Business Planning Strategies

Business Succession Planning

PRODUCER GUIDE

Buy-Sell Agreements

Your clients who are business owners may not see their business survive their...

Disability...Retirement...Death.

The healthiest, youngest, most energetic business owner will at some moment in time either sell his or her business or while owning the business become disabled, retire, or die.

As you work with your clients to protect the survival of their business, Columbus Life wants to provide you and your clients with the products and value-added service you have come to count on from us.

Why does a business owner need a Buy-Sell Agreement?

Most small businesses fail to survive beyond the first generation. One reason is the failure to plan for the disposition of the business at an owner's death, disability, retirement or withdrawal[1].

Structuring a Buy-Sell Agreement

Buy-sell agreements can be structured to meet the needs of both the business and the owners, taking into consideration tax implications and individual goals for the transfer of the business. In its simplest form, a buy-sell is generally structured in one of the following ways. Combinations of these are also possible.

In order for a buy-sell agreement to be effective to help set the value for estate tax purposes, the agreement must:

- Be a bona fide business agreement.
- Not be a device to transfer the business to family members for less than full and adequate consideration.
- Have terms comparable to similar agreements entered into by persons in an arm's-length transaction.
- Be valid and enforceable under state and/or federal law.
- Be binding on the parties during life and at death.
- Contain a formula for determining the price of the property when one of the parties dies or be based on an independent appraisal done after death.

1 The Family Business Institute. Family Business in Translation: Data and Analysis.January 2007. Website accessed on 5-16-2015.

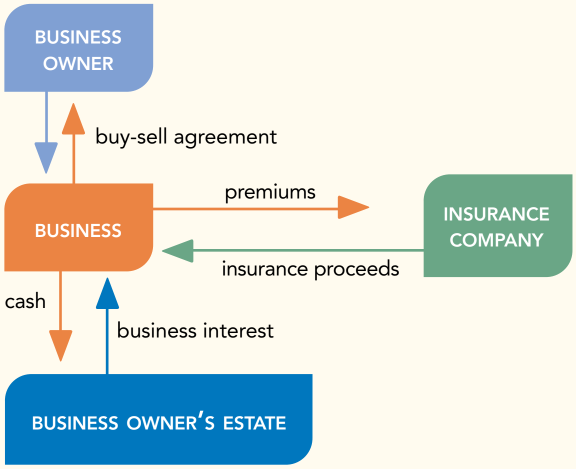
Entity Purchase Method

The entity purchase agreement uses a contract between the business and each of the owners. Under the terms of the agreement, the business promises to purchase the interest of a departing, disabled or deceased owner and each owner promises to sell.

When the buy-sell agreement is funded with life insurance, the business owns a policy on each owner. The business is named as the beneficiary and pays the premiums.

At the death of an owner, the business receives the policy benefits which may be used to meet purchase obligations.

BUY-SELL ENTITY PURCHASE METHOD



TAX CONSIDERATIONS: ENTITY PURCHASE AGREEMENTS

- Premiums paid by business are not income tax deductible.
- Policy proceeds paid to the business at death are generally received income tax free.
- Cash values within the policy accumulate on an income tax-deferred basis.
- The estate receives a stepped-up basis in the business interest equal to its value for federal estate tax purposes.

NOTE: Any form of business other than a sole proprietor may establish an entity purchase buy-sell agreement.

This method of establishing a funded buy-sell agreement is particularly useful when there is a desire to have your business pay for the insurance products funding the buy-sell or in situations where the use of other methods of establishing the plan would be impractical.

Family Attribution Rules

A stock redemption, except under IRC Section 303, will usually terminate the estate's or heir's interest in the corporation. The problem is that the estate or heir may be treated under the attribution rules as constructively owning stock actually owned by others: spouse, children, grandchildren, or parents *(and also certain entities such as trusts, estates and businesses)*.

However, assuming all direct interests in the corporation have ceased, including any interest as an officer, director or employee *(being a creditor is permitted)*, the family attribution rules may be waived by filing an agreement with the IRS not to reacquire an interest in the corporation in the next 10 years. This will then allow a redemption to be a complete termination of interest despite continuing ownership by close family members. NOTE that the entity attribution rules may not be waived.

Section 303 Redemption

Congress has recognized the unique estate liquidity problem faced by the estates of deceased shareholders of family corporations. Often, such shareholders want to retain the business within the family. But the sudden liquidity needs arising at death — death taxes, probate costs, funeral expenses, etc. — could require these estates to sell off part of the business to generate cash. This would create a new problem: outsiders coming into the business. Or, if the corporation redeemed part of its stock to get cash into the estate, the corporation's distribution could be treated as a dividend.

For this reason, Congress passed a special provision, Section 303 of the Internal Revenue Code. In brief, Section 303 allows a shareholder's estate or heir to sell to the closely held corporation enough stock to pay federal and state death taxes, costs of estate administration, and funeral expenses without treating the transaction as a dividend to the redeeming shareholder.

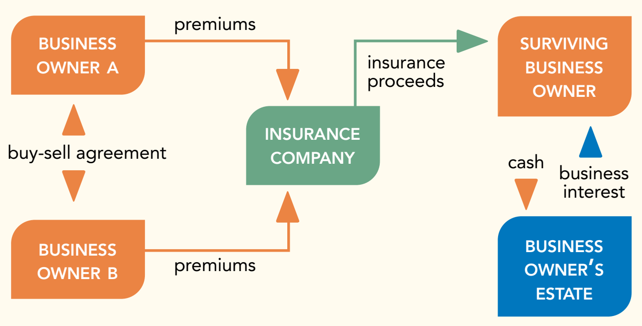
Cross Purchase Method

The cross purchase method of establishing a buy-sell agreement uses a contract between the co-owners. The business itself is not a party to the contract.

Each owner agrees to purchase a share of a departing or deceased owner's business interest according to terms spelled out in the contract.

When the cross purchase agreement is funded with insurance, each owner pays the premium and is the beneficiary of a policy on all the other business owners. At the death of an owner, each co-owner receives policy benefits, which may be used to meet purchase obligations.

BUY-SELL CROSS PURCHASE METHOD



Trusteed Cross Purchase Arrangements

Trusteed cross purchase arrangements use a revocable trust and a trustee to manage the insurance policies and fulfill the terms of the buy-sell agreement.

Trusteed arrangements may be advantageous when there are more than three partners or members. Under this arrangement, the trustee purchases only one policy on each owner, minimizing the number of insurance policies that need to be purchased.

Transfer for Value

A potential tax problem arises when you have a trusteed cross purchase arrangement among corporate shareholders. When a shareholder dies, the surviving shareholders will succeed to the beneficial ownership of the remaining policies by the trustee. There has been some speculation that this may be a transfer for value that would cause a forfeiture of the income tax exemption for death proceeds. This problem does not arise for transferee partners, who enjoy an exemption from the transfer-for-value rule.

TAX CONSIDERATIONS: CROSS PURCHASE AGREEMENTS

- Policy premiums paid by the owners are not income tax deductible.
- Policy proceeds paid to the co-owner at the death of the covered owner are generally received income tax free.
- If permanent life insurance is used, the cash values within the policy accumulate on an income tax-deferred basis.
- The estate receives a stepped-up basis in the business interest equal to its value for federal estate tax purposes.
- The purchasing owners receive an increased basis in their ownership interest equal to the purchase price of the shares. This can result in less potential reportable gain to the purchasing shareholder if these shares are resold at a future date.

Additional Types of Buy-Sell Agreements

One Way Purchase Method

This form of buy-sell agreement is used when only one of the parties to the agreement is selling an ownership interest.

If life insurance is used, the purchasing party obtains insurance on the life of the business owner, pays the premium and is named as the beneficiary.

At the death of the selling owner, the policy proceeds are paid to the purchasing party and may be used to assist in meeting purchase obligations spelled out in the buy-sell agreement.

Wait-and-See Method

Because buy-sell agreements are established to meet contingencies that may not occur for many years, it is sometimes difficult to know which method of establishing the buy-sell plan will be best when the plan is actually needed.

To accommodate a need to postpone the decision whether the business or the co-owners will purchase the business interest, a wait-and-see buy-sell agreement may be used.

The wait-and-see buy-sell agreement is a special type of buy-sell agreement between the owners of a business and the business itself. Unlike the traditional entity buy-sell and cross-purchase agreements, the specific purchaser of an owner's business interest remains uncertain until death, retirement, or disability actually occurs.

Let's assume that we have three shareholders: Tom, Dick and Harry. ***In the typical wait-and-see buy-sell agreement, this would be the situation at Tom's death:***

- The corporation would have a first option to buy Tom's stock from his estate.
- Should the corporation fail to exercise this option, or exercise it only with respect to a portion of Tom's stock, then Dick and Harry would have a second option to buy Tom's stock *(or the remainder of it)*.
- If Dick and Harry should leave any of Tom's stock unpurchased, then the corporation must purchase any remaining portion *(or all)* of Tom's stock. This assures Tom's family that all the stock will be purchased, and assures the surviving shareholders that they will succeed to full control of the corporation.

The wait-and-see approach is obviously not appropriate for a sole proprietorship or a single-owner corporation. Further, if the owners are related, the family attribution rules are a potential problem in the event of a redemption under the first option, or a mandatory purchase under the third step.

In some situations, your client or your client's advisors may want to implement a business planning strategy outside the normal planning techniques. There are significant tax advantages to the following techniques, but they each require more sophisticated documents, planning, and expense to set in motion.

Please email advanced.markets@columbuslife.com for additional information on any of these techniques.

Employee Stock Ownership Plan (ESOP)

An Employee Stock Ownership Plan (ESOP) is a qualified plan, similar to a profit sharing plan, except that contributions are made in the form of company stock or cash that is used to buy shares. It works best with C corporations, but it can be used with S corporations as long as certain rules are followed. Since it is a qualified plan, eligible employees generally receive a contribution.

An ESOP works well for business succession planning when the successor management is going to be employees, although it can be used for family businesses as well.

The Business Owner sells 100% or some portion of his or her shares to the ESOP at retirement. The ESOP uses either accumulated cash from employer contributions, or obtains a bank loan, to buy out the owner's interest. The ESOP uses employer contributions to repay the loan, or it can purchase life insurance on the selling owner to recover the cost of the loan.

One benefit to the owner from the ESOP sale is the ability to defer recognition of capital gains by making a Section 1042 Rollover, replacing his company stock with publicly traded stock. This enables the business owner to diversify his stock holdings and liquidate stock as needed for retirement income. If the owner dies while holding his replacement 1042 stocks, his heirs receive a step up in basis on the stock.

Sale of Stock to an Intentionally Defective Grantor Income Trust (IDGT)

A grantor trust involves the sale of an asset to a trust to remove the asset from the estate for estate tax purposes. The Grantor retains the right to substitute assets of equal value to those in the trust making the trust defective for income tax purposes.

Only investors willing to maximize gifts by paying income taxes will be interested in a defective trust. ***There are several key advantages of an IDGT.***

- First, by paying the income taxes on trust assets, the donor is essentially making additional transfers to the trust beneficiaries without paying additional gift tax. Usually income tax rates are lower than gift tax rates.
- Another advantage of the IDGT is the fact that the trust gains the value of full appreciation and income on a pre-tax basis.
- A third potential advantage of the IDGT is that the accumulation value is maximized if the grantor is in a lower income tax bracket than the trust. This is typically the case as trusts tend to be taxed at the highest income tax rates.

Excess income generated by trust assets can be used to purchase life insurance on the grantor, eliminating the need to use gifts to fund the premium. If the IDGT is established in a state that allows perpetual trusts, the transfer tax is eliminated for subsequent generations. Finally, the sale of discounted assets to IDGT allows transfer of substantial assets without significant estate, gift and generation skipping transfer tax.

Sale of Stock to a Charitable Remainder Trust

As the owner of C stock, the owner may gift shares to a special tax exempt trust called a charitable remainder trust *(CRT)*. The owner recognizes no gain at time of gift. He or she gets a current year income tax deduction for the remainder interest that will go to his/her selected charity at the end of the trust term. Excess deduction can be carried forward for another 5 tax years.

The CRT sells the shares back to the corporation with no tax to the trust. This is a redemption, but it does not trigger any dividend problems normally associated with a partial redemption under IRC Code Sec 302. The CRT invests the full value, which is used to produce the required income payment.

Donor-owner gets an income based on the full value, unreduced by capital gains tax. Income payments are taxable. Then the trust ends; the trust remainder is transferred to the charity.

To replace the asset going to charity, many owners buy life insurance in an irrevocable trust for the family heirs although surviving family members now own larger percentages of the business because of the redemption. Redeemed stock goes into treasury stock, which can be used to raise capital or to fund stock dividends.

Life Insurance to Fund the Buy-Sell

There are a number of advantages to using life insurance to fund the buy-sell agreement. A significant advantage is the fact that financing of the agreement is in place from the day the life insurance is issued. In the case of an unexpected accident or tragedy, life insurance is the one way to help assure that cash will be available to execute the agreement.

Other advantages include the fact that the proceeds are generally free from income tax and the cash values can be used for a buyout due to retirement or disability if a permanent insurance policy is purchased and adequately funded.

Life insurance is certainly one of the most economical methods.

ADVANTAGES OF LIFE INSURANCE

- Financing guaranteed at death.
- Death proceeds income tax-free.
- Cash values may be withdrawn or borrowed income tax-free for buyout due to retirement or disability *(will reduce the death benefit amount).*
- Economical.

Who is the Ideal Client?

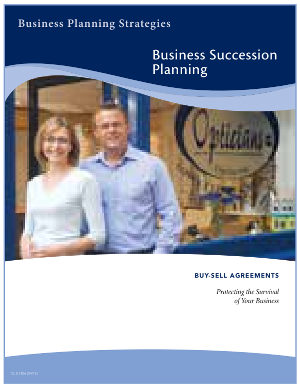
- Any small business
- Business owners over the age of 40 more likely to execute an agreement
- Positive cash flow a necessity

Steps in Establishing a Buy-Sell Agreement

1. Propose concept to client
2. Accountant or independent appraiser to value business
3. Attorney to draft buy-sell agreement
4. Life insurance to fund agreement

To ensure the income tax-free nature of the death benefit for certain business owned life insurance policies, it is necessary to comply with Internal Revenue Code Section 101(j) for policies issued after August 17, 2006. These rules require that the insured/employee receive notice of, and consent to, the life insurance policy prior to its issue where the business/employer is the owner and beneficiary of the policy and will continue to be the beneficiary after the insured leaves the business.

For more information on these rules and additional reporting requirements, please contact your tax advisor or Advanced Markets at 800.677.9696, Option. 8.



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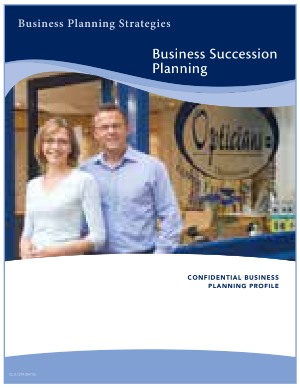

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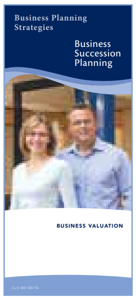

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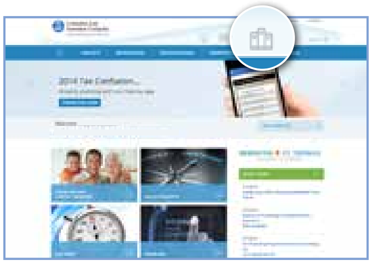

Columbus Life Extranet

Business Succession Client Brochure — CL 5.1806

Business Owners are often so focused on the current management of their business that they fail to plan adequately for the future preservation of their business. You can get them started in the process of Business Succession Planning. The number of small business is dramatically growing, yet less than one third continue to survive in the next generation. You won't want to miss out on this market!

Confidential Profile — CL 5.1274

A simple fact finder that helps you and your client determine their business planning needs so that they can develop an effective Business Succession Plan. This Confidential Profile can be emailed to Columbus Life's Advanced Markets for a full analysis.

advanced.markets@columbuslife.com

Business Succession Business Valuation Trifold Brochure — CL 5.1801

The vast majority of a business owner's wealth is tied up in their business. Do they really know what that dollar value is? There are a number of tax, business and financial planning reasons why your business clients should know the value of their businesses. This tri-fold brochure outlines the importance of proper business valuation.

Business Succession Key Employee Insurance Trifold Brochure — CL 5.1802

Key employees are valuable assets to a business. How would your client's business respond over the loss of a key employee due to an untimely death? Not only would there be time and dollars lost, but relationships within the business could be strained, especially if the key employee was a business owner. This tri-fold brochure outlines the importance of protecting against the loss of a key employee.

Supplemental Product Illustration

A Supplemental Buy-Sell Illustration can be run with any Columbus Life product illustration.

Additional Resources

A comprehensive collection of all the Business Planning Strategies Kit materials, client presentations, prospective letters and seminar tools is available for download on the Advanced Markets area of the Columbus Life Producer Extranet. Look for Sales Strategies and then Business Succession Planning.

Columbus Life Insurance Company

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