Wealth planning strategies for business owners
Areas of focus today

- Tax considerations under the new law
- Shielding assets from potential creditors
- Saving for retirement
- Planning for succession
Tax considerations under the new law
New deduction for small 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 new 20% QBI deduction works

<table>
<thead>
<tr>
<th>Taxable income (Single)</th>
<th>Taxable income (Married, filing jointly)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$210,700</strong></td>
<td><strong>$421,400</strong></td>
</tr>
<tr>
<td>Deduction fully subject to wage limitation*</td>
<td>No deduction</td>
</tr>
<tr>
<td><strong>$160,700</strong></td>
<td><strong>$321,400</strong></td>
</tr>
<tr>
<td>Deduction available, wage limitation begins to be phased in*</td>
<td>Income phaseout applies — partial deduction available</td>
</tr>
<tr>
<td><strong>$0</strong></td>
<td><strong>$0</strong></td>
</tr>
<tr>
<td>Non-specified service business</td>
<td>Specified service business</td>
</tr>
</tbody>
</table>

20% deduction

*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 $160,700 for individuals and $321,400 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.
Case example on the 20% QBI deduction

Alternate test for a non-specified service business

Rodney owns a small manufacturing firm filing a single tax return. He earns $400,000 in net business pass-through income. Total wages paid from the business are $140,000. Because his taxable income is over the threshold amount ($210,700 for single filers), he is subject to the alternate test to determine the QBI deduction.

His deduction is the lesser of A or B:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>20% of QBI ($400,000) = $80,000</td>
<td>The greater of:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50% of wages ($140,000) = $70,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>OR</td>
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<tr>
<td></td>
<td></td>
<td>25% of wages ($140,000 x 0.25 = $35,000) + 2.5% of unadjusted cost basis of property (assumed to be $800,000) = $55,000</td>
</tr>
</tbody>
</table>

In this case, his deduction for QBI would be $70,000
Maximizing the deduction for QBI

**Income management**
- Retirement plan contributions
- Timing of invoicing and other strategies

**Expense management**
- Enhanced expensing under § 179
- Bonus depreciation
Shielding assets from potential creditors
Lawsuits are unpredictable

U.S. Chamber of Commerce, *Here are the Top 10 Most Ridiculous Lawsuits of 2017.*
Determining what’s at risk

\[
\text{Total assets} \ - \ \text{Liabilities} \ - \ \text{Creditor-protected assets} \ = \ \text{Assets at risk}
\]
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
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

<table>
<thead>
<tr>
<th>Business ownership</th>
<th>Benefits</th>
<th>Considerations</th>
</tr>
</thead>
</table>
| **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.
Saving for retirement
Tax credit for starting a new plan

- 100 or fewer employees who received at least $5,000 in compensation from you for the preceding year

- At least one plan participant who was a non-highly compensated employee

- Credit is 50% of your ordinary and necessary eligible start-up costs up to a maximum of $500 per year (for first 3 years)
  - Eligible costs include start-up, administration, and education
  - Can’t both deduct the start-up costs and claim the credit for the same expenses
# Retirement plan options

<table>
<thead>
<tr>
<th></th>
<th>SEP IRA</th>
<th>SIMPLE IRA</th>
<th>401(k)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funding</strong></td>
<td>Employer contributions only</td>
<td>Employer + employee contributions</td>
<td>Employer + employee contributions</td>
</tr>
<tr>
<td><strong>Contribution limits</strong></td>
<td>25% of compensation (20% if self-employed); subject to annual maximum of $56,000</td>
<td>$13,000 by employee (plus $3,000 if age 50+); employer match up to 3% or 2% non-elective contribution</td>
<td>$19,000 by employee (plus $6,000 if age 50+); employer can provide match and/or profit sharing contributions (overall maximum of $56,000 not including catch-up)</td>
</tr>
<tr>
<td><strong>Benefits</strong></td>
<td>Very low cost and easy to maintain; employer can decide whether to fund contribution</td>
<td>Simple, low-cost plan that may be appropriate for a business looking to offer a plan for the first time</td>
<td>Wider range of features (e.g., loans) and ability to customize plan design to meet specific needs</td>
</tr>
<tr>
<td><strong>Drawbacks</strong></td>
<td>Lack of features, may have to include part-time employees</td>
<td>Cannot contribute as much as a 401(k) plan, not customizable</td>
<td>More costly and complex to maintain</td>
</tr>
</tbody>
</table>
A customized profit sharing design can direct more contributions to owners

<table>
<thead>
<tr>
<th></th>
<th>Annual salary</th>
<th>Traditional profit sharing</th>
<th>New comparability plan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Allocation</td>
<td>% of salary</td>
<td>% of contribution</td>
</tr>
<tr>
<td>Owner, age 55</td>
<td>$225,000</td>
<td>$45,000</td>
<td>20%</td>
</tr>
<tr>
<td>Employee, age 35</td>
<td>$80,000</td>
<td>$16,000</td>
<td>20%</td>
</tr>
<tr>
<td>Employee, age 32</td>
<td>$60,000</td>
<td>$12,000</td>
<td>20%</td>
</tr>
<tr>
<td>Employee, age 28</td>
<td>$35,000</td>
<td>$7,000</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Total contribution</strong></td>
<td><strong>$80,000</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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
Planning for succession
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

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)
Wealth planning strategies for business owners

Assembling a team

- Attorney
- CPA
- Risk management specialist
- Investment banker
- Financial planner
- Valuation analyst
- Banking/financing specialist
- Retirement/benefits specialist
- Investment advisor

Business owner
Different methods in valuing a business

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

### Determine a discount rate

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Risk-free rate</td>
<td>2%</td>
</tr>
<tr>
<td>Equity risk premium</td>
<td>6%</td>
</tr>
<tr>
<td>Small-cap risk premium</td>
<td>4%</td>
</tr>
<tr>
<td>Subjective risk factor premium</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Discount factor</strong></td>
<td><strong>15%</strong></td>
</tr>
</tbody>
</table>

### Apply discount rate to cash flows

<table>
<thead>
<tr>
<th></th>
<th>Cash flows</th>
<th>15% discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$450,000</td>
<td>$391,304</td>
</tr>
<tr>
<td>Year 2</td>
<td>600,000</td>
<td>453,686</td>
</tr>
<tr>
<td>Year 3</td>
<td>800,000</td>
<td>526,012</td>
</tr>
<tr>
<td>Residual value</td>
<td>5,333,333</td>
<td>3,506,753</td>
</tr>
<tr>
<td><strong>Business valuation</strong></td>
<td><strong>$4,877,755</strong></td>
<td></td>
</tr>
</tbody>
</table>

The calculation assumes hypothetical cashflows for three years and a residual value of future cashflows based on year 3 cash flow of $800,000.
A cross-purchase agreement provides liquidity for transition to other owners

XYZ Manufacturing
$3 million value

Owner A

Corresponding life insurance policies ($500,000)

Corresponding life insurance policies ($500,000)

Owner B

Corresponding life insurance policies ($500,000)

Owner C
Closing thoughts

• Business owners are increasingly 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.
Appendix:
More details on business succession planning
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.)
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?
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 3.15% (AFR rate, January 2019*); 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 over $5M at end of 15 years is transferred without any estate or gift taxes to trust beneficiaries.

* IRS Rev. Rul. 2019-03.
Transferring ownership through a Family Limited Partnership (FLP)

- Assets contributed to the partnership/LLC
- Parents receive GP and LP interests back
- Parents gift LP interests to children/beneficiaries (receive valuation discount)
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 trust 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.

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