Section 2
Retained Earnings Rescue

When a corporation who has retained earnings finally gets to the point of deciding that there is no reason to continue to retain the earnings, what options does the corporation have to remove those earning from the company?

The main option most clients and their advisors are familiar with is to simply have the company pay to the owners of the company a year end bonus. That bonus is a deduction for the company but 100% taxable income the employee. Bonusing out retained earnings is a painful thing to do since the company already paid a sizable corporate tax on the earning when retained. This is the classic double tax situation that makes business owners cringe.

Is there a better option than simply bonusing out retained earnings to the business owners or key employees?

Would the business owner like to use a technique where on average 85 cents of every retained dollar could come out of the company income tax free where it would be transferred into an investment where it would grow tax free and come out tax free in retirement? The answer is absolutely.

How? Using a preferred/non-preferred LLC structure. This structure was discussed in the deferred compensation chapter. Please turn to page ___ and read about this structure before continuing.

Using this technique to remove retained earnings from the company works virtually identical to the non-profit deferred compensation solution. The only difference is that the company with retained earnings will take the place of the non-profit.

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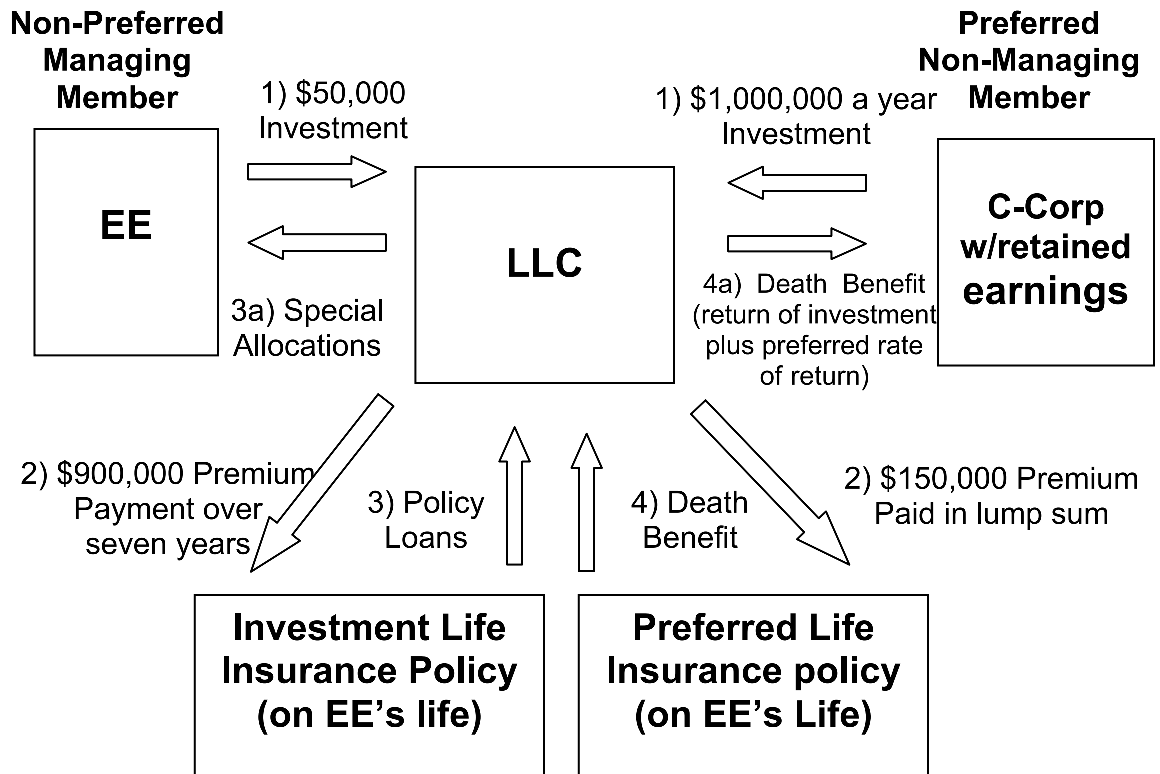

What happened with the above schematic?

1) The company funded as an investment an LLC with $1,000,000 of retained earnings. The company will be 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 the preferred life insurance policy purchased by the LLC using 15% of the retained earnings invested.

2) $850,000 of the $1,000,000 retained earnings was invested in a cash value life insurance policy which is specifically designed to build wealth.

The employee/owner is the managing member of the LLC and has the option of having the LLC borrow the money out of the life insurance policy income tax free (usually when he/she is in retirement). The LLC will pass the tax free borrowed money to the employee/owner through special allocations.

The loan from the life insurance policy will be paid back to the life insurance company at the death of the key employee through a reduction in death benefit (meaning the loan does not have to be repaid out of pocket by the owner/employee or his estate).

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Again, what was accomplished? The owner of a C-Corporation removed 85 cents on the dollar of retained earnings where that money will be able to grow tax free and come out tax free out of the life insurance policy when the owner is in retirement. Without using the above technique, the owner would ultimately have to take the retained earnings home as W-2 income which could subject that income to 40%+ income taxes.

What if the business owner already near retirement age?

If the owner of a corporation with retained earning is already near retirement 60+ years old, it will be difficult to use a life insurance policy as a good investment for retirement plan purposes (the costs for the death benefit will be too high). The business owner can still use the preferred/non-preferred LLC in two different ways to remove the retained earnings in a tax favorable manner.

1) The non-preferred managing member could be the business owner's son or daughter (or both). Why would this make sense? Most clients who have this dilemma who are close to retirement have sizable estates and estate tax problems. They have no need for additional retirement income and can't gift enough money out of the estate to lessen the estate tax problem.

If a child becomes the non-preferred managing member where his/her life is used to purchase the insurance a nice estate transfer can be accomplished. Affectively the parent business owner who would normally have to take the retained earnings out of the company, pay tax on it and then try to gift it to the children, can simply transfer it to a child through the LLC without gift or income taxes. This is a powerful estate planning solution that also solves the retained earning problem.

2) The non-preferred managing member could be an irrevocable life insurance trust (ILIT). Why would this make sense for the older client? Again, the business owner probably has a large estate and therefore estate tax problem. The traditional way to solve an estate tax problem is to purchase life insurance. The problem with buying life insurance in most traditional estate plans is that a client has to pay sizable premiums which also create gift tax problems when gifting that 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 is partially owned by the ILIT) will receive a sizable death benefit which 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.

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-The premium for the life policy in the LLC was affectively 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).

-There was no gift tax issue to deal with 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 on retained earning rescue:

There are thousands of clients who are owners of C-Corporation who have retained earnings and are disgusted with the thought of taking the retained earnings home and paying ordinary income tax on that money (the classic double tax).

With the preferred LLC structure, clients can affectively remove approximately 85% of the retained earnings out of the company without tax where the business owner can have access to the money income tax free in retirement.

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

There are only a handful of attorneys around the country that are familiar with the simple structure. If you have an interest in finding one, please contact one of the authors.

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