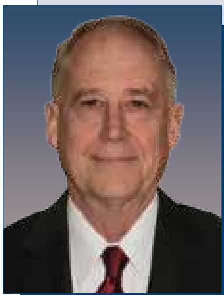
Hot Trends Turning Heads With Business Executives



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Small to medium-sized businesses are more important than ever to the U.S. economy. However, the failure rates at death or disability of the key players in the business can potentially be detrimental and hard to overcome. These factors, combined with the driving need to prepare for retirement, could create a sense of urgency in using insurance products to help put a strategy in place for proper business succession.

The changing face of the business community and the proliferation of different forms of business organization have led to the rise of additional forms of selective executive retirement plans. Some traditional forms of executive planning, such as Section 409 deferred compensation plans and split-dollar plans, are dependent on the differential tax brackets of traditional C corporations and their employees. They are also dependent on the financial stability of the corporation. Because of these factors and the fact that they only apply to C corporations, these plans are less versatile in the current environment. Section 162 executive bonus plans, on the other hand, are being heavily used for their utility with all forms of business organization—traditional C corporations, S corporations, partnerships and LLCs. There is a newer qualified plan also available—premium financed executive bonus plans.

While executive bonus plans do not provide the immediate tax benefits to executives that a deferred compensation plan provides, executive bonus plans do not pose the risk to the employee's retirement income that deferred compensation plans entail. If a corporation fails, deferred compensation plan participants stand in line with other creditors of the business. Employee retention could still potentially be achieved because they lose the employer contribution if they leave. Since the employee owns the policy, the benefits are secured even if there is a future business failure or change of ownership.

Although an executive bonus plan provides an immediate deduction to the business entity, there has always been a tax consequence to the employee. This tax impact quantifies as the employee's top marginal tax rate times the premium paid by the employer. For example, if the premium is $10,000 and the employee's top marginal rate is 33 percent, the added tax would be $3,300. Some of the top carriers in this space now allow first-year loans from the policies' cash value to cover the tax owed by the employee. This new approach overcomes one of the major objections to the executive bonus approach. It effectively grosses up the employee without any additional cost to the employer.

The current state of affairs with premium finance restricts its use to individuals with a minimum net worth of $5 million and target premiums in the $100,000 to $200,000 range with significant external collateral requirements. Several premium finance providers have developed plans in which a group of key executives can be aggregated so that their executive bonus plan can enjoy the cost savings attendant to premium finance.

These plans allow executives making more than $100,000 per year and needing more than $1 million in coverage to super-fund their policies to provide excellent death benefits. For businesses and executives comfortable with the use of leverage, these plans can provide benefits that would previously have been prohibitive from a cost standpoint.

"In an increasingly aggressive tax environment, the tax advantages of life insurance products are becoming sought after and even recommended by other professionals."

Relationships matter. Top tier IMOs and proactive carriers provide a complete range of services to address the valuation and succession planning needs of small to medium-sized businesses. These services cover every step of the succession planning process from fact finding to case analysis to a complete written succession plan, including funding and recommendations.

With different types of business organization achieving prominence in the current business environment, new strategies are being used.

The traditional cross purchase buy/sell agreement still holds sway in the C corporation space. Even though these plans require multiple insurance policies, their ability to control alternative minimum and excess accumulated earnings corporate tax issues make cross purchase agreements the prime alternative. These plans also support a step-up in basis for the surviving owners. Care must be taken in family-owned businesses because the family attribution rules can cause the distribution to be treated as a dividend rather than a capital transaction, resulting in much higher taxation.

The S corporations have become the go-to form of business for all service-type organizations, such as doctors, attorneys, accountants and consultants. Since these businesses are pass-through organizations, there are minimal issues with alternative minimum or excess accumulated earnings taxes. Entity buy/sell agreements probably fit well with S corporations in that they can help reduce the number of policies required to fund the plan. The main attribute of this form of organization is its ability to help characterize the sale as a capital transaction. Care must still be taken as family attribution rules apply.

Partnerships and limited liability companies provide a lot of options in structuring a small business. These are also pass-through entities and are hardly impacted by alternative minimum tax or excess accumulated earnings tax issues. They are well-served by an entity-style buy/sell agreement. This business form is ideal for family-owned businesses, as the family attribution rules do not apply. This means that sales between family members will be treated as a capital transaction and not a dividend, thus reducing the tax impact of the sale. The only caveat with this form of business structure is it isn't suitable for service type organizations, as the buy-out will be considered income rather than a capital transaction.

Family limited partnerships (FLPs) present unique estate as well as business planning opportunities. While traditional buy/sell agreements have the power to properly valuate the property of a business interest for estate tax purposes, family limited partnerships are a valid value reduction technique. FLPs allow the principals in the business to maintain control, while with a minority interest and while transferring ownership to other family members or units. The value of the business for estate tax purposes is reduced, because the interest is a minority share and it lacks marketability. This type of plan is particularly effective in maintaining the land legacy in agribusiness. In other words, by separating the farming business interest from the land legacy, optimum succession planning can be achieved. The farming business interest can use a traditional buy/sell approach.

Taking full advantage of some of the techniques mentioned can help with proper succession planning. The new wave of flexible premium insurance products is offering recognized solutions. Whether they need to be temporary or permanent, for life, long term care or disability, these insurance products can help fulfill most of your insurance needs. Furthermore, other professionals are becoming more supportive of insurance-based solutions. In an increasingly aggressive tax environment, the tax advantages of life insurance products are becoming sought after and even recommended by other professionals.

As we approach retirement for the largest generation in our nation's history and the largest amount of wealth transfer ever, executive retirement planning and business succession planning are critical services that can provide life-changing solutions for those who have an ownership interest or play a key role in a successful business. Yes, the current business climate provides a tremendous opportunity for our industry to serve the public.

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