John Hancock
LIFE INSURANCE

Sales Strategy

One-Way Buy-Sell Arrangements

THE SITUATION

Many business owners do not make formal plans to transfer the business to a successor in the event of retirement, disability or death of the owner. However, lack of succession planning can cause a business to fail because of the significant changes that follow these triggering events. A well-drafted and properly funded buy-sell arrangement can clarify who will own and run the business upon the owner's death, retirement or disability. For situations where there are multiple business owners, there are several buy-sell options such as cross-purchase, entity redemption or cross-endorsement arrangements. However, in some cases there may be only one business owner and the owner may have identified one valued employee as a potential successor.

WHAT IS A ONE-WAY BUY-SELL ARRANGEMENT?

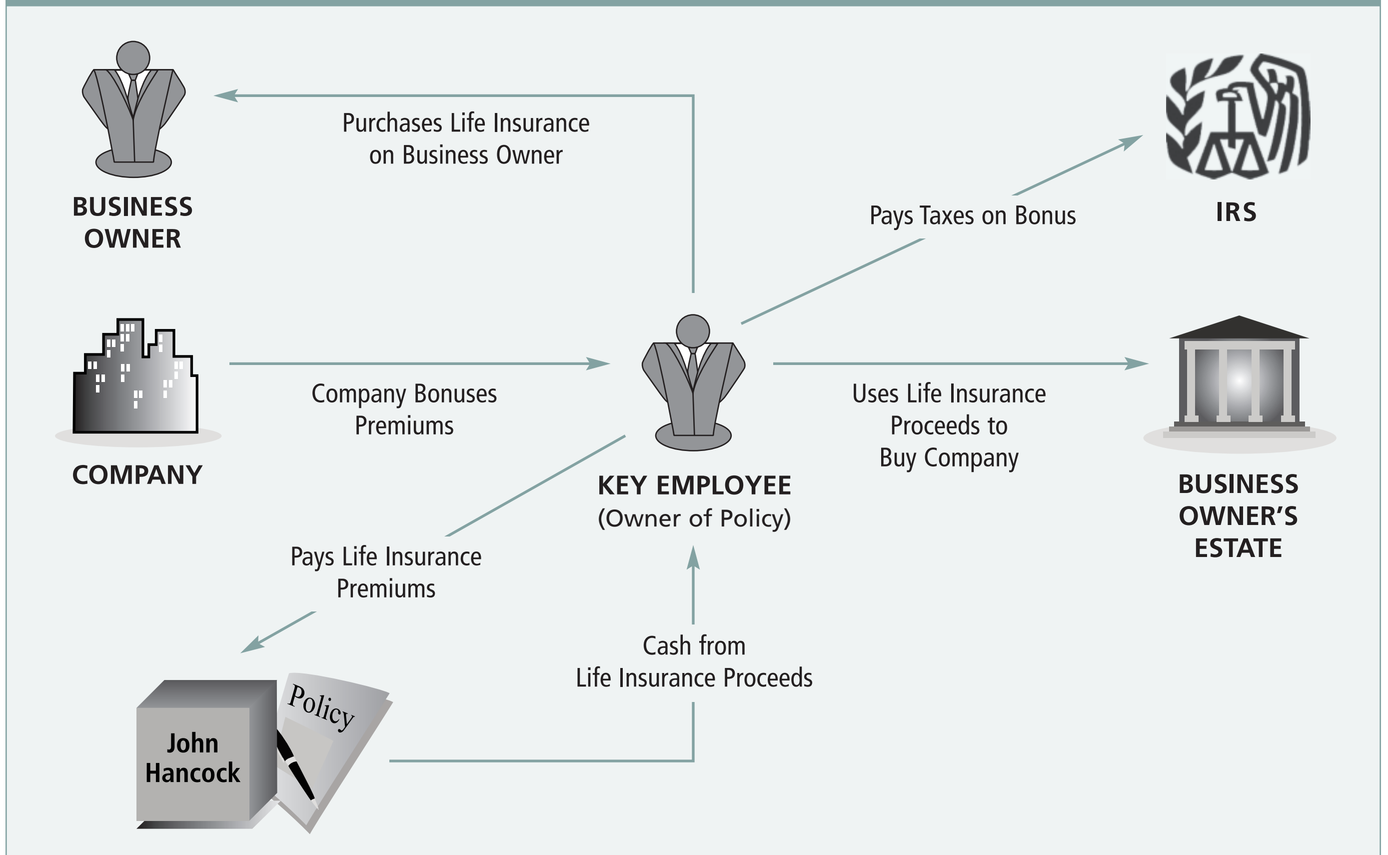
A one-way buy-sell arrangement is a succession planning arrangement in which a key employee agrees to buy the business in the event of the owner's death, disability or retirement. Unlike a typical cross-purchase buy-sell arrangement, in which two or more business owners own life insurance policies on each other's lives, a one-way buy-sell arrangement only requires the purchase of one life insurance policy on the owner of the business. The arrangement can be funded with a permanent life insurance policy to provide the flexibility needed to accommodate changing needs over the life span of the business.

HOW DOES IT WORK?

In accordance with the terms of the buy-sell agreement, the intended successor will purchase and own a permanent life insurance policy on the owner's life. The valued employee, who may be a family member or a key person in the business, will also be the beneficiary of the life insurance policy. The company will pay a bonus annually to the key employee in the amount of the premium payment due, 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 key employee.[1] The company may also choose to make a double bonus, which is equivalent to the premiums due plus the income tax due on the bonus.

It is necessary to establish the value of the business in order to ascertain the value of the life insurance policy that will be used to fund the buyout. Fixing the value of the business can eliminate future disagreements and avoid confusion and additional expenses. The valuation may also be relied upon for estate tax purposes to provide a fixed value for both a lifetime transfer of the business as well as the transfer of the business at death.[2] There are a number of valuation methods that can be used including a multiple of book value, qualified business appraisal or capitalization of earnings method.[3]

The life insurance policy can be cost effective and sufficiently flexible to supply liquidity to facilitate the buyout when needed. When permanent life insurance is used to fund the plan, it may also be possible to design the policy to fund a buyout at retirement or to fund payments to the owner upon disability.



THE BENEFITS

- The life insurance proceeds should not be subject to income taxes.[4]
- The company will receive a tax deduction for the bonus payments.
- The successor/employee should receive a full basis step-up for the purchase of the business interest.
- The life insurance policy does not increase the value of the business.
- The family attribution rules do not apply to a one-way buy-sell agreement.[5]
- Since the business entity is not a party to the buy-sell agreement, the corporate alternative minimum tax (AMT) and accumulated earnings tax do not apply to the policy proceeds.
- The value of the business may be fixed for estate tax purposes.
- Policy cash value may be available for purchase of the business during the owner's lifetime.

THE CONSIDERATIONS

- The successor/employee will have to recognize the bonus amount received for life insurance premium payments as taxable income.
- Since the successor/employee owns the life insurance policy, the policy cash value will be includable in his/her estate, if he/she predeceases the business owner.[6]
- Access to the policy's potential cash values may lower the death benefit needed to satisfy the buy-sell obligation.

CASE STUDY: MICHAEL EVANS AND JUDY SMITH

Michael Evans, age 55, is the sole owner of a successful furniture business, Evans Design, and he has decided that he wants to put a succession plan into place for the business. His designated successor is Judy Smith, one of his long-time employees. They have consulted with a financial advisor and determined that Michael and Judy should establish a one-way buy-sell agreement, with a life insurance policy on Michael's life to fund the arrangement. Michael has started to plan his retirement, and the buy-sell agreement states that Judy would use the insurance proceeds to buy out Michael's business interest.

Since the value of Michael's business interest is $5,000,000, Judy will be the owner and beneficiary of a $5,000,000 John Hancock Accumulation UL policy on Michael's life. Evans Design will pay Judy a bonus each year to cover the annual premium amount of $185,962 for twelve years and Judy will be responsible for the income tax that will be due on the bonus payments. John Hancock's Accumulation UL product has high potential cash values which can allow Judy to begin the buyout during Michael's lifetime; this approach can also enable Michael to use some of the buyout payments for his retirement. The chart below shows that after Michael begins retirement at age 67, Judy can start taking annual withdrawals of $250,000 from the policy for ten years to complete half of the business purchase during Michael's lifetime.

Year	After-Tax Corporate Annual Outlay*	Annual Premium Payment	Available Policy Cash Value	Annual Policy Withdrawal[7]	Net Policy Death Benefit
1	$120,875	$185,962	$156,355	$0	$5,000,000
5	$120,875	$185,962	$866,374	$0	$5,000,000
10	$120,875	$185,962	$1,982,797	$0	$5,000,000
15	$0	0	$2,166,736	$250,000	$4,250,000
20	$0	0	$1,327,926	$250,000	$3,000,000

This is a supplemental illustration authorized for distribution only when preceded or accompanied by a basic illustration from the issuer. Benefits and values may not be guaranteed; the assumptions on which they are based are subject to change by the insurer. Actual results may be more or less favorable. Refer to the basic illustration for guaranteed elements and other important information. Based on Male, Preferred Non Smoker, age 55, twelve-pay policy, Massachusetts resident.

* The After-Tax Corporate Annual Outlay includes the bonus payment of $185,962 less the tax deduction of $65,087 on the bonus.

As the chart indicates, the life insurance policy will help ensure that the succession plan outlined in the buy-sell agreement can be successfully implemented. Using the Accumulation UL product to fund the buy-sell arrangement will allow Judy to begin buying out Michael's interest during his life, and also help fund Michael's retirement. The death benefit will be available for Judy to complete the buyout of the business following Michael's death.

1. 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.
2. IRC Section 2703 provides certain tests that the taxpayer must meet to permit the value of the buy-sell arrangement to set the value of the business for federal estate tax purposes. First, the buy-sell agreement must reflect a bona fide business arrangement. Second, the buy-sell agreement must not represent a device to transfer the business interest to the decedent's family or the natural objects of the decedent's bounty for less than full and adequate consideration. Third, the terms of the buy-sell agreement must remain comparable to similar arrangements entered into by persons in arms-length transactions.
3. Generally, the business should obtain an independent audit of its books and financial records prior to use of the book value method.
4. See IRC Section 101(a)(1) and Treas. Reg. Section 1.101-1(a)(1). 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.
5. See Internal Revenue Code Section 318. In some entity redemption arrangements, the family attribution rules may apply; an individual may be considered to own the stock owned by some of his/her family members. The family attribution rules do not apply to one-way or cross-purchase buy-sell arrangements.
6. The successor's estate may receive a corresponding tax deduction for the liability associated with the buy-sell agreement.
7. 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. Cash value available for loans and withdrawals may be more or less than originally invested. Withdrawals are available in the 2nd policy year.

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