BAIRD
Private Wealth Management

Business Continuation Arrangements

In the small business market, there is a compelling need for business continuation agreements. There are two popular types of buy-sell arrangements; cross-purchase & entity purchase.

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CROSS-PURCHASE ARRANGEMENT

HOW DOES IT WORK?

Each business owner is the applicant, owner and beneficiary of a life insurance policy on the other owner's life and is contractually obligated to purchase the deceased owner's business interest. Although the agreement can be between as many owners/shareholders as there are in the business, this approach generally works best when there are two owners close in age who are interested in obtaining an increase in cost basis after the death of one of the owners. The death benefit is determined by the sales price set in the agreement – each owner's share of the fair market value of the business. Each owner pays the premiums on the policy they own. Alternatively, the business could give the owners bonuses with which to pay the premiums. These bonuses would be taxable income to the owners and deductible by the business. The owners should periodically review their buy-sell agreement and update as needed to reflect changes in the value of the business.

WHAT HAPPENS WHEN AN OWNER DIES?

Assume a business has two owners, Owner A and Owner B. At Owner B's death, his stock passes to his estate. The death benefit is paid to Owner A for the policy she owned on Owner B's life. Since Owner B had no incidents of ownership in the policy, the proceeds are not included in Owner B's estate. The actual purchase and sale takes place between Owner B's beneficiaries and Owner A, who pays cash to Owner B's family in exchange for Owner B's stock. This leaves Owner A as 100% owner of the business. Owner B's family has the cash needed to pay the costs of settling his estate.

As a general rule, when property is transferred at death, the basis of that property is increased (or stepped-up) to its full fair market value. So, in our example, when Owner B died, the basis of his stock was stepped-up to fair market value to his beneficiaries. Also, because the policies in a cross-purchase arrangement are owned by the individual owners and not by the business, the policies are not subject to the claims of creditors of the business.

ENTITY PURCHASE ARRANGEMENT

HOW DOES IT WORK?

An entity purchase (also called stock redemption agreement) provides that the corporation will purchase the interest of a departing shareholder upon the occurrence of a triggering event. The shareholders enter into a binding agreement with the corporation for the purchase of the shareholders business interest. This agreement obligates the deceased shareholder's estate to sell its share of the entity at an agreed upon or determined price. The corporation is in turn obligated to purchase the shares. To crease the liquidity necessary to buy out the deceased owner's interest, the corporation purchases, owns and is the beneficiary of the life insurance policies insuring the lives of each owner.

WHAT HAPPENS WHEN AN OWNER DIES?

Assume shareholder A and shareholder B own a corporation at 50% each. What would happen if shareholder B dies?

- B's stock passes to his estate
- The death benefit is paid to the corporation. Generally, these proceeds are received income tax free by the corporation[1]. Since he had no incidents of ownership the proceeds are not included in B's estate.
- The purchase and sale then takes place between the corporation and shareholder B's family. The corporation uses the cash it has just received to redeem shareholder B's stock. After the redemption, shareholder A is the sole owner of the corporation. B's family then has the cash needed to pay his estate settlement costs.

Unlike cross-purchase buy-sell, and entity purchase is funded using one policy per shareholder. Many business owners are attracted to the simplicity of the stock redemption buy-sell. Since the cross-purchase pan typically involves more policies and cross-ownership of those policies, the mechanics of the buy-out can seem complicated. With the stock redemption, the business simply buys the owner out.

Also, the business uses its own funds to pay policy premiums, which do not constitute taxable income to the shareholders (in a C-Corporation). This can be especially attractive if the corporation is in a lower tax bracket than the individual shareholders. However, because the corporation owns the policies, both the cash values and the death benefit are available to the corporation's creditors. Should this happen, the corporation could be left with a contractual obligation to buy-out a shareholder, but have no source of funds to do so.

For more information about business continuation planning, please contact your Baird Financial Advisor.

[1]For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).