# Protect the Future of Your Business

**A buy-sell agreement fully funded with life insurance greatly increases a company's ongoing survival after an owner's death, disability or retirement.**

In a small business, the owner is not the only stakeholder. Co-owners, employees and clients may be affected when an owner retires, becomes disabled or dies. Planning ensures that the business that has been created can continue.

A buy-sell agreement—a formal agreement that arranges for the purchase of the business upon the occurrence of certain events—is often a good strategy.

A well thought out, adequately valued and funded buy-sell agreement can:

- Assure a buyer for the business
- Assure the business owner's family a fair value for the business while reducing the costs and delays of probate
- Reduce the risk of a proposed assessment from an IRS audit*
- Spell out the terms of the buyout, which can be funded with life insurance
- Provide a smooth transition of complete control and ownership
- Assure business continuity

* For estate tax purposes, the IRS will usually accept valuation from an arms-length negotiated buy-sell agreement.

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## Succession planning

Owners of newly formed businesses should incorporate succession planning into their overall business plans. Successful owners of closely held businesses and professional practices with higher incomes usually have more complex problems and, therefore, need a detailed succession plan.

## Buy-sell agreements

In order to assure a buyer for an interest in a business—particularly a minority interest that may be of little value to beneficiaries—a lifetime agreement among business owners for the disposition of the business should be considered.

## Redemption agreement

Under a redemption plan, the corporation, LLC or partnership buys the interest of the deceased shareholder/member/partner. This type of arrangement
is often used when there are several owners.


## Cross-purchase agreement

Under this arrangement, each surviving owner agrees to buy the interest of any deceased business owner.


## Wait-and-see agreement

When it is difficult to decide which plan to use, a wait-and-see buy-sell agreement should be considered.

- The business entity has the first option to purchase the deceased owner's interest at the price or formula set in the agreement.
- If the business entity fails to exercise its option, the surviving owners have a second option to purchase the deceased owner's interest.
- If they fail to purchase the deceased owner's interest, or only purchase a portion of it, then the business entity is required to purchase the remainder.
- If the insurance policies are owned by and payable to the owners, the surviving owners may decide to lend the proceeds to the business entity after a death occurs, if they determine that a deceased owner's interest redemption would be most advantageous.
- When the business entity pays back the loan, it will not be considered income to the owners, except for interest which is paid on the loan.
- On the other hand, if a cross purchase plan is more advantageous the business entity will not exercise its first option to buy the deceased owner's interest.

## Trusteed agreements

One of the advantages of a cross-purchase buy-sell agreement is that each surviving owner gets a new income tax basis in the business interest purchased from the deceased or departing owner. The new basis is equal to the amount paid for the interest. This reduces income taxes if the business interest is sold for a higher amount at a later date.

One disadvantage to insurance-funded cross-purchase buy-sell arrangements becomes apparent when there are several owners. For example, if there are five owners, each of them would have to own a policy on each of the other four owners. This means that a total of 20 different policies would be required.

To get the benefits of the increased tax basis with fewer policies, a trusteed buy-sell agreement should be considered.

1. Each of the business owners signs an agreement with an independent trustee to accomplish the following:
   - Endorse stock certificates/member certificates in blank and deliver them to the trustee.
   - Agree to allow the trustee to purchase life insurance on each of the business owners.
   - Agree to allow the trustee to pay premiums on policies on the lives of the other owners from funds periodically contributed by owners.
2. When an owner dies:
   - The trustee collects the life insurance proceeds and delivers them to the estate of the deceased owner in exchange for deceased owner's interest in the business, which is then allocated to the surviving owners.

| | Cross-Purchase Buy-Sell | Redemption Buy-Sell |
|---|---|---|
| **Parties to the plan** | The plan is between the owners. | The plan is between the business and its owners. |
| **Income tax treatment by surviving business owners** | Purchasing business owners get a new basis in acquired ownership interest. | Survivors own a larger percentage of the business, but the basis in the interest does not change. |
| **State law restricting redemptions** | N/A | State law may require redemptions to be made from surplus only. |
| **Family attribution rules (IRC Section 318)** | N/A | These rules may cause what appears to be a total redemption of a decedent's stock to be treated as a taxable dividend. |
| **Availability of life insurance policies to business creditors** | Not usually. If creditors are able to "pierce the corporate veil," policies may be available to them. | Cash values and proceeds are generally available to the creditors of a business. |
| **Premium payer** | Business owners. If the business pays, it must be treated as additional compensation. | The business. It is the owner, beneficiary, and premium payer. |
| **Transfer for value issues** | A purchase of policies by a surviving owner creates a transfer for value. This will cause proceeds to be partially subject to income taxation unless the surviving owner is the insured. | Since policies are owned by the business, there is no need to make a transfer when an owner dies. |
| **Complexity** | At death, there may be multiple buyers of the decedent's business interest. In an insured plan, this also means multiple policies on each owner. | At death, there is only one buyer (the business) and one seller (the deceased owner's estate). |
| **Number of policies required** | May require many policies. The formula is: Number of owners multiplied by numbers of owners - 1. For example, if there are 5 owners, you need 20 life insurance policies: 5 x (5 – 1) | Requires only one policy for each owner. |
| **Other considerations** | 1. If an owner is having trouble paying premium, the policy may lapse.<br>2. The cost of the plan may be higher if the business is in a lower tax bracket than the individuals.<br>3. Voting power may be altered in an undesirable way.[1] | 1. It permits pooling of premium obligations.[2]<br>2. "Unreasonable compensation" questions do not arise. This issue arises when salaries are increased to pay premiums for life insurance used to fund cross-purchase agreements.<br>3. Life insurance proceeds are included in adjusted current earnings for purposes of corporate alternative minimum tax. |

[1] Example: Father owns 30%, son owns 30%, and unrelated key person owns 40%. A combined vote of father and son controls the business. If father's stock is redeemed at his death, the unrelated key person would own a majority of the outstanding ownership interest, and control the business.

[2] When one owner is older and/or the majority owner and the other is younger and/or a minority owner, the life insurance premiums may be similarly disproportionate.

## Setting up the insurance

It is essential to name the appropriate owner, insured and beneficiary of the life insurance. If not done correctly, several problems can result:

- A potential transfer-for-value can subject the death benefit to income tax.
- The deceased's estate can be increased unnecessarily. If the deceased possessed incidents of ownership in the policy insuring his or her life, both the value of the business and the insurance proceeds may be included in the estate.
- Changing beneficiary designations prior to death may leave a buy-sell agreement unfunded.

As with any discussion of life insurance, the parties must determine whether term or permanent insurance is more appropriate. As a rule of thumb, term can be effective for a short period of time, but it becomes more expensive over longer time periods. Cash value insurance can be purchased with level annual premiums and the built-up cash values can be used to fund a retirement buyout. As a blended alternative, a new business may start with term and switch to a more cost-effective permanent plan as the corporation's financial position improves. For many people, the subject of buy-sell agreements can be as uncomfortable as discussing a will. But business owners work hard building their businesses and need to plan for unforeseen or inevitable events.

## Company owned life insurance

Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by any business (Corporation, LLC, Partnership, or Sole Proprietor) on the life of an employee are generally includable in income, unless certain requirements are met before the life insurance policy is issued, specifically: 1) the employee is notified in writing that the employer intends to insure the employee's life and lists the maximum face amount of the coverage at the time the coverage is issued; 2) the employee gives written consent to being insured under the contract and continuation of such coverage after the insured employee terminates employment; and 3) the employee is informed in writing that the employer will be a beneficiary of all, or a portion of, policy death proceeds. The signature on the life insurance application does not satisfy the requirement for 101(j).

State or local law may vary. Professional legal and tax guidance on this issue is strongly recommended.

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