# Life Insurance's Role in Family Business Planning

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Life insurance professionals can help drive family business succession planning action. However, determining if life insurance makes economic and planning sense takes multiple perspectives. Each advisor in a team may provide insight into the insurance decision-making process that's both essential regarding the value of life insurance in the family's plan, but also helpful in educating the business owner and his family. Here are some interesting uses of life insurance for family business advisory teams to consider.

**Entity Redemption Agreement**

This is a legal agreement obligating the business entity to purchase all or part of an individual owner's interest in the business for an agreed-on price. The primary reason a family business would consider implementing such an agreement with life insurance is to help create liquid dollars to pay estate taxes. Liquidity is vitally important in family business succession planning, and finding it often isn't easy.

Traditionally, under Internal Revenue Code Section 2042, the proceeds (death benefits) of a life insurance policy owned by an individual are included in that individual's estate, regardless of who the beneficiary is. However, life insurance owned by a business on an individual owner or keyperson generally isn't includible in the insured's estate. In addition, life insurance benefits payable to the business are typically received free of income tax.

The proceeds of life insurance owned by a business are, however, typically includible as an operating asset in the valuation of the business. Therefore, using life insurance as a financial tool inside the family business for succession success has often gone unexplored, given the valuation challenges (that is, the concern that the death proceeds will add to the value of the family enterprise; thus, negating the benefits of the life insurance liquidity). Instead of focusing on the family business as a potential owner of life insurance, many business owners have used traditional irrevocable life insurance trusts (ILITs) in concert with a gifting strategy to fund liquidity needs at death.

**Combining With Buy-Sell Agreement**

Using life insurance in concert with a buy-sell agreement isn't a new idea. employing an entity redemption agreement alongside a buy-sell agreement simply expands this type of planning.

**How it works.** The agreement itself creates a legal requirement that the business must purchase part, or all, of the stock at the time of the business owner's death. The amount of business interest to be redeemed is often equal to the estate tax projected.

The family business applies for and owns a life insurance policy on the business owner's life. The business pays

the policy premiums and is the policy's beneficiary—the premiums aren't deductible. When the business owner dies, the business receives the life insurance proceeds, in most cases, income tax-free. Then, pursuant to the entity redemption agreement requirement, the business purchases, using the cash from the insurance policy proceeds, the agreed-on business interest from the owner's estate. The estate's executor then has cash that may be used to meet estate tax obligations and other settlement costs, and the business may redistribute shares to the remaining owners or hold them.

## What does the life insurance provide to a family business?

Acquiring life insurance inside the business using an entity redemption agreement can be a straightforward way to help provide liquid dollars for payment of federal and/or state estate taxes. Its lack of complexity may minimize planning delays, and cash can become available for the premium payments, all of which can help a business owner take planning action. Using a redemption agreement also reduces or eliminates the use of personal assets (cash) to pay for life insurance premiums to perpetuate the family business. There's also no need to use the gift and generation-skipping transfer tax exemptions.

**Combining the entity redemption agreement with traditional ILIT planning.** It's important that you continue to monitor this strategy, as you'll want to ensure that the amount of the redemption does, in fact, cover the estate tax due. Also, as with any existing life insurance that you consider, you'll also need to monitor the transfer-for-value rules.

**Using a Grantor Trust**

**Equalizing wealth transfer using a grantor trust.** Family business owners, whether they have their entire lifetime exclusion amount (currently $5.43 million) remaining or have already gifted to a grantor trust using the lifetime exemption gift limits—can consider grantor trust planning as a means to equalize wealth transfer to heirs when the intent is to have only those children, or family members, working in the family business receive stock ownership. Using lifetime exclusion gifting to centralizing the business interests in those who work in the business is a common succession strategy. Adding life insurance inside the grantor trust to enhance, or leverage, the trust assets can further aid this approach.

To illustrate this idea, here's a simple example: Consider a family business worth $10 million owned by a couple who have two adult children: Adam, who works in the business and is capable of running it someday; and Ben, who's enjoying a different career with no interest in the family business. Ideally, the couple would like the family business decision making and control to lie with Adam, but they still want to be fair to Ben.

The couple isn't ready to give up control of the business just yet, so they create a grantor trust for the benefit of Adam and place $8 million of the family business stock in it. At the same time, they create an ILIT for the benefit of Ben and gift $2 million to it, which the trust then uses to acquire an $8 million survivorship policy on both the parents' lives. This combined use of a grantor trust and an ILIT helps the couple achieve both their business and estate-planning objectives. They've given away $10 million of their lifetime exemption, but because of the leverage of the life insurance, they've given both children the same amount.One heir received cash and the other the business interest.

Although recent tax law changes have alleviated some of the need family businesses have for liquidity at death, life insurance still has a key role to play in succession planning.

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