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Implementing a Successful Buy-Sell Funding Strategy

After carefully considering what terms should be included in your buy-sell agreement, it is equally important to craft a funding strategy that is aligned to the plan so those terms can be carried out.

Business owners enter into buy-sell agreements to help plan the smooth transition of their companies. Unfortunately, in too many cases the plans are not sufficiently funded, making it nearly impossible to execute them as intended. Acquiring an appropriate amount of life insurance coverage, properly structuring ownership and beneficiary designations, and aligning the type of life insurance policy with the terms of the buy-sell agreement are critical to implementing a successful funding strategy.

Finding Your Goldilocks Zone

Scientists say a planet is in the Goldilocks zone when it is an optimal distance from its sun to potentially support life. The planet cannot be too hot or too cold. We believe buy-sell funding also has a Goldilocks zone of sorts in that parties to a buy-sell agreement will seek to find an optimal funding level. Acquiring a life insurance policy with too much death benefit will result in unnecessary premium expenses. Acquiring a life insurance policy with too little death benefit may lead to cash flow issues, shareholder conflicts, and possible time-consuming litigation.

Assume a hypothetical business valued at $15 million, owned equally by three shareholders, A, B, and C, each owning 100 shares of the business. Further assume the buy-sell agreement requires the business entity itself to purchase the shares of a deceased shareholder (an entity-purchase agreement). In this example, the business may be inclined to purchase $5 million of coverage on each shareholder's life because each owns one-third of a $15 million business.

However, it is not as straightforward as it may appear. The terms of the agreement can be a strong factor influencing how much and what type of life insurance coverage is most appropriate. A key is acquiring sufficient life insurance protection to avoid creating cash flow issues for the business that negatively affect operations going forward. It might not be necessary to buy coverage equal to the full amount of the share purchase. The amount of coverage should, however, reflect how the sale of the shares back to the company is structured and the expected financial strength and liquidity of the business.

It is common for a buy-sell agreement to allow the future purchase of shares to be structured as a lump sum payment with the remainder paid out over several years. When the business entity is the buyer, this purchase structure reduces the burden on operational

Aligning Life Insurance to Buy-Sell Terms

The terms of the buy-sell agreement can influence how much and what type of life insurance is appropriate. The death benefit, beneficiary, and policy type may be affected by:

- who is responsible for buying out the shares, that is, the business, or the other owners;
- the company's liquidity and financial strength when there is an entity purchase agreement;
- the financial resources of the owners should the buy-sell agreement be structured such that they are repurchasing the ownership interest, known as a cross-purchase agreement;
- timing of the buyout terms—lump sum payment, installment payments, or a combination;
- timing of funding needs, that is, lifetime versus death; and
- handling policies after the buy-sell need ceases.

Acquiring a life insurance policy with too much death benefit will create unnecessary premium expenses. Acquiring a life insurance policy with too little death benefit may lead to cash flow issues, shareholder conflicts, and possible time-consuming litigation.

cash flow immediately following the death of an owner. The owner in our example might only need to make a lump sum payment of $3 million, with installments covering the remaining $2 million.

In determining the amount of death benefit to purchase, the company's income history should be considered. Businesses with a history of strong, consistent liquidity and/or income ratios may be able to manage larger installment payments and therefore lower upfront lump sum payments. They might also be able to manage a share of the payments from cash flow and not need to rely on the death benefit. This would in turn allow them to fund the agreement with a lower death benefit.

If the buy-sell agreement requires each shareholder to acquire the shares of a deceased shareholder (a cross-purchase agreement), each shareholder's individual financial capacity may help determine the appropriate amount of death benefit.

If the agreement allows for an initial down payment followed by a period of installment payments, then life insurance sufficient to cover the full amount of the initial down payment may be necessary.

If a shareholder has substantial liquid assets, it may be appropriate for that shareholder to acquire life insurance equal to a portion of the initial down payment. The goal of the client will be to balance the desire to limit premium expenses with the need to provide sufficient death benefit for each shareholder to fulfill such shareholders' commitments.

Lifetime versus Death Benefits

Buy-sell agreements often create obligations and rights that are triggered by events other than the death of a shareholder. These may include the disability, divorce, bankruptcy, involuntary termination, or retirement of a shareholder. Term life insurance policies only provide funding when the triggering event is death. Cash value policies may be used to fund lifetime buy-out triggering events in addition to death. For example, a business may use tax-free withdrawals and/or loans from a corporate-owned policy to meet the company's buy-out obligations when a shareholder retires.

A key is acquiring sufficient life insurance protection to avoid creating cash flow issues for the business that negatively affect operations going forward.

Aligning the Buy-Sell Terms with the Insurance Policy

The terms of a buy-sell agreement should be aligned with policy ownership and beneficiary designations. It's important to have a clear understanding of the rights and obligations created by the agreement. These terms may be provided for in a stand-alone buy-sell agreement, or in some cases they may be included in other documents such as operating agreements or partnership agreements.

When the agreement calls for the business to redeem the shares of a deceased shareholder, the business will be the owner and beneficiary of the policy. When the agreement calls for each shareholder to purchase the shares of a deceased shareholder, each shareholder will own policies on the lives of the other shareholders and name themselves as beneficiary.[1] This may seem straightforward, but errors are made more often than one might think. Imagine the potential for conflict should a business be contractually obligated to purchase the shares of a deceased shareholder, yet the surviving shareholders are the ones who receive the death benefits.

Buy-sell agreements that provide multiple parties with options to purchase a business interest present funding challenges. So-called "wait-and-see" buy-sell agreements may provide the business entity with an option to purchase a deceased shareholder's interest, and if the business declines, the surviving shareholders may have an option to purchase. This creates a dilemma as to which party should receive the death benefits. Various factors are considered in determining the structure of a buy-sell agreement. But when looking through a funding lens, it may be better to agree on a specific approach so a clear funding mechanism can be identified.

Beyond the proper owner and beneficiary designations, there are a number of other considerations for aligning the agreement with the funding vehicle. In a cross-purchase agreement, the owners may want to require the beneficiary to use death proceeds as an initial down payment, with any shortfall being paid out in installments. This will help avoid the situation where a surviving shareholder receives a substantial lump sum death benefit and elects to retain those funds for personal use.

Business owners may also see value in a provision that grants them the right to purchase policies taken out on their lives. This right may be triggered when shareholders sell their shares and are no longer

[1] An alternative would be to implement an endorsement split-dollar arrangement in which a cross-purchase agreement may be funded with cash value life insurance policies owned by the business. The goal is to reduce the taxable income realized by the shareholders.

owners. An alternative could be to permit the business to retain the policy as a means to recover the cost of premiums when the insured passes away.

Tax Considerations

The Internal Revenue Code (IRC) contains a number of tax provisions specific to life insurance policies that have the potential to create unexpected negative tax issues. For example, while life insurance death benefits are generally received income tax free, there are a number of transactions that will cause the death benefits to be taxable.[2] The internal growth of cash values inside a policy generally do not trigger an income tax, but in some situations they may be subject to the corporate alternative minimum tax.[3] Also, there is often confusion over the deductibility of life insurance premiums, which are not deductible as a business expense when the business is the owner and beneficiary of the policy.[4]

Each of the tax issues above may be addressed with proper planning. Buy-sell agreements should be drafted by attorneys and with the advice of tax professionals.

Conclusion

Running a successful business requires you to have one eye focused on the day's tasks and the other focused on tomorrow's opportunities and challenges. Buy-sell agreements are one tool business owners may use to help provide for the continued success of a business should unexpected events occur. Proper funding of the obligations help to assure your plans are carried out.

For more information, please contact your PNC advisor.

[2] Policies transferred for valuable consideration. IRC Section 101(a)(2). Employer owned policies. IRC Section 101(j).

[3] IRC Section 56, Treasury Regulation 1.56(g)-1(c)(5). Small corporation exemption for corporations with average annual gross receipts for all three taxable-year periods does not exceed $7,500,000 ($5 million in the first three years of the corporation). IRC Section 55(e).

[4] IRC Section 264.