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The Accidental Entrepreneur – Part IV – Creating the Family Pension Plan

I have been pontificating ad nauseam some readers might say, on the benefits of structuring a family business and investment holdings in my recommended version of the ideal corporate set up. My recommended structure is the formation of a new family limited partnership (LP) using a general partner that is structured as a regular corporation. In certain instances, we might be flexible and suggest structuring the general partner as an LLC since it previously noted that I disfavor S corporations generally.

The taxpayer following the creation of this family business corporate structure transfers through assignment, business holdings and investment holdings typically owned in separate LLCs to the new LP. The LP has a calendar year end, and the corporate general partner has a fiscal year end - say November 30th. This stagger creates a tax deferral opportunity within the corporate general partner.

This structure has several important management, asset protection and tax benefits. First, the separate business and investment holdings are segregated from each other, isolating each entity from the liabilities of each separate business and investment activity. Second, each entity starting at the LP level, has charging order protection. Think of it as a big envelope holding several separate envelopes each with separate contents. If you manage to open the larger envelope, you still must pry open each separate envelope to reach the contents of each envelope. Third, the staggered year end creates a significant tax deferral opportunity through the payment of a management fee to the corporate general partner by the LP. Fourth, the current top marginal tax bracket for a regular corporation is much lower than the top marginal tax bracket for individual taxpayers. California and New York residents, are you listening? Lastly, the corporate general partner but importantly, the taxpayer retains management and administrative control over the LP's entities.

This article picks up on the point that the corporate general partner is an ideal entity to structure employee benefits - pension and healthcare. I have previously articulated the point that every taxpayer is potentially a business owner, an accidental entrepreneur, even if the corporate employee that owns a few rental properties and a stock portfolio.

This article focuses on the creation of a family pension plan and the addition of children to the corporate payroll and participation in a corporate retirement plan structured as a Roth Plan. If you are going to create a savings plan for children and yourself, why not use it with a tax advantage with expanded contribution limits?

Oh, The Places You Will Go!

I must admit that when my three daughters were growing up, I purchased each of them the Dr. Seuss classic, *Oh, The Places That You Will Go*, on the occasion of their high school graduation. I also admit that I am more sentimental than I realized. It was their graduation but personally I felt the theme of the book inspired the same promise and hope of a great future full of adventure within me. It resonated with me more than it did with them. My mother (of blessed memory) use to frequently say in adverse situations, "This too shall pass."

The planning strategy in this segment focuses on the idea calls of adding the taxpayer's children and spouse to the payroll. As a regular corporation, the corporation has a withholding obligation for FICA and FUTA purposes on children under the age of 18. The standard deduction for an individual taxpayer in 2020 is $12,400 meaning a child does not have to file a federal tax return until his income exceeds this level.

However, if the corporate general partner is an LLC taxed as a sole proprietor or partnership, the FICA and FUTA obligation on minor children employed by the corporate general partner is eliminated at the general partner and employee level. So, in this case, we modify our ideal corporate structure to include the use of a general partner structured as a LLC to avoid the FICA and FUTA withholding obligation while paying the children a salary that is within the standard deduction and not subject to any withholding obligation. Hence, no federal or state income taxation is due on the salaries to minor children along with no FICA and FUTA withholding.

The Family Pension Plan

One of the benefits in the creation of a corporate general partner is the ability to create a qualified retirement plan within the corporate general partner. This plan can include a cash balance defined benefit plan and 401k/profit sharing plan. These contributions use tax deductible contributions to the corporation. The benefits provide tax deferred benefits that are taxable as ordinary income upon distribution. One qualified plan solution that is much simpler and less costly for administrative purposes is a 408(k) which offers greater flexibility for an expanded list of exemptions for the early withdrawal penalty.

The 408(k) is like a Roth 401k component but is created under a Salary Reduction Simplified Employee Pension Plan. The 408k has greater flexibility in the number and types of early distributions that are exempt from the early withdrawal penalty under IRC Sec 72(t). An individual Roth IRA has an annual contribution limit of 6,000 which is increased to $7,000 for a taxpayer who is age 50 or older. The individual IRA is also capped by the taxpayer’s income. Taxpayers filing a joint return with more than $206,000 of adjusted gross income (AGI) cannot make a Roth contribution. For single taxpayers, the income limit is $139,000.

These income and contribution limitations disappear for a Roth 408k Plan. In 2020, the contribution limit to a Roth 401k is $19,500. A taxpayer who is age 50 or older can contribute an additional $6,500 to the Roth 401k for a total contribution of $26,000. The children’s salaries can be deferred into their 408(k) account. The Roth 408(k) provides interesting possibilities in that is allows for tax-free accumulation and tax-free distributions. However, different that an individual Roth, the 401(k) and 408(k) Roth are subject to the minimum distribution rules at age 70 ½. You can’t have everything!

However, the family corporate structure adopting the 408(k) plan has a maximum contribution level that is three times greater than an individual and almost four times greater for a taxpayer that is fifty years old or older. At a minimum, every taxpayer of reasonable means should create the proposed corporate structure to add a Roth 408k. A couple can double the benefit. A couple can also begin this process for the children and grandchildren.

The corporate 408(k) salary deferral arrangement has interesting possibilities for minor children that are added to the payroll of the corporate general partner structured as a limited liability company (LLC) in this case to legally avoid FICA and FUTA withholding on the business owner's minor children paid at a level up to the standard deduction amount. The funds will grow on a tax-advantaged basis within the Plan.

As an alternative, IRC Sec 529 provides an excellent vehicle for accumulation funds for higher education. The cost of undergraduate education at a private university with room and board can average $200,000- 250,000. 529 plans allow for the use of after-tax dollars that can be invested without taxation and then distributed tax-free for qualifying expenses such as tuition, room and board, books, and the repayment of student loans. the 529 plan does not provide any benefits beyond qualified higher education costs.

The Roth 408k provides similar benefits to the 529 Plan for minors but with greater planning flexibility by providing the possibility of early distributions before age 59 1/2 without penalty. These exemptions include early distributions for death, disability, qualified higher education expenses and first-time home buyers. The taxpayer can also take early distributions for the payment of medical expenses that exceed ten percent of adjusted gross income.

Strategy Example

Wile E. Coyote has his attorney create a new corporate structure. He creates WEC, LLC to serve as the corporate general partner of a new limited partnership, WEC Family, LP. WEC, LLC is wholly owned by Wile E. Coyote. WEC LLC owns a one percent interest in Wonka LP.

Wile E has a wife and three minor children who he would like to employ within WEC, LLC. He would like to pay his wife a salary equal of $26,000 which is the maximum contribution limit including the catch-up provision for a 408(k) Roth plan. Wile E is also older than age 50 and can contribute $26,000 into his own 408(k) Roth account. The company defers each child's salary of $12, 400, an amount equal to the standard deduction, into a 408(k) Roth account.

The accounts will grow on a tax-deferred basis year by year. The accounts will be self-directed. The Plan allows for early distributions after a five-year period but before age 59 ½ for qualified higher educational expenses, death or disability and a first-time home purchase. High net worth taxpayers go to incredible lengths to try to achieve the benefits of a Roth IRA. Taxpayers with large traditional IRAs pay tremendous amounts of taxes while converting to a Roth IRA. For the high net worth taxpayers who make too much money, there is no other path. The corporate structure is a path towards the Roth IRA.

Summary

The deeper we dig into the possibilities of the ideal corporate structure; the planning jewels appear at the edge of the surface. The ideal corporate set up creates an avenue to make the benefits of Roth planning available for every taxpayer (I did mean to say every!) with annual contribution limitations that are three times the contribution limits for an individual without income limits. The list of planning benefits for adopting the ideal corporate structure continues to expand. Stay tuned for the next installment.