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Wealth planning strategies for business owners

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No bank guarantee

Areas of focus today

- Tax considerations
- Shielding assets from potential creditors
- Saving for retirement
- Planning for succession

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Tax considerations

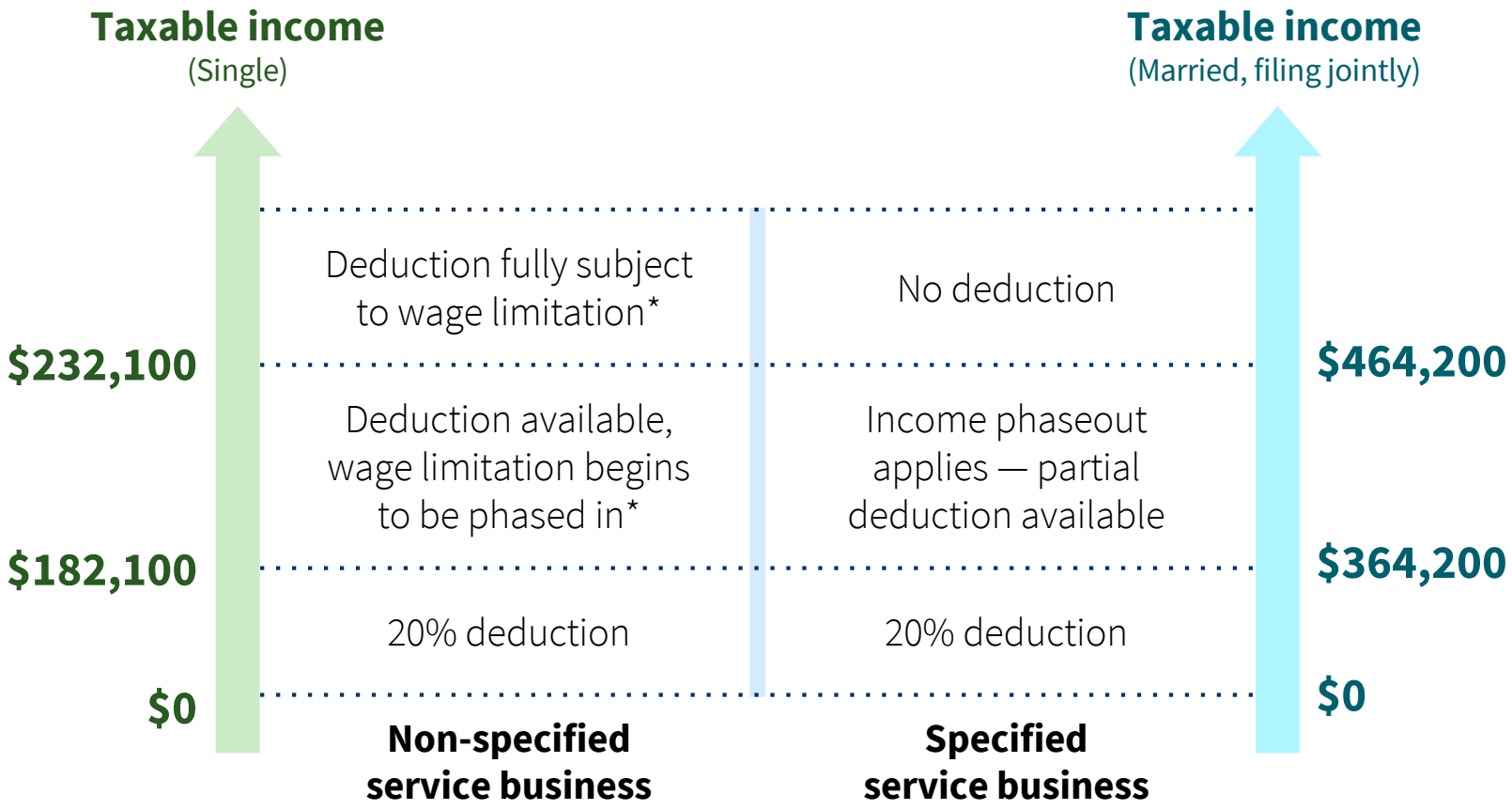
PPT019 AD2954915 6/23

Tax deduction for business owners

- Applies to businesses that are structured as pass-through entities for taxation purposes (sole proprietorship, LLC, partnership, S Corp)
- 20% on qualified business income (QBI), cannot include compensation, pre-tax retirement contributions, or investment income
- At higher income levels, specified service trade or businesses (SSTBs) are not allowed to take the deduction
  - According to the law, *"A specified service activity means any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or investing, trading, or dealing in securities, partnership interests, or commodities."*

Source: Joint Explanatory Statement of the Committee of Conference.

How the 20% QBI deduction works



* 2023 tax figures. The wage limitation refers to an alternate test that must be applied to determine the deduction for QBI (for non-specified service businesses) when taxable income exceeds $170,050 for individuals and $340,100 for couples. The alternate test is the greater of (a) 50% of total wages paid by the business or (b) 25% of wages plus 2.5% of unadjusted cost basis of qualified property.

Maximizing the deduction for QBI

Income management

- Retirement plan contributions
- Timing of invoicing and other strategies

Expense management

- Enhanced expensing under § 179
- Bonus depreciation

SALT deduction workaround strategy

- Available in 30 states including higher-taxed states such as CA, NY, and NJ
- Allows pass-through business owner/partners to elect to pay state taxes at the entity level as a means of avoiding the $10,000 deduction cap on SALT
- In almost all states (ex. CT) taxpayers need to elect to pay the state pass-through entity (PTE) tax
- Single member LLCs/partnerships and certain businesses (ex. passive business structures) may not be eligible
- Because of the disparity among different state structures and requirements, business owners should consult with their tax professional to determine if this option makes sense for their personal tax situation

IRS Notice 2020-75 provides guidance that entity level tax payments imposed by states are deductible for federal income tax purposes. Roughly 20 states impose a PTE tax, and several others are pending. While most PTE taxes are elective, the state of CT version is mandatory. In some states, single member LLCs/partnerships are not eligible for the PTE tax election. State-level PTE taxes vary widely in design, so it is important for business owners/partners to consult with a qualified tax professional regarding their personal situation.

Utilizing business operating losses to create tax-free retirement income

- Net operating losses (NOLs) may occur in a year when business deductions exceed income, resulting in negative income
- Business owners who operate as pass-through entities may be able to apply an NOL to offset other taxable income
- Unlike net capital losses (subject to a $3,000 limit), there is more flexibility to apply NOLs against ordinary income
- Business owners with losses may consider using an NOL to offset income arising from a Roth IRA conversion

Rules for calculating and utilizing NOLs are complicated and require expertise from working with a qualified tax professional. For additional information, refer to IRS publication 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts."

S-Corp to C-Corp conversion?

- Tax-related factors which may prompt business owners to consider converting their S-Corp entity to a C-Corp instead:
  - Tax proposal to apply a 3.8% surtax on net S-Corp profits for higher-income business owners
  - Expiration of the 20% QBI deduction in 2025
  - Permanency of the 21% corporate tax rate

S-Corporation
Top marginal tax rate of 37%, QBI deduction of 20% available depending on circumstances
C-Corporation
21% corporate tax rate, distributions to shareholders generally taxed as dividend income

- The decision to revoke S-Corp status and convert a business to a C-Corp is very complex and requires careful legal and tax analysis. There may be adverse tax issues associated with the conversion that could be averted by keeping the current business structure.

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Shielding assets from potential creditors

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Lawsuits are unpredictable

U.S. Chamber of Commerce, *Here are the Top 10 Most Ridiculous Lawsuits of 2017.*

Determining what's at risk

Total assets – Liabilities – Creditor-protected assets = Assets at risk

Build your protection plan

Basic components

- Insurance
- Titling assets
- Homestead exemptions
- Protecting retirement and college savings
- Life insurance and annuities

Complex techniques

- Incorporating your business
- Insulating “hot” assets such as real estate
- Equipment leasing and multiple LLCs
- Using trusts to protect your assets

This material is for informational purposes only. It should not be considered legal advice. You should consult with an attorney to determine what may be best for your individual needs.

Is your business putting personal assets at risk?

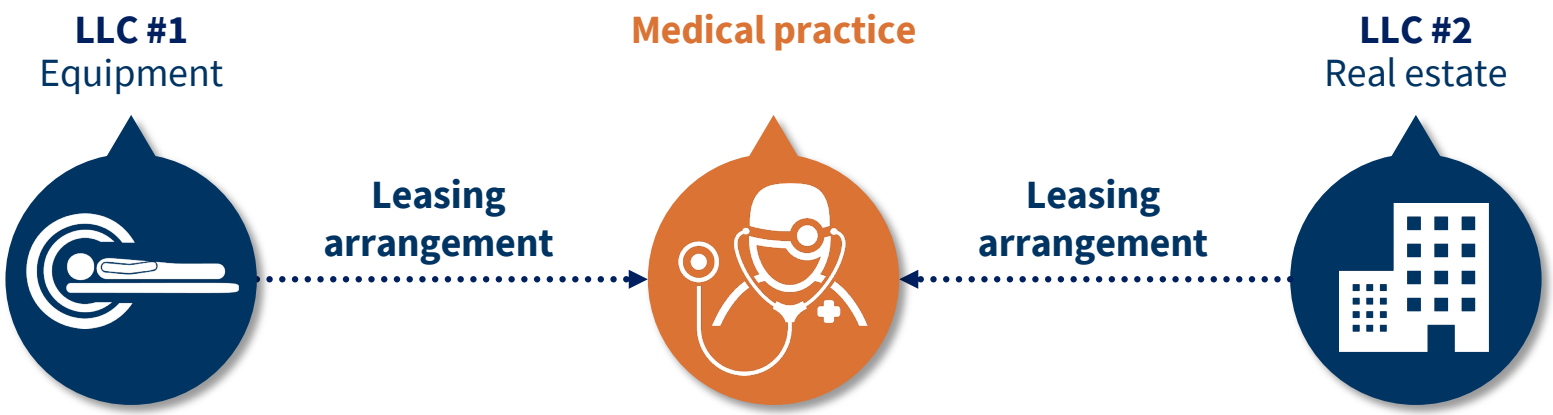
- Business owners may be at risk of legal claims by patients, customers, or employees
- Without a formal business structure, your personal assets may be at risk
- Select a method of ownership for your business to make it difficult — or expensive — for someone to access your assets

Structuring your business

Business ownership	Benefits	Considerations
Corporation (C corp or S corp)	• Business owner does not bear personal liability for debts of the corporation	• May be more complex to establish and maintain • Adverse legal judgment could result in plaintiff receiving ownership shares
LLC or LLP	• Easy to establish and maintain • Potentially better liability protection than corporations; creditor attachment may be limited to distributions, not shares of ownership — "charging order" protection	• Some states may allow creditors to attach ownership interest of LLC or LLP • Single-member LLCs may not receive same level of creditor protection

LLC case example: Private medical practice

The medical practice strips equity by establishing separate LLCs to own real estate and equipment with a leasing arrangement.



Equity in these assets is **NOT** contained in the medical practice, where it could be at risk

LLC case example: Multiple real estate holdings

LLC #1
Summer rental cottage

LLC #2
Apartment building

LLC #3
Commercial real estate

Personal assets
Primary residence, bank and investment accounts, etc.

Liability "event" affecting one property is contained from affecting other properties or personal assets

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Saving for retirement

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Start-up plan tax credit enhanced by SECURE 2.0

- 100% of administrative costs (up to $5,000 annually) for the first three years of the plan (50 employees or fewer)
  - For businesses up to 100 employees credit is still 50% of administrative costs
  - Can't both deduct the start-up costs and claim the credit for the same expenses
  - Eligible costs include start-up, administration, and education
- New credit of up to $1,000 per employee to offset employer contributions
  - 50 employees or less (credit phased out as employee count reaches 100), credit cannot be claimed if employee earns more than $100,000

Consolidated Appropriations Act, 2023, DIVISION T, SECURE Act of 2022

Retirement plan options

	SEP IRA	SIMPLE IRA	401(k)
Funding	Employer contributions only	Employer + employee contributions	Employer + employee contributions
Contribution limits	25% of compensation (20% if self-employed); subject to annual maximum of $66,000	$15,500 by employee (plus $3,500 if age 50+); employer match up to 3% or 2% non-elective contribution	$22,500 by employee (plus $7,500 if age 50+); employer can provide match and/or profit-sharing contributions (overall maximum of $66,000 not including catch-up)
Benefits	Very low cost and easy to maintain; employer can decide whether to fund contribution	Simple, low-cost plan that may be appropriate for a business looking to offer a plan for the first time	Wider range of features (e.g., loans) and ability to customize plan design to meet specific needs
Drawbacks	Lack of features, may have to include part-time employees	Cannot contribute as much as a 401(k) plan, not customizable	More costly and complex to maintain

Figures based on 2023 IRS contribution limits.

A customized profit sharing design can direct more contributions to owners

		Traditional profit sharing			New comparability plan		
	Annual salary	Allocation	% of salary	% of contribution	Allocation	% of salary	% of contribution
Owner, age 55	$225,000	$45,000	20%	**56.25%**	$45,000	20%	**83.72%**
Employee, age 35	$80,000	$16,000	20%	20.00%	$4,000	5%	7.44%
Employee, age 32	$60,000	$12,000	20%	15.00%	$3,000	5%	5.58%
Employee, age 28	$35,000	$7,000	20%	8.75%	$1,750	5%	3.26%
Total contribution		**$80,000**			**$53,750**		

Accelerate contributions with a cash balance plan

- Best for highly profitable businesses where owners wish to maximize retirement savings
- "Hybrid" plan — combines features of DB and DC plans
  - Employer funds retirement trust account that provides a promised benefit at retirement for participants
  - Separate hypothetical participant accounts are maintained
  - Funding consists of a benefit credit + interest credit each year
- Can be utilized in addition to a 401(k) plan — allows significant, tax-deferred contributions, especially for older owners
- Employer must meet funding requirements and retains investment risk

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Planning for succession

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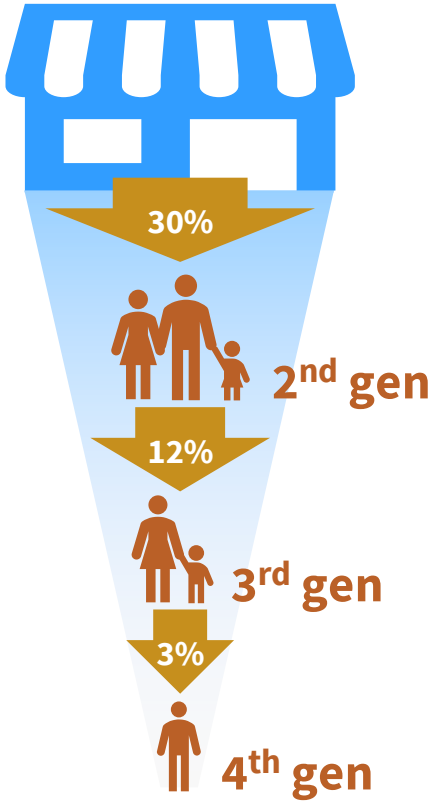
Lack of preparation leads to bad outcomes



- Only 30% have a formal succession plan in place
- 30% of family businesses survive next generation, 12% third, 3% fourth
- Why no plan?
  - Too busy or succession too far off in future

FPA/CNBC 2015; Harvard Business Review, 2015; Wilmington Trust, 2017.

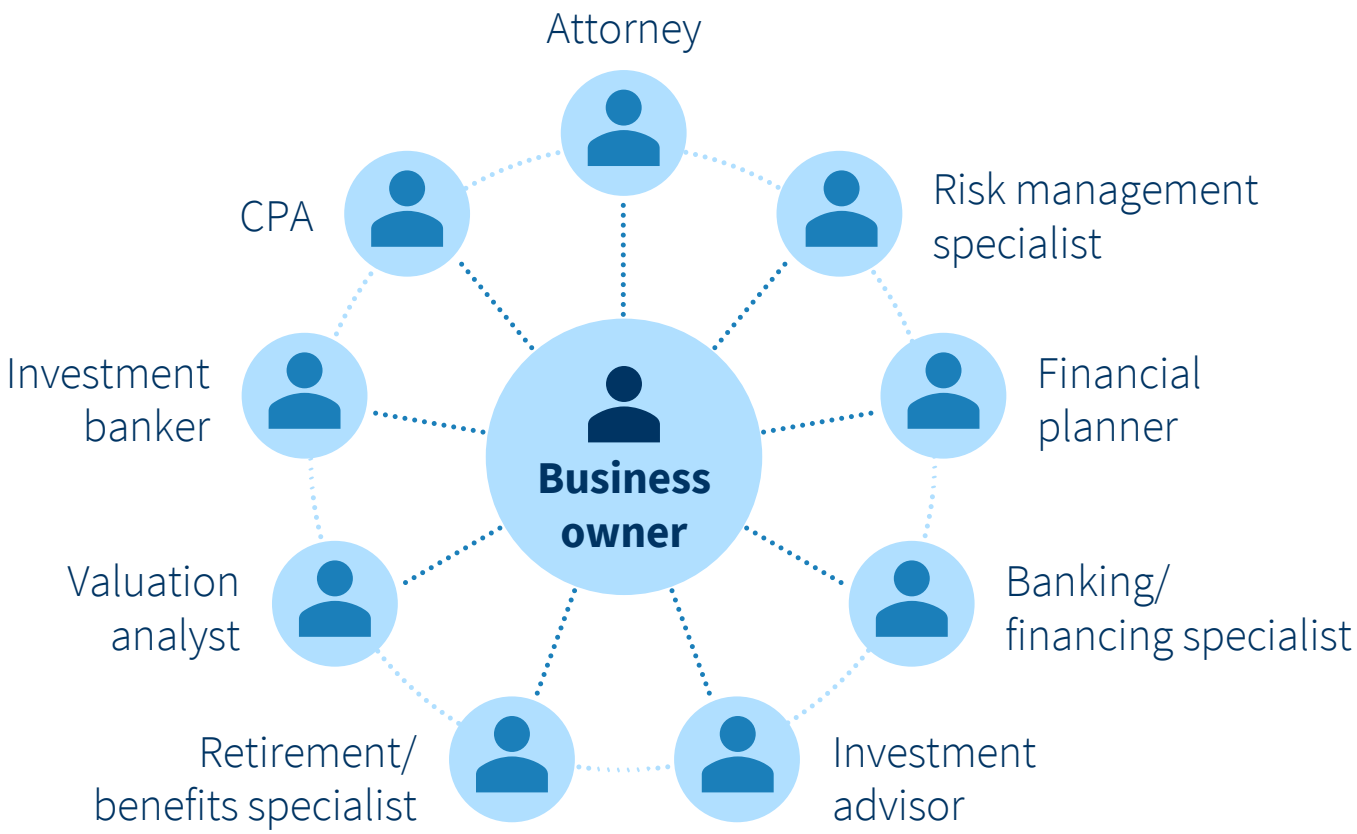
Benefits of having a succession plan

- Maximize value of the business
- Business continuation
- Retirement security for the owner
- Provide for family members
- Minimize income and transfer taxes, preserve family wealth
- Eliminates confusion — sets clear path for next steps, reduces discord among family members, provides clear communication around process and expectations
- Establishes a plan to deal with contingencies (disability, early death, etc.)

Critical steps for business succession

1. Getting started — **define goals and expectations**, evaluate risks, identify key stakeholders, assemble a team of advisors, make sure records and manuals are updated, replace equipment if necessary, organize inventory
2. Conduct **financial analysis** including business valuation
3. **Outline options** for succession — outside sale, transition to other family members or key employees, buyout from partners, liquidation
4. **Examine options** to structure the sale (installment, financing, earn-out agreement, etc.)
5. Utilize **tax-advantaged strategies** for effective wealth transfer
6. **Develop a communication plan** — customers, suppliers, management, employees, other relationships and partners (banking, legal, accounting relationships, for example)

Assembling a team



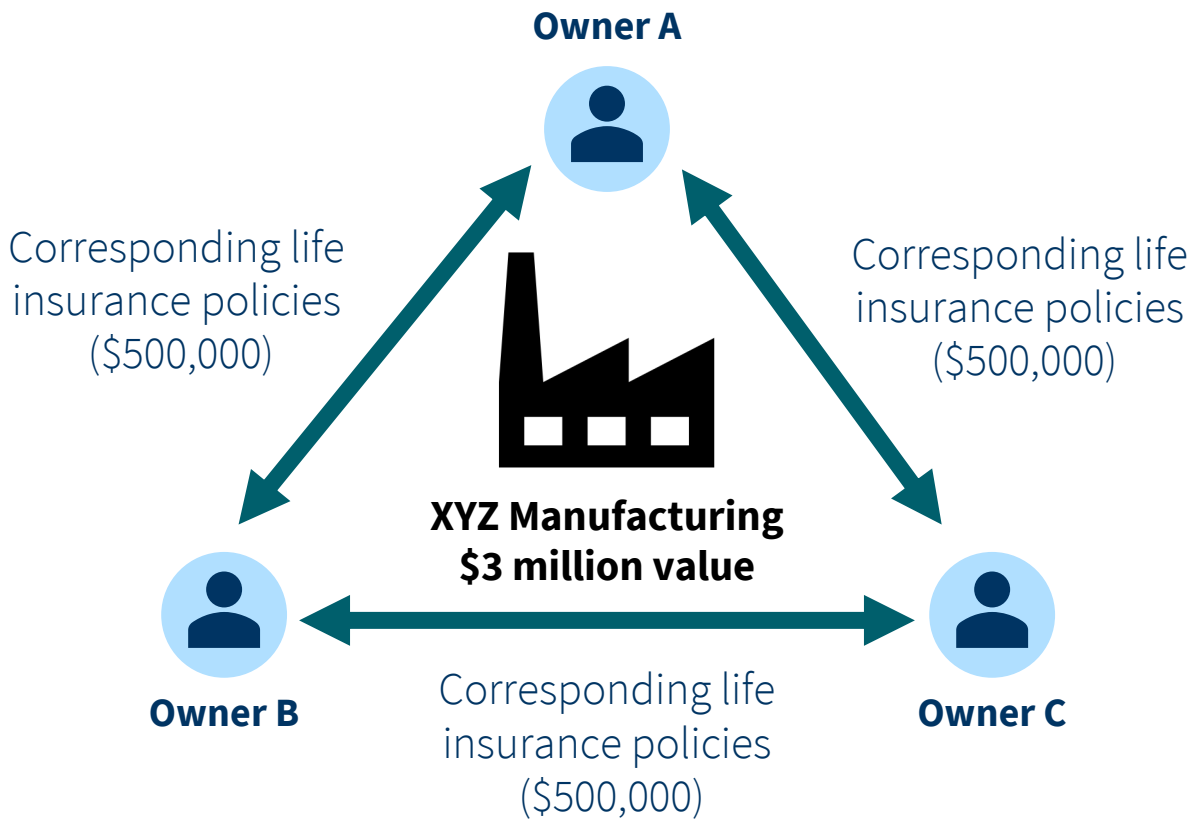
Different methods in valuing a business

- Market comparison
- Multiple of earnings or revenue (EBIT or EBITDA, for example)
- Asset valuation
- Discounted cash flow

Considerations on structuring the sale

- Asset or stock sale?
- How much cash up front? How much financing?
- Will previous owner(s) stay on in some capacity?
- Is there an earn-out clause or similar agreement?

A cross-purchase agreement provides liquidity for transition to other owners



Closing thoughts

- Business owners are increasing challenged with the complexities of managing their businesses on a daily basis; areas of wealth planning may be neglected
- It's critical to work with a team of qualified experts to maintain, grow, protect, and eventually transition business wealth

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Appendix:

More details on business succession planning

Discounted cash flow example

#1 Determine a discount rate

Risk-free rate	2%
Equity risk premium	6%
Small-cap risk premium	4%
Subjective risk factor premium	3%
Discount factor	**15%**

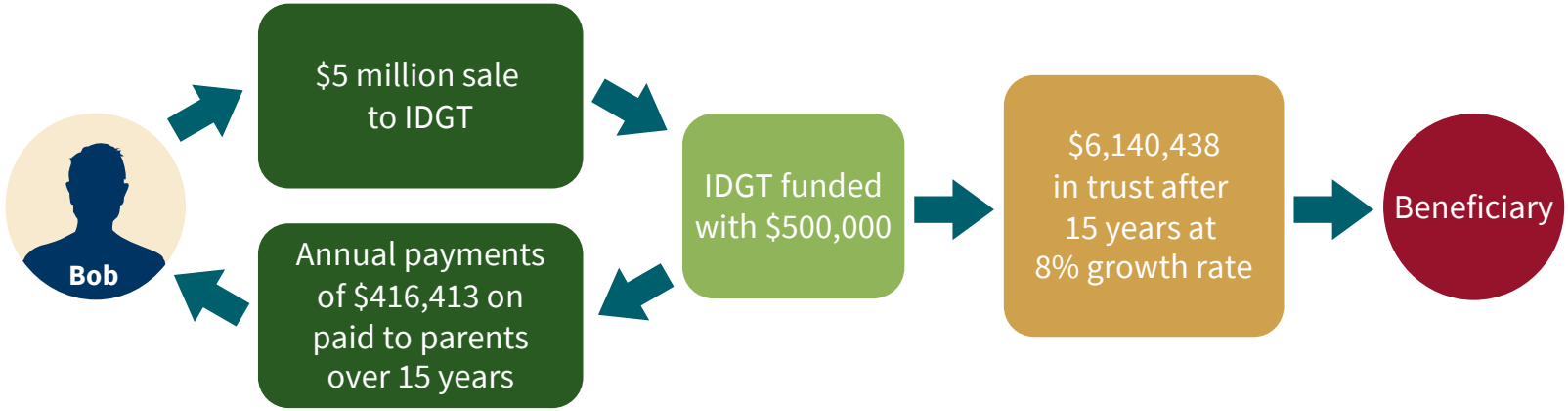
#2 Apply discount rate to cash flows

	Cash flows	15% discount
Year 1	$450,000	$391,304
Year 2	600,000	453,686
Year 3	800,000	526,012
Residual value	5,333,333	3,506,753
Business valuation		**$4,877,755**

The calculation assumes hypothetical cashflows for three years and a residual value of future cashflows based on year 3 cash flow of $800,000.

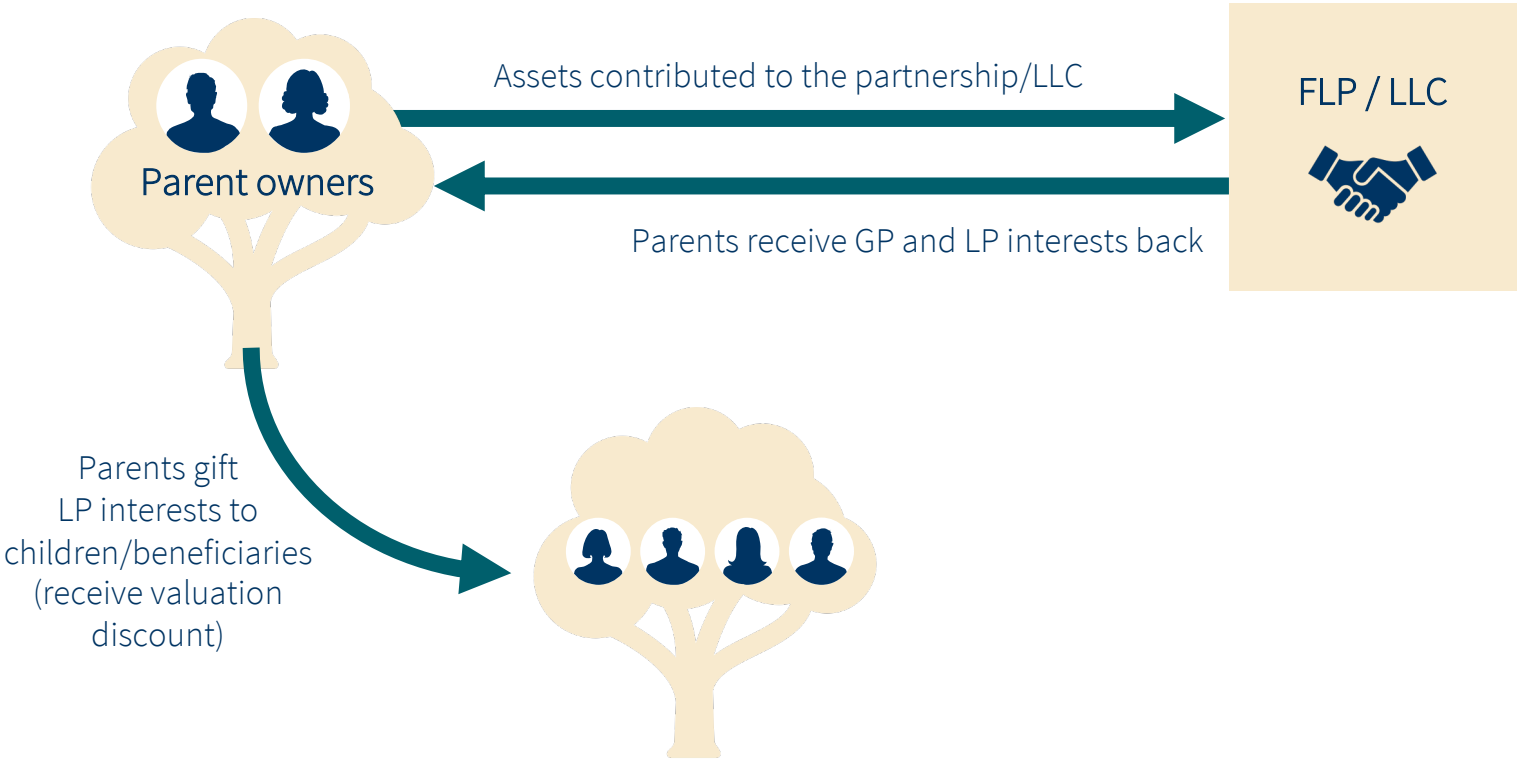
Sale of family business interest to an IDGT

- Bob sells limited partnership interest to IDGT for $5 million after valuation discounts; IDGT funded with seed capital of $500,000 — no capital gain generated on sale to IDGT since it is a grantor trust
- There is a 15-year note at $2.92% (AFR rate, March 2023*); IDGT pays back to Bob roughly $400K annually for the term of the note, and there is no completed gift (other than the initial seed gift)
- If trust assets grow at 8%, then roughly $6M at end of 15 years is transferred without any estate or gift taxes to trust beneficiaries



* IRS Rev. Rul. 2023-03.

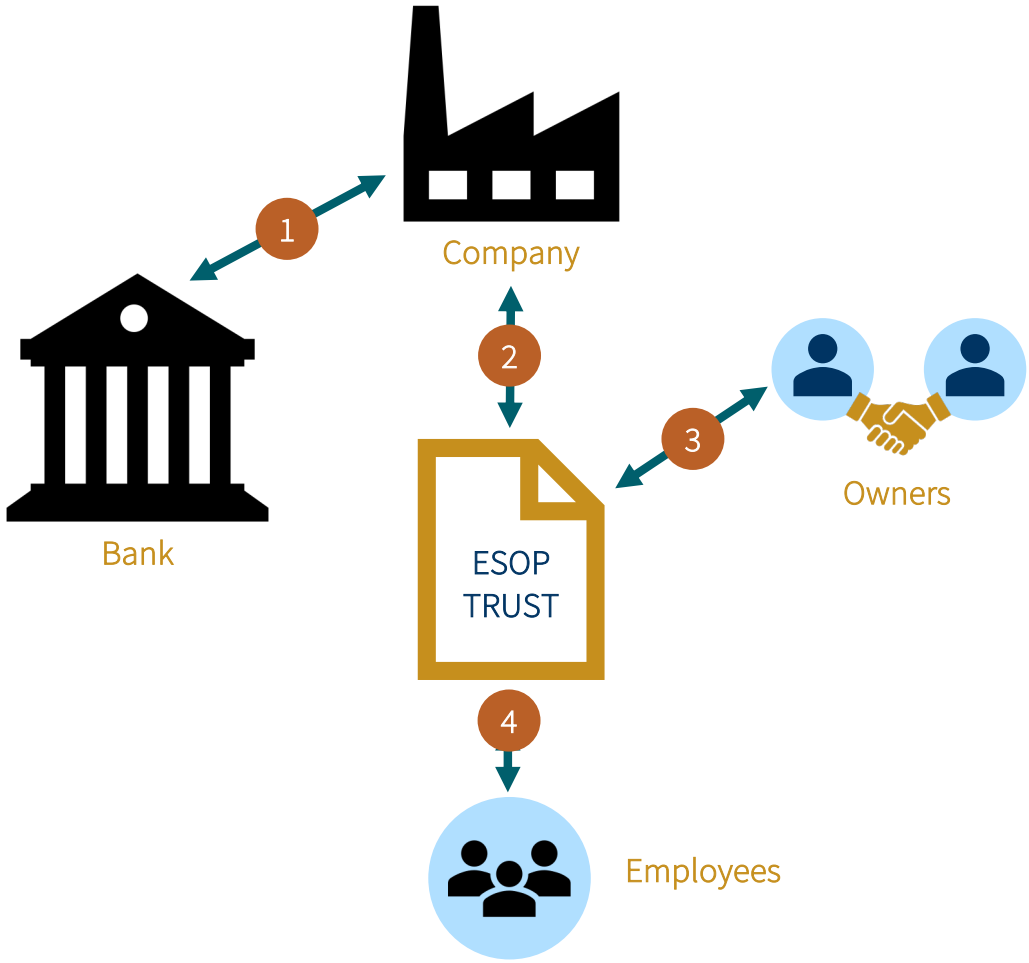
Transferring ownership through a Family Limited Partnership (FLP)



Using an ESOP to create a market for closely held stock

- ERISA-qualified defined contribution plan
- For a closely held business, can create a market for company shares
- Plan contributions are deductible (subject to ERISA limits)
- Tax-deferred retirement benefit for employee participants
- May be leveraged (company secures outside financing to fund the ESOP) or non-leveraged

Leveraged ESOP example



1. Company secures financing
2. Company loans funds to the ESOP trust
3. The ESOP trusts uses funds to purchase stock from owners
4. Employees receive stock in participant retirement accounts

All funds involve risk, and you can lose money.

This information is not meant as tax or legal advice. Please consult your legal or tax advisor before making any decisions.

For informational purposes. Not an investment recommendation.

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