



HIGHLAND
CAPITAL BROKERAGE

Buy-Sell Planning & the Impact of Connelly

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The Problem

Many closely-held businesses do not make formal plans for transitioning the business in the event of the premature death of the owner, the lifetime transfer or sale of the business, or the retirement of one of the key business owners.



What you Know and Love




Cross
Purchase



Stock
Redemption

What you
Know and
Love May
not be
the Best
Way to
go



- Stock Redemption
 - Must be 101(j) compliant
 - Cash values may be subject to company's creditors
 - Step up in basis issues

What you Know and Love May not be the Best Way to go

- Cross-Purchase
 - Could require too many policies
 - Policies may have to be transferred in the future



The Situation

- Business owners and many advisors have a knee-jerk reaction to buy-sell planning. It is simply assumed that term insurance is without a doubt, the best way to go

Term Insurance

Inexpensive

Inflexible

- Tough to change death benefit amounts

Irrevocable

- May be financial implications, if the policy is to be utilized on a personal level

Underwriting



Business Owned Life Insurance

- Typically, the death benefit will be based upon the value of the business
- Where is the value coming from?
- Can the value be justified?
- Has there been a valuation done?

Personal Owned Life Insurance

- Based upon personal income
- Can be 10-30 times annual compensation

What do we know about Business Owners?

Usually in higher tax brackets.

Would rather plan for themselves
before planning for their employees.

In love with qualified plans.

Usually have a need for personal life
insurance.

One Life Insurance Policy for Everything

Cross-Endorsement Buy Sell

- The buy-sell plan that provides the liquidity needed to transfer a business when one of the business owners passes away prematurely. However, since the policy is owned individually, it can also be used to supplement retirement. And if the family needs change, the policy could be used to provide some estate liquidity.

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How It Works

Each owner owns a policy on their life.

- Can be done with ILIT's

Each owner will endorse or RENT out all or a portion of the death benefit to the other owner or owners.

Each owner will pay a rental charge to each other for the amount of the death benefit being endorsed.

Each owner will recognize “rental income” in the amount of the rental charge

What if the Business is Sold?

The rental agreement or split dollar agreement is terminated.

No policies have to be transferred.

The policy could be used for income.

The policy could be sold to an ILIT

The policy could be gifted to an ILIT.

Things To Consider

Cash Flow.

Cash value
restriction.

Increasing
Economic Benefit
or rental charge.

Marketing



Sample agreement to be used
with most carriers



Third party article

One Life Insurance Policy for Each Owner-Part Deux

The Insurance LLC

- The owners establish a Special Purpose LLC.
- They enter into a cross-purchase buy-sell agreement for both the primary business and Insurance LLC.
- The Insurance LLC is the owner, beneficiary, and pays the premiums on all policies.
- The owners transfer cash to the partnership as a tax-free capital contribution.
- Partnership “Special Allocations” are carefully crafted.

- Business Owners looking for ways to structure a buy-out in the event an owner dies or retires.
- Concerned about income and estate taxes.
 - Connelly
- One of the owners may have been sued in the past so creditor protection is a concern.

Why Does the Insurance LLC Make Sense?

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A closer look at the Insurance LLC

Business owners have two concerns regarding the estate tax:

1. Incidents of ownership that cause the business owned policy to be included in the insured's taxable estate [IRC § 2042]
 2. Inclusion of the owner's business interest in their taxable estate [IRC § 2033]
-

IRC § 2042: Incidents of Ownership

The right, either alone or in conjunction with another person or persons, of the insured or his estate to the economic benefits of the policy:

- power to change the beneficiary,
- surrender the policy
- cancel the policy,
- assign the policy,
- revoke an assignment,
- pledge the policy for a loan, or
- obtain from the insurer a loan against the surrender value of the policy

IRC § 2033: Value of Business Interest

Ownership % of business could be included in taxable estate.

Life insurance proceeds could add to the value of the business.

Partnership “Special Allocation” Rules

General rule: items of income and deductions are allocated on a pro-rata basis according to the operating agreement.

Allocate the cash value, death benefits and premiums to the non-insured partners.

This will keep all of the death proceeds (even a partner’s pro-rata share) out of the insured partner’s estate.

Retirement of the Business Owner

- If permanent insurance is used then the departing member has the added luxury of accessing policy cash values (income tax-free) for supplemental retirement income or other lifetime needs.

Combo Plan

Utilizing a mix of permanent and term insurance

Assigning Personally owned life insurance back to company

Underwriting is based on personal income

Term could be owned by company, and permanent could be owned personally

The ILIT Plan

High Net Worth Business Owners

- ILIT is the owner and beneficiary
- ILIT will Endorse (rent) death benefit to other owner(s)
- Death benefit is outside taxable estate after buy-sell is needed
- May alleviate future gifting issues

Buy-Sell Agreements - FAQ's

Are the premiums deductible?

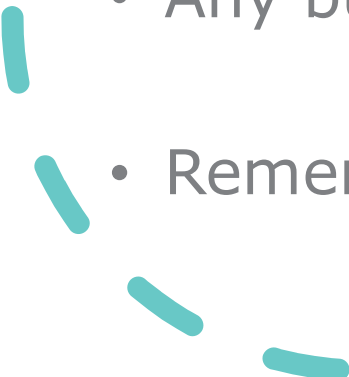
Are there tax implications if policies are transferred?

Where does the value of the Buy-Sell come from?

Which type is the best?



Buy-Sell Agreements Target Market

- Any business without a Buy/Sell Agreement.
 - Any business with a Buy-Sell Agreement.
 - Any business with an unfunded Buy/Sell Agreement.
 - Remember Disability Buy/Sell.
- 

A tale of Two Brothers

- Michael (owned 77%)
- Thomas (owned 23%)
- Created Shareholder Redemption Agreement:
 - Bought \$3M in life insurance on each brother (despite the disparity in ownership)
- Business worth \$3.6M when Michael died in 2013

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The Agreement

Agreement between brothers called for an annual “certificate of agreed value” between the brothers, fixing the value of the business for the buy-sell

They never completed any certificate of agreed value

The same amount of life insurance was applied on each, despite the difference in ownership



The life insurance proceeds were supposed to be used to fund the shareholder redemption

Bad Facts make...



Surviving Brother, Thomas, acted as executor of Michael's estate, AND represented the corporation in agreeing on the value of the business for the buy-out

Didn't look like an arms-length transaction



Agreement largely disregarded (makes it hard to argue the Service should pay attention to it, if you didn't)



No Valuations ever performed



No relationship between applied-for insurance and their ownership interests

77% of the business...

Was worth
approximately
\$3,000,000

IRS filed notice of
deficiency for
\$889,914 in estate
taxes, arguing the
value should have
been \$5.3M

- \$3.86M enterprise value
- \$3,000,000 life insurance proceeds
- = \$6.86M
- 77% of \$6.86M = \$5.3M

Connelly family filed
suit in District Court,
asking for a refund of
\$889,914

Question Presented



WHETHER LIFE-INSURANCE PROCEEDS THAT WILL BE USED TO REDEEM A DECEDENT'S SHARES MUST BE INCLUDED WHEN CALCULATING THE VALUE OF THOSE SHARES FOR PURPOSES OF THE FEDERAL ESTATE TAX?



UNANIMOUS SUPREME COURT HELD: YES.

What does this mean?

Entity purchase agreements will need to include the life insurance proceeds in the fair market value of the shares for *estate tax valuation purposes*

- Not always a disaster, particularly if the business / estate are relatively small

Re-writing buy-sell agreements to now be a cross-purchase – the easiest route may be to also re-write insurance (where the shareholders are still insurable)

Example

5 equal shareholders, own a business worth \$10M

Biz bought \$2M LI on each

Shareholder Dave Dies.
Company receives \$2,000,000 DB, uses it to redeem Dave's shares.

Dave's estate tax return, however, must report the fair market value of the shares as \$2,400,000

If Dave's estate (and cumulative lifetime gifting) is below \$13,610,000 – this has no real impact

Dave's estate >\$13,610,000, this would increase his estate tax by 40% of the "extra" \$400,000

What does this mean?

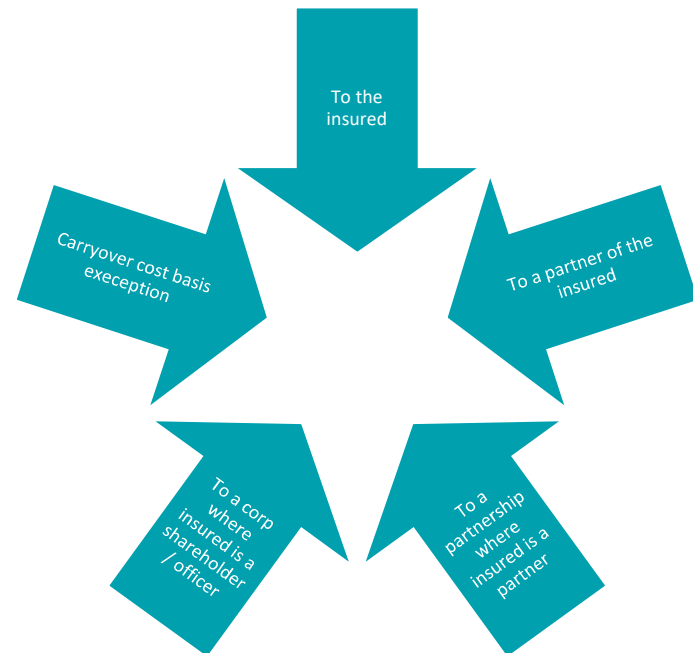
1. Not INCOME tax – this is just for valuation of estate tax
2. Many advisors & clients may want to “unwind” existing entity-owned arrangements – but need to be mindful of the **transfer for value** rule
3. New plans will likely be structured differently:
 1. Cross purchase
 2. Insurance LLC
 3. Cross-endorsement

Transfer for Value rule

The Rule

- § 101(a)(3):
 - Life insurance payouts, by reason of death, are generally not included in income, except if there was a transfer for valuable consideration
 - Both *transfer* and *valuable consideration* are interpreted broadly

Exempt Transfers



Transfer for Value Exceptions

There is NO “shareholder to shareholder” exception

This means:

- Entity owns LI on shareholders, Al and Bob. Decides to convert to a cross-purchase. Entity distributes to Al the policy on Bob, and to Bob the policy on Al.
- This is a violation of TFV. The death benefit would be taxable to Al / Bob to the extent it exceeds the amount they’ve paid for it

Next Steps



Revisit existing Entity Purchase / Stock Redemption agreements

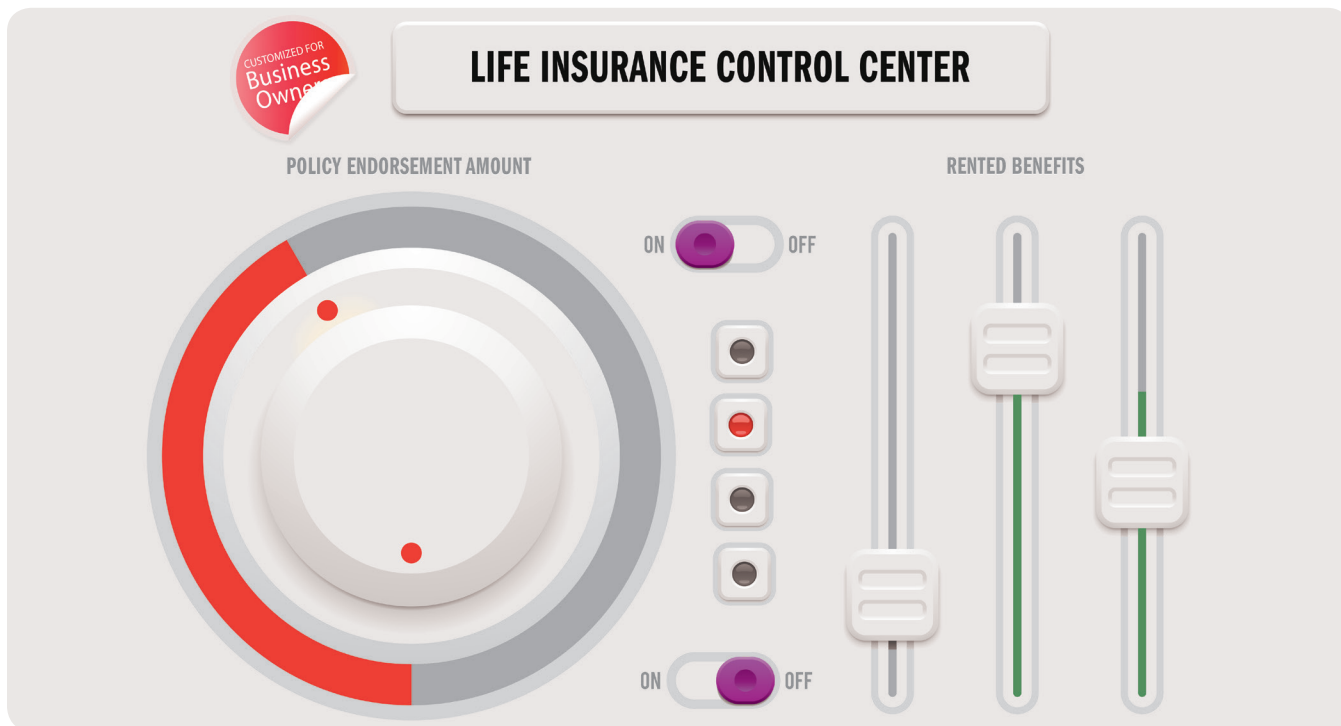


Are they impacted by Connelly? Is their estate taxable now (or likely to be taxable in the future?)

If so – are they insurable?
Are there more than 2-3 shareholders?

QUESTIONS??

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A Buy-Sell Plan That Gives Owners Life Insurance Control

▶ Permanent life insurance can fund a cross-purchase arrangement between business owners in which each owner agrees to purchase the deceased owner's interest in the business.

By Howard Jonas and William R. Buslee

All companies have buy-sell agreements, whether their owners realize it or not. However, only a fraction of these agreements exist as legal documents and fewer are funded, according to the LIMRA report "U.S. Small Business in 2000."

For owners whose plans have yet to be committed to paper or even discussed, their buy-sell agreements, or "business wills," will be created upon their deaths. What ultimately happens to the business may not be what the original owner intended. Without a written and funded buy-sell agreement, there could be valuation issues.

There also could be problems for the owner's family, other business owners and even the employees. A buy-sell agreement also can spell out what triggers the buy-sell. For example, the buy-sell often may be triggered by events other than death.

Life insurance policies are an excellent funding source for buy-sell agreements. For those agreements that already use life insurance, there is a strong probability that the insureds may not own the policies on themselves. If the agreement was set up as an *entity purchase arrangement*, the company is the owner and beneficiary of the life insurance policies. If it was established as a *cross-purchase arrangement*, then the other business owner owns the policy — Owner A owns a policy on Owner B and vice versa. Having a policy owned by someone other than the insured could present some problems, not just now, but also in the future.

Many people start their own businesses because they don't want to have a

boss — they want to be in control. Naturally, it would make sense for business owners to own or control the life insurance policies covering their own lives. A cross-endorsement buy-sell agreement can allow the business owners to fund their portion of the buy-sell and obtain the coverage they need with only one policy per owner. Later, if the business is sold, there's no need to worry about transferring or selling any policies. Because the policy is personally owned, the owner could use the policy for income later in life if it was no longer needed for buy-sell purposes.

In a cross-endorsement buy-sell, the owners of a business enter into a cross-purchase arrangement. Under this arrangement, each owner agrees to purchase the deceased owner's interest in the business from the deceased owner's spouse, heirs or estate.

To facilitate the purchase of the deceased owner's interest, each business

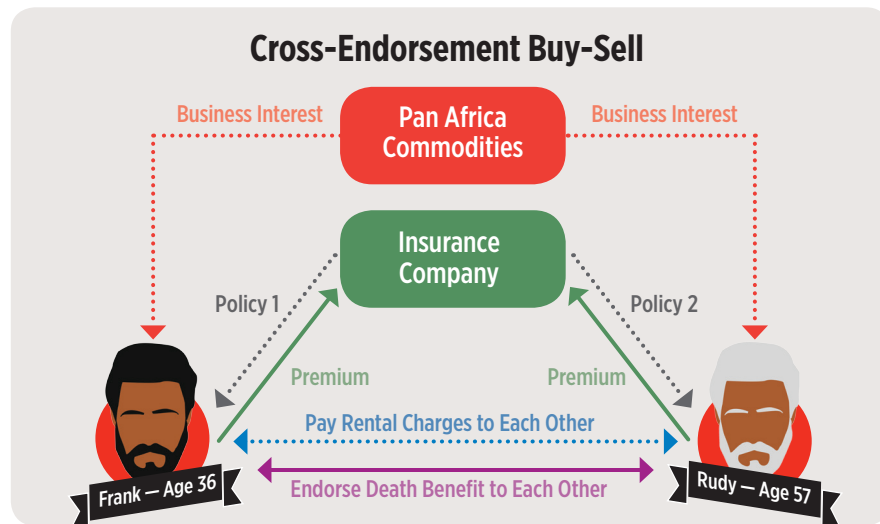
owner endorses or “rents out” either a portion or all of the policy death benefit to the other business owner or owners, from their individually owned policy. Because each policy is individually owned, the owner — or each business owner — will pay for the premium out of their own pocket, using after-tax dollars. By doing so, each will have a basis in the policy, which could affect their ability to receive tax-advantaged income years later, if the policy is no longer needed for buy-sell purposes.

Because this arrangement closely resembles an endorsement split-dollar arrangement, the annual rental charge is equal to the economic benefit of the endorsed death benefit. This amount can be calculated using either the Table 2001 rate or a carrier’s alternative term rate for the insured’s corresponding age. Generally, as long as the economic benefit is paid, the death benefit will be income tax-free when received. However, the economic benefit received by the policy owner most likely will be taxable income.

Case Study

Frank and Rudy own equal interest in Pan Africa Commodities, a high-end import/export business that specializes in raw materials and finished goods. After a slow start, the company is experiencing growth and profitability. Recently valued by an outside firm at \$2 million, Frank and Rudy agree that the time has come for Pan Africa to establish and fund a buy-sell agreement. Both also recognize their need to purchase additional personal insurance.

After first establishing the value of Pan Africa, and then establishing and ratifying the buy-sell agreement, both business owners purchase \$2 million life insurance policies on their own lives. Because the owners are funding the agreement with personal policies, a third-party valuation may not be necessary. As long as the value is reasonable and customary, the value can be an amount upon which the owners agree. Although both Frank and Rudy are healthy, there is a sizable difference in their respective ages — Frank is 36 and Rudy is 57. Because of the premium differences tied to their age disparity, they decided not to pursue a cross-purchase buy-sell agreement. Following a discussion



with their agent, Bob, they decided that a cross-endorsement buy-sell agreement would be the correct course of action.

Because both owners are in the 40 percent tax bracket, they each agree to pay themselves an additional \$3,334 per month. This will create an after-tax cash stream of an additional \$2,000. Frank will use his \$2,000 to purchase, own and pay premiums on a \$2 million permanent policy on himself; Rudy will do the same with his additional income. If needed, they will be responsible for any additional premiums.

Funding

To fund the cross-endorsement buy-sell, Frank will endorse \$1 million of his policy’s death benefit to Rudy and Rudy will endorse \$1 million of his policy’s death benefit to Frank. Rudy and Frank will pay each other the economic benefit cost for the \$1 million benefit.

We calculate the cost of the economic benefit using the Table 2001 rates. Although the IRS has not formally adopted Table 2001, it is commonly used for this measurement pending IRS publication of specific directions for the determination of an economic benefit factor.

The rate for a 36-year-old is \$1.01 per thousand. The rate for a 57-year-old is \$5.20 per thousand.

Rudy pays Frank \$1,010 this year for the right to receive \$1 million of Frank’s death benefit this year. Frank will show this amount as taxable income on his tax return. Likewise, Frank will pay Rudy \$5,200 to receive the same amount of Rudy’s death benefit this year and Rudy

will show this amount as taxable income on his tax return.

The rates will increase each year based on their respective ages. The following year, Rudy’s monthly cost for Frank’s coverage will be \$86.67 and Frank’s monthly cost for Rudy’s coverage will be \$471.67.

Later, if Rudy dies, \$1 million of his policy’s death benefit is paid to Frank. The remainder goes directly to Rudy’s heirs. Subsequently, Frank will use the \$1 million benefit to purchase Rudy’s interest in Pan Africa from Rudy’s heirs according to the buy-sell agreement. Rudy’s family will receive the \$1 million (provided the buy-sell agreement is executed in a reasonable period of time) and Frank’s basis in the business will increase by \$1 million.

If Rudy or Frank leaves Pan Africa or retires, they can terminate the buy-sell agreement without the associated expense in distributing the policies — Frank and Rudy’s heirs will receive the full \$2 million in death benefits. Remember, both Frank and Rudy own the policies on their respective lives so they can fund them and use them however they wish. If funded sufficiently, Frank could use the cash values in the contract to augment his retirement funds. Alternatively, when there is no longer a need to use the policies to fund the buy-sell agreement, both Rudy and Frank could gift or sell their respective policies to their own trusts.

Flexibility

There’s no limit as to how many individuals can participate in the agreement.

Further, depending on their percentage of ownership, different owners can rent different amounts of benefit to and from each other.

What's more, the permanent policies can meet other needs. They can accumulate cash for retirement. They can include a long-term care rider and provide what could be a much-needed benefit in Frank's and Rudy's old age. (Please note that policy riders are available at an additional cost and may not be available for all products. Terms and conditions apply.)

This planning method may prove to be more expensive since it works more effectively with permanent life insurance policies. The method doesn't preclude someone from using term insurance but the economic value of a term policy is its cost per thousand term rate. For example, the cost per thousand for Frank, who qualifies for preferred non-tobacco underwriting, for a 15-year term policy is \$0.44 per thousand. The Table 2001 rate used for permanent policies is \$1.01. Likewise, the cost per thousand for Rudy is \$4.71 for a standard non-tobacco 15-year term policy. The Table 2001 rate used for Rudy's permanent policy is \$5.20. In both instances, the 15-year term rate is lower than the Table 2001 rate.

However, alternative term rates can

TABLE 1

AGE	TABLE 2001 RATES
FRANK	
36	\$1.01
37	\$1.04
38	\$1.06
...	...
50	\$2.30
RUDY	
57	\$5.20
58	\$5.66
59	\$6.06
...	...
71	\$22.72

The cost to Rudy for Frank's coverage: $1,000 \times \$1.01 = \$1,010/\text{year} = \$84.17/\text{month}$

The cost to Frank for Rudy's coverage: $1,000 \times \$5.20 = \$5,200/\text{year} = \$433.33/\text{month}$

TABLE 2

AGE	TABLE 2001 RATES	15-YEAR TERM RATES	ALTERNATE TERM RATES ¹
FRANK			
36	\$1.01	\$0.44	\$0.29
37	\$1.04	\$0.44	\$0.29
38	\$1.06	\$0.44	\$0.29
...
50	\$2.30	\$0.44	\$0.75
RUDY			
57	\$5.20	\$4.71	\$1.24
58	\$5.66	\$4.71	\$1.38
59	\$6.06	\$4.71	\$1.52
...
71	\$22.72	\$4.71	\$4.20

Author's Note: Not every insurance company offers alternate term rates and some companies state that they have them but do not support them. It is best to confirm availability before starting the formal underwriting process.

¹ Rates published by National Life/Life of the Southwest (male alternate term rates).

be used in place of Table 2001 rates if these rates are published and regularly sold through the insurance company's normal distribution channels. The difference between these two sets of rates can be dramatic.


Like the Table 2001 rates, the alternate term rates will increase each year. The alternate term rates shown for Frank ultimately exceed the rate for the 15-year term product, but the cumulative difference in total out-of-pocket cost over the 15-year period is negligible. The alternate term rates for Rudy never exceed the 15-year term rate.

If the parties involved fail to see the value of permanent life insurance, then this plan is probably not for them. But as a final note, here is a list of reasons why those clients should see the error of their ways:

- » A term policy offers no premium payment flexibility.
- » Term policies do not offer long-term care riders.
- » Not all term policies offer conversion privileges.

» Converting a term policy to a permanent policy in the future will be more expensive than purchasing a permanent policy now.

» The cash values in a permanent policy are available for use to the policy owner. Funded correctly, a policy owner may even surrender the policy (if it's no longer needed) and recover all of the premiums. Only select term policies offer this feature.

» A cross-endorsement buy-sell agreement is flexible and allows each owner to control his or her individual premium schedule and death benefit. It is possible to change the benefit that is "rented out" annually, based on either the value of the business, or on what the owners would like to have their families financially extract from the business. 

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Buy-sell planning: Cross endorsement

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INSURANCE PRODUCTS	
MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED
NOT INSURED BY ANY GOVERNMENT AGENCY	





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The buy-sell plan where you own your policy

Most buy-sell arrangements require someone other than you to be the owner of the life insurance policy on your life. In these arrangements, because you do not own your policy, there are some important considerations:

- **If you retire or leave the business,** your partners or the business itself will own the policy on your life
- **If one of your business partners dies,** and they own a policy on your life, your partner's spouse or estate will own the policy on your life
- **If your health deteriorates,** your life insurance policy is not yours for personal use

Life insurance, like any other asset, can have personal value to you as your needs change. Accordingly, you may prefer to keep that asset in your control and not have it owned by either the business or your partners.





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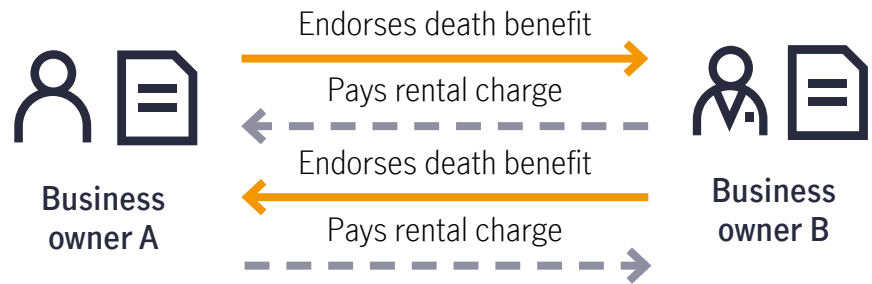
What if there were a way to have both a funded buy-sell arrangement and the benefits that come with owning your own policy? A cross endorsement buy-sell agreement may be the answer — it is the one type of buy-sell plan that allows you to own your own policy.



The cross endorsement buy-sell agreement is unique because it allows you to own your life insurance policy to cover obligations needed for the buy-sell agreement, in addition to being able to provide for your own personal needs.

By owning your own permanent life insurance policy under this arrangement, you may be able to access the life insurance policy's potential cash value to help fund a lifetime buyout of the business or supplement retirement income if or when the buy-sell agreement is no longer needed. Lastly, the life insurance policy death benefit can help provide financial security to you and your family beyond what is required in the buy-sell plan.

How it works



Step 1

You and your business partners enter into a buy-sell agreement whereby each owner agrees to buy out the other upon a triggering event, such as retirement, disability or death.

Step 2

To help provide funding for these buy-sell obligations, you purchase a life insurance policy on your life. The death benefit on your policy is, at a minimum, sufficient to meet the needs of the buy-sell agreement.¹

Step 3

You enter into an agreement with your business partners to “rent” to them the amount of death benefit needed to satisfy their obligations under the buy-sell agreement. Each partner’s interest in your policy is secured using a policy endorsement.

Note: These steps are duplicated with each of your partners. They will each own a life insurance policy on their own life and “rent” the death benefit to the other owners, including you.

Step 4

Each of your business partners will pay you a rental charge annually for their share of the death benefit that is apportioned to them under the agreement. The rental payment you receive from your partners generally is based on the “Economic Benefit value” of the death benefit being endorsed.

The Economic Benefit value is calculated using either a government or insurance company rate table based on your age. Although these rates increase each year with age, they are generally very low in cost, and do not discriminate for gender or health. See Table 1 for sample rental charges using Economic Benefit rates.

Table 1:
Annual rental fee on \$100,000 of death benefit

Insured's age	Based on JH alternative term rates	Based on IRS table 2001 rates
40	\$45	\$110
45	\$59	\$153
50	\$79	\$230
55	\$108	\$415
60	\$117	\$651



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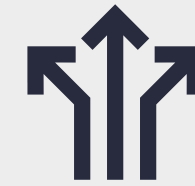


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What happens next

As long as the cross endorsement buy-sell agreement is in force, the amount of death benefit you rent to your partners will be paid to them at your death. Your partners will then use the death benefit proceeds to buy out your interest in the business from your estate/heirs and the obligations under the buy-sell agreement will be satisfied. Thereafter, your partners will now own your share of the business and your family will receive a cash inheritance.

The cross endorsement buy-sell plan can be terminated at any time subject to agreement. Once terminated, rental payments stop and you can use the policy exclusively for your own personal planning needs. This can be a distinct advantage compared to other buy-sell approaches where policies often must be transferred between business owners when the business terminates or there is a change in ownership.



Built-in flexibility

As the value of the business fluctuates or ownership interests change, so too can the amount of insurance being endorsed to the other owners. **For example,** Allen and Bob are 50/50 owners of a real estate management company. They each own \$1 million of life insurance on their own lives and are each endorsing \$500,000 of death benefit to the other for buy-sell purposes. After a recent business valuation, Allen and Bob need an additional \$200,000 each to satisfy the buy-sell obligations. Pursuant to their cross endorsement buy-sell agreement, each can update the endorsement on their personal policies from \$500,000 to \$700,000 to reflect the appreciation of their respective business interests.



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Combine with personal planning – a key differentiator

The cross endorsement buy-sell agreement is unique because you own the life insurance policy on your life. Therefore, you can combine personal planning with buy-sell planning to create a hybrid plan that satisfies both your personal and business insurance needs.

Under this type of agreement, you can purchase additional death benefit protection to help cover personal needs. For example, if the death benefit needed for the buy-sell plan is \$1 million and you need \$500,000 of death benefit for personal reasons, you could purchase a life insurance policy with a death benefit of \$1.5 million to satisfy both your business and personal needs under one policy.

Another option is to overfund the premium on your life insurance policy to build potentially higher cash value; this cash value may then be accessed after the buy-sell agreement ends to help provide supplemental retirement income.²



Interested in seeing a model of the cross endorsement buy-sell plan? Ask your financial professional to request a customized sample from John Hancock.





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Value of life insurance

Life insurance is often used to fund a buy-sell agreement because the policy's death benefit can provide immediate liquidity necessary to buy out your interest in the business upon death, ensuring that your heirs receive a cash inheritance, while allowing the remaining owners to continue to run the business. Moreover, when a permanent life insurance policy is purchased, the potential cash value that accrues inside the policy may be accessed in a tax-efficient manner during life to help fund a lifetime buyout of an owner – for example, at retirement.

Life insurance generally provides these distinct tax advantages:

- 1 Income tax-free death benefit
- 2 Tax-deferred growth
- 3 Income tax-free access to cash value



Important considerations

- Cash flow is required to pay the permanent life insurance premiums and rental charges to your partners
- Rental charges increase with age
- Rental income may be taxable
- Accessing the life insurance policy cash value may lower the death benefit
- May not be appropriate for C and S corporation owners due to transfer-for-value rules³

Please consult with your financial, legal and tax professionals before determining if a cross endorsement buy-sell agreement is right for you.



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Talk to your financial professional about creating and funding a cross endorsement buy-sell agreement as a strategy to help with the succession and transition of your business.

1. A qualified appraisal of the business should be completed.
 2. The parties to the cross endorsement buy-sell agreement may wish to restrict access to the policy's cash value either in whole or to the extent that access does not impair the death benefit being endorsed. That is, loans and withdrawals will reduce the death benefit and cash surrender value, which may cause the policy to lapse or become insufficient to satisfy the buy-sell obligation. Additionally, the surrender or lapse of a policy with a loan may cause the recognition of taxable income.
 3. The owners may want to consider a partnership or limited liability company (if one does not already exist) between the owners to avoid any transfer-for-value issues with respect to the cross endorsements of the policy death benefits. Clients should consult their tax professionals to discuss this issue.
- This material does not constitute tax, legal, investment or accounting advice and is not intended for use by a taxpayer for the purposes of avoiding any IRS penalty. Comments on taxation are based on tax law current as of the time we produced the material. All information and materials provided by John Hancock are to support the marketing and sale of our products and services, and are not intended to be impartial advice or recommendations. John Hancock and its representatives will receive compensation from such sales or services. Anyone interested in these transactions or topics may want to seek advice based on his or her particular circumstances from independent professionals. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. No legal, tax or accounting advice can be given by John Hancock, its agents, employees or licensed agents.

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.

Insurance policies and/or associated riders and features may not be available in all states.

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.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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The LLC buy-

A business-planning game changer

The LLC buy-sell is a recent innovation in business succession planning that emphasizes the advantages of standard buy-sell arrangements while mostly eliminating the hurdles. Advisors who gain an understanding of the LLC buy-sell concept will be in a better position to help their business-owner clients. It is truly a game changer in the buy-sell world.

Buy-sell planning: the hurdles

The buy-sell planning universe contains two bedrock types: (1) Stock (entity) redemption; and (2) Cross-purchase. Nearly all variations of buy-sells, such as wait-and-see buy-sells or trusted buy-sells, trace their roots back to these "big two." Both types of plans have advantages, but business owners and advisors often struggle with the hurdles.

1) Stock (entity) redemption hurdles

- Lack of basis increase. In other words, when stock is redeemed by a business, the remaining owners generally do not receive a stepped-up basis in their ownership interest.
- Business owned life insurance is potentially subject to the claims of company creditors.
- Business owned life insurance is an Alternative Minimum Tax (AMT) preference item for large C corporations. Both the accumulating cash value and death benefit may contribute to AMT exposure.
- Transfer-for-value (TFV) rule may apply in some cases. The TFV rule, found in Internal Revenue Code Section 101(a)(2), applies when a life insurance policy is transferred for valuable consideration. For instance, if a corporation transfers an existing life insurance policy to a co-shareholder to achieve cross ownership, the transfer is most likely a transfer-for-value. It makes no difference whether the policies are term or permanent. The TFV rule is harsh. It results in a taxable death benefit.

2) Cross-purchase hurdles

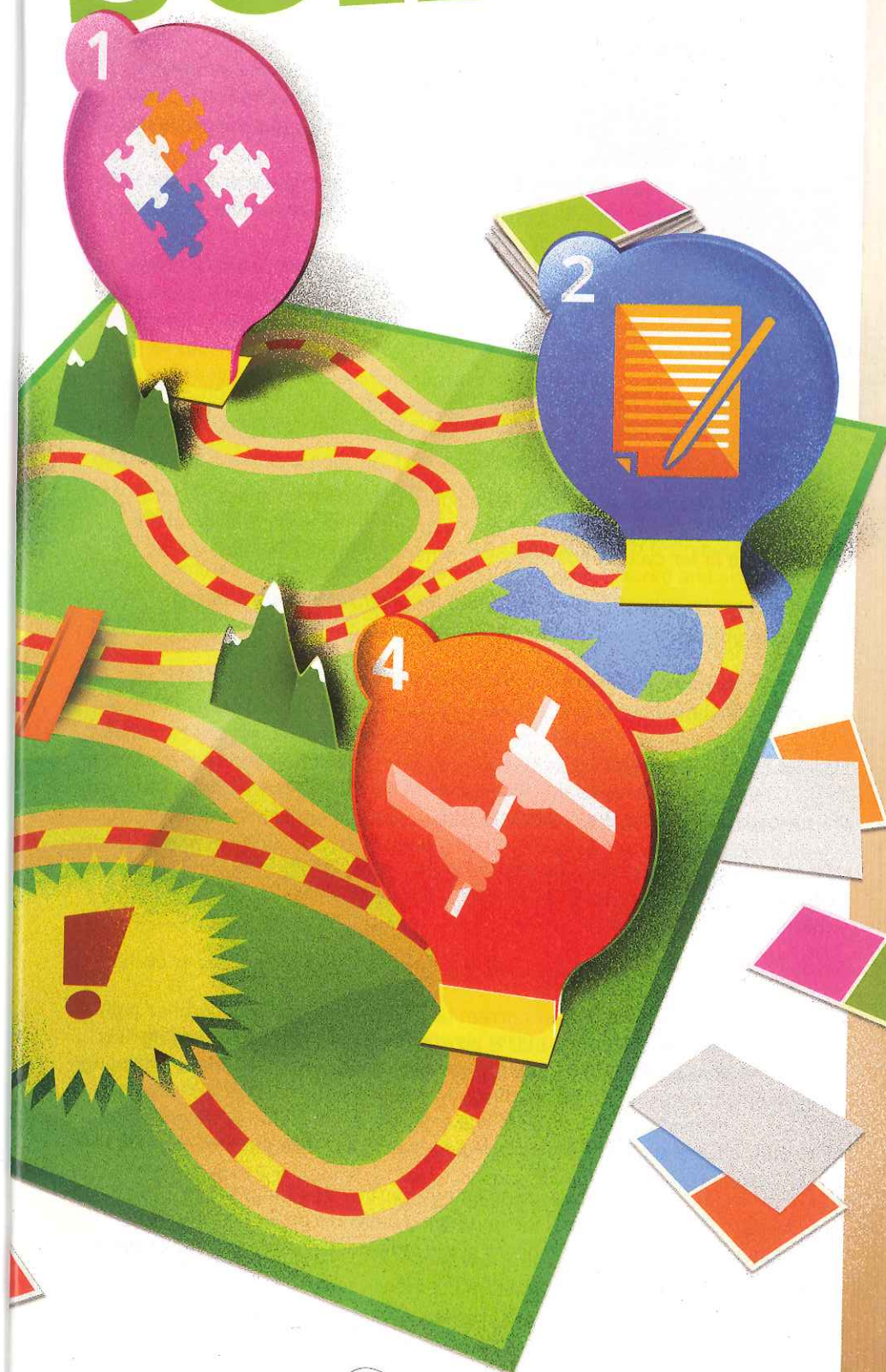
- The number of policies can become unmanageable if a business has three or more owners. For example, a four-owner business would require up to 12 policies.
- Cross-purchase life policies are personally owned and may be subject to the claims of personal creditors and/or ex-spouses.
- Plan compliance can be an issue. Parties to a cross-purchase are relying on each other to pay premiums on time, maintain beneficiary designations, and avoid "raiding" policies of their cash values.
- Issues of premium inequality can surface. For example, a young, healthy owner may not like the idea of paying the premium on an older, unhealthy owner.
- Transfer-for-value may apply if a shareholder is added to an existing cross-purchase.

Enter LLC buy-sell

It is possible to deliver the benefits of stock redemption and cross-purchase buy-sells while mostly eliminating the hurdles. The LLC buy-sell strategy combines two simple business planning techniques: a limited liability company (LLC) and a cross-purchase.



-sell



The elegance of the LLC buy-sell is in its simplicity.

The 4-step process:

1 Form the LLC

This is the entity that will oversee and administer the buy-sell agreement. The LLC must be valid under state law. The LLC is separate from the underlying business.

2 Draft a cross-purchase buy-sell

The client's attorney will draft a tailor-made cross-purchase agreement. The agreement will cover the underlying business and the LLC. It can be either a separate document or made part of the LLC operating agreement. The parties to the buy-sell agreement are the business owners.

3 The LLC purchases a life insurance policy on each business owner

Cash value life insurance is preferred because of the potential to fund lifetime triggering events — retirement and disability comes to mind.

4 The triggering event occurs

In the case of a triggering event, such as death, the LLC receives the policy proceeds and allocates the proceeds to each LLC member. The LLC members purchase the exiting owner's business interest in both the LLC and the underlying business. Each purchaser is generally able to increase his or her basis in the businesses based on the purchase price.

TAXING MATTERS:

Premium Payments

For the LLC buy-sell strategy, the insurance premiums are often supplied to the LLC by the underlying business. In cases where the underlying business is a pass-through entity (such as an S corporation), premiums paid are a nondeductible expense for the underlying business. Also, the individual owners of the underlying business must recognize income generated by the business.

In other words, there is no immediate tax benefit by using the underlying company's checkbook to pay insurance premiums.

Nonetheless, many business owners prefer to pay premiums using the company checkbook for a variety of non-tax reasons.

There are cases where the underlying business may be entitled to a tax deduction. For instance, where the underlying business is a C corporation, it may make tax sense for the corporation to make a tax deductible bonus to each owner. The bonus is generally income tax deductible under Internal Revenue Code Section 162.

The bonus passes to the LLC and is used to pay the life insurance premium.

Each shareholder is taxed on the bonus as ordinary income.

Paying the premium

The most common funding strategy is to flow earnings through the underlying business to the LLC as capital contributions. The funds passing from the underlying business are taxable to the business owners, but the capital contributions increase each owner's LLC basis.

In some cases, each owner contributes an existing insurance policy to the LLC as a capital contribution. This strategy is sometimes employed where an owner is no longer insurable but personally owns life insurance.

The funding method selected will depend on a variety of tax and accounting issues that are best left to a tax specialist.

Which funding vehicle?

- **Term Insurance.** Provides short-term protection at the lowest possible cost. It is appropriate for short-term needs or for start-up businesses where cash flow is a concern.
- **Universal Life Insurance.** Look for a policy that offers business owners maximum flexibility and a wide range of premium choices. Universal life is a good fit for cyclical businesses or where business cash flow varies.
- **Whole Life Insurance.** The best choice for business owners seeking strong guarantees and predictable cash accumulation.
- **Disability Buy-Sell Insurance.** Business owners should not overlook this critical funding vehicle.

The LLC buy-sell sizzle

The LLC buy-sell emphasizes the advantages of standard buy-sell planning while mostly eliminating the disadvantages:

- **Stepped-up basis.** The LLC buy-sell is built on a cross-purchase chassis. Each purchasing owner may increase his or her cost basis by his or her share of the purchase price.
- **Simplicity.** The LLC buy-sell requires only one life insurance policy per owner.
- **Transfer-for-value (TFV).** Under current law, transferring a life insurance policy (or portion) to a co-owner of a LLC is an exception to the TFV rule. Adding new owners to the agreement or transferring policies among LLC members does not trigger a TFV trap.
- **No Alternative Minimum Tax (AMT).** The corporate AMT does not apply to an LLC.
- **Creditor protection.** LLCs provide an extra layer of protection from two types of creditors. First, creditors of the underlying business generally cannot attack LLC assets. Second, creditors of the individual owners generally cannot attack LLC owned life insurance.
- **Plan compliance.** The LLC owns the insurance and pays the premiums.

Exit strategies

AT RETIREMENT

For a retirement buyout, the life policy is transferred to the exiting owner as part of the purchase price. Transfer of a life policy to the insured is an exception to the TFV rule. The exiting policy owner can subsequently access policy cash value in retirement. If policy cash flow is properly structured and the policy remains in force, it can be received income tax-free.

If the policy cash value is inadequate to cover the full purchase price, the shortfall is often paid in installments (most common) or with a bank loan. In some cases, the purchasers access cash value from multiple life insurance policies. This is common if the exiting owner is the majority owner and the purchase price is significant.

After the buyout, the remaining LLC owners can either go forward with the existing LLC arrangement or the LLC can be wound up and terminated. If the LLC is terminated, the policies are distributed to each insured and should not result in any immediate taxation (assuming the LLC capital accounts were properly accounted for).

AT DEATH

The life insurance death benefit is paid to the LLC income tax-free. The LLC distributes the proceeds to the surviving owners, income tax-free. The LLC members then complete the purchase of both the LLC and underlying business from the exiting owner.

After completion of the purchase, subject to the LLC operating agreement, the LLC may continue with the remaining owners or new owners may be added. If the LLC members decide to terminate the LLC, the existing policies are distributed to the insureds. The transfer is tax-free as a return of basis and is not considered a transfer-for-value.

Although the LLC buy-sell is a relatively recent innovation, it is already generating interest among business owners, insurance advisors, CPAs and attorneys. It emphasizes the benefits of standard buy-sell plans while mostly eliminating the hurdles. It is a business life insurance game changer.

Prior to implementing any strategy, clients should also consult with their tax and legal advisors regarding their particular situation and the potential tax and legal consequences for the buy-sell strategy chosen. ■

David Szeremet, JD, CLU, ChFC, is second vice president, advanced marketing, at Ohio National Financial Services based in Cincinnati, Ohio. Szeremet is responsible for the advanced marketing team that provides estate planning, executive benefits, business insurance and life insurance planning.



Motivating clients to action

A properly drafted and adequately funded buy-sell agreement is often the keystone of a business succession plan.

While most owners of closely held businesses understand this, many of them fail to follow through.

Comparing buy-sell planning to estate planning may help motivate business owners to action. A buy-sell agreement is analogous to a last will and testament. Everyone should have a last will and testament as part of an estate plan to control disposition of their probate estate.

Likewise, a buy-sell agreement controls the disposition of a business interest at a triggering event. Unlike a will which only takes effect at death, a buy-sell can cover a variety of lifetime events such as retirement, asset sale, or disability.

SPECIMEN LLC BUY-SELL AGREEMENT

AGREEMENT, made this _____ day of _____, 20____, by and between (member's name), (member's name) and (member's name) (hereinafter called "Member" and collectively the "Members"), and (name of LLC) (hereinafter called the "LLC"), created and existing under the laws of the State of _____, with its principal office at _____.

WHEREAS, the Members own the following percentage of capital interest in the LLC:

<u>(member's name)</u>	_____ % of capital interest
<u>(member's name)</u>	_____ % of capital interest
<u>(member's name)</u>	_____ % of capital interest; and

WHEREAS, the parties to this Agreement believe that it is to their mutual best interests to provide for continuity and harmony in management and the policies of the LLC; and

WHEREAS, the parties to this Agreement have determined that such continuity and harmony can be best attained by imposing certain restrictions on the disposition of capital interests in the LLC owned by the parties;

NOW, THEREFORE, in consideration of the mutual covenants to buy and sell and the performance thereof expressed herein by the parties, each of the Members does hereby bind himself/herself, his/her heirs, executors, administrators and assigns, and the LLC does hereby bind itself and its successors, and all hereto agree as follows:

ARTICLE 1 - Disposal of Capital Interest During Lifetime

During his/her lifetime, no Member shall give, assign, sell, transfer, encumber or otherwise dispose of all or any part of his/her capital interest in the LLC, except with prior written consent of Members, or unless and until he/she shall comply with the requirements of this Article:

A. If a Member desires to give, assign, sell, transfer, encumber or otherwise dispose of all or any part of his/her capital interest in the LLC, he/she shall give written notice of his/her intention to do so to the LLC and Remaining Members. Such notice shall set a time and a date of not less than ____ days nor more than ____ days from the date of the notice when a meeting of the LLC shall be held and the LLC's principal place of business.

B. Said notice shall constitute an offer on the part of the Offering Member to sell to the LLC and to the Remaining Members all of the capital interest held by the Offering Member.

C. The LLC shall have the first option to purchase all or any part of the Offering Member's capital interest that has been so offered for sale. Should the LLC refuse or fail to purchase all of the Offering Member's capital interest, Remaining Members shall have the right to purchase such unpurchased capital interest in proportion to the respective interests of the interested Remaining Members. If any such Remaining Member declines to purchase such proportionate share of the unpurchased capital interest, the other Remaining Members shall have the right to purchase such capital interest pursuant to the above formula, but for the deletion of the capital interest of the Declining Member.

D. The purchase price of the Offering Member's capital interest offered for sale shall be determined as provided in Article 4. Such purchase shall be effected in the manner and upon the terms and conditions set forth in Article 5.

E. If all of the capital interested offered for sale by the Offering Member shall not be purchased in accordance with the provisions of this Article, then all restrictions upon the sale of such capital interest imposed by this agreement shall terminate. It is the intention of the parties to this agreement that if an offer and acceptance is made in accordance with the provisions of this Article, it shall not be for less than all of the capital interest owned by the Offering Member.

ARTICLE 2 - Termination of Service

If any Member's LLC employment shall cease, whether as a result of retirement, voluntary termination or involuntary termination for sufficient cause as defined in paragraph D., such Member shall immediately offer or be deemed to have offered to sell all of his/her capital interest to the LLC and to the Remaining Members.

A. The LLC shall have the first option to purchase all or any part of the Offering Member's capital interest that has been so offered for sale. Should the LLC refuse or fail to purchase all of the Offering Member's capital interest, Remaining Members shall have the right to purchase such unpurchased capital interest in proportion to the respective interests of the interested Remaining Members. If any such Remaining Member declines to purchase such proportionate share of the unpurchased capital interest, the other Remaining Members shall have the right to purchase such capital interest pursuant to the above formula, but for the deletion of the capital interest of the Declining Member.

B. The purchase price of the Offering Member's capital interest offered for sale shall be determined as provided in Article 4. Such purchase shall be effected in the manner and upon the terms and conditions set forth in Article 5.

C. If all of the capital interested offered for sale by the Offering Member shall not be purchased in accordance with the provisions of this Article, then all restrictions upon the sale of such capital interest imposed by this agreement shall terminate. It is the intention of the parties to this agreement that if an offer and acceptance is made in accordance with the provisions of this Article, it shall not be for less than all of the capital interest owned by the Offering Member.

D. "Sufficient cause" for termination includes conviction of or a plea of guilty to a felony, any criminal conduct against the LLC or the continuing violation of any duties or responsibilities under any written policy, rule or regulation of the LLC, after written notice from any Member specifying such violation.

ARTICLE 3 - Transfer at Death (or Disability)

In the event any Member dies during the term of this agreement, the legal representative of such Deceased Member's estate shall give written notice to the LLC, which shall have the right to purchase all or part of the Deceased Member's capital interest for the purchase price as determined by Article 4 and under the terms and conditions provided in Article 5. The right shall be exercised by giving written notice to the legal representative of the Deceased Member's estate. If this right is not exercised as to all of the Deceased Member's capital interest, Remaining Members shall purchase the balance of the Deceased Member's capital interest for the purchase price as determined by Article 4 and under the terms and conditions provided in Article 5. Each Remaining Member shall purchase an amount of such capital interest equal to the amount of such capital interest not purchased by the LLC in proportion to the respective interests of Remaining Members.

(NOTE: If desired, the following language for a disability buy-out may be included.)

In the event any Member becomes totally and permanently disabled before reaching age ____, and remains so for a period of ____ months from the onset of such disability, then at the end of such period, the Remaining Members shall purchase and the Disabled Member shall sell his/her interest in the LLC. For purposes of this agreement, "disability" or "total and permanent disability" shall be a disability of an Insured Member determined by the insurer as total and permanent disability in the disability insurance policy on such Insured Member as listed on Schedule B. The purchase price shall be as determined by Article 4, except that such purchase price shall not be paid in a lump sum, but instead shall be paid in installments of \$_____ per month until the total purchase price shall have been paid, plus an amount equal to ____ percent per year of the declining balance of said purchase price.

In the event of a lifetime sale, a negotiable promissory note shall be executed by Remaining members to Disabled member in the amount of the purchase price plus interest at ____ percent compounded annually. In the event of default in the payment of principal or interest for a period of ____ days, the balance remaining to be paid under such promissory note shall become due and payable without further notice at the election of the holder.

If Disabled Member should cease to be totally and permanently disabled at some time after such installment payments have begun, but before they have been completed, then such installments shall be spread out at the rate of \$_____ per month until the balance of said purchase price and interest on the declining balance of ____ percent per year shall have been totally paid.

If Disabled Member should die after such installment payments have begun, but before they have been completed, it is understood by Remaining Members that the disability insurance policy funding this agreement shall not continue to provide benefits for the purchase of Disabled Member's capital interest. Any life insurance policy or policies still owned by the Remaining Members on the life of the Disabled Member shall be used to make the remaining payments.

Each Member owning a disability insurance policy agrees to pay all premiums on the insurance policies owned by him/her and taken out pursuant to this Article and shall provide proof of premium payments to the Other Members whenever any of them so request such proof. If a premium is not paid within 30 days after its due date, the insured shall have the right to pay such premium and be reimbursed by the Other Members.

Upon completion of the purchased of a Disabled member's capital interest in the LLC, the Disabled member shall have the option to purchase any life insurance policy or policies on his/her life pursuant to Article 6.

The (insurance company) that has issued the policy or policies pursuant to this Article shall not be under any obligation with respect to the performance of the terms and conditions of this agreement and shall be bound only to the terms of the policy which it has issued or shall hereafter issue and shall have no liability except as set for in its policies.

ARTICLE 4 - Purchase Price

At the time this agreement is executed, and at least once in each calendar year thereafter, the fair market value of the LLC shall be agreed upon by the Members. The purchase price for each Member's capital interest shall be his/her share of the LLC's capital times the value of the LLC as agreed upon. At the time this agreement is executed, and at each subsequent valuation date, a statement shall be filed with all parties to this agreement certifying the values so agreed upon and the valuation date thereof, and such statement shall be signed by all parties to this agreement. Regardless of cause, the failure to revalue the LLC and Members' interests shall not operate to terminate this agreement.

If the Members fail to revalue the LLC and their interests for a particular year, the last previously agreed upon value shall control, except that if Members have not so agreed to such value within two years prior to the offer to sell by a Member in accordance with Articles 1, 2 or 3 of this agreement, the value shall be determined by the certified public accountant regularly retained by the LLC to audit its books. If no such accountant has been retained, then said value shall be determined by any other certified public accountant or certified appraiser selected by the mutual agreement of the Remaining Members and the Selling Member or the legal representative of a Deceased Member's estate. Fees and expenses incurred in the performance of said accounting or appraisal services shall be paid by the LLC.

ARTICLE 5 - Closing Terms and Conditions

A. At the closing, the Selling Member shall deliver:

1. All documents that counsel for the LLC and/or the Purchasing Members shall reasonably deem necessary or advisable in order to accomplish a complete transfer of the Selling Member's capital interest in the LLC to the LLC and/or the Purchasing Members; and

2. If the sale is pursuant to Articles 1 or 2 of this agreement, the written resignation of the Selling Member from employment with the LLC, effective immediately.

B. The payment of the total purchase price due to the Selling Member shall be made as follows:

1. If the sale is pursuant to Articles 1 or 2 of this agreement, an amount equal to the purchase price as determined under Article 4 will be paid to the Selling Member at the closing in cash or by certified check. Any balance of the total due from the LLC and/or the Purchasing Members shall be paid in equal quarterly installments of principal and interest on the unpaid balance of ____ percent per year on the first business day of January, April, July and October, beginning with the first business day of the first such month immediately following the date on which the closing took place. The LLC and/or the Purchasing Members shall have the right, without penalty or discount for anticipation, to prepay an installment obligation, together with interest, at any time.

2. If the sale is pursuant to Article 3 of this agreement, an amount equal to the purchase price as determined under Article 4 will be paid to the Deceased Member's legal representative at the closing in cash or by certified check.

ARTICLE 6 - Life Insurance

A. In order to assure that the purchase price for the shares of a Deceased Member will be available immediately in cash upon the death of a Member, the Members have procured life insurance upon each other as listed in Schedule A. Each Member shall retain possession of the policies procured by him/her on the other Members. This agreement shall extend to and include all additional policies issued pursuant to this agreement, such additional policies to be listed in Schedule A attached hereto and made a part hereof. The aforementioned life insurance policies shall be subject to the provisions of this agreement.

1. Each Policyowner Member shall designate a settlement option to receive life insurance policy proceeds in a lump sum payment.

2. Each Member owning a life insurance policy agrees to pay all premiums on the insurance policies owned by him/her and taken out pursuant to this agreement and shall provide proof of premium payments to the Insured Members whenever any of them so request such proof. If a premium is not paid within 30 days after its due date, the insured shall have the right to pay such premium and be reimbursed by Policyowner Member.

3. Members shall have the right to purchase insurance or additional insurance on the lives of each other, along with any substitution or withdrawals of life insurance policies subject to this agreement. In the event that Members decide to purchase life insurance or additional life insurance on any Member, each Member agrees to cooperate fully by performing all the requirements of the (insurance company) which are necessary conditions preceding the issuance of life insurance policies.

B. If a Member sells or otherwise disposes of all of his/her capital interest in the LLC during his/her lifetime, or if this agreement terminates before the death of a Member, then such Member shall have the option to purchase any policy or policies of insurance on his/her life owned by Remaining Members for the price and upon the conditions that follow:

1. The option to purchase such policy or policies shall be exercisable within a period of ____ days following termination of this agreement or closing pursuant to Article 5 of this agreement, as the case may be.

2. If a Member desires to exercise his/her option to purchase the insurance policy or policies on his/her life, he/she shall give written notice to the Remaining Members, prior to the expiration date of the option period, of his/her intentions to exercise the option. Such notice shall fix a time, place and date, not less than ____ days or more than ____ days from the date such notice is given, when the closing of the sale and purchase of the life insurance policy or policies shall be held.

3. The price which the Member exercising the option shall pay to purchase the insurance policy or policies on his/her life shall be equal to the interpolated terminal reserve as of the date of such purchase, plus any unearned portion of the gross premiums last paid thereon, plus any premiums paid in advance but not yet due, and less the amount of any policy loan or loans with accrued interest which may then apply against said policy or policies.

4. At the closing, the Member purchasing the insurance policy or policies on his/her life shall pay the total purchase price in cash or by certified check. The Remaining Members shall deliver to the Member purchasing the insurance policy or policies instruments of assignment and other documents, duly executed, sufficient to transfer ownership of the said policy or policies to the Member.

5. In the event of the death of a Member, the Surviving Members shall have the option to purchase from the Deceased Member's estate the insurance policy or policies owned by the Deceased Member for the price and upon the same terms and conditions set forth in Parts 1, 2, 3 and 4 of Section B of this article.

ARTICLE 7 - Liability of Insurance Company

No insurance company which has issued or shall issue a policy or policies subject to this agreement shall be under any obligation with respect to the performance of the terms and conditions of this agreement. Any such company shall be bound only by the terms of the policy or policies which it has issued or shall hereafter issue and shall have no liability except as set forth in its policies.

ARTICLE 8 - Amendment

This agreement may be amended in whole or in part by a writing signed by the LLC, all Living Members and the legal representative of any Deceased Member's estate still having an interest herein.

ARTICLE 9 - Termination of Agreement

This agreement shall be void and of no effect on the occurrence of any of the following events:

- A. The written agreement of all parties to the agreement to that effect.
- B. The termination of the LLC for any cause.
- C. The purchase of the capital interest of a party to this agreement, which leaves only one Member party to the agreement; such purchase will, however, subject the parties to the agreement to fulfill their obligations pursuant to the agreement.

ARTICLE 10 - Specific Performance

The capital interest of the LLC cannot be readily purchased or sold in the open market. For that reason, among others, the parties will be irreparably damaged in the event that this agreement is not specifically enforced. Should any dispute arise concerning the sale or disposition of capital interests of the LLC, an injunction may be issued restraining any sale or disposition pending the determination of such controversy.

ARTICLE 11 - Agreement Binding

This agreement shall be binding upon the parties hereto, their heirs, executors, administrators, successors and assigns of each of them, and said parties do hereby agree for themselves and their heirs, executives, administrators and assigns, to execute any instrument in writing, and to do any and all acts which may be necessary, convenient or expedient to carry out the purposes and intent of this agreement.

ARTICLE 12 - Governing Law

This agreement shall be subject to and governed by the laws of the State of _____, irrespective of the fact that one or more of the parties now is or may become a resident of a different state.

IN WITNESS WHEREOF, the parties hereunto have executed this agreement at _____, in the County of _____, State of _____, on this _____ day of _____, 20____.

ATTEST:

Witness

Member

Witness

Member

Witness

Member

LIMITED LIABILITY COMPANY

By

By

SCHEDULE A
Schedule of Life Insurance Policies

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring the life of _____ in the face amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring the life of _____ in the face amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring the life of _____ in the face amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.

SCHEDULE B
Schedule of Disability Insurance Policies

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring _____ in the event of a disability as defined in the policy for the amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring _____ in the event of a disability as defined in the policy for the amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.

Policy No. _____ issued by (*insurance company*) on _____, 20__, insuring _____ in the event of a disability as defined in the policy for the amount of _____ dollars (\$_____), the owner and beneficiary of said policy being _____.



Home



Overview



Traditional
buy-sell
agreements



How it works



Benefits and
important
considerations



Contact us



Advanced **Markets**

Insurance LLCs

Client guide

INSURANCE PRODUCTS	
MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED
NOT INSURED BY ANY GOVERNMENT AGENCY	





Home



Overview



Traditional
buy-sell
agreements



How it works



Benefits and
important
considerations



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Overview

Buy-sell agreements, which are often funded with life insurance, are critical to help ensure the orderly transfer of business ownership upon the death, disability, or retirement of an owner.

The Insurance LLC, a hybrid of two traditional buy-sell arrangements, is often used to create more efficiency in the ownership and management of life insurance policies purchased to fund buy-sell obligations, and can help avoid common tax issues that arise under other arrangements.





Home



Overview



Traditional
buy-sell
agreements



How it works



Benefits and
important
considerations



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Traditional buy-sell agreements

A buy-sell agreement is a formal contract between you and your fellow 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. A well-drafted and properly funded arrangement can protect your family and help facilitate the continuation of the business. Traditional buy-sell agreements are often structured and funded in one of two ways.



Cross-purchase plan

- Each owner agrees to personally buy a departing owner's interest upon a triggering event
- Each business owner purchases life insurance on the lives of the other owners



Entity-purchase plan

- The business entity agrees to buy back a departing owner's interest upon a triggering event
- The business purchases life insurance policies on the lives of the business owner



While both plans offer many benefits, there are several notable drawbacks with traditional buy-sell agreements, leading some business owners to seek alternative structures that are easier to administer and more adaptable to changing family and/or business needs.



Home



Overview



Traditional
buy-sell
agreements



How it works



Benefits and
important
considerations



Contact us

Insurance LLC agreements

An Insurance LLC may be a compelling alternative to a traditional cross-purchase or entity-purchase buy-sell design. The Insurance LLC strategy combines a buy-sell agreement with a limited liability company (LLC) created to own and administer life insurance policies on you and your co-owners' lives that will fulfill each owner's obligations under your buy-sell agreement.

To properly prepare for both lifetime buyouts and those occurring at the death of an owner, permanent life insurance is often preferable to term because it provides both death benefit coverage and the opportunity to build policy cash value that can be used or leveraged to help fund lifetime obligations.

How it works

1

Form the LLC

You and your co-owners create an LLC taxed as a partnership. The LLC is separate from your primary business and is created to administer your buy-sell agreement, which includes owning life insurance to fund the purchase obligations under your agreement. This agreement will also specify what is to happen to the co-owners' interests in the LLC when an owner departs from the primary business.

2

Draft a buy-sell agreement

An attorney drafts a buy-sell agreement with you and your co-owners as the parties to the agreement. The buy-sell agreement will generally provide that in the case of a triggering event, your interest in the primary business will be purchased by your remaining co-owners, and vice versa.

3

Purchase life insurance on each owner

To fund the buyout of your primary business and your Insurance LLC interests, the Insurance LLC will purchase a permanent life insurance policy on each owner.

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How it works, *continued*

4

Make ongoing payments of life insurance premiums

You and each of your co-owners will transfer money to the LLC as a contribution to fund the policy premiums. You will work with your co-owners to come to an agreement regarding the source of funds. For example, the business can make additional distributions to you and your co-owners, or the business may lend premiums to the Insurance LLC as part of a formal lending arrangement.

5

Leverage life insurance upon an owner's death or departure

Upon the death of an owner, the life insurance death benefit will generally be paid income tax-free to the LLC to facilitate the underlying buy-sell agreement. The death benefit will be used to both liquidate the deceased owner's interest in the Insurance LLC and by the surviving owners to buy out the business interests of the deceased owner in accordance with the buy-sell agreement. The surviving owners will receive a basis increase in the value of their company interests and the family of the deceased owner will receive cash equal to the market value of their business interests.

Upon the departure of an owner (i.e., lifetime buyout), the policy owned on the departing owner can be transferred to that owner as part of the liquidation from the Insurance LLC and buyout from the primary business. The owner can then use the policy's cash value as a potential source of tax-free discretionary income during their retirement years and as death benefit protection for their family. To the extent the policy's value is insufficient to cover the full purchase price under the buy-sell agreement, any shortfall can be made up by tapping into the cash values of the other policies held by the Insurance LLC, via bank loans, or in installments paid over time.





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Benefits

Utilizing an Insurance LLC to facilitate the administration of your business's buy-sell agreement offers many potential benefits, including:

Simplicity

Only one policy per owner is needed

Promoting equity among owners

Premium funding disparities related to age, health, or ownership percentage can be addressed through negotiation among all owners

Flexibility

New owners can be incorporated into the agreement with relative simplicity

Creditor protection

Policies are protected from debts of primary business and of individual owners

Limits transfer-for-value concerns

This technique may help avoid transfer-for-value issues that often arise, especially as new owners come into the business and others leave

Step-up in basis

The surviving owners receive a step-up in basis on the purchased interests of a departing owner, which can help reduce tax burdens for the surviving owners if the business is later sold

Estate tax exclusion

Life insurance proceeds can be excluded from the deceased owner's taxable estate with proper planning



Important considerations

Estate taxes

Owners must work with legal counsel to ensure that the terms of the LLC operating agreement meet certain requirements and do not inadvertently create estate tax inclusion

Employer-owned insurance

Business owners should comply with §101(j) requirements, including Notice and Consent

Ongoing management and coordination with the planning team

These plans require a level of sophistication and coordination with financial professionals, including attorneys and CPAs



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Is an Insurance LLC right for you?

A buy-sell agreement is one of the most important ways to help ensure both your business and family are financially protected. An Insurance LLC can be a compelling alternative to traditional buy-sell options, eliminating some of the drawbacks of these standard plans and providing administrative flexibility, tax advantages, and more.



For more information on these plans or to create a customized plan design, please consult with your financial professional.

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Loans and withdrawals will reduce the death benefit and the 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. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, 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 after the first policy year.

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.

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