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SPECIAL REPORT

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TOP 10 USES OF LIFE INSURANCE IN A FAMILY BUSINESS SUCCESSION PLAN

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A key part of estate planning for business owners who want to keep their business in the family is deciding when and to whom to transfer the business. The particular tools and techniques used in a business succession plan will vary based on the goals and objectives of the four groups affected by the plan: the senior generation business owner, the junior generation family members involved in the business, key non-family employees, and family members not involved in the business. It is important to examine how life insurance plays an essential role in the typical family business succession plan.

1. ESTATE LIQUIDITY

Under the American Taxpayer Relief Act of 2012, the federal estate and gift tax exemption is $5 million per person with a top tax rate of 40%. The exemption is adjusted annually for inflation. For 2015, the exemption is $5.43 million ($10.86 million for a married couple). In addition, since 1981, there have been no estate or gift taxes on transfers between spouses.

Some business owners will wait until death to transfer all or most of their business interests to one or more of their children. If the business owner has a taxable estate, life insurance can provide the recipients of the business with the cash necessary to pay estate taxes. Using life insurance to pay estate taxes is particularly useful for business owners because their ownership interests cannot be readily liquidated. The children receiving the business may also need life insurance to pay estate taxes. Usually, the insurance policy will be owned by an irrevocable life insurance trust so that the beneficiaries will receive the death proceeds both income and estate tax free.

2. BUY-SELL AGREEMENTS

A properly designed buy-sell agreement guarantees a market and fair price for a deceased, disabled or withdrawing owner's business interest. It also ensures control over the business by the surviving or remaining owners and can set the value of the business interest for estate tax purposes. Life insurance is an excellent way to provide the cash necessary for the business or the surviving owners to purchase a deceased owner's interest. In many instances, the cash surrender value in a life insurance policy can also be used (tax free) to help pay for a lifetime purchase of a business owner's interest.

3. ESTATE EQUALIZATION

A business owner can use life insurance to provide the children who are not involved with the business with "equitable" treatment. Leaving the business to the active children and life insurance to the inactive children equalizes the inheritances among them. In addition, it avoids the need for the active children to purchase the interests of the inactive children, perhaps at a time when the business may be unable to afford it. Depending on the particular facts and circumstances, the insurance may be owned by an irrevocable trust for the benefit of the inactive children, and the insured may be the business owner or the business owner and his/her spouse.

4. NONQUALIFIED DEFERRED

A nonqualified deferred compensation (NQDC) plan can be used by a small business to provide members of the senior generation with death, disability, and retirement benefits. An NQDC plan may be particularly useful in situations where the senior members have transitioned the business to the junior members and are no longer receiving compensation. An NQDC plan also ensures that key employees remain with the business during the transition period — a so-called "golden handcuff." Because life insurance offers tax-deferred cash value growth and tax-free death benefits, it is a popular vehicle for “informally” funding NQDC plan liabilities.

5. KEY-PERSON INSURANCE

Many family businesses depend on non-family employees for the company's continued success. To guard against financial loss due to the absence of a key employee, and to ensure that the business stays in the family, many companies take out "key-person" life insurance, disability insurance, or both.

6. SECTION 303 REDEMPTIONS

Internal Revenue Code Section 303 enables the estate of a business owner to remove cash from a corporation with no tax cost. To be eligible for a Section 303 redemption, the stock's value must exceed 35% of the shareholder's estate. Also, the maximum amount that can be redeemed is limited to the amount of the federal estate tax, state death taxes, funeral, and administrative expenses. The corporation can purchase a life insurance policy on the shareholder's life to ensure that the corporation has sufficient funds with which to accomplish the Section 303 redemption.

7. GRATS

With a Grantor Retained Annuity Trust (GRAT), the grantor transfers a business interest to the child or children active in the business (the “remaindermen”), while retaining the right to receive a fixed annuity from the trust for a stated term of years. The longer the stated term and the larger the annuity, the smaller the taxable gift. At the end of the stated term, the balance of the trust property passes (gift tax free) to the remaindermen. The risk with a GRAT is that if the grantor dies during the stated term, all of the assets in the GRAT are included in the grantor's estate for federal estate tax purposes. But, in such case, by funding an irrevocable life insurance trust for the benefit of the GRAT's remaindermen, the grantor can leave the business interest to the GRAT's remaindermen who can then use the life insurance proceeds to pay the federal estate taxes due. Alternatively, a married grantor might qualify the assets in the GRAT for the marital deduction and have an ILIT (for the benefit of the GRAT's remaindermen) use the life insurance proceeds to purchase the assets from the grantor's estate.

8. ASSET PROTECTION PLANNING

Businesses assuming the risk of potential environmental contamination (e.g., waste hauling, landfills, chemicals, etc.) are subject to liability under federal and state pollution laws. Moreover, such liability is not limited to the business itself, as the business owners also may be personally liable under such laws. As the business passes to the next generation, so does the potential liability. Life insurance is ideal in this situation. The business owner can establish an irrevocable life insurance trust to run for the maximum period permitted by state law. The trust would provide the business owner’s descendants with income and principal as needed for health, education, maintenance and support. If properly structured, the assets in the trust cannot be reached by the beneficiaries’ creditors, including state and federal environmental agencies.

9. PRIVATE ANNUITIES AND SCINS

With a private annuity, the business owner (the annuitant) sells the business interest to the child or children active in the business (the purchaser) for an unsecured promise to make periodic payments to the business owner for the rest of his/her life (a single life annuity) or for the life of the business owner and his/her spouse (a joint and survivor annuity). Because the private annuity is a sale and not a gift, it allows the business owner to remove the business interest from his/her estate without incurring gift or estate tax. The child or children purchasing the business interest can fund an irrevocable life insurance trust for his/her/their family's benefit in order to have the cash to continue to pay the annuity should he/she/they predecease the business owner. Conversely, the business owner can fund an irrevocable life insurance trust for his/her family's benefit as a hedge against the business owner's premature death. In either case, the amount of life insurance needed would be based on the present value of the future annuity payments.

When a business owner decides to sell the business to a child in installments, the promissory note may be a self-canceling installment note (SCIN). With a SCIN, upon the seller's death, all remaining payments under the note are canceled, similar to a private annuity. The purchaser must pay a "premium" for this cancellation feature, either by a higher interest rate or a higher purchase price. Like a private annuity, a SCIN avoids estate and gift taxes. Unlike a private annuity, a SCIN allows the seller a security interest in the transferred business. When using a SCIN, just as with a private annuity, the business owner can fund an irrevocable life insurance trust for his/her family's benefit as protection against the business owner's premature death. Conversely, the purchaser can fund an irrevocable life insurance trust for the benefit of his/her family so that they will have the cash to continue to pay the SCIN should the purchaser predecease the seller.

10. FAMILY BANK

When the decision is made to leave the business to both active and inactive children, it is usually advisable to leave only the active children with voting interests in the business. In addition, "put" and "call" agreements should be entered into. Usually, a put option requires the business to purchase all or a portion of the inactive children's interest in the business upon a set price and terms. Without a put option, there may be no practical way for an inactive child to benefit from owning the business interest unless the business is sold. On the other hand, a call option allows the active children (or the business itself) to purchase the business interests of the inactive children upon a set price and terms. Without a call option, there may be no effective way for the active children to avoid conflicts that can occur between the active children who are receiving salaries and bonuses, and the inactive children who are not. By having the active children own life insurance on a senior family member's life, a "bank" is created to provide the funds to satisfy any such puts and calls. Usually, the policy will be owned outside of the business entity, such as in a trust for the benefit of the active children, or by a limited liability company owned by the active children.

Succession planning seeks to help a business owner confronting many issues. There is no "one size fits all" approach to keeping the family business in the family. The tools and techniques best suited to a particular business are fact-specific. Life insurance plays an important role in helping a business survive and thrive as it moves from one generation to the next.

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