

# Entity Redemption Buy-Sell Arrangements

*Proactively Planning for the Transition of Your Business*



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Company

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## *Buy-Sell Arrangements*

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Representation of the tax law in this illustration are based on the law existing at the time of publication. John Hancock makes no representation as to future federal or state tax law.

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## ENTITY PURCHASE BUY-SELL ARRANGEMENTS

### THE PROBLEM

Many business owners do not make formal plans to transfer ownership of the business in the event of the premature death of a business owner, an owner's disability, the lifetime transfer or sale of the business, or the retirement of one of the key business owners. Lack of planning can cause a 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.

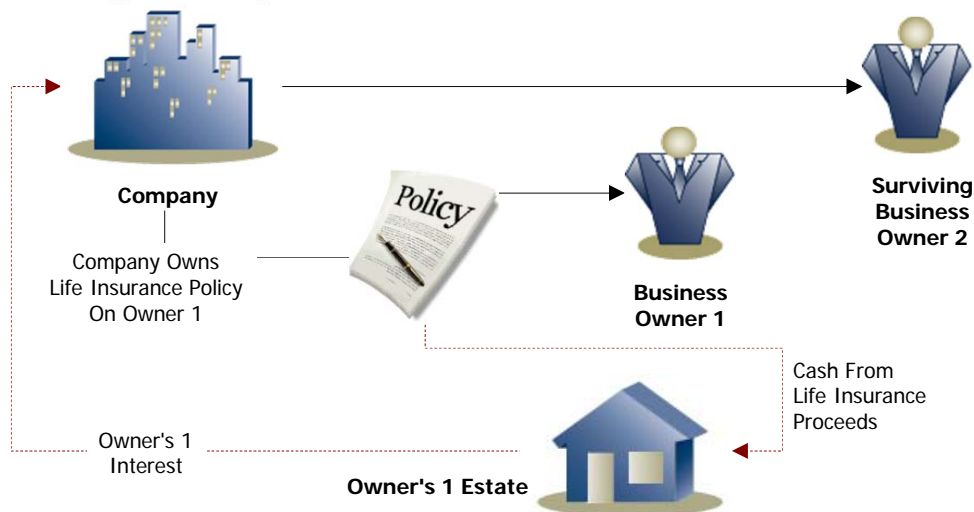
### THE SOLUTION

A well drafted and properly funded entity purchase buy-sell arrangement can be established between the company and its owners in which the business agrees to redeem the business interest of an owner in the event of death, disability, retirement or other termination event. The arrangement can be funded with a permanent life insurance policy on each owner to help ensure that the company has the liquidity necessary to transition the business according to a prearranged plan. A permanent life insurance policy can provide the flexibility needed to accommodate changing needs over the life span of the business.

### HOW IT WORKS

The company purchases and owns a life insurance policy on the lives of each business owner with death benefit equal to each business owner's interest. The company will remain the policy owner, beneficiary and premium payer. Although the payment of premiums is not a tax-deductible expense to the company, the premiums paid by the company will not be taxable income to each of the owners<sup>1</sup>. Upon the death, disability or retirement of an owner, the business can use the death benefit or potential cash surrender value of the policy to make payments under the agreement. The business receives the life insurance death proceeds income tax free<sup>2</sup>. If distributions are taken from the policy instead, the distributions will be tax-free providing that withdrawals up to tax basis are taken first with policy loans taken thereafter.

It is necessary to establish the value of the business in order to ascertain the value of each 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>3</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>4</sup>.



<sup>1</sup> See IRC §101 and Regulation Section 1.101-1(a)(1)

<sup>2</sup> 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.

<sup>3</sup> IRC §2703 provides certain tests the taxpayer must meet to permit the value of the buy-sell agreement to set the value for federal estate tax purpose. 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>4</sup> Generally, the business should obtain an independent audit of its books and financial records prior to use of the book value method.

## ENTITY PURCHASE BUY-SELL ARRANGEMENTS

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

## BENEFITS

- The company receives the life insurance death benefits free of income taxes.
- Premium payments made by the business are not taxable income to the owners.
- The life insurance premiums can be pooled so that any discrepancies regarding the ages of the owners and or ownership percentages among owners can be shared equally.
- Unlike a cross purchase buy-sell plan in which multiple life insurance policies may be required, the entity purchase buy-sell plan requires the company to purchase only one policy on each owner.
- You may structure the entity purchase buy-sell plan to fix the value of the business for estate tax purposes<sup>5</sup>.
- The use of corporate funds to pay policy premiums may be a cost-effective tax strategy when the business is a C-Corporation.
- For tax accounting purposes, a stock redemption reduces the corporation's accumulated earnings & profits balance, reducing exposure to a potential accumulated earnings tax<sup>6</sup>.

## CONSIDERATIONS

- The stock redemption by the entity may receive treatment as a dividend distribution, rather than a sale with capital gain treatment given family and entity attribution rules that may treat the redemption as a dividend distribution<sup>7</sup>.
- Although the remaining owners own a larger percentage of the business after the redemption, their cost basis may not change. Therefore, the later sale of the business may result in higher capital gain taxes<sup>8</sup>.
- Corporate ownership of life insurance may subject the company to the alternative minimum tax in some circumstances<sup>9</sup>.
- Ownership of the life insurance policy to fund the buy-sell plan may increase the value of the company. The value of the insurance proceeds will not be part of the valuation of the decedent's interest when a valid agreement fixing the price for estate tax purposes exists and the purchase price under the terms of the buy-sell plan specifically exclude the life insurance proceeds.
- Corporate owned life insurance maintained to fund a buy-sell agreement remains subject to corporate creditors claims. Moreover, state law may restrict or prohibit redemption if the corporation lacks adequate capital or if the corporation is insolvent.
- Representation of the tax law in this illustration is based on the law existing at the time of publication.
- The value that is fixed in the buy-sell agreement may change by the time of a triggering event such as death, although the valuation method may remain the same. If the value of the business decreases by the time of a triggering event, then the remaining owners may not need to use all of the life insurance funding for the buy-sell arrangement.
- 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 entity purchase buy-sell plan to the business and each business owner.

<sup>5</sup> See IRC § 2703.

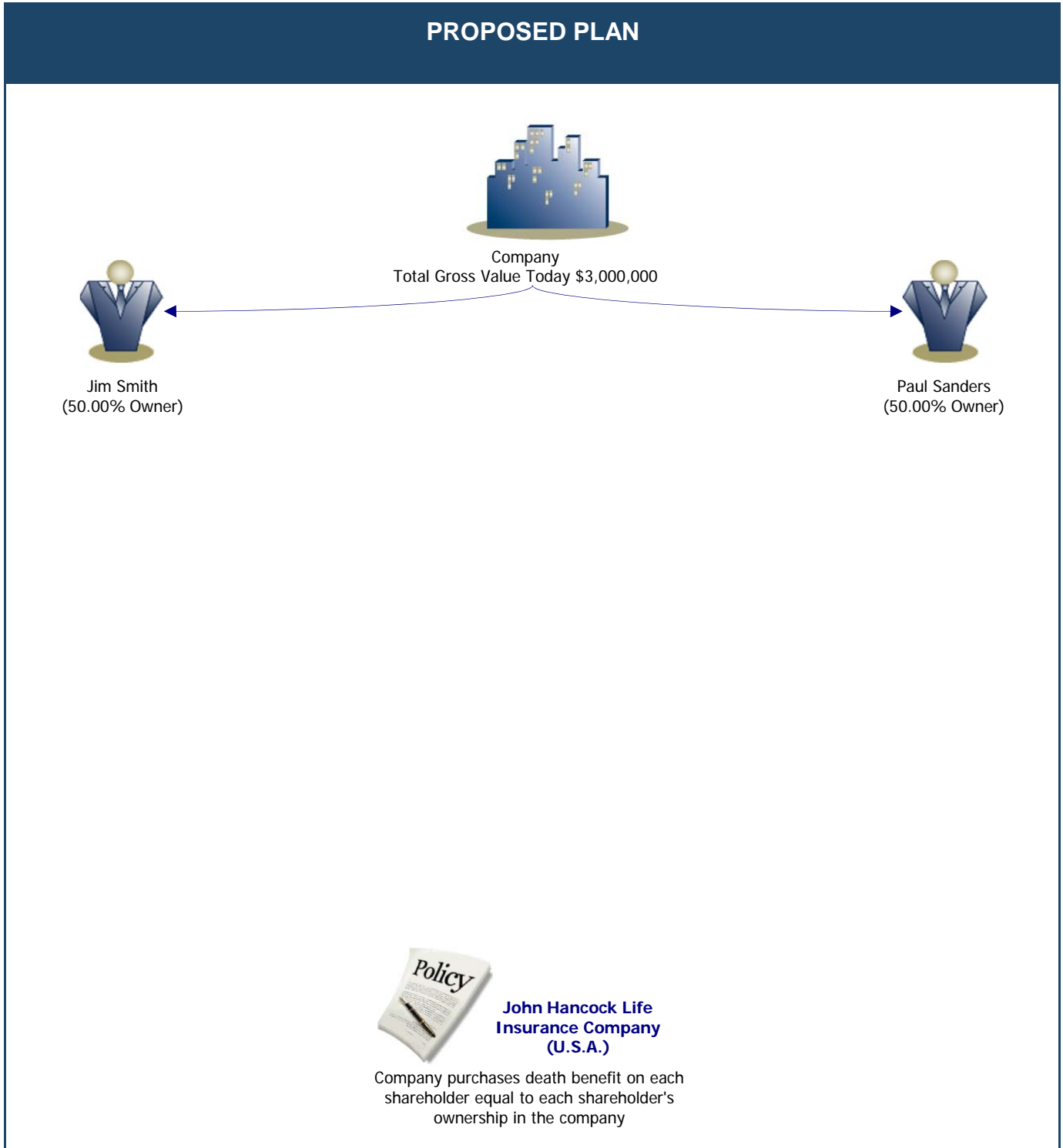
<sup>6</sup> See IRC §312(n)(7).

<sup>7</sup> See IRC §301,302 and 316 that deal with tax treatment of corporate distributions to shareholders.

<sup>8</sup> C Corporation shareholders do not receive a step up in basis for a stock purchase through an entity redemption plan. However, receipt of life insurance proceeds by a partnership permits a step up in basis for a partner's interest. Likewise, in certain circumstances S Corporation shareholders may receive a partial or full step up in basis from an entity redemption plan.

<sup>9</sup> See IRC §56 (g).

ENTITY PURCHASE BUY-SELL ARRANGEMENTS



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**ENTITY PURCHASE BUY-SELL PLAN ON JIM SMITH**

**JIM SMITH**

John Hancock's Protection UL 16 with Initial Death Benefit of \$1,500,000 & Initial Premium of \$9,554						
Yr	Att. Age	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
1	48	9,554	0	0	1,500,000	9,554
2	49	9,554	0	0	1,500,000	9,554
3	50	9,554	0	0	1,500,000	9,554
4	51	9,554	0	918	1,500,000	9,554
5	52	9,554	0	5,285	1,500,000	9,554
6	53	9,554	0	9,753	1,500,000	9,554
7	54	9,554	0	16,622	1,500,000	9,554
8	55	9,554	0	23,686	1,500,000	9,554
9	56	9,554	0	30,878	1,500,000	9,554
10	57	9,554	0	38,240	1,500,000	9,554
11	58	9,554	0	42,771	1,500,000	9,554
12	59	9,554	0	47,468	1,500,000	9,554
13	60	9,554	0	52,314	1,500,000	9,554
14	61	9,554	0	57,294	1,500,000	9,554
15	62	9,554	0	62,368	1,500,000	9,554
16	63	9,554	0	67,487	1,500,000	9,554
17	64	9,554	0	72,641	1,500,000	9,554
18	65	9,554	0	77,784	1,500,000	9,554
19	66	9,554	0	82,853	1,500,000	9,554
<b>20</b>	<b>67</b>	<b>9,554</b>	<b>0</b>	<b>87,768</b>	<b>1,500,000</b>	<b>9,554</b>
21	68	9,554	0	92,392	1,500,000	9,554
22	69	9,554	0	101,420	1,500,000	9,554
23	70	9,554	0	111,290	1,500,000	9,554
24	71	9,554	0	121,626	1,500,000	9,554
25	72	9,554	0	132,404	1,500,000	9,554
26	73	9,554	0	143,590	1,500,000	9,554
27	74	9,554	0	155,181	1,500,000	9,554
28	75	9,554	0	167,155	1,500,000	9,554
29	76	9,554	0	179,489	1,500,000	9,554
30	77	9,554	0	192,140	1,500,000	9,554
31	78	9,554	0	204,949	1,500,000	9,554
32	79	9,554	0	218,032	1,500,000	9,554
33	80	9,554	0	231,341	1,500,000	9,554
34	81	9,554	0	244,840	1,500,000	9,554
35	82	9,554	0	258,355	1,500,000	9,554
36	83	9,554	0	271,832	1,500,000	9,554
37	84	9,554	0	285,209	1,500,000	9,554
38	85	9,554	0	298,436	1,500,000	9,554
39	86	9,554	0	311,397	1,500,000	9,554
40	87	9,554	0	324,026	1,500,000	9,554
Totals:		382,160	0			382,160

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ENTITY PURCHASE BUY-SELL PLAN ON JIM SMITH

JIM SMITH

		John Hancock's Protection UL 16 with Initial Death Benefit of \$1,500,000 & Initial Premium of \$9,554				
Yr	Att. Age	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
41	88	9,554	0	336,302	1,500,000	9,554
42	89	9,554	0	348,130	1,500,000	9,554
43	90	9,554	0	359,415	1,500,000	9,554
44	91	9,554	0	370,107	1,500,000	9,554
45	92	9,554	0	380,036	1,500,000	9,554
46	93	9,554	0	389,105	1,500,000	9,554
47	94	9,554	0	397,211	1,500,000	9,554
48	95	9,554	0	404,295	1,500,000	9,554
49	96	9,554	0	410,470	1,500,000	9,554
50	97	9,554	0	415,795	1,500,000	9,554
51	98	9,554	0	420,236	1,500,000	9,554
52	99	9,554	0	423,518	1,500,000	9,554
53	100	9,554	0	425,238	1,500,000	9,554
54	101	9,554	0	430,273	1,500,000	9,554
55	102	9,554	0	434,948	1,500,000	9,554
56	103	9,554	0	439,457	1,500,000	9,554
57	104	9,554	0	444,145	1,500,000	9,554
58	105	9,554	0	449,528	1,500,000	9,554
59	106	9,554	0	456,349	1,500,000	9,554
60	107	0	0	459,945	1,500,000	0
61	108	0	0	464,584	1,500,000	0
62	109	0	0	471,381	1,500,000	0
63	110	0	0	481,968	1,500,000	0
64	111	0	0	499,075	1,500,000	0
65	112	0	0	527,151	1,500,000	0
66	113	0	0	573,230	1,500,000	0
67	114	0	0	625,227	1,500,000	0
68	115	0	0	670,136	1,500,000	0
69	116	0	0	717,887	1,500,000	0
70	117	0	0	768,660	1,500,000	0
71	118	0	0	822,644	1,500,000	0
72	119	0	0	880,044	1,500,000	0
73	120	0	0	941,076	1,500,000	0
74	121	0	0	1,005,969	1,500,000	0

Totals: 563,686

0

563,686

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**ENTITY PURCHASE BUY-SELL PLAN ON PAUL SANDERS**

**PAUL SANDERS**

John Hancock's Protection UL 16 with Initial Death Benefit of \$1,500,000 & Initial Premium of \$10,530						
Yr	Att. Age	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
1	50	10,530	0	0	1,500,000	10,530
2	51	10,530	0	0	1,500,000	10,530
3	52	10,530	0	0	1,500,000	10,530
4	53	10,530	0	1,200	1,500,000	10,530
5	54	10,530	0	6,011	1,500,000	10,530
6	55	10,530	0	10,916	1,500,000	10,530
7	56	10,530	0	18,432	1,500,000	10,530
8	57	10,530	0	26,137	1,500,000	10,530
9	58	10,530	0	33,958	1,500,000	10,530
10	59	10,530	0	41,936	1,500,000	10,530
11	60	10,530	0	46,783	1,500,000	10,530
12	61	10,530	0	51,773	1,500,000	10,530
13	62	10,530	0	56,870	1,500,000	10,530
14	63	10,530	0	62,055	1,500,000	10,530
15	64	10,530	0	67,298	1,500,000	10,530
16	65	10,530	0	72,507	1,500,000	10,530
17	66	10,530	0	77,683	1,500,000	10,530
18	67	10,530	0	82,762	1,500,000	10,530
19	68	10,530	0	87,658	1,500,000	10,530
<b>20</b>	<b>69</b>	<b>10,530</b>	<b>0</b>	<b>95,411</b>	<b>1,500,000</b>	<b>10,530</b>
21	70	10,530	0	105,303	1,500,000	10,530
22	71	10,530	0	115,691	1,500,000	10,530
23	72	10,530	0	126,559	1,500,000	10,530
24	73	10,530	0	137,878	1,500,000	10,530
25	74	10,530	0	149,622	1,500,000	10,530
26	75	10,530	0	161,759	1,500,000	10,530
27	76	10,530	0	174,288	1,500,000	10,530
28	77	10,530	0	187,161	1,500,000	10,530
29	78	10,530	0	200,341	1,500,000	10,530
30	79	10,530	0	213,798	1,500,000	10,530
31	80	10,530	0	227,331	1,500,000	10,530
32	81	10,530	0	241,064	1,500,000	10,530
33	82	10,530	0	254,815	1,500,000	10,530
34	83	10,530	0	268,530	1,500,000	10,530
35	84	10,530	0	282,143	1,500,000	10,530
36	85	10,530	0	295,605	1,500,000	10,530
37	86	10,530	0	308,800	1,500,000	10,530
38	87	10,530	0	321,662	1,500,000	10,530
39	88	10,530	0	334,106	1,500,000	10,530
40	89	10,530	0	346,030	1,500,000	10,530
Totals:		421,200	0			421,200

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**ENTITY PURCHASE BUY-SELL PLAN ON PAUL SANDERS**

**PAUL SANDERS**

John Hancock's Protection UL 16 with Initial Death Benefit of \$1,500,000 & Initial Premium of \$10,530						
Yr	Att. Age	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
41	90	10,530	0	357,390	1,500,000	10,530
42	91	10,530	0	368,132	1,500,000	10,530
43	92	10,530	0	378,146	1,500,000	10,530
44	93	10,530	0	387,342	1,500,000	10,530
45	94	10,530	0	395,560	1,500,000	10,530
46	95	10,530	0	402,737	1,500,000	10,530
47	96	10,530	0	408,986	1,500,000	10,530
48	97	10,530	0	414,371	1,500,000	10,530
49	98	10,530	0	418,859	1,500,000	10,530
50	99	10,530	0	422,173	1,500,000	10,530
51	100	10,530	0	423,914	1,500,000	10,530
52	101	10,530	0	428,956	1,500,000	10,530
53	102	10,530	0	433,612	1,500,000	10,530
54	103	10,530	0	438,067	1,500,000	10,530
55	104	10,530	0	442,646	1,500,000	10,530
56	105	10,530	0	447,836	1,500,000	10,530
57	106	10,530	0	454,329	1,500,000	10,530
58	107	0	0	456,780	1,500,000	0
59	108	0	0	459,552	1,500,000	0
60	109	0	0	463,278	1,500,000	0
61	110	0	0	468,781	1,500,000	0
62	111	0	0	477,431	1,500,000	0
63	112	0	0	491,628	1,500,000	0
64	113	0	0	514,929	1,500,000	0
65	114	0	0	553,172	1,500,000	0
66	115	0	0	610,276	1,500,000	0
67	116	0	0	654,240	1,500,000	0
68	117	0	0	700,986	1,500,000	0
69	118	0	0	750,689	1,500,000	0
70	119	0	0	803,536	1,500,000	0
71	120	0	0	859,727	1,500,000	0
72	121	0	0	919,473	1,500,000	0

Totals: 600,210

0

600,210

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**COMPOSITE ENTITY PURCHASE BUY-SELL PLAN FOR 2 SHAREHOLDERS**

**COMPOSITE FOR COMPANY**

Yr	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
1	20,084	0	0	3,000,000	20,084
2	20,084	0	0	3,000,000	20,084
3	20,084	0	0	3,000,000	20,084
4	20,084	0	2,118	3,000,000	20,084
5	20,084	0	11,297	3,000,000	20,084
6	20,084	0	20,669	3,000,000	20,084
7	20,084	0	35,055	3,000,000	20,084
8	20,084	0	49,823	3,000,000	20,084
9	20,084	0	64,836	3,000,000	20,084
10	20,084	0	80,175	3,000,000	20,084
11	20,084	0	89,554	3,000,000	20,084
12	20,084	0	99,241	3,000,000	20,084
13	20,084	0	109,184	3,000,000	20,084
14	20,084	0	119,349	3,000,000	20,084
15	20,084	0	129,666	3,000,000	20,084
16	20,084	0	139,994	3,000,000	20,084
17	20,084	0	150,324	3,000,000	20,084
18	20,084	0	160,546	3,000,000	20,084
19	20,084	0	170,510	3,000,000	20,084
<b>20</b>	<b>20,084</b>	<b>0</b>	<b>183,179</b>	<b>3,000,000</b>	<b>20,084</b>
21	20,084	0	197,695	3,000,000	20,084
22	20,084	0	217,112	3,000,000	20,084
23	20,084	0	237,849	3,000,000	20,084
24	20,084	0	259,504	3,000,000	20,084
25	20,084	0	282,025	3,000,000	20,084
26	20,084	0	305,349	3,000,000	20,084
27	20,084	0	329,470	3,000,000	20,084
28	20,084	0	354,316	3,000,000	20,084
29	20,084	0	379,830	3,000,000	20,084
30	20,084	0	405,938	3,000,000	20,084
31	20,084	0	432,280	3,000,000	20,084
32	20,084	0	459,096	3,000,000	20,084
33	20,084	0	486,155	3,000,000	20,084
34	20,084	0	513,370	3,000,000	20,084
35	20,084	0	540,498	3,000,000	20,084
36	20,084	0	567,437	3,000,000	20,084
37	20,084	0	594,009	3,000,000	20,084
38	20,084	0	620,099	3,000,000	20,084
39	20,084	0	645,503	3,000,000	20,084
40	20,084	0	670,055	3,000,000	20,084
Totals:	803,360	0			803,360

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**COMPOSITE ENTITY PURCHASE BUY-SELL PLAN FOR 2 SHAREHOLDERS**

**COMPOSITE FOR COMPANY**

Yr	Annual Premium	Annual Withdrawals and/or Loans	Net Surrender Value	Total Net Death Benefit	Total Cost
41	20,084	0	693,692	3,000,000	20,084
42	20,084	0	716,262	3,000,000	20,084
43	20,084	0	737,561	3,000,000	20,084
44	20,084	0	757,449	3,000,000	20,084
45	20,084	0	775,596	3,000,000	20,084
46	20,084	0	791,843	3,000,000	20,084
47	20,084	0	806,197	3,000,000	20,084
48	20,084	0	818,666	3,000,000	20,084
49	20,084	0	829,330	3,000,000	20,084
50	20,084	0	837,968	3,000,000	20,084
51	20,084	0	844,151	3,000,000	20,084
52	20,084	0	852,473	3,000,000	20,084
53	20,084	0	858,849	3,000,000	20,084
54	20,084	0	868,340	3,000,000	20,084
55	20,084	0	877,594	3,000,000	20,084
56	20,084	0	887,293	3,000,000	20,084
57	20,084	0	898,475	3,000,000	20,084
58	9,554	0	906,308	3,000,000	9,554
59	9,554	0	915,901	3,000,000	9,554
60	0	0	923,223	3,000,000	0
61	0	0	933,364	3,000,000	0
62	0	0	948,812	3,000,000	0
63	0	0	973,596	3,000,000	0
64	0	0	1,014,003	3,000,000	0
65	0	0	1,080,322	3,000,000	0
66	0	0	1,183,507	3,000,000	0
67	0	0	1,279,467	3,000,000	0
68	0	0	1,371,122	3,000,000	0
69	0	0	1,468,576	3,000,000	0
70	0	0	1,572,196	3,000,000	0
71	0	0	1,682,371	3,000,000	0
72	0	0	1,799,517	3,000,000	0
73	0	0	941,076	1,500,000	0
74	0	0	1,005,969	1,500,000	0

Totals: 1,163,896

0

1,163,896

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## ENTITY REDEMPTION BUY-SELL ARRANGEMENTS - CENSUS

### PARTICIPANT INFORMATION

Participant	1	2		
Mode	Active	Active		
Name	Jim Smith	Paul Sanders		
Age	47	49		
Sex	Male	Male		
Risk Class	Preferred NonSmoker	Preferred NonSmoker		
Company Ownership	50.00%	50.00%		
State	Michigan	Michigan		
Income Tax	35.00%	35.00%		
Vitality Status	Gold	Gold		

### LIFE INSURANCE

Policy Name	Protection UL 16	Protection UL 16		
Type	Single Life	Single Life		
Initial Death Benefit	\$1,500,000	\$1,500,000		
Annualized Premium	\$9,554	\$10,530		
Premium Years	99	99		
Policy Rate	5.05% Gross	5.05% Gross		
1035 Exchange Amount	\$0	\$0		
Life Track Billing	FALSE	FALSE		

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## GLOSSARY OF LEDGER TERMS - ENTITY PURCHASE ARRANGEMENTS

**Entity Redemption Buy-Sell Arrangements** – This is a type of buy-sell arrangement in which the company purchases and owns a life insurance policy on the lives of each business owner in an amount equal to each business owner's interest. The company is the policy owner, beneficiary and payer of the premiums on the life insurance policy. Upon the death, disability or retirement of an owner, the business can use the death benefit or potential cash surrender value of the policy to make payments under the agreement. This type of arrangement is generally used with C Corporations.

**Census Summary** – The Census Summary is a listing of each of the owners of the company, their ages and risk class as well as each owner's current ownership percentage in the company.

**Annualized Premium** – This row under the Census Summary shows the premium required on each policy based on the total death benefit purchased.

**Initial Death Benefit** – This row under the Census Summary shows the amount of the death benefit that each individual owner owns on the other shareholders. The death benefit may be either equal to the insured's ownership percentage or a portion of the insured's ownership percentage, depending on the total number of business owners.