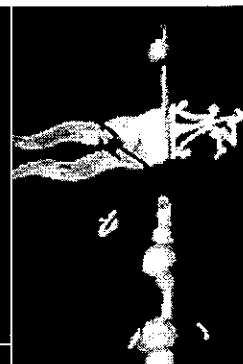


## The Cross Endorsement Buy-Sell Arrangement



Many closely held businesses do not make formal plans to transition the business in the event of the premature death of a business owner, the lifetime transfer or sale of the business, or the retirement of one of the key business owners. Lack of planning can cause a business to fail because of the significant changes that are brought about due to one or more of these triggering events. By utilizing a Cross Endorsement Buy-Sell Arrangement funded with a permanent life insurance policy, the funds required to transfer the business efficiently can be available.

### **WHAT IS A CROSS ENDORSEMENT BUY-SELL ARRANGEMENT?**

This arrangement provides the business owner and his or her family the liquidity needed to transfer the business when one of the business owners dies prematurely. Alternatively, since the business owner owns the life insurance policy outright under this type of arrangement, the business owner can access the policy's potential cash value to supplement retirement income or to fund a lifetime buy-out of the business if and when the buy-sell plan is no longer needed. Moreover, this type of plan may also provide the estate liquidity needed in the future to account for the wealth created from a successful public offering of the company's stock. Because of its inherent flexibility, a permanent life insurance policy is an adaptable financial tool that can address a business owner's changing needs over time.

### **HOW DOES IT WORK?**

Under a Cross Endorsement Buy-Sell Arrangement, the business owner purchases and owns a life insurance policy on his or her life while the other business partners purchase and own policies on each of their respective lives. The value of each policy will

be based on the projected value of the business and each business owner's proportional interest in the business.<sup>1</sup> The arrangement is structured as an Endorsement Split-Dollar Plan so that a portion or all of the death benefit can be endorsed for a "rental charge" to the other business owners<sup>2</sup> to satisfy the obligation under the Buy-Sell Agreement.<sup>3</sup> Consequently, each business owner will recognize rental income on what they charge on their own policy. The business owner as owner of his or her own policy continues to have access to the policy's potential cash values.<sup>4</sup> To minimize the cash outlay needed to pay premiums, the company may make annual bonus payments to each business owner in the amount of the premium.

The value of the rental charge is based on the economic benefit cost of the death benefit, which initially represents only a fraction of the premium. The economic benefit cost is measured annually using either a government or insurance company rate table that takes into account the owner's attained age as well as the amount of the death benefit being endorsed.

Under the 2003 Final Split-Dollar Regulations (Final Regulations), the calculation of the annual economic benefit rates involves the use of the government Table 2001 rates, or the insurer's alternative term rates, whichever are lower. An insurer's alternative rates can be used only if the insurance company issuing the policy meets certain requirements outlined in the Final Regulations.<sup>5</sup> Finally, when the Cross Endorsement Plan is terminated, the rental charge stops and each business owner retains his or her respective policy.

## ESTABLISHING ARRANGEMENTS BETWEEN IRREVOCABLE LIFE INSURANCE TRUSTS<sup>6</sup>

Alternatively, the Cross Endorsement Buy-Sell Arrangement can be structured so that an Irrevocable Life Insurance Trust (ILIT) established by each business owner is the owner of the policy, and the ILIT endorses the death benefit to each of the other owners or respective ILITs.<sup>7</sup> In this case, the insured business owner makes annual exclusion gifts to the trust equal to the premium. Annual exclusion gifts are the amount of annual gifts that can be made to any one person annually that are not subject to gift taxes. In 2006, the amount of annual gifts made to any one person that will not be subject to gift taxes is \$12,000.<sup>8</sup>

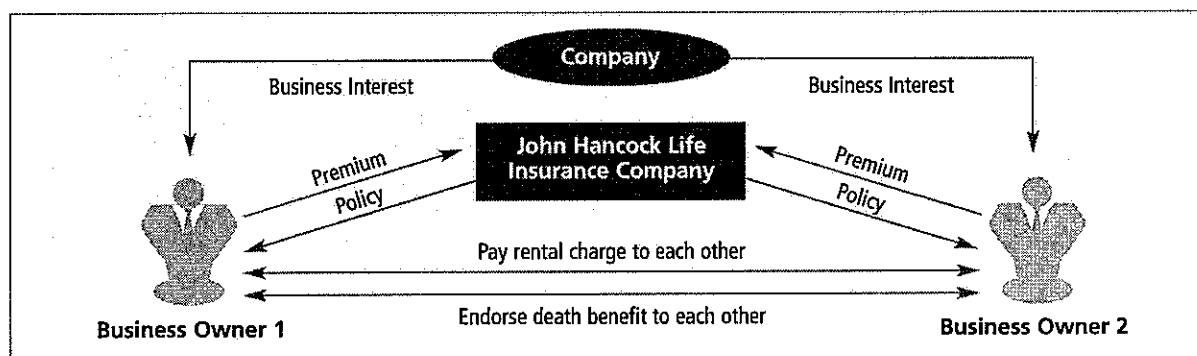
While the buy-sell plan is in place, the life insurance proceeds are to be paid to each surviving owner (or their respective ILIT) to fund the buy-sell obligation. However, if the plan is terminated, the business owner can continue to own the policy and use the policy cash values to supplement retirement income or to fund a buy-out of the business. The policy can also be retained by the business owner to cover estate tax liability. Although the life insurance proceeds are includible in the taxable estate when the policy is not owned by an Irrevocable Life Insurance Trust, the estate receives a corresponding deduction for the liability associated with the buy-sell plan.

## BENEFITS

- **Estate liquidity** – Cash is available from the life insurance proceeds for the efficient transfer of the business due to an owner's death, retirement, or sale of the business.
- **Potential cash values** – Unlike a term insurance policy, the potential accumulation of the life insurance policy's cash values can be used to accommodate a lifetime buy-out or to supplement income when the buy-sell obligation is no longer required.
- **No cost at termination** – Unlike other types of split-dollar plans, there is no cost to the business owner when the buy-sell plan is terminated.
- **Flexibility of permanent insurance** – Permanent insurance provides the flexibility needed to transition the business based on an owner's changing needs over the life span.

## CONSIDERATIONS

- **Cash flow** – Cash flow to fund premiums is required.
- **Increasing economic benefit cost** – The economic benefit costs increase with age.
- **Taxable rental income** – It is likely that the rental income received by each business owner for the rental of the death benefit will be subject to ordinary income taxes under IRC §61 and/or under the 2003 Final Split-Dollar Regulations (Final Regulations).
- **Final Split-Dollar Regulations** – A review of the Final Regulations that dictate how a split-dollar plan can be structured and describe the tax consequences of such a plan is recommended.
- **Potential transfer-for-value** – The owners may want to consider a partnership (if one does not already exist) between the owners (and/or ILITs created by the owners) to avoid any transfer-for-value issues with respect to the cross endorsements of the policy death benefits. Clients should consult their tax advisors to discuss this issue.

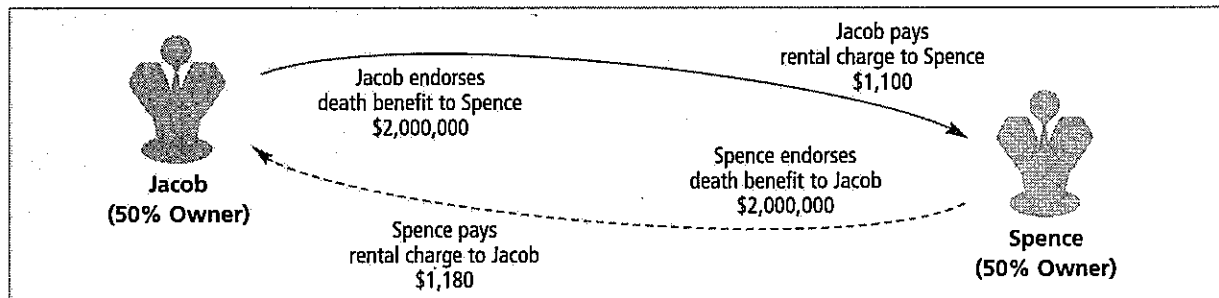


## CASE STUDY: SPENCE WILLIAMS AND JACOB JAMESON

**Facts:** Spence Williams (45) and Jacob Jameson (46), preferred non-smokers, each own 50% of BioTech Solutions, Inc. The value of the business has been appraised at \$4,000,000, but the owners project their business to grow by 10% annually for the next 10 years. Spence and Jacob want their growing families to have the funds available to sell the business to each other should either one of them die prematurely. They also want flexibility to account for a buy-out before or at retirement, or to cover the estate taxes that may be due as a result of the personal wealth the business creates, especially if a public offering of the company stock is made in the future.

**Solution:** Spence and Jacob have decided to enter into a buy-sell agreement in which each promises to buy out the other in the event of premature death. Each purchases John Hancock's Performance UL-08 policy for \$2,000,000 and endorses or "rents-out" the death benefit on the policy to the other. Each will pay a rental charge based on their partner's age and the economic value of the death benefit being endorsed. Consequently, each of them will receive rental income based on the rental fee received from the other. The rental income will be taxable at their ordinary income tax rate, assumed to be 35%.

### Here's What It Looks Like:



### CROSS ENDORSEMENT BUY-SELL PLAN COSTS – YEAR 10

|                 | CROSS ENDORSEMENT COST |                          |            | LIFE INSURANCE COST |            | NET BENEFIT   |
|-----------------|------------------------|--------------------------|------------|---------------------|------------|---------------|
|                 | Rental Charges Paid    | Rental Charges Collected | Net Outlay | Cumulative Premium  | Net Outlay | Death Benefit |
| Spence Williams | \$15,580               | \$14,660                 | \$920      | \$227,030           | \$227,950  | \$2,000,000   |
| Jacob Jameson   | \$14,660               | \$15,580                 | \$(920)    | \$241,460           | \$240,540  | \$2,000,000   |

The data shown is taken from an illustration. It assumes a hypothetical interest crediting rate and may not be used to project or predict investment results.

The rental charge is based on the insurance company's alternative term rate table. The premiums due on Spence's policy, \$22,703, and on Jacob's policy, \$24,146, are based on 20 premium payment years.

When the buy-sell plan terminates, the endorsement will terminate and each owner will continue to own the policy. The potential cash value accumulation can partially fund a buy-out at retirement or the policy death benefit can remain intact to provide the family with estate liquidity at death. Clearly, a permanent insurance policy can go a long way in providing security for changing needs.

**For more information, please contact your local John Hancock representative or call the Advanced Markets Group at 888-266-7498, option 3.**

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1. A qualified appraisal of the business should be completed.
2. Each owner may desire to endorse one hundred percent (100%) of the death benefit to the other owners during the buy-sell period. The split-dollar final regulations are silent as to whether this is permissible. Clients should consult their tax advisors to discuss this issue.
3. Under the split-dollar final regulations, the economic benefit amounts received by each owner will be treated as rental income and taxed at ordinary income tax rates. In essence, the sum of all anticipated economic benefit amounts represents twice-taxed dollars. The present value of the combined income taxes on the sum of all anticipated economic benefits is essentially an option price the parties have agreed to at the outset to purchase the flexibility provided by the Cross Endorsement Buy-Sell Arrangement. Clients should consult their tax advisors to discuss this issue.
4. The parties to the Cross Endorsement Buy-Sell Arrangement may wish to restrict access to the policy's cash values to the extent that access does not impair the death benefit being endorsed. That is, 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.
5. See IRS Notice 2002-8 referenced in the 2003 Final Split-Dollar Regulations. Briefly, in order to use an insurer's alternative rates, the insurer must make such rates known to prospective purchasers of their term insurance product and the insurer must regularly sell its alternative term product.
6. Each owner's legal advisor should determine if applicable state trust law permits the owner's ILIT to endorse death benefits to the other owners (or ILITs created by the other owners) as part of the buy-sell arrangement to which the owner's ILIT is a party. Special provisions may have to be included in an owner's ILIT instrument to satisfy (or override) state trust law with respect to this issue. Clients should consult their tax advisors to discuss this issue.
7. Trusts should be drafted by an attorney familiar with such matters to take into account income and estate tax laws (including generation-skipping transfer taxes). Failure to do so could result in adverse tax treatment of trust assets.
8. Annual exclusion gifts are indexed annually for inflation and subject to specific rules. See IRC §2503 (b).

Insurance policies and/or associated riders and features may not be available in all states.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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