

# Benefit Insights

## **Striking a Blow for Business Continuation Planning Using Stock Redemption**

Business owners are always looking for creative ways to maintain a company's continuity if one of the major partners dies. Recently the 11th Circuit Court of Appeals gave companies another continuation strategy with its favorable ruling regarding the use of life insurance purchased by the corporation to buy back the insured's stock shares in the event of death. In spite of the stance taken by the IRS and the Tax Court to the contrary, the Court of Appeals ruled in the *Estate of Blount v. Commissioner* No. 04-15013, F. 3d, that the amount of the policy proceeds should not be included in the calculations to determine the corporation's fair market value. In the decision handed down, the court said that even though the company did receive the death benefit, it shouldn't be included in the corporation's net worth because in effect, the money was already spent as the life insurance was purchased for the express purpose of buying back the insured's shares upon his death. The decision also included a "dollar for dollar" offset for life insurance proceeds that must be used when these proceeds are designated to purchase stock.

The ruling is a definite shot-in-the-arm for business continuation planning structured around stock redemption arrangements. These plans offer some distinct advantages over the more commonly used cross purchase agreements. The cross purchase sidesteps the issue of insurance proceeds being part of a corporation's net worth because the policies are owned by the individual partners. However, cross purchase plans lead to difficulties when a company is trying to cover shareholders with different ownership levels, wide age differences, or unfav-

orable health conditions. Stock redemption plans allow the company to pool premiums, which is a more equitable way to deal with diverse shareholders, as well as reduce the number of policies to be purchased.

The Blount decision also stated that the stock redemption agreement didn't "peg" the value of the business for federal estate tax purposes. The court disregarded the amount stated in the agreement because as the majority stockholder, Blount could unilaterally change it at any time while he was alive. In fact, he had changed it a few months before his death.

According to the U.S. Treasury, a buy-sell agreement can only set the value of a business for tax purposes if:

- The agreement price is fixed and determined by a formula.
- The estate is obliged to sell under a valid and enforceable agreement.
- The obligation to sell must be binding during one's lifetime.
- The agreement constitutes a bona fide business agreement and is not merely a ruse to pass shares to beneficiaries without full and adequate consideration.

The IRS also has similar statutory requirements for determining a business' value for estate tax purposes. Known as the three-point "safe harbor" test, it applies to any agreement entered into or materially modified after 1990.



**Welcome to Our Newsletter!**

**TOBIAS**  
INSURANCE GROUP, INC.

**JUST IN CASE YOU OVERLOOKED REGISTERING YOUR BENEFIT PLAN:** All Employers with Prescription Drug Coverage - were to file by March 31, 2006 the Creditable Coverage Disclosure Form with the Centers for Medicare & Medicaid Services (CMS). The form is available to electronically file at: <http://www.cms.hhs.gov/apps/ccdisclosure/default.asp>  
Please contact our Benefits Department with questions at (317) 844-7759.

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## ***Non-Qualified Benefits Can Help Retain Key Employees***

Often, the success of a business depends on the company's ability to attract and retain key employees and executives – a company's most valuable asset. Unfortunately, today's top executives jump from one corporate ladder rung to another, reaping rewards and quickly moving on. It is more difficult than ever to retain top executives. How do companies combat this phenomenon? What strategies can they implement to overcome the increasing costs of attracting and retaining key employees and executives? Three benefit options can help with this balancing act: split-dollar life insurance, deferred compensation and SERP plans.



Unlike most other retirement plans, split-dollar life insurance, deferred compensation and SERP plans are non-qualified retirement plans exempt from most of the requirements of Employee Retirement Income Security Act (ERISA), such as nondiscriminatory participating and vesting rules; allowing more flexibility in designing a plan to meet an employer's business objectives and benefit its key executives at the same time.

Split-dollar life insurance is a benefit from you to your executive that enables him/her to purchase life insurance at a cost that is typically a fraction of what it otherwise would be. In the most common variation of this benefit, the executive pays the portion of the premium that covers pure death protection; the employer pays the rest of the premium. Under the agreement, the employer would receive back all of its outlay if the executive leaves – thus creating an incentive for continued employment, often long-term.

Here's how it works: the employer pays \$10,000 a year for a \$1 million life insurance policy for a top manager. If the manager dies at the end of one year, the employer gets back the \$10,000 and the manager's family gets \$990,000. An employer can ask the executive to pay back its outlay on premiums if the employee chooses to leave before a certain time period is completed.

As of September 2003, the IRS has issued new regulations which dramatically affect the value of split-dollar agreements. Hence, it is unlikely that new split-dollar arrangements will, in most cases, make financial sense under the new regulations. However, it may be possible to structure split-dollar and other

types of insurance arrangements that will meet some of the corporate objectives addressed by traditional split-dollar programs.

Deferred compensation is a program that in essence uses the executive's money rather than the employer's, yet is still beneficial for attracting and retaining key employees. This is a way to meet the long-term needs of the employee with even more flexibility than the split-dollar option. With deferred compensation, the employer sets aside a certain amount of an employee's yearly pay and invests the money in life insurance, money market funds, or even securities. In order for the employee to benefit from the tax advantages of the deferred compensation plan, his/her money must remain in the general assets of the company. If there is no risk of forfeiture, then the IRS deems all deferrals as immediately taxable. Provided the deferred compensation agreement is structured properly, for the employee, it's a tax-deferred benefit that can accumulate more money the longer he/she remains employed. For the employer, it offers more flexibility in benefits.

Another strategy an employer may utilize to attract and retain executives is a supplemental executive retirement plan, or SERP, which is designed for highly compensated executives and is used to enhance their other retirement plans, such as 401(k) plans or pension plans.

A SERP consists of three parts. The first is the plan document, which establishes the terms of the SERP. It is an unsecured, unfounded promise to pay benefits. Secondly, benefits must be paid from corporate assets. Life insurance on the lives of the participants is usually the most efficient way to provide financial assets to cover the corporate liability created by the plan document. Thirdly, in order for the SERP to function at its maximum level of efficiency, there should be no tie whatsoever between the life insurance informally funding the plan and any one participant. Instead, plan costs and benefits are aggregated for the entire group of participants. By using this approach, the eventual return to the employer is the highest.

Any one and/or combination of these strategies can be used to attract and retain key employees and executives to combat the ever-increasing cost of competitive compensation. When an executive brings breadth of experience and insight to a company, it is important that both the executive and company benefit from that employee's judgment, skill and integrity.

Please remember that tax laws change frequently so you are best advised to contact your attorney, accountant and insurance agent before proceeding with a non-qualified benefit.

## Changes to Retirement Plans Limits for 2006

Recently the IRS released IR-2005-120 that sets forth the cost-of-living adjustments (COLAs) applicable to retirement plans for 2006. In addition, the Social Security Administration has announced the increase in the Social Security taxable wage base for 2006.

### Significant changes for 2006 from the 2005 limits:

Calendar Year	2005	2006
Annual Additions (415 limit)	\$42,000 (or 100% of compensation, whichever is less)	\$44,000 (or 100% of compensation, whichever is less)
Annual Compensation Limit	\$210,000	\$220,000
Highly Compensated Employee	\$95,000	\$100,000
Social Security Taxable Wage Base	\$90,000	\$94,200

### Gradually Increased Retirement Plan Limits

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") gradually increases various retirement plan limits.

401(k)/403(b) Elective Deferrals	\$14,000	\$15,000
SIMPLE IRA Elective Deferrals	\$10,000	\$10,000
401(k)/403(b) Catch-up Amount*	\$4,000	\$5,000
SIMPLE IRA Catch-up Amount*	\$2,000	\$2,500

\* For individuals age 50 or older

### Traditional and Roth IRA Contribution Limits:

Base limits for Traditional and Roth IRA contributions will remain the same for 2006. Catch up contributions will increase by \$500 for those 50 or older.

Traditional IRA/Roth IRA Contributions	\$4,000	\$4,000
Traditional IRA/Roth IRA Catch-up amount*	\$500	\$1,000

\* For individuals age 50 or older

*The above does not constitute, and should not be considered to be, legal or tax advice. The tax rules are complicated and their impact on a particular individual may differ depending on the individual's specific circumstance. Please consult with your legal or tax advisor regarding your specific situation.*

## IRS Clarifies FSA Grace Period Rules

Employers opting to extend the grace period for flexible spending accounts will provide employees a partial reprieve from the "use-it-or-lose-it" rule. However, the grace period may create a headache for employers looking to offer health savings accounts in the future.

The IRS says employers need to amend their FSAs, if they aren't HSA-compatible, so participants can make HSA contributions. Otherwise, the FSA disqualifies an individual to contribute to an HSA during the grace period. For more information on FSA and HSA compatibility, see IRS Revenue Ruling 2004-45.

In Notice 2005-86, the IRS explains other details for employers implementing the FSA grace period:

- The maximum allowable grace period is the 15th day of the third calendar month following the plan year end.
- The grace period must be available to all participants who are covered on the last day of the plan year, including participants with COBRA coverage.
- The FSA must remain in effect for the entire period, even if the participant terminates employment before the grace period ends.

Employers may apply the grace period to their dependent care FSA without making it available in their health FSA, or vice versa.

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make appropriate changes. However, whenever conducted, dependent eligibility standards must be clearly communicated to employees, along with what they must do to verify their dependents' eligibility status and the consequences for maintaining an ineligible dependent. In regard to consequences, an employer also must decide whether to permit an "amnesty" period, i.e., a time during which employees are encouraged to report any covered but ineligible dependents, with no adverse consequences.

In addition to the prospect of substantial cost savings, a dependent eligibility audit presents an employer with the opportunity to review plan provisions concerning eligibility for dependents, and to make any revisions or clarifications in the definitions.

A dependent eligibility audit can result in immediate, definite and substantial cost savings for a health plan. It is a logical and effective supplement to other cost-savings measures.

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## **Monitoring Dependent Eligibility Can Catch Coverage Errors, Reduce Unnecessary Spending**

With health care costs annually on the rise, employers continue to search for ways to get a handle on overspending. One approach that does not involve plan redesign or cutbacks, cost shifting or vendor switching is to make sure that the plan is covering—and paying the claims of—only those individuals who indeed are eligible. Monitoring dependent eligibility through a dependent eligibility audit offers the opportunity to catch coverage errors and cut potentially costly overspending.

Individuals who are ineligible for coverage under the terms of the plan could be on the plan rolls for many reasons. These individuals include divorced spouses, dependent children who have reached the age of majority, and grown children who remained eligible due to their full-time college student status but who no longer attend school. The continued presence on plan rolls of such individuals could be the result of sloppy recordkeeping, administrative error, or employee oversight...or fraud.

Whatever the reason, continuing these individuals in an “eligible” status can result in the plan paying claims it does not need to, and thus incurring unnecessary—and possibly very high—extra costs. Also, compliance with COBRA continuation rights and COBRA notice requirements could be an issue, for individuals who once were eligible and then lost eligibility due to a COBRA qualifying event.

An eligibility audit helps to determine whether the plan is

carrying any individuals who are enrolled as dependents but who do not meet the plan’s requirements for “eligible dependents,” and thus should be removed from the plan’s rolls. Through the process, employees who are eligible for the plan and who have enrolled dependents will be asked to show proof that these individuals do in fact meet the plan’s requirements for dependent status. Such proof could include (depending on the plan’s terms): a marriage license; a domestic partnership affidavit; a birth certificate; an adoption decree; college transcripts; or a disability determination.

Going into the audit, the employer has a number of decisions to make. Should the audit be conducted of all plan members, or on a more limited basis (such as requiring verification only of certain dependent classes, for example, full-time college students)? What type of dependent eligibility verification will be required (will copies of the relevant documentation suffice)? Who will examine the documentation that employees provide—the employer’s human resources/benefits department, or will this task be contracted out? These decisions can impact not only the cost of the audit process, but also the quality of the results.

The timing of the audit also must be decided. One choice is to time the audit to run with benefits renewal, when employees will be thinking about benefits coverage and can readily

*continued on page 3*

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