New Rules to Prepare and Protect Your Business

Planning for Business Owners and
Key Employees: The Basics

Agenda

- Small Business Landscape
- Types of Plans
- Who is Eligible
- Owners' Needs
  - Succession Planning
    - Buy-Sell Agreements
  - Key Person
  - Insurance-Based Income Solution
- Employees' Needs
  - Executive Bonus Arrangement
  - Restricted Bonus Arrangement
  - Nonqualified Deferred Compensation
- Split Dollar Life Insurance

Small Business Landscape

- The Small Business Administration defines small businesses as those with fewer than 500 employees
  - 29.6 million small businesses in 2014
  - Only 19,000 large businesses (more the 500 employees) in 2014
  - Over 5 million of those have employees (other than the business owner)
  - Small businesses accounted for 61.8% of net new jobs created between 1993 and mid-2016
  - The vast majority (90%) of small businesses with no employees are sole proprietors and partnerships (including limited liability companies)

SBA Office of Advocacy, Frequently Asked Questions About Small Business, March 2014

Types of Plans

For Owners

- Business Succession
- Key Person
- IBIS

For Key Employees

- Executive Bonus
- Restricted Bonus
- NQDC / SERP

Split Dollar

Who is Eligible?

- Sole Proprietor
- Limited Liability Company (LLC)
- Partnership
- Corporation
- May have
  - One or more owners
  - One or more key employees
- Must be
  - Stable, profitable business
  - In need of financial, retirement or succession planning

Owners' Needs

- **What would happen to your business if you were not here to run it?**
  - Do you have a plan for who will succeed you in owning or running the business?
  - How will that transition occur?
- **Do you have key employees that are vital to the success of your business?**
  - If they were to die prematurely, how long would it take to replace them?
  - Do you have sufficient incentives to keep them from moving to a competitor?
- **Do you have a retirement plan for yourself?**

Succession Planning

Will I have to sell the business to fund my retirement?

If I give the business to one child will the others feel slighted?

Do I want to go into business with my partner's spouse or children?

Is the business valuation current?

Succession Planning
Buy-Sell Agreements

- An agreement among the owners of a business to divide the business share of an owner who has died, become disabled, is about to retire or who wants to sell his/her share of the business
- The agreement states a predetermined formula for valuing the business
- Often funded with cash value life insurance
  - Provides funds to help buy out a disabled or retiring owner through tax-free withdrawals and loans
  - Policy can be used as collateral
  - If an owner dies, it provides a tax-free death benefit to purchase the business share from the decedent's estate/heirs

Loss of a Key Person

Loss of a Key Person

- Key person life insurance
  - Term insurance
    - Inexpensive
  - Permanent insurance
    - The business may purchase a policy and split the death benefit with the insured key employee while he/she is employed
    - Can also provide a source of tax-free cash to the business in the future

Sources of Cash for Self-Employed Individuals

- Sale of the business
  - Will it be a forced sale due to illness? Will the seller be relying on the buyer for future income?
  - What if the seller is a professional (doctor, lawyer, etc.) and doesn't have a business to sell (other than a client list)?
- Social Security
  - Will this be sufficient to maintain current style of living?
- Qualified plan
  - Does the self-employed individual have a qualified plan that will provide sufficient income for his/her lifetime?

Insurance-Based Income Solution

Life-insurance as a savings vehicle

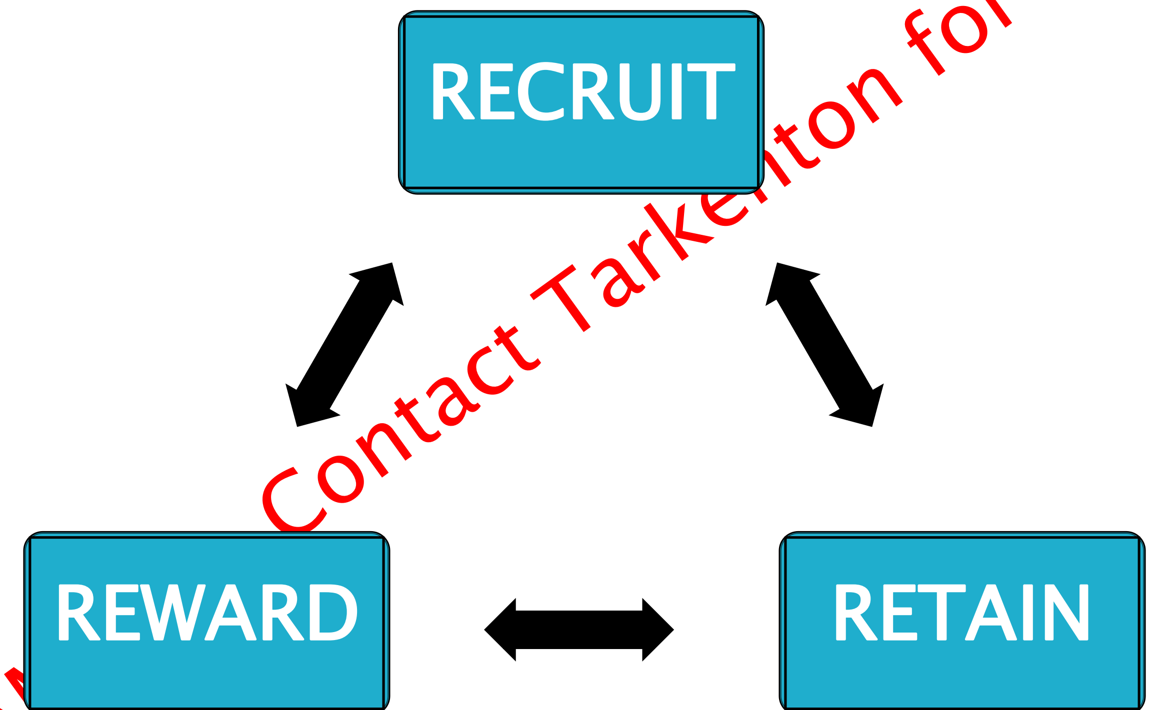
- Permanent, cash value life insurance can provide tax-free income (up to the owner's basis in the policy) and then tax-free loans from the cash value in the future, AND
- Income-tax free death benefit to owner's heirs/estate now and into the future

Individual must have:

- Sufficient after-tax cash flow to fund the policy appropriately
- A need for personal life insurance
- At least 15 years before retirement (or other event that will precipitate a withdrawal)

Key Employees' Needs

Employees' needs are an owner's problems!



Key Employees' Needs

- Not all employers are able to maintain a qualified retirement plan for all employees
  - Cost prohibitive
  - High turnover of lower-paid employees
- Quite often, a qualified plan does not provide a highly-paid employee with an adequate pre-tax way to save for the future
- Employers often need to provide special benefits to the employees who are key to the continued success of the business
- These benefits are not for business owners

Who is a Key Employee?

- Select group of management and highly compensated employees
  - Key employee benefits are not for "rank and file" employees
- ERISA does not protect key employees' retirement benefits that are outside a qualified plan
- Courts apply a two-part test to determine if a plan covers the appropriate employees
  - Quantitative
  - Qualitative

Executive Bonus Plan

Employee

- Owner
- Insured

Employer

- Bonus to employee
- Used to pay premium

- Also known as a "162 bonus plan"
- Tax deductible to the employer
- Taxable compensation to the key employee
- Employer may also "gross up" the employee for the tax that will be due on the bonus

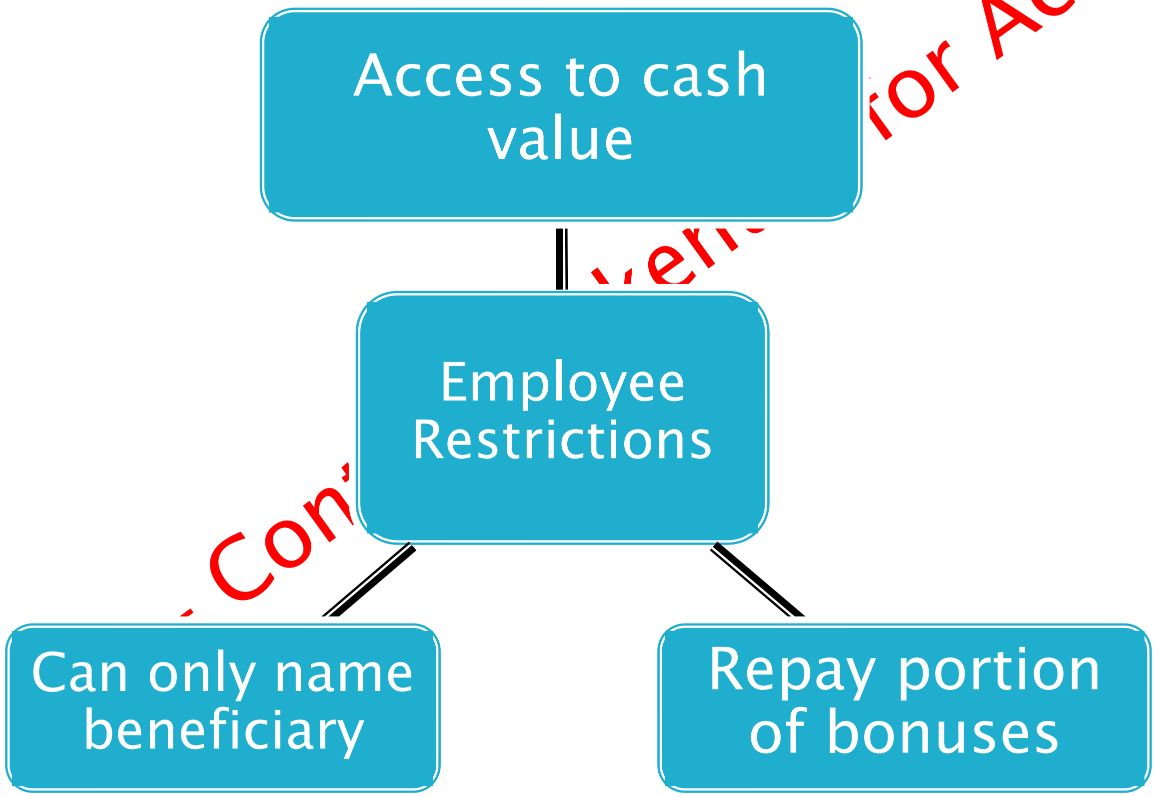
Executive Bonus Plan

- Benefits to the key employee(s)
  - Feels good about getting a special benefit
  - The policy is portable
  - Provides tax-free death benefits for the key employee's heirs
  - Provides a source of tax-free income in the future for the key employee
  - The employee may pay additional premiums to save more on a tax-deferred basis
  - The policy is not subject to the claims of the employer's creditors
- Disadvantages to the key employee(s)
  - The bonus (premium) is taxable compensation
  - No guarantee that the employer will continue to pay premiums unless there is a written plan

Executive Bonus Plan

- Advantages to the employer
  - Premiums/bonuses are tax deductible
  - Little or no administrative cost to maintain
- Disadvantages to the employer
  - Cannot recover the cost of the plan
  - No vesting schedule to act as a retention tool
  - May be subject to ERISA disclosure and reporting rules as a welfare benefit plan

Restricted Executive Bonus



Nonqualified Deferred Compensation

- Any plan or arrangement that pays an employee or independent contractor in a later year for services rendered in the current or any prior tax year
- Not appropriate for <u>owners</u> of pass-through entities (partnership, LLC, sole proprietor, S corporation)
- Governed by Internal Revenue Code sec. 409A
  - Restrictions on timing of distributions, timing of elections, taxation
- Failure to comply with 409A may result in 20% penalty tax on deferred amounts, plus interest at the underpayment rate plus 1 percentage point, plus regular income tax on amounts deferred
  - Assessed to the ***<u>employee</u>***

Nonqualified Deferred Compensation

Access

Account Balance Plans

ELECTIVE

NONELECTIVE

Nonaccount Balance Plans

DEFINED BENEFIT

Nonqualified Deferred Compensation

- Financing a NQDC plan
  - Plans do not need to be funded and employers are not required to set aside any assets
  - Any assets that are set aside to informally fund the plan are assets of the employer; employees have no claim to those assets
- Corporate-owned life insurance (COLI)
  - Tax-deferred build-up of cash value can be used in future to pay employee benefits (tax-free withdrawals up to basis)
  - Tax-free death benefits provide plan cost recovery feature
- Taxable investments (mutual funds)
  - Gains and distributions are taxable to the employer each year
  - Liquid asset; easily accessed to pay employee benefits
  - No insurance charges; no death benefits for cost recovery of plan

Nonqualified Deferred Compensation Taxation

- Employee deferrals reduce taxable compensation
- FICA due when deferrals occur (or vesting, if later)
- Employee pays income tax when benefits are paid
- Employer gets no deduction for amounts deferred
- Employer takes deduction for benefits paid

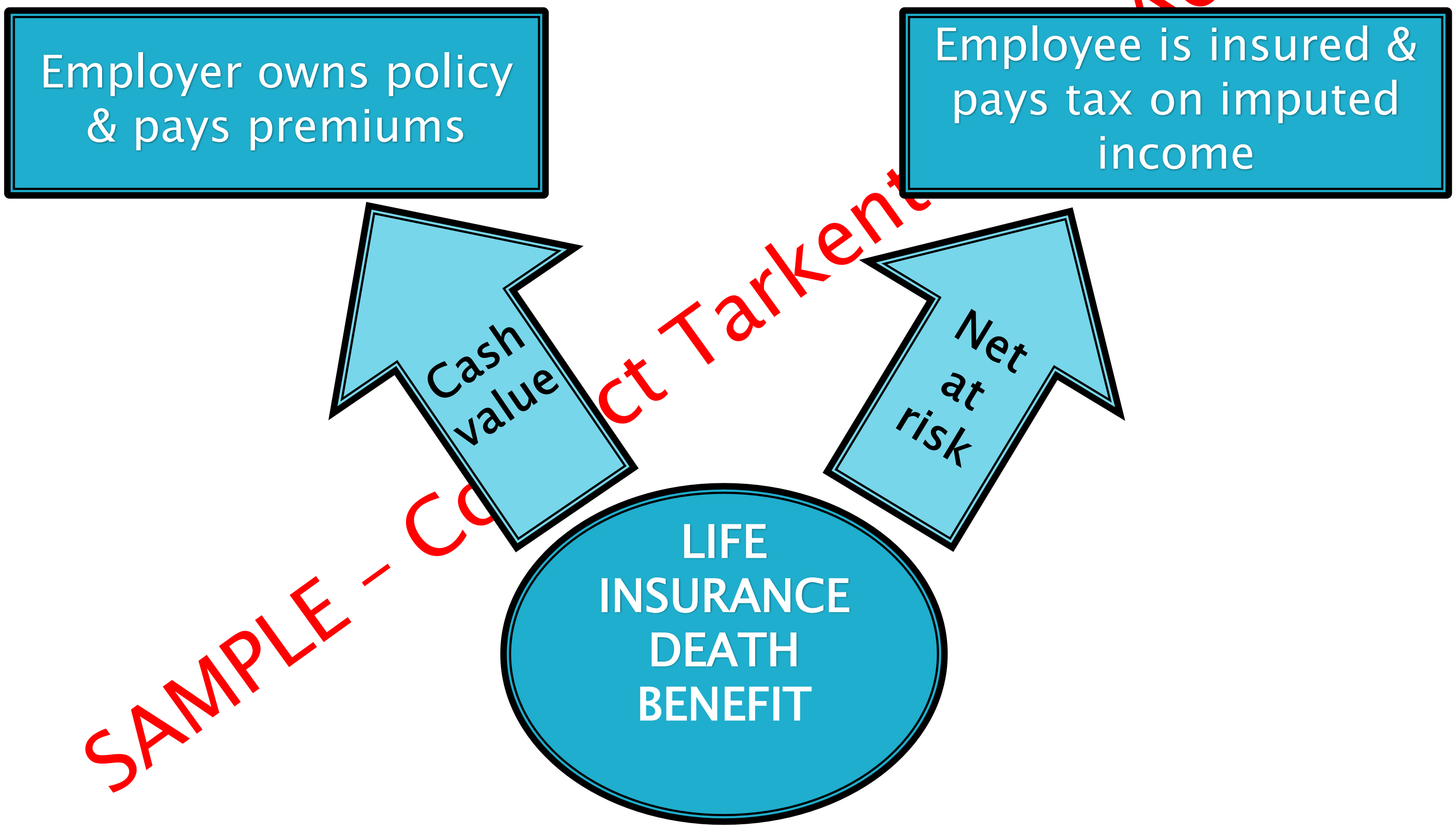
Split Dollar Agreements

- Split dollar is a method of splitting premiums, cash values and death benefits between a policy owner and non-owner
- Two methods of taxation, depending on who owns the policy and cash values
  - Economic benefit regime
  - Loan regime
- Final Treasury regulations were effective in 2003
  - Watch for any agreements entered into before September 17, 2003 as they may be grandfathered and not subject to the final regulations

Split Dollar Agreements

- Can provide low-cost life insurance protection for a key employee
- May “rollout” the policy (cash values) to the key employee at retirement to provide additional source of income and post-retirement death benefits
  - Be careful! If the agreement requires the policy to be transferred to the employee, or if the loan will be forgiven, the entire arrangement may be subject to Code sec. 409A as a deferred compensation plan!
- Split dollar arrangements are also used in estate planning and sometimes in a buy-sell arrangement

Economic Benefit Split Dollar



Loan Regime Split Dollar

- Insured employee owns a cash value life insurance policy
- The employer agrees to loan the premium amount to the employee
- The employee collaterally assigns the policy to secure the loan
- If the interest rate on the loan is below market, then the employee will pay tax on the imputed interest
  - Interest will be calculated based on the Applicable Federal Rate
- Term loans
- Demand loans
- Hybrid term/demand loans

"Switch Dollar"

- Switch dollar is a method to keep the cost to the employee as low as possible
  - Begin with economic benefit regime when the ART rates are lower
  - When the ART rates become higher than what the imputed interest would be, terminate the economic benefit regime split dollar agreement and switch to a loan regime agreement
- Added benefit: any cash value that accrued after the switch will belong to the employee so that portion would not be taxable income if the policy is later rolled-out

Split Dollar Rollouts

- Although not required, some employers may want to get the policy and its cash values into the hands of the employee at retirement
  - Care should be taken to make sure Code section 409A does not apply to the split dollar agreement
- Employers may
  - Transfer ownership of a policy to the employee
  - Forgive any outstanding loan
    - Employee will have taxable income

Summary

- Life insurance can be an effective solution for a number of business-related problems
- Self-employed individuals with earned income (as opposed to W-2 wages) pose unique challenges when planning for future cash needs
  - Consider qualified plan options
  - IBIS
  - Business succession planning
- Employers with key employees may need to consider
  - Life insurance on the key people
  - Nonqualified plan options to supplement Social Security and qualified plans
    - Executive bonus or restricted bonus plans
    - Nonqualified deferred compensation plan