MAXIMIZE THE RED ZONE

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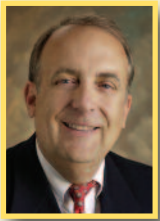
The Importance of Converting Equity to Capital

Most business owners work a lifetime building an organization so they can convert it to income at retirement. But when is the best time to start the process? We call this time the *Red Zone*. It is the final distance between where you are today and where you will be when you are ready to turn off the lights for the last time. Maximize The Red Zone describes what you need to do during the short time you have left to develop your plan. Experience tells us that the sooner you start to plan, the more compound interest you have available to help you, and the easier it will be to make a successful conversion.

This Booklet was written to help you jump start the thinking process and to give business owners, like you, an understanding of the issues and opportunities they have available to help them score big in The Red Zone.

ABOUT THE AUTHOR



Guy Baker MBA, PhD, MSFS, MSM – was recently recognized as one of *Worth Magazines*' top 250 advisors. Established in Orange County in 1970, Guy has built a financial service company serving the needs of business owners who are looking to have a trustworthy relationship to help them manage their Three Circles of Wealth.

For more information on these concepts, issues and perhaps an assessment, contact ***info@bmiconsulting.com.***

MAXIMIZE THE RED ZONE

Getting the Most Out of Your Privately-Held Business

As any professional football fan knows, efficiency in the last twenty yards, (coined the Red Zone) determines the ultimate success of the team. Red Zone statistics measure the success of the team and the quarterback. Success here increases the chances of winning. Continued failure in the Red Zone marks lost opportunity and eventually causes poor performance and a low finish in the standings.

There is a Red Zone in the business world. It is the last few years before the ultimate score, the sale, or transition of the business to new management. And in the same way the quarterback knows the Red Zone is crunch time, the business owner soon realizes the few years before they sell the business is when they need to maximize profitability, develop a management team, and build financial independence. Maybe you started from scratch. Maybe you built a product, a production process and distribution system for one primary purpose – profit – the ultimate measure of business success. Profit eventually becomes income and is often converted to equity as the owner adds to retained earnings or the capital account.

Is profit the endgame? Probably not! It is only a measure of the final score – the time when you, the business owner, are finally ready to convert your equity into capital. This is where Red Zone planning pays off. Converting equity into capital lays the foundation for passive income and is usually the last step to financial independence.

Red Zone capital is usually the cornerstone to retirement for most business owners – income you and your family can live on during your non-income earning years. Effective Red Zone Planning must occur during the last few years (months?) prior to the sale – the years before you turn out the lights for the last time. You really only get one chance to truly score in the Red Zone and it takes a lot of planning and preparation to successfully pull it off. Will you be ready? To answer this question, perhaps we need to go back in time a bit and review how you got here.

The Beginning

Think back to when you first conceived your business concept – to when you first started to convert your dream into a business. How did you start? Most business owners tell us they turned their business into a separate entity because their attorney or CPA told them it was a smart thing to do. And perhaps it was. But now that you have been a business for several years, what have you done to leverage the value you have created into value for your own personal benefit?

Most owners answer this question by saying they have received a consistent salary and frequent bonuses throughout the years. But business is cyclical; it ebbs and flows. When it flows, compensation can be quite rewarding. But when it ebbs, you may be forced, like a lot of business owners, to put money back into the business, to take out a loan in your own name to provide liquidity or cut your own salary to make ends meet. This is a reality of business and many business owners have, at one time or another faced the reality of economic cycles.

Why did I write this booklet? To help business owners undestand the relationship between the entity and their capital. And to show you how to convert equity into personal wealth you can use to gain financial independence. Too often, business owners fail to concentrate on wealth accumulation. They focus instead on building a successful business and figure the conversion will take care of itself. They get to the Red Zone by default, with no preparation, no plan and run the risk of a fumble of the worst magnitude. A Red Zone failure will cost significant tax dollars and often a reduced selling price

Please understand, this booklet is NOT meant to be a comprehensive discussion on various tax strategies or the full array of problems facing the business owner. Rather it is meant to give you a brief overview to help you start thinking. To help you identify ways you can create and preserve your wealth and to attract and retain superkeepers, (your key employees) who can help make your company a standalone business. (Read *E-Myth* by Michael Gerber).

Corporations have an intrinsic value beyond just the monthly paycheck you receive. Eventually you should be able to convert the value of your company's equity into investment capital. When you accomplish this, you will be finally independent of your company's financial statement. But until then, you are figuratively, a slave to the business cycle (Read *Good to Great* – Jim Collins).

Preparing For the Red Zone

Why is preparing for the Red Zone important? Every business owner will ultimately reach the point where they have to solve the Business Rubik's Cube. There are three questions which rattle around in the mind of virtually every business owner:

1) How do I build value in my business?
2) How do I attract and retain the super-keepers who will help me build this value? And how do I compensate them?
3) And finally what are the ins and outs of creating an exit strategy? How do I extract myself from this business? How can I convert the Fair Market Value into retirement capital effectively and efficiently?

The Red Zone solutions can be complex. To be effective you have to convert a business into an enterprise. You must solve the superkeeper dilemma and the wealth accumulation Rubik's Cube. These are issues every business owner either faces or ignores. But eventually, they will have no choice. If you don't deal with these problems effectively, the only solution will be to liquidate the business. And what makes it more difficult, is the longer you wait to start Red Zone planning, the fewer good, ethical and economically sound solutions will exist. But even so, they do exist.

The question will ultimately be, is time your ally or enemy? Do you have time on your side?

This booklet is hopefully the beginning of a process to help you identify possible solutions to these three primary Red Zone questions and will help you formulate a plan to "convert man at work to money at work."

The following is a short discussion on the basic business tax entities and the tax treatment of each. I suggest you skip down to "*The Three Circles of Wealth–The Common Denominator*" if you are familiar with these tax principles. The following discussion is a simple review of the tax basics that drive wealth planning in a business.

Why Have A Business Entity?

You may remember Julie Andrews in the *Sound of Music*. She sang this lyric – "Let's start at the very beginning." So let's ask, "What is the primary reason you have a legal entity?" After all, you could just operate as a sole proprietor and put all of your accounting on a schedule C on your personal tax return. There is nothing you can deduct in a corporation or LLC that you essentially cannot deduct on a schedule C attached to your individual return. So why incorporate? Why a corporation and not an LLC or a partnership?

The general reason for forming a separate business entity is liability. If you can keep the liability at the entity level, you protect your personal assets. By being an employee, all liability stays at the entity level, providing you operate the entity with good governance. This means you have to keep accurate accounting records, hold a board of directors meeting, and document your meetings in the minutes of the corporation. In other words, you have to play the game by the rules. Your tax advisor has probably explained all of this to you at some time. But it is good to review.

Another reason for forming a separate business entity is the separate tax bracket. An entity files a separate tax return and pays taxes at a different tax rate than you do and by having multiple tax payers, you may be able to shift income legally from one entity to another for services, purchases or other expenditures. But these are only timing considerations. In the final analysis, at higher levels of income, this benefit is probably negligible and could add additional costs. Why? Because at higher levels of income the current tax brackets are higher for the corporation than for you as an individual.

Health insurance benefits for the employee/owner of a separate tax entity are deductible. They are not subject to the 3% AGI limitation on the individual return. You can also have a flexible spending account so long as you offer it to all your employees. This could allow you to pay your deductibles and co-pays with tax deductible dollars. But this is a case by case issue, so you need to do some analysis here to make certain there is a real benefit here. Also entertainment, travel expenses, and automobile deductions may be treated more favorably in an entity than on your schedule C. This is an issue to discuss with your tax advisor.

The biggest benefit of an entity is the ability to isolate personal liability and shift income

Forming a separate entity also gives you the ability to build a standalone organization and eventually capitalize on the value of your company's income stream. Although it is possible to sell a sole proprietorship, a large company is rarely sold as a sole proprietor. It is almost always an entity because they are easier to audit and transfer. Another reason is that employees prefer to work for a company, rather than a sole proprietorship. An entity makes it easier to provide discriminatory benefits for these superkeepers if you think it will cause them to stay with you longer. You can also fractionalize ownership in an entity, which you cannot do with a sole proprietorship.

> **Key Points:** *The biggest benefit of an entity is the ability to isolate personal liability and shift income. There can be additional tax benefits such as lower cost for health benefits or disability coverage. You can also have a flexible spending account. A company allows you to build leadership and a succession management team. Plus an entity is easier to transfer to either management or a new buyer.*

To Pass Through or Not

Let's look at the differences in business entities. There are basically only two forms: a closed entity and a pass-through entity. Each of these methods can be derived in different legal forms (corporate, LLC, partnership), but when you boil down their differences, it is how they are taxed that determines their applicability and utilization.

A closed entity simply means it is a separate and distinct legal entity. It has its own tax bracket and tax ID number. It files a tax return and pays tax on taxable income. Any losses are carried over to future years and applied against income in those future years. These loss-carry-forwards can be very valuable when doing tax planning with companies that have wide fluctuations in income.

The most common closed entity is a C Corporation. As a separate entity, you own it by purchasing stock. If you are the forming shareholder, you are issued stock in exchange for the initial capitalization of the company. The company has two financial statements, a profit and loss (called the income statement), and the balance sheet. The balance sheet shows the book value of the corporation which will increase or decrease based on the income and expenses of the company and any changes in the value of assets or liabilities due to business decisions (examples: increase inventory, buy machinery, borrow money, pay off loans.) Here is the important point - all income held in the corporation and not distributed will be taxed. This income represents a gain to the corporation but it is referred to as trapped gains because it will have to be taxed when it is distributed in future years as either dividends or liquidation proceeds to the shareholders. In essence, building retained earnings subjects all the gains to a second level of tax.

Pass through entities do not trap gains. Although this kind of entity has a tax payer ID number, it only files an information return. But all the income "passes through" to shareholders, members, or partners on their personal tax returns. The legal forms of this kind of entity can be an S Corporation, LLC taxed as a partnership or limited and general partnerships.

A Limited Liability Company (LLC) could elect to be taxed as a closed entity or as a pass through. Ownership in an LLC is not stock but is expressed in member interests. When it operates as a closed entity, the LLC files a tax return and is taxed similar to a C corporation.

Closed Entities And Pass Through Entities

So, which is better? Since the real issue is how the income of the entity is going to be taxed, the IRS has established the bar for this question. It is called “unreasonable compensation.” Essentially, the IRS has established a principle for all shareholders. Regardless of whether the shareholders are employees or not, they are entitled to earn a fair rate of return on their invested capital. If the executive/shareholder extracts too much compensation from the entity, they are cheating other shareholders of a fair rate of return. Therefore, the IRS places a restriction on how much compensation can be taken – an amount that is deemed to be reasonable. Any amount above that level of compensation will not be deductible as compensation and if distributed, will be considered a dividend and double taxed.

This restriction primarily affects a C corporation. The corporation is forced to pay tax at the corporate level and the shareholder now must pay another tax. The penalty for not following this rule is simple. The IRS caps the compensation and reclassifies the excess as a dividend. It then adds penalties and interest. Some CPAs worry about this problem, others don’t.

How do you avoid this problem? Two ways. One, be aware of the limitation but continue to accumulate earnings in the corporation. (You must be aware of the accumulated earnings tax for excess accumulations. This is a whole other issue). The other way is to convert your entity to a pass-through. If you become an S Corp, then your strategy changes. Instead of taking as much compensation as possible (subjecting all of it to payroll taxes), the shareholder/executive usually tries to suppress their compensation to minimize the payroll taxes and takes excess income as a K-1 distribution. Employing this approach, avoids any excess accumulation problems or unreasonable compensation concerns. All of the income is taxed at the personal level.

Note, personal tax brackets are usually higher than the closed entity tax brackets, but this strategy does avoid the onerous double tax.

Even though the shareholders are proportionately responsible for the tax on 100% of the net income of the S Corp entity, distributions may be limited to only the tax. Why? Primarily so they can leave working capital in the company. Money left in a S Corp is called their AAA account (accumulated adjustment account). Unlike retained earnings in a C Corp (which will always be subject to a second level of tax when distributed), the AAA account has already been taxed, so when it is distributed, it is tax free.

It is possible for a C Corp to convert to an S Corp. But there are a few restrictions which may be of concern. There is a limitation on the number of shareholders, and benefits for shareholder employees have limitations. There are also accounting issues if a C converts to an S, because all trapped gains must stay trapped for 10 years even though the entity becomes a pass through entity. To avoid dealing with this trapped gains problem, you might consider starting a new S Corp from inception and leave the gains alone to avoid increasing them in the future.

The Benefits Of Owning A Closed Entity

Years ago, one of the main benefits to a C Corp was the ability to put significant contributions into a retirement benefit. In recent years, the IRS leveled the playing field. All contributions are the same regardless of the form of doing business. So a sole proprietor can put in the same contribution or have the same benefit as a corporation. The same is true of an LLC or a partnership. So this difference has narrowed significantly. There are only two remaining benefits but they are not significant enough to dictate one best entity. One is for executives of C Corps, who can deduct 100% of their medical costs, unlike a pass through which has limitations. As the cost of health insurance benefits increase for older shareholder/employees, the ability to deduct 100% of the cost may be a valuable reason to keep a closed entity. But in the future, it is likely there will be a cap placed on these deductions just as the IRS has capped entertainment expenses at 50%.

One significant benefit of having a closed entity is the ability to use separate tax brackets to manage your tax liability. This allows you to move money from one year to the next through purchases and income timing. But in the final analysis, this is only a delaying tactic. The tax will ultimately be paid, the only question is when.

The Benefits Of Owning A Pass Through Entity

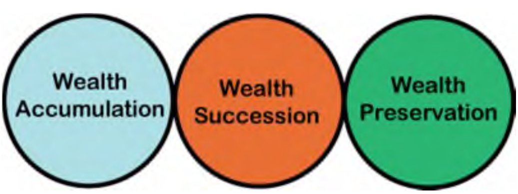
As we just discussed, with a pass through entity, there is no threat of being challenged on unreasonable compensation. But because it is possible to underpay yourself, the IRS could come in and actually cause you to increase your payroll compensation. This would be costly. S Corp compensation is an anomaly and will likely be rectified as the government seeks new sources of income. It is probable that dividends from a closely-held business could have the Medicare tax attributed to even the dividends. The theory would be all closely-held income is a form of compensation even if it is classified as a return on capital.

Building wealth in the corporate AAA account tax free ultimately becomes a benefit when you want to exit the entity. AAA is much better than facing a deferred tax liability when you liquidate a C Corp in an asset sale. If the sale is structured as an asset sale, the C Corp has to pay tax on the gain over basis and then you have to pay tax on the liquidation value. An asset sale in an S Corp eliminates this problem. Here the tax on any gain in the value of assets (such as land) will avoid tax at the entity level, but because the income passes through to the shareholder, the proceeds would be taxable at the personal level.

There is much written on the tax treatment of these entities and the pros and cons of pass through entities and closed entities. This little booklet was NEVER meant to be comprehensive. I just wanted to give you the highlights of the tax principles. The following pages will describe wealth building strategies and these basic tax strategies are important elements in that discussion.

The Three Circles of Wealth–The Common Denominator

Every business owner I have ever met says they are "So busy being successful, they don't have time to evaluate the impact of legislative change on their personal planning." The tyranny of the urgent overcomes their ability and energy to deal with their personal affairs as forward thinkers. Another frustration occurs if they have taken the time to do planning. The effort and emotional energy as well as the financial resources are staggering to them. But again, legislative changes have come along and rendered much of what they did in the past, obsolete. They once had a plan by design, but now through time and erosion due to these changes, their plan became one by default.



Another common denominator is every business owner is trying to manage their *Three Circles of Wealth*. I call these circles – *Wealth*

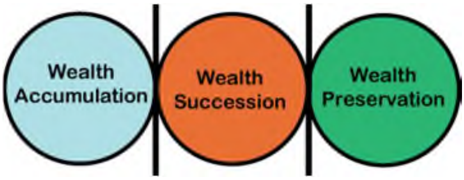
Accumulation, *Wealth Succession*, and *Wealth Preservation*. The three circles comprise many tools and the cost can be significant to implement and maintain them. But the "too busy" problem and the velocity of change renders many of these choices ineffective and inefficient. Systemic barriers are erected to prevent the circles from being efficient and effective.

Wealth Accumulation–In this circle we see investment vehicles designed to preserve and grow assets. The most common tools are retirement plans for the owner. These plans usually include employees to meet specific tax rules. In addition, most owners have purchased some real estate, often for the business. In some cases they have purchased a vacation home and perhaps have built a stock portfolio, which often is under-performing the markets.

Wealth Succession–This circle refers to the continuity of the business. Owners usually have some type of buy and sell agreement to make sure their family gets some value if they die. If they have partners or perhaps a key person, the buy-sell will include them. Many times the plan is funded with term life insurance. In some cases, they may have looked at an ESOP as a way to extract capital from the company. There may be some type of executive compensation plan for top employees. And in some cases, they may have sold stock to one or two key employees as a way to tie them to the company for the long run. These are all viable strategies.

Wealth Preservation–This final circle protects the value of the business owner's estate from forced liquidation at death to pay estate taxes. And while in a community property state, the payment of taxes can be postponed until both spouses die; the magnitude of the problem can be devastating to the estate. There are over 400 planning tools which can be used to eliminate or avoid estate taxes entirely.

Here is the Systemic Problem – These circles operate independently and there is often no coordination of thinking being employed. As a result, inefficiencies occur and money is often wasted.



The Three Big Questions

So, let's go back now and look again at the three most often asked questions by business owners.

1) How do I create and retain value in my business?

2) How do I attract and retain the superkeepers who will help me build this value?

3) And finally what is an effective exit strategy? How do I convert my enterprise value to retirement income efficiently?

The remaining parts of this booklet will cover some of the current strategies to build wealth using the business dollar.

I. CREATING AND RETAINING VALUE

The single biggest problem for most company owners is their inability to extract and retain money distributed from their company. In the good times, they often take out significant bonuses and dividend distributions, but when the economy tightens they usually have to put it back in out of necessity. It is a known fact that nearly 80% of the net worth of most business owners is locked up in their business. So even though the company continues to increase in value (by increasing the retained earnings of the company), the net result is the reduced personal liquidity.

I call this lack of liquidity – margin. Lack of margin is not a good situation because there is no margin for error. If and when the economy tightens or if interest rates rise before the liquidity is restored, what happens? Where do you go for money? The loss of margin means that despite success, owners often live on the edge of economic disaster and ruin. We must remember there really is a difference between profit and financial independence.

What are some ways to resolve this problem? Besides cash distributions that are invested in an investment portfolio, there are two commonly used strategies for increasing wealth: 1) a well funded retirement plan and 2) a split-funded investment grade life insurance program. Both are tax efficient and provide a systematic way to transfer wealth from the company to the owner's pocket. In looking back at several severe business cycles, the primary asset to sustain value throughout the convulsions is not bonds, not large cap value stocks, not commodities or real estate – but cash values in life insurance and annuities.

This is not meant to be a sales pitch, but rather a fact. While insurance companies in the past have failed, not one policyholder has lost money.

Let's look at these two remarkable plans.

Corporate Retirement Plans

A well funded, tax deductible retirement plan is called a *qualified* plan. (It is called *qualified* because it meets the rules set out under the Internal Revenue Code.) The most common qualified plans are profit sharing plans and 401(k) plans. Contributions are tax deductible going in and the benefits are taxable coming out. The Department of Labor regulates these plans and the IRS determines if they receive tax benefits. Both regulatory bodies place requirements on the legal way to operate the plan.

In a profit sharing plan the first rule is qualification. All eligible employees must be included in the plan to be qualified. If the company is going to fund the program, then all employees have to be funded equally. But equally does not always mean a pro-rata contribution based on salary for each employee. Equal can mean the contribution is adjusted for social security benefits, age and compensation levels based on job titles. The common term for this assessment is cross testing and these rules allow the plan actuary to reallocate a significant portion of the contribution to the highly compensated executives. I have seen plans where 85% of the total contribution goes to the top executive(s) – i.e. the owner – and still meet the qualification rules.

In addition to these rules, all funds have to be protected in a trust and the trustee (generally you) has fiduciary liability if the plan is not run properly. The funds have to be properly allocated as to risk and the employees need to have some communication on the quality and performance of the investments. If the fiduciary does not act properly, they have personal liability. This is why more and more plans are hiring Registered Investment Advisors to help protect against this liability.

There are basically two types of qualified retirement plans – defined benefit (DB) plans and defined contribution (DC) plans.

Defined Benefit Plans

A DB plan specifies the benefit to be funded. Once this benefit is defined, an actuary then calculates how much it will cost each year to fund the benefit. The funding is based on a targeted amount at retirement. The funding can change based on the investment performance. So it is possible the plan could cost a lot less if the investment performance is higher than was originally estimated. But it can also cost a lot more if investment performance is less than originally projected. This cost is determined year to year.

Benefits are usually based on age and salary. So if there are a lot of younger participants, it might be very possible a defined benefit plan for the entire company could be implemented for a very reasonable cost with the top paid, older executives getting the highest share of the contribution.

Defined Contribution Plans

A DC plan takes a percentage of company profits and allocates it among the participating employees. The cost is defined by formula and cannot be arbitrarily increased. The contribution will grow over time but the benefit will fluctuate because of investment returns. Here is where we can use the rules to help shift costs. By cross testing (described earlier), much of the contribution can be allocated to the highly compensated, if this is advantageous and what you want to accomplish.

Another way to increase the benefits to the highly compensated is to use a *safe harbor* (SH) contribution. This means your plan is guaranteed to remain qualified while in operation, if you follow the SH rules. Doing this eliminates all of the discrimination tests the IRS uses to determine if the plan is discriminatory year to year. Here is why SH is so valuable.

Essentially, the government says the Highly Compensated Employees (HCEs) cannot benefit disproportionately in a retirement plan. A test determines if the non-HCEs (all the rank and file) are receiving less than 2% in contributions compared to the HCEs. All eligible participants count whether they contribute or not. So if the non-HCEs average 4% of compensation, the HCEs can only put in 6% of compensation. If they put in more, the plan could lose its qualification. The bad thing about this calculation is that ALL employees who are over age 21, work full time and have been with the company longer than 1 year are eligible. And they count in the calculation of total employees whether they contribute or not.

The safe harbor match eliminates this problem. A safe harbor match allows the employer to match the first 3%, dollar for dollar. The next 2% is matched at 50% per dollar. This totals 4% of compensation if the employee contributes 5%. By doing this, the HCE can contribute any amount they want up to the annual IRS limits.

There is another approach called the "safe harbor profit sharing contribution" which also eliminates all testing. This option requires the company to contribute 3% of everyone's pay who is eligible. Usually this approach is more expensive than the match because the company must contribute to all eligible employees. But it accomplishes the same objective; it allows the company to pass the IRS qualification tests and allows the owner to put away a significant contribution for himself.

Both the SH profit sharing contribution and the SH match MUST vest 100% from day one. But it is rare to find employees who will leave just because they are vested in the plan. They still have to pay the penalty tax and the income tax to withdraw the money. But of course, it could happen. The cost of the SH match is limited only to those who participate. But because it eliminates the HCE test, the top executives can put away as much as they want up to 15% of compensation – the maximum. However, by combining the profit sharing and the 401k, these plan designs can allow the owner to contribute up to $50,000 annually if they are over 50 ($45,000 if they are not) and earn more than $100,000.

How Do You Justify Funding Costly Benefits For The Rank And File Employees?

Let's assume you give cost of living raises to the employees frequently. Those would be typically 3-4% of payroll. A raise would be taxable and subject to payroll taxes. So it is possible a 4% cost of living raise would only put 60% in their pocket with 40% going to income and payroll taxes. Maybe less. But if it goes into the qualified plan, 100% is invested for the benefit of employees. That 40% savings will be leveraged for the benefit of someone – either the corporation (in tax deductions) or the employees through increased contributions. The net result is this: the top executives would receive approximately the after-tax cost of the plan, which is the real cost of the plan. This makes the plan very efficient because the government paid for the rank and file employees. The after-tax cost funded the top executives and the owner's benefit.

Capital Split Dollar – Split Funded Life Insurance

As discussed, the qualified plan must include all employees. What if you want to do something just for yourself or for your key employees? Another tax efficient benefit is what is often called the split funded life insurance plan. This plan is discriminatory and allows the corporation to offer a significant benefit just to the HCEs. There are two ways to do it. One is with after-tax company contributions. The other is to use leverage. The corporation could borrow the contributions and deduct the interest. This is a way to provide the benefit and not have any company capital in the plan. Proper design makes the ultimate benefit exactly the same, but the cost savings due to the tax deduction significantly reduces the company's cost if it can qualify.

Split funded (sometimes referred to as split dollar) life insurance programs were a very popular benefit for decades, dating back to 1955. The corporation would loan the premium on an insurance policy to the employee and the owner of the policy would have the benefit of all the cash value net of the loan. Over many years, this could amount to a significant amount of cash value which would then provide tax free distributions through policy loans during retirement.

The IRS finally decided to close this "loophole" in 1998. In 2003, they came out with new regulations that significantly changed in the economics of the plan. Fortunately, this opened up the leverage opportunity. With leverage, instead of the company putting their capital into the plan, it could borrow the premium in a lump sum and deposit it over the first three years. This would supercharge the accumulation in the plan. Even though it is a loan to the corporation, there is no impact on the company financial statement. The company can deduct the interest on the loan and the owner of the policy still receives the net growth tax free so long as the policy does not lapse. The internal rate of return (IRR) of the leveraged plan can be in excess of 12% in most cases. It can be over 20% depending on how the costs are paid.

Other Benefits

There have been many other programs designed for business owners but the IRS has made changes to minimize or eliminate their effectiveness. Programs like Retired Lives Reserves, Welfare Benefit plans, 412i pension plans, and Section 79 plans were all opportunities in the tax code to provide deferred compensation benefits for the highly compensated. Some of these are still viable and can be utilized. But you need to be careful when a promoter comes to you with a "good idea." Many of these good ideas have no real economic substance and could be a tax trap, waiting for the unwary. So be sure to get good counsel and look for an opinion letter from a reputable law firm that is covered under Circular 230.

Good stewardship demands that business owners create a contingency plan

The Three Basic Problems Every Owner Faces

Before we look at the other two questions, let's look at the three basic problems common to every business owner. If the owner cares for their employees, these problems need a viable solution. Good stewardship demands that business owners create a contingency plan in the event of his 1) death, 2) disability, or 3) changes in the ownership structure of the company. It takes time and thought to put a satisfactory plan together. But without this planning, everything you worked for could fall apart when you are not there to manage the outcome.

1) Disability – Ask yourself this question. Can you afford to take a 6 month vacation and never call the company to see how things are going?

If we are honest, most of us would say “no way.” Yet that is exactly what could happen if the heart attack comes up short.

No one ever thinks this will happen to them. But it does happen. And when it does, it means there is no one to run the company. Worse, since 90% of all business owners are dependent upon their company for their income, it means a wounded company has to use its cash flow to fund the owner’s living expenses while trying to remain economically viable. This is hard to do.

Fortunately, there are quality, tax deductible disability programs available either on a group basis or an individual basis to help fund any income shortfalls. In addition, there are business expense policies to reimburse expenditures used to pay overhead during disability. Most disabilities last less than 30 days. But the ones that go longer can last 6 months or longer.

2) Death – If you became part of the grill on a Mack Truck going home tonight, havoc would likely reign in your world. Everything would stop and all options would suddenly be on the table; options you may have rejected while you had the choice. Heirs often just shut down the business. Your spouse may have to sell your house. What would happen to the kid’s college education? How would your family pay for food? It can get down to the basics real fast. And to the extent you have provided some margin, how long will that margin last? Many families suffer tremendous economic loss, in addition to the emotional loss, when the money machine stops producing money.

Most families have less than 6 month’s income in cash or cash equivalents. National statistics show the average household has less than $50,000 of life insurance. The reason? Cost. Yet, a $1,000,000 term policy often costs less than $500 a year. Is this a false economy? Again, it always comes down to trade offs. The motorcycle, boat, Jet Ski, or family ski trip often competes with providing financial stability in case the unimaginable happens. And in the final analysis, I have never seen anyone who has provided adequately for their family actually have to give up any recreational opportunities. It is only the fear of it that prevents people from taking action.

3) Business Continuity – As a business owner, this is where the rubber hits the road. What happens to your business if you don’t make it into work tomorrow? This almost happened to me. I was driving a car on the desert between Barstow and Sedona, Arizona. It flipped at 75mph and landed smack dab on the roof. The car was absolutely demolished. But I walked away with no injuries. It could have been a whole lot different. If I had perished, who would fund payroll? What do you tell your vendors? The customers? Who runs the business? Who makes the rain? The point is, when you stop, will everything else stop?

Contingency Planning

A contingency plan is important. A business that is dependent upon the efforts of the business owner to survive is particularly vulnerable. So having a continuity plan in place, a contingency plan for shutting down the business, shoring it up, continuing to have it run is important. Who will call the shots? Who will make sure there is money to pay the bills? How does the ownership transfer if that is necessary? Any business owner who cares about his company and his employees would want to take time to think about these issues. Have you?

Many business owners have a buy-sell agreement especially if they have a partner. But a buy-sell agreement funded with life insurance doesn't do the whole job. It is certainly a good first step. But it does not address the bigger issues such as, can the company remain a going concern? Who will be the boss? Will the employees stay? Will the customers go? So building an organizational chart that is not dependent upon you is a good first step. There are a lot of professional consultants who can help you think through these issues.

If you do have a partner, then you absolutely need to have a written buy-sell agreement. Here are five important issues that every buy-sell needs to address.

1. What happens in the event of death?
2. What happens in the event of disability? What is the definition of disability?
3. What happens in the event one of the partners goes bankrupt?
4. What happens if one of the partners gets a divorce?
5. What happens if one of the partners wants to retire or sell?

I have seen a lot of buy-sell agreements through the years. Most would get less than a C grade. I saw one just recently where the agreement gave either partner the ability to sell their interest. But the agreement was written so the one partner who wanted to buy the other's interest, was forced to sell at the same price, first. It was what might be considered a poison pill. So unless you wanted out, you were frozen and there was not a way to extricate yourself from a relationship that wasn't working.

In another instance, a widow was stuck with her husband's partner. He was a cantankerous, older gentleman who couldn't understand why the business was not doing as well now that the boss was dead. The widow had untold grief and stress trying to resolve issues that could have been resolved with some planning.

It is so important to make sure your agreement is written by a qualified attorney who knows the issues and the solutions, and can guide you through the thought process to avoid obvious errors.

II . KEEPING SUPERKEEPERS

Most business owners will face, at some time in their business cycle, the pressure to sell stock to key employees. The pressure will be to keep their superkeepers (super performers) – the key people you do not want to lose from your team. I have only one thing to say – don't sell stock. Don't sell stock unless you are ready to begin your exit strategy. Why?

I cannot tell you the number of situations where this has been a disaster for the owner. Something happens when stock transfers that turns your cooperative, malleable employee into a different person. When a loyal, dedicated, uninvolved employee is given stock, they become super vigilant, diligent, an audit hawk. What was once a very congenial, "go along with anything" associate now wants to know every detail related to everything going on in your business and will make your life miserable. You can no longer take long lunches; deduct golf games with potential consultants or key accounts.

Your life will change. Your car will come into question, along with your gas card and your salary will become an issue. The bonus program will suddenly become a major sticking point. Maybe you don't believe me? So go ahead and try it and find out. Many owners have and then have regretted it.

What Is The Solution?

Unfortunately, the real problem with selling stock does NOT solve the superkeeper issue. In fact it often exacerbates it. It also does not answer the question of how to attract and retain top talent. Remember, if you sell stock, you are limited to 100% of it. If you are concerned about your own financial security, giving away value at a bargain price is going backwards. The argument is that by selling stock, the overall value of the enterprise is not necessarily going to go up. This is the business conundrum. If you want to build a valuable business, you have to create an independent management team. If you want to retain your entrepreneurial independence, you can't build an independent management team. Talk about conflict. So what do you do?

First you have to decide what is important to you? What is your goal? Are you going to build to sell? Or build to hold? Or build to transfer to family? Or build to transfer to key employees?

If you are going to build to sell, then you need to give your superkeepers an incentive to help you make the company saleable. If you are going to build to hold, the superkeepers need to know there is a pot of gold at the end of their rainbow for helping you be an absent owner. If you are going to build to transfer, then the superkeepers need to feel secure about their position and know there is an economic benefit for helping you pass the business to family members. If you are going to pass it on to key employees, who? when? for how much?

But in all of these scenarios, the key question is – do you share equity or income? Income is a lot easier to share than equity. Income is very measurable and can be easily administered. Equity is nebulous and has no real value unless the company is sold to an outside buyer.

If you sell stock to superkeepers but you don't sell the company, you will ultimately have to buy it back. That is an expensive proposition with no tax benefits. But you can defer that decision until you pull the trigger on a deal. If you are going to transfer the business to internal buyers, you have a bit more latitude on what you can do. But in the end, you will have to decide if you want to compensate your key people with more than income and then be willing to stick with it. Otherwise, the business will be schizophrenic and so will you.

What tools are available to help you, besides selling stock?

Non Stock Alternatives

One of the best tools for building wealth without unleashing the audit monster are Equity Participation Plans sometimes referred to as phantom stock plans, Incentive Stock Plans or SARS – Stock Appreciation Rights. They generally all work the same way.

You allocate a certain amount of shares (phantom shares) to a pool. You then allocate those shares each year based on a formula and the shares are valued based on measurable metrics using the balance sheet. This metric is often just an increase in EBITDA. But it could be based on increases in retained earnings or some multiplier of net profits. By definition, this type of program is unique and distinctive for each business and each industry.

As I stated, you can only sell 100% of your stock. If you have 100,000 shares and you sell 20,000 shares, you have 80,000 shares left (80%). So by selling, you dilute your ownership. But if you allocate by formula 20% of the income, based on the salary of each participant, you will still retain 100% of the stock. You don't give away control. You don't have the audit hawks looking over your shoulder and the money is not payable except by the terms of the agreement. Plus it is deductible. You can also put limits on when you pay and how much. So a contribution can be withheld if the company does not hit certain growth metrics. Once you sell stock, it is virtually impossible to ever take it back and if you try, it will be very expensive.

What are the terms of an EPP? You tell me, you write the rules. You could cliff vest them at 100% when they retire, or upon sale of the business. This means they have no vested value until then. Now frankly, this approach won't work with highly competent, transient executives – so you probably are going to have to give up something sooner than retirement. But the point is, you control the rules.

Stock Sale

Against all odds, let's assume you decide you want to sell stock. There are good ways to do this and bad ways. Most every superkeeper is deficient in one important ingredient when it comes time to buy in – money. Unless they can borrow at the bank, mortgage their homestead, or liquidate their inheritance, they are usually month to month. So for them to buy stock, guess who has to help them? **You.**

There are two axioms that are ever present when discussing business succession strategies. The first is – there is NO SUCH THING as NEW MONEY. Every owner will get bought out of their own business with their own money. Don't believe me? Think about this. If you want to sell your business to an outside strategic buyer – how is the price determined? There are various methods – appraisal, capitalization of net income, multiple of sales, comparison to other companies that have sold recently and the book value. There are at least five methods. A good appraiser will often weight all five methods to give you a value. But when you get down to it, no one buys a business for an amount greater than 4 to 5 times net income. They want to pay off the purchase within a few short years.

there is NO SUCH THING as NEW MONEY!

Where does this number come from – 4 to 5 years? If you have substantial capital and you are money wise, you probably feel you can make 10% to 12% annually. Most equity buyers are thinking 20%. If we use 20%, that is a pay back in 5 years. The higher their expected return, the fewer years to pay them back.

So let's say you pull the trigger and sell your business to outside money. If the buyer gives you cash, it is really just an advance of money they expect to earn. Whose money do they expect to earn? If you had not sold the business, you would have earned the money they are going to turn around and give back to you. Sometimes, however, they make it a contingency sale. They give you money up front but hold back value to see how the company performs. Their payment is contingent upon performance. This gives you an incentive to make the deal work. But regardless, where did the money come from to buy you out? Once again, it was your money. They earned it from the company but they turned around and gave it back to you.

So in every instance, whether the payment is cash from liquidation of assets, borrowed funds, a private offering or an installment sale funded from cash flow, the results are always the same. It is a reflection of the income the company would have earned. The outside buyer is a facilitator. All they did was turn around and give you your money back. Granted, they may have taken some of the risk out of it, but in the final analysis, it was your money. And when it is over, what do you have? Nothing but the net proceeds from the sale.

If you sell to an internal buyer, the economics are exactly the same except you will give the internal buyer the money as salary first. So now what happens? They will pay tax at their top bracket and then turn around and give it back to you. This brings the second axiom into play. We call it the $1.82 story. The taxes on the sale of a business can be more than the fair market value of the company. This is especially true when you sell to an internal buyer.

Think about it.

The taxes are going to be 100%+ of the fair market value.

How is this possible?

Let's suppose you are to receive $1.00 of net proceeds. The internal buyer must earn $1.82 in the 45% bracket to net $1.00. (Proceeds divided by (1 – tax bracket)). So you pay the superkeeper extra income and they then, turn around and pay tax of $.82.

What happens next?

They now give you back your dollar.

Now what happens? You have to pay capital gains tax at 25% on your dollar. Add those two taxes together. It adds to 107% of the sale price.

You read that right – **107% of the sales price**. Done wrong, the sale of a business is the MOST HEAVILY taxed transaction in the Internal Revenue Code.

There must be a better way. Fortunately, there is.

III. EXIT STRATEGIES

Ok! So you are nearing retirement and you are thinking it is time to begin the transition process. What are you going to do? Let's review your basic options. Obviously, you could hold on to the business as long as possible and then just have your family liquidate the business, and sell off all the assets. This might be very profitable and a great option. But in most cases this just means you hold a fire sale and sell these valuable, income-producing assets at a substantial discount. This can be very painful and tedious. It is a well known truism (maybe a myth?) you will always get more for your business selling it as a going concern than you will selling it piece meal.

Your next option is to sell to an internal buyer. We have discussed the problems this poses. But basically, just as a review, inside buyers rarely have any money and are unable to provide capital or collateral without your help. So you have to be flexible and willing to work with the buyer. But I will tell you an intriguing little secret. If done properly, you can sell 50% of your business for 100% of the FMV today and then still be positioned to participate in any upside. Yes, you read correctly. If your company is worth $2,000,000, you can sell it for $2,000,000 today and still receive 50% of the increased income and value in future years. How?

We use this strategy a lot. Go ahead and arrange for the internal buyer to purchase your business, recognizing they are going to give you back your own money. Here is the trick. If you are willing to *convert* capital gains to *ordinary income*, you can accomplish some amazing results. And they are all legal under the tax code. You read right.

Now who would ever willingly and knowingly convert capital gains to ordinary income? No one would, unless there was a distinct advantage. Yet, this results in some incredible results for you and your family. More important, it eliminates 40% to 50% of the taxes. So instead of paying 107%, the tax will be under 40%. The best part is, the superkeeper can now afford to buy your business, and if structured correctly, it will never cost them anything out of pocket to do it.

The third scenario is what might be termed the "Holy Grail" of business succession. It is the one event every business owner is hoping for – sale to an external buyer. But let me point out something to you that may have escaped your radar. Many of the business owners today are baby boomers or may be even leading edgers. If you look at the impact baby boomers have had on every demographic milestone throughout their life, it has been pretty awesome. When they had babies, the diaper and baby furniture business became an industry. This then carried over to housing and recreation. And now as they head towards retirement, the world shudders to think what this will mean for long term care. But one thing we know, it will mean if boomers own a business, they may have a hard time finding a buyer. Why?

Think about this. If all the baby boomers were to decide to sell their business at the same time, how many buyers would be needed to purchase these businesses? Where would they come from? This is called supply and demand. When there is unlimited supply, what happens to prices? They decline to help move the products. But if there is limited supply, what happens? The price jumps through the roof. In other words, the more businesses for sale, the higher the chance the price will decline. More important there will be fewer buyers scrambling to find a good deal. So every buyer will become a precious and dear commodity. It will be a buyer's market.

What does this mean to you? If you think your company should sell for $3,000,000 in a hot market, what is it worth with no buyers available? The economic law of supply and demand suggests the price will likely decline. If it declines, you may find it harder and harder to pull the trigger to make the deal. So this will limit your options and you may find yourself running this business a lot longer than you meant to or you may just decide to liquidate it.

Another Issue To Consider

There is another problem that is not always foreseen. Assume you are making $250,000 a year, a relatively steady income, and one that suits your life style and personal ambitions. Someone comes to you and asks, "Have you ever thought about selling your business?" This gets you to thinking. "So what price would I want?" Well at 10%, I need about $2,500,000 you figure. But with inflation and taxes, maybe I really need closer to $3,000,000. This is often how the reasoning goes. But then you sit down with your accountant. He runs the figures and you find out you will pay close to $750,000 in capital gains taxes – which nets you only $2,250,000. Then your investment advisor tells you that 10% is a very aggressive figure. You should really think more in the range of 4% if you want to preserve your capital and protect your income against inflation. So now your sale, if you actually could get your price of $3,000,000, is only going to give you $92,000 a year. This is a far cry from the $250,000 you have been getting.

So, you begin thinking to yourself, this is not right. “I worked my entire life to build up this business so I could sell it and live a relaxed, comfortable retirement. If I want to maintain my lifestyle, I am going to have to stay active in this business for a lot longer than I ever planned. I am tired and ready to do something else.” We have found that almost every business owner will face this issue, if they haven’t already. Is there a solution?

If you are 70 years old and already lived through much of this nightmare, there may not be a traditional solution. We think there is, but it is not a size 10 shoe. You require a customized fitting and it will require some creative thinking to get there.

If you are 50 years old, the time to start Red Zone planning is right now. I know, you are not ready to sell. You have just hit your stride and you want to ride this wild pony until it drops. You want to milk a lot more profit out of the company and that is good. There is nothing wrong with a good, profitable wild ride. But we have found that now is the BEST time to lock in your succession plan – right now! Remember, you WILL be bought out with your own money. So why not start moving some of your money out of the business now, while time is on your side? Start your exit strategy right now. If you plan properly, you can get much more value out of your business than you ever thought possible.

Additional Strategies To Build And Retain Wealth

Making this decision, I have found, is the hardest thing for any business owner to do – diversify risk and cash flow. They are always fighting the cash flow boogie man. They often get too conservative and are reticent to make any long term commitments to a wealth accumulation plan for fear they will need the money if the business cycle turns. And unfortunately, this has happened. But when was the last time the company’s success depended upon your outside capital? But more important unless it is down to survival, your money should be the last source of capital, not the first. Unfortunately though, it is often the first source.

Whatever your situation, here are some exciting ideas you need to consider while time is on your side. Now, don't misunderstand me, you don't need to do all of them. Actually, you don't need to do any of them. But the purpose of this booklet is to introduce you to some of the strategies we are seeing business owners use to diversify their risk and build capital for their low stress years.

Captives – Many companies have risks that are uninsurable. If the uninsured event occurs, it could destroy the company. These risks are unique to each company. Congress authorized the formation of small captive insurance companies to help fund these risks. There are some very specific rules, but the rules allow each corporation to make deposits into a tax exempt entity for this expressed purpose.

You own this tax exempt entity – called a captive company. All the money accumulated in the company is invested and reserved in case of a claim. But if the claim never materializes, the assets remain in the captive and increase in value, as the captive grows. Since the premiums are tax deductible, a captive can be a significant long-term wealth accumulation tool for shareholders.

There are limitations and rules that have to be followed. There are also administration costs and reinsurance costs annually. But the set up cost is about 5% compared to a tax cost of 40% on the premium. When the company is liquidated, the retained earnings are taxed as capital gains. This would seem to offer a significant cost benefit ratio.

LTCI – Extended health care costs are a growing concern. Long term care insurance is becoming more important as a benefit. The statistics now show 1 in 2 people who reach age 70 are likely to need some type of special care before they die. How to best provide for this health care service is a nagging question. Most wealthy families would prefer to stay in their home rather than go to a senior housing facility. Medicare and Medicare supplements do not currently cover daily home care. What is the best way to finance these health care costs?

Based on our experience, the best way to cover costs that can last 2.5 years on average is to purchase long term care insurance. These plans pay a monthly benefit which can be used to pay for any type of services at home or in a care facility. The benefit payments are income tax free and the premiums are tax deductible if paid by the corporation. You can also pick and choose who you want to cover. So this can be a highly compensated executive only benefit.

Long term care insurance is a very important benefit for most families. It protects the family's wealth from liquidation and guarantees the family income is not going to be dissipated for health care to the detriment of the non-infirmed spouse. We have even seen the super wealthy purchase this coverage as a hedge against market turmoil.

419e – You have probably heard some of the negative publicity associated with welfare benefit plans. Many of these plans deserve the bad press. But there are still some plans that meet the spirit of the law and conform to the IRS guidelines. What makes a 419e so attractive? The strategy is a lot like the captive. You accumulate money in a trust for the purpose of funding health benefits. It can be used to buy life insurance, to pay co-pays and deductibles. It can also pay premiums on long term care and medical care supplements.

The plan utilizes the same rules as qualified retirement plans. All full time employees must participate in the plan for it to qualify for the tax deduction. But there are certain eligibility rules that allow latitude in the cost and structure of the plan. This can be a meaningful benefit for the owners of the company who often outlast most of their employees.

Defined Benefit plans – The IRS announced in 2005 they were going to scrutinize all 412i defined benefit plans. Why? Previous plans were deemed to be too aggressive and abusive in operation. What is a defined benefit plan? You can refer to the previous discussion. But to summarize, it is a plan that defines a benefit and then funds for that benefit using age and compensation variables. The funding is actuarially calculated based on certain interest assumptions and is adjusted annually based on actual performance. The lower the interest assumption is the higher the cost of funding the benefit.

Even though the benefits were reduced by the IRS audits, 412e(3) plans still provide substantial benefits and are worth analyzing as a way to build retirement wealth for business owners.

401(k)s – For a long time, 401(k) plans were not useful to the highly compensated or the owners of the companies. But Congress has remedied that problem by putting in guidelines for minimum contributions to the non highly compensated. So for employers who are willing to meet those guidelines, not only can the highly compensated executives contribute a lot of money, the plan can be designed to avoid expensive testing.

It is possible, with a well constructed plan for the owner to put away as much as $50,000 a year under current limits. However, it is important to note qualified plan assets become tax inefficient if you have a large net worth. These accounts are subject to both income and estate taxes, making the total tax in excess of 75% in most cases. The same is true for money accumulated in a defined benefit plan. So unless you are planning on taking significant distributions during your lifetime, these plans may be undesirable. Again, a wealth advisor can help you determine the benefits for your specific situation.

Capital Split Dollar – An alternative to selling stock or putting in a qualified plan for your superkeepers is to implement a Capital Split Dollar benefit plan. This strategy calls for the company to lend significant premiums to the executives for a period of 10 to15 years. The money is invested in a capital rich insurance policy designed for maximum accumulation. The cash account grows tax free until the executive is ready to borrow from the account during retirement. If the corporation borrows the capital for the plan, the interest on the loan is deductible, making Capital Split Dollar the only leveraged program with tax deductible interest.

Conclusion

Again, the sole purpose of the booklet is to give you a condensed overview of issues business owners will face in the coming years and explain some of the wealth accumulation opportunities available to mitigate those issues. Years ago, I discovered busy, successful business owners have precious little time to manage their Three Circles of Wealth. As a result, these circles are often mismanaged. Thousands of dollars are invested each year in these three circles with the primary purpose of trying to accomplish their desired objectives. These strategies are meant to help you reach your end result. The anticipated results are rarely achieved because of inefficiency and ineffective oversight. Instead, two things happen.

First, selected advisors for each circle who are focused on their own specialties are too busy being successful in their own practices to help you coordinate their planning efforts. Hence, inefficiencies occur and planning becomes default planning instead of purposeful planning.

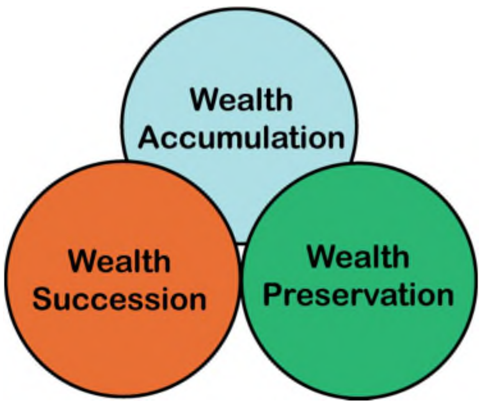
The second thing that happens is barriers to communication are erected by default between the circles causing each circle to work in isolation. And instead of being a coordinated plan, the plan becomes more and more disjointed as the laws change and the years pass, adding to the inefficiency of the plan.

So this combination of many advisors and inefficient communication causes the three circles to do less and less of what was originally intended. And unfortunately, no one advisor has enough authority or economic incentive to fix the problems.

This caused us to see things differently. We took a step back and looked at all three circles in a coordinated way. We found there were overlapping strategies that could use the same dollars to accomplish multiple objectives, thus turning inefficiency to efficiency. I think of it like the Olympic rings, where all three circles overlap and there are possibilities of creating double duty and triple duty dollars.

In order to determine whether or not there are efficiencies being overlooked or mismanaged, an assessment should be performed by a qualified consultant. The deliverable would be an analysis of your existing circles and a suggested course of action to increase efficiency.

For more information on these concepts, issues and perhaps an assessment, contact **info@bmiconsulting.com**. A representative in your area would be glad to contact you and discuss how you might be able to become more efficient and effective with the dollars you are already spending to help you reach your ultimate objective, financial independence.



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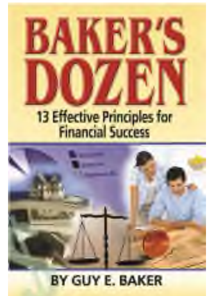
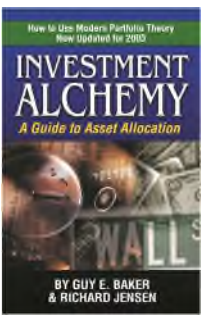


Guy's 13 fundamental principles for financial independence are time-tested and philosophically sound principles. You will learn firsthand from Guy's own experience how he applied these principles to create wealth in his own life. Recently updated, this 188 page book highlights the value of securing the family's welfare before taking on the risk of higher yields.

Investment Alchemy

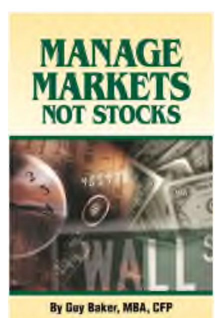


What investment strategies should an investor mix together to achieve long term financial success? *Investment Alchemy* describes a sensible, systematic method for shaping your investment decisions for the long term.

Written by Guy Baker and Rick Jensen, this 180 page book was also recently updated. It guides you through the components of Modern Portfolio Theory and gives you a method to make intelligent investment choices. Learn how to manage risk using concepts such as diversification, efficient frontier, efficient markets, asset allocation, and market timing.

Manage Markets Not Stocks

Can you answer these important questions?



- Every portfolio buys risk. Not all risk is equal. Do you know how much risk and what type of risk you are buying?
- Based on your Investment Policy Statement are you buying more risk than you need?
- Do you know in which markets you are invested?
- Do you know how the largest institutional investors manage their portfolios?
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