

Business Continuation SALES KIT



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Business Succession Planning

in the Business Planning Market

Business Succession Planning

Succession planning is critical to supporting the effective transition of a business from one owner to the next; whether that transition occurs due to a planned exit by the owner — like the owner's retirement — or an unexpected or tragic event — like death or disability. Without a plan in place, a thriving business could fail in an instant, jeopardizing the financial futures of all those who rely on the business and its continued success.

Unfortunately, statistics show that **up to 60% of business owners do not have any formal succession plan for their business.**¹ Why is this the case?

- For more established businesses, the owner has probably spent a good portion of his or her life creating or supporting the business and working to make it profitable. Given how much these owners have sacrificed to build their "life's work," they cannot imagine (or do not want to imagine) a time when they will not be involved in their business.
- For newer businesses, the owner may be more concerned about keeping the business afloat and thriving in the present rather than spending time to consider what will happen to the business in the future.
- For all owners, the process of creating a business succession plan also may seem too cumbersome and time-consuming, especially when a "successor" is not already identified or requires the owner to choose among family members or valued employees. When so much of a business owner's time is consumed by the day-to-day activities associated with running the business, taking the time to discuss what should happen to the business at some unknown date in the future may have the owner running for the hills.

Despite many owners' reluctance to sit down and make a plan, the reality is that no owner will be involved in his or her business forever. **In fact, 40% of business owners have indicated that they expect to retire in the next 10 years.**²

For family businesses, which comprise 80% to 90% of all business enterprises, lack of planning also could have a significant effect on the viability of a business as it passes down through the generations — considering that currently **only 30% of family owned businesses survive into the next generation and 12% remain viable until the third generation.**³

For "key questions" to help initiate the creation of a business succession plan and identify potential successors, see page 12.

WHAT IS BUSINESS SUCCESSION PLANNING?

The answer to this question may seem obvious, but many people incorrectly talk about succession planning or continuity planning interchangeably with buy-sell planning. Although a buy-sell plan (also referred to as buy-sell agreement) may be an important element to the continued success of a business, succession planning is much broader than just a buy-sell agreement.

Succession planning is the process of identifying the key factors that help make a particular owner's business successful — e.g., management, employees, customer relations, owner involvement, etc., — and creating a “blueprint” that helps support these key factors when a business transitions from one owner to the next.

A succession plan generally will outline these key factors:

- **The owner's goals for the business**
- **When the owner wants to leave the business**
- **How he or she wants to leave the business — sell, retire, etc.**
- **To whom he or she wants to leave or sell the business**
- **How to fund transfers, sales, retirements and disability**
- **Who will manage the company after the owner's departure**
- **How to retain key employees vital to the transition of the business**
- **Considerations to avoid family discord**

Getting a business owner to sit down and think about these important factors helps secure the business' future by having a plan in place — especially when the unexpected occurs.

It is important to note that a succession plan for one owner may look completely different than another owner as each one is customized to the owner's unique goals, objectives and circumstances. For example:

- In a family-owned business, the succession plan may outline the transition of ownership to the next generation without necessitating any type of formal buy-sell agreement. This type of succession plan may be focused on when the business will transition to the next generation, how to mentor or train the next generation so they are prepared for ownership, and how to protect the value of the business for the next generation at the death of the owner.
- For a business with multiple owners, the succession plan may require that ownership stay among current and active owners, necessitating an exit strategy for an owner who retires, becomes disabled or dies. This is where a buy-sell agreement, which is part of the overall succession plan, would likely be used to ensure that the business properly transitions among the owners.

Just as a **business plan** can be vital to the creation and on-going success of a business, a **business succession plan** is vital to the continued success of a business after a key owner has left.

Planning Opportunities

The most common planning opportunities considered when working on a business succession plan are discussed below and based upon who the client has identified as a possible successor or person essential to the continued success of the business:

- **Family member**
- **Another business owner**
- **Key employee**
- **Successor unknown**

These opportunities are not exclusive to any one group and there may be cross-over between groups. For example, if a client indicates that he is in a family business with his two brothers and his son, he may want to simply leave his interest in the business to his son via the Last Will and Testament or may want to have a more formal buy-sell agreement that requires the co-owners to purchase his interest at death. You should consider both planning opportunities for a family member and opportunities when there are multiple owners.

Family member as successor

When working with a business owner who plans to transition his or her business to a family member, the owner may want to transition the business via lifetime gifts and/or at the owner's death. Although transitioning the business via a gift or bequest is fairly straightforward and may not require complicated documents, life insurance could be an essential factor in this type of plan to ensure that both the family and the business are protected after the owner is out of the business.

Consider the importance of life insurance in the following scenarios:

Estate Taxes

Estate taxes can have a debilitating effect on a closely-held business if there is not enough liquidity in the estate to pay the tax liability within the 9 month window allowed after the business owner's death. Life insurance provides cash right when an estate needs it most.

Estate Equalization

Passing on a family business to the next generation can present challenges, especially when there are some heirs more active in running the business than others. To avoid creating conflict and inequality amongst the heirs, the purchase of a life insurance policy on the senior generation business owner would provide a resource to equalize the inheritance at the owner's death for the non-active heirs while protecting the business for the active heirs.

Key Person Insurance on the Business Owner

In many family businesses, the death of the primary business owner (usually a senior generation owner) could result in detrimental financial loss that may threaten the company's ability to continue its operation. Life insurance can help the business stay afloat while the younger generation becomes acclimated to running the business and forging new business relationships previously secured by the older family member. Additionally, a key person policy could be used to pay off any debts that may be called by the bank at the death of the senior owner or to help retain key employees that otherwise may leave at the death of the owner.

Co-owners as successors

Very often a business with multiple owners will want the succession of the business to stay with the active or current owners. Consequently, a buy-sell agreement, which provides an option or requirement that a departing owner transfer his or her business interests to the remaining or surviving business owners, will likely be used as part of the overall succession plan — especially when working with business owners who are not family members.

WHAT IS A BUY-SELL AGREEMENT AND HOW DOES IT FACTOR INTO SUCCESSION PLANNING?

A buy-sell agreement is a legally binding contract that provides for the transfer of ownership in the business upon a “triggering event” — e.g., death, disability, retirement, divorce, bankruptcy, etc. Working with tax and legal counsel, the owners of a business (and possibly the business itself) enter into a written agreement that provides rights and/or obligations for the purchase of a business owner’s interest in the business should one of the specified triggering events occur. The owner, in turn, agrees that he/she (or his/her estate, in the case of death) will transfer the business interest to the other owners (or the business itself) for an agreed-upon price.

By implementing a buy-sell agreement, the business is more likely to continue running smoothly after the departure or death of one of the owners due primarily to the fact that the remaining owners can rest assured that the business will remain in their control and they will not need to work with any outside parties. The departing owner and his/her family is also protected by a buy-sell agreement in that there is a designated buyer for his/her interest in the business if a triggering even occurs, which means the owner (or his/her estate) can be fairly compensated for his/her interest in the business.

Does your client already have a buy-sell agreement in place?
If so, see page 9 for questions and tips to determine if the
current buy-sell agreement needs to be updated.

A buy-sell agreement can be an essential factor in planning for the continued success of a business, particularly in the following areas:

- **Creating a market for an owner’s interest** in the business, usually when it is needed most — e.g., death of the owner, disability or retirement
- **Establishing a purchase price** for the business interests
- **Protecting owners** who continue in the business interest by restricting transfer of ownership interests to outside parties
- **Providing liquidity** for the deceased owner’s estate to pay estate taxes or other debts of the estate

WHAT ARE THE MOST COMMON TYPES OF BUY-SELL AGREEMENTS?

Entity Redemption

Provides that the business will pay the owner or the owner's estate an agreed upon amount for the owner's interest in the business upon a triggering event — e.g. death, disability, or retirement. The owner, in turn, agrees that he/she (or his/her estate, in the case of death) will transfer the business interests back to the entity for the agreed-upon price. To meet the obligations under the buy-sell agreement, the business will purchase life insurance on each of the participating owners. The policy is employer-owned and therefore must comply with IRC 101(j) to ensure the death benefit will be received tax-free. See the *BYA: 101(j) Requirements for Employer Owned Life Insurance* for important information about employer-owned insurance requirements under IRC 101(j).

Cross Purchase

Provides that each owner of the business will purchase another owner's interest in the company upon a triggering event. Typically, each owner is required or has the option to purchase a percentage or proportional share of a departing owner's interest in the business. In turn, each owner also agrees that he/she (or his/her estate, in the case of death) will transfer his/her business interests to the other owners for the agreed-upon price when a triggering even occurs. The cross-purchase agreement is negotiated amongst the owners of a business themselves; this means that not all owners must participate or be included in the buy-sell obligations.

Wait and See

A wait and see buy-sell arrangement is a hybrid buy-sell arrangement that combines features of both an entity purchase and a cross-purchase buy-sell agreement. With a wait and see buy-sell arrangement, the buy-sell agreement generally will provide the entity with the first option (aka the "right of first refusal") to buy any portion of the departing or deceased owner's interest within a certain time period after a triggering event. If the entity does not fully exercise this option, the business owners have the second option or right of refusal to purchase the business interests from the departing/deceased owner. Finally, if the remaining owners do not exercise their right of refusal, the entity will be required to purchase the balance of the departing/deceased owner's interest for the agreed-upon value. To meet the obligations under the buy-sell agreement, either the business (generally preferred) or the individual owners will purchase insurance policies on the lives of the business owners.

Cross Endorsement

A cross endorsement arrangement is an alternative to the typical funding approach used with cross-purchase buy-sell agreements.

Under a cross endorsement arrangement, each business owner purchases and owns a life insurance policy on his or her own life and endorses a portion of the death benefit to the other owners.

In return for the business owner endorsing the death benefit to his/her co-owners, the other owners will pay a rental fee equal to the “economic benefit” costs of the endorsed amounts, similar to the economic benefit fees charged under a split dollar arrangement. When the business owner dies, his/her co-owners will receive the portion of the death benefit endorsed in their favor, tax-free,⁴ and will use those funds to meet the purchase obligations under the cross-purchase buy-sell agreement. Any death benefit not endorsed to the co-owners will be paid to the owner’s designated beneficiaries (e.g., spouse and children).

Trusteed

In a trusteed arrangement, a trustee purchases life insurance on the life of each business owner who is a party to the cross-purchase buy-sell agreement and pays the premium on such policies via contributions from the business owners. Upon the death of an owner, the trustee (1) collects the life insurance proceeds, (2) purchases the business interests from the estate of the deceased owner, and (3) distributes the business interests to the surviving owners.

Partnership

This arrangement is similar to the trusteed arrangement; however, instead of creating a trust, the business owners form a partnership. The partnership then purchases a life insurance policy on the life of each business owner and pays the premium via contributions made to the partnership each year by the business owners.

WHAT ROLE DOES LIFE INSURANCE PLAY IN A SUCCESSION PLAN?

Life insurance is a powerful tool that allows a business owner to protect the value of the business by having access to liquidity at the most critical of times. Not only can life insurance provide much needed liquidity after the death of a business owner or other key employee, but a cash value permanent life insurance policy can provide access to cash during the life of the insured, which can be used as a funding source for a lifetime buy-out of the business owner, for a deferred compensation plan, as security for a bank loan...just to name a few.

The tax advantages of life insurance also make it very desirable and a competitive asset for business planning purposes. The proceeds paid upon death typically are received income-tax free and the owner can access the cash that has accumulated in the policy while the insured is alive also free of income taxes. Given that so many businesses today are designed to be pass-through entities (whether it’s in the form of an S corporation, partnership or LLC), which requires the business owners to pay taxes on all income generated by the business (including investment income), the tax advantages of life insurance may make this type of asset even more desirable than other investments.

WHAT TYPE OF BUY-SELL AGREEMENT IS RIGHT FOR MY CLIENT?

Choosing the right structure for a buy-sell agreement can depend on a lot of factors, including:

- **How many owners are involved in the business;**
- **What is the business structure (e.g., C corp, S corp, partnership, LLC); and**
- **Who will pay the premiums and how much control does each owner want over his or her policy.**

While the client's tax counsel will likely help decide what type of arrangement is most appropriate, here are some helpful items to consider:

Basis Increase	With a cross-purchase buy-sell agreement (or variation thereof), the surviving business owners receive basis in the purchased shares or interests equal to fair market value. This is often referred to as the "step-up" in basis associated with a buy-sell obligation. An entity purchase buy-sell arrangement with a C corporation does not provide a similar increase in basis of the remaining shareholders' stock. However, life insurance proceeds received by an S corporation can increase the basis of its shareholders' stock (if certain requirements are met), providing a "step up" to the surviving shareholders.
Number of Policies Required	When there are more than two or three owners, a traditional cross-purchase buy-sell arrangement funded with life insurance can be complicated due to the number of policies that are required. Where there are more than two or three owners, an entity purchase, cross endorsement, trusted cross-purchase or partnership arrangement may be considered.
Transfer for Value	Under IRC section 101(a)(2), the transfer of a life insurance contract or any interest in the contract for valuable consideration can result in a portion of the death benefit being subject to income tax, unless an exception to the transfer-for-value rule applies. Exceptions to the transfer-for-value rule include a transfer to (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, or (4) a corporation in which the insured is a shareholder or officer. Care should be taken when choosing a buy-sell arrangement to ensure that there is not an obvious or hidden transfer for value situation for which there is not a permissible exception in order to avoid adverse income taxation. For more information on the application of the transfer for value rules, see our <i>BYA: Understanding Transfer for Value</i> or call Advanced Markets.

BUY-SELL POLICY REVIEW

For your clients with existing buy-sell agreements

Ask the business owner these questions to determine whether their current agreement needs to be updated:

Is the agreement between all of the owners or just some owners?

A buy-sell agreement does not have to apply to all owners of a business, nor does it have to apply the same terms and conditions among the owners, but the owner should be aware of this discrepancy and the reasoning behind why the agreement treats owners differently.

What are the triggering events for the buy-sell obligations?

Triggering events may typically include provisions for death, disability, incapacity, bankruptcy, loss of a professional license, divorce, and/or retirement. If a buy-sell agreement lacks one of these important triggering events, it may be worthwhile to discuss this with the owner.

Who is designated as the buyer of a deceased owner's interest — the company or the other owners?

Whoever has the obligation to buy a departing owner's interest in the business is usually the person (or entity) that will own the life insurance so that the financial obligations can be met at a triggering event. If the business owner has a buy-sell agreement and life insurance to fund the buy-sell, check to see if ownership of the insurance makes sense given the purchase obligations. For example, if the company is required to buy out a deceased owner's interest but a co-owner is the owner of the insurance, there may be a disconnect that needs to be addressed.

Is the buy-sell obligation voluntary or mandatory?

A voluntary agreement means that at a triggering event — e.g., death, disability, retirement, etc. — the remaining business owners have the option to buy out the business interests of the departing or deceased owner. A mandatory agreement mandates that the remaining owners purchase the departing or deceased owner's interests. A voluntary agreement may not adequately protect a business owner or his or her family as it is merely an agreement to agree on how negotiations may take place in the future.

How is the price of a departing owner's interest determined?

The most common methods to determine the price of a departing owner's interest are: by appraisal, book value, a multiple of earnings, discounted cash flow method, or as agreed on annually by the owners. Many of these valuation options — like book value or multiple of earnings — can be susceptible to manipulation and may not provide a departing owner's family with the best value. An appraisal method or an agreed upon price may create less conflict when a purchase is required but have their own costs or administrative issues to consider.

Is your buy-sell adequately funded?

Typically a buy-sell agreement should have provisions that address how a departing owner will be paid by the remaining owners. Common methods for funding a purchase obligation include: an installment sale, creating a sinking fund of investments for the future purchase, borrowing money, and/or life insurance. Life insurance usually is the preferred method of funding.

Is there a management succession plan in place?

A management plan as part of the overall succession plan is especially important with family owned businesses as this is where the most conflict can occur at the death of a senior owner.

Key person or non-owner as successor

It is not unusual for a business owner to indicate that he or she is interested in leaving the business to a key employee or someone else who is not a current owner of the business. Even if the owner names someone else as the successor — like a family member or co-owner — retaining a key employee that knows the business inside and out may be imperative to the successful transition of the business from the owner to the appointed successor.

To help with the successful transition of the owner's business in these scenarios, consider the following opportunities:

Key person or non-owner as successor

➔ One-way buy sell

A one-way buy-sell arrangement is a succession planning solution in which a key employee (or multiple key employees) agrees to buy the business in the event of the owner's death, disability or retirement. Unlike other buy-sell agreements, the obligation to purchase the business falls squarely on the key employee and the owner has no reciprocal responsibilities. As with other buy-sell agreements, life insurance is typically used as the funding source to meet the purchase obligations of the business from the deceased owner's estate.

➔ Employee Stock Ownership Plan (ESOP)

An ESOP is a special type of qualified retirement plan (like a profit sharing plan) created for the benefit of the company's employees that invests primarily in the stock of the employer/company. An ESOP is most commonly used to provide a ready market for the shares of a closely held corporation when a business owner is ready to depart. If a corporate owner does not have a family member, co-owner, or outside buyer interested in taking over the business, or would like to see the ownership of the business transition to the employees, an ESOP can be an effective way to create a source of funds to purchase the owner's interest in the company.

Key person imperative to continued success of the business after transition

➔ Key person insurance on the business owner

In many small businesses, key employees often are as critical to the continued success of a business as the business owner. These individuals have often been with the company from the beginning, know the ins and outs of the business, and may be responsible for maintaining the relationships with clients, customers, vendors, etc. Upon the death of the business owner to whom these key employees are loyal, these individuals may decide to seek opportunity with a competitor (or start a competing business) rather than stay through the transition of the business to a new (and possibly unknown) owner. With that in mind, a key person policy on the life of the business owner would be one way to infuse the business with liquidity that could be used to provide a lucrative incentive to keep these key employees involved in the business, at least for a period of time, so that the business can transition without skipping a beat.

Successor unknown

For a business owner who has no successor in mind, it is important to ask your client what he or she sees happening to the business if something were to happen. Could the client's family step in and take over the business? Would the owner want to put that sort of pressure on his or her family to preserve the value of the business and support themselves? Could the business realistically be sold to a third party and what sort of value could the family expect? At a minimum, are there assets of the business — e.g., inventory, real estate, intellectual property, etc. — that could be sold?

Although there is likely some value that can be generated from the business after an owner decides to retire or passes away, it may be pennies on the dollar compared to the business' value while the owner is alive and well. When there is no true succession plan, a life insurance policy should be considered as a way to protect the owner's family and help replace the value of the business in the estate via the death benefit.

WHERE CAN I LEARN MORE?

Visit the Advanced Markets section on JHSalesHub.com!

In the Business Planning - Succession Planning section you will find:

Web Tools

- Business Valuation Calculator

Supporting Marketing Materials , including fact finders and client pieces for:

- Buy-Sell Arrangements
- Key Person

Technical Marketing Material

- BYA: 101(j) Requirements for Employer Owned Life Insurance
- BYA: Understanding Transfer for Value
- BYA: Business Valuation

In addition, our proprietary JH Solutions can produce custom client presentations. Some of the presentations available are:

- Cross Endorsement Buy-Sell
- Cross Purchase Buy-Sell
- One Way
- Key Person

These are just some of the materials and tools we have available to better help you. If you need help please feel free to contact the Advanced Markets Group.

Key Questions TO ASK

How do you effectively demonstrate to your clients the need for succession planning in a way that will actively engage your clients and convince them to start planning? The answer may be as simple as asking them some key questions that can expose significant impacts to the business if a succession plan is not in place.

If you were unable to come to work for the next 6 months for whatever reason, who would run the business for you? In what condition would you find the business upon your return?

This is a great question to start with as it does not mention business succession planning — a term that could scare the business owner and shut down the conversation — but helps the owner begin to recognize important issues associated with lack of planning and also may help identify key players in the business (other than the business owner) who might be natural successors.

Have you ever thought about who you want to take over the business from you? If so, who is that person?

These questions are meant to determine if the owner has thought about the business' future and, if he or she has, whether those plans are in line with whom the owner identified in the previous question as the person or persons who would be relied upon today to run the business if something happened. For example, the owner may "want" to have his or her business transition to the children, but the children may be young and/or inexperienced. In reality, if something happened to the owner today, a key

employee or other family members might actually be charged with keeping the business afloat until the younger generation is ready to take over. Factoring in these key employees into the business succession plan will be imperative to helping the client realize his or her goals for the business' transition in the future

If you die unexpectedly, can your family continue to run the business?

This question may uncover potential issues or pitfalls associated with not having a succession plan. If the answer is yes, you should ask follow-up questions as to who in the family would take charge, what might be the potential issues associated with an abrupt transfer of the business, etc. to get the owner on his or her way to creating a business succession plan. If the answer is no, you should think about following up with questions that address who might be able to step in and whether the owner is worried about protecting his or her family in this were to happen.

Will your estate have enough liquidity to pay taxes, etc. if you died unexpectedly?

For many business owners the business interests may make up a very large portion of the owner's overall net worth. If that is the case and the owner has (or may have) exposure to estate taxes at his or her death — either at the state and/or federal level — not having liquidity to pay estate taxes could force the owner's estate to sell or liquidate the business interests or take on debt to come up with the estate tax, which is due 9 months after death. Life insurance may be extremely valuable in this type of scenario to ensure the estate has money to pay the estate tax and not force the family to sell or liquidate the business to come up with this payment.

JUST GETTING STARTED

Depending on whom the business owner has named as a possible successor (or whom you have helped identify as a natural successor), here are some more follow-up questions that may help the owner understand (and embrace) the importance of succession planning.

IF THE OWNER WANTS TO LEAVE THE BUSINESS TO HIS FAMILY:

- Would you like your business to remain in your family?
- Are there family members currently active in the business? If so, is there one person that is more of a leader?
- Do you have family members not involved in the business that you want to provide for in your estate plan?
- Do you want your heirs to share equally in your estate?
- How confident are you that the active and inactive members of your business could successfully work together to run the business?
- Would you like to provide a source of funds, other than your business, to provide for your heirs who are not involved in the business?

IF THERE ARE CO-OWNERS:

- Have you and the other owners discussed what will happen if one of you leaves the business?
- Do you have any type of arrangement already worked out between you and the other owners? If so, when was that agreement created and/or last reviewed?
- Will your family be adequately provided for via income from the business if you died unexpectedly?
- Would you want to be in business with a spouse of a co-owner if the co-owner were to die?
- Would you like to have your interests in the business purchased upon your death? What about if you retire or become disabled?
- Do you think the other owners of your business want the same thing?
- How important is flexibility to you in terms of how a purchase or sale of business interests is handled?

IF A KEY EMPLOYEE MIGHT TAKE OVER OR IS IMPERATIVE TO THE CONTINUED SUCCESS AFTER THE OWNER'S DEPARTURE:

- Who are the key employees or "superstars" in your business?
- Have you ever thought about transitioning your business to this key person?
- Would this person have the ability to purchase the business from you? Would you even want them to purchase it or would you rather have the business just go to him/her?
- If you are not around, would you want or need this key person to help transition the business successfully to the next intended owner?
- Would you ever consider having the business become employee-owned?

SUCCESSOR UNKNOWN AT THIS TIME:

- Do you want to be able to take care of your family without being dependent on whether your business will succeed after you are gone?
- Have you considered whether your business is an asset you can sell to a third party? If so, what sort of value do you think you can get and who would be the buyer?
- Would you ever consider having the business become employee-owned?

Notes

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**For more information please call the Advanced Markets Group
at 888-266-7498 option 3**

1. 2015 U.S. Trust Insights on Wealth and Worth Survey: Key Findings" available at www.ustrust.com/ust/pages/insights-on-wealth-and-worth-2015.aspx
2. Family Business Alliance. Retrieved May 2015: http://www.fbagr.org/index.php?option=com_content&view=article&id=117&Itemid=75
3. Ibid.
4. Transfer for value rules under IRC Section 101(a) must be considered in this type of arrangement in order for the death benefit to be received tax-free.

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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.

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. 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 registered representatives. Prospective purchasers should consult their professional tax advisor for details.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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BUSINESS STRATEGIES

The Three Levels of Family Business Succession Planning

BY JULIUS GIARMARCO, J.D., LL.M.

OVERVIEW

One of the chief concerns facing family business owners is how to effect an orderly and affordable transfer of the business to the next generation and/or key employees. In other words, the concern is how to keep the family business in the family. Failure to properly plan for a smooth transition can result in monetary

losses and even loss of the business itself.

However, given adequate time and proper planning, a business succession plan can be implemented easily and, often, profitably.

IT IS ESTIMATED **70%** OF FAMILY OWNED BUSINESSES DO NOT SURVIVE THE TRANSITION FROM FOUNDER TO SECOND GENERATION.*

THERE ARE ESSENTIALLY THREE LEVELS TO A BUSINESS SUCCESSION PLAN.

The first level of a business succession plan is **management**. It is important to recognize that management and ownership are not the same. The day-to-day management of the business may be left to one child, while ownership

of the business is left to all of the children (whether or not they are active in the business). It is also possible that management may be left in the hands of key employees, rather than family members.

The second level of a business succession plan is **ownership**. Most business owners would prefer to leave their businesses to those children who are active in the business, but would still like to treat all of their children fairly (if not equally). Yet, many business owners lack sufficient non-business assets to allow them to leave their inactive children an equal share of their estates. Thus, a business succession plan must provide a means of transferring wealth to the children who are not interested in, or not qualified for, continuing the business. Business owners must also assess the most effective means of transferring ownership and the most appropriate time for the transfer to occur. Two other issues concerning ownership must be addressed. The first is whether the business owner will have continued economic benefit from the business after the transfer of ownership. The second issue is whether the business owner will continue to control the business after the transfer of ownership is complete.

The third level of a business succession plan is **transfer taxes**. Estate taxes alone can claim up to 40% of the value of the business, frequently resulting in a business having to liquidate or take on debt to keep the business afloat. To avoid a forced liquidation or the need to incur debt to pay estate taxes, there are a number of lifetime gifting strategies that can be implemented by the business owner to minimize (or possibly eliminate) estate taxes.

This report summarizes the fundamentals of business succession planning to help family business owners assess their goals and consider the economic, legal, and tax implications of various plans. It is by no means an exhaustive source on business succession planning. Business succession planning involves complex questions of law, tax, and business planning. The only way to find the best business succession strategy for a particular family business is to work closely with a lawyer, an accountant, and a licensed financial advisor experienced in business succession planning.

References to a “business” in this report include corporations, limited liability companies, and partnerships. References to “shares” include stock in a corporation, membership interests in a limited liability company, and partnership interests in a partnership.

Whenever the words “he,” “his,” or “him” appear in this report, they have been used solely for literary purposes in the interest of having a smooth reading text. They are meant to include all persons—whether male or female.

* Family Business Center, <http://www.familybusinesscenter.com/resources/family-business-facts/>, Accessed April 12, 2018.



LEVEL ONE: MANAGEMENT

Whether management of the business will rest in the hands of the next generation, in the hands of key employees, or a combination of both, the business owner must learn to delegate and work on the business. It can take many years to train the successor management team so that the business owner can walk away from day-to-day operations. For many business owners, giving up such control can be difficult.

All too often, business owners focus more on the ownership and transfer tax issues involved in a business succession plan and ignore the people issues. In the typical family business, the future leader is likely to be one of the business owner's children. If so, steps must be taken to assure that the future leader has the support of the key employees and other family member owners. Generally, a gradual transfer of roles and responsibilities gives the successor time to grow into his new position and allows the business owner some time to get used to his diminishing role. Thus, lead time is important for a smooth transition.

Many family businesses are dependent on one or two key employees who are critical to the success of the business. These key employees are often needed to manage the business (or assist in the management of the business) during the transition period. Therefore, the succession plan must address methods to guarantee that key employees remain with the business upon the death, disability, or retirement of the business owner. Following are three techniques often used to assure that key employees remain with the business during the transition period:

- ▶ **Employment Agreements.** A written employment agreement will set forth the employee's duties, compensation, and fringe benefits. The agreement can also provide for some form of profit sharing or incentive compensation, as well as a covenant not to compete. To protect the employee, the agreement can have a set term and can provide the employee with severance pay if his employment is terminated without cause (as defined in the agreement).
- ▶ **Nonqualified Deferred Compensation Plans.** A nonqualified deferred compensation plan (sometimes referred to as a "golden handcuffs" plan) is an agreement whereby the business promises to pay the key employee a benefit at retirement, death, or disability in return for the employee's continued employment through the specified age for retirement. The benefit is usually paid in monthly installments for a set term of years and can be based on a set dollar amount, on a specified percentage of the employee's average final pay, or on the future value of the business (a so-called phantom stock plan). In exchange, the employee promises not to voluntarily terminate employment prior to the retirement date and not to compete with the business after retirement. An employee's violation of either promise results in the forfeiture of all benefits promised to him under the agreement. An ideal way to fund a nonqualified deferred compensation plan is for the business to purchase a life insurance policy on each employee covered under the plan.
- ▶ **Stock Option Plans.** A stock option plan is a contract between a company and one or more key employees that gives the employee(s) the right to purchase a specific number of the company's shares at a fixed price within a certain time period. The option usually has an exercise price set to the market price of the stock at the time the option is granted. If the underlying stock increases in value, the option becomes more valuable. If and when the option is exercised, the employee must pay income tax on the "spread" (the difference between the value of the stock and the amount paid for the option). At the time of exercise, the company receives an income tax deduction for the spread. To encourage a key employee to remain with the company following the owner's death, disability, or retirement, the option can include a vesting period. Finally, to assure that the stock remains in the hands of insiders, the agreement can contain provisions that restrict the transfer of the option to outsiders.
- ▶ **Change of Control Agreements.** A change of control agreement generally provides that the employee's terms and conditions of employment (i.e., duties, compensation, benefits, etc.) will not be adversely changed for a set period (usually one to three years) following the transfer of the business to the next generation. Thus, if the new owners terminate the employee's employment for reasons other than death, disability, or termination for cause (as defined in the agreement), the employee will continue to receive his compensation and benefits for the remainder of the set period.

To assist the successor managers during the transition period, the business owner should consider establishing an advisory board. Upon the business owner's death, disability, or retirement, the advisory board can provide counsel to the successor managers and suggest strategic policy. The advisory board can comprise key employees, customers, and suppliers; the business's attorney, accountant, and financial advisor; and/or other business owners. The advisory board can be established in the business's governing documents (i.e., the bylaws for a corporation or the operating agreement for a limited liability company) or as part of the business owner's estate plan. For example, a business owner's revocable living trust can establish an advisory board upon the business owner's death to manage the business during the transition period.

LEVEL TWO: OWNERSHIP

Often, a major concern for family business owners with children who are active in the business is how to treat all of the children equally in the business succession process. Other concerns for the business owner include when to give up control of the business and how to guarantee sufficient retirement income. Following are 10 techniques commonly used to resolve these concerns:

- ▶ Selling (as opposed to gifting) the business to the active children results in all children being treated equally. The sale price would be the fair market value of the business determined by an independent appraisal. Typically, the purchase price would be paid in installments with interest. An added advantage of a sale is that it provides an income stream for the business owner's retirement needs. The problem with a sale, however, is that it is not tax-efficient. The purchasers must use after-tax dollars to make the principal payments and the business owner must pay a capital gains tax on any gain realized on the sale, plus ordinary income taxes on the interest payments.
- ▶ Gift and/or sell the business to all of the children but deliver voting shares to the active children and nonvoting shares to the inactive children. In addition, grant either the business and/or the active children the right to call (purchase) the nonvoting shares of the inactive children. Conversely, grant the inactive children the right to put (sell) their nonvoting shares to the business and/or the active children. The purchase price and payment terms for the puts and calls must be in writing.
- ▶ Gift and/or sell the business to the active children, and leave the inactive children nonbusiness assets. If, as a result, the inactive children will not receive an equal (or fair) portion of the business owner's estate, make up the difference by establishing an irrevocable life insurance trust for their benefit.
- ▶ If the active children have been instrumental in the success of the business, give them credit for their involvement in the business, particularly if their salaries have been less than the going rate. This credit could be in the form of lifetime gifts of business interests and/or a larger portion of the business owner's estate (in the form of business interests), compared with the inactive children.
- ▶ Generally, it is not necessary to treat adult children equally under state law. Therefore, a business owner need not base his succession plan on treating the inactive children equally, or even fairly. Of course, treating one's children unequally can create acrimony between family members.
- ▶ For the active children, the most pressing need is likely the assurance (in writing) that they will eventually control the business upon the owner's death, disability, or retirement. For the business owner, the need to control the business for the time being is likely to be of utmost importance. Therefore, the parties can enter into a buy-sell agreement (see page 4) that allows the business owner to retain the voting shares until his death, disability, or retirement.

- ▶ If more than one child is active in the business and the business owner is not certain which of the active children should have control over the business, the business owner can retain the voting shares until that decision is made. However, the business owner's revocable living trust should distribute the voting shares to one or more of the active children (or hold them in trust for such children) in the event the business owner dies before transferring the voting shares.
- ▶ When more than one child is active in the business, specific criteria that the children must meet in order to receive voting shares can be established. For example, earning a college degree or obtaining outside work experience are common requirements.
- ▶ If the decision is made to gift the business to the active children, a salary continuation agreement can be used to provide the business owner with retirement benefits. If properly designed, the benefits paid to the business owner will be deductible to the business but taxable as ordinary income to the business owner. Alternatively, the business owner can remain as a consultant to the business or serve as a board member in order to receive some compensation.
- ▶ Simultaneous with the gifting and/or selling of business interests, the new owners should enter into a buy-sell agreement. A buy-sell agreement is a legal arrangement providing for the redistribution of shares of the business following the death, disability, retirement, or termination of employment (triggering events) of one of the owners. The buy-sell agreement would also set forth the purchase price formula and payment terms upon a triggering event. If properly designed and drafted, a buy-sell agreement will create for the departing owner a market for what otherwise would be a non-marketable interest in a closely held business, will allow the original owners to maintain control over the business by preventing shares from passing to the departing owner's heirs, and will fix the value of a deceased owner's shares for estate-tax purposes.

LEVEL THREE: TRANSFER TAXES

The transfer tax component of business succession planning involves strategies to transfer ownership of the business while minimizing gift and estate taxes. The gift and estate tax consequences deserve special attention. Unanticipated federal estate taxes can be so severe that the business may need to be liquidated to pay the tax.

The Tax Cuts and Jobs Act of 2017 doubles, through 2025, the exemption amount for estate, gift, and generation-skipping transfer (GST) taxes, which are unified and indexed for inflation, rounded down to the nearest \$10,000. In 2018, the amount is \$11.18 million per person, or \$22.36 million per married couple.

Following is a description of a number of tools and techniques commonly used to transfer ownership of a family business. The factors to be considered in determining which techniques to use include the size of the business owner's taxable estate, the owner's need for retirement income, the owner's desire to control the business during the transition period, and the desire to treat the inactive children equally or fairly.

For lifetime gifts or sales of the business, nonvoting shares are usually used for two reasons. The first is to accomplish the business owner's desire to retain control of the business until a later date (i.e., the owner's death, disability, or retirement). The second reason is to reduce the gift-tax value of the shares because of valuation discounts for lack of control and marketability.

GIFTING TECHNIQUES

- ▶ **Annual Exclusion Gifts.** Gifts of business interests up to \$15,000 (\$30,000 for married couples) can be made annually to as many donees as the business owner desires (for 2018). Such gifts remove not only the value of the gifts from the business owner's estate, but also the income and future appreciation on the gifted property.

- ▶ **Gift Tax Exemption.** Beyond the \$15,000 annual gift tax exclusion, the business owner can gift \$11.18 million (\$22.36 million for a married couple) during his lifetime. While the use of the gift tax exemption reduces (dollar for dollar) the estate tax exemption at death, such gifts remove the income and future appreciation on the gifted property from the business owner's estate.
- ▶ **Gifts of Family LLC Interests.** A family limited liability company (FLLC) is a standard LLC that only includes family members. It can be a valuable tool to transfer a business or business real estate to children. In the typical FLLC, there are two types of membership interests: voting and nonvoting. The business owner retains the voting interests (1%) and gifts and/or sells the nonvoting interests (99%) to those children active in the business (or to trusts for their benefit). With the voting interests, the business owner names himself as the manager of the FLLC, thereby retaining control over the FLLC. Because the nonvoting interests lack control and marketability, they are discounted for valuation purposes. These discounts can be as high as 30% – 45%, thereby allowing the business owner to gift and/or sell more of the business. The same results can be accomplished with a family limited partnership (FLP).
- ▶ **Gifts in Trust.** While a business owner can gift shares in the business outright, consideration should be given to making the gifts in trust. One advantage of making gifts in trust for the benefit of the active children is to protect them from their inability, disability, creditors, and “predators,” including divorced spouses. Another advantage to making gifts in trust is that the assets in the trust at the children's deaths can (within limits) pass estate tax-free to the business owner's grandchildren. These are sometimes known as generation-skipping or dynasty trusts.
- ▶ **Gift to Charity and Corporate Repurchase.** Regular corporation business owners who are charitably inclined can gift some shares to children and the balance to charity. Several months later, the corporation can then redeem the charity's shares, leaving the charity with liquid assets and the children as the sole shareholders of the corporation. As long as the charity is a public charity, the repurchase may be achieved with either cash or a note. The net effect of using this technique is to reduce the number of shares that will eventually need to be transferred to the active children. This strategy saves income, gift, and future estate taxes. The business owner receives a current charitable income tax deduction, avoids capital gains taxes, and reduces his gift and estate taxes. It is important that there be no prearranged agreement that the charity's shares will be redeemed. Specifically, on the date of the gift to the charity, neither the corporation nor the charity may be bound to effect a repurchase.

STRATEGIES

- ▶ **Installment Sales.** An installment sale is an excellent way to provide a steady stream of cash flow to the business owner, while transitioning ownership to the active children. The installment sale must bear interest at not less than the applicable federal rate published monthly by the IRS. To the extent that the purchase price is less than the fair market value of the shares, the business owner has made a gift to the purchaser (i.e., a bargain sale).
- ▶ **Private Annuities.** With a private annuity, the business owner (the annuitant) sells the business interest to the active children (the purchasers) for an unsecured promise to make periodic payments to the annuitant for the remainder of the annuitant's life (a single life annuity) or for the remainder of the lives of the annuitant and his spouse (a joint-and-survivor annuity). The size of the annuity payments is dependent on the business owner's life expectancy. Since the payments terminate upon the business owner's death, neither the business interest nor the annuity is included in the owner's estate. Because the private annuity is a sale and not a gift, it allows the business owner to remove the business interest (and the future income and appreciation thereon) from his estate without incurring gift or estate tax. Each annuity payment received is taxed as part capital gain, part ordinary income, and part tax-free return of basis. The annuity cannot be secured and the purchaser cannot deduct any portion of the payments.

The IRS has issued proposed regulations that would eliminate the income tax advantages of selling appreciated property in exchange for a private annuity. The proposed regulations would do this by causing the seller's gain to be recognized in the year the transaction is effected, rather than as payments are received. In the context being referred to herein, the proposed regulations generally would apply for private annuity transactions entered into after April 19, 2007.

A private annuity is an excellent vehicle for a business owner who wants to sell his business during his lifetime and receive income until he dies. Of course, there is always the possibility that the business owner will outlive his life expectancy, in which case the children purchasing the business will pay more than expected. Private annuities can be particularly helpful from an estate tax perspective when the business owner is in poor health and not likely to live out his life expectancy. The business owner could sell the business to the active children, who would only make payments until the owner's death. Thus, the children could pay very little for the business. However, in order to rely on the IRS's actuarial tables to determine the amount of the annuity (as opposed to the owner's actual life expectancy), the business owner must have a 50% chance of living one year beyond the agreement. If the business owner lives for at least 18 months beyond the agreement, there is generally no challenge by the IRS. In any event, a medical assessment to document the business owner's health condition should be obtained.]

- ▶ **Self-Canceling Installment Notes.** When a business owner decides to sell his business to a child on installments, the promissory note may be a self-canceling installment note ("SCIN"). With a SCIN, upon the seller's death, all remaining payments under the note are canceled, [similar to a private annuity.] The purchaser must pay a premium for this cancellation feature, in the form of either a higher interest rate or a larger purchase price. Like a private annuity, a SCIN avoids estate and gift taxes.

FREEZING TECHNIQUES

- ▶ **[Grantor Retained Annuity Trusts.** A grantor retained annuity trust (GRAT) is an irrevocable trust to which the business owner transfers shares in his business (typically Subchapter S stock or interests in an LLC or FLP), but retains the right to a fixed annuity (payable annually) for a stated term of years. At the end of the trust term, which must expire during the business owner's lifetime, the property remaining in the GRAT (i.e., the appreciation and income in excess of the annuity) will pass to the children active in the business. Only the value of the remainder interest (passing to the active children) is subject to gift tax. Thus, the larger the annuity, the longer the term, and the lower the IRS assumed interest rate, the smaller the gift. The catch is that, if the business owner fails to survive the term, the property in the GRAT will be included in his estate. The freezing occurs because the future appreciation and income on the business interest (in excess of the annuity) is removed from the business owner's estate. The business owner's estate is also reduced by the income and capital gains taxes he must pay on the GRAT income. In other words, the business owner is not taxed separately on the annuity payments, but instead is taxed on all of the capital gains and income incurred by the GRAT. The taxes paid by the business owner are effectively tax-free gifts to the remainder beneficiaries of the GRAT.]
- ▶ **Installment Sales to Grantor Trusts.** The business owner can sell shares in his business (typically Subchapter S stock or interests in an LLC or FLP) to a grantor trust for the benefit of the active children. A grantor trust is an irrevocable trust that is valid for estate tax purposes, but "defective" for income tax purposes. This means the business owner (as the grantor) is the owner of the trust for income-tax purposes. Since the business interests are sold to the grantor trust, there are no gift taxes. Moreover, there are no capital gains taxes to the business owner because sales between a grantor and a grantor trust are disregarded for income tax purposes. The terms of the sale are usually zero down with annual interest payments at the lowest rate permitted by the IRS and a balloon payment in nine years. This technique is similar to a GRAT, but without the mortality risk. The freezing occurs because the future

appreciation and income on the business interest (in excess of the interest rate) are outside the business owner's estate. The business owner's estate is also reduced by the income and capital gains taxes he must pay on the trust's income. In other words, the business owner is not taxed separately on the interest payments, but instead is taxed on all of the capital gains and income realized by the trust. The taxes paid by the business owner are effectively tax-free gifts to the beneficiaries of the trust. Finally, the installment note from the grantor trust can be in the form of a SCIN [or a private annuity] (see page 5).

STATUTORY RELIEF

- ▶ **IRC Section 303 Stock Redemption.** Generally, the redemption of stock in a closely held corporation is taxed as a dividend. IRC Section 303 makes an exception to the general rule for sales by an estate or heir (to the extent of the estate tax). This exception results in the taxation of the gain on the sale at capital gains rates. Since the stock receives a new basis equal to its value on the date of death, the estate or heir will recognize no gain on the sale. In order to qualify for IRC Section 303 treatment, the stock to be redeemed must be included in the deceased shareholder's estate and the value of the stock must exceed 35% of the deceased shareholder's adjusted gross estate. The primary benefit of IRC Section 303 is to permit the tax-free use of a closely held corporation's cash to pay a deceased shareholder's estate tax.
- ▶ **IRC Section 6166.** Generally, the federal estate tax is due and payable in cash within nine months of death. IRC Section 6166 provides a way for estates of closely held business owners to spread out estate tax payments. If the value of the closely held business is more than 35% of the business owner's adjusted gross estate, then the estate taxes attributable to the business interest may be deferred for four years, during which only interest on the tax is due. Thereafter, a maximum period of 10 years, over which annual payments of principal and interest must be made, is allowed. However, the number of qualifications and restrictions (including security requirements) that must be met in order to defer estate taxes under IRC Section 6166 often relegates its use to a planning technique of last resort.

LIFE INSURANCE APPLICATIONS

Life insurance often plays an important role in a business succession plan. Following are some of the common ways that life insurance can be integrated with many of the tools, techniques, and strategies discussed in this report.

- ▶ **Estate Liquidity.** Some business owners will wait until death to transfer all or most of their business interests to one or more of their children. If the business owner has a taxable estate, life insurance can provide the children receiving the business with the cash necessary for them to pay estate taxes. Using life insurance to pay estate taxes is particularly useful to business owners because business interests cannot be readily liquidated. Life insurance is also a much easier (and less expensive) alternative to deferring estate taxes under IRC Section 6166. The children receiving the business may also need life insurance to pay estate taxes at their deaths. Typically, the insurance policy will be owned by an irrevocable life insurance trust so that the beneficiaries will receive the death proceeds both income and estate tax-free.
- ▶ **Estate Equalization.** A business owner can use life insurance to provide those children who are not involved in the business with equitable treatment. Leaving the business to the active children and life insurance to the inactive children equalizes the inheritances among all of the children. It also avoids the need for the active children to purchase the interests of the inactive children—perhaps at a time when the business may be unable to afford it. Depending on the particular facts and circumstances, the insurance may be owned by an irrevocable trust for the benefit of the inactive children, and the insured(s) may be the business owner or the business owner and his spouse.

- ▶ **Buy-Sell Agreements.** As mentioned previously, a properly designed buy-sell agreement can guarantee a market and fair price for a deceased, disabled, or withdrawing owner's business interest, ensure control over the business by the surviving or remaining owners, and set the value of the business interest for estate-tax purposes. Life insurance is the best way to provide the cash necessary for the business or the surviving owners to purchase a deceased owner's interest. In many instances, the cash surrender value in a life insurance policy can also be used tax-free (by surrendering to basis and borrowing the excess) to help pay for a lifetime purchase of a business owner's interest.
- ▶ **Nonqualified Deferred Compensation Plans.** A nonqualified deferred compensation ("NQDC") plan can be used by a small business to provide members of the senior generation with death, disability, and/or retirement benefits. An NQDC plan may be particularly useful in those situations where the senior members have transitioned the business to the junior members and are no longer receiving any compensation from the business. An NQDC plan is also useful to ensure that key employees remain with the business during the transition period—a so-called golden handcuff. Because life insurance offers tax-deferred cash value growth and tax-free death benefits, it is the most popular vehicle for funding NQDC plan liabilities.
- ▶ **Key Person Insurance.** Many family businesses depend on nonfamily employees for the company's continued success. To guard against financial loss due to the absence of an indispensable key employee, many companies take out key person life insurance, disability insurance, or both.
- ▶ **Section 303 Redemptions.** As discussed previously, IRC Section 303 allows the estate of a business owner to remove cash from a corporation with no tax cost. To ensure that the corporation has sufficient funds with which to accomplish the Section 303 redemption, the corporation can purchase a life insurance policy on the shareholder's life.
- ▶ **Hedge Strategy.** Life insurance can also be used to provide a "hedge" against the business owner's premature death in several of the techniques described in this report. [For example, if the business owner established a grantor retained annuity trust and died before the end of the set term, the life insurance could be used to pay the estate taxes on the GRAT assets that would be included in the business owner's estate.] [In addition, if a sale with a private annuity is used, life insurance could provide funds for the business owner's spouse (and/or other family members), since the annuity payments would terminate on the business owner's death.] Similarly, life insurance could provide funds for the business owner's spouse and other family members should he die prematurely after using a self-canceling installment note to sell the business interest. In all of these situations, it is advisable to have the life insurance owned by an irrevocable trust so that the insurance proceeds will escape estate taxes.
- ▶ **Family Bank.** When the decision is made to leave the business to both active and inactive children, it is usually advisable to leave the active children with voting interests and the inactive children with nonvoting interests in the business. In addition, put and call options should be given. Generally, a put option given to the inactive children allows them to require the active children (or the business itself) to purchase all or a portion of their interest in the business at a set price and terms. Without a put option, there may be no practical way for an inactive child to benefit from owning the business interest unless and until the business is sold. Conversely, a call option given to the active children (or the business itself) allows them to purchase the business interests of the inactive children upon a set price and terms. Without a call option, there may be no effective way for the active children to avoid the potential conflicts that can occur between the active children who are receiving salaries and bonuses and the inactive children who are not. By having the active children own life insurance on the business owner's life, a "bank" is created to provide the funds to satisfy any such puts and calls. Typically, the policy will be owned outside of the business entity, such as in a trust for the benefit of the active children or by a limited liability company owned by the active children.

SUMMARY

Succession planning is critical to ensuring the continuation of any family-owned business, particularly if the owner plans to retire in 10 years or less. An effectively developed succession plan provides for a smooth transition in **management** and **ownership**, with a minimum of **transfer taxes**. Given the number and complexity of succession options available, effective succession planning requires time, the assistance of outside advisors, the input of family members, and the willingness to address interpersonal conflicts that can arise during the planning process. Once completed, the succession plan may provide confidence for the business owner and key employees, personal satisfaction for family members, and new opportunities for the business itself.

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Julius H. Giarmarco, Esq. is a partner in the Troy, Michigan, law firm of Giarmarco, P.C., where he is chair of the firm's Trusts and Estates Practice Group. Julius received his law degree (J.D.) from Wayne State University and his master of laws (LL.M.) from New York University. His primary practice areas include estate planning, business succession planning, wealth transfer planning, and life insurance applications. Julius is a former instructor in both the Chartered Life Underwriter (CLU®) and Certified Financial Planner (CFP®) programs. He also lectures frequently on a national basis, including speeches before the American Law Institute - American Bar Association (ALI-ABA), the International Forum, the Association for Advanced Life Underwriting (AALU), the Million Dollar Round Table (MDRT), the Financial Planning Association, and numerous life insurance companies, brokerage firms, and trade associations. Julius has published a number of articles on estate planning appearing in professional journals, such as the Estates, Gifts and Trusts Journal (BNA), The Practical Tax Lawyer (ALI-ABA), the Journal of Practical Estate Planning (CCH), the Michigan Bar Journal, and Advisor Today magazine. Julius is a featured columnist on estate planning topics for producersweb.com. He is the author of the chapters on succession planning in Advising Closely Held Businesses in Michigan and The Michigan Business Formbook, published by the Institute of Continuing Legal Education (ICLE). Julius has also been selected by his peers as a Michigan "Super Lawyer" in estate planning, as one of the "Best Lawyers in America" in Trusts and Estates, and as a "Top Lawyer" by dbusiness magazine.

FAMILY BUSINESS SUCCESSION PLANNING PYRAMID

Life insurance applications;
estate liquidity; estate equalization;
funding buy-sell agreements; etc.

Minimizing gift and estate
taxes in transferring the business

Transferring the business to next
generation; treating inactive children fairly

Attracting and retaining non-family key
employees to assist in the succession plan

Selecting and transitioning to the succession managers

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Great Model Questions To Ask Business Owners

Business Continuation and Transfer:

- Do you have a business will (buy-sell agreement)?
- If you got sick or hurt or died, who would keep the business running?
- Do you have an exit strategy, or do you plan to work until you die?
- Do you have a written business succession plan to cover the possibilities of your retirement, death or disability? (If yes, ask to review the plan as it is may be inadequately funded)
- Do you have a plan in place whereby the taxes will be paid for your estate rather than from your estate?
- If one of your partners should die, would you want the surviving spouse to have a voice in the management of your business?
- If one of your partners should die, what would you want to do about the business rights of the surviving spouse? Take that person into the business or buy them out?

Ask these together...

- What do you want to happen to your business when you die?
- What do you want to happen to the business when a co-owner/partner dies?
- Do you think your co-owners/partners want the same sort of things to happen?
- Have you considered the practical, legal, and financial roadblocks that might prevent this from happening when one of you dies?
- Did you know that your business might live only as long as you do, unless special arrangements are made before your death? How do you feel about that?
- Have you made a provision in your will for disposition of this valuable business when you die?
- Does your will authorize anyone to open the doors of your business tomorrow if you should die tonight?
- Who would you want to take over your business if you should die tonight? (Wait for response) Why this person? Is there anyone else? Would anyone be upset with this? Have you made any plans?
- Have you ever considered the possibility that your business might die with you? (Wait for response) What would that mean to your family and your business partners?
- Would you be interested in a way to make your business worth as much after your death as it is today?
- If you wanted to buy out your competitor, do you have an idea what it would cost? Are you aware that his business could be available at half price if your competitor were to die tonight?
- Do you want your family to keep your business going after you die? Why do you feel that way?

Great Model Questions To Ask Business Owners

- Is any member of your family completely willing and as capable as you to run this business?
- If you had died last night, would it make more sense for a member of your family to run this business or for your family to sell it to your employees or competitors?
- If one of your associates should die, would you and your surviving partners be certain of future control of the company?
- If anything happens to you, could your spouse devote full time to the business?
- Would you like to know what your competitors and other business owners are doing about the problems we've been discussing?

Key Person Retention and Protection:

- Who beside yourself is responsible for profits of your business?
- If they were to get sick or hurt or died, what impact would this have on your business success?
- If they were recruited away, what impact would this have on your success?
- Do you have a plan in place to protect your profits in the event you lose a key employee?
- Do you have a "golden handcuffs" plan in effect to reward those key employees who have helped your business grow by providing additional incentives for them to stay?
- Do you have insurance on any of the key profit makers...to help make up for lost profits and added costs you will have if one dies or becomes disabled?
- Has your CPA ever talked with you about the consequences of your death – or another key person's death – or the consequence of disability on the financial viability of the business?
- Do you think your employees would look for other jobs if you had died last night, or would they wait to see what would happen to your business?
- Whom have you trained to run the business after your death, disability or retirement?

Competitive Qualified Retirement Plans:

- Do you have a SIMPLE/401k or other type of plan in place?
- Are you satisfied with the service, reporting, investment options and returns on the investments inside these plans?
- Have you reviewed new types of plans for greater contributions to owners and key people?

Great Model Questions To Ask Business Owners

- Do you have a business-sponsored tax-deductible retirement plan? Are you satisfied with the number of dollars going into the plan for you personally (compared to the amount for employees)?

Executive Bonus/Deferred Compensation Plans:

- Would you like to use your corporate checkbook to pay for personal benefits?
- Are you paying taxes on money you are not using today?
- Are your highly compensated employees (owners) being discriminated against in your qualified plan (limited in the amount they can contribute)?
- Would you like to set up a “selective bonus” plan that is not subject to tax law nondiscrimination rules?

Others

Physical print out of Language - For Internal Use Only.

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FACT FINDER**Business Continuation Supplement**

If you have multiple businesses, complete for each business. Please also complete the Confidential Business Fact Finder (0185400).

1**BUSINESS VALUATION**

Date of last formal business valuation: _____

Fair Market Value (FMV) as of date of valuation: _____

Net Earnings (before taxes) for last five years:

Current year: N/A Prior year 1: _____ Prior year 2: _____ Prior year 3: _____ Prior year 4: _____

2**BUY-SELL INFORMATION**Is a buy-sell agreement in place? ☐ Yes ☐ No Date agreement was implemented or last updated: _____If yes, specify type: ☐ Entity Agreement ☐ Cross Purchase ☐ Wait-and-See

1. Describe your business succession objectives and the steps you have taken to accomplish these objectives. _____

2. How much longer do you want to work in the business? _____

3. What is the annual after-tax income that you want during retirement? _____

4. Who do you want as successor owner(s) of your business interest (e.g., third party, selected employees, ESOP, family members)?
Please explain: _____

5. If you want your business interest transferred to your family, answer the following questions:

a. Do you have any children who are active (employed) in the business and some who are not? _____

Who will be active? _____

Who will decide which children will be active? _____

b. Do you have plans to give an inheritance to the inactive children? _____

If the plan is to give inactive children "fair value," how will that be determined? Please explain: _____

c. If inactive children are to own an interest in the business, what rights to income and liquidity should they have relative to the active owners? Please explain: _____

Continued on next page.

6. Describe how (sale, gift, inheritance, etc.) and when you want to begin to transfer ownership of your business interest. If applicable, at what point would you be willing to give up control?

7. Do you have management people in place who can run the business in your absence? Explain:

3

FUNDING INFORMATION

1. Is a funding mechanism in place? ☐ Yes, life insurance ☐ Yes, disability insurance ☐ Yes, other than insurance ☐ No

If "Yes, other than insurance," describe the financing arrangement: _____

If "Yes, life insurance" and/or "Yes, disability insurance," list the following information:

Insured	Owner	Premium Payer	Beneficiary	Face Amount Policy Type Annual Premium

2. What safeguards are in place, or would be desirable, to protect your interest during the transition of your business interest (i.e., in the event of death, disability, bankruptcy, or transfer to a successor)? Please explain:

3. Have you worked out a plan so that estate or other taxes will not interfere with your plans for business continuation or family "equity"? Please explain:

Investment and Insurance Products:

Not Insured by FDIC, NCUSIF, or Any Federal Government Agency.
May Lose Value. Not a Deposit or Guaranteed by Any Bank, Credit Union, Bank Affiliate, or Credit Union Affiliate.

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Advanced Markets

Key Person producer guide

looking to protect your business clients' most valued assets?



**business-owned
life insurance**

Life Insurance: • Is Not a Deposit of Any Bank • Is Not FDIC
Insured • Is Not Insured by Any Federal Government Agency • Is Not
Guaranteed by Any Bank or Savings Association • May Go Down in Value

For Financial Professional Use Only. Not for Use with, or Distribution to, the General Public.



Key Person protection

Just as every family has a breadwinner — businesses have key individuals whose management role, special talents or revenue-generating ability are critical to a business's success.

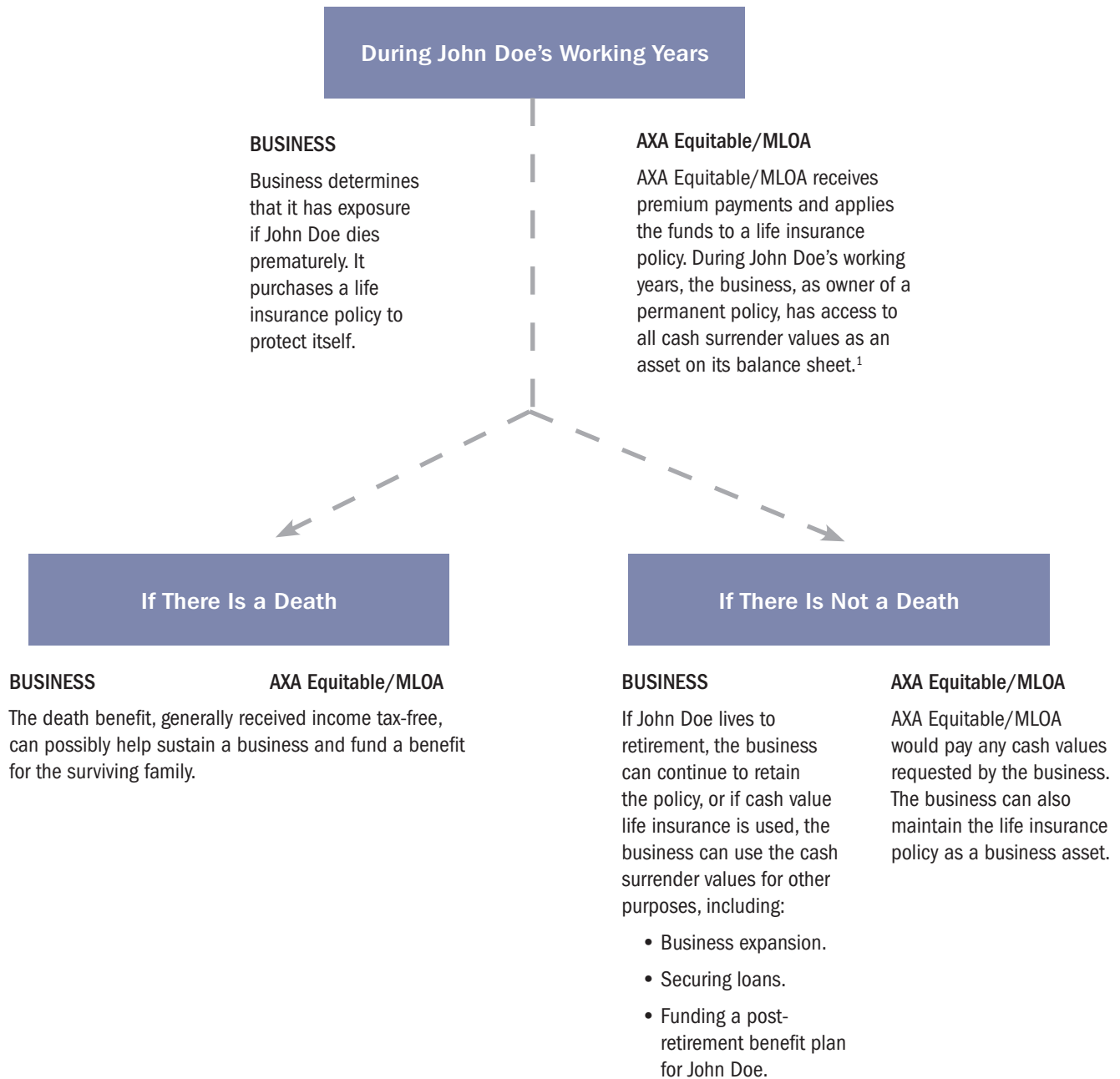
Life insurance is often used to protect surviving families. In a business setting, life insurance can also protect the business and its employees after the death of a Key Person.

In the case of a death, the life insurance proceeds can help offset:

- Declines in sales revenue
- Losses of key clients
- Losses of special talents
- Costs associated with hiring a replacement
- Issues with credit and loans
- Stay Bonus payments to selected executives and employees

The life insurance death proceeds can help tide a business over as it recovers from an unexpected loss, and also provide revenue to help recruit, relocate and train a replacement. Inside this Producer's Guide you will find a hypothetical Classic Case, profiles of ideal business clients and questions you should ask your clients, as well as questions your clients will most likely ask you.

typical Key Person arrangement



¹ Loans and withdrawals reduce the policy's cash surrender value and death benefit, and increase the chance a policy may lapse. The client may need to increase premiums in later years to keep the policy from lapsing.

life insurance and Key Person protection

Classic Cases

Let's look at two successful manufacturing firms, both with long-term track records, loyal clients and widely regarded products. Both were dependent on a successful key sales representative. Peter worked with **Acme, Inc.** for over 10 years and increased sales each year with the firm. Paul worked at **Cogswell Cogs** for nearly as long and with an equally successful record. Ironically, both firms lost their Key People within weeks of each other. Three years later, Acme is still struggling from the loss, while Cogswell is doing as well as ever. Why did one firm falter while the other succeeded?

Acme, Inc.

Acme was caught off guard when it lost its key salesperson, Peter. He had strong relationships with many of Acme's key accounts, and its other sales reps were not skilled in handling larger high-volume accounts.



Moreover, Acme did not have funds on hand to recruit and hire a replacement. Instead, it struggled with the existing sales staff who were not prepared to handle Peter's former accounts. As a result, Acme found that there was reduced attention to both the key accounts and its reps' regular accounts. The result – profits fell.

Acme was ready to introduce a new product line and counted on Peter's relationships to help meet sales numbers. Although the accounts stayed with Acme, reduced attention cost it sales from both its existing lines and from the new lines. Acme missed Peter's close focused attention on the launch and follow-up training. Without him, the sales figures from the new products were a fraction of what Acme hoped to receive from these accounts.

As profits fell, Acme faced difficult issues. Creditors became skeptical of future sales, and one credit line was called. In the face of reduced revenue, Acme struggled to meet its day-to-day expenses. It was forced to cut staff and drop a planned expansion.

Three years after it unexpectedly lost Peter, Acme is still coping with the loss.

Cogswell Cogs

Cogswell also suffered when it lost Paul. He had recently signed on its largest account. The relationship was still new when Paul died, and Cogswell was concerned if it could keep the new account. Paul also worked with two additional accounts that brought in 15% of the company's other revenue.



However, Cogswell held a \$1,000,000 "Key Person" policy on Paul's life. The death benefit from that policy provided Cogswell with the funds it needed at a critical time. The life insurance death benefit was allocated in a manner that helped tide the business over and also expand.

- **\$125,000** — was used to recruit, offer a significant sign-on bonus and to relocate a new sales representative, Jeff, who was highly regarded by both the new account and one of Paul's existing accounts. This allowed Cogswell to maintain its critical accounts.
- **\$10,000** — was allocated to special training to help Jeff get up to speed more quickly than an average new recruit. This included training and meetings with Cogswell's key customers.
- **\$200,000** — was posted as collateral to help keep one of its creditors from raising the rate on a credit line.
- **\$250,000** — was paid to Paul's widow as a special bonus for his years of service.
- **\$415,000** — was held in reserve by Cogswell as a cushion against any possible dips in revenue.

Three years after its unexpected loss, Cogswell is as strong as ever.

This information is for illustrative purposes only. Please evaluate your clients' situation carefully before recommending any financial strategy.

important note:

Promoters of certain benefit plans may advocate these programs as allowing deductible life insurance premiums as funding for the promised benefits. Some of these plans might contend that they can offer the business life insurance benefits for certain business purposes on a deductible basis. Clients should approach these plans with caution. As attractive as the deductions may be, clients will find that these programs can be complex, expensive and carry risks, including the possible loss of the tax deductions.

Ideal Client

Any successful business should consider Key Person protection. However, look to these businesses as those likely to need coverage:

- **Strong Entrepreneurial Owners** — Often a business is dependent on its owner or founder. While the loss of this person will be substantial, businesses frequently will continue in the hands of co-owners, heirs or employees. However, such a loss might trigger credit and cash flow issues, licensing issues (in the case of businesses depending on state contracts or professional skills), or management issues. The death proceeds from life insurance can provide the funds to help tide the business over until it can right itself.
- **Key Sales Personnel or Managers** — The loss of key sales personnel can trigger a loss of revenue or clients. In the case of managers, critical projects or divisions may lose direction. The death proceeds will provide cash until a business can replace these individuals and possibly help recruit a replacement.
- **Businesses That Hire Skilled Professionals** — These individuals have special skills, clients or practices. The loss of these individuals will result in reduced business income until their expertise or niche practice can be replaced. Examples include: physicians, attorneys, architects or engineers, skilled artisans or writers, real estate brokers or business managers with select clients.
- **Businesses That Run Specialty Products or Services** — When a business is dependent on a special skill, line or product, or offers services that are key to its operations, the loss of its Key Persons will result in reduced income or trigger credit issues until operations can return to normal.

All these businesses could suffer a loss until these key individuals can be replaced. Replacing them will take time locating, recruiting and grooming a replacement either to take over the role, or carve out a role of his or her own. The death proceeds from life insurance will provide a business with the necessary cash to stem business losses during this replacement period.

consider our Long-Term Care ServicesSM Rider*

In addition to death, the loss of the services of a Key Person due to impaired health can be just as devastating to a business. The addition of a long-term care rider on a life insurance policy, may offer an appropriate solution, making cash available to the business via an acceleration of the death benefit, if there is a long-term care event. This allows the business to move ahead with its plans, without waiting for a death to occur.

* The Long-Term Care ServicesSM Rider is available for an additional cost and does have restrictions and limitations. Be sure to review the product specifications for details.

questions to ask clients

Who Are the Most Critical Employees or Consultants to Your Business?

Virtually no businesses exist without at least one Key Person. Often it is a founder. Frequently, the business has other key employees that fit the profile. In many cases, you may know the business operations well enough so that you have already identified some key individuals; however, be prepared to ask your business clients:

- Do you have someone with special skills or client relationships?
- Do you have someone with specialized product, information technology (IT) or other expertise?
- If your business is a professional firm (physicians, attorneys, etc.), is someone central to an area in which your firm specializes, such as energy law, cardiology, etc.?

What Are Your Plans in the Event You Lose That Person?

Expect that many companies will not have a plan. In many cases, they will try to suffer through the loss and may not have considered that life insurance can help stabilize their businesses. AXA has several marketing pieces, including client-facing pieces, that emphasize the need for Key Person protection and the impact losing a Key Person can have on a business.

Be Prepared to Ask Your Clients Questions about Their Financials.

Valuing a Key Person can be a simple process. Sometimes a company may have a “ballpark” sense as to the amount it would need to spend to replace such a person. More often, you will need to work with a business’s CPA or financial officer to gather pieces of information that can be used in valuing the potential loss to the company. Also, work with your underwriters to determine what might be an acceptable death benefit or what items might need to be documented to underwrite higher face amounts. Use AXA’s Key Person Underwriting in a Nutshell to help you package your case for underwriting.

If Your Clients Say They Have a Business Continuation Plan — Examine the Plan.

This may lead to planning that you can do in the event a Key Person dies. Very often the basic business continuation plans may be underfunded or out of date. From a Key Person perspective, the successor owner may rotate into a control position from elsewhere in the company. Even though the current control position may be covered, your clients may need to fill a different key slot. They may need to fill the role of the person moving into the control position. You will want to be certain that your clients’ Key Person coverage is coordinated with their business continuation plans. Often the business may want to purchase additional insurance as part of the business continuation plan to help facilitate some Key Person coverage or implement a Stay Bonus for key affected employees. See AXA’s Stay Bonus brochure.

recordkeeping required

For tax years after November 13, 2007, IRS guidelines for EOLI include a requirement that employers file an annual report with their tax return, using IRS Form 8925, identifying any life insurance that they own on the lives of their employees that was purchased or subject to a material change after August 17, 2006. Information requested includes the number of employees insured, the amount of life insurance, and whether they have received valid consent from their employers.⁴

Tax Consequences of Key Person Life Insurance

- Premium payments are not deductible as a business expense.
- Cash Surrender Value, an amount up to the business's basis, may be withdrawn from the policy, generally income tax-free,² as long as the policy is not an MEC.³
- Policy loans in excess of basis may be taken without triggering income tax, as long as the policy is not an MEC.
- Upon surrender, any gain on the contract is subject to income tax as ordinary income.

Preserving the tax-free benefit Special EOLI Guidelines

A major attribute of Key Person Insurance is that, properly arranged, the death benefit paid to the business is received income tax-free. Current Internal Revenue Code provisions⁵ contain special guidelines and requirements for employer-owned life insurance, including Key Person coverage. Among these requirements is receiving and maintaining a record of written consent from employees prior to new life insurance coverage. Detailed information and assistance in addressing the special EOLI rules is available with AXA's educational and support materials for EOLI. One important aspect for employers is obtaining the written "Notice and Consent" from the insured employee prior to policy issue. AXA has developed sample notice and consent forms for use by our clients.



² The Tax Reform Act of 1986 makes certain withdrawals during a policy's first 15 years partially taxable.

³ For Modified Endowment Contracts (MECs), withdrawals from or loans against policy gains are considered income, and may be subject to a 10% federal income tax penalty. Loans and withdrawals reduce the policy's account value and death benefit, and increase the chance that the policy may lapse. The client may need to increase premiums in later years to keep the policies from lapsing.

⁴ IRC Section 6039i.

⁵ IRC 101(j) is effective for employer cases issued or subject to a material change after August 17, 2006.

frequently asked questions from clients

Why Life Insurance?

Life insurance offers many planning opportunities, but its most fundamental objective is to provide a death benefit to individuals when they need it most — after the death of a Key Person.

Some businesses may elect to self-finance (set up a sinking fund) to protect themselves against a loss. They need to weigh what they will do if the loss occurs before they can accumulate sufficient funds. Some businesses may believe that they can borrow their way out of such a loss, but few might be able to obtain favorable terms when lenders see the business is vulnerable after the death of a key individual.

Why Permanent Life Insurance?

This is a balancing act for some business clients. Some clients will like and want the lower cost of term insurance. Although term may be an easier sale, many clients should look at permanent life insurance as it can provide the business with certain advantages:

- It builds cash value each year and this becomes a business asset. At some point, the cash value growth may outpace the cost of the premiums;
- The cash value can provide the business with a source of revenue;⁶ and
- In the event a Key Person does **not** die, the policy can be used by the business for other purposes, including expansion, benefits for key executives or collateral for loans.
- The Key Person plan can be structured to also offer a “golden handcuff” benefit program for select key employees or their families.

Only life insurance can provide a specified amount at the time most needed and shift the risk from businesses to life insurance carriers.

important note:

The business might also choose to self-fund. However, it always runs the risk that the Key Person need will appear before the funding is completed. Life insurance partially shifts the risk away from the company, and it may be less expensive. For example, a business looking to self-insure a 45-year-old against a \$1,000,000 loss would need to set aside \$30,504 per year if it hoped to receive a hypothetical 4.5% after-tax rate of return. After 20 years (when the individual is age 65), the business would have accrued \$1,000,000 based on these assumptions. That is a total expense over 20 years of \$610,070, but the business has assumed all the risk of loss.

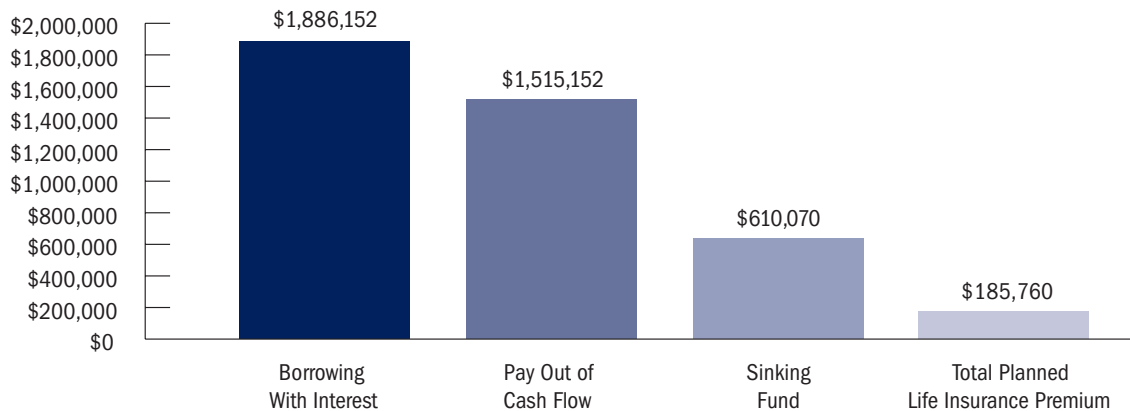
Using life insurance, in some situations, allows a business to accomplish the same goal at a fraction of the cost. See the example on the next page.

⁶ If properly handled, cash values can generally be accessed income tax-free through loans and withdrawals. However, loans and withdrawals will reduce net cash values and death benefits. Excessive loans and withdrawals may cause a policy to fail to maintain its status as life insurance and may trigger inadvertent income taxation.

How Can I Fund Key Person Coverage?

The chart below illustrates a hypothetical comparison of the key alternatives. This shows what costs a client might incur under each method when addressing a \$1,000,000 Key Person need.

Ways to Fund a \$1,000,000 Key Person Need



The policy premium and death benefit amounts used for this case are intended only to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy of this type and size for the insured's good health and the ages noted in the example. To determine how this approach might work for your client, individual illustrations based on their own individual age and underwriting class, containing both guaranteed charges and guaranteed interest rates as well as other important information, should be prepared or requested for their review.

Borrowing: \$1,886,152 — A business that expects to borrow to meet its Key Person needs risks being denied the financing, since the loan would occur at a time when the business and its management team are under stress. The value presented here is what a business would pay by way of interest and principal if it could receive a 20-year loan at an 8% hypothetical loan rate.

Funding Out of Cash Flow: \$1,515,152 — This is what a business, in a 34% overall average tax bracket, will need to net (after expenses) to meet its Key Person need.

Sinking Fund: \$610,070 — This is what a business would need to set aside each year, between an employee's age 45 and 65, to amass the same amount a \$1,000,000 policy will provide. This assumes an annual contribution of \$30,504 and an after-tax growth rate of 4.5%.

Life Insurance: \$185,760 — This represents the cumulative premiums a business might pay over a 20-year period for a hypothetical universal life insurance policy on a 45-year-old, non-smoking male with a preferred underwriting class.

All these numbers are based on after-tax and after-expense earnings. Depending on a business's tax bracket and expenses against gross income, even more will need to be brought into the company. All these costs will come at a time following the stress of losing a Key Person. For example, a business in a 34% tax bracket would need to bring in \$1,515,152 before taxes if it hoped to net \$1,000,000.

How Can I Value a Key Person?

There are many approaches to valuing a Key Person. These can range from:

- **Multiple of Salary** — The easiest of all approaches is based on a multiple of the Key Person's salary and assumes that this will cover the approximate loss of a Key Person. Although it does not calculate any specific financial loss, it is easy to calculate. A general rule of thumb is ten times salary, with adjustments for the Insured's role and age. This approach is the one most frequently used by Underwriting.
- **Cost to Replace the Key Person's Contributions to Income or Earnings** — This method examines gross sales that would be lost and then matches those sales to estimates of sales that would be generated by a replacement. The difference is then present-valued. Additional adjustments may be made for the costs associated with searching for a replacement, hiring, relocation and training costs.
- **Cost to Replace the Key Person's Sales Profits** — If the Key Person was not at your client's company, his or her contributions to its profits would be lost. This method examines those lost profits and then estimates the profits that might be generated by a replacement over a period of time. The difference, the lost profits, are present-valued to determine the value of the Key Person.
- **Capitalization of Excess Earnings** — Excess earnings are earnings over what the owner's equity would earn in an ordinary investment. Where the Key Person has a direct impact on earnings, the loss of a Key Person could result in a loss of excess earnings. This method is generally used for upper managers who are part of the strategic decision-making team.
- **Cost to Replace Experience** — Where a Key Person has special duties or valuable experience, the cost to replace those skills and/or experience is quantified.

Typical costs would be the cost of searching for a replacement, hiring, relocation and training costs.

- **Loss of Value to the Business** — This approach is based on determining the percentage of the business value that is tied to the Key Person. If that person were to leave the business, you believe the business would decline in value by that percentage or amount. This method is more commonly used when the loss of the Key Person would result in a market value drop of 20% or more. For example, if the Key Person were a company's only salesperson who had a very good rapport with the company's clients, his or her loss could cause a drop in revenue of 20% or more. Loss of a founder still running the business could be even higher.
- **Known Key Person Value** — This is determined by the business owner's perception of the key employee's worth. This is the most subjective of all methods. Where it varies from other formulas or multiples it may be heavily scrutinized.

Businesses will sometimes use some or all of the approaches, taking an average of the methods to determine their Key Person needs. In other cases, they may focus on one approach as providing the targeted amount of life insurance protection.

Is This a Qualified Valuation?

No. A qualified valuation can be done only by a licensed valuation expert. However, many professionals may be able to offer valuation estimates as a service to clients to help them in their planning. Moreover, for Key Person purposes, a qualified valuation may not be necessary. Instead, this is to help peg a value to a Key Person, as opposed to a value for tax or audit purposes. Some business clients might defer to their CPAs; some may defer to their attorneys or other financial advisors. In all cases, clients should consult with their legal and tax advisors.

I Have a Specialized Business. Do the Same Rules Apply to My Business as to Every Other Business?

No. Every business has certain idiosyncrasies that call for its valuation to vary from other businesses. For example, with professional practices, certain adjustments might need to be made because of the nature of the practice, the types of services performed, and whether or not the client base is steady or not. An example of this might be seen in comparing a dental practice, with a regular client base, to that of a surgeon, whose clients will rarely visit on a regular basis.

Certain adjustments might be made when there is a need for professional licensing or other government approvals. For example, this might be important for medical practices where a Key Person holds specialized skills and has passed certain medical boards. Similarly, certain businesses might hold government contracts based on the skills of certain individuals.

Finally, the valuation report relies on many financial items from a business. You will want to work closely with the business's financial advisors. Keep in mind, some adjustments might need to be made for accounting purposes. For example, if a business is a cash-basis taxpayer, where income and expenses are deducted as incurred, you might wish to adjust the business income and expenses to more accurately reflect when the services for the income were performed or the expensed items actually utilized.

What Do I Do with the Policy If the Employee Leaves?

Life insurance is a valuable asset for the business. Many companies will elect to maintain the policy beyond the Key Person need. They can retain the death benefit for other business planning purposes.

Alternatively, the policy could be cashed in, with its after-tax values used for other business purposes. Some businesses may use the policy values to back an executive benefit retirement plan for the key employee or his or her family. Other businesses might transfer the policy to the departing Key Person.

I Am a Sole Proprietor. Do I Need Key Person Protection?

Possibly. All types of businesses need protection. This is true of C Corporations, S Corporations, LLCs and Partnerships. Emphasize to sole proprietors that they may still need Key Person protection. The only difference is that they, their families or an irrevocable trust — but not the business — would own this life insurance. What would this insurance do?

- Protect their surviving families
- May offer creditor protection to pay loans transferred to the families
- Protect these clients against the loss of Key Personnel they employ

What Is the Importance of an Annual Review?

Your client's business is constantly evolving. As a result, it is of utmost importance to make certain that adequate life insurance coverage is in place on each Key Person in the firm. This can best be done by conducting a comprehensive annual review to make certain that the coverage in place corresponds with the business's needs.



Backed by the strength of AXA

Have confidence in the insurance company that you choose — with financial strength to fulfill its duty to you, now and in the future. AXA Equitable Life Insurance Company (AXA Equitable, New York, NY), which enjoys an illustrious 150-year history, and MONY Life Insurance Company of America (MLOA) have a shared tradition of helping their customers reach their most important goals. All guarantees are based solely on the claims-paying ability of the issuing company — either AXA Equitable or MLOA.

For more information, please call the AXA Life Sales Desk or visit www.axaforlife.com.

All guarantees are based on the claims-paying ability of the issuing insurance company, either AXA Equitable Life Insurance Company or MONY Life Insurance Company of America, an Arizona Stock Corporation with its main administrative office in Jersey City, NJ. Life insurance products are issued by AXA Equitable Life Insurance Company or MONY Life Insurance Company of America (MLOA), and Variable Life is co-distributed through AXA Advisors, LLC and AXA Distributors, LLC, members FINRA. Fixed life products are co-distributed by AXA Network, LLC and its subsidiaries and AXA Distributors, LLC. AXA Equitable, MLOA, AXA Advisors, AXA Network and AXA Distributors are affiliated companies and do not provide tax or legal advice. You should remind your clients to seek assistance from their tax and legal professionals before implementing the complex financial strategies mentioned here.

Life insurance is medically underwritten, so all candidates should be in reasonably good health. Your clients should not cancel their current coverage until their new coverage is in force. Surrender charges may be due on an exchange of one contract for another. A change in policy may require an examination. Surrenders may be taxable. Your clients should consult their own tax advisors regarding tax liability on surrenders.

Important Notice: The foregoing discussion involves complex tax and legal issues. This discussion is not a legal opinion; it is only meant to provide guidance. Any decisions about whether to implement these ideas should be made by the client in consultation with professional tax and legal counsel.

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Cat. #137915 (3/18)



Advanced Markets

Underwriting Uncovered



tips on preparing your cases for financial underwriting

Key Person

Business clients may sustain substantial economic loss upon the death of a key person whether it is an owner, partner, or non-owner employee. Generally, these individuals have specialized talents, skills, or unique experience critical to business operations. Businesses need a source of funds for protection in the event of such a key person loss. Key person life insurance provides a business with the liquidity it needs upon the death of a key person along with flexibility in funding and access to cash surrender values.

Knowing in advance what AXA Equitable/MLOA requires when underwriting a key person case allows financial professionals to proactively approach businesses with an appropriate strategy.

key person cases should include a cover letter that describes:

- who is covered, including details on the role as a key contributor and annual compensation
- the formula for determining the coverage amount
- what, if any, valuation approaches were used aside from multiple of salary
- type of business, years in operation

Multiple Considerations

See below for details on the general rule and considerations for a greater multiple or key person valuation.¹

Amount Qualified for Key Person ²		Sample Calculation
1. General Rule: Multiple of Salary A reasonable multiple of the key person's annual compensation (includes salary, commission, and bonus). Without other factors, this is often the default method.	Maximum 10 X Annual Compensation	John's annual compensation includes: Base salary \$100,000 Bonus \$20,000 Commission <u>\$30,000</u> Annual compensation \$150,000 Max coverage = \$150,000 X 10 = \$1,500,000
2. Higher Multiple or Valuation A greater valuation may be accepted where the Underwriter determines the supporting evidence justifies the amount.	See Table of Alternative Valuation Approaches below <ul style="list-style-type: none">• A track record of reasonable business success (i.e., sustained annual revenue growth)• Detail on the key person's specialized talents, skills, or unique experience	Key Person (KP) annual compensation is \$150,000. The business has been consistently growing for the past 5 years and KP is key to that growth with highly specialized experience in their niche technology market. Finding a replacement would be very expensive, and bringing that person to KP's level would take years. Given that KP is directly responsible for business growth and the additional replacement factors, they seek coverage of \$2,000,000, an amount \$500,000 in excess of the 10X income multiple. After review of the business and receipt of details on KP's experience, the \$2,000,000 was found to be justified.

There are a number of additional factors that may be considered in determining the potential key person loss. Note that businesses may need to provide financial data, including:

- Gross and net earnings for multiple accounting periods
- Key persons' salaries, bonuses and their contributions to accounts or business initiatives
- Evidence of loans requiring key person insurance to secure or partially back the loans
- Evidence of costs of recruiting if it was part of the calculation of the key persons' needs

Table of Alternative Valuation Approaches

Valuation Approach	Description
Multiple of Salary	The value of the key person is based on a multiple of earnings. This value can be determined with their earnings with or without any bonus. The multiple is generally between five and ten times compensation, depending on the years remaining until the key person's normal retirement date.
Cost to Replace Contributions of the Key Person	A key person contributes to the company's earnings each year. This valuation focuses on the replacement cost to recover the portion of lost earnings that would arise upon the key person's death.
Cost to Replace Lost Sales Profits	This method examines the potential loss of key person contributions to profits and estimates the profits that might be generated by a replacement over a period of time. The present value in today's dollars of the difference in profits determines the value of the key person. The estimated number of years the replacement will take to recover the lost profits would be selected.
Cost to Replace Experience	A key person may perform special duties in addition to his or her routine. With these special duties, the key employee brings valuable experience that the company would need to replace at his or her untimely death. The key person's annual salary in excess of the salary for routine duties represents compensation paid for that experience. The cost to replace this value presents a loss to the company.
Loss of Excess Earnings	Excess earnings are the earnings of the business over and above what the owner's equity would earn in an ordinary investment. The key person's compensation is divided by the total compensation of all key persons. The resulting percentage is applied to the excess earnings (pre-tax earnings minus the earnings attributable to management), and the outcome is offset by the contributions made by the key person replacement.
Loss of Value to the Business	The key person contributes to the success of the business. With this method, a percentage of the business value that is tied to the key person is assigned. If that person were to leave the business, the business anticipates a decline in value by that percentage or amount.

"EOLI" Rules

Note that Internal Revenue Code 101(j) provides special employer-owned life insurance ("EOLI") rules in order for an employer to receive an income-tax-free death benefit.³ Those rules include a requirement that the employer provide notice and obtain consent from the insured PRIOR to issue of the insurance policy. In addition, there are annual reporting and recordkeeping requirements. See AXA's "Important Information Regarding Employer-Owned Life Insurance" (Cat. #137310) and related support materials.



1 Note that AXA's Guaranteed Issue program for permanent, single life products has separate and specific face amount limits and participation requirements. Check with Underwriting for details.

2 The amount of creditor insurance is included in the total amount of coverage available on the life of a key person. Consult Life Underwriting Condensed Guide for Business Debt Repayment Financial Underwriting Requirements.

3 The law was enacted as part of the Pension Protection Act of 2006 and is effective for policies issued after August 17, 2006.

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Cat. #153013 (1/18)



Advanced Markets

**protect your business from the loss of
a key employee**



Key Person coverage

Life Insurance Products: • Are Not a Deposit of Any Bank • Are Not FDIC
Insured • Are Not Insured by Any Federal Government Agency • Are Not
Guaranteed by Any Bank or Savings Association • May Go Down in Value



what if your business lost a key employee?

You've worked hard to make your vision a reality. Your business is successful, thanks in part to at least one Key Person. It could be someone you depend on for leadership, support or important relationships. While you've made sure that your business is protected in case of theft or fire, have you thought about what would happen if you lost your key employee?

Now is the time to protect your business and make sure you're successful in the future, even if you lose that Key Person. AXA can help.

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Who is your Key Person?

Key employees are the ones who have special skills, experience or relationships. They are the ones whose absence would really hurt your business. Unless you plan ahead.

Your key employee(s) can be any of these people:

- You, your partners or co-owners.
- Your most valuable senior executives.
- Highly skilled technicians who make the business operate efficiently.
- Productive sales people who keep business coming in the door.
- Someone whose special skill set is imperative to the success of your business.
- The ones who maintain the best customer service relationships.
- An employee who drives one of your key business lines.

Designing Key Person coverage to meet your needs — and theirs

A Key Person protection program can help both you and your key employees, if designed properly.

For you, it can:

- Protect against the unexpected death of a Key Person by providing the funds needed to help sustain your business following the loss of a Key Person. Funds can be used to cover debts and operating expenses in the face of lost sales, or to recruit and hire a qualified replacement.
- Protect against the unexpected departure of a Key Person by acting as “golden handcuffs” to help keep key employees with your company.

For your Key Person(s), it can:

- Show them that you value their contribution to your business.
- Provide financial incentives for them to stay with your business as long as possible, instead of going elsewhere for a better offer.

What are “golden handcuffs”?

These arrangements offer a strategic benefit to the employee, as well as your business; the longer the key employee stays, the larger the financial reward.

- **Executive bonus plans** — Pay a bonus to the key employee, which is used to fund high cash value life insurance protection for the employee’s family.
- **Split-dollar life insurance** — The business and the key employee share the cost of a permanent life insurance policy, to benefit the employee’s family.
- **Non-qualified deferred compensation** — As a supplement to a standard qualified retirement plan, these types of plans can provide additional retirement income for key employees if they stay with the company until retirement.

A comprehensive and properly funded Key Person program using cash value life insurance can allow you to protect yourself against the death of a Key Person, and have the cash values available to fund a living, golden handcuff executive benefits program. AXA has a number of ways to help you select and present the most appropriate golden handcuff executive benefit plan, but let’s focus on protecting your business from the unexpected death of a Key Person.



Tying a dollar amount to your Key Person protection

One of the first things you'll need to do to put Key Person coverage in place is determine the costs associated with losing your Key Person. This includes funds needed to cover debts, expenses and replacing that position.

Things to consider:

- Salary – typically allow for ten times the Key Person's salary
- Include bonus or equity participation in the business
- The cost of hiring, training and relocating a replacement

AXA's life insurance illustration software will help you estimate of the cost to replace a Key Person. Your financial professional can work with an AXA office to help determine your need. Your CPA can also help determine a realistic valuation.

how life insurance can help

An AXA Key Person protection program uses life insurance as the funding vehicle. Your business purchases a permanent, cash value life insurance policy that insures the key employee's life and holds that policy as an asset of the business. Then, when you need it most, the policy can provide the funds you need.

If the Key Person unexpectedly dies:

The life insurance policy provides a death benefit in the form of cash – free of taxes.¹ Those funds can be used to sustain the business, cover debt and operating expenses, and recruit and train a qualified replacement.

If the Key Person retires:

The life insurance policy could be used as a funding mechanism for a selective non-qualified benefit. The policy cash value can then be used to provide retirement income for the key employee. As an added value, the death benefit can also be used to provide cash for the family if the key employee dies prematurely.

As you can see below, there are other ways to fund a Key Person need, but life insurance is by far the most cost-effective:

Important life insurance benefits

- **Tax advantages** – The cash value in the policy generally accumulates without triggering current taxes, potentially grows tax-deferred and the life insurance benefit is federal income tax-free.
- **Guarantees** – The policy is backed by the claims-paying ability of the insurance company. All U.S. life insurance companies are state-regulated to make sure they maintain enough reserves to meet claims.
- **Life insurance protection** – Permanent life insurance protects your business or your employees' family for as long as the employee lives, and provides a cash benefit right after death.
- **Cash value accumulation** – The cash value in a permanent life policy can grow over time. When the policy is company-owned, the cash value is considered an asset on the balance sheet, and can be used to fund golden handcuff arrangements.
- **Other Considerations** – Please remember cash value life insurance does have many other considerations clients should review carefully before selecting a Key Person life insurance policy.

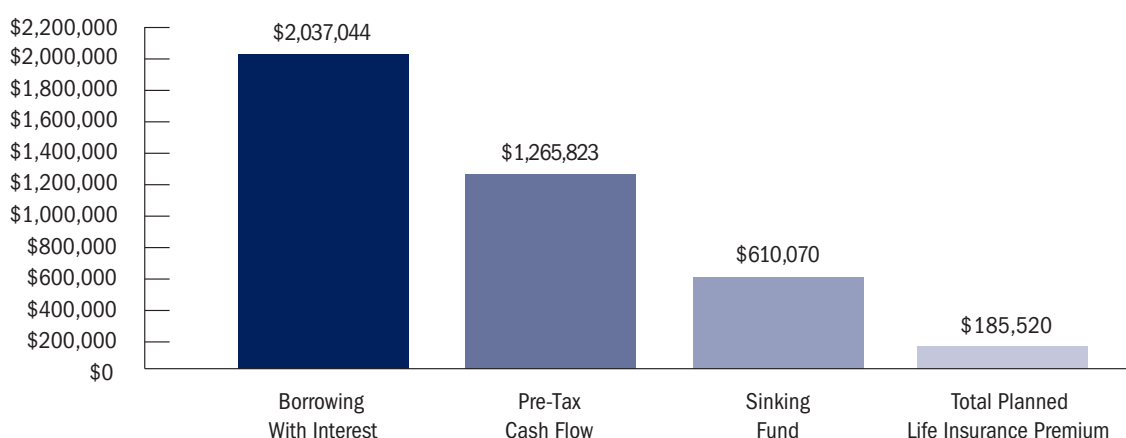
Please keep these important points in mind:

- Clients must keep paying the required premiums; missing or skipping premiums will negatively impact the amount of loans and withdrawals available. A life insurance policy generally takes years to build up a substantial cash value. To be effective, the policy should be held until death.
- Clients must qualify both medically and financially for the life insurance.
- How much life insurance can be purchased and the premiums paid will depend on the medical and financial underwriting.
- Generally, there are many additional charges associated with a life insurance policy, including, but not limited to, a front-end load, monthly administrative charge, monthly segment charge, cost of insurance charge, additional benefit rider costs and a 15-20-year surrender charge.
- Tax-free distributions will reduce the cash value and face amount of the policy. Clients may need to pay higher premiums in later years to keep the policy from lapsing.

Life insurance can be the most cost-effective way to fund Key Person coverage

As you can see below, there are other ways to fund a Key Person need, but life insurance is by far the most cost-effective. See the example below for a healthy 45-year-old male.

Ways to Fund a \$1,000,000 Key Person Need



The policy premium and death benefit amounts used for this case are intended only to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy of this type, and size for the insured's good health and ages noted in the example. To determine how this approach might work for your client, individual illustrations based on their own individual age and underwriting class, containing both guaranteed charges and guaranteed interest rates as well as other important information, should be prepared or requested for their review.

Borrowing with Interest: \$2,037,044 — A business that expects to borrow to meet its Key Person needs risks being denied the financing, as the loan would occur at a time when the business and its management team are under stress. The value presented here is what a business would pay in interest and principal if it could receive a 20-year loan at an 8% rate.³

Pre-Tax Cash Flow: \$1,265,823 — This is what a business, in a 21%² tax bracket, will need to net (after expenses) to meet its Key Person need.¹

Sinking Fund: \$610,070 — This is what a business would need to set aside each year, between an employee's age 45–65 to amass the same amount a \$1,000,000 policy will provide. This assumes an annual contribution of \$30,504 and an after-tax growth rate of 4.5%.

Permanent Life Insurance: \$185,520 — This offers cash values that can be used as a business asset — as collateral for a loan, an informal line of credit, or to help fund a benefit program for a retired key employee.⁴

see a Key Person program in action

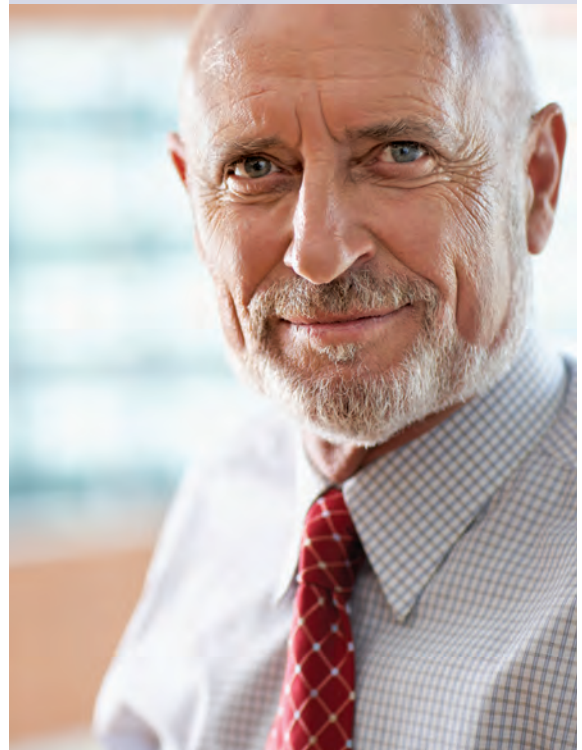
The owner of Cogswell Cogs recognized Paul as a Key Person in the business. Paul recently signed one of their largest accounts and worked with two other accounts that brought in 15% of the company's total revenue. So a \$1,000,000 Key Person life insurance policy was established on Paul's life, in case something should happen to him.

When Paul passed away unexpectedly, Cogswell Cogs was saddened by the loss of a valued employee and friend, but the company was not devastated financially, because it had the Key Person policy. The business received the \$1,000,000 cash tax-free, and was able to use it to help the business adjust to Paul's loss:

- \$125,000 was used to recruit, offer a sign-on bonus and relocate a replacement for Paul.
- \$50,000 was allocated to special training and marketing to help the replacement get up to speed more quickly.
- \$200,000 was posted as collateral to help keep one of the business's creditors from raising the rate on a credit line.
- \$250,000 was paid to Paul's widow as a special bonus for his years of service.
- The balance was held as a cushion against any possible dips in revenue in the future.

Three years after this unexpected loss, Cogswell Cogs is as strong as ever.

Key Person coverage should also be coordinated with your business continuation plans.



Why AXA?

You may want to consider AXA as a resource for Key Person coverage. Here's what we offer:

- A strong life insurance portfolio, with the death benefit coverage you need, and a line of high potential cash value product options and term products with flexible conversion privileges.
- Illustration support to show how your specific Key Person plan might work.
- A wide selection of riders,⁵ including:
 - An enhanced cash value rider that allows the life insurance cash value on your business's books to offset the premium expense.
 - The Long-Term Care ServicesSM Rider that can accelerate the death benefit to help your business in case the Key Person cannot work because of a qualifying long-term care event.
 - The Charitable Legacy Rider[®] that offers an additional death benefit to the charity(ies) of your choice at no added cost.
- The financial strength of AXA Equitable Life Insurance Company or MONY Life Insurance Company of America.

taking the next steps

Are you ready to find out how the loss of a Key Person would impact your business? Contact your financial professional today. During a fact-finding session, he or she can help you define your business and personal goals, and can act as a planning resource for your business — to help protect against the loss of a Key Person and provide you with a valuable asset in a life insurance policy.

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

1 Effective August 17, 2006, the Internal Revenue Code Section enacted 101(j), otherwise known as Employer-Owned Life Insurance (EOLI) Notice and Consent. Among other things, EOLI requires that the employer must give the following notice and consent before the insurance policy is issued: • The employee must be informed in writing that the employer intends to insure his or her life, and the maximum amount for which he or she could be insured. • The employee must provide written consent to being insured and that such coverage may continue after he or she terminates employment. • The employee must be informed in writing that the employer will be the beneficiary of the death proceeds. Key Person coverage should also be coordinated with your business continuation plans. If this notice and consent is met, as well as certain additional requirements related to reporting, and insurance coverage is maintained once an employee separates from service, the death proceeds should generally remain income tax-free.

2 The tax bracket is based on an overall average.

3 This percentage is based on a hypothetical loan rate.

4 Policy withdrawals are not subject to taxation up to the amount paid in the policy. Policy loans and/or withdrawals will be taxable to the extent of gain if the policy is a Modified Endowment Contract. Policy loans and/or withdrawals also reduce the cash surrender value and policy death benefit. Taking a policy loan could have adverse tax consequences if the policy terminates before the insured's death. Clients may have to pay additional premiums in later years to keep the policy from lapsing.

5 Some riders have an additional cost and all have restrictions and limitations. Be sure to review with your financial professional for further details.

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Personal Key Person

ADVISOR COMPANION

BUSINESS PLANNING

A small business owner's protection, succession and supplemental income plan

Defining the market

A decorative graphic of two interlocking gears, one larger than the other, positioned to the left of the text.

Conversations about business succession planning often focus on businesses that have multiple partners, owners and/or key employees. But for many businesses, there may only be one owner and few, if any, key employees, which can make it challenging to find a successor. For these single-owner businesses, succession planning is not about funding a buy-sell arrangement, but rather ensuring that the owner's family can continue to prosper once he or she is no longer involved in the business.

Consider the following:



SMALL BUSINESSES (defined as businesses with fewer than 500 employees) **MAKE UP OVER 99%** of all U.S. businesses;¹



80% (OR 23 MILLION) of these small businesses have no employees and most are sole proprietorships;¹



FOR THE 20% OF SMALL BUSINESSES THAT DO HAVE EMPLOYEES (employing 48% of the U.S. workforce), those that have less than 100 employees make up the largest share of small business employment.¹

Defining the challenges

With a single-owner business, the viability and success of that business often falls primarily on the owner's shoulders. Besides being key to the business itself, that owner, by extension, is also key to his or her family's current and future financial security. For example, if that owner were not able to go to work for 6 months, a year, or more, the loss of income and business value could severely impact that owner's family's well-being. Moreover, it is often more difficult to sell a small business than most people realize, which can also leave a lasting impact on the owner and his/her family, regardless of whether the exit from the business is unexpected or intended.

As an advisor, it is important for you to ask your small business owner clients and prospects the following questions:

1. What would happen to the business in the event of the owner's death or disability?

- ***Could the survivors sell the business and receive full value?*** A single-owner business may have little to no value to the family after the owner's death as it may be very difficult for the family to continue the business or, alternatively, find a buyer. This can be particularly true in service-oriented businesses where most of the business's value was derived by the experience, specific skill set, and goodwill of the business owner, and there are no hard assets to sell at the owner's death.

- ***Do the survivors have the skill set and expertise to continue to run the business successfully?***

Depending on the business, the survivor (or another family member) may be unable to run the business due to lack of experience, expertise or specific designations or licenses (for example, attorneys, accountants, architects, contractors, etc.)

2. If the owner is forced to sell the business to fund his/her retirement, will it sell for its fair market value? What valuation is proper?

- ***Will the sale proceeds provide sufficient income to maintain his/her standard of living?*** Timing is everything when it comes to a sale. It is important to consider that different markets will lead to different business valuations and the market may not be in the owner's favor when he or she decides to retire.
- ***Will the proceeds last throughout his/her lifetime or is there a risk the owner may outlive the funds?*** Whether the sale proceeds will be sufficient is highly dependent on the age of the owner at the time of the sale, the value received, and the longevity experienced by the owner and/or owner's spouse; and these factors are incredibly hard to predict in advance.

3. Will those retirement assets be protected from unexpected financial events?

Consider how the following events could derail an owner's retirement plan:

- Long-term care needs
- Unexpected housing and other personal costs
- Loss of income due to investment losses and market fluctuation

To help business owners prepare for the future and protect their families, consider the "Personal Key Person" plan funded with permanent life insurance.

According to an FPA/CNBC study:²



78% OF SMALL BUSINESS OWNERS PLAN to sell their business to fund their retirement, and



Proceeds from the sale are needed to fund **60%-100% OF THEIR RETIREMENT NEEDS**

How it works

Similar in nature to traditional key person insurance, the personal key person plan insures against the loss of a "key" employee, i.e., the owner, but its focus extends beyond trying to cover costs associated with finding a replacement. Instead, the personal key person plan is individually owned permanent life insurance meant for sole business owners and their families to help protect against many uncertainties and challenges faced by these small business owners.

Key benefits — preserve, provide, protect



TAX-FREE DEATH BENEFIT

Life insurance provides a tax-free death benefit, which helps to *protect* the financial well-being of the owner's family by *preserving* the value of the business. This protection can relieve any pressure felt by surviving family members regarding how much value they will get for the business. Additionally, even if the owner has a potential successor in mind, the death benefit ensures that the family receives full value regardless of whether the continuation of the business is successful.



ESTATE EQUALIZATION

If the owner has multiple beneficiaries, but only one who will take over the business, life insurance also can *provide* the funds needed to equalize the estate – the spouse and other children receive a cash inheritance via the life insurance proceeds while the other child receives the business interests.



CASH VALUE GROWTH POTENTIAL

Cash value life insurance can *provide* supplemental retirement income via tax-favored loans and withdrawals. Unlike qualified plans, there are no penalties for early withdrawal, no contribution limits, and amounts received may not be subject to tax.



CREDITOR PROTECTION

Depending on state law, life insurance proceeds receive favorable *protection* from creditors, including bankruptcy protection. This may be a huge benefit for small business owners who are concerned about creditors of the business, especially in fields that have higher liability risks, such as a law or medical practice.



LONG-TERM-CARE PROTECTION

A long-term care rider can *preserve* retirement income and savings from the cost of long-term care. The long-term care rider allows the policy owner to accelerate the death benefit to help pay for costs associated with qualified long-term care expenses.



DISABILITY PAYMENT OF PREMIUM

The Disability Payment of Specified Premium (DPSP) rider will pay the business owner's premium during periods of total disability.



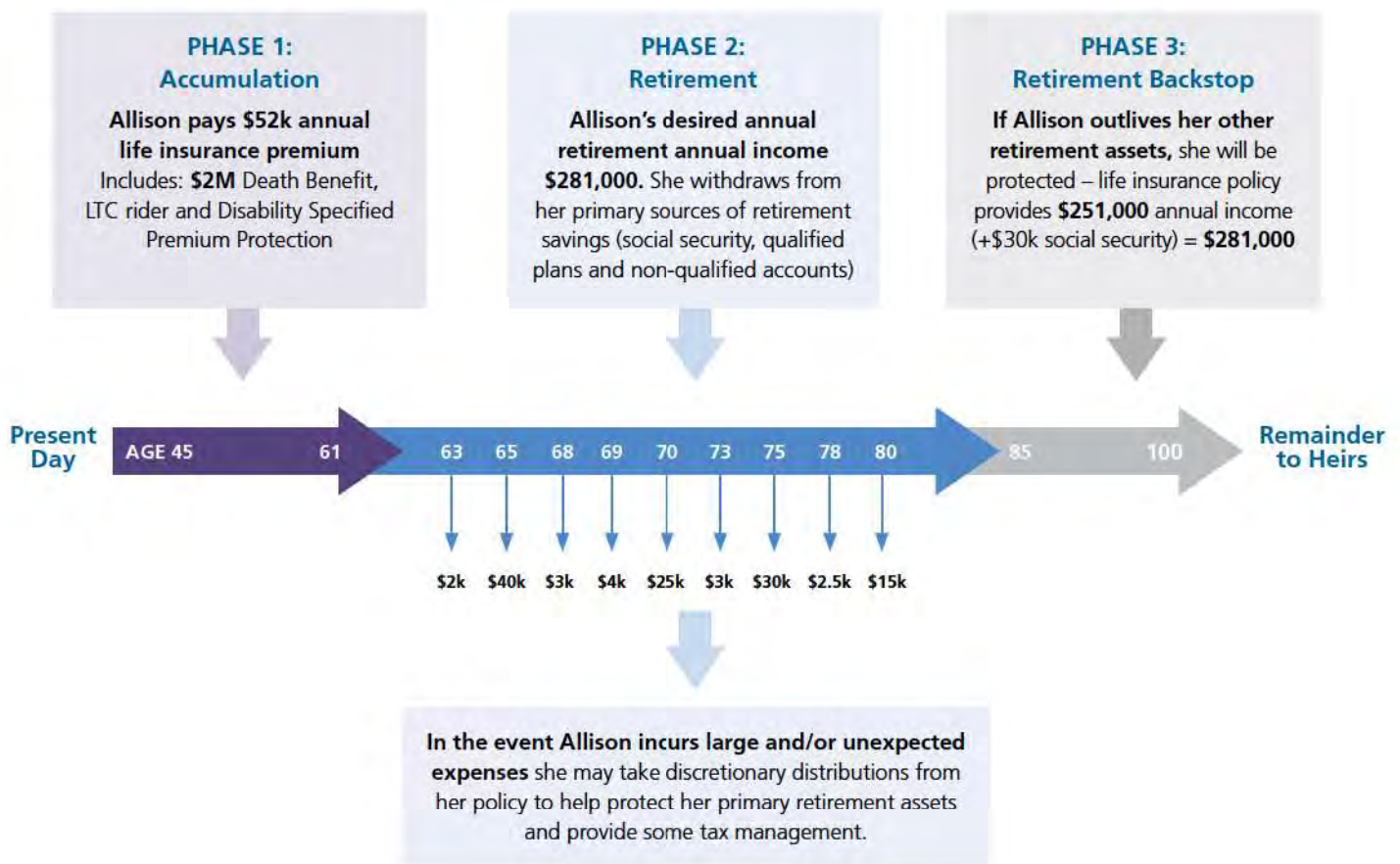
REWARDS FOR HEALTHY LIVING

The John Hancock Vitality Program can be used to earn valuable rewards and discounts, in addition to reducing the premium or enhancing the cash value potential.

HYPOTHETICAL EXAMPLE

Allison, age 45, is the sole owner of ASC Consulting, which was recently appraised at \$2M. Allison currently takes a \$300k annual salary. She has been diligent about saving for her retirement but while she would like to retire in 15 years, she is concerned she does not have enough saved to maintain her current standard of living. Allison is also concerned because her business has little to no value without her skill-set and unique expertise. She currently has no succession plan for the business and it is very unlikely that any of her children will succeed her.

Personal Key Person – Accumulation & Income Summary



Accumulation IUL with Vitality (Gold): (6%) Death Benefit \$2M– 15-Pay Premium \$52K.

RIDERS: 2% LTC Rider & Disability Payment of Specified Premium (DPSP) rider. This is a supplemental illustration. Not all benefits and values are guaranteed. The assumptions on which the non-guaranteed elements are based are subject to change by the insurer. Actual results may be more or less favorable.

Conclusion

Permanent life insurance can fulfill many needs of a business owner:

- **The death benefit can offer the protection** to take care of the family to continue to prosper and grow – even if the business and the business owner were no longer in the picture.
- **The tax-favored access to cash value may help** in many different stages of life. If the policy is funded earlier, it could be used to fund college, supplement retirement income, and even be used prior to age 59 ½. If the policy is funded later in life, the policy cash value can be used later in retirement as a “backstop” to outliving the other retirement assets available.
- **Adding riders such as the Long-Term Care rider and Disability Payment of Specified Premium** can help in the event of a disability or chronic illness.

For more information on Personal Key Person, please contact John Hancock’s Advanced Markets Group at 888-266-7498 and select Option 3 to reach an AMC, or Option 4 to reach an attorney.

1. From the United States Small Business Profile, 2016; SBA Office of Advocacy.

2. FPA/CNBC Business Owner Succession Planning Survey, April 2015 @ <http://www.cnbc.com/2015/04/13/ew-small-biz-have-an-exit-plan.html>.

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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.

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 59 1/2.

The Long-Term Care (LTC) rider is an accelerated death benefit rider and may not be considered long-term care insurance in some states. There are additional costs associated with this rider. The Maximum Monthly Benefit Amount is \$50,000. When the death benefit is accelerated for long-term care expenses it is reduced dollar for dollar, and the cash value is reduced proportionately. Please go to www.jhsalesnet.com to verify state availability.

Enhanced income potential will apply based on the Status attained by the life insured.

Vitality is the provider of the John Hancock Vitality Program in connection with policies issued by John Hancock.

Rewards may vary based on the type of insurance policy purchased for the insured (Vitality Program Member) and the state where the insurance policy was issued.

John Hancock Vitality Program rewards and discounts are only available to the person insured under the eligible life insurance policy.

Rewards and discounts are subject to change and are not guaranteed to remain the same for the life of the policy.

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Personal Key Person

CLIENT SNAPSHOT

Your protection, succession and supplemental income plan

As a small business owner, the value of your business is intrinsically linked to the skills and know-how you provide. This is especially true if you own a service-oriented business where most of your company's value is derived by your experience, specific skill set and goodwill. In addition to being a "key person" to your company, you are also key to your family's current and future financial security. Consequently, it is important to think about what would happen to both your family and your business upon your retirement or if you became unable to run the business due to death or disability.



What are the risks?

Consider how your business (and by extension, your family) might be impacted if something unexpected were to happen to you. For example, what would happen if:

YOU PASSED AWAY TOMORROW?

- Could your heirs sell the business and receive its full value?
- Or, alternatively, do they have the skill set and expertise to continue to run the business successfully?
- Do you have a known successor or succession plan in place?

YOU BECOME DISABLED OR NEED LONG-TERM CARE ASSISTANCE?

- How would your inability to work affect your family and their financial health?
- How might it affect the success of your business?
- How might an event like this affect your retirement savings?
- Would you have sufficient income or assets outside of the business to pay for your care?

Planning for Retirement

Premature death or a disability can undoubtedly cause financial hardship to both your business and your family. However, even if you end up living a long, healthy life, it is essential that you properly plan for your retirement now. Implementing a plan today affords you the flexibility to decide in the future if you want to stay active in the business or step away entirely — there is a big difference between wanting to work and *having* to work in retirement.

While many business owners expect the business to provide some, or all, of their retirement income via a sale of the business, there are a multitude of factors that influence whether or not the business ultimately sells for its full fair market value. As you plan for your retirement, consider the following:


SELLING TO A THIRD PARTY:

- **Will there be a willing buyer** at the time you're ready to retire?
- **Will the sales proceeds provide you with adequate income** for your lifetime?
- **What if you sell in a down-market?**
- **Does your business require unique qualifications or licenses** (e.g., accountant, lawyer, doctor, etc.)? If so, it may be difficult to find a successor who possesses the skills required to continue the business. How might this affect the outcome of selling your business?

KNOWN SUCCESSOR:

- **If you plan to transfer your business to a family member or key employee**, is your retirement income dependent on the business's continued success? In other words, if the new owners/managers are not as successful in running the business, how will that affect your (and your spouse's) retirement income?

Timing a Sale



Timing can be everything when it comes to selling a business, and it is often difficult to predict what type of market you'll face when (or if) you decide to sell your business. Ideally, you will be able to time your sale with a booming economy so that you receive top dollar. However, many owners are forced to sell (or liquidate) for reduced value due to unforeseen events related to family, health, a change in the economy or customer need.

With all of this uncertainty, is there a plan that can provide protection from these risks, preserve the value of your business to your survivors and heirs, and provide a source of supplemental income during retirement?

The value of the Personal Key Person plan

The Personal Key Person plan considers purchasing a life insurance policy on the most valuable person you know—YOU! This life insurance policy is designed to provide you and your family with the following benefits:

**TAX-FREE
DEATH BENEFIT**
TO YOUR SURVIVORS
TO PROVIDE FINANCIAL
PROTECTION

**ACCESS TO
TAX-FREE INCOME**
FROM THE CASH VALUE
THAT ACCUMULATES INSIDE
YOUR POLICY¹

**ACCESS TO
UP TO 100%**
OF YOUR DEATH
BENEFIT INCOME-TAX FREE
SHOULD YOU NEED
LONG-TERM CARE²

**WAIVER
OF PREMIUMS**
IN THE EVENT OF A TOTAL
DISABILITY³



DEATH BENEFIT

The amount of death benefit to purchase will depend on your unique needs and goals for your family. As a starting place, consider:

- **The amount of income your heirs stand to lose** in the event of your premature death.
- **The amount needed to equalize your estate** among all beneficiaries. For example, if only one of your children will take over the business, your spouse/ other children can receive a cash inheritance via the life insurance proceeds.
- **The shortfall between how much your heirs could potentially sell the business for** after you are gone versus what you project to be the full market value of your business.



SUPPLEMENTAL INCOME

Access to the cash value in your life insurance policy may provide an essential backstop should you outlive your retirement savings. What's more, unlike qualified plans accounts (IRA, 401(k), etc.) there are no penalties for early withdrawal from a life policy, no contribution limits, and amounts received may not be subject to tax.

Even if you adequately save for retirement, various unforeseen factors may diminish savings more quickly than anticipated:

- **A below-market sale of your business** (or lack of a buyer)
- **Market downturn**, particularly when you start drawing from your retirement accounts for income
- **Health care issues** and/or other unexpected expenses
- **Increased taxes in retirement**
- **You (or your spouse, if applicable) live beyond your planned life expectancy**



LONG-TERM CARE

More than 70% of people age 65 years and older will have a need for long-term care during their life.⁴ To help address this risk, adding a long-term care rider on your life insurance policy allows you to accelerate the policy's death benefit, income-tax free, to pay for long-term care expenses.

Consider how a prolonged long-term care event could affect:

- **Your ability to work and produce income** for your family
- **Your retirement savings** when large withdrawals are needed to pay for care
- **Your ability to leave your spouse and/or children with an inheritance**



DISABILITY

This optional rider will pay your premium during periods of total disability.

Next Steps: Talk to your financial advisor today about your retirement planning goals and how your business may be affected by your death or disability. Planning for all contingencies and utilizing a permanent life insurance policy can help you with many of the planning goals that you need to address. Focusing on what makes your business unique and the overall future of the business can ultimately protect your family and your business, but can also help you with your supplemental income needs, including but not limited to your retirement goals.

Talk to your financial professional about creating and funding a personal key person plan to help protect you and your business in the event something should happen to you.

1. 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 59 1/2. Withdrawals are available after the first policy year.

2. When an LTC rider is added to your policy.

3. When a disability rider is added to your policy.

4. Source: <https://longtermcare.acl.gov/the-basics/>

The Long-Term Care (LTC) rider is an accelerated death benefit rider and may not be considered long-term care insurance in some states. There are additional costs associated with this rider. The Maximum Monthly Benefit Amount is \$50,000. When the death benefit is accelerated for long-term care expenses it is reduced dollar for dollar, and the cash value is reduced proportionately. In the event of total disability, this rider waives the premium, up to a \$5,000 per month maximum. Rider available to issue age 55. If disability occurs before age 60, premiums are waived until recovery or the termination of the contract, whichever is earlier. If disability occurs between age 60 and 65, premiums are waived until the earliest of contract termination, recovery or age 65. The cost for this rider is based on your age at issue and the face amount. Some riders may have additional fees and expenses associated with them.

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Some riders may have additional fees and expenses associated with them.

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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Not a Deposit	Not Insured by Any Government Agency	



Helping to Protect the Future of Your Business

A BUY-SELL AGREEMENT SOLUTION



Life Insurance



The Prudential Insurance Company of America

1002355-00001-00 Ed. 07/2018



Prudential
Bring Your Challenges®



HOW PRUDENTIAL CAN HELP

The Prudential Insurance Company of America and its affiliates offer a wide range of insurance products that can help your business continue successfully in the event of your death or disability. Insurance is a vitally important business tool that is often overlooked.

Whether your business is a sole proprietorship, a partnership, a limited liability company, or a closely held corporation, Prudential can help. Purchasing life insurance for business needs may prove to be one of the most important decisions of your life.

Your time, your efforts, your money

All of these have contributed to making your business a success. And because you have worked so hard and put so much into “it,” you want it to continue to provide for you and your family.

- ▶ **Do you dream of a carefree retirement** and passing the business to family members or other key employees?
- ▶ **Do you anticipate your golden years but fear** that you can’t make ends meet without the income generated by your business?
- ▶ **Do you worry that if you or a business partner were to die today** your business would be at risk?

Countless businesses have been reduced to a fraction of their value following the death or disability of one of the owners. Regardless of your business structure, taking steps now to ensure that the business and your family are protected in case of your or another owner’s death or disability can help your business and family carry on.

It’s time to work with your tax, legal, and financial professionals to develop a strategy to help make sure that your “dreams do come true.”

**One easy solution can be through using
life insurance in a Buy-Sell Agreement.**





Evaluate your business risk.

If your business is structured as a...



... SOLE PROPRIETORSHIP

You own and operate your business. You are one of those people who enjoy the challenge of being your own boss, the master of your own destiny. You are the business.

Have you considered?

- ☐ What will happen to your business when you die or if you are disabled before you retire?
- ☐ Who will step into your shoes when you leave the business?
- ☐ Can you and your family continue your present lifestyle if you are unable to work in the business?



... PARTNERSHIP

You and your partners have created a profitable business based on teamwork. Together you make the day-to-day decisions that contribute to the harmonious operation of your business.

Have you considered?

- ☐ What will happen to the business if you or your partner isn't there anymore?
- ☐ Have you protected your business interest from the financial disruptions that typically follow the death or disability of a partner?
- ☐ Will your partnership be terminated at the death of your partner, or do you want to be able to regroup and reorganize?
- ☐ Will the business suffer from lost sales or revenue as a result of the death or disability of a key partner?
- ☐ Can you work effectively and successfully with family members or heirs of a deceased or disabled partner?

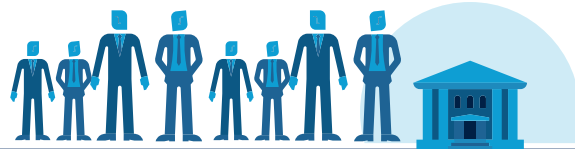


... LIMITED LIABILITY COMPANY (LLC)

Your limited liability company is just like a partnership—built on the efforts, labor, time, and money of the various owners to make the LLC a success. The continued success and growth of an LLC business often depends on the joint efforts and commitment of all owners.

Have you considered?

- ☐ Do your heirs or family members want to participate in the business? Do they have the ability to contribute to the business?
- ☐ Do the remaining owners want heirs or family members of a retiring or departed owner as co-owners?
- ☐ How will heirs or family members of a disabled or deceased owner affect company profits and distributions? How will the workload be divided?
- ☐ Does the company or a co-owner have the financial ability to buy out the business interest of a deceased or disabled owner? Have you established a binding “fair and reasonable” buyout price?



... CLOSELY HELD CORPORATION

Your efforts, time, and money have gone into creating a successful business, and the continued success and growth of the business typically rests upon the efforts and commitment of all owners.

Have you considered?

- ☐ In the event of your death or disability, are family members or your heirs qualified to take an active role in corporate management? Do they even want to be involved?
- ☐ In the event of a co-shareholder’s death or disability, do you and the other shareholders want to deal with the decedent’s heirs or family on an ongoing basis?
- ☐ If your business interest has to be sold, have you protected the value of your stock, and have you done all that you can to establish the value of your interest for estate tax purposes?

Your business represents a large positive financial asset for you and your family. **Life insurance can help to guarantee its value.**

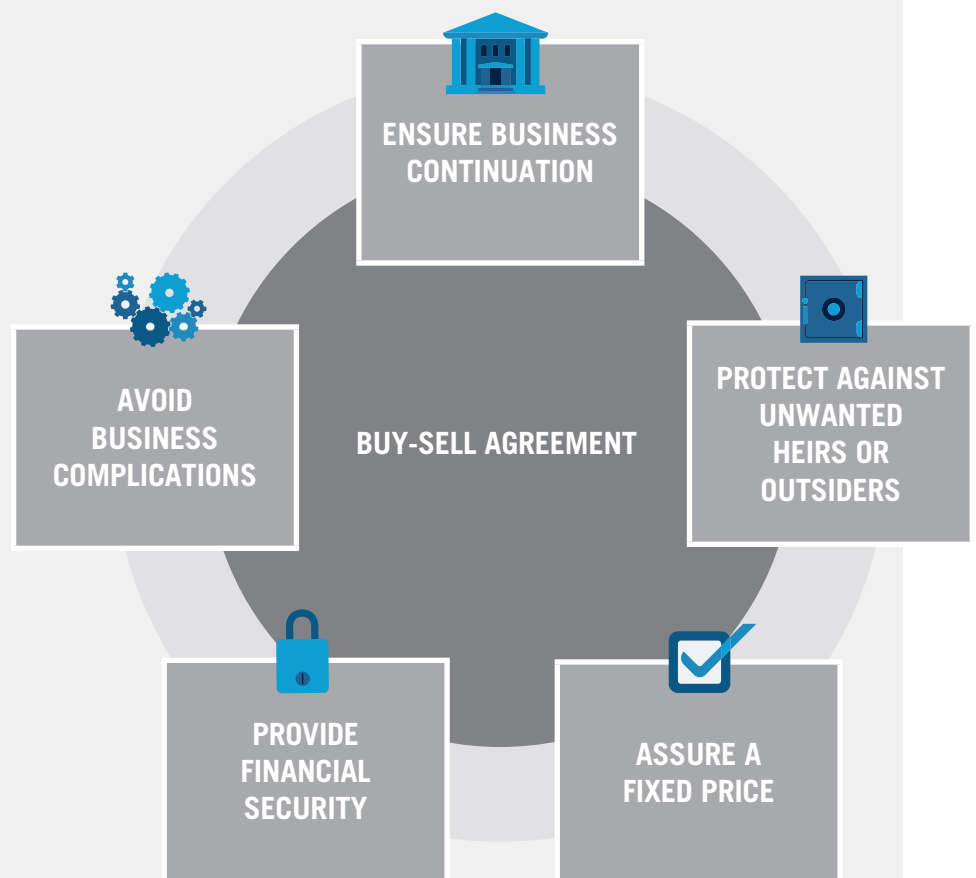


The place to start is with a Buy-Sell Agreement.

A Buy-Sell Agreement is a written legal document that establishes a market for your business should you die, become disabled, or leave the business.

It will:

- ▶ predetermine the business price.
- ▶ identify the future buyer(s).
- ▶ identify the events that trigger the buyout.
- ▶ create a legal obligation between you and the buyer(s) of your interest.



A written Buy-Sell Agreement is the place to start to protect your business and your personal interests.



THE PROTECTION COMPANY FOR OVER 140 YEARS

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LIFE INSURANCE



SALES STRATEGY

BUSINESS

Advanced Markets

Buy-Sell Planning

Succession Planning for Business Owners

Situation

Business owners should plan to protect their business in case of the sudden death, retirement, or disability of one of the owners. This plan should be put in place long before it is needed to avoid pitfalls resulting in the separation of service.

Solution

Succession planning is the process of formally adopting a plan to arrange for the disposition of business interests. A well drafted and properly funded buy-sell arrangement can protect the interest of the business owners and help facilitate the successful continuation of a business in the event of death, disability or retirement of its current owners.

Buy-sell arrangements can take different forms including: (1) entity purchase or stock redemption, (2) cross-purchase, (3) one-way, (4) wait and see, and (5) cross-endorsement. The "best" type of arrangement depends upon several factors, including the type of business structure (e.g., C Corp, S Corp, etc.), and the number of owners. This Sales Strategy will describe the primary types of arrangements, popular methods of funding arrangements, and other important considerations when contemplating a business succession plan.¹

Benefits

- **Guarantee a Buyer.** A buy-sell arrangement benefits the selling owner's family by providing a guaranteed buyer(s). The remaining owners are protected against the sale of a significant (or, worse yet, majority) interest to an outside investor.
- **Create Liquidity.** Upon a business owner's death, his or her family has a continuing need for cash to pay ordinary living expenses as well as any estate tax liability. Estate taxes are typically due nine months after the date of death. Without a buy-sell agreement, the estate of the deceased may have to sell a business to create the necessary liquidity, often resulting in the family receiving less than the fair market value.
- **Set a Fair Selling Price.** A business valuation strategy that is determined while all owners are active can usually be negotiated on an arm's-length basis. Once a business owner has left the business, negotiating a fair sales price is much more difficult for the owner (or the owner's estate) because the remaining owners hold most of the cards.
- **Fix Value.** A buy-sell arrangement negotiated at arm's length ordinarily determines the valuation for estate tax purposes. This allows the owners to plan their estates and can reduce the risk of costly valuation disputes among business owners or upon estate tax audit.
- **Maintain Harmony.** Because of the pressures of business ownership and everyday life, it is often difficult for owners of a closely held business to maintain friendships and camaraderie. Maintaining harmony becomes more difficult after the family (spouse and/or children) of a deceased owner enters the business. A buy-sell arrangement can protect the owners and the business from problems that arise when a deceased owner's family joins the business.

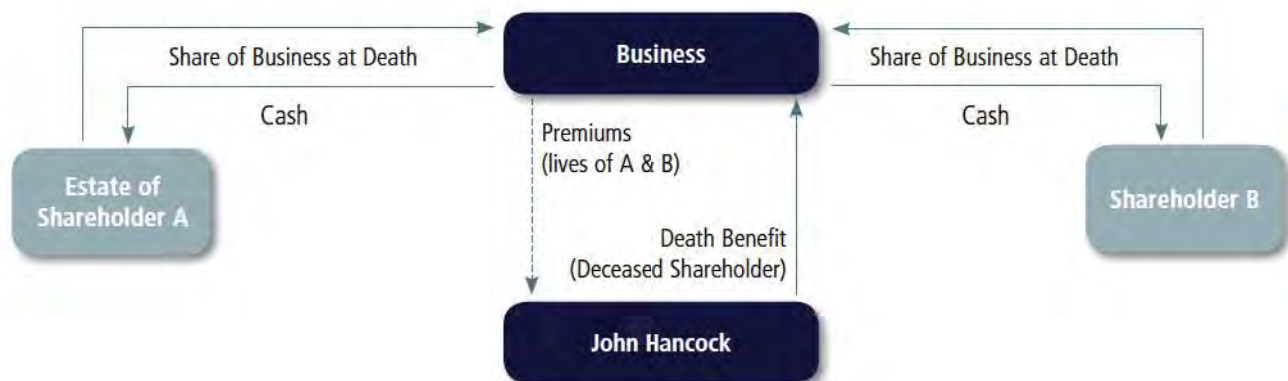
Types of Buy-Sell Arrangements

Entity Purchase Buy-Sell Arrangement. An entity purchase buy-sell arrangement (or “stock redemption arrangement”) is an arrangement among the owners and the entity. The entity agrees to purchase (or redeem) all of the interest of a deceased owner and the owners agree to sell their interests to the entity.

How it Works

ENTITY PURCHASE BUY-SELL ARRANGEMENTS

This diagram reflects a standard entity purchase buy-sell arrangement among a corporation and its two shareholders. The dotted line demonstrates the payment of life insurance premiums on policies used to fund the arrangement. Upon the death of either shareholder, the corporation will redeem the stock owned by that shareholder’s estate and will continue to own a policy on the life of the surviving shareholder.



Considerations

Shareholder Consequences

- **No Basis Increase.** An entity purchase buy-sell arrangement with a C corporation does not increase the basis of the remaining shareholders’ stock. However, life insurance proceeds received by an S corporation may increase the basis of its shareholders’ stock.²
- **Possible Ordinary Income Treatment.** Ordinarily, amounts received in a stock redemption are treated as a dividend to the shareholder that is having his or her stock redeemed. If treated as a dividend, the entire redemption amount (not just the gain) is taxed as ordinary income. However, if certain requirements are met, the redemption can be taxed as a sale. Taxation as a sale is usually beneficial because only the gain (i.e., the redemption price reduced by basis) is subject to tax at capital gain rates. When a redemption occurs at death, there is generally no gain to report because the deceased shareholder’s estate received a basis step-up.³
- **Risk of Corporate Creditors.** Life insurance purchased by a corporation to fund a buy-sell arrangement will be subject to claims of the corporation’s creditors. Moreover, state law may prohibit a redemption if the corporation is insolvent or lacks adequate capital.

Corporate Consequences

- **Premiums are Non-Deductible.** Life insurance is a common means of funding a buy-sell arrangement. Life insurance premiums paid by a corporation are not deductible.
- **Alternative Minimum Tax (AMT).** Life insurance proceeds are ordinarily received income tax free. However, in some instances, life insurance proceeds received by a C corporation can cause an alternative minimum tax liability. The possible application of the AMT is often cited as a primary reason not to use an entity purchase buy-sell arrangement. In reality, the AMT will not be applicable in many instances or may be nominal in amount. Therefore, the possible application of the AMT should be considered on a case-by-case basis.
- **Employer-Owned Life Insurance.** Section 101(j) of the Internal Revenue Code imposes income tax on the death benefit of life insurance contracts owned by the employer of the insured unless certain exceptions apply and Notice and Consent are obtained from the insured before the policy is issued. If the Corporation will

own a policy on a shareholder who is also an “employee,” the requirements of 101(j) should be followed to avoid adverse tax implications.*

- Increased Value of Corporation.** Any assets held by an entity to fund a buy-sell arrangement increase the value of the entity. This increase in the entity’s value (including the amount of life insurance proceeds received upon an owner’s death) should be considered when determining the selling price under an entity purchase buy-sell arrangement.

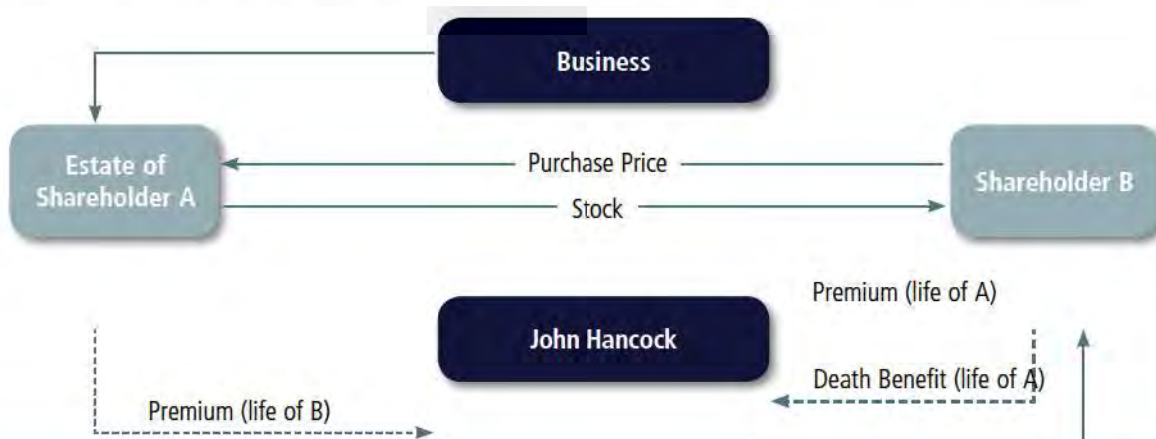
- Accumulated Earnings Tax.** When earnings are accumulated to fund an entity purchase buy-sell arrangement (including the cash value of a life insurance policy), the corporation can become subject to the accumulated earnings tax. However, a reasonable accumulation of cash to fund a buy-sell arrangement may be considered an exception to the prohibition on excess accumulations.⁴

Cross-Purchase Buy-Sell Arrangement. In a cross-purchase buy-sell arrangement the owners (or their estates) are obligated to sell their interests to each other. The entity is not a party to the arrangement.

How it Works

CROSS-PURCHASE BUY-SELL ARRANGEMENTS

This diagram reflects a standard cross-purchase buy-sell arrangement between two shareholders. The solid lines demonstrate the events upon the death of Shareholder A. The dotted lines demonstrate the payment of life insurance premiums on the policies used to fund the arrangement. Upon the death of Shareholder A, Shareholder B will buy out Shareholder A’s stock. Shareholder A’s estate will continue to own a policy on the life of Shareholder B. This policy can be sold to the corporation or to Shareholder B.



Considerations

Shareholder Consequences

- Basis Increase.** The surviving owners receive a step-up in basis in the purchased shares. This cost basis increase is the primary advantage of a cross-purchase buy-sell arrangement.
- Capital Gain Treatment.** With a lifetime sale, the selling owner recognizes capital gain to the extent the purchase price exceeds his or her basis.⁵ Upon an owner’s death, there is ordinarily no capital gain because the value of the shares

receive a basis step-up to reflect fair market value — hopefully the same price received under the buy-sell arrangement.

- Transfer for Value.** Ordinarily, in a cross-purchase buy-sell arrangement, each shareholder owns a life insurance policy on the life of each of the other shareholders. Upon the death of the first shareholder, each of the remaining shareholders will use the proceeds of the policy they own on the life of the deceased shareholder to carry out their obligation to purchase a pro rata share of the deceased shareholder’s stock.

*An in-depth discussion of 101(j) is beyond the scope of this piece. For more information, see “Because You Asked: Understanding Employer-Owned Life Insurance (EOLI) and 101(j),” which can be found on JH SalesNet.com under the Advanced Markets library.

After this, the remaining shareholders will need to acquire additional insurance to fully fund their continuing obligations under the arrangement because each remaining shareholder will now own an increased portion of the business. If the remaining shareholders purchase the policies held by the estate of the deceased shareholder, the purchase may be transfer for value.⁶ Sometimes the transfer-for-value rule can be avoided after the death of the first shareholder by allowing the deceased shareholder's estate to sell policies (on the other shareholders) to the corporation and then converting the arrangement to an entity purchase buy-sell arrangement.⁷

- I **Complications.** Where there are more than two or three owners, a cross-purchase buy-sell arrangement funded with life insurance can be complicated. The number of policies needed to fund the arrangement is typically equal to $[(n-1)*n]$ when "n" is the number of owners. Because of the necessity of purchasing multiple policies, the entity purchase buy-sell arrangement is commonly used in situations where there are more than two or three owners. However, because of (1) the tax disadvantages of entity purchase buy-sell arrangements (primarily the lack of basis increase to the remaining shareholders), (2) the desire to avoid the purchase of multiple life policies, and (3) concerns regarding the consequences of the transfer-for-value rule, attorneys have created alternatives to the standard cross-purchase buy-sell arrangement. Two such alternatives, the "trusteed arrangement" and the "partnership arrangement," are discussed in more detail below.

Corporate Consequences

- I **No Alternative Minimum Tax (AMT) or Accumulated Earnings Taxes.** Because the corporation does not own the policy, there are no potential AMT and accumulated earnings tax problems.
- I **No Increase in Corporate Value.** Life insurance (or other assets) used to fund the arrangement will not increase the value of the corporation. The value of life insurance policies (or other assets) will not be reflected on the corporation's balance sheet. Although a cross-purchase buy-sell arrangement has no impact on the value of the corporation, the deceased shareholder's estate will be increased by "funding" assets (such as the cash value of life insurance on the other shareholders) owned by the deceased shareholder.

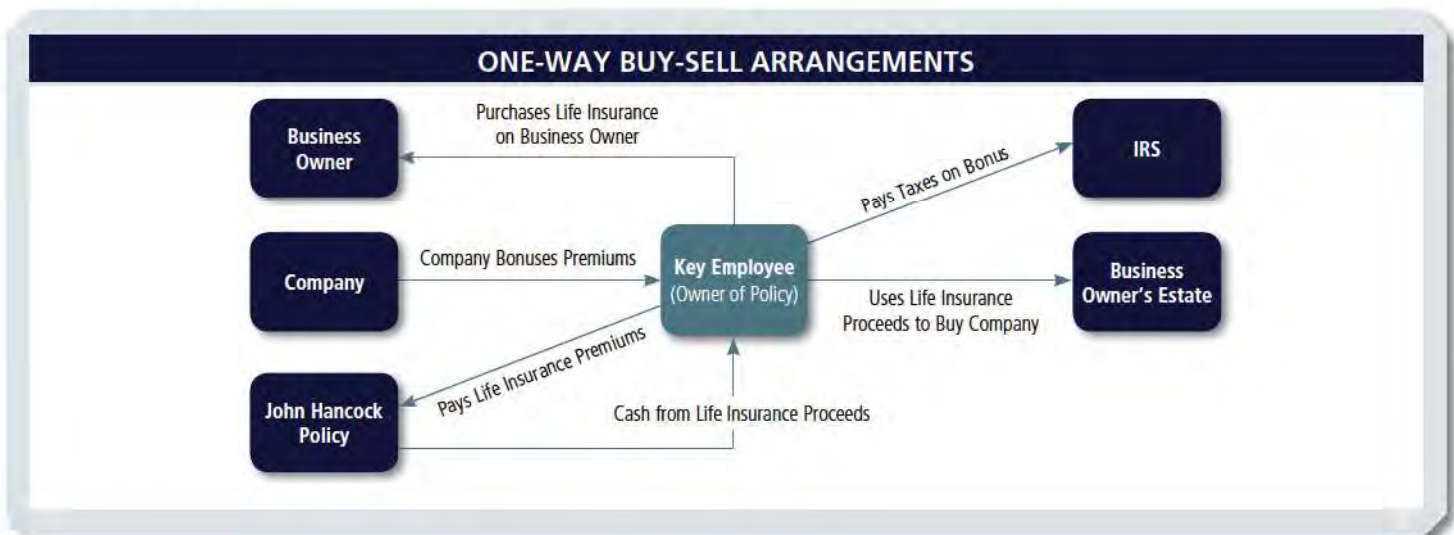
Variations in Cross-Purchase Designs

- I **Trusteed Cross-Purchase Arrangements.** In a trusteed arrangement, a trustee purchases life insurance on the life of each shareholder who is a party to the arrangement. Upon the death of a shareholder, the trustee (1) collects the life insurance proceeds, (2) purchases stock from the estate of the deceased shareholder, and (3) distributes the shares to the surviving shareholders. The trustee may facilitate the transfer by holding the shares of each shareholder subject to the arrangement. It is uncertain whether the use of a trusteed arrangement avoids the transfer-for-value problem. The death of a shareholder could be construed as causing a transfer of the deceased shareholder's beneficial interest in the policies on the lives of the survivors to the surviving shareholders for value.
- I **Partnership Cross-Purchase Arrangements.** Because the transfer-for-value rule may apply to a trusteed arrangement, the "partnership" arrangement has become popular. This arrangement is similar to the trusteed arrangement. However, instead of creating a trust, the shareholders form a partnership. The partnership then purchases a single life insurance policy on each shareholder. The partnership arrangement should avoid transfer-for-value problems because the transfer of a life insurance policy to a partnership in which the insured is a partner is an exception to the transfer-for-value rule. However, if the partnership is created exclusively (or primarily) to facilitate the buy-sell arrangement, the IRS may not respect the validity of the partnership. Although the IRS approved of a partnership structured solely for the purpose of funding a buy-sell arrangement in PLR 9309021, the IRS subsequently adopted a no-ruling position on the use of partnerships to fund buy-sell arrangements in Rev. Proc. 96-12.

In PLR 200747002, three business owners established an "Insurance LLC" (Limited Liability Company) to own life insurance policies on the lives of the business owners with management of the policies by an independent manager. The IRS ruled that the business owners would not have any incidents of ownership in the life insurance policies. Using an LLC with a cross-purchase buy-sell agreement can also help the shareholders avoid a transfer-for-value problem, assure that the parties comply with the buy-sell agreement and keep the policy proceeds from the reach of the insured's creditors.⁸

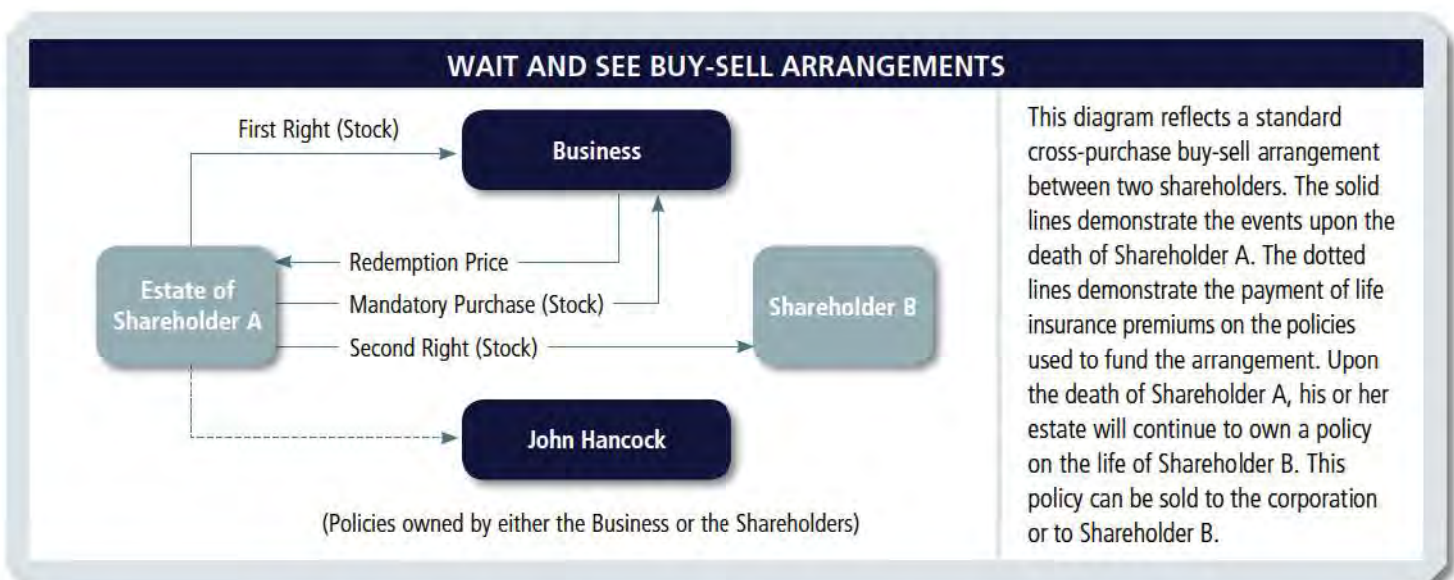
One-Way Buy-Sell Arrangement. A one-way buy-sell arrangement is a type of a buy-sell arrangement in which a valued employee, who may be a family member or a key person in the business, will purchase and own a life insurance policy on the life of the business owner. In this situation, because there is generally only one business owner and one designated successor, only one life insurance policy is required to fund the arrangement. The valued employee, who may be a family member or a colleague, will also be the beneficiary of the life insurance policy. The company will pay a bonus to the successor/policy owner in the amount of the premium payments annually to minimize the out-of-pocket expense of the arrangement. The bonus payments may be tax-deductible to the corporation when they are paid, but the payment will also be taxable to the recipient.⁹

How it Works



Wait and See Buy-Sell Arrangement. A wait and see buy-sell arrangement is a hybrid arrangement combining the features of both the entity purchase buy-sell arrangement and the cross-purchase buy-sell arrangement. A wait and see buy-sell arrangement generally gives the entity the option (or "right of refusal") to buy any portion of the deceased owner's interest within a certain time period after the owner's death. If the entity does not fully exercise the option, the remaining owners have the second right of refusal. Finally, if the remaining owners do not exercise their right of refusal, then the entity must redeem the balance of the deceased owner's interest. Depending upon how the arrangement is funded and whether the entity or the surviving owners acquire the deceased owner's interest, the arrangement will function as either an entity redemption or a cross-purchase arrangement.

How it Works



Benefits

- Maximum Flexibility.** The primary advantage of the wait and see buy-sell arrangement is that it offers maximum flexibility. Rather than committing to an arrangement, the business owners can adopt the most advantageous strategy after the death of an owner.

Considerations

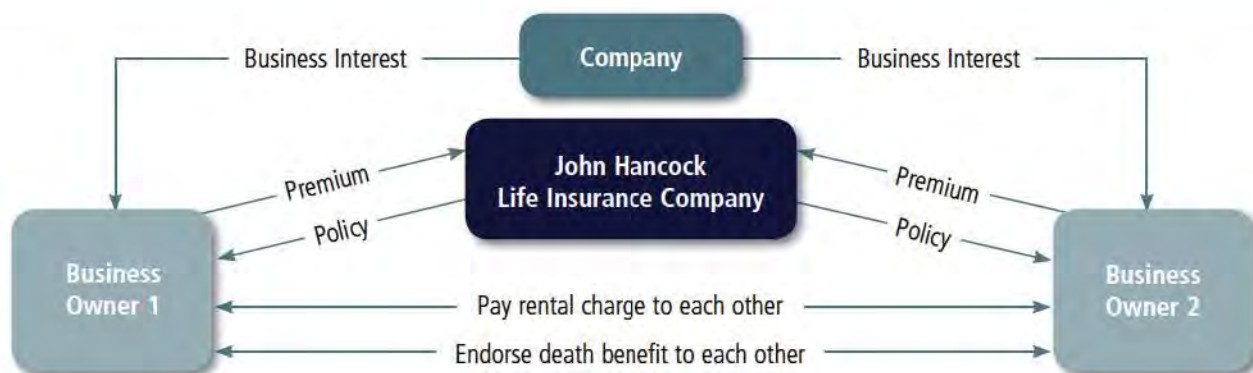
- Difficult to Fund.** One disadvantage of a wait and see buy-sell arrangement is that it can be difficult to fund. Ordinarily, the arrangement is funded as if it were a traditional cross-purchase arrangement. If it later appears likely that the entity will exercise its option, the policies can usually be sold to the entity.

- Possible Dividend Treatment.** Care must be taken to avoid dividend treatment to the purchasing shareholders. If the corporation is given the right of first refusal and the shareholders are required to purchase the stock if the corporation does not exercise its right, a corporate redemption will be treated as a dividend to the remaining shareholders. In addition, such arrangements must also be carefully structured to avoid possible dividend treatment to selling shareholders (as with an ordinary entity purchase arrangement).

Cross Endorsement Buy-Sell Arrangement. In a cross endorsement buy-sell arrangement, each business owner will purchase and own a life insurance policy on his or her life.¹⁰ The arrangement is structured as an endorsement split-dollar plan so that a portion or all of the death benefit can be endorsed for a "rental charge" to the other business owners¹¹ to satisfy the obligation under the buy-sell agreement.¹² Each business owner can use his/her policy for personal planning reasons if desired.

Each business owner will recognize rental income on what they charge on their policy. To minimize the cash outlay needed to pay premiums, the company may make annual bonus payments to each business owner in the amount of the premium. Each business owner, as owner of his or her own policy, will continue to have access to the policy's potential cash values.¹³

How it Works



Considerations

- Possible Transfer for Value.** Clients should consult their legal and tax advisors to avoid any transfer-for-value issues arising from cross endorsements of the policy death benefits.

Under Internal Revenue Code ("IRC") section 101(a)(2), the transfer of a life insurance contract or any interest in the contract for valuable consideration can result in a portion of the death benefit being subject to income tax, unless an exception to the transfer-for-value rule applies. The statutory exceptions in IRC section 101(a)(2)(B) are often used to avoid this issue. Statutory exceptions to the transfer-for-value rule under IRC

section 101(a)(2)(B) include (1) a transfer to the insured, or (2) a partner of the insured, or (3) a partnership in which the insured is a partner, or (4) to a corporation in which the insured is a shareholder or officer. Exceptions (2) and (3) require partnerships, and these two exceptions do not extend to S or C corporations. Although the IRS treated a limited liability company as a partnership for purposes of the transfer-for-value exceptions in PLRs 9625013 and 9625019, PLRs are only binding authority for the taxpayer to whom they are issued. Some commentators have questioned whether the IRS will challenge the business purpose of a newly formed partnership, particularly if it appears that its only purpose is to avoid the transfer-for-value rule.

Funding a Buy-Sell Arrangement

- I Life Insurance.** Purchasing life insurance on the lives of the business owners is one of the most common methods of funding a buy-sell arrangement. In addition to being cost-effective, a primary advantage of life insurance is that it makes cash available upon the death of an owner. Note that it is generally advisable for the insured not to have any incidents of ownership over a policy on the insured's life to avoid estate tax inclusion under IRC §2042. Where an entity is used in the planning process, the client should discuss with their legal and tax advisors how to structure the entity to avoid giving the insured incidents of ownership over the policy.¹⁴ Moreover, if the arrangement is funded with permanent life insurance, the policy's cash value may be sufficient to fund a buyout at retirement. In a cross-purchase arrangement, life insurance is sometimes purchased on a split-dollar basis or with a bonus to mitigate the cost to the shareholder. It is also important to note that when a corporation purchases life insurance on the majority shareholder to fund an entity purchase buy-sell agreement, the proceeds of the life insurance can increase the value of the corporation for estate tax purposes.¹⁵
- I Borrow Funds.** If the business or its owners plan to fund a buy-sell arrangement by borrowing funds after the death or retirement of an owner, several problems can occur. The business or the remaining owners may have difficulty obtaining a loan after the death or retirement of a key owner. Even if the business (or its remaining owner(s)) is able to get a loan to fund the buy-sell arrangement, the ability to get additional loans, for expansion or working capital, may be dramatically diminished.
- I Sinking Funds.** A buy-sell arrangement can be funded with a sinking fund in which earnings of the business are retained to fund the arrangement. If an owner dies soon after the arrangement is executed, this strategy will not enable the business to accumulate the necessary funds to fulfill its redemption obligation. Retention of assets in a C corporation can trigger accumulated earnings tax.
- I Installment Purchase.** A buy-sell arrangement can be funded by structuring the purchase as an installment purchase. However, this strategy puts a strain on cash flow that can be especially dramatic when the interest being purchased belonged to a majority or key owner. Such a cash flow strain can result in business failure.
- I Specific Fixed Price.** Shareholders fix the price periodically by arrangement. The primary disadvantage of this approach is that shareholders often fail to adjust the price for changes in value. If the price is not adjusted regularly, the purchase price may prove to be wholly unfair to the selling shareholder. Moreover, the IRS may disregard the actual selling price and attribute a higher value to the business interest. The primary advantage to this approach is that it is simple.
- I Book Value.** Value is determined by book value on the date of death or on the close of the last fiscal year preceding the date of death. Book value represents the fair market value of the assets minus liabilities. The primary disadvantage of this approach is that book value is seldom an accurate reflection of value because it (1) reflects depreciated historic (and not current) values and (2) ignores the entity's earnings potential. The primary advantage to this approach is that it is simple.
- I Capitalization of Earnings.** Value is determined by multiplying earnings by a capitalization factor. The capitalization factor is generally obtained by analyzing the price-earnings ratio of comparable businesses in the same industry. If this method is utilized, earnings over several years should be examined to alleviate the consequences of economic cycles. The primary disadvantage to this approach is that earnings of closely held businesses are often manipulated (through salaries) for personal tax planning purposes instead of the business needs of the entity.
- I Formula.** Value can be determined by a combination of factors. It is not unusual for a sales price to be based upon both book value and capitalization of earnings. Sometimes, a combination of these approaches is incorporated into a formula to mitigate the disadvantages of each approach.
- I Appraisal.** Value is determined by an independent appraisal at the time of sale. Sometimes an appraiser is agreed to in the arrangement. In other instances, both the selling shareholder and the remaining shareholders are allowed to pick an appraiser with the value being an average of the appraisals. This approach probably provides the value that most approximates fair market value. The primary disadvantages of obtaining an appraisal are that it can be expensive and that it can delay the settlement process.
- I Cut Throat.** The purchase price is determined by the shareholders at the time of sale. A shareholder contemplating a sale will offer his or her shares to the other shareholders at a price determined by the offering shareholder. If the other shareholders do not purchase the shares at this price, the shareholder who made the offer must buy the shares of the other shareholders at this price. This approach sets a theoretically fair price. However, it favors the shareholder with the "deepest pockets." It is primarily used for lifetime sales and usually in businesses owned equally (or nearly equally) by two individuals.

Valuation Methodology

An important consideration when structuring a buy-sell arrangement is the method by which the business will be valued (i.e., the "valuation methodology"). The following are several common methods of business valuation:

A well-drafted and adequately funded buy-sell arrangement is an important piece of a business owner's succession and estate plan. Start a conversation with your clients today about the importance of protecting their business. John Hancock's Business Valuation Calculator is a useful tool to help determine the approximate value of a business. Visit www.jhbusinessvaluation.com to learn more.

1. For simplicity, this Sales Strategy will ordinarily refer to business entities as corporations. However, buy-sell arrangements can be used in any type of business arrangement. Tax consequences differ depending upon the entity involved. The triggering event for the buy-sell arrangement is typically the death of a shareholder. However, triggering events in a well drafted buy-sell arrangement ordinarily include a shareholder's death, disability, retirement, or other termination of a shareholder's employment.
2. See IRC section 1367(a)(1). In many instances, a portion of the basis increase is "lost," as a pro-rata amount of the basis increase may be allocated to the shares of the deceased shareholder. The allocation of the basis increase will depend upon the corporation's accounting method and whether it makes a "short year" election under IRC section 1377(a)(2).
3. A redemption of stock under IRC section 302 is eligible for capital gain tax treatment if (1) the distribution is not essentially equivalent to a dividend, (2) the redemption is "substantially disproportionate" with respect to the shareholder (i.e., the shareholder's interest after the redemption is less than 80% of the interest before the redemption and the shareholder's interest is less than 50% of the total voting power), or (3) there is a complete termination of the shareholder's interest (including an interest as officer, director, or employee). The "family attribution" rules of IRC section 318(a) can complicate the application of IRC section 302. If the stock is more than 35% of the decedent's adjusted gross estate, IRC section 303 may provide an additional "safe harbor." The amount of the redemption that can be protected by section 303 is limited to the extent of the estate's federal and state estate taxes, administrative expenses, funeral expenses, and generation-skipping transfer taxes (to the extent that funeral and administrative expenses are allowed as deductions under section 2053.) For an S corporation, the estate receives a step-up in basis for the value of the shares. In addition, the basis of the shares in the hands of the estate will need to reflect its percentage of the income/loss items from the date of death to the date of purchase.
4. To avoid accumulated earnings taxes, the accumulation must meet a business (not shareholder) purpose. With a single majority shareholder, it is more likely that the IRS will find the accumulation is serving a shareholder purpose.
5. The buy-sell arrangement should require a sale at fair market value. Sale to a family member for less than fair value constitutes a gift to the extent that the fair market value exceeds the transfer price. See IRC §2703(b).
6. See IRC Section 101(a)(2). The death benefits of a life insurance policy obtained in a transfer for value will not be free of income taxes unless the transfer falls within an exception to the transfer-for-value rule.
7. See IRC section 101(a)(2)(B). The exceptions to the transfer-for-value rule include the transfer of a policy to (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, or (4) a corporation in which the insured is a shareholder or officer.
8. A Private Letter Ruling (PLR) is merely an IRS interpretation of law and is only binding upon the taxpayer to whom it is issued.
9. The use of a bonus arrangement creates additional compensation to the recipient and must fall within the reasonable compensation guidelines of the Internal Revenue Code Section 162 in order to be deductible by the corporation.
10. A qualified appraisal of the business should be completed.
11. Each owner may desire to endorse 100% of the death benefit to the other owners during the buy-sell period. The split-dollar final regulations are silent as to whether this is permissible. Clients should consult their tax advisors to discuss this issue.
12. Under the split-dollar final regulations, the economic benefit amounts received by each owner will be treated as rental income and taxed at ordinary income tax rates. In essence, the sum of all anticipated economic benefit amounts represents twice-taxed dollars. The present value of the combined income taxes on the sum of all anticipated economic benefits is essentially an option price that the parties have agreed to at the outset to purchase the flexibility provided by the cross endorsement buy-sell arrangement. Clients should consult their tax advisors to discuss this issue.
13. The parties to the cross endorsement buy-sell arrangement may wish to restrict access to the policy's cash values to the extent that access does not impair the death benefit being endorsed. Loans and withdrawals will reduce the death benefit and 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. Cash value available for loans and withdrawals may be more or less than originally invested.
14. See PLR 200747002, in which three business owners established an "Insurance LLC" (Limited Liability Company) to own life insurance policies on the lives of the business owners with management of the policies by an independent Manager. The IRS ruled that the business owners would not have any incidents of ownership in the life insurance policies. PLRs are binding authority only for the taxpayer to whom they are issued.
15. See Treas. Reg. §20.2042-1(c)(6).

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. 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 registered representatives. Prospective purchasers should consult their professional tax advisor for details.

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BUSINESS STRATEGIES

Unilateral Buy-Sell Arrangement



BUSINESS CONTINUATION

Establish a ready market for your business by using a one-way buy-sell agreement with a key employee or family member.

PREPARING FOR YOUR BUSINESS TO CONTINUE WITHOUT YOU IS A SMART GOAL.

If you know who you'd like to take over your business, you've taken one important step toward preparing for your business to continue when you're no longer a part of it. Take the next step. A unilateral buy-sell arrangement funded with life insurance can help you with your business legacy goals. Consider whether these statements are true of your situation:

- ▶ You are the sole owner of your business.
- ▶ You want to establish a ready market for your business interest at your death.
- ▶ You have an "heir apparent" in mind, perhaps a family member or a key employee who is capable of running the business.
- ▶ You want to establish an estate tax value for your business interest in order to reduce potential IRS disputes.
- ▶ You want to be certain that funds will be available to help with the buyout of your interest.

If you can identify with one or more of those statements, establishing a unilateral buy-sell arrangement funded with life insurance may be something you should consider.

WHAT IS A UNILATERAL BUY-SELL ARRANGEMENT?

- ▶ A binding contract between you (the seller) and a willing purchaser (the buyer) providing for the transfer of a business interest under specified conditions and terms.
- ▶ An arrangement that, when funded with life insurance purchased by the buyer, helps to ensure that cash will be available to complete the buyout.

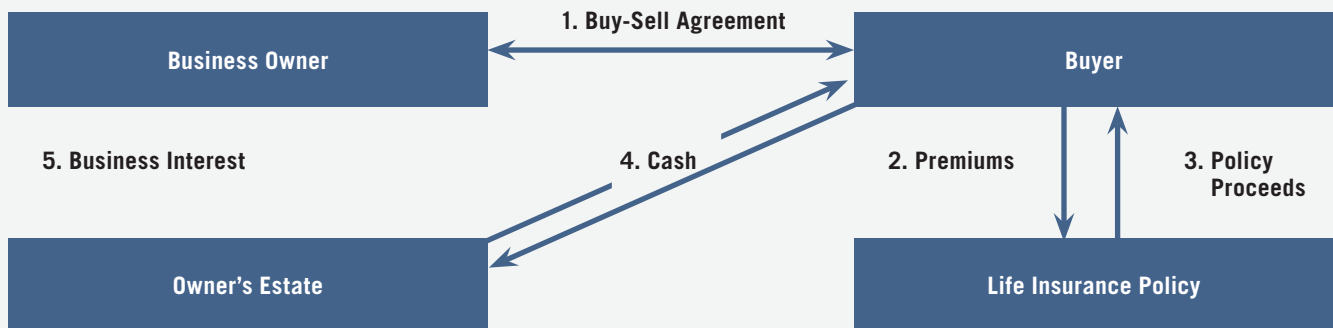
BENEFITS TO THE BUYER

- ▶ A funded buy-sell arrangement provides needed cash at the owner's death to help meet purchase obligations created by the agreement.
- ▶ A valued key employee or a family member is assured that his or her loyalty and dedication are recognized and that his or her role in the business will continue in the future.
- ▶ Where permanent life insurance is purchased, the policy cash values, if any, can be accessed by the policyowner for use in a lifetime purchase of the business interest.¹

¹ Life insurance cash values are accessed through withdrawals and policy loans. Outstanding loans and withdrawals will reduce policy cash values and the death benefit and may have tax consequences.



BENEFITS TO THE DEPARTING OWNER OR HEIRS



- ▶ The buy-sell arrangement provides a ready market for the sale of the business.
- ▶ Cash paid for the business interest is available for estate liquidity or other family needs.
- ▶ The departing owner and his or her heirs are relieved of the business responsibilities.

HOW A UNILATERAL BUY-SELL ARRANGEMENT WORKS

1	The business owner and the buyer enter into a binding buy-sell agreement. This agreement does two things: 1) obligates the business owner's estate to sell his or her business interest upon death; and 2) obligates the buyer to purchase the business owner's business interest upon death. Where desired, additional language can be added to the buy-sell agreement to cover a proposed lifetime sale due to disability or retirement.
2	The buyer obtains life insurance on the life of the business owner. The buyer is the owner, beneficiary, and premium payer of the policy. You should consult your legal counsel to determine whether notice and consent under IRC §101(j) is required before the policies are issued to receive tax-favored treatment. ²
3	At the death of the business owner, the buyer receives the policy proceeds.
4	The buyer uses the life insurance proceeds to fulfill his or her purchase obligation according to the terms of the buy-sell agreement.
5	The business owner's estate releases the business interest and/or assets to the buyer.

² For employer-owned life insurance policies issued after August 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally income tax-free under IRC §101(a). Internal Revenue Bulletin 2009-24, Notice 2009-48 provides further guidance concerning ownership.

TAX CONSIDERATIONS FOR THE BUYER

- ▶ Policy proceeds are generally received income tax-free under IRC §101(a). For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met, and certain exceptions apply, death proceeds can be received income tax-free under IRC §101(j).
- ▶ Premium payments for life insurance are not income tax-deductible.
- ▶ An employee benefit strategy such as a bonus arrangement [or a split-dollar arrangement] may be negotiated with the business owner to help defray the buyer's personal cost of the life insurance policy.
- ▶ Policy cash value increases generally accrue income tax-deferred.
- ▶ The buyer will receive the benefit of a basis in the purchased business interest equal to the price paid.

TAX CONSIDERATIONS FOR THE DEPARTING OWNER OR HEIRS

- ▶ If properly drafted, buy-sell agreements can help establish the value of the business interest for estate tax purposes.
- ▶ The sale of the business interest at death generally does not result in income taxable gains due to the step-up in basis received by the estate. However, where “hot assets” such as unrealized receivables or appreciated inventory are sold to the purchaser, ordinary income results.
- ▶ The lifetime sale of the business will generally result in capital gains income taxation unless “hot assets” are sold.

RECOMMENDED ACTION PLAN

1. Seek the professional advice of your attorney regarding your personal needs and objectives for the disposition of your business interest.
2. Meet with your accountant, attorney, and/or professional appraiser to determine the value of your business interest.
3. Determine the appropriate insurance solution.
4. Have your attorney draft the buy-sell agreement and other appropriate documents.
5. Have the potential buyer apply for the life insurance and have the business owner (you) complete all medical and underwriting requirements.

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