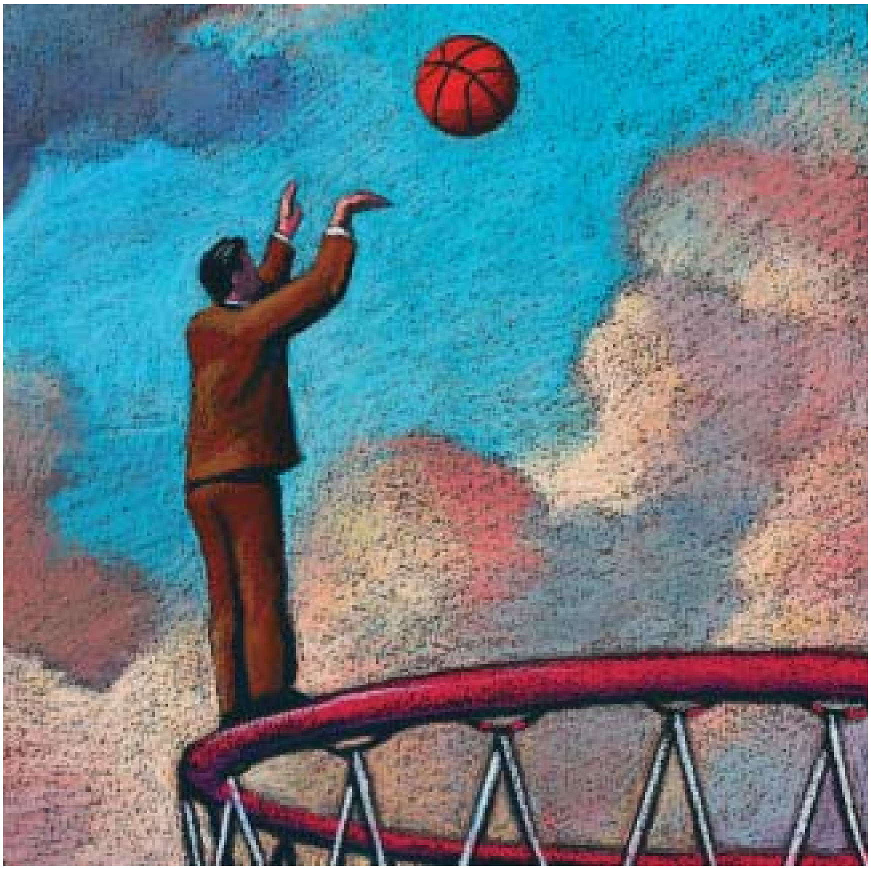
As Simple as ABC

By selling a portion of their accounts receivables to a factoring company, small business owners can defer income tax in a straightforward way.

By Roccy DeFrancesco



IF YOUR CLIENTS MAKE SIGNIFICANT taxable income, you are probably tired of insurance companies telling you to use 412(i) plans as "the best" income tax reduction tool. Although 412(i) plans are indeed a nice fit for some clients, many times the costs of the plan are too prohibitive when a client has more than a handful of employees.

If you are ready for a simple income deferral plan, you are ready to review the accounts receivable-business continuation (ABC) plan. The ABC plan is the simplest "advanced" plan that's available today. Any CPA or attorney in the country will understand it with relative ease, and they should also approve it without a hard sell.

The ABC plan is a program created for small business owners who use an installment sale of their accounts receivables (A/R) to further business continuation and defer income tax. So how does it work? There are six steps:

1. A business sells a specific amount of A/R to a factoring company (FC), typically ranging anywhere from $25,000-$100,000 or more.

2. The FC takes a 5% factoring fee on the A/R factored and issues to the business an installment note requiring payment of the remaining 95%. This note has repayment terms as dictated by the business that's selling the A/R.

3. When the business collects the A/R that was sold, that money is transferred to the FC.

4. The FC then invests the money it receives (minus the 5% factoring fee). Typically, that money is invested in equity indexed annuities that have minimum guarantees and growth pegged to the S&P 500.

5. When the installment note comes due to pay the business, the FC pays back to the business the initial amount factored (less the original factoring fee), plus any growth on the money (as it was pegged to the S&P 500).

6. The business then can choose to use the money for any business purpose, including paying it to the owners or employees as a bonus.

For example, assume that Dr. Smith, age 40, who works for XYZ Orthopedic Clinic, P.C., makes about $600,000 a year, $100,000 of which she does not need to take home as income this year. Further assume the medical practice at any given time has $700,000 of real A/R on the books, and Dr. Smith's patients represent $200,000 of that A/R.

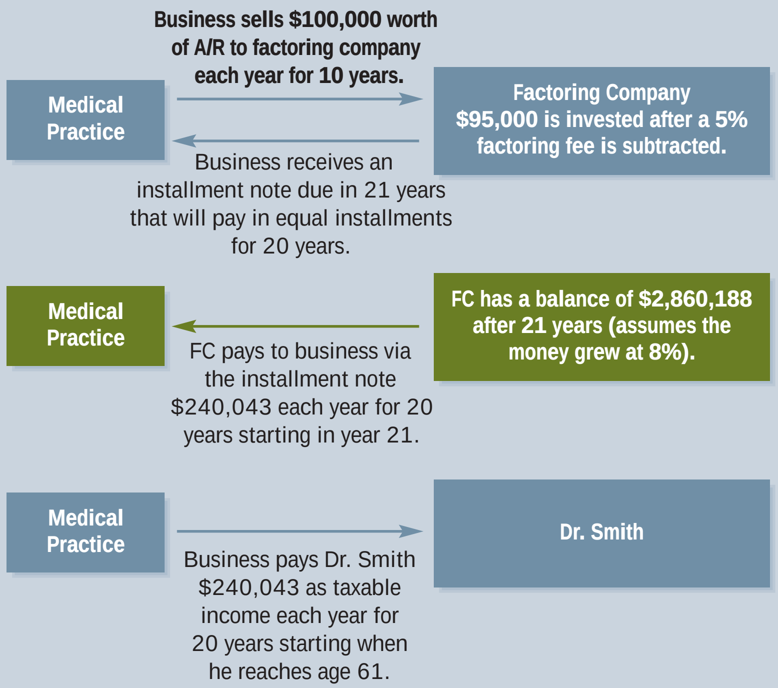
XYZ Orthopedic Clinic contracts with the FC to sell $100,000 of A/R in exchange for an installment note that will be payable starting in 21 years and that will pay in a lump sum when Dr. Smith is 60 years old. The FC takes a 5% factoring fee and invests $95,000 in equity indexed annuities with a minimum guarantee and growth pegged to the S&P 500 .

If that $95,000 grew at 8% for a total of 21 years, there would be $371,380 at the end of the period. That $371,380 would come back to the medical practice via the installment note in a lump sum at the end of the 21st year (when Dr. Smith is age 61).

The medical practice can use the money for any business purpose, and it can choose to disperse it to Dr. Smith as income. So if Dr. Smith received the

The 10-Year Option

In an ABC plan with 10-year continuous contracting, if the money at the factoring company grew at 8%, $2.8 million could be paid in a lump sum to the business at the end of 21 years. Alternatively, the business could choose to take $240,043 a year for 20 years.



$371,380 in a lump-sum bonus from the medical practice, then she would have $222,828 left after paying tax on the money in the 40% tax bracket.

In the above example, if Dr. Smith invested $60,000 post-tax in the stock market for the same 21-year period, she would have $162,019 in a post-tax brokerage account. Consequently, the ABC plan provided a return 38% better than post-tax investing.

If the medical practice so desires, it can choose to sell a similar or a different amount of A/R each year. Using the Dr. Smith example, XYZ Orthopedic could factor $100,000 each year for 10 years. If we assume the money at the FC grew at 8%, then a total of $2,860,188 could be paid in a lump sum to the medical practice at the end of the 21-year period.

Also, if the medical practice prefers not to have an installment note paid in a lump sum, it could direct via the installment note to have that money paid to the medical practice over any period of time up to 30 years. For example, if the contract called for equal payments for 20 years, then the medical practice could receive $240,043 per year for 20 years. Again, the medical practice can use the money for any business purpose it likes, including paying bonuses to its key employees—Dr. Smith, for example, starting when she is age 61. (See "The 10-Year Option" above for a diagram of the 10-year funding example).

In the 10-year continuous contracting example, Dr. Smith could take home $240,043 a year for 20 years as taxable income (leaving $144,629 a year after tax in the 40% bracket). If instead of implementing the ABC plan, Dr. Smith took her $60,000 home after tax ($100,000 x 40% tax) and invested it in the market at 8% (assuming typical income and dividend taxes are levied every year), Dr. Smith could withdraw $99,820 a year from her brokerage account after tax for that same 20-year period. In this case, therefore, the ABC plan returned 45% more income to Dr. Smith from ages 61-80, or an additional $896,180 of post-tax money over the 20-year period.

In this example, the money invested post-tax and the money at the factoring company has an annual money management fee of 1%. In addition, the use of a 1% bonus for 12 years on new money goes into the equity indexed annuity to fund repayment of the note.

The ABC plan isn't the most tax-favorable plan in the advanced planning world, but it is the simplest advanced tax topic out there It's easy to implement, guarantees principal, allows flexibility, and uses no fancy tax strategies.

Ease of implementation. To to able to use an ABC plan, all a business has to do is identify A/R it would like to factor, sell the A/R via an installment note, and at a set time in the future, have the amount factored and the growth on that money returned to the business.

Guarantee of principal. The FC typically uses those products with guaranteed minimum rates of return to ensure that it will have the money to pay the installment when it comes due.

Flexibility. The business chooses to implement the plan annually for whatever amount it sees fit. One year the business could factor $100,000 and the next year $250,000—or nothing at all. Because each year is a new installment note payable by its own terms, there is no requirement to fund every year.

Simple tax strategy. CPAs and attorneys may not be used to reviewing the "creative" income tax reduction plans in the marketplace, but all are familiar with installment notes and factoring. They should be able both to review and approve the ABC plan as a conservative asset protection, income tax reduction, and business continuation plan.

There are also a few negatives to the ABC plan. Specifically, the company lacks investment control and flexibility when repaying the installment note.

The FC has the ultimate authority to invest the money as it sees fit. The business selling the A/R can't control the investment or direct where the money will be invested. As mentioned earlier, the FC typically uses principal-guaranteed products so it will have the money

Continued on page XXX

AS SIMPLE AS ABC

Continued from page XXX

to pay back the installment note (and the FC typically uses indexed annuities pegged to the S&P 500, which should generate rates of return between 6% and 10% long term).

In addition, except for the circumstances discussed below, the timetable for repaying the note will be set when the installment note is issued. So, if the business selling its A/R accepts a note in which payment won't occur for 15 years, and the business subsequently needs to raise money, it will not be able to go to the FC and demand early payment.

The following circumstances allow the seller to receive early payment :

- Death of an identified key executive;
- At the discretion of the seller—anytime after the note has been in place for five years, with 90-day written notice to the FC. With this option, the seller is assessed a 6% penalty on the balance to be paid back; and
- Any changes in the tax law that would make the ABC plan not viable for either the seller or FC.

The main question a CPA will have is why the client doesn't constructively receive the money in the ABC plan when it is collected. The IRS defines constructive receipt as the date when a taxpayer received income (which is interpreted also as the first date the taxpayer has the right to claim it, whether or not that claim was actually exercised).

Without getting into a long discussion about constructive receipt, the simple answer is that the client sold the A/R before it came into the business. Therefore, when the A/R was collected and transferred to the factoring company, it was no longer owned by the client's business and therefore is not income to the business.

If a business selling A/R kept control of the money while at the FC (i.e., controlled the investments) or if the business could call the note early without a substantial penalty (6% or more), then the IRS would have a good argument that the client constructively received the money in the ABC plan. Since the client can't control the money (it went into indexed annuities) and because the installment note can't be called early without incurring a 6% penalty, constructive receipt should not be an issue.

An ABC plan will benefit advisers as well as their clients. The adviser will receive commissions from the annuities purchased by the FC as well as from the 1% administration fee the FC charges the client to administer the plan.

So if you want to help your clients defer income and are tired of 412(i), 419, and Section 79 plans, consider the ABC plan. It can play a starring role in financial plans designed to help clients reach financial security as early as possible. **FP**

Roccy DeFrancesco, the author of The Doctor's Wealth Preservation Guide, *is president of TriArc Advisors, a company that educates advisers on advanced planning techniques. For more information, go to www.triarcadvisors.com or contact him at roccy@triton.net or (269) 469-0537.*

To take the CE Quiz online, go to www.Financial-Planning.com

CORRECTION

Roccy DeFrancesco: I need to make a correction and a clarification on my two-part article that ran in October and November about the maxi-IRA . In the schematic diagram on page 122, I note that there is a $55,000 gift. It should be a $55,000 loan.

Also, due to an oversight, the article did not give editorial credit to attorney Andrew Willms, J.D. LL.M., who has written extensively on investing money held inside a qualified plan or IRA in an FLP to facilitate the purchase of insurance on the account owner's life with pre-tax dollars, while also avoiding estate taxes on the death benefit protection provided by the policy. Some of the observations contained in the articles on the maxi-IRA were based in part on Mr. Willms' articles. We wish to give credit to Mr. Willms, who is the developer of the "Qualified Plan Insurance Partnership (or "QPIP"). "Qualified Plan Insurance Partnership" and "QPIP" are trademarks belonging to Mr. Willms.