Life Advanced Markets

TARGET MARKETING:

Professional Services Industry

2021: 3Q - 4Q

PROFESSIONAL SERVICES	
Industry	The Professional Services sector is composed of establishments that specialize in performing professional, scientific, and technical activities for others. These activities require a high degree of expertise and training, and include legal advice and representation; and accounting, architectural, and engineering services, among others. At the end of 1Q 2021, the Bureau of Labor Statistics reported over 9.6 million employed in this sector, with over 7.4 million in production or nonsupervisory roles. The BLS also reported a 4.2% industry unemployment rate.
Trends	Valuation is a persistent issue for most professional business owners. The bulk of the value of a professional services business will come from highly speculative or intangible assets, such as proprietary software or systems, contracts, client lists, and goodwill. Repeat business, recurring revenue, and a broad client base help alleviate the concerns of buyers. Pandemic impact has been varied, and largely dependent on the specific profession. Law firms, for example, have reported significant increases in their businesses from 2019. Many of these businesses are formed as professional corporations (or similar, depending on jurisdiction). In most cases an owner must be a licensed professional, which limits potential buyers. An early infrastructure bill proposal would increase the corporate tax rate from 21% to 28%.
Concerns	Nontraditional entrants into the professional services space are acting as disruptors and generating significant competition risk to "legacy" service providers. The 2017 Tax Act provided for a 20% Qualified Business Income (QBI) deduction for small businesses. This deduction is limited, however, especially for professional services firms (except architects and engineers). The QBI deduction is scheduled to expire in 2026. A significant majority (58%) of data breach victims are small businesses. Almost 25% of law firms have reported that they have been the victim of a data breach. Partners in professional businesses are not being replaced by young incoming professionals at a sufficient pace. This is creating a crisis of unfunded obligations where the retirements planned for these partners and other key employees are not sufficiently funded by new partners expanding the business. In most cases, the owners are the key employees who generate the value of the company. How can the value of a business be sustained if those key employees are no longer there?

[1] North American Industry Classification System.

[2] Verizon Data Breach Investigations Report, 2018, https://enterprise.verizon.com/resources/reports/DBIR_2018_Report.pdf.

[3] A Legal Technology Survey Report, 2018, https://www.americanbar.org/groups/law_practice/publications/techreport/ABATECHREPORT2018/2018Cybersecurity/.

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ISSUE	OPPORTUNITY
Professional services companies typically have fewer available deductions than other industries, and are consequently a prime target for marketers of aggressive tax strategies (e.g., discriminatory § 79 Plans, springing cash value policies in qualified plans, etc.)	**IRC § 7702:** Recent revisions to this section of the tax code provide an opportunity to discuss the advantages of using FIUL to accumulate supplemental retirement savings and provide death benefit protection. The tax advantages of this approach are well established, and no additional risk audit is necessary.
Business owners are also the business's key employees.	**Key person life insurance:** Owners often maintain many of the business's key customer relationships. The death of an owner may have a substantial negative financial impact on other partners. Also consider adding agreements to provide for the transfer of life insurance policies on the owners/partners from the business to the insured after the owners/partners retire.
Ownership in a professional services company is often restricted to licensed professionals. Family members may not be permitted to own stock.	**Buy-sell agreements:** Work with the client's legal professionals to review these agreements to ensure that they are properly funded, cover all potential triggering events, possess clear payout terms, are based on an appropriate valuation, and transfer ownership only to properly qualified individuals.
Owners' net worth may be tied largely to the value of their business (which they will likely overestimate, or do not know), and lack sufficient retirement plan funding.	**Buy-sell agreement:** Life insurance funding of the agreement may help the owner achieve two goals[1] – a death benefit to cover obligations under the agreement, and cash values through policy loans and withdrawals to help supplement retirement planning.[2]

Life insurance death benefit is generally income-tax-free when passed on to beneficiaries.

[1] FIUL policies provide a generally income-tax-free death benefit for beneficiaries.

[2] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

Fixed index universal life insurance requires qualification through health and financial underwriting.

ADDITIONAL TALKING POINTS:

- **Professional services firms often generate substantial income with few employees.** For example, law firms, health care practices, engineering firms, etc., may be lucrative financially for the owner, yet employ a small number of lower-paid employees. This dynamic has the effect of capping contributions to qualified retirement plans for higher-paid employees (including the owners) since, by their nature, these businesses are usually top heavy. When working with this type of client, it is important to understand what the alternatives are. It is also important to understand that they are an attractive target for aggressive tax plans as mentioned above.
- **Creditor protection is very important to owners of professional services firms.** First, they often practice in areas that attract litigation (e.g., health care, law, engineering, etc.). Second, they personally provide services to clients. (Contrast that with the owner of a manufacturing business who does not actively take part in manufacturing the product.) This hands-on involvement increases the potential for legal claims against them personally. Assets that have a level of creditor protection (such as life insurance, annuities, etc.) may be appealing for this reason. In addition, estate planning strategies that are designed to protect assets from creditors (including certain trust designs) may also be appealing.
- **This sector, more than any other, has needed to conform to the "gig" worker economy** (e.g., independent contractors, freelancers, etc.). This is especially true in firms that focus on technology. These workers may be providing key services to the firm, yet may not be participating in the company's qualified retirement plan. However, independent contractors may participate in nonqualified deferred compensation plans, split-dollar plans, key employee bonus plans, etc.
- **Nonowner key employees with professional service firms may desire and request an ownership interest.** This is especially true with firms that limit ownership to those with certain professional licenses. The key employee may have such a license, consider themselves an integral part of the company's growth, and want to be compensated based on that growth. The owners may consider granting an ownership interest as part of their overall compensation plan to retain the key employee. Alternatives to equity plans may provide similar financial rewards and retention incentives without the potential legal issues that are associated with outright ownership. These alternatives include phantom stock plans and stock alternative plans which, like nonqualified deferred compensation plans, may be informally funded with employer-owned life insurance on the life of the key employee.
- **Recent trend:** In June of 2021, a number of major law firms (starting with Milbank) increased their pay for new associates. This has set off a bit of a wage war between law firms.

RESOURCES: Click these links to learn more.

Each of the following publications provides industry-specific information, specifically on topics related to practice management in their respective fields:

- ABA Journal, American Bar Association
- Accounting Today
- Architectural Record
- Civil & Structural Engineer

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