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Utilizing a Defined Benefit Plan in Business Transitions

If you have been reading our newsletters, you already know how great defined benefit (DB) plans can be for small businesses (if you need a refresher you can visit our Pension Trends Archive page in the Resources section of our website). What you may not be familiar with is how DB plans can be part of a business transition strategy.

Many small business owners think of their business as a retirement "plan". When the time comes, they hope to sell the business and retire on the proceeds. Why not use an actual qualified retirement plan with all the associated tax benefits to achieve this goal?

How might this work? Let's look at a few scenarios:

Asset Sale:

Here a business owner sells the assets of the company to an outside buyer and retains ownership of the original company (note that the buyer can use the original business name as a dba to take advantage of client recognition and goodwill). Employees go with the "new" company, and the "original" company then sets up a DB plan with the owner as its sole participant. The original company can make fully deductible pension contributions equal to all or part of the sale proceeds. This can work if there is a one-time payment or if payments are made in installments.

Stock Sale to Internal Buyer:

Here a business owner wants to sell the stock of the company to a current employee or family member. Instead of having the buyer purchase stock directly, a DB plan is set up to provide a certain level of benefit to the owner upon retirement. The contributions are tax deductible, which is beneficial to the buyer, and the proceeds are tax deferred, which is beneficial to the seller. Under this scenario, the original owner would need to remain an employee for a period of time, so this is a strategy that is best implemented several years before the owner wishes to fully walk away from the business. There will also be nondiscrimination issues to consider with respect to benefits for non-owner employees.

Stock Sale to External Buyer:

Under this scenario, the seller would need to "start over" with a new company and receive a salary or other earned income from this new company in order to set up a DB plan. Often sale agreements include a period of consulting payments which can be used as earned income, with the remaining proceeds as pension contributions.

Because of the tax advantages of using a DB plan in a business transition, a sale can be more affordable (and therefore more feasible than it would otherwise be, especially with an internal stock sale).

If you or any of your clients are thinking of selling a business, consider adding a DB plan as part of the transition strategy. There is no charge for preliminary consulting or an initial feasibility study, so give one of our consultants a call to see if this might work for you. The slides from a recent presentation on this subject are available on our website at IndependentActuaries.com/Presentations.

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Author Profile:

This article was written by Karen Dunn, EA, QPA, MSPA. Karen is an IAI owner and consultant. She specializes in actuarial valuation services for large and small defined benefit plans including multiple-employer plans, defined benefit plan design and plan terminations.

INDEPENDENT ACTUARIES, INC.

4500 Kruse Way, Suite 200
Lake Oswego, OR 97035
Phone: 503.520.0848
Fax: 503.520.1147
IndependentActuaries.com

email:
info@indact.com