Business Succession Planning with Key Person Coverage and Buy-Sell Agreements

Program Highlights & Fact Finder

Transamerica®

You put maximum effort into establishing and running your business. But are you taking the right steps to make sure your business can survive the retirement, disability, or death of an owner or key employee?

When these events occur, your business may be significantly impaired or forced to close in a relatively short period of time, not because you did something wrong, but because you did *nothing*.

Business succession planning is crucial to ensure the successful transfer of your company or business interests. And yet few owners even know what their business is worth or have planned for the eventual transfer of their business interests. This brochure will discuss stabilizing and maximizing the value of a business and transferring it to the parties desired under specified, controlled circumstances. It is designed to help you retain control of your business and to assure that funds will be available to provide maximum financial flexibility in the event of retirement, death, or disability, or if you leave the business.

Key Person Coverage

Who do you consider a key person in your business? The person you rely on when you are not in the office? The one who works best with your customers? The person who finds creative ways to finance your business? You may already have a number of incentives to keep such employees working for you, including future ownership. But can the business afford to lose them now?

How long would it take to replace your key person(s) and how much business does your company stand to lose? An insurance policy on the key person's life, owned by the business, may be the answer. At the death of the insured, the business can use the federal income tax–free life insurance proceeds to find and train a successor and to replace the revenue lost by the untimely death of a key person.* An insurance professional can work with you to estimate the appropriate amount of life insurance needed within your business budget.

Buy-Sell Planning

Many business owners think a buy-sell agreement is not needed until the death of a business owner. While it is critical to have a plan in place at that time, the buy-sell is also important when any major life event changes the relationship of one of the owners to the business. Such an event could be disability, divorce, retirement, conflict between owners, or the desire of one owner to pursue another business opportunity. In each case, having a buy-sell agreement in place can help to mitigate conflict and speed up the transition by giving business owners a road map for handling the event.

What Is a Buy-Sell Agreement?

A buy-sell agreement is a legally binding contract that can be used with all types of businesses. It stipulates that upon a triggering event, such as the death, retirement, disability, or other withdrawal of a principal, his or her share of the business must be sold to the remaining partners or shareholders, or to the business itself. The remaining partners, shareholders, or the business itself agree to purchase the portion of the business owned by the deceased, retired, disabled, or withdrawing principal.

The agreement also helps to prepare for the manner of the owner's withdrawal from the company. For example, life insurance may be purchased to fund the agreement at death or retirement of an owner.

Key Provisions of a Buy-Sell Agreement

The buy-sell agreement, regardless of form, should specify certain key provisions. It must be drafted by an attorney. It is critical that the buy-sell agreement set out the intent of the parties in a manner that is legal in your state. The following information must be known for insurance planning and must be clearly explained in the buy-sell agreement:

- **Parties**—Who will be selling and who will be buying?
- **Mandatory**—The buy-sell agreement must state that it is mandatory for the seller to sell and for the buyer to buy the business interest.
- **What is to be purchased?**—This differs with each business type. For instance, it could be partnership interests, membership interests, stock—or for a sole proprietorship, the business' assets.
- **Price**—How much does the owner or the owner's estate get for his or her business interest and how much does the buyer have to pay for this business interest?
- **Timing of the sale**—For all parties involved, timing of the sale is critical.
- **Law**—Which state law(s) will apply?
- **Changes to the agreement**—A buy-sell agreement usually exists for a number of years. The process to update insurance coverage should be established.
- **Termination of the agreement**—There are valid reasons to terminate a buy-sell agreement, so having an exit provision can be useful.

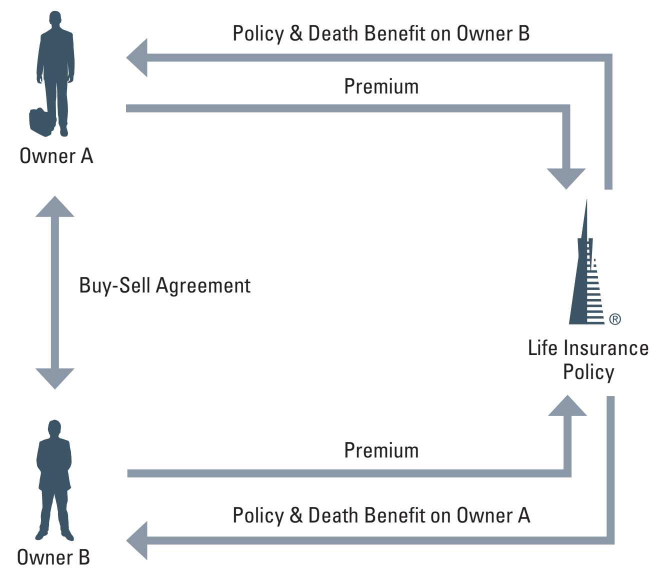
*For a C corporation, the life insurance death benefit and annual increases in policy cash value may be subject to the corporate alternative minimum income tax. Additionally the Notice and Consent requirements of IRC Sec. 101(j) must have been met prior to policy issue. State restrictions may also apply.

Types of Buy-Sell Agreements

Cross-Purchase

With this arrangement, each business owner purchases life and/or disability insurance on the other business owners. Each owner is the beneficiary of his or her respective policy(ies). The business is not part of the agreement. Upon the disability, death, or withdrawal of one owner, the remaining business owner(s) can use the policy proceeds or cash value to purchase their pro rata shares of the withdrawing owner's interest in the business.

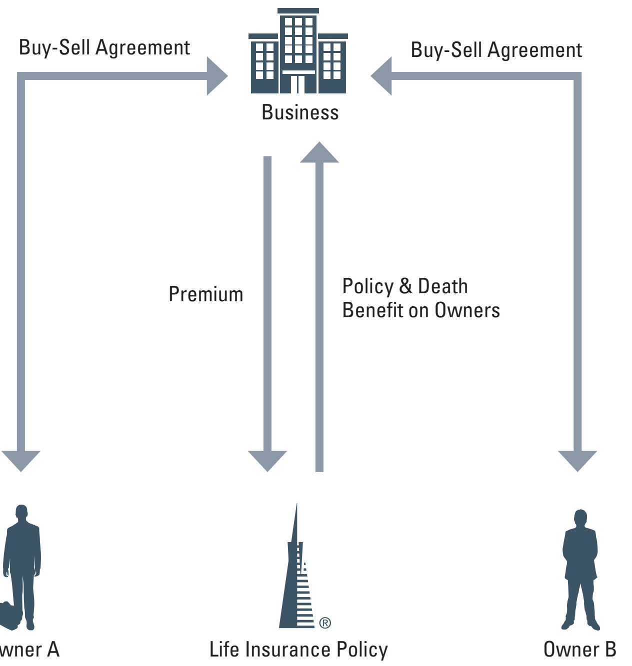
In the case of sole owners, this agreement can be structured as a one-way agreement, where a buyer such as a key employee or third party purchases a life insurance policy on the sole business owner. At the owner's death or retirement, the buyer uses the policy proceeds or cash value to purchase the owner's entire business.



Redemption

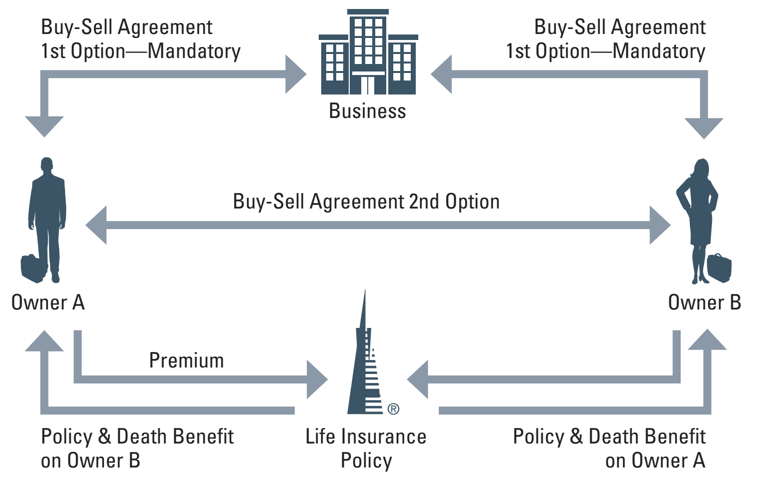
The redemption buy-sell agreement is generally used with any business entity that has multiple owners who want to use the assets of the business to fund the agreement. The business is the purchaser, owner, premium-payor, and beneficiary of life insurance policies on each owner's life. When an owner dies, the business receives the death benefit and uses the proceeds to purchase the business interest from the deceased owner's estate. The estate is paid the agreed-upon price, and the surviving business owners own the entire business.

The business will show the life insurance policy cash value as a business asset. However, premiums paid by the business are nondeductible. Redemption may not be as advantageous for C corporations because policy cash value accumulations and death benefit may be subject to alternative minimum income tax and, in the case of closely held businesses, family attribution rules may result in unforeseen tax consequences.



Wait-and-See

The primary advantage of the "wait-and-see" buy-sell agreement is its flexibility. Often, the decision between cross-purchase and redemption is difficult because of the inability to predict the future and determine which plan will be better for all parties. The wait-and-see agreement can adjust to future tax law changes, fluctuating economic times, or owner uncertainty. The wait-and-see is a hybrid agreement containing language of both previously mentioned buy-sell agreements which allows either the surviving principal(s) or the business itself to purchase the with-drawing owner's interest. The decision is not made until an owner actually withdraws from the business.

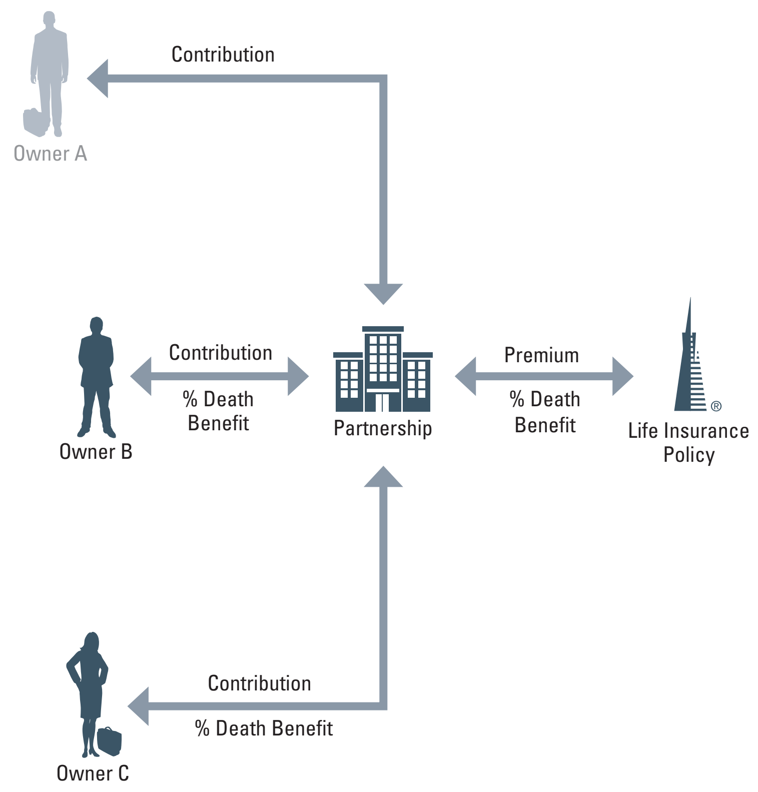


Combination Buy-Sell

The combination buy-sell is a nontraditional arrangement in which a general partnership is used to structure and fund a business buy-sell. This special arrangement combines the benefits of both a cross-purchase and stock redemption/entity purchase, while avoiding their negative aspects. With this arrangement—in addition to establishing a traditional buy-sell agreement for the business—the owners of the business establish a separate general partnership, which owns and names itself beneficiary of life insurance policies insuring the lives of the owners. The owners make contributions to the partnership to fund the payment of the premiums.

At the death of one of the owners, and according to the terms of the buy-sell, the death benefits can be:

- **distributed to the surviving owner(s)/partner(s) to fund a cross-purchase-type buyout;**
- **lent by the surviving owners to the business to fund a stock redemption or entity purchase; or**
- **used by the partnership to buy the deceased owner's interest.**



Advantages of Buy-Sell Agreements to the Owner and His or Her Heirs

- Creates liquidity for what might otherwise be an illiquid asset.
- Helps avoid family disagreements regarding the value of a business, as well as the legal and emotional costs of a valuation dispute.
- The heirs' economic futures will no longer be tied to the fate of the business and they will be free from worry about the financial success of the business.
- Specified proceeds can provide the decedent's estate with funds to help meet estate obligations that can reduce or eliminate the need to liquidate other estate assets.
- Helps establish the value of the business for federal estate tax purposes and may, therefore, avoid costly and aggravating IRS litigation.
- May avoid the conflict of interest issues that arise when a key employee takes over business operations.

Advantages of Buy-Sell Agreements to the Business and/or Surviving Principal(s)

- Ensures a smooth and complete transition of management and consolidation of business control in the hands of the agreed-upon group.
- Protects the business against inactive, unqualified, and/or potentially dissident heirs in the management of the business.
- The business and/or the surviving principal(s) are assured of the cash necessary to purchase the decedent's interest.
- Prevents potential impairment of the business' credit line.
- A properly drawn buy-sell agreement can protect a corporation's subchapter S status by avoiding inadvertent conversion to C corporation status.

Notice and Reporting Requirements for Employer-Owned Policies

Life insurance policies owned by an employer or corporation (commonly referred to as "EOLI" or "COLI") where the employer or a related person is the beneficiary are subject to legislation, known as the "COLI Best Practices" rules, enacted in August 2006. The Best Practices rules require that notice be given to, and the consent of the individual to be insured be obtained, before the policy is issued. If the notice and consent requirements are not followed, then the death benefit would be included in the beneficiary's gross income.

These rules generally limit COLI to officers, directors, and highly compensated employees. There are exceptions to the employee rule. If the notice and consent requirements are met and the insured fits into one of the following three exceptions at the time that the policy is issued, then the death benefit will be income tax–free to the beneficiary:

- The employee is a highly compensated individual or director (i.e., among the highest paid 35% of all employees as defined in IRC Section 105(h)(5)), or
- The employee is a highly compensated employee as defined by IRC Section 414(q), or
- The insured was a director within the 12 months preceding his/her death.

The employer must comply with annual record-keeping and tax return reporting requirements pursuant to these rules. Since buy-sell agreements such as stock redemptions, wait-and-see, or combination buy-sell agreements may involve a life insurance policy owned by the employer, such policies can be governed by the rules.

Although most buy-sell agreements would appear to fall within one of the exceptions to the rules, due to changing circumstances the purpose of holding a policy may vary over time. For instance, a policy intended to be used for a stock redemption may ultimately be used as key person insurance. Nevertheless, the employer must continue to follow the notice and reporting requirements of the rules to remain within one of the exceptions.

Business Valuation

In order to proceed with a buy-sell agreement, it is important to determine the value of the business entity both now and periodically in the future. An accurate valuation allows for all parties to be treated fairly and can minimize conflict at the time of the business transfer.

It is advisable to seek a professional evaluation in order to make sure the buy-sell agreement can withstand scrutiny by all parties involved at the time of the triggering event.

Planning Ahead to Minimize Risk

All business owners want to minimize risk in order to protect themselves and their businesses from economic loss and to increase the likelihood of success. For the protection of yourself, your family, and your business, it makes sense to reduce the risk of loss at the death of a key person or at the time of business transfer. Business succession planning is key to the successful transfer of your company or business interests.

An insurance professional can help you plan today to retain control of your business and to assure that funds will be available to help provide financial flexibility in the event of retirement, death, disability, or other severance of relationship with the business.

While this brochure explains the reasons for key person and business succession insurance coverage, your insurance professional and other advisors can assist in reviewing your particular situation and your best options. In some cases, an endorsement split dollar arrangement may be appropriate.

Funding a Buy-Sell Agreement

There are three primary methods to immediately fund a buy-sell agreement upon the death of a business owner.

Pay Cash

Requires large sums of liquid assets that may not be readily available, particularly at the time of an unforeseen event.

May have to liquidate valuable personal or business assets below market value in order to raise cash quickly.

Borrow the Money

The loss of an owner or key person may impair the credit rating of the business and its ability to borrow.

Principal plus interest must be paid. This could be a tremendous strain on the business budget.

Purchase a Life Insurance Policy

Money is available from the policy cash value or death benefit for the purchase of the business interest.

Policy cash values grow tax deferred and death benefits are federal income tax–free.*

*For a C corporation, the life insurance death benefit and annual increases in cash value may be subject to the corporate alternative minimum tax. Additionally the Notice and Consent requirements of IRC Sec. 101(j) must have been met prior to policy issue. State restrictions may also apply.

Business Succession Planning with Key Person Coverage and Buy-Sell Agreements Fact Finder

Company Identification

Name ______________________ Address ______________________

City ______________________ State __________ ZIP ________ Telephone ______________

Entity Type: ☐ C Corporation ☐ S Corporation ☐ Partnership ☐ Sole Proprietorship

For C Corporation, Marginal Federal and State Income Tax Bracket: ______ %

	Business Owners	Age	Sex	Smoker Y/N	% of Ownership	Tax Bracket	Relationship to Others
1.							
2.							
3.							
4.							
5.							

Employee Benefits

What employee benefit plans do you have and how are they funded?

Pension Plan ______________________ Profit-Sharing Plan ______________________

Keogh (HR 10) ______________________ SEP ______________________

Group Health ______________________ Group Life ______________________

Group Disability ______________________ Other (Describe) ______________________

____

Are there any special benefit plans just for owners and key employees? If “yes,” describe: ______________________

____

Do you plan to add anyone to the plan(s)? __________ If “no,” have you considered any? ______________________

Business Stability

Do any owners have personal liability for business debts? ______________________

If “yes,” are these debts covered by life insurance? ______________________

Are there key employees whose death or disability would jeopardize company profits? ______________________

What has been done to protect the business in the event of death or disability of one of these key employees? ______________

____

If key employees are insured, who are the insured? ______________________

If not insured, who should be? ______________________ Is the insurance adequate today? ______________

Business Continuity

What are the names and ages of any relatives or children who may enter the business? ____________________

____

In the event family members are too young or lack experience, who would run the business? ____________________

What have you done to guarantee that this person(s) will stay? ____________________

Do you have a Buy-Sell Agreement? (Y/N) What type? ☐ Entity or Stock Redemption ☐ Cross-Purchase ☐ Other

If "yes," when was it last reviewed? ____________ Is it funded with life insurance? ____________

If funded with insurance, when was the policy(ies) last reviewed? ____________________

How is the business value in the agreement determined? ____________________

If unknown or out-of-date: Book Value: What is the book value of your business? $____________________

Earnings & Growth: Average earnings—last five years $__________ Capitalization rate (reflects risk of business/industry) ______ %

Years of goodwill (number of years that goodwill would last after owner's death, generally higher for service than manufacturing) ________

Return of tangible assets______% Annual business growth rate ______% Estimate value of the business $ __________

Are there any other agreements concerning your business interest in existence? ____________________

If "yes," please explain: ____________________

Does your will contain any provision regarding the disposition or retention of your business interest? ____________

Does your will direct or authorize your executor to retain or operate the business? ____________________

Company Advisors

Accountant ____________________ Address ____________________

City____________________ State______ ZIP Code __________ Telephone ______________

Attorney ____________________ Address ____________________

City____________________ State______ ZIP Code __________ Telephone ______________

Other (Banker, etc.) ____________________ Address ____________________

City____________________ State______ ZIP Code __________ Telephone ______________

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