TDC LIFE

Business Continuation, Key Person Protection and Retirement Planning

BUSINESS CONTINUATION, KEY PERSON PROTECTION AND RETIREMENT PLANNING

Proper risk management for business owners involves making sure that in the event of an untimely death and/or disability of an owner; arrangements are in place to protect the interests of surviving owners and the deceased owner's heirs. An untimely death of an owner without proper buyout agreements and funding sources present unique planning challenges for both the heirs of the deceased owner and the business itself. These could include the following:

- Who will purchase the business interest?
- Are the surviving owners willing to share ownership with the deceased owner's spouse and/or heirs?
- Are the surviving spouse and/or children of the deceased owner comfortable being dependent on the surviving owners for their income?
- What is a fair buyout price of the deceased owner's interest?
- When and how is the sale to be made?
- What is the funding source of the buyout and what impact will it have on future cash flow/operations of the business?
- How will the death of an owner impact the future revenue and/or credit quality of the business?
- Are the unique skills and/or responsibilities of the deceased able to be fulfilled by the surviving owners? If not, how will the business be impacted by and fund the costs to find and hire a replacement?

These challenges can often be resolved, or prevented, with a properly drafted buy-sell agreement funded with a well-structured life insurance program.

A buy-sell agreement is a legal document obligating one party to buy and another to sell the interests of a business upon the occurrence of certain triggering events. The most common triggering events include death, disability and retirement but the agreement can also be structured to address divorce or bankruptcy of an owner. In the case of death, for example, it will assure that someone (i.e. the business itself, surviving owners a key employee, etc.) will be obligated to buy the interests of the deceased owner and the estate of the deceased owner will be obligated to sell his or her interests to the acquiring party. This type of planning can create certainty in otherwise tumultuous times.

THE BENEFITS OF A PROPERLY DRAFTED BUY SELL AGREEMENT UPON DEATH OF AN OWNER INCLUDE:

- Creates a market for closely held business interests, which may be difficult to dispose of by other means because, often times, no readily available market exists.
- Provides for the orderly transfer of the deceased owner's interest according to the terms of the agreement that are agreed upon by the respective parties when calmer heads exist.
- Minimizes the risk that ownership interests could fall into the hands of inexperienced and/or unwilling outsiders.
- Establishes a value for the business to ensure the surviving heirs of the decease receive the full fair market value and reduces the risk of a post-mortem valuation disputes.
- Fixes the value of the business for estate tax purposes (assuming certain requirements are satisfied).

THE BENEFITS OF A BUY-SELL AGREEMENT WITH PERMANENT LIFE INSURANCE ON THE LIVES OF EACH OWNER INCLUDE:

- Ensures the funding is available at the time it is needed (the event that creates the liability (at death) is also the event that triggers the funding (death benefit)).
- Ensures the estate of the deceased a liquidity source to convert an illiquid asset to cash.
- A cost effective way to fund the buy-out as the death benefit is typically far in excess of the premiums paid.
- Helps hedge against "mortality risk" of an early death where the funds needed to buy out the deceased may not yet be available through traditional savings techniques.
- Provides flexibility with tax-deferred policy cash values that can be accessed income tax free if circumstances change, (e.g. – disability, down payment on a lifetime buy out, supplemental retirement income or funding future business projects).
- Additionally, coverage above and beyond the actual buyout price can be acquired to provide additional protection to the business to cover any additional costs resulting from the death of an owner, such as lost revenue and/or clientele, diminished credit standing, expenses related to hiring a replacement, etc. (i.e. – key man coverage).

MOST COMMON TYPES OF BUY SELL AGREEMENTS:

- *Cross purchase:* The agreement is between the owners themselves where each agrees to buy out the interests of the other. Life insurance is typically purchased by each owner on the life, or lives, of the other(s) to provide the necessary funding at death based on the value of each owner's respective interests. The purchase price can be set in one of two ways: A fixed amount stated in the agreement or a formula by which a definite price can be established.
- *Entity purchase:* The agreement is between the business itself and each respective owner individually where the business agrees to redeem, or repurchase, the interests of each owner. Life insurance is typically purchased by the business on the lives of each owner to provide the necessary funding at death based on the value of each owner's respective interests. Similarly, the purchase price can be set in one of two ways: A fixed amount or a formula.

BENEFITS OF A LIMITED LIABILITY COMPANY (LLC) ENTITY PURCHASE ARRANGEMENT WITH LIFE INSURANCE:

Using a newly formed LLC to serve as the purchasing party in an entity purchase buy-sell arrangement can offer some unique planning opportunities.

One Policy per Owner with Cost Allocated Based on Ownership, Not Age/Health: Because an entity purchase agreement results in a one-way transaction between the LLC and the deceased owner's estate, only one policy per owner is needed. The LLC will be the owner and beneficiary of a life insurance policy on the life of each owner. This simplifies the life insurance ownership structure particularly when there are more than two owners. For example, in a business with three owners, typically six policies would be purchased; however, in an LLC structure, only three policies would be required.

Additionally, the LLC will pay the premiums with after tax earnings on which the members have paid taxes on in proportion to their ownership interest. This proportional allocation of taxes on the premiums can help equalize the cost of the life insurance between all owners based on their respective ownership interest which can be particularly attractive if the ages and/or health status of the owners vary dramatically resulting in varying amounts of premium expense per 1,000 of coverage.

Full Step Up in Basis for Surviving Owners: LLCs are “pass-through” entities regarding the taxation of its earnings. That is, all items of LLC income and loss pass through to the owners individually for tax purposes who then pay the taxes on the earnings regardless of whether distributed. All earnings of the LLC, then, increase the owner’s basis in the LLC and the character of taxation on those earnings flows through to the owners individually as well. Therefore, earnings from the receipt of life insurance proceeds should increase the basis in the LLC in proportion to a member’s ownership interest and the income tax free character of those proceeds should be maintained as they flow through for tax purposes.

Furthermore, due to the fact that special allocations can be made to the capital accounts inside the LLC (subject to certain requirements), a properly drafted operating agreement can allocate the earnings from receipt of life insurance proceeds following the death of an owner to the surviving owners’ capital accounts so that they can realize a full step up in basis on the value of interests redeemed from the deceased. The LLC will uses the life insurance proceeds to redeem the interests of the deceased owner whose heirs will also receive a step up in basis to the value of his or her interests at death under current transfer tax law (IRC Section 1014(a)).

Supplemental Retirement Income: LLCs also can enjoy favorable income tax treatment on the transfer of life insurance policy ownership from the entity to the insured owner. This transfer would simply reduce the owner’s capital account and, hence, his or her basis in the LLC, but there would be no deemed compensation to him or her and the LLC itself would not have to recognize gain in the policy. Once the transfer is complete, the owner could then take income tax-free withdrawals and loans from the policy to supplement retirement income. Note that a transfer to the insured would qualify as an exception to the transfer for values rules. Alternatively, the owner could leave ownership of the policy with the LLC which could take withdrawals and loans from the policy and, in turn, make tax-free distributions to the owner assuming his or her capital account is sufficient to characterize the distributions as reductions in basis.

This alternative approach could be appealing in situations involving large face amounts and/or where the insured’s personal net worth is large enough to result in an estate tax exposure. When an individual has incidents of ownership over a policy on his or her life, the death benefit proceeds are includible in his or her estate and subject to estate taxes, which could exacerbate the estate’s settlement costs. An LLC as the policy owner and beneficiary can exclude the death benefit proceeds from the estate of the deceased insured while still allowing for access to cash values as described above, assuming certain requirements are met. To do so, it is critical that the operating agreement is written accordingly so that the insured is not considered to have any incidents of ownership under IRC Section 2042 over the policy on his or her life that is owned by the LLC. In other words, the operating agreement must specifically prohibit the insured Members from voting on any matter relating to any life insurance policy owned by the LLC. For example, a special Manager can be appointed for the sole purpose of exercising any and all incidents of ownership with respect to the policy(ies). This special Manager can be removed and replaced by majority vote of the Members if necessary.

Although the death benefit should be excluded from the deceased insured’s estate, the value of the deceased’s LLC interest, which appears to be based on his or her capital account in the LLC, is includible in the estate. See Private Letter Ruling 200747002 for additional information regarding the considerations associated with this technique.

Creditor Protection: Assets owned by the LLC are subject only the claims of the LLC’s creditors and not to personal creditors of the insureds. There may be additional creditor protection characteristics pertaining specifically to the life insurance policy itself based on the statutes of the state of issue.