Rescuing Retained Earnings And Mitigating The Double Tax

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THOUSANDS OF C CORPORATION owners get hit every year with both corporate and ordinary income taxes because they have retained earnings. What options are there to remove those earning from the company so as to mitigate this double tax?

The solution is to leverage a preferred/non-preferred limited liability company. The retained earnings, once invested in the LLC, can be used to purchase a cash value life insurance policy that ultimately will enable most of the retained dollars to pass tax-free to the owner and grow tax-free during retirement. Pre-retirees for whom a life insurance policy would not be cost-effective because of the high premiums can achieve the same result by either making a child or an irrevocable life insurance trust a non-preferred managing member of the LLC.

These options are superior to one with which most clients and advisors are familiar: having the company pay the owners a year-end bonus. That bonus is deductible for the company but 100% taxable income for the employee. Bonusing out retained earnings is painful because the company already paid a sizable corporate tax on the earnings when retained.

A schematic detailing how the LLC works is shown in the chart. What happened in the schematic? First, the company invested $1,000,000 of retained earnings in the LLC (1). The company then paid back its $1,000,000 investment, plus a long-term rate of return pegged to the long-term AFR interest rate (using simple interest). The return is guaranteed by a preferred life insurance policy does not have to repay the loan out of pocket (4)(4a).

What was accomplished? The owner of the C corporation removed 85 cents on the dollar of retained earnings so the money could grow tax-free and come out of the life insurance policy tax-free when the owner is retired. Without using the above technique, the owner would have had to take the retained earnings home as W-2 income, which could subject that income to 40%-plus income taxes.

ALTERNATIVES FOR PRE-RETIREEES

A C corporation owner who is already near retirement (i.e., 60 years or older) will have difficulty using life insurance for retirement plan purposes because the costs for the death benefit will be too high. However, the owner still can use the preferred/non-preferred LLC in two ways to remove the retained earnings in a tax-favorable manner.

Option 1: Transfer the retained earnings via the LLC to a son or daughter who is a non-preferred managing member. Most pre-retirees who choose this option stand to pay a large estate tax. They also have no need for additional retirement income and can't gift enough money out of the estate to lessen the estate tax.

If a child becomes the non-preferred managing member, using his/her life to purchase the insurance, an estate transfer can be accomplished. The parent business owner who would normally remove the retained earnings through a bonus from the company (which is income taxed), sets up a situation where the children (as the non-preferred managing members) can access continued on page 38
the cash value in the policy owned by the LLC without gift, income or estate taxes. This is a powerful estate planning solution that guarantees an investment return to the C corporation.

Option 2: Make the non-preferred managing member an irrevocable life insurance trust (ILIT). Again, the business owner probably has a large estate and estate tax issue. The conventional way to obviate estate tax—purchasing life insurance—is a problem in most traditional estate plans because the client has to pay large premiums. This also creates gift tax problems when gifting the premium to an ILIT.

When using the preferred/non-preferred LLC structure, instead of buying a cash building policy for retirement income, the LLC would buy the largest guaranteed death benefit possible on the life of the retiring business owner. When the business owner dies, the LLC (which the ILIT partially owns) will receive a large death benefit that will pass income and estate tax-free to the heirs.

The use of an ILIT in the LLC structure with retained earnings has two powerful benefits:

► The premium for the life policy in the LLC is paid for with pre-tax dollars (remember that the business owner would normally have taken the retained earnings out and paid tax on it before gifting it to an ILIT); and

► There is no gift tax issue when funding the life policy in the LLC. Normally when a client funds a sizable premium for a policy owned by an ILIT, the client must use his/her gift tax credit or pay a large gift tax. There is no gift when implementing the LLC technique and, therefore, no gift tax issues.

CONCLUSION
With the preferred LLC structure, clients can remove approximately 85% of the retained earnings from the company without tax, giving the business owner access to the money income tax-free in retirement.

In the event the business owner is too old to use life insurance as a retirement tool, the LLC structure could be used to move money to a child income and estate tax-free by making a child or an ILIT the non-managing member.