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Succession planning using retirement plans

Owner–employees may benefit from deferred payment arrangements

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March 2015

Owners of successful closely held businesses may find themselves in a unique position when they are ready to exit the business. The past success of the business tends to reduce the number of potential buyers that can afford to purchase the business. This is particularly true with proposed management buyouts.

While this does not seem like a bad problem to have, it may require some foresight to plan an exit strategy. This third article in a series on the use of compensatory devices in succession planning explores the role retirement plans can play in such a strategy.

Use of retirement plans

The tax system in the United States currently allows employees and employers to set aside current earnings in retirement accounts and to not pay tax on those amounts until the employee receives a distribution from the account. While some individual savings plans fall under this umbrella, this article focuses on plans sponsored by employers. Many businesses sponsor retirement plans and contribute money to them on behalf of employees to provide additional remuneration for employees' services.

While in most cases a business offers retirement plans to benefit employees directly, retirement plans can serve another purpose in the context of succession planning. Because a retirement plan creates a vehicle to which the company can transfer assets (most commonly cash) that then become

assets of the plan and its beneficiaries (i.e., the employees) rather than the company, the overall value inside the company is reduced. By reducing business value, retirement plans may help alleviate the issue of finding potential buyers that can afford to purchase the business. Obviously, a company could find a number of ways to spend cash, but not all will offer this opportunity to reduce company value at the same time. For example, a company could use the money to purchase new equipment instead. However, because the purchased equipment would be an asset to the company, it most likely would not reduce the purchase price of the company.

Many closely held business owners actively provide services to the businesses they own, and the use of retirement plans makes the most sense in these cases, because the owner can be a direct beneficiary of the retirement plan. Therefore, an asset that is removed from the business via a transfer to the plan will still be an asset to that owner; it is merely in a different form and most likely transferred without current taxation. On one hand, the owner receives a lower purchase price currently for the business equity, but on the other hand, the owner may be able to sell the business sooner and defer tax on the portion of the value that was set aside in the retirement plan.

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As with many other business decisions, an analysis of whether to implement a retirement plan will need to weigh other factors as well. For example, any distributions the former owner ultimately receives from the retirement plan will be taxed as ordinary income, while gain on the sale of the business will generally be taxed at capital gains rates. The projected tax difference will have to be weighed against the benefit of deferring the tax and optimally positioning the company for sale.

Types of retirement plans

An employee stock ownership plan (ESOP), a type of retirement plan, owns stock in the employer. Thus, transfers to an ESOP reduce value, but also result in company ownership shifts. See the second article in this series, Succession planning using employee stock ownership plans. In contrast, the retirement plans discussed in this article transfer value from the company without changing the ownership of the company.

Defined benefit plans. A defined benefit plan promises a specific benefit amount to the beneficiary upon future distribution, which means that the employer has to monitor and vary its level of contributions in order to meet that fixed, future obligation. The most familiar defined benefit plan is a fixed pension. These plans follow the qualified plan requirements provided in the Internal Revenue Code, which include eligibility, vesting, distribution and nondiscrimination parameters. If all requirements are met, the employer's contribution to the plan is a current deduction for tax purposes, and the income is not taxable to the employees until distributed in the future.

Because of the difficulty and cost associated with managing to meet that future fixed benefit, defined benefit plans have fallen out of favor with most middle-market employers. Nonetheless, such plans can be valuable and should not be overlooked, particularly by companies that are on the smaller end of the middle market. Under current law, contributions to cash balance and other defined benefit plans can exceed $200,000 per year for individuals over age 60. In certain fact patterns, an actuary can design a plan that: benefits the company's senior ownership, excludes the next generation of highly compensated employees, still meets all coverage requirements, and keeps plan funding levels manageable.

For example, a business owner over age 70 may be able to use a combination of a defined benefit plan and a 401(k) plan to accumulate a retirement benefit well in excess of $1 million over the course of five or six years. Putting the money into these plans reduces the value of the company for the purposes of an ultimate sale to younger family and nonfamily management team members. At the same time, that value still inures to the benefit of the owner through the plan, rather than through the sale price of the company.

Defined contribution plans. As the name suggests, defined contribution plans promise a specific level of current employer contribution, rather than a defined future benefit level. Removing the promise of the future value places the risk on the employee, rather than the employer, and also makes the plan much easier and less costly to manage for the employer. Similar to defined benefit plans, defined contribution plans are generally tax-qualified plans subject to specific coverage and operations requirements. However, defined contribution plans generally have lower limitations than defined benefit plans on the amount that an employer can contribute.

Defined contribution plans may be structured as money purchase pension plans or profit-sharing plans. The main difference between these two classifications is that contributions under a money purchase pension plan are made according to a fixed formula, whereas contributions in a profit-sharing plan are generally discretionary, although they may use a formula that incorporates employer profits, and thus, can provide the employer more flexibility. Regulations require profit-sharing contributions to be "substantial and recurring" in order for the plan to retain its tax-qualified status, but a large amount of discretion is retained. Because the hybrid nature of money purchase pension plans results in larger administrative burdens that are very rarely, if ever, outweighed by any additional benefit, profit-sharing plans are much more common.

In typical defined contribution plans, once the amount of the employer contribution is determined, the contributions are allocated to employees based upon each individual employee's eligible compensation relative to the eligible compensation of all participants. However, generally, it is not mandatory to use relative compensation to allocate contributions. An employer can use a target benefit or other nonuniform method to allocate employer contributions. These nonuniform approaches can take into consideration, among other things, an employee's age, position within the company, years of service, or compensation in excess of the Social Security wage base or different variations and combinations of these factors. However, the ability to use a nonuniform contribution formula will depend on the composition

of the workforce. If the workforce has a high average age, it may not change the contribution by employee significantly.

A profit-sharing plan can also include a 401(k) feature that allows employees to direct a portion of their money into the plan in addition to receiving discretionary employer contributions. With such a plan, an employer often makes its contribution a matching contribution up to a certain percentage of the employee's contribution. Using this matching formula, the employer can incentivize employees to save their own money, which increases the employee's eventual retirement benefit. In addition, using a matching formula may encourage non-highly compensated employees who might otherwise choose not to participate in the plan to participate, which lets highly compensated employees contribute more to the plan, while still having the plan meet nondiscrimination testing rules covering employer contributions.

For example, in a 401(k) plan with an employer contribution, employers may match an employee's contribution 100 percent up to 3 percent of an employee's compensation. While the 3 percent of compensation would apply to all employees, there is a maximum amount of compensation that can be considered for these calculations. Therefore, employees earning over the maximum would receive an employer contribution of less than 3 percent of their total compensation.

Nonqualified retirement plans. While defined benefit and defined contribution plans are tax-qualified plans, a number of other nonqualified options exist that do not meet the rigorous qualification requirements. While nonqualified sounds unfavorable, it merely means the employer does not get a current tax deduction. Instead, the employer generally receives a deduction in the year when the employee reports the income. In turn, such plans do not have to follow the strict rules related to eligibility, vesting, nondiscrimination, etc.

Therefore, nonqualified plans provide the employer greater flexibility, and the plans can take a number of forms. For example, an employer could create a nonqualified arrangement that mirrors a defined contribution plan, allowing contributions to exceed the limitations that exist for qualified plans. Another example would be a compensation arrangement that ties vesting to certain performance goals or other milestones that differ from the standard qualified plan vesting options, which are based solely on years of service. In addition, nonqualified plans can be used only for key executives, whereas qualified plans generally cannot favor highly paid employees because of nondiscrimination provisions.

It should be noted that while the tax qualification requirements do not apply to nonqualified plans, another set of rules set forth in section 409A do apply and provide some amount of structure. These rules were adopted following some of the collapses similar to Enron in which company executives drained a lot of money out of the company through compensation to themselves immediately before the company went bankrupt. The section 409A rules require the plans to be written and restrict the ability to change payment schedules or to defer or accelerate payments, among other requirements. However, these rules do not govern which employees must be given benefits or the amount of those benefits.

Compared to qualified plans, where the plan itself is actually a trust for legal purposes with the employees as beneficiaries, nonqualified plans are not as protected. Qualified plans are provided special treatment that essentially allows the asset (i.e., the employer contribution) to be transferred to employees currently, while the tax on the income is deferred. If the qualified plan requirements are not met, this special treatment is not available, and the employees would generally be taxed currently on any money set aside for their benefit. Therefore, employers typically do not actually segregate funds into accounts maintained for employees for a nonqualified plan. Even though the asset is not transferred in a nonqualified plan, the company has created a liability to pay the amounts in the future and company value is still reduced, which is the goal.

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A rabbi trust is a unique type of trust that allows the employer to set money aside to fund a nonqualified plan without currently subjecting the employees to income tax on the amount set aside. While the trust remains an asset of the company, the terms of the trust prevent the employer from having control over the money, providing employees with more protection from events that might cause the company to be unable to meet the future obligation. Because the trust remains subject to creditor claims, employees still escape current taxation. The IRS has supplied a model rabbi trust agreement, and if that model is followed, the employees will not be taxed currently.

A rabbi trust provides minority owner employees with "change of heart" protection. In the context of ownership transition, this protection may also be valuable since a portion of the proceeds will be paid over time in future years, rather than with the sale proceeds from the business sale.

It is important to note the effect that the lack of a current employer deduction has if the business is taxed as a partnership or S corporation, and the owners pay the current tax liability from the business operations. The nonqualified plan is a true liability that reduces enterprise value, but the liability is not deductible for tax purposes until it is paid in the future. Therefore, the owners do not effectively defer tax the same way as with a qualified plan, which allows a current tax deduction.

This concept is best understood with an example. Imagine an S corporation owner enters an agreement to receive $100,000 per year for 10 years, beginning five years from now. The business has a real obligation to pay $1 million, which should reduce the value that a buyer will pay for the company. Assuming a rabbi trust is used or that the plan is unfunded, the owner will report the $100,000 payments as income in each of the future years as received. But, the S corporation will not receive a deduction for the payments until those future years, when, presumably, that owner is no longer an owner. Therefore, the owner does not benefit from the tax deduction

and effectively pays tax on his or her share of the $1 million when the current S corporation income is reported on his or her current income tax return. Alternatively, if the S corporation received a current deduction under a qualified plan, the owner would benefit from the deduction now and report the income in the future years.

Even though the same tax shift is not achieved with a nonqualified plan, the liability associated with a nonqualified plan could still help facilitate a sale through the reduction of enterprise value. And the flexibility available with nonqualified plans is still an important factor to consider. Owners simply need to understand the tax treatment differs between the two types of plans.

Choosing a retirement plan

Typically, employers implementing retirement plans early in the life of a business choose a plan that positions the employer to be competitive in attracting employees, while also balancing the employer's financial situation and not overpromising benefits that cannot be funded. On the other hand, implementing a retirement plan to bolster succession planning might look quite different. In this case, the employer is likely less concerned about being able to make contributions that are stipulated in the plan and more concerned about transferring value out of the company to benefit owners. As discussed above, owners can receive additional benefit from implementing retirement plans if they are also employees who can be plan beneficiaries. Even in the event the owners are not employees or a qualified plan is used (which requires nondiscrimination in allocating contributions between employees), the owners' goals may still be met. Many entrepreneurs of closely held businesses have a good relationship with their workforce and are interested in transferring additional benefits to employees before they transition out of ownership.

Overall, there are many factors to consider when analyzing retirement plans for succession planning purposes. Who should receive the future benefit, and how much value should be transferred through these plans? Does the owner want to transfer as much value as possible to himself or herself? If this is the case, a nonqualified plan will likely need to be used to ensure the nondiscrimination requirements are not violated. Is the owner only interested in reducing the value of the business to help it attract more buyers? If this is the goal, maybe a qualified plan that benefits all employees is the best option. In most cases, a company will likely offer a combination of retirement plan options. A qualified service provider can help a business owner weigh the various options and calculate how much could be transferred and to whom in a given type of plan.

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As compared to ESOPs, the retirement plans described in this article will generally need to be effective for a longer period of time prior to an owner's exit from the business. Although an ESOP transaction can be structured to slowly purchase the business, it also provides the option to purchase 100 percent at once. Alternatively, transferring value out of the company through other types of retirement plans will almost certainly need to take place over a number of years. Nonetheless, retirement plans can offer unique opportunities in a succession plan, and planning well in advance of an intended exit is important.

Conclusion

Retirement plans require professional oversight and should not be entered into lightly. Qualified plans must follow fiduciary guidelines in addition to tax rules, and nonqualified plans need careful attention paid to plan documents and operations to ensure the employee does not have to pay tax on the income prior to receiving it. However, if the rules are appreciated, retirement plans can be a valuable tool in succession planning by allowing business owners to set aside money for future use, while reducing value in the company to facilitate a sale of the business.

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