Business Succession Planning Case Study

Simple and Easy Life Insurance to the Rescue

A man in his sixties was the sole shareholder of a closely held business. The man died suddenly and the company's shares were divided among the man's children, all of whom were in their twenties and only one of whom (Child A) was active in the business. The company's management positions were filled by individuals in their mid to late fifties (the management), who were worried about the future of the company, not to mention their employment status, should something happen to Child A.

Management and Child A identified three main concerns in the event something were to happen to Child A and he could no longer participate in the affairs of the company. The first concern was that there would be no one to run the company if Child A were to die or become disabled. The second concern dealt with management's ability to find employment if the company were to fail because of Child A's death or disability. Since all managers were over fifty years old they were particularly worried about having to start new careers. Lastly, Child A was concerned that his estate may not have enough liquidity to pay estate and inheritance taxes should he die prematurely.

To resolve these issues and provide an amicable solution to this situation, Child A and the managers formed a general partnership for the purpose of owning a life insurance policy on the life of Child A. The corporation paid the premiums on the policy, which were treated as compensation to the managers on their W-2s and as contributions by the managers to the partnership as general partners. Because of Child A's relative youth, the partnership purchased a whole life policy on Child A's life. The premium was spread among the five managers; therefore their taxable income was not significantly increased. Further, the corporation grossed up each manager's compensation so that each manager's take home pay was not affected.

The partners of the partnership also executed a buy-sell agreement that provided for the purchase of the corporation's stock from Child A's estate in the event of his death. Because the corporation was an "S Corporation" for federal tax purposes, the partnership could not directly purchase the corporation's stock without affecting the corporation's S Corporation status. The partnership's buy-sell provisions therefore provided that, upon the partnership's receipt of the life insurance proceeds, the partnership would distribute the proceeds to the partners to facilitate their individual purchases of the company's stock from Child A's estate.

Child A's interest in the partnership was a one percent general partnership interest. This arrangement was advantageous because it avoided a potential federal income tax problem (known to many as the "transfer for value" problem) associated with the transfer of a life insurance policy. In addition, the partnership buy-sell agreement was also written in a manner

that added flexibility in determining who would ultimately hold the corporation's stock. This was accomplished by adding a provision to the partnership agreement that stated that any partner's interest (except Child A's) in the partnership would terminate in the event of that partner's death, disability, or termination from employment with the corporation.

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