

# BUSINESS STRATEGIES

Managing Risk in a Privately-Held Business





## Risk Protection in a Privately-Held Business

Business owners live with risk. That's the nature of business. Business owners take on risk when they borrow money, launch a new product or service, hire new employees, extend credit, purchase new equipment, and sign leases or other contracts. Business owners are also responsible for hiring and retaining key people — an essential ingredient to business success. In addition, business owners need to provide for retirement for themselves and their key employees. Last but not least, since a business interest is almost always the biggest single asset in a privately-held business owners' estate, owners need to be concerned with estate planning issues and opportunities.

In short, when it comes to business, there are many risks and challenges and few guarantees. Nonetheless, risk can be managed. That is why businesses like yours insure their assets against loss by theft, fire, accident, and natural disasters. That's why you buy liability coverage and errors and omissions insurance.

Life insurance can play a similar role both in managing risk and in accumulating capital to meet future needs. Life insurance can be used to protect your business and your family in the event of loss due to premature death of an owner or a critical, key employee. Life insurance can also be used to reward key employees and to accumulate funds to supplement qualified retirement plans.



# Five Critical Management Considerations

This brochure outlines five critical areas that businesses like yours need to consider—to protect the business and to provide supplemental retirement funds for you and your key employees:

**1**

**Key Employees:  
The Lifeblood  
of Business**

**2**

**Executive  
Compensation**

**3**

**Supplemental  
Retirement  
Planning**

**4**

**Succession Plans:  
Every Business  
Needs One**

**5**

**Estate Planning:  
Protecting  
Your Heirs**



# 1 Key Employees

## The Lifeblood of Business

What are a business's most valuable assets? Not the facilities, inventory, or even clients or customers. The most valuable assets a business has are its employees. The success or failure of virtually all businesses hinges entirely on the experience and talents of the men and women who keep the organization running. It is all of the people who know what to do, when to do it, and how to get the job done right and on time.

Ignore titles. Whether critical people go by Vice President, Director, Comptroller, or Manager, they are the highly-compensated executives who are vital to the continued profitability of the company.

## When a key employee dies, trouble may be ahead.

### **Productivity and Profits Could Decline**

As the business struggles to fill the gap left by the loss of a vital employee, profits and productivity may slide. Indeed, the business could come to a complete standstill while other employees regroup and the organization reviews their options going forward.

### **Customers May Look Elsewhere For Services**

Customers may become wary about the company's ability to continue fulfilling their requirements. Meanwhile, competitors will be more than willing to take advantage of the situation.

### **Overhead Expenses Continue**

Leases, rent, medical insurance premiums, telephone services, salaries, and other expenses still must be paid.

### **Expenses Rise**

It takes time and money to find "just the right" replacement, hire that individual with a competitive compensation package, and give the new employee time to become fully productive.

### **Credit May Shrink or Dry Up Completely**

As lenders adopt a wait-and-see position, credit may be jeopardized until lenders and vendors see how the company weathers the setback.

The financial loss could be staggering. The exact dollar amount of the potential loss is impossible to estimate. It could total tens of thousands of dollars, perhaps even hundreds of thousands. Fortunately, there are simple, direct steps business owners like you can take to protect the organization against the loss of a key employee.



# Insuring Key Employees

A business may own a life insurance policy on the lives of its key employees. Insurance on the life of a critical, key person is purchased to compensate a business for losses it will suffer as a result of the employee's death. Doing so not only protects the stability and profitability of the company, it also protects jobs and the financial security of other employees. Key employee insurance protects a wide variety of interests.

## How Key Employee Insurance Works

With the employee's approval, the company purchases a life insurance policy on the individual's life. The business owns the policy, pays all premiums, and is the beneficiary of the policy. If the employee dies, the proceeds are available to help offset the financial loss and, literally, buy the company time to find, hire, and train a replacement.

## Key Employee Insurance in Action<sup>\*</sup>

Charles Morrissey and David Cahn started Flat World Imports 15 years ago importing and distributing retail merchandise from Thailand and China. Their company has 190 employees and grosses \$150 million a year. Juliet Chang worked her way up from merchandise buyer to Vice President. She maintains a wealth of contacts in Asia that are crucial to the business and has been a major factor in the company's expansion.

Charles and David recognize Juliet's contributions; consequently, she is well-compensated. All three know that if Juliet died prematurely, the loss to the business would be catastrophic. So, with Juliet's consent, FWI purchased a \$500,000 life insurance policy on her life with the company as owner and beneficiary of the policy.

If Juliet were to pass away, the proceeds would provide FWI with the funds to absorb immediate losses while searching for someone to fill Juliet's very big shoes.

<sup>\*</sup>This is an illustrative example and not based on actual events.





# 2 Executive Compensation

Executive compensation can play an important role in helping small businesses attract and maintain the human capital the organization needs to succeed. You and your financial advisor can find the best ways to use these strategies to realize immediate and long-term goals. Consider some of the benefits executive compensation offers:

- Recruit the talent you need
- Retain the people you hire
- Compensate for benefits lost under qualified plan limitations
- Reward talent and service
- Retire key employees when the time comes

There are a number of Executive Compensation strategies to choose from. Two of the most popular are Deferred Compensation and Code Section 162 Executive Bonus. The problem with Deferred Compensation is that the money going into the funding vehicle is not tax-deductible to the company until years later when the money is paid out to the employee after a term of years or at retirement.

Typically, closely-held business owners need to be able to deduct the amount of money used to fund the plan. In the case where this deduction is needed, the Section 162 Executive Bonus is utilized. With a 162 Executive Bonus, the employer can

directly fund an indexed universal life insurance policy, or a fixed or indexed annuity in cases where the individual is highly rated for life insurance or does not have a minimum of twelve years to grow the cash value in a policy. The employer adds the amount paid into the life insurance policy or annuity to the employee's W-2, thereby allowing the employer to deduct the funding. The employer can also provide a double bonus where a second amount is paid directly to the IRS to cover withholding taxes on both bonuses, with both being deductible for the employer. In this way, the employee benefits because the second bonus goes toward the employee's withholding tax, and the company breaks even because they are able to fully deduct the bonuses provided on behalf of the employee. The employee will own the policy and name the beneficiaries. If the company is looking for a "golden handcuff", they can execute a side agreement with the executive so that if he or she leaves before a specified date, the executive would need to pay back the bonus.

Each executive can have a different amount based upon how much the company deems they want to provide. No two executives need to be treated equally. The 162 Executive Bonus is limited to the top 15% to 20% of paid workers in the company. The goal is for the company to retain key executives and not lose them to a competitor.

# Creative Ways to Compensate Talented Employees

Why have employers been quick to add executive compensation plans to their overall benefit mix? There are two good reasons for the sudden increase in the popularity of these strategies. Employers want to:

- Find creative ways to retain and compensate talent
- Reimburse talented employees “maxed-out” by qualified plan restrictions

## Caps on Qualified Plans Are Real and Restrictive

Contribution limits coupled with anti-discrimination rules are clearly restrictive against highly-compensated employees. A non-qualified executive benefit plan lets highly-compensated employees accumulate substantial and meaningful benefits that are impossible to amass under the restrictive rules that govern qualified plans.

Let’s look at a scenario that will increase future retirement income for a key employee while tying them to the company until retirement:



### Scenario

50-year-old executive with a \$300,000 salary and no retirement savings.

### Goal

Retire at age 65 with 75% of pre-retirement income, or \$225,000 per year from ages 65–87.

### Problem

The required contribution of more than \$162,000 per year exceeds maximum qualified deferral limits.

### Solution

162 Executive Bonus Plan

## Designing an Executive Compensation Strategy

Every organization is different, and therefore, every executive compensation plan is tailored to fit the goals and concerns of both the individual and the business. Since one size does not fit all, it’s best to talk to your financial advisor about how executive compensation might be structured to benefit you and your business. Together you can begin the process of:

- Determining the kind of plan that would work best in your situation
- Choosing the products that will help you meet your objectives

# 3 Supplemental Retirement Planning

Comprehensive retirement planning, designed to meet future needs and realize long-term goals, must consider many retirement income variables including qualified retirement plan limits, potential social security shortfalls, inflation, the cost of health care, and even the possibility that premature death will destroy family savings goals. Retirement planning means building significant financial resources designed to extend over a longer period of time to maintain lifestyles that are far more complicated and diverse.

## How much is enough?

How much money will you need to retire in addition to social security and qualified plans? Every situation is unique and depends upon:

- How much you save
- How much your savings earn
- How much you plan to spend during retirement
- How long you expect to live

According to U.S. Census figures, individuals that retire at age 65 can expect to live another 25 years which means they will need savings sufficient to generate 25 years of income during retirement.



**Assuming the real returns shown in the table below are available from U.S. Treasury inflation-indexed securities, the table illustrates how much your needed savings can change. It is important that you discuss your needs with your financial advisor in order to plan for your situation.**

| Real return | Years of retirement | Savings needed to produce \$1.00 of retirement income | Total savings needed for an annual income of: |             |             |
|-------------|---------------------|---|---|-------------|-------------|
|             |                     |   | \$50,000                                      | \$75,000    | \$100,000   |
| 2%          | 25                  | \$19.52   | \$976,173                                     | \$1,464,259 | \$1,952,346 |
| 4%          | 25                  | \$15.62   | \$781,104                                     | \$1,171,656 | \$1,562,208 |
| 6%          | 25                  | \$12.78   | \$639,168                                     | \$958,752   | \$1,278,336 |
| 8%          | 25                  | \$10.67   | \$533,739                                     | \$800,608   | \$1,067,478 |



# Saving for Retirement Using Life Insurance

Saving for retirement using life insurance offers a number of important advantages. First and foremost, cash values accumulate and grow tax-deferred. When properly structured, these values can also be withdrawn on a tax-free basis. In addition, death benefits are generally paid to named beneficiaries income tax-free. However, there are some disadvantages to keep in mind. First, premiums must be paid annually to keep the policy in effect. Second, premiums are paid with after-tax dollars. Lastly, the purchase of life insurance of course creates an expense.

There is an additional benefit that distinguishes life insurance from all other financial vehicles: with a single premium, life insurance protects what we value most - our families and our businesses. That's because if an insured does not live to retirement, benefits are paid to beneficiaries immediately. The reason? Life insurance pays the full face amount of the policy from the first day the policy is in force! No other product can make this promise nor offer this peace of mind and potential return.

|                                  |   |
|----------------------------------|---|
| <b>Tax-Deferred Growth</b>       | No current income tax is due on cash value growth in a life insurance policy. Indeed, life insurance offers one of the few opportunities – outside of qualified plans – for individuals to enjoy tax-deferred growth over a lifetime.   |
| <b>Tax-Free Withdrawals</b>      | With life insurance, tax-free income opportunities are also available through partial withdrawals. Partial withdrawals are generally not taxed until the cash value withdrawn exceeds the total amount of premiums paid and the policy lapses. If the policy never lapses, withdrawals made in excess of the premiums paid are not taxed. Of course, withdrawals reduce the death benefit and the cash available to pay for the costs of insurance. |
| <b>Tax-Free Loans</b>            | Generally, loans are not taxable. However, if the policy lapses and the amount loaned exceeds the premiums paid, a tax liability may exist. Loans are subject to interest charges and they reduce the death benefit paid to beneficiaries. It's important to note that loans may affect both the policy's death benefit and its account value and may affect the length of time the policy remains in force.  |
| <b>Flexibility</b>               | Unlike qualified plans, life insurance distributions can be made prior to age 59½ without IRS penalty.  |
| <b>No Required Distributions</b> | Unlike an IRA, life insurance cash values are not subject to required minimum distributions at age 72.  |

# 4 Succession Plans

## Every Business Needs One



We have discussed the financial problems that can result if a key employee dies. Now let's consider what happens when a business owner dies. In every situation, a succession plan is needed to assure that heirs, co-owners, and employees are protected.

The first step when thinking about a succession plan is to be assured of competent successor management. No succession plan can be successful without competent executives to manage, market, and run the business.

## Different Succession Plans for Different Scenarios

### The Business Has Multiple Owners

When one owner dies, what happens to the co-owners' shares of the business? What happens to the deceased owner's family, who count on income from the business? Could a spouse or children step into the business? Would you want to own and operate your business with your deceased partner's spouse and children?

**Solution:** Arrange for the surviving owners to buy the deceased owner's share. This provides: (1) the surviving family members working in the business with control of the business, and (2) a spouse or children who are not working in the business, with a fair price for their share of the business interest.

## There Are Family Members to Take Over the Business

When an owner wants a spouse or a child to take control of the company, plans need to be made to assure that other members of the immediate family (who do not work in the business) receive cash instead of partial ownership. A succession plan assures that this will happen. A succession plan designates which family member(s) will receive full control in the form of ownership, while non-participating family members receive their inheritance in cash.

**Solution:** One of the best solutions is a buy-out. The company or the family member who participates in the business buys the deceased owner's share from the heirs. This provides the surviving buyer(s) with control of the business, and the deceased owner's heirs with a fair price for the business interest.

## There Is a Loyal, Non-Owner Employee to Take Over the Business

It is not uncommon for a business owner to groom a replacement—someone capable of stepping in and running the business. A succession plan can assure that (1) this employee has the right to buy the business, and (2) the money is available to make the purchase.

**Solution:** When a qualified and motivated non-owner successor is available, a succession plan can protect assets, assure the continued operation of the business, and provide heirs with immediate cash in return for a business interest. This benefits all the parties—competent successor managers, family members, and employees.





# 4 Succession Plans continued

## Buy-Sell Agreements

One of the best solutions for succession planning is to create a Buy-Sell Agreement whenever there are co-owners, capable heirs, or a motivated, qualified employee ready to step in. A succession plan can be arranged to accomplish these important goals:

- Ensure control of the business passes to successor(s) who will buy out the deceased owner's share
- Provide fairly, adequately, and promptly for the deceased's family members
- Assure crucial business resources are not used to buy out the deceased owner's share
- Provide a fair, objective means to value the business
- Prevent legal entanglements, delays, and ill-will between family members

The agreement is a legally binding contract drafted by an attorney which can be as simple or as complex as needed, and can be custom-tailored to meet each individual situation, no matter how unique. Generally, agreements call for the survivors to buy the deceased owner's share in the business at an agreed-upon price, or at the fair market value of the business interest when the owner dies. However, it takes money to make a Buy-Sell Agreement work. When an owner dies, the surviving owners, a key employee, or the business is legally bound to purchase the deceased owner's

share. This will generally require that a significant amount of money be available in a short period of time which is why funding should be discussed.

### Funding with Life Insurance

Historically, life insurance has proven to be an effective buy-sell funding choice. The benefits of cash value life insurance as a buy-sell funding vehicle are numerous:

- The proceeds can be delivered tax-free. Knowing the funding will be there provides peace of mind for all parties and it assures that the agreement can be executed to the benefit of everyone.
- The cost can be minimal compared to other methods. The policy owner buys future funds with discounted dollars in the form of scheduled premium payments.
- Cash values accumulate and grow on a tax-advantaged basis. Should all parties live to retirement, these cash values can be used tax-free (through loans and withdrawals) to buy out a retiring owner.

### Disadvantages

- Loans can have an adverse effect on the policy cash value and death benefit
- Premiums must be paid annually to keep the policy in effect



## Example: A Fully-Funded Buy-Sell Agreement in Action

Twenty-eight years ago, Joe Pollack, John Matthews, and Jim Lucus bought an old farm near a gravel pit on the far outskirts of town. They incorporated and began an asphalt paving business as equal shareholders with 100 shares each. Their corporation flourished, and soon had a fair market value of \$3,000,000. When Joe died suddenly, there were concerns about the future of the business. Fortunately, they had a Buy-Sell Agreement funded by life insurance.

Each of the owners had purchased and owned a \$500,000 life insurance policy on the other two partners to fund the Buy-Sell Agreement.

When Joe died, John and Jim each received \$500,000 as the beneficiaries of the life insurance policies they owned on Joe's life. They each used their \$500,000 death benefit payment to each purchase half of Joe's 100 shares from Joe's family. Jim and John continued the business as equal co-owners, both now owning 150 shares.

See American National's Buy-Sell Agreement brochure (10562) for more information.

# 5 Estate Planning

If you are like most privately-held business owners, your business is the largest single asset in your estate. That is only one reason why estate planning, with all of its challenges and opportunities, should be a primary planning priority. If you want your business to go on after you are gone, proper planning is necessary. See American National's Estate Planning Strategies Brochure (10290) for more information.

**There are four important opportunities estate planning offers estate owners beyond transferring assets and implementing appropriate tax planning strategies.**

|   |  |
|---|--|
| <b>Avoid Conflicts</b>                              | Inevitably, the death of a closely-held business owner presents multiple opportunities for conflict. If there are children in the business, they need direction as to who will take over. Children outside the business may want to get their inheritance now and not simply an interest in a closely-held company that does not pay them a dividend. Having an estate plan and updating it regularly can avoid conflicts. |
| <b>Reduce Delays</b>                                | Estate planning provides executors and administrators with a blueprint of the estate owners wishes. It also assures that property which passes to heirs by contract or by law does so quickly and without delay.   |
| <b>Shrink Expenses</b>                              | Clear directives from the estate owner can guarantee efficient estate transfer. Efficient asset transfer minimizes expenses and estate taxes, ensures estate conservation, and provides for an orderly distribution of assets.   |
| <b>Provide Ready Cash to Pay Estate Obligations</b> | In addition to providing for the orderly disposition of assets, comprehensive estate planning strategies should also make certain that the executor has ready cash to pay estate obligations promptly, including final expenses, estate transfer taxes and administration costs, along with all of the costs associated with transferring a business interest.   |





## Estate Tax Depletion: A need for liquidity

A typical estate faces four major sources of depletion:

### **Probate costs**

Court costs, attorneys' fees, and executors' commissions can amount to 8% or 9% of a typical estate valued at \$100,000 or less, and may average 4% or 5% of a \$1,000,000 estate. If the estate is complex or ambiguous, costs can be substantially higher.

### **Inheritance tax**

For highly-valued estates, the inheritance tax can be a major source of depletion.

### **Estate tax**

Several states levy a estate tax on property passing from a decedent. The severity and nature of estate taxes vary from state to state.

### **Sacrifice sales**

Debt, taxes, and probate costs must be paid soon after death and they must be paid in cash. If an estate lacks the liquidity to pay these costs (and to provide for the support of the decedent's family), it may be necessary to sell property at a discounted price.

## The Role of Life Insurance

Life insurance can help provide liquidity by assuring that the estate has sufficient cash to satisfy creditor claims, pay taxes, and settle all of the additional expenses associated with transferring estate assets to heirs.

When an estate owner dies, expenses must be paid promptly and in cash. The estate liquidity crunch that may result can pose serious problems for executors. With life insurance, estate owners are assured that their wealth will not shrink dramatically because they avoid having to sell estate assets at severely reduced prices in order to pay estate taxes that come due nine months after the estate owner's death. Life insurance can help assure that assets can be held or disposed of in a careful, orderly, and timely fashion.

Additionally, when a closely-held business is involved, the need to pay estate taxes could force a partial or full sale of the business the owner has worked so hard to build. Life insurance can be used to:

- Pay estate and inheritance taxes
- Provide an inheritance to children not working in the business
- Provide working capital until the company can overcome the loss of the owner



# What is the next step?

Does life insurance have a role to play in your business? That's something only you can decide. There are many details to consider.

Perhaps the best place to start is to discuss your specific situation and needs with your financial advisor. Together, you can decide what the next step should be.

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