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INSURANCE PRODUCTS	
MAY LOSE VALUE	NOT A DEPOSIT
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As a business owner, you realize that the future success of your business often depends on you, any co-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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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 retire, die, or become disabled:

- Who would control your share of the business?
 - Is that who you would want 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 retires, dies, or becomes disabled:

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



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A buy-sell plan can offer you and your business co-owner(s) several benefits, including:



Eliminating uncertainty

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



Setting 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 may also help you in your estate planning as the value of the business is more clearly understood.¹



Creating 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.



Maintaining harmony

A buy-sell plan can help secure peace of mind and maintain harmony because there is no uncertainty about how a 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.



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The value of life insurance

Life insurance is often used to fund a buy-sell plan because it can provide the 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 potential 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 three distinct tax advantages:

1. Income tax-free death benefit
2. Tax-deferred growth
3. Income 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, including:



Borrowing 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. Depending on a number of factors, it may be difficult to obtain a loan after the death or retirement of an owner. Also, keep in mind that even if a loan is obtained for the buyout, 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.



Leveraging sinking fund

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



Purchasing by installment

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. Ultimately, it could result in the business' failure if additional capital is not available.

Help eliminate uncertainty and the need to determine how to fund a buyout when the firm is in crisis by implementing a buy-sell 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.



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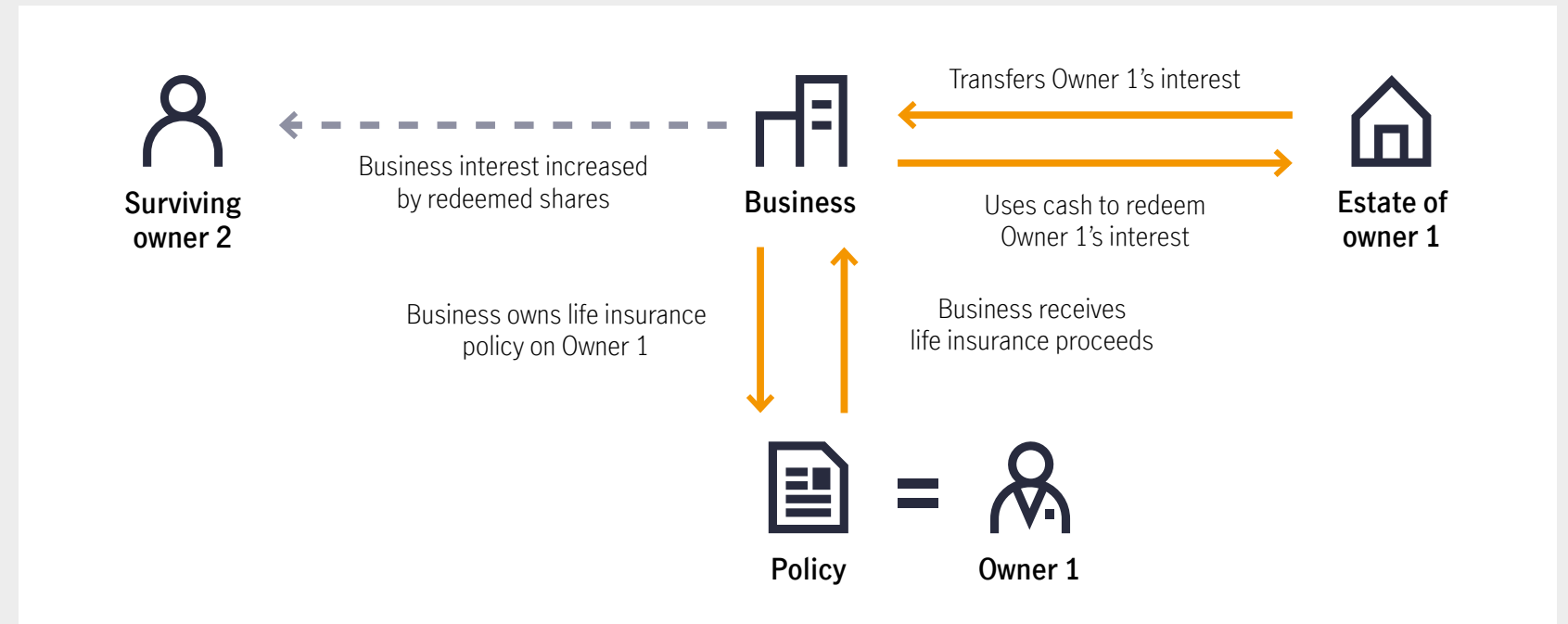
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Entity-purchase

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

When this type of buy-sell arrangement is funded with life insurance, the business is the owner and beneficiary of the policy and will pay the corresponding premiums. Upon the triggering event, the business uses the policy's death benefit or cash value to purchase your interest.



Key benefits

- **Multiple owners:** offers a simple approach that can work 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, 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 Consent²
- **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



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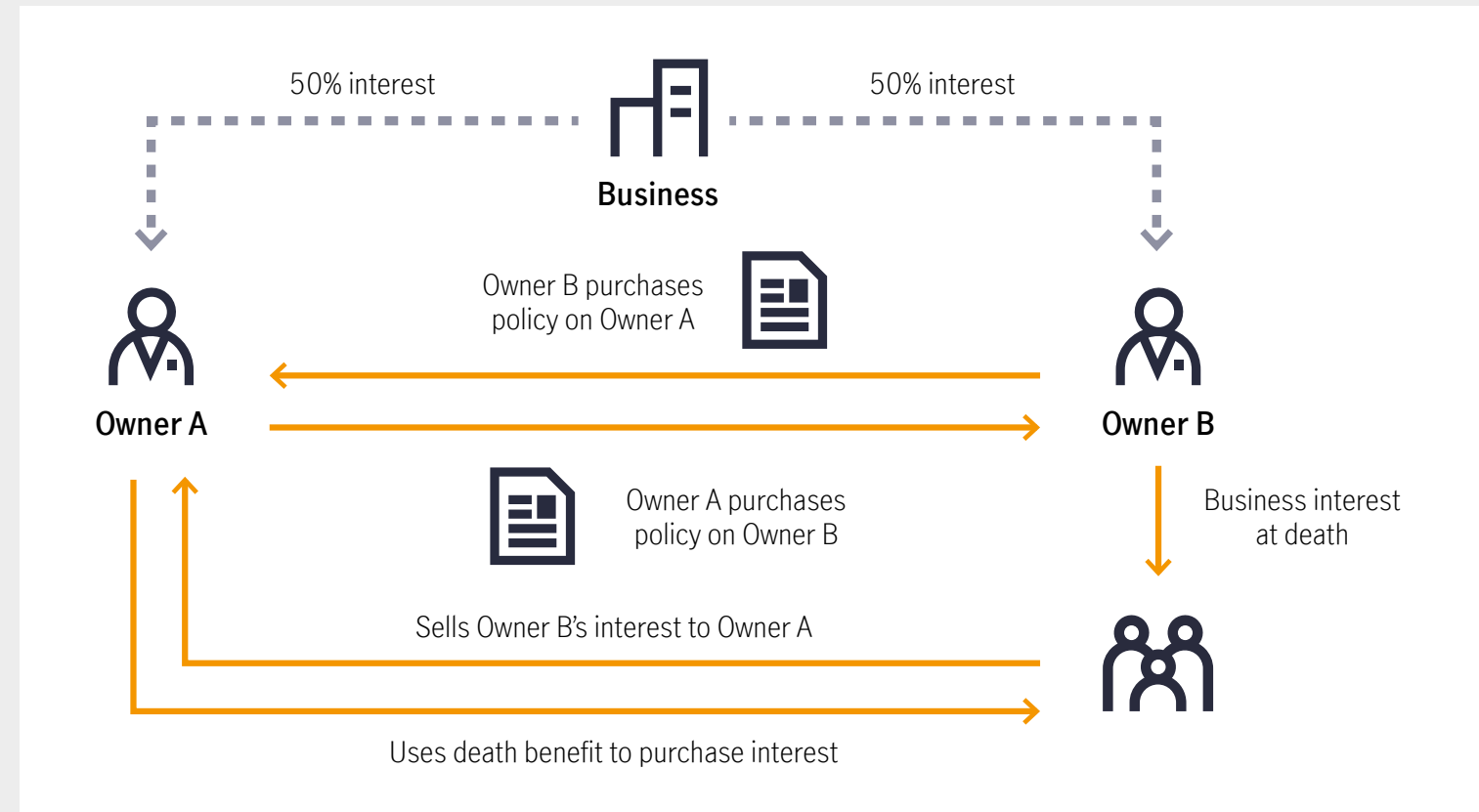
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Types of buy-sell plans, continued

Cross-purchase

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 owner B to purchase your shares. Your estate will continue to own a policy on the life of owner B, which 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, their 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^{3,4}
- **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 when the plan is terminated may have income tax ramifications



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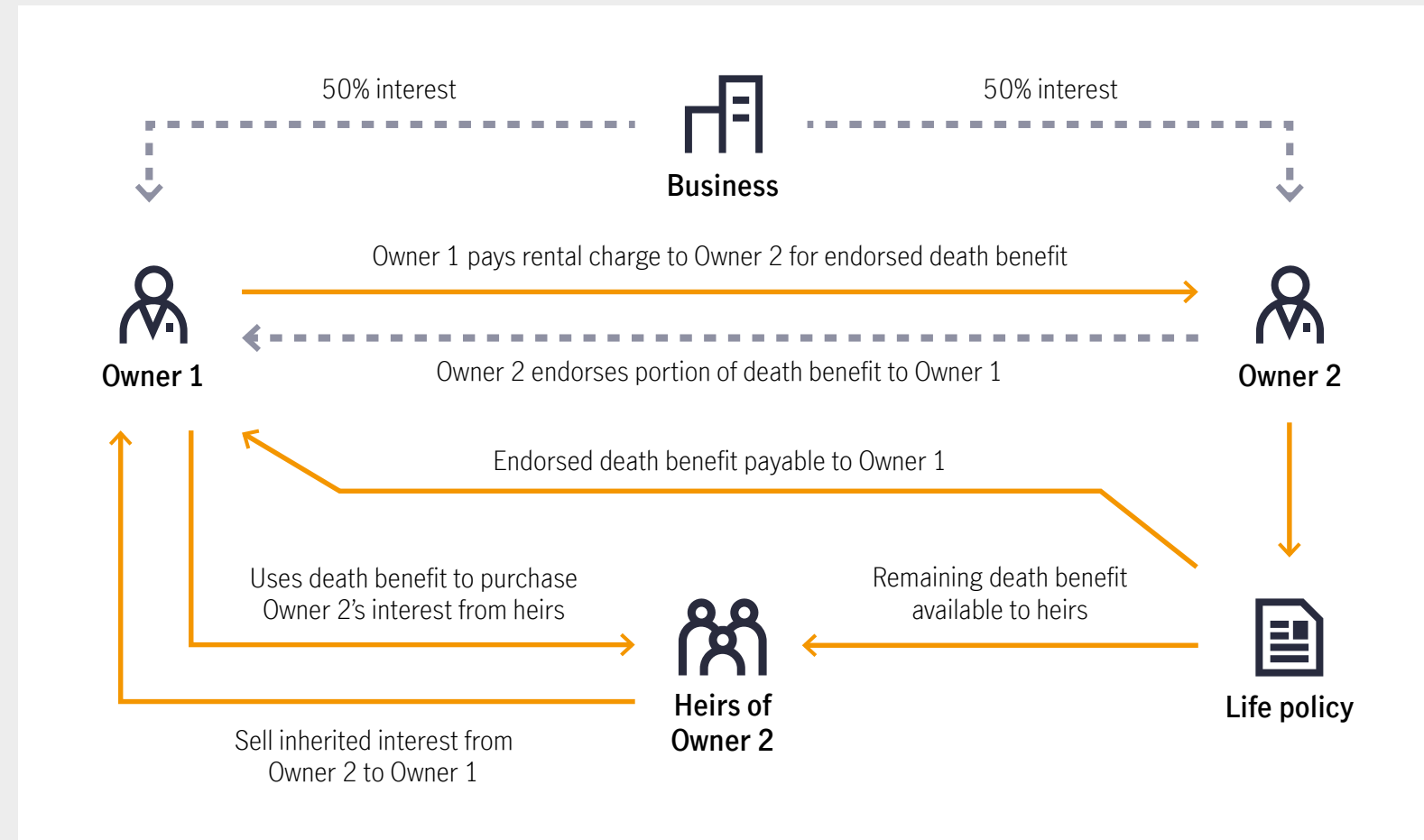
Types of buy-sell plans, continued

Cross-endorsement buy-sell (CEBS)

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

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.⁵ Any death benefit not endorsed to your co-owners will be paid to your designated beneficiaries (e.g., spouse and children).

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



Key benefits

- **Personal ownership** creates a hybrid plan that can help 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 increase over time:** Economic Benefit costs increase with age
- **Death benefit impacts:** accessing the life insurance policy's potential cash value may lower the death benefit
- **Tax implications:** rental income may be taxable
- **C and S corporation owners:** may not be appropriate for these owners due to “transfer-for-value” rules⁶



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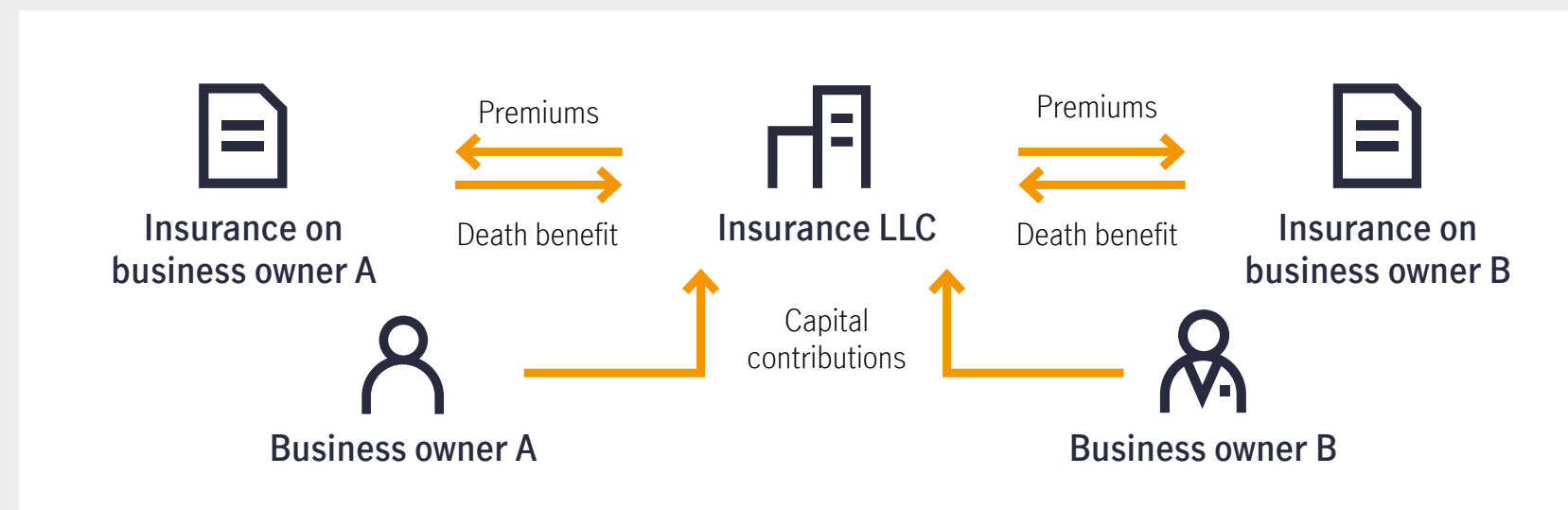
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Types of buy-sell plans, continued

Insurance LLC

An Insurance LLC is another alternative to the typical funding approach used with traditional cross-purchase arrangements. With an Insurance LLC, you and the other owners of your business form an LLC taxed as a partnership, which is separate from the primary business. The LLC facilitates the cross-purchase obligations under the buy-sell arrangement; to fund buy-sell requirements, the LLC will purchase a permanent life insurance policy on the life of each owner.

Upon your death, the proceeds are paid to the Insurance LLC and distributed to the surviving co-owners to buy out your interest for its agreed-upon value. For a lifetime buyout, the policy on your life can be transferred to you tax-free as part of the liquidation from the LLC and the primary business. After your departure from the business, the policy can be used for personal planning needs, such as a source of supplemental retirement income or for death benefit protection for your family.



Key benefits

- **Simplicity:** only one policy per owner is needed
- **Promoting equity among owners:** premium-funding disparities related to age, health, or ownership percentage can be addressed through negotiation among all owners
- **Flexibility:** new owners can be incorporated into the plan with relative simplicity
- **Creditor protection:** policies are protected from debts of primary business and of individual owners
- **Limits transfer-for-value concerns:** this technique may help avoid transfer-for-value issues that often arise, especially as new owners come into the business and others leave
- **Basis increase:** surviving owners receive a step-up in basis on the purchased interest of a departing owner
- **Estate-tax exclusion:** life insurance proceeds can be excluded from the deceased owner's taxable estate with proper planning⁷

Important considerations

- **Estate taxes:** owners must work with legal counsel to ensure that the terms of the LLC operating agreement meet certain requirements and do not inadvertently create estate-tax inclusion
- **Employer-owned insurance:** business owners should comply with §101(j) requirements, including Notice and Consent²
- **Ongoing management and coordination with the planning team:** these arrangements are complex and require coordination with financial professionals, attorneys, and CPAs



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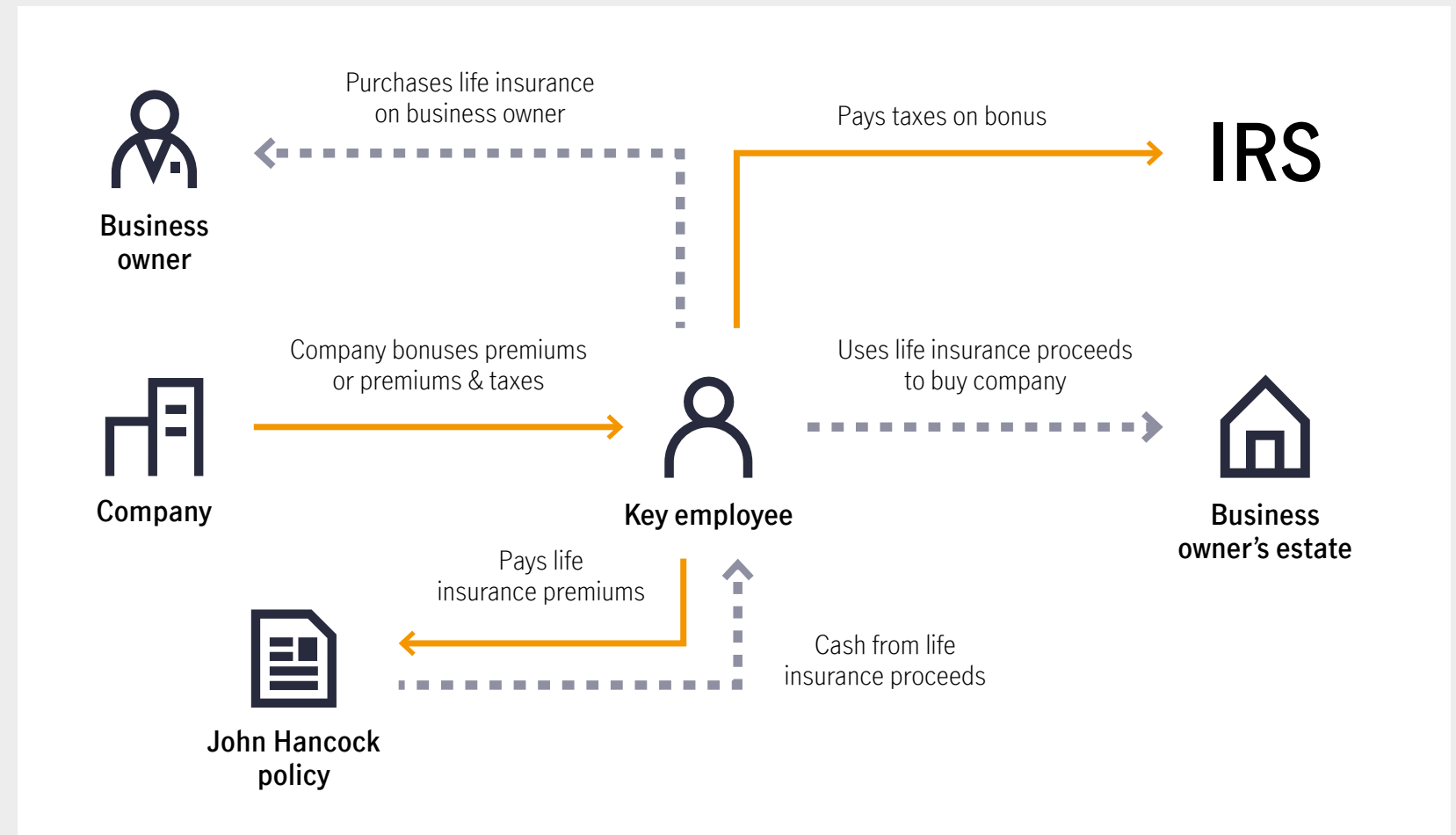
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Types of buy-sell plans, continued

One-way

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 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 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

Important considerations

- **Access to policy cash value** may lower the death benefit needed to satisfy the buy-sell obligation
- **Income taxation:** if you pay a bonus to the key employee in the amount of the premiums, the bonus amount will be taxable income to them
- **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)



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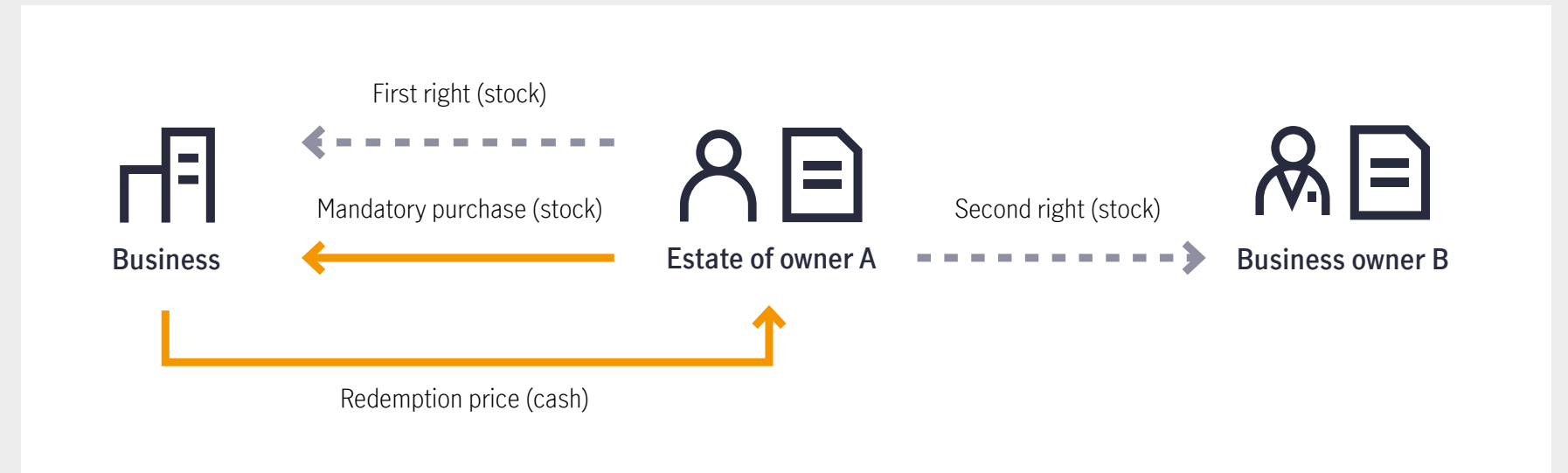
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Wait-and-see

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

Important 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 professional for more information



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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 business owners, and who will own any life insurance purchased (i.e., the business, your partners, yourself). As you consider your options, refer to the following chart for highlights of each of the common buy-sell plans discussed in this guide.

	Entity-purchase	Cross-purchase	Cross-endorsement	Insurance LLC	One-way	Wait-and-see
What is it?	Business agrees to buy the interest of departing 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	Partnership created to own and manage life insurance policies as funding for cross-purchase arrangement	Key employee agrees to buy the business from the owner	Hybrid arrangement that combines features of entity-purchase and cross-purchase arrangements
Funding with life insurance?	Business buys a policy on the life of each owner	Each owner buys a life insurance policy on the life of each of the other owners	Each business owner buys a policy on their own life	LLC buys policy on the life of each owner	Key employee buys the life insurance policy on the 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 buyout	Each owner endorses a portion of the death benefit on their life to the other owners	Proceeds paid to LLC used to purchase interests of departing business owner	Key employee enters into a one-way arrangement with the owner	Business typically has right of first refusal, then owners have right to purchase. If owners do not exercise right, business 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	Owner pays the premiums on their own life and a rental charge to the other owners, which may be funded with help from the business	LLC pays the premiums via contributions from owners	Key employee 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	No	Yes, if owned by the business
For whom does it work best?	C corporations and businesses with several owners	Businesses with three or fewer owners	Business owners looking for additional flexibility and who want to use the insurance for personal needs as well	Business owners who want to limit number of policies purchased and create flexibility	Business with one owner	Business owners who want flexibility for changing needs
Is there a basis adjustment for surviving owners?	Maybe (depending on entity type)	Yes	Yes	Yes	Yes	Maybe (depending on outcome)



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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.¹

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.

Cutthroat

The purchase price is determined by the owners at the time of sale. The selling owner will offer their 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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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 and tax professionals about the importance of protecting your business and your family. Ultimately, an effective succession plan can give you peace of mind 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 when necessary, such as increases in the value of the business or changes in ownership structure.

1. In *Connelly v. United States* (No. 21-3683 (8th Cir. June 2, 2023)), the Eighth Circuit rejected, for estate tax purposes, the value of the business negotiated between the estate of the majority owner and the business. The Court concluded that the amount agreed upon was not a “fixed or determinable” price set out in the buy-sell agreement, and therefore not controlling. Clients should consult with experienced legal and tax professionals to discuss the business valuation methodology in any buy-sell agreement.
2. 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 §101(j).
3. See IRC §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.
4. See IRC §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.
5. Transfer-for-value rules under §101(a) must be considered in this type of arrangement for the death benefit to be received income-tax free.
6. 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 discuss this issue with their tax professionals.
7. 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.
8. The use of a bonus arrangement creates additional compensation to the recipient and must fall within the reasonable compensation guidelines of IRC §162 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 59½.

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Talk to your financial professional about creating and **funding a buy-sell arrangement** to help with the succession and transition of your business.