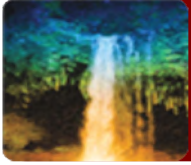


The Qualified Retirement Plan as an Estate Planning Tool

Many business owners have thought about retirement and planned wisely, setting up a qualified retirement plan of one kind or another – traditional defined benefit plan, fully insured plan, profit sharing plan, 401(k), or a combination. Often overlooked is how that qualified retirement plan can fit into the business owner's estate planning goals – be they financial security for the family, creditor protection, estate equalization among family members, or business continuation. Let's look at a few examples of how a qualified retirement plan may serve a dual purpose - a comfortable retirement and achieving estate planning goals. Perhaps you may see yourself in one situation or another.*

*(*Note that retirement plans such as SEPs, SIMPLEs, Traditional and Roth IRAs are not considered qualified retirement plans under the Internal Revenue Code.")*

Financial Security for the Family on the Death of the Business Owner

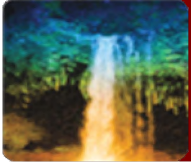
Bill is 45, with a $200,000 annual salary. He is a self-employed plumber with no employees. He has no retirement plan for his business, but has $500,000 in an IRA rollover account from a previous employer's retirement plan. His new wife has read an article about estate planning and retirement planning, and wants him to buy life insurance. He is not sure he can afford both a retirement plan and the insurance – the alimony and child support from his first marriage are a big drain on his income. He also maintains a $2 million policy for the benefit of his ex-wife. He feels he can afford to only contribute $42,000 to a retirement plan. What can he do?

A profit sharing plan allows him to contribute the $42,000 and take a tax deduction on his income tax return. He can use $20,995 of that on permanent whole life insurance premiums (limited to 49.99% of total contributions by what is known as "the incidental benefit rule" per the Internal Revenue Code). That could allow him to buy over $1 million of whole life insurance in the profit sharing plan and use pre-tax dollars to pay the premium. However, the problem remains – his ex-wife has a $2 million policy and the new wife wants the same. How does he afford it?

The solution could be to roll his IRA, or a portion of it, into the newly created profit sharing plan for his business. Fortunately, this rollover money is not subject to the incidental benefit rules mentioned above. He can use up to 100% of the rollover money to pay life insurance premiums. He can use some of the rollover money to make up what is needed to buy that $2 million coverage, accomplishing his retirement plan goals and his life insurance goals, paying the premiums with pre-tax dollars.

Creditor Protection and High Current Income Tax Deductions

Andre is a 53 year old thoracic surgeon making $600,000 a year as an independent contractor for a hospital. He has one employee – a secretary/bookkeeper. He is offered the professional challenge of tackling high risk surgery and wants to take it. He understands the potential for personal liability, yet, regardless of the risk, he wants to take on the challenge to build his reputation. Although he carries malpractice insurance, his wife is worried about a lawsuit wiping out what they have saved. He also needs to save more for retirement. What is the solution?



Estate Planning

With the help of his Guardian Financial Representative, he learns that by establishing a qualified retirement plan, he can accumulate money on a pre-tax basis to help him with his retirement, and secondarily, he learns that qualified retirement plan assets are essentially creditor proof from all creditors (except the Internal Revenue Service (IRS), ex-spouses in a divorce action, child support obligations, and certain fiduciary breaches) under the Employee Retirement Income Security Act of 1974 (ERISA) so long as the plan also covers at least one "common law" employee. In Andre's case, his plan will also cover his bookkeeper. Accordingly, these assets would be protected from any potential malpractice claims. He creates a Fully Insured Plan, also known as a 412(e)(3) Plan after an Internal Revenue Code section. The Fully Insured Plan is a defined benefit pension plan that is funded solely with annuities or annuities and life insurance so plan assets are protected from potential losses due to market fluctuations, unlike other investments. In this plan, he can make nearly $290,000 in tax-deductible contributions, buy nearly $4.9 million in life insurance death benefit, and provide for an annual lifetime pension income of almost $124,000 starting at age 62, all while being protected from potential creditors.

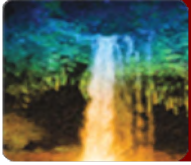
Retirement Security and Estate Equalization

Stan, a 54 year old lawyer, is divorced and earns $500,000 to $1 million per year. He has 3 employees including his son, Tim, also a lawyer. Tim is 30 and earns $170,000. Stan also has a secretary, age 34, earning $42,000, and a paralegal, age 36, earning $35,000. Stan wants a big tax deduction, can budget $350,000 each year, and wants his son to take over the practice. Stan also has two daughters. Unfortunately, aside from his house and some other investments, the practice is Stan's biggest asset. He wants to leave it to Tim, but it is more important to him that he treat all his children equally. How might a retirement plan work to help Stan accomplish his goals?

The Fully Insured Plan can provide the solution he needs. At age 54, Stan can contribute over $296,000 for himself and $41,000 for his two employees. Tim is excluded from the plan since he will be left the law practice and Stan will have enough retirement assets to be able to retire. Under the plan design, Stan will have over $110,000 a year in retirement income, and have over $4.7 million in death benefit. He leaves the death benefit in equal shares to each to his daughters, and the practice to Tim, thus enabling his retirement and accomplishing estate equalization.

Business Continuation Using a Profit Sharing Plan to Fund a Buy-Sell Agreement

Emily and Alice are 50% owners of a corporation, E&A Inc. They have a profit sharing plan and are looking for ways to provide that on the death of one, the survivor can continue the business as 100% owner. They have been advised by their attorney and CPA to establish a buy-sell agreement that provides that on the death of one, her estate will be obligated to sell, and the survivor obligated to buy, her share of the business. They have also been advised that the most efficient way to provide the money for the purchase is for each to own life insurance on the other in what is called a "cross purchase" buy-sell agreement. The problem is, they are contributing the maximum to their profit sharing plan annually, $53,000 each for 2015, and have little extra money to pay life insurance premiums. How can they accomplish their goals to maximize retirement benefits while also buying life insurance to fund a buy-sell agreement?



Estate Planning

Unlike some other qualified retirement plans, participants in a profit sharing plan may purchase life insurance on the life of anyone in whom they have an insurable interest, including business "partners" or fellow shareholders using their account contributions, and possibly balances, to pay the premiums. The profit sharing plan must provide that the participants can direct their investments and the plan must allow for life insurance as an investment. If their plan does not already permit it, it can be amended to do so.

There is a rule about how much of an annual contribution can be used to pay life insurance premiums – called the incidental benefit rule. No more than 49.99% of the contribution can be used to pay whole life insurance premiums. This is a cumulative rule, therefore each year the plan must satisfy the incidental rule. Rollover monies from another plan or an IRA are not subject to this rule, nor is "aged" money, provided the plan document allows it. Aged money is money that has been in the profit sharing plan for at least two years and may be withdrawn by the participant, or account balances of a plan participant who has been in the plan for at least 5 years. Again, the plan must allow this and if not, may be amended to do so.

Emily and Alice's plan allows for directed investments, investment in whole life insurance, and the use of aged money. As advised by their attorney, Emily and Alice, as trustees of the plan, purchase life insurance on the life of the other, respectively, using their plan contributions and balances to pay the premiums, and the plan is amended to provide that on the death of the insured, only the death benefit in excess of the policy's cash value be distributed to the survivor to be used by the survivor to buy the decedent's share of the corporation from her estate. This amount is known as "the amount at risk" and is important because this amount is not income taxable to the survivor. The buy-sell agreement should further provide that any value of the decedent's interest in excess of the "amount at risk" be paid in installment payments, with interest, over an agreed upon period of time.

So Emily and Alice still have their retirement security being built with their annual contributions and the growth of cash value in the life insurance policies, they have provided the funding for a buy-sell agreement, and they have done so with contributions to a qualified retirement plan that are tax deductible to the business.

These are but a few examples of how a qualified retirement plan may provide not only a retirement income, but may be used to help achieve estate planning goals as well.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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