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MAKING ALL THE PIECES FIT IN YOUR BUSINESS'S STRATEGIC PLAN

Strategic plans most often focus on the business operation itself. After all, if a business fails to function as a valuable, profitable entity, other concerns can quickly become irrelevant.

But a successful business must also make an effort to tie together its strategic plan with the income and estate planning goals of its owners and key executives. A business that ignores these considerations may miss a great opportunity and open itself to problems that threaten continued growth and, ultimately, survival.

This guide identifies a range of considerations that businesses can integrate into their strategic planning. By taking time to review these issues, you can help fulfill the financial needs of both your business and its key executives.

DOES PLANNING REALLY MAKE A DIFFERENCE?

Each business has its own particular needs, which change as it grows and evolves. Three of the most important are choosing the best business structure, providing for a financially smooth succession by funding buy-sell agreements and offering benefits that serve as incentives to key employees — both within and outside the ownership group.

At the same time, business owners and executives have their own special needs,



which undoubtedly also change with time. These needs include funding their retirement and passing on to their heirs the most assets at the least tax cost.

Owners who fail to take advantage of the many tax savings options must build up much greater value to achieve the same results. For example, remember that the estate tax repeal is scheduled to be in effect only in 2010, so depending on it to solve your estate tax problem isn't wise.



WHAT ROLE DOES INSURANCE PLAY?

In many instances, life insurance can play an important role in all of these planning decisions. You can use it to develop a business succession plan, to create an overall key-employee benefits strategy, and to integrate retirement and estate planning for owners. In addition, the unique and favorable treatment life insurance enjoys under the tax law may present other valuable opportunities.

This guide aims to provide you with some new ideas and jog your memory about some issues that may have faded into the background over time. But it won't replace

personalized, professional advice. Congress is continually weighing changes to income, gift and estate tax laws, which may materially affect some of the strategies discussed here. To ensure that you tailor each approach to your specific needs and that your plan is completely up to date with the most recent tax laws, please consult us before implementing any of the ideas we describe.

We can work with your other professional advisors to create a plan that fits your personal goals and those of your business, or to refine or expand on the strategies you already have in place.

CHOOSING YOUR BUSINESS STRUCTURE

anyone starting a business today has several structures from which to choose. While some structures are somewhat similar, such as S corporations and limited liability companies (LLCs), they can differ greatly in flexibility, basis, taxation and liability protection. Selecting the one that will best suit your needs involves weighing the advantages and disadvantages of each.

Your options fall into three categories:

- Those that “pass through” taxation to the individual owners without liability protection (sole proprietorships and general partnerships),
- Those that pass through taxation with liability protection (limited partnerships, LLCs, limited liability partnerships [LLPs] and S corporations), and
- Those that are taxed as a separate entity with liability protection for shareholders (C corporations).

The advantage of pass-through status is that income tax is generally paid at the shareholder level only. In contrast, C corporation income is potentially subject to double taxation, with tax at both the corporate and shareholder levels. Dividends are paid from funds that have been taxed at the corporate level, and shareholders pay tax on the dividends they receive. And even though the second tax on dividends is currently only 15%, it’s still an additional level of tax. To defer this second layer of tax on amounts that exceed reasonable salaries, a C corporation may retain earnings. But if it does so without a business purpose — other than avoiding tax on the dividends — the IRS may assess an additional accumulated earnings tax.

Planning tip 1

LIMITED LIABILITY COMPANIES’ POPULARITY CONTINUES

With all 50 states now recognizing LLCs as a viable business form, they continue to grow in popularity. And with good reason: The IRS recognizes that a properly structured LLC can be taxed as a partnership. Moreover, an LLC provides the advantages of an S corporation while avoiding its restrictions and limitations. Many states allow single-member LLCs to be treated like a sole proprietorship and don’t require them to file an additional income tax return. Thus, single-member LLCs can be the simplest form of liability protection.

For many existing corporations that have built up value, the LLC form isn’t a viable option because the conversion is a taxable event, often carrying with it a substantial tax cost. However, existing entities may be able to use the LLC form for new ventures within their businesses, or for joint ventures with other businesses.

As the owner of an existing business, you may want to review your business structure periodically to weigh its advantages and disadvantages and how they relate to your company's future profitability and your objectives. Even more important, you need to know how these advantages and disadvantages offset each other.

INCOME TAXES

Income tax considerations go beyond a comparison of

the top federal income tax rates. First, you must also consider the impact of state income taxes in the various states where your company does business. In some states, the combined federal and state rates may be higher for C corporations while in others individuals are taxed at higher rates.

Second, a different income tax consideration applies to businesses that are expecting losses. If owners can create tax basis in the entity, organizing as an S corporation, LLC or partnership may be beneficial. Why? Because these entities allow losses to be passed through to the owners. Thus, owners may realize current tax savings by taking the losses individually. A new C corporation, on the other hand, generally can only carry forward losses against future corporate income.



Finally, you need to consider whether income or loss that's passed through to an owner is active or passive. Passive losses are generally deductible only against passive income or when the passive activity is disposed of. Generally, if an owner doesn't materially participate in the business (as determined by certain participation tests), the income or loss is passive.

So if a business generates passive losses, pass-through treatment may be a disadvantage because owners may not be able to currently deduct the losses. By contrast, a C corporation isn't subject to the same passive loss limitations. But if owners have other passive activities, a structure that allows pass-through treatment can be advantageous because it may allow the owners to deduct passive losses from other activities.

SALE OF THE BUSINESS

The way you structure your business has implications that affect how you'll be taxed if you sell it later on. When considering these implications, you need to examine two levels of taxes:

1. Shareholder level. A key advantage of a pass-through structure is that it may avoid or reduce any capital gains tax on the sale of a business interest. When an S corporation retains earnings over the years by earning income and not distributing all of it to shareholders, the shareholders' tax basis in their stock increases, reducing or eliminating their capital gain on a sale.

For example, assume a sole owner of an S corporation has an original investment of \$100,000. The business retains earnings of \$500,000 over a period of years, so the owner's tax basis increases to \$600,000. If the owner then sells the company's stock for \$1 million, the owner's gain would be \$400,000.

In contrast, if the business is a C corporation, the gain would be \$900,000 because the owner's tax basis would remain the \$100,000 initially invested.

The capital gains question has another side. If an owner plans to keep the business in the family and bequeath his or her interest at death, the capital gains tax may never apply.



Currently, when heirs sell inherited property, they don't pay capital gains tax on appreciation that occurred before their loved one's death. But with the scheduled 2010 estate tax repeal, this step-up in basis is scheduled to be limited to \$1.3 million plus another \$3 million for assets going to a spouse. The limits are adjusted for built-in losses and loss carry-over amounts. Because the law is complex, consult your advisor on how this might affect your estate plan.



FRINGE BENEFITS

The cost of providing many fringe benefits is a deductible business expense, regardless of your business structure. But for pass-through entities, the cost of certain benefits provided to most owners (except S shareholders owning less than 2%) is taxable to the owners.

FICA TAX

Business structure also affects owners' FICA tax liability. While salary in excess of the statutory limit (annually indexed for inflation) isn't subject to the Social Security portion of FICA tax, it is subject to the Medicare portion. Furthermore, the Medicare tax applies differently to different types of income.

2. Corporate level. On the sale of C corporation assets, there may be a substantial corporate-level tax if they're sold for more than their tax basis. Take an example of a building that was purchased for \$1 million and depreciated over a period of years, reducing the tax basis to \$400,000. If the building is sold for \$2 million, the corporation pays tax on a gain of \$1.6 million. If the corporation is then liquidated, the shareholders pay a second level of tax. In contrast, an S corporation usually pays no corporate-level federal tax, and sole proprietorships, partnerships and LLCs never do.

If you're contemplating the sale of your business, contact your tax advisors immediately. They may be able to help you minimize the tax on the sale.

The absence of a wage cap on income subject to the Medicare tax hits general partners, or LLC members who work in the business, especially hard. Their entire share of business income — whether paid out or not — is subject to Medicare tax.

However, the Medicare tax doesn't apply to S corporation income passed through to shareholder-employees. To reduce this tax, S corporation shareholders may want to keep their salaries reasonably low and offset this with increased distributions.

On the other hand, many C corporation owners prefer to take money out of the company as salary, to the extent reasonable, to avoid the double tax on dividends. But, by doing so, they'll owe Medicare tax on the increased wages.

CONTROLLING YOUR DESTINY WITH A BUY-SELL AGREEMENT

buy-sell agreements can be powerful tools to help you control your business's destiny. These contractual agreements typically involve shareholders and their corporation or are executed between a shareholder and the other corporate shareholders. Partners or limited liability company (LLC) members can also enter into buy-sell agreements.

A buy-sell agreement controls what happens to a business when a specified event occurs, such as a shareholder's death or disability. An agreement might provide that, when a shareholder dies, the corporation will buy back the stock (a redemption plan) or that one or more of the remaining shareholders will buy the stock from the deceased's estate (a cross-purchase plan).

A well-drafted buy-sell agreement can help solve several estate planning problems for the owner of a closely held business. An agreement also may help protect and preserve the business against internal squabbles, whether among family members or unrelated business owners.



A key issue with any buy-sell agreement is providing the buyer with a means of funding the purchase. Life or disability insurance often helps fulfill this need. Using insurance to fund a buy-sell agreement can give rise to several tax and nontax issues and opportunities.

Because shareholders typically expect a business's value to rise, the price under the buy-sell agreement will likely also change. Thus, funding through insurance must be adjusted over time and periodically reviewed to ensure adequate coverage.

LIFE INSURANCE AND INCOME TAX

Life insurance proceeds generally are excluded from the beneficiary's taxable income, whether the beneficiary is a corporation, another shareholder or a separate entity. An exception is the transfer-for-value rule, under which proceeds will be taxable if an existing policy was acquired for value by someone other than the insured or a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder.

Planning tip 2

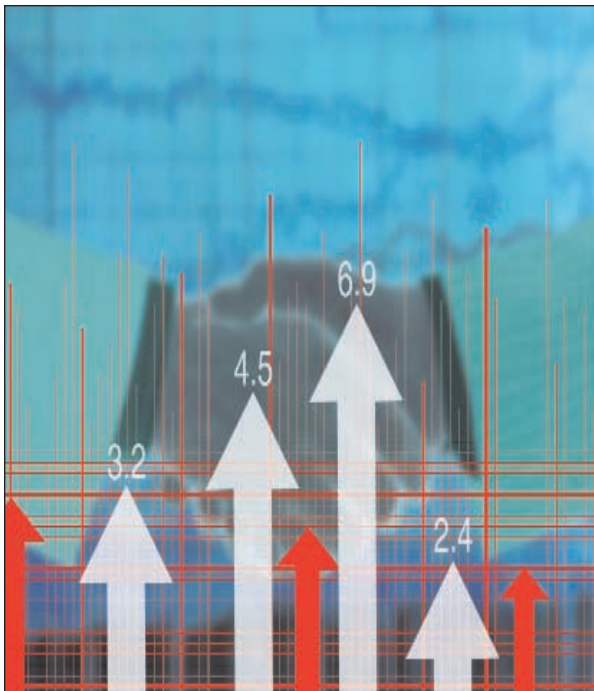
POTENTIAL BENEFITS OF A BUY-SELL AGREEMENT

Buy-sell agreements can be quite powerful. Among other benefits, a well-drafted agreement:

- Provides a ready market for the shares if the owner's estate wants to sell the stock after his or her death,
- Sets a price for the shares — in the right circumstances, it also fixes the value for estate tax purposes, and
- Allows business continuity by preventing unnecessary disagreements caused by new, unwanted owners.

This issue often arises when structuring or changing a buy-sell agreement using existing insurance policies. Be careful to structure the agreement so that the transfer-for-value rule won't have an impact; otherwise the amount of after-tax insurance proceeds will be reduced.

The other side of the income tax equation is that life insurance premiums aren't tax-deductible in a buy-sell situation, even though they're being paid to accomplish a clear business purpose.



REDEMPTION AGREEMENTS

With a redemption agreement, the corporation itself buys back a shareholder's stock. Thus, this type of agreement proportionately increases each remaining shareholder's ownership. This may or may not be the desired result, because a big difference may lie between what each shareholder wants and what each will end up with under a redemption plan. (See Chart 1.) If a proportionate distribution of shares isn't the goal of your buy-sell agreement, you may want to use a more flexible cross-purchase plan.

A redemption doesn't provide the remaining C corporation shareholders with an additional tax basis in their newly acquired stock. Assume, for example, that two 50% shareholders each paid \$500 for their stock when they started a business. When Shareholder 1 dies, his stock is redeemed for \$1 million. Shareholder 2 (now the 100% shareholder) still has a tax basis of \$500 in her stock. By contrast, under a cross-purchase arrangement, Shareholder 2's stock would now have a tax basis of \$1,000,500.

Chart 1

Does a redemption produce the desired results?

Shareholder	Ownership before buyout	Hypothetical desired result	After redemption of the stock of A
A	45%	—	—
B	45%	90%	82%
C	10%	10%	18%

Redemptions also can cause a potential income tax problem for C corporations, because receiving life insurance proceeds, while not taxable for regular tax purposes, can result in additional tax under the corporate alternative minimum tax (AMT). When insurance proceeds are large in relation to a business's net income, the AMT could be substantial. This often occurs in shareholder buyouts.

CROSS-PURCHASE AGREEMENTS

To avoid the potential pitfalls of a redemption plan, consider using a cross-purchase arrangement instead. In a business with only two shareholders, a cross-purchase plan is relatively simple: Each owner need only apply for and hold a life insurance policy on the other. As the number of shareholders grows, however, the number of policies involved increases dramatically. Three shareholders would need six policies (each shareholder would have policies on the two others), while a business with six shareholders would need 30 policies. This need for multiple insurance policies, paid for outside of the business, creates the complexity that has traditionally been cross-purchase agreements' major drawback.



Of course, shareholders spend their own money every year for these insurance costs. Premiums will vary for each policy — sometimes significantly — depending on each individual's age and other insurance rating factors, as well as his or her ownership percentage. Such amounts can generally be paid as additional compensation to each shareholder. But to fully cover the cost, the additional compensation would have to be “grossed-up” to cover income and payroll taxes. (See Chart 2.)

Chart 2
Gross-up of additional compensation

Cash compensation	\$1,667 ¹
Income and payroll taxes (40%)	<u>(667)</u>
Net cash to shareholder	\$1,000

¹ For a \$1,000 insurance premium.

Yet in businesses with very disproportionate shareholdings, such as 90/10, it may not be fair to the majority shareholder if the company funds the insurance (either directly or through salaries). In such cases, the 90% shareholder would effectively pay 90% of insurance costs on his or her

own life and thus end up paying for most of his or her own buyout. You'll need to closely examine the overall agreement's economics to understand how it will affect those involved.



In a cross-purchase agreement, the party who receives the proceeds should maintain the policy. The insured, however, is the one who will suffer if a policy lapses and leaves insufficient funds for the purchase of his or her share of the business. Yet many agreements fail to provide a means to notify the insured if premiums aren't being paid. This problem can usually be solved by verifying that each policy owner has provided evidence to the insured that premiums have been paid and permitting the insured, if necessary, to pay premiums and then seek reimbursement.

WAIT-AND-SEE BUY-SELL AGREEMENTS

Deciding between a redemption and a cross-purchase agreement can be difficult. There are many variables: Not only can the business's and shareholders' circumstances change, but so can the tax laws. The "wait-and-see" agreement offers more flexibility. Unlike other buy-sell agreements, the purchaser isn't specifically identified.

The shareholders, the business or both can buy life insurance. When a shareholder dies, the business has the first option to buy the stock. If the business opts not to buy or to buy only some of the stock, the shareholders have the option to buy. The business must buy any remaining stock.

USING A PARTNERSHIP TO HOLD INSURANCE

Partnerships have become an excellent way to address some of the issues with buy-sell agreements. The partnership can own and handle the premium payments on all policies. Because there's one central entity, only one policy per person is required. And because of a specific exemption, the transfer-for-value rule isn't a problem. (This isn't the case for trusted or escrowed agreements, under which a trust or escrow agent — rather than a partnership — holds all policies.) A clear business purpose, apart from the ownership of life insurance, must be shown for the partnership's existence.

TAKING CARE OF THE KEY EXECUTIVE

business owners are scrutinizing executive compensation and benefits more than ever. A business today, whether publicly or privately owned, is likely to need a direct link between its compensation package and the value it receives from the employee. Deferred compensation plans, which enable companies to provide additional benefits to key executives, often are the best way to provide long-term performance incentives. Welfare benefit plans and other insurance arrangements also can be used to sweeten the compensation package.

NONQUALIFIED DEFERRED COMPENSATION PLANS

The popularity of nonqualified deferred compensation plans has risen dramatically in recent years, especially among midsize to large businesses. Their relative flexibility means that the plans are limited only by your compensation objectives and creativity.

Over the years, the rules governing how nonqualified deferred compensation plans are drafted and operated have been tightened. Be sure any existing plans have been amended as necessary to comply with the new guidelines.

Because a deferred compensation program isn't qualified under tax law, its creation or funding doesn't create an immediate tax deduction for the business. Amounts are deducted only when paid to the employee. Unlike qualified retirement plans, which are subject to ERISA requirements, certain nonqualified plans can cover only a select group of management or highly compensated employees. This means that nonqualified plans are almost always a more cost-effective way to provide benefits to a small group of key executives.



Planning tip 3

KEY ATTRIBUTES OF A NONQUALIFIED DEFERRED COMPENSATION PLAN

- The plan must be for a select group of management or highly compensated employees.
- Flexibility allows design for maximum employee incentive/retention.
- Compensation must be deferred before it is earned.
- Amounts are deductible to the company when paid and income is taxable when received.
- Any amounts used to informally finance the benefits promised to participants must be reachable by the business's creditors.
- Distributions aren't subject to the various penalties, restrictions and requirements that qualified retirement plans are.
- A life insurance contract can be used to informally finance the agreement.

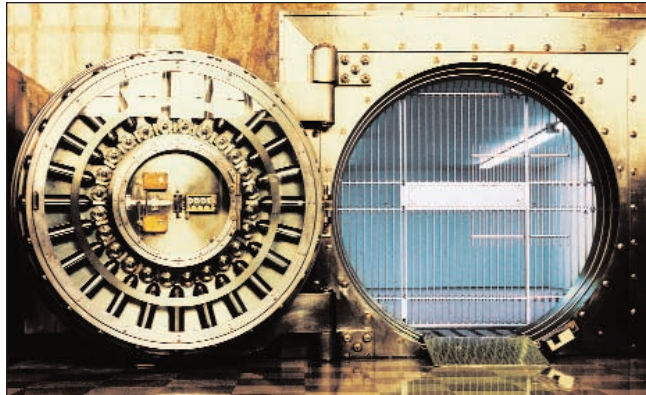
You can tailor your nonqualified plan to fit the specific needs of the business and each executive. Common examples include:

- **401(k) excess plans.** These allow executives to defer plan amounts that they could have contributed to a qualified 401(k) were it not for qualified plans' nondiscrimination rules and compensation limits.
- **Supplemental executive retirement plans.** These provide retirement benefits above and beyond those defined by qualified plans' limitations.
- **Stock and phantom stock plans.** These provide benefits tied to the business's overall performance.
- **Other deferred compensation tied to the performance of individuals, smaller work groups or divisions.** These can be based on any criteria and may differ for each plan participant. They contain vesting schedules and other restrictions on the availability of funds.

FUNDING DEFERRED COMPENSATION PLANS

A key issue for any deferred compensation plan is the funding of future benefits. Even though a plan need not provide for any funding mechanism, key executives generally want some security that benefits will actually be paid.

An accepted practice, recognized by the IRS, is funding through what is known as a rabbi trust. The employer can't have access to funds once they're contributed to a rabbi trust, but the business's creditors can. Thus, the plan's participants are protected unless financial disaster strikes the business.



Income tax implications of a rabbi trust include:

- Funds aren't taxable to executives and aren't deductible to the company until paid out of the trust, and
- Earnings within the trust are taxed to the company.

Life insurance can be an ideal financing vehicle for a nonqualified plan. It allows the company to invest funds, directly or through a rabbi trust, and get competitive returns that are sheltered from current taxation.

When the company or trust receives a death benefit, it incurs no taxable income. Of course, when benefits are paid out, they're deductible to the company and taxable to the recipient. But beware of the impact of the alternative minimum tax (AMT) if the business is a C corporation.

Using life insurance also can bolster participants' security. If a company refuses to pay premiums when due, the trustee could surrender the policies and generate cash to cover the benefits. This surrender could cause adverse tax consequences to the company, which may help ensure it will continually pay the premiums.

Planning tip 4

KEY-EMPLOYEE LIFE INSURANCE CAN PROTECT YOUR BUSINESS

In addition to offering attractive compensation to key employees, businesses need to protect themselves in case they lose such employees. Key-employee life insurance replaces the earnings that may be lost if executives or other valuable employees die. But these employees must have a great impact on the business's profitability, such as a salesperson who has the sole working relationship with most of the major customers. This type of insurance policy helps the business sustain itself during the initial loss period while it finds and trains a replacement. One caveat: If notice and consent requirements aren't followed carefully, employer-owned life insurance can lose its income tax exemption.

EXECUTIVE BONUS SECTION 162 PLANS

By using an Executive Bonus Sec. 162 Plan, you can distinguish among employee groups. This plan type is an insurance policy not wrapped in a formal "compensation plan." The employee personally acquires the policy (ideally through an insurance trust, as discussed on page 25). The employer then pays the premium either directly or indirectly through an employee bonus.



This payment is deductible to the business as compensation, assuming total compensation isn't unreasonably high. And the employee has a portable benefit that he or she can take to another job. This means that, while simple and effective, this plan may not be the best way to retain key people.

GROUP TERM CARVE-OUT

Many businesses have group term policies covering their employees. Such policies are cost-effective, particularly for larger groups, and are often the most appropriate means of coverage for the employee group as a whole. Plus, group term life insurance enjoys a unique tax benefit: Premiums are deductible to the company while coverage of up to \$50,000 per person is a tax-free benefit to employees.

Including the company's key executives and shareholders in the group may not, however, make as much sense. Over the long term, this insurance may become very expensive and still leave you with nothing for retirement. And the above-mentioned special tax break? It works for everyone except the partner, the limited liability company member, or the 2% or greater S corporation shareholder.

Instead, it may be advisable to "carve out" certain individuals from the group and convert their policies to permanent insurance. This may better meet their estate planning needs and may not cost as much over the years.

QUALIFIED RETIREMENT PLANS

Qualified retirement plans offer many tax benefits for business owners and their employees, but are subject to many rules and limits. There are two basic types of qualified retirement plans, each with many variations, twists and features. The defined benefit pension plan is funded to provide a specified benefit at a specific retirement age, based on actuarial assumptions. The defined contribution plan specifies only the contribution going into the plan or, in the case of a profit-sharing plan, may leave contributions to an employer's discretion.



Decades ago defined benefit plans were quite popular with small but profitable businesses whose owners were in or

approaching the second half of their working lives. But various tax law and regulatory changes systematically reduced the benefits of these plans by increasing the overall cost to the business.

In many cases, pension plans have been replaced by 401(k) or other defined contribution plans that leave much of the funding responsibility to employees.

Today's plans are likely to provide for a more limited matching contribution (designed to encourage employee participation) as well as for a lesser profit-sharing contribution from the employer. Despite these changes, a defined benefit plan can still be a powerful tax-deferral strategy in the right situation.

INSURANCE WITHIN A QUALIFIED RETIREMENT PLAN

From an income tax standpoint, a qualified retirement plan isn't always the best owner for life insurance. The typical advantage of life insurance (death benefit proceeds are free from income tax) is reduced when the policy is part of a qualified plan. On the other hand, tax-deductible dollars can be used to fund the premiums. Thus, it may still be the vehicle of choice depending on where you have the bulk of your available money.

As a business owner — even one who may have substantial wealth — you probably have money tied up in some or all of the following:

- The business's assets,
- Qualified retirement plans or IRAs,
- Residences, vehicles or other personal assets,
- Other real estate, and
- Other investments you wouldn't want to part with.

At the same time, your liabilities and responsibilities are free to grow. You may need to invest your cash flow back into business assets, fund your children's

or grandchildren’s education, fund your retirement plans, pay for weddings and, of course, support a comfortable lifestyle. Meeting these demands often leaves fewer funds available for long-term investments, including life insurance, than you would prefer to maintain.

Meanwhile, the qualified retirement plan you’ve been funding is sitting with liquid assets available for investment. Yet taking money out of the plan may not make sense when you consider income tax obligations as well as the additional 10% early withdrawal tax that will generally apply

Chart 3
Features of popular retirement plans

Plan type	Funded by	Are contributions tax-deductible?	Plan overview
Defined benefit plan	Employer	Yes, to contributing employer; pretax for the employee	Employers can make much larger contributions for older participants than are allowed under other plans. So these plans can be effective for older business owners.
SEP	Employer	Yes, to contributing employer; pretax for the employee	A basic retirement plan for small businesses. Employers don’t have to file a separate annual tax return, and they can create a plan after year end until the extended due date of their income tax return. Catch-up contributions for those age 50 or older aren’t permitted.
Profit-sharing plan	Employer	Yes, to contributing employer; pretax for the employee	A typically discretionary and flexible retirement plan that allows catch-up contributions and other enhancements.
401(k) plan (part of a profit-sharing plan)	Employee; employer can fund matching contributions	Yes, to contributing employer; all contributions are pretax for the employee	A popular plan suitable for businesses of any size. Employees may contribute up to 100% of their compensation within each year’s limit; employers may match contributions under a formula. Catch-up contributions are permitted. Testing is required for highly compensated employees, but “safe harbor plans” can avoid the testing rules.
Roth 401(k)	Employees only	No, but qualified distributions are tax free	These plans are typically offered as an option within a 401(k) plan. Unlike Roth IRAs, Roth 401(k)s have no income limitations on eligibility.
SIMPLE	Employee; with matching or nonelective contributions by the employer	Yes, to contributing employer; all contributions are pretax for the employee	A simplified plan for employers with 100 or fewer eligible employees. This plan is subject to lower contribution limits than other employer-sponsored plans. Catch-up contributions, though also lower, are permitted.
IRA	Individual	Yes, unless participant is covered by another plan and adjusted gross income exceeds certain levels	The retirement vehicle for individuals who don’t have other retirement plans available. Contribution limits are much lower than for other plans. Catch-up contributions are permitted. May be used to accept rollovers from other retirement plans.
Roth IRA	Individual	No, but qualified distributions are tax free	A plan generally best suited for younger people or those in lower tax brackets. Contribution limits are the same as for traditional IRAs, but contributions may be further limited or eliminated if adjusted gross income (AGI) exceeds certain limits. Catch-up contributions are permitted. Amounts can also be converted from traditional IRAs by paying the income tax, provided AGI doesn’t exceed \$100,000. (Rules are liberalized beginning in 2010.)

Source: U.S. Internal Revenue Code



if you are under age 59½. Instead, the answer to your particular situation might be to buy life insurance within the retirement plan.

If it makes sense to have insurance within the plan, you'll need to address two key issues: Is insurance permitted under your plan and can proceeds be kept out of your taxable estate?

CAN A RETIREMENT PLAN HOLD LIFE INSURANCE?

In general, profit-sharing plans, including 401(k) plans, may be used effectively for buying life insurance. Many profit-sharing plans permit these purchases at the participant's election. Including such a provision in a plan can be important because it will allow you to design a program that fits the needs of one key plan participant without doing the same for everyone.

The amount in a profit-sharing plan that can be used to buy life insurance is subject to what's known as the "incidental death benefit rule." It states that anything up to 50% of the cumulative employer contributions to the account may be used to buy whole life insurance; up to 25% can be used for term insurance or universal life.

Although the rule's cumulative nature often allows enough room for planning, some exceptions can provide even more room. You can also simplify things by using all of any amounts that have been in the plan for at least two years, and you may use the entire account balance of any participant who has been in the plan for at least five years.

Bottom line: If you're aware of the restrictions, you should generally be able to accomplish your insurance goals within a profit-sharing plan. Other types of retirement plans, however, may not be as flexible.

KEEPING QUALIFIED PLAN INSURANCE PROCEEDS OUT OF YOUR TAXABLE ESTATE

In general, all amounts in a qualified retirement plan are part of your taxable estate. Thus, proper planning is important to ensure that insurance proceeds won't become part of your estate. Otherwise it may face a larger than necessary tax burden. Remember, the scheduled estate tax repeal is only for 2010. So you must assume there will be at least some estate tax in effect at the time of your death.

The ideal insurance policy to use within a

profit-sharing plan may be a “second-to-die” type, which pays proceeds only after the death of both the plan participant and his or her spouse. These policies are typically designed as follows:

If the participant dies first, the only amount included in the estate generally will be the policy’s cash surrender value, because the proceeds aren’t yet payable. This is, in general, a relatively small amount. The policy should then be transferred to an irrevocable life insurance trust (ILIT) designated by the participant. Transferring the policy to an ILIT keeps the eventual proceeds out of the spouse’s estate. The only cost comes from including the policy value (cash surrender value, not face amount) in the participant’s taxable estate.

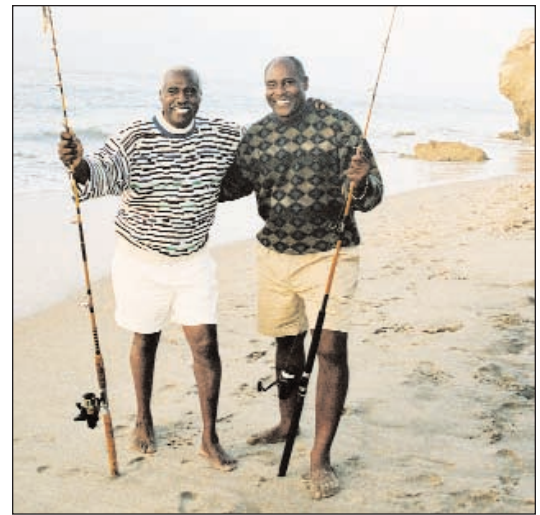
If the participant’s spouse dies first, the participant should immediately remove the policy from the plan and transfer it by gift to an ILIT. Distributing the policy to the participant results in income tax and a potential penalty tax. Or the participant can buy the policy from the plan for its fair market value.

The participant must survive for at least three years after the transfer to the ILIT to keep the proceeds out of his or her estate. The transfer to the ILIT is a gift, measured by the policy’s fair market value — generally the cash value at transfer. Annual gift tax exclusions and the lifetime gift tax exemption can be used to minimize the transfer’s gift tax burden.

DISTRIBUTION PLANNING

Retirement plans have been excellent tax-advantaged investment vehicles for years, and many businesses have taken full advantage of the opportunity to contribute large amounts and let them grow tax deferred.

The result is that today, in many closely held businesses, the owners and key employees who are nearing or have reached retirement age have built up substantial sums within qualified retirement plans, including IRAs.



What’s so terrible about this financial bonanza? Nothing, except for the income tax that will need to be paid, and likely the estate taxes, too. In a nutshell, qualified retirement plans are subject to federal income taxes at ordinary — not long-term capital gain — rates and to state income taxes in some states. Even with certain deductions, and not counting any state taxes, nearly two-thirds of the plan assets could be lost to income and estate taxes before this money finds its way to the next generation.

If you plan to retire and live off your plan distributions, the total tax burden won't be so bad. But if you won't need all of your retirement plan funds, an important question arises: What can you do to lessen the overall income and estate tax burden on the money you won't need and will eventually pass on to your heirs?

The answers to this question are complex and should be analyzed on an individual basis. You'll need to consider the amounts in your qualified plans and IRAs, your age, your spouse's age, your income needs, and your estate planning goals. Generally:

- If you or your spouse lives a long life (to age 90, for example), you'll almost certainly be better off if you postpone taking distributions until required beginning after age 70½ and then take the minimum required amount. As a general rule, deferring the income tax and getting additional years of tax-deferred income and/or appreciation will yield the best results.
- If neither you nor your spouse lives as long a life, a portion of the plan assets will probably end up being distributed directly to your beneficiaries — and will be taxable to them at their income tax rates. Consider whether this will create an advantage or a disadvantage.

- Even if you bet on living a long life, other factors could possibly shift the advantage toward taking money out faster and sooner (perhaps beginning in your 60s, rather than at age 70½). Such factors generally hinge on your ability to achieve estate planning goals that wouldn't be possible without the use of this money, such as:
 - Using the funds (after paying income tax) to make gifts that qualify for annual gift tax exclusions or even establishing a family limited partnership (FLP), or
 - Using the funds (after paying income tax) to purchase life insurance in an ILIT.

A projection of the after-tax amount left for your heirs will sometimes dictate taking the money out sooner than required if you'll then be able to do something with it that will also save estate taxes.

You may have an additional option to roll over existing qualified plan balances or IRAs to a Roth IRA. This may be the best option of all, but you only qualify if your adjusted gross income (AGI) is under \$100,000 and you don't file your tax return as married filing separately. You must also be willing to pay taxes on any previously untaxed

contributions and the IRA's earnings up front. But the \$100,000 AGI limit is eliminated starting in 2010, providing more taxpayers with this tax-saving opportunity.



ESTATE PLANNING FOR THE BUSINESS OWNER

business owners have several options to consider when planning to transfer their assets. Because estate taxes can be substantial, you need to investigate approaches that will maximize the potential savings while still providing you with some degree of control over, or continuing cash flow from, the asset being transferred.

There are many issues, though, that can complicate your estate tax planning strategies. For one thing, although the estate tax is scheduled to be repealed in 2010, in 2011 it will return unless Congress passes further legislation. (See Chart 4 below.)



Other scheduled tax law changes further increase the complexity of estate planning, such as the repeal of the generation-skipping transfer (GST) tax, the reduction in the top gift tax rate but no repeal of the gift tax, and the repeal of the step-up in basis at death.

As a result, estate planning is more important than ever — without proper planning, your family could still lose to estate taxes a large share of what you've spent a lifetime building.

Chart 4
Transfer tax exemptions and rates

Year	Estate and GST tax exemptions ¹	Gift tax exemption	Highest estate, GST and gift tax rate
2007	\$ 2 million	\$ 1 million	45%
2008	\$ 2 million	\$ 1 million	45%
2009	\$ 3.5 million	\$ 1 million	45%
2010	(repealed)	\$ 1 million	35% ³
2011	\$ 1 million ²	\$ 1 million	55% ⁴

¹ Less any gift tax and GST tax exemptions used during life.

² The GST tax exemption is adjusted for inflation.

³ Gift tax only. Equal to highest marginal income tax rate.

⁴ Reverts to 2001 rules. The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates and gifts over \$10 million.

Source: U.S. Internal Revenue Code

Chart 5

Leveraging your gifts with a family limited partnership

	Gift of cash	Gift of an interest in an FLP	Difference
One annual gift tax exclusion (assuming \$12,000 exclusion)	\$ 12,000	\$ 12,000	—
Hypothetical minority/marketability discount (e.g., 30%)	—	\$ 5,142	\$ 5,142
Undiscounted value of assets transferred	\$ 12,000	\$ 17,142	\$ 5,142
Appreciation in value at 8% annually for 25 years	\$ 70,182	\$100,255	\$ 30,073
Value of gift after 25 years	\$ 82,182	\$117,397	\$ 35,215
Eventual estate tax savings (assuming a 45% rate)	\$ 36,982	\$ 52,829	\$ 15,847

Source: U.S. Internal Revenue Code

FAMILY LIMITED PARTNERSHIPS

Are you looking for a way to save estate taxes and leverage your use of gift tax exemptions while protecting and maintaining some control over the assets you are giving away? If so, a family limited partnership (FLP) may be the perfect estate planning strategy for you.

Ever since the IRS agreed that gift tax valuation discounts should apply in family



situations, the FLP has enjoyed great popularity. The IRS continues to fight FLPs every step of the way, however, particularly if they're not structured or operated properly. And it's possible that these discounts will eventually be curtailed or even eliminated.

The key to enjoying discounts is to use a vehicle, such as an FLP, that doesn't give the recipients complete control over the investment they end up owning. Of course, the discount's amount must be determined, ideally by a formal valuation, and will vary depending on the partnership agreement and the nature of the assets transferred to it. Discounts generally range from 20% to 40%.

In the typical FLP, the parents or grandparents making the gift become the general partners, while children and/or grandchildren become limited partners.

In recent years, and in response to court cases, it's become generally recommended that the donors divest their controlling interest, leaving others in control. The limited partners have neither control over the partnership's management or assets nor any personal liability beyond their interest in the partnership itself. As a result, the parents may gift all or most of the partnership to younger generations. They can make the gift all at once (using their lifetime gift tax exemptions and perhaps even paying gift tax beyond that point), or over a period of years (using their gift tax annual exclusions — under the annual exclusion, you can make



gifts up to the annual exclusion amount per year per recipient free of gift tax and without using any of your lifetime exemption.)

Various assets can be transferred to an FLP, including marketable securities, real estate or interests in closely held businesses. The partnership may become an owner in other partnerships, limited liability companies or C corporations (but still not S corporations).

FLPs at least partially protect assets from outsiders. A limited partner's creditor or a divorcing spouse may be able to become a limited partner, but he or she may not be thrilled with an investment that an adverse party controls, that may not generate any cash flow, that can't be sold or borrowed against, and that may create substantial income tax liabilities.

Chart 5 on page 21 shows the additional leverage that can result from the minority discount on gifts of FLP interests. Note that after 25 years it can amount to an additional \$35,215 transferred tax free to a loved one — and save nearly \$16,000 more in estate tax, too. This scenario is based on the use of just one \$12,000 annual exclusion gift. Of course, these benefits can be multiplied if you make multiple annual exclusion gifts each year for a number of years.

Planning tip 5

ARE YOU READY FOR A FAMILY LIMITED PARTNERSHIP?

Despite all the advantages of a family limited partnership (FLP), this approach isn't for everyone. Answering the following questions can help you decide whether it's the right approach for you.

Are you concerned about estate taxes and looking for a way to maximize lifetime giving?

Are you willing to reduce the actual value of your estate? (Keep in mind that income and borrowing power may be reduced as well.)

Are you willing to have distributions made *pro rata* to all the partners, if they're made at all? (Distributions need not be made; alternatively, the partnership could distribute only enough for the partners to pay their income taxes. The general partner can also take a reasonable annual management fee from the partnership.)

Are you willing to incur some additional costs for legal fees, appraisal fees and annual partnership tax returns?

GRANTOR RETAINED ANNUITY TRUSTS

It's safe to say that many of those who have not done so already would be happy to give away substantial assets to their children if not for three critical concerns:

- They don't feel comfortable parting with the income stream an asset generates.
- They aren't sure whether their children can handle full control of, or full income from, an asset.
- They don't want to pay a large gift tax or use up a big chunk of their lifetime exemption.

Interestingly, a grantor retained annuity trust (GRAT) can go a long way toward addressing all these issues. With a GRAT, you can make a substantial gift today while retaining an income stream for some period of time. You may also be able to keep control within a trust that may not pay out income to beneficiaries for even longer. And yet, a gift today that's relatively small for tax purposes can turn into a substantial transfer.

A GRAT pays a predetermined amount, which may vary in size or duration, back to the grantor. It may be a fixed percentage of the original value or a percentage based on the trust's annually recalculated value. The annuity's term must be fixed at no less than two years.

The amount of the taxable gift is determined upon the initial transfer based on a government-derived interest rate factor. But the transferred asset must first be valued and, just as with an FLP, a minority or marketability discount may affect its value.

Planning tip 6

DEFECTIVE GRANTOR TRUSTS CAN BE EFFECTIVE

One popular planning strategy is the use of a "defective" trust. A defective trust purposefully contains one or more provisions that result in its being treated as a grantor trust for income tax purposes. This means that all the trust's income is taxed to the grantor on his or her individual return. It also means, for example, that you can sell an asset to the trust at a substantial gain but incur no income tax on the gain because, for tax purposes, the transaction is treated as a sale to yourself.

Meanwhile, this same trust, if properly drafted, will qualify as a separate entity for estate tax purposes. Therefore, the transfer to the trust will remove the asset from your estate. Although this may sound like an unintended quirk in the law — and perhaps it is — it has been recognized by the courts and has become an accepted estate planning technique.

What this means is that selling to a defective trust can accomplish similar results as gifting to a grantor retained annuity trust (GRAT). Payments are made back to the seller (grantor), typically over a period of years as an installment sale with interest.

The real impact, of course, is that you're making a gift with a built-in delay mechanism because of the annuity coming back to you. In the meantime, if the asset increases in value at a rate faster than the government tables assume it will, you can get substantial gifting leverage.



For example, let's say you have a closely held business that you believe will grow

20% annually for the next five years. The business is worth \$2 million and you want to transfer 25% of it to a GRAT, taking an annuity for five years that's large enough to make the gift's value close to zero.

First, you would need to value the asset being placed in the GRAT. For instance, though 25% of a \$2 million business equals \$500,000, a discount may be taken because the GRAT is receiving a minority interest. If this discount is 40%, the value of the transferred asset itself would be \$300,000.

The amount of the annuity necessary to reduce the gift to near zero will depend on government interest rates, which are adjusted monthly. Let's say, in round numbers, that the annuity to be paid back to you might be \$78,000 annually (totaling \$390,000, or 130% of the discounted value, over the five-year period).



Indeed, the business might earn enough in net income each year (in this example, exactly 15% of its nondiscounted value) so that the trust could pay the annuity every year out of its cash flow from the business.

Thus, the results might be as follows:

- 25% of a \$2 million company is eventually transferred without any gift tax or use of the lifetime exemption.
- 25% of future appreciation in the business also will escape gift tax because the gift is being made now.
- The actual financial impact of the gift is delayed for five years because the trust has little or no cash flow during the annuity period, beyond what it needs to pay the annuity.

What could go wrong? Not much, other than the fact that the GRAT may not work. If so, the following can occur:

- The IRS can adjust any gift's value, but with a properly drafted GRAT this won't necessarily cause a taxable gift. The trust can provide that such an IRS adjustment is "corrected" by giving back a portion of the transfer originally made to the trust.
- You always have the risk that, when a taxable gift is made, you'll have wasted the exemption or annual exclusions if the asset's value declines. But in a GRAT similar to the above example, that risk is small because the taxable gift is minimal.
- You (or you and your spouse) could die before the annuity term's end. The transfer to the trust won't be effective for estate tax purposes unless you outlive the annuity term. This is an issue that certainly can be addressed with life insurance.

IRREVOCABLE LIFE INSURANCE TRUSTS

Buying life insurance via an ILIT will typically allow for a tax-free death benefit. Life insurance in an ILIT will normally remain outside the insured's estate. However, the purchase and/or transfer of the policy should be handled with care to avoid incidents of ownership. You'll need a lot more insurance — almost twice as much, in fact — to provide the same benefit to your family if the proceeds must first be used to pay estate tax — see Chart 6.

If you own life insurance policies when you die, the proceeds are includible in your taxable estate. Ownership is determined not only by whose name is on the policy, but also by who controls certain rights, such as the right to change the beneficiary. The solution? Be sure you aren't considered the owner of insurance on your own life.

Instead, create an ILIT. The trust owns the policies and pays the premiums. You can make a gift to the trust every year so that it has the funds to pay premiums. And, if properly structured, these gifts can qualify for the gift tax annual exclusion.

When you die, the proceeds pass into the trust and aren't included in your estate, nor will they be included in your spouse's estate (although the trust can be — and generally is — structured to provide benefits to a surviving spouse as well as other beneficiaries).

Chart 6

Amount of insurance needed to provide children with \$1 million after estate taxes

	In irrevocable life insurance trust	Owned by insured
Insurance proceeds	\$1,000,000	\$1,818,182
Estate tax (assuming 45%)	0	(818,182)
After-tax proceeds	\$1,000,000	\$1,000,000

Is there any reason *not* to use a trust to hold insurance on your life? Generally no, but certain situations may preclude this approach. Insurance that provides funding for a buy-sell agreement will be held by another individual or entity. Policies can be owned by the insured's adult children rather than a trust. And if your estate, including insurance, is small enough that you don't need to be concerned about estate taxes, you can be spared the complication. Finally, if you believe you'll need to access the policy's cash value, ownership in a trust can complicate the situation. In general, ILITs have become an integral part of many people's overall estate plan.



CHARITABLE REMAINDER TRUSTS

A properly structured charitable remainder trust (CRT) provides you with several benefits:

- You can avoid paying capital gains tax currently on the sale of an appreciated asset. When the trust sells an asset, it pays no tax on the gain.
- You get a partial charitable income tax deduction when you fund the CRT. The amount of that deduction is based on interest-rate-sensitive government tables. The present value of the interest eventually going to charity must be at least 10% of the total.
- The CRT pays you income during its term (which can be for the remainder of your life). You'll pay income tax as you receive funds from the trust. Your investment yield may actually go up because the CRT can sell a highly appreciated — but low yielding — asset without paying tax and replace it with another, more suitable investment.



Although not immediately, a CRT also provides a substantial benefit to the charity, because it will someday end up with the remaining balance in the trust. Yet you may still retain almost as much (possibly even more) for yourself and your heirs as if you had kept the asset, because of increased cash flow during the trust's term and an immediate tax deduction.

Planning tip 7

GETTING AN EXISTING INSURANCE POLICY INTO THE TRUST

What if you want to move an existing insurance policy to an irrevocable life insurance trust (ILIT)? This may not be easy if the policy isn't a term policy. If it has been around for a while, the policy's cash surrender value may be high enough that the transfer would create a large gift, using up not only your annual gift tax exclusion but a portion of your lifetime exemption as well. You must also survive the gift of the insurance policy to the trust for three years to keep the proceeds out of your estate.

If the trust buys the existing policy, you may run afoul of the transfer-for-value rule and subject the eventual proceeds to income tax. One exception to this rule allows a transfer to a partner of the insured. Interestingly, that partner can own a very small interest (there's no minimum percentage) and there need not be a connection between the insurance and the partnership. As a result, one strategy is to make the insurance trust a partner in an FLP, thereby qualifying for this exception.

The risks? Your death at an early age (if income was being paid for your lifetime) could trigger an earlier transfer to the charity and many years' less income for your family. Or, you may enjoy a long life, but suffer a financial downturn. The solution may be to use some of the income stream from the CRT to buy life insurance. It will provide you or your heirs with an additional source of funds.

This is an example of how life insurance can round out a great strategy. Adding the life insurance policy can help you turn your CRT into a “win-win” situation.

Planning tip 8

CHARITABLE TRUSTS AND S CORPORATIONS: A GOOD MATCH?

Because charitable trusts and foundations can be shareholders in S corporations, you can receive an income tax deduction for contributing S corporation stock.

Doing this, however, can be quite complicated and may not work favorably. Someone, either the trust or a beneficiary, will have to pay tax on the trust's share of S corporation income and gains. As long as the trust gets enough cash flow to pay its share of the tax, though, the charitable organization should still be very happy to receive the gift.

PREPARING FOR THE FUTURE: A BUSINESS OWNER'S CHECKLIST

As you can see, planning for your future and the future of your business involves making many choices. This checklist can help you assess your needs and determine the best plans to lay for the future. If you would like more information on any of the areas we've discussed in this guide, mail or fax these two pages (or copies of them) back to us. We can help you create a plan that will best suit both your needs and the needs of your business.

BUSINESS STRUCTURE	Yes	I would like to consider it	I need more information
■ Have you considered all the advantages and disadvantages of each type of entity and how each could apply to your business?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Do current S corporation rules allow you to use that business structure?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Can new shareholders now be brought into an existing S corporation because of tax law changes?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Can an LLC be used for a new business structure or a new portion of your existing business?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

(Continued on next page)

PREPARING FOR THE FUTURE: A BUSINESS OWNER'S CHECKLIST (CONTINUED)

BUY-SELL AGREEMENTS	Yes	I would like to consider it	I need more information
■ If your business has more than one owner, do you have a buy-sell agreement in place?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Have you kept your buy-sell agreement up to date, accounting for any changes in business value or ownership structure?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Are you using the appropriate structure for your buy-sell agreement (redemption vs. cross purchase)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Do you currently have the right amount of insurance to fund the agreement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Should you use a separate entity to hold the insurance policies?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
NONQUALIFIED DEFERRED COMPENSATION PLANS			
■ Have your plans been reviewed to determine if they are in compliance with current law?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Do you have the appropriate compensation plans in place to motivate and retain key people?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Does it make sense for key executives to be part of a group term policy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Have you considered using life insurance as an informal funding mechanism for a deferred compensation plan, or in place of such a plan, for your business?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Would the use of a welfare benefit plan be appropriate for your business?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
QUALIFIED RETIREMENT PLANS			
■ Have you considered the various plan types and adjusted your strategy to balance maximizing your deferral and minimizing your cost?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Is your plan the best place to purchase life insurance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Have you planned for the distribution of large retirement plan balances?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
ESTATE PLANNING			
■ Is a family limited partnership right for you?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Could a GRAT be an effective means of shifting value out of your estate while maintaining control, retaining an income stream and leveraging your use of the gift tax exemption?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Are you making maximum use of an irrevocable life insurance trust?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
■ Have you considered the use of a charitable remainder trust?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
TYPES OF INSURANCE			
■ Have you evaluated the various types of insurance and determined which one or combination best suits your needs today and for the future?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>