By Robert M. Barnes

3 options for family-owned business continuity plans

Out of roughly 20 million family businesses in the U.S., 30 percent make it to the next generation, 12 percent make it to the third generation, and only 3 percent make it beyond that. Experts cite three primary reasons for these low percentages: family conflict, estate taxes, and failure to design a proper succession or continuity plan. A well thought-out written plan that provides for liquidity when needed can dramatically shift the odds in favor of multi-generational survival.

It's not easy to get business owners to adjust their focus from running their business to planning for its future. Advisors can help them by asking questions to identify their desires and the best course of action.

Business owners have three options for what happens when they leave the business. They can sell, gift, or liquidate the business. Let's examine these three options.

Sell

Your clients will want to get fair value for selling their business. They will also need to be clear about their own role in the transition and/or financing of the sale, and whether they want to provide for children or key employees. Ask the following questions.

1. How will you determine a fair market value?

- What does your accountant say?
- What have similar businesses sold for in the past?
- Should you hire a professional valuation firm?

2. How will you find a buyer?

- Would a competitor be interested?
- Should you hire an investment banker to match you with a buyer?
- Will networking or trade associations lead you to a buyer?

3. How involved will you be in the transition of your business?

- Are you willing to stay on for a while after you are no longer the boss?

- What type of economic environment will you and your former employees be in?
- What happens if there is conflict during the transition?

4. How can your buyer retain key employees or your children who work in the business?

- How can you retain key people to stay during and after the transition?
- Is it possible a key employee or child could purchase your company?

5. Do you want to play any role in the financing of the sale?

- Should you finance the sale, even if you sell to one of your children?
- What happens if the business takes a dip and the buyer has trouble making payments?
- What happens if your buyer drives the business under?

Gift

If your clients intend to gift the business, they should share the plan with all of their children, as well as with key employees. Gifting business assets to non-employee children can create conflict among siblings. It may even cause a permanent divide. The advisor should suggest a family meeting to discuss the transition. True, family business transition meetings can be a challenge. As uncomfortable as they can be, it is worse for family members to confront the plan after the transition starts.

Clients should also make sure that their business plan aligns with their estate plan and provides the liquidity they need. If the business continuity plan will be addressed via gifting, you must make sure it is in sync with the estate plan. This situation calls for different questions from when clients sell a business.

1. Do your children have the ability to run your company?

- If not, how will you groom them?
- What are their strengths and weaknesses, and is there outside training that can help?
- Do you have a management team that can help?
- How can the business retain key people during the transition?
- How will you provide for children who don't work in the business?

2. Do you intend to gift the business after your passing or during your lifetime? If during your lifetime:

- Will you maintain control?
- Will you have enough income and liquidity during the rest of your life?

Liquidate

Not every business can continue indefinitely. This is especially true for service businesses.

To decide whether to liquidate, start by asking:

- What is unique about the business?
- If the business were to close, where would the customers go?
- Does anyone in the family have the ability and willingness to take over?
- Do any employees have the ability and willingness to take over?
- Would a competitor consider buying it for more than liquidation value?

Many business owners believe that their business will be worth a lot when they retire. But that isn't always true. If it's not an easily transferrable business, it's especially important that the owner save for retirement.

Role of insurance in the plan

No matter which of the three solutions the owner pursues, it is important for continuity that the business owner (and perhaps key employees) be properly protected with insurance in the event of the death or disability of the active owner.

Some continuity plans will fail without proper protection. If an owner is selling the business and staying on for a transition, the coverage could be important during those crucial transition months or years. If the owner is gifting it to family members at death, insurance coverage could help equalize the estate or pay estate taxes. For the business that plans to liquidate, it will be vital for that owner to protect the family as long as the business is operating, much like a recipient of a regular paycheck would do. For this business, income will likely diminish or disappear in the event of a death or disability.

Not every business can continue indefinitely. This is especially true for service businesses.

It is important to discuss whether coverage should be owned by the company or the owner individually. Sometimes it makes sense to have some of both. If you decide to have life insurance owned by the business, make sure you comply with the employer-owned life insurance (EOLI) laws to keep the death benefit income tax free – and contact your insurance consultant for information on EOLI laws.

Robert M. Barnes, CLU, ChFC, CWPP™, is president of Integrated Insurance Consulting, LLC, a NAPFA Resource Partner. Rob works closely with advisors and their clients and specializes in the use of insurance for business and estate planning. Contact him at (708) 307-2577 or rob@intinsconsulting.com.

Key Questions™- Business Continuity Planning

Counseling Clients from Business to Retirement

Business Owner Questions

1. Do you have an exit strategy?
2. Would you advise your family to invest in your business if you were not here to run it?
3. What is your vision for your business? Your Family?
4. Have you decided what you will do with your business?
    a. Liquidate
    b. Sell
    c. Gift to family
    d. Combination of above

Retirement Planning Questions

1. When you retire, what will you say when someone asks, "So what do you do?"
2. What are you going to do when you retire? What will that cost?
3. Where will your retirement income come from?
4. Do you want to guarantee any of your retirement income?

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Business Succession Checklist

Could Your Business Benefit? To see if your business could benefit from business success planning, jot down the answers to these 10 questions

	Is it time to look at your business plan?	Y or N	Thoughts to consider
1	Do you have a business continuation plan?	☐	You control your business now. Why let fate (the IRS or government) take over at death?
2	Is your plan current?	☐	Periodic reviews help assure that the proper business value is maintained, and applicable tax rules are met.
3	Do you know the value of your business from an IRS Standpoint?	☐	You can establish the value in many cases. If you don't the IRS often pursues high values to generate more taxes.
4	Are your business associates and family members aware of your business continuation plans?	☐	If not, serious conflicts could develop in the future. Besides, an acceptable plan can reassure all parties.
5	Is your business interest the lion's share of your estate?	☐	A large business interest can interfere with your overall estate planning objectives. It should be fully integrated into your plan to work effectively.
6	Does business success hinge upon the work of one, or a few, key employees?	☐	Key executive life insurance protection can help you find a qualified replacement employee if a key employee dies.
7	Do you expect your business to give you retirement income?	☐	There are several approaches you can take, ranging from the sale of your business interest to a formal retirement plan.
8	Are you planning to transfer your business to a family member?	☐	Does this person inherit the business while everyone else pays the tax? Is it better to sell the interest to the family member instead?
9	Do you have a minority interest in your business?	☐	Minority interests may have surprisingly little value due to lack of control in the decision-making process.
10	Are you interested in reducing your business interest during your lifetime?	☐	Lifetime gifts and/or business restructuring can be great ways to remove business assets from your estate without losing control.

If you answered "no" to any of the first four questions or "yes" to any of the other six, business planning may just be what you need to make the most of your hard work, even after your death.

Your financial advisor, attorney and accountant can help you structure a plan to help minimize taxes. More importantly, you will determine who will ultimately control your business. You'll decide who gets what, and when.

Business success planning may help you answer important questions you haven't yet considered. Work with your professional advisors to come up with a plan that will do just what you want tomorrow – and give you peace of mind today.

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Source: Lincoln National, Should you have a business succession Plan? Form #LFD0608-1818, 10/06

BALANCE CHECK

Defining Points®

Directions

If your answer is "yes" to any question below, enter the number to the left of the question in the space provided on the right.

Defining Point #1: Unexpected Departure of an Owner

5	Do I have a written buy-sell plan for my business in the event something unexpected happens to me or other co-owners?	
4	In the last three years, has the buy-sell plan been reviewed by specialized business advisors?	
4	Has the business been valued by a certified appraiser in the last three years?	
4	Are there enough funds or financial resources to carry out the terms of the buy-sell plan?	
4	Are there safeguards in place to protect my interest during the transfer of the business?	
	TOTAL #1:	

Defining Point #2: Loss of a Key Person

5	Do I have key employees who are capable of managing the business in my absence?	
4	Do I have performance-based incentive plans for retaining my key employees?	
3	Have the incentive plans been recently reviewed to determine if they are competitive?	
3	Do I have strategies in place that protect my business in the event a key employee leaves?	
5	Have provisions been made to offset the loss to the business caused by my death or disability or that of other key employees?	
	TOTAL #2:	

Defining Point #3: Retirement of an Owner

5	Do I have a business succession plan in place?	
5	Do I have successors or key managers in place who are capable of running the business?	
5	Have I determined my retirement income goal, and do I know how many dollars it will take to achieve this goal?	
5	Will less than one-half of my retirement income be dependent on the business?	
3	Have I started to create retirement assets from sources not dependent on the business?	
3	Do I review my financial goals with my financial advisor(s) at least annually?	
	TOTAL #3:	

CONTINUED

Please note: Important disclosures on reverse side of flyer.

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Defining Point #4: Not Doing Long-Term Planning

5	Do I have a team of specialized business advisors?	
4	Have I involved my family, advisors, and key employees in my plans for the business?	
4	Do I regularly meet with my advisors so they understand my business activities and coordinate them with my personal goals?	
4	Do I discuss business financial results, marketing plans, and operations with my family and key employees?	
5	Do I have strategies in place for growing and protecting the value of my business?	
	TOTAL #4:	

Defining Point #5: Death of an Owner

5	Have my estate plans been reviewed in the last three years by legal advisors who are specialized in estate and business planning?	
5	Do I know if my business plans provide for the same distribution provided by my estate documents?	
5	Do I have strategies in place that provide for the equitable (not necessarily equal) distribution of my assets to all my family members while giving business control to my selected individual(s)?	
4	Do I know if the estate strategies in place minimize tax consequences?	
5	Will there be enough cash to pay my debt and tax obligations and provide my family sufficient income without affecting the financial health of the business?	
	TOTAL #5:	

Score	Status
98 – 113	Your preparation is well underway.
80 – 98	You have a good start.
Below 80	We suggest you call your advisors today.

Add Your Totals

TOTAL #1	
TOTAL #2	
TOTAL #3	
TOTAL #4	
TOTAL #5	
SCORE	

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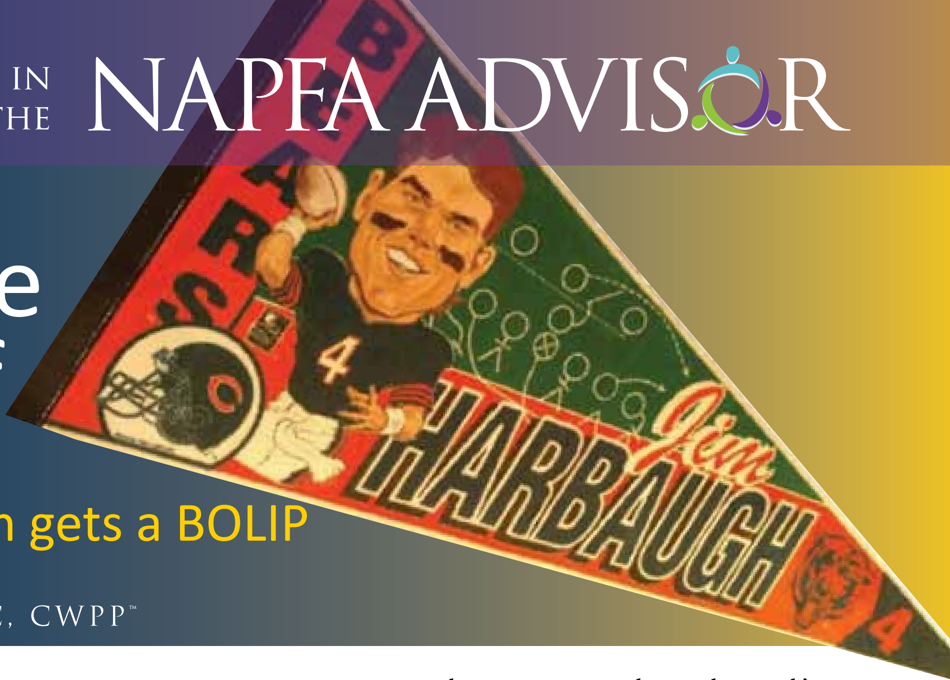

Using insurance to reward staff

University of Michigan Head Coach Jim Harbaugh gets a BOLIP

By Robert M. Barnes, CLU, ChFC, CWPP™

I am a HUGE Chicago Bears football fan. A sign in one of my stairways says, "We interrupt this marriage to bring you football season." In fact, the picture at the start of this article is of a pennant I still have today. I discovered an intriguing article about former Bears player Jim Harbaugh's life insurance. Jim is now the head coach for the University of Michigan. The school is clearly a fan, too, because it made an interesting move with insurance to reward and retain its star head coach.

"Jim Harbaugh's pay now up to $7 million with UM paying insurance premiums" was the title of the article in Crain's Detroit Business. As I read the story, I realized the university used a split-dollar technique called collateral assignment. Essentially, the university is lending Harbaugh money to purchase a Big Ole Life Insurance Policy (BOLIP). This is a strategy that businesses use to reward and retain their key people.

Lending money to buy life insurance

I decided to show Harbaugh's arrangement with a life insurance ledger so you can understand how it works, and how both sides benefit. An employer and employee might want to implement something similar – perhaps with fewer zeroes on the end of the check. I cannot guarantee that the analysis I did is correct because I have not been involved in Harbaugh's contract or planning any way. However, I believe it to be a pretty close approximation, assuming I am correct that either indexed universal life or blended whole life insurance is used.

It appears that the university will lend Harbaugh $2 million a year for seven years. When you use seven-pay testing with the intent to avoid a modified endowment contract (MEC) you will acquire a death benefit valued at about $35 million. The university will get its money back – without interest – either at the coach's death or at rollout at age 70. At that time, the school will withdraw the $14 million from the policy, while Harbaugh keeps the policy and remaining cash value. Harbaugh will be the owner of the policy and can name his beneficiary. The school will have a collateral assignment on the policy, which will restrict his use of the cash value and ability to surrender the policy without first paying back the university.

Variations are possible when an employer is not comfortable with this type of decision because it gives too much control to the employee. In those cases, you tend to see endorsement split dollar plans. With an endorsement split dollar plan, the company owns the policy and "endorses" some of the death benefit to the executive's desired heirs. In this situation, the company retains full control of the policy. You will often see

Continued on next page

Age	University of Michigan			Coach Harbaugh		
	Annual Premium	Net Cash Value	Death Benefit	Income Tax Due	Net Cash Value	Death Benefit
52	$ 2,000,000	$ 619,000	$ 2,000,000	$ 13,650	$ -	$ 33,000,000
60	$ -	$ 14,000,000	$ 14,000,000	$ 95,550	$ 771,000	$ 21,000,000
65	$ -	$ 14,000,000	$ 14,000,000	$ 95,550	$ 5,899,000	$ 22,862,000
70	$ (14,000,000)	$ -	$ -	$ -	$ 11,454,000	$ 26,342,000
75	$ -	$ -	$ -	$ -	$ 14,624,000	$ 26,342,000
80	$ -	$ -	$ -	$ -	$ 18,510,000	$ 26,342,000
85	$ -	$ -	$ -	$ -	$ 23,611,000	$ 28,805,000
90	$ -	$ -	$ -	$ -	$ 29,945,000	$ 34,737,000
95	$ -	$ -	$ -	$ -	$ 37,634,000	$ 41,774,000
100	$ -	$ -	$ -	$ -	$ 47,405,000	$ 51,671,000

Continued from previous page

this enhanced with a salary continuation agreement at retirement. The participants use the policy cash value as a syncing fund and the death benefit for ultimate reimbursement of their costs.

The dollar values

Coach Harbaugh is expected to pay $1.4 million in income taxes on what's essentially a tax-free loan over 18 years. Looking out 18 years (when Harbaugh will be 70), he will have a cash value over $11 million and a death benefit above $26 million if the policy performs as projected. Harbaugh has an equivalent investment yield over 20 percent because he spent $1.4 million and has over $11 million.

Why would the University of Michigan do this?

The quick answer is likely both to retain and reward the coach after a successful first year that convinced the school to enhance Harbaugh's compensation package. The university is essentially giving him an interest-free loan. If you consider that it's using money normally allocated to cash or bonds, it is not sacrificing a tremendous amount of interest or opportunity cost. Life insurance is often used for certain non-qualified executive benefits because of tax benefits and cost recovery.

Think about it this way: If the school gave Harbaugh $2 million more in salary, it would be able to deduct the additional salary, but would never get the money back. The approach we're discussing ensures Michigan will get $14 million back if Harbaugh completes the seven-year tenure (early if he dies, or at rollout). If the coach quits, he must pay back the cumulative debt balance, and the collateral assignment protects the school. In the meantime, the coach wants to stay and continue to win so the university will continue to pay his premiums. Thus, the arrangement helps with both retention and reward.

Why would Coach Harbaugh do this?

I think the better question is: Why wouldn't Harbaugh do it? True, there are costs to him. He will pick up the imputed income (essentially the forgone loan interest from the university) as taxable income. He needs to pay the tax on this amount each year. Based on our numbers, he is likely to pay a little over $1.4 million in taxes over the next 18 years.

What does Harbaugh get for this cost? He will have a death benefit for his family that would fluctuate through the years from as low as $21 million to a starting high of $33 million. After the university recoups its money, Harbaugh will retain a policy with a death benefit in excess of $26 million and cash value over $11 million. The coach will have an equivalent investment yield of over 20 percent if the policy performs as projected. If the policy underperforms, he will likely still be in a cushy situation, with an extremely attractive return and minimal risk to him.

What do the attorneys and accountants think about the situation?

I spoke with a few attorneys and accountants with expertise in this area. They agree this is a fairly basic collateral assignment form of split dollar. A few expressed concern about how it was used in this case with a non-profit institution, observing that it could be in violation of 457(f) rules regarding separation from service. There is very little concern if your client used this in a true for-profit business for which section 409A regulations would be in play.

What can we learn from this arrangement?

Is this a unique situation for a high-priced coach, or is this relevant for a wide range of business owners to retain key talent? How would they feel about the idea of offering a benefit that can return every dollar they spend on their key people? Wouldn't your clients' key employees – or your clients who are key employees – want to know about this type of benefit?

I think there can be great value in a key-employee situation when the employer helps the employee prepare for a smoother retirement. Imagine retiring and taking a $1 million life insurance policy with a long-term care rider with you. What would that do to the employee's retirement safety and flexibility? As an advisor, you can bring this concept up with your business owners and/or the key employees you serve.

Seek an experienced life insurance agent

Plans like this are not used enough, in my opinion. They are especially useful for employers who want to take care of their most important and productive employees. They can help employees who are reverse-selected against with qualified and ERISA benefit plans. Arrangements like this can be layered on top to alleviate the discrimination. Employees, of course, want to be rewarded for their loyalty and hard work.

Unfortunately, an advanced life insurance agent capable of implementing a plan like this is harder and harder to come by. In the next 10 years, we will be losing some of the best life insurance agents in the business to retirement. Younger advisers do not seem to be following the path of an advanced life underwriter.

Split dollar and other non-qualified arrangements are sometimes very complex situations. It's important to have the right team on your side when you are beyond a simple family term insurance situation.

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