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retirement plans redefined

April, 2009

USING TAX QUALIFED RETIREMENT PLANS FOR FAMILY BUSINESS SUCCESSION PLANS

Introduction – Succession planning in closely held, family-owned business continue to present challenges to tax, financial and personal advisors. There is no single, easy answer. This article explores the design and use of sophisticated, tax-qualified retirement plans as one piece of the solution, and does not deal with the other critical aspects of family business succession planning, including (but not limited to) buy/sell agreements, life insurance funding, etc. These areas of expertise are separate and distinct from the skill set required in connection with the tax qualified plan piece of the family business succession planning puzzle.

One of the challenges in family business succession planning is the ability of the members of the older generation to maintain their standard of living after control of the business (and a significant portion of their compensation) shifts to the younger generation. Unless proper advance planning has occurred, there frequently will not be enough money to satisfy the needs of both generations. This pattern often creates conflict between the founder or current business leader and the success(s), preventing a comfortable and effective transition form parents to children. The accumulation of funds for parents in a well-designed, tax qualified retirement plan will go a long way to removing these obstacles, thereby relieving inter-generational tension and facilitating the smooth transfer of the business.

Objective – While tax qualified retirement plans may be established for different reasons, the objective of this type of qualified retirement plan program is the accumulation of substantial funds to provide retirement security for those owners who will be phasing out of the family business.

Prerequisites – There are three prerequisites to the effective use of qualified retirement plans in family-owned business succession planning:

(1) **Depth of Knowledge** – The most successful tax qualified retirement plan designs require a depth of knowledge of the applicable Internal Revenue Code provisions include in and supporting IRS regulations. The laws governing tax qualified plan designs are difficult to navigate, and because of family attribution rules and nondiscrimination requirements, their application to family-owned businesses is particularly challenging.

(2) **Flexible Plan Design** – Since tax qualified retirement plans are subject both to legal requirements and to the specific provisions included in the plan document, the plan documentation not only must adhere to the law and meet the contribution objectives of the business (as discussed below), but also must allow for the greatest level of flexibility to implement and operate the plan as circumstances (such as employee demographics and tax law) may change.

(3) **Collaborative Consulting** – The effective use of a tax-qualified retirement plan as part of family business succession planning requires coordination with other aspects of the succession plan. This can be accomplished only with effect communication and collaboration among all advisors, including corporate/business attorney, financial advisor and accountant. Challenging human issues may necessitate the involvement of business consultants specializing in the dynamics unique to family owned businesses.

Legal Requirements – One of the fundamental legal requirements for tax qualified retirement plans is that they may not discriminate in favor of highly compensated employees. Implicit in this principal are two corollaries:

- Tax qualified plans may discriminate against highly compensated employees.

- Tax qualified plans may discriminate in favor of non-highly compensated employees.

Theses corollaries may be exploited to the advantage of the older generation. Because all immediate family members are deemed to be highly compensated (regardless of their level of compensation), additional contributions may be made in favor of the older generation by "discriminating" in the level of contributions made to the younger generation (who will get their turn in the future). Similarly, if relatively large contributions are made in favor of a limited number of valued, non-highly compensated employees, these contributions may be used as leverage for making substantial contributions to the older family members.

By digging deep into the regulations under Internal Revenue Code Section 401(a)(4), a knowledgeable tax attorney may utilize various discrimination testing techniques that will enable a plan design to skew tax deductible company contributions in favor of the retiring owners, so that the tax on such contributions and growth within the plan will be deferred for extended periods of time. To pursue this approach, the retirement plan contribution allocation must make sense from a business and economic viewpoint. The questions that must be answered in order to design the plan include the following:

(1) **Annual Contribution** – How much money per year is the company willing and able to contribute to the plan?

(2) **Flexibility** – How much flexibility does the company need on a year-to-year basis with respect to the contribution amount?

(3) **Target Contributions** – what is the maximum percentage of the contribution that the company is willing to allocate to non-family members?

Alternative Plan Designs – The most effective retirement plan design always is based upon the answers to the three questions above.

(1) **Defined Contribution Plan** – A well-designed defined contribution plan may provide for pre-tax contributions for an owner and working spouse of up to $109,000 per year in 2009. If this type of program were in place for 10 years, and if the plan investments grew at a 6% annual rate, the accumulation amount would be $1,436,707. Even using a conservative, ten year guaranteed annuity approach; payments could be $10,982 per month, beginning at age 65.

(2) **Defined Benefit Plan** – If a company is willing and able to contribute larger amounts, contributions for an age 55 owner and working spouse may easily exceed $240,000 per year. Using the same 6% earning assumptions, the 10 year projected lump sum is $3,163,440, which may produce $24,180 of monthly payments for life, guaranteed for ten years.

(3) **Combination Benefit and Defined Contribution Plans** – While a two plan approach creates additional challenges, the implementation of such a program may result in a combined accumulation (pursuant to the above examples) in excess of $4,600,000, generating lifetime payments of more than $35,000 per month, guaranteed for 10 years.

What is the Best Choice? – The best possible qualified retirement plan design is the one that comes closest to achieving the family's goals, balancing the needs of both the founder and successor generations while taking into account the company's financial resources. This part of the business succession plan must be handled with the highest level of legal expertise, complementing the other advisors involved in the progress.

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