BUSINESS PLANNING WITH LIFE INSURANCE

CAVITCH, FAMILO & DURKIN CO., L.P.A.

1300 EAST NINTH STREET
20TH FLOOR
CLEVELAND, OHIO 44114
(216) 621-7860
www.cavitch.com

N. Lindsey Smith, Esq.
Attorney at Law

This article is written to provide advisors with information needed to assist them in the delivery of professional services to business owners. It provides a context for understanding the myriad issues that must be considered in crafting advice for the use of life insurance as part of an overall business plan. The objective of this article is to present important information in an integrated manner to make the reader more effective as a communicator and an advisor.

A. THE DISTINCT BENEFITS OF LIFE INSURANCE IN BUSINESS PLANNING

The premise of this article is that life insurance can be an effective tool for achieving many business planning objectives if properly applied. There are multiple reasons for this statement, the primary ones being:

1. The income tax favored status granted to life insurance death benefits.

2. Capital creation for achieving business planning objectives.

3. A predictable rate of return on premium dollars spent.

4. Potentially significant leveraging of premium payments to death benefit received.

5. An effective tool for risk management.

In this article we will demonstrate in different planning contexts how life insurance is valuable for helping business owners achieve their objectives.

The planning strategies discussed herein also focus on creating the planning environment that maximizes flexibility over ownership of life insurance policies to make sure that the policies' full value can be realized when future events dictate a change of direction.

> **Observation:** Life insurance is a <u>solution</u> for a potential problem or a <u>tool</u> that allows our clients to pursue opportunities. We must first design the overall business plan which identifies these problems and opportunities. Context makes it easier for our clients to understand how insurance products fit into the overall picture.

B. TYPES OF ENTITIES

Insurance planning is affected by the type of business organization that the client has, so we start with some basic information about the various entities that are available. The forms of business ownership discussed are arranged from the most simple to the more complex. This order of discussion also reflects the historical order for the development of how businesses are owned and controlled. Note that as we go down this list the entities become increasingly more flexible in terms of management and tax planning issues.

1. **Sole Proprietorship**

   This is the simplest form of ownership. Property is owned directly by the business owner. The tax identification number is the business owner's social security number. All economic activity is reported on his personal tax return.

   The sole proprietorship form of business has the virtue of simplicity. There are no legal fees or costs to set up this type of business. However, simplicity comes at a price as the owner of a sole proprietorship is not insulated from personal liability and this might not be the most tax-efficient choice of business organization. For these and other reasons, few substantial business enterprises are operated as sole proprietorships.

2. **Partnership**

   When two or more persons want to work together in a business enterprise, they might form a partnership. This is the next step in the evolution of business entities. A partnership is a mutual arrangement to pursue their business plan. There can be a written agreement setting forth the details as to the partnership or it can be an arrangement based on an oral agreement.

   Of course, the best practice is to have a written agreement which is the set of rules for governance of the partnership. If there is not an agreement, then the rules of the partnership are provided for Ohio business owners by the Ohio Revised Code (specifically Chapter 1776, The Ohio Uniform Partnership Act). Even if there is a written agreement, there are certain rules that must be followed and these are set forth in Chapter 1776.[1]

   Partnerships file income tax returns. For the federal partnership tax return is a 1065. However, partnerships do not pay income taxes. The purpose of the return is to report the economic activity of the partnership for that year. Attached to the return are K-1 forms which state, among other things, the amount of taxable income and gains (or losses) allocated to each of the partners. Partners attach their K-1's to their personal returns and report this income and gain there. The filing of the 1065 return is also a way for the IRS to cross-check to make

[1] For the curious, it is easy to see Ohio law on the various forms of business entities. On the internet, type in Ohio Lawriter and go to Title XVII.

sure that the partners have included their K-1's information on their personal tax returns.

Even though there is not any tax paid on a partnership return, it is still necessary to file it. There is a statutory penalty of $10 per day that the IRS can assess.

The major shortcoming of a partnership is that all of the partners are personally liable for all of the obligations of the partnership and are also liable for any judgments. Liability exposure can be limited by the creation of a limited partnership where only the general partner is liable for the debts of the partnership. As to the person to be designated as the general partner, this may not be a satisfactory solution.

3. Corporation

Next in our survey of business entities is the corporation, which is an entity created by a group of persons to pursue a common objective. In this article, we are focusing on for-profit organizations, but keep in mind that corporations can be formed for virtually any reason.

The concept of a corporation is to allow people to combine resources to achieve common objectives. The set of rules that governs the corporation is frequently called a Code of Regulations. It sets forth the rules for corporate governance such as how a President is appointed, the role of the Board of Directors, etc.

DO YOU KNOW… where the word "corporation" comes from? It is derived from the Latin word "corpus" which means body or body of people.

An important feature of corporations is that the shareholders cannot be held personally liable for claims against the corporation. This protection was granted so as to encourage the development of businesses without requiring owners to put all of their assets at risk.

However, to maintain this protection it is important that the shareholders and officers managing a company follow all of the governance rules that are imposed by either the Code of Regulations of the corporation and state law. Failure to do so can allow claimants to "pierce the corporate veil" and assert claims directly against the shareholders asserting that the shield of the corporation does not protect owners of a company that does not act like a corporation.

Many states, including Ohio, allow corporations to operate more informally than normally required. They can do this by electing to be treated as a close corporation. This minimizes administrative burdens without surrendering the protection granted to shareholders.

Corporations can elect to be taxed in different ways. Below, we discuss businesses that elect to be taxed as either C corporations or Subchapter S corporations. There are significant consequences that result from how a corporation elects to be taxed.

4. C Corporation

A C corporation is a separate legal entity with its own tax identification number. It reports all of its income, gains and losses on its tax return (Form 1120) and pays taxes. It takes a deduction for distributions that it makes to employees. However, dividends paid to shareholders are not deductible expenses and are included by the shareholders as part of their taxable income.

Shareholders who are also employees can avoid this double taxation by distributing the corporate income to themselves as taxable income. However, this is not without risk. The IRS can disregard the payment of excessive income and treat a portion of it as a dividend distribution. Also, payments of income to employee/shareholders trigger the payment of employment taxes.

Keep in mind that employee/shareholder income in excess of the FICA limit is still subject to the Medicare tax of 1.45% and the employer matching payment of the same percentage, so payments as compensation to clear out income from the corporation and avoid the payment of taxes at the corporate level are not without costs. This also means that shareholders will not want to reduce income to reduce FICA taxes by paying out income as dividends as it will result in double taxation.

Dividend distributions must be equal among all shareholders with the same class of stock. As an example, all shareholders of a corporation with one class of stock, say common stock, must receive the same amount per share.

5. S Corporation

Prior to the creation of S corporations, business owners had only two choices of entities for tax planning, individual ownership and partnerships (for a single layer of taxation) or C corporation, (with taxation at two levels). C corporation owners enjoyed protection from liabilities while owners of partnerships and proprietorships did not have that protection. To resolve this quandary, in 1958 during the Eisenhower Presidency, S corporations were created.

To avoid double taxation a corporation can elect to be taxed as an S corporation by filing Form 2553. All profits and losses are taxed directly to the shareholders even if they are not distributed. If there is more than one shareholder, the S corporation must file a tax return (Form 1120S). It is an informational return which provides the IRS with information about the corporation's economic activity. Attached to the 1120S are copies of the K-1 forms that are provided to each shareholder. The K-1's are also attached to each shareholder's personal income tax return.

There are restrictions on S corporations that limit their usefulness in some situations. They can have only one class of stock. You cannot have, for example, preferred and common stock. All S distributions must be pro rata among the shareholders. There can be no more than 100 shareholders.

DID YOU KNOW…that the name S corporation is derived from the fact that the corporation is created under the provisions of Subchapter S of the Internal Revenue Code. The company "elects" to be treated as an S corporation.

Shareholders must be individuals who are U.S. citizens, residents or certain types of trusts. Trusts that are classified as grantor trusts (the grantor is treated as the owner) or qualified Sub Chapter S trusts can be shareholders. However, there are limitations to these types of trusts that may make them less attractive.

S corporations can allocate their income between earned income, subject to FICA taxes, and unearned income, which is not, so there is some opportunity to manage tax costs. However, amounts allocated to each must be reasonable.

6. Limited Liability Company

The next step in the evolution of business entities is the Limited Liability Company. It is a hybrid between the asset protection planning of a corporation and the tax benefits and flexibility of a partnership. It is legislatively created to combine the benefits of both types of entities in one business structure.

LLC's have a simplified management structure and do not have all of the bureaucratic requirements of a corporation. An LLC is either Member Managed (the Members manage) or Manager managed (an appointed Manager runs the

LLC). You can choose to have appointed positions such as President, but this is not necessary.

LLC's have several advantages over S corporations, such as no limitation on the number of owners or who can be an owner. Any person, corporation or other entity can be a Member. The number of LLC's in the United States has increased dramatically over the years. In 1995, there were about 120,000 LLC's and now there are estimated to be over 1,000,000 of these entities. They provide great flexibility and are the choice for most new businesses.

Owners of LLC's are called Members and their interests are often represented by "Units", not shares of stock. However, these names do not alter the underlying nature of ownership.

As the name states, there is limited liability for the Members. Liability is restricted to the assets of the LLC and personal assets of the Members cannot be reached by creditors. Further, a creditor who seeks attachment of a Member's interest in the LLC to satisfy obligations of that Member may find that he has swallowed a difficult pill. Under the charging order rules, a creditor who attaches a Member's interest is not entitled to receive anything unless there is a distribution to the member and can find himself subject to paying income taxes on the Member's share of profits even if there is not a distribution.

LLC's are governed by rules set forth in an Operating Agreement, which is similar to the Code of Regulations for a corporation. It sets forth the rules for governance. One rule, which can be of substantial benefit, is that income, gains and losses do not have to be allocated among the Members in proportion to their ownership percentages. The Operating Agreement can specify some other method for determining how to allocate income and gains. Compare this to the S corporation which requires pro rata allocations. This feature can be useful in many circumstances.

Observation: Ohio recently changed its law governing LLC's and now the sole remedy of a creditor of a Member is the charging order. Knowledgeable commentators state that Ohio is among the leaders for asset protection planning benefits provided by LLC ownership.

Ohio has enacted its own Limited Liability Company Statute (Chapter 1705) that provides the rules for operating an LLC. It contains rules that must be followed in all instances and that can also provide solutions for issues not addressed by the LLC Operating Agreement.

LLC's can elect to be taxed as a proprietorship (but only if it is a single Member LLC), a partnership, a C corporation or an S corporation. A single Member LLC does not need to file a separate tax return at all and the Member can report all income, gains and losses on his personal tax return. This also means that he does not have to incur any costs for tax return preparation. An LLC that elects to be treated as a partnership files a 1065 and issues K-1s to its Members.

A disadvantage of an LLC is that all income is treated as earned income and subject to self employment taxes. By comparison, an S corporation can allocate income between earned an unearned income. This issue can be favorably resolved by having the LLC elect to be treated as an S corporation.

C. EMPLOYEE BENEFITS

We now turn our attention to discussing various types of employee benefits that are supported by the use of life insurance.

1. Life Insurance as an Employee Benefit

This discussion focuses on the purchase of individual policies for select employees. This is not controlled by Federal ERISA law and there are not any non-discrimination requirements. Purchase of life insurance as an employee benefit is done for a number of reasons. From the perspective of the business owner, it is to promote loyalty among the employees.

The policy can be owned by either the company, with the employee entitled to name the beneficiary, or owned by the employee, with the premium payments made by the company. Keep in mind that the insurance premium is not a deductible expense regardless of how ownership is structured.

In select circumstances, the company may want to own the policy even if the employee is given the right to name the beneficiary. Life insurance policies have an economic value. Should an employee terminate employment, the company is in a position to determine if it wants to keep the policy in force. It is allowed to do so and there is not a question of having an insurable interest. You only need to have an insurable interest at the time of the purchase of the policy.

Where the company is paying for the policy, this option should not be ignored. An insurance policy becomes a much more valuable asset if the health of the insured changes during or after employment.

Split dollar life insurance is where ownership of a life insurance policy, payment of premiums and the death benefit is divided between the business and the employee. There are two types of split dollar life insurance.

- Collateral split dollar insurance is owned by the employee and the employer pays the premium. The employee assigns the policy to the employer as collateral for the loans it made to pay the premium.

- Endorsement split dollar insurance is owned by the employer and the employee has the right to name the beneficiary.

2. Funding Deferred Compensation, Stock Bonus and Phantom Stock Plans.

These non-qualified arrangements are valuable for maintaining employee loyalty. Stock bonus and phantom stock plans have the additional benefit of allowing employees to participate in the growth of the value of the company, which should be a great incentive for getting them to work harder and not seek other employment. The catch is that eventually obligations under the contracts have to be paid. Life insurance is useful for creating a death benefit and cash value that grows on a tax deferred basis.

3. Key Man Insurance

The benefits of key man insurance are frequently overlooked. It can be critical to maintaining the momentum of a company during a difficult period. Also, unused death benefit is not wasted; it will go into the pockets of the remaining owners.

As with our discussion above, it is important to properly structure ownership and the same concepts apply.

4. Long Term Care Insurance

Like other insurance products, long term care insurance can be provided to employees on a selective basis. Employers need to consider this for their own benefit as well. Unlike life insurance, premium payments are a tax deductible expense.

D. TAX IMPLICATIONS OF LIFE INSURANCE

There are some important tax issues that must be factored into an insurance planning strategy for a business. First, life insurance premiums are not a deductible expense to the company. Part of the trade-off is that dividends paid under the policy are not taxed, except if withdrawals are made that exceed the basis of the policy. The basis is the amount of premium payments made. Also, the death benefit is received income tax free.

Life insurance death benefit can be subject to income taxes where the owner/beneficiary is a C corporation. The receipt by the business is, of course, not subject to income taxes. However, death benefit proceeds paid out to shareholders are treated as taxable dividends. If they are paid out to employees, then there is a tax deduction to the company for the expense but this is then taxable income to the employees. If the payments are to shareholder/employees, they have essentially lost the tax free feature of the death benefit.

> **Planning Tip:** C corporations that want to own insurance on employees, including shareholder/employees, should own the insurance outside of the company. This avoids the income tax issues. If funds are needed for satisfying obligations on the death of the insured/employee, use corporate funds which are paid out as a tax deductible expense. If the corporation has insufficient funds, money from the death benefit can be lent back to the corporation to be repaid as funds become available.

Yes, death benefits paid out for a deductible expense, say salaries or to satisfy obligations under a deferred compensation plan, are deductible expenses, but why not use other funds that are subject to taxation to pay these expenses and preserve the tax free benefit of the life insurance?

The tax issues for C corporation ownership do not apply to entities that are taxed as S corporations or partnerships. These are pass through entities where the owners are taxed directly. Life insurance proceeds are not subject to tax on distribution to them. However, there are other important reasons why ownership of the policies should be placed outside of them in a separate entity. This is discussed later in this article when we look at structuring ownership of life insurance policies.

Since ownership of a life insurance policy by a C corporation is probably not optimal, what can be done to minimize the tax issues that we have been discussing? One option is for the C corporation to convert to another type of entity. However, a conversion from a C corporation may trigger income taxes. The C corporation must pay taxes on unrealized gain and other items that have not previously been taxed.

Another option is to distribute the policy out to the shareholders, but this has issues that must be addressed. Before we discuss the options, we need to briefly review what is called the transfer for value rule. It states that the IRS will tax life insurance death benefit where the underlying policy was transferred for valuable consideration. The rule is applied very mechanically.

> *Example: Bill and Don own XYZ Manufacturing Company and it owns life insurance policies on their lives. They determine that the policies should be cross owned (Bill owns the policy on Don and vice versa) to support a cross purchase agreement. To accomplish this, they have their agent transfer the policies to them. They have inadvertently triggered application of the transfer for value rule. There was an exchange of consideration and death benefit in excess of cash value is subject to income taxes.*

There are four exceptions to the transfer for value rule:

- Transfer to the insured.
- Transfer to a partner of the insured.
- Transfer to a partnership where the insured is a partner.
- Transfer to a corporation where the insured is either an officer or a shareholder.

With this very basic description of an important tax matter, we now address what can be done.

- The policy may be distributed to the insured and there are not any problems doing this. However, if the policy is to be used by the other shareholders to fund obligations, such as a purchase, which is quite probable, then this is not an acceptable option.

- If the policy is distributed to the other shareholders, assuming they are not partners in another business arrangement, then it is considered a transfer for value and upon the death of the insured/shareholder the other shareholders must pay income taxes on the amount of the death benefit in excess of the tax basis of the policy (*i.e.,* the cumulative premium payments).

- The desired option is to transfer the policy to a partnership. This avoids the transfer for value tax issue and preserves the use of the policy in a controlled environment that supports the business planning objectives of the owners. This is discussed more fully later in this article.

E. ASSET PROTECTION PLANNING

Increasingly, clients look to us to provide proactive solutions to protect their assets from the claims of creditors. As applied to a discussion on business planning, they usually think of liability arising from business activities and we assure them that they are not liable for problems that arise within their businesses. This is correct, but hardly the whole story.

We generally accept that life insurance policies and their cash value are protected from the claims of creditors. However, on closer examination we see that this is not completely accurate.

> *Example: Jerry and Bruce own a construction business. It is a corporation that owns, among many assets, life insurance contracts on their lives. Jerry makes a bad driving decision, turning his vehicle in front of an oncoming motorcyclist who is seriously injured. Is his interest in the business protected and are the life insurance contracts exempt from attachment?*

The answer to both questions is no. A successful plaintiff can attach his interest in the corporation and own his stock. As a shareholder, the plaintiff now has an interest in the assets of the corporation, including the insurance policies.

There are solutions to the situation Jerry is faced with, but they require pre-planning that cannot be done after the fact. Probably the best solution is to have the policies owned by a LLC that is owned by Jerry and Bruce. Under Ohio law, the sole remedy of a creditor of a Member of an LLC is a charging order. With a charging order, the creditor is only entitled to receive a distribution made by the LLC. If there are not any distributions, the creditor does not receive anything.

> **Asset Protection Planning Tip:** Have the business set up as an LLC taxed as an S corporation. This allows the owners to avoid all income being taxed as earned income subject to employment taxes while allowing them the greater asset protection planning features of an LLC. Recent Ohio legislation titled the Asset Management Modernization Act (AMMA) has increased the protection granted to business owners.

F. BUSINESS SUCCESSION PLANNING

Every business owner should address his business succession strategy and every situation is different. It is never too early to start.

1. Intra Family Sale

Frequently there is a younger family member who wants to take over the business. This presents multiple insurance planning opportunities:

- Use of insurance to fund a buy-out of the senior family member.
- Financial resources needed to fund a salary continuation plan for the spouse of the deceased senior family member.
- Source of funds to provide an inheritance to other family members.

The last reason is frequently not examined closely enough, especially where there is a gift of the business interest that does not include all of the children, which is quite common. Clients have three viewpoints on this issue: (a) they want all children treated equally, so insurance to accomplish this goal is tied to the value of the business; (b) they recognize the value the younger member of the family has provided and, thus, do not feel that they have to give the other family members an offsetting gift; and (c) something in between (a) and (b). This is the in-between example:

Example: Joe and Joan are farmers with a business that owns 750 acres of prime Ohio farmland. It is by far their most valuable asset. Their son, Jason, now runs the business. They have three daughters, none of whom are active in the business.

The solution in this situation was to buy a substantial second-to-die life insurance policy that is owned by an irrevocable life insurance trust. They could not afford to purchase a policy that is three times the value of the farmland. On their deaths, each of the four children will receive one-fourth of the death benefit. They wanted their son to receive some cash to make sure the business was adequately capitalized. Each of the daughters will receive one-fourth of the death benefit so that they have a significant inheritance from Joe and Joan.

Timing of a transfer of ownership is important, and there may be more flexibility when the transfer is between family members.

Example: Richard, who was elderly with serious health problems, offered to transfer to his sons, our clients, his interest in his business. The current value of the business was $1,750,000. The tax basis was virtually zero. At our recommendation, our clients declined to accept the gift. When Richard died, which unfortunately was only several months later, they inherited the property.

The tax benefit of the delay was that inherited property receives a new tax basis equal to the date of death value. This is called stepped up basis. The tax savings on the subsequent sale of the business will save at least $400,000. Delaying the transfer did not affect federal estate taxes. Remember that a taxable gift during lifetime reduces the estate tax credit.

2. Sale to Co-Owners

This type of transaction is structured differently as there are competing interests of the different shareholders. The terms of the transaction are controlled by the buy sell agreement. There are essentially three types of agreements:

- **Stock redemption.** The shares of stock of the selling shareholder are brought back into the corporation. Say there are 500 shares outstanding and 100 shares are to be purchased. After the purchase, there will be 400 shares that own all of the value of the business.

- **Cross purchase.** The shares being sold are transferred over to the purchaser. The corporation has the same amount of shares after the purchase.

- **Hybrid Agreement.** The corporation and the shareholders can determine how to allocate shares between a stock redemption and a cross purchase.

Most sales between owners are cross purchase agreements for the reason that the purchasing shareholders receive a tax basis in the shares purchased equal to the price paid. With a redemption, there is no adjustment to the basis of the existing shares owned by the purchasing shareholder. Say the value of a share being purchased is $1,000 and its tax basis is zero. With a redemption, the redeemed shares are returned as treasury stock and the tax basis of the outstanding shares, in our example 400, remains at zero. With a cross purchase arrangement, the purchasing shareholders now own 500 shares and the 100 shares that were purchased have a tax basis of $100,000. The significance is that on a subsequent sale of the corporation the shareholders have eliminated capital gains taxes on those shares.

The benefit of the hybrid agreement is flexibility in case some reason surfaces that would dictate that some of the shares should be redeemed. Say for example that the corporation is taxed as a C corporation and it has substantial cash on hand. It might be appropriate for the corporation to use the cash to purchase the stock that is being sold.

G. IMPORTANT PROVISIONS OF BUY SELL AGREEMENTS

The buy sell agreement will cover all aspects as to the transfer of shares of stock. It is the agreed upon set of rules.

1. Events Triggering Sale of Shares of Stock

The buy sell agreement has to address when sale of the shares is to occur. What event will trigger the sale of stock?

- **Involuntary Transfers.** Should an attachment of a shareholder’s stock in the corporation require the sale of that stock? Frequently, a buy sell agreement will require this. The other shareholders do not want to have the creditor of a former shareholder as a shareholder in the corporation.

However, triggering a buy out under these circumstances can be the worst thing for the shareholder who is experiencing financial difficulties.

One solution, which is a relatively recent development, is conversion of the corporation to an LLC with the option, as discussed above, to be taxed however it wants to be. The AMMA provides that the sole remedy of a creditor is a charging order. There is no right of the creditor to own the Units of the LLC owned by its debtor and exercise ownership rights. The Operating Agreement should specifically state what the rights of a creditor are, or more precisely, are not.

> **Caution.** It is important that LLC's have the proper documentation to secure all of the benefits of this form of ownership. A good LLC company record book will have an Operating Agreement that includes all of the allowable provisions that support asset protection planning. Do-it-yourself kits that are not custom designed for Ohio law should be avoided.

- **Termination of Employment.** Usually both the shareholder/employee and remaining shareholders want a buy-out when employment terminates for the simple reason that they no longer want to have a business relationship. This is a harder situation to plan for because funding the payment obligation can be more challenging. It is important that the buy sell agreement address this issue and provide an agreed method for payment.

- **Third Party Offer.** The agreement should address the rights of shareholders should an outside party offer to buy some of the shares of the business. It is assumed that the other shareholders want control over who they are in business with. This issue is addressed by including a right of first refusal exercisable within a stated time period. Frequently, the right of first refusal is structured on matching the terms of the offeror. However, this is not necessarily the best arrangement. The agreement can state the terms of payment so as to protect the other shareholders and help to ensure their ability to purchase the shares offered for sale.

Example: John owns a controlling interest in the family business and receives an offer from an outsider to purchase his interest. The offeror is willing to pay cash. The other shareholders want to continue family ownership but cannot afford to pay cash. Fortunately, the right of refusal in the buy sell agreement allows for installment payments.

- **Death.** Purchase of shares on the death of a shareholder is in certain respects the easiest situation for which to plan. Life insurance is the preferred funding vehicle. Discussion as to who should own the policies is discussed in paragraph, **I. OWNERSHIP OF LIFE INSURANCE POLICIES.**

Termination of employment and death are not necessarily triggers for the sale of shares owned by the departing shareholder.

Example: Matt, Mark and Luke are co-owners of a business. Matt and Mark have sons who are employees of the company and they do not want their shares sold on their retirements or deaths as they want their families to continue ownership. Luke's children are otherwise employed and will not be part of the business.

The solutions for these clients are addressed separately. One size does not fit all. As to Matt and Mark, should either one die, share ownership is maintained and their spouses are entitled to payments under a non-qualified salary continuation plan. As to Luke, his interests are bought out.

Life insurance is also a component of the plan and life insurance policies on all three individuals are owned by a Life Insurance Limited Liability Company (see below). On the death of Matt or Mark, life insurance proceeds are paid to the LILLC and allocated to the capital accounts of the surviving shareholders. An LLC does not have to allocate receipts in proportion to ownership if the Operating Agreement allows this. The estates of Matt and Mark have the right to require purchase of their shares at any time during the twelve month period following death and subsequent rights to have the shares purchased on succeeding fifth anniversaries of their deaths. This provides their families with flexibility going forward and unused life insurance premiums are invested within the LILLC for future use. As to Luke, life insurance proceeds received on his death are allocated to the capital accounts of Matt and Mark and distributed to them for purchase of Luke's stock.

2. Determining the Value of the Company

The buy sell agreement will address how value is to be determined. There are several different approaches and pros and cons for each one.

- **Agreed Value.** The parties to the agreement agree on the value to be used. The agreement should also state the time period that the agreed value shall be in force and how value is determined at the end of the period or if there is not a subsequent agreement to value.

  The pros of this method are that there are not costs for professional valuation and the shareholders have agreed on the price so there can be no argument. The cons are that the price may be materially wrong, there may be changed conditions during the agreed period and the fact that, shareholders frequently overlook determining a new value at the end of the agreed period.

- **Value Determined by Valuation.** The use of a professional is the most reliable way to determine value. The valuation expert will value the business several different ways and then advise the method of valuation most appropriate to the particular circumstances of that business. The negative of using a valuation expert is the cost. There is a lot of work involved in reviewing all of the information needed to assess value and prepare the report. The benefit of using a skilled professional is reliability. We observe that an owner's estimate of value of his business is often significantly different from the professional business valuation that we have had done.

The most common valuation techniques are:

- **Book Value.** This is the cumulative value of the assets of the business as shown on its accounting records, less liabilities. While it is easy to determine the book value of a company, generally, this is not a reliable estimate of value as it does not take into consideration a number of factors such as the goodwill of the company.

- **Discounted Earnings.** The value of the business is determined by projecting future earnings over a specified period and then reducing this number to its present value.

- **Capitalization of Earnings.** This analysis focuses on determining the net cash flow of the company, perhaps taking an average of the earnings of the company over the current year and two to four prior years, and multiplying the average by a capitalization rate. The capitalization rate reflects the percentage rate of return sought for the capital invested. This method looks forward and the projections are based both on the financial history of the company and what is expected to happen over the selected future time period.

  If the capitalization rate is 8 and the average annual earnings of the company over the past five years was $200,000, the value of the company would be $1,600,000. This means that a purchaser at this amount is expecting a 12.5% rate of return on the amount invested.

  This valuation method also requires normalization of expenses. For example, if the owner is paying himself $250,000 per year for a position where salaries are normally $100,000, the “excess” earnings, in this example $150,000, are added to the income of the company for purposes of determining its value.

  > **Observation:** We like the capitalization of earnings approach as it focuses on a rate of return. However, it is based on an assumption that the company will continue to perform as it has in the past. Other factors, such as changing market conditions, loyalty of the company’s existing client base and competitive factors for the company, also matter.

There are several other matters that need to be considered. Is the value to take into account discounts to value for lack of control (minority interests) and lack of marketability (not traded publicly, etc.)? These discounts are real and can substantially reduce the value of the company and the purchase obligation. Remember that if nothing is said in the buy sell agreement or if there is not a buy sell agreement, expect that the valuation expert will apply these discounts. If discounts are not to apply, then this needs to be stated in the agreement.

The agreement should also state that the value is not to take into consideration life insurance death benefits received by the business because of the death of a shareholder. If this is not stated, the value of the death benefit will be included as an asset of the corporation.

3. Payment Terms

The agreement will set forth how the purchase price is to be paid. This is a very important part of the agreement and focuses on:

- If not an all cash deal (and most are not), the amount of the down payment to be made. Example: 20% of the purchase price.
- Period over which installment payments are to be made. Example: 60 months.
- Interest to be paid on unpaid balance. Example: Prime rate plus 1% at commercial bank that company regularly uses.
- Security for the payment. Example: Pledge of stock of company.

Usually, the agreement will state that any life insurance death benefits received by the company or its shareholders who are obligated to purchase shares must be used to satisfy obligations under the terms of the buy sell agreement.

H. SELECTION OF TYPE OF INSURANCE TO BE USED

Most business owners will select term insurance for their buy sell arrangements. Most persons leave their businesses before they die and insurance is not needed for satisfying the terms of a buy sell agreement. Also, the cost of insurance is, at least in the near term, significantly less.

Permanent insurance may be advisable if the owner wants to build up cash value to be used to buy out a withdrawing shareholder or to fund something like a deferred compensation plan.

Also, the prudent business owner will keep in mind that he may want to later use the insurance on his life later to achieve personal estate and income tax planning objectives. Experience teaches us that life insurance policies are frequently used for objectives that are completely different from those that existed at the time of the purchase of the policies.

I. OWNERSHIP OF LIFE INSURANCE POLICIES

There are multiple options for ownership of the policies, and this part of the succession planning process should be carefully addressed. There are four options:

1. Ownership by the Company

This has the virtue of simplicity and seems less expensive as the business pays the premiums. However, simplicity overlooks other objectives that can be achieved. Further, as discussed above, payment of the premium is not tax-free and is either a non-deductible expense if the corporation is a C corporation, a taxable S distribution if it is an S corporation or a taxable distribution if it is an LLC taxed as a partnership. There is no free lunch.

2. Shareholder Ownership

This is the most common form of ownership where shareholders own policies on each other. The owner of the policy pays the premium because he will receive the financial benefit of the policy. This also has the virtue of simplicity. As we shall see, however, there are shortcomings with this approach and ownership by an entity may be preferable.

3. Ownership by Another Entity

This option is frequently overlooked or not adequately evaluated. Historically, shareholders interested in controlling policies would set up a trust to own the policies. A Trustee is designated to supervise the terms of the trust and carry out its provisions as set forth in the trust agreement. The trust agreements are usually very simple (*i.e.*, if a shareholder dies, pay out the death benefit to the other shareholders so that they can pay for the shares to be purchased).

A more sophisticated option is to set up a Life Insurance Limited Liability Company (LILLC) which will own the life insurance policies. Its Operating Agreement will address all significant issues as to the ownership of the policies and distribution of death benefits.[2] In this article we briefly survey why business owners should consider the benefit of life insurance policies being owned by an LILLC. There are many benefits, including:

[2] At our website, www. cavitch.com, under News & Publications is an article that explains in detail how an LILLC can be used for business succession and planning

- Reduction in the number of policies needed. Example: A business owned by four shareholders only needs four policies, not twelve.

- Control over the allocation of the death benefits. Example: Upon the death of a shareholder, the LILLC directs payment to the Member/Shareholders to be used to purchase shares.

- Control over allocation of policies not needed for buy sell agreement. Example: A retiring shareholder is given right to acquire unneeded insurance on his life. This avoids a situation where the other shareholders own the policy and refuse to transfer it to the retiring shareholder.

- Avoids problem of ownership and beneficiary designation on death of a shareholder who owned policies on other shareholders.

- Protects life insurance policy from attachment by creditors as statutory protection of these policies does not apply to owners of policies insuring non-related persons.

4. Ownership by a Trust

Asset protection planning along with the increased federal gift tax credit have led many clients to move their business interests to irrevocable trusts. There are many benefits to this type of planning and several ways to accomplish this. Owners may transfer business interests to a trust that we call a Spousal Gift Trust. While the owner can be the Trustee, he cannot be a beneficiary of the trust.

The reverse option, which is new to Ohio and provided for in AMMA, is the Ohio Legacy Trust (OLT).[3] With an OLT, the owner can be the trust beneficiary but cannot be the Trustee.

[3] See our website at www.cavitch.com under News & Publications for an article on the Ohio Legacy Trust.

J. TALKING TO BUSINESS CLIENTS ABOUT LIFE INSURANCE

It is our experience that business owners present significant opportunities for advisors to provide assistance. We observe that these clients either do not have business plans that address important planning issues or that the plans that they do have are very outdated.

It is simple to begin a dialogue with your business clients. Ask if they have a business succession plan. When was it last reviewed? Do they know where the planning documents are located? Can they locate their corporate record book and when was the last time it was updated? It is rare that a client who can positively answer these questions.

Engaging clients in this manner can result in both general and specific benefits to both your business clients and to you. You want them to see you as a trusted advisor helping them to focus on the big picture. In the process of doing this, the business planning process can lead to your own business opportunities including management of financial assets of the company and the placement of insurance products. The process also helps you to deepen your relationship with your clients and in many cases you receive the additional benefit of getting to know and develop relationships with their family members and other shareholders.

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