Top 4 Ways Life Insurance Is Used for Business Planning

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Business owners can use life insurance to protect their businesses and provide important benefits to their employees. Without proper planning and funding, many businesses fail to continue to the next generation.

Here are 4 ways life insurance is used in business planning:

1. Key Person Insurance

Business owners are often concerned about protecting the business from the death of a key employee whose knowledge and contributions to the company are invaluable. The loss of a key employee may result in not only a loss in sales, but also a potential loss of brand value, important contacts and goodwill. The company's credit position may also be at risk.

The business owner can protect the business from the loss of a key person by implementing a Key-Person insurance plan (also referred to as Key-Man) in which the company purchases and owns a life insurance policy on the life of a key employee. By implementing such a plan, the insurance advisor:

- can illustrate how a life policy offers liquidity to keep the business running during a transition in the event of a key person's premature death or disability;
- provides cash needed to hire a qualified replacement and/or to purchase the additional human capital or assets necessary to keep the business operating;
- helps to replace lost profits.

2. Business Succession Planning

The owners of a successful business, including a closely-held family business, should plan for the transfer of the business to the next generation. Different types of Buy-Sell plans can go a long way in transferring business interests to surviving business owners in the event of the death of one of them. However, having a Buy-Sell arrangement is only 50% of the task. Funding the Buy-Sell is the other part of the planning. Without the funding, the arrangements themselves may be compromised. Further, it is best to establish the Buy-Sell arrangement when a formal valuation of the business value is completed.

Generally, there are 2 main types of Buy-Sell arrangements:

- **Cross Purchase Buy-Sell**
- **Entity Purchase Buy-Sell, or a Stock Redemption Agreement**

Cross Purchase arrangements refer to each business owner having a policy on the life of each of the other business owners based on each business owner's share of the business. Typically, the arrangement will look to buy-out whoever is due to inherit the business interest of that deceased owner, often the surviving spouse or family member. Because this arrangement can be very cumbersome when there are more than 2 owners, an Entity Purchase agreement is often considered as an alternative when there are more than 2 owners.

Entity Purchase arrangements refer to the entity or business owning each policy, with the life insurance proceeds being paid into the business, at which point the business facilitates the buy-out of the interests or shares with the surviving family members who inherited them. Often, these Entity Purchase agreements are set up as stock redemptions.

There are various other ways to set up a buy-sell arrangement, including a One-Way Buy-Sell or a Cross Endorsement Buy-Sell:

- **One-Way Buy-Sell** is exactly what it sounds like: only one of the two parties purchases life insurance on the other's life. Typically, this is the case between an older and a younger employee, like a father and a son, because the younger one is designated as the successor.
- **Cross Endorsement Buy Sell** is helpful when the business owner wants to own the policy on his life and prefers to endorse over to the surviving business owner a portion of the death benefit to facilitate the buy-out. This type of Buy-Sell is appealing but does come with some tax issues relative to transfer-for-value rules that the client's attorney will need to assess.

Business Succession for Families can be a bit more complex and may require consideration of how to equalize inheritance among heirs not involved in the business. To this end, arrangements for family business transfers may include the use of *succession trusts* such as:

- **Sale to a Defective Trust, or Sale of Asset to Grantor Trust (IDGIT/DIGT/SAGT)**
- **Grantor Retained Annuity Trust (GRAT)**
- **Irrevocable Life Insurance Trust (ILIT)**

Sale to Defective Trust, or transfer of the business to a grantor trust (IGIT/DIGT/SAGT), a **GRAT,** or an **ILIT** allows the business to transfer over time through the use of an installment note, annuity payment, or a one-time liquidity event, to the designated successor, respectively. Life insurance can fund these types of 'succession' trusts to provide the liquidity needed to pay income and transfer taxes, to equalize an inheritance, and/or to provide the repayment of the note connected to the sale or transfer.

3. Executive Benefit Plans

Executive Benefit plans are used by employers to attract, retain and reward key employees of the business. There are two main types of plans in this category:

- **Executive Bonus Plan**
- **Restricted Bonus Arrangement (REBA)**

Executive Bonus Plan, refers to an employer paying a bonus to the executive in an amount equal to the annual premium on a life insurance policy that is owned by the executive and is on his or her life. The executive, as the owner of the policy, has the right to name the beneficiaries of the policy and to enjoy the potential accumulation of cash values on the policy, if any. This can serve as a valuable non-qualified benefit to the executive because it provides income protection for survivors, as well as access to tax-favored cash values for the executive to use toward supplementing and diversifying his or her income from other sources at retirement. In addition, the policy can include a rider to cover longer term care expenses on a tax advantaged basis. In this way, the cash value life insurance policy provides the flexibility to cover various needs over lifetime without committing the policy today to any one need.

When an employer imposes a vesting schedule on the bonuses to create a 'golden handcuff', or an incentive to remain with the company, the Executive Bonus Plan becomes a **Restricted Bonus Plan or REBA**. The restrictions can be minimal or extensive. The more extensive the restrictions are the more complex and the more administrative it may become. Although the executive owns the policy subject to the restrictions, the restrictions are typically in the form of restricted access to the policy's potential cash values.

4. Deferred Compensation Plans and Supplemental Executive Retirement Plans (SERP)

Executives, like all employees, are limited in the amount they can contribute to a qualified plan, like a 401(k) or 403(b) plan, annually. A non-qualified plan like a deferred compensation plan– also referred to as a salary deferral plan or 401(k) mirror plan– may help executives to save more for retirement. Although the contributions to the plan cannot be made on a pre-tax basis like contributions to a 401(k), the contributions grow on a tax-deferred basis like a 401(k). And unlike a

401(k) plan, the amount that can be contributed to a salary deferral plan is unlimited. A Salary Deferral Plan can mirror a 401(k) plan in that the executive makes contributions to the plan while the employer may match those non-qualified contributions.

A Supplemental Executive Retirement Plan (SERP) is another type of non-qualified plan that an employer can sponsor. However, in this type of plan the employer makes all the contributions on behalf of the executive. When the employer makes the contributions to the plan, they are non-deductible. However, when the benefits are paid out, the employer gets the tax deduction at that point and the employee pays taxes as he or she receives the benefit.

Both of these types of non-qualified plans allow executives to save more for retirement on a tax-deferred basis to supplement other employer-sponsored plans, if any. These types of plans generally have vesting schedules on the employer matches that serve as incentive for executives to remain with the company.