MassMutual

Estate Planning Strategies for Business Owners

ESTATE PLANNING FOR BUSINESS OWNERS

A proper estate plan should accomplish the following goals:

Determine who will get what, how they will get it, and when they will get it.

Maximize the amount of wealth and assets your intended beneficiaries will receive.

Help minimize estate taxes and administrative expenses required to settle your estate.

Provide the required liquidity to pay any remaining taxes and expenses.

A proper estate plan can assist you in maintaining control over your wealth by allowing you to pass the maximum inheritance on to your heirs in as tax advantaged manner as possible. However, there is a twist for you. It's the fact that your estate includes a different type of asset—the business—which is likely the largest asset in your estate.

Isn’t my will enough?

Everyone has different goals for their estates, which will necessitate different documents and plans to accomplish those goals. Yet, many business owners say they aren’t concerned about estate planning because either they don’t expect the size of their estates to surpass the current estate tax thresholds or they believe their will is a sufficient estate plan.

For a business owner, an effective estate plan goes beyond wills and trusts or taxes and probate. It’s about helping to ensure the transfer of your wealth, the continuity of your business, and harmony in your family.

There are four specific areas of estate planning that business owners should consider:

- **Estate reduction:** reducing the size of your taxable estate while you are alive.
- **Estate liquidity:** having liquid assets available to pay any estate tax.
- **Estate equalization:** being fair and equitable to your children with the assets that comprise your estate, including the business.
- **Business value:** having the right formulas documented to determine the true value of your business.

Estate Reduction

Business owners may want to consider reducing the size of their estates before they die so that assets can transfer to the next generation as tax efficiently as possible. It's likely the business is your largest asset and may comprise the majority of your estate's value. That's why it may be a sound decision to work with your estate planning attorney to address transfer of ownership once you have identified appropriate successors.

One option may be to transfer ownership shares by utilizing lifetime gifts to children and grandchildren. Each year, you can gift the shares tax-free up to the gift tax exemption limit to help transfer ownership of the business to the next generation and reduce the size of your taxable estate.

A Family Limited Partnership is another strategy to assist families in reducing the size of their estates while at the same time transferring ownership to the next generation. Through the FLP, the senior family members can transfer the value of the ownership stock to their children typically at a discount because they retain decision making control of the business and make the children "limited partners." In addition, depending on the business's entity structure, an FLP may not be necessary to transfer minority interest and obtain discounts.

Other estate reduction strategies may also be available. Consult with your estate and tax attorney to help determine the most appropriate strategy.

Estate Liquidity

Death triggers numerous costs that must be paid from an estate. These costs can include paying for an estate valuation, probate costs, legal and accounting fees, paying off debts, and paying estate tax obligations. If an estate lacks sufficient liquidity to meet these obligations, there are two ways to raise the necessary funds: sell off assets or borrow the money.

Selling business assets should be viewed as a last resort. In addition to losing the asset, it's difficult to find the sale quick or easy. Done in haste to meet obligations currently due, your family, ownership partners, or executor may have to forfeit value for the convenience of a speedy sale. In other words, the cash received in a "forced liquidation" will usually be less than the true value of the business.

It's possible to preserve the business assets and still satisfy the estate's cash obligations by borrowing the funds. However, there are issues with this approach as well: 1) a lender must be found that is willing to make a loan of sufficient size, for an appropriate duration, and at a reasonable interest rate; 2) the estate must remain open until this new debt obligation is satisfied; and 3) another source of liquidity must be found to pay off the loan principal and interest.

Selling business assets or financing estate obligations postpones the problem until after your death—it becomes your heirs' problem. Using life insurance can help bring the cost forward into the present. The life insurance premiums are a current cost, but the death benefit proceeds can help pay the estate's obligations, preserve business assets, and make the administration of the estate easier.

	LIQUIDATE ASSETS	BORROW	LIFE INSURANCE
SOURCE OF FUNDS	Immediate sale of business assets	Loan	Life insurance death benefit
DISPOSITION OF ASSETS	Business assets are gone	Business assets are preserved provided loan obligations can be met with assets outside the business	Business assets are preserved
DIRECT COST	Discounts on asset value due to forced liquidation	Debt service (principal and interest)	Life insurance premiums

Estate Equalization

The statistics on estate planning tell an interesting story. According to the 2018 MassMutual® Business Owner Perspectives Study, estate taxes are not top of mind for many business owners, with 72% "rarely" or "never" thinking about paying them. However, 60% of business owners do think about a fair and equitable distribution of the business as part of their estates.[1]

Here's the concern: Nearly 60% of business owners say they plan to divide ownership in the business equally among all their children regardless of their individual roles in the business.[1] That means children working in the business day in and day out will have to share in the decision making, and profits, of the business with siblings who may have no involvement. That may be equal, but it certainly isn't fair.

Estate equalization is a strategy to help resolve this issue. It involves equalizing the estates of those children working in the business with those who are non-active by using other assets, such as real property, cash, or a life insurance death benefit.

The process of estate equalization involves making some tough decisions. You should ask yourself some key questions as you begin to think about how to best equalize your estate.

1. Do you want the business ownership to be divided equally between children working in the business and children not involved in the business?

In many cases, the answer to that question should be no. Ownership interest should be given to those who are active in the business. Children not involved in the business will typically make decisions that are in their best financial interest as opposed to what's in the best interest of the business. This can create acrimony among the children, and ultimately, the business suffers.

2. If children not involved in the business do not receive ownership, then what other assets can they receive that are equal in value?

This involves taking inventory of your estate. What else, other than the business, is in there? Life insurance can be a useful tool for estate equalization. Making the non-active children the beneficiary of your life insurance policy can help provide an equitable distribution of wealth at your death.

3. Is it a problem that the children working hard in the business are receiving an asset that is illiquid, while those working outside the business are often receiving assets that are liquid?

This is a reality for which there is no easy answer. The hope is that the children working in the business are comfortable with this outcome because working, owning and growing the family business is the most important thing and where they truly want to be.

4. I can begin to transfer ownership interest to the children working in the business while I'm alive, but will the other children have to wait until my death to receive their inheritance?

The timing of the distribution of your assets may differ depending on which children receive which assets. Determine which assets, business and non-business, can be efficiently transferred while you are still alive to both equalize and reduce your estate.

Business Valuation

The foundation of a proper estate plan is knowing what your business is worth. Building a plan with a weak foundation can lead to an illiquid estate, having to pay potentially avoidable taxes, inequality in the distribution of your assets, and discord between family members and business partners.

You can't do effective estate planning without knowing the value of what may be the largest asset in your estate—the business. With that knowledge, you can build a more effective strategy that helps ensure your wealth, including your business, transitions in the manner in which you choose, on the timeline that you set, and as tax efficiently as possible.

Your business isn't just a large asset in your estate, it also provides income for your family and the families of your employees, a legacy for the next generation, and may be the lifeblood of your community. Begin by working with your financial professional to determine your long-term personal and business goals. With proper planning, you can help secure your financial future and protect your business and wealth for those who depend on it most.

[1] MassMutual Business Owner Perspectives Study, 2018.

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Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

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