Retirement Buy Sell

Every business owner knows that planning is an important part of running a successful company. However, concentrating on meeting customer needs, boosting sales and keeping employees motivated can make it difficult for owners to find time to plan for the company's long-term future and their own retirement. Many business owners are concerned about how to accumulate sufficient retirement assets and what happens to the business if a partner dies.

In the past, addressing both the owner's retirement and buy-sell needs often meant proposing two independent strategies. Traditionally, buy-sell needs were met with term life insurance which was unable to address an owner's retirement needs, so another strategy was needed to address retirement income.

An option that integrates both needs can be achieved with the Retirement Buy-Sell strategy.[1] From a taxation perspective, this technique is generally only practical for pass-through entities with two owners.

Mechanics of the Retirement Buy-Sell Strategy

The traditional buy-sell strategy used by business owners generally involves each business owner purchasing a life insurance policy insuring the life of their partner. However, as the business value grows, the purchase of additional policies might be required. Additionally, upon the death of a partner, the value of the policy on the surviving owner is included in the deceased owner's estate.

The Retirement Buy-Sell strategy avoids these issues by using a permanent, cash value life insurance product and, with the help of the client's legal and tax advisors, restructuring the transaction. With three steps, business owners in a partnership or similar business arrangement may create dual purpose financial protection that helps ensure business continuity and provides the potential for supplemental retirement income.

Of course, before entering into the arrangement, business owners should review these concepts with their business or tax advisor in regard to their particular circumstances.

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Step One: Section 162 Bonus

A business owner who wants to set aside significant funds for retirement and minimize income taxes will find that traditional retirement plans (such as 401(k), defined benefit and deferred compensation plans) have certain limitations. Step one of the Retirement Buy-Sell strategy, the §162 Bonus (Internal Revenue Code Section 162), is an alternative. It uses a permanent, cash value life insurance policy that enables business owners to save with after-tax dollars, earn tax-deferred, potential growth on their investment, receive income-tax free money in retirement (assuming the policy is properly structured)[2] and provide an income tax-free death benefit for their beneficiaries.[3]

The company pays the premiums for life insurance policies covering each business owner. When a §162 Bonus is paid to a non-owner, it is a taxable bonus to the employee and thus qualifies for a tax deduction for the business, subject to reasonable compensation guidelines. However, §162 Bonus plans do not provide sole proprietors, partners and S corporation owners with similar tax leverage (due to the pass-through nature of taxation in such entities). Nonetheless, owner-employees in such pass-through entities should still consider bonus plans, since individual ownership of the policy typically offers more tax favorable access to living values and better insulation from business creditors.[4, 5]

Unlike a traditional buy-sell arrangement where one owner insures the other owner(s), each business owner owns the life insurance policy which insures his or her life. For flexibility, a policy may be structured to provide an increasing death benefit. This would provide upside protection in the event the business appreciates.

At retirement, the business owner can access policy values through withdrawals and loans to receive money in retirement that is generally income-tax free.2 Of course, this will reduce the cash value available to help facilitate a lifetime buyout.

Step Two: Buy-Sell Agreement

Within a closely held business, uncertainty about what will happen if one of the owners dies. Common concerns are whether the deceased shareholder's family will retain the interest in the business, or if the surviving owner has financial resources to purchase the deceased owner's interest. A buy-sell agreement is a binding contract between business owners that can address these concerns and is a vital component of the Retirement Buy-Sell strategy. This agreement is drafted by the client's attorney.

Step Three: Split Dollar Agreement

After the purchase price has been determined, surviving business owners need a strategy for funding their legal obligation to purchase a deceased or retiring owner's share. The third step of Retirement Buy-Sell, the split dollar agreement, may provide the right amount of money to the right owner at the right time.

Each business owner's life insurance policy purchased in Step One is designed to create sufficient death benefit to fund the purchase price under the buy-sell agreement. The §162 bonus continues to be the source of funding for the premium on the respective life insurance policies. Each business owner implements a private split dollar agreement, drafted by the client's attorney, endorsing the death benefit from their own life insurance policy in the amount of the purchase price of their business interest to the other business owner(s). As a result, at the death of an active business owner, the life insurance death benefit, which is sufficient to purchase the deceased owner's business interest, is paid to the surviving owner(s). The surviving owner(s) then has the necessary funds required to purchase the deceased owner's business interest.

What are the Tax Ramifications?

There are annual tax implications associated with a private split dollar agreement, which can best be explained with an example. Say you have two business owners, Betsy and Abby. Betsy pays the premium (via the company bonus) for the death benefit on her policy (the endorsed amount), and Abby receives an economic benefit (the annual economic benefit is derived from a calculation based on the endorsed death benefit). Therefore, Abby pays Betsy, via personal check, the value of the economic benefit each year. Betsy reports the amount received from Abby as taxable income. Similarly, Betsy issues a personal check to Abby for the value of the economic benefit from the death benefits endorsed from Abby's policy, and Abby reports the amount received from Betsy as taxable income.

Keep in mind that another important advantage of the Retirement Buy-Sell strategy is that since either Abby or Betsy is facilitating the buy-out, the survivor obtains a step-up in income tax basis upon purchase of her deceased partner's business interest.

Advantages of the Retirement Buy-Sell Strategy

The purchase of one life insurance policy for each business owner is economically efficient. Using one policy may reduce the overall costs of insurance and is, therefore, often more cost-effective than investing in taxable investments or purchasing numerous policies to meet multiple planning objectives. An exception to this situation may occur when the business owners are young (in their 30's) and rated preferred. Of course, the economics depend on the circumstances.

The private split dollar arrangement, with its "value of the economic benefit" expense, may cost the business owners less to obtain the needed amount of death benefit than paying the entire premium for an equivalent amount of term insurance.

Considerations

If both the buy-sell agreement and private split dollar agreement are properly structured, the Retirement Buy-Sell strategy should be "estate tax neutral." At death, the full amount of the death benefit is included in the deceased owner's estate. However, the private split dollar agreement is a legal obligation to pay a predetermined, specified amount of death benefit to the surviving owner(s). Therefore, the death benefit amount is a deductible liability for the estate. In a private split dollar agreement, the mutual endorsement of the death benefits may be considered a "transfer for value" under Treas. Reg. Section 1.101-1(b)(4) and may render the death benefit paid to the survivor taxable. To receive exemption from this rule, the business owners should form a bona fide partnership before the arrangement is structured.

Business owners should review their policies and agreements at least every three to five years. If the business grows, they may need to increase contributions to the policies, amend the purchase price specified in the buy-sell agreement and/or increase the amount of the policy endorsements specified in the private split dollar agreement. Loans and withdrawals from the life insurance policy will decrease the cash value and death benefit of the policy, which may reduce the death benefit available to satisfy obligations under the buy-sell agreement.

Conclusion

Cash value life insurance is a cornerstone of many successful business owners' financial plans because of the flexibility and tax advantages it provides. The Retirement Buy-Sell strategy can be an appealing alternative for business owners seeking a singular approach for their business continuation and supplemental income needs. Consider this option when approaching business owner clients who have these dual planning goals.

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[1] The Retirement Buy-Sell strategy has various benefits but, in exchange, there exists additional intricacy. Ultimately, it is up to the client, with counsel from his or her tax and legal advisors, to determine whether this strategy meets the needs of the business owner.

[2] Distributions are generally treated first as tax-free recovery of basis and then as taxable income, assuming the policy is not a Modified Endowment Contract (MEC). However, different rules apply in the first fifteen policy years, when distributions accompanied by benefit reductions may be taxable prior to basis recovery. Non-MEC loans are generally not subject to tax but may be taxable when the policy lapses, is surrendered, exchanged or otherwise terminated. In the case of a MEC, loans and withdrawals are taxable to the extent of policy gain and a 10% penalty may apply if taken prior to age 59½. Always confirm the status of a particular loan or withdrawal with a qualified tax advisor. Cash value accumulation may not be guaranteed depending on the type of product selected. Investments in variable life insurance are subject to market risk, including loss of principal.

[3] For federal income tax purposes, life insurance death benefits generally pay income tax free to beneficiaries pursuant to IRC Sec.101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec.101(a)(2) (i.e. the transfer for value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec.101(j).

[4] With respect to a §162 Executive Bonus Plan, the employer should consult with and rely on independent legal and tax advisors regarding whether any executive bonus plan may be considered a welfare benefit plan under ERISA and if so, what requirements must be met.

[5] Creditor protection laws vary dependent upon governing federal and state law. Individuals should be sure to confer with their independent tax and legal advisors regarding how applicable laws apply to their particular situation.

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