John Hancock INSURANCE

# Buy-Sell Arrangements

## CLIENT GUIDE

BUSINESS PLANNING

The future success of a business often depends on its owners and certain key employees. The untimely death, disability or retirement of one or more of these individuals may have a devastating effect on the business if adequate planning has not been implemented. Buy-sell plans, often funded with life insurance, allow for the orderly transfer of ownership between owners of a business.

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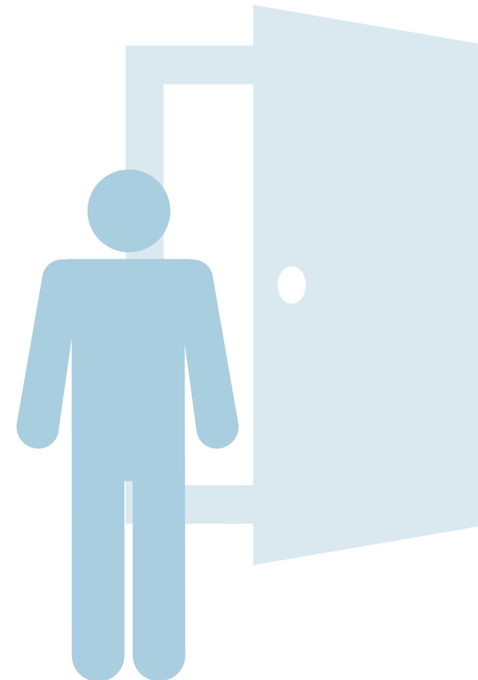


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# What is a buy-sell plan?

A buy-sell plan is a formal contract between you and your fellow business owners that lays out what will happen to each owner's share of the business upon a triggering event, such as disability, retirement, or death. A well-drafted and properly funded plan can protect your family and help facilitate the continuation of the business.

## Key Questions To Ask

**IF YOU BECAME DISABLED, RETIRED, OR DIED:**

- Who would control your share of the business?
  - Is that person the ideal person to control it?
  - How would that person fit in with the other owners, management, and staff?
- Who would perform your day-to-day responsibilities in the business?
- Do the other owners know what you want to happen with your share of the business?
- Would your family have enough cash to maintain their current lifestyle?

**IF ONE OF YOUR FELLOW OWNERS BECAME DISABLED, RETIRED, OR DIED:**

- Who would control his/her share of the business?
  - Is that who he/she would want to control it?
  - How would that person fit in with you, the other owners, management, and staff?
- Who would perform those responsibilities in the business?
- Do you know what the other owners want to happen with their share of the business?
- Would his/her family have enough cash to maintain their current lifestyle?

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# Benefits of a buy-sell plan

### PREDETERMINED BUYER

A buy-sell plan benefits your family by providing a guaranteed buyer(s) for your shares. Moreover, remaining owners are protected against the sale of a significant (or, worse yet, majority) interest to an outside buyer.

### SET A FAIR SELLING PRICE

A business valuation strategy that is determined while all owners are active can usually be negotiated at arm's-length, eliminating possible valuation disputes when an owner leaves. It will also help you in your estate planning as the value of the business is more clearly understood.

### CREATE LIQUIDITY

Upon your death, your family may need liquidity to replace your lost income and to pay estate taxes, if necessary. Without a buy-sell plan, your estate may have to sell the business in a rush to create liquidity, often resulting in your family receiving less than the fair market value.

### MAINTAIN HARMONY

Provides peace of mind and maintains harmony because there is no uncertainty about how the business transition will occur. Without a plan, conflicts may arise about how to transition the business at the worst possible time - when an owner is leaving the business.

# Funding a buy-sell plan

### THE VALUE OF LIFE INSURANCE

Life insurance is often used to fund a buy-sell plan because it can provide immediate liquidity necessary to "buy out" your interest in the business upon death, ensuring that your heirs receive a cash inheritance while allowing the remaining owners to continue to run and maintain the business. Moreover, when a permanent life insurance policy is purchased, the cash value that accrues inside the policy may be accessed on a tax-preferred basis during life (e.g., at retirement) to help fund a lifetime buyout of an owner.

**Life insurance generally provides these distinct tax advantages:**

1. **Tax-free death benefit**
2. **Tax-deferred growth**
3. **Tax-free access to cash values**

**While permanent life insurance is one of the most common and effective buy-sell funding options, consider other funding alternatives, and the drawbacks of these methods, below:**

### BORROW FUNDS

To come up with the necessary funds under a buy-sell plan, the company (or the surviving business owners) may borrow funds from a third-party lender. However, depending on a number of factors, it may be difficult to obtain the requisite loan after the death or retirement of an owner. Also, keep in mind that even if a loan is obtained for the buy-out, this could affect the business' (or owner's) ability to get additional loans in the future for other purposes - e.g. new equipment, working capital, etc.

### SINKING FUNDS

A buy-sell plan can be funded with a "sinking fund," where the business' earnings are retained and invested to fund a future buy-out obligation. However, this type of funding approach may require a longer-time horizon to accumulate the necessary funds and could be problematic if an owner dies or retires sooner than expected or a buy-out occurs turning a down market.

### INSTALLMENT PURCHASE

While an installment obligation gives the business (or the remaining owners) a period of time in which to buy-out the interests of a deceased or retired owner, such a sale can put a significant strain on cash flow, especially if the interest being purchased belongs to a majority interest holder, which could result in the business' failure without additional capital being available.

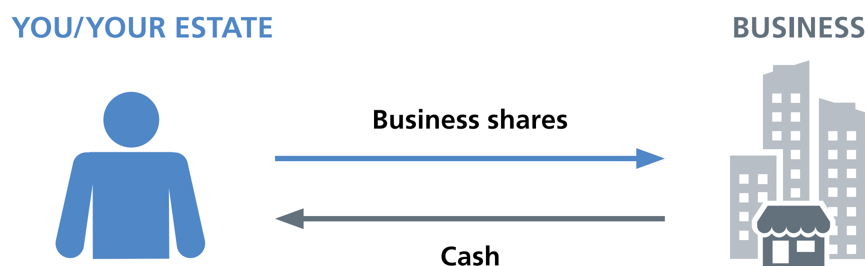
**Eliminate uncertainty and the need to determine how to fund a buy-out when the firm is in crisis by implementing a plan funded with life insurance. The cost of funding the insurance can be managed and will be paid while all current owners are actively involved in the business.**

# Types of buy-sell plans

## Entity purchase buy-sell plan

An entity purchase buy-sell arrangement (or "stock redemption arrangement") is an arrangement between you and your business. The business agrees to pay you or your estate an agreed upon amount for your interest upon a triggering event.

When funded with life insurance, the business is the owner and beneficiary of the policy and will pay the premiums on the policy. Upon the triggering event, the business uses the death benefit or cash value to purchase your interest.




### KEY BENEFITS

- **Multiple owners:** Simple and works well with three or more owners.
- **Transaction is between you and the business:** Upon a triggering event, you/your estate exchange business ownership for cash.

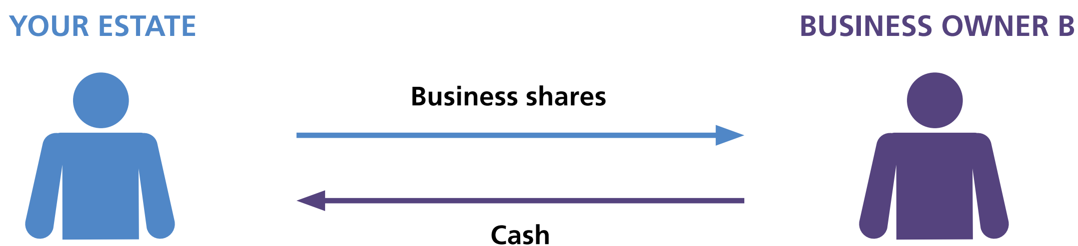
### IMPORTANT CONSIDERATIONS

- **Risk of creditors:** Life insurance is subject to creditors of the business (i.e., if business goes bankrupt and life insurance is an asset of the business).
- **Life insurance premiums are non-deductible** by the business.
- **Employer-owned life insurance:** Business must comply with §101(j) requirements, including Notice and Consent.[1]
- **Increased value:** Assets held to fund the plan, including life insurance death benefits, may increase the value of the business.
- **Basis adjustments:** After a redemption, remaining owners may not get an increase in basis even though they now own a larger interest in the company.
- **Unwinding the plan**: If you were to separate from the business (e.g., at retirement), the business may continue to own the policy on your life.

## Cross purchase buy-sell plan

A cross purchase plan is an agreement in which you and each of the other owners agree to personally buy the interest of the others upon a triggering event. Typically, you will be required to purchase a percentage or proportional share of a departing owner's interest in the business. In turn, you (or your estate) agree to transfer your business interest to the other owners for the agreed-upon price when a triggering event occurs.

When funded with life insurance, you will purchase a life insurance policy on the lives of each of your co-owners and they will do the same. For example, assume you and Owner B are each 50% owners of a business and enter into a cross purchase buy-sell arrangement. Upon your death, Owner B will be required to buy your shares from your estate. The death benefit proceeds will provide a source of liquidity for B to purchase your shares. Your estate will continue to own a policy on the life of Owner B. This policy can be sold to Owner B or to the business.




### KEY BENEFITS

- **Basis increase:** Surviving owners receive a step-up in cost basis in the acquired business interest.
- **Value of business does not increase** because the entity does not own the policy.

### IMPORTANT CONSIDERATIONS

- **Complexity if multiple owners:** If there are more than two or three owners, the plan becomes administratively complicated because several policies must be purchased.
- **Transfer-for-value:** Upon the death of an owner, his/her estate will own policies on the other owners. If the other owners purchase the policies from the deceased owner's estate to fully fund their continuing obligations under the plan, the purchase may be a transfer-for-value and be subject to special tax rules.[2,3]
- **Premium payments:** Owners pay the insurance premiums, which are non-deductible; however, funds to pay premiums may be obtained from the business via dividends, distributions, bonus payments, etc.
- **Exchanging policies at plan end:** Swapping policies to each other may have income tax ramifications when the plan is terminated.

## VARIATIONS IN CROSS PURCHASE DESIGNS

There are several variations of cross purchase designs which may help to address some of the issues discussed above (e.g., transfer-for-value, complexity due to multiple policies). Two of these alternatives, "Trusteed Cross-Purchase" and "Partnership Cross Purchase" are discussed below. Another alternative, Cross Endorsement Buy-Sell, is discussed in the next section.

1. **Trusteed cross purchase plans:** In a trusteed arrangement, a trustee purchases life insurance on your life and on each of the other owners who is a party to the agreement. The trustee will pay the premium on the policies via contributions from you and the other business owners. Upon the death of you or another owner, the trustee (1) collects the life insurance proceeds, (2) purchases stock from the estate of the deceased owner, and (3) distributes the shares to the surviving owners.
2. **Partnership cross purchase plan:** This approach is similar to a trusteed arrangement, however, instead of creating a trust, the business owners form a partnership. The partnership then purchases a life insurance policy on the life of each business owner and pays the premiums via contributions made to the partnership each year by the business owners.[4]

**Using a partnership (e.g., LLC) may help the shareholders avoid a transfer-for-value problem**, assure that the parties comply with the buy-sell agreement, and keep the policy proceeds from the reach of the insureds' creditors.[5]

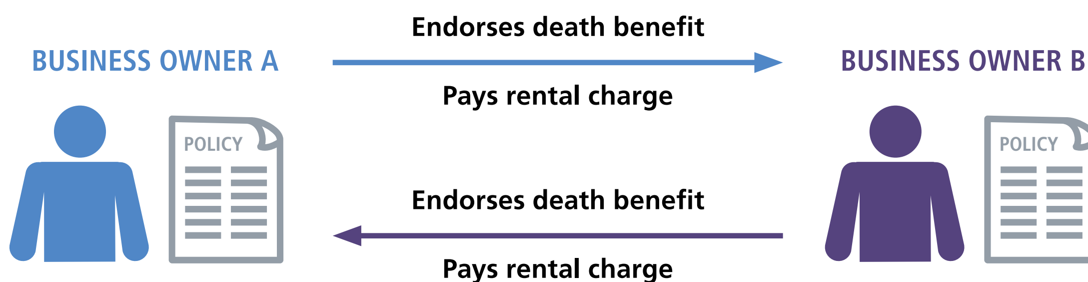
Discuss the benefits and drawbacks of these cross purchase variations with your advisor.

## Cross endorsement buy-sell arrangement (CEBS)

A cross endorsement arrangement is an alternative to the typical funding approach used with a traditional cross purchase buy-sell arrangement. A cross endorsement arrangement is unique because each business owner purchases and owns a life insurance policy on his/her own life and endorses a portion of the death benefit to the other business owners.

**CEBS can offer maximum control and flexibility because you own a life insurance policy on your own life.**

In return for endorsing your death benefit to your co-owners, the other owners will pay a rental fee to you equal to the "economic benefit" costs of the endorsed amounts, similar to the economic benefit fees charged under a split dollar arrangement. Upon your death, your co-owners will receive a portion of the death benefit that you endorsed in their favor, and will use those funds to meet the purchase obligation under the cross purchase buy-sell arrangement.[6] Any death benefit not endorsed to your co-owners will be paid to your designated beneficiaries (e.g., spouse and children).




### KEY BENEFITS

- **Personal ownership** creates a hybrid plan that can satisfy both your personal and business needs. For example, you may be able to access cash value to supplement retirement income and the death benefit can be structured to provide financial security to you and your family beyond what is required in the buy-sell plan.
- **Flexibility:** The amount of death benefit endorsed each year can be adjusted to reflect the changing value of the business interest.
- **Basis increase:** Surviving owners receive a step-up in cost basis in the acquired business interest.
- **Value of business does not increase** because the entity does not own the policy.

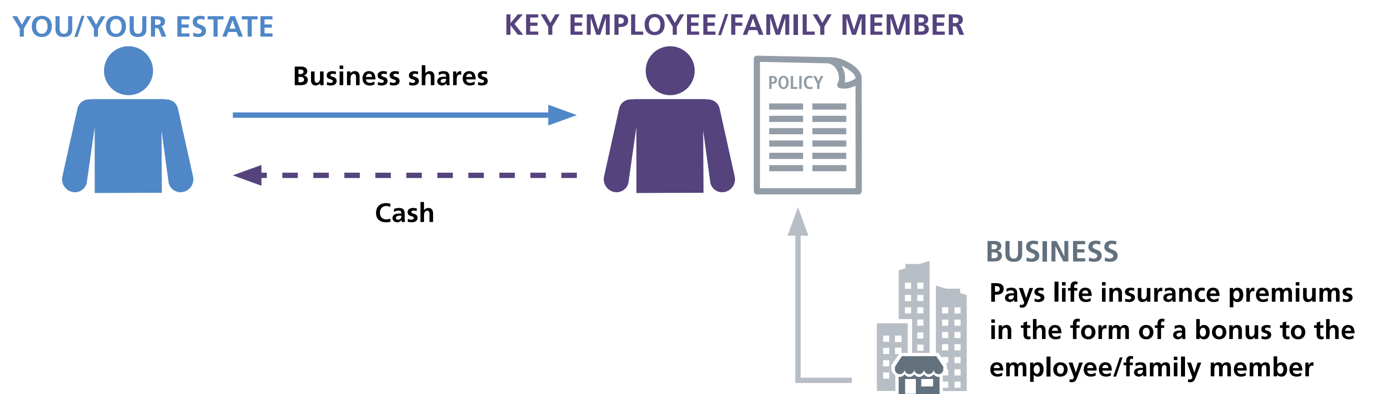
### IMPORTANT CONSIDERATIONS

- **Rental charges (i.e., "economic benefit" costs)** increase with age.
- **Accessing the life insurance policy cash value** may lower the death benefit.
- **Rental income** may be taxable.
- **May not be appropriate for C and S corporation owners** due to "transfer-for-value" rules.[7]

## One-way buy-sell plan

A one-way buy-sell plan is a type of a buy-sell arrangement in which a non-owner, such as a key employee, agrees to buy your business upon a triggering event. This design is typically used when you are the only business owner and there is one designated successor owner. Accordingly, only one life insurance policy is ordinarily required to fund the arrangement. Your intended successor will be the owner and beneficiary of the life insurance policy and will buy out your shares upon your death.

Typically, the business will pay a bonus to the successor/policy owner in the amount of the premium payments annually to minimize the out-of-pocket expense of the arrangement. The bonus payments may be tax-deductible to the business when they are paid, but the payment will also be taxable to the recipient.[8]




### KEY BENEFITS

- **Basis increase:** The employee/successor should receive a full basis step-up for the purchase of the business interest.
- **Tax deductible for business:** Insurance premiums bonused to the key employee are tax deductible to the business.
- **Value of business** does not increase because the entity does not own the policy.
- **Fixed value:** May be structured to fix value for estate tax purposes.

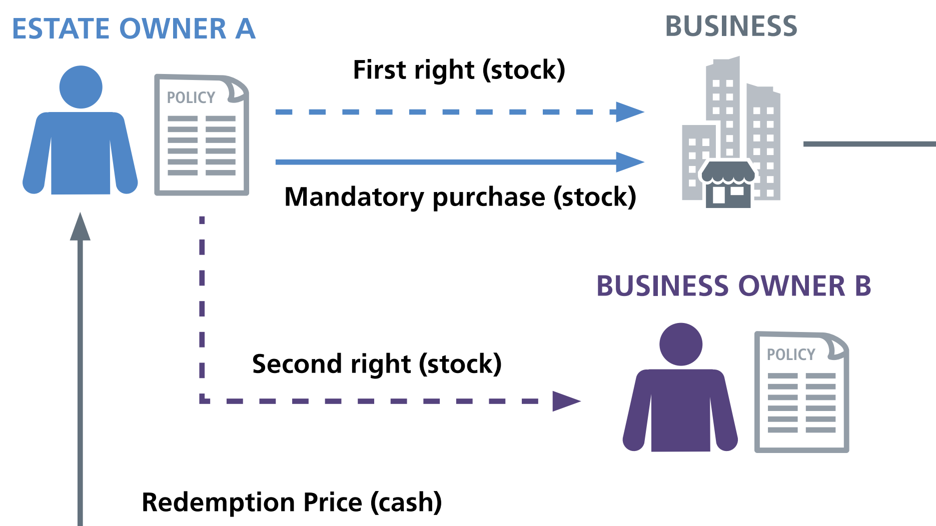
### IMPORTANT CONSIDERATIONS

- **Access to policy cash value** may lower the death benefit needed to satisfy the buy-sell obligation.
- **Income taxation:** If you bonus the key employee the premiums, the bonus amount will be taxable income to him/her.
- **Termination of employment:** Arrangement should consider what happens to the policy if the key person terminates employment prior to a triggering event (e.g., business owner has right to buy policy from employee).

## Wait-and-see buy-sell plan

A wait-and-see buy-sell plan is a hybrid arrangement combining the features of both the entity purchase buy-sell arrangement and the cross purchase buy-sell arrangement. A wait-and-see buy-sell arrangement generally gives the business the option (or "right of refusal") to buy any portion of your interest within a certain period after your death. If the entity does not fully exercise the option, the remaining owners have the second right of refusal. Finally, if the remaining owners do not exercise their right of refusal, the entity will be required to purchase the balance of your interest for the agreed-upon value.

To meet the obligations under the buy-sell agreement, either the business or the individual owners will purchase insurance policies on the lives of the business owners.




### KEY BENEFITS

- **Maximum flexibility:** The primary advantage of the wait-and-see buy-sell arrangement is that it offers maximum flexibility. Rather than committing to an arrangement, the business owners can adopt the most advantageous strategy after the death of an owner.

### KEY CONSIDERATIONS

- **Difficult to fund:** One disadvantage of a wait-and-see buy-sell arrangement is that it can be difficult to fund. Ordinarily, the arrangement is funded as if it were a traditional cross purchase arrangement. If it later appears likely that the entity will exercise its option, the policies can usually be sold to the entity.
- **Possible dividend treatment:** In a corporate context, care must be taken to avoid dividend treatment to the purchasing shareholders. Consult your tax/legal advisor for more information.

# Which type of buy-sell plan is right for you?

The "best" type of arrangement depends upon several factors that will be unique to your business, such as the type of business structure (e.g., C Corp, S Corp, LLC, etc.), the number of owners, and who will be the owner of any life insurance purchased (i.e., the business, your partners, yourself).

See the below chart for a summary of some of the most common buy-sell plans as discussed in this Guide.

TYPES OF BUY-SELL PLAN

| | ENTITY PURCHASE | CROSS PURCHASE | CROSS ENDORSEMENT | ONE-WAY | WAIT-AND-SEE |
|---|---|---|---|---|---|
| **What is it?** | Business agrees to buy the interest of deceased owners | Each owner agrees to personally buy the business interests of the other owners | Each owner agrees to personally buy the business interests of the other owners | Key employee agrees to buy the business from the owner | Hybrid arrangement that combines features of the entity purchase and cross purchase arrangements |
| **Funding with life Insurance?** | Business buys a policy on the life of each owner | Each business owner buys a life insurance policy on the life of each of the other owners | Each business owner buys a policy on his/her own life | Key employee buys the life insurance policy on the business owner's life | Either the owners or the business owns the insurance depending on the terms of the arrangement |
| **How does it work?** | Business and each owner enter into a redemption agreement | Each owner uses the policy owned on the life of the departing business owner to complete the buy-out | Each owner endorses a portion of the death benefit to the other owners | Key employee enters into a one-way arrangement with the owner | Entity typically has right of first refusal, then owners have right to purchase. If owners do not exercise right, entity required to redeem interest |
| **Who pays the life insurance premiums?** | Business pays the premiums | Policy owner pays the premiums, which may be funded with help from the business | Policy owner pays the premiums and pays a rental charge to the other owners, which may be funded with help from the business | Policy owner pays the premiums, which may be funded by a business provided bonus plan | Depends on the terms of the arrangement |
| **Does insurance increase the value of the business?** | Yes | No | No | No | Yes, if owned by the entity |
| **For whom does it work best?** | C corporations and businesses with several owners | Businesses with three or fewer owners | Business owners who want additional flexibility and who want to use the insurance for personal needs as well | Business with one owner | Business owners who want flexibility for changing needs |

# Valuation methodology

An important consideration when structuring a buy-sell arrangement is the method by which the business will be valued. The following are several common methods of business valuation:

### SPECIFIC FIXED PRICE

Owners periodically fix the price by agreement. Although this approach is simple, owners often fail to adjust the price for changes in value, which may be unfair to the selling owner. Moreover, the IRS may disregard the actual selling price and attribute a higher value.

### BOOK VALUE

Value is determined by book value on the date of death or on the close of the last fiscal year preceding the date of death. Book value represents the fair market value of the assets minus liabilities. This approach is simple, but is seldom an accurate reflection of value because it (1) reflects value after depreciation was applied (not current values) and (2) ignores the entity's earnings potential.

### CAPITALIZATION OF EARNINGS

Value is determined by multiplying earnings by a capitalization factor. The capitalization factor is generally obtained by analyzing the price-earnings ratio of comparable businesses in the same industry. If this method is utilized, earnings over several years should be examined to account for the up-and-down, nature of the business. The primary disadvantage is that earnings of closely held businesses are often manipulated (through salaries) for personal tax planning purposes instead of the business needs of the entity.

### FORMULA

Value is determined by a formula that incorporates several factors. It is not unusual for a sales price to be based upon both book value and capitalization of earnings. Sometimes a combination of these approaches is incorporated into a formula to mitigate the disadvantages of each approach.

### APPRAISAL

Value is determined by an independent appraisal at the time of sale. Although this approach often provides the value that is closest to true fair market value, it can be expensive and delay the settlement process.

### CUT THROAT

The purchase price is determined by the owners at the time of sale. The selling owner will offer his/her shares to the other owners at a price determined by the selling owner. If the other owners do not purchase the shares at this price, the owner who made the offer must buy the shares of the other owners at this price. This approach sets a theoretically fair price. However, it favors the owner with the "deepest pockets." It is primarily used for lifetime sales and usually in businesses owned equally (or nearly equally) by two individuals.

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# Conclusion

A well-drafted and adequately funded buy-sell plan is an important piece of a business owner's succession and estate plan. Start a conversation with your co-owners and with your legal/tax advisors about the importance of protecting the business and your families. Having a succession plan in place provides you with peace of mind knowing that your family will be taken care of and the business will continue as you want it to. Once a plan is in place, conduct regular reviews of the plan to be sure that is adjusted for any needed changes, such as increases in the value of the business or ownership structure.

1. Section 101(j) of the Internal Revenue Code imposes income tax on the death benefit of life insurance contracts owned by the employer of the insured unless certain exceptions apply. In addition, the employer must show satisfaction of notice and consent requirements set forth in Section 101(j).
2. See IRC Section 101(a)(2). The death benefits of a life insurance policy obtained in a transfer for value will not be free of income taxes unless the transfer falls within an exception to the transfer-for-value rule.
3. See IRC section 101(a)(2)(B). The exceptions to the transfer-for-value rule include the transfer of a policy to (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, or (4) a corporation in which the insured is a shareholder or officer.
4. If the partnership is created exclusively (or primarily) to facilitate the buy-sell arrangement, the IRS may not respect the validity of the partnership. Although the IRS approved of a partnership structured solely for the purpose of funding a buy-sell arrangement in PLR 9309021, the IRS subsequently adopted a no-ruling position on the use of partnerships to fund buy-sell arrangements in Rev. Proc. 96-12.
5. In PLR 200747002, three business owners established an "Insurance LLC" (Limited Liability Company) to own life insurance policies on the lives of the business owners with management of the policies by an independent manager. The IRS ruled that the business owners would not have any incidents of ownership in the life insurance policies. A Private Letter Ruling (PLR) is merely an IRS interpretation of law and is only binding upon the taxpayer to whom it is issued.
6. Transfer-for-value rules under §101(a) must be considered in this type of arrangement in order for the death benefit to be received income-tax free.
7. The owners may want to consider a partnership or limited liability company (if one does not already exist) between the owners to avoid any transfer-for-value issues with respect to the cross endorsements of the policy death benefits. Clients should consult their tax advisors to discuss this issue.
8. The use of a bonus arrangement creates additional compensation to the recipient and must fall within the reasonable compensation guidelines of the Internal Revenue Code Section 162 in order to be deductible by the corporation.


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Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2.

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