BY JOHN J. HIGGINS

Is Your P&L Statement As Protected as Your Balance Sheet?

A company's balance sheet is a reflection of past performance as well as a gauge of a company's success. Having hard assets on a balance sheet (i.e., plant, property, equipment, inventory, capital) in excess of debt and liabilities indicates that a company has been successful. On the other hand, a profit and loss statement (P&L) indicates where a company is going in the future. When establishing business protection strategies, most companies focus on the assets on the balance sheet resulting in the protection of plant, property and equipment from theft, fire or damage. Protecting the assets that a company has accumulated is important; however, consider safeguarding the P&L—a company's future depends on it.

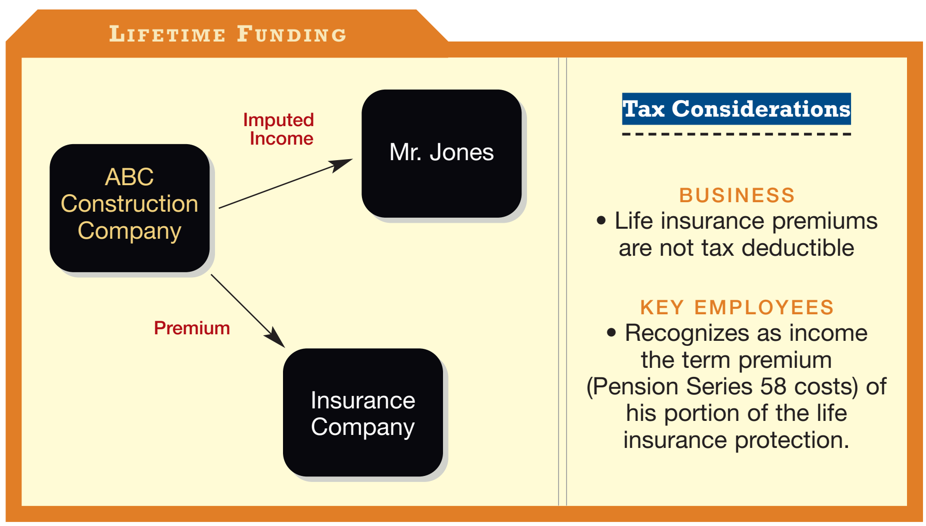
KEY EMPLOYEES IMPACT BUSINESS HEALTH

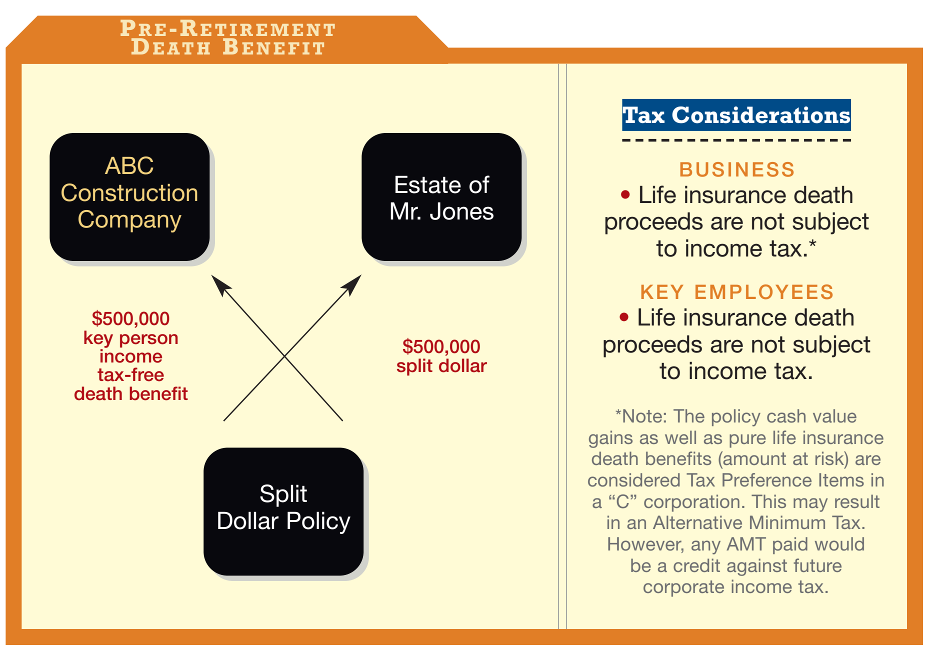
Although assets are important, they depend greatly on the ability of owners and key employees to sustain their value. The skill, experience, integrity and leadership that these select few employees possess provide the foundation for sustained profitability of any construction company.

The death or departure of an owner or key employee may significantly impact the immediate financial health and future viability of a business. Those who may be most concerned include:

- family members of owners, a surviving spouse or children involved in the business;
- employees about job security;
- sureties about the continuation of the business;
- banks and creditors about the ability to repay any outstanding debts; and
- customers about key contact loss.

Most businesses define a key employee as highly paid with specialized skills. The employee has significant impact on gross sales or pre-tax profit and a special relationship with vendors, customers or other construction firms.





THE P&L PROTECTION STRATEGY

A construction company that is concerned about potential economic loss in the event of the premature death of a key employee should consider ways to gain the allegiance of the employee.

Without offering an ownership interest in the company, the company can enhance the employee's fringe benefits package. The company can consider:

- structuring a combination of plans—key person, endorsement split dollar and deferred compensation;
- serving as the applicant owner of a $1 million life insurance policy with a special endorsement that splits the death benefit between the employee's family and the company;
- entering into a separate deferred compensation agreement outlining the terms and conditions. The amount could be based on the performance of the company stock (phantom stock plan).

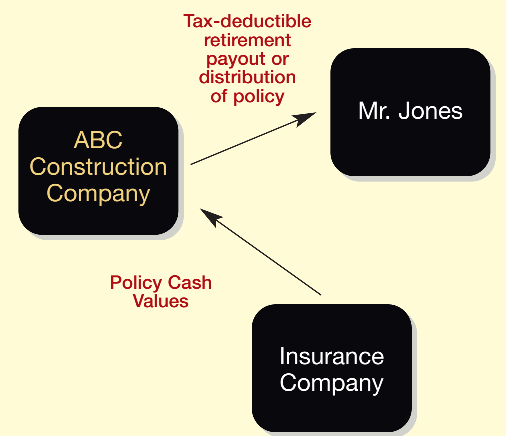
If the company pays the insurance premiums on a High Early Cash Value policy and carries the cash surrender value as an asset of the company, the employee recognizes the term cost for the $500,000 life insurance protection as income. Other tax considerations include:

- premiums paid by the corporation for life insurance are not tax-deductible (IRC 264 (a)); and
- the employee recognizes income (P.S. 58 cost) on the term portion of life insurance protection.

However, if the employee dies before retiring:

- life insurance proceeds received by the corporation are income tax free (IRC 101(a)); and

RETIREMENT BENEFITS



Tax Considerations

BUSINESS

- Income tax is payable on the gain if the policy is surrendered or distributed to the key employee.
- Retirement payout to employee is tax deductible if the amount is reasonable.

KEY EMPLOYEES

- Retirement benefit is taxable income.

- life insurance proceeds received by the beneficiaries are not subject to income tax.

RETIREMENT BENEFITS

If the employee remains with the company for a specified term, the policy cash values can be used to provide supplemental retirement income. In this case, the benefit payments made to the employee or his family are tax deductible in the year received (IRC 404(a)) and the present value of future benefits should accrue as a liability over specified term (Financial Accounting Standards Board 87/Accounting Principles Bulletin 12).

The employee incurs no tax liability on the corporation's payment of insurance premiums as long as the corporation retains all rights to policy (Revenue Ruling 68-99).

In addition, there is no income tax liability on the increase of the corporate-owned life insurance (IRC 7702). Deferred compensation payments made by the company to the employee or his family are taxable as ordinary income in the year received (IRC 61(a)).

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ADDITIONAL ADVANTAGES

If the company does incur IRS reporting or Employee Retirement Income Security Act approvals, only a one-time notification to the Department of Labor is required. The plan is simple to implement, administer and maintain. One-time legal costs for the proper deferred compensation and split dollar agreement are minimal.

The plan will help to attract and retain key employees. The company has total discretion in selecting its key employees.

In establishing this P&L protection strategy, consider the amount of insurance to carry depending on the size, value and profitability of the company. Although there is no set formula to measure a key employee's value, some common yardsticks do exist, including:

- multiple of salary;
- capitalization of excess earning;
- cost to replace key employee's experience; and
- cost to replace lost profits from key employee's sales.

By establishing a P&L protection strategy on owners/key employees, the business shows its employees, banks, sureties, creditors, suppliers and customers that the financial condition of the business is more likely to remain sound following a loss of a key employee.

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