

## **FINANCIAL PLANNING CONSIDERATIONS FOR BUSINESS OWNERS**

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Ownership of a corporation can provide a shareholder with many financial opportunities both business oriented and personally. The business owner who uses these opportunities carefully, avoiding possible pitfalls, will reap the rewards of financial planning. There are four general considerations to be addressed when implementing a financial plan. They are: life insurance, charitable gifts, buy-sell agreements, and the rules regarding transactions between the shareholder and the corporation such as leasing and loans.

### **LIFE INSURANCE**

The essential function of life insurance is to provide for a surviving spouse and children in the event of an untimely death. Because the business owner's estate will most likely consist of relatively illiquid closely held stock, life insurance becomes important as a source of easily obtainable cash, which the estate can use to pay taxes and expenses.

In order for the life insurance proceeds to be included in the business owner's estate the policy must be payable to or for the benefit of the estate or the business owner must die possessing "incidents of ownership" in the policy. An incident of ownership is the policy owner's retention of an economic benefit which includes the powers to change the beneficiary, surrender or cancel the policy, assign the policy, pledge the policy for a loan or borrow against the policy's cash value.

However, depending on the size of the business owner's estate, the policy proceeds may need to be kept out of the estate for estate tax avoidance. In order to accomplish this, the above incidents of ownership must be avoided either by assigning away all incident of ownership to the beneficiary or establishing a trust for the beneficiary's benefit. When an existing policy is transferred, there is a three-year waiting period before the policy proceeds would not be pulled back into the business owner's estate. Therefore, if the goal is to avoid having the policy considered a part of the owner's estate this three-year transfer rule must always be considered.

To the extent that a policy which is owned by the corporation is payable to a beneficiary other than the corporation, the incidents of ownership held by the firm will be attributed to its controlling (more than 50 percent) shareholder. Therefore, any proceeds which are payable to a beneficiary other than the corporation will be included in the controlling shareholder's estate. Given this, the majority shareholder in a corporation should pay careful attention to life insurance policies owned by the corporation and the effect they may have on the shareholder's financial and estate planning.

### **CHARITABLE GIFTS**

The owners of closely held corporations are significant contributors to charity and

will often accomplish this through a direct corporate gift. The direct corporate gift is advantageous because the contribution is made with pretax earnings, which is not the case if the corporation first distributes the earnings to the shareholders, who then makes a donation to charity. Although the shareholder has a charitable contribution deduction to offset the additional income, the corporation cannot claim a deduction for the distribution which is presumably a dividend. This results in the contribution being made with after-tax earnings.

When a corporation makes a charitable contribution, there is always the potential that the Internal Revenue Service will assess a constructive dividend. A constructive dividend will occur where the corporation's contribution provides a shareholder with an economic benefit. The shareholder receives a benefit if the corporation assumes any pledge for which the shareholder is personally or legally obligated, and the corporation relieves the owner of that obligation by making a contribution on the owner's behalf. Therefore, as long as the shareholder is under no legal obligation to make the contribution there is little possibility that a constructive dividend will be assessed.

## BUY-SELL AGREEMENTS

Properly drafted a Buy-Sell Agreement serves as a sound business and estate planning tool. A Buy-Sell Agreement is simply a contract between the individual shareholders (known as a cross purchase agreement) or between the shareholders and their closely held corporation (known as a stock redemption agreement) which imposes a restriction on the individual shareholder's right to dispose of the closely held stock during the shareholder's lifetime. At the same time, the agreement also provides a framework for the sale and purchase of a shareholder's interest in the corporation after death. Generally, the agreement sets forth that either the shareholders or the corporation is obligated to purchase the deceased shareholder's stock from the estate, which is under a similarly binding obligation to sell the stock.

Most buy-sell agreements are funded through the purchase of life insurance on the lives of the individual shareholders which is reduced to cash upon their death. Because of this, it is essential to make a threshold inquiry into the insurability of all concerned before making any decision on the form of the agreement to be used. The uninsurability of a key party may effectively preclude the use of a buy sell arrangement.

The key advantages to using a buy sell agreement include that the price specified in the agreement places a value on the corporate stock which is essential in planning the shareholder's estate, a purchaser is designated in the agreement for what is probably an unmarketable stock, the remaining shareholders are protected by giving them the right to prevent stock from falling into the hands of outsiders, and a continuity of ownership and management is provided by keeping the stock in the hands of those who are active and interested in the business and removing it from those who are not.

## SHAREHOLDER TRANSACTIONS

The leasing of business property to the corporation is one effective way for a shareholder to take cash out of the company at minimum tax cost. The corporation's rental payments provide a steady stream of income for the shareholder. As the lease from the corporation is an asset, the shareholder should be able to pledge the leasehold as collateral for a loan. The corporation also benefits as it gets to deduct the fair and reasonable rent it pays to the shareholder for the use of the building or business equipment. Any excessive rent collected by an owner of the corporation will not be deductible to the corporation. Excessive rental may be defined as the shareholder's receipt of anything over the freely bargained reasonable rental value by unrelated parties.

Another effective and simple way for the corporate owner to take cash out of the corporation is by borrowing. Because the shareholder is not taxed on the receipt of borrowed funds, he or she is economically better off than if an equal amount had been withdrawn as compensation or a dividend.

As such loans are carefully examined by the IRS, and could possibly be recharacterized as a dividend distribution, it is essential that at the time the loan is made it is clear that it will be repaid. Therefore, there should be a legally enforceable promissory note evidencing the debt. The strongest evidence of a real obligation to repay is a secured note with a fixed maturity date. Also, every effort should be made to meet the payment schedule set out in the note as a pattern of haphazard repayments will hurt.

Look for our article entitled "Estate Planning Considerations for Business Owners" which will pick up where financial planning left off.