Specialty Markets

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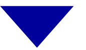

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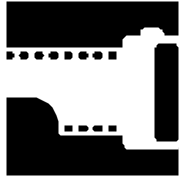


INTRODUCTION

The term "specialty or advanced markets" in the insurance industry generally refers to unique risks in quality markets. Agents and insurers operating within these markets can face difficult insurance challenges and problems. The risks in these areas are special ones and can be difficult to plan for and place.

What Are Specialty Markets?

Essentially, special life or advanced markets are market niches. Servicing these markets may be an agent's complete and total focus or a matter of upgrading the level of clientele that an agent already serves. Exploring and conquering these new markets can generate substantial rewards.

Servicing special life markets is accomplished by penetrating a particular market. The first goal toward penetrating these new markets is to carefully analyze their advanced sales potential. In the insurance industry today, the most common targets for advanced markets are:

1) The medical field.
2) The legal field.
3) The banking industry.
4) The small business community.

The Medical Field

The medical field is a hotbed as an advanced market. It has great potential. However, it is also a highly specialized market. The medical field is made up of professionals who speak a language all their own. To be successful in this market, the agent must be confident and well-poised.

In a busy medical office, it is often difficult just to secure an interview. Physicians and other medical professionals are busy people, and they do not waste their time. When approaching this market, the agent should have a familiarity of the business language of the medical community and a knowledge of their buying decisions. With the proper training and background, an agent can demonstrate how insurance planning techniques can improve the viability of the medical practice.

The Legal Field

Like the medical field, the legal field is also a highly specialized line of work. There are two obvious advantages of penetrating this market:

1) Lawyers typically see the need for selling their practice at retirement or death at a fair market value, and a well-poised agent can meet this need.
2) Lawyers are in an especially good position to offer referrals. The growth opportunities in this market can be boundless.

Since the legal field is so specialized, it may be difficult to penetrate. Like those in the medical profession, attorneys often prefer doing business with their peers. Generally, they appreciate dealing with someone who can understand the pressures and challenges they face. The agent

who services this advanced market must have an understanding of legal jargon and the legal process. He must be able to communicate comfortably with attorneys and other law professionals.

To be successful in this market, the agent must understand the attorney's decision-making process. He should have a grasp of the resources that may be used to fund insurance proposals. The agent's ability to establish rapport can create trust.

The Banking Industry

The banking industry is also a field of growth for agents wishing to expand their markets. Bankers are typically successful, and they see the need for strategies such as executive retirement plans, salary continuation agreements and other long-range benefit plans. Because of their positions, they relate to other successful people who can understand the difficulties they face.

Ideally, the agent who pursues this market should know key banking officials and move within their circles. First, the agent must possess a practical knowledge of the financial world. He must be able to relate to the banking community and help key officials understand the importance of suitable business planning and tax management.

In penetrating this market, an existing business or social relationship is helpful. The agent should have some understanding of the management challenges faced by these professionals. He must be able to spot potential opportunities within the field.

The Small Business Community

While the small business community is not as highly specialized as the advanced markets described above, penetrating this market can be just as challenging because of its sweeping nature. Business owners have obvious needs. If they have successful and growing businesses, they have concerns such as key employee insurance, business and salary continuation plans, executive bonus and compensation plans, retirement plans, estate planning, disability income, group medical plans, and other long-term benefits.

In servicing this market, the agent should have a broad understanding of the business community. He must be able to appreciate what it takes to be successful. Fortunately, many agents already have associations with business owners. With the proper training and the proper approach, this business relationship can grow into a more favorable relationship for both the agent and the business owner.

The Agent's Role in Specialty Markets

There are many levels that agent's may operate in these advanced markets.

On one level, you may be helping individuals within these markets insulate their exposure to personal and family economic loss through the sale of personal life insurance. You may also be licensed in property / casualty in order to help clients manage and mitigate loss of personal and business property and/or help reduce claims through structured loss control measures.

On another level, you may be advising individual clients on methods and ways to grow their estates using a variety of insurance and/or securities products.

On an even higher level, you may be the ultimate business counselor, by helping clients study their business for the greatest return via structure, reduced taxes and the best methods to liquidate when needed. For the highly-compensated, you may also be the source for understanding disability, retirement and executive bonus planning to maximize "pre-tax" investment results.

It is this last level that we are most concerned in the specialty market field. In order to achieve this level of service, you must understand:

Business formation
Business continuation
Business benefits (bonus and long term care plans)
Business estates

These are the target subjects of this course.

Penetrating Specialty Markets

Not surprisingly, special or advanced markets can be difficult to break into. Naturally, not every agent can possess a medical background, have an understanding of legal jargon, hold banking contacts or be proficient in long term care. Therefore, it is not likely that a single agent can infiltrate all of these markets in his career. However, let's remember that these markets are termed "advanced" because they take time to develop.

With tenacity and determination, an agent can penetrate one or even more of these advanced markets successfully.

To be most effective when penetrating a particular advanced market group, it is important for the agent to position himself in the company of the individuals within the group. Some means of accomplishing this are:

1) Understanding the basics of business formation, business continuation business compensation and business estates as explained in this course,
2) Be able to effectively communicate with those within the target market, understand and use their terminology and phraseology.
3) Get to know the industry and the lifestyles of those who are in it.
4) Be able to identify the areas of commonality with those within the target market.

By developing himself in these areas, the agent will be able to penetrate target markets. He can create a credibility about himself. The most practical way to accomplish this goal is for the agent to read as much industry material as he possibly can. By doing so, he can keep himself up to date on current movements within the industry, make himself aware of new industry trends, and learn and develop industry-specific language skills.

Reading in the form of books, trade magazines or newsletters is a must. Other areas of activity include:

1) Develop industry insight.
2) Learn of industry associations and organization so that the agent can attend meetings, and gain further knowledge.
3) Learn of challenges that face the industry.

4) Learn to relate to industry issues.
5) Examine the advertising focus to learn the benefits being sold to the industry.

BUSINESS FORMATIONS

A business enterprise may be operated or conducted by a sole proprietorship, a partnership, a corporation, a limited liability corporation or some other form of business organization. The selection of the particular form of business unit is a matter for the owner or owners of the venture to determine -- possibly with your assistance. Often a business will begin as a sole proprietorship, later develop into a partnership, and finally be incorporated. Whenever a new venture is begun, there are many factors that affect the decision to use one form of business enterprise over another.

Careful consideration must be given to the many issues and factors that influence the choice of a business's organization. The determination must be made for a legal structure that will best suit the needs of the particular business, as well as for the owner or owners of the business.

There are ***three major factors*** that must be considered when determining the legal structure to best suit the needs of a particular business. These factors affect both the formation or start of the business and its eventual sale or liquidation.

1) The first factor to influence the choice of entity decision is ***the relationship between the parties*** and the relationship between the investors and third parties. The choice of entity typically require determining the extent to which the owners and investors wish to avoid personal and financial liability for losses and claims that may arise in connection with the ownership and operation of the business.

2) Another factor to be considered is the ***changing federal and state income tax laws***.

3) Another major factor influencing the decision of which form of business to select is the ***fluctuating availability of capital***.

Of course, there are other considerations, as well, such as the personal circumstances and the objectives of the owner or each of the owners involved and the goals of the business enterprise. Where the business is to be owned by more than one person, these individuals may have significantly different tax, business, and personal objectives.

All forms of business organization have their own advantages and disadvantages. Creating a business requires skill, knowledge, strategy, and planning. To be successful, the prospective owner or owner must understand the rules that govern the operation of the business and the local, state, and federal laws by which the business must be conducted.

THE SOLE PROPRIETORSHIP

The sole proprietorship is the most simple form of doing business. Legally, to establish a sole proprietorship, the owner only needs to obtain the required licenses and permits.

A sole proprietor means that there is one single owner of the business. He makes all of the business decisions, and always remains the sole owner. This sole proprietor of a business has

great liability. He is personally liable for all the debts, taxes, and liabilities of the business. This includes claims not only made against him, but any claims made against employees acting in the course and scope of their employment.

In a sole proprietorship, the business does not pay taxes as an entity. The owner reports and pays taxes on the profits of his business on his own individual income tax return; no other tax return is required. Bookkeeping and tax accounting in a sole proprietorship are often elementary and inexpensive.

The sole proprietorship is the most prevailing form of small business organization. Possibly, the main advantage of a sole proprietorship is that fact that there is only one boss. Potential conflicts are thereby eliminated. The disadvantages of a sole proprietorship stem from the same situation—there is only one owner. The sole proprietor has no one to share the responsibility or the decision making with. If the sole proprietor wants vacation time or becomes ill, he is unlikely to find someone competent and willing to fill in for him on a short-term basis.

If a business owner decides that he likes the role of the sole proprietor but finds that he wants some of the advantages of shared ownership, he may offer a profit sharing agreement within the framework of the sole proprietorship to one or more of his employees. The sole proprietorship is often the most advantageous business form for a small retail or service operation.

Advantages

Some advantages of sole proprietorship are:

Ease of formation. There is less formality and fewer legal restrictions associated with establishing a sole proprietorship. It needs little or no governmental approval and usually is less expensive than a partnership or a corporation.

Sole ownership of profits. The proprietor is not required to share profits with anyone.
Control and decision making vested in one owner. There are no co-owners or partners to consult.

Flexibility. Management is able to respond quickly to business needs in the form of day-to-day management decisions.

Freedom. Because of the simple nature of the sole proprietorship, there is relative freedom from government control and special taxation.

Disadvantages

Some disadvantages of sole proprietorship are:
Unstable business life. The business enterprise may be crippled or terminated upon the illness or death of the owner. In addition, the sole proprietorship can be severely affected by swings in the economy.

Less available capital. Typically, the sole proprietor has less available capital than in other types of business organizations and likely has relative difficulty in obtaining long-term financing to grow his business.

Limited experience. Generally, the single owner may keep a relatively limited viewpoint and experience as opposed to a multiple-owner situation.

The Death of a Sole Proprietor

Simply, when a sole proprietor dies, the sole proprietorship ends. In contrast, a partnership or a corporation can continue under the direction of the surviving owners. Practically, the sole proprietor who wants his business to continue beyond his death can leave the assets remaining, after discharging the debts and obligations of the business, to whomever he chooses. He may leave the assets to a beneficiary, to be done with as that beneficiary desires, or he may leave the business to a beneficiary with the stipulation that the business continue to operate.

In most instances, when a person dies owning property of any value, it is necessary to appoint someone to administer the estate. This person who acts for the deceased is called the personal representative, and may be one or several persons, a bank or trust company, a lawyer, or a combination of all of these. The title of the personal representative depends on the method by which the individual is selected or appointed. The duties and responsibilities of the personal representative, and even the title of the personal representative, may change, depending on the state laws and the circumstances involved. However, the necessity for such a person to administer the estate does not change.

If a deceased specifically names a person or an institution to act for him in his will, and if the will is accepted as valid, the named personal representative is known as the executor or executrix. If the deceased leaves no valid will and, therefore, has failed to designate his personal representative, the personal representative is called an administrator. The administrator is appointed by the Probate Office or the Register of Wills Office having jurisdiction over the deceased's estate. This usually takes place in the state and county of the deceased's residence.

State statutes typically stipulate the person who is entitled to be the administrator. Usually, the spouse or an adult child is named administrator. If the deceased failed to take advantage of his right to name a personal representative, and if no persons with close relationships are available, the court may appoint someone unknown to the deceased and unfamiliar with his affairs.

Most executors and administrators handle their task in an expeditious and prudent manner. Sometimes, however, this is not the case. State law usually holds the personal representative to the standard of care of a "reasonable, prudent individual" under all circumstances. The personal representative is obligated personally to perform all acts and duties requiring the exercise of discretion. In fact, he must act as a prudent person in both what he does and in whom he hires. The personal representative can be held accountable for hiring someone who is not suited for the job. Unfortunately, what is reasonable and prudent to the personal representative when performing his tasks is not always so to the beneficiaries, and this can cause problems for the estate, as well as for the surviving business operation.

Probate

Probate means "to prove." The probate process is:

- The legal process of proving the validity of the will.
- The legal process of proving the competence of the deceased to make that will.
- The procedure by which the personal representative is appointed to handle the affairs of the deceased.
- The entire process of settling an estate.

Most of the formalities involved in appointing the personal representative are similar throughout the country. However, many states and counties have their own regulations which must be followed.

There are four ways to transfer property at death. These are:

1) Probate.
2) Contractual arrangements such as life insurance, where the promise involves a contract for a named beneficiaries upon death.
3) Joint ownership, where upon the death of one of the joint owners, the jointly held property is passed to the other joint owner.
4) Living trusts, where during lifetime, the assets are placed in the trust of another and provided for distribution.

One of the most important functions to be accomplished by the personal representative after the death of a sole proprietor is the transfer of the title of the business. The will should contain provisions authorizing the personal representative to carry on the business, either temporarily or permanently.

Certain business agreements can provide that buy-outs or interests in the business can be paid or transferred directly to a named person or to a trust upon death, thereby avoiding the probate of the business.

When an estate is properly planned, the sole proprietor may name one beneficiary to receive his business. He may name one primary beneficiary and one or more contingent beneficiaries to receive his business, based on the desires and financial considerations of the beneficiaries. Even in the event that the estate is properly planned, there must still be provisions made for temporarily operating the business until the time of transfer or sale.

If There Is No Will

No one really dies without a will. If the deceased has not prepared a will, or if his will is determined to be invalid, the state "makes a will." If a person dies without having prepared a will, he is said to have died in testate. When this happens, the intestacy laws of the state command the distribution of his assets. Provisions are made for the spouse, children, grandchildren, et cetera.

When a person dies, his property, including his business, must be collected. After debts, taxes, and expenses are paid, the remaining assets are distributed to the deceased's beneficiaries. Distribution is determined by the person's will, or the laws of the state in which the deceased was living at the time of his death. It is the executor's responsibility to collect and distribute the assets and to pay the death taxes and any other expenses of the deceased.

Business After Death

As the result of a death, the business may be closed. Yet, someone has to be available to handle or terminate the work in progress, pay the outstanding bills and salaries, collect the outstanding obligations, and make the larger decisions about what ultimately will happen to the business.

The most difficult asset to administer in any estate is the business. There are at least four major problems for the administrator to deal with.

1) *Lack of liquidity.* Typically, a great deal of the assets are tied up in the business. Sometimes there is simply not enough cash available to pay administration expenses, death taxes, et cetera.
2) *Lack of diversification.* Often, all or most of the deceased's wealth is in the business.
3) *Nonmarketability.* There may simply not be a viable market for the business at the time of death.
4) *Emotional involvement.* The family's emotional involvement and company-employee relationships are difficulties often encountered because decisions are not always made rationally.

In addition to these major issues, other areas to be dealt with may be real estate included in the business, tools, equipment of all sorts, vehicles, finished and unfinished good, raw materials, minerals in the ground, cash, securities, accounts receivable, customer lists, patents, copyrights and so on.

There are many decisions to be made by the personal representative. Some of these include whether or not to carry on the deceased's business, to sell the business, to sell or hold certain securities, and what rate of return to seek on investments. The handling of the estate by the personal representative can often cause complaints by the beneficiaries. Sometimes complaints can escalate into lawsuits against the personal representative. If the courts feel that the personal representative has not acted reasonably and in the best interests of the estate and beneficiaries, the personal representative can be surcharged. If the personal representative is surcharged, he is held personally liable for any undue mistakes made in the administration of the deceased's estate.

The personal representative cannot make repairs to business property, unless the will expressly or implicitly authorizes it. There is the question of what a repair is, as opposed to an improvement. Naturally, business equipment can quickly become old and ineffective.

There is the consideration of whether or not new machinery or office equipment should be purchased to maintain the business. If the will does not give clear and unequivocal guidance, court permission should be sought. If court permission cannot be obtained and the business cannot be run effectively with its present equipment, the business should be sold or liquidated.

It is rarely desirable to simply close up a business immediately upon the death of its owner. A one-person service business may be an exception to this general rule. Even if the heirs decide to sell the business, there must be some flexibility with respect to the timing of the sale. The business must be capable of continuing to operate in a profitable fashion for some period of time until the probate process can be completed.

One way of achieving lack of interruption in the business is for some employees to remain and continue to run the business for a short time after the death of the owner. This may even be predetermined.

In handling the estate of one who was a sole proprietor of a business, some personal knowledge of the estate, the business, and the beneficiaries are helpful to the personal representative. If no such arrangements were made, the personal representative is required to assume the role of the deceased. Depending on the circumstances of the appointment and the nature of the business, the personal representative has one of two options—to continue the business or terminate it. If the deceased had a will specifically providing for the continuation of the business, the personal representative could perform his duties without the pressure of finding an immediate buyer.

If, on the other hand, the personal representative were acting without a will, he should obtain court approval before continuing to run the business.

In most instances, the personal representative who handles an estate with a sole proprietorship as one of the assets works with the beneficiaries and various supporting personnel. These can include lawyers, insurance agents, stockbrokers, and accountants. Therefore, the personal representative must act responsibly and be able to function as part of an administrative management team.

The Decision to Continue or Sell the Business

Before the personal representative decides whether to continue or to sell a business, he must determine the amount and the availability of operating funds of the business. He probably does not have the right to use money from the deceased's general estate for operating the business. Generally, the only funds that can be used to carry on the business are those funds invested in the business at the time the sole proprietor dies.

Obtaining loans to run the business may be difficult. To mortgage estate property as security for any loan, there must be the express or implied authority from the will or from state laws. Because of the nature of the sole proprietorship, the assets invested in the business as well as all of the assets in the estate, are subject to the liability of any new business creditors.

The following issues must be considered when making the decision to sell.

- Can the direction of the business be effectively controlled?
- Is there enough business-generated income, after debts and obligations, to pay the appropriate dividends to the beneficiaries?
- Can the business survive in the hands of others? Small service businesses typically do not survive the death of an owner.
- Is the retention of the business primarily intended to create employment opportunities for family members?
- On a long-term or short-term basis, is the personal representative capable, either personally or through agents, of managing the business?
- Is there enough liquidity to cover estate taxes, administration expenses, and cover the surviving spouse and children who are not actively engaged in the business?

If the business can survive, the decision of whether to continue or sell should be promptly made.

Often, when a business owner dies, the business may simple come to an end. Perhaps the owner totally personified the business and cannot be replaced. Maybe he had special skills or a way with customers that was unrivaled. Maybe his service was unequaled. Perhaps none of the other family members are interested in continuing the business. If the business cannot be handed down through the will, it must be liquidated.

Before the final determination of whether the business should be sold or continued, the following questions must be answered:

- What type of business is it, and are there people capable of running it?
- What is the condition of the physical assets involved, and do they need repair or replacement?
- Who is operating the business, and are they capable of continuing to operate it?

- What is the overall financial condition of the business?
- If not already, is the business expected to become profitable soon?
- What is the spirit of the employees after the owner's death?
- Is there reliable management who can step in and take the place of the deceased owner, such as a manager or the wife of the deceased? Can outsiders be brought in at a reasonable expense?
- Is there a buy-sell agreement? What are its terms? The existence of a buy-sell agreement might eliminate all other problems.
- What are the current and potential liabilities of the business?
- How quickly do beneficiaries need cash, and what are their other money needs?
- Can the business even be sold and to whom and at what price?
- Can money be borrowed to maintain, improve, or expand the business?

Continuing the Business

As a general rule, the personal representative does not have the legal right to continue the business of the deceased, unless he is expressly named as a beneficiary. His job is to conserve estate assets and liquidate them as soon as reasonably possible. Without state law, court, or the specific authority in the deceased's will, the personal representative continues the business at his own risk. Any income and gains from the business during this time go to the beneficiaries, while the personal representative is responsible for any losses.

The personal representative can continue a business under certain provisions. He must be specifically permitted by the will to do so without personal risk. State statutes may have certain limitations restrictions on business continuation. An attorney may petition the Probate Court for permission to continue the business. Finally, the personal representative may continue the business with the written consent of all interested parties, as long as they are fully informed of the facts, and they are all competent adults.

If the business is to be continued under the authority of state statutes, the personal representative will probably be permitted to continue only as long as is necessary to "wind up" the business, that is, getting the affairs of the business in order. The business cannot be run indefinitely by the personal representative. The safest authority for continuing to run a business after the death of its owner is a written court order.

As a personal representative managing a business of a deceased person, he may be sued for not giving to the estate the standard of care that an ordinary, prudent business person would; for mismanaging any phase of the business; or for the improper use, operation, or distribution of the enterprise. Those bringing suit might be the spouse of the deceased, a beneficiary, a creditor, or anyone else with a direct interest in the estate. In managing a business, the personal representative is held to the standard of care that an ordinary, prudent business person should exercise. If a loss or injury occurs, therefore, the personal representative should be adequately insured against this.

If the personal representative and those interested in the estate cannot come to terms on these issues, the courts may have to decide if the acts of the personal representative are those of an ordinary, prudent businessperson. Long delays and inconvenience may result.

The personal representative needs specific guidance to continue a deceased's business. He must have even greater authority if he wants to expand the business. The personal representative's job is to conserve estate assets, rather than to continue or expand the

enterprise. Therefore, the business should not be expanded without the proper authority of the court.

Any personal representative should have an attorney examine the will of the deceased and give an explanation of it with respect to continuing the business. The advice received must be clear. Simply, either the business can or cannot be safely continued. If the will is silent or ambiguous on this issue and state law provides no help, the court should be petitioned for permission to continue the business, or the written consent of all beneficiaries should be obtained. In any event, the business should be adequately protected and should be kept running until the decision is made whether to sell it or to continue it.

Succession

The succession of a business is a delicate affair. Ideally, the reins should be relinquished while the owner is still alive. Too often, however, the reins to the business are not handed over, or even shared. The business owner may still be contributing greatly to the business, he may feel the successor is not yet ready, or he may die suddenly. The issue of succession must be addressed early on, and it should be reevaluated as circumstances change.

In many families, one or two children are interested in the business, while others are not. Some children may want the business to be preserved, while others do not. If this element is not addressed, siblings can turn against one another, and the business will not progress successfully.

Frequently, the business is the dominant asset in an estate. It must be the source of inheritance for the surviving spouse and all children, whether they want to succeed to it or not.

Selling the Business

If the personal representative decides to temporarily operate a sole proprietorship until the estate issues can be fully resolved, he has complete authority to make business decisions, and he has complete responsibility for the decisions made. He is personally liable for any losses that may result from these business decisions, though any profits belong to the heirs.

If there has been no will, the business has not been specifically bequeathed, or if the estate is in need of funds to pay taxes and other expenses, the business must be sold to produce these needed funds.

If the sale of the business is in order, the wheels for doing so must be set in motion as quickly as possible. This will prevent potential loss of the business itself and further depreciation of assets. The beneficiaries and all other interested parties should be given written notice of the sale.

The sale of the business may be made through prospecting by means of local advertising, networking, and offering referral fees. Or, the business may be offered for sale through a business broker. However, these types of prospecting and other word-of-mouth plans are not normally successful, since time is of the essence in these transactions because the business can quickly deteriorate. As is often the case with small business, especially service-oriented businesses, the hard assets are sold outright, and the business simply ceases to exist.

Liquidation of the Business

If the business can be neither continued nor sold, its assets must be liquidated. Though a private sale is an option for liquidation, a public auction is typically a more efficient process.

Before the liquidation process may begin, two things must happen. First, to exactly determine the assets of the business, there must be an inventory of assets prepared. Next, there must be the determination of whether the deceased had any outstanding claims at death and whether these claims can be reduced to cash for the estate and for the beneficiaries. The most considerable of these claims are accounts receivables. Legally, these claims can be classified under the general heading of causes of action. A cause of action is a legal, enforceable claim of the deceased at the time of death.

For example, suppose the deceased owned a retail clothing store and sold several suits on credit to a well-known customer prior to his death. The outstanding bills for these suits are considered assets of the estate, under the heading of accounts payable to the business. Personal loans and other obligations owed to the deceased at the time of death are also considered. An investigation should be performed through all of the deceased's business records to ascertain that no claims are overlooked.

It is essential to understand what legally does and does not constitute an asset of the business. Any owned property undoubtedly constitutes an asset of the business. In the case of any joint property, however, such as property owned by husband and wife, this property automatically passes to the spouse at death by the laws of survivorship. Survivorship is a right whereby a person becomes entitled to property by reason of having survived another person who had an interest in it. These assets are eliminated from probate. This property then becomes the spouse's asset controlled by him or her. This property is not an asset of the business. Ownership of all perceived assets must be first determined to establish who has the right to any property outside the business and to the property of the business.

In determining the value of the business for liquidation, the following tasks should be undertaken:

- Conducting an extensive a review of the deceased's books and all records as soon as possible under the circumstances.
- Making a list of all potential claims for recovery.
- Determining whether or not these claims can be reduced to cash.

At this point, there should be a fairly clear picture of the assets that comprise the business. The next step is determining how to go about securing all property listed in the inventory, deciding which matters should have priority, and collecting all other assets of the business.

In terms of priority, those matters in which time is a factor in preserving or creating property for the business is the priority. Priority matters can vary, and some situations can require more prompt attention that others. For example, if the deceased owned a wholesale dairy business dealing in perishable items such as milk, it would be essential to dispose of the property before it becomes worthless.

One of the most time consuming tasks in handling the liquidation of a business is the disposition of tangible personal property. Tangible personal property is specific items that can be touched and seen. Some examples are automobiles, office furniture, factory equipment, finished and unfinished goods, and other materials and supplies. Intangibles, on the other hand, is a category in which the assets are represented by the value of an article. Examples of these are

certificates of stock, savings certificates, and insurance policies, which, of course, do not have value in themselves, but they represent a monetary interest.

All assets—tangible, intangible, and liquid—must be inventoried and appraised. In some cases, it may be necessary to seal the premises of the building and to make certain that the tangible personal property remains intact. A prompt inventory should be taken, locks should be changed where circumstances warrant it, and insurance policies should be checked to make certain that all valuable assets are properly and adequately covered. If the estate contains items that could harm others in the wrong hands, such as drugs possessed by a doctor or hazardous chemicals used in some processing operations, there are specific regulations for compliance with federal and state procedures.

If the deceased left small valuable collectible items in his business such as coins, guns, antiques or stamps, these should be placed in an estate safe deposit box as quickly as possible for safety.

In almost every instance, an appraisal of all tangible property must be obtained prior to any liquidation. This is likely in accordance with the will. Often, this falls under the provisions of state statute. The appraisal can be brief, as in the case of minor articles that have no certain value. For example, a list of these articles indicating their approximate value is sufficient in most cases. On the other hand, the value of trade equipment such as dentistry equipment, carpentry tools or an extensive law library should be determined by a competent appraiser.

In instances where the business is typically valued in terms of net earnings, the use of the capitalization of net earnings formula may be applied. Using this formula, a numerical multiplier that has been generally defined and accepted in the trade is used to calculate the value of the business.

Capitalization of earnings is a term that determines the worth of a business based on what it makes. Sometimes the best estimate of what a business is really worth, without an open market to set a price, is the earning capacity of the business. In the case of automobiles titled in the deceased's name or in the name of the sole proprietorship, a transfer of the title is necessary at the liquidation or sale. A review of the rules and regulations of the department of motor vehicles is a good idea.

In all other instances, the possession and disposition of an automobile is treated in the same way as any other tangible assets of the estate.

Finally, the property of the business is liquidated or sold at fair market value. Fair market value is the price that goods or property would bring in a market of willing buyers and willing sellers, in the ordinary course of trade. It cannot be determined on the basis of a price that would be acceptable to a buyer or to a seller operating under pressures or constraints. Liquidation may be accomplished through private sale, but public auctions are generally more productive. The net proceeds are divided between the beneficiaries.

THE PARTNERSHIP

The theory of partnership is primarily an Italian discovery. Italian merchants, operating as partners, took their commercial customs with them throughout Europe. The partnership came to England with the great explorers. Partnership law developed in the courts of the merchants themselves. The use and growth of partnership emerged in the 17th century.

Most people have a common sense understanding of what partnership is, that is, the partners in a partnership are in business together. This is true. However, there must be a clear and further understanding of what is really involved in a partnership, that is, the commitment that the parties are undertaking when deciding to establish a partnership.

A partnership is often useful when there are to be two or more owners of a business enterprise. The partnership is a close and confidential relationship. A partnership is often referred to as the business equivalent of marriage. The partners are deeply involved with each other, and they learn much about one another. Years of shared experience offer insight and understanding. However, a partnership can also involve friction, arguments, and antagonism. As with any relationship, the partners must be able to speak openly and candidly with each other.

The legal definition of a partnership is "an association of two or more persons to carry on as co-owners of a business for profit." This concept of a partnership is broad. A partnership may be a syndicate, pool, joint venture, or other unincorporated organization through which any business is carried on, as long as it is not a corporation, a trust, or sole ownership.

It is not required that the words "partners" or "partnership" be used in order to form a legal partnership. Simply joining with other persons and running a shared business creates a partnership. However, using these words insures that a partnership is intended. For example, if there is a question about whether a person is an employee of a sole proprietorship or a partner, calling him partner will make him a partner. The following factors indicate that a partnership has been created:

- The receipt or right to receive a share of the profits.
- The expression of an intent to be partners.
- The participation or right to participate in the control of the business.
- The sharing or agreeing to share losses or liabilities.
- The contributing or agreeing to contribute money or property to the business.

As a practical matter, partnerships should always be formed with a written partnership agreement, rather than verbally. However, oral or handshake partnerships are often legal, although highly inadvisable. If there is even a minor disagreement between the partners, it is difficult to prove what the agreement is, or even that the partnership exists.
Partners do not have to share ownership equally. The partners can agree on any percentage of individual ownership or distribution of the profits that they desire. For example, one partner could own 50 percent of the partnership, and five others could own 10 percent each.

Partnerships can be organized for many different purposes. They can sell products, manufacture, sell services, or even operate as agents. Professional partnerships, however, such as those of accountants, doctors, or lawyers are subject to special professional partnership rules which are set by members of their professions. Typically, the prevailing rule is that everyone in the partnership be a member of the profession.

Partners do not normally receive salaries per se. Usually, they get a percentage of the profits, and they take the same percentage of the debts and other obligations. However, it is common and practical for partners to take out an agreed upon amount from the business at regular intervals. This is not a salary but is commonly called a draw. These might be monthly or biweekly, taken against the yearly partnership shares.

Partners, as well as the partnership itself, are personally and individually liable for all of the legal obligations of the partnership.

The Uniform Partnership Act

The Uniform Partnership Act (UPA) is a body of law which establishes basic legal rules applicable to partnerships. All but a few of the states' UPA rules can be varied. Those states which have not adopted the UPA have similar statutes.

The UPA partnership rules are not a requirement. The purpose of a partnership agreement is to tailor the agreement to suit the needs of the partners.

The rules of an agreement may be varied by an express statement in the partnership agreement. Even if the partners know their state's UPA rules and decide they want to use them, it is not wise to rely solely on the UPA to define key clauses in a partnership agreement. These clauses should be created by the partners, and this decision should be expressed explicitly in the partnership agreement.

Advantages

Some advantages of a partnership are:

Ease of information. Legal informalities and expenses are few, compared with the requirements for creating a corporation.
Direct rewards. Partners are motivated to apply their best abilities by directly sharing in the profits.

Growth and performance facilitated. In a partnership, it is often possible to obtain more capital and a better range of skills than in a sole proprietorship.

Flexibility. A partnership may be relatively more flexible in the decision making process than in a corporation.

Freedom. The partnership has the relative freedom from government regulation and special taxation.

Disadvantages

Some disadvantages of a partnership are:

Unlimited liability of at least one partner. A partner is responsible for the full amount of business debts which may exceed his total investment. This liability extends to all of the partner's assets, such as his house, car, and bank accounts. Additional problems of liability such as physical loss or personal injury may be lessened by obtaining proper insurance coverage.

Unstable life. The elimination of any partner constitutes automatic dissolution of the partnership. However, the operation of the business can continue based on the right of survivorship. A new partnership can be created to succeed the old one. Therefore, a partnership can be dissolved without notice by the unexpected death of a partner or by one partner leaving the partnership. Because of one of these events, the partnership, as it was created, ceases to exist.

Financing. It is relatively difficult to obtain large sums of capital in a partnership. This is particularly true of long-term financing when compared to a corporation.

Binding. All of the partners are bound by the acts of the others.

Disposal. There is typically difficulty in disposing of a partnership interest. The buying out of a partner may be difficult unless this situation is specifically arranged for in the partnership agreement.

Types of Partnerships

Partnerships may take several forms affording the member partners varying powers and subjecting them to varying liabilities.

General Partnership

A major partnership form is the general partnership, primarily governed by the UPA. In a general partnership, all of the partners are actively involved in the conduct of the business. A general partnership is an association of two or more persons to carry on as co-owners of a business, including every trade, occupation, or profession for profit, whether or not this association is called a "partnership." The term of a general partnership is a matter of the partners. The partnership agreement establishes the business for a fixed term. Without such an agreement, the rules of the UPA will prevail. The formation of a general partnership is a relatively simple matter. As long as the partners are alive and well, the business is prospering, and the partners are cooperative toward their goal, the partnership works.

The existence of a partnership is largely based upon general contract law principles. For example, a partnership is a voluntary and consensual arrangement between the partners, based upon a verbal or written agreement. Anyone can enter into a partnership, unless he lacks legal capacity. The purpose of the partnership must be legal and not otherwise prohibited to be conducted as a partnership.

The receipt by a person of a share of the profits of a business is the primary evidence that the person is a partner in the business. This does not include wages, annuities, interest on a loan, or as consideration for good will of a business.
Unlike corporations, general partnerships may be reconstituted, that is, they may be reformed, rather than be dissolved at the end of the fixed term.

Joint Venture

A joint venture is essentially an express or implied contractual arrangement in the nature of a general partnership engaged in a particular transaction for a specific limited purpose, which is intended to be accomplished within a specified duration. It is a limited purpose partnership. Examples of joint ventures are building a single restaurant, renovating one house, or giving one series of dance performances. People involved in joint ventures should have a partnership agreement covering the basics of the partnership, as well as some additional matters including:

- The extent of the venture.
- Management issues.
- Staffing and control of hiring.
- Conflicts of interest.
- Tax issues.

Limited Partnership

A limited partnership is a statutorily authorized entity. It is a partnership between two or more persons, having one or more general partners and one or more limited partners. The limited partner is sometimes referred to as a passive partner. The passive partner is not actively involved in the conduct of the business. The limited partnership must be attached to an ongoing business. Like the sole proprietor, the general partner has personal and unlimited liability for the debts and the obligations of the business. The limited partner, on the other hand, only contributes capital and has no right to participate in the management and operation of the business. He also assumes no liability beyond his capital contribution. Most states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties, and liabilities of limited partnerships. In most states, a limited partner may be granted the right to seek dissolution of the partnership by court decree, and the existence of a limited partnership is not terminated by the death of a limited partner.

Registered Limited Liability Partnership

A registered Limited Liability Partnership (LLP) is a separate form of a general or limited partnership. An LLP may be formed by filing an application with the office in the state in which it is registered. This document lists the basic facts of the partnership. A partner in an LLP is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by another partner, unless at the time the first partner was directly involved in that activity or had notice or knowledge of it at the time of occurrence. In most states, the registration must be renewed on an annual basis.

Limited Liability Company

The Limited Liability Company (LLC) is a relatively new type of partnership. Its regulations and articles of organization are similar to a corporation's bylaws. All equity holders of an LLC have the limited liability of corporate shareholders, even if they participate in the business of the LLC. An LLC may be structured as a partnership for federal income tax purposes. Owners of an LLC have the maximum freedom to determine the internal structure and operation of an LLC.

Purpose of the Partnership

A partnership business must have an identity by which it presents itself to the public and to the Internal Revenue Service. Some professional partnerships, such as consultants or law firms, choose the last names of the partners as their partnership name. It is possible for a partnership to have two names. The partners use their own last names for the agreement, and a separate business name is used. Partnerships must comply with any applicable state laws governing the use of names.

The partnership agreement normally contains a short statement of the purpose of the business. An example of such a statement is, "The purpose of the XYZ partnership is to produce and sale continuing education courses and products." Generally, a broadly stated purpose is recommended.

Most partnership agreements do not specify a termination date. The partnership will continue as long as it is profitable desirable to continue.

When the partners prepare the statement of purpose of the business, there should be a discussion and review of each partner's personal goals for the business. Each partner should

know the other's fears, limitations, and goals. Ideally, well-acquainted partners and a well-planned partnership will have covered these issues. However, a focused examination can eliminate possible problems.

The Intention to Be Partners

Often there is confusion over whether or not a true, legal partnership actually exists. Any questions in this area are answered by the intentions of the people doing business together. Partnership is a voluntary relationship, either express or implied. A partner cannot be drafted against his will. However, one's intention to be a partner can be implied from the circumstances of a business operation. For example, if three brothers who have no other business relationship each inherit one-third of their father's business, they do not automatically become partners, since they have never agreed to do business together. However, if the three brothers proceed to operate the business, they have essentially become partners, even if there is no written partnership agreement.

Conversely, not every joining of interests makes people partners, legally or for tax purposes. For example, mere co-owners of a duplex are not partners, even if they lease the duplex and share rents, if they do not actively carry on a business on or with the property.

The sharing of project expenses does not automatically create a partnership. For example, if two adjoining landowners construct a common driveway to facilitate entry to their properties, there is no partnership for tax or legal purposes.
Generally, a partnership is established by the receipt of a share of the profits (and losses) of an unincorporated business.

Authority and Legal Relationship of Partners

The first and most important decision made in organizing a business is choosing the partners, and no partner may be forced to accept any person as a partner whom he does not choose. The relationship of partners to one another is considered separately from the relationship of partners to third persons.

When partners enter into a partnership, they are legally bound to certain obligations and certain rights. As long as the rights of third parties are not affected, the partners may vary their rights and obligations by agreement. The rights and powers of partners can be defined in the partnership agreement with any degree of specificity desired. Some partnership agreements contain numerous pages defining the authority, duties, and restrictions of partners. Usually, this type of endless detail is not helpful. Mistrust between the partners is not part of a sound basis for the partnership. Trust is the central ingredient in any partnership. Partnership agreements, amendments, clauses, and provisions cannot compensate for the absence of faith and trust. If mistrust seems prevalent, the partners should question whether the partnership is a good idea.

A partner has the authority to bind the partnership. This does not mean, however, that one partner can bind all of the other partners, no matter what he does. There are many actions that the UPA prohibits. Those outside the partnership are presumed to know that a partner cannot do certain things in the course of ordinary business. The following is a list of actions prohibited by the UPA.

- To convey one's interest in any partnership property.
- To mortgage or otherwise subject partnership property to a lien to cover one'spersonal debts or borrowing.

- To attempt to dispose of specific partnership property, rather than one's own interest in the partnership, through one's will.
- To assign partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership.
- To dispose of the "good will" of the business.
- To commit any act that would make it impossible to carry on the ordinary business of the partnership.
- To agree to a judgment for the other side in a lawsuit against the partnership.

Even though the UPA prohibits these acts, the partnership agreement may supersede these, with express provisions. All of these factors play an important role in creating a solid partnership. If a sound partnership has not been created, there may be nothing left of it, or worse, more liabilities than assets, in the event of the death of one partner and a resulting termination of the partnership. No matter what the partnership agreement may state, partners in what have traditionally been called trading partnerships have the apparent authority to borrow money or to execute loans on behalf of the partnership. Apparent authority is discussed in further detail below.

Trading partnerships are, as the name states, those directly involved in trade, like merchants selling a product. Examples of nontrading partnerships include service businesses like maid services, accounting firms, restaurants, banks, real estate enterprises, and law firms. Partners in nontrading partnerships do not have the apparent authority to borrow money on behalf of the partnership. In many partnerships, such as trading partnerships, there is additional exposure if one partner is unreliable. Without actual authorization, this partner can borrow money and leave the other partners stuck for the loan. In the absence of a specific rotation, any partner can bind the partnership by decisions made in the ordinary course of partnership business. A partner may bind the partnership by his act if he has actual authority, express or implied, or if he has apparent authority. While the rights and duties of the partners between themselves are primarily controlled by the partnership agreement, that is not necessarily true for other people dealing with a partner. After all, outsiders usually do not have any idea what is in the partnership agreement.

Express actual authority is authority actually bestowed upon a partner. It may be specifically set forth in the partnership agreement, or it may arise from decisions made by a majority of the partners.

Implied actual authority includes authority that is neither expressly granted or expressly denied, but is reasonably deduced from the nature of the partnership. Apparent authority may or may not be actual. In view of the circumstances and the conduct of the parties, apparent authority may be considered to exist by a person who has no knowledge otherwise. An outsider can legally rely on the "ostensible" or "apparent" authority of a partner. This is authority that has been demonstrated by the partner in the course of business or authority that is normally granted to partners in similar business partnerships.

The Silent Partner

The term "silent partner" is applied to a real partner who has no voice and takes no part in the partnership. A silent partner can be a partner whose involvement is not revealed to the public, or it can mean a partner who contributes only cash to the business and does not work in it, or both.

The issue of a silent partner should be given careful consideration. Under some circumstances, it may be helpful. A knowledgeable lawyer should be sought. He can review the situation

carefully, and the other partners can examine whether or not they actually want a silent partner before agreeing to a general partnership with a partner who is not going to take a publicly acknowledged role in the business, or who will not work in it.

If the silent partner only contributes cash to the business and does not work, this creates inherent conflicts. The other partners are working to keep the business going, while the silent partner is not. Remember that as a full-fledged owner, the silent partner is entitled to his share of profits of the business, and he has an equity share of the business. If the business prospers because of the work of the other partners, they are likely to become increasingly resentful of the benefiting the silent partner. From the silent partner's perspective, he has potentially unlimited liability for partnership debts. He may not learn about a problem because he does not actively participate in the business.

A silent investor-partner can be advantageous in capital intensive partnerships, such as those that purchase real estate. The silent partner offers the funds, and the other partners offer the skills. This type of arrangement works best in businesses that do not require much management. However, where necessary, this goal can be achieved without making the investor a partner. The partnership agreement can be structured so that the investor's contribution is an interest in a limited partnership, specifically defining the investing partner's role and return. The investor's return can include a share of the profits.

The Duties of the Partners

The partners are fiduciaries to each other. The fiduciary relationship between them means that they owe complete loyalty to the partnership and cannot engage in any activity that conflicts with the partnership's business or interest. Each partner owes a duty of good faith and utmost loyalty to his co-partners. It is only upon this basis that the partnership may function successfully. The rule of undivided loyalty is relentless and supreme. This fiduciary relationship exists based upon the high standard of trust and confidence which the partners have a right to expect from one another. Many forms of conduct otherwise permissible in the work world are forbidden to those bound by the fiduciary ties of a partnership. Honesty and honor are the most important requirements of a partnership.

Since any partnership must be formed with the intention of making a profit, the fiduciary ties between the partners are the ties that keep the partnership together. This is critical in the long-term success of a partnership. If the partnership is not successful, there can be little or nothing available for the surviving partners or for the surviving family, upon the death of a partner.

The UPA provides that every partner must account to the partnership for any benefit derived by him. This rule also applies to a deceased partner whose estate is engaged in the liquidation of the affairs of the partnership. A partner may not prefer himself over the partnership.

There has been a great amount of litigation on the rights and duties of partners to each other. This is unfortunate evidence that partnerships can become unfavorable. There are some absolute things that a partner cannot legally do. Common sense indicates that these are not ways honest people deal with each other under any arrangement. For example:

1) A partner cannot secretly obtain for himself an opportunity available to the partnership.
2) Partnership assets cannot be diverted for personal use.
3) Partners cannot fail to distribute partnership profits to other partners.
4) Each partner must disclose any and all material facts affecting the business to the other partners.

The courts have often ruled that those who have even seriously discussed a partnership must adhere to the same exacting standards of good faith that bind partners, even if an actual partnership agreement is never entered into. For example, if two people seriously plan to open a body building gym and find the perfect location, it is likely a breach of fiduciary duty for one person to try and cut out the other by leasing the spot as a sole proprietor and engaging in that business alone. Exactly when this partner-like responsibility commences is not totally clear. However, when any negotiating begins, there are fiduciary duties of trust involved. Since partners must be trusted eventually, it makes sense to start building that trust by full disclosure and square dealing from the start.

The Rights and Responsibilities of Partners

Each partner is entitled to share the profits. Conversely, he must contribute toward its losses. In the absence of an agreement otherwise, partners share this equally, regardless of the initial contributions to the partnership. They also share the losses equally, if not otherwise stated. This must be fully and clearly understood by all partners, especially because it directly affects the financial outcome of each partner's estate.

Upon termination of the partnership, such as the death of a partner, each partner is entitled to be repaid his capital contribution. Unless otherwise agreed, he is not entitled to interest on this. However, if there is a delay in the return of his capital contribution, he is entitled to interest at the legal rate from the date when the return should have been paid.

Although each partner may choose for himself certain activities within the business for which he is responsible or in which he may specialize, each partner should have an equal voice in the management of the business.

Each partner has the right and full power to represent and bind the partnership within the normal course of business. This is why trust is so crucial in a partnership. One partner can obligate the other partners, even if they never authorized him to do so. In many circumstances, a partner can bind a partnership even when the other partners instruct him not to. For example, three people are partners in a retail clock store, and they discuss buying an expensive assortment of grandfather clocks. They vote two-to-one against it. The losing partner may go out and sign a contract for 200 grandfather clocks with a manufacturer who has no knowledge of the other partners' opposition. Since this is within the normal course of business, this act binds the partnership.

The powers of any partner may be limited by means of the partnership agreement. However, those limits are unlikely to be binding on people outside the partnership who have no actual knowledge of them. Outsiders are entitled to rely on the apparent authority of a partner, as determined by the customs of the particular trade or business involved. In the example above, when the grandfather clocks were purchased, the manufacturer had no actual knowledge of the partnership's limits on the decision-making authority of the individual partner. The manufacturer relied on the apparent authority of one partner, who could reasonably be expected to have the authority to buy the clocks.

Personal Liability for Partnership Debts

Partnership implies the unlimited personal liability of each partner. A crucial partnership principle is that each partner is personally liable for all partnership debts and obligations that cannot be paid by the partnership itself. This rule is a UPA rule.

Partners are not, however, liable for the personal, non-partnership debts and obligations of other partners. Aside from debts and obligations incurred in the normal operation of the business, partners are liable for any money damages that result from the negligence of another partner, when engaged in the business of the partnership. Further, partners are liable for damages that result from any frauds or other intentional acts done by another partner in the ordinary course of the partnership business. It stands to reason that all partners must conduct themselves with the highest degree of reliability and credibility.

For example, suppose three people are partners in a small delivery service. One partner is wealthy, and the other two are not. The partnership just opened and the partners have not bought insurance yet. While one of the poor partners is delivering packages, he hits another car and injures all of the occupants. The occupants of the car then sue the partnership and are awarded a substantial judgment against the business. The wealthier partner is personally liable for any amount unpaid by the business, that is, what is left unpaid after all partnership assets have been used. If the wealthier partner does not have sufficient cash or liquid assets to cover the judgment, his other personal property such as his home, or cars, with the exception of whatever property is protected by state debtors' exemption laws, can be seized to satisfy the judgment.

Further, a silent partner, one whose membership in the partnership is not revealed to the public, is every bit as liable for partnership debts as any other partner. However, a subpartner is not. A subpartner is a person who agrees with one member of the partnership to share in that partner's profits. This is a separate agreement between these two, and it does not legally involve the subpartner in the partnership.

Liability of the Partnership to the Public

Conventional legal rules of responsibility are applicable to partnerships. For example, as in all businesses, partners must perform any services provided to the public competently, or the partnership can be liable for negligence. Competence means a partner must use the level of professional skill, care, and diligence generally applicable in the profession or trade. In a service business, this standard usually applies to all partnership enterprises, whether they are set up to repair computers, trains, or washing machines. It applies regardless of what the partnership is selling.

So, if one partner or an employee of the partnership in a refrigerator repair business does not properly install an ice maker, the partnership is liable for any loss that results from this negligence, such as water damage. The partnership is also liable for "any wrongful act or omission of any partner acting in the ordinary course of business of the partnership where loss of injury is caused to any person."

So, if a partner negligently causes an accident while driving a car on partnership business, the entire partnership is liable for the damages. The partnership is liable for intentionally wrongful acts, deceit, assault, or trespass committed by a partner during the course of partnership business.

The conventional way to protect against most business risks is to buy liability insurance. Here, premiums are paid for protection against occurrences that are somewhat unlikely.

However, liability insurance protection against traditional types of negligent actions, such as someone who drinks tainted milk in a restaurant and sues, can be judicious, especially in

situations where the insurance is relatively affordable. Other insurance dilemmas such as insuring against professional incompetence, medical malpractice, or intentional injuries are often more difficult. One strong negligence action can wipe out a partnership, leaving the partners and their families without support. The decision of whether or not to buy this liability insurance generally depends on the partners and the nature of their business.

For example, medical malpractice insurance is quite costly, and some doctors no longer purchase it. They choose to accept the risk that if they are sued for malpractice, they will have to pay legal defense costs themselves, that is, they are self-insured. If they lose their case, the judgment must be paid from the practitioner's own personal assets. While this approach may make sense to dentists, who are rarely sued, it may be too risky for heart surgeons, whose work involves more serious risks.

After full consideration of the risks, liability insurance is probably wise. If some negligence should result in the death of a partner, liability insurance would likely make it possible for the partnership to continue. An option for those partnerships engaged in high-risk occupations and which cannot afford liability insurance is to incorporate, thereby limiting their liability.

Legal Rights of Partners Against Partnerships

Despite the best of intentions, it is possible for the partners to have a serious disagreement. If it cannot be resolved, the partners have formal legal rights via their partnership by way of the provisions of the UPA. These include:

- Each partner is entitled to full information with respect to all partnership matters at any time. Further, each partner has a duty to supply this information.
- Each partner is entitled to an accounting of the partnership assets when circumstances warrant it, that is, an examination of the books by an outside accountant. Periodic accountings are often provided for in the partnership agreement. They are typically paid for by the partnership itself. However, if an accounting is made as part of a lawsuit, a court has the right to apportion the cost of an accountant in a way that it decides is fair.
- The partners have the right to a legal action for dissolution of the partnership under certain circumstances.
- The partners have the right to legal action for an injunction to restrain illegal partnership acts and the appointment of a received to handle the partnership assets.
- Each partner has an equal right with the co-partners to possess partnership property for partnership purposes. A partner may not assign his right of partnership property.
- All partners have the right to ordinary breach of contract actions with respect to the partnership agreement and any other contracts.

Continuity of Life

A partnership will continue after the death of a partner or after an event requiring a winding up of the business of the partnership until the winding up of the partnership is completed. A withdrawal happens upon the occurrence of events specified in the partnership agreement; when the partnership receives notice of a partner's election to withdraw; the expulsion of a partner by partner vote; by judicial decree; upon the bankruptcy of a partner; or upon the death of a partner. Upon the occurrence such as the death of a partner, the partnership is not required to be wound up. The partnership must be dissolved because the partnership, as it was created, no longer exists. However, it may be reconstituted under another form, perhaps with the remaining partners or the addition of a new partner.

The Partnership Agreement

The rights, management, and ownership interests of the partners are generally set forth in a partnership agreement. These may be as simple or as complex as the business situation dictates. Articles of Partnership are not specifically required by the UPA. However, written partnership agreements are customarily executed. The articles are intended to outline the contribution by the partners into the business, whether financial, material, or managerial. Generally, they delineate the roles of the partners in the business relationship.

The processes of establishing and maintaining a small business partnership are not difficult. Once the basic partnership agreement is determined, the partnership must file appropriate papers with:

1) The Internal Revenue Service to obtain a taxpayer identification number.
2) The appropriate local agency, if the partnership operates under a fictitious name (a name other than those of the partners). For example, if the partners John, Ed, Sam and Theo do business as Noble Delicatessen, they must meet state requirements for all businesses operating under a fictitious name.

Partnerships must comply with the routine record keeping and paperwork common to any other business. This includes getting a state tax resale permit if goods will be sold, filing payroll and unemployment tax returns if there are employees, keeping sales records, accounts receivable, accounts payable, general accounting practices, and generally dealing with any other procedures that go with starting and operating a business.

Just as it is crucial to know what qualifies as a partnership, it can be important to recognize a partnership that is not legitimate. Lawful partnerships, like any other business form, can be legitimately used to limit or reduce taxes in some circumstances. However, partnerships are particularly vulnerable to being ruled invalid by the Internal Revenue Service if they are unreal or simulated relationships designed primarily to lower tax liability.

For example, a couple lives together, and one is a poor medical student who works part time at the hospital, but spends most of the time studying. The other runs a small, but profitable, cigar store and pays substantial taxes. They consider declaring themselves partners and forming a partnership to operate the cigar store. For federal income tax purposes, each would report half the store's profits as their separate incomes. This would lower the total amount of taxes paid between the two of them. If the purpose of this or any partnership is simply to escape from or reduce taxes, the Internal Revenue Service will not recognize the partnership as valid. There must be some genuine sharing in a partnership, other than the profits. There must be either the management and control of the business, or an investment in it for there to be consideration for a tax-valid partnership. The partnership cannot exist solely in bookkeeping terms.

In addition, those enterprises that are not arranged to make a profit fail to qualify as partnerships. These are termed nonprofit corporations, if the business is incorporated, or unincorporated associations, if they are not. These are not considered partnerships. Examples of unincorporated associations are organizations such as religious, charitable, educational, scientific, civic, social, athletic, and patriotic groups or clubs, and trade unions and associations.

Eventually, one or more of the partners may want, or be forced, to discontinue his interest in the partnership, perhaps upon the death of a partner. This event should be planned for in the partnership agreement. In addition to establishing the rules governing the partnership during its existence, the partnership agreement should establish the basics of what will happen if the partnership ends. Concerns for continuing the partnership upon the occurrence of certain

events, such as death, must be addressed at the time the partnership is formed, not after the death or disability of one of the partners.

The termination of a partnership takes place when the business no longer functions as a partnership, that is, for whatever reason, the partnership is no longer whole, for example, when one partner dies. The partnership books are closed, and the surviving partners go their separate ways. The partnership business may be reconstituted, that is, it may be continued in some other form by one or more of the former partners or, the business may end altogether.

Communication is essential to making a partnership work, and that starts at the beginning with the partnership agreement. One of the primary reasons to prepare the partnership agreement is to see if or where the partners might disagree and to fully disclose those concerns. There is no legal formula that can be followed to create a viable partnership agreement. A lawyer specializing in partnership law can assist the partners to focus on issues and can suggest a variety of possible solutions to any concerns. However, the lawyer cannot make basic choices and decisions for the partners, such as what happens when the partnership ends. A partnership agreement should address the real needs and concerns of the partners and the partnership.

The ***partnership agreement must represent*** that:

The partners all know each other. The business partnership is not the place for making new friendships. A partnership should not be entered into casually.

All partners understand and agree that they are going to run a business with the aim of making a profit. Any enterprise in which there is shared making money qualifies as a business.

All prospective partners are approximately on the same economic plane. If not, there is the possibility that some partners' decisions may be made not on the basis of the business's economic realities, but on their outside financial resources. One of the primary elements of partnership is that no partner may prefer himself over the other partners or over the partnership.

There is some personal, as well as professional, chemistry with the partners. Under some circumstances, people with different natures and backgrounds work well as partners.

On the other hand, sometimes people who are longtime friends with similar personalities and backgrounds are not able to develop a harmonious business relationship. The partners must ask themselves if they can envision themselves being in this close business relationship many years down the road. If not, this probably will not be a successful partnership.

A well-drafted partnership agreement should be clearly written, in plain English, to express decisions that the partners have made to meet their needs. Of course, a particular situation may require that certain things be added or changed.

However, caution is urged. Changes may create ambiguity, which is not a good thing in a partnership agreement. If significant changes are made, they should clearly express everything that the partners have agreed upon. In addition, an evaluation should be made with respect to whether or not it is sensible to hire a lawyer to review the agreement and situation.

Caution and selectivity is suggested regarding the amount of detail included in the partnership agreement. The basics must be decided, and the basics must be covered. However, it is never possible to cover every conceivable contingency and likelihood in the partnership agreement.

Legally, the partnership begins when the partners agree that it does. In some circumstances, partnerships can be based on an oral agreement, or can even be implied from the operational realities of a business.

However, for the obvious reasons, implied or oral agreements are not a good idea. A common sense approach of putting the partnership agreement in writing is the best one. Further, many state statutes require partnership agreements to be in writing.

For example, under the New York Statute of Frauds, any partnership agreement must be in writing if:

- The agreement is to last for more than one year.
- Real property is involved.
- An arbitration clause is included.
- There are guaranteed payments to partners.

A written partnership agreement becomes effective when it is signed, unless the agreement itself specifies a different date.

However, the full fiduciary duty of trust is owed to prospective partners even before the partnership legally exists.

The following lists the major areas covered in the partnership agreement:

1) The name and purpose of the partnership.
2) The date of commencement and the duration of the partnership, specifying a termination date.
3) Contributions to the partnership such as cash, property or services.
4) The authority of each partner.
5) Payments from the partnership to the partners, that is, profits, losses and draws.
6) Management duties of the partners.
7) Methods of accounting.
8) Expansion.
9) The admission of new partners.
10) Required and prohibited acts.
11) Rights of first refusal.
12) Events causing dissolution or termination of the partnership, such as withdrawal or death of a partner and buy-out provisions.
13) Methods of dispute resolution, such as mediation or arbitration.

Categories of Partners

There are many categories of partners found in partnerships. These are:

Ostensible Partner -- This partner is active in the partnership, and he is known as a partner.

Active Partner -- This partner is active in the partnership. He may or may not be ostensible.

Secret Partner -- The secret partner is active, but he is not known or held out as a partner.

Dormant Partner -- The dormant partner is inactive and is not known or held out as a partner.

Silent Partner -- The silent partner is always inactive. He may or may not be known to be a partner.

Nominal Partner -- This partner is also referred to as a partner by estoppel. He is not a true partner, since he is not a party to the partnership agreement. However, the nominal partner holds himself out as a partner, or he permits others to make this representation by the use of his name or otherwise.

Therefore, the nominal partner is liable, as if he were a partner, to third persons who have been given credit to the representation.

Subpartner -- The subpartner is one who, not being a member of the partnership, contracts with one of the partners in reference to participation in the interest of that partner in the firm's business and profits.

Limited Partner -- The limited partner is also referred to as a special partner. Assuming compliance with statutes, the limited partner risks only his agreed investment in the business. As long as he does not actively participate in the management and control of the enterprise or in the conduct of its business, the limited partner is generally not subject to the same liabilities as a general partner.

Operational and Management Responsibilities

For the obvious reasons of the shared partnership responsibilities, it is fundamental that each partner be actively involved in managing and operating the partnership business. Apart from the practical reasons for this, it is generally desirable for income tax purposes, given the active and passive tax issues. All of the partners should feel comfortable with how the work and responsibilities have been divided up. If there are only two or three partners and they will all be involved in all phases of the business, as with many small partnerships, these points are relatively simple.

On the other hand, if the business involves more separation of management roles, these roles and responsibilities should be understood and agreed upon by all partners.

Some key issues to cover here are:

- The work duties of each partner, that is, the specific tasks and functions of the business that each partner is responsible for.
- Any limitations on the nature or the amount of liabilities any partner may incur on behalf of the partnership with respect to operations and transactions.
- The skills, knowledge, and experience to be contributed by each partner.
- The time devoted to partnership business and activity, that is, the number of hours worked by each of the partners and which hours worked.
- The management roles, that is, aspects of the business that each partner has primary responsibility to control and direct, either by his own efforts, delegation or by supervising others.
- Specific partnership projects.
- Check-signing procedures.
- Expense account rules.
- Each partner's authority, that is, partnership affairs requiring consent of more than one or all partners. These may be borrowing money; selling, leasing, or transferring all or some of partnership property; selecting and compensating employees; selecting independent

certified public accounts to provide the annual audit; and paying salaries or fees to the partners.
- Any other important considerations such as noncompetition agreements, partnership opportunities, and any restrictions on operations and transactions.

Decision Making

The authority, or power, of the partners must be determined. This must be decided between the partners themselves and should be set forth in the partnership agreement. This authority may be bestowed in any way that the partners desire. Commonly, the democratic one partner/one vote is employed. It is fair and simple. The UPA provides that each partner has an equal vote. However, the partnership agreement may state otherwise, based on the monetary contributions to the partnership, services provided, or whatever method the partners may choose to apply. The issue of voting power is a reflection of how the partners view themselves in relation to each other and to the partnership.

Many partnerships have only two partners or an even number of partners. Under these circumstances, there is always the possibility of a stalemate under the democratic one partner/one vote approach. In theory, having an unequal number of partners eliminates the possibility of a stalemate. However, this is not always possible. Besides, a serious conflict has not been avoided just because there is an odd number of partners. For example, if five members of a partnership consistently outvote the other two partners in a seven-member partnership, the conflicts have not been resolved, and this is not a good sign for the partnership. Some useful approaches for handling this dilemma are:

- The partnership agreement can provide that each partner's vote is in proportionate to his contribution of the partnership capital. This approach leaves those without significant capital invested in the partnership also without any significant say in the management of the business.
- The partnership agreement can proportion voting rights according to each partner's share of profits. Each partner's share of the profit is likely to reflect his own contributions of services, initial capital to the partnership, and other contributions.
- The partnership can provide for the partners to arbitrarily agree on what proportion of voting power each partner should receive. For example, one partner could be given 50 percent of the voting power, with the remaining two partners each receiving 25 percent, based upon capital investments.
- The issues of voting rights, power, and authority must be given serious consideration. A partner's financial position may be at stake. This can impact the relative well being of the partnership and its success and, ultimately, what is left for the partnership, should a partner die.

The UPA calls for the one partner/one vote approach, even if there has not been an equal contribution of assets to the partnership by the partners, and this rule will prevail in the absence of any other provisions.

Deciding on a clause for the provision for the control and management of a partnership can be precarious. Sometimes partners try to handle this by going into great detail about how, when, and who makes decisions. However, this is usually not helpful. A more appropriate approach might be to require that all decisions be made equally by all partners, with the exception that another approach be used only when major concerns are involved.

Even defining these major concerns can be an issue. The type of business and the responsibilities and relationships of the partners come into play. Sometimes money limits can be used as a measure to define the authority of each individual partner. For example, all decisions which would involve the expenditure, or potential expenditure, of more than $10,000 would have to be discussed and voted on by all partners.

Partnerships often need to borrow money, either to get started or to expand the partnership. Generally, the signatures of all the partners are required for this. In the instances where this is not a necessary requirement, there are the questions of which partner or partners have the authority and the power to borrow money and obligate the entire partnership to repay it, should there be express approval of the partners for this, and if so, at what limit. Again, there should be a provision in the partnership agreement to handle this occurrence.

Contributions to the Partnership

A sensible respect for money is essential for a partnership business to work. Conflicts over money can consume a partnership. Therefore, it is essential that all of the prospective partners reach a genuine understanding of how they will handle money matters. They must explicitly describe that understanding in the partnership agreement.

The sum total of the money and property contributed by the partners and dedicated to the permanent use in the enterprise is called the partnership capital. Except upon the dissolution of the partnership, to which a partner's death may be a factor, no partner may withdraw any part of his capital contribution without the consent of the other partners. Obviously, the partnership will need some assets to commence business. The initial contributions are made by the partners, and partnership property is the sum of all of the partnership assets, including capital contributions.

In the simplest situation, each partner contributes cash only. Often, but not always, partners contribute equal amounts. In any case, if the partners are all contributing cash, the partnership agreement should specifically state how much money each partner has contributed or will contribute.

A partner may contribute no capital and only his specific skill or personal services. For example, two partners may decide that a third partner will receive a partner's interest, not just wages, in a partnership business because of a promise to contribute needed accounting or writing skills.

Another type of contribution is that of property—as well as, or instead of, cash to a partnership. Property contributions can be simple, such as office furniture, or complex such as the building which will house the partnership. Or, the partner may contribute the use of the building, but not the building itself. The value of the property contributed and the conditions placed on its transfer to the partnership must be ascertained. A two-step process is involved. First, the partners must agree on how to value property a partner contributes, and they must decide on any other issues pertinent to acquiring that property. Second, this arrangement should be written into the partnership agreement.

A partner can sell, loan, lease, or rent property to the partnership. A loan by a partner, however, should be distinguished from capital. Loaning property to a partnership can be appropriate in a situation in which one partner possesses an item that the partnership wants to use. An example might be an expensive set of medical reference books. Perhaps the partner does not wish to give it to the partnership, and it is too expensive for the partnership to buy. A leasing arrangement fits the situation.

Tracking cash, service, and property contributions to a partnership can be complicated. Typically, it becomes more complicated as the partnership progresses, and there are more assets. It is essential that this be done carefully and mindfully. Only then can accurate distributions be made to surviving partners, upon the death of a partner.

If the partnership agreement does not state otherwise, the UPA provides that all partners share both profits and losses equally, even if they contributed unequal amounts of cash, property, or labor to the partnership. This is the essence of the partnership. Profits, however, must always be distinguished from capital. If the partnership agreement defines how profits are to be distributed but does not mention losses, the UPA provides that each partner must contribute toward the losses according to his share of profits.

Many partnerships decide to divide profits and losses unequally. Some reasons for this include the additional skills of one partner, or disproportionate investments. There is no set formula for distributing profits or losses.

The areas of concern when considering the ratios in which the partners decide to share the income and losses from the business are:

- Percentage interests.
- Any special allocations.
- Operational transactions.
- Capital transactions.
- Liquidation.

Once again, the partners may divide the profits and losses in any way. Further, all of these transactions must consider the possibility that one partner might die during the duration of the partnership.

Sometimes partners decide that one or more partners will receive a draw. A draw is a periodic payment against future partnership profits. It is generally not practical to wait until all of the revenue is in, all of the debts have been paid, and the profit is established to allocate each partner's share of the profits. Therefore, each partner takes a draw at each agreed upon period, typically twice a month or monthly.

Working partners can also receive salaries from the partnership. These salaries are not draws. They are considered normal partnership business expenses. The salary, of course, must be reasonable with respect to industry standards. The Internal Revenue Service has rules on permissible partners' salaries and what must be paid out as profits.

Ownership of Partnership Property

The title to real estate that is purchased with partnership funds may stand in the name of the partnership, a partner or a third party.

Other property owned by a partnership is typically held in the partnership name. Partners, however, are free to decide whether property used by the business will be partnership property or will be owned by an individual partner and merely used by the partnership, that is, rented, leased, or loaned and used free. Unless an express agreement to the contrary is made, property acquired with partnership funds is partnership property. With respect to a deceased partner's estate, it is important to remember this because it can adversely affect the estate in favor of the partnership. If the partners have not defined what is partnership property, there are

several questions the courts typically ask in determining the nature of possible partnership property. These are:

- What was the source of funds used to buy the property?
- Were taxes, liens or expenses such as insurance paid by the partnership?
- Was the property purchased in the partnership's name?
- Was the property improved with partnership funds?
- Was the property used in the partnership business?
- Were income or proceeds from the property treated as partnership funds?
- Was the property carried on the books of the partnership as an asset?
- Were there admissions from the partners with respect to declaration of the property?

Tax Considerations

Partnerships are not liable for federal or state income taxes. However, an informational tax return must be filed once a year. Any profits or losses from the partnership flow through the partnership to the individual partners. Thus, taxes on partnership profits are paid only by the individual partners. This informational tax return must be filed on Internal Revenue Service Form 1065 on or before the first day of the fourth month following the close of the partnership's fiscal year. The return sets out partnership income, losses, deductions, credits and other items. The partnership is required to provide each partner with a written statement setting out that partner's share of the partnership items. Some partnerships are also required to file a balance sheet, Schedule L to Form 1065.

There cannot be double taxation of partnership profits, once at the partnership level and then a second time when partnership profits are distributed to the individual partners. Under the 1986 Tax Reform Act, partners' incomes or losses may be, for Internal Revenue Service purposes, either active or passive. All partners who essentially participate in the operation and management of the business are considered to have received active income. Those who do not essentially participate in the operation and management of the business are said to have received passive income.

An organization that is classified as a partnership for federal income tax purposes is generally treated as a tax conduit. It is not a taxable entity and incurs no federal income tax liability itself. Instead, any resulting attributes from the partnership are passed through to the respective partners. Each partner is required to take into account, in computing his own federal income tax liability, his allocable share of income, gains, losses, deductions, and credits of the partnership, regardless of whether cash distributions are made.

In the case of a cash distribution by a partnership to a partner, as in the case of the death of a partner, the gain is not recognized to the partner, except to the extent that the money distributed exceeds the adjusted basis of the partner's interest in the partnership. The partners are taxed based upon partnership performance. The partnership agreement should specifically address the allocation of income, gain, loss, and credit among the partners proportionately to their share of investment. The partnership structure avoids the issue of double taxation imposed on some corporations.

One of the most often asked questions when entering into a partnership is, "Are the partners likely to pay more or less taxes as a business than they would have as salaried employees?" We must begin the comparison assuming that the partners' gross income is comparable to their previous salaries. As individual partners in a partnership business, the partners are likely pay less taxes. The reason for this is that the partners can make allowable tax deductions. The

Treasury Department is considerate to business activity and the money spent for business purposes.

It is important for prospective partners to be realistic about taxes. If the business is successful, the partners must pay income taxes. Business expenses are generally deductible. Congress has made recent attempts to cut back on some business deductions. However, this was intended only to curtail those expenses being deducted which were not valid in connection with the business. There are still many business expenses which remain deductible. Some legitimate deductions are:

- Eighty percent of business entertainment is deductible, as long as the meeting can be said to have furthered the business.
- Business travel is deductible.
- Automobile expenses, except travel to or from home, are deductible.
- Classes taken to improve skills needed in the business are deductible.
- Child care expenses necessary to permit a parent to work are deductible, but only according to a complex formula that allows deduction for far less than actually spent.

The most basic tax rule on partnerships is that the partnership itself is not subject to taxation. The partnership is simply a money conduit to the individual partners, who pay their shares of income tax through their own individual tax returns. Each partner is taxed on his distributive share of partnership income. A partner's distributive share can be more than the profits or payments he actually receives, particularly if any profits are retained in the business. The distributive share is the amount of money a partner is deemed to have been received as income under Internal Revenue Service rules.

An example of distributive income follows. Suppose a two-person partnership in the foreign-language teaching business secures some lucrative contracts with local employers. At the end of the tax year, after paying all debts and obligations, the partnership has $500,000 in the bank. The partners cannot simply say that none of that $500,000 is profit, that they are setting it aside for upcoming expenses, expansion or for some other reason. Even if the money is left in a partnership bank account and never paid out to the partners, the Internal Revenue Service will deem that most of it is distributed and is as taxable income to the partners. There are provisions for maintaining some portion of this money as a business reserve.

Partnership business cannot retain significant earnings for the future expansion, or for some other reason, of the business without the partners having to pay tax on that money. On the other hand, corporations have the opportunity to retain earnings for certain purposes. Income taxes must be paid, but they are paid at the corporate level.

Tax Consequences of Contributions

No taxable gain or loss occurs simply because money is transferred from a partner to the partnership. Similarly, there is no taxable gain or loss if a partner withdraws some or all of the money he has contributed to the partnership. However, if a partner contributes property, especially property that has increased or decreased in value since he bought it, the tax consequences of these transactions can become complicated and may affect the partnership only upon the death of a partner.

When establishing capital accounts and the partners' respective capital investments, thereby tracking each partner's contribution for later consideration in the event of the death of a partner, consideration must be given to:

- The capital required for the operation of the partnership.
- The ratios of capital to be contributed by each partner.
- Mandatory or voluntary additional contributions.
- Complete descriptions of the property being contributed, if other than cash.
- Valuation of the contributed property, other than cash.
- Loans to the partnership by the partners.
- The withdrawal of cash or property contributed to the partnership.

If a partner contributes property whose current market value is the same as the partner originally paid for it, there is no complex tax issue. As with cash, no taxable transaction occurs merely because property is transferred from an individual owner to the partnership. Tax situation is more complex if the property has gone up or down in value since the partner bought it.

There are other complex tax problems involving contributed property. In particular, issues are raised by the contribution of real estate with an outstanding mortgage or any encumbered property, such as a car with a loan balance. If mortgaged or encumbered property is contributed to a partnership, the partnership's liabilities are increased by the amount of the debt.

Business transactions such as this between a partner and the partnership can get much more complicated. For example, a partner can sell a partial interest to other partners, and then each partner can contribute their interests to the partnership. A partner can lease, rent or loan property to the partnership, or combine these methods. Serious thought should be given to these types of transactions, especially when dealing with the issues surrounding planning for the dissolution of the partnership, in the event of the death of a partner.

The tax code permits tax-free exchanges of real estate. A partner can sell one parcel, buy another for what he sold the first parcel for and not be subject to any tax. In other words, the partner is allowed to roll over any profits from the sale of the first property into the second.

However, Internal Revenue Service rules require that the same type of legal entity be both the seller of the first property and buyer of the second. If a partnership sells the first property and an individual partner buys the second, this does not qualify as a tax-free exchange.

Conversely, if a partner, as a separate individual, buys one property, but a partnership sells another, this does not qualify. These issues must be kept in perspective when allowing for the distribution of property after the death of a partner.

The tax consequences of a person receiving an interest in a partnership in return for the contribution of services must also be considered. Services are not regarded as property. If the contributing partner receives a capital interest in the partnership in exchange for services, then he has received taxable income.

For example, suppose three people form a partnership to operate a meat processing business. The two partners, Ed and Theo, each contribute $15,000 for start up capital and plan to work part time in the business. The third partner, Sam, has no cash to contribute, but he receives a one-third ownership of the partnership in exchange for promising to work full-time for a year.

As far as the tax laws are concerned, the third partner has received present taxable income by this agreement. The cash contributions to the business total $30,000, and the third partner now owns one-third of the business. According to tax law, he has received taxable income of $10,000.

In the example above, the tax laws favor capital over labor. The promise to work is not equal in value to property. The third partner has not really received any money. If the business were sold and he got one-third of the cash for the sale, he could clearly see this as taxable income.

An alternative to engaging in exchanging property or services for ownership interest, or even the right to receive future profits in exchange for these, is to hire a potential partner as an employee first. He could be paid enough that he could eventually buy a partnership interest. He is motivated to do this, and this arrangement solves the tax issues here, especially where the potential partner must consider what may happen to his family and to his estate in the event of his death.

Taxation and Partnership Management

Aside from ongoing tax matters, there are other operating tax issues the partners must determine. These include:

- Deciding which accounting methods to use (accrual, cash, or other permitted methods).
- Deciding the depreciation method to use for partnership property.
- Choosing the partnership's fiscal year. The Internal Revenue Service requires that a partnership use the tax year used by the partners that own the majority of the partnership interest.

Filing Tax Returns

These issues must be considered as they relate to the eventual death of one of the partners. As the partnership grows, it is particularly important to determine whether there are tax or financial reasons for varying the way the partnership income is distributed to partners.

Specifically, tax laws allow any particular partnership income, profit, loss, or deduction to be distributed between partners in a way that is different from their standard division if this is permitted in the partnership agreement and if the particular distribution has "substantial economic effects."

These issues of partnership taxes are typically beyond what is necessary for beginning partnerships. However, if this proves advantageous years down the road, the partnership agreement can always be amended to include exactly the words that the tax law then requires.

Additionally, the desires of the partners may change with respect to their anticipated needs at the time of death.

Family Partnerships Used for Tax Advantages

A family limited partnership is a legal agreement that allows business owners and their children to address tax, business succession, and estate planning issues all at once. This vehicle allows parents to give assets to their children at highly discounted rates, while still maintaining control of those assets. In addition, eventual estate taxes are reduced by virtue of reducing the total estate.

A family limited partnership is set up like any limited partnership, that is, it has two classes of partners. The general partners (the parents) hold one percent of the shares of the partnership, but maintain all the power and control. The limited partners (the children) own a percentage of

the shares but have no authority, rights, or control over the operation and management of the partnership.

At the start, the parents are both general and limited partners. When they begin giving partnership shares to the children, the children become limited partners. The parents can give as many shares to their children as they want. However, like most limited partnerships, family limited partnerships are often appraised at less than the value of their assets.

When parents anticipate leaving a substantial amount of money to their children, there is relative flexibility with the family limited partnership, compared with the various trust mechanisms available for structuring the children's inheritance upon the death of one or both of the parent partners. Family limited partnerships are not limited to stock, and there is the potential to keep the assets within the family.

Tax Returns

The partnership itself is not subject to income tax at the state level or at the federal level. Income and profits generated by a partnership business flow through the partnership and are taxed to the individual partners.

Nevertheless, a partnership must file an informational federal tax return Form 1065, listing the partnership income, expenses, and other required financial data, much of which must be separately identified. This return must be filed by the fifteenth day of the fourth month following the close of the partnership tax year. In addition, most states require the filing of an informational state tax return.

A thorough explanation of the intricacies that can be involved in reporting a partner's share of partnership income on his individual tax return is complicated. However, some basic points follow.

The federal government and most states require all self-employed persons, including partners, to file quarterly estimates of this income with the appropriate tax payments.

An individual partner's yearly tax return must report a partner's distributive share of the taxable income or loss of the partnership. A partner's distributive share of partnership profits is determined by the partnership agreement. If the agreement makes no specific mention of the manner of sharing particular income, gains, losses, depreciation, or credits to be allocated, a partner's distributive share is determined by the Internal Revenue Service, in accordance with the provision of the partnership agreement for division of general profits or losses.

The Internal Revenue Service will disregard special provisions as to distributive shares of partnership profits if it determines that the provision lacks "substantive economic effect," that is, it has been adopted as a tax dodge. In that case, they allocate distributive shares according to the partners' ownership interest in the partnership.

There are special income tax rules governing allocations of partnership interest to individual partners. There are also special income tax rules where there is a shift of the percentage of ownership interest or sharing of profits and losses during the year. Each partner must take his share of any loss into account each year. It may become part of his carry-back or carry-forward for tax purposes, used to offset positive income in other years.

Each partner must pay his own Social Security tax separately, as part of his annual tax return and make quarterly payments.

If a partner has a subpartnership contract sharing his partnership profits with someone who is not a member of the partnership, that partner is still required to report as income the entire amount of the profits he was entitled to receive from the partnership, with a subsequent deduction for the share allocated to the subpartner.

Tax law provides different tax treatment for active and passive income. Active income is received as the result of the partner's own efforts. Active income and losses are, for federal income tax purposes, taxed separately from passive income losses. A partner's income is active if he materially participates in the partnership business. Materially participating is defined as "regular, continuous and substantial involvement in partnership business operations."

Income received from businesses in which the partner does not materially participate throughout the taxable year is passive income. A loss in passive income cannot be used to offset profits from active income.

It is generally desirable to have partnership income treated as active income. If it is treated this way and the partnership suffers a loss, the loss can be used to offset a partner's income earned from other active sources such as other employment. This reduces the size of the partner's income which is subject to taxation. By comparison, losses that result from passive investments cannot be offset against income actively earned. They can only be used to offset passive income from profitable investments. Such losses are held in suspense until the tax payer has passive income or until the taxpayer disposes of his entire interest in the passive activity. The characterization of business income, that is, whether in tax terms that income is active or passive, is made at the partnership level, not by each partner.

It is established that, for income tax purposes, a partnership is basically a conduit allowing income to pass through to the individual partners. However, for certain specific purposes, a partnership is not treated as this conduit, but is viewed as a distinct entity by the Internal Revenue Service. For example, for computation of partnership income profits and losses, a partnership is regarded as a unified enterprise. In other words, whether a profit or loss has been made is determined by looking to the partnership as a whole, not to any individual partner.

Certain tax elections, such as the choice of the method to be used for accounting purposes, must be made by the partnership as an entity. In the unusual event that a partner has a different tax year than that of the partnership, the time for inclusion of an item or distributive share of income or loss in a partner's tax return will depend on the tax year of the partnership itself.

Expansion of the Partnership

There are many ways to define success. Partners must ask themselves whether the additional burdens that are bound to accompany running a bigger business would be worth it. Partners should discuss and review what they want to happen if the business does well. How much additional work is involved? How will that affect time spent with family? How much added income is sufficient before each partner will feel accomplished? Are any partners likely to buckle under the added pressures and responsibilities? How will the hiring of more employees be handled? Is a move appropriate? Can a similar business be acquired? How will necessary additional machinery or a larger inventory be financed? If individual partners feel differently

about these issues, it is an indication that perhaps they should reconsider the idea of expansion or perhaps even the partnership itself.

The expansion of a partnership and the timing of it could have a profound impact on the plans all partners have for what happens to the partnership when they die. Perhaps the partnership has grown too much too fast and is overextended. This could leave the surviving partners with perplexities. Perhaps the partnership could have grown into more than its original framework. This could leave the surviving partners at a loss in the event they must wind up the business upon the death of one partner.

As a practical matter, any specifics that are put in the partnership agreement, with respect to expansion, are not likely to be of any use in legally binding a partner. If a partner does not like the way the business is expanding, all the legal jargon in the world is not likely to make him more cooperative. Courts will not issue orders compelling a partner to live up to a clause agreeing to work productively for an expanded business because it could not be enforced.

The essence of partnership is voluntary cooperation. If the partners begin to fundamentally disagree about the direction the partnership business should take, it is perhaps time to terminate the partnership. A well-drafted partnership agreement can contain provisions governing a break up of the partnership, but it cannot make the partners continue to work together productively.

If the business has sustained or is experiencing expansion, the partnership may be incorporated. Specific notices of the intention to incorporate and the intent to transfer assets must be made for the partners to be released from the debts of the partnership. In addition to these notice, corporate documents must be drafted. One of the primary concerns here is the transfer of partnership assets to the new corporate entity. This necessitates an in-depth review of the Internal Revenue Service provisions for incorporation. Some considerations are the preparation of the bill of sale, assumption agreements, powers of attorney, assignments of leases, and conveyances of real property. All of these issues affect the solidarity of the partnership and, therefore, the potential distribution of partnership shares, should a partner die.

Generally, a partnership that wants to incorporate will want to capitalize. If money or other property is used to purchase stock, no adverse tax consequences arise to the corporation, since it does not recognize gain or loss on the sale of its own shares. In the cases of partnerships becoming incorporated, frequently the stock of the corporation is issued in exchange for appreciated property. In this case, the gain is recognized by the transferor which is now shareholder.

Disputes

Partners must know how to handle disputes that they cannot resolve. These inevitably occur. It is common sense to work out the method for handling disputes in advance of their occurrence. Unfortunately, dispute resolution may be the last resort if a compromise is impossible. All partnership agreements should have a provision for handling unresolved disputes.

Fortunately, most partnership disputes evolve and resolve in their own way. Discussions over a long lunch are often beneficial. Vacations are often suggested to remove the partners from the anxiety and numbing effects of everyday stress. The pressures of work can be left behind, and the "business" of resolving issues can take place. Of course, nothing takes the place of good communication. Sometimes, however, the partners must step back and take a good, hard look

at where the partnership is headed and reassess their routes. Business is not just about hard work. It is also about working well.

Despite the partners' best efforts, a dispute may arise that cannot be resolved. Alternative dispute resolution (ADR) procedures are required for getting the partnership back on track. ADR employs traditional negotiating techniques and also uses certain novel methods which have been proven successful in helping the disputing partners to reach prompt, rational, and mutually agreeable resolutions to their conflicts.

Mediation and arbitration are forms of alternative dispute resolution. These are probably the best options available for resolving conflicts which cannot be solved informally. Both procedures involve using a private, non-court structure to handle partnership disputes, that is, they are set up outside the judicial system. Their advantage is that the expensive, time consuming, and slow process of the involvement of the court system is replaced with a procedure that is less expensive, more humane, and speedy. Both procedures are simple and informal.

Often, the results obtained through ADR procedures do not result in the termination of the partnership, as might have been without ADR. The partners are able to reconvene as a stronger and more united partnership.

Mediation is often the first step before arbitration. It is a process in which an outside party, called the mediator, attempts to convince the disputing partners to settle their dispute before it advances to the point of litigation or to the point of termination of the partnership. The mediator has no real power to bind a decision.

Hopefully, however, his efforts can accomplish reaching a mutually satisfactory compromise or resolution.

Arbitration, like mediation, channels disputes into private arbitration, rather than into court. Unlike mediation, arbitration is a process upon which a decision is final and binding. The partnership dispute is submitted to an arbitrator. Like mediation, this process is informal. The arbitration process is not voluntary.

All partnership agreements should contain a mediation/arbitration clause, providing for its demand.

Transfer of Interests

The transfer of interests by or among the partners is an important consideration. Sales and transfers of interests among partners are the most challenging tasks, especially after the death of a partner. In addition to what types of transfers are permitted, matters to be considered are:

- Buy-sell provisions.
- The method of determining the purchase price.
- The valuation of interests for different purposes. These include withdrawal, death, retirement or expulsion.
- The method of payment of the purchase price such as cash, insurance, or installments.
- Rights of first refusal. Some considerations here are notice and time to accept, price and terms, "all on none" right, and third-party offers.
- Events of default. These include bankruptcy proceedings, insolvency, receiver for assets, charging order, and the failure to perform according to the partnership agreement

- Withdrawal or death of a partner. Is the withdrawal voluntary or involuntary? What are reasons for the expulsion of a partner? What are the rights of the remaining partners with respect to the purchase?
- Dissolution and winding up. Issues here are the effect of a dissolution, procedures for reconstitution, and procedures for winding up.

Death of a Partner

The UPA provides that every partnership, whether existing at will or for fixed terms, dissolves by the death of one of the partners. Dissolution of the partnership will not automatically result. If the deceased partner, through his will instructs that the partnership be continued after his death, the partnership may be continued with the consent of the other partners. However, surviving partners may not continue the business in the absence of such an agreement.

If the deceased instructs that the personal representative continue the partnership business, the surviving partners cannot be forced into this arrangement. If they desire this arrangement, the partnership may be reconstituted with the personal representative as a full member of the partnership. This is technically the creation and formation of a new partnership.

Technically, when one partner leaves the partnership, for any reason, the partnership dissolves. The partnership is no longer the same entity without the same partners. If the deceased partner had no buy-out agreement with the other members of the partnership, his share of the partnership would have to be handled through probate. If the partnership agreement provides for the remaining partners to buy-out the deceased partner's share, the probate process is generally eliminated.

The formation of a new entity does not necessarily have to be another partnership. If a new entity is created and there is only one survivor, a sole proprietorship may be formed. If, upon the death of a partner, the surviving partners decide this would be a good time to incorporate, the new entity created may be a corporation.

It is essential that the partnership agreement be structured to address what will happen if a partner becomes mentally ill, disabled, or dies. It is clearly not advantageous to leave this question unsettled and unresolved. If this issue is not dealt with beforehand, there is a serious risk of conflict. Any rules set forth in the partnership agreement, with respect to provisions for the disability or death of a partner, are legally enforceable.

The first issue to resolve is whether a partner can freely transfer his interest in the business by will or through a living trust when he dies. Most partnership agreements contain clauses prohibiting a partner from transferring his interest in the partnership to a third party without giving the remaining partners the opportunity to buy him out first. The right of the remaining partners to have the first opportunity of buying a deceased partner's share is commonly called the right of first refusal. Using the right of first refusal, if one partner dies, the surviving partners have the option to buy the deceased partner's share and to continue the business. If such provisions are not made, one or more of the following may happen. The deceased partner may have attempted to transfer his interest in the partnership without the surviving partners' consent. This, of course, is not allowed by the UPA. Further, this can create new or additional conflict among the surviving partners and for the estate.

The business may have to be liquidated. Offering used office furniture or factor equipment for sale will not likely bring in much revenue. The partnership is probably worth more as a whole than it is in pieces. If the partner withdraws as a result of disability or death, the surviving

partners may be left to deal with guardians or heirs who will try to sell off the deceased partner's interest or actively participate in the business. Although selling off the deceased partner's interest cannot be done without offering the surviving partners the right of first refusal, the surviving partners may not be in a financial position to do this within a timely fashion, especially if the death was unexpected.

The ***right of first refusal*** is designed to protect the remaining partners. The partnership agreement should contain provisions allowing the remaining partners to purchase the interest of the deceased partner. A typical clause for this purpose might be:

"If any partner leaves the partnership for reasons of withdrawal, expulsion, or retirement; becomes mentally or physically incapacitated; or unable to adequately function as a partner; or dies, he or his estate shall be obligated to sell his interest in the partnership to the remaining partners, who may buy that interest under the terms and conditions set forth in this agreement."

Under the UPA, the partnership agreement can be anything the partners want it to be. If someone inherits a partner's share of the business, that heir may prefer not to be bought out by the remaining partners. He may want to retain this share. With a properly drafted partnership agreement, the heir has no right to force himself into the partnership. He must sell his partnership share, if the partnership enforces the above clause. The remaining partners could decide, if they wish, to take the heir in as a new partner owning the deceased partner's share. Or, they may decide they do not want the heir as a partner, and they can buy him out.

If one partner dies and the remaining partners cannot afford to buy out the interest of the heir, the partnership must be liquidated. The heir and the remaining partners must understand that the partnership business as a whole is often more salable than only a share of a business. The entire business might be sold, and the proceeds can be divided. This gives the remaining partners a choice. They may either buy the deceased partner's share of the business or lose their own. A common time frame for this decision is six months to a year, depending on the type of partnership and what kind of business it is engaged in. This gives the remaining partners a reasonable time to experience how the business works without the deceased partner. It also allows the surviving partners to fully consider their options of reconstituting the partnership or terminating it all together.

Many partnerships decide that they want and require some type of advance notice before a partner leaves. These events may be planned for, of course, and should be. Most departures can be covered with preplanning, that is, an agreement among the partners as to what will happen to the partnership of a particular departs.

It is generally not possible to make arrangements if a partner suddenly becomes seriously injured, mentally incompetent or dies. These circumstances also require preplanning. The scenarios resulting from a partner's death could be different, with the passing of a particular partner. For example, if the major investor in a partnership dies and the business has become quite prosperous, the partnership could probably be reconstituted without the deceased. However, if the deceased contributed a particular indispensable skill or was the brains behind the business, the partnership may not be able to continue at all without him.

A buy-out provision may be prepared within the partnership agreement defining the terms upon which the surviving partners can buy-out the inherited interest of the deceased partner. There are some essential areas that must be covered when formulating a buy-out clause. These are:

- There must be the determination of how the worth, or the valuation, of the partnership will be decided, in the event of a partner's death.

- There must be a determination of how the payments will be made to the inheriting partner.
- There must be decisions on provisions for providing for the continuity of the business. These can include the control of the business name, disability provisions, mental incompetence provisions, provisions regarding the drug or alcohol dependence of a partner, and others.

Valuation of the Partnership

Usually, the most important consideration for drafting a buy-out provision is the valuing of the business. Even for successful partnerships, locating someone who wants to buy either a share or the entire partnership, and who will pay fairly, can be difficult, sometimes impossible. If the partnership business is only bordering on successful, the possibility of selling it, except at a great loss, is often quite poor.

First, there must be a fair method for determining the worth of the business. Naturally, for many partnerships, this is not an easy assignment. There are many different methods for the valuation of a business. There is not one method of valuation which is superior to all others. The method of valuation depends on the nature of the business and the surviving partners' relationships and expectations. A method must be employed that fits the situation. Since the partnership agreement may be whatever the partners wish it to be, methods may be modified, blended, or new ones may be invented to befit a particular purpose or need. The goal is to achieve as fair a method as possible for determining a buy-out price.

Occasionally, there are industry-specific approaches which may lead to an accurate estimation of the worth of a business. For the vast majority of small businesses, such detailed methods merely hinder the partners with complexities, without leading to fairer results.

Without a doubt, the partnership agreement should be configured so that the partnership is given the maximum chance to survive. If the buy-out price is unfair or too high, the surviving partners may understandably decide to liquidate the business. If they decide to liquidate the partnership and the business cannot be sold to outsiders, everyone will likely receive much less than the optimal scenario of the existing partners buying out the heir and the partnership continuing. For example, if a business ends because of the death of one partner, and the remaining partners decide they do not want the heir as a partner, the money received from the sale of equipment, supplies, and other business assets will probably be much less than a share in the ongoing business.

As seen above, not only is the buy-out method a consideration, the determination of how the necessary payments will be made needs careful thought. The heir may, for whatever reason, require a lump sum, and the idea of the surviving partners making monthly payments may not be acceptable to him. It is advantageous to make some earnings projections for the partnership to see how a buy-out method appears in the context of the amount of cash that is likely to be available after the death of a partner.

In the beginning stages of a partnership, the business is probably not worth more than the value of its tangible assets. In this case, adopting valuation and buy-out provisions permits the partners to make some thoughtful and sensible conjectures as to how the hopefully profitable business will be valued in the future. In that future, it may be necessary to reevaluate and rewrite these provisions, after the business is underway and has become large enough so that a more complex, focused, and effective valuation method is possible.

No method of valuing a partnership can be precise or scientific. Some common methods of valuing a partnership after the death of a partner follow.

Asset Valuation Method

The asset valuation method of valuing a business is based on the current net worth of the business, that is, all of the assets of the partnership minus all of its liabilities. This is the method the UPA requires if the partnership agreement fails to adopt a valuation method. It works as follows. As of the date of the death of a partner, the net dollar worth of all partnership assets is calculated and all outstanding business debts are deducted. This figure represents the net worth of the partnership. The deceased partner's heir or his estate receives this amount, or this is the amount for which the surviving partners acquire the deceased partner's share. The assets that are normally included in the asset valuation method are:

1) All cash, after subtracting all partnership debts owed.
2) The current market value of all tangible assets of the partnership. This includes the net value of current inventory, plus the present value of other items, known as fixed assets, such as office furnishings, manufacturing equipment, the building housing the partnership, etc.
3) All accounts receivables which are determined to be reasonably collectable. This is money still owed for work already completed and billed.
4) All earned but unbilled fees and all money presently earned for work in progress. These fees hold notable importance in professional partnerships, such as law or consulting firms. It applies where construction work is being done or where an invoice, for whatever reason, has not yet been sent, but the revenue has been earned. This is not really the same as an account receivable.

For example, suppose three men have been equal partners in a repair business for four years. One partner dies and has willed his partnership share to his two sons. If the remaining partners decide they do not want the sons as partners, under the right of first refusal, they are permitted to buy the sons' shares of the partnership. Naturally, the sons' shares represent one-third of the worth of the repair business, as determined by the asset valuation method.

In providing for the settling of partnership accounts by this method, the UPA ranks the liabilities of the partnership for payment as follows.

1) Those owing to creditors, other than partners.
2) Those owing to partners, other than for capital and for profits.
3) Those owing to partners with respect to capital.
4) Those owing to partners with respect to profits.

This is typically recognized as the order for payment of partnership liabilities. Any surplus may then be applied to pay, in cash, the net amount owed to the partners.

The asset valuation method is probably most effective for new businesses. New businesses really do not have much, except for their fixed assets. They do not yet have a reputation, good will, a fine name, or a lengthy customer or client list. There is no equitable way to estimate future profits when the business has yet to establish these things and to prove itself. This method is also often employed for a business whose worth is primarily determined by the value of tangible assets, such as a clock gallery or a gift store. However, for many businesses that have been established and are profitable, this method fails to include the abstract and elusive, although real, aspects of a business's real worth, such as reputation. Many ongoing businesses are worth much more than the net value of their assets minus their liabilities.

Book Value Method

Another method of valuing a partnership, after the death of a partner, is called the book value method.

Book value is defined as the money value of the partnership interest. It calculated the value, which was arrived at by taking the total value of the partnership assets as shown on the general ledger and other books of accounting, and deducting the total partnership liabilities.

The book method of valuation is quite simple. Generally, this should be determined by a full examination of the books of the firm. The procedures or the accounting methods to be used in determining a book value figure are matter for agreement of the partners.

Unfortunately, when using the book value method to determine the value of a deceased partner's interest in a partnership, there is little relation to reality with respect to addressing such issues as reputation, good will, a well-respected name, etc. When the partnership agreement specifically eliminates it from consideration in computing the value, book value does not include good will. It is also excluded when there is no satisfactory basis for assigning a value to it. However, a provision excluding good will does not require the exclusion of present values, as opposed to prospective values.

The amount of life insurance on a deceased partner is included in determining the book value of the partnership. This is especially true where the surviving partners or the partnership are the beneficiaries of the policy.

The book value often refers to the acquisition cost. Further, the acquisition cost of any property probably does not reflect its current and genuine worth.

For example, some property, such as office furnishings and the inventory a partnership carries is probably worth far less than its acquisition cost, given the effects of depreciation. On the other hand, given appreciation, some property, such as real estate, is often worth much more than its acquisition cost. When using the book value method, consequential assets, such as any earned but unbilled fees and money earned for work in progress, are not included at all, as in the asset valuation method.

The book value of a partnership and its assets are generally seen as an arbitrary method of valuation, and the courts are hostile to this method of valuation, since the book value does not actually represent the fair market value. It is considered an inequitable method of valuation. This exception to this, of course, is where the partnership agreement specifically states that the book method of valuation is to be used in valuing the partnership after a partner's death.

Set Dollar Method

The set dollar method is the epitome of preplanning. Under the set dollar method, the partners agree in advance that if one partner dies, the others will buy out his share on the basis of a predetermined price. Although the price selected can be arbitrary, these issues can be circumvented by revaluing the partnership every year or so. Given natural business fluctuations and the changing economy, the worth of any partnership business will fluctuate. Revaluing the partnership at certain predetermined periods can solve these problems.

The set dollar figure method works well when the primary worth of the business is the activity of the partners, that is, where there are no substantial hard assets or much value in the inventory of goods. This set of circumstances describes most partnership service businesses, particularly

in their first few years of business. From consulting firms to hair salons, new service businesses generally do not have costly fixed assets. What they do have is the energy and hopes of their owners. These things can hold a tremendous value in the business's first few years. The set dollar method of valuation is often used when the partners' primary concern is the preservation of the business and their relationship with each other. For example, a two-man partnership runs a local delivery service. Suppose neither partner has immediate family to inherit his interest in the delivery service, and they both want to ensure the business survives the death of one partner, for the benefit of the other. They may select the set dollar method of valuation to estimate on the low side for the worth of the business. They plan for this method to be used in the event of the death of either partner.

By valuing the partnership in advance, the deceased partner's estate does not get involved in valuing the partnership interest; it has been predetermined. Further, by making this valuation reasonably low, the surviving partner will not be excessively burdened to come up with the money to buy-out the deceased partner's share. Since a partnership dissolves upon the death of a partner, the surviving owner would have to continue to operate as a sole proprietor or form a new partnership with a new partner.

The set dollar method of valuation is commonly used when the partnership is involved in property investment. Of course, the partners hope that their property will increase in value, although any amounts of increase cannot be predicted. Annual appraisals by professional real estate appraisers can be costly and time consuming. Further, they may result in unexpected discrepancies between one experts' appraisals. The reality of real estate appraisals can be disturbing.

For example, suppose that in a three-person real estate partnership, the partnership agreement provides that upon the death of one partner, the surviving partners and the deceased estate would each hire appraisers. If the appraisals differ, they would split the difference.

When one partner dies, the partnership's legally qualified appraiser values their apartment building at $500,000. The deceased's estate's appraiser, who is also legally qualified, values the property at $740,000. The surviving partners would then have to pay for more than they thought was fair for the deceased partner's interest. The partners may agree on the amount or percentage rate that they calculate the value of the partnership will increase or decrease over the next year, or some other specified period of time. If a partner dies within a short period of time after the last yearly valuation, the surviving partners would have a formula for the partnership's valuation, which would include any recent price fluctuations.

The set dollar method of valuation combines fairness and simplicity. The buy-out price is fair because all agreed to it. Once the price is determined, appraisals and accountants are not necessary when a partner dies. In effect, the set dollar method says that the valuation of a small business partnership that cannot be readily sold on a market is inherently subjective. So, the partners face that subjectivity directly, rather than look to some other valuation method to contend with this. Since the set dollar method requires the partners to sit down regularly and work out the worth of the partnership, this can help to keep all partners up to date on valuation issues.

Post Departure Appraisal

Using the post departure method of partnership valuation, the partners agree to have an independent appraiser determine the worth of the partnership at the date of a partner's death. Sometimes the particular independent appraiser is even specified in the partnership agreement. This method is also called the appraisal method. This method may seem sound, since the at the

time of the drafting of the partnership agreement, the partners cannot know the valuation of the partnership sometime down the road when a partner dies.

Unfortunately, appraisals rarely work so easily. Many small businesses are not amenable to precise valuation, no matter how expert the appraiser. There are several other reasons to be cautious about using appraisers to determine the value of a business. It can take some time to get the appraiser's report, unless an appraiser who is both experienced in the particular partnership business is also prepared to appraise it immediately. Also, the appraisal method of valuation makes it difficult to determine in advance what a partnership interest might be worth. The partners do not have this essential information if they need it.

On the other hand, there is a positive side to the appraisal method that must be considered. There are situations where the appraisal method may be the best of choices. Some businesses are inherently more suitable to valuation by appraisal than are others. These include real estate partnerships, antique shops, and businesses that sell collectibles such as baseball cards, coins, stamps, etc. Any business where there is a closely followed market that can be used to determine the price of inventory can effectively use the appraisal method. If employing the appraisal method to value a partnership, the partners must agree on an appraiser in which all of the partners have confidence.

Capitalization of Earnings Method

So, if the business is successful and is likely to flourish, even in the event of a partner's death, the capitalization of earnings method is used to demonstrate that there is a real value in the ongoing nature of the successful business. For example, suppose there are two businesses in the same part of town that are each worth $75,000 according to the asset valuation method. Further suppose that one of these has yearly profits of $55,000, while the other has yearly profits of only $25,000.

Clearly, the currently more monetarily successful business is the one with the greatest annual profit, although they both take in the same amounts each year. The capitalization of earnings method is an accurate way of showing this.

This is the theory behind the capitalization of earnings method: First, there is a determination of what the business earns, usually on a yearly basis. Second, this earnings figure is multiplied by some multiple. The multiple is a preset number used to determine the worth of the business.

For example, suppose five partners of a retail clothing store plan their business well. They negotiate a long-term and low-rent lease on their store. After ten years in the business, their store is in the center of a densely populated, high-income area of town. Clothing sales are good and profits of the store are in excess of $300,000 per year.

Unfortunately, one partner dies. The surviving four partners and the deceased's estate decide that the fair value of the business is two times the average net profits for the past four years. Two times the average net profits of the partnership for the past four years is the buy-out price.

If the partnership is new, then using the capitalization of earnings method to value the partnership is untimely. To be fair and effective, the capitalization of earnings method requires several years' history and profits before it can be used practically. The multiple used is typically not higher than three.

If using a multiplier based on gross earnings, rather than on profits, the partners should think in terms of a fraction.

In the case of ambiguity in the partnership agreement with respect to the method of valuing the business or if the agreement has no express provisions for this, the courts typically construe the agreement in favor of the estate. Typically, too, the surviving partners are required to pay fair market value for the deceased's share in the partnership.

Further, the surviving partners owe a duty to the deceased's personal representative to make full and voluntary disclosure of all facts bearing on the value of the partnership.

Good Will

Good will is generally defined as "the well-founded expectation of continued public patronage." Good will has a value, and it is part of the worth of the business. Some prosperous businesses are naturally worth more than their tangible assets because, as the result of hard work and fair business dealings, they have earned a good business reputation. That reputation brings in continued business. This abstract asset is good will.

Since good will is an accountable asset, the good will of a partnership sometimes has value that survives the death of a partner. This concept is especially applicable for successful retail businesses. However, it is often less of a factor with businesses that depend primarily on individual service or are professional partnerships.

For example, the good will of an accounting practice does not generally survive the dissolution of a partnership, upon the death of a partner. Here, the good will asset of the firm consists solely of the professional skills and qualifications of the partnership members. When that asset is no longer a part of the partnership, due to the death of a partner, there is no good will to which a value can be attached.

The estate of the deceased is entitled to a proportionate share of the value of the value of the good will. The surviving partners must protect the good will of the partnership and turn it over to whomever is entitled to it.

In the absence of an agreement to the contrary, the surviving partners have the right and authority to sell the good will.

Beginning businesses do not have much good will. Therefore, it is wise to adopt a market value buy-out strategy for the first year, or some other specified time, with the express provision that another more comprehensive method will be adopted at the end of that specified period, when the partnership has progressed and some good will value has developed.

The value of the good will of a business, upon the death of a partner, may be estimated by the annual profits of the business before the death of the partner. If good will is included in the business valuation, it is simply added to the list of assets to be valued. If good will is genuinely a valuable asset of the partnership business, the capitalization of earnings method should be used the valuation of the partnership.

A provision in the partnership agreement may specifically provide that good will may not be taken into consideration when valuing a partnership, upon the death of a partner. On the other hand, if the partnership agreement provides that the surviving partners may purchase the partnership interest for its book value, the surviving partners are relieved from any duty to actually account for the value of the good will. These accounting maneuvers are almost always the exclusive procedures between the personal representative and the surviving partners. As

part of the accounting process, the surviving partners must render a detailed account of the performance of their trust to the personal representative, pay the deceased partner's share, and account for all the profits from the partnership's real and personal property which rightfully belong to the estate of the deceased.

Under the UPA, when the partnership continues after the dissolution by the death of a partner, the deceased partner's personal representative has the option to have the value of the interest of the deceased ascertained on the date of dissolution.

Other Factors Included in the Buy-Out Price

Partners can decide that, upon the death of one partner, they want the buy-out price to be determined by a combination of methods. Again, there are no rules. Partners should be careful not to create a method that makes the buy-out price so high that no one can pay it.

Some partnerships adopt different prices or methods for calculating the price for a partner's interest, depending on the reason the partner leaves. For example, since insurance can cover most of the cost if the partner becomes disabled, mentally incompetent, or dies, the highest buy-out provision might prevail. On the other hand, if a partner simply quits, for whatever reason, the buy-out valuation probably should not be as high, since this can cause some hardship on the remaining partners.

Using Insurance to Value a Partner's Interest

Simply because there is a provision in the partnership agreement that a partner's interest in the partnership will be paid off in a lump sum or on a set schedule does not necessarily mean that the partnership will actually have sufficient money to make that payment. Sometimes the business may be barely able to make the payments. Further, doing so may force a serious drain on cash necessary for other business purposes. So, many partnerships decide to protect themselves to some extent by purchasing insurance against each partner's serious illness, incapacity, or death. Naturally, these types of insurance policies do not help to pay off a partner who simply quits or who is expelled from the partnership.

A business can easily buy life or disability insurance on each partner. The partnership agreement can state that the money paid to the estate of a deceased partner, or to a disabled partner, by the proceeds of the insurance policy will be the full worth of his interest in the partnership. This makes the valuation of the partnership easier in the unfortunate event of disability or death of a partner.

For many partnerships, life insurance can be a way to set a specific price for the purchase of the deceased's interest in the partnership and for the surviving partners to fund this valuation. Each of the lives of the partners is insured. This is a practical way of obtaining the money needed to pay off a deceased partner's interest, especially by purchasing term insurance, the least expensive form of life insurance.

A life insurance policy serves as legally adequate consideration in exchange for a deceased partner's interest in the partnership. If a partner dies, the partnership-financed insurance policy pays off the deceased's share. Thus, the policy proceeds become partnership property, and partnership operating income does not have to be used for buying the interest of the deceased.

For the partnership agreement to effectively provide for this set of circumstances, the agreement should state that upon the death of a partner, the proceeds of the insurance policy

will be payable to the estate of the deceased or to designated beneficiaries in the purchase of the partnership interest. The estate will, in turn, convey the proceeds to the surviving partners to be used to purchase the deceased partner's interest.

If the partners decide to buy life insurance for this purpose, they should consider that they are solving two problems at once by providing in the partnership agreement that the amount of the life insurance pay out is also the value of the deceased partner's interest in the business. However, these do not have to be tied together. But there does need to be a certainty that there is enough life insurance to make any necessary payment if a partner dies.

The partners' agreement for the purchase of the interest of a deceased partner may set a specific price for the purchase and fund of this valuation of each prospective decedent's interest by insuring the lives of the partners. So, a life insurance policy serves as a legally adequate consideration in exchange for a deceased partner's interest in the partnership. The policy proceeds become partnership property, provided that the partnership pays the premiums and that the partners' original agreements anticipates that all of the partners will maintain the partnership as the designated beneficiary of their policy.

For the partnership agreement to be effective in providing a life insurance fund for the surviving partners to purchase the deceased partner's interest in the partnership, the partnership agreement should state that upon the death of a partner, the identified proceeds of the insurance policy will be payable to the estate of the deceased or designated beneficiaries in the purchase of his partnership interest. The estate will then convey this to the surviving partners.

These issues should be addressed in the original partnership agreement for the life insurance to provide funds for the surviving partners to purchase the deceased partner's interest in the partnership:

- The names and addresses of the partners to the agreement.
- The identification of the original partnership agreement, that is, the date of the agreement, the names of the parties and the name of the partnership.
- The provisions for the purchase of life insurance policies, that is, the types of policies to be purchased, the value of each policy, the purchaser of the policies (partners or partnership), the owner of the policies, and the beneficiaries of the policies.
- The provisions for the payment of premiums, that is, the designation of a responsible party, a reference to when the premiums are due and where they are to be paid, and provisions for any default in the payment of premiums.
- Any requirements for additional insurance in the event of an increase in the partners' interests.
- The method of valuation of the partners' interest and the deceased's share.
- A formula for the purchase of the deceased's share, that is, periodic payments, the identification of beneficiary of payments, and a description of whether the purchase is by the partners or by the partnership.
- The purchase of insurance policies by the surviving partners.
- The duration of the agreement.
- The signatures of all parties.

In addition, partners must have an insurable interest in the life of their partners, so they can buy policies on them directly. They can also purchase additional insurance to cover extra costs to the business caused by the death of a partner, such as hiring a new employee or the cost of an appraisal.

There are two different methods of buying life insurance policies. Either the partners buy policies on each other, which is referred to as a cross purchase, or the partnership itself buys the policies.

For small partnerships, a cross purchase plan is usually more practical. The partnership itself pays for and owns the policies on the partners. It has been held that, in some circumstances, the proceeds of the policy are partnership assets, and these assets are to be included in the valuing of the partnership. This reduces the possibility of unnaturally increasing the worth of the deceased partner's share. In a cross purchase agreement, each partner buys a policy on the life of each other partner.

On the other hand, in a larger partnership, a cross purchase plan is usually not manageable. For example, in a seven-person partnership, each partner would have to purchase six policies, one on each of the other partner's lives. This means that the partners would be purchasing a total of 42 policies. This is obviously too cumbersome. In this case, it is probably more practical to have the partnership pay for a single policy on each partner's life. The partnership agreement should explicitly specify that only the cash surrender value of the life insurance policies before the insured's death is a partnership asset, whereas the proceeds themselves are not. Insurance payments made by a partnership are normally not tax-deductible. If a partner cannot pass a life insurance physical, he may not be insurable.

When life insurance policies are involved, buy-out agreements should be coordinated with each partner in his individual estate planning. For example, if the proceeds of the insurance are payable to the deceased partner's estate, these proceeds are subject to probate, thereby increasing the probate fees. To avoid probate and the probate fees, someone other than the personal representative or the estate of the deceased partner should be specified as the beneficiary of each policy.

For instance, if a partner intends to leave all his property to his spouse, that spouse could be named as beneficiary of the policy for the partner's interest in the partnership. If the partner had a number of beneficiaries; his spouse, several children, and some friends, this is more complicated. By using a living trust, the partner would name the spouse, children, and friends as beneficiaries of the trust to receive the gifts specified in the trust. Then the trust is named as beneficiary of the life insurance policy.

Accounting to the Deceased Partner's Estate

The UPA provides that any partner, or his legal representative, has the right to obtain accounting records of the surviving partners who continue the business upon the dissolution of a partnership, due to a partner's death. The estate of the deceased partner cannot act directly against the surviving partners. The estate must compel the personal representative to act for them.

Although the good will of the partnership can be included as one of its assets, proof that a partnership is unsuccessful and earned little or no profits negates the existence of any obligation of the surviving partners to account for good will.

Death Taxes

Death taxes are also referred to as estate taxes. A benefit of a buy-out provision involves death taxes. If the estate of a deceased partner is worth over $700,000, it is subject to federal estate taxes. In addition, many states impose state death taxes. If a deceased partner's estate is likely

to pay death taxes, the value of his partnership interest must be independently evaluated, unless there is a buy-out clause in the partnership agreement excluding this. Because of the valuation method used in determining the value of a partnership, an independent death tax evaluation can produce a higher figure for the worth of a business than the worth determined under a buy-out clause.

This makes it more difficult for the remaining partners, exercising their right of first refusal, to purchase the deceased partner's share. If there is a buy-out clause in the partnership agreement, the Internal Revenue Service will normally accept what is set forth in the agreement with respect to the valuation of the deceased partner's share if:

- The partnership agreement forbids the partners from disposing of their interests during their lifetimes, without first offering it to the other parties.
- The person who inherits the share of the partnership is obligated to sell it.
- The remaining partners are obligated to purchase the business interest of the deceased partner, or they have an option to purchase it.
- The agreement cannot be disguised as a gift.

The partnership agreement may expressly provide that good will may not be taken into consideration on an accounting necessitated by the death of one of the partners.

Tax Consequences of the Death of a Partner

Remember, when a partner dies, the partnership, as it is known, terminates. The remaining owners may reconstitute another partnership themselves, or they may bring in a new partner. In either case, the original partnership no longer exists after the death of one partner. Under federal law, a partnership is terminated for income tax purposes if:

- No part of the business is carried on by any partner.
- Fifty percent or more of the business (both partnership capital and profits) is sold or transferred within 12 months.

If the partnership is terminated, there can be serious adverse tax consequences to the partnership. All partnership property is considered as having been distributed to the partners and is subject to tax, even if, in fact, the remaining partners continue the business.

Payments to the Heir or the Estate

If the deceased partner has willed his share to his heir, thereby avoiding probate, and if the partnership agreement sets forth a first right of refusal provision, the surviving partners may purchase the deceased partner's share from the heir. Once the valuation method is determined for the partnership, the issue is whether the heir gets a lump sum or payments over a period of years. Payment made over a period of years is called a settlement option. A settlement option is also referred to as a commuted amount. This issue is closely related to which method is chosen for determining the buy-out price.

If the remaining partners can pay the price over a number of years, they are usually willing to pay a higher buy-out price than if they must pay all cash right after the death.

If the deceased has not willed his share of the partnership to a specific heir, the partnership must be probated, along with much of the estate. Once the valuation of the partnership is made, the buy-out is made.

If the remaining partners cannot raise the capital to buy out the heir or the estate, the partnership will have to be liquidated.

It is essential to decide on a payment schedule in the event of the death of a partner. If the partnership fails to adopt payment schedule provisions, the UPA provides that the heir has the right to collect for the full value of his interest promptly after the death of the partner. This can become a serious problem.

Due to the unexpected needs of the heirs, the deceased partner's estate and heirs often insist on exercising this right.

For example, suppose two men are involved in a partnership to build a house they intend to rent. Some years later, one partner dies suddenly and his share of the house is left to his daughter, who demands full payment of her father's share. If there is no payment schedule set forth in the partnership agreement, and the surviving partner cannot raise half the value of the house, he has no choice but to sell the house.

Pay-off of a deceased partner's share all at once often requires selling important partnership assets which may destroy the business. Further, it may bring in much less than the full value of the assets because of selling in distress.

The partnership agreement governs exactly what will happen in the event of the death of a partner. Of course, a well-planned partnership and partnership agreement can circumvent possible situations by providing for life insurance on the partners. When adopting a method of payment, it makes good business sense to adopt a payment method that puts a premium on the survival of the business. If the payment terms are so severe the business can not afford them, all involved will lose. Even if the terms would not necessarily end the business, if they are too severe or difficult to manage, the remaining owners may still decide they must liquidate the partnership business just to persevere.

A method for payments must be created that suits the needs of the heir or estate, as well as the survival of the business. In many situations, payments are not extended over more than two to five years. A common provision is to delay the first payment for some set time, such as 90 days, to give the surviving partners time to start gathering the money they will need. If the business is prospering, a bank loan may be an option. Or, perhaps a new partner with capital to contribute may be found.

In ending a partnership, as in starting and running one, the best approach is one that provides that all benefits should be shared fairly. If there is no heir, or if their is an heir and he does not want the share of the partnership, the deceased's family probably has a real interest in getting the money from their share of the partnership expeditiously. If the surviving partners make bad choices, or feel inordinately pressured by the deceased partner's family, the result could be detrimental for both the estate and the partnership. It is necessary to balance the many competing and conflicting concerns to arrive at what are fair payment terms for all.

Perhaps a combination of the lump sum and the installment methods of distribution is in order. A portion of the proceeds can be distributed immediately, then a set amount can be paid each month, quarter, year, or over some other period of time. This lump sum can be a set dollar amount or a percentage of the established buy-out figure. It is also possible to provide for the payments to increase or decrease over a set number of years. Payments may or may not reflect interest; this is a matter for the partners to decide. A practical option is to obtain a bank loan to pay off the deceased's heir or estate. The remaining partners can repay the bank in

installments. Of course, this method requires that the business be able to obtain a substantial loan, and that the remaining partners accept the added obligation of loan interest. If the partnership is established and growing, this may be the most suitable option.

The Deceased Partner's Rights

Upon the death of a partner, his right in specific partnership property becomes vested in the surviving partners.

The personal representative of the deceased partner has no legal interest in the partnership assets. He has no legal right to interfere. He does not succeed to any of the decedent's managerial rights with respect to the partnership property. The surviving partners take the legal title and full possession and managerial rights in the property for the purposes of winding up and accounting. The personal representative's only remedy is to compel the surviving partners to account for the settlement of all assets and liabilities. There is no specific partnership property or money belonging to the deceased's estate until the accounting is rendered.

The personal representative has the power or right to consent to the continuation of the partnership business by the surviving partners.

The personal representative has the right to have the partnership property applied to the payment or security of partnership debts to relieve the estate from any liability.

The Deceased's Responsibility for Partnership Debts

The dissolution of a partnership because of the death of a partner refers only to future transactions. The partnership continues with respect to past transactions until the winding up is completed. So, only the property engaged in the partnership at the time of the partner's death is subject to any future dangers of the business. The estate of the deceased is not liable for debts contracted by the partnership after his death.

However, a deceased partner is legally responsible for all outstanding debts and obligations of the partnership incurred up to the date of his death. Under the UPA, no partnership agreement can alter the deceased's liability to outside creditors. However, as part of a buy-out clause, the partnership can expressly assume the obligation to pay all debts of the firm, including any share owed by the deceased. In this case, if the partnership, or any of the surviving partners, have assets to pay off old debts, the deceased partner's estate or heir is protected.

The UPA makes individual property of a deceased partner liable for any contributions necessary to satisfy the liabilities of the partnership.

It is not unusual for the death of one partner to coincide with the admission of a new one. An incoming partner can also assume full responsibility for the deceased's partner's share of partnership debts. The new partner, however, is under no obligation to assume these responsibilities. This is a matter for the partners to agree upon.

If there has been consent for the continued use of the deceased partner's shares, typically, the estate is assuming the partnership liabilities.

Rights and Duties of the Surviving Partners

Under the UPA, the dissolution upon the death of a partner terminates the authority of the surviving partners to act for the partnership. The only exception is any act for the partnership that may be necessary to wind up the partnership affairs or to complete transactions that have been begun but not finished at the time of the death of a partner. They must complete all contracts of the partnership that remain in force. The powers of the surviving partners are actually the duties imposed upon them in performing the business necessary to settle the partnership affairs. They are limited to the powers enabling them to wind up the partnership business and preserve its assets.
Upon the death of a partner, the surviving partners must:

1) Collect the debts and obligation due the partnership.
2) Make payment of debts owed by the partnership.
3) Sell the partnership property.
4) Distribute the assets from the sale.
5) Carry on partnership business for the purpose of winding it up.

In the absence of some special grant of powers, such as by the court or by the partnership agreement, the surviving partners do not have the right to continue the partnership indefinitely. They may not take on new partnership business or enter into or make any contractual binding upon the partnership. The only contracts excluded are those necessary in settling the affairs of the partnership. So, the surviving partners may purchase additional goods in closing up the partnership business, where necessary to successfully close up the business.

In addition, the surviving partners have the power to borrow money in order settle the affairs.

Upon the death of a partner, the surviving partners continue to operate the partnership with a fiduciary duty to the partnership and the other partners, including the deceased partner. They are considered trustees. They are held to strict accountability for confidence. They must exhibit good faith in carrying out their duties. They must make full and accurate disclosure to the estate of the deceased partner.

Naturally, the heirs are seen as being at a distinct disadvantage in dealing with the surviving partners. They normally lack the knowledge of the extent of the partnership property or information about the amount of business conducted.

The surviving partners' ownership continues until the partnership affairs are settled. So, surviving partners in possession of partnership property have the right to hold it until the debts of the firm are paid. The surviving partners generally have discretion to avoid a sacrifice of the partnership's assets by delaying their sale in closing up the partnership business. Even undue delay typically does not destroy their power to sell the partnership property to pay debts. For example, while the surviving partners are liable for losses due to neglect or delay in the liquidation of the partnership affairs, they are not solely chargeable with a loss from a drop in prices for the property during a delay in its sale.

Generally, title to partnership real estate remains in the partnership. The deceased partner passes it to the surviving partners. In their hands, it is considered personal property. It is now subject to sale or conveyance by the surviving partners without conjunction of the deceased's personal representative or heirs. The surviving partners have the right to sell the partnership's real estate in the same manner as if they were their personal estates.

The surviving partners must protect the good will of the partnership turn it over as an asset to any parties entitled to it, and account for it to the estate of the deceased. However, since good will of the partnership is a part of its assets, in the absence of a contrary agreement between the partners, the surviving partners have the right to sell the good will. Unfortunately, the good will of a professional services partnership does not generally survive the dissolution of the partnership by death of a partner. It typically consists solely of the professional skill and qualifications of its members.

The surviving partners have the option to purchase a deceased partner's interest in the partnership, even when this option is not explicitly addressed in the partnership agreement. Typically, the courts and the Internal Revenue Service closely scrutinize such purchases. They are allowed if they are fair and free from fraud. However, the surviving partners must show the supreme fiduciary duties in connection with this. They may not obtain any advantage over the estate. Of course, the right of the surviving partners to purchase the deceased's interest in the partnership on stated terms and conditions is not questioned.

In the absence of an agreement to the contrary, the surviving partners may not purchase the deceased partner's interests, where the will of the deceased partner expressly forbids it.

Continuity of the Partnership

A partnership continuing after the death of a partner is technically regarded as a new partnership, even though the firm continues to operate without interruption. The new partners necessarily include both the surviving partners and the deceased's heirs, if there has been no buy-out agreement. So, when the firm business is continued in this way, a new partnership is created and formed. This process is called reconstitution.

Reconstitution is permitted after the death, disability, or determined mental incompetence of a partner, only if there are at least two remaining partners and the right to continue the business is contained in the partnership agreement. The remaining partners must not have wrongfully caused the dissolution of the partnership. So, if a partnership has more than two members, the remaining partners may continue the business in the partnership form when a partner dies. If there is only one partner left, he may do the same, but by definition he cannot continue the business as a partnership. If he continues the business alone, he must reform it as a sole proprietorship.

If the business continues as a partnership, a technical and formal dissolution of the old partnership can lead to disagreeable tax consequences. This can include regarding the former partnership property as having been distributed to the partners. These distributions are subject to federal income tax by the Internal Revenue Service. Even if the business will eventually be broken up and sold, all interested persons, including the heirs of the deceased partner, probably want the business to continue at least long enough so that it can be sold rather than sacrificed.

The dissolution and liquidation without the right to continue the partnership business could be ruinous to the remaining partners. The issues of continuity should be addressed in the event of a partner's death, permanent disability, mental incompetence, retirement, voluntary withdrawal, or expulsion from the partnership. There must be arrangements for the business to continue without any interruption or break in its continuity. These issues are:

- Which partners have the right to continue.
- Which particular dissolution events allow for the right of continuation.
- If the right to continue applies to the entire partnership business or only to a portion.

- How the interest of the withdrawing partner is disposed.
- How the price for the partner's interest is determined.

Further, if the intent is that it is to be continued, the partnership agreement should expressly state that the remaining partners will not liquidate or wind up the affairs of the partnership, but they will continue to conduct the partnership under the terms of the partnership agreement. Any payments made by the partnership in exchange for a deceased partner's interest in the partnership are liquidating distributions. This means that they are a tax free return of capital, up to the adjusted basis of the partnership interest liquidated. Capital gain is recognized only to the extent that the cash received exceeds the partner's adjusted basis for his interest.

A partnership agreement providing that the partnership is not to be dissolved by the death of a partner will be given this effect by the courts. Likewise, if the agreement stipulates that the partnership is to continue for a fixed term, such as 50 years, even if one partner dies, this is enforceable. Where the deceased, by means of his will, directs that a partnership of which he was a member will continue after his death, the partnership may be continued in accordance with these directions and with the consent of the other partners. However, where there is an agreement that the personal representative of the deceased may continue the partnership business, the partners cannot be compelled to do so. They are entitled to dissolution and an accounting of the partnership if they decide that they do not wish to continue the partnership without the deceased.

Partners may make a binding agreement that the surviving partners may continue the partnership business after the death of one of the partners, without liquidation by the surviving partners. However, a surviving partner cannot continue the business in the absence of permission for its continuation in the partnership agreement, in a will of the deceased partner, or by the consent of the deceased's representatives.

When the partnership agreement stipulates that, on the death of a partner, the business is to be continued until the end of the current year, the partnership must be dissolved at the end of that year. However, the failure of the surviving partners to exercise their limited rights to purchase the deceased partner's interest in the partnership, thereby continuing the partnership business after his death, effectively renders the death of the partner the dissolution of the partnership.

In the absence of an agreement to the contrary, the personal representative of a deceased partner may not insist on the surviving partners' continuation of the partnership business. However, the personal representative may agree with the surviving partners to permit the partners to continue the use of their inherited shares in the partnership or in the property. In fact, their mere continuation of the partnership business is sufficient for such consent.

The UPA provides that when a partner dies and the business of the dissolved partnership is continued in the absence, the permission of the personal representative and the rights of the creditors of the deceased and the partnership shall be as if there had been an assignment of the deceased's right in the partnership property. So, if the personal representative and the beneficiaries of the estate consent to the continued use of the partnership property in its business, or if the partnership continues without interference from the personal representative, they waive their right to any priority in partnership property, as against subsequent creditors. When a partnership is continued longer than necessary with the consent of the interested parties, creditors who contributed to the assets of the estate are entitled to payments of their claims. These claims are satisfied in preference to any claims of the surviving partners or of the personal representative.

The Control of The Business Name

In some businesses, the right to use a name has great value. On the other hand, Ed & Chuck's Computer Repair is not likely to be more valuable than Ed's Computer Repair, should Chuck die. If the partnership name lends significant value to the partnership, the partners should, by means of their partnership agreement, decide who owns the name and who keeps the name, if one of the partners dies. If there are several partners, the ongoing partnership typically retains ownership of the partnership name.

Perhaps one partner coined the name and wants to be entitled to use it if he is a surviving partner. Or, suppose the business uses the person's name who died. It may happen that when one partner dies, some of the remaining partners decide to form a new partnership. Perhaps a partner who decides not to be a part of the new partnership does not want the name of the former business used at all.

Some remedies for this situation are a partnership agreement that the partnership will continue to use its own name, that one partner alone owns the name, that the control of the name will be decided at a later date, or that the majority of the remaining partners own the partnership name and any other former partner is not entitled to use the name.

In addition to the partnership name, in the event of the death of a partner, some consideration must be given to other partnership assets. These might include the business telephone number, licenses, permits and similar values.

Termination of the Partnership

The termination of a partnership may come about for many reasons. Perhaps one or more partners die, and the rest do not wish to continue the partnership. Perhaps the surviving partners are not financially able to buy-out the deceased partner's heir or estate. Termination of the partnership may also result from the retirement, mental incompetence or disability of a partner. Maybe the partnership just is not working well. For whatever reasons the partnership is ending, the legal terms for termination of a partnership business are winding up and dissolution. These terms mean that all affairs of the partnership are settled, the partnership books are closed, and the partners go their separate ways. The former partnership business may be continued in some other form by one or more of the former partners, or the business may end altogether.

Inevitably, there are details and fine points to be resolved, matters that have not been foreseen. Some of the issues to be considered are:

- What is to become of the equipment owned by the partners and the partnership?
- Is someone entitled to keep that equipment, or must it be sold?
- Who will deal with outstanding debts, especially those over which there is some dispute?
- What will happen to the outstanding business of the partnership?

When the details are resolved, a separate termination agreement may be prepared, apart from and in addition to, the original partnership agreement.

Once the decision has been made to end the partnership, any existing partnership business should be completed as quickly as possible.

From a legal perspective, ending a partnership business involves three stages:

1) Dissolution. The UPA defines dissolution as the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on of the business, as distinguished from the winding up of the business. The dissolution of the partnership is the decision to actually end it. It is the point in time when the partners cease to carry on the business together. The dissolution of a partnership is an act that changes the legal relationship of the partners. Legally, no new partnership business can be undertaken after this time. To limit their liabilities, the partnership may send formal written notices to creditors and to other business contacts advising them that the partnership has been dissolved and cannot undertake new business. There is no official or government office, however, where this notice must be recorded.

Dissolution does not refer to the other steps in the process of completing and finishing of a partnership. The dissolution of a partnership is distinguished from the windup and the termination of the business. It has nothing to do with whether or not the partnership business is winding up completely or continuing with different partners as a new and separate entity. The partnership may be continued after the dissolution process by forming another partnership. The dissolution itself is not a termination of the partnership or the termination of the rights and powers of the partners or the partnership. Many of these rights and powers endure during the winding up process that follows. Dissolution simply describes the change in the partnership relation. Dissolution is a precursory step to winding up and termination.

2) Winding up*.* Next is the process of winding up the existing partnership business. Upon the dissolution of a partnership by the death of a partner, it is not only the surviving partners' right, but also their duty, to wind up the partnership affairs without delay. The surviving partners are excused from this duty only by the right to continue the partnership. The surviving partners do have some discretion as to the manner of winding up the partnership after the dissolution. They may do the things necessary to close down the existing partnership business. However, if the surviving partners do not act diligently and in good faith in winding up the partnership business, the courts may appoint a receiver.

Winding up is sometimes referred to as liquidation. The winding up of a partnership is the responsibility of the surviving partners, and not that of the personal representative. Partners in a dissolved partnership retain the authority to carry on only to the extent necessary to bring an end to existing partnership business. Under the UPA, each partner is liable for his share of any liability created by partners in the course of closing down partnership business, just as if the partnership had not been dissolved.

In some states, statutes require the surviving partners to give a bond as a condition of their rights to manage and settle the partnership. If the surviving partners do not give the required bond within the time specified, the personal representative of the deceased must give the bond and become the administrator of the partnership.

Although the UPA specifically provides that no partners are entitled to compensation for acting in the partnership business, they instead share in the profits, the surviving partners are entitled to reasonable compensation for their services in winding up the partnership affairs. Any breach of fiduciary duty on the parts of the surviving partners may disqualify them from receiving compensation for winding up the partnership business.

3) *Termination**.* Finally, there is actual termination of the partnership business. Once the partnership has ended, no further partnership business of any kind is legally authorized.

If a creditor, acting in a good faith and without the knowledge of the dissolution of the partnership, extends credit to a surviving partner, for matters that are represented as being

partnership business, but which, in reality, are not because of the dissolution and termination of the partnership, all of the partners may be held liable for this debt. The UPA requires that, to relieve the partners of this liability, an actual delivery of notice of the dissolution must be made to all individuals or businesses who have previously extended credit to the partnership.

The authors of the UPA suggest that these various terms be distinguished from one another when describing the process which leads to the final settlement of the partnership affairs. "Dissolution" designates that point in time when the partners cease to carry on the business together. "Winding up" is the process of settling partnership affairs after dissolution. "Termination" is the point in time when all the partnership affairs are wound up. This is judicially recognized as the correct sequence of events in the termination of a partnership.

Commonly, when partnerships end, things go easily as far as the major matters, such as the division of the partnership assets. However, even in the most amicable terminations, there are bound to be some things that were not foreseen when the partnership agreement was drafted. A separate termination agreement should be prepared covering, in specific detail, all matters in the termination of the partnership. This is the final partnership document, and it should be precise.

If the partnership is out of money and cannot pay its debts and obligations, and at least one, but not all, of the partners is insolvent, the solvent partners must contribute additional amounts to cover all liabilities of the partnership. If more than one partner is solvent, the solvent ones must contribute in the proportion that those partners shared in the partnership profits.

Under the UPA, dissolution of the partnership is caused by any event which makes it unlawful for the business of the partnership to be carried on, that is, by the death, bankruptcy, retirement, disability, declared mental incompetence, or voluntary withdrawal of any partner. The UPA also provides that the courts have the power to order a dissolution leading to the termination of a partnership for any of the following reasons, no matter what the partnership agreement provides.

1) A partner willfully or persistently commits a breach of the partnership agreement.
2) A partner is incapable of performing his part of the partnership agreement, due to illness of some type of disability.
3) The business can only be carried with a continuing loss.
4) A partner has been guilty of conduct that affects the carrying on of the business such as failure to contribute initial capital funds urgently required by the business; failure to account for proceeds of sales; appropriation of firm property to pay for personal debts; or constant quarrels, irreconcilable differences, intoxication or gambling.

Litigation With Respect to Deceased Partner

Since it is the duty of the surviving partners to wind up the partnership affairs, the entire debt of the partnership continues against the surviving partners. Any actions brought against a partnership dissolved by a partner's death must be brought against the surviving partners, not the partnership. The surviving partners also must defend actions brought to enforce partnership obligations and liabilities.

The surviving partners may sue the personal representative who has wrongfully obtained possession of property belonging to the partnership. They may also sue the estate of the deceased for damages for breach of the partnership contract.

If the surviving partners misappropriate the assets of the partnership in any way, cause an unreasonable delay in the settlement of the partnership affairs, or act in bad faith, the personal representative of the deceased may bring an action to compel a just and proper disposition of the partnership. The personal representative has "a right of action in equity" to oblige the surviving partners to settle the partnership affairs in a timely fashion and to pay the deceased partner's share. Only the personal representative has this right. The deceased's family or his estate do not.

Under the UPA, all partners are personally liable for the debts and obligations of the partnership. This includes the deceased partner. An action separate from that toward the surviving partners may be brought against the estate of the deceased partner by creditors for unpaid obligations.

Purchase of the Deceased Partner's Interest

The partners in a partnership have the right to make an agreement in which the surviving partners have the right or option to purchase the deceased partner's interest in the partnership. This agreement may state the terms and conditions of the purchase, including its purchase price or method of valuation, and these terms cannot be questioned by the courts, the Treasury Department, or by the estate of the deceased. Barring fraud, this holds true, regardless of the actual value of the interest of the partnership in relation to the stated terms of the agreement.

This agreement is typically called a buy-sell agreement. It is intended to relieve the surviving partners of the disruption and loss resulting from a forced sale or liquidation of the partnership. It also preserves the rights of the deceased partner, or his estate, to his fair share of the partnership. As with other terms of a partnership agreement, it is not necessary for the buy-sell provision to be made in writing. Of course, a written agreement will facilitate this event.

It must be remembered that this provision is only an option to purchase. It is not the obligation to purchase. Generally, the right to purchase must be exercised within a stated period of time following a partner's death or upon the qualification of the personal representative of the estate, whichever comes first. However, provisions can be made stating that, in the event of a partner's death, the surviving partners will pay a certain amount to the deceased partner's personal representative or to his estate, thereby becoming the new owners of the partnership business. Any ambiguities in these provisions are, typically, resolved in favor of the estate of the deceased.

These provisions in the partnership agreement should specifically state the method of the valuation of the partnership to be used. In the absence of any specificity, the surviving partners are, generally, required to pay fair market value, rather than book value. If they wish, the partners may establish, in their original partnership agreement, the value of the partnership, in the event of a partner's death. A set price may be used, or a prescribed formula may be used, regardless of the actual value of the interest. When the partnership agreement gives the surviving partners the right to purchase the deceased partner's interest at a fixed price, these survivors owe a duty to the deceased's personal representative to make full disclosure of all of the facts which have a bearing on the value of his interest in the partnership.
If the partnership agreement does not specify the method of valuing the partnership and its assets, or if the agreement is unclear, fair market value, sometimes referred to as reasonable market value, must be used to evaluate the deceased's partners' interest. The determination of fair market value does not necessarily require that the value be discounted by sales costs, minority interests, or capital gains taxes, even though these discounts may be appropriate.

A provision in a partnership agreement that a deceased partner's interest shall become the property of the surviving partners is valid. So, for example, where the partners maintain a joint bank account, and where there is evidence of joint tenancy, this right of survivorship prevails, subject, of course, to the rights of the partnership's creditors. Further, rather than acquiring the entire interest of the deceased partner, the partnership agreement may provide that the surviving partners receive a life interest in the property. Or, it may limit the interest to a specific number of years.

THE CORPORATION

When establishing a new business, the legal decision must be made whether the enterprise should be operated in an unincorporated form or as a corporation. The corporation is the most complex of the three business structures. A corporation is a distinct legal entity, and is separate from the individuals who own it. A feature of the corporation is its ability to exist for an unlimited period of time.

Under most state statutes, the corporation must state its period of duration, but this may be "perpetual." This is an advantage of corporations over sole proprietorships or partnerships. The corporation is not terminated by the death of an owner or stockholder. A corporation usually is formed by the authority of a state government. Corporations that do business in more than one state must comply with the state laws, which may vary considerably, as well as with federal laws regarding interstate commerce.

To form a corporation, organizers must decide on a corporate name. Federal law requires that the name of the corporation must include the words "corporation," "company," "incorporated," "limited" or an abbreviation of one of these. The purpose of this requirement is so that people who are not familiar with the corporation are made aware that they are dealing with an entity in which no individual may be held personally liable if, for example, the business is unable to pay its debts or obligations. The corporate name cannot inaccurately describe or mislead the public with respect to what the corporation does or does not do. Further, the name of a new corporation cannot similarly resemble or approximate any another corporation which does business within the same jurisdiction.

Next, the organizers of the corporation must subscribe for capital stock, and they must create a tentative organization. Shares in a corporation are generally considered securities, within the meanings of state and federal securities laws. Then, approval must be obtained from the secretary of state in the state in which the corporation is to be formed.

This approval is in the form of the ***articles of incorporation***. These articles are also referred to as the charter, or the bylaws. These articles state the powers and the limitations of the particular enterprise, and these articles must be signed by at least one incorporator. A corporation is created by its articles of incorporation. They define the corporation's essential characteristics and basic structure. This charter must be submitted and approved by the state before the corporation's legal existence may commence. The Model Business Corporation Act was prepared by the American Bar Association, and it sets forth the required contents of a charter. It is intended to serve as a guide for the revision of state business corporation laws.

When adopted, the provisions of the Model Business Corporation Act apply to all existing corporations. The 11 articles of incorporation are:

1) The name of the corporation.
2) The duration of the corporation's existence.

3) The purpose for which the corporation is organized.
4) A description of the corporation's stock, that is, the number of shares, how many classes of shares there are, and the par value of the shares ("Par" means equal. Par value is equal to the established value.)
5) Classes of shares, that is, the name of each class, its preferences, voting powers, limitations, restrictions, qualifications, and special or relative rights.
6) Series of classes, that is, the portion of a class of shares issued with a certain dividend rate, redemption privileges, liquidation preferences, conversion privileges, etc.
7) Preemptive rights, that is, the stockholder's right to buy a portion of any new stock of the same class authorized and issued by the corporation.
8) Any special provisions.
9) The address of the initial registered office of the corporation and the name of its initial registered agent.
10) The number and names and addresses of the members of the corporation's initial board of directors.
11) One or more incorporators either "natural persons" of another corporation, domestic or foreign. (Incorporators do not have to be residents of the state of incorporation.)

The attributes of any corporation can vary, according to its character. This is generally determined by the nature of the business of the corporation, as stated in its articles of incorporation. The nature and the character of a corporation, as disclosed by its charter, cannot be changed or enlarged in excess of its powers. Corporations may be classified generally as public or private. This distinction has reference to the powers of a particular corporation and to the purpose of its creation. A public corporation is "publicly held," and its stock is traded on one of the open exchanges. A private corporation is "privately held," and its stock is not openly traded.

Management of the Corporation

Of course, the centralization of management can be created in a partnership. In a corporation, however, the corporate statutes already encourage the centralized approach. A clearly defined management structure is set forth for the internal and external dealings of the corporation. Stockholders elect directors who are responsible for the management of the corporation. This board of directors elects officers who carry out the management policies. A president and a secretary are typically required, and other officers may also be necessary. The corporation's articles of incorporation and the state statutes further define the rights and responsibilities of the directors, officers, and stockholders.

Advantages

Some advantages of the corporation are:

Limited liability. There is limited liability of the stockholders' to their fixed amount of investment.
Ownership is readily transferable.
A separate legal existence. A corporation has status as a separate legal entity, which is separate from the stockholders who own it.
Stability. In a corporation, there is relative permanence of existence. For example, in the case of illness, disability, mental incompetence, or death of an officer or owner, the corporation continues to exist and to do business.
Ease of securing capital. With a corporation, it is relatively easy to secure capital in large amounts and from many investors. Capital may be acquired through the issuance of stock and

through long-term bonds. Long-term financing can be secured by taking advantage of corporate assets and, often, the personal assets of the stockholders and the principals of guarantors. In fact, personal guarantees are sometimes required by lenders.
Centralization of management. Centralized control is secured when owners delegate authority to hired managers, although in small corporations, these may be one and the same.
The availability of expertise and skills. The corporation has the ability to rely upon the expertise and the skills of more than one individual.

Disadvantages

Some disadvantages of the corporation are:

Some limitations. Some activities are limited by the charter and by various state laws. However, some states do allow broad charters.

Manipulation. Minority stockholders are sometimes exploited.

Regulation. There is extensive government regulation of corporations, and many local, state, and federal reports are required.

Expense. There are expenses in forming and maintaining a corporation, more so than with a sole proprietorship or a partnership.

Double tax. There is special tax treatment for corporations, that is, income tax on corporate net income, or profit, as well as on individual salary and dividends.

Tax and Non-Tax Factors Affecting the Corporation

In making the determination of whether a corporation is a suitable form of operating a business, all factors must be considered in the context of the specific business operation. Many of the issues may be tax-related.

There are also many non-tax factors to be considered in deciding which business form is the most suitable. Only the owners can decide which form offers the greatest advantages and the fewest disadvantages to them. Traditionally, the non-tax advantages of operating a corporation are most useful to larger organizations.

Liability and the Corporation

The most commonly cited non-tax related advantage of operating a business as a corporation is to be able to enjoy the protection of limited liability. This is, typically, the primary consideration.

Since a corporation is regarded as distinct legal entity, separate and apart from its stockholders, a corporation enjoys a restricted liability not afforded by the formation of a sole proprietorship or a partnership. Sole proprietors are liable to the full extent of their personal assets to the creditors of their unincorporated business, as are partners in a partnership. A sole proprietor is personally liable to the full extent of his assets by creditors for business related acts or omissions of himself, his employees and agents.

A partner is personally liable, too, for these, as well as for those acts or omissions of another partner.

A stockholder, on the other hand, is not personally liable for the debts and obligations of the corporation or for the acts of fellow stockholders, corporate directors, officers, employees, or agents. The stockholder of a corporation is liable for contractual obligations only to the extent of his investment in the corporation. Yes, a corporation may be sued, but the corporation is the proper party defendant, not the stockholders.

There are a few exceptions where corporate entity is disregarded, but this usually happens only in instances of fraud.

Limited liability is sometimes overstressed as a benefit of incorporation. To remedy the liability issue, sole proprietors and partners may take out liability insurance to cover most risks, thereby limiting their liability with an insurance policy. Any risk of loss by the owners of noncorporate organizations from wrongful acts or omissions by be substantially reduced by this insurance in the ordinary course of business.

Where the nature of the business is such that risk of loss cannot be adequately insured against, such as hazardous enterprises where liability insurance is either unavailable or prohibitively expensive, limited liability is then a crucial factor.

In making the determination of whether or not a corporation is a practical form of business operation, the following issues should be considered.

- What is the size of the risk, that is, what is the amount of the investor's liability for debts and taxes?
- What would the continuity of the life of the business be, if something happened to the principal or principals?
- Which legal structure would insure the greatest adaptability for the administration of the business?
- What is the influence of applicable laws?
- What are the possibilities of attracting additional capital?
- What are the needs for and possibilities of attracting additional expertise?
- What are the costs and procedures in starting up the business?
- What is the ultimate goal and purpose of the enterprise, and which of the legal structures can best serve its purposes?

If an existing sole proprietorship or partnership intends to incorporate, notices of the intention to incorporate and the intent to transfer assets must be made for the former sole proprietor or partner to be released from any debts of the former concern. Then, the transfer of the proprietary or partnership assets can be made to the corporate entity.

The following are necessary to transfer sole proprietorship or partnership assets to a corporation:

1) A bill of sale.
2) Assumption agreement.
3) Power of attorney.
4) Assignment of leases.
5) Conveyances of real property.

The Close Corporation

One common type of corporation is a close corporation. A close corporation is also referred to as a closely held corporation. Special statutes have been enacted in many jurisdictions to permit single individuals or closely knit groups of individuals to form either as a general business corporation or as a close corporation. In doing so, they limit their personal liability, but they carry on business without all of the formality required by corporations such as annual meetings, actions by boards of directors, etc. Close corporations are generally subject to rather broad transfer restrictions. Their operation and the relationship of the stockholders to each other typically resemble partnerships, rather than traditional corporations.

The outstanding shares of stock of close corporations generally are held by a single stockholder or by a small number of stockholders. Frequently, these are family members, so there is a tight relationship between the management and the principal stockholders. Because of the nature of the closely held corporation, the stockholders have a good knowledge of the corporation. These stockholders often have the desire to have voting rights with respect to the activities of the corporation. Typically, it is prohibited to transfer shares to individuals who are not family members or who are not employees of the corporation.

To protect the corporation, stockholders may enter into buy-sell agreements with each other at the time of incorporation to prevent the stock from getting into the hands of those outside the original group of shareholders. The shares of a closely held corporation are not traded publicly, that is, there is not a ready market for their stock. A closely held business typically lacks an established trading market. Naturally, there is the presence of informality in the management of a close corporation.

Within a close corporation, most of the stockholders participate in the management, direction, and operation of the corporation. The operation and the relationship of the stockholders to each other closely resemble a partnership. There are a small number of stockholders, and there is no ready market for their shares. The resemblance of a close corporation to a partnership holds that there must be trust, confidence, and loyalty to the other principles of the close corporation. Some courts have even applied partnership law to resolving disputes in a closely held corporation. Further, they have relaxed their attitudes concerning the statutory compliance of close corporations, permitting slight deviations in their behavior from traditional corporate norms.

Although the limited liability of the corporation is an advantage for the larger organizations, these advantages for a closely held corporation are practically contradicted. For issues such as bank loans, lease obligations, and major suppliers, owners and stockholders in a close corporation are often asked to personally guarantee the credit extended. Their limited liability is often waived. Further, the corporation does not limit the liability of a stockholder for his own wrongful acts or omissions. The stockholder may be held personally liable for the full amount of losses or damages resulting from these.

There is some question about whether a close corporation should be incorporated at all. Questions of liability and continuity may suggest that partners should incorporate a close corporation. On the other hand, tax factors may suggest that a close corporation should become a partnership. Some businesses try to use both forms of organization, attempting to gain all of the advantages of both forms of organization, while at the same time, not accepting the disadvantages of either.

The statutes dealing with close corporations are generally of two types. The first type are those that are simply a part of general corporation laws, although they authorize provisions in

corporation charters to modify the traditional corporate structure to fit the needs of the closely held business. The second type of statute is entirely devoted to the issue of close corporations.

To take advantage of close corporation status, most states required that a close corporation must state its intent to be considered a closely held corporation in its articles of incorporation. Many modern statutes actually define close corporations by barring their securities from the exchanges or from the organized over the counter market, by requiring them to make explicit the restrictions on the transfer of shares by agreements, and by providing limits on the number of stockholders allowed.

Many statutes define the various ways in which participants in close corporations can shape their arrangements to suit their needs. For example, close corporation founders may arrange matters so that persons contributing skill and efforts, rather than cash, have a larger say. Also, the members of a close corporation operate on the assumption that the membership is limited and that changes in ownership can be traumatic. Therefore, there may be some special provisions for the transfer of stock. Further, in some states, those forming a close corporation may reject one or all of the assumptions that the law typically makes about the allocation of control in an ordinary corporation. It may even be cumbersome to have a board of directors at all.

The rules about fiduciary obligations, as described for partnerships, are slightly different in the context of the close corporation. Distinctions between officers or directors and stockholders, naturally, tend to lose significance in such a small corporation. They are typically one and the same. Effective operations and rational decision making are often hard to maintain here. Some managers or stockholders have their own interests at stake, whereas, this is not typical of a traditional corporation. This factor should be considered when planning the estates of any of the stockholders of a close corporation. While personal factors sometimes occur in even the biggest corporations, they are one of the precursors in a typical close corporation. Personal motivations and feelings can often interfere with the objective performance of any duties, including fiduciary duties.

A subcategory of the close corporation is the incorporated joint venture. Within the incorporated joint venture, each stockholder is himself a corporation. The incorporated joint venture must be distinguished from the contractual joint venture previously discussed. Within the contractual joint venture, there is no separate entity. Naturally, this type of close corporation would be immune to the problems of death and generational succession, such as in a sole proprietorship or a partnership.

The following factors generally characterize a close corporation:

1) A small number of stockholders.
2) The recognition of partnership-like relationships.
3) The provision for minimum corporate formality.
4) No ready market for the shares of the corporation.
5) Shareholder knowledge of the corporation.
6) The recognition of the autonomy of the participants in a close corporation to achieve contractually desirable arrangements.
7) A tight relationship between management and the principle stockholders and the stockholders' desire for involvement in the decisions.
8) The provisions for certain dispute resolution techniques, such as provisional directors and optional dissolution by a stockholder.
9) The facilitation of enforcement of arrangements to preserve the close corporation status under a stockholder's agreement.

Death of a Stockholder

Within the true meaning of the corporation, the corporation's articles of incorporation typically provide for its perpetual existence. Since a corporation is treated as a separate entity with continuity of life, events such as the death of an owner really have no effect on the legal structure of the corporation. The exception to this rule is a shareholder agreement that specifies some other consequences of this event. Shares in a corporation can be passed to heirs, and these are personal property.

Retaining the Corporate Interest

After the death of a shareholder in a larger or publicly held corporation, the deceased's shares in the corporation may be left to his heirs. This has no real effect on the continuity of the corporation. In closely held or smaller corporations, however, a shareholder is also likely to be the President or CEO. The death of this shareholder may place the corporation in the position of having no management or marketing skills. Thiscan seriously weaken the entity and cause a major devaluation, if not, collapse of the corporate succession. *See Business Continuation for solutions and consequences of this event.*

Stock Purchase Plans

Stocks are considered securities. A security is an investment of money. They are regulated by both the federal government and various state governments. The issuance of stock is covered by the Securities Act of 1933 and the Securities Exchange Act of 1934. The purpose of the 1933 Act is to provide disclosure of financial and other information about the issuer of any security. Those making any sale of any security are required to file a registration statement.

These acts were formed to require the disclosure of information to investors, and they are designed to prevent fraud in securities transactions. The federal statutes typically apply only to larger, publicly traded corporations, especially where the securities transactions involve interstate activities. All states have their own laws, which regulate the purchase and sale of securities.

These laws are commonly known as "blue sky laws." This term was coined during the early legislation of securities laws, when one legislator asserted that stock salesmen were willing to sell investors anything, even the blue sky itself. These laws operate independently of the federal laws.

An employee stock ownership plan (ESOP) is an employee benefit plan that provides tax incentives to corporation owners. The U.S. Congress spends more than $1 billion each year in ESOP tax incentives, attempting to expand capital ownership and raise productivity.

Within some limits, the employer's contributions to an ESOP are fully tax deductible to the corporation. Any interest is also fully tax deductible. Any loans are repaid with pre-tax dollars. Once at least 30 percent of all classes of stock are sold to the ESOP, the selling owners qualify for rollover treatment on the gains of the sale. Under the Internal Revenue Code, if at least 30 percent of all classes of stock are sold to the ESOP and the proceeds must be invested in American operating companies in "qualified replacement property." Qualified replacement property is stocks or bonds of an American operating company. The deferral lasts as long as the qualified replacement property is held by the seller. If the qualified replacement property is held until the deaths of the surviving business owners, income tax on this transaction is deferred permanently.

Further, under the Internal Revenue Code, once at least 50 percent of all classes of stock, or 50 percent of the total value of all classes of stock are sold to the ESOP, qualified lenders can deduct 50 percent of the interest income from the loan, that is, they are required to report only 50 percent of the interest received from an ESOP loan. This is an obvious tax advantage to the lender. As a result of this lucrative loan, the interest rate is often lowered.

ESOPs are generally structured so that the corporation borrows the funds necessary for the sale of the stock. Naturally, the corporation must be profitable enough to pay back the loan.

The process is begun by setting up a trust fund. The fund is used to buy company stock or to contribute shares directly to the plan. These contributions are fully tax deductible. Next, the ESOP purchases the securities from the surviving owners. Under an ESOP, the corporate owners now share the ownership of the corporation with their employees. However, the employees do not actually purchase the shares.

Sometimes after the death of a corporate owner, the surviving owners are not able to raise the necessary funds to purchase the deceased's interest according to a buy-sell agreement or from the estate of the deceased. In this case, an ESOP can be used for this purpose. The surviving owners can sell holdings to the company-sponsored ESOP and still maintain control of the corporation. They may sell all, or only part of their holdings. In doing so, these owners are afforded the tax advantages of avoiding current income tax on the gain.

If the sale of the corporation is necessary and it cannot be sold, an ESOP may be used to liquidate the investments of the owners or major stockholders. Tax savings are obtained by selling holdings to the ESOP. The ESOP can facilitate the otherwise agitated transition of management and ownership in the event of the death of an owner. Effectively, new owners have been found.

In addition to the tax advantages of the ESOP, another major advantage to ESOPs is the ease of succession and the transfer of ownership. Entirely new management is not generally necessary, given the experience and knowledge of the now employee-owners. Hastily-chosen successors are not an issue here. ESOPs can offer financial power and benefits to the corporation owners and to its employees during the tumultuous time after the death of an owner or major stockholder. The new employee-owners are motivated by their new roles to make this transition as smooth as possible, thereby securing their own futures.

There are some disadvantages as well. Some of these are:

- ESOPs may not be used in sole proprietorships, partnerships, professional corporations, or Subchapter S corporations.
- The setup and administration costs can be prohibitive.
- ESOPs are not practical for those corporations with fewer than 15 to 20 employees, due to the set up and administration costs.

Not surprisingly, the management of a corporation changes once an ESOP has been put into effect. There are more owners to consider now than when managing a corporation that is not employee-owned. Generally, employee-owners want to participate in the decision-making and other consequential processes that affect the corporation, and this positively affects corporate performance. Typically, those corporations with ESOP plans grow more quickly and more substantially than do those corporations without ESOP plans. The new employee-owners see their new roles as managers and business owners. The ESOP allows more from its participants than mere complaining; it offers ideas on how to fix problems from those who know best.

Ideally, the plans for an ESOP should be put into effect before the sudden or unexpected death of an owner or major stockholder. The goals of the corporation are the main consideration when putting such a plan into effect.

Selling the Corporate Interest

Upon the ***death of a corporate owner or a major stockholder***, his shares in the corporation may be passed to his heirs, like any other personal property. If the corporation is a publicly held one, these shares can simply be sold on the open exchange. However, if the corporation is privately held, there is not likely to be much of a market for these shares. In addition, the surviving owners may not want just anyone as a new co-owner. Further, they may not be in a position to buy the deceased's shares in the corporation, and if there has been no buy-sell agreement made or no buy-out insurance provided, this can present problems for surviving owners, as well as for the estate of the deceased. In this case, if the shares cannot be sold, the heir has no choice, except to actively participate in the business of the corporation. If possible, the deceased's interest in the corporation may be passed along or sold to other owners of the corporation, and a buy-sell agreement may be drafted for this purpose.

If, for whatever reason, the surviving corporate owners decide that they wish to sell the corporation, rather than continue it without the deceased, they may do so. Prospecting may be done by means of local advertising, networking, and by offering referral fees. However, these types of prospecting and other word of mouth plans are not normally successful, since the surviving owners typically have a great amount of business to take care of in the event of a co-owner's death.

A business broker may be engaged for this purpose. Any business broker should be carefully screened to determine that he is aware of the intricacies and nuances of the particular corporation. Most corporations require some specialty knowledge. The business broker should be able to provide many credible references, and the surviving owners should not hesitate to contact those references.

Fees may be a consideration when engaging a business broker. Typically, sellers pay a 10 percent brokerage fee, and the listing agreement is for a specified period of time, usually six months or one year. These listing agreements are generally "exclusive," that is, the broker receives the full commission, whether he actually has a hand in finding a buyer or not. Further, a good broker should have available an ample inventory of potential buyers who are motivated and ready to purchase.

Financing is not too great a concern because potential buyers of a corporation will likely be able to collateralize a bank loan. However, in some instances, it may be an issue.

Another avenue for selling a corporation is to explore the possibility of a current employee or group of employees buying the business. In this case, the prospective buyer is probably not shopping for a business; he is more likely deciding whether or not to buy this corporation. An employee or group of employees can be a good risk for the seller because they are already familiar with the operation of the business. They are buying an entity which is known to them. This, too, minimizes the risk of those prospective employee-buyers. A significant consideration here for the seller is whether or not these people could successfully run the business at enough of a profit to pay for it over time.

The corporate owners may have time to apprentice a buyer. They may have even hired an employee with both sides' intentions being the future purchase of the business.

When selling the corporation, there are basically three forms of sale. These are:

1) ***The purchase of stock.*** This form of sale is executed between the stockholders and the buyer of the corporation. The corporation is not involved in this transaction; only the stockholder is involved. These transactions may be either nontaxable or taxable. The transaction is nontaxable when the acquisition is solely for voting stock. The transaction is taxable when there is a capital gain.
2) ***The purchase of assets***. Under this form of sale, the purchaser acquires all or most of the assets of the corporation for a price. When purchasing the assets of the corporation, the purchaser may or may not assume the liabilities of the seller.
3) ***Statutory merger***. A statutory merger is a transaction between two corporations. The acquired corporation essentially goes out of business, and the acquiring corporation survives.

Liquidating the Corporation

The terms "liquidation" and "dissolution" are often confused when referring to the termination of a corporation. Liquidation is the process of settling or winding up the corporation's affairs. It is the processing and orderly disposition of the corporation's assets. Winding up includes discharging the corporation's outstanding obligations and liabilities and distributing the remaining assets, if any, to the stockholders.

Dissolution, on the other hand, refers to the formal termination of the corporation's existence. It implies the termination if the corporation's existence and its extinction as an entity.

Generally, the process of liquidation occurs before the dissolution of the corporation. If a stockholder or creditor cannot be located, his allocation of the assets must be reduced to cash and deposited with the state treasurer. According to state statute, the missing stockholder or creditor has a specified number of years in which to claim his funds. After that time, these funds become the property of the state.

At the conclusion of the winding up process, articles of dissolution are filed. The existence of a corporation cannot be terminated except by some act of the power, that is the state, under which it was created. Therefore, a certificate of dissolution is issued by the secretary of state by which it is chartered. At this time, the legal existence of the corporation ceases for all purposes.

After the certificate of dissolution is issued, in most states the corporation may, under some circumstances, continue for a specified number of years for limited purposes. The corporation may not continue transacting business. However, it may prosecute and defend itself against any action, continue to hold title to and liquidate any assets or property omitted from prior distributions, and settle any other affairs not completed before the dissolution.

If there are any actions brought against the corporation after is dissolution, the plaintiff is generally without any remedy against the corporation. However, there are some instances in some states where personal liability may arise. These are:

- Where the corporate assets are distributed to the stockholders before all of the creditors' claims are satisfied. The stockholders receiving these distributions are liable to the creditors for any debts still owed.

- Where the corporation's assets are unfairly or incorrectly distributed. The failure to properly distribute the assets is a breach of the fiduciary duties of the directors. They may be held personally liable.
- Where the officers or directors knowingly sign and file incorrect articles of dissolution.
- Where the director authorizes distributions to stockholders without the corporation paying its liabilities first, or making adequate provisions for this.
- Where a building is owned and a hazardous substance has been disposed of or stored. Further, stockholders may be held liable for the clean up of hazardous waste if they actively participated in the management of waste control.

When a corporation finally dissolves, this generally spurs taxation at the corporate level, as well as at the stockholder level. Generally, gain or loss in recognized by both the corporation and its stockholders on any property or funds distributed. In terms of capital gain, the stockholder is treated as if the liquidation distributions were the proceeds from the actual sale of his stock. The corporation is generally required to recognize a gain or loss on a liquidating sale of its assets to third parties, even when those proceeds are made to the corporation's stockholders. Further, the corporation must, for purposes of taxable gain, recognize the distribution of any property.

LIMITED LIABILITY CORPORATION

A limited liability company, commonly called an "LLC," is a business structure that fits somewhere between the corporation and the partnership or sole proprietorship. Like owners of partnerships or sole proprietorships, LLC owners report business profits or losses on their personal income tax returns; the LLC itself is not a separate taxable entity.

Like a corporation, however, all LLC owners are protected from personal liability for business debts and claims -- a feature known as "limited liability." This means that if the business owes money or faces a lawsuit for some other reason, only the assets of the business itself are at risk. Creditors can't reach the personal assets of the LLC owners, such as a house or car.

For these reasons, many people say the LLC combines the best features of both the partnership and corporate business structures.

The LLC vs Partnership

The main difference between an LLC and a partnership is that LLC owners are not personally liable for the company's debts and liabilities. This means that creditors of the LLC cannot go after the owners' personal assets to pay off LLC debts. Partners, on the other hand, do not receive limited liability protection.

Also, owners of limited liability companies must file formal articles of organization with their state's LLC filing office, pay a filing fee and comply with certain other state filing requirements before they open for business. By contrast, people who form a partnership don't need to file any formal paperwork and don't have to pay any special fees.

LLCs and partnerships are almost identical when it comes to taxation, however. In both types of businesses, the owners report business income or losses on their personal tax returns; the business itself does not pay tax on this money. In fact, LLC and partnerships file the same informational tax return with the IRS (Form 1065) and distribute the same schedules to the business's owners (Schedule K-1, which lists each owner's share of income).

Exceptions to Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, it is important to realize that this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he or she:

- Personally and directly injures someone
- Personally guarantees a bank loan or a business debt on which the LLC defaults
- Fails to deposit taxes withheld from employees' wages
- Intentionally does something fraudulent, illegal, or clearly wrong-headed that causes harm to the company or to someone else, or
- Treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

This last exception is the most important. In some circumstances, a court might say that the LLC doesn't really exist and find that its owners are really doing business as individuals, who are personally liable for their acts. To keep this from happening, co-owners must be sure to:

- Act fairly and legally. Do not conceal or misrepresent material facts or the state of the LLC's finances to vendors, creditors or other outsiders.
- Fund the LLC adequately. Invest enough cash into the business so that the LLC can meet
- foreseeable expenses and liabilities.
- Keep LLC and personal business separate. Get a federal employer identification number, open up a business-only checking account, and keep personal finances out of the LLC accounting books.
- Create an operating agreement. Having a formal written operating agreement lends credibility to the LLC's separate existence.

Business Insurance

A good liability insurance policy can shield personal assets when limited liability protection does not. For instance, if a client is a physical therapist and he accidentally injures a client's back, his liability insurance policy should cover. Insurance can also protect personal assets in the event that his limited liability status is ignored by a court.

In addition to protecting personal assets in such situations, insurance can protect corporate assets from lawsuits and claims. Be aware, however, that commercial insurance usually does not protect personal or corporate assets from unpaid business debts, whether or not they're personally guaranteed.

LLC Management

The owners of most small LLCs participate equally in the management of their business. This arrangement is called "member management."

The alternative management structure -- somewhat awkwardly called "manager management" -- means that one or more owners (or even an outsider) is designated to take responsibility for managing the LLC. The nonmanaging owners (sometimes family members who have invested in the company) simply sit back and share in LLC profits. In a manager-managed LLC, only the named managers get to vote on management decisions and act as agents of the LLC. Choosing manager management, however, can complicate securities issues for an LLC.

LLC Taxation

Like sole proprietorships (one-owner businesses) and partnerships, an LLC is not a considered separate from its owners for tax purposes. This means that the LLC does not generally pay any income taxes itself; instead, each LLC owner pays taxes on her share of profits (or deducts her share of business losses) on her personal tax return.

LLC owners can instead elect to have their LLC taxed like a corporation. This can reduce taxes for LLC owners who will regularly need to retain a significant amount of profits in the company.

Forming an LLC

To create an LLC, "articles of organization" are filed with the LLC division of a specific state government. This office is often in the same department as the corporations division, which is usually part of the Secretary of State's office. Filing fees are typically $100 or less.

Many states supply a blank one-page form for the articles of organization which specify a few basic details about the LLC, such as its name and address and contact information for a person involved with the LLC (usually called a "registered agent") who will receive legal papers on its behalf.

Some states also require a list of the names and addresses of the LLC members.

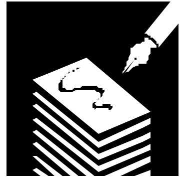
In addition to filing articles of organization, an LLC operating agreement must be created. While it may not be necessary to file the operating agreement with the state, it's a crucial document because it sets out the LLC members' rights and responsibilities, their percentage interests in the business and their share of the profits.

Finally, the LLC must fulfill the same local registration requirements as any new business, such as applying for a business license and registering a fictitious or assumed business name.

Ending an LLC

Under the laws of many states, and unless the operating agreement says otherwise, when one member wants to leave the LLC, the company dissolves. In that case, the LLC members must fulfill any remaining business obligations, pay off all debts, divide any assets and profits among themselves, and then decide whether they want to start a new LLC to continue the business with the remaining members.

The LLC operating agreement can prevent this kind of abrupt ending to a business by including "buy-sell" provisions, which set up guidelines for what will happen when one member retires, dies, becomes disabled or leaves the LLC to pursue other interests. *See Business Continuation for buy-sell details.*



BUSINESS CONTINUATION

The death or disability of a small business owner, major shareholder-owner or key employee is a devastating event. Both family and employees are impacted. Businesses must plan for this event by using tools and methods that will permit the successful continuation of the business by providing for a quick liquidation of the business estate or financially arranging for a "key man" within the business or an associate to fill the vacancy. This type of specialty market planning is the emphasis of this section.

The "winding down" of a client's business and/or the planning of an executive's retirement planning and long term care is also an important task for specialty agents. However, these will be discussed in later sections titled Business Benefits and Business Estates.

THE BUY-SELL AGREEMENT

Where business interests are closely held, a buy-sell agreement ensures that these interests can be converted into cash or notes upon the death of a principal owner or partner. Such arrangements serve to create cash at time of death, provide continuity of management and a method for shifting control of the business estate. In essence, the buy-sell agreement, helps to establish the value of a business entity and prearranges a market for the business to be sold or transferred.

The buy-sell agreement must contain a specified purchase price or some valuation formula that is to be applied at the time of death to produce a purchase price. The agreement must further provide that the buyer has the cash available to pay the price in full, or nearly in full, when the purchase takes place. It is not enough simply to find a buyer and to make some sort of promise that the transaction will take place. There must be an effective way to fund the buy-sell agreement.

The most effective, convenient and practical way to fund the buy-sell agreement is with life insurance on the life of the proprietor or business partner. The amount of the insurance is also the amount of the purchase price that has been agreed upon. By using such an arrangement, both the buyer and the seller are assured that the necessary cash to carry out their plan will be available when it is needed.

Alternatives to using insurance to finance the buy-sell agreement are not realistic. For the purposes of discussion, some of these plans include saving for the purchase price, making the payments in installments and borrowing the necessary funds. However, these methods are rarely practical.

An insured buy-sell agreement is basically an advance installment plan for the payment of the purchase price. These payments can be made on whatever schedule is convenient. They may be made monthly, quarterly, semi-annually or on some other basis.

The obvious benefit of the buy-sell agreement in this case is that the purchaser acquires the business as a going concern. When no such plans are made, the business is not likely to survive long without its owner or partner. Therefore, it loses its going concern value.

When a buy-sell agreement is in place, the deceased's estate does not suffer liquidation losses. The buy-sell arrangement permits the deceased's family to receive the full value of the business in cash.

Sole Proprietorship Buy-Sell Agreements

When a sole proprietor dies, he may will his business to a beneficiary, which sometimes involves probate. Or, he may leave his business to a beneficiary by means of a living trust, thus avoiding probate. A living trust is an efficient and effective way to transfer property at death. It is created while the business owner is alive, and a trustee is selected who will have control of the business. It is a legal document controlling the transfer of the ownership of the business.

Using a living trust, the control of the business may be in one name, while the benefits go to another person. Unlike a will, a living trust avoids probate and allows property to be transferred promptly to the beneficiary.

Buy-sell agreements between family members in a sole proprietorship are closely scrutinized by the Internal Revenue Service to determine whether they are actual business agreements or simply agreements used as devices to convey the deceased's ownership. Recent legislation has tightened the rules to prevent intra-family arrangements designed to pass business wealth through artificially low prices or impractical terms in the buy-sell agreement.

Generally, a buy-sell agreement carries no weight in setting the tax value of transfer tax purposes between family members. If three tests specified by the Internal Revenue Service are met, then there is an exception to this rule. The three tests are:

1) The agreement must be part of an actual business arrangement.
2) The agreement must not be a device to transfer the property to members of the deceased's family for less than full and adequate consideration in money.
3) The terms of the agreement must be comparable to similar arrangements entered into by persons in other transactions.

If there is no beneficiary, by means of preplanning and a buy-sell agreement, the sole proprietor may arrange for the sale of the business from the estate to a designated buyer. A typical sole proprietorship buy-sell agreement can be quite simple. It obligates the designated buyer to purchase the business, and it requires the estate to sell the business to that buyer. The buy-sell agreement should reference the name, address and owner of the business; a list of the assets of the business; a predetermined price for the sale of the business or a specific method of valuing the business; and any specific instructions for the continuation of the business.

Preplanning

There are complex issues of continuing or disposing of a sole proprietorship as part of an estate. Preplanning will help to ease the task. For example, the owner may arrange for successor management of his business or for the sale of his business. In fact, this can often be done more easily and profitably while the business owner is alive.

There is no more difficult asset to administer than an active business. When the deceased has made plans for the disposition of the business, the task is greatly simplified. For example, assume that knowing he was ill, the deceased sole proprietor had signed a business buy-sell agreement. Suppose the agreement provided that upon his death, the buyer would be obligated to buy, and the deceased's personal representative would be obligated to sell the deceased's

interest for a predetermined price. In this case, the personal representative would only have to transfer the deceased's business interest to the new owner.

On the other hand, bringing in family successors is an approach to preplanning. Training them, preparing them for the future, and doing this in a timely fashion is a difficult task. A healthy sole proprietor may hesitate or resist this, but an effort should be made by family and friends to bring the issue of succession into discussion. Naturally, this is a delicate affair, and offending the older person is easy to do. However, he should realize that he must take some preplanning measures.

Stifling a candidate for succession is also easy to do. Often it can impede any growth of the business. New approaches, new techniques, novel ideas, and contemporary attitudes introduce vitality into a business and create growth. Younger people should be encouraged to come forward, take responsibility, test themselves, and learn to face up to hard decisions, assuming the responsibilities of leadership.

There are countless issues that arise after the death of a sole proprietor. If there were a will and the business was left to more than one new owner, often one new owner wants to sell the business while the other does not. Perhaps they all want to sell but cannot agree on how to do it. Perhaps they want to operate the business but disagree on how to proceed. If a business has any real value that is likely to survive its sole proprietor, issues such as these must be anticipated and resolved as part of the estate planning process.

The Buy-Sell Agreement and the Partnership

A business partnership has a need for a buy-sell agreement for many of the same reasons as a sole proprietorship, although it is a completely different type of entity. The partnership is more complex, and more people are affected in different ways in the event of the death or disability of a partner.

A buy-sell agreement is essential for a partnership business for many reasons. Some of these are:

- There are greater liabilities involved. Essentially, a partnership implies that there is the unlimited personal liability of each partner. In other words, each partner is personally liable for all of the partnership debts and obligations that cannot be paid by the partnership.
- There are contributions from more than one source to the partnership. Initial contributions are made by the partners when forming the partnership. The sum of all of the partnership assets, including these initial capital contributions, are considered to be partnership property.

The Consequences of Not Having a Buy-Sell Agreement in Place

Given these crucial issues, the consequences to the surviving partners and the deceased partner's family can be devastating, in the event of the death or disability of a partner. A partnership differs greatly from a sole proprietor's business, which may be bequeathed like any other personal property, or the sale of which may be arranged in the event of the owner's death.

Without an express agreement, in the event of the death of a partner, the partnership itself is automatically dissolved. This is one of the fundamental rules of partnership law. The partnership may be reformed, or it may be reconstituted with the surviving partners or new ones. Technically, however, this process is the creation and formation of a brand new partnership.

When a partner dies, the partnership must be dissolved because the death has resulted in a change in the relationship of the partners. Therefore, the partnership, as it was originally formed, no longer exists. Next, the partnership business must be wound up or liquidated. Finally, the partnership must be terminated, eliminating the surviving partner's authority.

Alternatives to Forced Partnership Liquidation

If no buy-sell agreement has been made arranging for the disposition of the deceased partner's interest, many unfortunate events can take place. Inevitably, there are losses suffered by everyone. The following is a discussion of some of the alternatives to liquidating the partnership when no buy-sell agreement has been put into place:

- The surviving partners may form a new partnership with the heirs of the deceased. This is not a practical alternative, because the heirs cannot enter the partnership until the estate administration has been completed. Besides, this plan can work only if the personal representative is the heir. Further, since all partners must agree on who the partners are, this can only happen if the partners and the heir agree to be partners. Spouses who have not formerly been involved in the partnership business typically do not make good partners due to their lack of experience.
- The heirs may purchase the interests of the surviving partners. This plan is not a practical one for the partners because they would be left without their business, their jobs and their livelihoods. This plan is not a practical plan for the heirs, because they would have to carry on the business without the skills and expertise of the departed partners who made the partnership successful in the first place.
- The surviving partners may purchase the interest of the deceased. While this plan may seem like a sound one, the personal representative, acting in the best interests of the deceased's family, may demand that the partnership be liquidated. This plan also assumes that the partners would have the immediate cash available at the time of death, which is not a likely event without an insured buy-sell agreement in place.
- The buy-sell agreement seems to be the best alternative to the liquidation of the partnership. It can be set up prior to the death of a partner and can eliminate the possibilities of any liquidation losses to the partnership. However, as with the buy-sell agreement used in the sole proprietorship, although the objective of the arrangement may be noble, it must also be suitably financed.

Financing the Partnership Buy-Sell Agreement With Life Insurance

A partnership business financed with life insurance may be arranged in one of two ways:

1) A cross purchase agreement may be used. For smaller partnerships, the cross purchase plan is usually the most efficient method of financing. Using the cross purchase agreement, the partners agree to purchase a deceased partner's interest in the partnership. The partners themselves pay for and own the policies on the other partners. A cross purchase plan ensures the worth of each partner's share because the amount of insurance on each partner is the amount approximating his share of the purchase price, if another partner predeceases him.
2) An entity agreement may be used. In larger partnerships, a cross purchase plan doesn't make much sense. With each of the partners purchasing life insurance policies on each of the others, this plan could become unmanageable. An entity agreement involves the partnership itself. The partnership pays for a single policy on each partner's life. The parties to an entity agreement are the partnership and the individual partners. Using an insured

buy-sell agreement offers great advantages to the partnership. It assures the continuation of the partnership business without interruption, and any liquidation losses are averted. From the perspective of the estate, the family receives payment in full for the deceased's interest immediately.

The Buy-Sell Agreement and the Corporation

Unlike the sole proprietorship or the partnership, a corporation has a unique feature. That is, it is able to exist for an unlimited period of time. Under most state statutes, the corporation must state its period of duration within its articles of incorporation. However, the duration of the corporation may be perpetual.

The ability for the corporation to remain in existence permanently is considered an advantage that corporations have over sole proprietorships or partnerships. That is, the corporation is not terminated upon the death of a principal participant in the corporate business. This is not to say, however, that when a principal participant in a corporation dies, for example, a stockholder, there are no damaging effects on the corporation.

The close corporation, also referred to as a closely held corporation, is the type of corporation that agents will most often come in contact with. A close corporation is owned by a small group of stockholders who are actively involved in the day-to-day management of the business.

When a Stockholder Dies

When a stockholder in a close corporation dies, the continuity of the corporation survives. Whether the deceased stockholder is a majority stockholder, a minority stockholder or an equal stockholder has some effect on the degree of business interruption a close corporation may face. However, there are frightful consequences of the death of any stockholder if the event has not been planned for. Some of these consequences are:

Like other personal property, the interest in the corporation may simply pass to heirs or beneficiaries. During this time, the personal representative must act in the best interest of the family and the estate, which may not necessarily be in the best interest of the corporation.

The personal representative may have to liquidate the corporate interest. Unfortunately, there is typically not a ready market for stock in a close corporation, especially at a moment's notice. The corporation, as well as the family of the deceased, could suffer heavy losses.

The deceased stockholder probably contributed an essential skill or talent to the corporation. In a small corporation, his death can have a profound effect on the business.

Unfortunately, the other surviving stockholders have no say in the choice of a new corporate associate if the corporate shares are simply bequeathed. The new share owner may be inexperienced, unwilling or simply unable to contribute to the corporation in the same manner as the deceased.

Although the surviving stockholders could sell their interests, this is not likely. A close corporation's stock is not publicly traded. Therefore, there is no ready market for it. The stockholders may wish to sell their interests to other existing stockholders, but this plan is conditioned upon the others' willingness to buy.

Without a ready market for the stock and the willingness and ability on the part of surviving stockholders to purchase the deceased's interest, the corporation may have to be liquidated. Only liquidation may satisfy the needs of the family and the estate.

Retaining the Corporate Interest

There is a practical alternative to simply passing on the shares of corporate stock. A buy-sell agreement can be the solution to these dilemmas. Just as the sole proprietorship or partnership buy-sell agreements can provide for the disposition of the business or the partnership interest, the corporate buy-sell agreement can be used to provide for the disposition of corporate interest.

The corporate buy-sell agreement provides that the surviving stockholders will purchase the shares of any deceased stockholder. It assures the successful continuation of the business, and it assures that the family will receive the full value of the stock interest.

The insured buy-sell agreement guarantees that this transaction is properly and fully financed. The plan itself is not useful unless the funds to carry out the transaction are at hand.

Unfortunately, in a closely held or smaller corporation, the business may suddenly be without the skills, knowledge, abilities, or talents of an important individual who is not easily replaceable. The corporate entity may be unnerved. It may be in jeopardy, and the confidence of the clientele may be seriously weakened. Some options upon the death of a stockholder or owner are:

- The surviving stockholders may decide to continue the corporate enterprise with the heirs of the deceased shareholder as part of management.
- The surviving stockholders may want to purchase the stock of the deceased.
- The surviving stockholders may consider selling their own interests.

From the standpoint of the heirs, if they want to sell their newly acquired stock, they may learn that neither the corporation nor the remaining shareholders are financially capable of buying them, and there is no established market for these. In these circumstances, the heirs have no choice other than to retain the stock and to play some sort of role in the business.

Preplanning and a buy-sell agreement can ensure the financial security of the corporate owners and their families. The provisions of the agreement must be tailored to satisfy the requirements and the objectives of the stockholders, as well as those of the corporation. The purpose is to provide the funds necessary so that the deceased's interest may be purchased and to provide a way that the business can continue to carry on in a smooth and uninterrupted manner.

Corporation Buy-Sell Agreements

One of the main incidents of property is its transferability. The owners of property have the right and the power to dispose of their property. In general, one of the characteristics of a corporation is the free transferability of interest in the corporation. Shares of stock are considered negotiable instruments. Shares of stock may be transferred in the same manner as other personal property. Further, the owner is under no obligation to refrain from selling his shares.

In closely held corporations, restrictions on the transfer of shares of a corporation occur frequently. Often, the existing share owners want to maintain ownership, retaining the level of existing stock ownership. Sometimes fulfilling the obligations and functions of the corporation is

an issue. In addition to insuring the continuity of the corporate existence, these buy-sell agreements have the distinct advantage of guaranteeing a market for the sale of corporate stock and fixing the value of the stock for estate tax purposes.

The transfer of stock in corporations should not be impeded. The most common type of stock transfer restrictions apply to a stockholder who, for whatever reason, intends to sell or dispose of his stock, who has died or has become physically or mentally incapacitated for some length of time, who has become divorced and his share of the corporate stock has passed to a noncorporate insider, or who has terminated his employment with the corporation.

Typically, restrictions on the transfer of the securities of a corporation may be applied if they are for the mutual convenience and protection of the parties, if they are not unreasonable, and if the purchaser acquires the stock with the required notice of any restrictions. If the restriction is not noted conspicuously, it is not enforceable against any person without actual knowledge of its existence. They may be restricted by agreement, if these restrictions are not contrary to public policy.

After the transfer has been established, the new stock owner acquires all of the rights and security of the stock.

Types of Corporate Buy-Sell Agreements:

Redemption agreement. The redemption agreement is sometimes called an entity purchase agreement. This type of agreement binds both the stockholders and the corporation. Upon the death of a stockholder, the corporation is bound to purchase the stock to the extent of its available surplus. The redemption agreement allows for corporate funds to be used to purchase the stock. If the redemption agreement is funded by insurance, these funds are not tax deductible, and the insurance proceeds do not represent taxable income to the corporation. Naturally, the remaining stockholders own a larger portion of the corporation. However, there is no increase in the cost basis of their stock.

Cross purchase buy-sell agreement. Upon the death of a stockholder, this type of agreement binds the stockholders to purchase each other's shares. As in the redemption agreement, this agreement does not need to be written to force the corporation to purchase the stock. It can be intended to give the corporation the right of first refusal.

When using a cross-purchase arrangement, the individual stockholders enter into an agreement without the involvement of the corporation. They must purchase the stock from the selling stockholder or from the deceased stockholder's estate. Only his own funds may be used. If funded by insurance, such insurance premiums must be paid for with after-tax dollars. This agreement may be structured so that the deceased's estate must sell the interest in the business, leaving the surviving stockholders with the option of purchasing the interest of the deceased directly or directing that it be purchased by the corporation. The main advantage of a cross-purchase agreement is that the surviving stockholders receive an accelerated basis in that portion of the stock which was purchased.

Hybrid buy-sell agreement. This agreement combines the elements of a redemption agreement and a cross purchase agreement.

The purchase price used in the agreement can be established by one of the following methods:

- The price may be determined by a qualified appraiser.

- A fixed dollar price for the stock may be set. This method of valuing the stock sets a price for the stock. Any fluctuations in the market value of the corporation's assets are not reflected by this method.
- A fixed dollar price may be set, but is subject to an annual review. Under this method, any fluctuations in the market value of the corporation's worth are reviewed annually to take those changes into consideration.
- Book value is determined on a specific date. In some instances, this method of valuation may call for only the book value to be increased. This would reflect the fair market value of marketable securities or real estate. This method is often used for a service business that is not capital intensive.
- The price may be determined by some formula. Using this method, the price may reflect any type of formula upon which the stockholders agree.
- Life insurance may be used to fund buy-sell agreements. These premiums are relatively inexpensive, given that the intended continuity of the corporation may be at stake. Using a buy-sell agreement funded by life insurance allows the heirs of the deceased shareholder to receive cash in exchange for their stock. By funding the buy-sell agreement with life insurance, the buy-out and its method of funding are predetermined. The viability of the corporation is guaranteed.

In addition to dealing with the death of an owner, a buy-sell agreement should include provisions for dealing with the possibility of long-term or permanent physical or mental disability of one of the owners. This provision is another way to protect the continuity of the corporation.

Tax Consequences of the Corporate Buy-Sell Agreement

Because buy-sell agreements can have significant tax consequences, careful consideration must be given to the tax effects of these agreements during their planning and implementation. This is especially true in those situations where the primary objective of such an agreement is to provide for the valuation of the shares at the death of the shareholder.

If done correctly, a binding determination can be made for estate tax purposes.

The Internal Revenue Service provides that the basis of property acquired from the deceased stockholder is the property's fair market value for transfer tax purposes. The purchase price set forth in a buy-sell agreement is generally recognized, however, provided that:

1) The agreement is an actual business arrangement.
2) It is not just a method of transferring a stockholder's interest for less than fair market value.
3) The terms of the agreement are comparable to similar agreements.

Further, the following provisions are required for the agreement to be binding for federal estate tax purposes:

1) The deceased's estate has to sell its stock and a surviving stockholder or the corporation has to buy or have an option to buy the stock.
2) The agreement must restrict the stockholders from transferring their shares during their lifetimes.
3) The purchase price agreed upon must be reasonable at the time the agreement is executed.

If the earnings of the corporation are used to fund the buy-sell agreement, the accumulated earnings tax may be imposed. Further, when the appreciated assets of the corporation are used

to redeem the deceased's shares, the corporation may have to recognize a gain for the difference between the basis of the amounts distributed and their fair market value.

Unlike the payments made under partnership buy-sell agreements, payments made under a corporate buy-sell agreement generally do not result in income to the deceased, unless the sale occurs before his death, and the proceeds are received by the estate after his death.

Benefits of the Insured Corporate Buy-Sell Agreement

The benefits of the insured buy-sell corporate agreement are obvious:

- The insurance premiums are considered reasonable in relation to the future of the corporation.
- The deceased's estate receives the full value of the stock immediately.
- A market for the stock is guaranteed.
- The method of funding is guaranteed.
- The alternatives of saving for the purchase price, making installment payments or borrowing the funds are avoided.
- Liquidation losses are avoided.
- The uninterrupted continuity of the corporation is secured.

Provisions in the Buy-Sell Agreement

No two agreements for the sale of a business or business interest are the same. Naturally, the provisions of a document that carry so much weight should be drafted by a competent attorney. However, all such agreements should contain the following components:

1) The names of the entities and parties to the agreement.
2) The purpose of the agreement.
3) The commitment to sell and to buy.
4) A description of the assets and liabilities of the business in the case of a sole proprietorship or partnership.
5) A provision that if the owner wishes to sell his interest before his death, the purchaser shall receive the first offer to buy it.
6) The price to be paid for the interest or the formula to be used for determining the value of the interest.
7) A provision stating that life insurance is to be used to fund the agreement, identifying the insurance policies used to provide these funds, a commitment to maintain these policies, provisions for ownership and control of the policies, and beneficiary arrangements.
8) Provisions for a change in the life insurance policies resulting from a change in the value of the business interest.
9) A provision for the situation where the purchase price exceeds the life insurance proceeds.
10) A provision for the situation where the life insurance proceeds exceed the purchase price.
11) A provision relating to any debts in the case of a sole proprietorship or partnership.
12) Provisions for amending the buy-sell agreement, including revoking or terminating it under certain circumstances.
13) A provision unequivocally binding the heirs to the terms of the agreement.

Buy-Sell Agreements for Limited Liability Corporations

Many, if not most, LLC owners overlook a critical element of their operating agreement that can save them both money and angst: buy-sell provisions. When one creates a buy-sell, or buyout, provisions for your operating agreement, co-owners can prepare for events that have been the downfall of more than a few successful small businesses.

Continuing The LLC Interest

It's a huge mistake to ignore the fact that sooner or later any business, LLC formed or not, will change. Think about what would happen if a buy-sell agreement was not in place and one of the following occurs:

- An LLC member quits to move to another city or leaves to start another business. Without a buy-sell agreement, the LLC might be automatically dissolved, forcing others in the LLC to divide any assets and profits among the LLC members and decide whether to start a new LLC with the remaining LLC members. If the LLC doesn't end, remaining members must still decide whether they should buy out the departing LLC member's ownership interest, and for how much.

- An LLC member dies, gets divorced or becomes mentally or physically incapacitated. In this case, surviving or remaining members might have to work with the spouse or other family member of a deceased, disabled or divorced owner. There is a substantial possibility that the family member would be inexperienced or otherwise unable to act in the best interests of the business. On the flip side, the remaining members might get stuck with a small business interest that no outsider wants to buy and for which no insider will give you a decent price.

- A member sells his or her share to a stranger or a party with differing opinions. In this case, remaining members may be forced to share control of the company with an inexperienced or untrustworthy stranger -- or be faced with the struggle of running a business with an incompatible co-owner.

Just looking at this list, it should be obvious that if LLC members don't anticipate and plan for circumstances like these, they're risking serious personal and business discord -- perhaps even court battles and the loss of the LLC business.

What Should Be In an LLC Buy-Sell Agreement?

A buy-sell agreement is made up of several clauses in the written operating agreement (or it can be a separate agreement that stands on its own) that control the following business decisions:

- Who can buy a departing member's share of the business (this may include outsiders or be limited to other LLC members)
- What events will trigger a buyout (see the list below), and
- What price will be paid for a member's interest in the LLC.

The buy-sell agreement will instruct and remind you and your co-owners how to handle the sale or buyback of an ownership interest when one member's circumstances change. Typically, the events that trigger a buyout of a member's interest under a buy-sell agreement are:

- An attractive offer from an outsider to purchase a member's interest in the company
- A divorce settlement in which a member's ex-spouse stands to receive an ownership interest in the company

- The foreclosure of a debt secured by an ownership interest
- The personal bankruptcy of a member, or
- The disability, death or incapacity of a member.

DISABILITY INCOME

Experts say that only about 20 percent of all employees are fortunate enough to be furnished with employer-provided, long-term disability income coverage. This leaves most companies and businesses with a major disability exposure.

Disability Income Insurance and the Buy-Sell Agreement

As in the previous discussion of buy-sell agreements, it is important to remember that, in addition to being used for funding the sale and purchase of a business interest in the event of the death of the principal, these agreements can also be used to fund the risks of disability. Actually, the risk of disability can be up to four times greater than the risk of death prior to age 65.

Just as the death of a business principal can devastate a business, his disability can have the same effect. Therefore, the insured buy-sell agreement should make provisions for disability, in addition to provisions for the death of the owner, partner or stockholder.

Disability income insurance protects the insured, the business, the insured's family and the families of the employees whose livelihoods depend on the survival of the business. This insurance can provide tax-free funds to honor the obligations of the business and the key person on whom the disability income insurance policy is taken out. It removes the risk from the family of the disabled key person and the business itself.

When employing a disability provision of a buy-sell agreement, the buy-out is not generally triggered upon the immediate disability of the principal. It does not take effect for some specified period of time, typically one to two years following the onset of the disability. In fairness to all, one stricken with an illness or hurt in an accident needs some time to recover before being forced to sell out his interest.

Disability income insurance policies may be used to provide funding for buy-outs in the event of the disability of a business principal. From the agent's perspective, this subject should be covered along with life insurance and other planning issues.

The same potential results to the business may occur as the result of the disability of a key person as the death of that person. For example, suppose the business loses an important part of its core. Credit may be tight, sales may be off and finding a replacement could be expensive. Banks and suppliers may be reluctant to extend credit to a company paying off a large obligation to the family of a disabled owner.

In most cases, it makes more sense to pay a comparatively small premium when the business is thriving and productive than to have to pay a large settlement when the business is not doing so well due to the disability of a key person.

In some unfortunate cases, the health of the remaining associates may preclude the purchase of additional insurance. In such a case, an installment payout to the disabled colleague may be the only option available. This is why it is essential to insure the principals of the business while they are healthy.

KEY PERSON INSURANCE

Another important part of business continuation is key employee insurance.

Key person insurance is a death benefit only plan. It is used to provide some sort of compensation for the economic loss that is suffered in the event of the death or disability of a key person in the business.

There is no mandate that a company enter into a written agreement or contract when providing key person insurance. Only the decision to do so is necessary. Key person insurance is a relatively easy plan to put into place, and it offers many benefits to the company.

The key employee is an individual who is considered to be valuable to the company and the business. Without this individual the company may suffer a number of different types of losses which will ultimately effect the financial bottom line.

The insurance is purchased by the company as the owner of the policy, pays the premiums is usually the beneficiary. Typically, the insurance is purchased for the benefit of the business, not the employee.

The Cost of Replacing a Key Person

There are a number of costs associated with the disability or death of a key person. The most obvious of these are the costs of hiring and training the key person's replacement. The money expended here reduces the bottom-line profit.

When the key person's replacement is finally found, there are more costs connected with employment agencies, head hunters, relocation expenses, perhaps buying out this person's existing contract, etc. Even though the replacement person is probably well-qualified, his on-the-job training experience is likely to be slow. This results in reduced efficiency and lost productivity and revenue.

Key employee life insurance proceeds can help to balance some of the expenses incurred when a key person must be replaced. They can also help to compensate for the inevitable loss of profits that result during the training and learning period.

Consequences of the Death of a Key Person

Consider the following possible losses to a company and more specifically the possibility that they will cause damage to inventory, building, equipment and more:

- Fire
- Wind
- Theft
- Vandalism
- Robbery

Companies must consider how these perils can cause losses and more importantly, how to shift the risk away from the company. Yes, purchasing insurance will certainly provide a major way of shifting any potential losses to the insurance company.

But, what about potential losses as a result of the loss of a key employee? What about the costs of replacement and the loss of business? Without insurance, the loss from any one of the above risks might endanger the success of the company.

Unfortunately, key employees really can't be replaced. Finding the "right" replacement is a costly experience. The use of insurance will help.

A key employee is a valuable person to the business. If he should die prior to his retirement, his death would have unfavorable effects on the business. Some examples of these effects might be:

- The loss of profits.
- The loss or reduction of credit standing.
- The expense involved in hiring a qualified replacement.
- The expense involved in training this replacement.
- The down time associated with the new person's learning experience.
- Loss of managerial skill
- Loss of managerial experience
- Decrease in sales
- Decrease in customer service
- Reduction in production
- Potential loss of credit by creditors
- Cost of recruiting a replacement
- Training the replacement

Identifying the Key Person

The key employees must be identified by the company prior to the purchase of any insurance. After all, it doesn't make any sense to purchase life insurance on all of the employees. Obviously, this would be quite an expensive proposition.

Let's take a look at the following situations which may help search out who is a Key employee and would contribute to the success of the business:

- Managers
- Highly paid employees
- Responsible for sales
- Highly thought of individuals

The general criteria for determining a key person are:

1) Size of the key person's salary. Although this is not the most definitive criteria, it does indicate the important role that the key person plays.
2) Role within the company, especially as it relates to the administration and supervision over the business. Typically, a key person has direct culpability within the business. His area of specialty might be sales, production or management. His personal efforts are invaluable. A key person does not always have to be an employee of the company.
3) Existence as a root of capital. The person who is the source for developing capital for the business is, without a doubt, a key person.

4) Specialty. A person may be considered a key person based upon his special talent or skill. Talents and skills can be personal and highly developed. The loss of such a person could be costly to the business.

The consequences of the loss of a key person can be great. Most businesses, even smaller ones, have one or more key people. A successful business of any type has valuable employees who possess knowledge and skills and are great assets to the company.

The consequences of the disability or death of a key person naturally depend on the particular person and his contribution to the business. However, if a person is considered a key person, his contribution is significant and measurable. When his skills, talents, even his personality and other features are gone, the business can lose its capacity to operate efficiently.

Key employee insurance in the form of disability and life insurance can avert these unwelcome situations. Key employee insurance is designed to provide a fund for making up for economic loss sustained if the key person becomes disabled or dies.

While searching out those individuals listed above it is almost as important to determine whether training programs are available for management personnel. If the personnel in the company have not been adequately trained and if the managers have not received management training, identifying key employees would not be necessary as there wouldn't be any.

As a company identifies key employees the recognition of training must be discussed and reviewed. Obviously, if a trained individual was available to step into the position of the key employee, losses would be minimized by the company.

Larger companies usually provide its employees with more in depth training programs then usually found in smaller companies. The point I'm trying to make is that prospecting for key employee insurance is best with smaller, rather than larger companies.

Other Potential Key Employees

It is not always possible to identify key employees just from titles. It's probably just as important to look at the total contributions of these employees to help determine their importance. Most of the time you will have to analyze these indicators in a subjective way.

- Relationship with both employees and management
- Involvement in sales or production
- Non-employee owners or investors
- Character
- Ability
- Contributions
- Skill
- Experience

Insurable Interest in the Life of the Key Person

When a life insurance policy is purchased on the life of another person, an insurable interest must exist. The concept of insurable interest demands the existence of a consequential relationship between the insured and the person, object or activity that is the subject of the insurance transaction. In other words, there must be some reasonable ground, based upon the

relationship of the parties, to expect that an advantage or benefit will occur from the continuance of the life of the insured.

If this insurable interest does not exist, the insurance policy contract is considered nothing more than a wager. The party taking out the insurance has an evident and direct interest in the early death of the insured. The sheer existence of an employer-employee relationship is not enough to sustain insurable interest.

As this relates to key employee insurance, there are clear and evident reasons for the beneficiary of the life insurance policy to expect some economic benefits from the continuance of the life of the insured. Conversely, there must be some reason to believe that these economic benefits will be lost in the event of the key person's death or disability.

Because a business purchases insurance on a person whose ongoing contributions can be expected to play a role in the future and stability of the business, insurable interest exists.

In a sole proprietorship, the business owner may purchase key employee life insurance on a valued employee.

In a partnership, each partner has an insurable interest in a key person. It is not necessary that the key person in a partnership actually be a partner. Each partner's insurable interest is quantified in relation to his partnership share in the business.

In a close corporation, a key person does not necessarily have to be a stockholder. He may be invaluable to the business without actually owning stock in it.

In all states, insurable interest must exist only when the life insurance policy is purchased. There is no requirement that insurable interest must exist at the time of death of the insured. So, if a key person's employment is terminated prior to his death, for whatever reason, the business may elect to continue to make the premiums on the policy. Then, upon the death of the former key person, the business may take possession of the life insurance proceeds tax-free.

Policy Ownership & Key Employee Insurance

Because the company will suffer a loss upon the death of a key employee, the company has an insurable interest in the employee and may purchase a policy on the life of the key employee(s). It makes no difference whether the company is organized as a sole proprietorship, partnership or corporation.

We can take this concept a step further as shareholders of the company may also have an insurable interest in a key employee of the company and purchase a policy.

An issue that normally surfaces is who owns the insurance policy. Is it the person who took out the policy on the key employee or the company itself. Normally, the company itself owns the purchased insurance policy on the life of the key employee.

There may be instances in which a owner of a company may take out a policy on the key employee rather than the company itself owning it. When new companies start there is usually a cash flow problem and perhaps the company cannot afford to purchase the key employee insurance policy at that time. The individuals incorporating the company may instead choose to purchase the policy.

Another type of business, such as a partnership, may end up with having individual partners purchase key employee insurance policies rather than the partnership itself. As a review, partnerships are formed by two or more persons with the goal of making a profit. Unlike a corporation it will end upon the death of any of the partners. Also, partners are individually liable, unlike shareholders and owners of corporations. Another key difference is that partnerships are not tax entities. While both shareholders and corporations pay taxes, partnerships do not. Only the individual partners will play taxes.

If you are going to sell a key employee insurance policy to a partnership and the key employee is also a partner, it would probably be to their advantage for the individual owners of the partnership to be the owners of the insurance policy and not the partnership itself.

How Much Insurance Should Be Purchased on the Key Person's Life?

Key person insurance is designed to indemnify the business for the economic loss that it would suffer in the event of the death or disability of a key person. Therefore, there must be a meaningful way to determine the value of this loss. The value of the key person must be ascertained in light of his relationship to the business. Valuing a key person depends on what he brings to the business. For example, individual standards may be used to provide an impartial estimate with respect to the share of the annual earnings of the business that are attributable to the efforts of the key person.

Some of the following methods should be considered;

- Look at the key employee's salary and take some multiple of it. (e.g. 5 xs the salary)
- Take the key employee and project what a replacement would have to be paid.
- Relationship between the key employee and the profitability of the company. What happens to the net business profits if the key employee were to die? What death benefit should be established in the policy to replace the loss of these net business profits. One of the problems with this method is to separate any profits derived from the efforts of the key employee vs. Profits derived from other sources.
- The future value of a current key employee of a company must also be considered. You would take the current age of the employee and add to that the number of potential years of service left and then multiply the estimated loss of annual income times that number.

Example: A key employee at age 45 would have about 20 years of service left until retirement. If the estimated loss to the company was $20,000 annually, take 20 years times $20,000 and then discount this future value by a reasonable rate of interest by using discount tables. The final value will then represent the recommended death benefit.

The Disability of a Key Person

Obviously, the death of a key employee can have a devastating effect on a business. The same effect is realized if the key person becomes permanently disabled. The adverse effects are essentially the same. With key person disability income insurance, the business can be compensated for losses that result from his disability.

Premium payments for disability income insurance on a key person are also not tax-deductible. However, any proceeds received by the business are considered tax-free.

A disability waiver of premium benefit may be added to the life insurance policy for additional protection. Under the terms of this provision, the business is exempt from paying premiums during the key person's period of disability. The life insurance policy remains in full force, even though premium payments are not made during this time. Also, the cash values of the policy continue to increase just as if premiums were being paid.

The Retirement of a Key Person

Sometimes, a key person may retire from the company before his death. Or, he may retire without suffering a disability. Obviously, the business's need for indemnity no longer exists. The options for dealing with the disposition of a key employee policy are as follows:

- The business may continue to pay the premiums, receiving the insurance proceeds tax-free when the former key person dies.
- The company may surrender the policy for its cash surrender value.
- The policy may be sold to the retiring key person.

Surrendering Key Person Insurance

In most cases, key person insurance remains in effect until the death of the key person. However, if the relationship between the key person and the business is terminated for some reason, the insurance policy does not necessarily have to be surrendered.

Alternatives to disposing of the policy contract are:

1) The business may continue to own the policy and make the payments. Upon the death of the former key person, the business may collect the insurance proceeds tax-free. Remember, insurable interest does not have to exist at the time of death.
2) The business may elect to surrender the policy to the insurance company for its cash surrender value.
3) The business may decide to sell the policy to the key person.
4) If the insurance policy is surrendered or sold and the amount received by the company is more than its net premium cost, the surplus is taxable to the business as ordinary income.
5) The death proceeds of a life insurance policy may be included in the gross estate of the insured within the following limitations:
    - The insured, at the time of his death, must have possessed some incident of ownership in the policy.
    - The proceeds must be payable to or for the benefit of the estate of the insured, referring to the right of the insured or his estate to the economic benefits of the policy.

Therefore, if a sole proprietorship or partnership is the owner and the beneficiary of the life insurance policy and the insured possesses no incidents of ownership, none of the proceeds are included in the insured's gross estate for federal estate tax purposes.

In the case of a partnership, when a partner is a key person, the incidents of ownership in a life insurance policy that is owned by the partnership are not attributed to the individual partners. This is because a partnership is an entity separate from the individual partners.

Further, if a life insurance policy on the life of a partner is owned by and payable to the partnership and if premiums are paid from partnership funds, the death proceeds are not included in the deceased partner's gross estate. However, since they are received by the partnership, the proceeds are considered a partnership asset. This must be taken into

consideration when determining the value of the insured partner's interest for the purpose of federal estate taxes.

Termination of the Key Employee

After the purchase of a key employee insurance policy the key employee decides to leave that company. Well, the company has been paying the premiums on the policy and cash has been building up in the cash accumulation account of the policy. Now what? Does the company have to continue to pay the premiums, exercise the rights as the owner of the policy and surrender it or are there other options available.

Options available;

- Surrender the policy for the cash value that has accumulated in the cash surrender account of the fixed policy.
- Paid up insurance of a reduced amount may be purchased with the value of the cash accumulation account. Remember, as owner of the policy, the company can do anything it wants to do.
- Purchase paid up term insurance for a stated period of time with the cash accumulated in the accumulation account.
- As the owner, the company may drop the policy and pay premiums no longer.
- The company may choose to allow the former employee to purchase the policy for amount equal to the value of the cash accumulation account. This way the employee can continue the permanent insurance and not have to worry about the issue of insurability or difference in age if applying for a new policy.

Tax Issues Concerning Key Person Life

In general, death proceeds of a key person life insurance policy are tax-free. Typically, when a business obtains key person insurance, the premiums are paid by the business entity. The business is typically the owner and beneficiary of the policy. No income tax deduction is allowed for the payment of these premiums. On the other hand, the premiums are not considered taxable income to the insured. Now let's discuss these in greater detail.

Premiums

Generally speaking, premiums paid by a company for a key employee insurance policy are not deductible as a business expense. The reason for this is that the company is generally the beneficiary.

If however, shareholders of the company were the beneficiaries instead of the company but the company still paid the premiums, the premiums paid would probably be tax deductible. An exception to this rule is if the premiums were considered to be a distribution of dividends then not only wouldn’t the company be allowed a deduction but the shareholders would be taxed as receiving dividend income.

In normal circumstances the key employee doesn’t have any control over the policy decisions. Therefore, the premiums paid on key employee insurance will not be taxed as income to the insured employee.

As we discussed in the owner's rights section, the owner has a right to control the beneficiary. If the insured has the right to name the beneficiary then the insured will be considered to be the owner of the policy and the employee will be taxed on the premiums as income.

Policy Proceeds

Proceeds paid to the beneficiary upon the death of the key employee are received federally tax free just like with the proceeds of regular life insurance policies.

The cash in the cash accumulation account grows on a tax deferred basis and there wouldn't be any tax liability on behalf of the company or key employee unless money was taken on a policy surrender.

If the proceeds are later distributed to shareholders as dividends, then the proceeds distributed are taxable as dividends.

Just like regular life insurance death benefit distributions, if the beneficiary decides not to receive a lump sum benefit but rather take interest only, that portion that is considered interest will be taxed as income. Any portion of payments made that are considered to be part of the principal would not be taxed as income.

In spite of the general rule that life insurance proceeds will generally be received federal income tax free, life insurance death benefits received by a "C" corporation will generate "adjusted current earnings and profits" for purposes of computing the corporation's alternative minimum tax liability (AMT).

A corporation typically acquires a key person life insurance policy to assure working capital after a key employee's death. To the extent key employee death proceeds are used up in ordinary business operations, they should not cause an accumulated earnings tax problem.

Surrender, Policy Maturity or Transfer

When a life insurance policy endows at maturity or a policy is surrendered, any excess of the amount received over the cost basis of the policy is taxable as ordinary income.

Cost basis, of course, includes any premiums paid less dividends received.

Very often, a beneficiary decides to take an annuity payout option instead of a lump sum distribution. What portion of the payout that is taxable is determined by a formula which considers the total amount, type of payout option chosen and life expectancy. The ratio that determines how much of the payout is not taxable is called the tax exclusion ratio.

Example: A corporation has a total investment of $6,000 in a policy. Upon choosing a payout option it will receive a total of $8,000. The exclusion ratio is 6,000/8,000 or ¾ Three fourths of each installment will be excluded from taxation.

Without going into specific numbers and percentages it must be pointed out that one of the possible consequences of receiving a death benefit from a key employee insurance policy is the accumulated earnings tax. A corporation typically acquires a key employee life insurance policy to assure adequate working capital after a key employee's death. To the extent key employee death proceeds are used up in ordinary business operations, they should not cause an accumulated earnings tax problem. Keep in mind that "C" corporations are subject to an

accumulated earnings tax, a 28 percent surtax on unreasonable accumulations of earnings and profits.

If a corporation transfers a key employee policy to a former employee for less than its value at that time, the employee will realize taxable income equal to the difference between the fair market value of the policy and the amount paid by the employee. If the employee owns stock in the corporation, the IRS could classify the excess as a dividend rather than compensation. If the employee pays nothing for the policy, the entire fair market value is taxable to the employee.

Federal Estate Tax

The main issues for discussion is whether the proceeds from key employee insurance policies are considered part of the deceased key employee's estate and taxable and what effect, if any, if the deceased key employee was also an owner of the business. If the insured key employee did not have any ownership or beneficial interest in the insurance policy, the proceeds will not be subject to federal estate taxes in the insured's estate.

However, if the employer was the owner of the policy and/or controlled the choice of beneficiary then the proceeds will be includable in the estate for taxation purposes. The IRS looks at the "incidents of ownership" which we talked about in a prior chapter. Whenever the insured possesses any incidents of ownership in a policy, the proceeds are included in the insured's estate. As a review, the following are some examples of incidents of ownership;

- Right to change the beneficiary
- Right to surrender the policy
- Right to make a policy loan
- Right to assign the policy

If the key employee also has an ownership interest in the company, the proceeds from the policy will increase the value of the insured's partnership interest or stock. The increased value will be reflected in the value of the insured's estate.

When the partnership or corporation owns the insurance, the increase in value of the business will equal the amount that the policy proceeds exceed the policy's cash value at the insured's death.

Employee Selling Policy To The Company

If a key employee sells a policy on his/her life to the corporation which will use it as key employee coverage there may be some tax disadvantages. If the insured is neither an officer nor shareholder of the company, the transfer for value rule is triggered. A taxable gain as ordinary income will be realized by the seller to the extent that the amount paid by the corporation exceeds his/her net premium cost. If the employee sells the policy to the corporation at an amount less than his/her net premium cost then he/she will be able to claim a deductible loss.

Questions and Answers

How does a business account for key employee life insurance coverage?

The accounting would depend on what type of insurance policy was issued. Term insurance premium payments represent a current expense. Such costs should be charged against income rather than retained earnings.

Accounting for premiums paid on a permanent type of insurance policy must work in two ways;

1. If a premium payment generates an increase in the policy's cash value, a charge should be placed against an asset account.
2. If that part of the premium paid exceeds the increase in the policy's cash value, a charge should be made to expense.

There are a number of persons in the business that believe the above two accounting methods are not realistic.

What are the advantages of key employee life insurance?

- The business and its creditors have the assurance of having instant capital upon the death of the key employee.
- Many banks will refuse to make large loans to small corporations unless life insurance can be obtained on the key personnel in the business.
- The value of the business owner's investment is maximized.
- Policy cash values are carried as an asset and can be used for a corporate emergency.
- At death the death benefit paid in cash will serve as a cushion to the impact of any possible employee loss.
- Businesses are not restricted in the use of the cash received.
- Key employee proceeds can be used for any purpose including finding a replacement

Is there a way to determine how much insurance is needed to cover the life of a key employee? Well, there really is no set formula that can be used by everybody. It would depend on the value of the employee. If by the death of a key employee the company will "sink" then a higher premium would be appropriate.

Which is better - term or permanent insurance?
As there is no such thing as the perfect investment with securities, the same can apply for insurance. It is important that the product matches the situation and the problem. A lot would depend on cash flow, age of the employee etc.

Does a corporation have an insurable interest in a key employee?
As discussed in a earlier chapter, insurable interest is essentially the expectation of a financial benefit from the continued life of the key employee. Perhaps the key question to ask is as follows; "Does the business expect to benefit financially from its relationship with the proposed insured"?

What is a policy exchange rider?
This is also known as a substitute insured rider. It provides that if the key employee terminates, a new key employee can be substituted as the insured under the original policy. Of course the new employee will have to prove he/she is insurable. There will probably be an adjustment in the cash value, premiums and even death benefit. Because the insurer won't normally apply any extra charges, the company can save on underwriting costs and commissions.

Are the tax implications the same for both a "S" corporation as well as a "C" corporation? As an "S" corporation, shareholders elect to have the income of the business flow through directly to its owners, the shareholders. So, if a death benefit is paid on the life of a key employee, the proceeds will flow federally tax free to the shareholder owners but the basis of each shareholder's stock is increased by his/her share of the tax free proceeds.

If the key employee doesn't own a equity position in the company will a death benefit payout be taxable in the key employee's estate? No. There would be no estate tax inclusion due to the payment of the key employee life insurance proceeds.

Is it possible for a business to fail without key employee insurance?
Possibly. Almost always there are significant costs of searching for, finding, and hiring a successor. Key employee coverage can reimburse the business for those costs.

Under what circumstances would key employee insurance coverage be indicated?
Key employee coverage is usually indicated in a close held company where profits are often dependent on the ability and initiative of a single individual or small group of persons.

Can key employee insurance coverage help put the minds of shareholders of a public corporation at ease? Publicly held companies often use key employee insurance coverage to assure shareholders that the price of the stock will not plummet at the death of a key employee such as the president.

Alternatives to Key Employee Insurance

Prevention

A company or partnership can decide to pursue an aggressive loss control program aimed at preventing the death or disability of key employees. While this is a noble effort, no one can guarantee that such a program will prevent a loss.

Savings Accounts

Some companies believe that they can set aside savings to cove the potential loss of a key employee. Again a noble effort, but there are considerable problems with this theory, such as:

- Timeliness of a savings account
- Monthly or quarterly amounts saved
- Sufficiency of cash available at time of death
- Death of more than one key employee

The last point above raises a very serious issue. What happens if more than one key employee dies. This is not an unrealistic situation as many key employees of a company travel at the same time and a common disaster could occur.

If a business has more than one key employee, and most do, it will have to set up several funds or increase their cash contributions in order to have sufficient funds in the event of the death of a key employee.

Placing cash in a savings account precludes the use of the funds for needed corporate programs. If the company gets into a cash crunch and needs to place their hands on cash quickly there may be a tendency to use these funds first. The obvious problem, of course, is when the cash is being use for another purpose, a key employee dies and the cash needed is not available.

Investments

Investing is another way for a company or partnership to provide liquidity to cover the loss of a key employee. However, such a program assumes that the company is smart enough to place their money in the right type of investments and that the markets will provide favorable returns. The downside is the potential poor performance of the investment account. In fact, it is distinctly possible to end up with a value that may be less than what the company started with. Here is a summary of reasons why investing may not be the answer:

- Cash needed for investments can displace capital needed for the company
- Choosing appropriate investments is difficult
- Positive investment account results may vary
- Possibility of a down market may wipe out the account completely
- Lower returns because of interest rates may reduce desired results

Just like cash savings accounts, investment accounts will probably also fail to provide confidence or enough cash when a key employee dies. Sometimes timing is everything. Not knowing when funds would be needed it would be almost impossible to predict how much needs to be saved or when the funds would be used.

Conclusion

For purposes of providing adequate funds for the continued operation of a company in the most economical way, purchasing key employee insurance is recommended. The company doesn't have to worry about savings accounts, investment accounts, cash flow etc.

BUSINESS BENEFITS

Taking advantage of employment benefits can be an extremely important part of a person's financial planning and a lucrative specialty market for agents. Most benefits fall into three main categories: Insurance options, savings and retirement opportunities and income tax reduction arrangements.

GROUP INSURANCE

When exploring potential target markets, the agent may want to consider group life insurance. There are many differences between individual and group life insurance. These differences basically involve underwriting, marketing and administration, as opposed to the types of protection available.

Underwriting Group Life Policies

When underwriting individual life insurance, the focus is on the characteristics of the individual insured. By contrast, in group insurance, the underwriter evaluates the characteristics of the entire group of persons to be insured. Typically, the characteristics of individuals within the group are not considered in underwriting a group policy.

The Policy Owner

With an individual life insurance policy, the policy owner is an individual. In a group life insurance policy, however, a master contract is issued to the group plan sponsor. For example, when an employer provides group life insurance as part of its employee benefits plan, the parties to the master contract are the employer and the insurer. Of course, an employee covered under the plan has certain rights conveyed by the policy, but he is not the owner of the policy.

Marketing a Group Life Policy

We know that individual life insurance policies are sold on an individual basis. A significant part of the premiums collected during the first year are allocated for marketing expenses. Also, each policy requires that an individual record be kept and individual billing be maintained by the insurer.

On the other hand, with a group life insurance contract, these marketing and administrative expenses may be spread over the premiums charged for many persons under a single group policy. Further, the group sponsor often takes on some of the responsibilities for record keeping. Ultimately, this results in a lower cost than when compared to individual coverage.

Premiums & Rating a Group Life Policy

Premiums for group policies are determined by experience ratings. Using experience ratings, past losses sustained by the group are taken into consideration when determining the amount of policy premium. Generally, the larger the group, the greater the value placed on previous loss experience.

Groups Eligible for Coverage

Group insurance practices are regulated by the individual states. These regulations define the kinds of groups eligible for group life insurance coverage. Naturally, the regulations vary between states. However, the following list represents the organizations most commonly eligible to sponsor a group plan:

Employers

Those eligible for coverage by an employer-sponsored plan include current and retired employees of the business and its subsidiaries, directors of a corporation, partners, sole proprietors and independent contractors. In addition, some states permit dependents of employees to be covered.

Unions

Union members may be covered under a master contract issued to a union.

Creditors

Organizations in the business of making loans may qualify as a group. These include banks, mortgage companies, credit unions, finance companies, etc.

Other Groups

This includes professional, trade and veterans associations, as well as alumni, religious and social groups.

Group policy practices are regulated individually by the states. While these regulations may vary, the following represents the requirements most often imposed on group life insurance underwriting:

- The insurance must be incidental to the group. To avoid adverse selection against the insurer, the purchase of group insurance must be incidental to the purpose of the group. A group whose purpose is to purchase group life insurance likely consists of individuals whose health has prevented them from purchasing individual coverage at standard premiums.
- The group must meet minimum size requirements. Many states specify a minimum number that must comprise the group. Typically, this number is ten members.
- The group must meet minimum participation percentages. When an employer sponsors a plan and pays the full premium, 100 percent of eligible employees may be required. These plans are called noncontributory plans because the employee does not contribute to the cost of his coverage. A contributory plan is one in which employees contribute toward the cost of their coverage. Under a contributory plan, about 75 percent of eligible employees are usually required to participate in the plan.
- The insurer may have its own requirements. Insurers who underwrite group life insurance may have their own requirements in addition to the statutory requirements.
- Group composition is a consideration. Insurers take into consideration many factors such as the age, sex and other determinants.

- The stream of persons through the group is a consideration. From the insurer's perspective, a group should be ideally composed of individuals of many ages. This results when younger people continually join the group as older people leave. This permits the average age to remain relatively stable. The result is that the group's loss experience also remains stable, allowing an accurate prediction of loss costs and required premiums.
- Group size and persistency are considerations. When the group's size is large and maintained over a long period of time, the insurer can predict long-term loss costs.
- Sponsor cooperation is a consideration. Naturally, insurers prefer groups where the master contract holder is willing to provide assistance in the daily operation of the plan and share in the cost of coverage for plan members. In doing so, the contract holder has an incentive to control the cost of the plan.

DISABILITY INCOME INSURANCE

Many people are concerned about their disability income insurance. Disability income insurance is a means of insuring against catastrophic long-term disability. While many people have some sort of disability income insurance through their employers, many others do not. Even for those who are fortunate to have such insurance coverage, in most instances, it is not sufficient.

If a person suffers a serious illness or injury, his health insurance will pay most of the costs associated with the illness or injury. However, if that illness or injury keeps him from working for an extended period of time, he will likely lose income while the bills continue to roll in.

Disability income insurance can provide much-needed cash if a person is unable to work. The more exposed a person is to a loss of income, the more he needs disability income insurance.

When purchasing disability income insurance, the client pays a specified amount in annual premiums for a certain amount of disability benefits. While it is important to purchase enough coverage, it is also important not to buy too much coverage.

The greatest asset a person possesses is his ability to earn a living. This ability must be continual. The ability to provide for oneself and for one's family has the potential for earning a small fortune over a lifetime when multiplying annual earnings by the number of years a client can expect to work.

Average earnings are the most accurate way to measure earnings potential. For example, suppose a husband at the age of 35 has an estimated average annual income of $55,000. By the time he reaches age 65, he will have accumulated $1.65 million. Over this period, these dollars will provide for food, clothing, health care, transportation, savings and investments, education funds, luxuries, vacations, retirement and other necessities and luxuries.

Unfortunately, many people will be prevented from earning this wealth in their lifetimes because of a prolonged disability. For example, for people at age 35, the statistics tell us that 24 percent of them will become disabled for a period of 90 days or longer before reaching age 65. Further, the average duration of severe disability for Social Security benefits is 12 years. That is, once a person is disabled, he typically stays disabled for an average of 12 years.

With a disability income insurance policy, the client pays for a fixed amount of disability benefits, which are usually expressed as monthly income. The gap between the total anticipated income and the total anticipated expenses is what the family will need to live on or to get by without hardship, in the event of a disability. This gap represents the amount of disability income insurance a client needs to purchase.

Defining Disability

Defining disability within the terms of the policy is vital to the insured. In most policies, disability is generally defined as the "inability to engage in gainful activity by reason of a medically determinable physical or mental impairment that can be expected to last at least 12 continuous months or to result in death."

Some policies require total disability. Such a policy might state that if the insured can work at any job for which he is "reasonably suited by education, training and experience," then he is not considered to be disabled.

For example, a lawyer might be forced to teach school. Under a policy requiring total disability the lawyer could be reasonably suited for this. However, if this lawyer had to resort to being a janitor, he could be eligible to receive benefits. In this case, his education, training and experience would make him suitable for a more exacting type of work than performing janitorial duties.

In recent years, some disability income insurers have offered policies in which the insured is considered disabled if he cannot perform his own occupation, even if he may be able to do some other type for which he is qualified.

An example is a well-respected surgeon who would be forced to practice some other form of medicine than that for which he has been trained. These types of policies usually state that the insured is entitled to benefits when he cannot perform the "material and substantial duties of his primary occupation."

Naturally, this type of coverage is more costly than other types of disability income coverage, usually by about ten percent. For those who are in highly specialized fields, it is probably worth the cost. Essentially, such an occurrence like the one described above is exactly the sort of tragedy that disability income insurance is intended to prevent.

This type of coverage usually appeals to the client who feels that his work is so specialized that he must have the best possible coverage. For most clients, however, the more traditional and less expensive disability income coverage is probably satisfactory.

The Consequences of a Disability

Naturally, a person who is healthy, working and has a steady income has many routine expenses. The difference between this person's income and his expenses is what he saves. If an unfortunate disability strikes due to some illness or accident, a worker may be confined to a bed, a wheelchair or he may be housebound.

In such a case, two things happen. First, he is not able to work. Secondly, he is not able to earn money to pay his ongoing expenses. His normal income will decline or possibly even cease. An illness or accident usually causes expenses to increase. The result is that debt commences. This worker absolutely must get well. To get well, he needs time and money.

The question is where this money will come from. Some sources are:

- The worker may have some money coming from his salary or sick pay, but this amount is limited.
- The worker may have some savings, but these funds, too, are limited. Further, an extended disability can quickly deplete a savings.

The worker may be able to borrow funds to live on during his disability. He would have to borrow from family or friends, though, since he probably could not get a loan while he is not working. Regardless of where the funds might come from, the money would eventually have to be repaid.

The worker may have some assets to sell, however, he is not likely to get a fair price for them in a pinch. Still, these assets would eventually be depleted also.

Therefore, a plan for disability income is essential. The premium payments for disability income insurance are relatively small, considering the alternatives. Disability income insurance can create a fund for sustaining the flow of income when it is needed.

A disability plan is flexible. It can be used to provide almost any annual income for a specified benefit period, up to age 65. Naturally, this corresponds directly to the amount of the premiums paid.

Disability Income Benefits

Disability income benefits are normally expressed in terms of percentages of annual income. The table below illustrates the disability income benefit as it relates to annual income. For example, for the person earning between $15,001 and $20,000 per year, his disability income benefit would be 70 percent of that amount, or between $10,500 and $14,000.

Annual Income Benefit

Annual Income	Benefit
$ 15,001 - $ 20,000	70%
$ 20,001 - $ 30,000	65%
$ 30,001 - $100,000	60%
$ 100,001 - $200,000	55%
$ 200,001 - $300,000	50%
$ 300,000+	45%

To determine the amount needed for disability income, if married, the husband's and wife's needs should be determined separately. Factors for consideration are the objectives of the income and the sources of current income.

Likely, a client will need disability income in addition to amounts being provided by his employer, if any.

A recent study was conducted by the U. S. Bureau of Labor Statistics analyzing typical income objectives required to permit a worker to maintain his present standard of living after the onset of a disability. The Bureau found the following:

"Because most disability income is generally tax-free, a wife at age 35 whose present income is $42,000 would need 65 percent of her present gross income, or $27,300. Assuming that Social Security would be paid if she were disabled, the average benefit paid until the youngest child turns age 18 is approximately $21,000 annually. When the youngest child reaches 18, this amount is reduced to approximately $14,000 annually. This represents an annual income shortage of $6,300 at the onset of a disability."

This is a fair and impartial illustration that may be used by the agent when discussing the need for disability income insurance.

Why One Should Consider Disability Income Insurance

A client's need for disability income insurance depends on his circumstances. However, there are many current trends that make it necessary for all individuals to strongly consider the need for disability income insurance.

For example, medical science has made great strides in recent years. While the mortality rates from diseases such as hypertension, diabetes, arteriosclerosis and heart disease have decreased, the morbidity rates from these conditions have not. Morbidity rates refer to the relative incidents of disease. Morbidity rates are up approximately 60 percent.

Essentially, this means that we are more likely to survive illnesses and diseases than die from them. However, as a result, we often lose our ability to remain productive.

To illustrate, suppose a person had a sufficient amount of life insurance to protect his family in the event of his death. For example, if he suffers a massive stroke or is involved in a major traffic accident, he has a better chance of survival because of our advancements in medical technology. Not so long ago, the more likely situation would have been that the life insurance would have paid off.

Fortunately, today's modern medicine can save him. From a health perspective and from his family's perspective, it is a miracle that he has survived. From a financial perspective, however, the life insurance, in this particular situation, has served no purpose. This person is not able to earn an income. Therefore, his family suffers, doing its best to meet its daily expenses. Further, medical expenses have increased during this time.

Further consequences of the lack of disability income insurance involve debt burdens. These have changed greatly in recent years. During the 1980s, Americans began to borrow heavily, and this increased the ratio of their debt to their current income. It is not uncommon for individuals and families to carry a mortgage debt, an automobile debt, credit card debt, etc. Given the current average debt burden, most people may not be able to survive a period of six months to one year without income.

Finally, the issue of working couples must be discussed when examining the consequences of the lack of disability income insurance. If both spouses work, the family's standard of living depends on two incomes. A disability for either of them could be financially devastating. There are two incomes which may need protection.

Who Might Suffer a Disability?

The Society of Actuaries tells us that more than 50 percent of all people who are age 35 will suffer at least one 90-day disability before age 65. Even among those 50 years of age, more than 35 percent will be disabled at least once by age 65.

Further, if a person is not back to work within three months, the chances are that he will be out for a much longer period of time. The average duration of these long-term disabilities is more than five years at age 35 and more than six years at age 50.

It must be pointed out that those individuals whose occupations involve physical labor are much more likely to sustain injuries that cause long-term disability. Conversely, white-collar workers are not so prone to suffer these work-related disabilities. Their chances of sustaining such a long-term disability is approximately four percent. Even this bears some strong consideration.

Further, AIDS and other epidemics affect all people. Also, in today's highly driven society, stress-related illnesses such as heart attacks and even psychologically manifested diseases are more prevalent among executives, managers and other white-collar workers.

To illustrate, suppose a salesperson suffered back pain. While he might hurt, he could probably go to work during this time and continue to make his living. However, that same back pain could make it impossible for a computer operator to sit in one spot and work a full day.

When both spouses are working, a short-term disability would probably not bring tragedy. Likewise, wealthy families might not be so severely affected. However, if a longer-term disability strikes and the family is not wealthy, financial tragedy could result. Long periods of time without income, or reduced income, could cause great financial misfortune. If there are dependents involved, not providing disability income insurance is risky.

Determining the Amount of Disability Insurance Income

Deciding how much disability insurance income is needed can easily be done. There are three steps to this process:

1) Determine need.
2) Determine potential income and outflow of funds.
3) Measure the necessary amount of disability insurance income.

Determine Need

Need is simply determined by the amount of income a client must have each month to meet his minimum obligations. Similar to assessing the life insurance need, the client can most effectively determine his monthly requirements through an audit of his checkbook register for the previous 12-month period. This shows how much is actually spent. The client must ask himself how much he would need to keep spending in the case of a long-term disability.

Mortgage payments, car payments and credit card payments would probably continue. If the family has two cars, they might have to sell one in the event of a severe disability. Of course, utilities and property taxes would continue as before. Still to be considered are food bills, although these could be decreased. Entertainment and vacation expenses would have to be eliminated or reduced. New clothing cost for all family members would probably have to be put on hold. Private tuition costs would probably have to be eliminated. This assessment continues until the client can determine, within a close estimation, how much income his family would need in the event of severe disability.

Determine Potential Income and Outflow of Funds

The purpose of this step is to calculate how much income the client can expect in the event of a long-term disability. Is there a spouse who works, or is there a healthy investment portfolio that could be tapped? Are there IRAs, Keoghs or other retirement plans to access, if necessary? Is there investment property that might produce some income? Could this property be sold to invest the proceeds in instruments with greater returns?

When calculating ongoing income, the client must use after-tax figures. While it is accurate to say that the client's tax bracket will be likely lower if he is unable to work, he must still take into consideration the fact that state and federal income taxes and Social Security tax on a spouse’s earnings can take up to 20 percent of gross income.

There are other sources of possible income in the event of a disability. These may be an employer, Social Security or Workers' Compensation. Although these are valuable plans and will be greatly appreciated if they must be called upon, these plans are by no means complete.

Measure the Necessary Amount of Disability Insurance Income

After determining need and income potential and the outflow of funds, the next step is to determine how much disability income insurance is necessary. The gap between what the client is likely to need and what he is likely to have is the amount of disability income insurance he will need.

For example, suppose a client earns $10,000 per month, or approximately $8,000 per month after tax. After doing the calculations described above, the result is that the family can get by on $6,000 per month, in the event of a disability of one of the spouses. If $4,000, or approximately $3,000 after taxes, is derived from the second step as the potential income during the time of disability, the amount of disability income insurance protection the client needs is $3,000 per month.

Naturally, this amount only serves this person with these particular circumstances. Another client might have the same income and an identical need for $6,000 per month. However, he may have no investments, spousal income or employer support. Therefore, his need for disability income insurance would be greater.

The Cost of Disability Income Insurance

Naturally, the greater the disability benefit, the greater the cost of the policy. Therefore, it is important to purchase as much protection as necessary and, at the same time, avoid overpurchasing. Overpurchasing results in paying more than necessary.

The general rule within the life insurance industry is to purchase enough disability income insurance sufficient to replace 60 to 70 percent of the client's income prior to his disability. This seems practical, since with benefits as much as 100 percent, there would be no incentive to return to work. On the other hand, benefits must be sufficient to support the client until he can return to work.

It is important to remember that all circumstances are different. Every attempt should be made to sell enough disability income insurance, without overselling.

Selecting a Disability Income Insurance Policy

After establishing the need for disability income insurance, the next step is selecting the right policy. First, the client must examine any existing disability income insurance he may have, for example, through his employer.

The best approach to selecting a policy is to accept that the most efficient policy will allow the client to pay for small expenses himself in exchange for purchasing protection against a disaster. If the client is out of work for only a few months, he will probably be able to cover himself with his resources such as savings, lines of credit, reducing unnecessary expenses, etc. The disability income insurance should be used to get him through a longer period of time when his income ceases or is reduced substantially.

Qualifying for a Disability Income Insurance Policy

To qualify for a disability income insurance policy that will pay the desired benefits, the insured must be able to prove a certain level of income. He will also have to pass a medical exam to qualify for coverage. If he qualifies, he will probably pay the same level premium each year. However, the premium amount will be higher the older the client is when applying for coverage.
Just because a person recognizes his need for disability income insurance does not necessarily mean that he may qualify for any policy he wants. Insurers examine a prospect's income, medical history, age and other factors before determining whether he qualifies for the policy he requests.

For example, suppose using the previously described steps, a client learns that he requires approximately $3,500 a month in disability income benefits. To qualify for this amount of benefits, he will need to show that he has the corresponding income. In this case, he will need to show that his income is $5,000 per month. Insurers do not generally provide benefits exceeding 60 to 70 percent of the predisability income.

Suppose the prospect is self-employed and reports a gross income of $5,000 per month. After he deducts his business expenses, his net income may only be about $3,000 per month. This person will not likely be able to qualify for a $3,000 monthly benefit. In such a case, there is the obvious incentive to cease working full time to simply collect the disability benefits. Benefits in this amount are nicely adequate to support a $5,000 gross monthly income, but not a $3,000 net monthly income after expenses.

From the client's perspective, he should purchase as much disability income coverage as he needs without purchasing too much. From the insurer's perspective, the objective is the same.

If a person is unemployed, he will not be able to secure disability income insurance at all, since he cannot prove a need to replace income in the event he becomes disabled.
In addition to qualifying for disability income insurance based upon earnings, the prospect will also have to qualify for coverage based upon his health. This process is similar to the way in which one qualifies for life or health insurance. However, there are differences in the underwriting process.

While life and health insurance premiums are based on actuarial data concerning all types of health issues and life expectancy, this data on disability cannot be quite so precise. Naturally, while muscular or skeletal disorders might predispose a person to a higher incidence of disability, it is still difficult to predict with certainty if such a condition will cause a disability in the future.

Further, there is no way to predict disability based purely on the result of an accident. The underwriting of disability income insurance is more subjective than with other types of insurance.

Age is another factor considered when qualifying for disability income benefits. The likelihood of disability increases as one grows older. Further, the older a person is when he is disabled, the longer his disability is likely to last. Therefore, the older a person is when applying for disability income insurance, the more he can expect to pay.

Those who recognize a need for disability income insurance should purchase it as soon as possible. Standard disability income insurance is level premium. Its premiums' amounts are constant, as long as there is no change in the level of benefits. A client who purchases disability income insurance while he is younger can guarantee a lower premium.

Renewability

Some disability income insurance policies are noncancellable. The insurer cannot withhold coverage unless the insured stops making premium payments. The insurer also cannot increase the premium, which might force someone to drop the coverage.

Some disability income policies are guaranteed to be renewable. This means that the premium can be increased, as long as it is increased for an entire class of policyholders.

Other types of disability income insurance policies allow the insurer to drop the coverage, if the insured's health deteriorates.

Waiting Periods

Disability income policies do not begin to pay out on the first day an insured is not able to work. In some policies, benefits commence after seven days of disability. However, these policies are expensive. Some people can support themselves for 30, 60 or even 90 days of disability and, naturally, this results in a much lower premium.

This waiting period is also referred to as an elimination period. Typically, the most efficient elimination period is 30 to 90 days. After 90 days, there is not much benefit. For example, a one-year elimination period reduces the cost of a 90-day elimination period by only about 10 percent.

While for most people, a 90-day waiting period is satisfactory, this, like other elements of disability income insurance, depends on individual circumstances. However, using a longer elimination period to reduce premiums only works to the point where there are other adequate resources to see one through. Also, a 90-day waiting period may actually be 120 days because of the time it takes to receive the first check.

Finally, some policies count total and partial disability toward meeting the waiting period requirement.

Rehabilitation and Retraining

Of course, insurers want the disabled person to get back to work as quickly as possible. Therefore, they often pay for physical rehabilitation. Some policies even pay for occupational retraining when necessary.

Benefit Period

The purpose of disability income insurance is to provide coverage in the case of a catastrophe, that is, if the insured cannot work for a long period of time. Therefore, a policy that pays benefits only for a year or two is not really adequate. Even if cost is an issue for a client, a policy like this is not satisfactory. It does not meet the intention of disability income insurance.

Although a client can significantly reduce his premiums by limiting his benefit period, what if he is one of the few whose disability lasts longer than five years? He and his family could be devastated. The best policy is one that pays benefits until age 65. Under the terms of such coverage, if the insured is disabled before age 65, say at age 60, and is unable to return to work, he can collect benefits for five years.

Lifetime Benefits

By the time a client reaches age 65, disability income benefits may not be useful. This is because he will probably have stopped working by that time, so he will not be losing income if he becomes disabled. Also, at that time he will probably be collecting OASI, plus any employer-provided retirement funds.

However, for a small additional premium, about 10 to 20 percent, the client can purchase a disability income policy that will pay lifetime benefits. This is important if the client is in his 20s or 30s and has not worked long enough to qualify for much in the way of Social Security retirement benefits, or if he has not had an opportunity to build up any type of pension benefits.

Some "lifetime benefits" clauses will pay out for a lifetime, only if the client is disabled prior to age 60. Some are even more complicated. For example, if the client is injured after age 55, the benefit will decline by 10 percent per year after age 65.

Recurrent Disability

A recurrent disability is typically one that recurs within six months from the original disability. It occurs when, for example, a disability income policy has a 90-day waiting period. The insured cannot collect benefits until after that time. If he suffers a stroke and misses six months' work, he collects his disability income benefits only for the final three months. If he returns to work, has a relapse and misses three more months of work, this is where recurrent disability begins. In this situation, the insured would collect benefits without going through another 90-day waiting period, because this is considered a recurrent disability.

Pre-Existing Conditions and Other Exclusions

The issue of pre-existing conditions in a disability income policy is similar to those in most health insurance policies. Generally, the applicant for a disability income policy must complete a medical history form and take a medical exam. Pre-existing conditions that are discovered may be specifically excluded from the policy for two years. In addition, most disability income policies exclude benefits in cases of attempted suicide, drug abuse and normal pregnancy.

Partial Disability

In some cases, a disability may not be permanent or total. It may permit the insured to work part time. Although his income will be reduced, he may still not qualify for full disability income benefits. Most policies include a partial disability option. When taking advantage of this option, the insured may receive a specified amount if he can work part time.

Typically, partial disability coverage pays 50 percent of the basic benefit. So, for example, if the policy calls for $3,000 per month, the partial disability option would pay $1,500. This benefit is paid for a shorter period of time, usually not exceeding six months. Because of today's medical technology, most disability income claims are for partial disability.

Residual Disability

In addition to partial disability provisions, most disability income policies also offer residual disability provisions. Residual disability benefits are based upon lost income. For instance, after a disability, most people will go back to their previous occupation. However, the insured may be able to return to his previous occupation or profession, but only on a limited basis. This situation is covered by residual disability benefits. Residual disability benefits are also referred to as full recovery benefits.

Under this option, if the client's earnings are reduced, he may receive partial compensation, up to 80 percent of the full disability income benefit. Residual benefits cease when the income reaches 75 to 80 percent of the pre-disability earnings. In some policies, the insured must be totally disabled before collecting residual benefits. The greatest benefit of this feature is that the insured does not lose all of his benefits if he goes back to work part time.

The Future Increase Option

Suppose an ambitious young executive earns $3,000 per month and, using the calculations we have learned, purchases a policy that will pay him $2,000 per month in disability income. Further, suppose that 15 years later he is successful and earning $16,000 per month. His original policy will not take him very far toward his current obligations and debt.

The solution to this dilemma is for the insured, when he purchases his first disability income policy, to also purchase an option entitling him to step up his coverage. To illustrate this step-up option, if the insured gets a 10 percent raise, he can automatically increase his disability income benefit by 10 percent and by paying an additional 10 percent premium. No physical exam is necessary to qualify for this additional benefit. The only requirement is to be able to prove the additional necessary income.

Even if the insured does not choose this option, some policies automatically adjust the monthly benefit upward, regardless of income. This adjustment is intended to reflect changes in the Consumer Price Index. Naturally, the premium increases also.

Cost of Living Adjustments

The cost of living adjustment (COLA) is different from the future increase option discussed above. The future increase option offers the insured the opportunity to increase his coverage before he becomes disabled. The cost of living adjustment, on the other hand, is an option that increases the coverage after the disability.

For example, suppose five years into a disability, an insured is still disabled. Without the cost of living adjustment option, he would be collecting the same amount of benefits in the fifth year as he collected in the first year. There is no allowance for inflation. With the cost of living adjustment option, if the Consumer Price Index has risen 2 to 5 percent each year of the insured's disability, his benefits would automatically be adjusted to take these increases into consideration. The cost of living adjustment applies to partial disability and residual benefits.

The Social Benefits Rider

The social benefits rider is a feature that permits the insurer to reduce the monthly benefit it pays by the amount that Social Security would pay, if the insured were eligible for Social Security benefits. In return, the insured pays a lesser premium.

For example, instead of purchasing a $3,000 per month disability income policy as prescribed by the formula discussed earlier, the insured might purchase a $2,250 per month base policy, plus a $750 per month social benefits rider. If he becomes disabled, he would collect $2,250 each month from the insurer and $750 from Social Security.

Without selecting the social benefits rider, the insured would be entitled to collect $3,000 from his basic disability income policy in addition to any Social Security benefits for which he is qualified.

The Social Security Supplement

The Social Security supplement is separate and distinct from the social benefits rider. When employing the Social Security supplement option, the insured can collect an extra payment until his Social Security disability payments begin. This can add anywhere from 10 to 25 percent to the premium.

Nonoccupational Coverage

Nonoccupational coverage is usually aimed at labor or "blue collar" policyholders. These policies cover only injuries and illnesses that occur off the job. Therefore, if a person can collect workers' compensation, nonoccupational policies do not pay disability income. The insurer's risk is reduced, and the premiums for nonoccupational coverage are naturally lower.

The Waiver of Premium

The waiver of premium option is frequently added to life insurance and disability income policies. Essentially, if the insured suffers a disability and collects disability income benefits, he may skip paying his premiums until he is back to work. If premiums are prepaid, the insured may be able to collect a refund for the premiums that have already been paid.

Presumptive Disability

Some policies offer a presumptive disability feature. Using such a feature, for the purposes of collecting disability income benefits, the insured is considered disabled if he loses his sight, hearing, speech, two limbs, etc. He may continue to work in spite of his disability. Even if he continues to work, he can still collect disability income benefits if he has selected the presumptive disability feature.

Accidental Death and Dismemberment

Some disability income policies make available a large sum to the insured or his beneficiaries if the insured dies in an accident or loses a limb, his eyesight, etc.

The Return of Premium

Under the return of premium option, if the insured never collects on a disability, he gets some of his premium payments returned to him, typically about 80 percent. Or, if the insured makes small or only a few claims, he may receive less than 80 percent back. Some insurers make these refunds in scheduled intervals, e.g., every five years. Others require the insured to wait until age 65.

Naturally, a return of premium policy is more expensive than a standard disability income policy. Also, these policies frequently have surrender charges until age 65.

Annual Renewable Disability Income Policies

An annual renewable disability income (ARDI) policy to disability insurance is like term insurance is to life insurance. Permanent life policies have level premiums, while term life insurance policies have increasing premiums. However, term premiums are much lower than permanent life premiums, especially in the initial years of the policy.

Annual renewable disability income policies perform in much the same way. Premiums start low, and then they increase. They are especially suited for those clients who have bright futures but are just starting out.

However, after several years, annual renewable disability income policy premiums may be higher than regular level premium disability income insurance. Therefore, these types of policies are really a short-term fix. Typically, they are selected with the hope that the client's income will increase and he can afford to purchase a level premium policy.

To illustrate, suppose a $5,000 per month disability income policy with a 90-day waiting period and a moderate amount of extra features costs $1,500 per year at age 35. By comparison, an annual renewable disability income policy might cost only about $1,000 the first year and increase 8 to 10 percent each year. After several years into the policy, the premium could advance to a point where it becomes so high that the client should convert it into a level premium policy. Or, he might take out a brand new level premium annual renewable disability income policy, if his health permits.

Annual renewable disability income policies can be a fine way to save money on disability income coverage, even if it is only a short-term approach. A modified approach to annual renewable disability income is step rate coverage. Using step rate coverage, a multi-year schedule is part of the insurance contract. This schedule usually takes place over a period of five years. Initial premiums are much lower than the more traditional, fixed premium policy contracts.

Converting Disability Policies Into Long-Term Care Policies

There has been a recent trend within the insurance industry to convert disability income insurance policies into long-term care policies. This is because in most situations, an insured reaches retirement age with his disability income policy still in force.

Some insurers permit the insured to convert this policy into a long-term care policy. Essentially, if the insured becomes disabled after his retirement and must enter a nursing home, this policy will provide benefits, such as nursing home costs, instead of providing income replacement benefits.

These types of policies are similar to other kinds of convertible insurance. As long as the insured keeps making premium payments, coverage cannot be denied.

Using Social Security and Employer-Provided Benefits as Selling Tools

In 1935, the Social Security Act was created to provide a nationwide program of benefits to workers. The Social Security Act came about from observations of tragic events associated with the elderly, such as disability, loss of earning power and their dependency on public or private charities. It was intended as an insurance plan that would avoid some of the personal hazards and social problems which naturally came with old age.

The Social Security program has been greatly expanded since its beginning. The Social Security system encompasses the following benefit programs:

Old Age and Survivors Insurance (OASI)

These are retirement and survivors benefits. These benefits are conditioned upon the attainment of retirement, age or death. Those eligible for benefits under this program are retirees, disabled workers, dependents and survivors.

Disability Insurance (DI)

These are disability benefits. All disability benefits cease at age 65, and regular full retirement benefits are paid. This disability must not be connected with a work-related injury or accident.

Hospitalization Insurance (HI)

This coverage takes the form of Medicare benefits.

Supplemental Security Income Benefits (SSI)

This program provides financial assistance to those who have limited income and resources.

While these benefits are better than nothing, they do not go far enough. When a client accepts this and recognizes the potential shortfall if he relies on Social Security benefits alone, he is in a good position to appreciate the need for added coverage, the type of coverage that disability income insurance can provide.

GROUP LONG TERM CARE

The workplace long term care market is braced for a major expansion as more companies begin to realize its importance. For example, the annual cost to companies for lost productivity from elder care responsibilities is $17 billion a year or $3,142 per employee. By the year 2020, one in three workers will provide some type of elder care.

It is significant that for every person receiving care in a nursing home, there are four people receiving care outside a facility. In some states, that care is reflected by as much as 40 percent absenteeism from major employers. Elder care issues are being resolved by family members trying to take up the slack. Family members are required to care for elderly moms, dads, aunts, and uncles many times over because these individuals have failed to invest in a long-term care insurance policy.

Many companies are now offering employees, their spouses, parents, and in-laws group long-term care policies, and the number of persons who are enrolling in the long-term care policies is

rising rapidly. Under most plans, even though the premiums may be paid solely by employees with no employer contribution, coverage for active employees, and possibly spouses, can be guaranteed.

Under some plans, insurers apply underwriting standards to each employee, and coverage is not guaranteed. If a policy holder has controlled hypertension, for example, he may be automatically rejected, even though he would qualify for an individual policy.

Many group buyers are in their forties, attracted by premiums that may be only a few hundred dollars a year. Buying group insurance when an individual is in his forties, when he may not need the coverage until he is 80, can be risky. The health care delivery system is changing very rapidly so that if the company does not upgrade the policy, by the time the policy holder is 58, he may have to purchase a new policy. When an employer provides an opportunity to enroll in a group long-term care insurance plan, the employer will want to evaluate an individual policy along with the group coverage benefits and features. If an employee decides to enroll with the group long-term care insurance, he should inquire whether the coverage available in case he leaves his employer. Employers can offer continuation of coverage or conversion options to employees, and these employees may not have to pass any medical requirements.

How Group Long Term Care Policies Work

Group policies are an option for long-term care insurance in addition to buying an individual long-term care policy. For example, large employers increasingly offer long-term care insurance as a fringe benefit. Employer sponsored long-term care insurance is not a basic benefit like employer sponsored health insurance. Long-term care insurance may not be offered as a qualified benefit under a cafeteria plan. Employer provided coverage for long-term care services provided through a flexible spending arrangement will be included in the employee's gross income. Employees may choose long-term care insurance from a list that includes other benefits.

A few employers contribute toward the costs, and a some even pay the full cost. In some cases, employees pay all costs. However, since the employer creates a group for the contract, employees pay relatively low premiums. These premiums can be 20 to 30 percent lower than individual rates.

Group Benefit Models

Group policies can be identical to individual policies, but they are not required to meet the same regulations. Many people have private insurance when they reach age 65 that may be purchased through their employer or their spouse's current employer or union membership. If an individual has such coverage, he must determine whether the coverage can be continued when his spouse retires. Group health insurance that is continued after retirement usually has the advantage of having no waiting periods or exclusions for preexisting conditions. The coverage is usually based on group premium rates, which may be lower than the premium rates for individually purchased policies.

Under a group long-term care insurance policy, an individual qualifies for benefits when the doctor provides information that demonstrates that the policy holder needs personal assistance with two or three of the following activities of daily living:

Bathing, continence, dressing, transferring, toileting, and eating needs

Group long-term care coverage is designed to help protect assets, lifestyle, and peace of mind by providing benefits for medical problems or chronic impairments which require long-term nursing care. This can include nursing home care or home health care.

Group Long Term Care Policies and Small Businesses

Some insurance companies give smaller employers access to the lower premiums paid by large groups and self-insured organizations. Some states permit associations, small business alliances, or purchasing cooperatives to provide insurance to small companies in order to reduce the cost of group long-term care.

In addition, within the insurance industry, it is thought that smaller employers should be able to purchase insurance free of costly, state imposed mandates to cover wide ranging medical services. Extending the Employee Retirement Income Security Act (ERISA) downward would allow the smallest companies to reap the same benefits of self-insurance as larger companies. These reforms would be relatively easy to enact. And they would solve the problem of portability while allowing the insurance industry to continue doing what it does best, price and manage risk.

If an individual has a spouse under 65 who was covered under a prior policy, he must determine the effect the continued coverage will have on his insurance protection. Further, since employer group insurance policies do not have to comply with the federal minimum benefit standards for Medigap policies, it is important to determine what coverage the specific policy provides.

Advantages and Disadvantages of Group Long Term Care Policies

A disadvantage to the group long-term care policy is that the employee may wind up paying the cost of the long-term care policy, with little or no subsidy from the employer. Further, when an individual buys a group policy, he has no flexibility. For example, if the employer chooses a 30-day waiting period and a four-year payout period, that's what the individual policy holder is purchasing.

The advantage to a group plan is that the company's benefits specialist is checking on the quality of the insurer and the comprehensiveness of the coverage. Group policies may be 20 percent to 30 percent less expensive than individually purchased policies, mainly because selling costs are lower. Group policies may not require physical exams of the employees. This can be valuable if one wants to be insured in his 50s or 60s with diabetes, asthma, high blood pressure, or some other condition. Companies typically screen policies before selecting one, which helps their employees make choices in this complex field.

Another advantage is that the group long-term care policy premiums are generally fixed for life. The are portable if the employee leaves the company for another position or if he retires. Through a group employer's plan, an individual can cover a spouse and perhaps even a parent. This is a limited benefit, however, because secondary persons to be covered must have extensive physical exams.

Many group policies offer a return of premium, sometimes called ***nonforfeiture benefits.*** However, the insured will pay a higher premium for this benefit.

Employer groups are meeting only a small fraction of the need for group long-term care policies.

Under the ***higher level of care requirement*** , policies may require prior hospitalization before paying for nursing home care, or they may require skilled or intermediate nursing home care before paying for custodial or home care. While these limitations may make the policies more affordable, they may also make them less effective in meeting policy holders' needs. Therefore, it is essential that an insurance agent enable his client to become familiar with the specifics of any group long-term care policy that he considers purchasing.

Group Long Term Care Policies and the Kennedy Kassebaum Bill

The Kennedy Kassebaum bill will help one out of four Americans who have long-term care group policies and are caught in "job lock," afraid to change jobs or start their own businesses because they have preexisting conditions that would prevent them from obtaining new insurance coverage by limiting preexisting condition exclusions. Under the Kennedy Kassebaum bill, insurers may not deny coverage or impose preexisting condition exclusions for more than 12 months for any condition diagnosed or treated in the preceding six months, that is, if they have maintained continuous coverage with no more than a 63-day gap in coverage.

However, the bill does little to assure that an individual can afford these policies. This legislation does nothing to help the millions of Americans who are not covered by their employers or by any public program or who are unable to afford private coverage. The bill prohibits insurers from denying coverage or charging higher premiums to individuals in group plans who are in poor health. It prohibits insurers from refusing to sell plans to small employers who have from two to fifty employees.

Key Long Term Care Points To Be Considered

Some key points to be considered from an insurance consumer's prospective are:

- Premium costs
- How long has the company been writing this insurance?
- What is the history on pay outs?
- What is the company's history of premium increases?
- What does the insurance cover?
- What is the coverage with respect to nursing homes?
- What is the coverage with respect to home care?
- When does payment coverage start, day 1, day 30 or day 100?
- How does this fit with managed care coverage or Medigap insurance coverage?
- For how many years can benefits be received?
- How are preexisting conditions treated?
- How much is paid per day?
- Are benefits indexed for inflation?
- How is the indexing calculated?
- Under what conditions are premiums waived?
- What medical benefits are covered, besides basic nursing home costs?
- How many days must a policy holder wait before coverage starts?
- What is the daily maximum?
- What optional benefits are available?
- At what cost are optional benefits available?

Providers vary in the levels of care they provide, charges for services, and their policies. It is a prudent for potential policy holders to check out several different providers before making a final decision. Other considerations for evaluation are:

Residential facilities:

- Visit the facility unannounced several times and at different times
- Ask what levels of care are provided in the facility (total care, assisted living, occasional assistance, independent living)
- What type of health care and social services are provided
- What staff qualifications must be met
- Approximately how many doctors and nurses available at various times
- Listen to the staff talk among themselves
- Observe the way the staff and residents interact with one another
- Ask if background checks are done on employees and if they are bonded
- Inquire about employee turnover
- Who owns the facility
- Ask for copies of the accreditation or certification report, recent state inspection reports, the financial statement, the facility's liability insurance coverage
- Visit the rooms and baths
- Ask if there are limits for future increases in charges
- Get a "Plan of Care" stating all the services to be provided and the cost of these services

Home providers:

- Inquire about staff qualifications
- Inquire about the number of care givers to visit
- Will the care giver be the same person each visit?
- Do various care givers confer on a case?
- What kind of training the care givers receive?
- Is someone is available 24 hours a day, and how can they can be reached?
- Be sure the services start immediately after a hospital discharge
- Get a written description of services to be provided
- Get the costs in advance and ask what will be covered.

From an agent's perspective, the importance of having long-term care insurance is important with respect to a client's overall long-term needs. Long-term care insurance an important part of long-range financial security. The alternatives to buying a long-term care insurance policy are not attractive since accumulating sufficient funds to cover long-term care needs is simply not practical for most people.

RETIREMENT PLANS

Most people today live to retirement age. However, not so many of them actually retire successfully in terms of income. Although many retirees continue to work (many because they prefer to work), their earned income often incurs penalties by reducing their Social Security benefits. Without income from working, retirement income must come from Social Security, employer-sponsored pension plans, individual pension plans or savings and investments.

Life insurance can be an excellent way to help clients accumulate money for retirement, so that when they do stop working, there is sufficient money to produce some income. Successful retirement requires planning and a disciplined saving program.

The first step toward offering retirement benefits to a client is to determine what his estimated needs will be when he retires. This analysis is similar to the one performed for determining disability benefits.

Determining Need

A client's need at retirement is determined by the amount of income he must have each month to meet his obligations.

Determining Potential Income

This step calculates how much income the client can expect at the time of his retirement. All Social Security benefits, IRAs, Keoghs, pension plans and other retirement plans are included to determine his potential income.

Determining the Gap

After determining the need and the potential income for a client during his retirement years, the gap between what the client is likely to need and what he is likely to have is the amount of retirement coverage he must have.

Estimating Benefits

A knowledge of estimating retirement benefits is essential to determining the amount of insurance needed to fund a retirement plan. Within the Social Security Administration, rules of eligibility status determine who may receive benefits and when these benefits may be received. However, these rules do not determine the amount a person will receive. There are tables available from the Social Security Administration that are available for this purpose.

Any benefits from retirement plans that a client is already involved in are typically easy to calculate. If the plan is an IRA, a Keogh, an annuity or an employer-sponsored plan, the projected interest rates can simply be calculated based on contributions. The result will be a rough estimate of benefits at retirement, but they will be close enough.

Social Security benefits are a little more difficult to determine, however.

If a retiree or a surviving spouse must work to supplement his Social Security benefits, the result may be the loss of all of these benefits if the earnings exceed the exemption limit.

This fact is important for the agent to point out. Lack of retirement planning can cause severe hardship for workers and their families during a time that should be an easy one for them.

This earnings exemption is based on the worker's age. For example, in 1996, workers under the age of 70 but over the age of 64, could earn up to $11,520 and not lose any benefits payable for the year. Workers who were under age 65 could earn up to $8,280 and not lose any benefits payable for the year.

These annual earnings exemptions are increased automatically to keep pace with rising wage levels. After age 70, there are no wage limitations. The beneficiary is no longer penalized for any excess earnings. Earnings include wages, bonuses, commissions and fees from all kinds of work, whether covered by Social Security or not.

Many types of income do not count as earnings at retirement, however. These include dividend income, interest, annuities, pensions and retirement pay, life insurance proceeds, disability plans, hospital and medical expense plans, jury duty, contest prizes and rental income from personally owned property. A person may receive any amount of investment income without the loss of Social Security benefits.

Taxation of Benefits

Social Security benefits may be taxed up to one-half, if the income through the year exceeds the base amount. In 2001, this amount was $25,000 for the single taxpayer, $25,000 for married taxpayers filing separately who did not live together at any time during the year, $32,000 for married taxpayers filing jointly, and $0 for married taxpayers filing separately who lived together at some time during the year.

Base amounts are figured on the taxpayer's adjusted gross income, plus nontaxable interest income and half of the Social Security benefits received. Again, this is a crucial point for the agent to make on behalf of his client.

Social Security as a Selling Tool

Most people know that they have some retirement benefits coming from Social Security, but they typically do not realize how much they are entitled to receive. Unfortunately, most people assume that their Social Security benefits will be generous. They make this assumption based on the fact that they have contributed so many years into the system. Many people are stunned to learn that the Social Security benefits they have been counting on will not permit much more than mere existence.

This fact is a great introduction when talking with a client about using life insurance to fund a retirement plan.

Fortunately, the shortfall of sufficient Social Security survivor income and retirement benefits have invented a sales opportunity for insurance agents. When appropriately

used, offering to explain Social Security benefits can serve as a prelude to explaining how funding a retirement plan with life insurance can address the deficiency of Social Security benefits.

The benefits of Social Security cannot be overlooked. They provide partially for the needs of the client, but they do not go far enough.

In terms of replacing a person's earnings with Social Security benefits, the Social Security program is most favorable to people of lower to middle incomes. This is because the maximum benefit amounts under the program are limited, and the more a person makes above this limit each year, the less replacement percentage these benefits can provide. While everyone receives some benefit from Social Security, its appeal begins to diminish as the level of income increases.

When planning their long-term financial security, clients must be made aware that Social Security is not sufficient to adequately replace existing income. Not only do the benefits themselves not go far, they are likely to be worth even less at retirement, given the increasing costs of living.

Once the client understands and appreciates this unfortunate fact, the agent can introduce the concept of adding additional benefits to an existing benefit base. Helping a client to realize what he can expect to receive from Social Security and to recognize the obvious shortfall can effectively demonstrate the need to purchase insurance to supplement those retirement benefits.

For workers at any income level, the agent has an opportunity to point out that life insurance is an excellent way of funding retirement needs. In fact, it can be the difference between settling for a painfully reduced lifestyle and a financially secure future.

Retirement Funding

Generally, there are two categories of life insurance contracts used to fund retirement income -- cash value life insurance and annuities. Both of these have the advantage of tax deferral on the income earned on the investment portion of the contract. That is, the investment is not taxed until it is received.

Further, if a life insurance policy is exchanged for an annuity at retirement, the deferred tax on the investment earnings is diffused over the duration of the annuity receipts. Therefore, the longer the tax deferral period, the greater the tax advantage. Life insurance products can be used to offer the advantages of safety and liquidity. In addition, in today's market, they offer a competitive return on investment in relation to their high level of safety.

Tax-Favored Retirement Plans

There are many vehicles for funding retirement. Some of these are examined below:

The Individual Retirement Account

The individual retirement account (IRA) is a tax-advantaged retirement vehicle. It is intended to encourage people to save money for their retirement. The tax laws permit qualified individuals to make limited tax-deductible contributions and to earn tax-deferred investment income on these contributions.

IRAs offer deductible and nondeductible contributions. Deductible contributions can be made only by individuals who are eligible. Others can make nondeductible contributions to their IRAs. The advantage of making nondeductible contributions is that while the contributions themselves are nondeductible, the investment income received from them is afforded tax deferral status.

The maximum limits on contributions are the same for deductible and nondeductible contributions. The maximum limits are $2,000 of earned income for each person and $4,000 of earned income for two income earning married couples. More complex rules apply to married couples who file separate returns.

Eligibility for Deductible Contributions

The following individuals may make tax-deductible contributions to IRAs:

- Single people who are not covered by an employer-provided pension plan.
- Married couples where neither spouse is covered by an employer-provided pension plan. Special rules apply to married couples who file separate returns. Couples who have only one income earner may contribute $2,250. However, not more than $2,000 may go into either account.
- Single people who have an adjusted gross income of $25,000 or less and are covered by an employer-provided pension plan.
- Married couples who have adjusted gross incomes of $40,000 or less and are covered by an employer-provided pension plan.

IRA funds must be held by a life insurance company or a qualified trustee. If a life insurance company holds the IRA funds, the IRA contracts must be annuities and no death benefit can be provided.

Rollovers

Money may be placed in an IRA fund by means of a rollover. A rollover takes place when funds from an IRA or other retirement plan are placed with a new trustee. For example, a rollover takes place when someone takes IRA funds from one mutual fund and places them with another fund.

Rollovers may occur when an employee changes jobs. The employee may take his vested retirement benefits from a pension plan and roll them over into another qualified plan. Rollovers also occur when an employer terminates a pension plan. In such a case, the employee may roll these funds over into a new plan. When a rollover transaction takes place, a person has 60 days to move funds from one IRA trustee to another without having to recognize taxable income on the exchange.

Taxation Issues of IRAs

IRA withdrawals are taxed as ordinary income in the year in which the proceeds are received. Any portion of a payment that is attributed to a nondeductible contribution is

not taxed at the time of distribution. Only withdrawals of deductible contributions and tax-deferred interest are taxed at the time of distribution.

Generally, the earliest that a withdrawal can be made from an IRA without penalty is at the age of 59 1/2. If an earlier withdrawal is made, a 10 percent tax penalty is assessed, in addition to the ordinary income tax that arises when the withdrawal amount is included in the person's taxable income. Exceptions to this rule are withdrawal if the IRA owner dies or suffers a disability before age 59 1/2. The withdrawal of IRA funds must begin by age 70 1/2 or a penalty is applied.

Simplified Employee Pensions

Some employers offer employer IRAs as a benefit to their employees. These plans are known as simplified employee pension plans (SEPs). Employees who participate in these plans receive immediate vesting of all sums that have been contributed. Participants may also have some input into directing how the funds are invested.

When an employee is entitled to vesting, this means that he is irreversibly entitled to all of the contributions made to the fund on his behalf.

Keogh Plans

Keogh plans permit self-employed people to deduct from their adjusted gross income any money they contribute to a retirement fund. Keogh plans are also available to full-time employees of businesses who also have their own separate businesses. If the Keogh-eligible person has employees in his business, they must be included in the plan. Keogh plans permit participants to contribute 25 percent of their earned income to the plan, up to a $30,000 limit. Self-employment earnings must be reduced by the amount of the Keogh contribution and the self-employment Social Security tax. Unfortunately, these reductions essentially decrease the plan limits to less than 20 percent of self-employment income before making the Keogh contribution.

With a profit sharing Keogh plan in place, contributions may vary. These types of plans limit contributions to 15 percent of earned income instead of the 25 percent limit.

The assets of a Keogh plan must be held by a bank or some other independent custodian. Custodians typically charge an annual fee to administer these accounts.
The distributions from Keogh plans must begin by age 70 1/2. Minimum distributions must be based on life expectancy of the owner or the joint life expectancies of the owner and spouse. Like the IRA, withdrawals from Keogh plans taken before age 59 1/2 result in a tax penalty, except in cases of death or permanent disability.

Section 403(b) Plans

Section 403(b) of the Internal Revenue Code was established as a retirement plan for public education institutions and for 501(c) organizations. 501(c) organizations are tax-exempt nonprofit organizations. Section 403(b) plans are also referred to as tax-sheltered annuities (TSAs), tax-deferred annuities (TDAs) and 403(b) arrangements.
Under Section 403(b), certain employers are permitted to set up these contracts for their eligible employees. Employee contributions are tax-deductible, and the contributions

made into these plans are exempt from the requirements of qualified annuity plans. 403(b) plans are separate and distinct from other retirement plans; that is, they are controlled by their own requisites.

The following employers are eligible to operate 403(b) retirement plans:

- Universities (public and private)
- State-operated educational institutions
- Hospitals
- Museums
- Parochial schools
- Religious organizations
- Zoos
- Symphonies
- Research facilities
- The allowable funding vehicles for 403(b) plans are annuity contracts and custodial accounts.

Contributions to a 403(b) Plan

Employees of eligible institutions may enter into voluntary salary reduction agreements with their employers. Under such an agreement, the employer contributes the funds to the qualified carrier on the employee's behalf. Nonsalary reduction contributions may also be made. These take the form of matching contributions.

Section 403(b) funds are immediately vested. However, the employee may not assign the contract or realize funds from the plan in any way, except at his retirement. In the event of his death or disability, though, the funds may be withdrawn without penalty.
The maximum amount an employee can contribute to a 403(b) plan is based on a formula of 20 percent of his current salary, multiplied by the number of years of prior service, less amounts previously contributed to retirement plans.

Taxation Issues of 403(b) Plans

All withdrawals from 403(b) plans must be added to a person's taxable income in the year it is withdrawn. Early withdrawals result in a 10 percent penalty. In addition, insurance carriers may impose their own penalties for early withdrawal.

Current and Planned Changes in Retirement Planning

- IRA and Roth IRA limits will increase to $3,000 in 2002, $4,000 from 2005-2007 and top out at $5,000 in 2008.
- After 2001, individuals age 50 and above may make additional "catch-up" IRA contributions that can raise the limits above to $3,500 in 2002 to $6,000 in 2008.
- Contribution limits have also been raised for defined contribution and defined benefit plans: $40,000 in 202; $140,000 annual benefit for defined benefit
- The limit on compensation that may taken into account is increased to $200,000 beginning in 2002.
- Rollovers after 2001 have been liberalized. Now, distributions from qualified retirement plans, 403(b) annuities and government 457 plans may be rolled over to

any such plans. Similarly, IRA distributions may be rolled over into a qualified plan, 403(b) annuity or governmental 457 plan.

- The rule that required rollovers be made within 60 days can now be waived in certain cases.
- The definition of key employees for contribution purposes is now: 1) An officer with compensation in excess of $130,000; 2) A 5 percent owner; or 3) A 1 percent owner with compensation in excess of $150,000.

EXECUTIVE COMPENSATION PLANS

Some years ago, it was acceptable to pay executives and other highly paid individuals only a salary. However, in recent years, compensating these individuals has taken on added dimensions. Today, compensation is often seen as a package, and not just a single element. This is especially true in the ways in which executives are paid. Executives are typically a company's upper, middle and top managers. The components which collectively make up the package of payment for these executives is referred to as executive compensation.

Generally, executive compensation packages include the following:

- A base salary at stated level.
- Short-term incentives, typically annual.
- Long-term performance incentives in the form of cash bonuses, usually geared toward a percentage of corporate earnings and capital appreciation plans.
- Performance unit plans where the executive earns specially-valued units representing company shares at no cost, based upon his or her achievement or upon predetermined performance targets.
- Incentive stock options (ISOs), in which the executive receives the right to purchase stock at a stipulated price over a specified time period and in compliance with the Internal Revenue Code.
- Nonqualified stock options (NQSOs), which are similar to incentive stock options, but without the conformance with the Internal Revenue Code.
- Phantom stock plans offered only as a measure of cash compensation, in which the executive does not actually have to buy the stock but receives a given number of units representing company shares plus stock appreciation and dividends.
- Stock appreciation right (SARs), in which the company grants the executive the right to appreciation in underlying company stock over time.
- Restricted stock awards, which are the outright grant of shares free or discounted, but received only when certain conditions are met.
- Deferred compensation in which payments are made to the executive after his or her peak earning years, thus reducing his or her tax liability.
- Pension or retirement plans.
- Privileges.
- Perquisites, sometimes referred to as perques, perqs or perks.
- Golden parachutes, where an executive is paid up to the tens of millions if his or her company is taken over and he or she loses his or her job.
- Fringe benefits, although these are sometimes not considered part of the executive compensation package because they are typically offered to all of a company's employees.

Since many fringe benefits are tied to income level, higher ranking executives generally receive greater fringe benefits than other exempt employees. In addition to the traditional benefits offered to most employees such as health insurance, life insurance, dental coverage, vision coverage, paid vacation, sick leave and long-term disability insurance, many top executives also receive insurance benefits, exclusions from deductibles, and additional pension income.

High level compensation issues can be quite sensitive. Those executives who receive very large compensation packages also receive a great deal of publicity. Revelations of compensation for the highest paid executives of publicly owned corporations are compiled and offered to the public each year by business publications. Every year, the amount of the packages offered are greater than before. They often involve pay-offs for long-term compensation plans which take into account many years of effort. However, as the boom of the 1980s declined and recession took its place, people began to take a closer look at top executives and why they are paid so much more than the rest of the work force.

During the census years 1980 through 1989, the total compensation package of a typical CEO of a major company rose more than three times, given the inflation factor. During the same time, the wage of the average American worker decreased by nearly 13 percent, given the inflation factor. While it is possible that part of this is the result of the country's recent and ongoing shift from higher paid manufacturing positions to lower paid service jobs, there still remains a great disparity between the compensation of CEOs, presidents and chairpeople in contrast to other workers. Today, the average CEO earns approximately 150 times that of the average of a worker in the manufacturing and service industries, and this ratio seems to be widening.

This compensation differential is not common among our market competitors. In Japan, for example, the typical CEO earns only about 20 times the average worker, and in the United Kingdom, the typical CEO earns approximately 37 times the average worker.

Compounding what is seen as inequitable and blatantly unfair compensation of top executives is the issue of taxation. The tax load on high ranking executives has consistently declined, while the load on the average taxpayer has increased.

Is it really fair even to make such comparisons? After all, our country is driven by a free market economy. Sports and film stars, too, are paid what appear to be excessive extravagant sums. They are paid what the market will bear. Perhaps the true worth of a top level executive can be measured in his or her skills and responsibilities. He or she is paid for his or her performance. His or her responsibilities include the management of hundreds or thousands of people and millions or billions of dollars and products. He or she must have tremendous mental and physical stamina.

Further, the law of supply and demand has a significant impact on the compensation packages of top executives and studying their comparative worth. The low supply of talented executives is partly due to the low birth rate during the 1930s and 1940s. There are more people capable of doing routine, low risk tasks than there are of performing the duties of an executive who holds the livelihoods of many people within his or her grasp.

Current Trends

There are many recent trends in the field of executive compensation. A growing number of companies are using variable compensation methods for its executives, professionals and supervisors, as the gap between compensation and performance is closing. Pay increases for CEOs seem to be declining. Compensation for sales executives is increasingly linked to factors other than sales volume, such as quality, customer satisfaction and sales profitability. The concept of team selling is taking hold. Team selling allows companies to create teams involving technical, financial and other resources in order to promote cooperation within the company.

Tax Considerations

Taxes are one of the most important elements of executive compensation. The tax issues surrounding executive compensation became most prevalent as a result of federal income tax rules. With the Treasury Department taking an increasingly larger bite from high-ranking executives' earnings, tax matters have become a great concern. Compensation had to be channeled into some form which benefited from the deduction granted to capital gains, such as stock option arrangements, or which postponed the taxability to a later time, such as pension plans and deferred compensation.

In addition to the executive's personal interest in his or her compensation package, the companies paying the executives' compensation have an interest in the form of compensation, having their own strategy and agenda. These companies seek to assure as much deductibility as possible from these outlays. They seek to assure that any incentive program does what it is designed to do, that is, to motivate the executive to pursue the best interests of the company and its stockholders, rather than his or her own personal welfare. However, any well-planned executive compensation package will ultimately bestow personal success and prosperity upon the executive.

The United States Supreme Court heard the first case in history with respect to executive compensation in 1933. Since that time, there have been dramatic changes in incentive plans, the stock market and the Internal Revenue Code. Stock options became popular in the early 1950s. The Tax Reform Act of 1986 changed the context of stock option taxation, ending capital gains differential, placing corporate income taxes above the individual tax rate, and reducing individual rates. As a result, a corporate employer could generate a plan which permitted certain tax deductions and pass some of the savings on to the employee.

The Evolution of Executive Compensation

Stock options are an often used method of executive compensation. From the end of World War II until the beginning of the 1970s, our country enjoyed the greatest sustained bull market in its history. Stock options, which grant the executive the right to purchase stock at a future date at a price specified at the time the option is given, first came into vogue in 1950, when Congress passed legislation granting favorable tax treatment to stock options. Until the postwar bull market ended, few companies needed to spend much time on their executive compensation programs. They paid a fair and decent base salary, offered their executives a decent bonus and granted stock options. Senior executives become effortlessly rich through increasing stock prices.

The ***rationale behind stock options*** was that companies should link executive pay to the things that mattered to the company's stockholders, i.e, the price of his or her company's shares of stock. If the stock price increased, the executive should be rewarded. It was often overlooked that if the stock price decreased or stayed the same, the executive should probably not be so rewarded.

Stock options were simple. The measure of an executive's performance was simply revealed by the stock tables of the newspaper. It was plainly the market price of the stock. There were no elaborate calculations like discounted cash flow or earnings per share. Further, it was not possible that this measure could be rigged by management.

Inevitably, when the stock market suffered in the early 1970s, the companies could have chosen to ride out the bear market and continued to make regular grants of stock options. Executives might not have received any rewards in the short run, but since stock options are exercisable for a 10-year period they would likely, as we know today, be realized. However, that alternative was not given a chance. A process of rationalization that the stock market had gone completely awry developed. Companies no longer knew how to value equity securities.

This process of rationalization continued throughout the 1970s and into the early 1980s. It was during this time that, capitalizing on the theme that the stock market was unreliable, compensation consultants began to convince top executives that the reason they were not receiving the same level of compensation as previously was not due to lagging performance on the part of the executive, but rather the market price of their company's stock was not the appropriate measure of performance.

The movement began to use new forms of compensation which, by definition and design, would separate the link between an executive's pay and the performance that the stockholders desire the most, that is, stock price appreciation and dividends.

The newest measure of rewarding executives for increasing their company's success became earnings per share over a period of three or four years. These new plans were integrated into the company's existing framework of compensation plans, which necessarily required an attempt to measure their economic value. This further required that someone measure the economic value of existing forms of compensation, such as stock option grants. This quickly gave rise to a whole new generation of increasingly sophisticated compensation surveys designed to instruct each company as to where it stood competitively.

Compensation consulting firms thrived. They were hired to interview the executives, make an analysis of the company's executive compensation package, do compensation surveys and to make appropriate recommendations to make the companies more competitive. These recommendations take into consideration the size and type of the company and might include such things as short-term and long-term bonus opportunities, various stock award plans and greater fringe benefits.

Compensation surveys are performed by soliciting companies to complete lengthy questionnaires on the types of compensation plans they use, how the plans work and how much their executives earn from them. This data is analyzed. Then, the participating companies are given information with respect to the survey averages, medians, highs, lows, percentile ranks, etc.

Before the issue of executive compensation was so complex, compensation packages were reviewed by the CEO. Today, however, this is considered a highly specialized area, and the packages are typically reviewed by a compensation consultant, the shareholders or by compensation committees.

The swift and dramatic increase in executive compensation did not come about solely because of the proliferation compensation consultants. Another factor has been the regulation of compensation. The Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) regulate compensation practices. The FASB is the industry-sponsored rule making body for accounting practices and procedures in America. In 1950, the FASB was asked to rule on how companies should account for the granting of stock options. Typically, it takes three to five stock options to equal the economic value of one free share. They can generate great economic benefits to the executive. The FASB has decided to consider the value of stock options, as a charge to earnings, as zero. Not surprisingly, companies often prefer to use stock options heavily in their compensation packages predominately for this very reason.

The SEC, a government agency, has ultimate accounting authority over the FASB. It can overrule the FASB. The SEC requires that all publicly held companies must include in their proxy statements a table revealing the cash compensation of its top five executives. These top five executives are defined as "key policy making members of management." The degree of executive compensation disclosure in the United States now exceeds the disclosure of all other major countries.

Base Salary

Competitive salary levels, as defined by the going market, are important in determining executive base salaries at the top levels of management in any organization. The base salary is the primary means of executive compensation. Base pay is a guaranteed level of payment, irrespective of the executive's output. Base salaries go up, but they rarely go down, and they rarely increase dramatically. Therefore, companies have devised all sorts of executive incentive compensation plans over and above the base salary.

The salary that an executive receives is influenced by many factors. Some of these are:

- The executive's responsibilities. The responsibilities of the executive are the major duties to which he or she has been assigned. These are determined by his or her skills and the experience needed in order to perform the job.
- The executive's level within the organization. The executive's base salary is likely to be highest when there are the fewest number of management levels between him or her and the CEO of the company.
- Scope of responsibilities. Sales volume, profits, assets, the number of employees, the size of the organization and other similar factors are those which measure the scope of an executive's job. For example, two CEOs of similar companies may have the same or similar types of responsibilities, and both may hold the same or similar levels within their organizations. However, the executive with the greater sales volume to manage or the greatest number of employees to direct is likely to receive the higher salary. Typically, approximately 40 to 50 percent of the variance in executive salary levels can be accounted for by the differences in the ranges of their positions.

- Type of industry. The type of industry can be a factor in determining executive base salary levels. Some industries are specialized or highly technical. However, differences in pay among various industries are not so pronounced as they once were. This is mainly attributed to the mobility of today's executives and their ability to move from one industry to another. Those pay differences which cut across industry lines are typically the result of company performance, management challenges and governmental regulations. For example, a high-performing company may pay an executive more than a lower-performing company in the same industry, even when the executives' jobs are similar. A challenge to be factored into the compensation equation is running a highly-diversified or multinational company. This responsibility generally involves a greater challenge than running a less complex company. Further, an industry or company which is subject to heavy government regulation normally has a negative effect on executive pay.
- Incentives. Lesser base salaries are typically paid when some type of bonus plan is involved. When a combination of base salary and bonus plan is paid, this, too, typically exceeds the salary only plans.
- Supply and demand factors. The law of supply and demand plays an important role in executive compensation. The career executive is a free agent or a commodity. He or she has a talent to sell, and his or her price varies with the going market. These factors are the differential value which the market place authorizes at certain periods of time.
- Performance. The executive's performance is measured by the manner in which he or she discharges the responsibilities he or she has been assigned. The outstanding executive is likely to receive greater compensation than the more average executive. This is based on his or her personal performance, as well as the overall performance of the company.

Short-Term Performance Incentives

Many companies offer their executives an opportunity to earn extra money based on performance. This performance may refer to the personal performance of the executive, the overall performance of the company, the particular unit in which the executive is employed or a combination of any or all of these factors. Short-term bonuses are usually paid annually, semiannually or quarterly. These are designed to increase performance motivation.

The eligibility for participation in executive bonus plans is not generally available to all executives. It is typically available only to those executives who are in the top one to ten percent of all executives. This, of course, depends on the size of the company and the type of industry. Bonuses may range from a small percentage to as much as 300 percent of salary, or more. Sometimes, there is a "cap" put on the maximum allowable bonus, although in some companies the bonus potential is unlimited. Typically,when bonuses are expressed as a percentage of salary, this percentage increases as the base salary level rises. For example, the average bonus for an individual earning $50,000 per year might be approximately 25 percent of his or her salary, but the executive earning $150,000 per year may have a bonus potential of 50 percent of his or her salary.

Bonuses are typically tied into the concept of risk vs. reward. That is, the reward must equal the risk. In today's business at the executive level, a ten percent merit increase,

which would be considered generous at lower-ranking positions, is not considered a suitable reward for some risks being taken. If a company wants to attract aggressive executives who are willing to work and take risks, then some significant compensation must be offered.

Discounting the senior executive's total compensation opportunity by a higher percentage than for a lesser executive permits the senior executive to receive a lesser base salary, in relation to his or her total cash compensation opportunity, than the lesser executive. So, if the company performs poorly, the senior executive will be hurt in his or her wallet more than the other. On the other hand, if the company performs well, the senior executive is compensated more.

American businesses typically take a shorter-term perspective of accomplishments with respect to bonus incentives than do other companies in the world. Emphasizing short-term profits or objectives can distort the long-term picture, sometimes to the detriment of the longer-term objectives. The trend in the country today is to develop incentive plans of different durations, that is, those which meet both the long-term organizational objectives of the company, as well as the shorter-term objectives of an executive or of his or her immediate unit. Companies are placing more emphasis on the longer-term incentives, rather than on base salary, sometimes even at the expense of short-term profits.

The funds required for the short-term performance incentives are often determined by a formula. This formula is often tied into a percentage of pretax profits equal to a percentage return on stockholders' equity. The formula method offers the following features:

- It rewards increasing return on the stockholders' investment, not raw profits. The incentive here is for the executive to give the stockholders a better return than they could receive from other sources.
- It is based on pretax, rather than after tax, earnings. The executive offered this type of reward can adopt strategies such as raising prices, cutting costs, etc. in order to deliver a better bottom line result to the shareholders of the company. Most bonus plans are geared toward after tax, not pretax, profits.
- It reserves all of the first portion of company profits for the stockholders. Incentive funds are created only when the return on stockholders' equity falls within recognized parameters.

Having created the incentive fund, the company must then decide how the fund is to be apportioned among the executives in the company. Several methods may be used for determining this. If the company operates from divisions, parts of the fund may be distributed to each division, based on its particular performance achievements for the year. This approach motivates individual division performance, but it may sometimes create dissension among the various division managers. As a result, many companies distribute the greater portion of the fund based on divisional performance and then distribute the remainder of the fund based on overall performance.

In distributing its own fund, a division may employ one of three methods:

1) It may apportion all awards pro rata to salary. This method encourages a maximum degree of teamwork, but it gives no incentive for individual excellence.

2) It may distribute awards based solely on individual executive performance. This method gives incentive for individual excellence.
3) It may utilize a combination of these approaches. The combination approach seeks to achieve building teamwork and a large amount of individual initiative.

Incentive Distributions

Bonus awards are typically paid in cash and in a lump sum. They are often paid shortly after the close of the fiscal year on which they are predicated. Sometimes negotiable company stock is used. Sometimes a combination of cash and stock is used. In many cases, enough cash is paid to cover the taxes on the entire award. Some companies employ forcible deferrals. In these cases, the award is paid out in annual installments, typically five. If the executive voluntarily resigns from the company, he or she usually forfeits any remaining installments.

This approach is often justified on the grounds that it holds down the executive's tax payment, and it helps to retain good executives. It is seen as an incentive for the individual to remain with the company. However, many believe this approach does neither. From a motivational standpoint, forced deferrals are sometimes referred to as golden handcuffs. It is believed that they hold only the company's most consistent mediocre individuals, since the best performers can be bought out by a competitor. From the employee's perspective, this approach is often seen as a holding device and a disincentive to leave. Unfortunately, this approach is almost always resented.

Often, companies employ several holding devices over their executives at one time. These may be retirement, savings and profit sharing plans, as well as vacation and other length of service devices. The company generally reasons that if a little will help to hold a talented executive, more will help to hold him or her tighter. While these techniques probably hold a few good executives, they are more likely to hold the mediocre ones.

Some alternatives to the golden handcuffs situation are:

- To offer a combination of current cash and deferred compensation, although this increases the company's compensation costs.
- To concentrate on nonmonetary motivation techniques and devices.
- To individualize the total compensation package, offering the executive the option of deferred compensation.

Companies sometimes offer optional deferrals, as opposed to forced deferrals. Using this method, the executive can take his or her award in cash, or he or she may choose to defer any part or all of it. He or she can choose the length of the deferral period, the number of years over which the award will be paid, the types of securities in which it will be invested and even the disposition of dividends and interest. There is relatively little tax advantage in deferred compensation payments. However, there is some motivational appeal in giving the executive the ability to choose.

Long-Term Performance Incentives

Today, the results of most executive decisions are not realized in the same year in which the decisions are made. A plan based on annual results is valid only if the results and

the decision related to them were made in the same year. There are many complex situations, however, where the results of major decisions are often not known for many years. Factors such as long product lead time or an expanding market can cause decisions to be made in one year, while the results are not seen until the next year or even the next.

For example, a computer company may decide to build a big new manufacturing facility whose cost will be $300 million. Designing and building the plant may take three or four years. Further, a one-year or two-year period may be needed to break in the plant and bring it up to its peak efficiency. Several years may elapse between the time the decision is made to build the new facility and the time that the profit results of that decision may be judged. The company may incur significant costs for engineering talent, construction costs, interest charges on the debt, etc. During this time, profits would be increasing, if not for the demands of building the new facility. If the profits had increased, the incentive bonuses payable to the executives for their short-term performance would also have been increased.

Another need for the long-term incentive programs is the time necessary to develop new products. These products often require tremendous capital investments, with no expected return for several years.

An approach to center an incentive plan around a company's long-term goals and objectives is necessary. These plans might involve aligning the company's objectives to one to five years forward.

Short-term incentives intended to maximize the current years' profits do not go far enough in motivating optimum business behavior over the long term. Additional incentives for performance are needed. These are necessary, not just for a single year, but for the longer term. Long-term incentives fall into a number of categories:

Plans based on the increasing market price of the stock—The most often used plan in this category is the nonqualified stock option. This plan is flexible in that it may call for any option price and any length of exercise period. Typically, however, the option price equals 100 percent of the fair market value of the stock on the date of the grant. This option commonly has a term of 10 years. The theory here is that if the company does well over a series of years, its performance will be reflected in a higher stock price. Therefore, a spread is created between the option price and the fair market value of the stock at exercise. From a tax standpoint, the executive incurs no tax until the exercise takes place. At that time, the spread is taxed at personal income rates, with a maximum of 50 percent.

If the executive holds the stock past exercise, any further gain or loss between the date of exercise and the date of eventual sale is treated as a capital gain or loss. The company is granted a tax deduction in the year of exercise and for an amount equal to the option spread. Further, the company is generally not charged with its earnings with the option spread. However, this does not mean there is no cost to an option. There is a cost, but it is not as visible as is the cost of a comparable amount of cash.

Options may create problems for corporate officers, however. Being subject to the insider trading provisions of the Securities Exchange Act of 1934, these executives are barred from selling their option stock for six months, thereby avoiding the practice of

short swing trading. Under these circumstances, an executive must walk carefully around the provisions of these securities laws. As a result of this, they are burdened with interest costs to carry stock purchase loans. If the stock declines during the six-month holding period, the executive may receive no gain, but he or she may still have to pay the taxes attributable to the gain on exercise.

Because of these problems, many companies have added stock appreciation rights to their option arrangements. Under current SEC rules, a company can, under certain circumstances, permit the executive to receive a cash payment equal to his or her option spread, in lieu of exercising the option itself. This cash payment is not considered to be in violation of SEC buy-sell provisions. However, this payment must be charged to earnings, which is why stock appreciation rights typically extend only to the most senior executives. Under this plan, executives may, rather than exercising their options, tender them to the corporation. The corporation, in turn, pays the executive the amount of appreciation on the optioned shares, either in cash or in shares.

Plans based on internal performance measures—Theoretically, excellent corporate performance will, sooner or later, be validated by an increasing fair market value of the company's stock. Otherwise, the stock would eventually sell for less than its earnings per share. One of the major components of fair market value is the price to earnings multiple, and this is simply outside the control of any executive. Some companies have eliminated the fair market value incentive in their long-term incentive programs. They have instead geared payouts to long-term corporate performance achievements. Plans for this type are generally called performance unit plans.

In order to gain an economic benefit under a performance unit plan, the executive must deliver solid, long-term performance achievements. For example, one company might offer its executives a large bonus opportunity for achieving a 15 percent compounded annual increase in earnings per share over a five-year period. Another company might offer the same payout for achieving a 20 percent average return on equity over the same period. In either case, the executive is being rewarded for performance that is truly in the shareholders' interest and which is also more under his or her control.

Combination plans—Few companies have removed entirely the fair market value component in their long-term incentive plans. Many companies adopt a combination long-term incentive plan. Under this type of plan, the executive receives a lesser number of option shares, together with a number of performance units. In this manner, the executive is being given the incentive to achieve an excellent long-term internal performance and, in addition, to contribute to raising the fair market value of the company's stock.

Other plans—Sometimes the executive is granted the same number of option shares as he or she would be granted if the company were to employ only options. In this manner, the executive is also granted the same number of performance units as would be granted if the company were to employ only performance units. At the end of the performance period, usually four or five years, the executive is permitted to take whichever incentive, that is, the options or the units, has the greatest economic benefit to him or her.

Under this plan, the executive really has the advantages of both plans. If the company performs well, but the price to earnings ratio has declined, the executive has the same

economic benefit he or she would have received from a company offering only performance units. On the other hand, if the company performs only marginally, but the price to earnings ratio rises, the executive has the same economic benefit as he or she would have received from a company offering only stock options.

In some other companies, executives are given free shares of stock. These shares carry restrictions. They cannot be sold for some specified period of time. During this time, the executive receives dividends, and he or she may vote the shares. However, if he or she voluntarily resigns before the restrictions lapse, the shares are forfeited back to the company.

There are only few people in any organization who have a significant and profound impact on annual operating results. There are even fewer people who have this impact on long-term results. Therefore, eligibility for long-term incentive plans is typically more restrictive than that for the shorter-term annual bonus plans. However, companies employing stock options tend to be more liberal than those employing performance unit plans.

Some companies follow the practice of making annual long-term incentive grants. For example, suppose that in 1996, an executive will receive a contingent grant based on performance to be delivered during 1997 through 2000. In 1997, he or she will receive another contingent grant based on performance to be delivered during 1998 through 2001. These rewards paid during intervening periods are progress payments on future goals.

Perhaps reflecting the necessity to look more to the long-term than the short-term, many companies now offer their senior executives more in the way of long-term incentive opportunity than they do in the shorter term annual bonus opportunity. Among the larger companies, it is not at all uncommon to find that the annualized value of long-term incentive opportunities significantly exceeds 100 percent the base salary. Therefore, if the company's performance is excellent over a series of years, the executive will receive more of his or her total compensation through long-term incentive payments than through any other medium.

Both short-term and long-term formulas vary in their scope. They may be narrow in their scope and include only reducing labor costs or increasing bottom line profits. On the other hand, they may be more broad to include a wide and varying range of corporate goals. These might include a larger market share, increased production efficiency, better quality control and others.

Perquisites (Perks)

In addition to the more traditional elements of executive compensation, there is also the group called perquisites. Perquisites can include lavishly furnished offices; the use of company cars; wardrobe allowances; the availability of chauffeured limousines; country club memberships; the use of corporate jets; vacations and holidays at company lodges; additional medical, dental or life insurance coverage; enhanced pension plans; personal financial counseling; and other benefits.

Perks are usually termed as internal perks or external perks. Internal perks provide extras while the executive is inside the company. These include luxury offices and special parking or dining privileges. External perks, on the other hand, are those extras enjoyed outside the company, such as company paid memberships and expenses. There are also personal perks, which are low-cost loans, personal and legal counseling, free home repairs or improvements, personal use of company property and expenses for vacation homes. Personal perks are considered separately from internal and external perks because of their tax status. These benefits are sometimes subject to federal income tax, and the Internal Revenue Service is making strides toward requiring companies to place a value on these perks.

Perks are typically offered for status. Any benefit, whether its perceived value is great or not, that is offered to high-ranking executives and not generally given to those of a lesser rank carries instant status implications. Executives typically put great stock in these perks.

Perks are also offered for reasons of tax considerations. Many perks can be offered to the executive on a partially or totally tax-free basis. In recent years, the Internal Revenue Service has taken an increasingly closer look at perks and is likely to be even more strident in its view of them.

A discussion of some of the most frequently offered perks follows.

Charitable Donations

Helping the executive to meet his or her charitable obligations is a perquisite found in larger companies. Some companies make contributions to charities selected by their executives, up to specified dollar maximums. The company may grant its executives a charitable allowance of sorts, typically based on their job performance. These company contributions may be made in the name of executive, but they are by company check, payable to the charity. Amounts donated are not taxable to the executive or to the company, and the executive receives no tax deduction for the amounts contributed.

Company Automobiles

Until recently, the use of company vehicles was not considered taxable income at all to employees. Now the Internal Revenue Service imposes some tax liability on the personal use of company cars. However, company cars are still seen as an perk with great value. Some companies allow the executive to select the car of his or her choice, usually with some dollar limit.

The executive is required to pay income tax on the personal use of a company automobile. He or she is required to reimburse the company for the personal use of the automobile. Reimbursement is typically made on a mileage basis; that is, the executive determines how many of the miles driven are personal miles and how many are business miles. This is usually done on a weekly or biweekly basis. This arrangement is intended to cover gasoline, oil, insurance, tires, other maintenance costs and depreciation or cost recovery. Assuming the executive pays a fair mileage rate and reports personal use accurately, he or she has no further taxable income from the personal use of the company car.

Some companies lease their cars to the executive, then reimburse him or her for the expense of his or her business use of the car. Using this arrangement, the executive is not taxable on the lease or on the business expense reimbursements, assuming that the rental is fair and that the reimbursements match actual expenses or mileage allowances approved by the Internal Revenue Service.

Using either arrangement described above, the company may deduct the expenses it incurs for business use. If the company undercharges the executive for personal use or exempts the executive entirely from payment, the executive is taxable on this discrepancy amount.

Parking

Some companies provide free or reduced rate parking on company premises or authorized parking lots or garages. These are usually provided for a favored group, for example, middle and upper management. There is generally no tax consideration for parking perks.

Executive Dining Rooms

Lunches served in the executive dining room are a pleasant fringe benefit. The full cost of the meals and the dining room are fully tax deductible by the company. Employees are not subject to tax on the value of meals furnished to them free of charge on company premises, if the meals are provided to meet the business convenience of the company. The test of business convenience is satisfied if the employees who gather there discuss business issues during their meals. Generally, business guests may be invited to the executive dining room.

In some companies, the executive is charged nominally for his or her meal. In these cases, the company can deduct its subsidy, that is, it may deduct the cost of the meal, less the executive's payment, for tax purposes.

Although the Internal Revenue Service technically requires that any meals be furnished on the company premises, this practice is sometimes expanded to include hotel suites and private rooms in restaurants.
Company Apartments
Companies often provide free or reduced rate rental apartments or other dwellings to executives. These dwellings represent taxable income to the executive, unless all of the following conditions are met:

- The dwelling is provided for business reasons of the company.
- It is on the company's business premises.
- The executive must live on the premises in order to perform his or her job properly.

Executives who manage hotels, motels, funeral homes, farms and ranches are most likely to qualify for this perk. When all of these tests are met, the value of the quarters to the executive and his or her family is tax-free. The company may deduct its cost of providing the dwelling. Otherwise, the executive is taxed on the value of the lodging.

The company is allowed a tax deduction only if it has treated the value of these quarters as compensation, that is, withholding tax from the executive's pay.

On occasion, companies take long-term apartment space for executives who spend much of their work week in the apartment, but who spend the weekends in their own homes outside of town. Some companies may also take these long-term apartment or hotel suites for executives from company divisions out of town. The executive's business use of these quarters is tax exempt to him or her. The company may deduct the full cost of the business use of the quarters.

Office Furnishings

For tax purposes, there is no value on lavishly furnished executive offices. The company may fully deduct these costs for executive offices.

Executive Loans

Some companies offer interest-free or low-interest loans to their executives as part of their compensation package. This perk is considered to be a valuable one. These loans are often used to help buy a home or to exercise stock options. Depending on current interest rates, an interest-free or low-interest loan from his or her company could save an executive from a few thousand to several thousand dollars in interest costs.

When an executive borrows from his or her employer, he or she is not taxable on the principal amount of the loan. Suppose, for example, an executive takes a $100,000 interest-free loan from his or her company to purchase a vacation home. If the loan is granted at a time when the rate on similar loans is 12 percent, $12,000 or 12 percent of $100,000, is value of that loan to the executive. Further, the company is not considered to be receiving interest income with respect to this loan.

When an executive controls the company, this situation is a little different. In such a case, the Internal Revenue Service treats ***interest-free loans*** from a corporation to its controlling stockholder-executives as taxable interest income to the corporate lender, with an offsetting deduction to the borrower.

This tax exemption could be denied, however, if the borrowed funds are invested in certain ways. The principle behind considering low-interest loans as nontaxable is that if they were considered taxable income, an offsetting interest deduction would have to be allowed. So, interest deduction is not allowed on loans used to purchase tax exempt state or local municipal bonds. The situation is similar if the loan were used to invest in assets producing relatively little income. Some examples of this might be the investment in land under development or the purchase of company stock.

An executive's tax exemption on the principal amount borrowed for a interest-free or low-interest loan is considered tax deductible only if the transaction truly represents a loan. In other words, it cannot be disguised as a salary or a bonus.

When such a loan is made, it is typically made in a business like manner. It is made with the formality appropriate to loans made by other lenders, such as banks. The loan agreement is made in writing, stating the repayment schedule. In some cases, the loan

is made as a secured loan, that is, the executive must have some security for the loan. Often, company stock is used as the security for the loan. If any interest is charged, the rate is specified in the agreement, as well as the interest amount and the repayment dates.

Often, companies limit the use of interest-free or low-interest loans to specific purposes. These may be used to purchase a home; to purchase company stock, either directly or through a stock option plan; to purchase a car; to obtain life insurance; to pay tax liabilities; to pay family medical bills; or to pay for school tuition. Most companies offer moving expenses as a perk. However, lesser ranking employees are sometimes made loans to move to new job locations. The funds from these loans might be used to help purchase a new home or to carry the old home until it can be sold for a suitable price.

Interest-free or low-interest loans generally do not pique the interest of the Internal Revenue Service, unless they are not legitimate. In order to limit the interest of the Internal Revenue Service, some companies make the loan to the executive at full commercial rates, then they increase the executive's salary respectively.

Disadvantages to interest-free or low-interest loans are:

- Some companies may have difficulty in obtaining the repayment of loan funds. Providing for the repayment of loans through payroll deduction is a solution to this problem.
- Loans to executives who are also officers may be subject to legal restrictions under state law. State statutes vary greatly. For example, some states permit loans only with stockholder approval. Others expressly allows the loans without such restrictions. Even where loans to officers are allowed, restrictions are often imposed on loans to executives who are directors.
- Stockholders sometimes criticize low-interest and interest-free loans to executives, except in very special cases. These might include such loans as those for tuition, medical emergencies or job relocation. The outlay of cash for loans may represent forfeited investment opportunities for the corporation. This problem is often avoided by using the company's influence to get an outside lender, such as the company's bank, to make these loan funds available. Often this is accomplished on terms which are not typically available to the public.

Financial Counseling

Financial counseling is generally a package of financial advisory and planning services offered to top executives. These services are offered by financial counseling firms which are employed by the company. Typically, the company pays the entire fee for this service for selected executives, although, in some cases, the executive may contribute to part of the cost. Financial counseling offers the executive a full and accurate review of his or her personal financial affairs, which are often neglected. It can produce definite, visible and immediate profits for the executive.

Some of the financial services typically provided for the executive include:

- Estate planning. Offering estate planning services, the counselor determines the expected size of the executive's estate; assists in planning the manner in which it

should be most effectively disposed of at death, including dispositions that minimize estate taxes and probate expenses; and suggests appropriate insurance arrangements.

- Tax preparation. Counselors may prepare the executive's income tax returns.
- Tax advisory. Surprisingly, many executives are confused and perplexed about their profit opportunities under a company's many plans. The financial counselor may explain the benefits, risks, and tax consequences of such common incentives as stock options, stock appreciation rights, performance awards, restricted stock, deferred compensation, shadow stock, split dollar life insurance, group term life insurance, thrift or savings plans and profit sharing withdrawals. Often, top executives are so involved with their performance at work that they simply do not have the time to explore their own personal opportunities.
- Investment advice. Counselors may suggest appropriate investment vehicles.
- Typically, a financial counseling firm's work is extremely complex, requiring the services of attorneys, accountants, investment advisors, insurance advisers and estate planners. Not surprisingly, this service can be expensive. The financial planning perk is considered a valuable one.

There is no formality required when setting up financial counseling for executives. The company may offer this service to whomever it chooses. However, because of the cost involved, financial counseling services are typically offered only to top executives. Generally, companies ask the executive to sign a waiver to the effect that he or she will not hold the company liable for any negative consequences which may result from the advice furnished by the counseling firm.

For tax purposes, the amount that the employer pays to a consulting firm is considered additional and taxable compensation to the executive and is subject to withholding tax. However, there is a significant tax benefit available for financial counseling services. The Internal Revenue Service allows the executive deductions offsetting the income from these services.

For example, any amounts paid by the executive for services with respect to tax matters are deductible. The executive is permitted to deduct the costs of tax return preparation, tax disputes, tax advice and tax planning. Further, any amounts paid by the executive for investment advice are also tax exempt. This includes the full explanation of company benefits to the executive.

Moving Expenses

Companies typically provide for the payment or reimbursement of all out of pocket moving expenses for most employees in connection with a job related move. A company may fully deduct all expenses with respect to moving an employee, and there is a full tax deduction for the employee as well if he or she pays any of these expenses. Depending upon the rank of the relocating executive, the moving expenses which are normally paid by the company include:

Travel costs—If the travel is done by automobile, these travel costs include costs of gasoline, oil, tolls, meals, lodging, etc. The employee, as well as his or her family members, are covered. However, expenses for personal stopovers, side excursions and other detours are not covered.

Transporting household goods—This covers the costs associated with packing and crating all household goods and personal effects. It typically covers insurance and any storage required for up to 30 days after the goods are moved.

House hunting costs—House hunting costs are considered as those required to travel from the area of the old job to the area of the new job in order to search for a new residence. The new residence may be bought or rented. These trips may be made by the executive alone, with his or her family or by the family members alone.

Temporary living costs—Temporary living costs are those made for meals and lodging for up to 30 days in the location. These costs are necessary while a new residence is being painted, redecorated, cleaned, remodeled, etc.

Home sale expenses—Companies typically pay for the costs associated with the disposition of the former home and acquirement of a new one. These costs may include brokerage commissions, attorney fees, title search, title insurance, appraisal fees, escrow fees, mortgage points, transfer taxes, lease breaking charges and other fees and charges.

For the costs above, the executive is tax exempt on company payments or reimbursements, if the amounts are not extravagant. However, there are some limitations. The Internal Revenue Services imposes limitations on the deductions for some expenses. Also, in most cases, deductions are permitted only if the executive is a full-time worker.

Home sale losses—Any payments which are a result of the company's effort to protect the executive from loss by a forced sale of his or her home are deductible to the company. However, such payments are considered as taxable income for the executive. In some cases, the company may pay the difference between the fair market value of the executive's property and the amount actually received from the sale.

In some instances, if the executive cannot recover the full value on the sale of the old home, the company may purchase the home from the executive at fair market value, which is determined by an independent appraiser. The company is likely to face fewer time pressures than the executive in arranging the sale of the home. The company could hold out for a more suitable price. Or, the company might rent the house until the market improves. Ultimately, the house is sold by the company.

This procedure averts any loss resulting from the forced aspect of the sale. However, it does not protect the executive from any loss with respect to any decline in the value of the property below its cost. Any profit that the executive makes on the sale in general is often seen as a package, and not just as a single element. This is especially true in the way that executives are paid. Executives are typically a company's upper-middle and top managers. The components which collectively make up the package of payment for these executives is referred to as executive compensation. Generally, executive compensation packages include:

- A base cash salary at a stated level.
- Short-term incentives, typically annual.

- Long-term performance incentives in the form of one's home to the company is considered capital gain. This, of course, may be tax deferred when the executive purchases his or her new home, with certain restrictions.
- Moving bonus. Moving bonuses are often issued to cover such things as telephone and appliance installation costs and inconveniences such as registering children in new schools. These expenses are not ordinarily tax deductible, and these payments are considered taxable income.
- Mortgage differential. Mortgage differential is the difference between a favorable interest rate on the mortgage on the old house and a less attractive interest rate on the new mortgage. The company reimburses the executive for the extra interest expenses incurred for a specified period of time, typically three to five years, following the purchase of the new house. The mortgage differential is paid in a lump sum. This lump sum is considered taxable compensation to the executive in the year in which it is received. He or she can deduct interest on the mortgage as paid. Mortgage differential is considered an ordinary business expense of moving employees.
- Unsold former residence. When the executive incurs upkeep expenses for his or her unsold residence, the company often reimburses these expenses. These upkeep expenses are fully tax deductible by the company and are taxable to the executive.
- Property management. Sometimes executives are offered the option of property management. The old house is rented or, if vacant, is taken care of for a specified period, typically two to three years. This arrangement gives the executive the opportunity to hold out for a better price for his or her home in a soft market. This arrangement is also used by executives who expect to return to the residence, for example, those executives who are given an overseas assignment.
- Other moving expense items. Other moving expenses might include advice on finding a new residence, help in arranging inspection appointments, opinions of house value, cash allowances for renters becoming homeowners and automobile loans when there are new commuting patterns. Any cash allowances are taxable to the executive. The value of the other assistance is taxable in principle.

Death Benefits

In addition to the normal life insurance offered by a company, the company may make lump-sum payment or annuity payment to the beneficiaries of a deceased employee. Typically, this amount is expressed in a multiple of the deceased executive's salary. Company payments made to these beneficiaries qualify for limited tax benefits.

Any death benefits paid as compensation for services are fully tax deductible by the company. The company's deduction is subject to reasonable compensation ceilings, but deductions are typically allowed for sizable sums.

Sometimes insurance policies are taken out on an executive's life for this purpose, naming the company as the beneficiary. Under these circumstances, the company does not have to produce the funds at the executive's death in order to cover any death benefit obligation. The company may not deduct any of its premiums, but it is also not taxable on the proceeds.

Employment Contracts

Employment contracts are generally reserved for top executives. They are most common for those who are newly hired from other firms and for those in the immediate line of succession to the CEO or CFO. Items frequently covered in employment contract are:

- Salary. The salary is often stipulated with fixed annual increases or tied to the cost of living.
- Incentive plan. Short-term and long-term incentive plans are described and explained in detail.
- Contract duration. The duration of the contract is set forth, usually three to five years, sometimes longer. An option to renew may be included.
- Life insurance provisions.
- Medical benefits.
- Deferred compensation.
- Death benefits.
- Expense accounts.
- Retirement plans or other qualified plans.
- Miscellaneous. Items in this category might include interest-free or low-interest loans, parking privileges, the use of company vehicles, country club dues and fees, travel privileges such as first-class or with spouse, stock options, etc.

An employment contract may cover settlement terms in the event of termination, alteration in job assignment, title or authority, takeover by another firm, no competition clauses and other similar issues.

Termination Settlements

Termination settlements are amounts paid to an executive who leaves the company unexpectedly, that is, termination not resulting from normal retirement or from the expiration of a contract period of employment. A settlement may be paid to the executive in order to cancel his or her contract in the event of a disagreement. In some companies, the termination agreement may allow the executive to withdraw from the company with a substantial settlement, following an acquisition or a merger.

The settlement amount is usually based on a projection of the executive's earnings such as salary, bonuses, incentives, etc., for a specified period or for the unexpired period of the contract at the time of termination. Settlement amounts received under termination provisions are considered fully taxable income, and they are subject to tax withholding. Settlement amounts are fully deductible to the company.

Business or Professional Dues

A company often pays dues for top executives' memberships in business or trade associations. These might include the American Bar Association, the American Management Association, the American Bankers Association, the Sales Executives Club or other professional associations. Dues and memberships are fully deductible by the company, and they are tax exempt to the executive if he or she pays them.

Other deductible memberships are luncheon clubs. These clubs are considered to have a business purpose for the company. Business discussions and contacts of potential importance to the company frequently take place at these clubs during meals. Deductions for the cost of meals is another matter, however. In order for these meals to be tax deductible, and only at 50 percent, the following must apply:

1) The executive or the company must be expected to derive some business benefit from the meeting surrounding the meal.
2) Business must actually be discussed during the meeting surrounding the meal.
3) Business must be the dominant purpose of the meeting surrounding the meal.

The same applies to memberships in social, athletic or country clubs. Memberships and dues may be deducted only if their purpose meets the three requirements above.

Liability Insurance

For some executives, it is prudent for the company to pay the cost of liability insurance indemnifying executives for expenses arising from their wrongful acts committed in their official capacities. These wrongful acts might include breach or neglect of duty, wrongful act or omission, error, misstatement or misleading statement, etc. The cost of such insurance is fully deductible to the company.

Perk Disclosure Requirements

Any company registered with the Securities and Exchange Commission is required to disclose the compensation of its officers and directors to the public. The compensation to be disclosed is not commensurate with whether or not it is considered taxable income to the executive.

Pension Plans

A pension is a significant part of nearly all executive compensation packages. In fact, it is considered by some to be the most important benefit a company can provide to its executives. The basic theory of the pension plan is that pensions are a part of the labor cost of the current operations.

The Internal Revenue Code sets forth some limitations with respect to pension plans as part of an executive compensation package. Qualified pension plans may not discriminate in favor of employees who are officers, shareholders or other highly compensated employees. Qualified pension plans are those set up and operated in order to conform to detailed federal requirements. These plans must be made available to all employees, not just executives. This is unlike some other components of executive compensation packages, such as interest-free or low-interest loans, stock options, bonus awards and others. Generally, all employees must be entitled to pension or profit sharing plans, if executives are to receive them.

Although companies generally cannot design a plan to cover only executives or selected executives and exclude other employees, plans may be structured in order to favor some executives more than they benefit other employees. However, there are legal and practical limitations on these plans.

There can also be no discrimination in company contributions or employee benefits. So, a company cannot set up a plan which covers all employees, but distributes the funds excessively to executives and nominally to other lesser ranking employees.

Plans Favoring Selected Executives

Contributory plans are a way of favoring the more highly paid executive. This executive is more likely to have greater funds to invest than the lower ranking employees. The higher the executive's tax bracket, the more valuable is his or her tax exemption for his or her investment earnings during the time that the earnings remain in the fund.

If the plan requires the employee's contribution in order for him or her to participate in the plan, this favors executives. In such cases, the company incurs costs only for employment who have investment funds available.

There are two tests used to decide whether pension plan coverage is discriminatory:

1) ***The percentage test***. The percentage test dictates that if a certain percentage of employees is covered, the plan's coverage automatically qualifies as being nondiscriminatory. In deciding who should be covered under the plan, the company may exclude:

    - Employees under the age of 25.
    - Employees who have worked for the company for less than a specified period of time, typically one to three years.
    - Employees beginning their employment with the company within five years of normal retirement age.
    - Employees who are union members, if retirement benefits are an issue in collective bargaining.

    Using the percentage test, a plan is not discriminatory if at least 70 percent of the employees are eligible and at least 80 percent of those eligible actually participate.

2) ***The facts and circumstances test***. The facts and circumstances test is often used when the percentage test fails. When this test prevails, the plan can be determined to be nondiscriminatory. The Internal Revenue Services conducts a complex test of facts and circumstances when employing this test. It is neither brief or simple. Often, the matter can be negotiated and adjusted as part of the process of obtaining approval for the plan.

Integration with Social Security benefits is another way to favor selected employees. This plan is available for pension plans and for profit sharing plans which are retirement plans. It provides substantial benefits for higher paid employees at a relatively low overall cost to the company.

The integration plan works like this: The company contributes toward Social Security an amount based on an employee's compensation, up to a ceiling amount subject to Social Security tax. This is called the Social Security base. Under the Social Security system, a retired person's Social Security benefits depend on the amount of his or her covered salary, that is, the Social Security base while he or she is working. Because of ceiling

limitations, a highly paid executive receives no more in monthly Social Security benefits than the employee whose Social Security base just barely entitles him or her to the same benefits.

The integration process then begins. The plan may be designed so that the company contributes only for employees whose compensation exceeds the Social Security base amount. In this way, the company incurs pension costs only for those employees. This arrangement likely excludes lesser ranking employees but covers all executives. Further, the plan may be designed so that, as the Social Security base increases, plan contributions are eliminated for those employees whose compensation fails to exceed those amounts.

Vesting

Pension plans typically require a minimum period of coverage in the plan before the employee becomes vested, that is, before he or she becomes absolutely entitled to pension benefits. If an employee's employment is terminated before the expiration of this vesting period, all benefits are forfeited.

Employee Contributions

Some plans permit voluntary contributions by covered employees on their own behalf toward the pension plan. In some cases, the employee is covered only if he or she contributes to the plan. These types of plans are referred to as contributory plans. Using a contributory pension plan, the employee's contribution and investment earnings provide retirement benefits in addition to those provided by the company. Using such a plan, the employee's own contributions, plus his or her investment earnings, are returned, even if he or she forfeits the company's contributions and investment earnings because of early termination.

Since contributory plans may be used as a means to favor highly paid executives, the Internal Revenue Service limits the amount which an employee can be required or permitted to contribute under these plans. Voluntary contributions cannot exceed ten percent of the employee's compensation. The amount used for determining compensation is the amount earned during the entire period of the plan, rather than ten percent in a single given year.

Voluntary plan contributions are tax deductible, up to $2,000 per year. Unfortunately, each dollar of deduction claimed for a voluntary contribution to a pension plan reduces the amount the employee is permitted to contribute to his or her personal Individual

Retirement Account.

The company's contributions to the pension are considered a necessary business expense. They are fully tax deductible, if they are "reasonable," as defined by the Internal Revenue Service. These contributions are deductible, however, only if they are actually paid.

If a company offers both a pension and a profit sharing plan, its deduction for contributions to both generally cannot exceed 25 percent of the other compensation paid

to covered employees in a given year. This restriction can be avoided, however, by combining a defined benefit pension with a defined contribution pension plan. Any contributions in excess of deduction limitations may be carried over into later years and deducted at that time.

Distributions

Since a pension plan is effectively a retirement plan, an employee's share of the pension fund can be withdrawn only at retirement, with few exceptions. These exceptions are:

- Death.
- Disability.
- Termination of employment, in certain circumstances.
- Termination of the plan itself.

Distributions are usually made in the form of an annuity, typically for the life of the employee. In some cases, pension plans may permit the distribution in a lump sum. In such a case, the employee may or may not invest the sum in an annuity or some other investment vehicle. Some considerations for these two methods of distribution are:

The annuity--. If the employee does not contribute at all to the pension fund, his or her entire distribution is fully taxable. For example, if the pension distribution is $1,500 each month, the employee is required to report this amount as income.

If the employee contributes to the pension fund and the entire amount contributed is less than the amount distributed from the fund for the first three years of the annuity, the employee is exempt from tax on all annuity amounts until he or she recovers the full amount of his or her contribution. At that time, all distributions are taxable.

If the employee contributes to the pension fund and the entire amount contributed is more than the amount distributed from the fund for the first three years of the annuity, the employee is partly tax exempt from each annuity payment. The tax exempt amount of each annuity payment is obtained by dividing the employee's contribution by the amount he or she is expected to collect under the annuity.

The lump sum-- With some exceptions, using the lump sum method of distribution, if the employee contributes to the fund, his or her contribution is recovered tax-free upon the following requirements:

- The amount which represents the employee's share is distributed within a single taxable year.
- The distribution is made because of the employee's separation from employment or disability, or occurs after the age of 59 1/2.

The balance, other than the employee's contribution, is taxable, subject to special averaging provisions designed solely for the purpose of qualified pension plans. Effectively, this procedure reduces the tax below the amount that would be due at the regular tax rates.

For income tax purposes, in the event of a qualified pension plan participant's death, his or her heirs are entitled to a $5,000 tax exemption on the amount collected under the pension plan. For estate tax purposes, there is a further tax benefit for qualified plans. All contributions made by the company are exempt from estate tax.

Qualified plans are permitted to exclude employees who have worked for the company less than some specified minimum period of time.

There are many types of qualified plans. Typically, all qualified plans involve the employer, the employee covered and the trustee who invests and administers the funds of the plan. A qualified pension plan is a formal written document. It sets forth the rules governing which employees are entitled to benefits, when the benefits are payable, and their amounts.

There are great tax considerations to a qualified pension plan. These are:

- The employer can deduct its contribution to the fund in the year the contribution is made. In other forms of executive compensation, the company's deduction is postponed until the employee actually collects his or her share of the benefits.
- The employee is not subject to tax on any company contributions to the fund.
- Investment earnings on the amounts contributed to the fund are not taxable at all, that is, not to the employer, the employee or the trust. This holds true for as long as the funds are held by the trust.
- Amounts distributed to employees or their beneficiaries can qualify for tax benefits, including reduced income tax and exemption from estate taxes. The company and the trust have no tax liability on these distributions.

There are two types of pension plans:

1) The defined benefit plan. The defined benefit plan is also referred to as a fixed benefit plan. Using the defined benefit plan, the covered employee receives a specified benefit upon retirement. This plan is most common today. The amount received is usually an annuity of a specified percentage of the employee's regular salary.
2) The defined contribution plan. The defined contribution plan is also referred to as a money purchase plan. Using the defined contribution plan, the company makes a designated contribution for the employee each year. At retirement, the covered employee receives whatever retirement benefits the contributed amounts can buy, including interest earned.

Profit Sharing Plans

A company may choose to offer its employees a pension plan, a profit sharing plan, both or neither. Both plans may cover the same or different employees. However, the overall results may not discriminate in favor of executives. Most of the rules governing pension plans also apply to profit sharing plans. The tax rules, the vesting provisions and the death distributions are the same, and deduction limits apply.

The major differences between a pension plan and a profits sharing plan follow.

- Using a profit sharing plan, no company contributions are made for covered employees, unless there are profits. Using a pension plan, the company contributions are considered a fixed cost, whether there are profits or not. While there is less risk to the company with a profit sharing plan, the benefits of this plan might not be as favorable to the employees as a pension plan.
- A pension plan must be a retirement plan. A pension plan must distribute its benefits only when the covered employee retires, dies or becomes disabled. On the other hand, a profit sharing plan may be a retirement plan, but it is not required to be so. Company contributions for the employee's benefit can be distributed before retirement, death, disability, termination of employment or termination of the plan. The only requirement is that at least two years must elapse between the time the company makes the employee's contribution and the time the employee withdraws it.
- Profit sharing benefits usually vest and are distributed more rapidly than pension benefits. So, even if a pension plan and a profit sharing plan are relatively comparative, an employee who leaves before retirement has more to lose under a pension plan.
- Pension plans and profit sharing plans operate differently to build the fund, and there are different costs to the company.
- Under a profit sharing plan, profits are used to make company contributions. Profits are not necessarily defined with reference to taxable income. For example, a profit sharing plan may provide for accumulated profits, when current profits are insufficient. It may provide that contributions are made only if profits exceed a certain specified amount. Further, it may choose any percentage of profits it wishes to contribute toward the fund. A different formula may even be chosen each year. A profit sharing plan is recognized by the Internal Revenue Service only if contributions are recurring and substantial. So, a plan which is set up only to make a contribution in one year does not qualify as a profit sharing plan.
- The amount that a company contributes for covered employees is typically based upon their compensation. A plan is not considered as discriminatory in favor of executives if the company contributions bear a uniform relationship to the compensation of covered employees. For example, a profit sharing contribution for an executive earning $200,000 a year may be ten times the contribution for an employee earning $20,000 per year. This is not considered discriminatory. Further, company contributions can be based on other factors such as age or length of service.
- If the profit sharing plan is a retirement plan, distributions are treated the same way as are pension plan distributions. However, profit sharing plans are frequently not pension plans. In these cases, the employee is permitted to withdraw all or part of vested amounts, independent of his or her retirement.
- Typically, there are some penalties imposed for withdrawals. This may be in the form of a percentage of the employee's fund amount, waiting periods between withdrawals, committee approval of withdrawals or withdrawal only for certain reasons, such as medical care or tuition.
- Generally, executives are in profit sharing plans longer than the rank and file employees. This is because executives are typically employed longer than other employees. Executives are also less likely to withdraw funds from profit sharing plans. Therefore, these executives benefit from the funds forfeited on withdrawals by other rank and file employees. For the benefit of upper ranking executives, the plan may be designed to permit interest-free or low-interest loans against the funds as a perk available only to these executives.

Distributions

In some cases, employees are permitted to take all or part of their distribution of profit sharing funds in company stock. Normally, the employee is taxed on the fair market value in the year any property is received. However, when company stock is distributed, tax is imposed partly in the year the stock is received and partly in the year the stock is ultimately sold.

Some of the factors which contribute to the decision of whether to offer a pension plan or a profit sharing plan are:

- The expected retirement age of most of the employees.
- The expected rate of the return on investment of the contributed funds.
- The expected rate of pay increase of the favored executives or group from the beginning of the plan until retirement.

Profit sharing plans are typically favored in instances where the covered executives are relatively young or when rates of investment are relatively high. On the other hand, pension plans are preferred for older executives, where generous pay increases are presumed, where retirement is presumed to be before the traditional age of 65 and where there are provisions for cost of living increases after retirement.
ERISA

In 1974 Congress enacted the Employee Retirement Income Security Act (ERISA). ERISA was primarily designed to assure the security of pension plans. This legislation came about after the recession of the early 1970s. Many people who thought they were covered by pension plans were, in fact, not covered. This was the result of complicated rules, insufficient fundings, irresponsible or unwitting financial management, company bankruptcies and other reasons. Many funds were accused of mismanagement.

ERISA does not require that employers offer a pension plan. However, any pension plans which are in effect are strictly controlled by ERISA. The provisions of ERISA are designed to protect the interests of the workers who are covered by private pension plans and to stimulate the growth of these plans.

ERISA requires that employees be eligible for pension plans beginning at age 21. Further, employers may require one year of service as a condition before participation begins. This service requirement may be extended to three years, if the pension plan offers full and immediate vesting. Vesting refers to the length of time an employee must work for an employer before he or she is entitled to the benefits accruing in the pension plan. The concept of vesting has two components. First, any contributions made by the employee to the pension fund are immediately and irrevocably vested. Further, as mandated by ERISA, the employer's contribution must vest at least as quickly as one of the following two formulas:

1) Full vesting after five years.
2) Twenty percent vesting after three years and 20 percent each year thereafter, to be fully vested in seven years.

The vesting schedule an employer uses is often a function of the demographic makeup of the work force of the company. For example, an employer who experiences an

unusually high turnover may wish to use the five-year service schedule. Under this plan, any employee with fewer than five years' service at time of termination receives no vested benefits. Or, the employer may use the second schedule above in the hopes that earlier benefits accrual will reduce undesired turnover. The vesting strategy adopted is predicated upon the goals and objectives of the organization, as well as upon the characteristics of its work force.

The portability of pension benefits is an issue for employees who move to new organizations. ERISA does not require mandatory portability of private pensions. On a voluntary basis, though, the employer may allow an employee's pension benefits to transfer to his or her new employer. Even in such circumstances, in order for an employer to permit the portability of pension benefits, the pension rights must be vested. Various sections of ERISA and the Internal Revenue Code restrict employer ability to provide benefits for executives that are too far above those of other workers. ERISA requires that the plan cover a broad cross section of employees, generally 80 percent, provide definitely determinable benefits, and meet specific vesting and nondiscrimination requirements. The nondiscrimination requirement specifies that the average value of benefits for lower-paid employees must be at least 75 percent of the average value for more highly-paid employees.

Today, more than $400 billion exists in private pension plans in the United States. The irresponsible investment of these funds by a company representative could lead to substantial abuse and adverse consequences, exactly what ERISA was designed to prevent. Consequently, ERISA stipulates that the fiduciary who is entrusted with the pension plan investment decisions of a company is legally obligated to exercise due care, as any prudent person would do. ERISA includes prohibitions against investments made in self-interest.

Despite the number of restrictions imposed by ERISA, the potential still exists for an organization to go bankrupt, or fail to meet its vested pension obligations. To protect individuals confronted by this problem, employers are required to pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC) established by ERISA. These PBGC funds guarantee the payment of vested benefits to employees formerly covered by terminated pension plans.

Virtually all retirement plans are subject to the provisions of the ERISA. Naturally, there are certain standards of conduct imposed on plan fiduciaries. An ERISA fiduciary is required to discharge its duties with respect to a plan solely in the interest of plan participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, and for defraying reasonable expenses of administering the plan. A plan fiduciary must discharge its duties with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in a similar enterprise. The fiduciary must diversify the investments of the plan in order to minimize the risk of large losses. The fiduciary must implement the plan in accordance with the plan document and other governing instruments.

There are several exceptions to the coverage of ERISA. The fiduciary duties of ERISA, as well as its other provisions, do not apply to employee benefit plans maintained by a church, the federal government or any state governments. Additionally, a tax deferred

annuity plan may not be subject to ERISA, depending on the degree of employer involvement in the plan.

A tax exempt employer with a tax deferred annuity program for its executives must determine whether its program is a retirement plan subject to ERISA. If an employer simply makes tax deferred annuities available to its employees, the program may not be subject to ERISA. However, a tax deferred annuity program is subject to ERISA if any one of the following conditions exist:

1) Participation in the program is not completely voluntary.
2) The employer is able to enforce certain rights under the annuity contracts, other than as an authorized representative of the employees.
3) The employer may hold annuity contracts in its name on behalf of employees.
4) The employer makes a matching or other contribution to the plan or is otherwise involved in the plan in some way.
5) In order to avoid the application of ERISA, the employer must ensure that the number and variety of annuity providers which may approach executives is sufficient to afford those executives a reasonable choice.
6) If the tax deferred annuity program of a tax exempt employer has any of these characteristics or if the employer fails to offer a sufficient variety of annuity options, the program is determined to be an employee benefit plan subject to ERISA.

Generally, ERISA provides that a person is a fiduciary with respect to an employee benefit plan if:

1) The person exercises any discretionary authority or control in the management of the plan or in the disposition of the plan's assets.
2) The person renders investment advice for a fee or other compensation, direct or indirect, with respect to the plan's assets.
3) The person has any discretionary authority or responsibility with respect to the administration of the plan.

If a fiduciary fails to meet ERISA's standards of conduct, the fiduciary is personally liable for any losses resulting from the breach of the fiduciary duty. The secretary of labor, the plan administrator and participants or their beneficiaries are permitted to bring an action against the fiduciary. Civil and criminal penalties also may apply.

The board of directors of an organization usually authorizes the establishment of employee benefit and compensation plans and any related trusts or other funding vehicles of the organization. Therefore, the board and its members are the source of all authority. They have complete responsibility with respect to these plans. To the extent the board and its members retain or exercise any authority or responsibility with respect to the plans or trusts, they are ERISA fiduciaries.

A board of directors is not required to engage in the administration of the employee benefit plans and trusts on a day to day basis. ERISA expressly confirms and authorizes the delegation and allocation of fiduciary responsibilities. The board of directors may limit its activities, for example, to approving plan amendments, approving annual plan contributions and designating other plan fiduciaries. This approach traditionally has been followed in retirement plans.

It is possible to further limit the fiduciary responsibilities of the board of directors through a special committee whose responsibility it is to appoint, remove and review the performance of all individuals responsible for plan administration and those responsible for the management and investment of plan assets. With respect to the organization's employee benefit plans and trusts, this committee could be given virtually all of the powers of the board.

At reasonable intervals, the committee would review the performance of the trustees and investment managers who are expected to ensure that their performance has been in compliance with the terms of the plans and trusts and any applicable statutory standards. Continued service would be based on this performance. The committee's fiduciary responsibility in this respect would be limited to the review procedure. The committee would not be liable for the day-to-day investment decisions of the trustees and investment managers.

If such powers are allocated to a committee, the board of directors must retain the following duties and responsibilities with regard to the plans:

- Responsibility for the appointment and removal of members of the committee.
- The power to effect major amendments or to terminate the plans.
- Responsibility for funding plan benefits and other matters relating to the costs of providing plan benefits.

In such cases, the board of directors must act prudently and in the best interests of plan participants and beneficiaries in selecting committee members. This is an especially important function, since practically all responsibility for the plans is delegated to the committee. The board must also exercise oversight responsibility related to the results of the committee's activities, including a periodic review of committee performance in order to ensure that the committee's performance is in compliance with the terms and conditions of the plans. Continued service and reappointment to the committee would be based on this performance.

The Split Dollar Concept

The split dollar concept refers to the division of insurance proceeds between the company and the executive's beneficiaries. Split dollar is a type of insurance used for tax deferred compensation for senior executives. It is not term insurance, rather it is permanent. Split dollar insurance is often used for younger executives who are not yet able to afford a large insurance commitment on their own. Using a typical split dollar arrangement, the company and the executive are both obligated to pay part of the premium cost of insurance on the executive's life. However, after the early years of the policy, the executive typically is no longer required to pay into the policy.

In order to fully understand the concept of split dollar insurance, it is helpful to understand how life insurance is taxed. For example, when an ordinary life insurance policy is purchased, some of the premium payment is used to provide what is called pure death protection. The balance is held by the insurance company and called cash value. Any interest on the policy is not subject to taxation until the policy is cashed in.

Under the split dollar technique, the executive and the company split the cost of a life insurance policy. Using this concept, the company typically pays the part of the annual insurance premium which equals the increase in the policy's cash surrender value for the year. This is the portion which goes to the cash value of the policy. In exchange for this payment, in the event of the executive's death, the company is entitled to receive that part of the insurance proceeds which equals the policy's cash value. In the later years of the policy, these proceeds may exceed the company's actual investment in the policy.

On the other hand, the executive pays the balance of the premium due. That is, the executive pays the portion of the premium that covers the pure death protection, which is the benefit to his or her family if he or she should die young. He or she pays the total premium, less the portion paid by his or her company. Theoretically, the executive pays a substantial part of the premium cost in the first few years of the policy, and he or she pays little or nothing after that. In the event of the executive's death, the beneficiaries collect the entire proceeds of the policy, except the cash surrender value, which is paid to the employer.

Years later, upon the executive's retirement, the company gets back all of the premiums it has paid, without interest, of course. Effectively, the company has been giving the executive an annual bonus equal to the annual interest earnings of the policy. However, the executive has not been taxed on these earnings. He or she is taxed only when the policy is liquidated. If the policy is kept in force, the cash value should be sufficient to cover the premiums otherwise owed.

As the cash value of the policy increases, the amount to be collected by the executive's beneficiaries declines each year. For this reason, split dollar insurance is most frequently used for younger executives. The split dollar arrangement gives maximum protection while the children are young. The protection drops as the children get older. The insurance policy may be owned by the company or the executive.

Any company may limit split dollar coverage to executives, top executives or to any class of employees that it chooses. No formal plan is required.

Tax Consequences of the Split Dollar Concept

As with other life insurance proceeds, the proceeds of split dollar life insurance are free of income tax. This includes the proceeds to the company, if the company is named as the beneficiary. Also, with proper planning, insurance proceeds can be made exempt from estate tax in the executive's estate.

The split dollar life insurance concept is not, however, free from all tax liability. For example, the executive is subject to tax on part of the premium cost of the split dollar coverage. The Internal Revenue Service considers that the split dollar insurance arrangement uses the employer's payments for the executive's benefit. Therefore, these payments are considered compensation of sorts. The executive is taxed on an amount equal to the cost of one-year term insurance for the amount of coverage in that year, reduced by the amount of premiums that he or she actually pays.

For example, suppose $100,000 policy is taken out for a top executive. His or her share of the first premium is approximately $600. His or her share of the $100,000 is reduced

by the cash surrender value of the policy, which belongs to his or her employer. Therefore, his or her coverage is about $93,000. The executive is taxed on the cost of $93,000 of term insurance for one year at his or her present age. However, this taxable amount is reduced by the $600 premium he or she has paid. Therefore, there is little or no taxable income this year to the executive.

Then, suppose that two years later, the executive pays only about $200 of premium cost, and his or her share of the policy is now about $80,000. The cash surrender value is now about $20,000. He or she is taxed on the cost of $80,000 of term insurance at the age he or she is at this time, reduced by the $200 he or she has paid as premium. The executive is now taxed on approximately $400. So, for this year his or her split dollar insurance costs him or her up to $400, that is, $200 plus the tax, which is up to $200, on $400.

The cost of term insurance, used to determine the amount taxable to the executive, is prescribed by an Internal Revenue Service table. This table reflects a cost of term insurance which, in some situations, is less than the actual cost of the insurance. In this instance, although the executive is taxed on his or her split dollar insurance benefits, he or she is taxed on less than the true value of what he or she receives.

Therefore, there is a tax saving on the premium cost, as well as on the proceeds. The Internal Revenue Service recognizes that the cost figures in its table may sometimes be higher than some insurance companies actually charge. Therefore, it allows the tax to be computed by using the rates actually charged by the insurance company, when these are lower than those in the table.

The rules described above presume that any dividends on the policy are paid to the employer, or that they go to reduce the premiums. These dividends are not taxable to the employer. If the policy dividends are paid to the executive, they are typically taxable income to him or her. These dividends are exempt from any tax to the extent that the premium the executive paid that year exceeded the value of his or her term insurance coverage for that year. Dividends payable to the executive are sometimes used to buy additional insurance. Some executives do this because they want to offset the progressive drop in insurance coverage that occurs automatically as the cash surrender value, payable to the employer, increases. In this case, these dividends are considered taxable income to the executive.

The company is not permitted any tax deduction for its split dollar insurance premium. The company collects the cash surrender value completely free of income tax, but it receives no current deduction for the premiums paid to create that cash surrender value. In the event of the death of the executive, the company receives the amount paid into the policy and sometimes more. However, many companies are unwilling to tie up their funds that long, so they borrow against the cash surrender value of the policy in order to fund some of the cost of the premiums. This practice is referred to as financed life insurance. The use of financed life insurance can minimize the company's cash commitment in the split dollar arrangements. It does not affect the tax treatment of the premiums or the proceeds.

There are limitations on a company's tax deduction for interest which is paid on funds borrowed to buy or carry financed life insurance. Generally, the company cannot deduct interest on financed life insurance, whether the loan comes from the insurance company

or from another source, unless at least four of the first seven years' premiums are paid without borrowing. In the years in which the premiums are paid with borrowed funds the amount borrowed against the cash surrender value cannot exceed one years' premium.

For example, the company could pay premiums from its own cash funds for the first two years. Then in the third year, the company could borrow the amount of that years' premium and deduct any interest on that borrowing for that year. In the fourth year, they could borrow again the amount of that years' premium and deduct any interest. The company would pay the premium in the fifth year without borrowing, but deduct the interest on the two previous loans still outstanding, etc. After the seventh year, the company could then borrow the balance of the cash surrender value. At that time, the company is not limited to borrowing only one single years' premium.

There are some other exceptions to the rule barring the company's interest deduction. Interest on financed insurance may be deducted if the insurance is connected with the company's business. However, the Internal Revenue Service does not consider split dollar insurance to be business connected. Interest on financed insurance is deductible, even if no other exception is met, if it is less than $100 a year. However, this $100 cap is quickly exceeded if there is a sizable premium, more than one years' premium or if several executives are covered.

The executive covered by split dollar insurance must make a sizable premium payment in the first year and must make additional premiums in the following few years. Therefore, a company loan in the amount needed for these premiums may be in order. This loan can be made interest free, without tax consequences to the lender or to the borrower. This is considered a perk. If the company charges interest, the executive can deduct the interest paid.

Many companies provide split dollar insurance in manners which absorb some or all of the executive's cost, while retaining the company's share of insurance proceeds. This may be accomplished as follows:

- The company may pay the full premium cost. The company cannot deduct any of this premium since the company is a beneficiary of the policy. The executive is subject to tax on the full value of term coverage since the executive is not actually any premium cost.
- The company may pay the executive a bonus amount equal to his or her term insurance benefit. The executive contributes this amount as his or her premium cost. He or she is not taxed on the term insurance benefit, which is fully offset by the premium payment. He or she is taxed on the bonus. Using this plan, the result is the same as the company paying the full premium cost. This method is preferable to the company because it can deduct the bonus.
- The company may pay the executive a bonus amount equal to the term insurance cost plus the tax on that amount. For many executives, this amount is equal to twice the insurance cost. Using this method, the executive has no tax liability with respect to the insurance or the bonus. The company can deduct the entire bonus. Comparatively, the company's total cost is increased over the cost for the second method above by the amount paid to cover the executive's tax on the bonus less the tax saved by deducting that payment.

Split Dollar and Estate Planning

Although the split dollar method is commonly used for younger executives who are not yet able to afford large insurance commitments on their own, it is also often used among those older executives who are seeking to transfer some significant wealth to a noninsured spouse, children or grandchildren with minimal or no transfer taxes. Generally, this is accomplished when the spouse, child or grandchild applies for, owns and is the beneficiary of the split dollar life insurance policy. The executive may advance part of the policy premium in accordance with the split dollar arrangement. The balance is then contributed by the spouse, child or grandchild from annual exclusion gifts. Without using this technique, this transaction could generate as much as a 140 percent total transfer tax to the executive.

Using the split dollar technique, the death benefit of the policy is payable without income tax, estate tax or generation skipping transfer tax. The cash value and death benefit can roll over to the beneficiary outside the transfer tax system.

Security Aspects of Split Dollar

Purchasing company owned life insurance does not necessarily enhance the security aspects of nonqualified benefits, other than to provide a convenient, though sometimes costly, vehicle for the accumulation of the funds. Through the split dollar technique, employers have attempted to create additional security by sharing ownership rights to the policies with the executives.

Using the collateral assignment split dollar, the executive is designated as the owner of the policy. When the company agrees to make the premium payments, it has an ownership right to recover those premiums, normally without interest, when the employee retires. The employer is the beneficiary of death benefits which equal at least the premium payments. The employee names the beneficiary of the balance of the insurance proceeds. When the employee retires, the company recovers its premium, and the shared ownership of the split dollar agreement terminates.

At this time, the employee owns his or her policy free and clear. This is known as roll out, that is, the executive rolls out of the arrangement with his or her employer. Naturally, the split dollar arrangement may impose benefit forfeitures in the event that, at termination, the executive does not meet the predefined requirements of the agreement, such as specific age and service. Split dollar arrangements provide additional security for nonqualified benefits, at least with respect to the portion of the cash value owned by the executive. Because of the nature of the split dollar insurance, this is often not very substantial in the early years of the program.

The executive's portion of the cash value is not taxable to the executive before the roll out of the policy. However, whether the executive can avoid current taxation at roll out is open to question. Sometimes other insurance is offered together with the split dollar arrangement. This is intended to enhance benefit security. Using this arrangement, the company has only a limited security interest and the executive has rights in the cash value that would pass through in the event of the bankruptcy of the company.

The entire policy cash value is taxable to the executive as he or she becomes vested in the policy. After meeting specified age and service requirements, the executive has the

right to initiate vesting by making an advance election. A delicate balance exists in order for the funds to be protected from creditors without being determined as nonforfeitable, therefore, taxable to the executive before roll out.

Deferred Compensation

Deferred compensation refers to bonus deferral. It is compensation earned in one year but paid in another. Such devices used for deferred compensation are life insurance, retirement, profit sharing, savings plans, post retirement medical expense payments and others.

Deferred compensation for top executives takes one of three main forms, referred to as nonqualified deferred compensation plans:

1) Salary deferrals.
2) Bonus defers.
3) Employment agreements which provide for supplementary retirement payments, in addition to those provided under the company's other qualified retirement, profit sharing or savings plans.

Short-Term Deferrals

Short-term bonus deferrals involve the payment of an earned bonus in relatively few annual installments. Typically, part of the award is paid at the time it is declared, beginning in the year in which the bonus is granted. The remaining earned bonus is paid over a specified period of time, perhaps two, three, four or five years from the time of the award. The number of years used in deferral cycles ranges generally from two to five years. The most common deferral cycles are four years and five years. For example, a $10,000 award may be paid in five equal annual installments, consisting of $2,000 paid immediately and $2,000 paid each year for the next four years.

Short-term deferrals originally came about in the automobile industry. This industry is characterized by large bonuses relative to base salary and fluctuations in year-to-year profits. Consequently, bonuses may be generous one year and paltry the next. Further, if these bonuses are paid consistently, executives come to rely or depend on them in order to maintain their standard of living. In such cases, the purpose of the bonus is effectively eliminated.

Some Tax Consequences of Short-Term Deferrals

Since the Internal Revenue Code no longer allows for income averaging, these inconsistent bonuses are inefficient from a tax standpoint. The larger bonuses have extremely high marginal tax rates. So, initially, the short-term deferred cycle of payment is a sensible option. Also, from a stability standpoint, deferred compensation may offer security to some.

There are some tax consequences to the short-term deferral method of compensation:

- Since the payment installments under a short-term deferral compensation plan are made while the individual is still employed with the company, and, since the

executive's salary is likely to go up, he or she may find him or herself paying a higher marginal tax rate in the last few installment years of the award than if he or she had received the award in a lump sum.

- Tax rates may increase before the installments are completed.
- If the deferred funds are not wisely invested, the executive may suffer a penalty from short-term deferrals. He or she could have taken the monies immediately, paid the required taxes on them and put them to work.
- The tax consequences of short-term deferrals are to the company are less complex. The company can deduct deferred amounts on federal income tax returns, but only when they are actually paid to the executive.

Accounting Perspectives

The initial value of deferred compensation is charged against the company's reported pretax earnings in the year the executive performs the services. So, if a bonus of $10,000 is earned for one year performance, it is charged off totally that year, even though the executive may receives only part or none of it immediately during that year.

The company is not entitled to deduct a deferred compensation payment on its income tax return until the payment is actually made to the executive. This may seem to place the company in the position of reducing pretax income by $10,000, reducing the provision for federal income taxes by zero, and reducing after tax income by the same $10,000, instead of the $5,200 reduction that would normally be expected.

In requiring the company to take the $10,000 pretax charge to its reported earnings, the company is permitted to show the lowered provision for federal income taxes that would result if the deferred compensation had been paid immediately. Assuming a 48 percent marginal tax rate, the company lowers its reported pretax earnings by $10,000, its reported provision for federal income taxes by $4,800 and its reported after tax earnings by $5,200.

The company's tax bill has not actually been lowered by this $4,800 and will not be until the $10,000 is actually paid to the executive. To reconcile this discrepancy the company enters an IOU of sorts for the $4,800 on a balance sheet account called deferred income taxes. Then, when the $4,800 tax relief is actually received, the IOU for that amount is canceled.

Suppose this $10,000 bonus is deferred in cash with interest compounded at the prime rate. The principal sum has already been charged to earnings, but the interest must be charged to earnings as they are made. The company shows the tax relief that it would have received if the accrual had been immediately deductible. The IOU is entered in the deferred income tax account in the balance sheet.

If the $10,000 bonus is deferred in company stock the rules are more complex. For example, suppose that the company's stock is selling for $100 per share at the time the deferral is made. The executive's deferral account is credited with 100 shares. Suppose no dividends are paid during the deferral period, but that the stock rises to $200 per share by the time it is delivered. The company charges its reported pretax earnings by $10,000, shows the reduced provision for federal income taxes, and enters an IOU for $4,800 in its deferred income tax account. However, in determining its earnings per

share during the deferral period, the company must include the extra 100 shares in its share base.

The company has charged its reported pretax earnings with $10,000 but did not actually pay out any cash. Therefore, the stockholders' equity account rises by $10,000, compared with what would have happened had the bonus been paid immediately in cash. This amount is the same as the initial market value of the 100 shares.

In determining earnings per share, the company must lower the numerator of the equation, that is, the after tax earnings, by $5,200. This represents the after tax effect of the $10,000 bonus. Then, the denominator of the equation (the shares outstanding), must be increased by 100. This represents the promise of 100 shares. The company is permitted to adopt the reasoning that they will eventually have to issue 100 shares, but they have also created $10,000 of additional stockholders' equity.

On the date that the shares were credited to the executive's account, they could, if they wished, use this extra $10,000 of stockholders' equity to buy 100 shares of stock from the open market. In that case, they would keep the number of shares outstanding from increasing. Therefore, the only charge to earnings per share is in the numerator, and after tax earnings will decrease by $5,200. The number of shares outstanding will be the same.

During the year of payout, when the shares have appreciated in value to $200 each, the company is finally permitted to take a tax deduction on its income tax returns. At this time, the deduction taken is $20,000, representing the current value of the 100 shares. This reduces the company's actual income taxes for the year by 48 percent of $20,000, or $9,600. The first $4,800 of this $9,600 reduction in taxes goes into the deferred income tax account to cancel out the IOU which was deposited when the deferral was initially made.

The value of a tax deduction, with respect to a compensation payment, may be used to reduce the reported provision for federal income taxes only to the extent that the compensation payment itself is charged to reported pretax earnings. To the extent it is not, this value bypasses the income statement and is deposited directly onto the balance sheet as an additional contribution to stockholders' equity. In this case, since the $10,000 of appreciation in the shares was never charged to reported pretax earnings, $4,800 of tax relief generated by deducting this $10,000 of appreciation is also not charged to reported pretax earnings. Instead, the $4,800 increases the stockholders' equity by the same amount.

Now, the company still has the additional $10,000 of stockholders' equity created when the shares were promised, and now it has a further $4,800 in stockholders' equity created from the tax relief generated on the additional $10,000 in appreciation. If desired, the company can use this $14,800 to buy back shares from the open market. Since the shares are now worth $200 each, the company can buy back 74 shares from the open market, leaving 26 shares still outstanding. Whether the company actually buys back those shares or not depends on whether it has surplus equity capital or whether it can use the $14,800 for some other internal investment.

The cost of deferral compensation can be recorded in more than one way. In this illustration, the company took a charge to its earnings for the original deferral. It also

increased its shares outstanding by at least 26 at the end of the deferral period. These extra shares serve to dilute future earnings per share in every year that the company remains in business. The company might have increased its shares outstanding by as many as 100, but in doing so, it would have created extra equity capital, just as though these extra shares had been sold to the public.

For the sake of simplicity, this illustration assumed that no dividends were payable on the deferred shares during the deferral period. Generally, however, this is not the case. A charge occurs when dividends are paid. If the dividends are invested in more deferred shares, the appreciation in these shares is treated like the appreciation in the original shares. There is no charge to earnings, but the number of outstanding shares increases. If the executive had resigned prematurely and his or her shares were forfeited, the company would take a credit to earnings in the same amount in the year of the termination, since it had already charged these shares to its earnings.

Long-Term Deferrals

Long-term bonus deferrals require the postponement of the entire bonus award to be held until the retirement of the eligible executive or some other termination of his or her employment. At this time, the deferred amounts are paid in a series of annual installments, typically within ten to fifteen years. Long-term deferrals are usually offered to give the executive a tax advantage or to give the executive an incentive to remain with the company.

Tax Consequences of Long-Term Deferrals

Long-term bonus referrals have one primary tax advantage. The executive will probably earn less after retirement; therefore, he or she will be in a lower marginal tax bracket at that time. Deferred amounts taken after retirement will probably be taxed at a lower rate than at the time of the award. Of course, the extent of any tax increases will determine whether the advantages of long-term deferrals are eroded.

On the other hand, there is no real guarantee that deferring the award will result in a tax savings. The test with respect to whether tax rates are lower must be made between the year in which the bonus is declared and the year in which the installment is received, rather than the last year of employment and the first year of retirement. Therefore, given this inspection, perhaps there may be no tax advantage at all.

For example, suppose an executive with a $30,000 salary has some bonus money deferred until retirement. The company has a final pay retirement plan, which provides a benefit equal to 50 percent of the last year's salary. If the deferral occurred early in the executive's career and his or her salary has increased to $80,000 per year, he or she would retire with annual payments of $40,000 per year from the retirement plan and would, therefore, be in a higher bracket than he or she was in the year in which the money was deferred. Here, there is no tax advantage to deferred compensation.

This situation may occur even if the executive does not receive another promotion. Productivity increases advance going rates of compensation, as does inflation.

As with short-term deferrals, the company does not receive a tax deduction on long-term deferred compensation payments until they are actually made. At that time, the company can deduct the full value of the payment, including all appreciation above the original amount deferred. Of course, if the value has declined below the original amount contributed, the company loses part of its deduction.

Accounting reserves can be established for deferred compensation funds. Generally, however, these cannot be funded with payments guaranteed to the executive by some agency outside the company. The Internal Revenue Service typically holds that a company is not entitled to a deduction at the time the money is deposited in the trust, assuming the money could later be forfeited by the executive, for example, in the event of the executive's voluntary resignation. Further, if a trust is established and no conditions are imposed on the ultimate transfer of the funds to the executive, the executive would have immediate income, and he or she would be taxed on it at that time.

Generally, deferred compensation funds must remain unfunded. In this manner, they represent a lien of sorts on the company. Because of this, the executive could lose his or her entire deferred monies if the company should eventually go bankrupt.

The matter of the executive's ability to use government money is another tax factor in deferred compensation. This money represents the amount the executive would have paid as taxes if he or she had taken the income immediately. For example, suppose that a 45-year-old top executive receives a $50,000 bonus one year. Given his or her tax bracket, he or she would immediately have to turn over 50 percent of it, or $25,000, to the government, leaving him or her $25,000 to invest. He or she may invest his or her $25,000 in such a way that he or she receives no dividends or interest for the 20 years prior to his or her retirement, but increases his or her original $25,000 investment to $100,000, a fourfold appreciation. Therefore, this executive has achieved a long-term capital gain of $75,000.

Now, suppose the marginal tax bracket for this executive drops to 40 percent upon retirement, and he or she sells only a portion of his or her investment each year. This executive can expect to be taxed at a rate of only 20 percent on long-term capital gains, and can keep at least 80 percent of his or her total appreciation. The executive's after tax proceeds are 80 percent of his or her $75,000 appreciation.

Further suppose that the original award of $50,000 was deferred and invested in the same way. No tax is payable until the executive actually receives the securities. Therefore, the entire $50,000 is put to work. Assuming the same quadrupling in value, his or her investment appreciates to a total of $200,000 by the time the executive retires. The full value of these securities is taxable at ordinary income tax rates when distributed. However, by taking it over a period of time, the executive may maintain a 40 to 50 percent postretirement bracket. Given this set of circumstances, he or she may retain 50 to 60 percent of his or her $200,000 of deferred compensation, or $100,000 to $120,000. This is a substantial increase over the $85,000 which he or she would have received by paying his or her taxes at once and going for a long-term capital gain.

This supposition is only valid, of course, when the deferred compensation is invested. Unfortunately, many companies do not invest deferred compensation. Or, if they do, they do not give the executive the benefit of any appreciation. In such a situation, the $10,000

which is deferred is still only $10,000 at retirement. Unfortunately, the power of inflation will likely cause the $10,000 to be worth even less.

Another matter for consideration is outside income. Outside income has a tendency to rise as the executive grows older. It may represent a significant portion of his or her postretirement income. In this case, before there can be any tax advantages, the executive must receive substantially lower company retirement income when the installment is paid than he or she received in salary when the award was declared.

There really are no guarantees when it comes to long-term deferrals. Since they involve long periods of time, tax rates may rise, and other factors can affect the fund.

The Intent of Deferred Compensation

Deferred compensation is often employed as a device to cut down the executive's actual pay during the deferral period. For example, suppose an executive with a base salary of $140,000 who receives for the first time an $80,000 bonus payable in five installments. He or she actually has accrued compensation of $220,000. However, his or her actual cash compensation during that year is only $156,000. Therefore, the price the company has paid for establishing this holding device on one of its better executives is to leave the executive vulnerable to the recruitment of another company during the next four years.

With respect to deferred compensation, there are basically two trends:

1) Company stock as an investment medium is the most popular choice. However, today companies are using other more custom tailored portfolios as a means of providing deferred compensation. These include equities of other issuers, as well as established mutual funds. Since many executives are already establishing substantial company stock ownership through stock options, savings plans, etc., the use of other types of equities can be appealing.
2) Recent Internal Revenue Code rules have caused a renewed and growing interest in the use of restricted stock. Many companies are granting bonuses in the form of restricted stock. Using this approach, the entire bonus is paid in a lump sum in company stock which carries considerable restrictions concerning its sale for an extended period of time. When restricted stock is sold, the executive is taxed at capital gains rates on any appreciation above the market price since the date of the award. However, the price that the company pays in order to secure any capital gains advantages for the executive is the loss of its own corporate tax reduction on the executive's recognized capital gain income. Under most circumstances, using restricted stock, the executive nets more, but the net cost to the company is greater.

The issue of deferred compensation brings us back to the theory of the golden handcuffs. If an executive is made an offer from another company who will buy him or her out of his or her deferred compensation amount, he or she may make the move, even though the sums involved are equal. This reinforces the theory that types of deferred compensation are not really positive incentives to remain with the company, but rather disincentives to leave the company.

Therefore, the company offering deferred compensation may have to offer an even greater amount of money as deferred compensation. This, however, often results in a vicious circle, that is, the greater the amount of the deferred compensation, the easier it is to motivate the executive to accept an offer from another company. For example, the executive whose base salary is $140,000 and whose $80,000 bonus is given to him or her in five equal installments, receives only $220,000 during the first year of the plan. He or she is vulnerable to the company who offers him or her $220,000 with no deferrals. On the other hand, the first company is likely to find that it is difficult to attract a talented executive from a company which pays an immediate cash bonus.

Many companies who have tried this approach often abandon it because they learn that it ultimately fails to retain outstanding personnel. Some companies, however, believe strongly in this approach. Since all unpaid deferred compensation installments are deferred if the executive leaves the company voluntarily, this constant threat of losing their investment may create passive executives unwilling to take risks.

Those opposed to these deferrals argue that, through their year-to-year equalization of income, they actually provide diminished motivation since they weaken the impact of an exceptionally good year followed by an exceptionally poor one. For example, suppose Tom Miller is a top executive who receives a $25,000 bonus in each of the four years under a five-year, short-term deferral compensation plan. He will still receive $20,000 in the fifth year, even if he or she receives no new awards that year because his or her performance is poor.

Conversely, if the executive's performance is outstanding, and his or her bonus in the fifth year is doubled to $50,000, his or her cash flow that year will be only $30,000, that is, $20,000 from the previous bonus still due to him or her plus the first installment of $10,000 from the current bonus. Therefore, the difference between an outstanding or poor performance is a cash flow of $30,000 versus $20,000, rather than $50,000 verrsus $0.

It is obvious that the advantages of equalizing income from year to year are lost after a number of years in the company's deferral cycle. For example, an executive who receives a $25,000 bonus for five years under a five-cycle short-term deferral receives $25,000 cash flow in the sixth year and each year thereafter, as long as he or she continues to receive additional $25,000 awards. At this point, his or her cash flow compensation equals his or her nominal compensation. There is little further advantage accruing from the use of short-term deferrals.

However, this does not necessarily mean that a company should not employ some type of deferred compensation devices. Some executives may indulge in impulsive behavior which they later regret, and a moderate amount of holding power may be desirable to them.

Individualization

Perhaps a more motivational approach to deferred compensation is to permit each eligible executive to decide what is best for him or her and what he or she wants to do with his or her own money. If he or she elects to defer the funds, he or she may be granted his or her election without imposing on him or her any golden handcuffs.

In some instances, the compensation package is individualized to the executive's own needs. He or she is not forced to take something he or she does not want. Instead, he or she is offered the chance to take something he or she does want. The executive selects the type of compensation which best suits his or her needs. Therefore, he or she is motivated. Here, the company using this approach has an edge over the competition in attracting, retaining and motivating talented executives.

For example, suppose an executive elects to defer a $10,000 bonus. In addition to specifying the portion of his or her bonus to be deferred, this executive may be permitted to choose the manner in which the deferred funds are invested, such as company stock or cash with interest, as well as the disposition of dividends and interest, such as payment to him or her as declared or reinvestment. He or she may also be permitted choose the year in which the repayment of the deferred monies, plus any appreciation, would begin and the number of annual installments in which the entire amount would be paid to him or her.

Naturally, this individualized and flexible plan involves some additional administrative expenses. However, these are normally only a fraction of the total amount being deferred. Since the executive is receiving the type of compensation he or she prefers and which are most beneficial to him or her, the potential motivational benefits from this individualized approach are likely to outweigh the additional administration costs which are involved.

There is no single investment medium for deferred compensation funds that is best for all executives in all circumstances. However, some kind of equity securities are most often used because of the time element of the long-term deferrals. Some companies use fixed income securities. Others guarantee the executive the same rate of interest on his or her funds that the company itself pays to borrow money. The most common practice among those who do invest deferred compensation monies in outside securities is to place them in company stock. Company stock is considered an equity security. With the growth of a successful company, stock may protect against inflation. Further, it may offer more direct motivation, that is, on the job motivation, since the executive is likely interested in protecting his or her own investment.

There is a disadvantage to individualizing the deferred compensation plan. Under the Internal Revenue Service Code, deferred compensation cannot be counted as compensation for purposes of determining:

- A pension payment under a qualified pension plan.
- A contribution under a qualified profit sharing plan.

If benefits or contributions are predicated on the executive's base salary, the executive who defers some of his or her base salary therefore waives some eventual retirement income, and this may defeat any possible tax advantage. If benefits or contributions are predicated on total cash compensation and the executive defers some or all of his or her bonus, the same situation can apply.

This problem, however, can be avoided. In companies that do not include bonuses in their definition of pensionable earnings or of compensation for profit sharing plan purposes, the executive can defer his or her bonuses without penalty. Even if these

bonuses are included, the company's pension plan may be predicated on a five-year final average total cash compensation, for example. In this situation, the executive can take deferral up until the fifth year before retirement, without affecting his or her pension.

Another disadvantage to using company stock for this purpose is that the executive can risk becoming company stock poor, given his or her investments in company profit sharing, savings plans, retirement vehicles, deferred compensation, etc. It is usually not sound investment practice to heavily or disproportionately invest in any one company.

Some companies offer their executives the opportunity to place deferred compensation funds in the equities of other issuers. These may be in a diversified portfolio selected by company officers or the company's bank or investment in mutual funds. Typically, however, outside sources are used to select outside securities so that management will not be accused of any conflict of interest or blamed if the securities do not perform so well. From a practical investment perspective, this is a sound practices. This is especially practical when this approach is combined with some amount of company stock.

The use of outside securities can bring a company tax and cost problems. For example, suppose the company buys 100 shares of a blue chip stock for its executive at $300 per share. If the company later sells these shares at $600 per share to pay off the executive or gives him or her the 100 shares, the company is subject to a capital gains tax on the $30,000 gain. The company is not subject to such a tax, however, if it uses its own securities.

Most companies employing long-term deferrals generally offer either a choice of cash with interest or investment in the company's shares. If the executive chooses company stock, the company reinvests any dividends in more deferred company shares.

Deferred Compensation Contracts

Sometimes deferred compensation takes the form of individual executive contracts which specify that certain postretirement payments are to be made. Usually these contracts provide that the executive must actually retire from the company, as opposed to leaving voluntarily or being terminated, or are geared to his or her length of service. In addition, companies often require that the executive meet certain conditions as a part of the agreement. Often these include refraining from joining a competitor after retirement, making him/herself available as a consultant to the company, or both. Although these conditions may be considered a form of golden handcuffs, they are relatively insignificant.

The Doctrine of Constructive Receipt

Any such conditions are included to avoid any conflict with the Doctrine of Constructive Receipt. The Doctrine of Constructive Receipt is a doctrine of the Internal Revenue Service. The many long-term deferral options available to the executive are intended to be highly motivational, but they can also self-defeating, if the executive is require to pay full and immediate income taxes on the entire award at the time it is deferred.

This is the penalty if the company or the executive does not comply with the Doctrine of Constructive Receipt. The executive is presumed to have income at any time he or she can "reach out his or her hand and take it." Therefore, when company makes available the reward and the executive decides to defer it, the executive would have to come up with the taxes on the entire award by the following April 15. The fact that the executive does not take the award at the time it is offered is immaterial because "a taxpayer cannot turn his or her back voluntarily on income."

The Doctrine of Constructive Receipt can be difficult to apply. Although there are no hard and fast rules in the area of constructive receipt, it appears that an executive can voluntarily defer nonforfeitable compensation payments if he or she elects to do so sufficiently in advance of the time when the compensation is actually earned. For example, on January 1, at least one year prior to the date of a bonus award, the executive should give the company a statement to the effect that he or she would like to defer all or part of any bonuses awarded to him or her until retirement or other termination of employment. This is often done as a matter of formality at the time when the executive is hired.

Unfortunately, these conditions, which are made to protect the executive, sometimes cause the Social Security Administration to claim that the executive's deferred compensation payments represent income from gainful employment, thereby invalidating his or her claim to social security benefits. Only competent tax attorneys for both the company and the executive can help to resolve this and other compensation issues.

As with short-term deferrals, the company does not receive a tax deduction on long-term deferred compensation payments until they are actually made. At that time, the company can deduct the full value of the payment, including all appreciation above the original amount deferred. Naturally, if the value has declined below the original amount contributed, the company loses part of its deduction.

Accounting reserves may be established for deferred compensation funds. Generally, however, they cannot be funded with payments guaranteed to the executive by some agency outside the company. Such a process is called a trust. The Internal Revenue Service holds that such companies are not entitled to a deduction at the time these funds are deposited in the trust, assuming the money could later be forfeited by the executive, for example, in the event of voluntary resignation. Further, if the trust is established and no conditions were imposed on the ultimate transfer of the funds to the executive, then the executive would have immediate income and would have to be taxed on it.

Generally, deferred compensation funds must remain unfunded. In this manner, they represent a lien of sorts on the company. Because of this, the executive could lose his or her entire deferred monies if the company goes bankrupt.

Given the complexities of the accounting and tax issues surrounding executive compensation, many executives, even those concerned with company finance, often neglect their own personal planning and miss significant opportunities to increase their net worth.

New companies or specialized sectors of consulting firms and banks have recently been created to help the executive in his or her personal financial planning. Groups of experts

skilled in various types of investments can analyze the executive's total compensation picture and provide him or her with advice. The advice is truly unbiased because these groups do not receive brokerage fees, commissions, etc. Their fees for this service depend on the total assets being analyzed.

Some companies even pay for this type of service. They see it as a practical way of obtaining more of the executive's time and energy. There is the further advantage that, because an outside service is involved, the company can stay out of the executive's personal financial affairs.

Properly designed deferred compensation plans can have both motivational and tax advantages. This is complex and ever-changing area. Deferred compensation may motivate the executive only as much as it appeals to the individual executive. Even the most obvious tax advantages are worth little if the executive has an urgent need for the current income.

There are two basic principles which should be followed in making intelligent use of deferred compensation:

1) The executive should be given an opportunity to participate in his or her compensation plan.
2) The tax consequences of various deferred compensation alternatives should be analyzed by an expert.

Stock Options

Stock options are a form of deferred compensation. They are the granting to an individual the right to purchase a corporate stock at some future date at a price which is specified at the time the option is given, rather than at the time the stock is purchased. Stock options involve no commitments on the part of the individual possessing the stock option. He or she has only the right to purchase the stock. This option is usually exercised only if the price of the stock has risen above the price specified at the time the option was given.

Stock options are a form of executive compensation. They are usually given by a corporation in an attempt to motivate a top executive or officer to continue with the corporation or to improve corporate productivity in a manner which will cause the price of the stock to rise. Consequently, the executive increases the value of his or her option.

A stock option represents a corporation's offer to sell a specific number of shares of its stock to a class of employees at a specified price. Stock options give the executive the option of completing the purchase over a given period of time. If the value per share of the stock increases over the option period, it is to the executive's advantage to exercise his or her right to purchase the stock. He or she realizes a profit on the transaction. On the other hand, if the price per share declines during the option period, the executive will not want to exercise his or her right to purchase; he or she suffers no loss.

Stock option plans fall into two categories. They are classed as either statutory or nonstatutory. The differences between the two types lie in their design and in the tax treatment of any gain or profit.

Statutory stock option plans—Qualified stock options, also known as restricted stock options, and stock purchase plans are considered statutory stock option plans. To qualify as a statutory plan, the plan must be designed and administered according to statutes defined by the Internal Revenue Code. If all the defined conditions are met, the executive enjoys preferential tax treatment on the sale or transfer of his or her optioned stock. The spread, if any, between the option price and the fair market value at the time of the sale or transfer is taxed as a capital gain. However, the company does not receive any tax deduction on the transaction.

Nonstatutory stock option plans—Stock option plans which fail to meet one or more of the restrictions defined by the Internal Revenue Service Code necessary for statutory plans are termed nonstatutory stock option plans. For example, a nonstatutory plan can be structured so that the option period may extend beyond five years, the stock may be offered at less than its fair market value, or the three-year holding period need not apply. Plans of this type are often used where a major stockholder, rather than the corporation, offers option grants to executives.

Nonstatutory stock option plans have gained in popularity since the 1964 Revenue Act imposed additional restrictions on statutory plans. Bargain stock plans, options to independent contractors and options to employees by stockholders are typical nonstatutory plans. Generally, the executive, at some time in some amount, is subject to income tax on the transaction. At the same time, the corporation is entitled to its respective tax deduction. The time when the taxation occurs can be controlled by the restrictions placed on the executive by the company with respect to his or her rights to exercise the option or to dispose of the option stock.

Although nonstatutory stock option plans offer a company more flexibility in plan design, they present a different series of tax considerations and problems. Depending on how the plan is structured, the executive generally incurs a tax liability as compensation received at the time of the option grant, in the year that he or she exercises the option, or at some other time in the future. The company receives the respective tax deduction. However, after this tax has been paid, the basis of the shares are adjusted, and any further gain in the sale or transfer of the stock is taxed as capital gains.

Stock option plans are not without their opponents. Generally, those opposed feel that a stock option essentially provides an executive with a free stock market ride without any risk. If the stock goes up in price, the executive makes a bargain purchase. If the stock price declines, the executive does not suffer a loss. There is no risk. Some question why such options receive this preferential tax treatment.

Options are often challenged because of their cost to the company. When a statutory option is exercised by the executive, the company may sell the stock on the open market for its fair market value. Therefore, the cost to the company is the spread between the price of the stock on the date of the grant and its fair market value on the date of exercise, for which the company has received no tax deduction.

The Revenue Code-- Although used in various forms by companies since the early 1900s, stock options did not become subject to statute until the Revenue Act of 1950. The Revenue Act of 1950 was later manifested in the Internal Revenue Code of 1954. The Revenue Act of 1950 defined a class of restricted stock options. The 1954 Code provided that stock option plans which met a series of defined requirements, including

rules on timing and limitations on the amount of stock held, are classed as restricted stock options. An executive exercising restricted options receives preferential tax treatment at the time he or she disposes of his or her stock. Immediately, corporations recognized the tax advantages inherent in restricted stock option plans.

With few exceptions, if the recipient of a restricted stock option does not sell his or her stock for two years after the date of grant or six months after the date of exercise, he or she receives preferential tax treatment. Any profit he or she realizes on the transaction above the fair market value of the stock on the date of grant is taxed as a capital gain, not as ordinary income. Except in very limited situations, restricted stock options must have been granted prior to 1964.

The 1964 Revenue Act had the effect of freezing further use of restricted stock options and using qualified stock options and stock purchase plans in their place. Wisely, many companies with unexpired restricted stock option programs, amended their plans so that any options issued after December 31, 1963, would meet the requirements for the new qualified stock options.

Qualified Stock Options--The Revenue Act of 1964 provided for a new class of stock option called qualified stock options. Under qualified plans, the option price must be at least the fair market value of the stock. The option must be exercised within five years after the date of grant. To qualify for capital gains tax treatment, the executive must not sell his or her stock for three years after the date of exercise.

In order to meet the requirements of the 1964 Revenue Act, a qualified stock option must meet the following criteria:

- The plan requires stockholder approval—Options to purchase stock of the employer corporation, its parent or its subsidiary must be granted under a plan which includes the aggregate number of shares which may be issued under options. The plan must establish the employees or class of employees who are eligible to receive the options.

- Further, the plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.

- Options must be granted within 10 years—Options to purchase shares of stock authorized under the plan must be granted within 10 years from the date that the plan is adopted or the date that it is approved by the stockholders, whichever occurs first.
- Options must be exercised within five years—The terms of the plan must provide that options cannot be exercised after five years from the date the option is granted. This restriction, combined with the requirement that options must be granted within 10 years, places a maximum life on any one option program of 15 years.
- The plan participant must be an employee—The terms of the plan must provide that, at all times, from the date that the option is granted until three months before the date that the option is exercised, the participant must be an employee of the corporation, its parent or its subsidiary. This restriction is intended to prevent the use of qualified stock options as a device to compensate independent contractors and others who are not actually employees of the company.

- Shares must be held for three years—Under the 1964 amendments, a participant in a stock option plan must not sell or transfer his or her shares for a three-year period beginning the day after the date of transfer following his or her exercising the option. If the participant does sell or transfer his or her shares before the end of the three-year period, he or she is subject to income tax in the year in which he or she sells the stock. The tax is levied on the increment between the price of the stock on the date the option was granted and the price of the stock on the day of disposition. Naturally, the corporation issuing the option is entitled to its respective tax deduction for compensation paid.

- Old options must be exercised first. The plan must stipulate that options cannot be exercised by a participant while there are any unexpired, qualified or restricted stock options still outstanding to his or her account. This requirement prevents the possibility of an executive exercising only his or her newer options in the event that the per share value of his or her stock has fallen, and he or she also holds older, higher-priced options.
- The amount of stock already held is limited. Generally, no stock option can be granted to an employee who, immediately after the option is granted, possesses more than 5 percent of the total combined voting power of all classes of stock issued by the corporation, its parent, or its subsidiary. However, this 5 percent limitation can be increased to as much as 10 percent in corporations where the equity capital is $2 million or less.

Advantages of Stock Option Plans--Both statutory and nonstatutory stock option plans afford corporations the opportunity to compensate executives and other employees in a completely discriminatory manner. Stock purchase plans, on the other hand, require broad coverage of employees. Stock option plans enable the corporation to determine eligible executives. They may, within broad limits, arbitrarily determine the number of option shares to be granted to each eligible executive.

From a compensation perspective, stock option plans are a device to emphasize long-term corporate success, as opposed to more short-term incentive programs. From the executive's perspective, stock option plans represent a form of compensation which makes it possible for at least some of the income received to be taxed as a capital gain. This is particularly important for executives in the upper tax brackets.

Further, stock option programs enable corporations to conserve working capital, while providing substantial levels of compensation. To the extent that treasury, or authorized but unissued stock, is used, the compensation objectives of the company can be realized without the direct expenditure of corporate funds. This enables newer companies with limited capital, but good potential, to attract top executives from larger, more established firms.

Disadvantages of Stock Option Plans--Although stock options offer many advantages, there are also disadvantages. Stock options provide little incentive or compensation value to an executive in times of a declining stock market. Also, given stock market fluctuations, there is usually little correlation between corporate earnings and the market value of a company's stock.

If a qualified stock option plan is used, the executive must hold the option stock for three years after date of exercise in order to obtain capital gains tax treatment. Although these

difficulties can be lessened by using nonstatutory option plans, many employees have been forced to sell substantial amounts of option stock in order to help finance its purchase.

The Funding of Nonqualified Plans

Federal legislation has made all types of qualified plans gradually less effective in meeting the retirement income needs of executives and other highly paid employees. Therefore, many companies have found themselves investigating more tax effective ways to compensate for lost benefits and deferred compensation opportunities.

Naturally, the use of nonqualified plans is expanding in this environment. Nonqualified benefit obligations are increasing. Generally, nonqualified plans are unfunded, and they lack the security available under the well-funded qualified plans. In order for covered employees to avoid current taxation on their nonqualified benefits, such plans cannot be "funded" in the same way as qualified plans are funded. Even if the employer accumulates substantial assets in a trust solely designed to fund these benefits, there generally must remain a substantial risk of benefit forfeiture.

There are many risks to nonqualified plans. Some of these are:

- Corporate insolvency. Nonqualified plan benefits represent only a promise to pay. Therefore, unless there is some sort of a security vehicle, the executive is effectively made a general creditor of the corporation in the event of insolvency. In such a case, it is very likely that plan participants will suffer a significant benefit loss.
- Management change. Any future changes in management or company control could conceivably cause executive benefits to be reduced or even disavowed.
- Given the significant number of senior executives' benefits which have, and will continue to have, their genesis in nonqualified benefit programs, it is not surprising that the search for ways to fund and secure the payments of those benefits has become a substantial and consequential event for many companies.

With such a great significant proportion of their retirement benefits no longer backed by qualified plan assets, executives are concerned about the security and funding of those benefits. Considering the potential for all types of changes in companies over the years, such as possible insolvency and management change, companies are examining closely new opportunities for securing and funding their benefit obligations.

The issues of funding and security are two separate and distinct issues. Funding a benefit does not necessarily provide security, except to the extent that the assets which are accumulated can be immutably targeted for the payment of the benefits. Benefits can be secured in various ways, not all of which require the actual accumulation of assets in advance. The closer the plan comes to achieving full security from all risks and funding of all obligations, the greater the risk that covered employees are subject to current taxation on their benefits.

There are several methods commonly used in order to secure benefits. Each has its own advantages and disadvantages, striking different and separate balances between the levels of security and the desire to avoid adverse tax consequences. Some of the methods used to secure such benefits include:

Secular trusts—A secular trust is an irrevocable trust to which the employer contributes assets which are used to fund the benefits. This arrangement combines funding with complete security, that is, to the extent that benefits are funded. This is because the assets are not available to the employer's creditors. However, these trusts have negative tax consequences. For example:

- There is the potential for double taxation, and this sometimes limits the use of secular trusts for funding benefits.
- In an employer established trust, executives are taxed on the value of their vested account balances. This includes trust earnings to the extent that amounts are vested and have not been taxed previously.
- In an employer established trust, income on trust assets is taxed at the trust level. Further, they are later taxed to the executive when the funds are distributed. Income tax at the trust level can be avoided if the income is distributed by the trust soon after the trust's tax year ends.
- In an employee established trust, the plan cannot impose any vesting rules.
- The plan is subject to ERISA requirements, resulting in complex administration.

Nonqualified annuities—A company can purchase nonqualified annuities as a means to compensate its executives. In corporations which are established for profit, the annuity is typically owned by the executive. This avoids corporate tax on investment growth. The annuity amount is calculated in order to achieve the after tax benefit assured by the nonqualified plan, taking into account that a portion of each payment is taxable to the executive. The executive may receive a gross-up payment, along with the annuity premiums, to cover taxes. The value of the annuity and the gross-up payments is taxable when distributed. This approach provides both funding and security. However, there is a high cost involved because of the tax gross-up.

Surety bonds—Surety bonds are a form of third party guarantees. These became a favorite technique for funding in 1984 when the Internal Revenue Service legitimized their use as security vehicles. In 1986, however, the IRS suspended its ruling on surety bonds in order to reconsider whether employer involvement in their purchase provided an economic benefit to the employee. Today, surety bonds are still used, though not as commonly as some other sources of funding.

Letters of credit—Letters of credit are also a form of third party guarantees. Using this technique, employers can secure their obligations by acquiring an irrevocable letter of credit from a bank. There is no Internal Revenue Service guidance on the subject of letters of credit. Establishing this type of an arrangement may cause the plan to be considered funded because the letter of credit shifts assets out of the reach of creditors. This might influence taxation to covered executives.

Indemnity insurance—Indemnity insurance is a third form of third party guarantees. It is available to protect vested executives in the event that their benefits are denied. Indemnity insurance is a relatively recent phenomenon. Coverage is available for benefit loss because of insolvency, breach of contractual benefit rights, or both.

Under a 1993 Internal Revenue Service ruling, as long as the executive purchases indemnity coverage directly and the company is not involved in the transaction in any

way, these benefits are not considered to be totally secured. Therefore, the executive is not taxed currently on these benefits. This coverage has not yet become widely used. However, given the advantages of no corporate cash requirement, full security and no taxation, the use of indemnity insurance as a form of funding is likely to grow.

Rabbi trusts—Rabbi trusts, a third party guarantee, are probably the most widely used security device. Their name comes from the fact that the first rabbi trust was set up by a congregation for the benefit of its rabbi. Rabbi trusts are quite common among the sponsors of nonqualified plans. A rabbi trust is set up in order to pay nonqualified plan benefits. Using this device, the employer decides how well to fund the trust, and assets held in the trust are used as necessary in order to pay benefits as they become due. Although assets in a rabbi trust can be used only to pay specific nonqualified plan benefits, they are available to the general creditors of the company, in the event of corporate insolvency. Investment income is taxable to the company.

Although rabbi trusts are not effective in protecting against corporate insolvency, they can be useful as vehicles to protect against the loss of benefits because of a management change or control. When properly set up, rabbi trusts do not result in current taxation for covered employees. The Internal Revenue Service has even issued a "model" rabbi trust, further legitimizing their viability.

Springing rabbi trusts—A springing rabbi trust, like a rabbi trust, is a form of a third party guarantee. It is a type of grantor trust. This trust is either unfunded or minimally funded in advance of certain predetermined events. When such an event takes place, such as an executive acquiring 20 percent of the voting shares of the corporation, the company is then required to fund all benefits fully up to an already specified level. The advantage of a springing rabbi trust is that assets are not tied up in advance of the time when the benefit payments may be endangered. The disadvantage of a springing rabbi trust is that funding may not take place when it is required. Further, legal action by a potential acquirer also could prevent funding.

Rabbicular trusts—A rabbicular trust is a form of third party guarantee that is essentially a rabbi trust which, upon the occurrence of certain events, becomes a secular trust. Using rabbicular trusts, executives are taxed on all vested benefits to the extent they are funded under the trust when that conversion is effective.

Agency arrangements—Using an agency arrangement, a third party holds employer assets intended to pay executive benefits. The employer maintains investment control until the occurrence of a triggering event. Agency arrangements are also sometimes referred to as shadow trusts or escrow arrangements. These arrangements have no real tax advantages over rabbi trusts. Essentially, they are less secure than rabbi trusts.

Using Life Insurance in Deferred Compensation Plans

There are many advantages of using life insurance to fund a deferred compensation plan. Some of these are:

- The informal funding of a deferred compensation plan through life insurance is attractive when the plan provides the payment of death benefits. When life insurance

is used as a funding technique, the employer's obligation to pay the death benefit is met in the event of the early death of the employee.

- Using life insurance as an informal funding device takes advantage of the tax-free state of the cash value of the policy during the accumulation period.
- When the employee reaches his retirement age, the employer has the option of either using the cash values of the life insurance policy to pay the retirement benefits or, if other assets are available, it may use those, keeping the policy in force and collecting the death proceeds at the death of the employee. In many cases, the death proceeds that the employer receives from the insurance company can be more than the company would have paid out to the employee and his beneficiaries as benefits under the plan.
- Life insurance funding of a deferred compensation plan makes available the waiver of premium benefit, relieving the employer of the obligation to pay premiums if the insured employee becomes totally and permanently disabled. Using this waiver of premium benefit, even though the premiums are waived, the policy remains in force. Its cash values continue to grow. When these dollars are no longer needed to pay the premiums, they can be used in other ways. They can be used to provide disability income to the employee, or they can be used to reduce the employer's cost of the plan.
- Life insurance funding of a deferred compensation plan makes available settlement options. This is especially attractive when the plan requires the employer to pay a life income to the employee. By electing a life income option, the employer can essentially pass on the risk of the employee's living beyond his normal life expectancy to the insurer. When life insurance is used to fund a deferred compensation plan, the employer is generally the policy owner, the premium payer and the beneficiary of the policy.
- Premium payments are not considered tax-deductible. This is because the employer has a beneficial interest in the policy. The guaranteed cash values and policy dividends accumulate tax-free. However, if the dividends are left on deposit at interest with the insurer, the interest earned on these dividends is considered taxable income. Like other life insurance proceeds, any death benefit proceeds received by the employer are received tax-free.

The Executive Bonus Concept

Middle and top management employees are typically classified as special groups for the purposes of compensation. This is done to devise special compensation programs which are used to attract, retain and motivate exceptional people in order to perpetuate the business profitably. This profitability refers not only to the executive, but to the shareholders, to the management, to the workers within the company and to consumers. Not all managers are considered executives, qualifying them for these special compensation considerations. Those at a rank lower than middle managers are usually not considered for executive compensation bonus plans. It is the top 1 to 10 percent of executives whose compensation structure diverges from traditional company practices.

The major point of deviation in pay practices for this group is tied to the role of the competitive market. The performance of these highest ranking executives plays a major role in the performance of the entire company. Retaining these people on a long-term basis and effectively motivating them is particularly important. Naturally, the base salary

of these executives must be competitive. However, in addition to their base salary, highly ranked executives are offered a bonus as an incentive reward.

A bonus is an incentive payment given in a lump sum, or a series of payments, which is tied directly to the executive's achievement of performance standards. Generally, the achievement of goals is not expressed in standard output, rather it represents major steps toward the achievement of individual, divisional or organizational goals. Performance goals are revised annually to reflect the changing nature of the company's objectives. The importance of a company's annual bonus plan cannot be overlooked. It is potentially one of the most important motivational elements in the executive's entire compensation package.

Those in companies which offer bonus plans typically receive higher total compensation packages than in those companies that do not offer such programs. However, this is dependent upon the performance of the particular executive, his or her division and the overall corporate performance in a given year. Those companies offering bonus programs generally pay base salaries at a lesser level than nonbonus paying companies. The bonus system itself and the proportion an executive receives, relative to his or her base salary, are the motivational and financial incentives for the executive to perform well.

The annual executive bonus concept must be designed so that it stimulates the behavior which leads to attaining the company's objectives. Determining the company's objectives is the first step toward designing this bonus plan. It is an important task which requires a great deal of thought. The plan should be extended only to those executives whose duties and responsibilities give them the opportunity to make a meaningful and substantial impact on the company. Of course, all employees have some affect on the achievement of a company's goals. However, a few employees, mainly high ranking executives, have an extraordinary impact on the company. It is for these executives that the bonus plan is intended.

When designing any bonus plan, there should also be some consideration to awarding others at lower level positions who perform exceptionally and who have a significant and positive impact on the company.

The executive bonus plan should provide for payment of truly meaningful awards. For example, at the level of upper ranking executives, awards of a month's salary are not effective. Effective bonuses typically range from 50 to 60 percent of the base salary level and upward. Further, these bonuses should rise sharply as the company closes on its objectives. This provides a way to recognize that these last increments of performance are the hardest to achieve, and, at the same time, they are the most profitable.

Some of the major principles involved in developing a sound bonus plan design are:

- Adopting meaningful award levels.
- Providing some special awards for those not regularly eligible to participate.
- Appraising executive performance pragmatically.
- Granting outstanding executives the award they genuinely deserve.
- Restricting the eligibility of the bonus plan to executives who have a significant impact on the attainment of the company's major objectives.

- Designing an internal corporate funding formula to insure that those executives who are eligible are motivated to accomplish the company's goals and objectives.
- Designing an external corporate funding formula to assure the shareholders that the funds for executive bonuses are reasonable and in line with the company's ability to pay.
- Designing divisional funding formulas to generate part of the funds for the particular divisions.
- Developing allocation procedures which recognize that some units outperform others.
- Using the integrated compensation structure to establish bonus amounts.

Eligibility

Determining who is eligible for the executive bonus plan is a difficult task. Naturally, those whose duties and responsibilities offer them the greatest opportunity to make the most substantial impact on attaining the company's goals should be eligible. The converse is also true; that is, those whose duties and responsibilities do not offer them the opportunity to make a significant impact should not be eligible to participate in the plan. Distinguishing between levels of impact can be an a arduous assignment, especially when the responsibilities in any company overlap and are continuous.

Unfortunately, the result of this task will always be considered arbitrary. Some companies choose to make only officers eligible to participate in these plans. Some companies choose to make all exempt personnel eligible, and others determine participation on the basis of salary levels. Some even use the practices of competitors as a guideline.

Generally, larger companies whose employees number 25,000 or more typically extend bonus eligibility to approximately 10 percent of the total number of employees. Smaller companies usually extend bonus eligibility to 1 to 2 percent of the total number of employees. Some interesting points with respect to parameters for executive bonus eligibility are:

- The percentage of executives eligible for bonuses as part of their executive compensation is generally higher in the more labor-intensive industries than in capital-intensive industries. This is because in the capital-intensive industries, there are fewer major decisions made, though these often involve great amounts of money at one time.
- The percentage of executives eligible for bonuses is higher in highly technical companies than in companies making more ordinary products.
- The percentage of executives eligible for bonuses in divisionalized organizations is generally higher than that in centralized companies. Decision making is spread among more executives.
- The percentage of executives eligible for bonuses is generally higher in the more successful companies than in less successful companies.

Typically, those eligible for executive compensation plans are:

- Those with a specified base salary and above.
- Those assigned to a specified compensation grade and above.

- Those above a specified management level.
- Combinations of the above.

The Integrated Compensation Ranges

Bonus awards are generally expressed in terms of a percentage of base salary. However, these awards are administered in dollar terms within the integrated compensation structure. This avoids the possible pyramiding of compensation and the creation of other inequities.

Award levels should be probably not be established as a percentage of salary, but as the dollar distance between the executive's current base salary and the targeted position in the total compensation range that has been established for his or her performance level. This approach corrects, rather than intensifies, any compensation inequities.

One perceived disadvantage of this approach is that the dollar amount of bonus paid to an executive whose salary is below his or her targeted range point decreases, as his or her salary approaches its correct level, unless, that is, he or she simultaneously improves his or her performance. This standard is perceived as demotivating by some. However, others insist that any high ranking executive's performance should continue to increase as long as he or she is employed.

Incentives

Companies are naturally in business to make profits. Therefore, most annual executive bonus plans are designed to maximize the company's annual profits.

Annual profits are generally determined by the bottom line on a company's income statement, that is, the net income. There must be a determination made with respect to whether the company's executives should be rewarded or penalized for achieving extraordinary gains or losses. Some believe in assigning the blame to management for what goes wrong and extending the credit, too, for what goes right. The proponents of this reasoning believe that the bottom line tells the entire story.

On the other hand, there are those who believe that executives should be rewarded, or penalized, only for the results under their direct control. These people exclude extraordinary gains and extraordinary losses in defining profits.

The Financial Accounting Standards Board, the rule making body for the accounting profession, has issued a regulation that limits the variety of transactions that can legitimately be reported as extraordinary items. The FASB has adopted a philosophy toward the bottom line theory.

Many companies still choose to define profits, for bonus purposes, as net income before extraordinary items. There are exceptions where the company's board of directors or its compensation committee elects to include such items, sometimes on an individual case basis. This is geared more toward the "control over results" approach, since it implies that the executive management should not be held accountable for any extraordinary items, unless the executives can be genuinely charged or credited for them.

Income Taxes

An often asked question with respect to the definition of profits, for bonus purposes, is whether the definition of profits includes or excludes income taxes. Those who maintain the bottom line philosophy argue that since stockholders take their dividends and reinvested earnings out of after tax profits, executives should do the same. When taxes increase and dividends are often cut, executives should take the same hit.

Those who maintain the "control over results" philosophy see matters differently. They argue that since executives cannot control the income tax rates levied on the corporation, they should not be penalized or rewarded when tax rates change. Congress passed legislation affecting investment tax credit. The amount of capital expenditures, and the amount of any credit, is certainly under the control of top management. Further, they maintain that top executives are regularly presented with many variables and uncontrollables. Tax rates are simply one of these.

In the past years, the majority of executive bonus plans were predicated on pretax profits. More recently, however, most of the newer plans seem to be following the trend of basing these on after tax profits.

To illustrate, suppose a company decides to use pretax profits as the basis for its executive bonus plan. When the company looks at the costs that go into the determination of their pretax profits, it discovers a charge for the cost of the bonus plan itself. If the pretax profits are seen at approximately $1 million, the CEO reasons that his or her executive team will receive approximately 20 percent of the pretax profits, or $200,000. The comptroller argues that if bonuses of $200,000 are paid, the pretax profits then drop to $800,000. In such a case, the company would be exceeding their own 20 percent of profits bonus limit. When the CEO perceives that the bonus will be only $160,000, or 20 percent of $800,000, the comptroller explains that if bonuses of $160,000 are paid, the pretax profits still drop to $840,000, and so on.

This situation of leaving the accrued charges for bonuses in the definition of pretax profits causes a company never to realize its full pretax profits. Most companies, therefore, define profits before any charges for bonuses are levied against the profits. If pretax profits are used as the basis for the bonus plan, any amounts already accrued against profits for bonuses are added back to pretax profits. If after tax profits are used as the basis of the plan, an amount equal to the after tax cost of the bonus accrual is added back to the profits. For example, if a company that is at a 48 percent marginal tax rate and has already charged $1 million against pretax profits for executive bonus plan, $520,000 is added back to after tax profits, since that is the amount by which the after tax profits would be decreased, if the charges were not reversed out of the income.

Theoretically, a group of executives could be promised a bonus of $150,000 if pretax profits exceeded $1 million. As the year comes to a close, the group could run the numbers and determine that the pretax profits would likely peak out at $970,000. They could pool their funds and contribute $30,000 toward the pretax profits by creating a dummy sale, thereby effectively permitting the company to achieve its $1 million in pretax profits. The group receives its $150,000 bonus.

A bonus plan such as this is referred to as a go, no go plan, sometimes referred to as a cliff effect. No bonus funds are created up to a specified point in the profit stream. At this

point, a large fund is created, even if profits advance by only a single dollar. Obviously, there is an invitation to fraud at the "go, no go" point. The company's stockholders are not likely to see that final dollar of profit generated, knowing that single dollar would cost them $150,000.

In some instances, such a feature is necessary for other reasons. If this is the case, the impact can be mollified by defining profits as after the costs of the bonus plan itself have been charged to profits. This allows executives to receive 100 percent of the incremental profits for a time. Using such a plan, there is never a point in the profit stream where the executives stand to receive more than the incremental profits.

Divisional Bonus Plans

A division bonus plan is often used as part of the executive bonus concept. A company may choose to develop a bonus plan for a particular division, rather than for the company as a whole. Or it may offer varying bonus incentives for different divisions.

Again, there is controversy over what is considered divisional profits, for bonus purposes. Are the divisional profits considered before income taxes and before the costs of the plan are charged? Another issue concerns the inclusion or exclusion of charges for corporate overhead. Those who subscribe to the bottom line philosophy contend that the division should accept its fair share of corporate overhead charges, since such charges are simply another part of the cost of doing business. Further, as only a part of the entire company, the division is receiving services that it would otherwise have to purchase directly.

The other side contends that corporate overhead is a paradigm of uncontrollable charges and that these should be excluded when figuring divisional profits for bonus purposes.

Generally, the company CEOs choose to charge out the corporate overhead. On the other hand, the division managers and executives naturally take the opposite position. The division managers sometimes see the perspective of the CEOs when they consider that while they are being held responsible for company overhead charges, they are also getting the benefit of the services they provide.

Sometimes companies offer their divisions incentives only for raw profits, even though the corporate funding formula might be set forth on return on stockholders' equity. These companies reason that they will control major increments to capital through a tight capital budgets. Also, the profit budget imposed on a particular division naturally contains an genuinely acceptable return on investment.

Often companies develop an additional corporate funding formula to generate bonuses for corporate executives on the same basis as the divisional funding formulas generate them for divisional executives. If a division is to receive a particular bonuses for meeting its profit budget, the corporate executives within that division receive the same bonus. Sometimes this is referred to as an internal funding formula. This term is used because the formula is not submitted to shareholders for approval, and it is often revised annually in order to meet a particular year's profit objectives. However, when used, this formula

must operate like the stockholder approved formula, often called an external funding formula.

Once all of the funding formulas have been decided, it must be determined whether the division bonuses should be predicated on division performance totally or only in part. For example, the division may perform stellarly, although the performance of the company as a whole was not as bright. The question is whether the outstanding division and its executives are eligible for the full bonus, or whether their bonus is linked to the overall performance of the company. Perhaps because of the overall poor performance of the company, the available bonus funds are not what they should be.

In many instances, the division executives know that part of their bonus funding is predicated on the corporate results. Or, an individual executive's bonus may be predicated on the performance of his or her entire division. Sometimes the funds operate independently; often they are linked to one another. If, for example, a division exceeds its budget while the corporation comes in below its budget, the division may receive more than half its allocated bonus from the division fund and less than half, or perhaps nothing, from the corporate fund.

This type of funding encourages teamwork. This teamwork is an incentive for the executive, his or her division or profit center, and the corporation as a whole. Depending on the degree of interdivisional teamwork, the funding may be split 50-50, 75-25, 25-75, or any way seen fit.

Some companies approach bonus funding concluding that in order to obtain maximum motivation from all parts of the company, the divisions should be guaranteed their bonus funds if they perform, regardless of what occurs throughout the rest of the corporation. Those who argue in favor of this approach illustrate the corporation that lost $30 million in one year, and one high-ranking executive and those in his or her division still received hefty bonuses. When the stockholders cried that they didn't receive any bonuses and that the corporation as a whole had actually performed poorly, it was pointed out that had this particular division not performed so exceptionally, the corporate loss might have been $40 million or more.

Security Aspects of the Bonus Concept

Bonus plans often are used as a convenient and tax effective vehicle for companies to fund preretirement and postretirement life insurance benefits for their executives. Bonus plans can also provide a secured retirement benefit. Using the bonus benefit plan, the company makes a contribution to a life insurance policy which is owned by the executive. The executive is currently taxed on the premiums paid, and the company may gross-up for this. Part of the payment funds death benefit coverage. The remainder of the funds accumulate for retirement income.

Bonus plans are entirely secure, in that the executive has full title to the policy. From a security aspect, compared to split dollar insurance, bonus plans have certain advantages and disadvantages. These include:

- Nontaxable access of the funds through partial withdrawals. The executive may withdraw a significant portion of the accumulated cash value of the fund because it has been taxed in advance.
- No roll out taxation issues. A major disadvantage is the inability to provide vesting rules, or golden handcuffs, with respect to policy values.
- It is possible to build additional security into a nonqualified bonus plan. By using a Supplemental Executive Retirement Plan (SERP), the company can permit its executives to avoid the long-term reliance on the circumstances of the company. The SERP allows the company to offer accelerated payout provisions, such as a lump sum payout option or a payout over a period of three to five years. Longer payout options may be more appealing to the company for cash flow reasons, as well as to enhance the long-term business focus of executives who are approaching retirement age.

  The haircut provision of the SERP allows the executive to receive the value of his or her nonqualified benefits at any time, with a significant penalty, typically ten percent, and sometimes the permanent suspension of further plan participation. Stiff penalties are required in order to avoid adverse tax results. Theoretically, the haircut provision permits executives who believe that the company is in danger of insolvency an opportunity to get their money before this occurs. However, the bankruptcy courts may retrieve any amounts paid to insiders within one year of the insolvency and any amounts paid to noninsiders within three months of insolvency. Regardless, haircut provisions have some real value in certain cases.

Return on Investment

Bonus plans are usually spoken of in terms of incentives for profits. However, sometimes the issue of incentives for the conservation of capital is not even addressed. If the incentive is for only pretax profits alone, the company could conceivably sell an additional $100 million of stock to the public and invest this money in certificates of deposit at six percent interest. Although this strategy would increase the pretax profits by $6 million dollars and the extra profits would be used for paying a larger bonus, the stockholders would not likely be happy with their return on investment.

The executive bonus plan must consider the issue of how important the return on investment (ROI) is to the business. In some cases, certainly, there are cases where ROI is not so important, but these cases are unusual.

There are four ways in which to measure a company's return on investment for executive bonus plan purposes. These are:

Earnings per share—Using the method of earnings per share, profits, however they may be defined, are divided by the number of shares outstanding. This method offers only moderate capital conservation. If the company needs more capital, it can cut its dividend and divert more after tax profits to retained earnings. This does not trigger an increase in the number of shares outstanding. Further, the incremental retained earnings are interest free. Any return on these earnings goes straight into profits, further increasing the earnings per share.

If this strategy is not successful, the company can borrow the funds required. Using this strategy, interest will have to be paid, but any incremental return on the debt that exceeds the interest payment flows through to profits and to earnings per share. The total number of shares outstanding remains constant. The earnings per share incentive is typically significant only when a straight profit incentive is employed, such as the case when the company cannot raise enough capital from retained earnings and debt sources and is, therefore, required to sell more shares on the open market.

A criticism of the earnings per share measure is that it may give top executives an incentive to leverage the company, taking on additional debt when they should be selling more equity. This can create disaster for the company if profits decline significantly and render if difficult or impossible to service the higher debt load.

Another criticism of this method is that because the shares outstanding, that is, the denominator of the fraction, may increase only a little, if at all, in a single year, there is no real incentive to conserve capital. Or, the denominator may increase dramatically under such circumstances as the company's making a major equity offering or issuing large amounts of stock in order to acquire another company, causing bonuses to plunge without good cause.

Return on Stockholders' Equity--Using return on the stockholders' equity is a method of measuring ROI. The numerator of this fraction is profits, however they are defined. The denominator consists of the sum of the capital stock, the capital surplus and the retained earnings, sometimes referred to as earned surplus. These are measured either as of the beginning of the fiscal year or as the average during the year. This measure of ROI is usually more accurate and effective than the earnings per share method since executives are required to earn a fair return, not just on the monies received from the sale of new shares but also on the monies received through retention of earnings that are not paid out in dividends.

This method is probably the most frequently used incentive measure of ROI for executive bonus plans, especially in a healthy economy.

Return on capital employed—Another method of measuring ROI is to use return on capital employed. Using this method, the numerator is the sum of the profits, however they are defined, and the amounts charged against these profits for interest on long-term debt having a maturity of more than one year. The denominator of the fraction consists of the sum of the stockholders' equity and the long-term debt having a maturity of more than one year.

The capital employed, that is, the equity plus the long-term debt, represents the permanent capital any company has to work with. This is often considered the best measure of return on investment. The potential incentive to leverage the company with debt disappears when using this method, since the management is charged with producing an adequate return on all permanent capital in the business, not just equity capital.

When using this measure, however, it is necessary to reverse any interest costs on the long-term debt included in the investment base from the profits. Otherwise, there is the incentive to go too far in eliminating debt. There is the double penalty for taking on additional debt, the reduction in profits because of interest charges plus the increase in

the investment base due to the greater debt, as compared to only a single penalty for taking on additional equity where there is no reduction in profits because no interest charges are incurred, but there is an increase in the investment base due to the greater equity. By reversing the interest charges from profits, management receives the same single penalty for taking on either additional equity or additional long-term debt.

This method is probably the second most frequently used incentive measure of ROI for executive bonus plans. It is used most often when economic times are not so good because of the desire for little debt. The more capital-intensive companies are also most likely to use this method because of their concern for earning a fair return on the great amounts of capital they consume.

Return on assets—The final frequently used measure of ROI is measured by return on assets. Using this method, the numerator of the equation is the sum of the profits, however they are defined, and the amounts charged against these profits for interest on all debt, whether short term or long term. The denominator is the total assets.

Since total assets equal total liabilities, the difference between using the return on assets method and using the capital employed method as the investment base is in the amounts included under current liabilities. By using return on assets as its measure of ROI, a company is charging its executives with earning a suitable return on all capital in the business, including even temporary short-term borrowings needed for such things as financing receivables and inventories.

This plan is most often used for divisional bonus plans. This method is quite a restrictive measure of ROI that could be distorted by short-term swings in inventories and accounts receivable.

Once the issues of incentives have been resolved, the next problem to solve is to determine at what point in the profit stream are the bonus funds generated. At one point, it was simply the common practice to adopt a bonus funding formula such as paying executives a specified percentage of the pretax profits. However, as the base salaries began to rise and fringe benefits and other perks entered the picture, some began to question that if the executives get a percentage of even the very first dollar of profit, why are they paid base salaries at all? Should they not be required to perform adequately before earning the extra bonus money?

Companies began to revise their bonus funding formulas. For example, a company that had been granting executives bonuses of the percent of pretax profits might restate its formula to provide that six percent of all pretax profits would be paid the executives, but only on those profits exceeding a certain figure, perhaps $50 million or $100 million. Although this approach has merit, it became outdated quickly. If the company had established this $50 million or $100 million "deductible" at a time when it was earning $50 million or $100 million in pretax profits, with a viable market and proper incentives, the company's pretax profits could easily surpass the deductible. The $50 million or $100 million deductible is no longer much incentive.

Naturally, companies began to emphasize the need for a fair ROI, not merely to attain a specified raw profit figure. The deductible came to be defined in terms of the ROI measure. A company may state that no funds for bonuses would be generated until the return on the stockholders' equity, or return on capital employed, reached a certain

percentage. The deductible is no longer fixed; that is, it is a floating, or variable, number. Therefore, the dollar amount of the deductible increases as the investment base increases.

The higher the percentage return selected as the deductible, the higher the funding leverage. Once the funding threshold has been exceeded and profits are increased, the deductible causes the executive bonus fund to increase at a rate faster than the increase in profits. Conversely, when profits decrease, the deductible causes the fund to decrease faster than the profits. Further, the greater the deductible, the more bonus leverage is built into the plan.

There are basically three theories with respect to selecting the percentage return employed as a deductible:

Alternative economic benefit theory—This theory states that if the stockholders could invest their money in government bonds, certificates of deposit, etc., and earn, say, six percent, the company should be able to offer at least that return on their money. Therefore, a company might establish a deductible equal to a six percent after tax return on stockholders' equity. If the company were employing a plan based on pretax profits, the required return might be 13 to 14 percent, given a marginal tax rate of 50 percent. If using the return on capital employed method, the company might choose a percentage return that would generate sufficient profits after taxes and after interest costs to represent the same six percent return on stockholders' equity. This is the most often adopted theory.

Returns of comparable companies—Another theory for selecting a percentage return figure is to use the actual returns achieved by comparable companies. The company would select a representative number of companies in its industry and then choose a percentage return equal to a certain ranking percentile of the distribution. The percentage return selected might be minimal in relation to the actual performance of the companies, but it would be at least equal to the percentage return derived through the alternative economic benefit approach, possibly higher. Using this theory, there is no guarantee that the number chosen will not quickly become obsolete. For example, the lower-performing companies may improve their returns.

The company's own history—If the stockholders can earn six percent on their investment, the company might reason that since in the recent history of the company, there has never been less than a 14 percent after tax return on stockholders' equity, with the average being 17 percent, the deductible should not be less than a 14 percent return on stockholders' equity. This method subjects the company to its own high-performance history. The result may be the payment of average bonuses for outstanding performance.

Once the incentive measure has been selected and the deductible has been determined, the decision now is what portion of profits above the deductible should be diverted to the eligible executives for their bonuses. Given the stockholder equity, the average bonuses payable, and the average performance among comparable companies, a formula may be developed based on a percentage of after tax profits in excess of a certain percent return on stockholders' equity. For example, 5.5 percent of after tax profits in excess of a six percent return on stockholders' equity might be employed.

Often, there are certain limitations imposed on the bonus fund. For example, sometimes the plan will specify that no funds are payable unless:

- The company declares a dividend.
- The company's dividends per share are not less than a specified sum, perhaps $1.50.
- The company's earnings per share are not less than a certain sum, perhaps $5.

There is no federal law which requires stockholder approval for an executive bonus plan. However, such plans may require such approval by state statute. If the plan is to involve payments in company stock and if the company is listed on the New York Stock Exchange, there are rules requiring stockholder approval of executive bonus plans. Good public relations dictate that companies seek stockholder approval with respect to executive bonus plans. The stockholders are assured that no more than the amount approved for executive bonuses will be spent. Plans submitted for stockholder approval typically contain these components:

1) A statement of the eligibility for the bonus plan.
2) A statement of the administration of the plan.
3) A statement of the funding formula and that it cannot be increased without stockholder approval.
4) Statement of the payment methods and form, such as lump sum, deferrals and choice of cash or stock.

Bonus Allocation

Many methods are used to allocate the bonus fund.

One of the first used methods of allocation is the subjective allocation. Subjective allocation simply involves individual judgments made at the end of each year. First, there is the decision of whether or not to spend all of the funds produced by the bonus funding formula for that year. Sometimes, the bonus can become overfunded. The entire fund does not necessarily have to be spent each year. Also, if the company has been successful, the formula employed may generate too much money into the fund. Increases in the fund are typically unbalanced with respect to increases in the profits. Further, the number of executives eligible to participate in the bonus plan generally does not increase as quickly as do the profits. Also, those eligible executives being added typically receive lesser bonuses because they are at the bottom of the eligibility scale.

Once it is determined how much of the fund is required to pay the minimum and maximum bonuses, it must be decided if the performance was average or exceptional. This is purely a subjective decision, as is the amount to actually be spent. The fund must now be allocated among the executives, the divisions, the profit centers or however the bonus plan is set up.

The decision may be made to allocate the funds based on how well a particular division performed against its budget. Other assigned goals are considered as well. If the division performed well, but not exceptionally, the decision might be made to allocate funds somewhere between average and maximum distribution. If an outstanding performance were given, the allocation might be given closer to the maximum

distribution, or even the maximum distribution, although this is rare, as most companies hold something back based on the premise of further motivation or a greater incentive to achieve in the following year. Most employees, however, view this as being cheated out of their earned and deserved bonus, on which outstanding performance is achieved.

Since the amount allocated to individual, division, profit center, etc., is purely subjective, some units may receive little or no bonus, based on their performance. Further, one unit's share may be allocated to another unit, if a particular unit does not perform well enough to achieve the maximum bonus. Or, this amount may be held back.

Since this system is so discretionary, it is also highly flexible. Although flexibility is often seen as an advantage, it can, in this case, also be a disadvantage. It is obscured in secrecy, and sometimes distrust is born. In larger companies, unit or divisional managers are called upon to further allocate the funds to the divisions, profit centers, departments, etc., where, ultimately, these funds are appropriated to the individual executives.

A more sophisticated approach to allocating executive bonus funds is the allocation linked to goals approach. This process involves establishing of known amounts of money to the accomplishment of those objectives. This is a more quantitative and measurable approach. Rather than the arbitrary method of the subjective approach, executives begin the year knowing that if pretax profits do not reach a certain amount, there is no bonus at all.

On the other hand, if the pretax profits exceed a certain amount, they will receive a bonus equal to a percentage of the profit. If the pretax profits exceed a greater amount, they will receive a bonus of a greater percentage of the profit. There may be various degrees of bonus payable bonuses, based on profit or other performance standards. Most would agree that the best way to motivate desired behavior is to spell out in advance the rewards that will be given if the desired behavior is achieved.

Of course, this method must be approached evenly and fairly. For example, some divisions may have a greater capacity for growth or a greater opportunity to increase profits, based on new product introduction, moving to more modern facilities, etc. Other divisions may be spending more time and money on research and development in one year in order to realize greater profits in years to come. A fixed growth goal may be reasonable for the corporation as a whole, but it is often unfair to impose it on individual units or profit centers.

In order for this approach to be effective, the company must set equal stretch goals. If the corporate goal is to increase profits by at least 15 percent, a 30 percent profit increase may be needed from one division or profit center, and a 20 percent profit increase may be needed from another, etc.

Another type of allocation process for executive bonus plans is the allocation linked to budget approach. In using this method, budgeting devices are utilized. For example, a division manager may be told that he or she will receive a specified bonus fund if his or her division achieves its budget. He or she also knows the variance of the budget, that is, how much his or her division can come in below budget in order to receive a greater fund or how much over budget will bar the fund altogether.

The success of this approach depends almost entirely on the merits of the budgetary process itself. This budget process inherently has conflicts of interest built into it. Knowing that bonus funds are linked to budget gives the incentive to perform based on budget alone, regardless of what may be in the best interest of the company. There is also the incentive to initially create the various budgets artificially high so that it can be relatively easy to come in below them, which, of course, has nothing to do with performance.

External Events

Unfortunately, even the most well thought plans can go astray because of uncontrollable external events. A prime example is what happened several years ago to profit budget assumptions after OPEC quintupled the price of oil. Another example is that the profit budget assumptions of a coffee producer are no longer valid when weather factors cause coffee prices to skyrocket. A profit budget is based on a set of planned and rational assumptions. However, unexpected events may occur which are completely outside the control of the company.

Often, this situation is dealt with by recognizing some, but not all, of the impact created by a major unexpected event. Companies often determine the impact, then adjust the results as pragmatically as possible. Some companies even begin the year by declaring to determine the profit impact of any uncontrollable outside events which may occur during the year. If necessary, the original budget figure is adjusted. Sometimes, no adjustment is made if the impact is not significant. Adjustments are often made in degrees, according to the impact of the event.

Group Vs. Individual Awards

Some companies pay awards on a group basis. These are referred to as gain sharing plans. When the company achieves greater profits, the groups of executives participating receive a portion of the revenue. Each eligible executive receives his or her share based on the relationship between his or her salary and the salaries of the other eligible executives. Some say this approach encourages teamwork. Others say that it also encourages laziness and inactivity because those executives whose performance might otherwise be outstanding adjust their contributions downward. Regardless of the theories, group incentive plans are said to work not because executives, individually or collectively, decide to work harder, but rather because they work smarter, identifying means to meet their objectives more efficiently.

Typically, group awards are an attempt to tie pay to performance by giving executives an additional payment when there is an increase in profits, a decrease in costs, or both, as measured by the performance of a division, a profit center or some other unit. Group awards are inclined to intensify the inequities in base salaries.

All executive bonus plans have one common feature, that is, there is an established standard against which performance is compared in order to determine wages. Some companies base bonus awards entirely on individual performance. This assumes that if the executive is properly motivated, teamwork will ultimately result.

Naturally, there are varying degrees of excellence, even in top management personnel. One may think that these executives are outstanding, or they would not hold the positions they do. Therefore, the most appropriate basis of performance assessment for these top level executives is to compare them to their peers. This comparison is made in the executive's own company, as well as in similar ones. From this perspective, then, it appears that, comparatively, not every executive is quite so outstanding. In fact, there is reason to believe that there must be as many competent executives as there are incompetent ones.

It can be quite difficult to reward performance in a truly fair manner. Visceral performance assessments are difficult to avoid. Those CEOs making these assessments sometimes increase or decrease individual bonuses from year to year only as a function of the total amount of funds' increasing or decreasing. Often, they reason that withholding a bonus from an individual, who has had one for several years, may ruin his or her motivation or compromise his or her standard of living. These hardly seem fair and appropriate assessments for awarding bonuses. Generally, only the combination of a equitable and rational performance appraisal system and a good sense of management brings a solution to this problem.

When available bonus funds are limited, perhaps because of overall poor corporate performance, some companies tend to allocate the relative small amount of bonus funds to all eligible executives, offering each only a small bonus, something for everyone. For example, suppose in this case, every eligible executive received an award one year. The smallest award is three percent of salary, and the largest is five percent. The awards are so small because of the bad year and a tiny allocation. The difference between three percent of salary and five percent of salary cannot possibly adequately reflect the difference between the lesser performing and the better performing executives. A better approach might be to give nothing to those who are not the top of the top and award only those who are truly deserving.

The first step toward this is to rank all eligible executives in descending order of their relative performance contributions. Having established this ranking of the executives' performance, the awards are bestowed from the top of the ranking downward. For example, the highest ranking executive receives an amount of bonus which, when added to his or her salary, will give him or her total compensation appropriate to this rating, that is, the highest total compensation. No reductions are made reflecting the size of the unit's allocation. This procedure is followed for the second-ranked executive, and so on, until the funds are exhausted.

Using this procedure, it is likely that the lowest-ranked executives receive no awards at all. Naturally, the smaller the availability of bonus funds, the more executives will be left without a bonus. From a purely performance perspective, this is the only way to allocate executive bonuses. The only exceptions should be those few executives whose performance falls just below the awards cutoff. Under some circumstances, perhaps these individuals should receive some minimum award amount. If so, the awards can be slightly adjusted to provide the funds for these few.

The merit of this procedure is that the dollars required to give the lesser-ranked executives any award at all must literally come out of the pockets of those whose executives whose performance contributions are truly outstanding. The motivational value of this bonus plan is that the best executives receive maximum awards, while

others receive no awards at all. This plan offers greater motivation to all, compared to awarding everyone a little something.

Integrated Compensation Structure

Some companies offer a combination of group and individual incentive awards. This is referred to as an integrated compensation structure. The objective here is to emphasize both teamwork and individual achievement. Using this system, a percentage of the overall fund, typically 20 to 50 percent, is distributed for group rewards. Each eligible executive receives his or her group distribution. The group distribution is generally prorated to the executive's salary. Then, the remainder of the fund is distributed on the basis of individual performance.

When a company employs the combination approach, the group award portion is typically prorated to award ranges, rather than to salary. The range of awards, stated as a percentage of base salary, increases as the salary increases. For example, suppose that the highest range of awards is 30 to 90 percent of salary, and the lowest range of awards is 10 to 30 percent of salary. If 25 percent of any funds generated is to be paid in the form of a group award, and the company has an outstanding year, permitting the fund is sufficient to pay every eligible executive his or her maximum award, the group award would consist of 25 percent of each eligible executive's award maximum.

Therefore, the eligible executive with the highest award range would receive 22.5 percent of his or her salary as part of the group award. Those with the lowest award range would receive 7.5 percent of their salary.

On the other hand, if the awards are strictly prorated to base salary, every eligible executive would receive the same award percentage. As a result, the proportion of total award opportunity represented by the group award would be significantly higher for the lowest-paid executives than for those who are highest paid. Distributing group awards in proportion to the award ranges avoids these problems.

When distributing the bonus fund using the combination approach, the intention is to provide the appropriate recognition for both the individual executive's performance, as well as the group performance. The performance of the various levels are recognized as follows:

- The group performance at the organizational level is recognized by the fact that the size of the fund itself depends on company profit performance.
- The group performance at the unit or divisional level is recognized by allocating the fund among these units on a basis that takes into account the performance of these units individually.
- Individual performance is recognized by determining the portion of the unit's allocation that is to be awarded to eligible executives based on their individual performance.

The supporters of the combination award approach believe that it lessens the tendency to weaken the efficacy of the awards, while motivating both teamwork and individual achievement. Everyone gets the group award, and only the best performers get an additional bonus. Some may argue that some of the monies allocated for group awards

might be better spent on greater awards for the most outstanding performers. However, the combination approach works in may instances.

The proper amount of individual award is the difference between the executive's base salary, plus his or her group award, and the position in his or her total compensation range that is appropriate for his or her performance. However, a large group award granted in a year of outstanding corporate performance can, when combined with the executive's base salary, increase the average performing executive's total compensation beyond his or her appropriate range position. In these instances, no further individual bonus should be awarded to the average performing executive.

The combination approach is sometimes used as a transition scheme for a company which is moving from a group approach to an individual performance approach. Naturally, the change cannot be made overnight. However, the company may begin by using a combination plan, starting with a certain percentage of the funds distributed on a group basis and using the remainder for individual bonuses. During this transition, the group percentage can be decreased, and the individual performance percentage can be increased. Finally, the objective of the individual performance approach is achieved.

The executive should receive the amount of bonus money necessary in order to raise his or her total compensation to his or her appropriate range position. However, this amount should not be granted unless it is meaningful. The best approaches to this must take into consideration organization size, the salary distribution of the group of eligible executives and the range of bonus opportunities. Awards may be restricted as follows to:

- Payments of at least a certain percentage of the executive's salary.
- Payments of a certain percentage of salary, but not less than a stated dollar amount.
- Payments of a minimum percentage of salary for the lowest level of eligible executives.
- Payments increasing upward to a certain percentage for the highest level.

Sales Executives and Bonus Plans

Compensating sales executives can provide special challenges. A large part of a sales executive's job is unsupervised. Therefore, it is essential to compensate him or her specifically for his or her measured sales activity. This is relatively easy to do, since the sales executive's compensation is usually contingent upon units sold, dollars sold or some other quantitative measurement.

The factors included to determine the compensation of a high ranking sales executive are:

- The kind of product sold. For example, in consumer goods industries, top executives earn approximately ten percent more than top executives in industrial goods industries. However, the opposite is true at low executive levels in these industries. The industry in which a sales executive works has a direct impact on his or her compensation arrangement.
- Sales volume. There is a relationship between sales volume and executive earnings. Among sales executives, earnings are 40 to 70 percent higher for those with high sales volume in comparison to those with lower sales volume. The greater the

volume of sales in a territory, district, division, etc., the greater the responsibility of the executive, and the more he or she can be expected to be compensated.

- Type of market. Those executives selling to wholesalers and retailers are typically compensated more that those who sell directly to the consumer or whose who sell goods which require further processing or assembly. Again, this relationship is directly reversed at lower organizational levels for sales personnel.
- Selling situation. In terms of sales executives' compensation, there must be a distinction made between selling technical and nontechnical goods. Because it is so highly specialized, the sale of technical goods frequently involves a team selling approach. Team selling involves the technical personnel assisting the sales representative in the selling situation. Executive sales personnel in these technical markets earn approximately 15 percent less than executives in nontechnical fields where team selling is not a factor.

Sales compensation plans come in one of three forms:

1) Straight salary.
2) Commission only.
3) A combination of salary plus commission plan.

Each of these forms is designed to focus pay incentives on one or more sales objectives. Consequently, the type of plan appropriate for an organization depends on how it wants to use the incentive plan.

Straight Salary--In a salary plan, the sales force is paid a base salary which is not dependent upon sales volume. This strategy is appropriate in circumstances where the major function of the salesperson is to provide customer service or to prospect for new accounts. The straight salary plan can be shifted to emphasize increased sales volume when necessary and can be handled with some type of short-term incentive plan.

The straight salary plan is also appropriate when individual sales performance is difficult to measure. This may be due to the sales volume being based on group effort with individual contributions difficult to separate or when the sales volume is not a suitable measure of individual sales effort.

Some advantages of the straight salary plan are:

- It assures regular income.
- It develops a high degree of company loyalty.
- It simplifies the reassignment of sales people or territory, if necessary.
- It ensures the performance of nonselling activities, as well as selling activities.
- It facilitates administration.
- It provides relatively fixed sales costs.

Some disadvantages of the straight salary plan are:

- There is little incentive to increase effort.
- It favors the least productive sales personnel.
- It leads to overemphasis on the items easiest to sell.
- There are typically higher direct selling costs, compared to other plans.

Commission Only--A sales compensation plan may be based on straight commission. A commission is a method of compensation based exclusively on a unit such as dollar or volume of sales. The commission only method of compensation for a sales executive is appropriate where the market possibilities are broad and the sales boundaries are vague. Likely, these types of situations produce prohibitively high administrative costs compared to other types of compensation plans. Straight commission is also appropriate where the company's objectives are specifically geared toward motivating sales volume through incentives.

Some advantages of the commission only plan are:

- Pay is tied directly to performance.
- Compensation is relatively easy to communicate and to compute.
- Unit sales costs are proportional to net sales.
- Some disadvantages of the commission only plan are:
- There is a high variance in income between sales executives.
- It may decrease company loyalty.
- The emphasis is on volume, rather than on profits.
- It may lead to the neglect of nonselling activities.
- A change in territory or the reassignment of executive can create administration problems.

Salary Plus Commission--The combination of salary plus commission is the method most often used for compensating sales executives. Most sales positions do not fit the ideal specifications for either straight salary or commission only compensation.

Some advantages of the salary plus commission are:

- It offers the benefits of both the salary and the commission plans.
- The executive may feel a greater sense of security due to a stable base income.
- It allows a greater latitude of motivation possibilities.
- It compensates executives for all selling activities.

Some disadvantages of the salary plus commission are:

- It is complex and sometimes difficult to communicate.
- It is often costly to administer.

Designing a Sales Compensation Plan

There are five basic factors to consider when designing a sales compensation plan for executives. These are:

1) The customers. Centralized buying personnel do not have much impact on buying decisions. On the other hand, more sophisticated buyers have a greater awareness of cost, profit margins, etc., and a highly-motivate sales executive may succeed best here.
2) Corporate trends. Corporate trends are a factor because they tend to change as the corporation grows and changes.

3) The sales force. Current and projected costs of the current compensation must be considered. Are sales positions likely to become more routine, or are they likely to become more technical, requiring more experienced sales executives?
4) Competition. The practices of a company's competitors is a factor in its own compensation plan. They most highly motivated and best performing executives are likely to leave for a more lucrative package.
5) 5) The plan objective. The objective of the compensation plan itself plays probably the most important role in the plan. Is it designed to increase the customer base, as well as sales volume? How will new customers fit into the existing customer base? How is recruitment planned, and who are the prospective new sales executives? What is to be the cost of administering the plan? These are some issues to study when putting a compensation plan into action.

Further, the compensation plan objectives are likely to change as the company matures. A young and developing company may prefer to emphasize such devices as large stock options and relatively smaller cash compensation. The objectives may change as the company grows, and the company may take on a more traditional balance. When a company is more established, it may become more conservative and turn itself more toward deferred compensation devices.

Compensating the CEO, Chairperson and President

Awards for the CEO, chairperson and president are especially difficult to determine and administer because there is an obvious conflict of interest here. Most companies have a committee which is comprised of a board of directors or other executives who are assigned to approve the awards. However, this committee is dependent upon top executives of the company for receiving the data on which its decisions are based. Further complicating the issue is that the CEO, chairperson and president are board members. Determining the bonus awards for these executives can be difficult, embarrassing and unsettling.

This problem is often resolved by providing for automatic awards for the CEO, chairperson and president. This may be done with an express exception when the board purposely acts to disregard the formula amount or to issue an award at all. The performance of these top officials is ultimately measured by the company's overall performance. Therefore, since the company's overall performance determines the total availability of bonus funds provided, the awards for the top executives are often distributed according to the internal funding formula.

For example if the other executive bonuses are awarded for meeting budget, the top executive's bonuses should be predicated upon the company meeting its corporate profit budget. Using this method, if the awards of the top executives increase or decline according to the same funding formula, the awards of the other eligible executives do likewise.

Since the divisions are motivated to submit low profit budgets in order to receive the maximum bonus funding, the top executives may be influenced to accept low profit budgets, knowing that they will, in turn, be positively affected by the result of a low corporate budget. Usually, there is some protection against this. For example, the corporate profit budget is generally approved by the board of directors. Also, the

stockholders must approved the bonus funding formula. Even an absurdly low profit budget that gets by the board could run into problems with the limitations imposed by that formula.

Further, most of the top executives are given long-term incentives in addition to their incentives for annual performance. These long-term incentives are usually predicated upon achieving absolute performance improvements, not performance relative to some management standard such as a budget. The result of approving low profit budgets and then barely achieving them would likely be the elimination of further payments under the company's long-term incentive plan, since their absolute performance will probably not be acceptable. Besides, the board, or its committee, can overrule the automatic award feature if it produces an unfair award for the top executives.

Compensating the Board of Directors

The Board of Directors is compensated similarly to the top executives in a company. The board is made up of 10 to 20 individuals who meet on a regular basis. These people serve a variety of roles in the interest of the company and of its stockholders, such as the strategic planning, executive compensation and evaluation. The members of the board are usually people somehow affiliated with the company. For example, they might be retired corporate officers, suppliers, major stockholders or attorneys. They may also be chosen from outside the company, having the ability to offer a different perspective.

Generally, the members of the board of directors are given a base salary, referred to as a retainer fee, of $10,000 to $30,000 per year for an outside director of a major company, and offered added incentives for attending board meetings. Their packages are not as complex as those offered to full-time top executives, although the more recent trend has been to offer these board members the added benefit of pension plans, restricted stock and stock options.

Surplus Bonus Funds

Surpluses of bonus funds may accumulate when there are not enough outstanding executives in a particular year to utilize the entire fund. Sometimes, the funding formula is too liberal, or sometimes it becomes more liberal as the corporation grows and changes. When there are surplus bonus funds, some companies restore these to the bottom line net income of the company. Other companies retain these funds for use in the following or future years.

If the surpluses are retained for future years, there is the provocation of using these funds to equalize the executive bonuses from one year to the next, when they actually have nothing to do with that fiscal year. The differential between periods of poor and excellent corporate performance can be reduced.

On the positive side, retaining surplus bonuses from previous years can be helpful in certain situations. For example, if one division in a company has an exceptionally poor year, this may they cancel out the funds generated for use by the satisfactorily performing divisions. Surplus funds could effectively be used to correct this.

When the executive bonus fund formula is properly designed and the bonus funds are used in the maximum motivating fashion, it is probably acceptable practice to retain surplus bonus funds from year to year.

Formula Revision

Naturally, formulas do not last forever. After a while, they wear out and lose their usefulness. Therefore, a company's external funding formula should be reviewed periodically in order to determine whether or not it is still working properly.

There should not be difficulty in finding the funds for awards to new executives, whether they are newly hired or newly eligible. Theoretically, the company's growth which allows for the addition of newly eligible executives should allow for their compensation. For example, if the funding formula is predicated on return on stockholders' equity, the doubling of stockholders' equity and the maintenance of the same percentage return on that will automatically double the bonus funds. Such a growth in the size of a company is not likely to justify a twofold increase in the number of executives eligible for the bonus plan; therefore, the company may actually be ahead.

Perhaps, over the years, the industry changes its standards of performance. For example, suppose that due to increased governmental regulation or a change in the Internal Revenue Code, the average return on stockholders' equity for an entire industry drops significantly over a period of years. In this instance, a company within that industry will certainly have difficulty in meeting its own standards of the previous years. Its bonus fund will be significantly reduced. At the same time, judging by the new industry standards, this company may actually be performing outstandingly.

Conversely, with rising industry standards of performance, a company's bonus plan may be overfunded. Although this problem is not as troublesome as the reverse situation, it should be corrected.

In these situations, the executive bonus formula may have to be overhauled. This procedure is actually like starting over, designing a formula as was done in the beginning.

Bonus Erosion

Sometimes, the executive bonus formula is no longer workable because of a significant increase in the number of executives eligible for awards. This is not an uncommon instance because, in a successful company, more and more executives become eligible. In addition, the number of special awards also rises with a successful company. When this set of circumstances occurs, it is referred to as bonus erosion.

Initially, erosion is often dealt with by cutting down the size of each bonus. Eventually, however, this approach becomes disadvantageous because, ultimately, those executives who have been around the longest become disenchanted. Wishing for or working toward just a little greater percentage point or multiplier does not effectively solve this problem. Unfortunately, the only remedy for bonus erosion is to reduce the number of executives who are eligible for awards until sufficient funds are available. At

that time, the funds can be used to provide genuinely meaningful awards for those who truly deserve them.

Frequency and Method of Award Payment

Once the amount of executive bonus, individual or group, has been established, the company must also decide on the frequency of payment and the method of payment. Rewards work best when administered immediately after the completion of the task. Most frequently, awards are paid on standard time schedules such as quarterly, semiannually, or annually. Award payments can be made in full at the time the award is declared, or it may be deferred.

The choice of payment medium may involve cash or something other than cash, such as company stock. The tax consequences are the same, whether the medium is cash or stock. The executive receiving the award must pay his or her ordinary federal income tax on the cash received or on the market value of the stock on the date either is paid to him or her.

The Tax Reform Act of 1969 established that there are two classes of ordinary income. Income derived from personal services is considered earned income and sometimes referred to as personal service income. On the other hand, income produced from capital, such as interest, rents, dividends, etc., is considered unearned income. However, as of the tax year 1995, tax rates for both earned and unearned income are the same. And all bonuses, whether they are cash, stock, or some other commodity, are considered earned income and are taxed like any other income.

If company stock is used to make an executive bonus payment, the executive is generally free to convert his or her stock to cash at any time. The exception to this is when unregistered shares are used. However, this rarely occurs in immediate cash payments. When an award is made entirely in company stock, the executive may convert to cash all or part of his or her award.

The significance of using company stock as all or part of an executive's bonus payment is in hoping that he or she will retain as much of it as possible in the form of stock. Therefore, the company's outlay of cash is minimized.

Sometimes authorized but unissued shares, commonly termed new shares, are used for the payment of executive bonuses. New shares increase the number of shares outstanding and, therefore, cause a dilution in earnings per share held by all stockholders. Stockholders may be disturbed if there is a pattern of frequent sales of new shares. A company may still elect to distribute the executives' full bonus in new shares, if for instance, the company is in need of cash. This is probably the only circumstance in which the use of new shares is justified.

These new shares have a double negative impact on earnings per share. First, the number of shares outstanding is increased. Secondly, the after tax earnings of the company are reduced because of the charge for the bonus amounts. On the other hand, the company has not only avoided laying out any cash, but it actually receives additional cash in the form of equity capital. This is because, like the depreciation of capital

facilities and equipment, the company has charged the executive bonus payments to income, although it has not incurred any actual expenditure.

Stock Bonuses for Officers and Directors

The Securities Exchange Act stipulates that if an officer or director makes a profit by selling those shares awarded to him or her as part of his or her executive bonus plan within six months, or if he or she makes a profit by purchasing shares within six months of selling the same or other shares, the profit must be returned to the company. Regulations interpreting this act define the transactions deemed to be purchases or sales in applying this rule, known as the rule of "six month profit and return."

Generally, the payment of company shares for an executive bonus are not considered as a purchase by the Securities and Exchange Commission. However, the subsequent sale of those shares is considered a sale by the SEC. Therefore, in these situations, the executive is free to sell his or her bonus shares at any time, although he or she must remember that he or she may suffer financially over the purchase of other shares.

For example, suppose that in May, an executive receives a bonus of 1,000 shares in his or her company. He or she sells the shares in June when the stock has a fair market value of $100 per share. If the executive also has a stock option on 1,000 shares at an option price of $50 per share, he or she will not be able to exercise the option to buy the shares until at least six months after selling his or her bonus shares.
Because of the issues of insider trading, companies must take special care to see that they are not putting their officers and directors in the position of receiving profits from company stock but not being able to realize them, on account of the "six month profit and return" rule. Companies must consider the effect of all of their stock plans, not just one single plan. In some cases, the two plans together can combine to create a problem for those receiving the awards.

The insurance industry has done a very good job of educating agents about product. Unfortunately, there is not the same emphasis on business estates. One of the reasons is that a going business is complex and business estates and a most difficult asset to administer. Factors that come into play are the agent's lack of knowledge, emotional involvement of the family and employees, complex tax rules, the lack of available cash to pay expenses and an unavailable market for the sale of the business.

Business Estate Planning Considerations

Estate planning is an approach to planning ahead. With the proper planning, there are many opportunities to postpone, lessen and even eliminate a client's tax burden. In a large part, death is about taxes. In addition to the tax that a client pays on his income during his lifetime, he is taxed as he spends it. He pays sales taxes, property taxes and more. He pays taxes for the last time when he dies and transfers his accumulated wealth to his heirs.

At the time of death, the federal government levies an estate tax. In addition, states may levy their own taxes. Sometimes, these are referred to as estate taxes or inheritance taxes. The Internal Revenue Code permits a credit for federal estate taxes in the amount of the state death taxes already paid. There are some restrictions on these taxes, depending on the size of the estate. All states have death taxes that are at least equal to the credit allowed by the Internal Revenue Code.

When helping to plan an estate, it is important to remember one of the most attractive features of life insurance and retirement benefits, that is, their unique tax advantages.

Determining the Need

The process of estate planning is one that is approached out of care to preserve assets for beneficiaries. Business estate planning can be similar; the beneficiaries, however, may instead be key employees, family members, partners or shareholders. In either case, life insurance and other insurance products can play a major role. Their basic purpose is to provide the protection for whatever the rest of the estate may lack. It is essential, regardless of the size of the estate. Those who have large estates require protection from estate taxes. Those with smaller estates can benefit from life insurance as a means of estate planning, also.

Naturally, the agent's first objective is to define the client's need and fill it with the appropriate insurance product. Once the need is acknowledged, the next step is to determine exactly how much insurance is needed. Naturally, the cost of the insurance must be considered. The amount of insurance needs is typically influenced by its cost.

Settlements

When using life insurance as a tool for business estate planning, the insured must consider how the insurance proceeds are to be paid. They may be paid in a lump sum, which is the simplest method of paying the proceeds. However, given the beneficiary's possible inexperience in financial matters or spending prejudices, perhaps a lump sum is not a good idea.

Perhaps the insured feels that some sort of management of the proceeds is advisable for the beneficiary. In such a case, the insurer can make installment payments over time to the beneficiary. This practice is known as an optional settlement. There are two disadvantages to optional settlements: (1) The plan is sound only as long as the insurer remains solvent and (2) The plan can fall victim to inflation.

Trusts

An attractive alternative to settlements in some business owner cases is the trust. Using a trust arrangement, a trustee serves in a fiduciary capacity and is named as beneficiary of the policy. The trustee collects the insurance proceeds and invests them for the beneficiary. The trust may be made up of insurance alone, or it may be connected with other assets of the insured.

When all of the assets, including the insurance, are together in one fund, the insurance is made payable to the estate of the insured. The trust is created by the will. The trust takes over the insurance money and other assets such as cash, stocks, bonds and other investments. In this manner, all financial matters are governed by a single instrument.

There are disadvantages of using this technique:

- The insurance is subject to the claims of the creditors of the estate. If the insurance is made payable directly to a trust created separately from the will or to an individual beneficiary, the insurance may be exempt from creditor claims.
- In some states, the inheritance tax exemption for insurance may be forfeited.
- The personal representative may be entitled to a fee for collecting the insurance.
- If the insured wishes to decrease a surviving spouse's inheritance, this plan effectively defeats that objective, since the estate is now essentially larger.
- Some states do not allow using only a trust in a will to dispose of property, although this situation could be circumvented by making a separate trust during the lifetime of the insured.

Tax Issues

When the insurance proceeds are collected in a lump sum by an individual, a beneficiary, the estate of the insured or by a trust, the insurance proceeds are received tax-free. There is no limit on the amount of these tax-free proceeds. When the insurance proceeds are collected in installment payments, there is the element of earnings associated with the periodic payout to deal with. These earnings are subject to income tax. When the trustee collects the insurance proceeds and reinvests them in the trust, and a cash flow is paid to a beneficiary, the usual income tax rules regarding dividends apply.

Fortunately, the Tax Reform Act of 1976 (TRA '76) permits the estates of stockholders in closely held corporations to pay federal estate taxes in equal annual installments over a period of years.

Under TRA '76, the federal estate tax that is attributable to a deceased's business interest is payable in equal annual installments over a period of two to ten years. The first payment is made with the tax on the other estate assets when the return is initially filed nine months after death. Interest is charged at the rate of 12 percent on the remaining installments, although this interest rate is subject to periodic adjustments.

The amount of the federal estate tax that is eligible for installment payments is the portion which bears the same ratio to the total net estate tax that the value of the business interest bears to the gross estate.

To qualify for installment payments, the decedent's business interest must be more than 35 percent of his gross estate or more than 50 percent of his taxable estate. The business may be:

1) A proprietorship.
2) A partnership if there are 10 or fewer partners or if the deceased's capital interest was at least 20 percent.
3) A corporation if there are 10 or fewer stockholders or if the deceased's stock was at least 20 percent of the total stock value.

If the deceased owned more than 50 percent of two or more businesses, they may be combined to qualify.

In community property states, only the deceased's half applies to the 35 and 50 percent tests. Also, in community property states, when applying the 50 percent ownership test to combine two or more businesses, the surviving spouse's community interest is counted in the businesses.

When selecting the installment plan, the unpaid amount of tax becomes due immediately if withdrawals of money and property from the business total at least one-half of its value. This result also follows if at least one-half of the business interest is sold, exchanged or redeemed, except in a Section 303 redemption, in which all proceeds are applied to the estate tax.

In the fifth taxable year following the death, the estate must apply all of its undistributed income toward the estate tax payments. Generally, the estate must remain open during this entire period.

A 15-year period for the payment of federal estate tax on a closely held business interest is permitted if the value included in the gross estate exceeds 65 percent of the deceased's adjusted gross estate. Eligible businesses under this section are:

1) A proprietorship.
2) A partnership interest which has 15 or fewer partners, or where at least 20 percent of the partnership's capital interest is included in the deceased's gross estate.
3) A stock interest in a close corporation with 15 or fewer stockholders, or where at least 20 percent of its voting stock is included in the deceased's gross estate.

Using the 15-year installment plan, the maximum amount of estate tax that may be paid in installments is the part which bears the same ratio to the net estate tax as the value that the business interest bears to the adjusted gross estate.

When electing the 15-year installment plan, during the first five years, only the interest on the deferred amount of tax must be paid. Then, the deferred part of the estate tax may be paid in 10 equal annual installments. An interest rate of four percent applies to the first $1 million of the value of the business interest. A 12 percent interest rate applies to any excess value, although this rate may change.

If the personal representative sells, exchanges or distributes at least one third of the business interest, the privilege of using this plan may be lost. The remaining payments of estate tax may be accelerated. This also results if withdrawals of money or property are made totaling at least one third of its value.

Estate Planning and Retirement Benefits

Most employers offer their employees retirement plans. Typically, these benefits are a vital source of support for heirs in the event of the employee's death, whether this occurs before or after retirement. By way of the Employee Retirement Income Security Act of 1974 (ERISA), employers are encouraged to offer retirement plans for their employees. However, these plans must meet strict qualification rules. If these qualifications are met, the employer's contributions to the plan are tax-deductible.

The earnings and gains from investments made by the retirement fund are not taxed. However, this does not mean the employer or employee has no tax liability at all in one of these qualified plans. Sooner or later, the government gets its share. The two tax issues at stake here are estate tax and income tax.

Retirement Planning and Estate Tax

For estate tax purposes, all death benefits from qualified pension and profit sharing plans, IRAs and Keogh plans are considered part of the employee's estate.

If an individual or his spouse participate in another tax-favored retirement plan, if they file a joint tax return and if they report income over $40,000, the $2,000 tax-deductible contribution to the IRA is not permitted. The same rules apply to a single person if his reported income is over $25,000.

Like the IRA, a Keogh plan is a retirement plan. The Keogh plan, however, is designed for self-employed people. This includes partners in a partnership. If the business is a corporation, a Keogh plan may not be used. A corporate plan must be used in this case, and the employer makes contributions for its employees. In some cases, the employees can contribute to the plan.

Estate tax deals with the benefits available under these retirement plans when the employee dies. The $700,000 estate tax exemption (going to $1 million after 2006) may assist in protecting these benefits from tax. If this exemption is used elsewhere in the estate, the marital deduction may be used to protect the estate from tax.

The marital deduction can protect the inheritance of a spouse from estate tax. The Internal Revenue Code provides that, without his written consent, a surviving spouse cannot be deprived of enjoying a joint and survivor annuity that arises from the deceased spouse's participation in a qualified pension plan.

A joint and survivor annuity begins in favor of the employee at his retirement and at his later death. The payment continues in favor of the surviving spouse for the spouse's lifetime. The payments to the surviving spouse must be in an amount that is not less than 50 percent of what the deceased employee had been paid.

If the employee dies before retiring, his spouse is entitled to annuity payments, although not necessarily right away. The payments commence on the date that the pension plan prescribes as the earliest time when the deceased employee could have retired.

When the employee is covered by a profit sharing or stock bonus plan and if he dies before the benefits have been completely distributed, his spouse cannot be cut off from the death payment without that spouse's written consent.

Written consent is vital in the cases where the employee wishes to have someone other than the spouse as the beneficiary. It is also crucial if the employee wishes to have the benefits collected by a trust for the surviving spouse.

The marital deduction permits the surviving spouse's right to an annuity for estate tax purposes. However, this is not so for other taxes. For example, if an employee retires and has an excess retirement accumulation, there is a 15 percent tax on the excess distribution in any year. If the employee possesses the excess accumulation and if he dies before retirement, the 15 percent tax looms at the time of death.

This 15 percent tax is imposed in addition to any estate tax. It is not affected by the $700,000 estate tax exemption or the marital deduction. Avoiding this tax comes about only if the surviving spouse is the beneficiary of all retirement and IRA benefits and if that spouse elects to assume the deceased's excess distribution when the surviving spouse retires. Such a set of circumstances creates a deferral.

A complicated computation establishes what is an acceptable amount of retirement accumulation and what is excess. It goes like this:

- Step 1. The value of all of the deceased employee's interests in IRAs and qualified retirement plans is determined as of the time of death.
- Step 2. The discounted present value of an annuity that would have been paid to the deceased employee over his lifetime, up to the maximum permissible limitation, is subtracted from the figure from Step 1.
- Step 3. The resulting difference is the amount to which the 15 percent excess accumulation surcharge applies.

Retirement Planning and Income Tax

Retirement planning and income tax rules are many. Ultimately, income tax cannot be avoided. The only exception to this is if the employee makes a charity the beneficiary of

the death benefits under his retirement plan. Because of its non-tax status, the charity would receive the benefits free of all taxes.

Retirement benefits must eventually be reconciled with income tax. This is because the initial contributions to the retirement plan were deductible when they were made. Secondly, the funds in the retirement plan earned interest and dividends that were not taxed.

There are basically two occasions when the tax of retirement benefits must be faced. These are:

1) When the employee retires and collects his benefits.
2) When the employee dies and his beneficiary collects the benefits.

The first consideration is the types of payment plans that are available under a particular retirement plan. All plans specify that distributions must either be paid out over a number of years or that they are paid as a lump sum.

If a lump sum is authorized by the plan, the employee's spouse must consent in writing. By giving this consent, the spouse surrenders the right to be paid benefits as an annuity. If the employee had participated in a profit sharing plan, spousal consent is not generally required when a lump sum payment is taken. However, without consent, the spouse cannot be denied as the beneficiary when a death benefit is paid by a profit sharing plan.

If a lump sum distribution is available, this distribution commands a different tax treatment than installment payments. Basically, a lump sum payment occurs when the plan pays out everything within one year and the employee retires at least by 59 1/2 years of age, or when the employee dies at any age.

An IRA plan cannot make a lump sum payment. When the retirement or death benefit is available in a lump sum, the recipient may have the option to collect it at that time or not. For whatever reasons, he may choose to defer the benefit, thereby deferring the payment of the tax.

The same concept applies to the lump sum death benefit payable to a surviving spouse. He may prefer to postpone collecting the benefit and having to pay income tax. A deferral is available through a rollover. The benefit may be rolled over into an IRA or other qualified plan until the recipient is ready to accept the payments or is compelled by law to do so.

The rollover continues the income tax-free earning status of the retirement funds. During this time, dividends and interest continue to accumulate without income tax.
Sooner or later, however, the rollover fund must be taken. In fact, there are tax disadvantages to leaving it too long. These funds may not be postponed beyond the age of 70 1/2.

Only a surviving spouse may achieve income tax deferral through a rollover. No other beneficiary is entitled to this.

The benefits paid over time from any of these retirement arrangements are taxed as ordinary income when they are collected.

Two types of taxes can apply to a death benefit. If the benefit is not payable to the surviving spouse under protection of the marital deduction, the estate tax applies. And, naturally, income tax applies. However, the recipient of the death benefit is entitled to a deduction on his income tax return for the estate tax that is attributable to the benefit.

Section 303 Planning

A deceased stockholder's best intentions for the disposition of his stock and the successful continuation of the business can quickly be destroyed if his personal representative is forced to sell the stock to pay the debts, taxes and other costs of administering the estate. Therefore, there must be a plan for supplying the estate with cash.

In the best of all possible circumstances, the deceased stockholder will have determined the amount of cash necessary that the personal representative will need. Naturally, this can only be an estimate. Therefore, this estimate should be a generous one. The use of Section 303 of the Internal Revenue Code is a means by which this cash can be provided.

Providing Cash for the Settlement of the Estate -- Section 303 of the Internal Revenue Code was specifically enacted for making available most of the cash needed when a close corporation stockholder dies. It includes close corporations, as well as Subchapter S corporations. Section 303 sets forth certain requirements and limitations. If these are met, the redemption payments are treated as purchase price for the stock, rather than as the distribution of a dividend.

When the value of the deceased stockholder's shares of a corporation is included in his gross estate and this value exceeds 50 percent of his adjusted gross estate, a partial redemption under Section 303 is permitted. The adjusted gross estate is not difficult to determine.

First, funeral expenses, administration expenses, debts, taxes other than death taxes owed by the estate, casualty losses and thefts are subtracted from the gross estate. When the deceased stockholder owns more than 75 percent of the stock of two or more corporations, these may be treated as a single corporation when applying the percentage requirement.

In states where community property laws apply and if the corporate stock is community property, the community stock interest of the deceased's spouse is treated as having been included in the gross estate to meet the 75 percent requirement.
If qualifying stock is exchanged for new stock in a tax-free organization, or if new stock is issued as a tax-free dividend on the qualified stock, the new stock qualifies for the redemption. When the deceased's stock represents voting control, this control may be retained by the redemption of new, nonvoting stock issued in a tax-free recapitalization.

If, when planning for the Section 303 redemption, the stockholder anticipates that the value of his stock may be close to the 50 percent qualification threshold, he may increase the percentage by making *inter vivos* gifts of property other than the stock.

"Inter vivos" comes from a Latin phrase that means "between the living," or "from one living person to another." This type of gift is distinguished from a case of succession.

Alternatively, he may have the corporation purchase additional key person insurance on his life, thereby increasing the value of his stock.

The sale of some personal insurance to the corporation and its replacement of new insurance owned by the spouse or an irrevocable trust has the following effect: It increases the stock's value and decreases the value of other property included in the gross estate.

A Section 303 redemption is permitted only to the extent that the burden of paying debts, expenses and taxes falls on the interest passing to the stockholder having his stock redeemed. Therefore, the tax benefit of Section 303 is barred unless the stockholder who receives the distribution in redemption of his stock pays a portion of the death taxes, funeral and administration expenses that are at least equal to the distribution.

Clearly, a great deal of advance and coordinated planning is required when a Section 303 redemption is contemplated. The advice of a competent tax attorney should be sought in these matters.

Maximum Redemption – The purpose of Section 303 is to protect possible dividend treatment. Using the rules described above, the protected amount is the amount distributed in the redemption of qualified stock to the extent that it does not exceed the total amount of allowable funeral expenses, administration expenses, death taxes and any interest.

If the amount distributed exceeds the protected amount, the excess amount is subject to the rules of Section 302. Section 302 of the Internal Revenue Code determines whether or not the distribution represents a sale, an exchange or a taxable dividend.

Section 303 and Time Limitations -- There are time limitations on using Section 303. To qualify for the protection granted by Section 303, the distribution must be made within three years and 90 days after the federal estate tax return is filed.

The exception to this is a bona fide petition for a redetermination of federal estate tax. This petition must be filed on a timely basis with the federal tax court. Under these circumstances, the distribution may be protected if it is made within 60 days after the court's decision becomes final.

Under certain circumstances, the time limit for a protected distribution can be extended as much as 15 years, if the estate elects to pay such taxes under Internal Revenue Code Section 6166 or 6166A. However, when the Section 303 redemption occurs more than four years after the stockholder's death, the amount redeemed cannot exceed the lesser of the death costs remaining unpaid or the amount of the costs paid within one year after the redemption.

Life Insurance and Section 303 -- For a Section 303 redemption to take place, the state statute and the corporation's charter must permit the corporation to redeem its stock. Today, nearly all states permit Section 303 redemption, if the corporate surplus is

sufficient to do so. The corporation must have the surplus available to make the redemption payment without exhausting its working capital.

The corporation may essentially supply the necessary cash to itself and increase its surplus with the proceeds of key employee insurance on the stockholder's life. Such an arrangement assures the stockholder of two things:

1) That the redemption will be made.
2) That the redemption payments will supply needed cash to his estate.

Double Duty Dollars -- The dollars used for this purpose are often referred to as double duty dollars. These funds ensure that the corporation has the surplus in cash for making the redemption. Further, these funds ensure that the personal representative has the necessary cash for the purpose of administering the estate.

The plan described above of utilizing double duty dollars when making a Section 303 redemption presumes that the corporation has surplus sufficient for redemption. However, the corporation could be short of cash for this purpose.

Naturally, the corporation should not support the amount of its surplus with proceeds of key employee insurance. Therefore, the insurance must be arranged to achieve a different objective. That is, using the corporate surplus or future earnings for the support of the family after the stockholder's death.

This plan can normally be accomplished as follows:

The insurance on the stockholder's life is purchased, owned by and payable to one or more members of his family. After his death, the beneficiaries lend the proceeds to the corporation in exchange for interest bearing notes or bonds. The corporation uses these borrowed funds to redeem the stock from the personal representative of the estate. From the standpoint of the beneficiaries, these payments are simply a return of their own funds.

These insurance dollars perform two functions -- to redeem the stock and to support the family.

Section 303 Redemption and Accumulated Earnings Tax -- Typically, if the earnings of a corporation are used to fund a buy-sell agreement, the accumulated earnings tax may be imposed. Also, when the appreciated assets of the corporation are used to redeem the deceased's shares, the corporation may have to recognize a gain for the difference between the basis of the amounts distributed and their fair market value.

This accumulated earnings tax is essentially a penalty tax on earnings accumulated beyond the reasonable needs of the business.
Prior to 1969, it was held that accumulation of earnings for purposes of a Section 303 redemption were not for the reasonable needs of the business. They were principally for the personal needs of the stockholder and his estate.

As a result of the amendments to the Internal Revenue Code in 1969, accumulations made in the year of death or a later year are considered to be reasonable needs of the business. If funds are used for a Section 303 redemption, no judgment may be made

that accumulations in the years prior to the death represent unreasonable accumulations. This determination must be made regardless of the redemption.

Funding a Section 303 Redemption With Life Insurance -- A prudent plan would be to fund a Section 303 redemption with annual premium life insurance. The premiums on annual premium life insurance represent a small accumulation in any one taxable year. They are seldom significant enough to draw the accumulated earnings tax.

Also, the insurance should not be linked to the Section 303 redemption by agreement. Alternatively, the insurance should be purchased as key employee insurance. This arrangement is clearly an accumulation for a reasonable business purpose. Using such an arrangement, in the event of the death of the insured, the corporation can elect to use the proceeds to fund the Section 303 redemption.

Life Insurance on the Stockholder -- When the requirements of a Section 303 redemption cannot be met, a plan is needed for estate cash to be supplied by insurance on the stockholder's life. For example, a buy-sell agreement may provide that a family member active in the corporation will purchase enough stock from the stockholder at his death to supply the necessary cash. Such a plan also serves the purpose of dividing the stockholder's estate equitably among the members of his family.

Regardless of the circumstances, an insurance plan should be put into place for supplying the estate with cash.

--END OF COURSE--

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