Utilizing a DB Plan in Business Transitions

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About IAI

Independent Actuaries, Inc. (IAI)

- IAI is the largest independently-owned actuarial consulting firm in the Pacific Northwest. We provide customized retirement plan design, valuation, administrative and consulting services to a wide array of clients, including small business owners, large corporations, and public sector employers.
- We have 12 professional credentialed consultants on staff, including 9 credentialed actuaries.
- We specialize in defined benefit plans (both pension and retiree medical) and the majority of our clients are small businesses.
- For additional information and resources, visit our website at:

www.independentactuaries.com

Why Underutilized?

- Bad press.
- Not well understood (so mistrusted).
- Hard to find actuarial firms that specialize in small businesses.
- Lack of quality ongoing consulting.

Agenda for This Session

- A general overview of DB vs DC plans
- How a DB plan can be utilized in the sale of a business
  - Asset sale
  - Stock sale
- Identifying the best candidates for this strategy
- Case studies
- Discussion and questions

Defined Contribution vs. Defined Benefit Plans

- Defined Contribution plans (401k, profit sharing, money purchase, SEP, SIMPLE)
  - The contribution is the defined element
    - E.g. – Employer contributes 5% of pay for participants each year
  - Amount of savings at retirement is uncertain: depends on investment return and annual contributions
  - Contributions are subject to maximum limits
  - Investment risk borne by employee

Defined Contribution vs. Defined Benefit Plans

- Defined Benefit plans (DB, pension, Cash Balance, Floor Offset)
  - The benefit at retirement is the defined element
    - e.g., a lifetime annuity equal to 5% times average compensation for each year of benefit service beginning at age 62
  - Benefits are subject to maximum limits
  - Maximum benefit payable between ages 62 and 65 is a lump sum of about $2.6 million
    - Expressed as annual annuity of $215,000 (in 2017)
    - Smaller at earlier ages, larger at later ages
    - Further limited to highest 3 consecutive year average compensation
    - Phased in over ten years of participation

Defined Contribution vs. Defined Benefit Plans

- Defined <u>Benefit</u> plans (continued)
  - Annual contributions needed to fund the benefit are uncertain (determined annually by the actuary)
  - The closer to retirement, the larger the contribution
  - Contribution range:
    - Minimum required contributions
    - Maximum deductible contributions
  - Investment risk borne by the employer

Defined Contribution vs. Defined Benefit Plans

Defined Contribution (DC) Plans

- **Advantages**
  - Appreciated by employees
  - Easy to understand
  - Extremely flexible
  - Discretionary contributions
- **Disadvantages**
  - Low contributions make it difficult to build sufficient retirement plan assets
  - Lower deductible contribution limits
  - Need high current compensation to maximize contribution

Defined Benefit (DB) Plans

- **Advantages**
  - Substantially higher contribution limits
  - Greater assurance of achieving retirement goal
  - Generally higher benefits for owners relative to rank and file employees
  - Wide range of allowable contribution provides some flexibility
  - Current salary not necessary
- **Disadvantages**
  - Minimum employer contributions required
  - More complex

DB Plans Work Best for:

- The business owner who:
  - wants larger tax deductions,
  - wants to "catch up" their retirement savings,
  - is over age 45,
  - has historical compensation in the six figure range,
  - has no employees or the employees are younger and lower paid than the owner.

Utilizing a DB Plan in a Business Asset Sale

- Owner retains “old” company
- Sells assets to “new” company
- Employees go with new company
- Works best if sale proceeds are made in installments

Utilizing a DB Plan in an Business Asset Sale

- Old company retains existing DB plan or sets up a new one
- Sale proceeds are all or partially deducted as pension plan contributions
- May be able to “front load” the contributions, but may require the plan continue for a period with no contributions

Case Study #1

- Joe Owner owns an S corp.
- Joe is the only employee
- He is age 54 in 2015
- His compensation is $200,000 / year
- He has had a DC plan and has been making the maximum contributions

Case Study #1

- In 2015 he sets up a DB plan
- In 2018 he sells the business (asset sale) for annual payments of $250,000 for three years
- In 2022 he terminates the plan and rolls a lump sum benefit of approximately $2,000,000 into an IRA
- Annual contribution amounts are summarized on the next page

Case Study #1

	Year	Compensation	Plan Contribution
DC Plan	2012	200,000	49,000
	2013	200,000	50,000
	2014	200,000	50,000
DB Plan	2015	50,000	250,000
	2016	50,000	250,000
	2017	50,000	250,000
Sale	2018	0	250,000
	2019	0	250,000
	2020	0	250,000
	2021	0	0-?
	2022	0	0-?

Utilizing a DB Plan in a Business Stock Sale

- Works best when the sale is to family member(s) or current employee(s)
- Usually a longer term strategy – owner is generally still working when process is started
- DB is set up primarily to benefit owner with minimal benefits to other employees

Utilizing a DB Plan in a Business Stock Sale

- A benefit with a lump sum value equivalent to all or part of the sale price is provided as retirement income
- Allows buyer to purchase company with tax-deductible contributions
- Owner receives sale proceeds as tax deferred income

Utilizing a DB Plan in a Business Stock Sale

- Putting proceeds from a sale into a DB plan may provide protection from creditors that would not otherwise be available

- Consider the fact that some sale proceeds are taxed at capital gains rates and retirement income is taxed at ordinary income rates

Case Study #2

	No DB Plan	With DB Plan	Comparison
Value of business	$1,500,000	$1,500,000	
Cost to Buyer			
Cash Down Payment	$500,000	$500,000	
PV of after-tax principal payments over 10 years	$1,000,000		
PV of tax-deductible Pension Payments		$1,000,000	
	$1,500,000	$1,500,000	
Annual P&I payment at 5.5% interest	$126,000		
Annual pension contribution over 10 years		$126,000	
Deductible amount @ 50%	-$13,000	-$63,000	
Average annual after-tax cost @ 50%	$113,000	$63,000	
Total cost to buyer over 10 years	$1,130,000	$630,000	($500,000)
Proceeds to Seller			
Down payment at capital gains tax @ 30%	$350,000	$350,000	
After-tax sale proceeds - Interest @ 50%	$130,000		
After-tax sale Proceeds - principal @ 30%	$700,000		
Accumulated value of proceeds at 5.5% @ 30%	$198,000		
Single sum value of pension benefit (rolled into an IRA)		$1,712,000	
Total proceeds a*vailable* to Seller at end of 10 years	$1,378,000	$2,062,000	$684,000
Single sum value of pension benefit (paid directly to seller @ 50%)		$856,000	
Total After-tax Proceeds to Seller	$1,378,000	$1,206,000	($172,000)

Stock Sale with Outside Buyer

- Can work with outside buyer, but is more complex:
  - Seller sets up a separate business (consulting?)
  - Avoid Controlled Group or Affiliated Service Group relationships
  - Need some service and salary in the new business
  - Sale proceeds are paid to new business
  - Especially important to get good legal and tax advice in this situation

Comments, Caveats and Cautions

- There are many things that go into setting up a DB plan for a business sale. It is important that all legal and tax as well as actuarial issues are considered. The actuary setting up the plan will want to consult with the business' attorney and CPA as well as the plan sponsor to make sure all bases are covered.

- The case studies shown in this presentation are for illustration and discussion purposes only. In the interest of clarity, they have been simplified and generalized and do not necessarily represent any real-life situations.

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