Business Succession Planning
With a Fully-Insured Defined Benefit Plan

The subject of business succession planning is coming up more and more as baby boomers approach retirement age. Typically, your first thought may likely turn to a traditional cross-purchase or entity redemption buy-sell agreement using life insurance. Sometimes, however, you can think outside the box. This is especially true when it comes to a family run business. The primary reason is two-fold:

- First, the business owner will eventually want to retire but has been so focused on building the business that he/she may have neglected his/her retirement planning. In other words, he/she may not have enough saved for retirement. As a result, the business as the primary source of retirement funds.
- Second, the business owner may desire that the business stay in the family and remain successful.

Sounds simple enough, right? It's just a buy-sell agreement between the owner of the family business and his/her successor(s) (child/children). But this initial reaction is deceptively simple and may not take into account some unique issues, such as:

- With an installment sale, the installment payments may not be enough to meet the business owner's retirement income needs. An installment buyout is commonly used for owners desiring to exit their business during lifetime and rely on the business as part of their retirement income.
- The business successors will likely depend on the business as the source of funds for the installment buyout. The more they need to "tap" from the business, the more financial stress placed on the business – which means, the more likely the business will fail.
- If the business fails, then the business owner's desire to ensure the business succeeds are dashed and his/her retirement income needs are jeopardized.

Family Business In Jeopardy

- 90% of the U.S. businesses are family owned
- 33% or less survive to the second generation
- 13% survive to the third generation
- 3% survive to the fourth generation

Source: Clear plan helps family businesses survive to next generations, Z.Meyer, July 26, 2014, Kansas.com (Kansas.com/news/business/article 1151453.html)

On second glance, it becomes apparent that this type of situation requires a unique solution. That's where a defined benefit plan may need help.

A Unique Combination for a Unique Situation: Buy-Sell Planning with a Defined Benefit Plan

Tyler is a 55-year-old family business owner seeking to retire in 10 years and leave the business to his children, who are already heavily involved in the enterprise. Tyler determines that he wants $3 million to "walk away" from the business. Unfortunately, like many business owners, Tyler has not saved enough for retirement and is relying on the business as his primary source of retirement income. He understands, however, that if the business fails, his retirement will be in jeopardy and the business may not make it to the next generation. How can life insurance help Tyler with his retirement savings dilemma while minimizing the pressure on the family buy-sell arrangement?

> A defined benefit plan is a qualified pension plan that does not have contribution limits similar to those of defined contribution plans. A business owner may contribute as much as he or she needs to receive the maximum retirement payout. [1] The greater the contribution, the more the business owner may deduct as an ordinary business expense.[2]

For Tyler, establishing a defined benefit plan today may allow him to fund a retirement benefit and need less money from the business. Not only is Tyler setting aside money today to prepare for his retirement but the contributions the business makes to the defined benefit plan are generally tax-deductible to the business (currently, Tyler's allowed maximum annual defined benefit payout is $210,000 or a lump sum of approximately $2.7 million). An added feature of a defined benefit plan is that the assets inside the plan are protected from the owner or the business's creditors under the Employee Retirement Income Security Act of 1974 (ERISA).

Whether Tyler funds his retirement with a defined benefit plan or a one-way buy-sell funded with life insurance, he's using the same source – the business. Therefore, rather than just relying on the one-way buy-sell arrangement, combining it with a defined benefit plan not only reduces the burden on the future of the family business but also may provide him with a more stable and predictable retirement income stream. With the defined benefit plan in place, Tyler anticipates getting half of the income he wants in retirement. Consequently, Tyler may choose to sell the business at a reduced value to his children, thereby further easing the business' obligation under the buy-sell.

---

[1]Factors such as a client's age, income, length of time before retirement and rate of return on investment portfolio impact the required annual contribution amount. On an annual basis, an actuary, makes calculations to determine the amount that needs to be contributed into the plan to ensure the target retirement income goal is reached. A reduced business value for buy-sell agreement may not be controlling for IRS purposes. A gift or estate tax return may need to be filled to report the difference between the fair market value and the sales price as a taxable gift.
[2]The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).

Life Insurance May Help the Business Succeed

While it may not be possible for Tyler to fund a buy-sell agreement to cover every contingency, it's important that he uses one that covers the lifetime buyout and at least the possibilities of death or disability. A "max-funded" cash value life insurance policy on Tyler's life may be used as the funding vehicle to accumulate the cash needed for the lifetime buyout. The business would be the owner and beneficiary of the policy and make the premium payments. [3] At Tyler's retirement, the available cash value can be used at the time of the buyout for the down payment and/or installment payments. [4] This tactic may further reduce the amount of operating income the business needs to allocate for the buyout. While the life insurance policy may cover the lifetime buyout, it may also protect the business and provide for his family in the event he dies prematurely.

> Purchasing life insurance inside the defined benefit plan (split funded) may provide death benefit protection needed for the family members should the participant die prior to retirement. In other words, a life insurance death benefit may be able to make up the difference between what the participant expected to receive at retirement and what is actually available to the participant's heirs due to a premature death. Adding life insurance to the plan does not reduce the retirement income benefit; rather, it may provide a larger retirement benefit than would be possible under a profit-sharing plan, especially if the participant is close to retirement. There is a limit on the amount of life insurance that may be held inside a qualified plan. The participant may require additional life insurance protection outside of the plan.

The Takeaway...

Combining a defined benefit plan with a life insurance funded buy-sell may help your business owner clients prepare and achieve their retirement goals while also ensuring the business succeeds to the next generation.

---

[3]If the business is the owner and beneficiary and intends to keep the policy beyond retirement, the business must comply with requirement set forth in the IRC 101(j).
[4]Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 72, 7702(f)(7)(B), 7702A. Any policy values and may reduce benefits.

Please note that the reduction in the face amount of the life insurance policy may have additional tax consequences. A reduction in the face amount will not necessarily result in a proportionate reduction of all associated policy fees and charges. The life insurance policy may need to be retested under the 7-pay test for Modified Endowment Contract (MEC) purposes. Prior to authorizing the reduction in the face amount, consult your insurance producer and tax advisor as a reduction may cause the policy to become a MEC.