Allianz Life Insurance Company of North America

LIFE ADVANCED MARKETS PRODUCER GUIDE

Family business succession planning

Strategies and life insurance opportunities

Planning for the transition of a family-owned business from one generation to the next presents a number of unique challenges.

For example, unlike sales to third-party buyers, the succession plan for a family-owned business may involve gifts of ownership interests. Or, when the plan does involve a sale, the next generation may not have sufficient personal funds to acquire the business outright. And unlike sales to third-party buyers, developing a succession plan for a family-owned business requires consideration of potential family conflicts and emotional issues.

While every family business is unique, and every business owner will have their own goals in transitioning the business to the next generation, there are a number of goals that are common.

On the following pages we introduce a number of common goals families have when it comes to passing on the family business, along with potential strategies to accomplish these goals – and the role life insurance may play in each strategy.

Keep in mind, these strategies and opportunities may be combined to address multiple client goals.

CLIENT GOAL #1:

Treating all children equally, avoiding family conflict

"The family business makes up the majority of our estate. A primary estate planning goal of ours is that all three of our children should be treated equally, but only two of our children are actively involved in the business. The third has other career interests. We see the potential for family conflict and would like to implement a plan that limits that potential."

POTENTIAL STRATEGY: If all the children receive an equal ownership interest in the family business, there is an increased possibility of family discord, since the non-active and active children may clash over business decisions. One common area of potential disagreement is decisions over the distribution of profits. Non-active children may see the business as simply a financial investment that provides them with income (in the form of distributed company profits).

Active family members will want to make decisions based on the long-term success of the business, which in some years may involve reinvestment in the business as opposed to distributions. Parents/owners may want to consider alternatives to passing on equal shares of the business in this situation.

Providing an equal inheritance does not mean it needs to be an inheritance made up of the same assets. If a substantial portion of the estate consists of family business interests, clients may want to consider passing on the business to the children who are active in the business and giving life insurance death benefits to any children who are not.

CLIENT GOAL #2:

Transfer business via lifetime gifts, minimizing gift taxes

"The family business is expected to grow substantially in the coming years. We would like to transfer the business, or a partial ownership interest in the business, to the next generation during our lifetime, and we have a specific time frame in mind. But we would like to minimize the gift tax exposure."

POTENTIAL STRATEGY ONE: A grantor retained annuity trust (GRAT) may provide a means to accomplish this goal. In a GRAT, the donor transfers an asset (such as an ownership interest in the family business) to an irrevocable trust. The GRAT then makes fixed distributions to the donor for a term of years. The amount of the payment is a fixed amount based on a percentage of the asset transferred and must be paid at least annually. At the end of the term period, the asset is distributed to the named beneficiary, which may be the donor's children or a separate trust for their benefit.

The primary advantage of a GRAT is that, to the degree the growth rate of the assets exceeds the IRC §7520 rate, the excess will pass to the remainder beneficiary free of gift taxes.[1] The GRAT may even be designed so that the value of the gift for gift tax purposes is zero (referred to as a Walton GRAT or "zeroed-out" GRAT).[2]

Should the grantor pass away during the term of the GRAT, the property is brought back into their gross estate for estate tax purposes. Life insurance may be purchased on the grantor's life to address this risk.

POTENTIAL STRATEGY TWO: Another way to transfer a business interest without incurring gift taxes is to sell the asset instead of gifting it. But a sale to the children directly may trigger capital gains taxes. As an alternative, parents may sell the business interest to an intentionally defective grantor trust (IDGT). The terms of the sale may allow the trust to pay the sale price over a period of years (i.e., an installment sale).

[1] For gift tax purposes the value of the gift on the date of the transfer is equal to the current value of the transferred asset minus the value of the retained annuity interest measured by using the IRS Sec. 7520 rate. In order for the GRAT to be successful, the rate at which the asset appreciates inside the GRAT needs to be greater than the IRS assumed rate of growth (IRC §7520).

[2] Walton v. Commissioner, 115 T.C. 589 (2000).

CLIENT GOAL #2 (continued)

Transfer business via lifetime gifts, minimizing gift taxes

An IDGT is specifically designed to be a grantor trust for income tax purposes, which means the grantor and the trust are treated as the same person for income tax purposes. A sale to oneself does not trigger capital gains taxes.[1]

Besides avoiding gift taxes and potential capital gains taxes, there is an additional wealth transfer advantage. Since the grantor/parents are responsible for taxes on income generated inside the IDGT, the trust may grow without a tax drag. The IRS does not deem this tax drag to be a gift from the grantor.[2] When designed properly, the assets inside the trust may also escape estate taxation upon the grantor's death.

Since the IDGT must meet their payment obligations under the terms of the installment sale, and the death of any children now operating the business as trustees of the IDGT may cause financial hardship to the trust's ability to meet those obligations, life insurance on the children's lives may also be considered.

CLIENT GOAL #3:

Progressive transition of the business while retaining control

"Our children are interested in taking over the family business in the future. We would like to get them involved in the business as owners and allow them to participate in the financial success of the business now, but we are not ready to give up control of business operations just yet. We are also concerned about gift taxes applying to any gifts of ownership we make."

POTENTIAL STRATEGY ONE: If a substantial portion of an estate is made up of stock in a closely held business, the owners may hesitate to gift a portion of that stock. Whether the gift is made directly to family members or to a trust for their benefit, transferring the right-to-vote shares in the business may not be appropriate at this time.

One way to avoid this issue while still taking advantage of gifting strategies is to recapitalize the stock into voting and non-voting shares prior to making the gift and then gifting the non-voting shares.[3]

There are a number of advantages to recapitalizing:

- The value of the gift may be discounted for lack of marketability and/or receive a minority interest discount. An additional valuation discount may be available due to the lack of voting rights.[4]
- As the original owner of the business, the parents may retain total control over the business by retaining 100% of the voting shares.
- A gift of non-voting shares removes the value of a portion of the stock (plus future appreciation) from their estate, thereby reducing exposure to federal transfer taxes.

POTENTIAL STRATEGY TWO: Family Limited Partnerships (FLPs) can be an effective vehicle for the management, accumulation, preservation, and transfer of family wealth. There are many advantages that may be gained by implementing an FLP – including an increased level of creditor protection for family assets and a reduction in federal transfer taxes (estate, gift, and generation-skipping taxes).

[1] Revenue Ruling 85-13.

[2] Revenue Ruling 2004-64.

[3] IRC §1361(b)(1)(D) – S corporations may not have more than 1 class of stock. However, based on IRC §1361(c)(4) – "For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock."

[4] Estate of Lea K. Hillgren, T.C. Memo 2004-46, 3/3/04 – court accepted an additional 5% discount due to lack of voting rights. Okerlund v. United States, No. 03-5054, United States Court of Appeals, Federal Circuit, DECIDED: April 9, 2004 – Both experts agreed that a further 5% discount for the lack of voting rights was appropriate. The Court of Federal Claims accepted this assessment. Wall v. Commissioner, TC Memo 2001-75 – court approved 5% discount based on lack of voting rights.

CLIENT GOAL #3 (continued)

Progressive transition of the business while retaining control

While there are many ways an FLP may be used, a common strategy involves the following steps:

- Assets are gifted to the FLP, which is then divided into general partnership interests (providing the owner with control over the management of partnership assets, including a business interest) and limited partnership interests (providing no control over management of partnership assets). The limited partnership interests are then gifted to family members. While the gift is considered a gift for federal gift tax purposes, the value of the asset gifted may be reduced based on available minority and lack of marketability discounts.
- Because of these available valuation discounts, the FLP permits senior family members, as general partners, to reduce the value of their estates without losing control of their business. This is a highly beneficial opportunity under the federal estate and gift tax laws.

CLIENT GOAL #4:

Selling the business to the next generation

"Our children are interested in taking over the family business in the future, but we are not in a financial position to simply give it to them. Any transfer of the business would need to be in the form of a sale. However, these family members may not have the full financial capacity to buy us out. Our goal is to find a way to make the transaction more viable for them."

POTENTIAL STRATEGY ONE: One way to reduce the financial burden for children acquiring the family business is to implement a nonqualified deferred compensation plan (NQDC) for the current owner/parent. An NQDC plan is basically a promise made by the business to pay compensation to an employee at some point in the future. In contrast to qualified plans, nonqualified plans may benefit only a select group of key employees. It is therefore permissible to implement a nonqualified retirement plan that benefits the owner of the business (as long as the employee is providing services to the business).

Such an arrangement creates two potential advantages for children looking to purchase the business:

- The promise of payment creates a liability on the books of the employer which in turn reduces the value of the business.
- After the sale is executed, the children then own the business and must make payments to the parent under the terms of the NQDC plan. These payments are deductible to the business, whereas payments made to purchase the business are not.[1] The result is that they have replaced a non-deductible payment (installment payments to the owner to purchase shares) with deductible payments (deferred compensation). This creates a tax savings for the business and therefore improves the cash flow for the purchasing family member – making it easier for them to purchase the business.

A primary consideration is that this also creates an additional tax burden for the selling parent, as more of their future income will consist of compensation taxable at ordinary income tax rates as opposed to installment payments taxed at lower capital gains tax rates.

The business may consider acquiring cash value life insurance on the life of the purchasing child. Any cash value accumulation may be accessed through policy loans and withdrawals[2] used by the business to meet their obligations under the NQDC plan, and the death benefit provides protection for the business against the premature death of the new owner.

POTENTIAL STRATEGY TWO: If the children do not have sufficient liquid assets to purchase the business outright, some form of installment sale may be necessary. An installment sale is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.[3]

[1] IRC §162.

[2] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

[3] IRC §453(b)(1).

CLIENT GOAL #4 (continued)

Selling the business to the next generation

A self-canceling installment note (SCIN) is an installment sale in which the obligation to make the payments terminate at the death of the seller. The obligation should be for a term of years that is shorter than the life expectancy of the seller and generally requires some amount of "risk premium" above the purchase price in consideration for the note being canceled at the seller's death (by increasing the sales price or increasing the interest rate).

The primary advantage for children purchasing the business is that they may pay substantially less than the fair market value of the business if the parent passes away prematurely. In addition, from the moment the sale is finalized, the asset is removed from the parent's estate for estate tax purposes, regardless of whether or not the parent lives for the entire term of the SCIN obligation.

The premature death of the selling parent terminates a purchasing child's obligation to continue making installment payments. If this would cause financial harm to a surviving spouse, life insurance on the life of the selling parent may be considered. In addition, life insurance on a purchasing child may be considered since the parents will rely on the child to make payments under the SCIN arrangement.

CLIENT GOAL #5:

Sell to the next generation and support charitable organizations

"Our children are interested in taking over the family business in the future, but we are not in a financial position to simply give it to them. Any transfer of the business would need to be in the form of a sale. We also have a desire to support the mission of certain charitable organizations."

POTENTIAL STRATEGY: A "charitable bailout" is a term used to describe the concept of transferring ownership in a business (typically to family members or key employees) by gifting all or a portion of the business to a charitable organization (or charitable remainder trust), followed by the sale of the business interest to the next generation. While there are numerous versions of this concept, they all have the same basic features – a transfer of a business interest, a charitable contribution, avoidance or deferral of capital gains taxes, a substantial income tax deduction, and removal of the business interest from the estate.

Here is how a charitable bailout strategy may work: The owner/parent gifts shares in the family business to a charitable remainder unitrust (CRUT). For their contribution, they receive 1) an income stream from the CRUT for the remainder of their life, and 2) an immediate income tax deduction for a portion of the gift. The CRUT then may sell the stock to their children. In order to achieve the desired tax advantages, there cannot be a formal, written, binding agreement to purchase the stock prior to the gift to the CRUT.[1] The payment from the children would be in the form of installments paid out over a period of years.

Since the CRUT is a tax-exempt entity, the trust itself will not pay taxes upon the sale of the stock. Based on the four-tiered accounting rules for distributions from CRUTs, the parent will be able to spread out any taxes triggered by the sale over a long period of time. The children will then own the stock and may use business profits to make their installment payment obligations.

When the parent passes away, the CRUT payments will end and the charity designated receives the remainder of the trust principal.

There are numerous tax laws that apply to gifts to charitable organizations and/or charitable trusts. For example, in general a charitable remainder trust may not own an S corporation. Therefore, the charitable bailout strategy is not available to owners of S corporations.

One other consideration is that the children's inheritance will be reduced by the amount of wealth transferred to charity. To replace that wealth for the children, a life insurance policy could be purchased by the parent for the parent's life.

[1] PLR 200230004 provides favorable guidance regarding the binding agreement to sell rule and self-dealing issues with sales to family members.

CLIENT GOAL #6:

Continue the legacy of the family business

"Our family business has provided our family with financial security and opportunities for generations, has provided employment opportunities for people in our community, and has supported local charitable organizations. Our primary goal is to see the business continue having a positive impact on future generations and our local community."

POTENTIAL STRATEGY: The long-term success of a family-owned business requires planning in a number of areas. One crucial tool is the buy-sell agreement. Families are particularly prone to dismiss the need to formalize restrictions for transferring ownership, assuming the family will work those issues out as they arise. But the emotional elements of family-owned businesses make it even more important to document ahead of time how to handle changes in ownership. A properly designed buy-sell agreement should establish what triggering events require action on the part of the owners, how to value the business, the terms of any sale, how a sale will be funded via life insurance, etc.

One strategy that may help to achieve the business owners' goals is the partnership/LLC buy-sell agreement.

In general, the strategy works as follows:

- If a business is an S or C corp, establish separate partnership or LLC. Business owners are also the partners/members of the newly established entity.
- Attorney drafts the buy-sell agreement (cross-purchase or wait-and-see).
- Business bonuses funds to owners who then contribute those funds to the partnership/LLC (increasing their basis).
- Partnership/LLC acquires a life insurance policy on each owner. The partnership/LLC is the beneficiary of each policy.
- Upon retirement of an owner, the policy is transferred to the owner and may be used to provide supplemental retirement income. (The transfer is not taxable under IRC §731). The retiring member's partnership interest is terminated.
- Upon death of an owner, the partnership/LLC receives the death benefit tax-free. A special allocation is used to allow distributions to the surviving owners. The surviving owners either purchase the deceased partner's business interest from the estate, or contribute the funds to the business which redeems the interest.

The advantage of the partnership/LLC buy-sell agreement include:

- One policy per owner.
- Policies are not owned by the business, therefore not exposed to business creditors.
- Avoids transfer-for-value issues under IRC Sec. 101(a)(2)(B). Transfers to a partner of the insured or to a partnership in which the insured is a partner are exceptions to the rule.
- The partnership/LLC may provide funding for buy-sell agreements of multiple business entities.
- Owners who retire from the business have access to policy cash values from their policy, not a policy on the life of another owner (as in a typical cross-purchase agreement).

A few considerations to keep in mind regarding a partnership/LLC buy-sell agreement:

- It is a more complex arrangement.
- Additional fees to legal/tax professionals will be required to establish the agreement.
- The partnership/LLC must have a legitimate business purpose to be treated as a partnership by the IRS and by state law.

Additional planning considerations:

- As business owners plan to transition the family business to the next generation, they should keep in mind existing key employees who are not family members. These key employees may have unique experience, knowledge, and skill sets that will be critical during the transition period. Key employee compensation plans – such as life insurance bonus plans, split-dollar, nonqualified deferred compensation, and business continuation bonus plans – may provide the necessary incentive for these employees to continue performing at a high level for the business during and after a transition.
- And finally, as ownership interest changes hands, buy-sell agreements should be reviewed and amended as needed. This may be a good time for the family to work with their professional legal and tax advisors to determine if existing agreements contain the appropriate triggering events, business valuation terms, and other restrictions regarding the transfer of business interests. This is also a good time to review life insurance policies purchased to fund buy-sell obligations.

TO LEARN MORE, contact the Advanced Strategies and Planning Platforms Team at
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