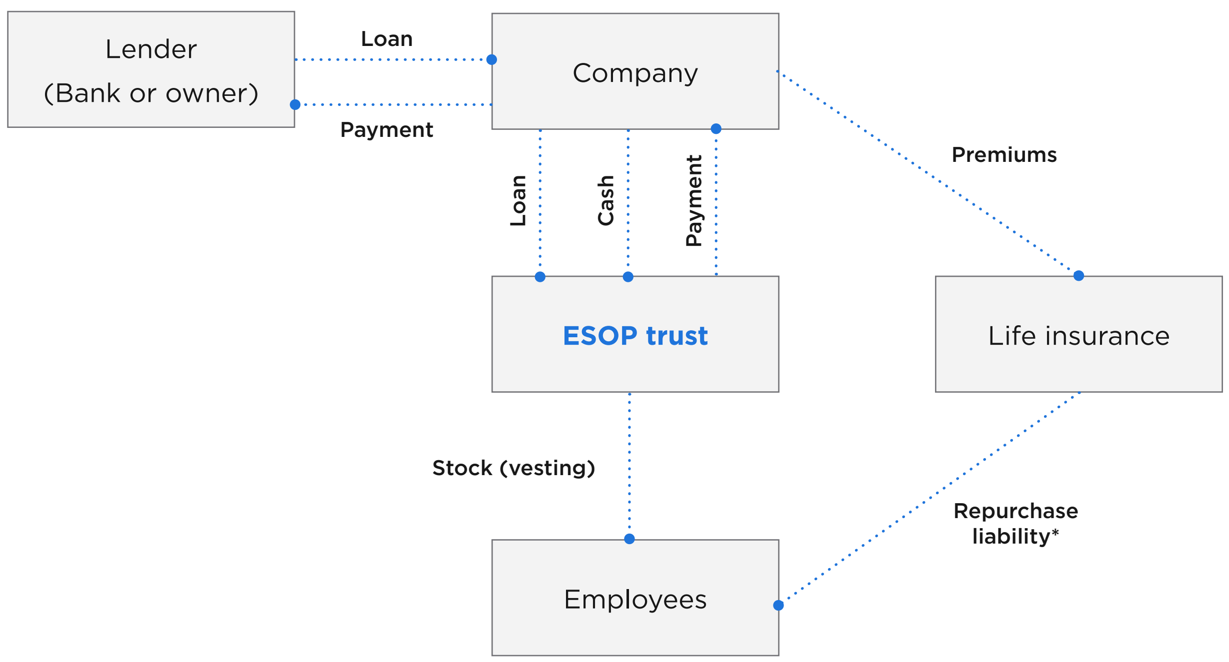
Tax considerations

- Tax and labor regulations require that the company's obligation to repurchase departing employees' shares be backed by adequate security
- Where the repurchase obligation is funded through life insurance, the buildup of cash value inside the policies remains as an asset on the books of the corporation
- All the investment growth inside the policies is tax deferred

Steps

- The company forms a trust and establishes the retirement plan
- The company obtains financing and lends the proceeds to the ESOP trust to buy out all or a portion of owner shares
- The company makes annual contributions to the trust to repay the loan
- As the trust repays the loan, shares are allocated to employee accounts
- Departing or retiring employees typically redeem their shares for cash
- To fund the company's repurchase obligation, the company buys cash value life insurance policies on selected company management personnel

How it works



* Repurchase takes place typically upon retirement or another separation of service event.

Key person indemnification

The concept

The loss of a key person may adversely impact the value and viability of a business. Consequently, the business owner should consider purchasing life insurance on key persons who are important to the business's bottom line.

Benefits

The business receives income tax-free funds at the key person's death to offset lost revenue and increased expenses in the form of the cost of finding, hiring and training a replacement. In addition, while the key person is alive, the business has access to the policy's cash value if needed.

Tax considerations

The premium contributions are nondeductible, but the death proceeds are received income tax free.

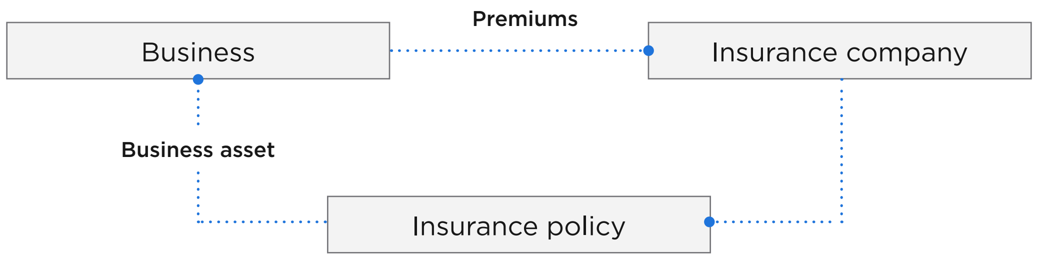
Steps

- The business purchases and owns a policy on the life of a key person
- The amount of insurance should equal the estimated lost revenue and additional expenses associated with the key person's premature death
- The business makes nondeductible premium payments
- The business has access to cash value that grows inside the policy tax free
- If the key person dies, the business receives income tax-free death proceeds[13]

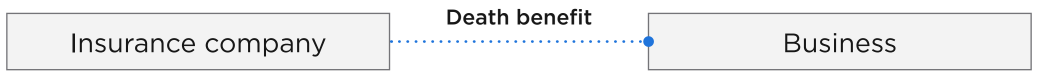
[13] Pursuant to IRC Section 101(j), certain requirements must be met for the death proceeds to be income tax free, including getting consent from the employee regarding the insurance coverage. Please see the marketing resources referenced on Page 60 for more information.

How it works

During lifetime of key person



Upon death of key person



Equity loan regime split dollar plan

The concept

An employer assists an employee in acquiring life insurance protection by lending money to the employee for the purposes of making the premium payments on the life insurance policy. The employee pledges the policy as collateral for the loan and retains the ability to name the beneficiary for the balance of the death benefit.

Benefits

For this strategy, the employee obtains life insurance protection with the financial assistance of the employer. The employer's loan, by way of the collateral assignment, is protected and reimbursed either from the cash value of the policy at retirement or the death benefit at death. The employee determines the beneficiary(ies) for the balance of the policy.

Tax considerations

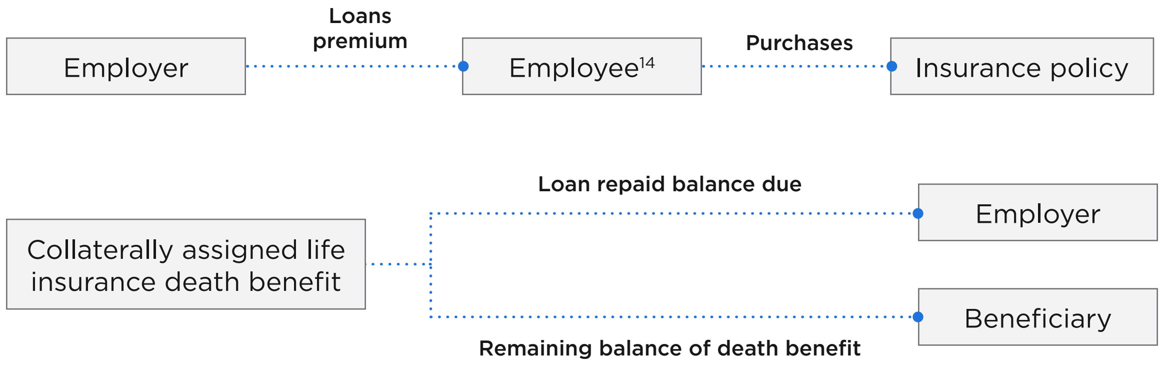
- The employee is taxed on the imputed interest income of the loan
- If the employee is limited to the death benefit (nonequity collateral assignment), the arrangement is treated as an endorsement split dollar plan and the employee is taxed on the economic benefit of the life insurance

Steps

- The employer and employee enter into a written split dollar life insurance agreement
- The employer creates a loan for the employee for the payment of premiums, and the policy is put in place with a collateral assignment in favor of the employer
- The employee names the beneficiary(ies) of the amount in excess of the loan

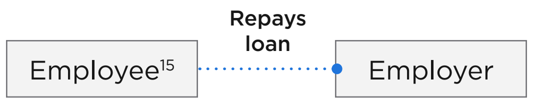
How it works

During working years

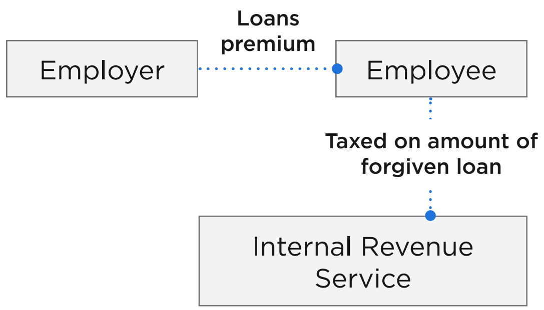


Upon separation from service/end of agreement

Loan is paid back by employee



Loan amount is forgiven



[14] The employee is taxed on the imputed interest income of the loan.

[15] The agreement is terminated and the employee owns the life insurance policy free and clear of pledge.

Nonequity endorsement split dollar plan

The concept

An employer assists an employee in acquiring life insurance protection by purchasing and owning a policy on the employee's life while permitting the employee to name a personal beneficiary for the death benefit in excess of the employer's premium contributions or policy cash value, whichever is greater. The employee is taxed annually on the value of the employee's life insurance protection.

Benefits

The employee obtains life insurance protection with the financial assistance of the employer. The employer, as the owner of the policy, is reimbursed its premium advances or policy cash value, whichever is greater, from the cash value during the employee's life or from the death proceeds at the employee's death. The employee is taxed at favorable rates on the value of the life insurance protection.

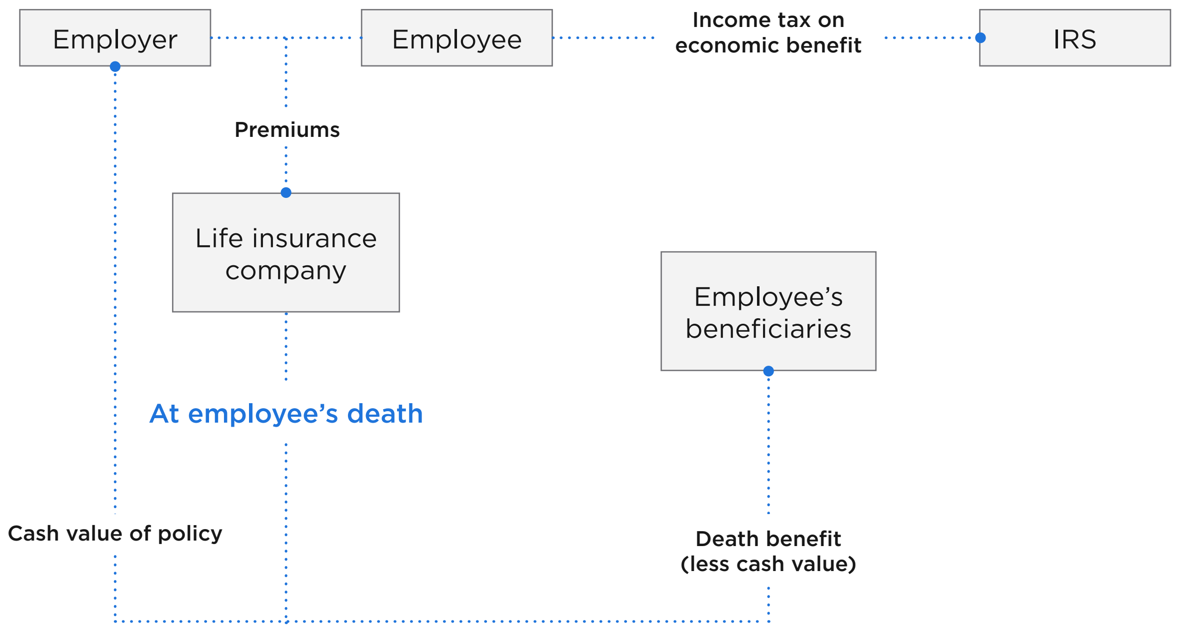
Tax considerations

- The measure of the value of the employee's life insurance protection for income tax purposes is the government's Table 2001 rates or the insurer's alternative one-year term rates, if available
- Because the employee has no interest in the cash value of the policy, the employee is taxed annually only on the value of the life insurance protection

Steps

- The employer and employee enter into a written split dollar life insurance agreement
- The employer purchases and owns a policy on the employee's life
- The employee names a personal beneficiary for the amount of death benefit in excess of the employer's premium advances or the policy's cash value, whichever is greater
- The employer pays the policy premiums
- The employee reports each year on his or her taxes the value of the life insurance protection using the Table 2001 or the insurer's one-year term rates, if available
- At the employee's death, the death benefit reimburses the employer for its premium advances or the policy's cash value, whichever is greater, with the balance paid income tax free to the employee's beneficiaries

How it works



Supplemental executive retirement plan

The concept

Small-business owners need to show top performers they're appreciated to ensure they stay with the business. One way to accomplish this is with a defined benefit or defined contribution supplemental executive retirement plan (SERP) funded with life insurance.

Benefits

A SERP benefits not only the employee who is the eventual recipient of the supplemental income, but also the employer who puts the plan in place. It can be a recruiting and retention tool for valued employees. It has fewer administration and filing requirements than traditional qualified plans. The business owner has the ability to choose which employees receive the benefit and when and how much they will receive.

Defined benefit SERP

A defined benefit SERP allows an employer to provide defined benefit payments to a key employee at a predetermined age of retirement and/or years of service. Instead of funding the employee account on an annual basis, the employer simply books the expense and liability for the benefit annually, to be recognized in the future.

Defined contribution SERP

A defined contribution SERP is an arrangement in which an employer makes contributions to a retirement account earmarked for a key employee until a predetermined age of retirement and/or years of service. Upon retirement, the employee will receive distributions based on the account value at that time.

Tax considerations

- There is no immediate tax deduction for the employer
- SERPs lack the contribution limits and regulatory rules associated with traditional qualified retirement plans
- There's no impact on existing qualified retirement plans — you can have both a qualified retirement plan and a SERP
- Retirement benefits, when paid, are taxable to the employee and tax deductible to the employer
- If the employee dies prior to retirement, the SERP may have provisions to provide a tax-free death benefit to the employee's estate

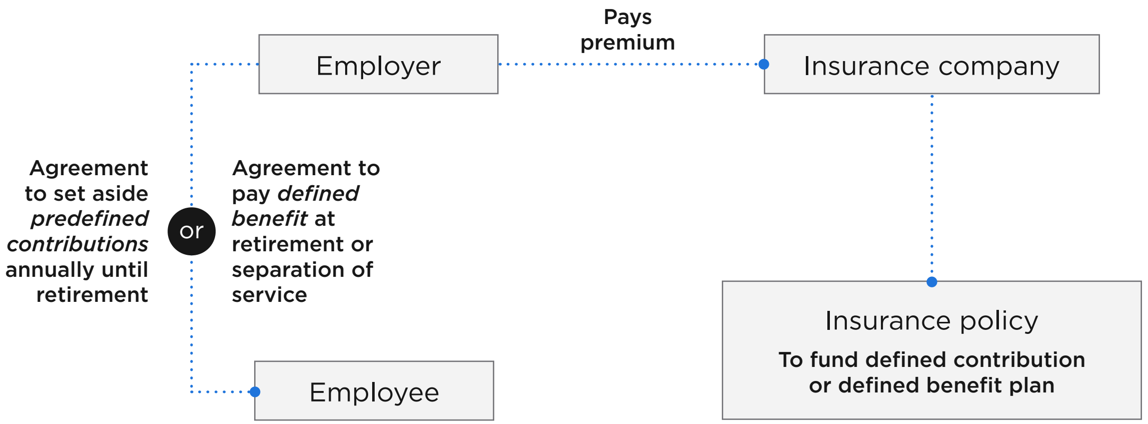
Steps

- The employer determines whether to put a defined contribution or defined benefit plan in place
- The employer determines who will be covered by the plan
- The employer pays the premium to the life insurance carrier based on the lives of the plan participants
- The employer pays out the benefit at the employee's retirement

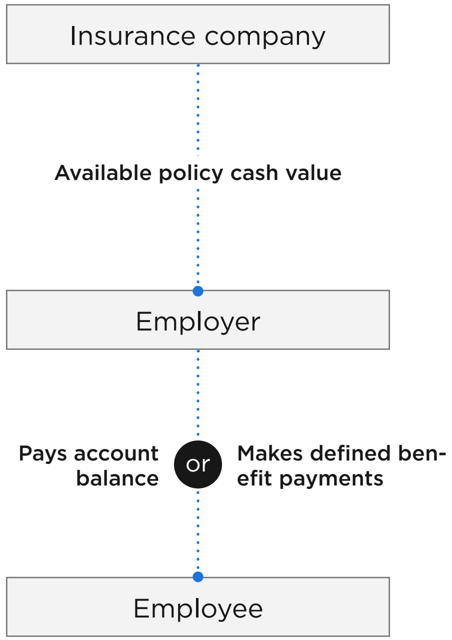
Supplemental executive retirement plan (continued)

How it works

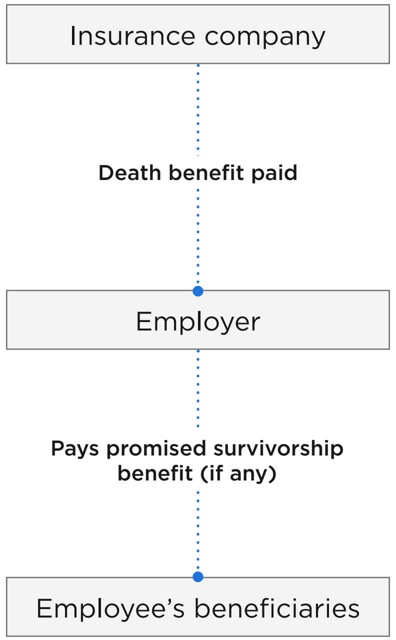
During work years



At retirement



At death



Nonqualified deferred compensation plan (NQDC)

The concept

Your business clients know that once they've secured top talent, it's important to keep those individuals happy. One way to show them they're appreciated is with a nonqualified deferred compensation plan (NQDC) funded with life insurance.

Benefits

With a nonqualified deferred compensation plan, the employer gives the key employee the opportunity to save for retirement through salary deferrals, company contributions or a combination of both. It's both a recruiting and a retention tool for employees who are specialized or valued, and it has less administration and fewer filing requirements than qualified plans subject to ERISA.

NQDC plans offer flexibility in plan design to meet specific needs, and if informally funded with life insurance, the corporation, as the beneficiary, will receive the death benefit, which can be used to recover costs associated with the plan.

Tax considerations

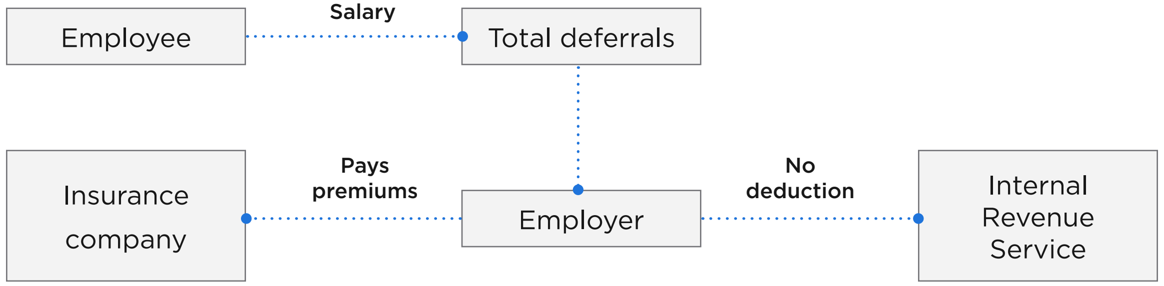
- There is no immediate tax deduction for the employer
- The business gets to take a tax deduction when an employee receives distributions from the plan, and these are taxed as ordinary income to the employee
- There's no impact on existing qualified retirement plans — you can have both a qualified retirement plan and an NQDC plan

Steps

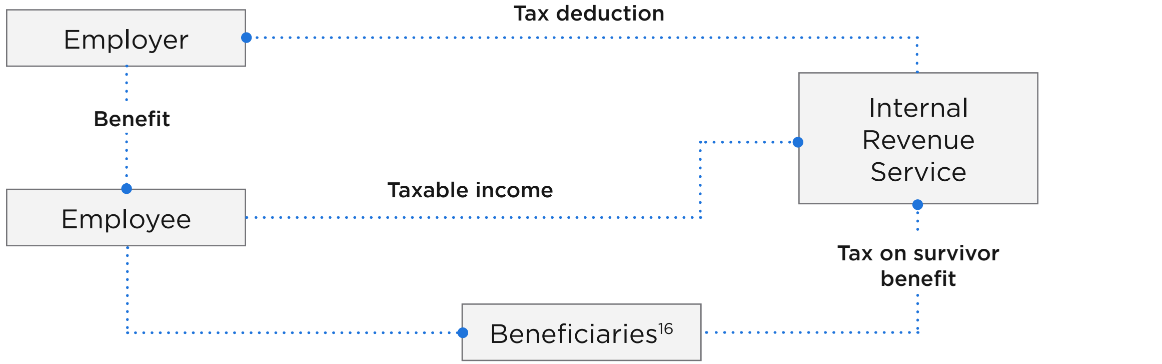
- The employer puts the plan in place, and salary deferrals (and possibly employer contributions) begin
- The employer may choose to purchase life insurance on some or all eligible employees to informally fund the plan; life insurance enables the employer to avoid taxable gains on the plan assets
- The plan uses contributions to fund the life insurance premiums
- Upon a qualifying event, such as retirement, disability or separation from service, benefits are paid to the employee

How it works

Pre-retirement deferral cash flow diagram



Post-retirement benefit cash flow diagram



[16] If the employee dies during post-retirement distribution (or pre-retirement employment), there may be distributions payable to the employee's beneficiaries and taxed accordingly.

Life insurance in qualified retirement plans

The concept

Life insurance can be used to provide a tax-advantaged incidental death benefit in a qualified retirement plan, whether defined benefit or defined contribution.

Benefits

In the case of the defined benefit plan, the use of life insurance provides a more affordable and efficient method of delivering the amount of pre-retirement death benefit mandated by the plan's formula than funding through traditional plan assets. By utilizing life insurance in a defined contribution plan to provide a pre-retirement death benefit, participants can leave a legacy to their beneficiaries substantially in excess of the amount that would be provided by the accumulated balances in their respective participant accounts.

Tax considerations

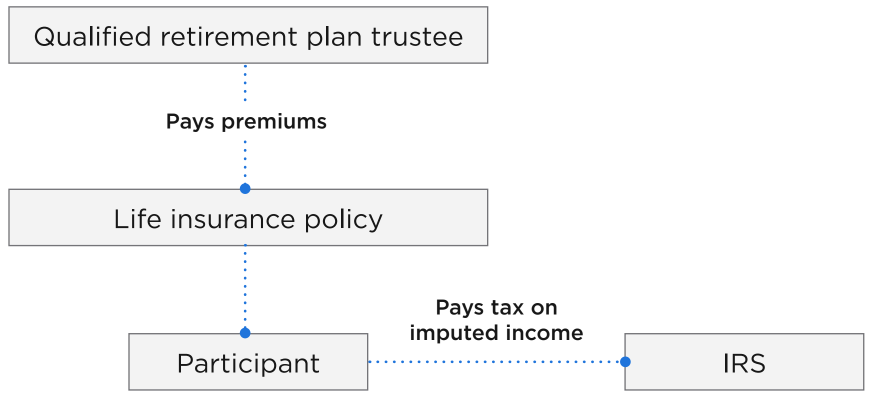
- Contributions to the plan to purchase life insurance are deductible within the normal limits that apply to the type of qualified retirement plan in which the policy will be utilized
- Participants incur a yearly tax cost, computed in accordance with the Table 2001 rates, for the net amount at risk; self-employed persons do not report any tax cost because they are not allowed to deduct the cost of their life insurance premiums
- The death benefit attributable to the excess of the life insurance policy's face amount over the cash value goes income tax free to the designated beneficiary(ies)

Steps

- The sponsor of the qualified retirement plan discusses with the trustee of such plan the benefits of including individual life insurance policies as an asset class within the plan
- In the case of a defined benefit plan, the trustee or other named fiduciary (e.g., an investment manager as defined by Section 3(38) of ERISA) will make a decision to purchase life insurance on the lives of participants who meet the insurability requirements of the respective insurers
- Most defined contribution plans allow participants to direct the investment of assets allocated to their respective individual accounts within the plan; the trustee or other named fiduciary (e.g., an investment manager as defined by Section 3(38) of ERISA) will make available to participants the option of including an individual life insurance policy as an investment choice among the available options afforded to plan participants

How it works

While in plan



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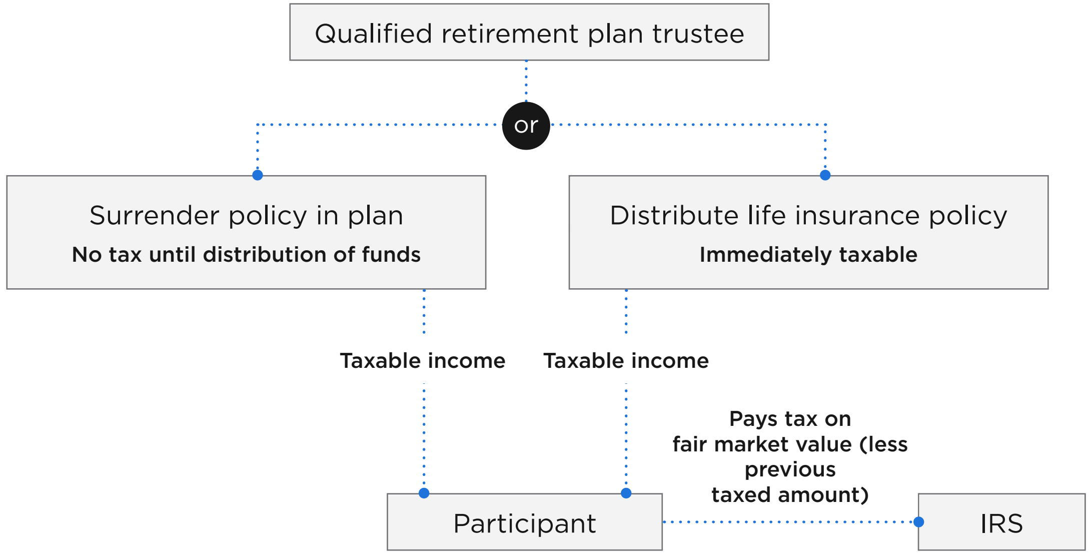
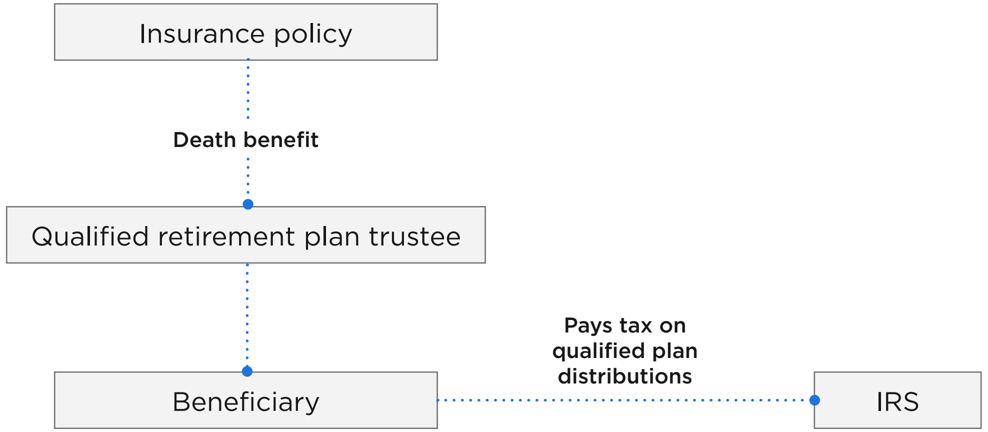
Life insurance in qualified retirement plans (continued)

How it works (continued)

Upon retirement of participant



Upon death of participant



Marketing resources

The Advanced Consulting Group offers a wide range of materials, including white papers, newsletters and PowerPoint presentations. Please refer to our literature guides for a comprehensive listing of materials.

- Annuities and IRA taxation and distribution strategies (NFM-13791AO)
- Life insurance and long-term care planning for individuals and businesses (NFM-13792AO)
- Qualified retirement plans and nonqualified benefit planning (NFM-13793AO)

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