National Life Group®

Experience Life®

ADVANCED MARKETS

Buy Sell Planning

Technical Guide

CPA ADVANTAGE®

In This Guide...

A business in transition due to the death, disability, retirement or resignation of an owner may be a very vulnerable entity. The surviving family (or the disabled or resigning owner) may also be economically vulnerable during and after a transition from ownership to non ownership. Forethought, planning and proper funding may be the elements required to get the business, family and co-owners through this transition successfully. These elements are addressed in business succession planning and more particularly in buy sell planning.

In this guide, we will look at some of the technical issues involved in buy sell planning. You will see, at various points, tax code sections and case citations. Not too many – but enough to give you a basic technical background in this area.

First Things First – The Basics

There are 3 buy sell types that we will review in this guide.

They are:

1. Entity Purchase (Stock Redemptions)

The business will purchase the business interest from the selling owner.

2. Cross Purchase

The co-owner(s) will buy the business interest from the selling owner.

3. Hybrid aka Wait and See

A hybrid arrangement generally involves a series of options. The business will have the first option to buy the business interest. To the extent the business does not exercise the option, the co-owners have the option (or requirement) to complete the purchase. There are many variations on the hybrid, providing for different option rules and results depending upon which party actually buys the business interest. Don't worry – more on this later.

Simple enough!
Of course, there are a lot of details hiding behind these simple explanations.

Stepping Up the Complexity – The Entity Buy Sell

This graphic reflects the entity buy sell arrangement. The purchaser is the business and the seller is the business owner(which may be the business owner's estate).

Entity Purchases are Sometimes Called Stock Redemptions

If you do an internet search for "entity buy sell" you may come across the term "Stock Redemption". A Stock Redemption plan is an entity buy sell where the business involved is a corporation. When a corporation purchases the shares in its own business that is called a "redemption".

Trigger Events

There are a number of events that may cause the terms of a buy sell agreement to be put in motion. Typically, the death, disability, retirement or resignation of one of the owners will trigger the buy sell. While these are the primary triggers, the client's attorney, in consultation with the client, may add others. For instance, a trigger event may be the divorce or bankruptcy of an owner.

Entity Purchase at the Death of an Owner

When an owner dies and an entity purchase is triggered, the business will purchase the business interest from the deceased owners' estate. Let's consider the tax results of this transaction.

1. Is there taxable income to the deceased's estate?

To calculate taxable gain, you have to start with the seller's basis. That means we need to know the estate's basis in the business interest.

The estate does not assume the deceased owner's basis. Rather, the estate has an adjusted basis equal to the fair market value of the business on the deceased's date of death. (See IRC Section 1014(a))

Because of the basis adjustment the buy sell generally results in no taxable gain. Why?

a.) If the estate's basis is equal to the fair market value of the business (i.e. $1), and

b.) If the estate receives an amount equal to the fair market value of the business (i.e. $1), then

c.) The calculation will result in a zero taxable gain ($1 - $1 = 0).

It's important to note that the buy sell agreement itself may establish the fair market value.

For example, let's say the business, Great Life, Inc. has two owners – Mr. Great and Ms. Life. They are 50/50 owners and their personal basis in the stock is $25,000 each. They have a buy sell that sets the value of the business at a total of $1,000,000.

Mr. Great dies. The buy sell is triggered. The estate will sell the business interest to the business for $500,000.

What is the taxable gain, if any? Remember, to calculate taxable gain you have to start with the owner's basis. The estate's basis is not $25,000 – rather it is adjusted to the fair market value at the date of death – that is $500,000. When the business pays the estate the $500,000 – there is no taxable gain to tax. ($500,000 - $500,000 = 0.)

2. What is the surviving owner’s basis in the business?

Ms. Life

Ms. Life is the sole owner. Her basis has not changed. It remains $25,000

Ms. Life did not personally take part in the buy sell transaction. The business is the purchasing party. Ms. Life’s basis in her business interest remains unchanged at $25,000.

What happens if Ms. Life sells the business sometime in the future? Let’s assume that she receives $1,000,000 (and that there were no other adjustments to her basis). With a basis of $25,000 she has a taxable gain of $975,000 and will pay the appropriate capital gain tax on that amount. ($1,000,000 - $25,000 = 975,000.)

3. Where does the business get the funds to pay for the buy out?

There are a number of resources the business may use to pay for the buy out.

Borrow the money from an outside lender.

This involves going to a bank or other third party and borrowing the money. But consider the situation. An owner has just died. Business stability may be in question. Cash flow may be hampered. Debt may be needed to maintain the business. Interest rates may be relatively high (or low). This doesn’t sound like an optimum moment to borrow money to complete a buy out. Relying on this option may be problematic. You may not be able to get a loan at all. If you can, the costs may be higher than anticipated. And, even if you can get the loan, will this new debt hamper the business’ ability to hire a replacement, pay off other debt, do the things the business needs to do to simply survive?

Borrow the money from the deceased’s family aka the installment buy out.

In an installment buy out, the business will pay the buy out price – generally to the surviving family – over a set period of time and at a set interest rate. Installment buy out provisions are often found in a buy sell agreement. It is typically the “back up” that protects the business in the event that it does not have sufficient surplus to complete a buy out. However, relying on an installment buy out as the primary means to fund the buy out raises a number of concerns. Will the business be able to survive the new debt load? Will the surviving family be able to handle the cash flow demands of receiving deferred payments rather than a lump sum? What happens if the business fails while the installment payments are still outstanding? Is this a cost efficient way of funding a buy out?

Savings/Surplus.

The business may use funds that it has accumulated. This assumes the business has had the time and discipline to create a sinking fund or accumulate value in other assets. It also assumes that the business did not want to deploy those funds for other business or personal purposes.

Business Owned Life Insurance.

Life insurance as the funding vehicle for all or a part of the buy out is a well established use of life insurance and will provide the business with funds at the death of the insured. How does it work?

- The business is the owner and beneficiary of a life insurance policy on the life of each owner.
- When an insured owner dies, the business receives the death benefit, generally, income tax free. See IRC Section 101(a) and 101(j).
- The business uses the death benefit to fund the buy sell.
- The cost to the business is equal to the premiums it has paid on the life insurance purchased for this purpose. Generally, the total premium paid will be significantly less than the buy sell amount itself. In addition, if the life insurance is a permanent life insurance policy, the policy may have cash value which is a business asset and a plus on the balance sheet, against the out of pocket cost to the business.

A Few More Words About Business Owned Life Insurance

Preserving the nature of the income tax free death benefit.

Because these are business owned life insurance policies, to preserve the income tax free treatment of the death benefit under IRC Section 101(a), the parties must meet the Notice and Consent requirements spelled out under IRC Section 101(j).

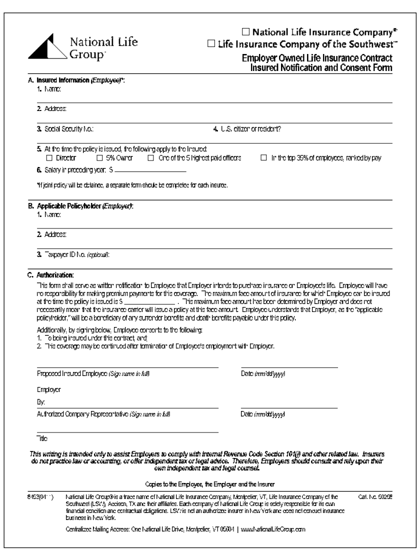
The business must notify the proposed insured, in writing, of the following:

1. Life insurance on that individual's life will be applied for by the business;
2. The maximum face amount at the time of issuance, and
3. A statement that the business will be the beneficiary of the death benefit.

The proposed insured must consent to the purchase in writing. The consent must state that the insured is aware that the business may keep the policy even after the insured has left the business.

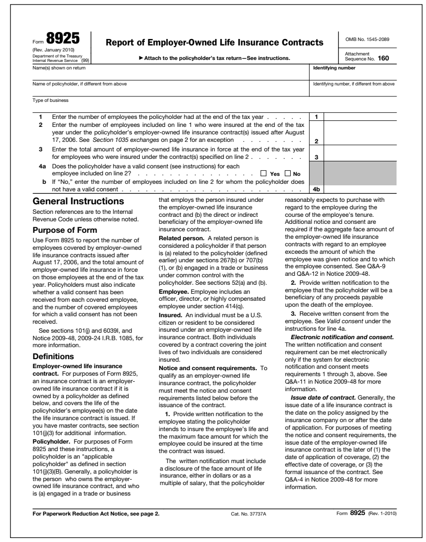
And yes, this requirement applies even where the insured is an owner of the business.

This notice and consent requirement must be completed BEFORE the policy is issued. If the notice and consent is not obtained before the policy is issued, the death benefit, when paid, will be treated as ordinary income to the business.


Employer Owned Life Insurance Contract Insured Notification and Consent Form

Please use National Life Group's Employer Owned Life Insurance Contract Insured Notification and Consent form – catalogue #50258.

Please note: National Life Group will not issue the policy until a Notice and Consent form is filed with the company.


Form 8925 Report of Employer-Owned Life Insurance Contracts

In addition, the business must comply with an annual tax reporting requirement. Called "Report of Employer Owned Life Insurance Contracts" this is Treasury Form #8925. It must be filed annually with the IRS.

On this form, the business will report on the life insurance owned by the business. While it is unclear what penalties might be applied if the annual reporting is not completed, the IRS may find that the client has not filed a completed tax return for the year in which it fails to file Form 8925. That could lead to late filing fees and penalties. The annual reporting is not the life agent's responsibility. However, it is good practice to note this requirement to the client when they are applying for the insurance.

Who Owns the Life Insurance in a Funded Entity Buy Sell?

In a funded entity buy out the policy will be owned by and payable to the business. The death benefit, when paid to the business, becomes cash on the business' balance sheet. Please remember, the premium payments are not a tax deductible expense.

The Cash Flow Needed to Fund the Buy Out

Another way to look at the buy sell funding issue is to consider the cash flow needed to pay for a buy out. For instance, let's consider the potential cash flow of a $500,000 installment buy out for Great Life, Inc. Assume that Great Life's gross margin is 20%. (Gross margin may be thought of as the gross profit margin.) For the technicians reading this guide, it is often represented by the following formula:

$$\text{Gross Margin (\%)} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

Let's also assume that the buy sell calls for a 5 year installment buy out with a 4% interest factor and no down payment.

What we need to remember, and what many clients are sensitive to, is that it's not just the check the business has to write, it's what the business has to earn to have the money to write the check.

Based on our assumptions, the business will need gross sales of at least $561,568 each year for 5 years (a total of $2,807,839). See the chart below:

Buy/Sell Details – The Installment Note

Purchase Price	$500,000
Down Payment	–
Installment Term	5
Installment Interest Rate	4%
Gross Margin	20%
Tax Rate	–

Year	Principal Remaining	Annual Payment	Gross Sales	Net Sales
1	500,000	112,314	561,568	112,314
2	407,686	112,314	561,568	112,314
3	311,680	112,314	561,568	112,314
4	211,834	112,314	561,568	112,314
5	107,994	112,314	561,568	112,314
		561,568	**2,807,839**	

If the gross margin is a bit higher, let's say 30%, the gross sales they will need for the installments will be reduced – here to a total of $1,871,893.

Buy/Sell Details – The Installment Note

Purchase Price	$500,000
Down Payment	–
Installment Term	5
Installment Interest Rate	4%
Gross Margin	30%
Tax Rate	–

Year	Principal Remaining	Annual Payment	Gross Sales	Net Sales
1	500,000	112,314	374,379	112,314
2	407,686	112,314	374,379	112,314
3	311,680	112,314	374,379	112,314
4	211,834	112,314	374,379	112,314
5	107,994	112,314	374,379	112,314
		561,568	**1,871,893**	

This dramatically demonstrates two of the key issues when considering the funding of a buy sell – the actual out of pocket cash flow and the gross sales needed.

Think about your conversation with a business owner client. When you talk about the challenges of running the business following the death of an owner you can point to the stress that this cost may add to the business and to the surviving owner. How concerned is the client about having to allocate that amount of cash flow and that portion of gross sales to complete the buy out?

Cash flow to pay the life insurance premium.

Let's say the annual premium to purchase $500,000 of life insurance on each insured totals $5,000. (Please remember – this is simply a hypothetical, the actual premium due on a case will depend on the amount of death benefit, age and health of the insured, type of life insurance product being used and other underwriting standards.)

Let's consider the gross sales the business will need to pay the $5,000. We'll use the same assumptions as above (20% gross margin).

Year	Annual Premium	Cumulative Premium	Gross Sales	Net Sales
1	5,000	5,000	25,000	5,000
2	5,000	10,000	25,000	5,000
3	5,000	15,000	25,000	5,000
4	5,000	20,000	25,000	5,000
5	5,000	25,000	25,000	5,000
6	5,000	30,000	25,000	5,000
7	5,000	35,000	25,000	5,000
8	5,000	40,000	25,000	5,000
9	5,000	45,000	25,000	5,000
10	5,000	50,000	25,000	5,000
	50,000		**250,000**	50,000

This chart shows payments through the first 10 years of the policy life. It Is designed to help give you an understanding of the gross sales that may be needed to have the funds to pay the premium. Life insurance premiums will be due through the entire term of the policy according to the terms of the life insurance policy. This chart is simply designed to demonstrate payment cash flows.

The business will need gross sales of $25,000 each year. Over 10 years, that's $250,000. Over 20 years that's $500,000 of gross sales. There is often a significant difference in the gross sales and out of pocket outlay needed when considering an installment sale vs. the use of life insurance.

By the way – these very calculations may be found in the Advanced Marketing business succession material.

Disability Entity Buy Out

A buy out triggered by the disability of an owner may also be traumatic to all the parties. Funding for a disability buy out has many of the same nuances as funding for a buy out triggered by death. Funding techniques include loans from a third party, installment payments, surplus and insurance.

Where disability buy out insurance is used, it is important to make sure that the buy sell agreement defines disability in the same way as the insurance defines disability. If there is a significant difference, you may have a buy sell triggered without the insurance benefits paid.

Some additional considerations:

1. Disabilities may start and stop and start again. It's possible that someone recovers for a period of time and comes back to work only to be taken ill again. How should the buy sell agreement treat this situation? The disability period may require a person to be unable to perform their duties for a consecutive period or the trigger may be based on a cumulative period of disability over a set period of time. There's no right or wrong – you just want to make sure everyone understands the arrangement and that the funding is properly aligned.

2. Understand the valuation issues. Disability buy out insurance may only cover a portion of the buy out price. In that case other funding techniques may be needed. For instance, the cash value of a permanent life insurance policy may be used to pay for a portion of the buy sell. (If the cash value is used in this manner different tax results may occur. If the policy is surrendered, the policy owner may have taxable gain. If the policy cash values are borrowed or surrendered, the death benefit will be reduced. If the policy is later surrendered, total gain in the policy will be taxable.) Of course, an installment pay out for the remainder of the buy out price should always be part of the buy sell agreement.

When Not to Use a Stock Redemption

The simple answer: When you have a family owned corporation. Where you have a family owned corporation – the "safest" buy sell arrangement is a cross purchase.

For those of you who want a little detail about this statement – and for those of you who don't mind a fair amount of complexity – the next few paragraphs will explain the reasoning behind this suggestion. Otherwise move ahead to the Cross Purchase section.

The Attribution Rules are to Blame

As you have seen, an entity purchase at death generally results in no taxable gain – in part because the transaction is assumed to be a sale and exchange.

There are situations though where a stock redemption will result in dividend treatment rather than exchange treatment. A dividend is a disadvantageous distribution because it is essentially taxed twice – once in the corporation as income and once to the shareholder upon receipt as a dividend. (Dividend payments are not tax deductible by the corporation.) In addition, there's no use of basis to offset the amount included. How can this happen?

First – you must understand the basic tax rules of distributions to shareholders. IRC Section 302 provides that a redemption may be treated as a dividend. However, IRC Section 302(b) provides that there will be no dividend treatment if the selling shareholder has sold all or a disproportionate amount of the stock he or she owns directly or indirectly.

We can really get into the technical weeds here – so let's keep it as simple as possible. It's pretty clear when someone owns something directly. But what about indirectly? That's where something called the attribution rules come into play.

What are the attribution rules? Found in the Income Tax Code (IRC Section 318), they establish when someone is **deemed** to own the stock that someone else owns. There are family, estate and entity attribution rules. Essentially, the rules create a legal/tax fiction. But that fiction can result in adverse tax treatment.

This guide is not meant to be a disposition on the complex set of laws that are the attribution rules. A quick synopsis and an example should suffice:

Family attribution applies where stock in the business is owned by the spouse, parents, grandparents, children or grandchildren of the person who stock is being redeemed. (IRC Section 319(a)(1)(A).) The family member's stock (although owned outright by the other party) will be attributed to the selling shareholder for the purposes of analyzing whether all the stock owned directly or indirectly by the person has been sold. So, for these purposes, the seller is deemed to own the stock held by their spouse, parents, children, etc.

Estate attribution occurs where the stock owned by a beneficiary of the estate is deemed to be owned by the estate.

Let's go back to Mr. Great and Ms. Life again and assume they are actually father and daughter. If Mr. Great retires and he sells his 100 shares back to the business in a redemption for $500,000 – it certainly looks like a sale and exchange. Except, to get that treatment Mr. Great has to have sold all the stock that he owns directly or indirectly.

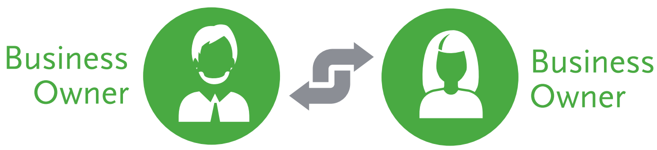
The indirectly – under the family attribution rules is an interesting tax fantasy. Mr. Great will be deemed to own his daughters' shares in the business. Of course he doesn't really own them, but for these purposes he constructively owns them under the operation of the family attribution rules. Mr. Great has not been redeemed of all the stock he owns directly or indirectly and the sale may be treated as a dividend.

There are some exceptions to the rule. For instance, in certain circumstances, it may be possible to waive the family attribution rules.

However, unless there are other compelling reasons, it may be best to avoid these complexities and the possibility of adverse tax consequences. This can be done through the use of a cross purchase arrangement. Dividend and attribution rules will not apply to a cross purchase.

Cross Purchase Arrangements

This graphic reflects a cross purchase arrangement. The purchaser is the co-owner (or co-owners if there are more than two owners).



If there are more than two owners, the arrangement generally provides for a pro rata purchase of the selling owner's interest.

Trigger Events

There are a number of trigger events that may cause the terms of a cross purchase buy sell agreement to be put in motion. They are the same as in an entity purchase and typically include the death, disability, retirement or resignation of one of the owners. There may be other triggers, such as the divorce or bankruptcy of an owner.

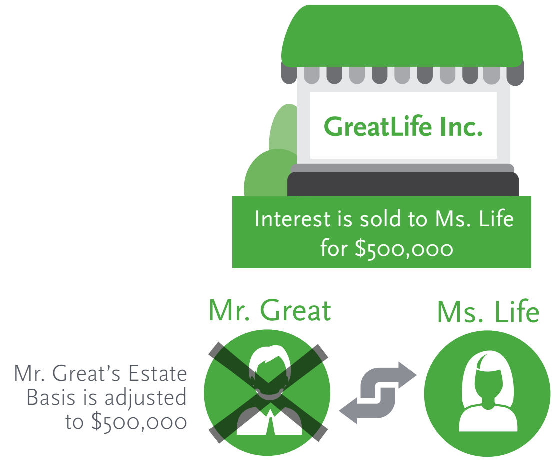
Cross Purchase at the Death of an Owner

When a co-owner dies and a cross purchase is triggered the surviving co-owner(s) will purchase the business interest from the deceased owners' estate. Let's consider the tax results of this transaction.

1. Is there taxable income to the deceased's estate? This result is exactly the same as in the entity purchase.

The estate's basis in the business will be equal to the fair market value of the business interest on the date of death. (See IRC Sections 1014(a).) This basis adjustment generally results in no taxable gain on the transaction. Why? Generally, the estate will sell the business interest for an amount equal to the fair market value.

Let's keep the same example that we used in reviewing the entity purchase. Great Life, Inc. has two owners – Mr. Great and Ms. Life. They are 50/50 owners and their basis in their stock is $25,000 each. They have a buy sell that sets the value of the business at a total of $1,000,000.



Mr. Great dies. The buy sell is triggered. The estate will sell the business interest to Ms. Life for $500,000.

What is the taxable gain, if any? To calculate taxable gain, you have to start with the owner's basis. Remember, the estate's basis is not $25,000 – rather it is adjusted to the fair market value at the date of death –$500,000. (See the full discussion of the adjusted basis under entity purchase.) When the business pays the estate the $500,000 – there is no taxable gain to tax.

As you can see, the type of buy sell agreement will not impact this result at all.

2. What is the surviving owner's basis in the business?

Because Ms. Life is the purchaser of the business interest, she now owns more shares (if a corporation) or a larger percentage of the business interest (such as in an LLC). Her basis in the newly acquired interest will be equal to what she paid for that interest. Her original basis was $25,000. Ms. Life's new basis in the business is $525,000 (the original $25,000 and the new $500,000).

What happens if Ms. Life sells the business sometime in the future? Let's assume that she receives $1,000,000 (and that there were no other adjustments to her basis). With a basis of $525,000 she has a taxable gain of $475,000 and will pay the appropriate capital gain tax on that amount.

One last point, please don't confuse this increase in basis with the Statutory Adjustment to Basis to the Estate that we discussed in question 1. These are very different concepts.

Let's take a moment to compare the potential results of the entity purchase to the cross purchase.

- Mr. Great's family will receive $500,000 in both arrangements.
- Ms. Life will be the sole owner in both arrangements.
- Ms. Life has an increase in basis under the cross purchase arrangement. The increase in basis may reduce future capital gain or income taxes. The increase in basis to the surviving owner is often cited as a reason to use the cross purchase rather than an entity purchase.
- No family, estate or entity attribution rules to worry about in a cross purchase.

3. Where will the surviving owner(s) get the funds to pay for the buy out?

There are a number of resources that surviving owner may use to pay for the buy out. They are similar to those noted under the entity buy out.

Borrow the money from an outside lender.

This requires each individual co-owner to be able to qualify for the loan – based on their personal worth and cash flow. Their ability to service the debt may be a question as a key person in the business has just died and cash flow may be reduced. The interest rates may be relatively high (or low). It may be difficult for the co-owner(s) to get a loan under these circumstances.

Borrow the money from the deceased's family aka the installment buy out.

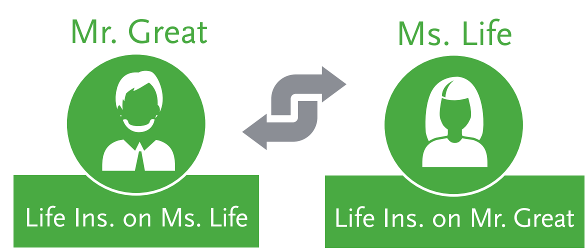
In an installment buy out, the surviving owner(s) will pay the buy out price over a set period of time and at a set interest rate. It is often the "back up" that protects the co-owners in the event that they do not have sufficient assets to complete a buy out. Relying on an installment buy out as the primary means to fund the buy out raises a number of concerns. Will the surviving co-owners be able to service the new debt load and by implication, will that personal debt load hamper business survival? Will the surviving family be able to handle the cash flow demands of the deferred payments? Is this a cost efficient way of funding a buy out?

Savings / Surplus.

It may be that the surviving co-owner(s) have accumulated funds on their personal balance sheet in an amount equal to the buy out price. But that assumes the co-owner(s) had the time and discipline to create a sinking fund. It also assumes that the co-owner(s) did not want to use those funds, through the years, for other personal or business purposes.

Alternatively, the business may have accumulated surplus that the surviving owners can use. However, this will generally require a distribution or compensation payment with potential income tax consequences to the owners. Relying on personal or business surplus is an unreliable methodology.

Cross Owned Life Insurance



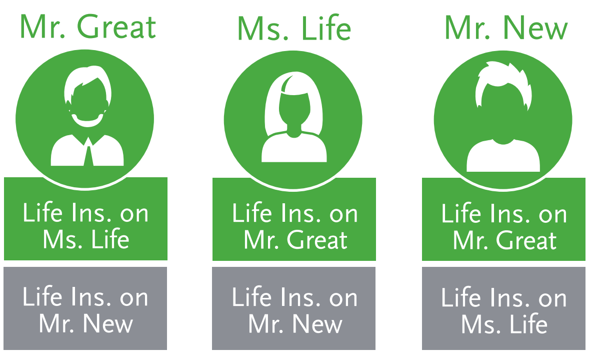
- Each co-owner will be the owner and beneficiary of life insurance on the life of their co-owner(s).
- The premium may be paid with personal funds, amounts received as a bonus or distribution from the business or through split dollar arrangements.
- When an insured owner dies, the policy beneficiary will receive the death benefit, generally income tax free. See IRC Section 101(a).
- The beneficiary (the surviving co-owners) will use the death benefit to fund the buy sell.
- The cost to the co-owners is equal to the premiums they have paid on the life insurance purchased for this purpose. Generally, the total premium paid will be significantly less than the buy sell amount itself. In addition, if the life insurance policy is a permanent policy, it may have cash value accumulations.

4. Making sure the death benefit will be used for the buy out – a trusteed arrangement.

It's natural to want some way to assure that the death benefit will be used to fund the buy out. After all, the surviving owners will have an infusion of cash and some people may be concerned that the surviving owner may not use the money to fund the buy out. One way to avoid this concern is to use a trustee to own the life insurance and to be the beneficiary of the policy. The trustee will receive the death benefit and will complete the buy out under the terms of the buy sell agreement. Generally, the trust language is found in the buy sell agreement.

5. What to do when there are more than 2 owners.

When you have more than two owners you start running into a variety of issues. Let's take the simplest case first – let's say there are three owners. Going back to Great Life, Inc. – let's assume that there are three owners rather than two – each owning 1/3 each. So we have Mr. Great, Ms. Life, Mr. New. In a standard cross purchase situation they will purchase 6 policies.



- Mr. Great will own a policy on Ms. Life and Mr. New.
- Ms. Life will own a policy on Mr. Great and Mr. New.
- Mr. New will own a policy on Mr. Great and Ms. Life.

That's not so bad, but it starts to get out of hand when you get to 4 or more owners. With 4 owners you need 12 policies and it's even more daunting when we get more owners than that. The calculation is N x (N-1). N is the number of owners. So if you have 5 owners: 5 x (5 -1) = 20

Over the years, there have been numerous attempts to solve this multiple policy dilemma. They include:

- Use an entity purchase arrangement. This is the path of least resistance – one policy per owner is all that's needed. Of course, you give up some of the benefits of a cross purchase arrangement.
- Use co-ownership on each policy. This will result in one policy per owner that is co-owned by the other business owners. However, there may be transfer for value rule complications – which will be reviewed in a moment. For instance...

Life Ins. on Ms. Life	Life Ins. on Mr. New	Life Ins. on Mr. Great
OWNED BY: Mr. Great Mr. New	OWNED BY: Mr. Great Ms. Life	OWNED BY: Ms. Life Mr. New

- Use a trusteed agreement and have one policy on each life owned by and payable to the trustee. There may also be transfer for value rule problems with this solution – which will be reviewed in a moment.

A little more complicated than it first seems.

For the trusteed and co-owned solutions, there are hidden complications and tax traps lurking for the unwary. The two key problems are:

1. At the first death what happens to the deceased's interest in the remaining policies, and
2. Following a death will there be a transfer for value of the deceased's interest in the remaining policies?

An example will help us focus on these two questions. Let's look at the three co-owners in Great Life, Inc. Here we see the three policies they have purchased.

Life Ins. on Ms. Life	Life Ins. on Mr. New	Life Ins. on Mr. Great
OWNED BY: Mr. Great Mr. New	OWNED BY: Mr. Great Ms. Life	OWNED BY: Ms. Life Mr. New

Let's assume that Mr. Great dies. The death benefit will be paid to Ms. Life and Mr. New and they use it to complete the buy out.

There are two life insurance policies still in force (the policy on Ms. Life and Mr. New). ½ of each policy is now owned by and payable to Mr. Great's estate. Part of this life insurance is now owned by and payable to the wrong party.

Life Ins. on Ms. Life	Life Ins. on Mr. New
OWNED BY: Mr. Great's Estate and Mr. New	OWNED BY: Mr. Great's Estate and Ms. Life

Of course, it's possible to set up the ownership to immediately transition to the surviving co-owner. That seems to work. Mr. Great's ½ interest in the policy on Ms. Life passes to Mr. New and Mr. Great's ½ interest in the policy on Mr. New passes to Ms. Life. This can be done in the ownership language in the life insurance policy. Or, the surviving co-owner may purchase the ½ interest in the policy from Mr. Great's estate.

(Please remember, the cash value in the policy will be included in Mr. Great's estate. A review of the estate tax consequences should always be a part of the analysis.)

This leads us to the transfer for value question.

Let's consider one of the policy's – Mr. Great's ownership interest on the policy insuring Ms. Life. If Mr. Great's interest passes to Mr. New is there a Transfer for Value?

The short answer: Yes. What is the penalty for violating the transfer for value rule? All or a large portion of the death benefit, when paid, is treated as ordinary income. (See IRC Section 101(a)(2).) This is not a result that we want.

There are exceptions to the transfer for value rule. The exception applies where the policy is transferred to:

a. the insured,

b. to a partner of the insured,

c. to a partnership in which the insured is a partner

d. to a corporation in which the insured is an officer or shareholder, or

e. where the transferee's basis is determined in whole or in part by reference to the transferor's basis.

How do we apply the available exceptions to the buy sell situation?

- If the co-owners are partners in the same partnership or members of the same LLC (operating as a partnership for tax purposes) at the time the transfer of the policy occurs, then nothing further needs to be done – the transfer for value exception applies.

- The challenge in meeting this exception is where the underlying business entity – in our example Great Life, Inc. - is not a partnership or LLC. If the business entity is a Corporation then it may be necessary to create a separate partnership among the co-owners so that the transfer for value rule exception will apply. The newly created entity should have a legitimate business purpose (something other than owning life insurance). As long as the parties are partners in a bona fide partnership at the time the transfer of the policy is made, then the exception to the transfer for value rule should apply. Please remember, the partnership may be unrelated to the buy sell.

Is the transfer for value rule avoided by using a trusteed agreement?

No, the transfer for value rule will also apply to trusteed arrangements. The trustee is holding the legal title but the beneficial interest is for the co-owners of the business. We end up with the same analysis on transfer for value as above. The same exceptions will apply.

Disability Cross Purchase Buy Out

Funding for a disability buy out may come from a number of sources. Loans from a third party, installment payments, surplus and disability buy out insurance are the standard options.

Where disability buy out insurance is used, it is important to make sure that the buy sell agreement defines disability in the same way as the insurance defines it. If there is a significant difference, you may have a buy sell triggered without the insurance benefits paid.

Please see the discussion of disability buy out under the entity buy sell section.

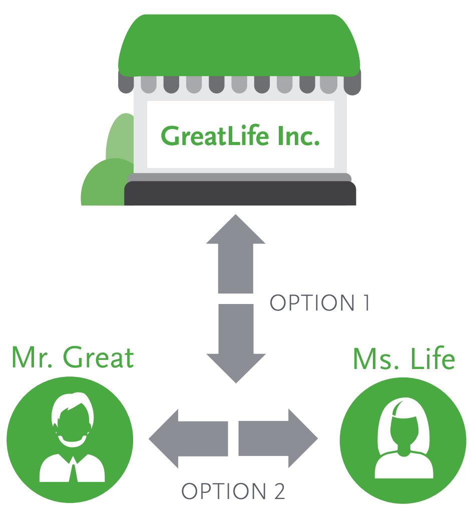
Let's move on to...

Hybrid Buy Sell – aka – Wait and See

When helping to develop a buy sell plan it would be nice to have a crystal ball that lets us see when a trigger event will happen, what the business' financial position will be at the time, what the family's financial position will be, whether the business will have a lot of creditors, the status of a variety of tax laws. But we don't have that crystal ball. Since we can't know what conditions will be in the future a key to planning is to have a flexible arrangement that can address these variables and give parties the ability to make choices at the time the facts are known. This is what the Wait and See Buy Sell attempts to do.

A wait and see buy sell is really a series of options. Generally, it starts with the business having the option to purchase the business interest from the selling owner. After the initial option period expires what happens next?

- Required cross purchase.
  In some wait and see buy/sell agreements, if the business does not exercise its option then the co-owners are required to complete the buy out through a cross purchase.
- Optional cross purchase.
  In other wait and see buy sells, if the business doesn't exercise the option then the co-owners have the option to purchase.



If the cross purchase option isn't exercised, then the business may be offered another option to buy. (In some agreements this is not an option but a required purchase.) If this is an option and the business does not exercise the option, the business may be liquidated or offered for sale to a third party.

As you can see, the wait and see has a number of variations. The client and the client's counsel will make the ultimate determination as to the form they prefer to adopt.

What is the benefit of this format? Think about the flexibility of this design. The surviving owners will be able to look at their business and personal situation at the time the buy out is actually triggered and make an informed decision as to whether an entity or cross purchase makes the most sense.

Who Owns the Life Insurance in a Wait and See Buy Sell?

The life insurance should be cross owned (as if it were a cross purchase agreement). Why? This ownership gives the parties the needed flexibility to move the money where it's needed without adverse tax consequences.

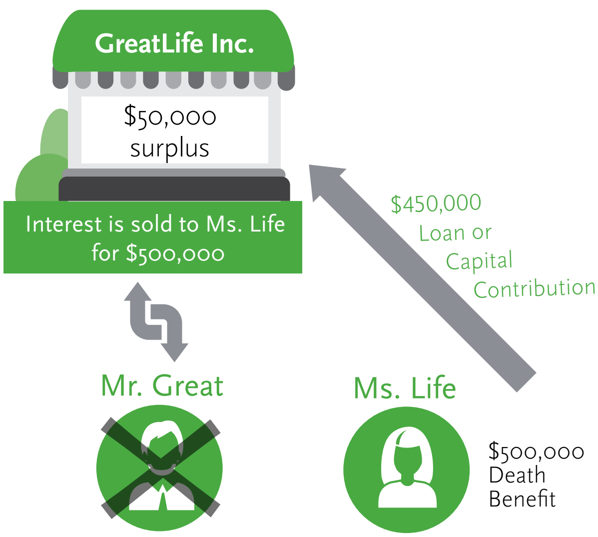
Let's go back to Mr. Great and Ms. Life. They have a wait and see buy sell. They will cross own the insurance, Mr. Great will own the policy on Ms. Life and Ms. Life will own the policy on Mr. Great. Mr. Great dies. The death benefit is delivered to Ms. Life on an income tax free basis.

Ms. Life now has the choice to have the business exercise the option to buy or to complete the buy out as a cross purchase. Let's say she knows that in the next couple of years she will want to sell the business. In this case she wants to maximize her personal basis and completes the buy out as a cross purchase. She has the death benefit in hand and completes the buy out.

Let's change the situation – Ms. Life plans on owning and running the business for many years into the future. She first looks to the business situation and – adding a new fact – Great Life, Inc., happens to have $50,000 of surplus. In this case, Ms. Life decides that she wants the business to complete the buy out.

Ms. Life decides that the business will use the $50,000 of surplus funds as the first source of money for the buy out.

That leaves the business $450,000 short. Of course, Ms. Life has the $500,000 of income tax free death benefit. She may loan or make a capital contribution of $450,000 to the business. The business now has the $500,000 and completes the buy out.



What does Ms. Life have? If the contribution to the business takes the form of a loan, then the business will repay her the $450,000 over the life of the loan. Principal will be paid to her income tax free. The business will pay interest on the loan. While the interest is taxable income to Ms. Life, it will not be subject to federal withholding taxes as it is not compensation. So there is an efficient flow of funds from the business to Ms. Life.

What is the impact on Ms. Life's basis? A loan to the business, where the business is a C Corporation will not impact basis. However, a loan to a pass through entity may increase basis.

If the contribution to the business was made as a capital contribution then Ms. Life's basis will increase in an amount equal to the contribution.

What happens if there are multiple owners?

Please review the discussion under the cross purchase analysis – it is the same analysis here.

Let's take a moment to compare the potential results of the entity purchase to the cross purchase and the wait and see.

- Mr. Great's family will receive $500,000 in all arrangements.
- Ms. Life will be the sole owner in all arrangements.
- Ms. Life has an increase in basis under the cross purchase arrangement. Under the wait and see, Ms. Life may choose an option which will increase her basis.
- No family, estate or entity attribution rules to worry about in a cross purchase.
- The flexibility to select the most appropriate form of buy out at the time of the trigger event is available only in the wait and see.

A Few More Thoughts – Buy Sells Triggered by the Retirement of an Owner

We spend a lot of time thinking about buy outs triggered by death (and disability). These are risk situations and the planning is designed to address those risks.

However, many times a business owner simply gets to the point where they start thinking about and planning for retirement. The buy sell agreement should address this scenario. Generally, a buy sell triggered by retirement is not a surprise situation. The parties have time to consider how to put the funding together and to assess (or reassess) the price of the buy out triggered by retirement.

Where permanent life insurance has been used as the funding vehicle for the buy out at death, the parties may benefit from having cash value in the policy. That cash value may be used as a source of the payments using policy loans or withdrawals (generally part or all of the down payment). An Installment buy is a typical means of completing the buy sell.

Policy loans and withdrawals reduce the policy's cash value and death benefit and may result in a taxable event. Surrender charges may reduce the policy's cash value in early years.

CONCLUSION

Buy Sell planning – as part of business succession planning – is a vital part of a business' operating plans and a family's financial security.

Understanding how buy sell arrangements work and how they are funded is an important aspect of your work with business owners.