

INDIVIDUAL LIFE INSURANCE

Foundations of Business Planning

*Understanding the Life Insurance Needs of Closely Held
Small Business Owners*



FOR LICENSED AGENT USE ONLY - NOT FOR USE WITH THE PUBLIC

Objectives

- Define the small business market
- Overview of different types of business entities
- Define the common planning needs of small businesses and small business owners
- Understand how life insurance can help meet some of those needs

What Is a “Small” Business

- Closely held vs. publicly traded
- “Small” not defined by
 - Number of employees
 - Revenue of business
 - Owner
 - All closely held businesses are not family owned

The Role of Small Business in the U.S. Economy

Small businesses (fewer than 500 employees):

- Employ over half of all private sector employees
- Generate 60% to 80% of net new jobs annually
- Account for 50% of the private sector output
- Vary greatly in size and entity type

Source: U.S. Chamber of Commerce Statistics and Research Center, *United States Business Facts*, 2006

Breaking Down the Market

- In 2006, there were 25.8 million small businesses,* with the highest concentrations in:
 - Services
 - Retail
 - Construction
 - Wholesale trade
 - Manufacturing

*Source: U.S. Chamber of Commerce Statistics and Research Center, *United States Business Facts*, 2006

Best Prospects – Industries with the Lowest Failure Rates

- Agriculture 17.25%
- Manufacturing 20.92%
- Financial 22.19%
- Services 23.42%
- Wholesale 23.47%
- Construction 24.13%

Source: Bizstats.com, June 2005

Importance of Choice of Entity

- Taxes
 - Entity level
 - Individual level (earnings and distributions)
- Creditor protection
- Personal liability
- Ease of formation/dissolution
- Cost of formation/dissolution
- Ability to control/manage
- Transferability of business interests

Types of Business Entities

- Sole Proprietorship
- Partnerships
 - General Partnerships
 - Limited Partnerships (including Family Limited Partnerships, or FLPs)
 - Limited Liability Partnerships (LLPs)

Types of Business Entities (continued)

- Corporations
 - C
 - S
 - Professional
- LLC (Limited Liability Company)

Sole Proprietorship

- Ownership
 - Owned by an individual
- Formation
 - No formal act or public filing needed
- Management
 - Managed solely by the owner
- Taxation
 - One level of taxation
 - All business income and losses taxed to individual owner using his/her own income tax rate (IRS Form 1040, Schedule C)
- Liability
 - Sole proprietor is fully and personally liable for all business activities and debts

Sole Proprietorship

- Advantages
 - Simple to establish and operate
 - Owner has complete control of business activities and assets
 - Owner has unlimited access to business assets and income
- Disadvantages
 - Unlimited personal liability for all business activities
 - All income subject to self-employment tax
 - Business and personal assets not protected from sole proprietor's creditors

General Partnerships

- **Ownership**
 - Association of two or more persons to carry on a business for profit
- **Formation**
 - Formal (written)
 - Informal (not written)
- **Management**
 - Equal control and management by partners unless partnership agreement says otherwise
- **Taxation**
 - One level of taxation (pass-through)
 - All business income and losses taxed to partners in accordance with percentage of ownership (IRS Form 1065 for partnership and K-1 income for partners on IRS form 1040)
- **Liability**
 - Each partner is personally and fully liable for all business activities (including those by other partners)
 - Partnership assets (not a partner's partnership interest) generally protected from personal creditors of the partners

General Partnerships

- Advantages
 - Easy to establish and operate
 - Partners decide on management and control
 - Partnership assets generally protected from creditors of partners
 - “Pass Through Entity (PTE)” - Only one level of taxation
- Disadvantages
 - Each partner personally and fully liable for all business activities (including those of other partners)
 - Partnership profits are taxed to general partners even if not distributed from partnership
 - Each partner has equal authority to manage

Limited Partnerships

(includes Family Limited Partnerships)

- Ownership
 - Association of two or more persons to carry on a business for profit
 - At least one person is designated general partner and at least one person is designated as limited partner
 - In a family limited partnership, all partners (both general and limited) are family members
- Formation
 - Must be written
 - Must file certificate of limited partnership with state
- Management
 - General partner (GP) vested with complete management control
 - Limited partners (LPs) have ownership interests, but no management control

Limited Partnerships (continued)

(includes Family Limited Partnerships)

- Taxation
 - “PTE” – Only one level of taxation
 - All business income and losses taxed to partners in accordance with percentage of ownership (IRS Form 1065 for partnership and K-1 income for partners on IRS form 1040)
- Liability
 - Each partner personally and fully liable for all business activities (including those of other partners)
 - Limited partners are personally liable for partnership debts and activities only to the extent of their investment in the partnership
 - Partnership assets (not a partner’s partnership interest) generally protected from personal creditors of the partners

Limited Partnerships

- Advantages
 - Partners decide on management and control
 - Partnership assets generally protected from creditors of partners
 - Limited partners have limited liability
 - “PTE” - Only one level of taxation
- Disadvantages
 - General partner has unlimited liability
 - Limited partners may be restricted from transferring ownership interests in the partnership
 - Partnership profits taxed to general partners even if not distributed from partnership

Limited Liability Partnerships

- Ownership
 - Association of two or more persons in the same profession to carry on a business for profit
 - Generally formed by professionals (doctors, lawyers, accountants, architects, etc.)
- Formation
 - Must file certificate of limited liability partnership with state
 - name of partnership must include “LLP”
 - No requirement of written partnership agreement
- Management
 - Equal control and management by partners unless partnership agreement says otherwise (same rules as for a general partnership)

Limited Liability Partnerships (continued)

- Taxation
 - “PTE” - One level of taxation
 - All business income and losses taxed to partners in accordance with percentage of ownership (IRS Form 1065 for partnership and K-1 income for partners on IRS form 1040)
- Liability
 - All partners are protected from liability for the debts and activities of the partnership
 - Partnership assets (not a partner’s partnership interest) generally protected from creditors of the partners

Limited Liability Partnerships

- Advantages
 - All partners are protected from liability for the debts and activities of the partnership
 - Partners decide on management and control
 - “PTE” - Only one level of taxation
- Disadvantages
 - Partnership profits are taxed to general partners even if not distributed from partnership
 - Each partner has equal authority to manage
 - LLP laws are relatively new and not allowed in all states

C Corporations

- Ownership
 - Shareholders (either individuals or entities) own the corporation
- Formation
 - Articles of Incorporation filed with state
- Management
 - Board of Directors – overall direction
 - Officers – day to day operations
- Taxation
 - Two levels of taxation
 - Corporation profits and losses taxed to the entity (IRS Form 1120)
 - Profits distributed to shareholders taxed to the individual shareholders (IRS Form 1040)
- Liability
 - All shareholders are generally protected from liability for the debt

C Corporations

- Advantages
 - Limited liability for shareholders
 - Can be owned by unlimited number of persons or entities (individuals, trusts, partnerships, etc)
 - Control and voting rights can vary by class of stock issued
- Disadvantages
 - Formal and complex process to implement and manage
 - Two layers of taxation (corporate and personal)

S Corporations

- **Ownership**
 - Shareholders own the corporation
 - Shareholders cannot be partnerships or corporations
- **Formation**
 - Same process as for C corporation followed by an election for taxation as an “S” corporation
- **Management**
 - Board of Directors – overall direction
 - Officers – day to day operations
- **Taxation**
 - “PTE” - One level of taxation
 - All profits and losses are passed through and taxed only once, at the individual shareholder level (Corporation files IRS form 1120S, shareholder files IRS form 1040)
- **Liability**
 - All shareholders are generally protected from liability for the debts and activities of the corporation

S Corporations

- Advantages
 - No taxation at the corporate level
 - Income and loss taxed only once (at the shareholder level)
 - Limited liability for shareholders
- Disadvantages
 - No more than 100 shareholders allowed
 - All income taxed even if not distributed to shareholders
 - Shareholders must be U.S. citizens or residents

Professional Corporations

- Ownership
 - Shareholders own the corporation
 - All must be licensed in the same occupation
- Formation
 - Same process as for C corporation
 - Name must contain “Associated”, “Professional Association”. “Professional Corporation”, “PC” or “PA”
- Management
 - Generally must be managed only by licensed professionals
- Taxation
 - Choice to be taxed as either a C or S corporation
- Liability
 - All shareholders are generally protected from liability for the debts and activities of the corporation

Professional Corporations

- Advantages
 - Limited liability for shareholders
 - Management and control by professionals in same occupation
 - Choice of taxation as a C or S corporation
- Disadvantages
 - Stock can only be issued to persons licensed in a specific profession
 - Limited liability generally does not extend to actions directly related to the profession
 - If C Corporation status is elected, all dollars are taxed at highest rate (35%, currently)

Limited Liability Companies (LLCs)

- **Ownership**
 - Owned by members
- **Formation**
 - Operating agreement
 - Articles of organization governed by state law
- **Management**
 - Member managed
 - Manager managed
- **Taxation**
 - Multiple member choice of taxation as corporation or partnership
 - Single member choice of taxation as sole proprietorship or corporation
- **Liability**
 - All LLC members generally protected from liability for the debts and activities of the corporation

Limited Liability Companies (LLCs)

- Advantages
 - Informal setup and management allowed in some states
 - Members choose centralized or equal management
 - Limited liability for members
 - Choice of taxation
- Disadvantages
 - Rules vary by state
 - LLC cannot go public
 - May be restrictions on transferability of ownership interests

Needs of Small Businesses and Small Business Owners

- Needs of the Business Entity
 - Business Protection
 - Asset Protection
- Needs of Owners/Key Employees
 - Estate Planning
 - Wealth transfer for business owners
 - Business succession planning
 - Retirement and Income Tax Planning

Business Protection Needs

- Traditional Property/Casualty
 - Repair or replace damaged property
 - Bodily injury and property damage liability
 - Workers' Compensation
 - Professional liability (errors and omissions)
 - Commercial auto coverage
- Key person protection
 - Business success and growth often lies in the hands of a single individual or small group of people
 - Loss of a key employee or owner could mean
 - Disruption of management
 - Reduction in earnings
 - Impairment of credit
 - Possible loss of customers to competitors

Role of Life Insurance in Helping Meet Business Protection Needs

- **Key Person**
 - Life insurance can be a cost-effective means of providing immediate liquidity to help recover from the death of a key employee
- **Life Insurance Policy Death Benefit Proceeds**
 - Help find and train a replacement
 - Help cover lost profits
 - Help protect credit rating
- **Life Insurance Policy Cash Value**
 - Help fund deferred compensation arrangements
 - Available for tax-advantaged loans and withdrawals if needed

For employer-owned life insurance , it is important to be aware of section 101(j) of the Internal Revenue Code.

Employer Owned Life Insurance

Internal Revenue Code Section 101(j) (IRC Section 101(j)) states:

- Death benefits from an “employer-owned life insurance contract” are subject to federal income tax in excess of premiums and other amounts paid,
- Unless the notice and consent requirements of section 101(j)(4) are satisfied and an exception under section 101(j)(2) applies.

An “employer-owned life insurance contract” is a contract that:

- i. is owned by a person engaged in a trade or business (“policyholder”) under which the policyholder (or a related person) is directly or indirectly a beneficiary under the contract, and
- ii. covers the life of an insured who is an employee with respect to the trade or business of the policyholder. For these purposes, the term “employee” means all employees, including officers and highly compensated employees, as well as directors.

Notice and consent is generally satisfied if, before the contract is issued, the employee

- i. is notified in writing that the policyholder intends to insure the employee’s life and the maximum face amount for which the employee could be insured at the time the contract was issued,
- ii. provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and
- iii. is informed in writing that the policyholder (or a related party) will be a beneficiary of any proceeds payable upon the death of the employee.

Employer Owned Life Insurance

After the notice and consent requirements have been met, the death benefit of an employer-owned life insurance contract will not be taxable provided that:

- (A) (i) the insured was an employee, with respect to the policyholder at any time during the 12-month period before the insured's death, or
(ii) the insured is, at the time the contract is issued—
 1. a director,
 2. a highly compensated employee within the meaning of Section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or
 3. a highly compensated individual within the meaning of Section 105(h)(5), except that “35 percent” shall be substituted for “25 percent” in subparagraph (C) thereof.
- (B) the death proceeds paid to insured's heirs as contemplated under IRC Section 101(j) (2)(B).
- (C) the death proceeds are used to purchase an equity (or capital or profits) interest in the applicable policyholder from certain of the insured' heirs

Section 6039(I) also imposes annual reporting and record keeping requirements on employers that own one or more employer-owned life insurance contracts.

This information is written in connection with the promotion or marketing of the matters addressed in this material. The information cannot be used or relied upon for the purpose of avoiding IRS penalties. These materials are not intended to provide tax, accounting or legal advice. As with all matters of a tax or legal nature, you should consult your own tax or legal counsel for advice.

Asset Protection for the Business

- Part of an effective estate and business plan
 - Strategies to protect business assets from the reach of business and personal creditors
 - Proper choice of entity
 - Qualified plans
 - Bankruptcy vs. non-bankruptcy creditors

Caution! Fraudulent transfers

Role of Life Insurance in Helping Meet Asset Protection Needs

- State Law
 - Death Benefits
 - Cash Values

Wealth Transfer Needs of the Business Owner

- Wealth Transfer/Estate Tax Planning
 - Reduce estate tax liability
 - Help increase wealth transfer to heirs
 - Establish a way to pay remaining estate taxes and other expenses upon death
- Business Succession
 - Provide for continuation of business ownership and control
 - Establish value of business for estate tax purposes
 - Establish a way to pay for estate taxes attributable to business upon death of owner(s)

Role of Life Insurance in Helping Meet Wealth Transfer Needs

- Wealth Transfer/Estate Tax Planning
 - Estate Planning

Role of Life Insurance in Helping Meet Wealth Transfer Needs

- Wealth Transfer/Estate Tax Planning
 - Executive Bonus Arrangements

Role of Life Insurance in Helping Meet Wealth Transfer Needs

- Wealth Transfer/Estate Tax Planning
 - Split Dollar

Both loans and withdrawals from a permanent life insurance policy may be subject to penalties and fees and, along with any accrued loan interest, will reduce the policy's Account Value and Death Benefit.. Assuming a policy is not a Modified Endowment Contract (MEC), loans are free from current Federal taxation and withdrawals are taxed only to the extent that they exceed the policyowner's cost basis in the policy. Distributions from MECs are subject to Federal income tax to the extent of the gain in the policy and taxable distributions are subject to a 10% additional tax prior to age 59 1/2, with certain exceptions.

Role of Life Insurance in Helping Meet Wealth Transfer Needs (cont'd)

- Business Succession
 - Buy-Sell Planning
 - Cross Purchase
 - Stock Redemption
 - Wait and See

Role of Life Insurance in Helping Meet Wealth Transfer Needs (cont'd)

- Business Succession
- ESOP

Retirement and Income Tax Planning Needs

- Non-qualified retirement plans
 - Attracting and retaining key talent
 - Providing retirement benefits to owners and key employees
 - Choice of employer funded, employee funded or combination
- Qualified Planning Options
 - Attracting and retaining key talent
 - Providing retirement benefits to owners and employees
 - Tax-deductible contributions

Role of Life Insurance in Helping Meet Retirement and Income Tax Planning Needs

- Non-qualified Executive Benefit Options
 - Deferred Compensation

In order to achieve the desired tax results, the plan itself must meet the requirements of IRC Code Section 409A. This code section provides rules relating to the constructive receipt of benefits under a non-qualified deferred compensation arrangement. Generally, according to IRC 409A, deferred compensation benefits will be includable in the participant's gross income if at any time during the taxable year a non-qualified deferred compensation arrangement fails to meet defined rules and the plan does not contain a substantial risk of forfeiture.

Role of Life Insurance in Helping Meet Retirement and Income Tax Planning Needs

- Non-qualified Executive Benefits
 - Life Insurance in Retirement Planning (LIRP)
 - §162 Bonus

Retirement and Income Tax Planning Needs (cont'd)

- Qualified Planning Options
 - Traditional IRA
 - Roth IRA
 - Profit Sharing Plan
 - Split Funded Defined Benefit Plan

Contributions to Qualified Plans

	Available Deduction	Maximum 2009 Allowable Contribution	Contributions Required or Discretionary?
Traditional IRA	Contribution may be fully deductible subject to client income limitations	\$5,000	Discretionary
ROTH IRA	Not Deductible	\$5000	Discretionary
Profit Sharing	25% Total Compensation plus Elective Deferral	\$49,000	Fixed or Discretionary
Split Funded Defined Benefit Plan	Contribution Fully Deductible, subject to IRC Section 415 limitations	\$*	Annual Contribution Required

* Allowable contribution is based on the target defined benefit for each plan participant but are not limited by the contribution limits of 401(k) or profit sharing plans.

Features of Qualified Plans

\$ Generally least expensive
\$\$ Generally more expensive
\$\$\$ Generally most expensive

	Primary Planning Need	Current Income Tax Deduction	Flexible Discretionary Contributions	Multiple Employees in Plan	Funded with Life Insurance	Setup and Admin Costs
Traditional IRA	Retirement Income	Y	Y	N	N	\$
Roth IRA	Retirement Income	N	Y	N	N	\$
Simple IRA	Retirement Income	Y	N	Y	N	\$
SEP IRA	Retirement Income	Y	Y	Y	N	\$
Safe Harbor 401(k)	Retirement Income	Y	Y	Y	N	\$\$
Split Funded DB Plan	Retirement Income	Y	N	Y	Y	\$\$\$

Summary

- Small business owner market opportunities
- Many different planning needs
- Life insurance plays a vital role in helping small business owners achieve their goals
- The Hartford can help