Succession and Exit Planning Using Life Insurance

May 2013
1 Hour CE
MKTG-OC-841B

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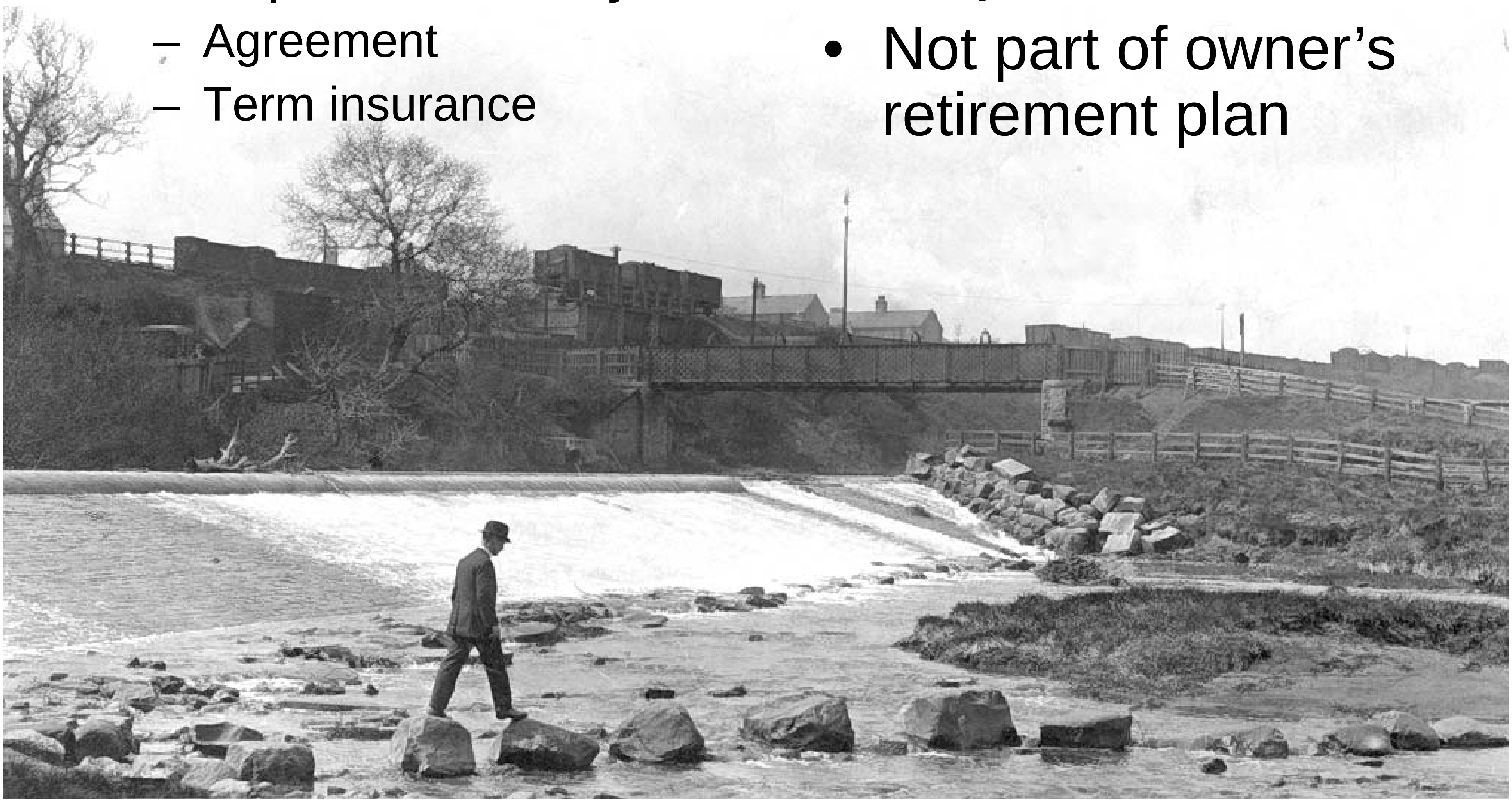
Agenda

- Role of business succession planning in overall business strategy
- Impact life insurance has on a business
- Case studies

Business Succession Planning – *The Old Way of Thinking*

- Two parts of a buy-sell
  - Agreement
  - Term insurance
- Only a term sale
- Not part of owner's retirement plan



Business Succession Planning – *The New Way of Thinking*

““There is simply no time that’s too early to plan for what will happen to the business…”

-- Karl Weger, Partner, Personal Financial Services, PricewaterhouseCoopers*

* “Succession Planning: Delaying Could Cost You,” Growing Your Business, Volume 64, PricewaterhouseCoopers (2012).

Part of the Overall Business Strategy

Business Succession

- ✓ More of a series of events
- ✓ Not an overnight phenomenon
- ✓ May take 10 – 15 years to complete

Planning Early Allows the Business Owner To:

- Protect against change in insurability
- Identify successor
- Retain key executives
- Accumulate cash for buyout
- Save on costs
- Carry-out overall estate plan

The Buy-Sell Agreement is Only One Part of the Overall Business Strategy:

Business Succession – *Starting Point*

Ask

- What happens to the business? The family? How will he/she retire?
  - Ask the tough questions

Write

- Write down what the business owner wants to accomplish

Talk

- Have the business owner talk with key employees or family members that will be included in the succession plan

Succession Planning is Often Retirement Planning

One-third of business owners plan to use their business as the major source of retirement income*

*Source: Wells Fargo/Gallup Small Business Index, July 2010."

Help a Business Avoid a Sad Ending

- Many businesses do not survive after the death of the owner
- Many family-owned businesses do not make it to the next generation
  - Failing to plan for the future of the business is a primary reason
- Without a proper plan, many businesses will need to be sold for less than fair market value

Life Insurance Death Benefits Can Infuse Business Capital at a Business Owner or Key Person's Death

- Life insurance can fund buy-sell agreements
- Buy-out a family member not interested in the business
- Cash for emergencies so you can avoid selling the business or its assets at an unattractive time

Why Cash Value Life Insurance?

- Policy's cash value may be used for lifetime buyout
- Possible change of insurability
- Flexibility
- Ability to accomplish more than one goal

Case Study #1: Gadget City

Retirement Planning:
Selling the Business to an Insider

Case Study: Gadget City

(Facts)

- Owner named Bernard
  - Age 50
  - Sole source of income for wife and 2 young children
- Business is a S-Corporation
- Bernard is looking to:
  - Find a successor
  - Protection for his family

Case Study: Gadget City (cont.)
(Facts)

- Key executive Frank
- Bernard has targeted Frank as a successor
- Bernard's ultimate goals are to:
  - Sell the business to Frank
    - At Bernard's death, or
    - At Bernard's retirement (age 65)
  - Use the sales proceeds to supplement his retirement income

Case Study: Gadget City (cont.)
(Challenges)

- Frank does not have the cash necessary to buy Gadget City
- Bernard is willing to provide bonuses, but,
  – Wants to make sure the bonuses will be used for the buyout
  – Be sure the life insurance in place for a buyout in the event of Bernard's death

Case Study: Gadget City (cont.)
(Solution)

- Combination of one-way buy-sell and restricted executive bonus (two separate agreements)
- Frank will buy-out Bernard at retirement with installment payments
  - Installment payment will supplement Bernard's retirement
- Frank will use death benefit to buy out Bernard's estate if early death

Case Study: Gadget City (cont.)
(Solution)

- Premiums will be paid via executive bonus
- Controlled executive bonus agreement establishes 15 year vesting schedule
- Frank can use policy cash values to make installment payments.

Gadget City Buyout

- Provide Frank with annual double bonus amount for 15 years

- Purchase cash value life insurance (indexed universal life)

Gadget City Buyout (cont.)

- Death benefit
  - Frank will use to buy-out Bernard's estate
- Tax-free policy distributions of starting at age 65 for 20 years*
  - Frank will use for installment payments

** Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.*

Case Study #2: *Squisito Restaurant*

Estate Planning: Transferring the Family Business

Case Study: *Squisito*
(Facts)

- Andrew (67) is the owner of the restaurant
- His two children (Brian and Cindi) work for the family restaurant
- Andrew's Goals:
  - ultimately pass on the business to both Brian and Cindi
  - Andrew would like to provide for his second wife, Diane, who is considerably younger than him

Case Study: *Squisito*

(Andrew's Concerns)

Leave Restaurant to Diane

- Due to the similarity in age between Diane and Andrew's children, Brian and Cindi may never take ownership of the restaurant
- Diane may disinherit Brian and Cindi
- Diane may feel pressure to "not spend the children's inheritance"

Leave Restaurant to Brian and Cindi

- Estate taxes* due may force them to sell the restaurant
- Diane may not have the income necessary to maintain her lifestyle

** According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).*

Case Study: *Squisito*
(Solution)

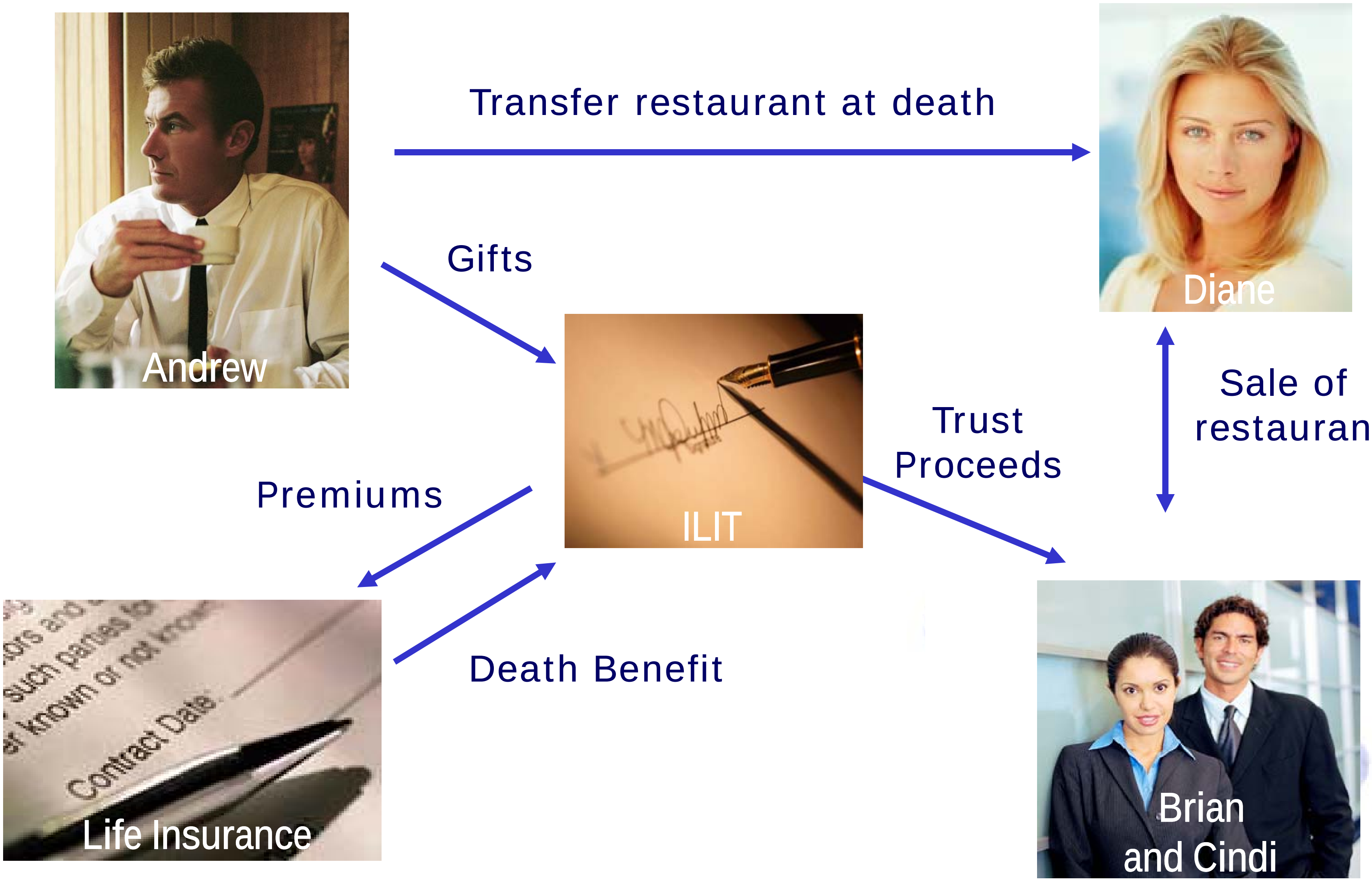
- Family buy-sell agreement
  - Leave restaurant to Diane, but have Brian and Cindi purchase it from her in a cross-purchase agreement
- Purchase life insurance on Andrew to help facilitate the transfer

Case Study: *Squisito*

(Life Insurance Ownership)

- Brian and Cindi could jointly own the policy
  - Andrew concerned about Brian and Cindi's access to the policy's cash surrender value
- Irrevocable Life Insurance Trust (ILIT) could own the policy
  - Universal Life Insurance Product

Case Study: Squisito
(Flowchart)



Case Study: Squisito

(Tax Implications)

- Gifts made using annual exclusions or lifetime exemption amount
- Restaurant passes to Diane free from estate taxes due to unlimited marital deduction*

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Case Study: *Squisito*
(Tax Implications)

- Life insurance death benefit paid to the ILIT income tax-free*
- Due to step-up in basis, Diane may not be required to pay capital gains taxes upon sale to Brian and Cindi

** For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

A Business Owner Can Write a Happy Ending By Including Succession Planning in the Overall Strategy Early On

- Sufficient time to "fine-tune" the plan
- Test potential successors and build their expertise
- Put in place the strategies and incentives to help

Closing Thoughts from One Business Owner

"One thing I would recommend is the best life insurance a business owner can afford. We don't all live to a ripe old age. You need to have money to make sure your heirs can take care of the operation."

--Dorothy Locklear-McNeill, owner, Five Gs Manufacturing

Source: http://www.buzgate.org/8.0/md/ft_splanning.html; March 2013.