An Insured Buy-Sell Plan for Sole Corporate Owners

While the death of a sole owner may have no legal effect on a corporation, without advance planning there are some very real practical consequences that can have an adverse impact on the owner's heirs, as well as on the ability of the corporation to continue as a viable business.

Prepared for:

Brought to you by:

MRW FINANCIAL BROKERAGE

Life Insurance, Annuities and Long-Term Care

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What Happens When a Sole Corporate Owner Dies?

While the death of a sole corporate owner may have no legal effect on a closely-held corporation, there are some *practical* consequences that can have a serious impact.

For starters, the business has lost its guiding force, undoubtedly a serious blow to the business.

Then there is the issue of the deceased owner's heirs.

In the absence of advance planning, the heirs:

1. may have to become active in the business;
2. they can remain inactive but look to the corporation for income...a corporation that has just lost its sole owner; or
3. the heirs can try to sell the stock...without the services of the sole owner.

Problems at a Sole Corporate Owner's Death

When a sole corporate owner dies, a number of problems may arise:

Survivor Income

How will an income be continued to surviving family members?

Debts

Will there be sufficient funds to pay the sole owner's personal and business debts?

Estate Settlement Costs

Will the executor or administrator have sufficient cash to pay estate taxes and the other estate administrative costs required to settle the estate?

Business Disposition

How can the value of the corporation best be preserved for the heirs?

Unfortunately, without proper advance planning, the only solution to these problems may be a financially-disastrous forced liquidation of the corporation in order to pay debts and estate settlement costs, with the heirs receiving the remainder of the liquidation value, if any.

There may, however, be another alternative...

A Potential Solution Using Life Insurance

When a potential purchaser for the corporation exists -- a key employee, a relative, or even a competitor -- an insured buy-sell plan can provide for an orderly transfer of business ownership at the sole owner's death.

With advance planning, an insured buy-sell plan can accomplish the following:

- A market for the sale of the corporation is created.
- The purchaser is committed to buy and the deceased owner's estate is committed to sell the corporation for a price that is agreed upon in advance.
- The full purchase price is available exactly when needed at the sole owner's death.
- The corporation is sold promptly and for its full market value, avoiding the losses associated with a forced liquidation.
- The value of the corporation may be fixed for federal estate tax purposes.
- Cash is available to settle the estate promptly and efficiently.

How Can a Buy-Sell Plan Be Funded?

There are **FOUR** ways the purchaser of a corporation can fund a buy-sell plan:

1. **Cash Method**

   The purchaser could accumulate sufficient cash to buy the corporation at the sole owner's death. Unfortunately, it could take many years to save the necessary funds, while the full amount may be needed in just a few months or years.

2. **Installment Method**

   The purchase price could be paid in installments after the sole owner’s death. For the new owner, this could mean a drain on business income for years. In addition, payments to the surviving family would be dependent on future business performance after the sole owner’s death.

3. **Loan Method**

   Assuming that the new owner could obtain a business loan, borrowing the purchase price requires that future business income be used to repay the loan PLUS interest.

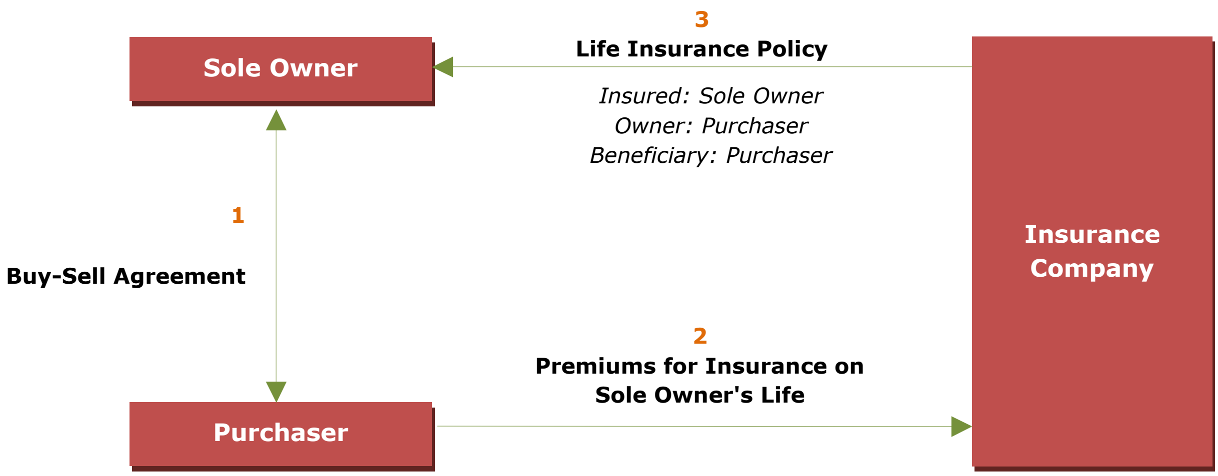
4. **Insured Method**

   Only life insurance can guarantee that the cash needed to complete the sale will be available exactly when needed, assuming that the corporation has been accurately valued (guarantee is based on the continued claims-paying ability of the insurer).

The Mechanics of an Insured Buy-Sell Plan

The bottom line is that a buy-sell plan funded with life insurance is an economical and efficient method of providing the cash necessary to complete the sale of the corporation at the sole owner's death.

Here's how an insured buy-sell plan could work for you and your corporation today...



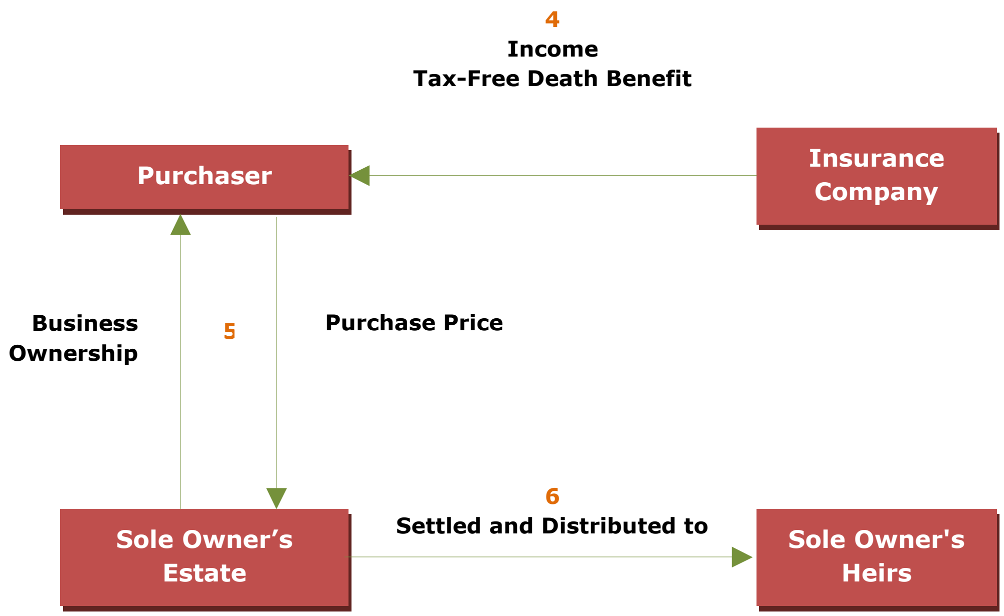
1. The sole corporate owner and purchaser enter into a buy-sell agreement in which the sole owner agrees to sell and the purchaser agrees to buy the corporation for an agreed-upon price.

2. The purchaser buys sufficient insurance on the sole owner's life to purchase the business and pays the premiums.

3. The life insurance policy on the sole owner's life is owned by the purchaser, who is also named as the beneficiary.

The Mechanics of an Insured Buy-Sell Plan

Here's how an insured buy-sell plan could work at the Sole Corporate Owner's death...



4. At the sole corporate owner's death, the life insurance death benefit is received free of income tax by the purchaser, who is policy owner and beneficiary.

5. The purchaser uses the proceeds of the life insurance policy to buy the corporation from the sole owner's estate for the purchase price agreed upon in the buy-sell agreement.

6. After settling the estate, the executor or administrator distributes the balance of the estate to the sole owner's heirs, according to the terms of the sole owner's will.

What Are the Other Features of an Insured Buy-Sell Plan?

In addition to serving as a source of funding, an insured buy-sell plan can provide a variety of other features:

- **Payment is prompt and certain.** Life insurance proceeds are not subject to the time and expense of the probate process, making them immediately available to complete the purchase of the corporation.
- **The event creating the need for cash –** the sole owner's death -- **also creates a source of cash** -- the life insurance death benefit. The life insurance policy provides the dollars for a certain need -- purchase of the corporation -- that arises at an uncertain time -- death.
- **If the death benefit exceeds the total premiums paid, this gain generally is received free of income tax.** For example, if only 20 cents of each death benefit dollar received has been paid in premiums, the 80 cent gain is received income tax free.
- **Life insurance avoids the problems associated with the other methods** for financing the purchase of a corporation at the owner's death.
- **Any cash value in the life insurance policy could be used to help purchase the business interest at the owner's disability or retirement** (withdrawals and loans will reduce the policy's death benefit and cash value available for use).
- **If the purchaser is an employee,** the sole owner can assist in funding the buy-sell plan through an endorsement split dollar program that includes a restrictive access endorsement on the employee-owned policy.

Summary of Insured Buy-Sell Plan Tax Results

- Premium payments for life insurance to fund an insured buy-sell plan are considered a personal expense of the purchaser and, as such, are not tax deductible.

- Generally, life insurance proceeds received by the purchaser at the sole corporate owner's death are not subject to federal income tax.

- The transfer of the sole corporate owner's business interest in exchange for the death proceeds is treated as the sale of a capital asset. The basis of this capital asset is adjusted to its fair market value on the date of the sole owner's death. Thus, if the amount received by the sole owner's estate -- the purchase price -- equals the fair market value of the corporation at death, no gain for federal income tax purposes will result.

- Assuming the policy is properly arranged, with the sole owner holding no incidents of ownership in the policy, the death proceeds will not be included in the sole owner's estate. If, however, the sole owner owns the policy, it is likely that the death proceeds will be included in the sole owner's estate. For this reason, a professional tax advisor should be consulted before naming anyone other than the purchaser as the policy owner and beneficiary.

- If the purchase price established in the buy-sell agreement is made at "arm's length" and realistically represents the value of the corporation, that purchase price may set the value of the corporation for federal estate tax purposes, assuming that the agreement prohibits the sole corporate owner from disposing of the business during life without first offering it to the purchaser for the same price.

Estate planning provisions, reviewed on the next page, should be taken into consideration in planning for the disposition of a corporation at the sole owner’s death.

Estate Planning Considerations

The federal estate tax is a **progressive tax on the right to transfer property at death**. In 2020, federal estate tax rates begin at 18% and increase to as much as 40% of the taxable value of an estate.

The **federal estate tax** is a transfer tax imposed on the privilege of transferring property at death, while the **federal gift tax** is imposed on the transfer of property during the property owner's lifetime. Both taxes are levied on the **right to transfer property**, and not on the property itself. The amount of tax payable, however, is measured by the **value** of the transferred property.

Once the tentative federal estate or gift tax is determined, it is then reduced by an **estate and gift tax unified credit**. This means that **taxable estates with a value equal to or less than the unified credit equivalent** will not be liable for federal estate tax. The same is true of **cumulative lifetime taxable gifts** which, however, will be brought back into the owner's estate for federal estate tax calculation purposes. **The unified credit equivalent is equal to $11,580,000 in 2020, as adjusted for inflation**, meaning that an individual currently can transfer property valued up to $11,580,000, whether during life and/or at death, without incurring a tax liability.

In addition, **"portability" of the maximum estate tax unified credit between spouses** is available, meaning that a surviving spouse can elect to take advantage of any unused portion of the estate tax unified credit of his or her predeceased spouse (the equivalent of $11,580,000 in 2020). As a result, with this election and careful estate planning, married couples can effectively shield up to $23 million plus (as adjusted for inflation) from the federal estate and gift tax.

Finally, **estate tax deferral** allows payment of estate tax attributable to the value of a closely-held business included in the estate to be deferred for up to five years.

No discussion of estate planning considerations in regard to business continuation would be complete without mention of the **generation-skipping transfer tax** (GSTT). An objective of the federal government is to collect taxes on the transfer of property from one generation to the next generation. If, however, an estate owner is able to skip the members of the immediately lower next generation and transfer property to someone two or more generations removed, the government is deprived of the estate tax that would have been collected on that property at the death of members in the immediately lower next generation. As a result, a generation-skipping transfer in excess of available exemptions is subject to the maximum federal estate and gift tax rate of 40% in 2020. The GSTT is **in addition to** any federal estate or gift tax due and is payable by the transferor, the transferor's estate or by the trustee of a trust making a generation-skipping transfer.

Your professional tax advisor can assist you in developing business and estate plans with the flexibility needed to adjust to an uncertain tax future.

Insured Buy-Sell Plan Action Checklist

Now…

- ☐ Establish the value of the corporation.
- ☐ Select the appropriate life insurance funding vehicle.
- ☐ Establish the sole owner's insurability.
- ☐ Arrange for payment of premiums.

Short-Term…

- ☐ Draft and execute a buy-sell agreement.
- ☐ Review the issued policy.
- ☐ Evaluate funding options for the purchase of the business at the sole owner's disability or retirement.

Longer-Term…

- ☐ An annual review can help ensure that the plan and its funding remain current.
- ☐ Consider the purchase of key employee indemnification insurance on the sole owner.

Important Information

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