A look at the basics of business buy-sell planning, as well as some of the nuances needed to plan for situations that don't fit the "prototypical" scenario.

The Role of Insurance in Continuation Planning of Closely-Held Businesses

By Peter Katt

The continuation of closely-held businesses must be planned for because there is no ready market for the transference of ownership and many owners do not have non-owner executives and managers. A central part of business continuation planning involves the appropriate purchase of life insurance and disability buy-out insurance. This column and my upcoming August column will address many of the important issues and subtleties that might be considered when establishing business continuation planning, commonly referred to as business buy-sell planning. (My November 1990 AAII column also dealt with business continuation and life insurance issues, some of which are repeated here.)

Prototypes vs. the Real World

The prototype business continuation situation involves unrelated business partners of about the same age having nearly equivalent ownership interest. Much of the business continuation training material used by attorneys, accountants, and life insurance agents are based on this prototype business ownership scenario. However, it has been my experience that few actual cases fit this scenario. Instead, actual cases present complicating factors, such as unrelated business partners ending up with their children in the business, or businesses with only one owner that need creative planning.

The first section of this column describes the basics of business continuation planning. For simplicity, it will assume a typical business continuation situation with unrelated owners that have equal interest in the business.

After identifying and explaining the basics, attention will be directed to examining the planning nuances needed to successfully plan for some of the atypical cases encountered via case studies.

The Basics

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.

Planning for retirement should not be part of a legally binding document because it is planned for, voluntary and not unexpected, and therefore negotiations with other partners should take place at the time retirement is being considered.

Sam and Pranab: The Early Years

Sam and Pranab are equal owners of an engineering consulting firm, which is a regular corporation. They employ five others, including two other engineers. They need to negotiate a buy-sell agreement. They will need to work with an attorney, insurance specialist and perhaps their accountant (to assist them in determining the value of their company). The buy-sell agreement is important because it establishes the ground rules of the business transfer and establishes a price for this transfer.

Further, a properly drafted buy-sell agreement will bind their families to the provisions they formalize in the agreement, making it much less likely that trouble will arise after a permanent disability or death.

Sam and Pranab decide their business is worth $1 million, about half of which is goodwill. They understand that the adjusted book value (assets plus cumulative depreciation minus liabilities) is not a good reflection of how valuable the business is to them, and they are therefore encouraged to revise the value each year on an exhibit to their buy-sell agreement rather than to rely on a formula provided in the agreement.

Once the value has been determined, Sam and Pranab need to decide whether the agreement should be an entity or

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cross purchase. The entity purchase is an agreement each shareholder has with the corporation to redeem his stock in the event of permanent disability or death. The cross purchase is an agreement between the shareholders themselves. The major difference between the entity and cross purchase is the impact each type has on the surviving shareholder. An example will illustrate this difference.

Sam and Pranab have valued their business at $1 million, or $500,000 each. They each own 50% of the stock and each has a $50,000 cost basis in their stock. They conclude an entity purchase agreement funded with life insurance their corporation owns. Sam dies and his stock is redeemed by the corporation for $500,000. This transaction leaves Pranab owning all of the outstanding stock, but his cost basis remains at $50,000. If Pranab subsequently sells the company for $2 million, he will have a capital gain of $1.95 million with capital gain taxes of some $546,000. However, a cross purchase arrangement would have Pranab owning the life insurance on Sam's life and purchasing his stock directly, thereby increasing Pranab's cost basis by $500,000 and decreasing his capital gain taxes by $140,000 at the time of Pranab's sale of the company.

Whether an entity or cross purchase is the better agreement is largely dependent on how likely it is that the business will be saleable to outside owners. If it is very likely that the business can be sold as an ongoing business, then a cross purchase is probably a better arrangement for Sam and Pranab to potentially increase the surviving shareholder's cost basis. However, if it is quite unlikely that their business will be sold as an ongoing business, an entity purchase might be the better choice. When in doubt, use the cross purchase approach if the two shareholders are about the same age and health.

Whether an entity or cross purchase is selected, life insurance should be purchased to fund the purchase obligation in the event of the death. For an entity purchase, the life insurance is owned by and payable to the corporation. For a cross purchase, a policy insuring Sam's life is owned by and payable to Pranab and a policy insuring Pranab's life is owned by and payable to Sam. Low-load universal life with a specified death benefit plus the cash value is ideal for either an entity or cross purchase because of its flexibility, since its premium can be treated as term insurance in years the company has cash flow problems, and in normal years, higher premium funding will cause the death benefits to increase, which might coincide with the company's value increasing. Tracking the company's value is important to keep the life insurance funding in line with increasing values. If significant increases in business value were to occur, additional life insurance might have to be purchased to keep up. Typically, any business value in excess of life insurance proceeds will be paid, usually over five to 10 years, to the deceased shareholder's family at an agreed upon interest rate. Therefore, keeping the life insurance funding up to date is important so the surviving shareholder's out-of-pocket obligations are manageable.

Disability Buy-Out Insurance

If the buy-sell agreement provides that a permanently disabled shareholder's stock is to be purchased, disability buy-out (DBO) insurance should be purchased to fund this obligation. As is the case with life insurance, the DBO policies can be owned by the corporation under an entity purchase plan, or owned by the shareholders—in this case Sam and Pranab—under a cross purchase plan. A DBO policy will offer different waiting periods (usually one or two years) and different payout alternatives (usually lump-sum to five years). As is the case with life insurance, a DBO policy owned by and payable, for example, to Sam will increase his cost basis when Sam uses the DBO proceeds to buy Pranab's stock following Pranab's disability. A common mistake occurs when business owners confuse disability income insurance with DBO. Disability income insures the disabled shareholder's loss of income, while DBO simply provides the funding to redeem stock. Finally, before including permanent disability as a buy-out trigger funded with DBO, thought has to be given to whether the shareholders really want this to occur. It is possible that, because of the business structure (S corporation, for example) and level of profits, shareholders would want to continue owning stock during a permanent disability and receive a share of the profits.

Handling Complexities

Crisp new businesses with relatively younger shareholders owning an equal number of shares are the prototype business continuation situation that can be planned for with few complications, but this is not the typical situation. The majority of business continuation cases have complicating factors that must be planned for. While these complexities can come from very numerous causes, there are several common situations encountered that will be the subject of the remaining case studies.

The case of Dave, the sole owner of a construction company, will be presented in this column. The cases of the Smith brothers, Al, Bill, and Bob, owners of an electronic office equipment wholesale company; Sam and Pranab 20 years later; and the Jonesville Orthopedic Clinic will be presented in my August column.

Dave's Construction Company

Dave is 40 and has been in the construction business for 10 years. He owns 100% of DCC stock that has an adjusted book value of $3.0 million. Dave has reinvested most profits and has accumulated few investment assets outside DCC. None of his three children are old enough for him to know if they will eventually come into the business with him. DCC has one key employee, Hal, who is 35. Dave is concerned about what would happen to his family and DCC if he had the bad judgment to die. A local insurance agent is trying to convince him to give Hal 1% of the stock and set up an entity buy-sell agreement with DCC to purchase his stock upon his death, leaving Hal with all of the outstanding stock. DCC would own a $3.0 million life insurance policy on Dave's life to fund this obligation. Dave wants a second opinion on this recommendation.

The net result of the recommended buy-sell plan is to give a $3.0 million business to Hal, via DCC's (really, Dave's) purchase of life insurance, and to have Dave's family exchange $3.0 million in DCC stock for cash without otherwise adding any value to the estate. This is a great deal for Hal, but a horrible deal for Dave's family. Instead, Dave should consider purchasing a $3.0 million life insurance policy to be owned by and payable to an irrevocable trust with his wife and children as the beneficiaries of this trust. Then he should privately instruct only his attorney, accountant, and wife, in writing, to work closely with Hal (since he knows the market and other construction firms) in the event of Dave's untimely death to begin immediate negotiations for the sale or liquidation of DCC with Hal receiving substantial compensation (say, the equivalent of 15% of the selling or liquidation price) for this service. In so doing, Hal may be able to secure key employment with DCC's successor owner, including the possibility of a minority ownership interest. What this does for Dave's family is to secure the value of DCC in the form of life insurance in the irrevocable trust, plus the additional value that will probably come from the immediate sale or liquidation of DCC, which might be close to the $3.0 million adjusted book value. By instructing his advisers and wife to move quickly to sell or liquidate DCC, with Hal's full assistance, Dave has substantially increased the prospects of getting the maximum value for DCC with the greatest likelihood that DCC employees will still have their jobs. For the same insurance costs, Dave has potentially increased his estate by some $3.0 million for his family's benefit rather than basically giving his company to Hal.

Dave might consider whole life, universal life, or variable universal life for the purchase of the life insurance policy in the irrevocable trust. If cash flow is a problem, he could fund the universal life policy as term insurance, but pure term insurance is probably not as good a choice since this policy will probably be used long term as Dave's estate planning needs evolve. Dave might purchase something less than a $3.0 million policy depending on how much estate he wants to leave his family and how confident he is in the full $3.0 million value being received for DCC.

Also, he can choose whether the policy has an increasing or level death benefit.

While this planning is a good match for Dave's current objectives, it needs to be reviewed every several years to properly manage the performance of the life insurance policy, confirm Hal's present key role and to check whether one or more of Dave's children might have entered the business.

In August I will continue with several other case studies as a way of explaining some of the complexities encountered in business continuation planning.