

# One-Way Buy-Sell Arrangement

*Proactively Planning for the Transition of Your Business*



**Prepared For:**

Company

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## *Buy-Sell Arrangements*

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## ONE-WAY BUY-SELL ARRANGEMENTS

### THE PROBLEM

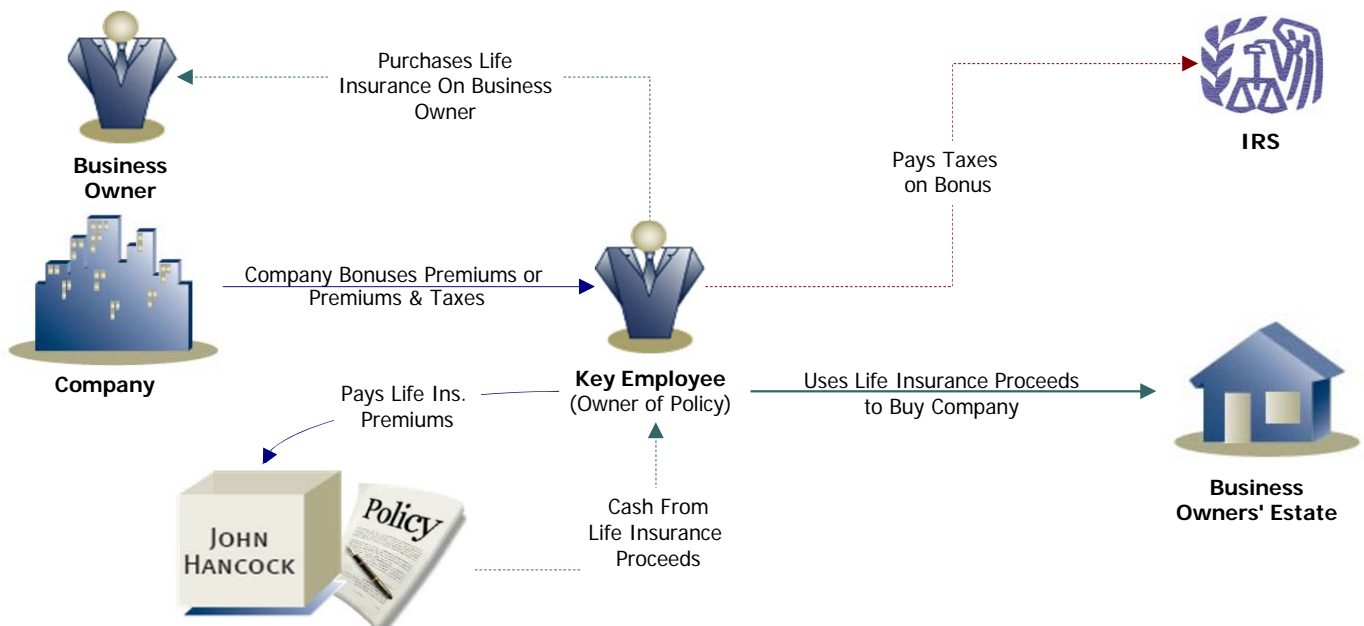
Many business owners do not make formal plans to transfer the business to a successor in the event of retirement, disability or death of the owner. However, lack of succession planning can cause your business to fail because of the significant changes that are brought about due to these triggering events. Although in some cases a buy-sell arrangement is in place dictating how the business is to transfer, often these arrangements remain unfunded. For situations where there are multiple business owners, there are several buy-sell options such as cross-purchase, entity redemption or cross-endorsement arrangements. However, in some cases there may be only one business owner, as in your case, and you may have identified one valued employee as your potential successor.

### THE SOLUTION

A well drafted and properly funded buy-sell arrangement can be established in which the key employee agrees to buy your business in the event of your death, disability, or retirement. This “one-way” buy-sell arrangement between you and your key employee provides the clarification as to who will own and run the business upon your death, retirement or disability. The arrangement can be funded with a permanent life insurance policy on your life to provide the flexibility needed to accommodate changing needs over the life span of the business.

### HOW IT WORKS

In accordance with the terms of the buy-sell agreement, your valued employee/intended successor will purchase and own a permanent life insurance policy on your life. The valued employee, who may be a family member or a key person in the business, will also be the beneficiary of the life insurance policy. Your company will pay a bonus annually to your key employee in the amount of the premium payment due, to minimize the out-of-pocket expense of the arrangement. The bonus payments may be tax-deductible to the corporation when they are paid, but the payment will also be taxable to the key employee<sup>1</sup>. In some cases, your company may choose to make a double bonus in which the bonus is equivalent to the premiums due plus the income tax due on the bonus.



<sup>1</sup> The use of a bonus arrangement creates additional compensation to the recipient and must fall within the reasonable compensation guidelines of the Internal Revenue Code Section 162 in order to be deductible by the corporation.

## ONE-WAY BUY-SELL ARRANGEMENTS

It is necessary to establish the value of the business in order to ascertain the value of the life insurance policy that will be used to fund the buy-out. Fixing the value of the business (as well as the valuation method) can eliminate future disagreements and avoid confusion and additional expenses. The valuation may also be relied upon for estate tax purposes to provide a fixed value for both a lifetime transfer of the business as well as the transfer of the business at death<sup>2</sup>. There are a number of valuation methods that can be used including a multiple of book value, qualified business appraisal, or capitalization of earnings method<sup>3</sup>.

The life insurance policy can be cost effective and sufficiently flexible to supply liquidity to facilitate the buy-out when needed. When permanent life insurance is used to fund the plan, it may also be possible to design the policy to fund a buy-out at retirement or to fund payments to you upon disability.

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. Cash value available for loans and withdrawals may be more or less than originally invested. Withdrawals are available in the 2nd policy year.

## BENEFITS

- The life insurance proceeds should not be subject to income taxes<sup>4</sup>.
- The successor/employee should receive a full basis step-up for the purchase of the business interest.
- The life insurance policy does not increase the value of the business because the policy is individually owned and the company is not required to reflect the value of the policy on its balance sheet.
- Since the business entity is not a party to the buy-sell agreement, the accumulated earnings tax does not apply to the policy proceeds.
- The value of the business may be fixed for estate tax purposes.

## CONSIDERATIONS

- The successor/employee will have to recognize the bonus amount received for life insurance premium payments as taxable income.
- Since the successor/employee owns the life insurance policy, the policy cash value will be includible in his/her estate, if he/she predeceases the business owner. The successor's estate may receive a corresponding tax deduction for the liability associated with the buy-sell agreement.
- Access to the policy's potential cash values may lower the death benefit needed to satisfy the buy-sell obligation.
- Representation of the tax law in this illustration is based on the law existing at the time of publication.
- If you are considering creating a policy with a long-term care rider where the owner is not the insured, there may be adverse consequences - both tax and contractual in nature. You should review the particulars of your intended ownership arrangement with your legal and tax counsels in light of the income, gift, and estate tax provisions of the Internal Revenue Code

## PLANNING OPTIONS

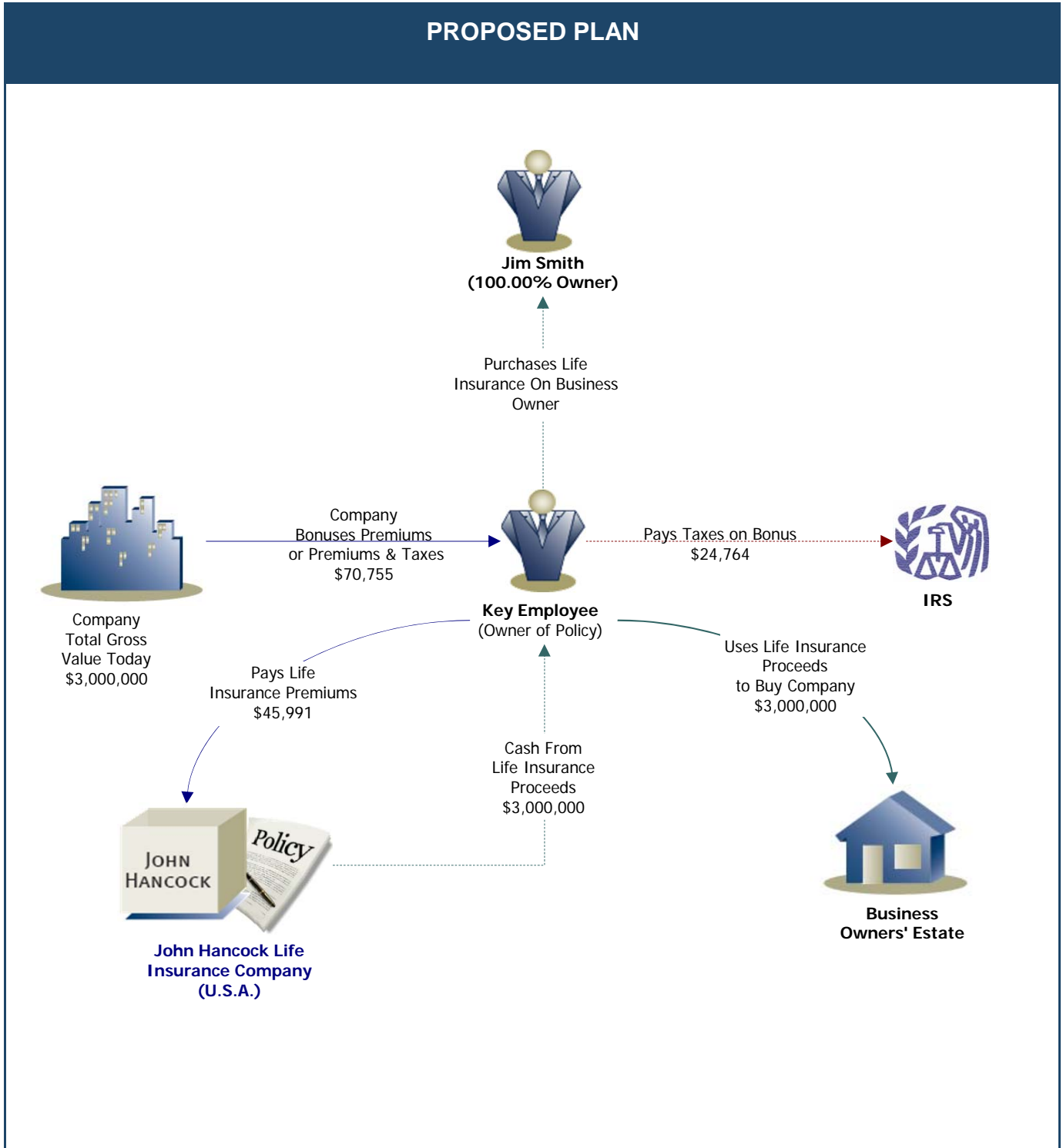
The following flowcharts and ledger pages illustrate the plan mechanics, and the costs and benefits of the "one-way" buy-sell plan for the business.

<sup>2</sup> IRC Section 2703 provides certain tests that the taxpayer must meet to permit the value of the buy-sell arrangement to set the value of the business for federal estate tax purposes. First, the buy-sell agreement must reflect a bona fide business arrangement. Second, the buy-sell agreement must not represent a device to transfer the business interest to the decedent's family or the natural objects of the decedent's bounty for less than full and adequate consideration. Third, the terms of the buy-sell agreement must remain comparable to similar arrangements entered into by persons in arms-length transactions.

<sup>3</sup> Generally, the business should obtain an independent audit of its books and financial records prior to use of the book value method.

<sup>4</sup> See IRC Section 101(a)(1) and Treas. Reg. Section 1.101-1(a)(1). Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration.

ONE-WAY BUY-SELL ARRANGEMENTS



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# One-Way Buy-Sell Arrangement

Prepared for Company  
Presented By Advanced Markets

## DOUBLE BONUS PLAN WITH LIFE INSURANCE FOR JIM SMITH

John Hancock's Protection UL 18 with Initial Death Benefit of \$3,000,000 & Initial Premium of \$45,991

### CORPORATION

### EXECUTIVE

Yr	Att. Age	Bonus to Executive	Tax Savings	After Tax Cash Flow	P&L Impact	Bonus to Executive	Tax On Bonus	After Tax Bonus	Annual Premium	Annual Withdrawals & Loans	Net After Tax Outlay	Cash Values	Death Benefit
1	61	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	0	3,000,000
2	62	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	0	3,000,000
3	63	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	0	3,000,000
4	64	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	18,782	3,000,000
5	65	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	47,225	3,000,000
6	66	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	76,522	3,000,000
7	67	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	105,201	3,000,000
8	68	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	133,069	3,000,000
9	69	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	159,883	3,000,000
10	70	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	186,253	3,000,000
11	71	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	198,925	3,000,000
12	72	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	213,047	3,000,000
13	73	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	243,013	3,000,000
14	74	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	274,031	3,000,000
15	75	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	305,886	3,000,000
16	76	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	337,854	3,000,000
17	77	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	370,619	3,000,000
18	78	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	404,104	3,000,000
19	79	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	438,249	3,000,000
20	80	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	471,411	3,000,000
21	81	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	503,254	3,000,000
22	82	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	535,017	3,000,000
23	83	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	566,593	3,000,000
24	84	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	597,712	3,000,000
25	85	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	628,083	3,000,000
Totals:		(1,768,885)	619,110	(1,149,775)	(1,149,775)	1,768,885	619,110	1,149,775	1,149,775	0	0		

For: Jim Smith, Male Age 60, Preferred NonSmoker

EE Tax Rates: 35.00%  
ER Tax Rates: 35.00% from 1 to Lifetime

See attached Glossary of Ledger Terms

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Yr	Att. Age	Bonus to Executive	Tax Savings	After Tax Cash Flow	P&L Impact	Bonus to Executive	Tax On Bonus	After Tax Bonus	Annual Premium	Annual Withdrawals & Loans	Net After Tax Outlay	Cash Values	Death Benefit
26	86	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	657,071	3,000,000
27	87	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	685,378	3,000,000
28	88	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	712,999	3,000,000
29	89	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	739,737	3,000,000
30	90	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	765,584	3,000,000
31	91	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	786,176	3,000,000
32	92	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	804,780	3,000,000
33	93	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	821,333	3,000,000
34	94	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	835,727	3,000,000
35	95	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	848,611	3,000,000
36	96	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	860,992	3,000,000
37	97	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	872,187	3,000,000
38	98	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	882,735	3,000,000
39	99	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	892,060	3,000,000
40	100	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	899,516	3,000,000
41	101	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	905,190	3,000,000
42	102	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	909,400	3,000,000
43	103	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	912,793	3,000,000
44	104	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	916,624	3,000,000
45	105	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	922,712	3,000,000
46	106	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	933,235	3,000,000
47	107	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	948,351	3,000,000
48	108	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	976,939	3,000,000
49	109	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	1,029,104	3,000,000
50	110	(70,755)	24,764	(45,991)	(45,991)	70,755	24,764	45,991	45,991	0	0	1,123,945	3,000,000
Totals:		(3,537,769)	1,238,219	(2,299,550)	(2,299,550)	3,537,769	1,238,219	2,299,550	2,299,550	0	0		

For: Jim Smith, Male Age 60, Preferred NonSmoker

EE Tax Rates: 35.00%  
ER Tax Rates: 35.00% from 1 to Lifetime

See attached Glossary of Ledger Terms

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## GLOSSARY OF LEDGER TERMS - "ONE-WAY" BUY-SELL PLAN

**One-Way Buy-Sell Arrangement** – This is a type of a buy-sell arrangement in which a valued employee, who may be a family member or a key person in the business, will purchase and own a life insurance policy on the life of the business owner. The valued employee, who may be a family member or a colleague, will also be the beneficiary of the life insurance policy.

**Bonus to Executive** – The company will pay a bonus to the successor/policy owner in the amount of the premium payments annually to minimize the out-of pocket expense of the arrangement. The bonus payments may be tax-deductible to the corporation when they are paid, but the payment will also be taxable to the recipient<sup>1</sup>. In some cases, the corporation may choose to make a double bonus in which the bonus is equivalent to the premiums due plus the income tax due on the bonus.

**Tax Savings** – This represents the deduction to the corporation for the bonus payment to the executive.

**After Tax Cash Flow and Profit Loss Impact** – Both the After Tax Cash Flow and the Profit and Loss (P & L) Impact represent the actual bonus amount paid by the corporation to the executive less the tax savings to the corporation (deduction) on the bonus amount.

**Tax on Bonus** – This is the income tax due on the bonus paid to the executive.

**After Tax Bonus** – This amount represents the actual bonus paid to the executive less the income tax due on the bonus.

**Annual Premium** – This is the annual premium amount due on the life insurance policy on the life of the business owner.