JohnHancock
LIFE INSURANCE

Business Analyzer

A Great Way to Identify Suitable Non-Qualified Plan Options

Assessing the Business Entity

When working with business owners, it is important to consider the business structure in which the business operates in order to assess the suitable options available for executive benefits offerings. In particular, non-qualified benefit plans, including Supplemental Executive Retirement Plans (SERPs), Non-qualified Personal Retirement Plans, 401(k) Mirror Plans, Split Dollar Arrangements and Section 162 Executive Bonus Plans can provide both business owners and executives a tax-favored retirement savings vehicle, potential creditor protection and estate planning benefits.

The *Business Analyzer* summarizes some of the more common types of business entities available followed by a decision matrix to help you narrow down which types of non-qualified benefit plans may work well based on business structure and planning objectives. This approach considers the owner's personal tax bracket compared to the entity's as well as the timing of deductions, and takes into account creditor protection and business transfer considerations for both a business owner and an executive.[1]

Consider the non-qualified plan options available to business owners and executives to fund their retirement and to address estate planning objectives.

Part 1: Questions and Design Options for the Business Owner

Question 1a: Is the life insurance or executive benefits intended for a business owner or a non-owner executive?

- If business owner, go to Question 1b
- If non-owner executive, go to Part 2

Question 1b: What is the business tax structure?

- If Sole Proprietor, consider Design I: Personal Retirement Plan
- If Partnership, LLC, or S Corporation, go to Question 1d
- If C Corporation, go to Question 1c

Question 1c: What is the annual net corporate profit of the company?

- If under $75,000, go to Question 1e
- If over $75,000, go to Question 1f
- For personal service corporations (doctors, etc.), go to Question 1f

Question 1d: What is the ownership percentage of the client?

- If under 25%, go to Question 1g
- If over 25%, consider Design I: Personal Retirement Plan

Question 1e: What is the personal tax bracket of the business owner?

- If over 28%, go to Question 1g
- If under 28%, consider Design I: Personal Retirement Plan

Question 1f: What is the personal tax bracket of the business owner?

- If under 34%, consider Design III: Bonus Plan
- If over 34%, consider Design I: Personal Retirement Plan

Question 1g: What is the purpose of the life insurance or executive benefit?

- If the need is primarily for death benefits, consider Design II: Split Dollar
- If the need is for retirement accumulation, go to Question 1h

Question 1h: What is the ownership percentage of the client?

- If under 50%, consider Design IV: Deferred Compensation
- If over 50%, consider Design III: Bonus Plan

Design I: Personal Retirement Plan

Typically used with sole proprietors, personal service corporations, and most S Corporation or partnership owners. The design issue for this client becomes "what is the best after-tax planning vehicle available?" This may be a life insurance retirement plan, a deferred annuity, a traditional IRA or a Roth IRA.

Design II: Split Dollar[2]

Provides needed life insurance coverage in situations where the corporate tax bracket is significantly lower than the business owner's personal tax bracket. By paying the life insurance premiums in the lower corporate bracket, and taxing the business owner on just the relatively small reportable economic benefit in his/her higher tax bracket, tax leverage can be gained.

Design III: Bonus Plan

Helps fund personal life insurance for either death benefit or retirement accumulation needs, or other tax-favored vehicles like a deferred annuity. It is used in those situations where the business owner's personal tax bracket is equal to or lower than the corporate bracket. This could occur in personal service corporations, high-net-profit corporations, or where the business owner has a low tax bracket due to other write offs or charitable gifts. By taking an income tax deduction in the higher corporate tax bracket and taxing the owner in his/her lower personal bracket, tax leverage can be gained. Taking a bonus also eliminates possible double taxation in the future, which would occur when money is left in the corporation.

Design IV: Deferred Compensation

Typically used with non-owner executives but can be used with business owners in situations where the personal tax bracket is higher than the corporate bracket and the business owner is not a majority owner. By leaving money in the lower corporate bracket, higher personal taxes can be delayed until a later date such as retirement. Deferred compensation is not recommended for majority corporate owners whether tax leverage can be gained or not. This design can also be used with S Corporation or partnership owners who have a very small ownership percentage of the business. However, given the pass-through nature of S Corporations and partnerships, owners pay tax on profits whether they leave them in the company or take them out. Consequently, deferred compensation provides no tax advantage. However, if the owner holds only a small percentage of the company, some of the personal tax can be deferred, and the money will be taxed to the other owners.

Part 2: Questions and Design Options for Non-Owner Executives

Question 2a: Who is going to be included in the executive benefit plan?

- If only the top executives in the company, go to Question 2b
- If a broader group of employees than the top executives, go to Question 2f

Question 2b: What is the financial stability of the company?

- If strong, go to Question 2c
- If company is new, or not in good financial condition, go to Question 2f

Question 2c: Where are the benefit funds going to come from?

- If from the employee, consider Design I: Voluntary Deferral Plan
- If from the employer, go to Question 2d
- If from both, consider Design III: 401(k) Mirror Plan

Question 2d: Are golden handcuffs an important design component for the employer?

- If yes, go to Question 2e
- If no, consider Design V: Executive Bonus Plan

Question 2e: Is a current tax deduction important to the employer?

- If yes, consider Design IV: Restricted Executive Bonus Arrangement (REBA)
- If no, consider Design II: Supplemental Executive Retirement Plan (SERP)

Question 2f: Is a current tax deduction important to the employer?

- If yes, go to Question 2g
- If no, go to Question 2h

Question 2g: Are golden handcuffs an important design component for the employer?

- If yes, consider Design IV: Restricted Executive Bonus Arrangement (REBA)
- If no, consider Design V: Executive Bonus Plan

Question 2h: Is life insurance the desired benefit?

- If yes, consider Design VI: Split Dollar
- If no, consider Design V: Executive Bonus Plan

Design I: Voluntary Deferral Plan

Here, the executive agrees to defer a portion of his/her salary on a pre-tax basis. Typically in this design the executive is making the maximum deferral to his/her 401(k) plan but would like to defer more. The money put aside in the Voluntary Deferral Plan is not taxed to the executive until it is paid out to him/her. Also, the employer does not get a tax deduction until the employee is taxed. Consequently the employer has a delayed tax deduction. One important issue for the executive is that the deferred compensation benefits payable by the employer are subject to attachment by the employer's creditors. Therefore, if the employer becomes insolvent, the employee could lose his/her benefits. All forms of deferred compensation plans can only be offered to the very top executives in the company (also referred to as a Top Hat Plan).

Design II: Supplemental Executive Retirement Plan (SERP)

A SERP is very similar to the Voluntary Deferral Plan. The significant difference is that instead of the employee, the employer is contributing the money to the plan. Since it is employer contributions, there is normally some sort of vesting schedule attached to the plan. The employer can select any vesting schedule desired, and the plan payments can be based on either a defined benefit or a defined contribution. The tax treatment for the employee and employer is identical to the voluntary deferral plan, as is the risk that the employee could lose this money if the company becomes insolvent.

Design III: 401(k) Mirror Plan

In the 401(k) Mirror Plan, the employee agrees to voluntarily defer some salary and the employer makes some sort of matching contribution. The employer can determine what the match is and when it becomes vested. All of the tax and insolvency issues that apply to a Voluntary Deferral or Restricted Executive Bonus Plan also apply to a 401(k) Mirror Plan.

Design IV: Restricted Executive Bonus Arrangement (REBA)

A life insurance plan that should allow the employer to take up-front deductions for the bonuses while putting a restriction on the employee's access to the cash value in the life insurance policy. The Restricted Bonus does not provide a true handcuff since the cash values of the policy can never revert back to the employer. If the employee forfeits access to the cash value, the money stays in the policy to provide continuing death benefit protection. The employee's access to the policy cash values can be arranged on a graded or vesting schedule. Once vested, the restriction is removed and the employee can use the policy cash values for supplemental retirement or other purposes.[3]

Design V: Executive Bonus Plan

A Bonus Plan helps fund personal life insurance for either death benefit or retirement accumulation needs or could fund other tax-favored vehicles like a deferred annuity or Roth IRA. The Executive Bonus has the advantages of a current up-front deduction for the employer, and can be offered to employees below the top executive level. The employee pays tax on the bonus, though the employer may "gross up" the bonus with an additional amount to cover the tax. The drawback for the employer is that there is no handcuff on the money bonused to the employee.

Design VI: Split Dollar[2]

Split Dollar can be used in situations where the desired benefit is additional life insurance coverage for the executive. Split Dollar can be offered to both the top executives and non-top executives without ERISA implications. Split Dollar can also be used as an additional benefit when life insurance is purchased to fund deferred compensation plans.

Check out some of the more common types of business entities.

Business Entities Comparison Chart

	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	LLC	Professional Corporation
Business Owned By	Sole proprietor	Partners	Partners	Shareholders	Shareholders	Members	Shareholders
Number of Owners	One	One to unlimited	One general & one limited partner minimum	One to unlimited	1 to 100	One to unlimited	One to unlimited
Liability Protection?	No	No	Yes for limited partners	Yes	Yes	Yes	Yes (except for professionals' own malpractice)
Management Decisions	Made by sole proprietor	Made by partners	Made only by general partners	Made by Board of Directors	Made by Board of Directors	Made by members unless LLC elects manager to manage	Made by Board of Directors
Transfer of Ownership	Easy	Consent of all partners usually required by agreement	Consent of all partners usually required by agreement	By stock transfer (securities law may limit)	By stock transfer (securities law may limit)	Consent of all members usually required by agreement	By stock transfers – transfers generally restricted to persons providing professional services
Tax Treatment	Disregarded entity – all income, etc., recognized on sole proprietor's individual income tax return	Paid by partners unless corporate tax status elected	Paid by partners unless corporate tax status elected	Paid by corporation	Passed through and paid by shareholders	Paid by members unless corporate tax status elected	Paid by corporation – 35% flat tax

Tax and ERISA Consequences

The possible application of the Employee Retirement Income Security Act (ERISA) should be considered for all non-qualified executive benefit plans, including a SERP. In most instances, a SERP may be exempt from most ERISA requirements as a "top hat" plan. A plan may qualify as a top hat plan if it is created for the purpose of providing deferred compensation for select management or highly compensated employees. A top hat plan must be in writing and a written plan document must be filed with the Department of Labor within 120 days. Qualification of a SERP as a top hat plan must be considered on a case-by-case basis.

In addition to ERISA considerations, Section 409A of the Internal Revenue Code can apply to any non-qualified plan that provides for the deferral of compensation. If a Deferred Compensation Plan does not comply with Section 409A, participant(s) income may be subject to immediate income taxation, as well as interest and a 20% excise tax on the taxable income.

Section 101(j) of the tax code (also known as COLI Best Practices) can also apply to a SERP and unless all of the requirements of Section 101(j) for an employer-owned life insurance policy are met, a portion of the death benefit may be subject to income tax.

Employer-owned life insurance taxation

Section 101(j) of the Internal Revenue Code may impose income tax on the death benefit of life insurance contracts owned by the employer of the life insured unless certain exceptions apply. All such exceptions include satisfaction of notice and consent requirements set forth in the section. See IRS Notice 2009-48 for further clarification.

Tax Law Considerations

The design options listed are based on current tax laws. Clients should consult their own tax advisors to address their particular situation and the tax laws that may apply at that time.

For more information about the Business Analyzer, contact the Advanced Markets Group at 888-266-7498.

1. This tool does not consider the effect that the Alternative Minimum Tax (AMT) may have on the owner's personal tax liability nor the entity's tax liability.
2. Sarbanes-Oxley Act of 2002 (the "Act") may prohibit a publicly traded corporation from entering into a Split Dollar Arrangement or 7872 loan with a Director or executive officer. Tax counsel should be consulted to determine whether the Act is applicable to a particular case.
3. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested.

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