



INSURANCE BACKED BUY-SELL AGREEMENTS

Leaving a Legacy Through Your Business

Closely held businesses create wealth for millions of American families. Unfortunately, significant additional wealth often evaporates at a business owner's death because of difficulty transitioning and monetizing the deceased owner's interest in the business. Basic business succession planning put into place with a buy-sell agreement backed by life insurance can ensure a smooth transition of the business and monetize it for the owner's heirs.

Buy-Sell Agreement

- An agreement among closely held business owners (which may be part of a shareholders' or operating agreement) that restricts the owners' rights to transfer their interests in the business.
- Buy-Sell Agreements give the business and/or owners the right (and sometimes the obligation) to purchase the interests of an owner when the owner dies or wishes to make a lifetime transfer of his or her interest in the business.
- In the case of death, this prevents the interest of a deceased owner from passing to others whom the remaining owners would not want to be in business with (e.g., a spouse) while simultaneously providing funds to the deceased owner's family from the sale of the deceased owner's interest.
- The buy-sell agreement also sets forth how to value an owner's interests in the business.

Funding a Buy-Sell Agreement

- In some cases, a business or its owners may have sufficient funds to purchase a deceased owner's interest in the company.
- Generally, however, it works best to fund the purchase with life insurance using a redemption, cross-purchase, or alternative structure.
- Business owners should consult a business valuation expert (such as a CPA) to assess value of their business to determine the level of insurance coverage needed and an insurance professional who can arrange funding of the buy-sell agreement and periodically review the plan.

Redemption vs. Cross-Purchase

- With a redemption, the company pays life insurance premiums, is the beneficiary of the policy proceeds, and uses the proceeds to acquire a deceased owner's interest in the business.
- A redemption structure is simple to administer because the business owns and manages the policies; however, because the business receives the insurance proceeds on the death of an owner, the remaining owners will generally not receive a step up in basis on the redeemed interest.
- With a cross-purchase, the business owners individually own policies insuring each other's lives and use the policy proceeds to purchase the interest of a deceased owner.
- Any interest the surviving owners buy from the deceased owner will have a basis equal to the purchase price for the interest, reducing their future income tax liability if the company is later sold.
- However, there are disadvantages to a cross-purchase, such as the number of policies required if there are more than 2 owners (e.g., 3 owners requires six policies), the complexity of administration, and the potential tax resulting from the transfer-for-value rules if surviving owners acquire policies held by a deceased owner that later payout on the death of an owner.
- An alternative to a cross-purchase arrangement that eliminates some of the aforementioned disadvantages is forming an "Insurance LLC" to own and manage the insurance policies.
- When an owner of the operating business dies, the LLC collects the proceeds and distributes them to the surviving owners who then acquire the deceased owner's interest in the operating business.