Advance Practice Webinar: Opportunities With Business Owners and High Net Worth Families in the New Normal

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"Creating Business Cash Infusions Through Net Operating Losses"

Net operating losses (NOLs) occur for small businesses when the company's deductions for the tax year exceed the company's income that year. For tax purposes, NOLs can offset income in other years. The Tax Cuts and Jobs Act of 2017 changed the rules so that businesses could no longer apply NOLs to previous tax years but had to carry them forward and could use them to offset only 80% of taxable income in those future years.

The CARES Act changed things once more, allowing NOLs from 2018, 2019, or 2020 to be carried back for up to five years and offset up to 100% of income. As a result, many businesses are able to receive a refund of taxes paid in prior years.

PHANTOM STOCK OR EQUITY PLANS

This creates opportunities for a variety of financial planning strategies for businesses. One plan involves putting the refunded money into phantom stock or phantom equity plans, Bilderback said. Under these plans, companies can give a key employee the right to receive cash at a specified date in the future based on the performance of the company's equity over a specified period of time.

This allows owners to avoid diluting ownership, but gives plan participants the feeling that they have an equity interest in the company. The amount of the benefit is linked to the value of the company, and the payout can be linked any of several events (subject to section 409A of the tax code):

- Separation from service
- Death of the employee
- Disability (in some cases)
- Change of control of the company (in some cases)
- Unforeseen emergencies
- At a specified date or on a set schedule

These plans have both advantages and tradeoffs for both the employer and the employee. For the employer, there is no dilution of company ownership and a minimal impact on cashflow, but the plans are not eligible for deductions until benefits are paid. Employees get a tax deferral but do not receive voting rights or dividends that would come with a true ownership stake.

SUPPLEMENTAL EXECUTIVE RETIREMENT PLANS

NOL refunds may also be used to create supplemental executive retirement plans (SERPs). These are 100% employer-paid qualified plans providing benefits to a select group of employees. Known as "top hat" plans, SERPs designated as deferred compensation for a select group of management or highly compensated employees generally qualify for ERISA exceptions, though they are subject to Section 409A.

Under these plans, employers make a specific contribution for a specific number of years and the employees may not contribute. The employer contributions are not current taxable income for the employees and are often subject to a vesting schedule. SERPs are also "subject to the business fortunes of the employer," Bilderback said. "So if the employer, for example, goes bankrupt or has creditor claims, any benefits would be subject to those claims. There's not the same kind of security for the employee as they have with a qualified plan, for example."

Using life insurance policies is another strategy to informally finance SERPs, Bilderback said. Policies on the employees provide tax-deferred cash accumulation, tax-free access to policy-value loans or withdrawals, tax-free death proceeds, and cost recovery from the proceeds. Potential drawbacks include: high policy costs early on, non-deductibility of premium payments, and difficulty in using policy values for older participants.

S CORPORATIONS AND PARTNERSHIPS

For S Corporations and partnerships to deduct NOLs, owners must have cost basis against which to deduct the losses. In other words, S Corporation owners must borrow from a third party and in turn lend that money to the company to establish basis. In general, partners in a partnership get basis when the partnership borrows from a third party.

Partners or owners may want to create a buy-sell LLC using life insurance on each of the owners to fund buyouts paid to the estates of owners who die. Cash value may be used to buy out owners or partners who leave the company before they die. NOLs provide a good way to pay for the life insurance policies.

Ron Lee, JD, CLU, ChFC, CAP,

Vice President, Advanced Markets and Brokerage Field Relations, Mutual of Omaha

"Stretch Options Under the SECURE Act"

The SECURE Act changed the rules for inherited "stretch IRAs," said Ron Lee. Generally, the new rules apply to beneficiaries who have inherited IRAs from people who have died in 2020. Under the new rules, only those who qualify as eligible designated beneficiaries (EDBs), a new classification under SECURE, are able to stretch the benefits from an inherited IRA. Those who are not surviving spouses or EDBs may not stretch out inherited IRA benefits over their own life times, as they could under old rules, but must take a distribution or distributions to deplete the entire IRA balance over or during the 10 years following the death of the original owner.

Surviving spouses may choose to take direct ownership of the IRA, meaning penalty and required minimum distribution (RMD) rules will be based on the beneficiary's age, or they may inherit the IRA as and EDB.

RULES FOR EDBS

EDBs, under the SECURE Act, may still stretch inherited IRAs under differing rules. They include:

- The surviving spouse – RMDs must begin when the participant would have reached age 72.
- A minor child of the deceased IRA owner – May take distributions based on their life expectancy, but when they reach the "age of majority" they must take all distributions over the next 10 years.
- A disabled individual – May stretch payments over their lifetime.
- A chronically ill individual – May stretch payments over their lifetime.
- A beneficiary who is less than 10 years younger than the deceased IRA owner – May stretch payments over their lifetime.

Because under the new rules most beneficiaries have a compressed time to take their inherited IRA distributions, it could make sense to do a Roth conversion, Lee said. This is particularly true if the beneficiary has estate tax issues. Better yet, Lee said, beneficiaries should consider purchasing life insurance with the IRA money.

Andrew J. Rinn, JD, CFP. CLU, ChFC,

Vice President of Markets and Practice Management and Development, Ameritas

"SECURE Act and Trust Planning"

SECURE Act changes affecting stretch IRAs have created opportunities involving a certain kind of trust called a see-through trust. Under the SECURE Act, Rinn said, trusts may still be beneficiaries of inherited IRAs. Under a see-through trust, individual beneficiaries are considered designated beneficiaries and may be considered EDBs if they meet the criteria outlined by Lee. See-through trusts must:

- Be valid under state law
- Be irrevocable or become irrevocable upon the death of the owner
- Have identifiable people (human beings, not entities) as beneficiaries
- Be provided to the IRA custodian before Oct. 31 of the year following the owner's death

See-through trusts may be conduit or accumulation trusts. Under a conduit trust, all distributions from an inherited IRA are paid to the beneficiary and taxed at the beneficiary's rate. A disadvantage of a conduit trust is that it provides less asset protection for the benefits than an accumulation trust. An accumulation trust receives the inherited IRA distributions over time and pays them out to the beneficiary under the terms of the trust. This protects the inherited IRA's assets, but undistributed income is taxed at trust rates. "And those trust rates are nasty," Rinn said.

"If we could engage in some smart estate planning under the new SECURE Act with a conduit trust, that would be the best of both worlds," Rinn said. "Because we can go ahead and pull those assets through the trust and not worry about those trust tax brackets and be able to stretch out an IRA for the beneficiaries."

Under SECURE, conduit and accumulation trusts with designated beneficiaries are subject to the 10-year distribution rule. Conduit trusts with beneficiaries who are EDBs may stretch distributions in a traditional manner or under the disbursement provision for minor children. The IRS has not clarified the distribution rules for EDBs of accumulation trusts.

CHARITABLE REMAINDER TRUSTS

A charitable remainder trust (CRT) is another estate planning option, Rinn said. When a CRT is the beneficiary of an inherited IRA, designated recipients receive income interest for life or for a term of up to 20 years, with the remainder of the trust going to charity. This allows a trust that does not have an identifiable human as its beneficiary to pay out beyond the usual five-year limit for trusts and beyond the 10-year limit for designated beneficiaries.