HEIRMARK®

Buy/Sell Planning

Introduction

BUY/SELL PLANNING OVERVIEW

The sudden death of a business owner can greatly impact a business if proper planning is not in place. The effect to employees and the other owners of the business can be devastating, along with a potentially significant financial impact to the business owner's family.

A Buy/Sell plan is a formal contract between the 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. Proper Buy/Sell planning can protect a family and help facilitate the continuation of the business.

A properly structured Buy/Sell plan may help minimize the effect of the loss. We recommend considering the implementation of a Buy/Sell plan using life insurance. A trusted insurance advisor will work with tax, legal, and other financial advisors to implement the Buy/Sell plan that best fits the needs of the business.

BUY/SELL PLANNING BENEFITS

CONFIDENCE

Buy/Sell planning can remove the worry of how the business will be preserved and how a family will be supported after the unexpected death of a business owner.

The plan establishes a buyer for shares and a formula for calculating the value of the shares.

The business is protected against the sale of shares to an outside buyer.

The business is protected against creditors and ex-spouses of a deceased owner who may claim an interest in the business.

HARMONY

Removing the uncertainty from the business transition creates harmony between the business owners and their families.

Using life insurance to fund makes it necessary to consider large parts of the planning pre-mortality, when emotions are low and all business owners are present.

Proper Buy/Sell planning protects surviving owners from dissident family members of a deceased owner who may complain about the size of dividends as well as salaries and other fringe benefits.

LIQUIDITY

The remaining business owners and the family of the deceased both need liquidity after a mortality occurs.

Without a Buy/Sell plan, the estate may have to sell the business in a rush to create liquidity, often resulting in a family receiving less than the fair market value.

Buy/Sell funding can be done through life insurance with discounted dollars by way of premium payments instead of extracting value from the business after an owner has passed away.

Funding Methods

CASH SINKING FUND

A sinking fund is created when a business puts aside earnings to invest over time to fund a future buyout obligation.

Considerations

Very few businesses have adequate cash on hand to fund the buyout of a significant owner.

Cash invested to fund a future buyout is not guaranteed to earn enough to cover the expense.

Depleting available funds would likely paralyze the business' operating capital and can cause other impairments to the business entity.

If the business starts putting away significant sums every year, there will rarely be enough to cover an early buyout at an unexpected mortality.

This approach may require a longer time horizon to accumulate the necessary funds.

A problem arises if the funds are needed sooner than expected or if the buyout occurs during a down market.

BORROWING

A company (or the remaining business owners) can borrow from a third-party lender to obtain the funds needed for a buyout obligation.

Considerations

This approach can create uncertainty, because the business valuation can fluctuate each year and the timing of an owner's death is unpredictable.

The total cost of the loan cannot be budgeted beforehand, because the loan terms are variable at any given time.

If the deceased owner was part of active management, the credit-worthiness of the business might be impacted when seeking a large loan.

The cash flow demands of repaying the loan can impact the operation of the business.

This approach could affect the business' (or owner's) ability to get additional loans in the future for other purposes.

INSTALLMENT PAYMENTS

An installment agreement gives the business and remaining owners a period of time to buy out the deceased owner.

Considerations

This approach merely delays the obligation and asks the deceased owner’s family to be patient as they wait to receive the funds.

The deceased owner’s estate must have adequate funding elsewhere to pay for estate taxes and estate settlement costs which could be sizeable for a wealthy business owner.

This approach does not provide cash to fund the buyout. Both the business and the deceased owner’s family are dependent on the assumed future profitability of the business.

This approach can put a significant strain on the business’ cash flow, especially if the shares being purchased belonged to a majority interest holder. Ultimately, it could result in the business' failure if additional capital is not available.

LIFE INSURANCE

Life insurance is often used to fund a Buy/Sell plan because it can provide the immediate liquidity necessary to buy out interest in the business upon death, ensuring that heirs receive a cash inheritance while allowing the remaining owners to continue to run and maintain the business.

Considerations

Premium payments for life insurance may be viewed as advance installment payments or as a cash sinking fund, but premium payments are not subject to interest and are illustrated to cumulatively be less than the principal sum (death benefit). An early or unexpected death prompts the payment of the full death benefit as long as all scheduled premiums are paid in full and on time.

When using a permanent life insurance policy, any cash value that accrues inside the policy can 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 (when using permanent life insurance)

Types of Arrangements

ENTITY PURCHASE / STOCK REDEMPTION

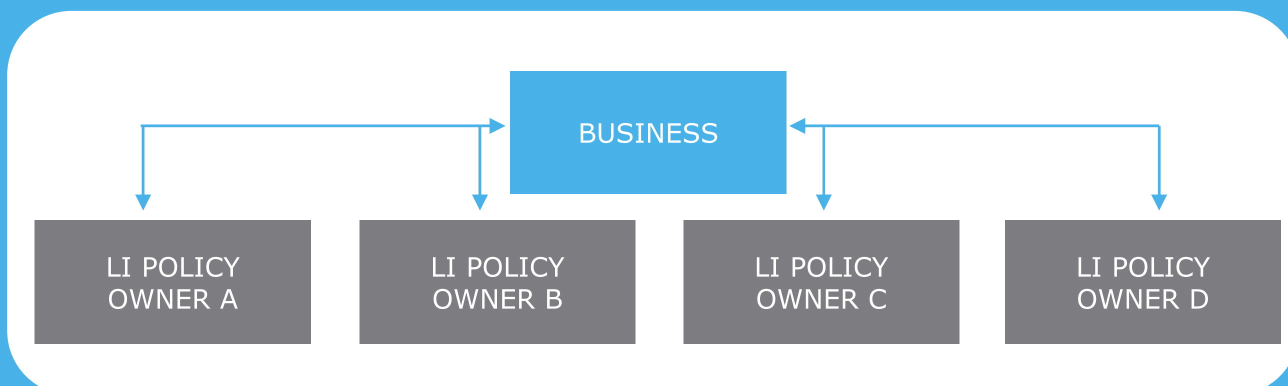
Business pays insurance premiums

Life insurance increases the business value

Works best for C corps and businesses with several owners

Corporate agreement between the corporation and a business owner to redeem the shares from an owner upon his or her death. Often funded with life insurance. Typically used in C-Corporations and when there are multiple owners.

ADVANTAGES	DISADVANTAGES
Simple & easy to understand	May trigger dividend treatment for family
Funded with corporate dollars	AMT issues for C Corporation
Preferred method with multiple owners	Lack of step-up in basis



CROSS PURCHASE

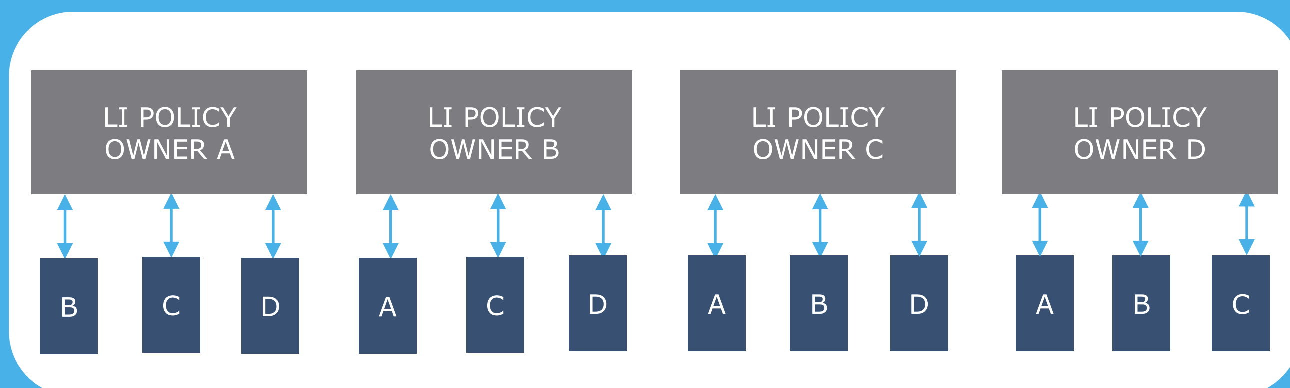
Business owners pay premiums, may be funded by a bonus plan

Life insurance does NOT increase the business value

Works best for businesses with three or fewer owners

Private agreement between an owner of a business to redeem the shares of another owner upon his or her death. Cross purchase agreements are often funded with life insurance. Typically used with pass-through entities (S-Corporations and LLC's) and three or fewer owners.

ADVANTAGES	DISADVANTAGES
Step-up in basis	Many policies for multiple shareholders
No Dividend Treatment	Must use after-tax personal dollars for premiums
No AMT impact (C Corp)	Transfer for value issues after 1st death



ONE WAY

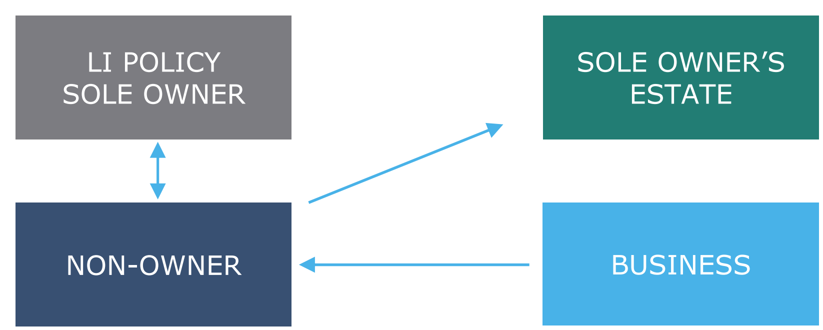
Non-owner pays premiums, may be funded by a bonus plan

Life insurance does NOT increase the business value

Works best for businesses with one owner and one successor

A non-owner (such as a key person) agrees to buy the business from the owner and purchases a life insurance policy on the owner. The non-owner enters into a one-way arrangement with the owner. Typically used for businesses with one owner and one designated successor owner.

ADVANTAGES	DISADVANTAGES
Step-up in basis	Bonus plan is taxable event to non-owner
Business can deduct premiums via bonus plan	Owner and non-owner relationship can end
Only one insurance policy is needed	Non-owner can die before owner



CROSS ENDORSEMENT

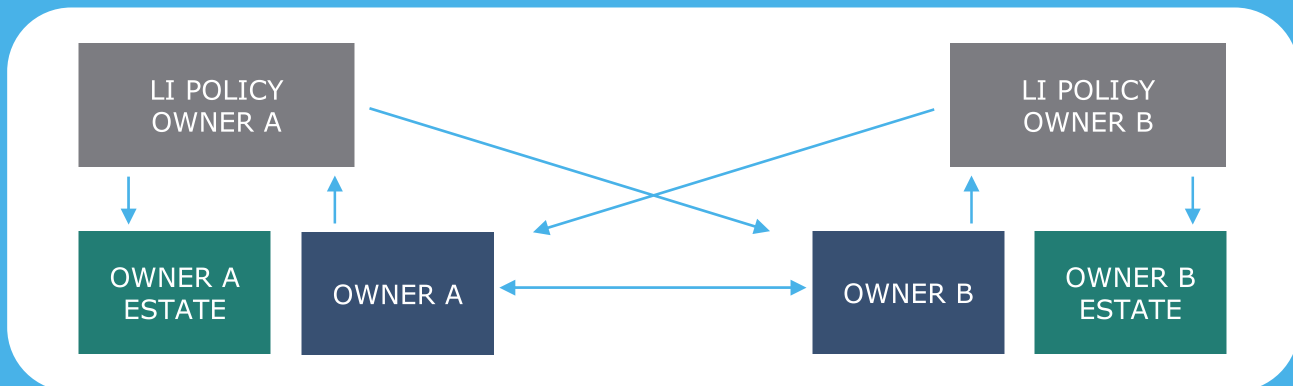
Each business owner pays premiums plus "rental" charges to the others

Life insurance does NOT increase the business value

Works best for business owners who want flexibility

Each business owner enters into an endorsement split dollar plan with the others and buys a policy on their own life. Each owner endorses a portion of the death benefit to the other owners. Each owner pays an annual "rental" charge to the others; may be funded with a bonus. Typically used for owners who want flexibility.

ADVANTAGES	DISADVANTAGES
Unendorsed death benefit is paid to family	Rental charges increase over time
Amount of endorsed death benefit can be adjusted	Rental income may be taxable
Step-up in basis	May not be suitable for C and S Corps



INSURANCE LLC

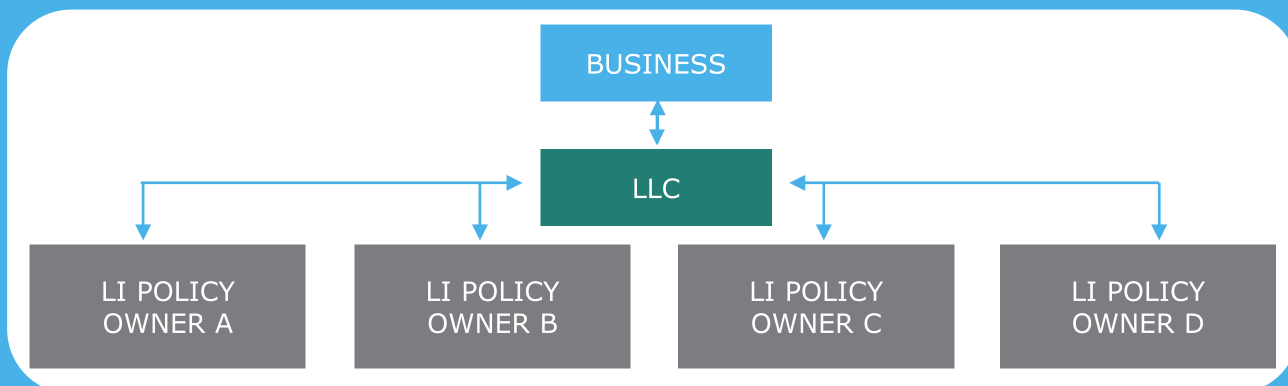
Business pays insurance premiums, considered compensation to owners

Life insurance does NOT increase the business value

Works best for businesses with several owners

A special purpose limited liability company (LLC) established under state law specifically for holding, managing, funding, and distributing life insurance proceeds within a Buy/Sell arrangement. Provides central ownership, administration, and maintenance of the necessary life insurance policies outside of the business.

ADVANTAGES	DISADVANTAGES
Distributions are generally tax-free	Appointment of an independent manager
Reduces policy exposure to business' creditors	Maintaining a capital account for each owner
Meets the exceptions to the transfer for value rules	Additional tax considerations for additional entity



WAIT AND SEE

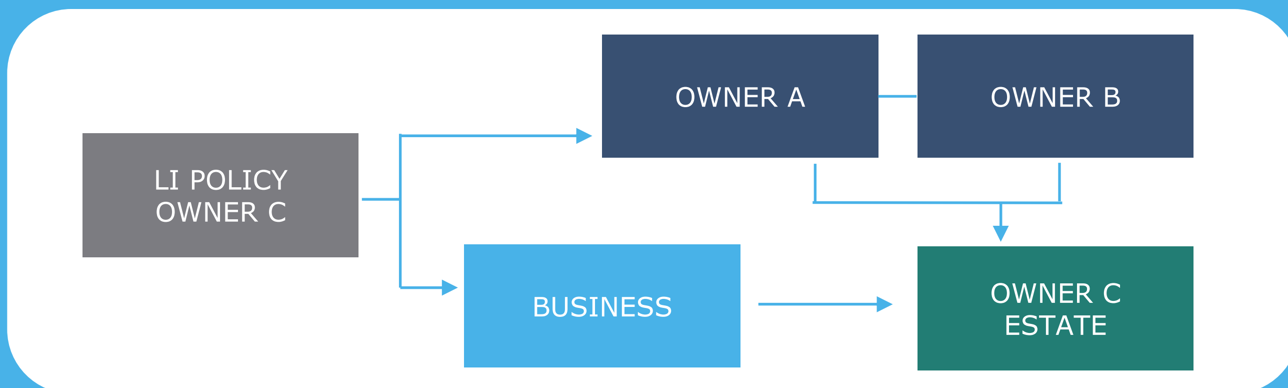
Policy owner pays insurance premiums

Life insurance might increase the business value

Works best for business owners who want maximum flexibility

A Buy/Sell arrangement that generally (1) gives the business the option to buy any portion of a deceased business owner's interest then (2) gives the remaining owners the second option to buy then (3) the entity is required to purchase the balance of interest for the agreed-upon value. Either the business or the individual owners will purchase insurance policies on the lives of the business owners.

ADVANTAGES	DISADVANTAGES
Maximum flexibility	Can be difficult to fund
The buyout is advantageously structured	Care must be taken to avoid dividend treatment
Policies can be sold or loaned to fulfill buyout	Planning takes place after mortality event



Connelly v. US
Supreme Court Decision

CONNELLY DECISION SUMMARY

WHAT HAPPENED?

The Connelly brothers ignored valuation provisions during their lifetime and their buy/sell agreement failed to establish a fixed or determinable price.

Upon Michael's death, his family agreed to value his shares at $3M and the estate's tax return was filed based on this amount. The IRS disagreed and audited the return. The Connelly family appealed.

The US Court of Appeals holding states the "courts thus recognize that an agreement must contain a fixed or determinable price if it is to be considered for valuation purposes."

On June 6, 2024, the U.S. Supreme Court affirmed the 8th U.S. Circuit Court of Appeals' decision in Connelly v. U.S.

CONSIDERATIONS

IRC SECTION 2703(B)

Property valuation exceptions

(1)It is a bona fide business arrangement.

(2)It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3)Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

TREAS. REG. 25.2703-1(B)(3)

A company automatically meets the criteria for the exclusion if more than 50% of the property is owned directly or indirectly by individuals who are not members of the same family.

EFFECT

This ruling determined that the value of the business at a shareholder's death can be increased by any life insurance proceeds that are received without an offsetting reduction for the amount of the stock redemption liability.

Whether the business is operated as a 'C' or an 'S' corporation, an LLC or as a partnership, all buy-sell agreements (redemption as well as cross-purchase) and business-owned life insurance coverage should be reviewed in light of the IRC Sec. 2703(b) exceptions, existing case law requirements, and, with respect to redemption agreements, the Connelly Supreme Court decision.

EFFECT ON ARRANGEMENTS

	STOCK REDEMPTION	CROSS PURCHASE	INSURANCE LLC	CROSS ENDORSEMENT
POLICY OWNER	The company owns policies on each shareholder	Each shareholder owns a policy on the other shareholder(s)	The company's shareholders are the members of the LLC, and the LLC owns life insurance on each member	Each shareholder owns a life insurance policy on their own life
PREMIUM PAYOR	The company pays the premiums for each policy	Each shareholder pays the premiums on the policy(ies) they own	Each member can either pay the premiums via a capital account or have the business pay the premiums via loans or as compensation	Each shareholder pays the premium for their own policy plus rental charges to the other shareholders
DEATH BENEFIT RECIPIENT	The death benefit is payable to the company for the purpose of fulfilling the buyout of the deceased shareholder	The death benefit of each policy is paid to the shareholder who owns it	The death benefit of each policy is paid to the LLC for disbursement via the capital accounts for each member	The death benefit is paid to the shareholders as endorsed in the policy
CONNELLY EFFECT	The death benefit that is owed to the company can be considered as part of the fair market value of the company at the shareholder's death	This arrangement keeps the life insurance proceeds out of the company and out of the deceased shareholder's estate altogether	This arrangement keeps the life insurance proceeds out of the company and out of the deceased shareholder's estate altogether	This arrangement keeps the life insurance proceeds out of the company and out of the deceased shareholder's estate, except for any amount that is unendorsed
ADVANTAGES	- Easy to understand - Funded with corporate dollars - Works well with multiple owners	- Step-up in basis - No dividend treatment - No AMT impact (C Corp)	- Distributions are generally tax-free - Reduces policy exposure to business' creditors - Meets the exceptions to transfer for value rules	- Unendorsed death benefit is paid to family - Amount of endorsed death benefit can be adjusted - Step-up in basis
DISADVANTAGES	- May trigger dividend treatment for family - AMT issues for C Corporation - Lack of step-up in basis	- Many policies for multiple shareholders - After-tax personal dollars for premiums - Transfer for value issues after 1st death	- Appointment of an independent manager - Maintaining a capital account for each owner - Tax considerations for additional entity	- Rental charges increase over time - Rental income may be taxable - May not be suitable for C and S Corps

CHANGING THE ARRANGEMENT

STOCK REDEMPTION ARRANGEMENT

Shareholders of family-owned companies who are in a taxable estate, might want to consider editing their stock redemption buy/sell arrangement

However, if a stock redemption buy/sell arrangement is left in place, there could be a capital loss in the estate to offset any additional estate tax

Adding a layer of company ownership via a dynasty trust could be a viable solution for some companies

Modifications to the existing agreement could create a layer between the company and the death benefit proceeds

BEFORE THEY UNWIND THE AGREEMENT

The company's shareholders will need to be on board with a lengthy process to unwind one agreement then implement another

The company's shareholders' sophistication levels should be evaluated to determine if a more maintenance heavy buy/sell plan will work for them

The Supreme Court's language is broad and up for interpretation

The age of the shareholders will determine how far back the Connelly decision will be in the rearview at life expectancy

LIFE INSURANCE POLICIES

Life insurance policies would need to be distributed or purchased from the company, or altered entirely, to fit the new arrangement

If the policies are term products, and if the insureds are healthy, consider surrendering the old coverage and writing new coverage with the proper owner and beneficiary in place from day one of the policy

For policies that can't be easily replaced, interpolated value can be used when determining the amount to purchase the policy from the company

TAXATION

If the policy is purchased from the company, any gains will be taxed to the company

If the transfer for value rule applies, a portion of the death benefit might be subject to income taxes

If the IRS determines that an Insurance LLC was established solely as a tax shelter, it could determine that the receipt of life insurance proceeds is includable in the deceased member's estate

IRC Sec.101(j) notice and consent can be applied broadly as interpreted by the IRS to include Insurance LLC's

NEW ARRANGEMENT

There is no one size fits all solution

Options include:
- Cross Purchase
- Insurance LLC
- Cross Endorsement

There are extenuating circumstances that can affect which arrangement will work best for each company

Family dynamics play a huge part in the appropriate structure for a buy/sell plan in a family-owned company

The pros and cons for each option should be evaluated to make the best decision for the structure of the arrangement and buy/sell agreement

GUIDANCE QUESTIONS

Is there an established buy/sell agreement?

YES

Does the business have a purchase obligation?

NO

Review the buy/sell agreement for accuracy and audit any life insurance that was implemented.

Create a plan for ongoing maintenance of the buy/sell agreement and business valuations.

YES

Any life insurance that will be paid to the business might end up adding to the value of the shares and increasing the deceased shareholder's net worth and estate tax liability.

Family-owned businesses where the shareholders' projected estate tax exceeds the exemption threshold might want to consider an arrangement with the death benefit outside the business.

Does the business want to change their arrangement?

YES

Considerations include, but are not limited to, the shareholders' sophistication level, any gains from transferring a policy, if the transfer for value rule applies, IRS code applicability, and family dynamics when determining which buy/sell arrangement works best for the business.
Refer to Heirmark's Buy/Sell Planning Client Guide.

NO

Create a plan for ongoing maintenance of the buy/sell agreement and business valuations.

NO

Consider establishing a buy/sell agreement. Refer to Heirmark's Buy/Sell Planning Client Guide.

Conclusion

INCORPORATING ADVISORY TEAM SYNERGY

SOURCING A LIFE INSURANCE NEED FOR A CLIENT REQUIRES A WELL-ORCHESTRATED SYMPHONY OF COLLABORATIVE MINDS.

A synergistic advisory team benefits not only the client but each advisor as well. The client receives guidance from knowledgeable resources to optimize their planning. Oftentimes, an attorney, accountant, wealth manager, and insurance producer all play important roles when determining, implementing, and servicing the best option for each client.

ATTORNEY CONTRIBUTIONS

Writing a new trust (ILIT, SLAT, IDGT, GST, etc.) to own the new insurance policy. Updating an existing insurance trust to reflect the current situation of the family before a new life insurance policy can be implemented. Periodic review of an insurance trust to determine that the trust still fits the client's needs.

ACCOUNTANT CONTRIBUTIONS

Providing guidance for the taxation of the death benefit distributions from a trust when a claim is paid. Providing guidance when a policy is surrendered for taxation of any cash value over the cost basis. Filing taxes for a trust(s) that houses the insurance policy(ies).

WEALTH MANAGER CONTRIBUTIONS

Providing guidance to determine the premium tolerance for life insurance. Determining the optimal allocation of funds inside a variable policy. Periodic review of the allocation inside a variable policy to determine if re-allocation is warranted.

INSURANCE AGENT CONTRIBUTIONS

Providing guidance on the available life insurance products to determine the right fit. Using relationships to negotiate for the best offer on a client's behalf. Acting as a liaison for the client to make any applicable changes to an existing policy. Offering annual policy reviews to gauge if the policy still fits the client's needs.

MAXIMIZING SYNERGY

VALUED CLIENT

A client wants to complete or update their financial planning and contacts their trusted advisors for options that will fit their planning needs.

TRUSTED ADVISOR

A life insurance need is identified, and the client does not have a strong relationship with an insurance specialist. The trusted advisor contacts Heirmark for planning, pricing, and implementation guidance.

HEIRMARK®

Raymond Nash is introduced to the client to determine next steps for fulfilling the client's life insurance needs. We enjoy teaming with advisors to put client needs front and center. By working side-by-side, we can deliver insurance solutions looking through a wider lens. This creates synergy between the life insurance acquisition and personal or business planning. Our best work is done when working in sync with a client's advisory team.

CONTACT US

Live for today.
Plan for life.

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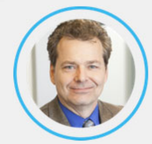

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