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Advanced marketing concepts

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Breaking down and simplifying financial planning techniques

When your clients have complex estate, retirement or business planning needs, 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.

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 is a technique that 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. Further, the death proceeds may be used for estate liquidity, estate equalization, wealth replacement or other life insurance needs while being creditor protected.

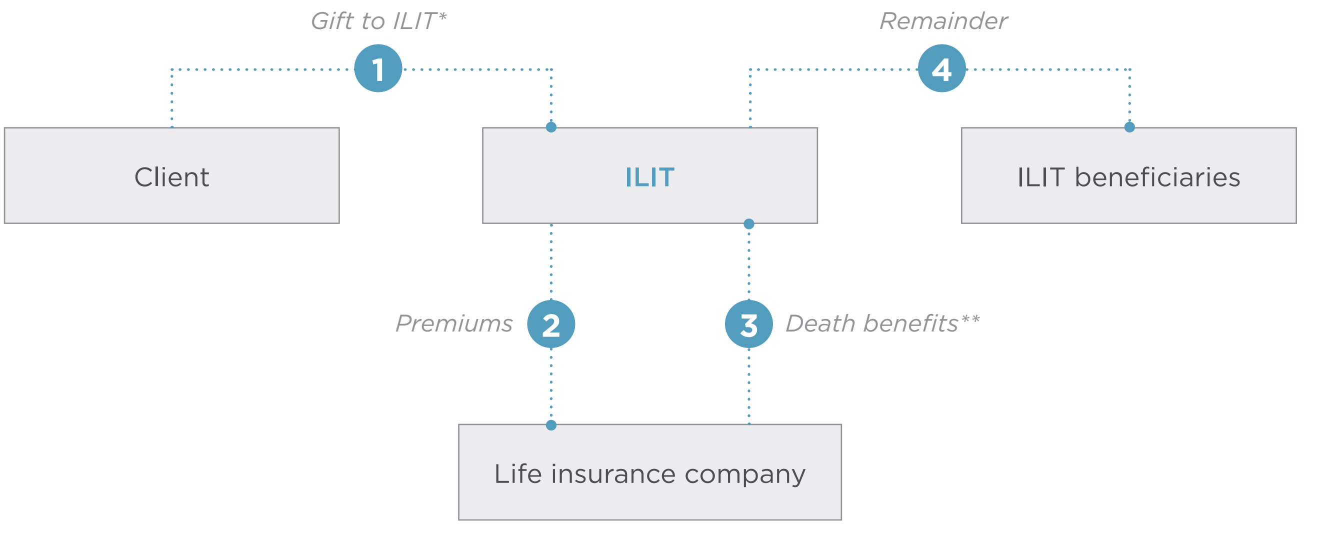
Tax considerations

- 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 not be a trustee of the trust or be 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

Steps

- 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 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



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

** If properly constructed, the ILIT 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 that person's 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.

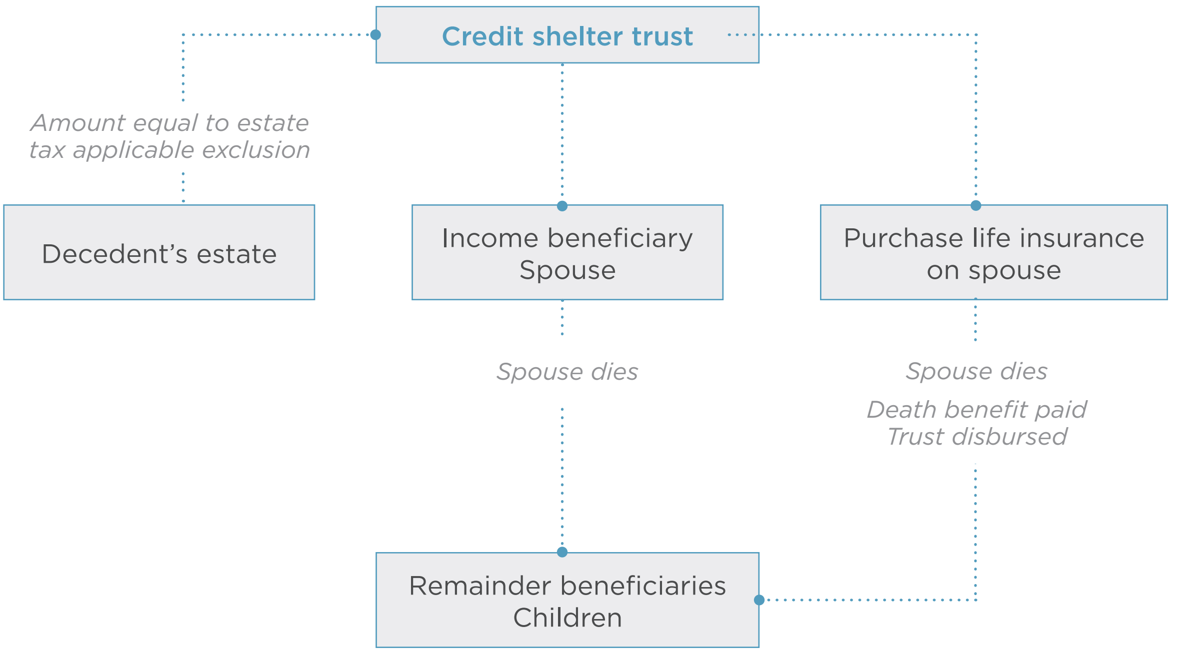
Tax considerations

- The surviving spouse acquires life insurance outside of his/her 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 income and estate tax free
- The death proceeds are distributed to the children estate tax free

Steps

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

How it works


Credit shelter trust
Amount equal to estate tax applicable exclusion
Decedent's estate
Income beneficiary Spouse
Purchase life insurance on spouse
Spouse dies
Spouse dies
Death benefit paid
Trust disbursed
Remainder beneficiaries 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.

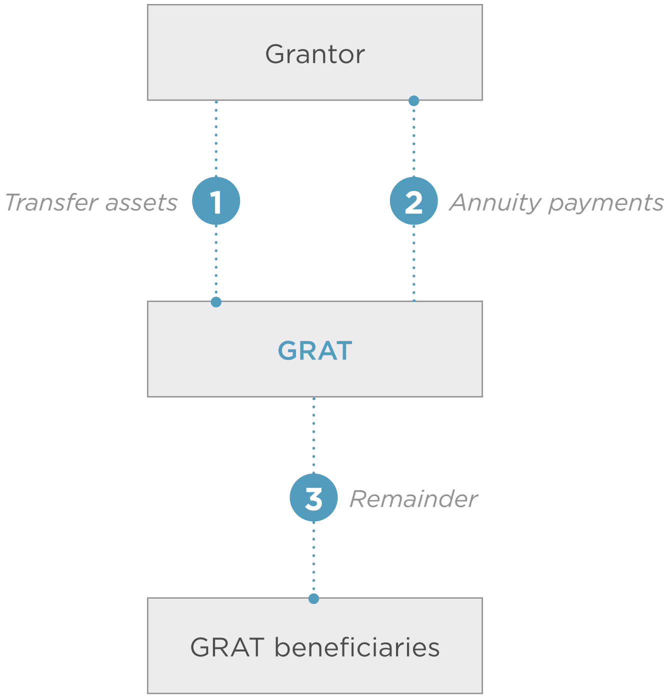
Tax considerations

- 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 and that means 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 should purchase a term life insurance policy for the duration of the income period to cover any potential estate tax stemming from the trust property being brought back into the grantor's estate

Steps

- The grantor transfers highly appreciated or income producing property to the trust in return for an income interest for a certain period of time
- The trust makes income payments to the grantor for the duration of the trust
- 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, and 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.

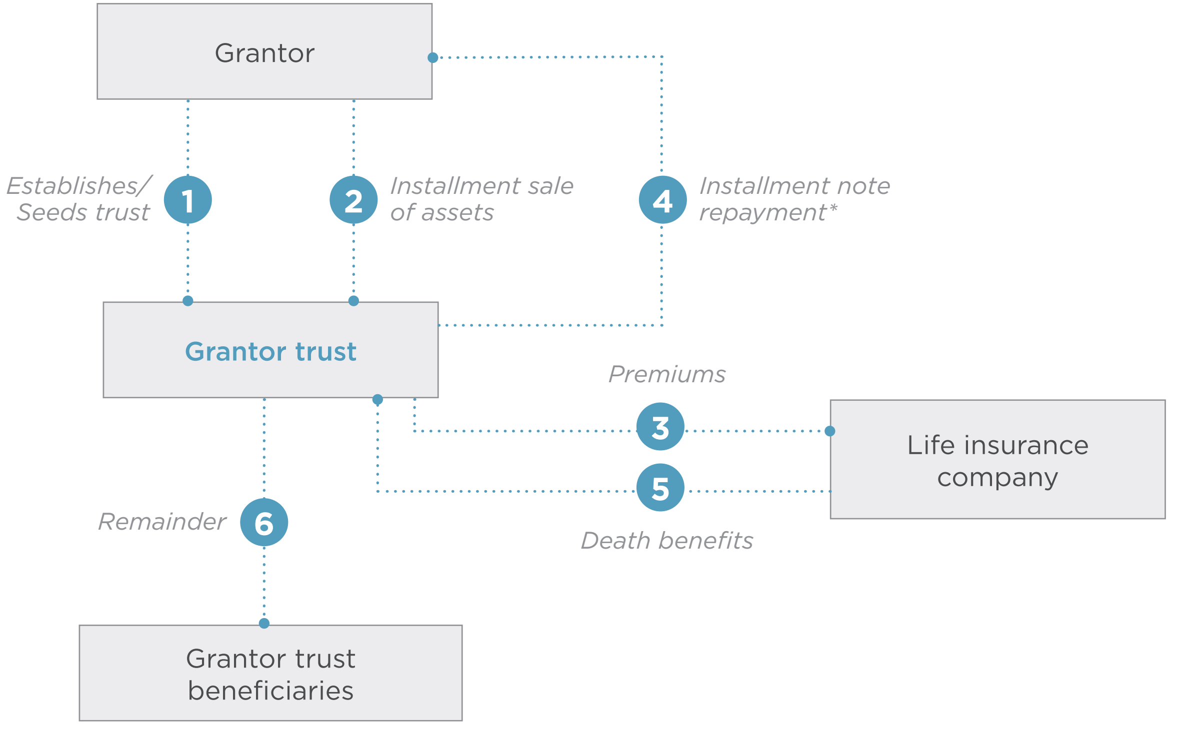
Tax considerations

- Since the trust is established as a grantor trust, no gain is recognized by the grantor on the sale of the assets to the trust
- Since 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
- Since 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
- Since 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



* The note could be set up as a self-cancelling 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 among heirs where some heirs would not receive an equitable distribution from a decedent's estate; as oftentimes can occur in cases where there is 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.

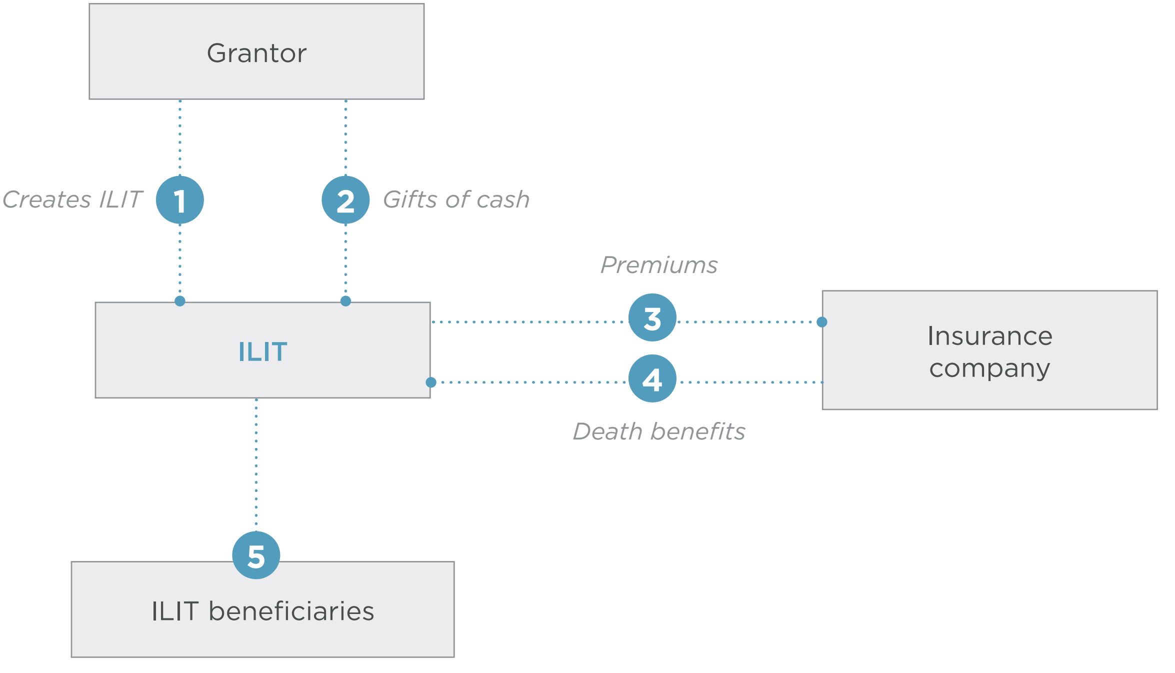
Tax considerations

- 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 so as 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


Grantor
Creates ILIT
1
2
Gifts of cash
Premiums
ILIT
3
Insurance company
4
Death benefits
5
ILIT beneficiaries

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 non-charitable beneficiary such as members of the donor's family.

Benefits

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

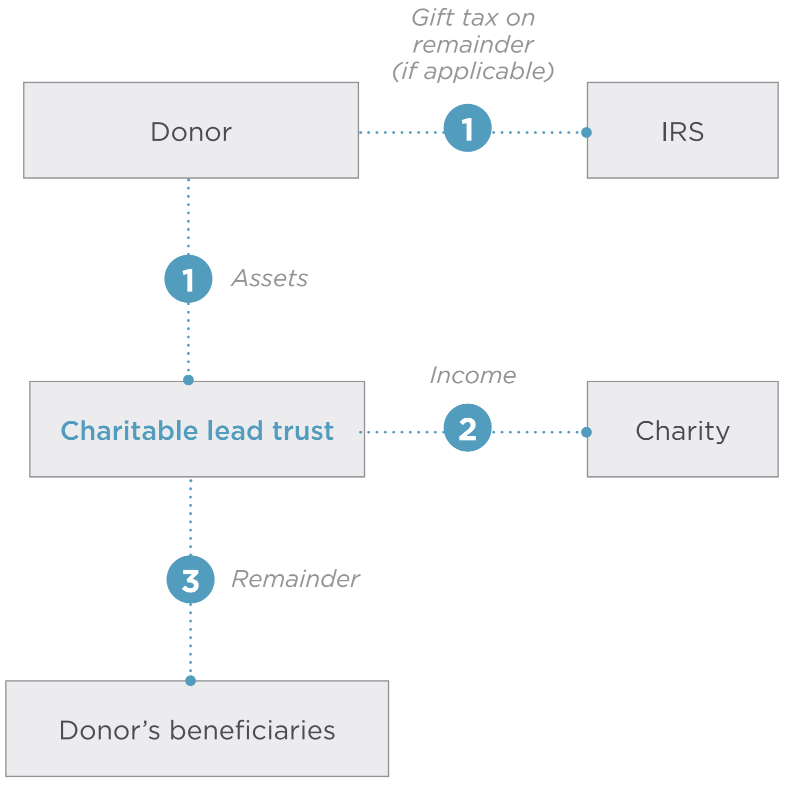
Tax considerations

- The value of the gift to the non-charitable 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 non-charitable 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 CLTs termination, the remainder interest, including the death proceeds, is paid to the non-charitable beneficiaries

How it works


Gift tax on remainder (if applicable)
Donor
1
IRS
1
Assets
Income
Charitable lead trust
2
Charity
3
Remainder
Donor's beneficiaries

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.

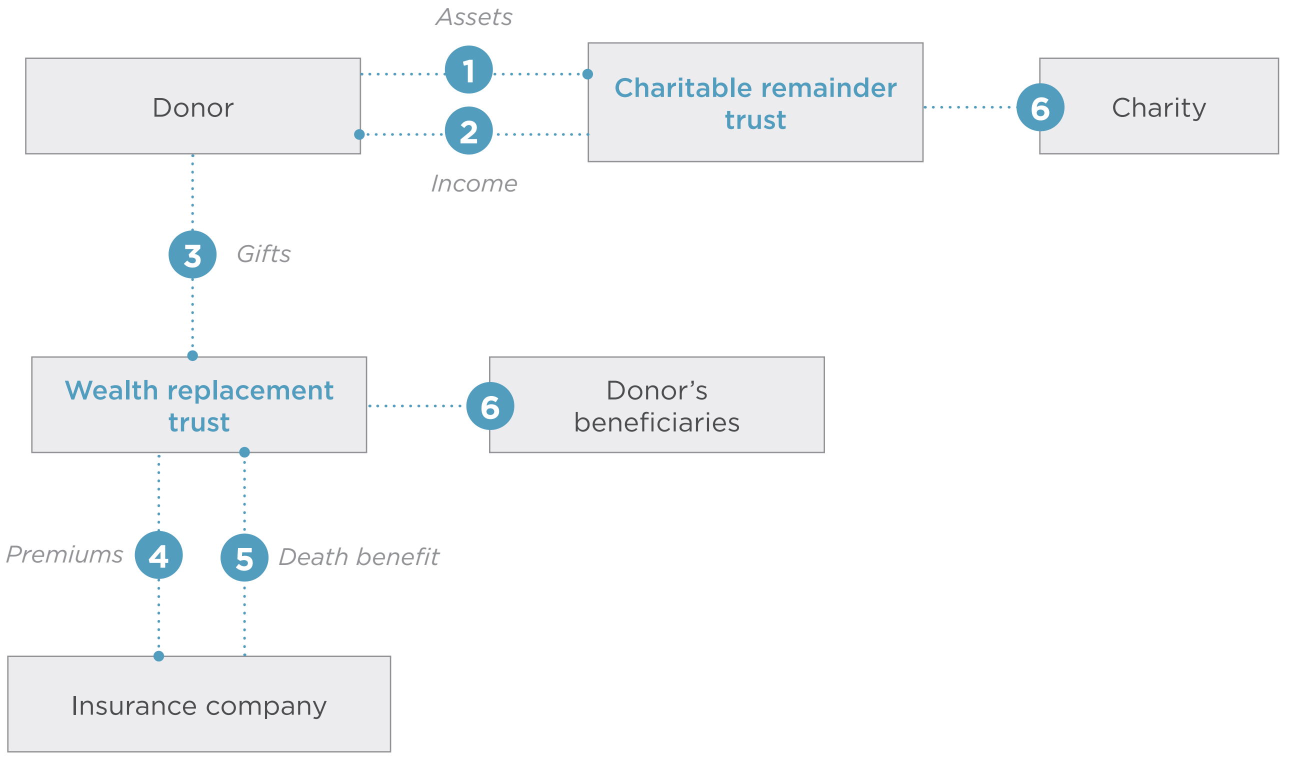
Tax considerations

- Since 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 funds it with some or all of the income received from the CRT; 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


Assets
Donor
1
Charitable remainder trust
6
Charity
2
Income
3
Gifts
Wealth replacement trust
6
Donor's beneficiaries
Premiums
4
5
Death benefit
Insurance company

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 since the policy premiums are relatively small as compared to 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

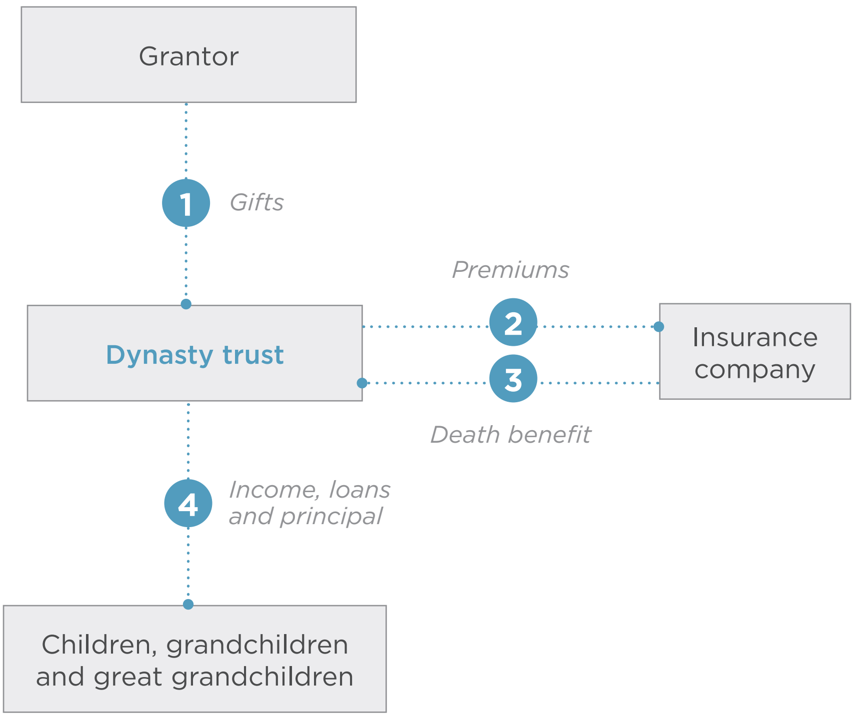
- The grantor's generation skipping transfer tax (GSTT) exemption is leveraged by applying it to the policy premiums as they are gifted to the trust, since the premiums are smaller than the death benefit
- The death benefit is paid to the trust income and estate tax free
- If the trust is drafted with 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 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 is a technique that enables the grantor to acquire life insurance without having to make a gift of premium dollars to the trust. This means that the technique is particularly useful where 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 and expose the grantor to taxable gifts. Further, it is a useful strategy where the grantor needs life insurance but is temporarily illiquid and unable to contribute premium dollars to the trust. It may also be advantageous where the grantor has an investment portfolio that is liquid but the grantor wants to maintain use of and control over the assets that would otherwise have to be liquidated to pay premiums.

Tax considerations

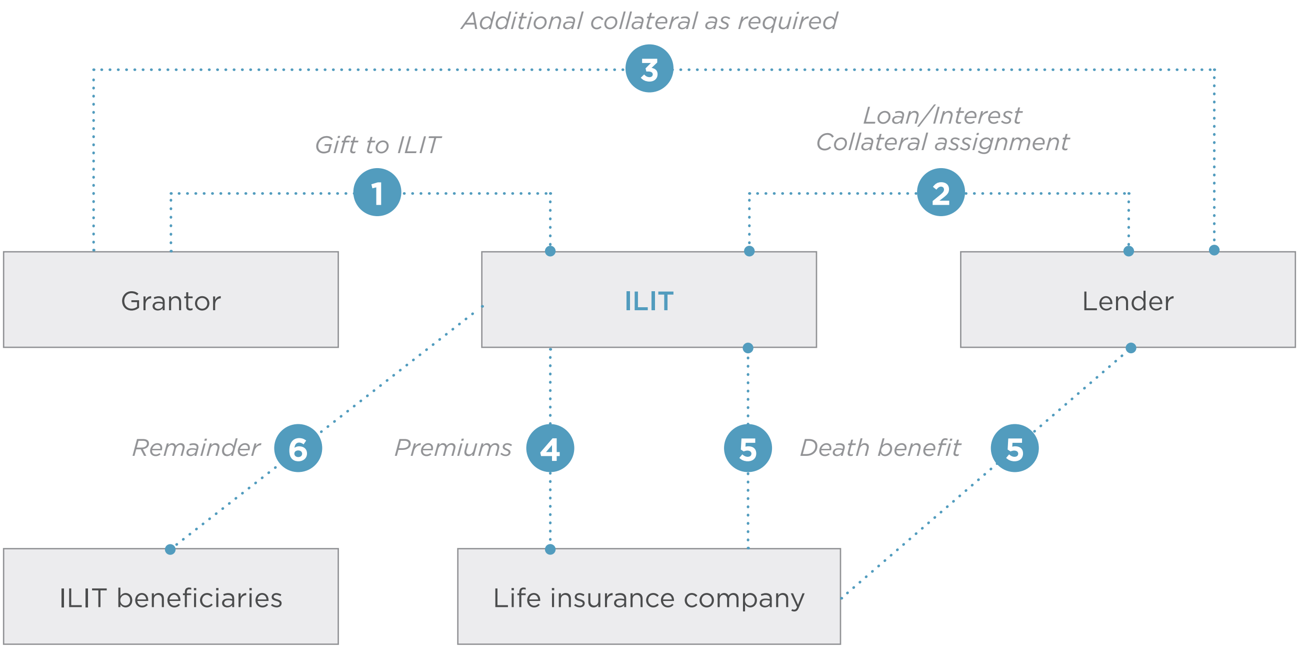
- The only gift to the trust by the grantor would be if the grantor chose or was required to pay all or a portion of the interest charges to the trust on the premium loans
- The death proceeds would be paid to the trust income and estate tax free

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 may not renew the loan or the policy may not perform as planned requiring additional collateral to be pledged; consequently, premium finance arrangements should be accompanied by an exit strategy and only undertaken by individuals or couples with substantial wealth.

How it works



Insurance based retirement plan

The concept

Oftentimes the best solution is the simplest solution. Whether you are a business owner or a highly compensated employee or just someone with a life insurance need and concerns about supplementing future cash needs, an insurance-based retirement plan (IBRP) gives you the opportunity to save more money for the future.

Benefits

An IBRP is a personally owned life insurance policy designed to maximize cash value and income while minimizing death benefit. If designed properly as a non modified endowment contract (non-MEC), it can be funded with after-tax dollars and offers tax-deferred growth, tax-free income and a tax-free death benefit.

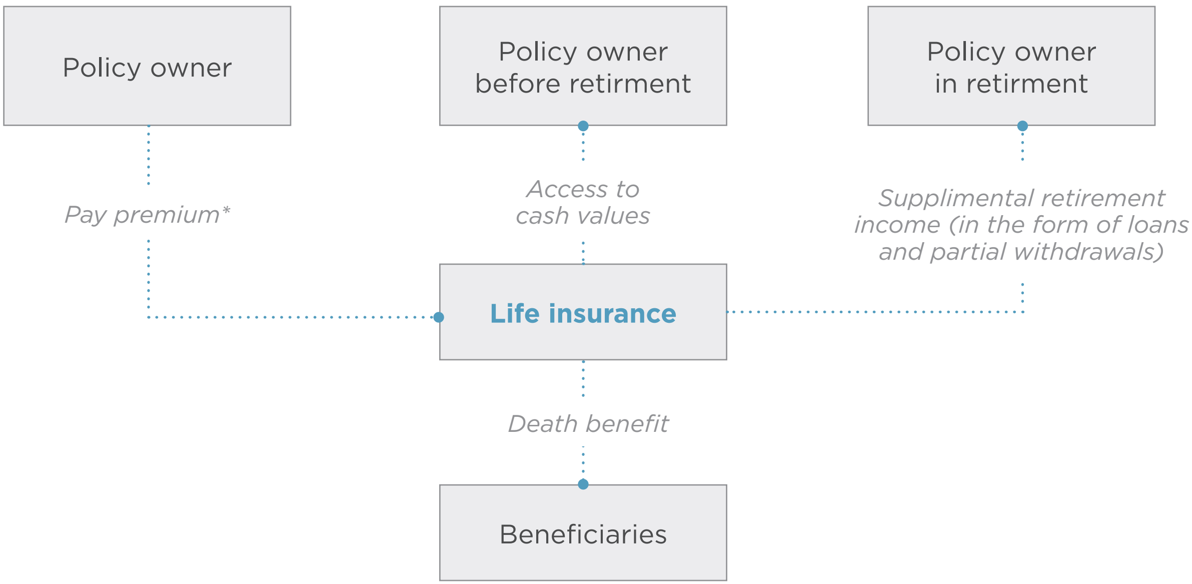
Tax considerations

- Tax-preferred cash flow can be withdrawn from the policy through withdrawals and loans (assuming policy qualifies as a non-MEC)
- Employees can defer additional after-tax money that can be accessed tax free when needed
- There are no pre-59½ withdrawal penalties and no required minimum distributions at age 70½
- It lacks the contribution limits and regulatory rules associated with traditional qualified retirement plans

Steps

- Purchase a life policy on yourself
- Make 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



* Policy must stay in force until death proceeds become payable, otherwise, lapses or surrenders may result in adverse tax consequences.

Executive bonus arrangement (I.R.C. 162 bonus)

The concept

An employer recruits and/or rewards employees by providing a bonus for the purposes 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 since 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 bonus" arrangement should be considered.

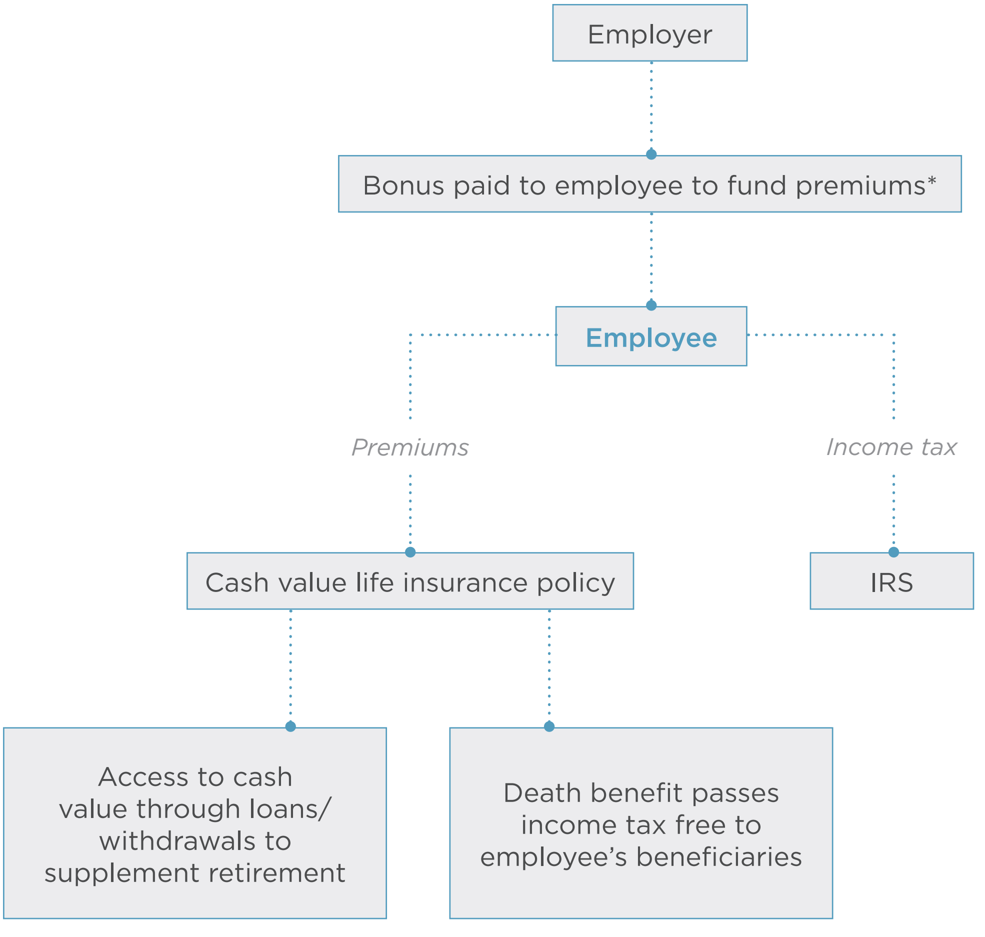
Tax considerations

- The employer's premium contributions are taxable as ordinary income to the employee and deductible by the employer under I.R.C. § 162 providing 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 funds bonused for this purpose or from other funds
- The employee has complete control of the policy, which means that the employee can name and change the beneficiaries, take withdrawals from the policy and make loans against the policy

How it works



* 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 a restrictive endorsement bonus plan, the employee's access to the policy's cash values 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 since the employee's access to the policy's cash values 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 cash values, the policy is owned by and under the complete control of the employee.

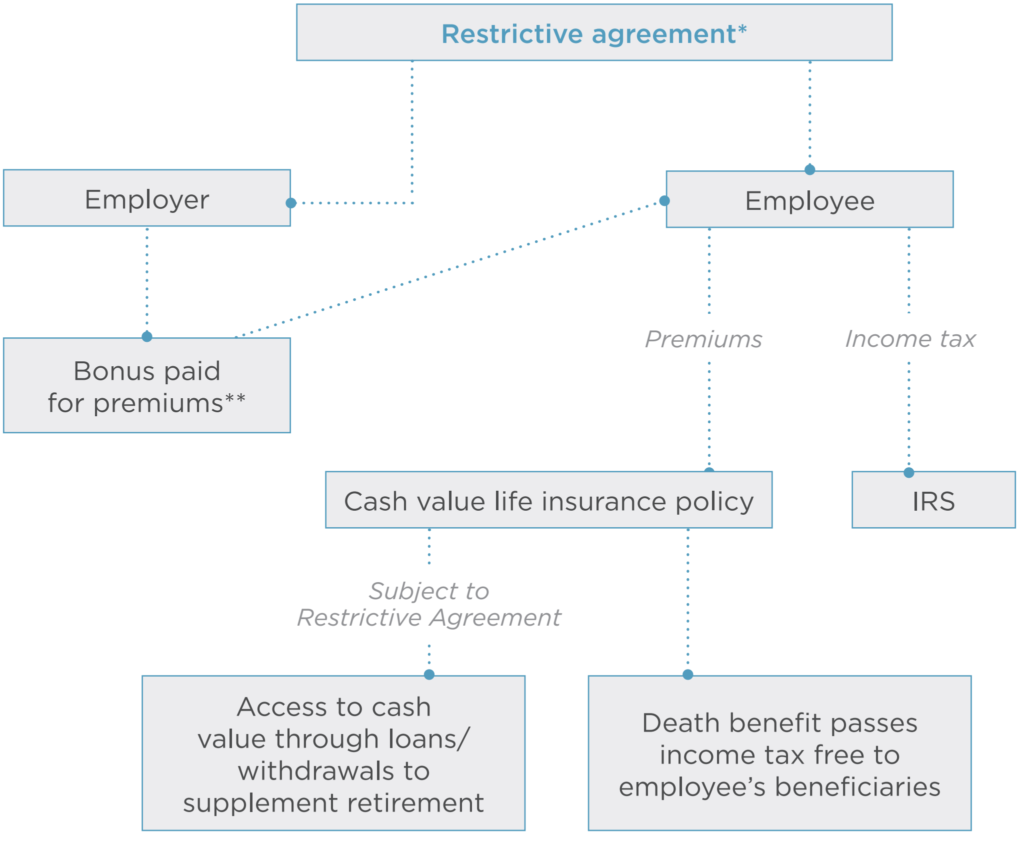
Tax considerations

- 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 deductible by the employer under I.R.C. § 162, providing 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 values through loans or withdrawals until the passage of a triggering event

How it works



* Restrictions on access to policy values commonly last until a specified date. Repayment obligations can remain at 100% until a specified date, or can gradually decrease. The terms of the restriction to policy values and the repayment obligation can be anything to which the employer and employee agree.

** 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 contract among themselves that if one of them dies, 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 each other's lives.

Benefits

This arrangement provides the business owners with a ready market for their interests at a fair price. Funding cross purchase buy/sell 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 policies' cash values may be used as a down payment with the balance of the purchase price covered by installment notes.

Tax considerations

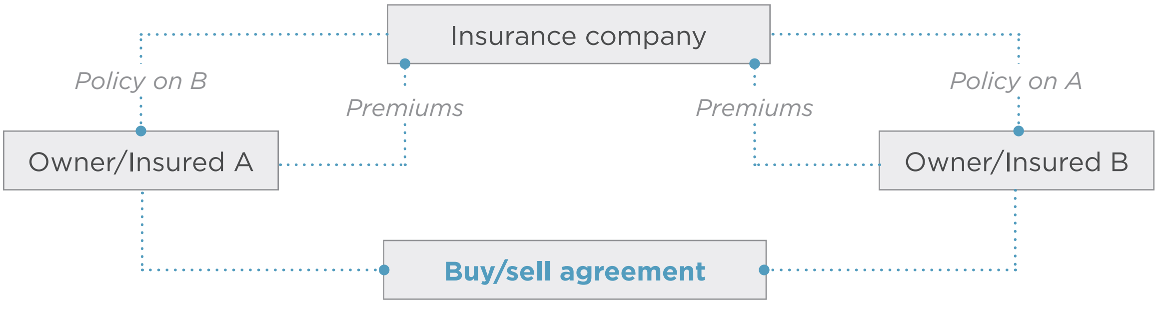
- The purchasers of the departing business owner's interest will receive a step-up in basis for their acquired interest

Steps

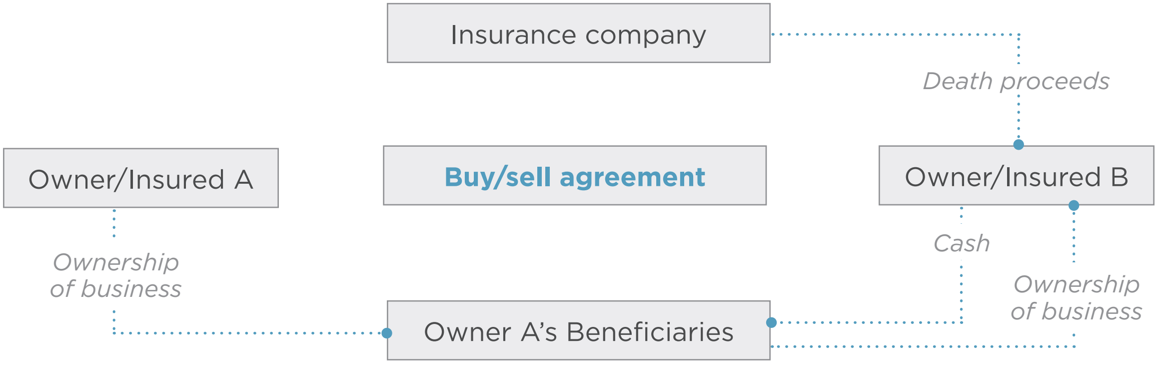
- The business owners enter into a written buy/sell agreement providing for the purchase and sale of a departing owners interest upon their death, disability or retirement
- The owners purchase life insurance on each other's lives
- Upon an owner's death, disability or retirement, a sale of the departing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

How it works while employed

During life



Upon death of owner/insured A



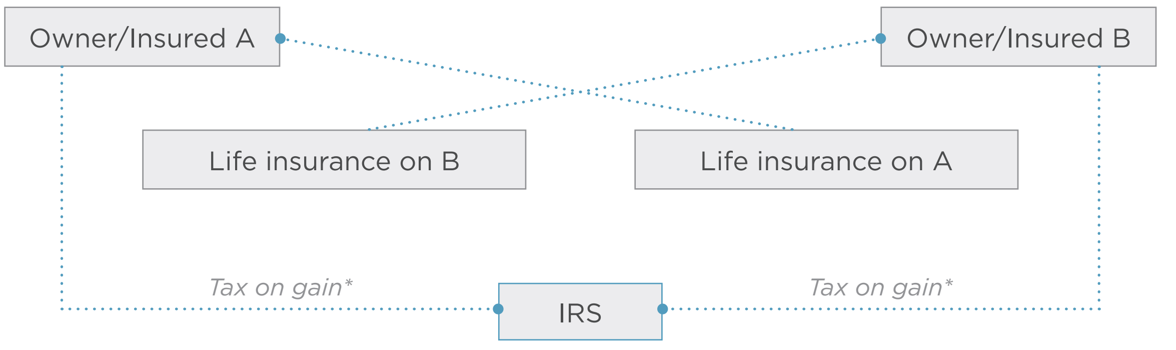
Cross purchase buy/sell arrangement *(continued)*

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 and this transfer is a bartered transaction and 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 their own policy and will be able to access policy 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)



* Per Rev. Rul. 2009-13, ordinary income taxation applies to the portion of the gain that represents the difference between fair market value and premiums paid. The remaining gain is taxable as capital gains.

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

Here 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

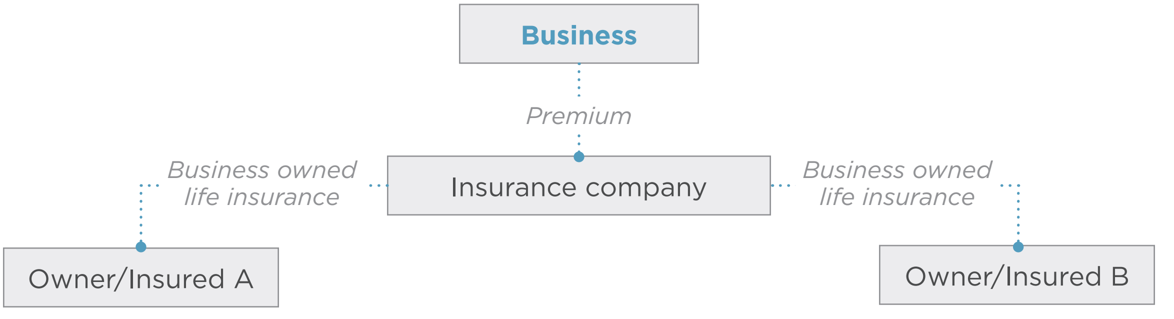
- The remaining business owners will not receive a step up in basis on the purchase of a departing business owner's interest

Steps

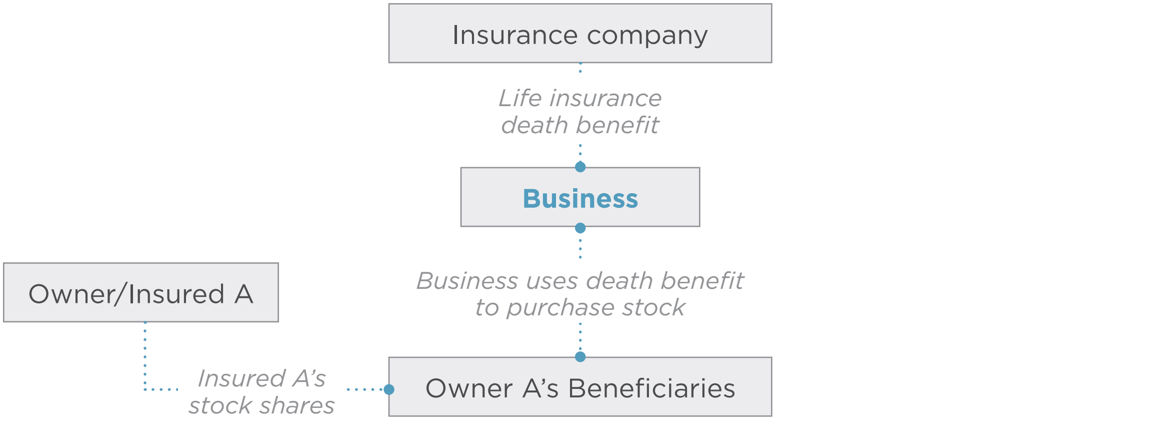
- The business owners enter into a written buy/sell agreement with the business entity, providing for the purchase and sale of a departing owners interest upon their death, disability or retirement
- The business entity acquires insurance on each business owner's life to fund its purchase obligations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

During life



Upon death of owner/insured A



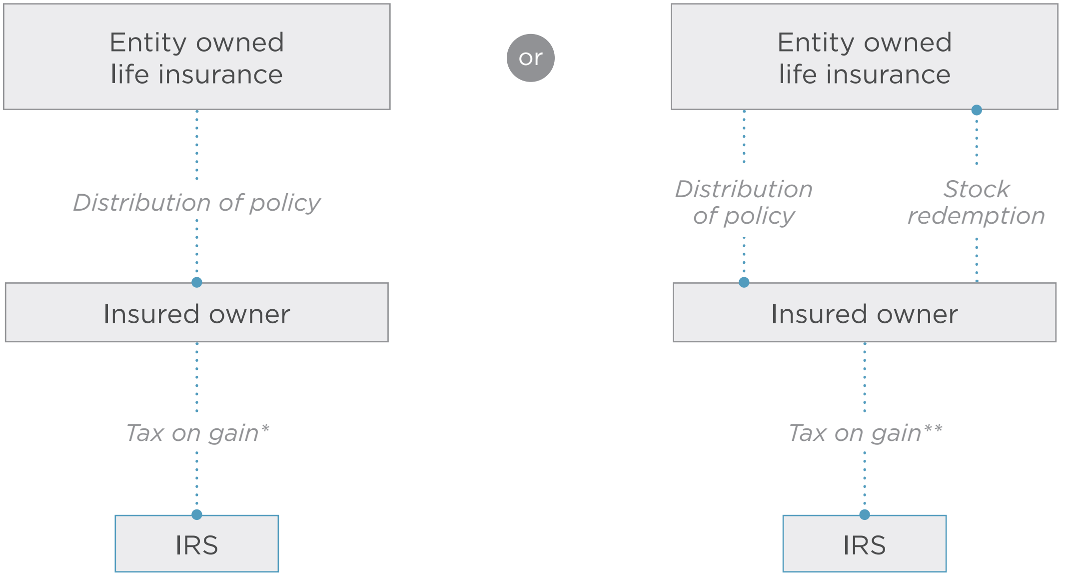
Entity purchase buy/sell arrangement *(continued)*

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 at 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 capital gain based on the fair market value on the policy
- The insured will now be the owner of their own policy and will be able to access policy 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)



* 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 at 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 is taxable as capital gain based on the fair market value on the policy.

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 revenues 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 policy cash values if they are needed.

Tax considerations

- The premium contributions are not deductible but the death proceeds are received income tax-free

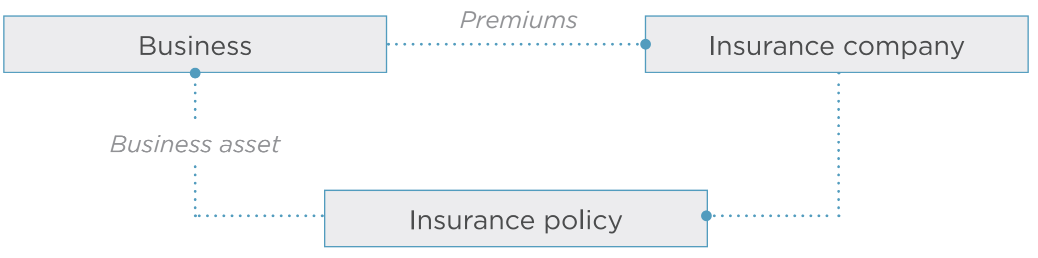
Steps

- 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 non-deductible premium payments
- The business has access to cash values that grow inside the policy tax free
- If the key person dies, the business receives income tax-free death proceeds*

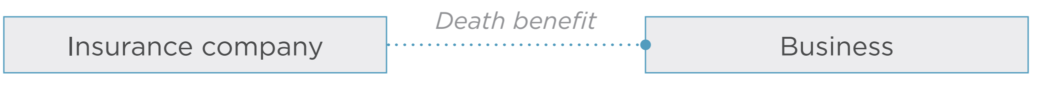
* Pursuant to I.R.C. § 101(j), certain requirements must be met for the death proceeds to be income tax-free.

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

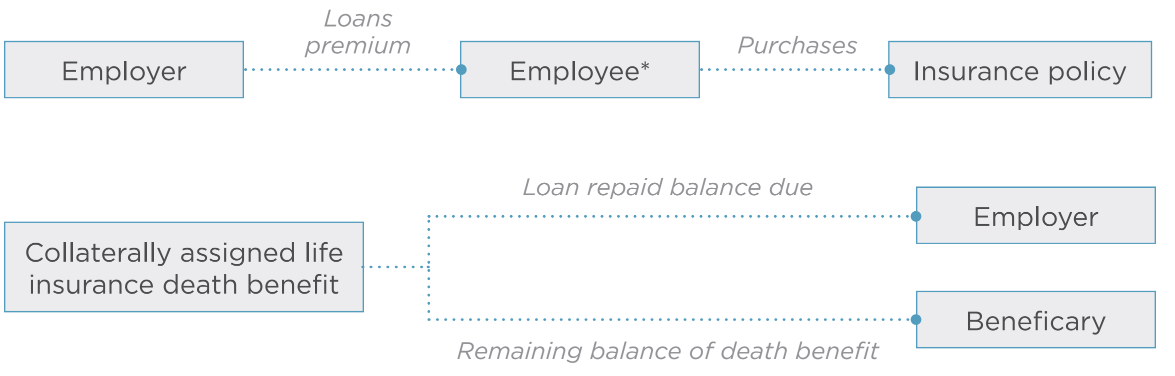
- The employee is taxed on the imputed interest income of the loan
- If the employee is limited to the death benefit (non-equity collateral assignment), the arrangement is treated like endorsement split dollar and the employee is taxed on the economic benefit of the life insurance

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

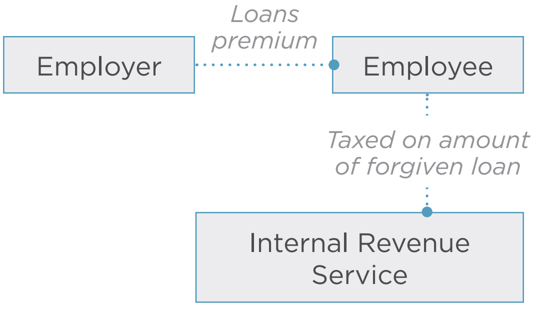
During working years



Upon separation from service/end of agreement

1. Loan is paid back by employee

1. Loan amount is forgiven



* Employee is taxed on the imputed interest income of the loan.

** Agreement is terminated and the employee owns the life insurance policy free and clear of pledge.

Non-equity 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

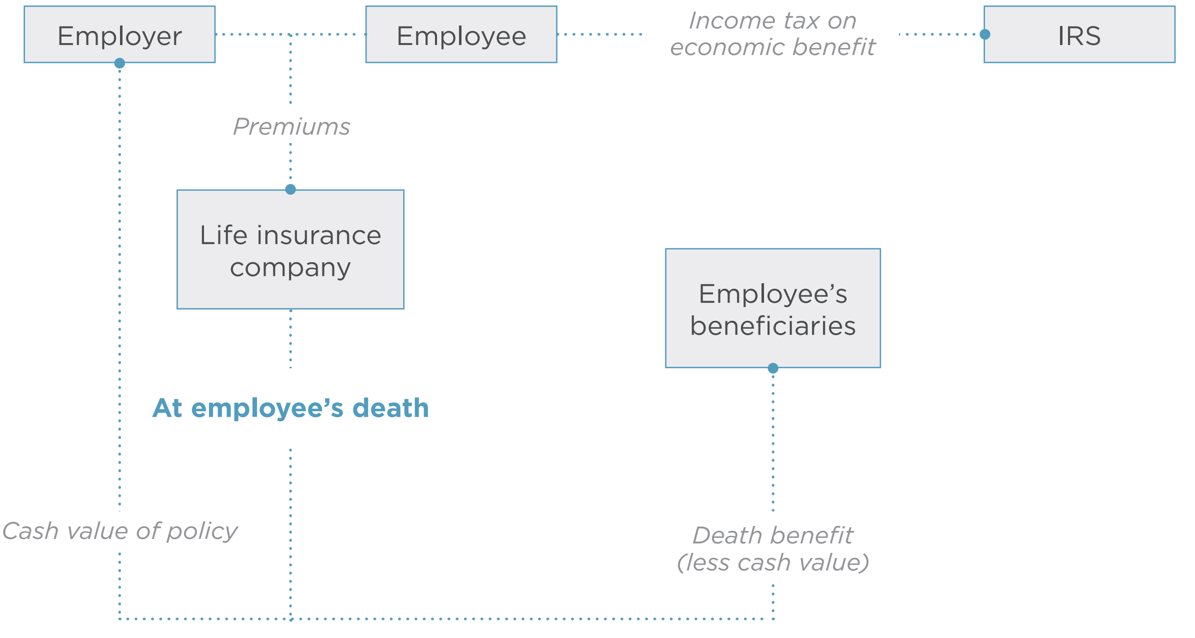
- The measure of the value of the employee's life insurance protection for income tax purposes is the government's Table 2001 rates or the insurer's alternative one-year term rates, if available
- Since the employee has no interest in the cash value of the policy, the employee is only taxed annually 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 policy cash value, whichever is greater
- The employer pays the policy premiums
- The employee tax reports each year the value of the life insurance protection using the Table 2001 or insurer's one-year term rates, if available

- At the employee's death, the death benefit reimburses the employer for its premium advances or policy 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

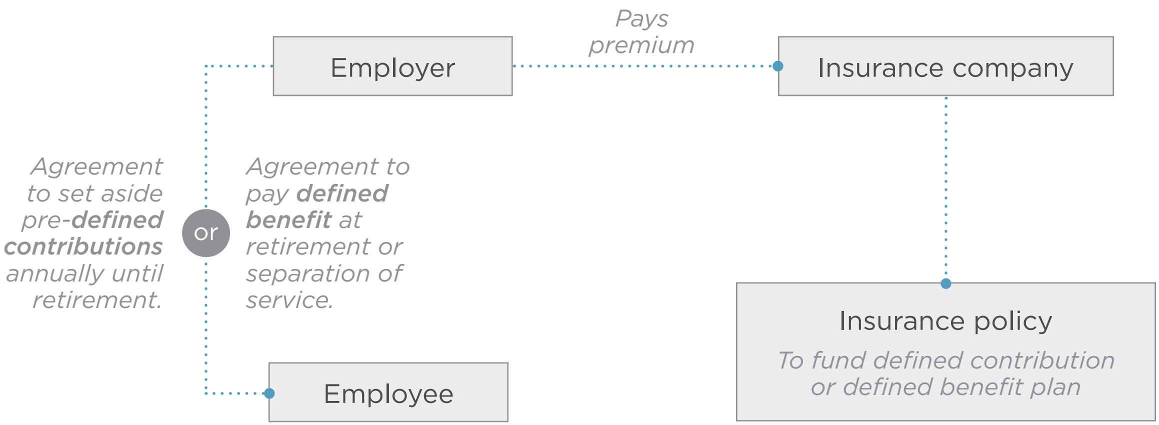
- There is no immediate tax deduction for the employer
- SERPs lack the contribution limits and regulatory rules associated with traditional qualified retirement plans
- There's no impact on existing qualified retirement plans — you can have both a qualified retirement plan and a SERP
- Retirement benefits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

Steps

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

How it works

During work years



At retirement

Insurance company

Available policy cash value

Employer

Pays account balance or *Makes defined benefit payments*

Employee

At death

Insurance company

Death benefit paid

Employer

Pays promised survivor's benefit (if any)

Employee' beneficiaries

Nonqualified deferred compensation plan

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 retention tool for employees who are specialized or valued employees, and 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

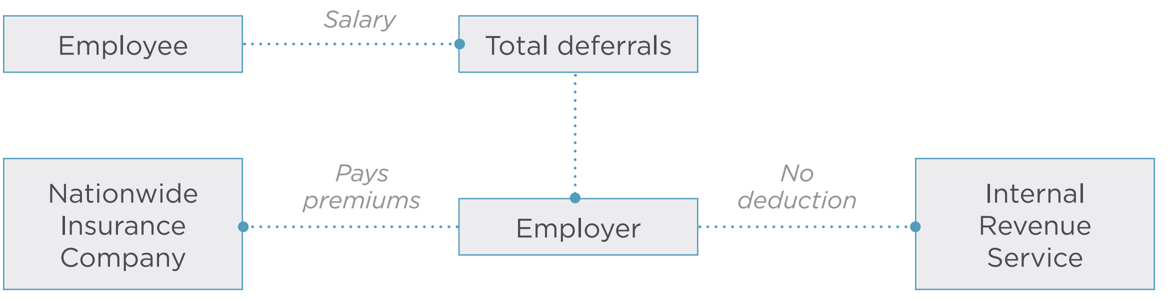
- There is no immediate tax deduction for the employer
- The business gets to take a tax deduction when an employee receives distributions from the plan and the employee is taxed as ordinary income
- There's no impact on existing qualified retirement plans — you can have both a qualified retirement plan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

Steps

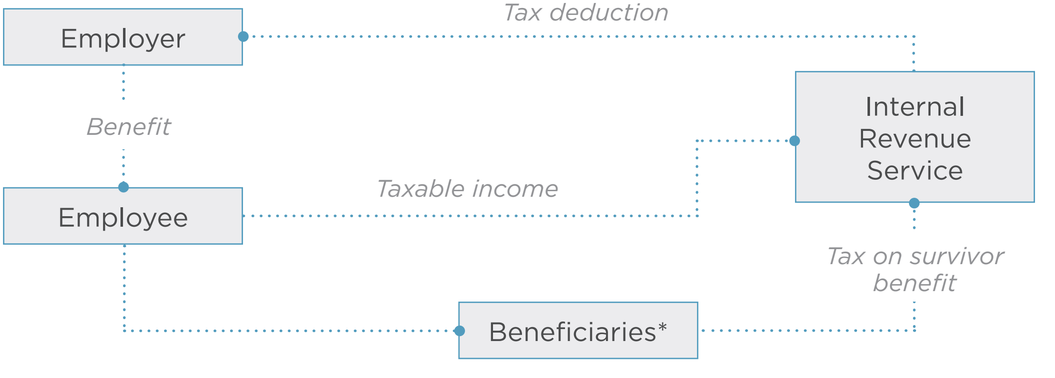
- Employer puts the plan in place and salary deferrals (and possibly employer contributions) begin
- Employer may choose to purchases life insurance on some or all eligible employees to informally fund the plan
- The plan uses contributions to fund the life insurance premiums
- Upon a qualifying event, 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



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

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 is income tax-free to the designated beneficiary(ies)

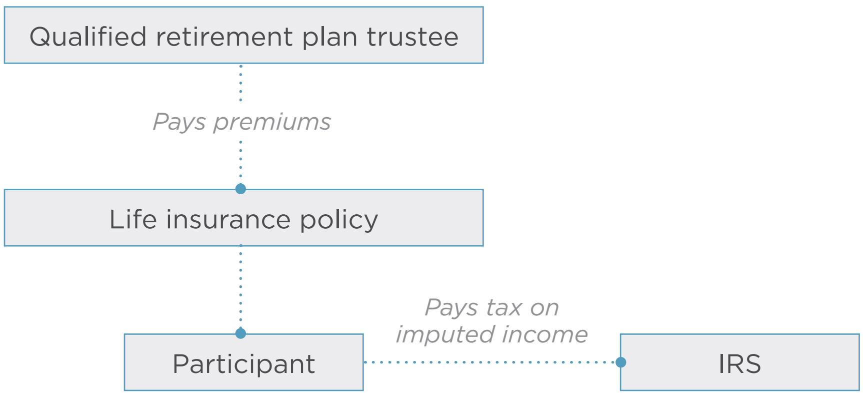
Steps

- 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 with the meaning of 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 with the meaning of 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 plan participants

How it works

While in plan



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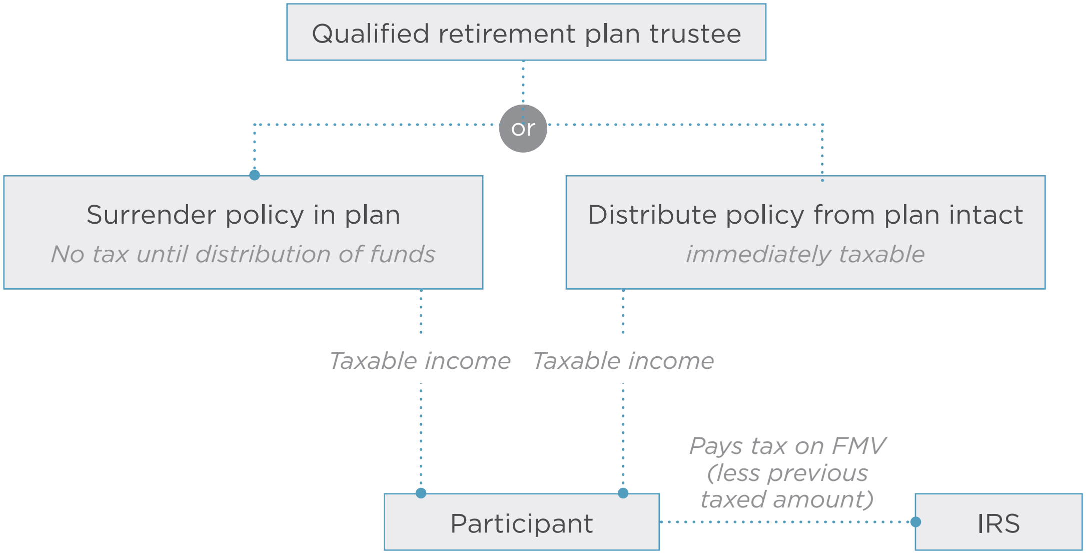
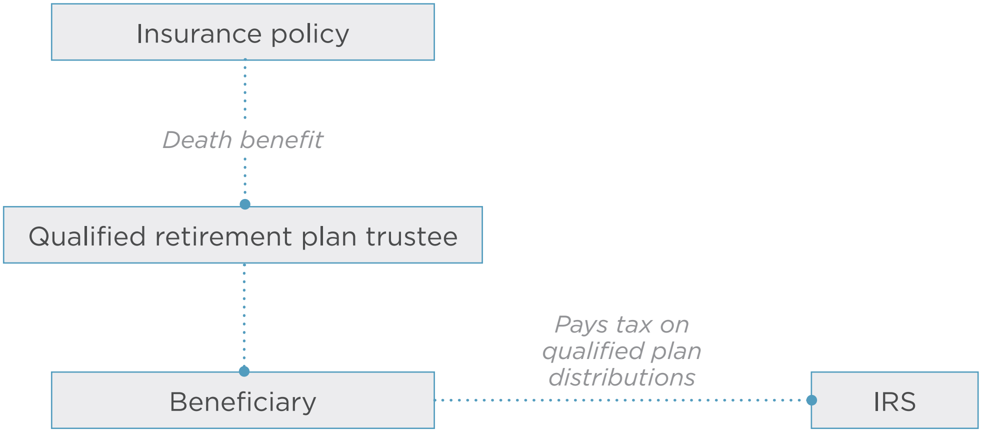
Life insurance in qualified retirement plans *(continued)*

How it works *(continued)*

Upon retirement of participant



Upon death of participant



Extended IRA and extended nonqualified annuities

The concept

Extended IRA and nonqualified (NQ) annuity stretch is a way for beneficiaries to ease the income tax burden on these accounts by taking only required minimum distributions each year over their life expectancy, thus maximizing the tax deferral period for the money remaining in these inherited accounts.

Benefits

With this strategy, the beneficiary may stay in a lower income tax bracket, instead of receiving the entire death benefit distribution at once and moving into a higher income tax bracket. They may also reap a greater reward from the inheritance because of the power of tax deferred compound growth. Lastly, the beneficiary has the ability to take more than the minimum distribution amount at any time.

Tax considerations

- For an extended IRA, individual beneficiaries and qualifying trusts can receive the distributions from the inherited IRA over their life expectancy, if the first required minimum distribution (RMD) is received by December 31 of the year following the year of owner's death, and then every year thereafter
- For NQ stretch, individual beneficiaries (but not trusts) can receive distributions from the beneficial NQ annuity over their life expectancy, if the first RMD is received within one year (12 months) of the date of the owner's death, and every year thereafter
- The beneficiary will pay ordinary income taxes on the taxable portion of each RMD
- Multiple beneficiaries may each use their own life expectancy to calculate their RMDs, as long as the IRA is separated into different shares/accounts for each beneficiary
- A successor beneficiary can finish taking the RMDs over the remaining life expectancy of the original beneficiary should the original beneficiary die prior to the end of the life expectancy period
- When a qualifying trust is the beneficiary of an IRA, the life expectancy of the oldest trust beneficiary is used to calculate the beneficial RMDs

Steps

- Roll over qualified plan accounts or transfer existing IRAs to an IRA that offers the stretch option to beneficiaries as systematic withdrawals
- Purchase an NQ deferred annuity or exchange existing NQ deferred annuities under IRC Sec. 1035 to an NQ deferred annuity that offers the stretch option to beneficiaries as systematic withdrawals
- Review beneficiary designations
- If multiple beneficiaries are named, the IRA needs to be split into separate shares for each beneficiary at the owner's death
- After owner's death, beneficiary may establish an extended IRA by receiving the first RMD by December 31st of the year following owner's death; to establish a beneficial NQ stretch each beneficiary must receive the first RMD within one year (12 months) of owner's death

How it works

IRA or NQ deferred annuity

IRA or NQ annuity owner dies

Surviving spouse rolls over IRA or continues NQ deferred annuity

Surviving spouse dies

Beneficiaries split IRA or NQ annuity death benefit into separate shares and take distributions over their own life expectancies*

* The beneficiary's initial life expectancy factor is determined by using the IRS Single Life table, and then one year is subtracted from that life expectancy factor for each subsequent year; for example, if the beneficiary's life expectancy factor is 35, the second year RMD is based on 34. RMDs are calculated using the 12/31 balance of the previous year divided by the life expectancy of the beneficiary.

Trust-owned annuities — death benefit protection

The concept

Many surviving spouses do not need or want the income from their deceased spouse's credit shelter, bypass or B trust. Instead, they want the maximum amount of trust assets to go to to their children (usually adults) who are the remainder beneficiaries of the trust. They also want to minimize on-going income taxes paid by the trust, and grow the assets as much as possible to pass to their children at death. To accomplish these goals, some or all of the assets may be used to purchase a nonqualified deferred annuity with the trust as owner, the surviving spouse as annuitant and the trust as beneficiary of the annuity. At the surviving spouse's death, the annuity pays the death benefit to the trust, which will distribute the proceeds to the children.

Benefits

For this strategy, less current income tax is payable by the trust, since the annuity can grow tax deferred inside the trust (as long as all beneficiaries of the trust are natural people). It also eliminates income distributions to the surviving spouse, since annuity growth is generally not considered as trust income. As a result, there is increased growth potential on the trust assets that pass to the children after the surviving spouse's death.

Tax considerations

- In order for a trust to receive tax deferral on annuities owned by the trust, it must be considered as acting as an agent for a natural person; if all the trust beneficiaries are natural people, a trust generally receives tax deferral
- Unless taxable income earned by a trust is distributed to a beneficiary of the trust in the same tax year, the trust pays income taxes on that taxable income
- If trust assets are sold to purchase an annuity, the gain on the sale of those assets may be taxable income to the trust
- If distributions are taken from the annuity when the trust is the owner and prior to the death of the annuitant, there may be a 10% premature distribution penalty tax on the taxable portion

Steps

- The trustee of the trust uses trust assets to purchase a deferred annuity with the trust as owner, surviving spouse as annuitant and the trust as the beneficiary
- At the surviving spouse's death, the annuity death benefit is paid to the trust as beneficiary of the annuity, and the cash death proceeds are distributed to the beneficiaries of the trust according to the trust provisions

How it works

Credit shelter/bypass/B trust (trust) purchases nonqualified deferred annuity

Surviving spouse is annuitant

Surviving spouse dies

Trust as beneficiary of annuity receives death benefit

Children as remainder beneficiaries of trust receive cash death proceeds per trust provisions

Trust-owned annuities — in-kind distributions

The concept

Many surviving spouses do not need or want the income from their deceased spouse's credit shelter, bypass or B trust. Instead they want the maximum amount of trust assets to go to their children (usually adults) who are the remainder beneficiaries of the trust. They also want to minimize on-going income taxes paid by the trust, and grow the assets as much as possible to pass to their children at death. To accomplish these goals, some or all of the assets may be used to purchase a nonqualified deferred annuity contract for the benefit of each child/remainder beneficiary with the trust as owner, the trust remainder beneficiaries/children as annuitant and the trust as beneficiary of each annuity. The trustee will distribute each annuity contract in-kind to the respective remainder beneficiary/child upon a triggering event according to the trust provisions, such as the death of the surviving spouse.

Benefits

For this strategy, less current income tax is payable by the trust, since the annuity can grow tax deferred inside the trust (as long as all beneficiaries of the trust are natural people). It also eliminates income distributions to the surviving spouse, since annuity growth is generally not considered as trust income. Each annuity policy is distributed intact to each respective beneficiary/annuitant. Each trust beneficiary now is the owner and annuitant of their own annuity policy, which was formally owned by the trust. Tax deferral continues and the new owner may name whoever they would like as beneficiary.

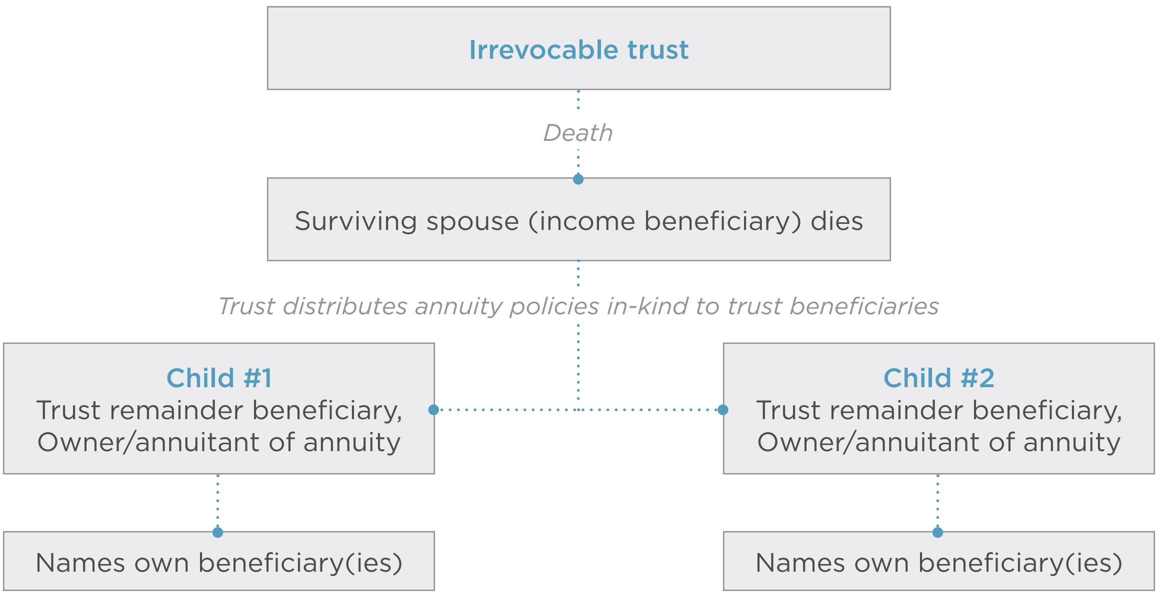
Tax considerations

- In order for a trust to receive tax deferral on annuities owned by the trust, it must be considered as acting as an agent for a natural person; if all the trust beneficiaries are natural people, a trust generally receives tax deferral
- Unless taxable income earned by a trust is distributed to a beneficiary of the trust in the same tax year, the trust pays income taxes on that taxable income
- If trust assets are sold to purchase an annuity, the gain on the sale of those assets may be taxable income to the trust
- In order to avoid the 10% premature distribution penalty tax, the remainder beneficiaries of the trust should plan to defer distributions of income from the annuity until after age 59½, or intend to pass the annuity death benefit to their heirs

Steps

- The trustee of the trust uses trust assets to purchase separate annuity contracts with the trust as owner, remainder beneficiaries of the trust as annuitants and the trust as the beneficiary
- The trustee will distribute each annuity contract to each respective remainder beneficiary in-kind upon a triggering event according to the trust provisions (such as the death of the surviving spouse) without triggering gift or income taxes, so long as the trust beneficiary taking over ownership of the respective policies is the annuitant on that policy. The annuities will remain income tax deferred until the death of the respective trust beneficiary as owner and annuitant, or until voluntary distributions are made from the contracts

How it works



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

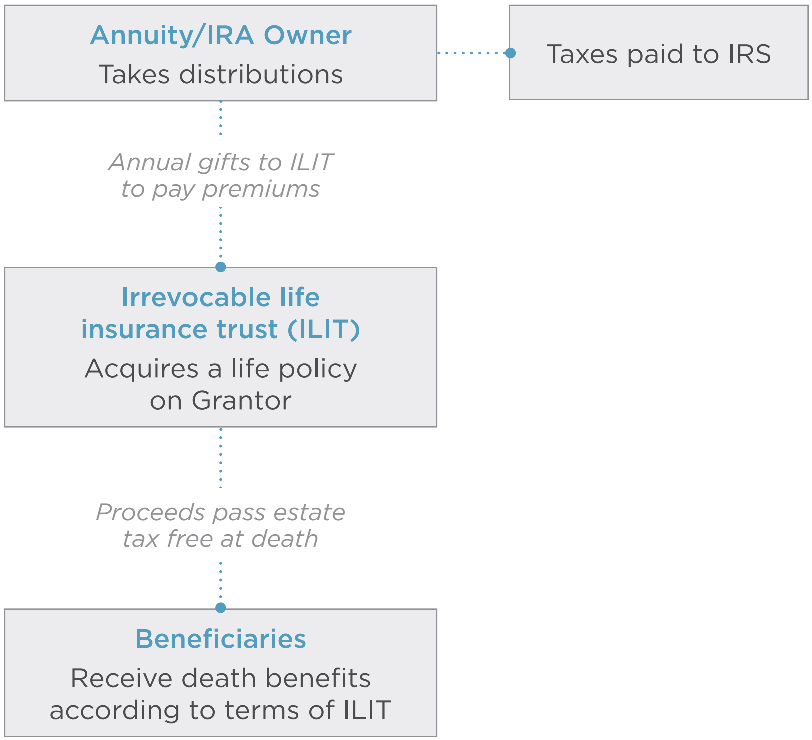
- Annuities are included in the owner's gross estate and increase the owner's estate tax exposure
- They do not receive a "step-up" in basis at the owner's death for income tax purposes
- Annuity payments to the decedent's beneficiary are characterized as "income in respect of a decedent" and taxed as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

Steps

- The owner takes distributions from the annuity or IRA and pays income taxes on the distributions
  - Annuity distributions may be subject to a surrender charges
  - A 10% penalty may apply unless an exception applies
- The owner establishes an ILIT
- The owner gifts the after-tax distributions from the annuity/IRA to the ILIT
- The trustee sends Crummey notice letters to the ILIT beneficiaries to make the client's gifts to the ILIT qualify for the annual gift tax exclusion
- Using the gifted after-tax annuity distributions, the ILIT purchases, owns and is the beneficiary of a life insurance policy on the grantor

- Upon the grantor's death, the trustee collects the death proceeds income and estate tax free
- The death proceeds are used to benefit trust beneficiaries pursuant to the terms of the ILIT

How it works



Marketing resources

The Advanced Consulting Group offers a wide range of materials including whitepapers, 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 non-qualified benefit planning (NFM-13793AO)

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