

A Sole Proprietorship Insured Disability Buy-Sell Plan

A business owner's disability can have some very real practical consequences leading to problems for the owner, the owner's family, and for any employees of the 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 Business Owner Becomes Disabled?

While the disability of a business owner may have no **legal** impact on the ability of a closely-held business to continue in operation, there are some very real **practical** consequences that can have a serious impact on...the owner...the owner's family...and on any employees of the business.

For starters, the **expertise of the disabled owner** has probably been lost, which can be a serious blow to the business.

Then there is the matter of **continuing an income** to the disabled owner and the impact this will have on the business and on its ability to remain a viable going concern.

Finally, there is the issue of the **firm's employees...**

Will they be able to manage and operate the business without the disabled owner's expertise, or will they find themselves out of a job?

Problems Faced by a Disabled Business Owner

A business owner who is disabled and unable to work is faced with problems such as:

Family Income

Will the business be able to continue an adequate income to the disabled owner in order to maintain the owner's and family's lifestyle? If so, for how long? If not, what other sources of income will be available to the disabled owner?

Value of the Business

What impact will the disabled owner's absence have on business profitability? How will continuing an income to a disabled owner impact on the value of the business? How can a disabled owner receive the fair market value of his or her share of the business?

Odds of Becoming Disabled

Consider the Odds of a Business Owner Becoming Disabled for 90 Days or Longer Prior to Age 65:

Age	Number of Business Owners				
	1	2	3	4	5
30	54%	79%	90%	96%	98%
35	50%	75%	88%	94%	97%
40	45%	70%	84%	91%	95%
45	40%	64%	78%	87%	92%
50	33%	55%	70%	80%	86%
55	25%	43%	57%	68%	76%

Source: *Commissioners Individual Disability Table A (NOTE: The 1985 CIDA is the most current morbidity table available for individual disability claim experience and is in use by many State Insurance Departments.)*

It's also important to know that a disability lasting for more than 90 days is likely to continue for:

Age When Disabled	Average Duration of Disability
30	2.2 years
35	2.5 years
40	2.7 years
45	2.9 years
50	2.8 years
55	2.5 years

Source: *Commissioners Individual Disability Table A (NOTE: The 1985 CIDA is the most current morbidity table available for individual disability claim experience and is in use by many State Insurance Departments.)*

There is, however, a potential solution to avoiding the problems that can arise when the possibility of a business owner suffering a long-term disability becomes a reality...

A Potential Solution Using Disability Buyout Insurance

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

When a business and its owner implement a disability buy-sell plan in advance, disability buyout insurance can be used to provide the funds needed to purchase the disabled owner's interest for a previously agreed-upon price.

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

- The sale and the price of a disabled owner's business interest are guaranteed.
- The funds to complete the sale are available exactly when needed at an owner's disability.
- The disabled owner benefits from a source of cash that can be used to meet ongoing income needs.
- A potential forced liquidation of the business is avoided.
- A loss of business momentum is minimized.
- Funds (or even an ownership interest) needed to hire a replacement are more readily available.

How Can a Disability Buy-Sell Plan Be Funded?

There are **FOUR** ways a disability buy-sell plan can be funded:

1. Cash Method

The prospective purchaser could accumulate sufficient cash to buy the business interest at the owner's disability. 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. In addition, accumulated earnings tax problems might arise for corporations.

2. Installment Method

The purchase price could be paid in installments after an owner's disability. For the new owner, this could mean a drain on business income for years. In addition, payments to the disabled owner would be dependent on future business performance after the owner's disability.

3. Loan Method

Assuming that the business or its new owner could obtain a business loan after the sole proprietor's disability, borrowing the purchase price requires that future business income be used to repay the loan PLUS interest.

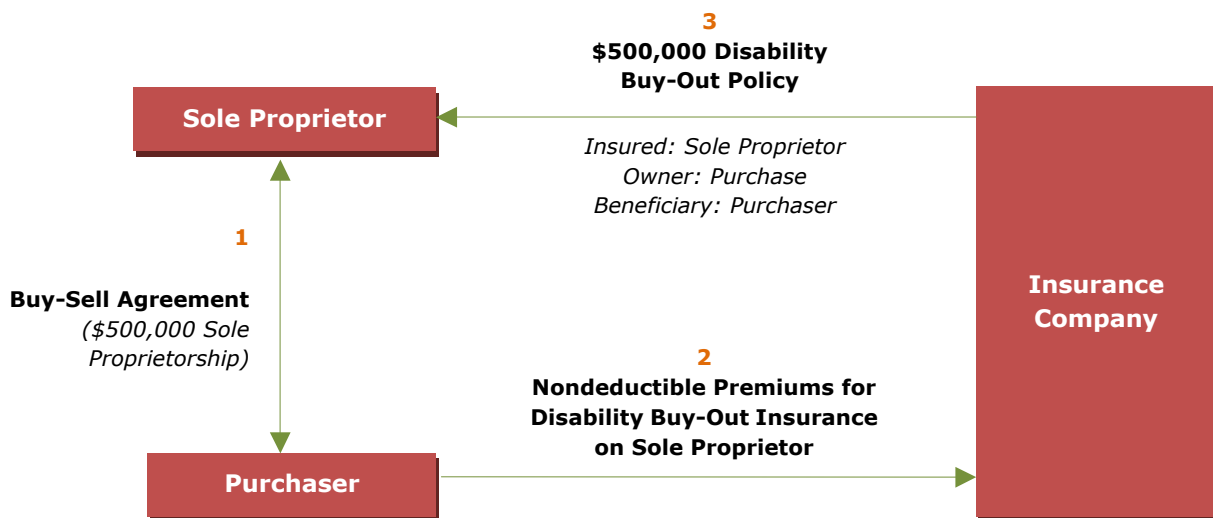
4. Insured Method

Only disability buyout insurance can guarantee that the cash needed to complete the sale, through either a single sum or installment purchase, will be available exactly when needed, assuming that the business has been accurately valued. Guarantees are subject to the claims-paying ability of the issuing insurance company.

The Mechanics of an Insured Disability Buy-Sell Plan

The bottom line is that a disability buy-sell plan funded with disability buyout insurance is an economical and efficient method of providing the cash necessary to purchase a permanently disabled owner's business interest.

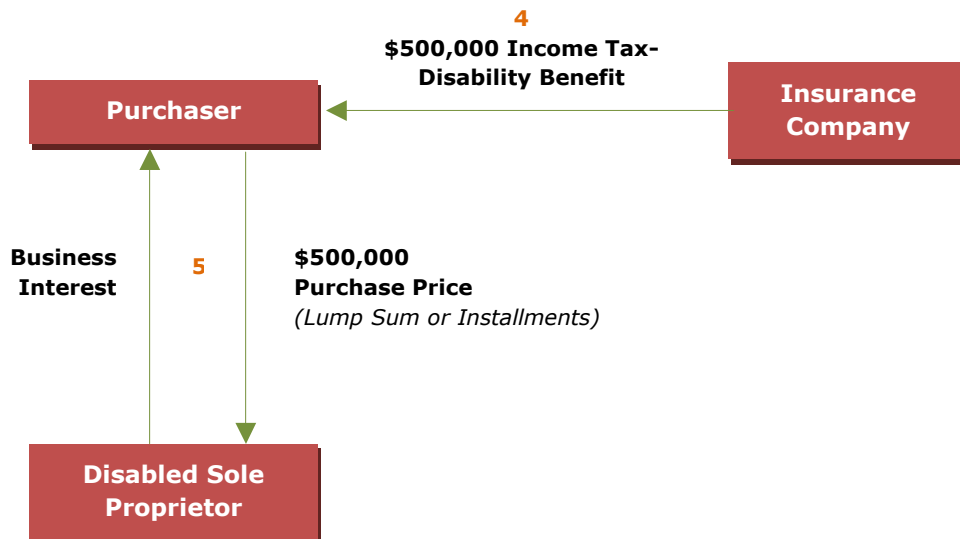
Here's how an insured disability buy-sell plan could work for you and your business **today...**



- 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 if the sole proprietor becomes totally and permanently disabled.
- 2.** The purchaser buys sufficient disability buyout insurance on the sole proprietor to purchase the business and pays the premiums.
- 3.** The disability buyout policy on the sole proprietor is owned by the purchaser, who is also named as the beneficiary.

The Mechanics of an Insured Disability Buy-Sell Plan

Here's how an insured disability buy-sell plan could work *if the sole proprietor is totally and permanently disabled...*



4. If the sole proprietor becomes totally and permanently disabled, the disability buyout proceeds are received in an income tax-free lump sum or in income tax-free installments by the purchaser, who is the policy owner and beneficiary.
5. The purchaser uses the proceeds of the disability buyout policy to buy the disabled sole proprietor's business for the purchase price agreed upon in the buy-sell agreement. The purchase price is paid in a lump sum or in installments, as specified in the agreement.

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

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

- When the definition of total disability is the same in the insurance contract and buy-sell agreement, as is recommended, **payment of the insurance proceeds** needed to purchase a disabled owner's business interest **is prompt and certain**.
- **The event creating the need for cash** -- an owner's total disability -- **triggers payment of the disability buyout proceeds**. The disability buyout contract provides the dollars for a certain need -- purchase of the business interest -- that arises at an uncertain time -- disability.

- Disability buyout insurance proceeds can be payable in a **lump sum**, in **installments** (the lowest premium cost), or in a **combination of both**.
- **If the disability buyout proceeds exceed the total premiums paid, this gain generally is received free of income tax.** For example, if only 25 cents of each dollar of disability buyout benefit received has been paid in premiums, the 75 cent gain is received income tax free!
- **Disability buyout insurance avoids the problems associated with the other methods** for financing the purchase of a business interest at an owner's total disability.
- **Selection of a waiting period**, such as 12 to 36 months, in the policy and buy-sell agreement **can be used to trigger the buyout** only after it can be reasonably assumed that the disabled owner will be unable to return to work.
- **During the waiting period**, a disabled owner's salary can be continued through a salary continuation plan funded with disability income coverage.
- **Disability buy-sell provisions can be included** in a buy-sell plan covering the purchase of an owner's business interest at death and/or retirement as well.

Summary of Insured Disability Buy-Sell Plan Tax Results

- Premium payments for disability buyout insurance to fund an insured disability buy-sell plan are not tax deductible, whether paid by the business or the individual owners.
- Generally, disability buyout policy proceeds are not subject to regular income tax, whether paid to the business or the individual owners. When paid to a corporation, however, they may be subject to the corporate alternative minimum tax.
- The transfer of the disabled owner's business interest in exchange for the disability buyout proceeds is treated as the sale of a capital asset. The disabled owner is subject to the payment of taxes at capital gains rates to the extent that the purchase price exceeds his or her basis in the business.
- In a partnership or corporation cross purchase buy-sell arrangement, the tax basis of the remaining active owners in the business is increased by the amount of the purchase price.
- In a partnership entity purchase or corporation stock redemption buy-sell arrangement, the remaining active owners receive an increased ownership share of the business, but no increase in their tax basis.

Guarantees are subject to the claims-paying ability of the issuing insurance company.

A professional tax advisor should be consulted for more detailed information on the taxation of insured disability buy-sell plans.

Insured Disability Buy-Sell Plan Action Checklist

Now...

- Establish the value of the business.
- Select disability buyout insurance with the appropriate definition of total disability, waiting period and payment method.
- Establish the owner's insurability.
- Arrange for payment of premiums.

Short-Term...

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

Longer-Term...

- An annual review can help ensure that the plan and its funding remain current.
- Evaluate the need for a salary continuation plan.

Important Information

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