

Untapped Executive Benefits in the Small Business Market

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I believe that the executive benefits market is still a widely untapped market. In addition, insurance professionals have a tremendous opportunity to learn more about advanced planning concepts that can assist the small business owner to achieve his or her goals. In sum, there has never been a better time to enter the executive benefits market.

From the outset, I'd like to provide some perspective and briefly review the radically changing demographics in the United States. Doing so will demonstrate that there will be tremendous opportunities in the executive benefits market over the next several years.

I've always been taught that you begin a presentation by explaining to the audience "what's in it for them?" In this regard, allow me to explain to you folks why you should think more about this market.

First, it's important to keep in mind that the United States population is getting older. In fact, every 7 seconds someone in this country turns fifty. In addition, our population is living longer and many studies suggest that as a society, we've generally done an abysmal job of planning for retirement.

We are now facing what Gerontologist Ken Dychtwald calls the "age wave".¹ You can see why this is so. There will be an explosive growth in our country over the next 15 years in the "55 years old and older" market. We're referring, of course, to the baby boomer generation.

Generally, this generation has done a poor job of saving for retirement. Yet it faces higher longevity than any generation in history, an uncertain social security system, and skyrocketing medical expenses. To emphasize this point, a recent study² found that 48% of all workers believe that they have not planned properly for retirement. The study also found that most greatly underestimate the likelihood of living beyond life expectancy and underestimate how much money they will need to retire.

In addition, we're facing a limited workforce and fierce competition for talent. In his book, *Doing Nothing is Not an Option!- Facing the Imminent Labor Crisis*³, Robert K. Critchley interesting point that over the next 20 years,

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citizens over the age of 65 will outnumber children for the first time. America's labor force is not only growing older, it's also ushering in a whole new set of work force issues to tackle — including an impending labor shortage. Critchley advises that by 2010, there will be 169 million jobs in the United States, but only 159 million workers to undertake them — a 10 million worker shortfall! He also lays out the statistics of the graying labor pool, the implications for business organizations, and suggested solutions and strategies. His thesis, therefore, is that organizations must plan and position for the changing labor market. In addition, they must effectively compete for the best and the brightest of the shrinking labor pool. In sum, businesses must now find solutions among an aging population that has not done an effective job saving for retirement, a potential labor crisis, and staff competition for the best and brightest.

How will all of this impact the small business market, which is the market I am going to focus on for this presentation? First, let's define "small business market". According to the U.S. Census, and a 2003 LIMRA International study⁴, "small businesses" are defined as having between 1-1,000 employees. I want to focus on the largest segment of the small business market, which are those companies having 1 to 19 employees. Half of the small business market fits into this category, representing 616,000 firms nation wide. Strikingly, 53% of these businesses have no sort of executive benefits.

The study also found that once firms offer key employees at least one type of executive benefit, they are likely to provide additional types of executive benefits in future years. The study found that the market is underserved — 55 percent of the firms without executive benefits have never been approached by a financial service professional about providing for key employees. These firms are the most skeptical about executive benefits, and only 15 percent plan to add executive benefits plans in the future. Lack of interest, as well as believing the company has no need for the benefits, are their main reasons for not providing them. This lack of interest seems to point to a need to educate business owners about the types of

executive benefits available, as well as the advantages of providing them to key employees. Simply talking with a financial services professional about executive benefits seems to raise a firm's interest in providing them.

What is the upshot of this? I don't think it's an exaggeration to state that never before in history have people (relative to capital) been as important to the success or continuing success of a business. For this reason, employers are more concerned about recruiting, retaining, rewarding, and retiring those individuals who contribute or add the most to their corporate profits. Of course, executive benefits are of tremendous interest to the small business owner as well!

As if that was not enough to convince you of entering this market, let me add one other item. Over the past three years, the life insurance industry has been (for lack of a better phrase) in a legislative nightmare. We've seen the IRS and Treasury Departments issue guidance on sales concepts including split dollar, I.R.C. Section 419A(f)(6) Welfare Benefit Plans, and the valuation of life insurance inside qualified plans, and just recently non-qualified deferred compensation plans. As we all are aware, the uncertainty involving the estate tax repeal has cast enormous planning uncertainty in the market. Consequently, some of these markets have either shrunk dramatically or disappeared altogether.

We've gone over the question of why producers need to explore this market further. As you can see, there are tremendous opportunities here. Now let's take a look at "how" producers should approach this market as they prospect. I'm going to focus this presentation on prospecting the small business owner. The million dollar question becomes, "how do you get your foot in the door to meet with that small business owner." While I can't offer you phone scripts, or a slick one liner, I can offer you another perspective. You must study and master these concepts. More important, you must believe that your experience brings an added value. By mastering some of the concepts I'll be reviewing shortly, you will be able to suggest creative (and much needed) possible solutions to the small business owner. To be sure, producers need fresh and innovative

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strategies with “soup to nuts” service. As an insurance professional specializing in the executive benefits market, you can provide this exceptional service.

Approaching the Small Business Owner

So you’ve successfully prospected this market and have made an appointment with Sally Small Business Owner and Bob Benefits Director. Both of these individuals are the company “decision maker” for prospective executive benefits. First and foremost, let’s get right to your biggest challenge. You are not there simply to sell them something. You are there to gain information, listen to how their current benefits package is structured, and suggest possible solutions. If you have not communicated that, you’ve lost the sale.

You must also be a student of this market. Of the research I’ve done for this presentation, here are some constant themes I’d like to share with you. First, successful producers tell me that in this market you have to be part financial professional, part amateur psychologist. By that, I’m referring to the politics and personal dynamics of the organization. We could spend 40 minutes just talking about that alone! In addition, understand that with most of these folks, the majority of their net worth is tied up into a single asset: the small business. Finally, these folks are busy. They have limited time and attention. So like most things in life, preparation is paramount.

What questions might you ask? First, does the business have a qualified plan? If so, what kind of plan? Are they satisfied with that plan? Are the executives satisfied with the amount of money they are able to contribute to the plan? These questions will almost always generate some interest and follow-up questions. The fact is that most highly compensated employees are taxed at the highest marginal rate, and would love to defer more of their income instead of paying “Uncle Sam.”

Obviously, you also need to determine whether the executives have sufficient life insurance protection. After completing the fact finding, you may have the opportunity to suggest some possible solutions. I’m going to go over four such solutions. I apologize in advance that time

prevents us from going deep into the technical aspect of each. But to that end, I’ve provided a host of resources at the end of the presentation for you to turn to if you are so inspired.

Non-Qualified Deferred-Compensation Plans

But what if the business has no qualified plan, or has a qualified plan that does not allow for the purchase of life insurance. Is all lost? Of course not. Another concept exists for the small business owner that allows the executive to defer large amounts of his or her income.

Ask the question of whether the business owner or some key employees believe they are paying too much in taxes? The fact is that highly compensated employees are being discriminated against by the government. This is because tax law changes have altered the realized benefits available to highly compensated employees within qualified plans. As I mentioned before, all companies are competing for new talent – and trying to retain top-tier executives. Here’s what I mean when I mentioned that the tax code discriminates against highly compensated executives in qualified plan contributions.

Take three people: Sally Secretary, who makes \$ 30,000 per year; Mike Manger, who makes \$60,000 per year; and Amy Executive, who makes \$300,000. Each participates in the company’s 401(k) plan. In 2005, the effective deferral limit is \$14,000. For simplicity, let’s assume there is no employer match. As such, Sally can defer 46.7% of her salary to the 401(k) plan; Mike can defer 23.3%, and Amy only 4.7%.

A non-qualified deferred compensation arrangement is a technique to provide meaningful benefits to select executives, and key persons. Non-qualified deferred compensation plans comprise of an agreement by an employer to make future payments to an employee as compensation for services to be rendered. Because these plans are non-qualified, it is exempt from most of the rules and regulations governed by ERISA that apply to qualified plans.

With the baby boomers retiring in record numbers, employers now more than ever, are looking to retain recruit, reward and retire key employees. The flexible non-

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qualified deferred compensation plans, allow the employer to pick and choose which executives will be covered, the level of benefits provided, and the agreement's terms and conditions. Additionally, the I.R.S. places severe limits on the amount of tax-deferred income that may be contributed to a qualified plan. Non-qualified deferred compensation plans are typically exempt from restrictions on funding limits, vesting, and funding rules imposed on qualified pension and profit sharing plans. While the employer faces the challenges stated above, today's executive faces serious concern regarding his or her own financial security, particularly with retirement savings.

Typically, these plans take one of two forms: salary continuation plans, or salary reduction plans. A salary continuation plan is an agreement wherein the employer promises to pay to an employee future compensation at retirement without a reduction in the employee's current compensation. The plan provides benefits in addition to the executive's salary, and does not require a reduction in the executive's salary. In a salary reduction plan, the executive defers receipt of compensation from the current year to his or her retirement. This typically involves an elective deferral of a specified amount of the compensation the employee could have taken, but chooses to defer. Employees will select this type of plan as a way to save more aggressively for retirement than otherwise possible.

These plans have been in the news lately, and I'd like to provide you with a very brief overview of how they have been impacted. The American Jobs Creation Act of 2004, passed by Congress on October 11 of last year, provides a set of new rules for nonqualified deferred compensation plans.⁵ These rules are not particularly favorable for deferred compensation, and will likely require redrafting of most existing plans.

Despite that, the major thrust of current deferred compensation planning, and the benefits of these plans, remains in place. Some more cautious practitioners may even welcome the certainty of the new rules as a replacement for the relatively vague guidelines of prior law.

One of the new provisions is a restriction on distributions from nonqualified deferred compensation plans.

Distributions may not be made earlier than separation from service, disability, death of the employee, a time specified under the plan, a change in ownership or control, or an unforeseeable emergency.

Two other provisions of the law deal with the acceleration of distributions and rules for the timing of elections by employees to defer compensation. Because of the time restriction, I won't discuss these.

Next, I'm going to provide you with two solutions in which the small business owner might be interested. First we'll take a look at a very popular qualified plan: a Section 412(i) plan. The second is for the "owner only business" and it's called an Individual(K) plan. Let's take a look at each.

Section 412(i) Defined Benefit Plans

A pension plan exists that may offer an attractive solution for small business owners looking for higher contributions, fixed accumulation guarantees, and a guaranteed stream of income at retirement. Introduced in 1974, §412(i) plans are well-established qualified plans that can provide safety from investment risk for both the employee and the employer. The plans have increased in popularity for many reasons. Defined benefit plans have become attractive to business owners aged 40 and older, as the maximum amount allowed to contribute may be significantly higher than a defined contribution plan. Along with the volatile stock market, the ability to purchase life insurance on a tax-deductible basis, and underlying product guarantees, 412(i) defined benefit plans have gotten the attention of many baby boomers who have not saved enough money for retirement.

What's great from the small business owner's perspective is that §412(i) plans are easy to understand. Annuities and optional life insurance contracts, with underlying guaranteed returns, are purchased to provide the retirement benefits promised in the plan. Benefits are funded over the working lifetime of each employee, and the deductible contribution funds these contracts each year. At retirement, employees can choose from a number of retirement strategies depending on their needs and interests.

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Section 412(i) plans have become popular for many reasons. First, employers can get the largest tax deductions of any qualified retirement plan, and both employees and employers are protected from stock market fluctuations. In addition, most types of business entities may utilize §412(i) plans, including Sole Proprietors, Partnerships, C-Corporations and S-Corporations. It is most advantageous for small stable business owners who are age 45 and over with ten or fewer employees. These business owners should also be seeking to maximize tax deductions and provide a substantial retirement benefit for themselves and other long-term employees.

The “ideal” prospect is a closely held business owner who, after expenses, realizes several hundred thousand dollars worth of profits. The owner would like to contribute much of this money to his or her qualified plan, but his or her qualified plan cannot accept nearly enough of the desired contribution due to its low maximum contribution limit. This candidate should also desire to contribute more money to fund for retirement and have a larger tax deduction.

All qualified plans involve significant tax benefits due to the fact that contributions are currently deductible by the employer and excludible from income by the participants in the year made. However, §412(i) plans can provide a greater initial contribution pattern that accelerates employer deductions and magnifies the economics. The increase in contribution is due to the low permanently guaranteed interest rate in the insurance or annuity contract. Because of these high initial payments into the §412(i) plan, the business owner is using the “time value of money” principle to his or her benefit.

Life insurance provides important additional benefits for a participant. If there is an insurance need, the plan may obtain the benefits of life insurance for plan participants on a pre-tax basis. For highly profitable, closely held businesses, there often exists a substantial insurance need for the owner. A “fully insured” plan not only can maximize the current deductions, but can also meet these needs by funding the benefits with life insurance contracts.

How can one determine the maximum benefits paid to the participants at retirement? The Internal Revenue Code provides the answer. I.R.C. Code §415 applies to all 412(i) defined benefit plans in the same way as in a traditional, defined benefit plan. In general, this limitation, when expressed as an annual benefit is the lesser of:

- (A) The specified dollar amount (Dollar Limitation), or
- (B) 100 percent of the participant’s average compensation for his/her high three years. (Compensation and Benefit Limitation).

For employers using calendar year 2005 as their taxable year, the plan has to be established by December 31, 2005. The insurance itself can be issued within a month after the end of the taxable year, but the adoption and initial funding of the plan would have to be in 2005. The employer, generally, has until it files its final tax return to make the balance of the contributions. Finally, producers should demand a carrier provide a recommendation of third party administration; turnkey marketing kits; knowledgeable wholesalers who offer concept expertise; and competitive product offerings for this market.

On February 13, 2004, the Treasury Department and IRS issued long awaited guidance on the valuation of life insurance policies as well as clarification on types of Section 412(i) plans it deemed “abusive”. Specifically, the IRS issued one set of proposed regulations, two revenue rulings and one revenue procedure. This guidance is significant in many ways. First, it is intended to eliminate abusive transactions involving life insurance, retirement plans, group permanent life insurance, and “Section 83” transfers. In addition, the guidance designates certain arrangements as “listed transactions” for tax shelter reporting purposes. Perhaps most significantly, the guidance provides that any life insurance contracts distributed by an employer tax-qualified plan to an employee must be taxed at its *full fair market value*. Determining the fair market value of a distributed contract is discussed below.

In the Proposed Regulation preamble, the IRS explains that due to the structure of some springing cash value life

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insurance products, it is sometimes inappropriate to use either the cash surrender value or the contract reserves to determine fair market value.

The preamble of the Proposed Regulations state **that neither the cash surrender value nor contract reserves should establish the fair market value of a policy, if those amounts are significantly less than:**

- (1) the premiums paid through the date of distribution, plus
- (2) the amounts credited or otherwise made available to the policyholder with respect to the premiums (such as dividends) and, in the case of variable contracts, the adjustments made with respect to the premiums paid during that period that reflect investment return and the current market value of segregated asset accounts, minus
- (3) the reasonable charges (including mortality and other charges) actually charged from the date of issue to the date of distribution, and including only those charges that are actually expected to be paid.

As you can see, the 412(i) plan offers producers a dynamic opportunity for the small to mid size business owner.

Individual(k) Defined Contribution Plans

Individuals who own their own "one person" businesses face many challenges in setting a profitable course for their futures. High on the list of many is the ability to retire with sufficient assets. Part of this frustration lies with the inability to contribute a greater amount of earnings into a qualified plan. . With profits increasing, retirement looming, and an insufficient balance in their qualified plan, a relatively new type of qualified plan might be a perfect solution.

The Economic Growth and Tax Relief Reconciliation Act of 2001 brought revolutionary changes to 401(k) plans. These changes have led to the creation of the Individual(k) plan, which offers potentially higher contributions than many defined contribution plans, as

well as contribution flexibility and minimal administration costs. These features, along with the possibility of purchasing life insurance with tax-deductible dollars and the ability to consolidate most other retirement plans, make the Individual(k) an attractive solution for many owner-only businesses.

Why should producers take a closer look at this concept? With an Individual(k) plan, an employer's deduction of employee elective deferrals is not subject to the employer general limitation of 25% of payroll. In addition, the amount that can be allocated to any individual (the IRC Section 415 limit) is 100% of pay to a maximum \$42,000 for 2005. This means that many business owners will be able to put more into an Individual(k) plan than a traditional SEP or profit sharing plan. Contributions are flexible and purely discretionary. For those small business owners (and their employees) age 50 and over, an additional catch-up elective deferral contribution of \$4000 can be made in 2005 on top of the general \$14,000 limit.

There are numerous prospects for Individual(k) plans, which are uniquely suitable for owner-only small businesses, partnerships and sole proprietors. Corporations are also eligible, so long as the owner draws a salary or wage (W-2 income) and there are no other eligible employees. Individual(k) prospects are numerous and include any business with only one employee (i.e. consultants), and any business which employs only owners of the business or family members.

It is notable that with the exception of certain family members, a business must not employ any "eligible employees". Consequently, owner-only companies that plan on hiring pension eligible employees in the near future may not be a good prospect for an Individual(k) plan. Eligible employees are required by qualified plan non-discrimination requirements to be included in a pension plan.

The Individual(k) plan may also allow the financial professional to benefit by controlling more assets under management. Specifically, a client's former retirement accounts (including traditional IRAs) can be rolled into a new Individual(k) account. By consolidating assets,

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clients will have all “retirement assets” in one account, with one statement and one professional to assist them with their financial and investment strategy.

Unlike an IRA, an Individual(k) permits the purchase of permanent life insurance with pre-tax dollars. This feature, of course, gives your client additional purchasing power. Because premiums are paid with pre-tax dollars, an owner in a high tax bracket may obtain more protection than he or she could otherwise receive by paying premiums with the same amount of after-tax dollars. Keep in mind that purchasing a life insurance policy in an Individual(k) causes current taxation to the participant. The taxable amount is the term cost of the pure insurance amount based on IRS table rates or alternative rates of the insurance company.

It is critical for producers to work with carriers which offer turnkey marketing kits that include producer guides, plan prototype documents, prospecting letters, and marketing materials. Also be sure the carrier offers preferred third-party administration. This feature is particularly important if the client plans to utilize the loan provision or purchase life insurance within the plan.

In sum, the Individual(k) plan benefits the owner-only business with a potentially higher contribution limit, and low administrative costs. Offering this business owner the unique solution of an Individual(k) plan may set the financial professional apart in this complex and highly competitive marketplace.

Taking it to the next level

So where do we go from here? We’ve reviewed several different sales concepts in just 40 minutes! Well, I hope as this session has gone on you’ve thought about who in your book of business fits these client profiles. No doubt, many of your small business owners are looking for solutions from you. What about taking your expertise in these concepts to the next level? What reference material should you consider as you enter these markets?

First, it’s imperative to keep current with these concepts by subscribing to such weekly and monthly periodicals as National Underwriter, Broker World Magazine, or Life Insurance Selling. I’d also recommend having the latest editions of Tax Facts and Field Guide. These publications are to the point, and do a great job of simplifying even the most complex of concepts.

The treatise “Tools & Techniques of Employee Benefits Plans” is also helpful, and covers the topics in depth. I’m also a big fan of Steve Leimberg. Steve’s web site, Leimbergservices.com, describes the many services he provides. These services are great at keeping a producer up to date on new sales strategies and legislative happenings.

You might also consider investing the money in purchasing a treatise Mr. Leimberg and Howard Zaritsky authored titled “Tax Planning with Life Insurance.”

Finally, I’ve found that carriers may provide valuable resources in these markets. Many offer advanced sales support, marketing kits, illustration systems, and a fleet of wholesalers who are technically proficient and can assist you in many ways.

In conclusion, I hope this information helps to prove that advisors can strengthen their relationship with business owners by approaching them with a genuine understanding of both their business and personal needs, and the means to help them prepare for and protect for their futures.

(Footnotes)

¹ See Generally: Dychtwald, Ken, and Flower, Joe, *The Age Wave: How The Most Important Trend of Our Time Will Change Your Future*, St. Martins Press, 1990.

² 2003 Met Life Employee Benefit Trend

³ See Generally: Critchley, Robert K., *Doing Nothing is Not an Option!-Facing the Imminent Labor Crisis*, Nelson Thomas Learning, 2004.

⁴ “Executive Benefits: Employer View Point”, Cheryl Retzliff, 7/20/04, study by LIMRA International

⁵ For a complete summary, See: Steve Leimberg’s *Employee Benefits and Retirement Planning Newsletter # 270* at <http://www.leimbergservices.com> Copyright 2004 Leimberg Information Services, Inc. (LISI)