Using life insurance in business succession planning

By: Randall A. Denha, Esq.***

Life insurance can play an important role in a business succession plan. Following are some of the common ways in which life insurance can be integrated with many of the tools, techniques and strategies commonly used in business succession planning.

Estate liquidity: 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 children receiving the business the cash necessary for them to pay estate taxes. Using life insurance (owned by an irrevocable trust) to pay estate taxes is particularly useful to business owners because business interests cannot be readily liquidated. Life insurance is also a much easier (and less expensive) alternative to deferring estate taxes under IRC Section 6166. The children receiving the business may also need life insurance to pay estate taxes at their deaths. Typically, 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.

Estate equalization: A business owner can use life insurance to provide those children who are not involved in the business with equitable treatment. Leaving the business to the active children and life insurance (owned by an irrevocable trust) to the inactive children equalizes the inheritances among all of the children. It also 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(s) may be the business owner or the business owner and his spouse.

Buy-sell agreements: A properly designed buy-sell agreement can guarantee a market and fair price for a deceased, disabled or withdrawing owner's business interest, ensure control over the business by the surviving or remaining owners, and set the value of the business interest aside for estate tax purposes. Life insurance is the best 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 (by surrendering to basis and borrowing the excess) to help pay for a lifetime purchase of a business owner's interest.

- **Non-qualified** deferred **compensation pans (NQDC):** A nonqualified deferred compensation plan can be used by a small business to provide members of the senior generation with death, disability and/or retirement benefits. An NQDC plan may be particularly useful in those situations where the senior members have transitioned the business to the junior members and are no longer receiving any compensation from the business. An NQDC plan is also useful to ensure 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 the most popular vehicle for "informally" funding NQDC plan liabilities.

- **Key man insurance:** Many family businesses depend on nonfamily employees for the company's continued success. To guard against financial loss due to the absence of an indispensable key employee, many companies take out key person life insurance.

- **Section 303 redemptions:** IRC Section 303 allows an estate a one-time opportunity to remove cash from a corporation (equal to the amount of estate taxes and administrative expenses), at little or no tax cost, through a partial redemption of stock. To ensure that the corporation has sufficient funds with which to accomplish the Section 303 redemption, the corporation can purchase a life insurance policy on the shareholder's life.

- **Hedge strategy:** Life insurance can also be used to provide a "hedge" against the business owner's premature death in connection with a grantor retained annuity trust. For example, if the business owner established a GRAT and died before the end of the set term, the life insurance could be used to pay the estate taxes on the GRAT assets that would be included in the business owner's estate. In addition, if a sale with a private annuity is used, life insurance could provide funds for the business owner's spouse (and/or other family members), since the annuity payments would terminate on the business owner's death. Similarly, life insurance could provide funds for the business owner's spouse and other family members should the business owner die prematurely after using a self-canceling installment note to sell the business interest. In all of these situations, it is advisable to have the life insurance owned by an irrevocable trust so that the insurance proceeds will escape estate taxes.

- **Family bank:** When the decision is made to leave the business to both active and inactive children, it is usually advisable to leave the active children with voting interests and the inactive children with nonvoting interests in the business. In addition, put and call options can be given. Generally, a put option given to the inactive children allows them to require the active children (or the business itself) to purchase all or a portion of their interest in the business at 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 and until the business is sold. Conversely, a call option given to the active children (or the business itself) allows them 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 the potential 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 the business owner's life, a "bank" is created to provide the funds to satisfy any such puts and calls. Typically, 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.

RANDALL A. DENHA, J.D,, LL.M., attended Wayne State University and graduated with a degree in Corporate Finance. After college, Mr. Denha then went to University of Detroit School of Law where he obtained his law degree. Feeling that he still needed more education he then attended the University of Miami School of Law and completed a masters in law (LL.M.) in estate planning. The University of Miami is regarded as the premier school in the country for its program in estate planning. Randy has hosted a radio program and has written many articles in the estate planning arena on the importance of planning. Additionally, he is a former faculty member at Oakland University's Personal Financial Planning Program where he taught estate planning for those wishing to obtain a Certified Financial Planning (CFP) degree. Mr. Denha also serves as General Counsel for both local and national organizations and is a member of the Bank of Michigan's Board of Directors, a member of the Board of Directors of Invescor, Ltd. (a national life settlement insurance provider) and volunteers his time to several community organizations.

In addition to the estate and succession planning areas of law that Randy practices on a daily basis, he also specializes in an area commonly referred to as Asset Protection Planning (APP). As an APP attorney Randy is frequently encountering those clients that are fearful of creditor claims that lack merit and for no other reason are brought into litigation because the client has "deep pockets". Typical clients in this area are physicians, business owners, builders and real estate developers. APP is concerned with establishing entities and rearranging assets that in the event of a lawsuit, a creditor would have a difficult time attaching to the true asset because of the way such assets arranged. Corporations, partnerships, LLCs, domestic trust and Offshore trusts are commonly used in this area.