Although circumstances may vary, the focus should be on the primacy of creative business continuation planning, not on life insurance products.

The Role of Insurance in Buy-Sell Planning for Businesses: Part 2

By Peter Katt

This column is the second part of a two-part series dealing with planning for the continuation of a closely-held business, commonly referred to as buy-sell planning.

As I noted in my April column, business continuation planning refers to the disposition of a closely-held business interest in the event of retirement, permanent disability, or death of business owners. Business owners should have a strategic legally binding plan for the continuation or liquidation of their business in the event of an unexpected permanent disability or death of a partner. Otherwise, its value could be greatly dissipated and the potential for conflict with the permanently disabled or deceased partner's family greatly increases. In contrast, planning for retirement should not be part of a legally binding document because it is planned for and voluntary, and negotiations with other partners about retirement should take place at the time it is being considered.

I also noted that crisp new businesses with relatively young shareholders owning an equal number of shares can plan for disposition with few complications, but this is not the typical situation. Rather, most business continuation situations have complications. This follow-up business continuation column presents three case studies as a way of identifying specific, yet fairly common, situations and possible planning solutions. For purposes of space and greater clarity, business continuation planning for permanently disabled shareholders has been ignored.

Smith Electronics Inc. (SEI)

Al, Bill, and Bob Smith, ranging in age from 37 to 41, are the sons of SEI's founder, who died seven years ago. SEI is a wholesaler of office electronic products. SEI has experienced tremendous growth and is very profitable. SEI is an S-corporation, and Al, Bob, and Bill each own a third of the stock. They are all married with dependent children. They presently have a buy-sell agreement funded with life insurance, but the amount of coverage is about a quarter of what is needed to cover the current value of SEI.

In consultation with their attorney and accountant, they are considering increasing their life insurance coverage to fund the total buy-sell obligation, meaning the purchase of many millions of additional insurance (which they can afford). But before rushing off to buy the additional life insurance to fully fund their buy-sell agreement that would purchase all of a deceased shareholder's family's stock, they took the time to consider whether a complete buy-out of a deceased's family's stock is the smart move. SEI stock is presently throwing off more cash profits, via S-corporation stock ownership, than any prudent reinvestment of buy-sell cash would generate. Therefore, consideration is given to a plan that requires the purchase of a portion of a deceased shareholder's stock, say 25%, but leaves a deceased shareholder's family in possession of their remaining SEI holdings as passive investors. Such a plan requires the brothers to explicitly agree on a specific amount of salary for their work (updated each year with an escalator clause) so that only profits in excess of these salaries would be paid out via S-corporation stock ownership. This creates a passive investor role for a deceased brother's family, who would receive their share of profits after generous salaries were paid to the surviving brothers who are running SEI.

This planning offers two other potential advantages to a deceased shareholder's family. First, in the event SEI is sold some years later for a large amount, the deceased brother's family would participate in such sale profits. Second, continued stock ownership will allow easier entry into the business in the event one or more of the deceased brother's children is interested in such a career.

While this kind of planning might not be ideal for the two surviving brothers because there is the potential that a deceased brother's family could cause problems, at the time the planning is consummated, each brother has an equal interest in both positions: potentially as

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the first-to-die, in which case he has probably struck a much better deal for his family; and as a survivor, in which case he might prefer a complete buy-out of the first-to-die's family.

Under the theory that what is good for the goose is good for the gander, Al, Bob, and Bill agree to this partial buy-out/passive-investor planning in the event any of them has the bad judgment to die before selling SEI or retiring. As such, no additional life insurance is needed. Instead, work is completed to put salary agreements into place, and corporate policies are tightened to provide better protection for the surviving shareholders from unnecessary intrusions by a deceased brother's family. This kind of planning is only appropriate when the amount of company profits, relative to the business' valuation, are enormous so that very generous salaries can be paid before profits are distributed, via S-stock. For example, if the valuation of SEI is $42 million with profits of $9 million—a 21% return—a deceased brother's family would sell 25% of their SEI stock for $3.5 million, retaining $10.5 million of stock as a passive investor. A salary agreement provides each surviving brother with an annual salary of $750,000 for running SEI, with remaining profits of $7.5 million ($9 million less salaries of $1.5 million) distributed—$2.81 million to each surviving brother, who each own 37.5% of SEI, and $1.88 million to the deceased brother's family, now owning 25% of SEI. The yield on the deceased brother's family's continued ownership in SEI is 17.9% ($1.88 million divided by their ownership value of $10.5 million), which is why this partial buy-out/passive investor planning is preferred. Combining the surviving brothers' salaries and profits, $3.56 million, they each have a 22.6% rate-of-return on their ownership interest. (Updating the Smith brothers' estate and life insurance planning would be done in conjunction with this revised business continuation planning.)

Sam and Pranab: The Late Years

Sam and Pranab are co-owners of the stock in Engineering Consulting Associates (ECA). Twenty-five years ago, they instituted a buy-sell agreement funded with life insurance. Sam now owns three universal life policies totaling $2.0 million on Pranab's life, and vice versa. Recently, their buy-sell perspectives have taken an interesting turn because Sam's son, John, and Pranab's daughter, Rekha, both engineers, are employed by the firm. Sam and Pranab agree that they would like these children to acquire their stock at their respective deaths. Buy-sell planning for the transference of stock within a shareholder's family should be incorporated within each individual shareholder's overall estate planning.

John is Sam's only child, so coordinating Sam's buy-sell and estate planning does not have to take into account possible inheritance equalization among several children. Therefore, Sam will simply leave his stock to John via his will or revocable trust. What must be planned for is making sure there are enough invested assets to provide sufficient income for Sam's wife if he predeceases her, taking into account the estate tax obligations. Besides the $2.0 million worth of ECA stock, Sam has acquired $1.5 million in marketable securities and $1.0 million in two homes, for a total estate of $4.5 million. It is recommended that the life insurance policies insuring Sam's life that are owned by Pranab be transferred to Sam, then transferred to an irrevocable trust established by Sam. Therefore, including the life insurance, Sam's assets now total $6.5 million, of which $4.5 will be included in his estate. The three policies have combined cash values of $396,017, which is the amount of gift being transferred to the irrevocable trust. There is a three-year period before the proceeds are out of Sam's estate. The projected target premiums to continue the $2.0 million of coverage are $15,983. Sam decides to continue the full amount of this life insurance by making annual gifts to the trust to pay the premiums.

In addition to leaving all of the stock to John upon Sam's death, Sam will also gift stock to John using annual exclusion gifts in order to ensure that the value of the stock that will be transferred at Sam's death doesn't become too large. The results of this planning are that upon Sam's death, John will inherit all of his father's stock even if Sam's wife survives him. Such a transfer will trigger an estate tax of some $600,000 (based on a value of $2.0 million), which could be avoided by having Sam's stock remain in a trust for his wife's benefit, but this could potentially cause people-planning problems for John because he would have to deal with his mother or trustees for some period of time regarding business ownership issues. Regardless of who dies first, the stock will go to John at Sam's death and there should be sufficient assets to pay estate taxes and provide for Sam's wife without encumbering the stock.

Planning for Pranab's transfer of his ECA stock, valued at $2.0 million, to his daughter Rekha is more complicated because the value of the stock is his largest asset and Pranab has two children who don't work in the business and therefore should not inherit company stock. Leaving such a large amount to Rekha causes inheritance equalization problems because Pranab's other assets total $2.0 million ($1.5 million in marketable securities and real estate worth $500,000). Pranab's inheritance equalization problem will be helped by the reciprocal transfer of the $2.0 million of life insurance insuring his life currently owned by Sam. Pranab will also transfer this life insurance, also with a cash value of $396,017, to an irrevocable trust, increasing the amount of assets to be ultimately distributed to his children to $6.0 million, of which only $4.0 million is included in his estate. ECA stock worth $2.0 million will be left to Rekha, combined taxes by the second death might be some $1.2 million, leaving $2.8 million to be split by Rekha's two siblings, or $1.4 million each. This is $600,000 less than Rekha's inheritance. Pranab wants to treat each of his children equally, so he acquires a survivorship life insurance policy, owned by a separate irrevocable trust that insures he and his wife for $1.2 million so the inheritances can be equal. The $2.0 million policies on Pranab's life and the $1.2 million survivorship policy will have annual target premiums of $25,500, which will be gifted to the trusts. The results of this planning are that Pranab's wife will be provided for from marketable securities within the estate and the $2.0 million life insurance in the irrevocable trust if she survives Pranab; estate taxes and equal inheritances for Rekha's siblings will be covered from estate assets, the $2.0 million insurance on Pranab's life, and the survivorship policy for $1.2 million; and Rekha will inherit all of Pranab's stock upon his death, even if her mother survives.

Sam and Pranab hope to continue working until a final illness overcomes them. Or, if they live some years after being unable to work, dividends would be paid to them to provide the income they need. At the same time, each will be gifting assets to children to keep their estate values relatively constant. As is the case with all planning, periodic reviews are needed to make adjustments as they may become necessary.

Jonesville Orthopedic Clinic

Jonesville Orthopedic Clinic (JOC) is a corporation; the four senior orthopedic surgeons are its shareholders. For some 10 years, life insurance issues have been a constant source of irritation among JOC shareholders. The cause of this irritation is confusion over the purpose of the many life insurance policies insuring the shareholders and owned by JOC. JOC's shareholders' confusion is well-warranted because each shareholder is insured with three separate policies. One set of life insurance policies was purchased to informally fund a deferred-compensation plan. Another set was purchased as key-man insurance, so JOC had the funds to retain another orthopedic surgeon if one of the shareholders died. The final set of policies was purchased to redeem a deceased shareholder's stock, but the shareholders were never able to agree upon a price for the repurchase of their stock. Annual JOC business meetings become chaotic when the office manager opens up the life insurance file for discussion and it's now time to clean up this mess.

The planning that justified purchasing life insurance policies to informally fund a deferred-compensation plan 10 years ago was seriously flawed. The promise made when the plan was set up 10 years ago—to provide a $75,000 annual benefit to be paid for 15 years starting when JOC shareholders reach age 62—is not going to be met because the life insurance policies' cash values are much less than had been projected. In fact, the current projection is that only about half of the $75,000 of annual deferred benefits will be possible without huge increases in premiums. This is because the benefits were defined 10 years ago with the payment of fixed premiums. As interest rates have fallen since 1987 (from 9.6% to 6.5%), the policies have become increasingly underfunded without anyone noticing. What JOC did not understand is that this program never could have worked without periodic adjustments to the funding levels in order to meet the defined benefits established by the plan. Since JOC doesn't have the funds to make up this funding shortfall, dramatic adjustments must now be made to the plan.

Deferred-compensation plans are used to motivate and reward employees, not employers. Each participant in the JOC deferred-compensation plan is a shareholder, or employer. In 1987 and pretty much to this day, there is a narrow spread between corporate and individual tax rates, so there was no rational justification for putting together a collective retirement income scheme funded with life insurance for employers. Each shareholder could have taken the amount of aftertax corporate earnings as income, paid their own taxes, and used the net to set up their own retirement fund. Purchasing a collective plan has been a constant problem, as three times in the past 10 years new life insurance salesmen have come forward to criticize the policies' funding deferred-compensation plans in order to recommend their replacement with new ones. Fortunately, nothing had been done because the four shareholders could never agree on new action.

JOC's shareholders decide to rid themselves of this deferred-compensation problem by transferring the life insurance policies that informally fund the plan to each insured. This will cause each of them to include the value of the policy in their income, but now the individual shareholders can continue their policy or reinvest as they choose, without convincing the other three shareholders.

JOC has $100,000 universal life policies insuring each shareholder to indemnify JOC for the cost of replacing a deceased surgeon. However, while a key-man life insurance need may have existed 10 years ago, JOC now employs four non-shareholder surgeons who are quite profitable to JOC. The need for key-man insurance no longer exists and therefore the life insurance policies used for key-man insurance are surrendered. The cash values are divided among the shareholders in the form of additional salary in order to help pay the taxes generated due to the transfer of the policies funding the now-defunct deferred-compensation plan.

The last set of policies, being used to fund the buy-sell agreement, are non-competitive universal life policies from a life insurance company that has increased the cost of insurance rates and are crediting the policies with below-market interest. Each shareholder is insured for $250,000, but the value of JOC stock has never been agreed upon. Shareholders have argued for an individual shareholder value of between $200,000 to $800,000 at various times over the years. A conclusion is reached that valuing such a medical practice in an era of HMOs and many different insurance payment arrangements is impossible. So rather than try to install a formula into the buy-sell agreement that can objectively calculate a value, the shareholders subjectively agree upon a $250,000 value and purchase cheap level term policies to fund this agreed-upon amount. This will end the potential for a pitched legal battle between JOC and a deceased shareholder's family, as each tries to argue a value for the stock to be redeemed. What had been a confusing life insurance mess is now cleaned up.

The Primary Focus

While circumstances may vary, one principle remains the same: The major focus should be on the primacy of creative business continuation planning rather than the rather one-dimensional aspect of the life insurance product for its own sake.