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Business Planning

Do's and don'ts for employing children in a family business.

By Eva Stark, JD, LL.M.

Parents typically want their children to learn the value of work while they are young to help them become productive members of society. Parents who own a small business and want to employ their children to help pass down family values, teach valuable skills and work ethic, and potentially save on taxes, should consider the following do's and do not's related to employing a child in a family business before adding Junior to the payroll.

DO learn about potential income tax advantages.

Employing a child in the family business may enable parents to shift income from the parents' higher income tax bracket to the child's lower income tax bracket—which can produce significant tax savings. The “shift” in income occurs because the payments for the child's services generally constitute a business expense that is deducted from the parent's business income (if the business is a pass-through entity) or the business's income (if the business is not a pass-through entity). Such wages are then includible in the child's income and taxed accordingly—ideally at a much lower rate. In some cases, the child's income tax bracket may be as low as 0% if the child earns less than the standard deduction amount (\$13,850 in 2023). The dreaded “kiddie tax,” which can mandate the taxation of a child's unearned income at the parents' higher income tax rate, generally does not apply because wages are earned income. State-level income tax benefits or drawbacks may also apply and their



potential impact also should be considered.

DO explore potential employment tax advantages.

While the child's wages are subject to income tax as mentioned above, they may be exempt from employment taxes in some cases. Social Security, Medicare, and Federal Unemployment Tax Act (FUTA) taxes may or may not be required depending on a combination of (i) the ownership structure of the business and (ii) the age of the child. If the business is a corporation, or a partnership with a partner who is not the child's parent, then payments to the child are generally subject to Social Security, Medicare, and FUTA taxes regardless of the child's age. However, if the business is a sole proprietorship or a partnership where each partner is a parent of the child, then Social Security and Medicare

withholding is generally not required if the child is under age 18 and FUTA tax is generally not required if the child is under age 21. As in the income tax arena, state-level unemployment taxes vary and also should be considered.

DO ensure that the child does actual and reasonably necessary work.

A business owner cannot simply add his or her child to the payroll and thereby manufacture a tax deduction. The child must perform actual work for the business by providing some service that is reasonably necessary or helpful to the business. Paying wages to the child for taking out the trash at home or watching cartoons on business premises is unlikely to withstand scrutiny. The child must also be capable of performing the services that the child is being paid

for. For example, it is unlikely that paying a four-year-old for clerical work would be respected by the IRS, but the child might be effective in providing “modeling” or similar services in company advertisements. Documenting services performed by the child, hours worked, or having an employment contract in place with the child may help substantiate that actual, necessary services were performed.

DO pay the child reasonable and actual compensation.

The child’s wages must be reasonable under the circumstances and wages must actually be paid. Paying a child \$100 per hour to work as a part-time receptionist may not be reasonable. On the other hand, if the child is capable of performing more skilled or specialized activities, such as a teenager developing the company’s website or managing its social media presence, higher wages may be reasonable. Comparing the child’s wages to those of other employees or obtaining wage information from unrelated businesses can help a business owner determine what may or may not be reasonable compensation under the circumstances.

The child’s wages also must be paid and generally cannot be in the form of support that the parent is otherwise legally obligated provide to the child, such as in food. Again, keeping records of services performed, hours worked,

information obtained on wage levels of unrelated businesses, and records that show that pay was provided (cleared checks, direct deposits, etc.) may help substantiate the existence of reasonable and actual compensation.

DO NOT run afoul child labor laws.

Federal laws such as the Fair Labor Standards Act of 1938 (FLSA) and applicable state and local laws generally place restrictions on child labor. Although rules tend to be somewhat less restrictive where the business employing the child is owned solely by the parents of the child, significant restrictions may still exist as to the number of hours that a child may work, when those hours can be worked, the type of work a child may perform, and so forth. Reviewing applicable child labor laws with an attorney prior to employing a child can help avoid significant penalties for violations.

DO NOT forget employment laws.

In addition to special child labor considerations, laws for employing any non-family employee also generally apply. Requirements may include ensuring that the business obtains an Employer Identification Number (EIN) if it does not already

have one, having federal withholding (Form W-4) and employment verification paperwork (Form I-9) completed for the child, issuing a Form W-2 to the child, or meeting record keeping and record retention requirements. The business owner’s CPA or attorney can provide guidance on the requirements that may be applicable.

DO consider leveraging earned income with a Roth IRA.

A popular wealth building tool for young individuals is the Roth IRA, which can allow for tax-free growth without required minimum distributions during the original account holder’s lifetime. Given the potential for extremely lengthy tax-free compounding, Roth IRAs can be especially advantageous for children. However, one of the most significant barriers to Roth IRA contributions by minors (or contributions on their behalf) is a lack of earned income. Roth IRA contributions are only permitted to the extent an individual has earned income (subject to annual contribution limits as well as annual income limits). Employing the child in the business can give the child earned income, potentially opening the door for Roth IRA contributions and tax-free wealth building.

Parents who employ their children should explore these potential benefits and drawbacks with their professional advisors to see how they may apply in their individual circumstances.



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Executive Benefits

Non-qualified deferred compensation plans: A tool for employers to attract and retain top talent.

By Karen Fishell, CLU®

In the current “hot” job market, employers are facing the threat of losing their top people through competitive offers from other companies. Losing key people who help the company achieve its goals adds additional financial stress for the employer associated with recruiting, hiring, and training suitable replacements. It can result in lost profits and clientele due to a disruption in the flow of business.

Competition is fierce. Employers must offer a competitive salary and benefit package to attract, retain, and motivate top talent. What can an employer do to gain an advantage over the competition? A properly designed non-qualified deferred compensation plan can give the employer a competitive edge over competing offers.

What Are Non-Qualified Deferred Compensation Plans (NQDC)?

A non-qualified deferred compensation plan is an unsecured contractual agreement between an employer and a key employee in which the employer promises to pay a future benefit to the key employee. The plans are exempt from most ERISA and reporting requirements and are not subject to the participation, non-discrimination, and funding requirements of qualified plans. They are not subject to IRC Section 415-dollar limitations imposed on qualified plans.



Unlike qualified plans, the employer has the freedom to pick and choose which employees will participate as long as the plan is maintained for a “select group of management or highly compensated employees.” The plans are flexible, enabling the employer to select a different benefit level for each key employee.

The plan is an additional financial incentive for the key employee to remain with the employer. The written agreement between the employer and the key employee will define what the conditions are for the key employee to receive the benefit, what the benefit will be and when it will be paid. As further motivation, a graduated vesting schedule might be

included within the agreement that could make the key employee think twice about leaving when he/she sees the amount of money that will be left on the table.

Plan Design Options – One Size Does Not Fit All

There are several options for NQDC plans. Selection of the type of plan depends upon the employer and key employee objectives.

Non-Qualified Defined Benefit Plan

A defined benefit plan typically provides a specific benefit at retirement or other stated time to be paid for a specified number of

years. It can be used to enhance a retirement benefit paid under a qualified plan which may be limited due to benefit limitations. The employer pays for the cost of the plan. The employee pays income tax on the payments when received at his/her ordinary income tax rate. The employer receives a corresponding tax deduction when the payments are made. The benefit could be based on a percentage of final pay or could be a stated dollar amount.

Non-Qualified Defined Contribution Plan

The employer sets aside a contribution amount each year for the employee and credits the account with interest. The contribution amount may vary each year depending upon the employer's objectives. The employee's benefit at retirement or other stated date is based on the account value at that time. The contributions could be based on company profits and achievement of individual performance benchmarks. The employee pays income tax on the payments when received at his/her ordinary income tax rate. The employer receives a corresponding tax deduction when the payments are made.

Non-Qualified Deferred Income Plan (DIP)

Deferred income plans allow the key employee to defer a portion of his/her salary and/or bonus each year. The amounts deferred are not subject to income tax until they are distributed. The plan can be structured to accommodate an employer matching contribution. The employee is vested in his/her deferrals; the employer may choose to impose a vesting schedule on the employer contributions. The payments are subject to income tax at the employee's ordinary income tax rate when received. The

employer receives a corresponding tax deduction when payments are made.

Deferred Compensation Plans for Non-Profits

Non-profit organizations may also enhance their benefit packages through the use of deferred compensation arrangements. Plans for non-profits are generally referred to as Section 457(b) plans (limited contribution amounts) and Section 457(f) plans (no contribution limits but accounts must remain subject to a substantial risk of forfeiture to avoid current income taxation).

Plan Funding

To maintain the flexibility and tax advantages that non-qualified plans afford, the plan must remain "unfunded." Assets set aside to meet the plan benefit obligations must remain a general asset of the company. Plan participants cannot have access to the assets before the benefits become due in order to avoid current income taxation.

Life insurance is frequently used as a method of "informally" funding the benefit plan, and it offers many advantages over other types of informal funding. Its cash values normally accumulate income-tax free, while income generated from other funding methods, such as mutual funds, would be currently taxable. The employer can use the cash value of the contract to provide the benefit payments when they become due.

Additionally, in the event of an early death of a key employee, the life insurance death benefit is received income-tax free by the employer. This provides assurance that the employer will have the funds available to pay any survivor benefit due and, structured properly, can also provide key person protection for the company.

Taxation of Non-Qualified Deferred Compensation Plans

THE KEY EMPLOYEE – The key employee has no reportable income prior to retirement or termination. When benefits are paid to the executive they are taxed as ordinary income in the year received.

THE BENEFICIARY – Payments made to the executive's beneficiary will be taxed as ordinary income in the year of receipt. The present value of benefits payable in installments will be included in the executive's estate, but if payable to the surviving spouse, may qualify for the unlimited marital deduction.

THE EMPLOYER – Benefits paid to the executive or to the executive's beneficiary are tax deductible in the year they are made. Life insurance premiums are not tax deductible, but insurance cash values accumulate on a tax-deferred basis and are recorded as an asset on the employer's balance sheet. Life insurance death proceeds used to offset benefit payment liabilities are received by the employer income tax free.

FICA/FUTA TAXES – Nonqualified plan contributions and earnings on them are generally taxable for employment tax purposes when they are vested.

IRC Section 409A

IRC §409A provides the rules that relate to most non-qualified deferred compensation plans:

DEFERRAL ELECTION – Time and form of distribution must be specified at the time of election to defer compensation. Election must be made before the beginning of the taxable year that the compensation is earned.

- Newly eligible employees may make deferral election within 30

days of first becoming eligible to defer compensation earned after the date of the election.

- Election for performance-based compensation that is based on service of at least 12 months may be made at least six months before the end of the performance period.

SUBSEQUENT DEFERRAL

ELECTIONS – An election to defer the timing of a distribution or change the form of payment.

- May not take effect for at least 12 months after the election;
- Must be made at least 12 months before the date of the first scheduled payment of previous election; and
- Must provide for additional deferral of at least five years.

PERMISSIBLE DISTRIBUTIONS –

- Death or disability (as defined by the Act);
- Separation from service (payment delayed at least six months after separation of service for key employees of a public company);

- A specified time or based on a fixed schedule under the plan (not an event);
- An unforeseeable emergency; or
- A change in control as defined by the IRS.

ACCELERATION OF

DISTRIBUTIONS – The Act prohibits acceleration of the time or schedule of payment(s) under a plan, subject to IRS regulation. Installment payments cannot be changed to a lump-sum payment unless commencement of payment delayed for at least five years from the previously scheduled commencement date.

COMPLIANCE WITH SECTION

409A – Plans must be documented in writing and must operate in good-faith compliance with Section 409A. Failure to comply with Section 409A results immediate taxation and a 20% penalty imposed upon the participant.

SHORT TERM DEFERRAL

EXCEPTION – Section 409A will not apply if payment is required to be made on or before the 15th day of the third month following the end of the employee's tax year or

the employer's tax year, whichever is later, in which the right to the payment vests.

In Summary

Non-qualified deferred compensation plans can provide employers with a competitive advantage in attracting, retaining, and rewarding employees that are key to the success of the company. They allow for design flexibility without the anti-discrimination provisions or funding and reporting requirements of qualified plans and can be customized for each key employee to align with corporate and individual objectives.

For the key employee, non-qualified deferred compensation plans can provide additional benefits beyond those provided through traditional qualified plans such as a 401(k) plan or other savings plans, without current income taxation, which can incentivize long term employee loyalty.



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Employers should be aware that the arrangements described herein may be subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) and Internal Revenue Code Section 409A (Section 409A), the tax rule applicable to non-qualified deferred compensation. ERISA imposes certain requirements on employee benefit plans and their sponsors, including but not limited to, fiduciary, disclosure and reporting requirements. These requirements depend on the type of plan ("retirement or welfare plan;" or "top hat retirement" or "top hat welfare plan"). Section 409A imposes certain requirements that, if not satisfied, can result in adverse tax consequences to employees. New York Life Insurance Company and its employees, agents and affiliates do not provide tax or legal advice. Employers should consult with their legal and tax advisors regarding the implications of ERISA and Section 409A on adopting these arrangements in their particular circumstances. New York Life Insurance Company, its agents and employees may not provide legal, tax, or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. The Nautilus Group® is a service of New York Life Insurance Company. SMRU 5345105 Exp. 12/27/2024

Life insurance 101: An overview of term life policies versus whole life policies.

By R. Matthew Pate, JD, LL.M.



Life insurance is commonly understood as a basic protection tool, similar to other types of property or casualty insurance. Most people are familiar with this concept – you pay a premium, and if the worst happens (in this case, the insured dies), the carrier pays out a benefit. By pooling the premiums of a large group of insureds, a small premium can offer a large death benefit, providing “leverage” of premium dollars. Insurance of this variety has been around in some form or fashion since ancient Rome, when Caius Marius, a Roman military general, created a burial club to help pay the burial expenses of troops in the event of an untimely death. Life insurance gradually evolved from closely

related risk pools to large corporate carriers serving the public at large.

Many individuals likewise have experience with basic “term life insurance” through an employer provided “group term” policy or with a personal term policy. Such policies generally provide the lowest premium cost for a given coverage level (e.g., \$1,000 annual premium for a \$1 million death benefit). Of course, while low cost and maximum leverage is initially attractive, term policies are a pure cost for approximately 98% of purchasers—in other words, 98% of term policies never pay a death benefit.

Why is this so? As individuals get older, the cost of providing insurance protection increases (since the risk

of dying increases). Term insurance becomes cost prohibitive for most individuals well before they reach life expectancy. As a result, most term policies are dropped, or “lapse” after many years of premiums having been paid. Where an individual’s health has declined, a renewal of coverage at that point may be cost prohibitive as well, or unavailable altogether.

Cash Value Whole Life Insurance

Whole life insurance was developed to provide insurance coverage for one’s “whole” or entire life, in contrast with temporary term life. To avoid the increasing costs and early lapse issues that affect term policies, whole life premiums are

typically much higher than term premiums. However, the higher premiums may not equate to a higher overall cost to the policy owner in light of the “cash value” component of whole life. While term insurance has no economic benefit apart from death proceeds, whole life policies devote a portion of each premium to an account tied to the policy. The carrier reinvests these proceeds and provides earnings back to the account in the form of interest or dividends.¹ As this cash value account grows, the pure death benefit portion of the contract is generally compressed, reducing the corresponding cost of insurance. At some point, the earnings attributed to the cash value may support premiums moving forward. Some whole life policies also can be designed to have a predetermined (shorter) pay period with guaranteed permanent death benefit.

Common Misperceptions with Whole Life

Whole Life and “Forced Savings”

Many people may be reluctant to provide larger premium outlays in exchange for a cash value tied to an insurance product. This “forced savings” pejorative belies two simple facts:

1. Budgeting for regular savings is generally sound financial advice.
2. Cash values are not simply a feature that helps support the coverage but rather liquid assets in their own right that can be accessed during lifetime without requiring additional premiums, in most cases.

For example, cash values can be withdrawn from a policy through surrenders or dividend payments (generally tax free up to basis in the contract), or more frequently,

through policy loans. Loans against a policy accrue interest and decrease the death benefit and available cash surrender value by the amount of the outstanding loan and interest. Accessing cash value will reduce the available cash surrender value and death benefit.

Cash Values Offer Low Returns

When analyzing returns on any type of financial instrument, the primary question should be “in comparison to what?” Whole life cash values are meant to support decades worth of policy performance—as a result, the corresponding investments underlying the contract are more conservative. When comparing the performance of whole life cash values to alternatives, comparably secure options should be the basis. Additionally, when factoring in the tax benefits of whole life, cash values frequently outperform comparable options.

Whole Life is Too Expensive

While premiums in relation to term products are certainly much higher, the corresponding benefits and value provided should be included in any cost comparison: e.g., the net cost of the insurance should generally be the cumulative outlays less cash values. Additionally, the death benefit protection above and beyond, particularly when the term policy would lapse, should be included in any cost analysis.

It’s Better to Buy Term and Invest the Difference

Perhaps the most common argument against paying higher whole life premiums is that it is better to simply buy the term (as a stop gap) and invest the difference of the whole life premium to effectively “self-insure.” In some situations, this may make mathematical sense, but it ignores practical reality of savings

habits, personal budgeting, and spending discipline. In many cases, the “difference” is never invested to begin with—making the budgeted “forced savings” of whole life a generally good thing.

For those confident in their ability to accumulate adequate savings nonetheless, a crucial facet of whole life remains worth exploring—namely, how life insurance cash values fit into one’s portfolio from a tax and asset allocation standpoint.

When investing the difference, there are generally two options to choose from: fixed income (bonds) or equities (stocks). There are different types and tax features within these asset classes, and most investment accounts adhere to some type of blended arrangement with adequate diversification within each class.

FIXED INCOME instruments typically provided greater security and stability, as most bonds and bond equivalents offer a stated rate of interest. Of course, other than tax-free municipal bonds, bond interest is generally taxable as ordinary income. Ordinary income is taxed at potentially higher rates (up to 37%) than qualified dividends and capital gains (15% or 20%). Additionally, interest income is subject to the tax on net investment income (NIIE) of 3.8% once one’s income exceeds a certain threshold. And while fixed income has a fixed principal (the original investment amount) repaid at maturity, changes in interest rates can impact the value of a bond at a given moment.

For example, in an increasing interest rate environment, the current value of a bond will generally decrease as the present value of the interest

¹ Depending on the carrier and the type of policy, a portion of account earnings may be guaranteed, and an additional component may be the non-guaranteed dividend or earnings paid by the carrier.

payments is reduced. If liquidity from a bond's value is needed, a subsequent sale can result in a loss in the initial investment. Lower rated bonds offering higher interest payments may also pose a higher risk of default (i.e., an inability to repay the principal as promised).

EQUITIES have generally provided robust growth over the long term but are subject to greater risk and volatility as well. Dividends paid are taxable and likewise subject to the tax on NII, as are capital gains when securities are sold. A common blended portfolio may require capital gains realization during an up market as securities are sold to rebalance to the desired allocation. Additionally, as one nears retirement, common investment wisdom suggests a movement towards more fixed income to provide greater stability and reduce risk and volatility.

In Summary

Fundamentally, life insurance has savings attributes in addition to insurance features—but for too many people it is not viewed that way. As a result, many of them may opt for a term insurance outlay that offers nothing in return other than peace of mind, for a while.

For those able to take advantage of the benefits of whole life, however, the savings component can serve as an important conservative allocation of an overall financial portfolio, while the insurance component can provide peace of mind for a lifetime.



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