

A Sole Proprietor Insured Buy-Sell Plan

At a sole proprietor's death, the business is dissolved and all business assets and liabilities become part of the sole proprietor's personal estate. Have you evaluated the impact this could have on your surviving family members?

Prepared for:

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FINANCIAL BROKERAGE

*Life Insurance, Annuities and
Long-Term Care*

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What Happens When a Sole Proprietor Dies?

Since a sole proprietorship has no legal identity apart from its owner, the death of a sole proprietor terminates the business.

All business assets and liabilities become part of the sole proprietor's personal estate.

It then becomes the responsibility of the sole proprietor's executor or administrator to settle the estate, including disposition of the sole proprietorship.

Problems at a Sole Proprietor's Death

When a sole proprietor 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 proprietor'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 business interest 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 sole proprietorship 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 sole proprietorship 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 proprietor's death.

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

- A market for the sale of the sole proprietorship is created.
- The price at which the sole proprietor will sell and the purchaser will buy the business is agreed upon in advance.
- The full purchase price is available exactly when needed at the sole proprietor's death.
- The business is sold promptly and for its full market value, avoiding the losses associated with a forced liquidation.
- The value of the sole proprietorship 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 sole proprietorship can fund a buy-sell plan:

1. Cash Method

The purchaser could accumulate sufficient cash to buy the business at the sole proprietor'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 proprietor's death. For the purchaser, 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 proprietor'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.

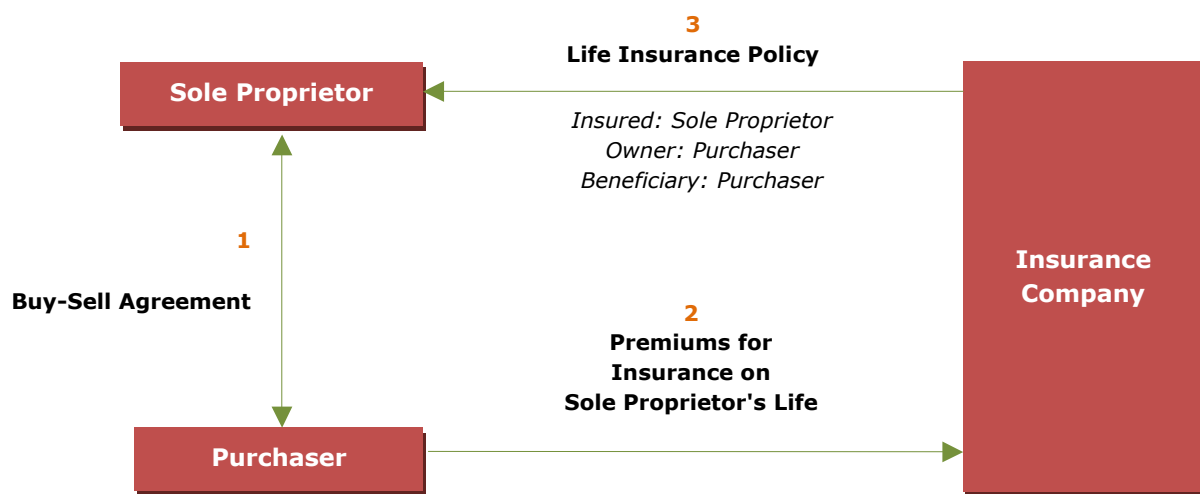
4. Insured Method

Only life insurance can guarantee that the cash needed to complete the sale will be available exactly when needed, assuming that the sole proprietorship has been accurately valued (guarantee is based on 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 business at the sole proprietor's death.

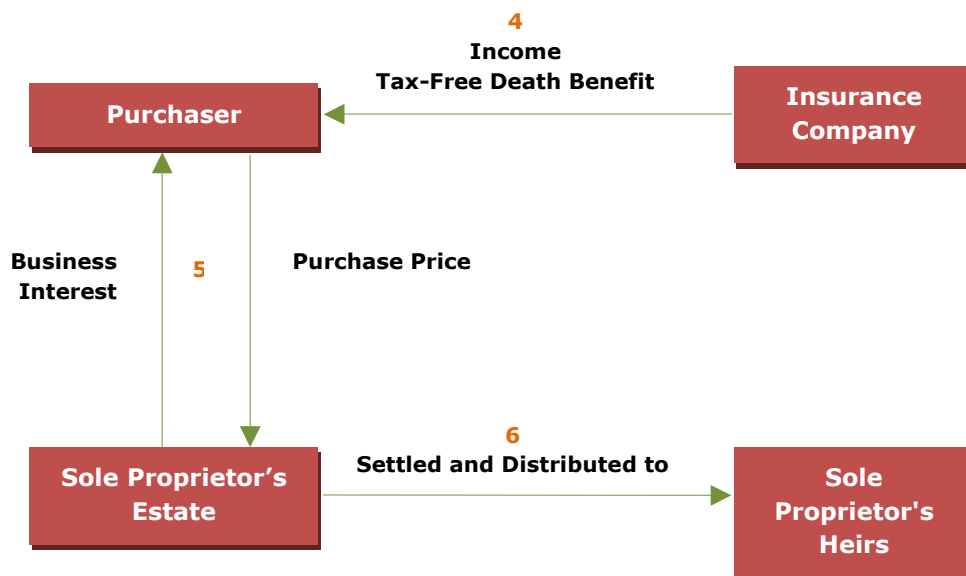
Here's how an insured stock redemption buy-sell plan could work for you and your business **today...**



1. The sole proprietor and purchaser enter into a buy-sell agreement in which the sole proprietor agrees to sell and the purchaser agrees to buy the business for an agreed-upon price.
2. The purchaser buys sufficient insurance on the sole proprietor's life to purchase the business and pays the premiums.
3. The life insurance policy on the sole proprietor'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 Proprietor's death...**



4. At the sole proprietor'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 business interest from the sole proprietor'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 proprietor's heirs.

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 sole proprietorship.
- The event creating the need for cash -- the sole proprietor'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 sole proprietorship -- 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 sole proprietorship at the owner's death.
- **Any cash value in the life insurance policy could be used to help purchase the sole proprietorship at the owner's disability or retirement** (withdrawals and loans will reduce the policy's death benefit and cash value available for use).

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 proprietor's death are not subject to federal income tax.
- The transfer of the sole proprietor'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 proprietor's death. Thus, if the amount received by the sole proprietor's estate -- the purchase price -- equals the fair market value of the business interest at death, no gain for federal income tax purposes will result.
- Assuming the policy is properly arranged, with the sole proprietor holding no incidents of ownership in the policy, the death proceeds will not be included in the sole proprietor's estate. If, however, the sole proprietor owns the policy, it is likely that the death proceeds will be included in the sole proprietor'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 sole proprietorship, that purchase price may set the value of the sole proprietorship for federal estate tax purposes, assuming that the agreement prohibits the sole proprietor 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 business at the sole proprietor'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 sole proprietorship.
- Select the appropriate life insurance funding vehicle.
- Establish the sole proprietor'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 proprietor'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 proprietor.

Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

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