

Life Insurance in Estate Planning

By Joel Kabaker

Strategic Uses of Buy-Sell Agreements

What happens to a client's interest in his closely held company when he dies? Estate planners who are familiar with their client's most valuable assets can manage transition of corporate ownership to the survivor's great advantage. The tool they use is a buy-sell agreement spun in a strategic direction.

The overriding purpose of buy-sell agreements is to provide control over the transfer of ownership under specified circumstances. Estate planners tailor this document to fit the client's overall plan. It should go without saying, but let us say it anyway: The time to craft the buy-sell agreement is well before it is needed.

Buy-Sell Triggers

The most obvious trigger is the death of a partner or shareholder. However, in practice early exit is often prompted by another business opportunity or a divorce. Divorce is of particular importance for clients living in community property states of which there are nine: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Puerto Rico allows property to be owned as community property. Alaska is an opt-in community property state where property is separate unless both parties agree to make it community property through a community property agreement or a community property trust.

Other buy-sell triggers include the disability or retirement of an owner. The truth is any specified triggering event named in the agreement can activate the buy-sell.

Necessity of Both Components

Well designed and effective buy-sell agreements always have two components: the legal document



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defining the agreement and the funding sources of the transaction, usually insurance. No buy-sell agreement is complete without both. There are countless horror stories where business owners neglected to include one or the other and scramble around trying to figure out what to do when a triggering event takes place. Without the legal document, owners are left to guess what the agreement intended. Without the funding component, they know what to do but lack the money to execute the transaction.

The legal component should provide a clear roadmap for ownership succession. For example, if a business owner dies, without a well-structured buy-sell agreement containing both critical components, the surviving owners suddenly have a new and possibly unwelcome partner, the heirs of the deceased owner.

Too often the spouse or children of a valued partner knows little or nothing about the business in which the survivors suddenly have an ownership interest. Nor do they have the valuable relationships with the other partners or the employees that the deceased owner did. For the first time, the surviving family may be in a position to influence corporate affairs. A comprehensive buy-sell agreement can eliminate the risk of having a surviving family (or others) assist in running the company. An orderly succession is a huge benefit to the decedent's surviving family and the surviving owners.

Of course there is always the issue of funding the business buy-out. Without a buy-sell agreement and the funding mechanisms that is usually incorporated, surviving owners must come up with the cash by themselves. Banks will look critically at a group of owners who want a loan to buy the interest of their deceased partner. This is especially true if the deceased owner provided a unique service to the firm not easily replaced, such as the CEO, the creative or engineering genius behind the firm or its major rain maker. Additionally, the cost of capital from a source other than insurance will assuredly be higher, if it's available at all. Surviving owners unable to buy out their deceased partner's interest may be forced to sell the company. If it cannot be sold, then liquidation of assets is a last resort. A well-crafted buy-sell agreement has the liquidity needed for funding the transaction exactly when it is needed. That is the function of insurance.

When to Use a Buy-Sell Agreement

Start-ups do not usually warrant the time and expense of establishing a buy-sell agreement because of their low initial value. However, be sure to review the new company's estimated value every year when you review the overall estate plan. There will come a time when the new company is a significant asset. When the enterprise value becomes a sizeable percentage of the client's overall estate, the buy-sell agreement is suddenly important.

Often clients are hesitant to begin the process of creating a buy-sell agreement. After all, everything is going well. They are healthy. All the owners like one another and work well together. Clients tend to think it is the other guy who suddenly will not be around rather than themselves. It does not always work that way. The estate planner must look at the

buy-sell agreement from all aspects, especially from the owner's and their families' perspective. The question posed to clients is, "Would you rather have this conversation while

everyone is healthy and the business is doing well or when things have gone south and a vital party in the business may not be available to discuss these issues and help in the planning?" The answer is clear: the sooner the better.

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Common Buy-Sell Structures

Practitioners structure buy-sell agreements in a variety of ways. The most common are the cross purchase and the stock redemption. The difference is in who buys what. Cross purchases require each partner or shareholder to buy all or a proportionate part of the exiting owner's interest. A stock redemption, on the other hand, has the enterprise buying all of the exiting owner's interest.

Occasionally, there is worry among some partners that a surviving shareholder will not honor the buy-sell agreement. They fear a partner will convert the insurance money to personal use rather than pay for their interest in the company. There are solutions to prevent such abuse. One of the easiest is to hold the insurance proceeds in an escrow account that is administered by a trusted professional. That person's fiduciary responsibility requires them to disburse

Table 1. Comparison of Structures

	Cross Purchase	Stock Redemption
Number of insurance policies	Each owner buys a separate insurance policy on every partner. For 7 owners there are 42 policies [7 X (7-1) = 42]	The corporation buys a separate insurance policy on each owner. For 7 owners, there are 7 policies.
Number of owners	Favors fewer owners	Doesn't matter
Differences in ages and health	Cost to each purchaser varies depending on the insured's age and health. Issues of varying premiums paid by different owners arise.	Cost to the company will vary depending on each owner's age and health. No issues of varying premiums arise.
Increase in basis	Those owners buying the interest of another owner receive an increase in basis	Basis is not an issue since the ownership interest becomes treasury stock and is retired.

the funds as the buy-sell agreement requires. It is common that the company's CPA who has a long-standing relationship with the partners serve as trustee of the escrow.

What Should the Enterprise Value Be?

This question always surfaces when formulating a strategic buy-sell agreement. The right answer depends on the client's goals. Some clients have provided for their families apart from the business so the company's value stated in the buy-sell agreement becomes less important. Others want to leave their families every penny they earned. For them, only the maximum value will do. Still others, possibly enduring a messy divorce, want a very low valuation to prevent the soon-to-be ex-spouse from enjoying the fruits of their labors.

Valuation of the company does not always require a professional firm doing an expensive study, but must be a reasonable value and arm's-length transaction. Instead, it can be an agreed-on formula whose result moves with the fortunes of the company. There are pros and cons for both. A market valuation performed by a respected professional is defensible should the estate of the dead owner challenge it. However, it is costly and must be regularly updated. A formula has an enduring applicability as profits rise and fall over time. However, the risk is that the formula may not produce the fair market value.

Be sure to recognize the plight of the minority owner. Whatever the valuation, they will suffer a discount from standard items that decrease value

such as minority interest, lack of control and loss of key partners. The company can reduce the impact of this discount by providing minority owners executive perks designed to make them whole.

Whatever the value of the enterprise, the buy-sell agreement must unambiguously identify at least a method of arriving at its value. Regardless of how the buy-sell agreement determines valuation, the question becomes one of managing that number to all parties' best interests.

Insurance As a Funding Mechanism

The question is not whether to use insurance as a funding source, but what type of insurance. Term and permanent insurance are the usual choices. If the agreement is not intended to last, then premiums on term insurance are less than for a permanent policy. Conversely, if the intent is to work with both

the death and retirement of owners, then permanent insurance can provide a solution for both the death and retirement needs of an owner.

Who Pays the Policy Premiums?

From a tax perspective, it is a moot point. Insurance premiums are not deductible regardless of the buy-sell agreement structure. If a cross purchase is used, each owner pays the premiums for each policy on the other owners. They both own and are the beneficiary of the policy. The higher premiums fall on the younger, healthy owners who must buy policies on the older and more-costly-to-insure

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owners. Offsetting this is the probability that they are more likely to collect sooner than the older owners. The solution used by many companies is to give the younger owners a raise whose taxable equivalent equals the higher insurance premiums for which they are liable.

The consequences of not treating the younger owners with equality may be significant. For example, the younger owners might mutiny and refuse as a group to fund their part of the buy-sell agreement.

If a stock redemption is used, then the enterprise pays the premiums on the policies it owns on each owner. The owners share the plan cost pro rata according to their business agreement.

When structured correctly, death benefits to the individual owners in a cross purchase agreement are received free of federal income tax. The deceased owner's basis is stepped up to fair market value (or that which is stated in the buy-sell agreement) at his death. The family's receipt of the buyout proceeds then equals the basis of their share in the company. The transaction results in no income tax liability.

Another element to note: Survivors receive an increase in basis using a cross purchase agreement caused by the money they paid to the decedent's family. This can reduce capital gains taxes when the

successor(s) sells their interest. Enterprises receive no such basis increase using a stock redemption because they buy treasury stock and retire it.

Under a stock redemption agreement, the corporation also receives death benefits free of federal income tax. However, these may be subject to corporate alternative minimum tax if the enterprise is a C corporation. A tax expert should contribute to the design of buy-sell agreements.

Future Trends

Business owners and their estate planners are getting smarter in the construction of buy-sell agreements. As the economy works through its troubles, look for owners to seek ways to make their enterprises more valuable. They will revisit such tried and true devices as reducing the company's dependence on a single individual to increase value. They will broaden the customer base so no single customer accounts for a material percentage of revenue. They will no longer allow the company to be overly reliant on a single vendor for key raw materials. All are valid value creation techniques. Astute estate planners who put the buy-sell agreement in place will take greater care to update it as changes in both the company and the client's overall plans occur.

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