Life Insurance Education Series
Part 5: Life insurance planning for businesses

Changes in income- and estate-tax laws as well as volatility in the market may require you to review your current financial plans. As part of that review, life insurance is often overlooked as a potential strategy, or may not be appropriately utilized and coordinated with other planning objectives. This six part educational series will address several uses of life insurance, why it should be reviewed periodically and specific issues to consider. Please speak to your Financial Advisor to obtain the remaining parts of this series or for more information.

Life insurance can play an integral role in both personal financial planning and business planning. Although there are many types of business insurance designed to mitigate various risks, this article will focus on the risks associated with the death of an owner or key employee.

Succession planning: funding buy-sell agreements with life insurance

One of the most important, and sometimes overlooked, issues for a business is planning for continuation after the death, disability or retirement of an owner. A buy-sell agreement can provide for the orderly transition of the business and avoid the need for a "fire sale" (or forced liquidation for less than market value) of the business or prevent transferring the business to family members who may not be capable of running the company.

A buy-sell agreement is a prearranged sale between a business owner and a purchaser. A key consideration is how the buy-sell agreement will be funded. There are many ways to fund a buy-sell agreement: take the funds from business assets, implement a savings program, make installment payments, or life insurance. Life insurance may be the least costly way to fund a buy-sell agreement and the death benefit ensures that sufficient assets are immediately available when needed. The other funding mechanisms rely on the availability of cash within the business and/or positive investment returns on savings, and there is no certainty that the amount needed would be available upon the death of a business owner.

Life insurance also provides the ability to fulfill the obligation under the buy-sell agreement without having to rely on business assets or personal funds at the time of the purchase. The cost of the life insurance can also be designed with some flexibility to take into account the timing and amount of premium payments based on the policy owner's preference and/or cash flow constraints.

Overview of a buy-sell agreement

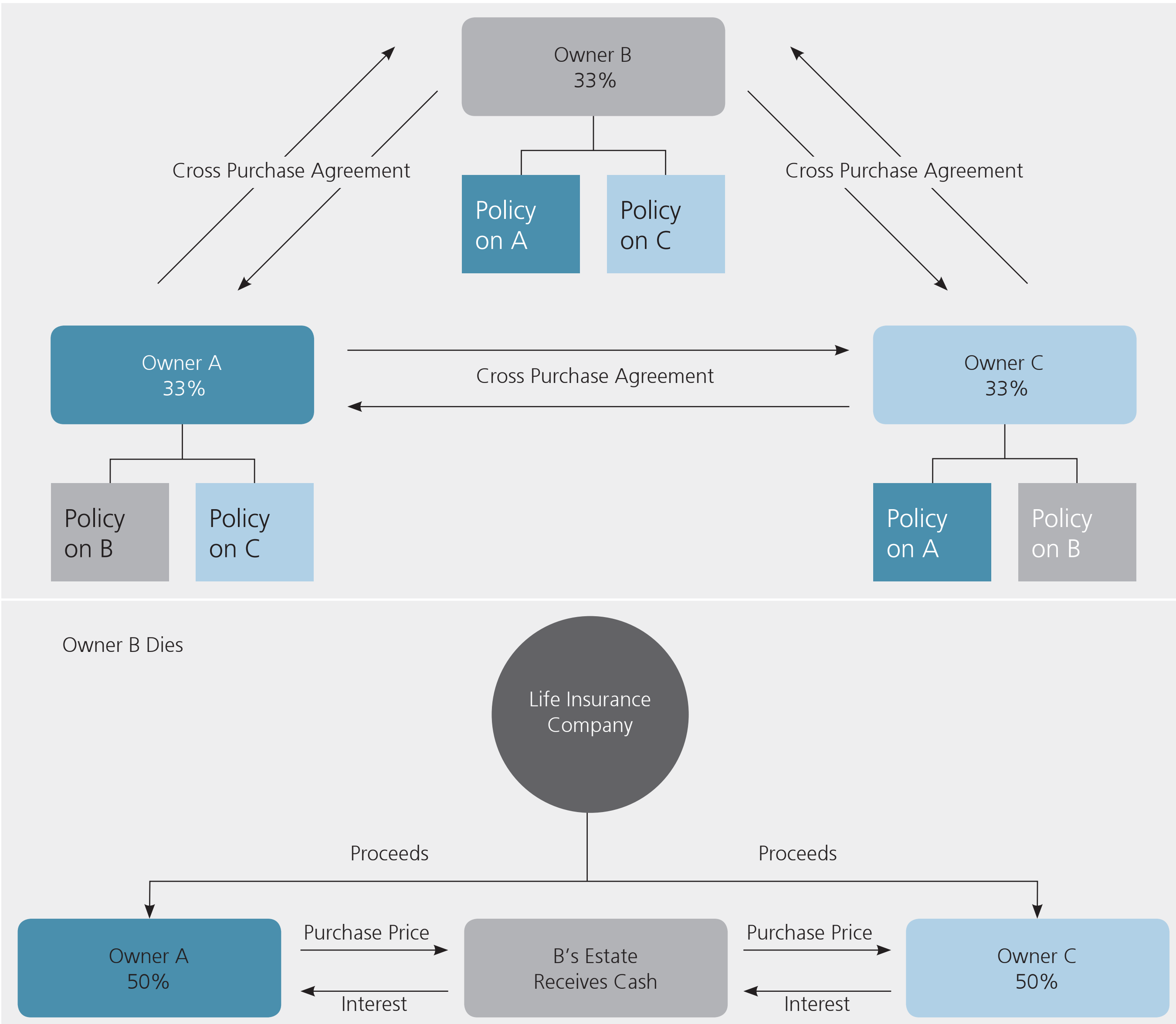
The main purpose of the buy-sell agreement is to clearly and concisely outline the sale of a business upon the death, disability or retirement of an owner to ensure a smooth transition to the next owner(s). The purchaser may be a key-employee, co-owners of the business, the business itself, or a third-party that has shown an interest in the business. Benefits of a buy-sell agreement may include creating a guaranteed market for the business interest, providing liquidity to pay estate taxes and administrative costs, establishing the estate tax value of a deceased owner's interest, and bolstering a business's credit risk since the likelihood of business continuity is enhanced with a buy-sell agreement in place.

A buy-sell agreement should include a method for determining the purchase price as well as state how the purchase will be funded. It is important for a qualified attorney to draft the buy-sell agreement. If the buy-sell agreement is not properly drafted, it may not accomplish the intended goals or may not be valid.

Types of buy-sell agreements

When there is more than one business owner there are generally three types of buy-sell agreements to consider: (1) the cross purchase plan, (2) the entity plan (known as a stock redemption plan when referring to a corporation), and (3) the hybrid method plan (a combination of the entity and cross purchase plans).

Standard cross purchase plan



Cross purchase plan

The cross purchase plan involves an agreement between the individual co-owners of a business. Each co-owner agrees to purchase a share of the deceased co-owner's business interest. In addition, each co-owner must legally bind his or her estate to sell the business interest to the surviving owners pursuant to the agreement.

Insurance

When insurance is used to fund a standard cross purchase agreement, each business owner purchases a separate insurance policy on each of the co-owners. The formula for calculating how many policies are needed in a cross purchase plan is P x (P-1), where P stands for the number of business owners. For example, a business with six owners will need 30 insurance policies (6 x (6-1)).

As the number of business owners increases, the complexity of managing the number of policies required under the standard cross purchase plan increases exponentially, and can become onerous. Establishing a trusteed cross purchase agreement is one way to address this concern.

Trusteed cross purchase agreement

A trusteed cross purchase plan limits the required number of insurance polices to the number of owners in the cross purchase agreement. Under this arrangement, the trustee purchases one insurance policy for each owner and collects the premiums from each owner. (Note, because this trust is established in a business context, the owners' contribution of premium amounts to the trust does not constitute a "gift," nor does it trigger gift tax implications as it might with other trust arrangements). When an owner dies, the insurance proceeds are collected by the trustee who then distributes a proportionate share to each of the surviving owners. The surviving owners in turn use the proceeds to buy the decedent's business interest as outlined in the cross purchase agreement. The life insurance proceeds received by the trust are not subject to estate tax. However, the decedent's business interest is includable in his estate and may or may not be subject to estate tax.

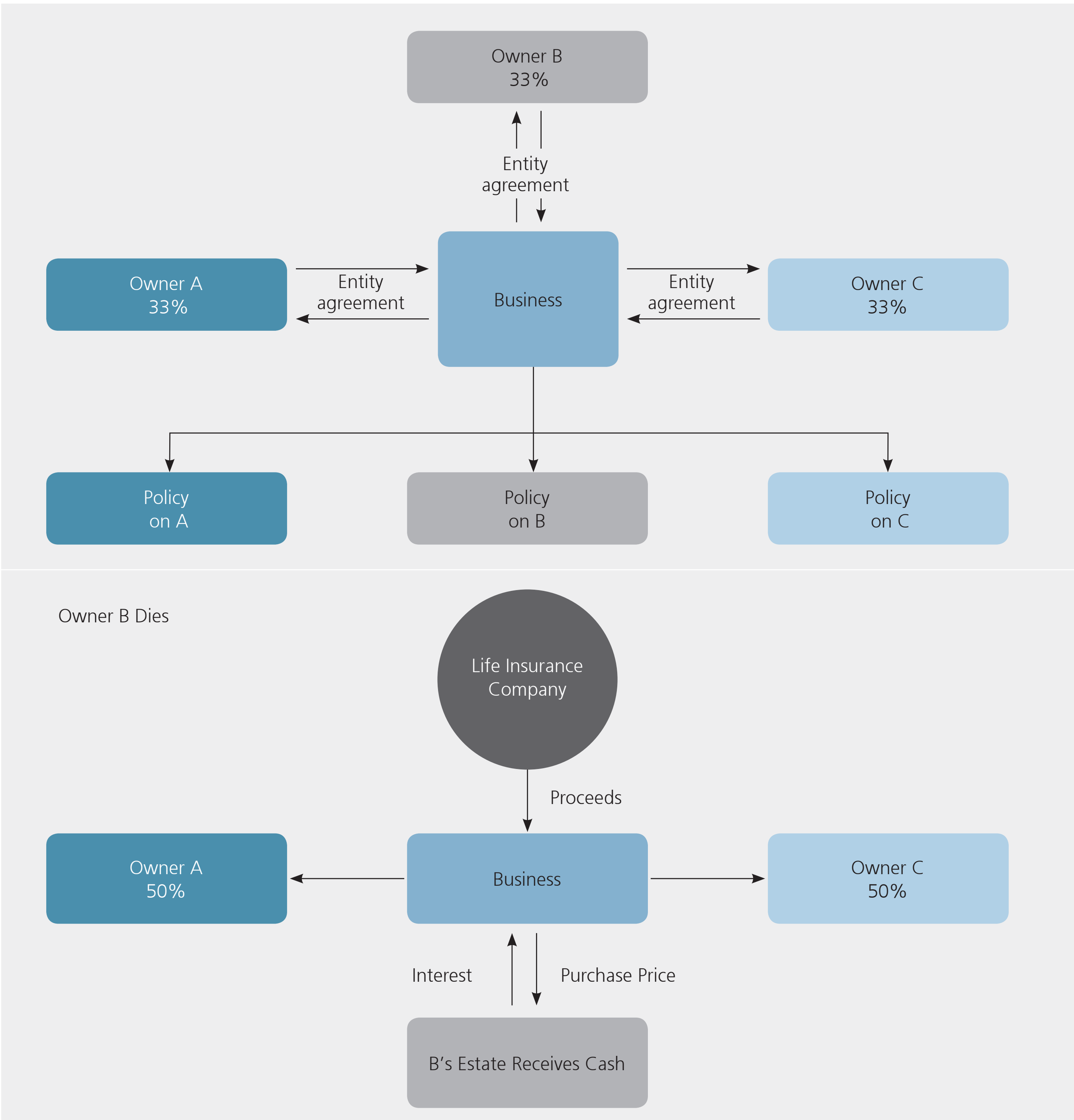
Example: John, Dave and Tom are equal owners of a business valued at $3 million. Pursuant to the trusteed cross purchase agreement, the trustee purchases a $1 million policy on the life of each owner (a total of three policies). Each owner contributes their share of the insurance premiums to the trust. At Tom's death, the trustee collects the $1 million insurance proceeds and distributes $500,000 each to John and Dave. They each use the proceeds to purchase Tom's interest from his estate.

In contrast, if John, Dave and Tom funded a standard cross purchase agreement with life insurance, there would be a total of six $500,000 insurance policies (3 x (3-1)).

Other considerations

Note that younger co-owners will likely pay higher premiums on their older counterparts. As such, the financial burdens of funding a cross purchase plan are not necessarily shared equally among all co-owners.

Entity buy-sell



Entity plan

With an entity plan approach, the business agrees to purchase the deceased owner's interest. As with the cross purchase plan the business owner must commit his estate to sell his interest to the business at his death. This arrangement is typically chosen when there are a large number of owners because of its simplicity relative to the cross-purchase approach.

Insurance

With an entity plan, the business buys a life insurance policy insuring each owner. At the death of an owner, the insurance proceeds received by the business are then used to liquidate the deceased's business interest.

Hybrid method

The hybrid method, also referred to as the wait-and-see method, provides more flexibility to the owners by allowing them to defer the decision on which method to use, cross purchase or entity. Often, determining whether the business or the owners should be the "buyer" may be difficult to assess at the time the buy-sell agreement is executed. The hybrid method allows the business owners to wait until the death of a business owner to decide and allows for the purchaser to be the business, the owners or both.

Upon the death of an owner, the business has the first option to purchase the deceased owner's interest. If the business does not buy the decedent's full interest, the surviving owners will have the option to purchase any remaining interest. If, after the surviving owners exercise their option, the decedent's estate has any remaining interest in the business, the business is required to purchase the remainder from the estate.

Insurance

Funding the hybrid buy-sell agreement with insurance may seem difficult because the buyer is not identified at the outset. However, either the business or the owners can purchase the life insurance and still accomplish the goal. If the business owns the insurance and does not exercise the option to purchase, the business can loan the insurance proceeds to the surviving owners to use for the purchase. Conversely, if the owners purchase the insurance and the business is the ultimate buyer of the decedent's interest, the owners can use the insurance proceeds to make a capital contribution to the business. The business then uses these proceeds to complete the purchase.

As with most sale transactions, there will be income tax implications that should be considered when deciding which buy-sell approach is most appropriate for your business. The complexity of this issue is beyond the scope of this article. Please consult with your legal and tax advisors prior to making any decisions.

Life insurance funded buy-sell arrangements

	Entity plan *(Business purchase)*	**Cross-purchase** *(Owner Purchase)*	**Hybrid** *(Wait-and-see)*
Purchaser (in agreement):	Business	Owner	May be business or owner
Number of insurance policies:	Business purchases one policy on each owner	Each owner buys one policy on each of the other owners	May be business or owner
Beneficiary:	Business entity	Individual owner	Depends on arrangement: business or owner
Suitability:	When there is a great number of owners		When business and owners want the flexibility to decide how the purchase will be structured at the time of an owner's death
Considerations:	One policy per owner	Administrative complexity: multiple policies per owner (unless trusteed approach used)	
	Business pays premium cost	Individual pays premium	
	Equalization of premium costs	Potential disproportionate cost of premium between younger and older owners	
	Cash value of policies are a business asset	Cash value of policy is a personal asset	
	Policies and cash values are subject to creditors of business	Policies and cash values are subject to owner's personal creditors	
	Life insurance proceeds may increase the value of the business for estate tax purposes		
Complexity:	Simple	Complex	Flexible

Implementing a funded buy-sell agreement that fits the needs of the business is critical to ensuring the successful transition of a business upon an owner's death. When a business owner dies, the business interests or shares owned by the deceased business owner may trigger an estate tax. Typically, estate taxes must be paid within nine months of the date of death, so it is important to plan how to pay for any taxes due. An advantage to a funded buy-sell agreement is that the life insurance provides liquidity to the decedent's estate to cover the estate taxes and it provides a ready market for the business interest that might not otherwise exist. The liquidity from the buy-sell agreement also allows the deceased's estate to avoid a forced liquidation of the business interests, which may result in a lower than fair market value sale price.

The buy-sell agreement should be reviewed periodically to ensure it continues to meet the owners' needs particularly when there are material changes in the business (e.g., death of an owner, extraordinary growth in the business and change in ownership structure). As well, periodic reviews of the life insurance policies should be conducted to evaluate policy performance and ensure the death benefit amounts remain adequate to fund the buy-sell agreement. Having a funded buy-sell agreement in place provides additional assurance that neither the business nor the careers of the surviving owners and/or employees will be interrupted.

Business planning with key person insurance

Owners of a closely-held business not only face the risk of a co-owners death, they may also face the risk of losing a valued employee to disability or death. The disability of a key employee may result in lost revenue and the impact could be far greater in the event of a key employee's death. One way to protect the business against this risk is to purchase "key person" or "key employee" life insurance. The name of this insurance refers to the purpose of the insurance rather than the type of insurance.

Selection and valuation of key employees

The first step is to determine which employees are critical to the success of the business. Contributing factors may include:

– Management responsibility
– Specific knowledge, skills or experience
– Generation of revenue or contribution to profits
– Personal relationships with customers or vendors

Once an employee has been identified as a "key person," the next step is to determine the potential financial impact the business may suffer in the event of the employee's death. There are several approaches to this valuation exercise.

Multiple of income method: The method applies a multiple to the employee's salary based on factors such the employee's current position, or how long the employer believes it would take a new employee to acquire the same skill set. The employer has full discretion over choosing an appropriate multiple. However, multiples are commonly chosen between 1 and 10 times earnings.

Contribution to earnings method: This method is calculated based on a determination of the percentage of the employer's profits attributable to the key employee. The value of those profits may be multiplied by a factor (e.g., the time it would take to replace the key employee) to determine the business's risk exposure.

Replacement cost method: This attributes a value to the key employee based on an estimate of the costs involved in recruiting, hiring, and training a replacement.

Determining the value of the key employee will identify the potential loss at stake and can guide the decision on the appropriate amount and type of life insurance to purchase.

Insurance policy selection

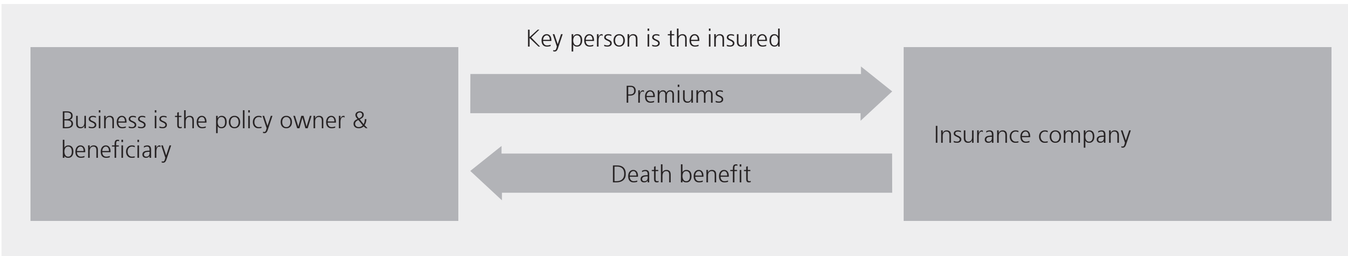
After a key person's value to the business has been assessed, the business will need to consider what type of life insurance is most appropriate to offset the potential loss of value. There are two main types of life insurance: term and permanent. Term insurance is typically purchased to provide a benefit for a defined period of time. Permanent insurance, on the other hand, is commonly selected when the goal is to provide a death benefit for the duration of the insured's life.

If the period of risk has a specific duration then term insurance may be the best option. For example, if an employee is currently 45 years old and expects to retire at age 65, then a 20-year term policy may be appropriate. Term policies are generally less costly than a permanent policy and there would be no need for the extended coverage.

It is important, however, to note that life insurance can serve multiple purposes. Permanent life insurance is often used by an employer to fund employee benefits and create a competitive compensation package to recruit a new employee. Employers structuring benefit packages involving nonqualified deferred compensation plans often use permanent life insurance contracts as a funding mechanism to meet their obligation to pay for future benefits.

A permanent policy could be used to serve the dual purpose of providing life insurance coverage for a key person and, if death benefit proceeds are never collected (e.g., the employee retires), the cash value accumulation can then be used by the employer to fund the key employee's retirement benefit.

Key person insurance arrangement



Life insurance adds a layer of protection that may make the difference in a business's success or failure when it is used to address the risks associated with a business. Life insurance may be able to off-set the potentially devastating losses caused by the business's lack of liquidity or loss of a key employee. When planning for a business's continuation after the death, disability or retirement of an owner, a properly structured and funded buy-sell agreement may expedite the transition process and potentially avoid considerable stress and financial loss to co-owners and family members. Key employee insurance may provide the buffer necessary to reduce loss of revenue and fund recruitment expenses. Life insurance often serves multiple purposes and may provide a solution to many of the planning concerns of a business. Therefore, when designing a business plan, it is prudent to identify and analyze all forms of risk and consider life insurance where applicable.

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