

Life Insurance in Estate Planning

By Joel Kabaker

Estate Planning and the Family Business

Family members can wreak havoc on even the most carefully constructed estate plans. Introduce a valuable closely held business into the equation and disaster can result. The challenge is to distribute the estate according to the client's wishes while keeping peace in the family, no easy task under the best of conditions. Here are some solutions when working with family-owned businesses that are a significant part of the estate but not easily divisible among heirs.

Communication and Participation

The first challenge facing estate planners may well be the family business owner who is concerned about the effects on his company when he relinquishes control. His apprehension may be so great he delays ownership succession planning until it is too late. For such business clients, integrating the business ownership succession plan into the overall estate plan may be difficult. Listen closely to the owner who cannot give voice to fears of no longer being needed or useful. Deep down some are afraid of having nothing to do if they begin grooming another person to take over. These are the people who need another outlet, apart from the company, for their creative, emotional, and commercial energies. Often a psychologist who specializes in family business situations can open doors that once appeared barricaded. This is where the estate planner assumes the role of a trusted advisor in their client's overall life, not just in their finances. It is all part of the job.

The next step is to help the business owner communicate the succession plan to all parties who might be involved, including the spouse who does not participate in the business and those siblings not involved in the business. This is not a democracy. The best results usually come when the owner retains control over



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the conversation. The business belongs to him. He built it into the valuable enterprise it is and he can and should distribute it the way he wishes.

Professionals in the area of estate taxation, wills, and trusts can be helpful in assisting families in making decisions regarding the distribution of assets including the family's business. This must be done with consideration of the impact it will have on each child's life. The intent is to make ownership succession of the company a benefit granted by the parents at their sole discretion. This helps turn estate planning into a celebration of the parent's success rather than a burden to their kids.

The Most Likely Situations

You may encounter these three situations most frequently associated with ownership succession of a family-owned business:

- The parents did nothing to plan for the next generation's ownership.
- One or more siblings executed a complete buyout after the death of the parent who founded and operated the company.
- There is a partial distribution of the company's ownership after the death of the first parent and then a second distribution after the second parent's death.

Let us assume the Brown family owns a paper bag manufacturing company, BrownCo., that grosses \$10M annually. The father runs the company. The mother has no involvement. The eldest son has been executive vice president and second in command for ten years. The daughter is a CPA in private practice with a family of her own and no role in BrownCo. What happens when the father dies?

Without any estate planning intervention, the gross estate including the business if it is in the father's name, will pass according to the intestate laws of the state where the father lives. In many states, company ownership might pass to the surviving spouse at the first spouse's death. Upon the death of the surviving spouse, the company would be divided equally between the children. This would be unfair to the son who has been running the company and maintaining or even increasing the value since the father's death.

With a little thought, an astute estate planner could present a plan that gives the mother the liquidity required to maintain her lifestyle and makes fair distribution to the children. If this is the business owner's intent, one way to accomplish both goals is to allow the son to buy the business from the mother and whomever else may have inherited a share of the business. Funds to buy the

How do we implement the idea of a life insurance policy on the father that enables the son to buy the company from the mother, if she is the inheritor of the business at the death of her husband?

1. Design a business succession plan containing a well-crafted binding buy/sell agreement that stipulates the son's obligation to buy the business and the mother's obligation to sell. This eliminates the possibility of the son collecting the insurance benefits and then absconding with the money rather than paying it to mom for the business.
2. If the planner is still uncomfortable, consider using an escrowee, such as a CPA, attorney or a trusted family friend, who owns the policy on behalf of the son. The escrowee is directed to disburse the insurance proceeds to the surviving spouse to redeem the company shares in whole or in part according to the agreement.
3. Depending on the family dynamics and the terms of the agreement, the sibling may buy most but not all of the company shares. This allows the other siblings to participate in the upside potential in proportion to their stake, while acting as passive investors.

business could come from a life insurance policy on the father with the son named as beneficiary, along with a binding buy sell agreement between father and son and others who may have or inherit the business. The mother should be aware of this planned transition with each side benefiting from the arrangement. Under this plan, the son is able to buy the business and benefit from any future value he adds to the company. The mother receives the cash, allowing her to maintain her lifestyle and not be burdened with the management or oversight of the business. The mother will plan her estate as she sees fit, providing for her surviving children from the funds she has received in payment for her share of the company. This is an elementary plan that serves as the base from which to build a more complete estate plan addressing all the family's needs.

What happens if the son takes over but instead of prospering, he drives BrownCo. into the ground? Mom had no further financial stake in the company when the son bought out her interest with the insurance proceeds. The sister never had a financial interest in the company, or if

she did, she too has been compensated for her interest in the business. If the son did not want to continue to run the business or foresaw a business downturn, he was free to hire professional management or sell the company as is any prudent business owner's right.

A third common possibility is a plan granting partial distribution over a period of time. For BrownCo., this could be granting the son a 25-percent share of the company on the father's death. Now the son has an incentive to continue building the company's value. Often there are succeeding grants of additional ownership shares throughout the mother's lifetime. The final distribution is made after the death of the second parent.

Importance of a Binding Buy/Sell Agreement

A binding buy/sell agreement is crucial for the succession plan to work. Such an agreement ensures the payment amount, form of payment, timing and terms of the plan. It also forces the participants to behave in the way the business owner intended. When part of an overall estate plan, distribution of the company's shares among family members is more likely to reflect the contribution, interest and effort of those siblings working in the company.

On the other hand, if there is no binding buy/sell agreement, the surviving spouse may try to run the company on her own. This will work if he or she is capable of managing the business. However, when an unknowledgeable spouse attempts to run a company, the company will suffer. She may end up selling the company for less than its value just to avoid disaster. This is not the best succession planning

Dividing Illiquid Assets Equitably

The first question to ask siblings concerning their roles in the family business has to do with executive decisions. For example, assume the son has been second in command at BrownCo. for the last ten years and his sister, the CPA in private practice, continues to have no involvement. Ask the son what impact on the business

would occur if he had to ask for his sister's approval on all decisions. The company would languish while waiting for the sister to learn the issues, ponder her opinion and negotiate a compromise with her brother when they are in disagreement. It is unrealistic to assume a sibling who is not active in the business can participate in day to day decisions of the business. The person working in the business must have the ability to make decisions and manage the business as he sees fit.

The solution for such a situation is to create a liquidity event for the company so the sibling who will run it can buy the majority share. The key to executing such a plan is to begin talking about it far enough in advance to implement the steps needed to execute the plan when the time comes. Insurance is often an ideal vehicle because it provides a solution exactly at the moment liquidity is required.

Future Trends

Many of today's family-owned businesses were created by successful, affluent and business savvy entrepreneurs. I have found today's generation of family business owners share one behavioral aspect with our fathers and grandfathers: DENIAL. Too many assume they will live forever, or at the least do not want to think about their demise. They have a difficult time dealing with a new owner of their now successful business. As a result, too often they do nothing to facilitate a fair and orderly ownership succession. Estate planners must confront the aftermath of such denial and the inequity that often results. Planning well in advance of the business owner's death will always prove to be more tax efficient, better for the business, and more advantageous for the heirs of the estate. Trying to plan after the death of the business owner can never be the optimal scenario.

Estate planners must encourage clients to establish an orderly ownership succession plan for the family business. Of necessity they will seek the assistance of insurance experts skilled at using the policy benefits as a funding vehicle for company buyout. Such relationships will likely spill over into the many other aspects of the estate planner's business.

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