



Wait-and-See Buy-Sell Arrangement

“This solution provides you with the ability to delay the decision of who will buy your business interest, the business or co-owners.”

We offer you this concept piece to help you understand how life insurance can be used to help provide funds for business continuation arrangements. This material contains references to concepts that have legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Consult your own attorney and/or tax advisor for advice regarding your particular situation. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code.

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Do you identify with the following?

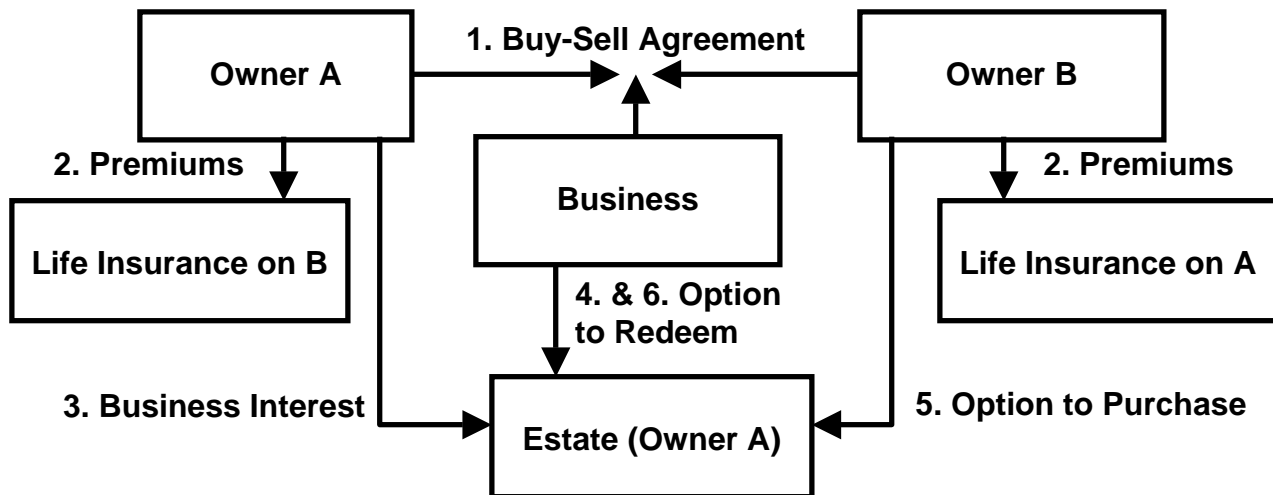
You are a business owner who:

- ◆ Would like to create a ready market for the sale of your business.
- ◆ Wants to maintain control of the business within a family or group of owners.
- ◆ Sees the need to establish an estate value for your business interest in order to reduce potential IRS disputes.
- ◆ Wants to be certain funds will be available to help with the buyout of a deceased or departing owner's interest.
- ◆ Wants the decision as to who will be the purchasing party – the business, the remaining owners, or both – to be determined by the facts and circumstances of the triggering event (generally death, disability or retirement).

If so, you may want to consider establishing a wait-and-see buy-sell arrangement funded with life insurance. A wait-and-see buy-sell arrangement is:

- ◆ A hybrid buy-sell agreement combining the cross purchase and stock redemption approaches, resulting in additional flexibility as to how the actual buyout will be accomplished and by whom – the business, the owners, or both.
- ◆ An arrangement that, when funded with life insurance, helps ensure that cash will be available to help with the buyout.

Wait-and-See Buy-Sell Arrangement



1. The owners and the business enter into a binding but flexible, buy-sell agreement that doesn't specifically identify the purchaser (business or business owner) until an owner's death.
2. Life insurance is purchased on the life of each business owner. Generally, the business owners are the owners, premium payers, and beneficiaries of the policies. You should consult your legal counsel to determine whether notice and consent under IRC § 101(j) is required before the policies are issued to obtain tax-favored treatment.¹
3. At the death of owner A, the estate receives the business interest.
4. Pursuant to the buy-sell contract, the business is given the first option to purchase/redeem all or a portion of owner A's interest at a price or formula specified in the agreement. If the redemption option is exercised, the surviving shareholder B can help finance the repurchase by lending policy proceeds to the business or by making an additional capital contribution.
5. If the business fails to purchase the stock or purchases only a portion of it, then B's cross purchase option is exercised, and the insurance proceeds can be used to finance the purchase of the business interest from owner A's estate.
6. If B (and other owners, if any) fails to purchase all of the business interest, the business is required to complete the purchase/redemption of any remaining interest.

¹ Life insurance death proceeds are generally received income tax-free [IRC § 101(a)]. For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free [IRC § 101(j)].

Benefits to the Business and Remaining Owners:

- ◆ The wait-and-sell buy-sell arrangement provides the flexibility needed to accommodate changing circumstances that may impact the purchasing decision to be made in the future.
- ◆ A buy-sell arrangement funded with life insurance provides policy proceeds to finance the buyout of a deceased owner.
- ◆ Where permanent policies are purchased, cash values can be accessed for use in a lifetime purchase to buy out an owner who becomes disabled or withdraws from the business.²
- ◆ A funded buy-sell arrangement minimizes the risk of the business being sold to outsiders and allows surviving owners and/or family members to retain control.
- ◆ Employees, creditors, and suppliers gain added security that the business will continue.

Benefits to the Departing Owner or Heirs:

- ◆ The wait-and-see buy-sell arrangement provides a ready market for the sale of the business.
- ◆ It ensures that cash will be available to pay estate taxes and/or to meet family needs.
- ◆ If properly drafted, implemented, and maintained, the arrangement helps to establish the business value for estate tax purposes.

² Life insurance policy cash values are accessed through withdrawals and policy loans. Loans are at interest. Loans and withdrawals cause a reduction in cash values and death benefits, may affect any guarantees against lapse, and may have tax consequences.

Tax Considerations for the Business and Remaining Owners:

- ◆ For employer-owned life insurance policies issued after August 17, 2006, IRC § 101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally received income tax-free under IRC § 101(a).
- ◆ Premiums paid for personally owned life insurance policies are not income tax-deductible by the business owners.
- ◆ Life insurance cash values generally accrue income tax-deferred.
- ◆ Where the wait-and-see buy-sell arrangement is funded with personally owned policies, there are income tax consequences to the owners if the business provides the needed premium dollars, that is, premium dollars may be considered compensation, dividends, distributions, etc. The business may receive a tax deduction if premiums are paid out in a bonus arrangement.
- ◆ If the business is a C corporation and business is the owner, premium payer, and beneficiary, life insurance proceeds and cash value increases may trigger the alternative minimum tax (AMT).³
- ◆ The wait-and-see buy-sell arrangement is not appropriate for a sole proprietorship or a single-shareholder corporation.
- ◆ For a wait-and-see buy-sell arrangement to be successful, both pieces of the hybrid transaction (the redemption and the cross purchase sale) need to qualify for capital gains treatment. To avoid an IRS argument that there is a step transaction and the redemption is really a dividend, there must be an integrated plan resulting in a complete and total termination.⁴
- ◆ Where shareholders are related, the family attribution rules under IRC § 318 are a potential problem in the event of redemption, as it may be difficult to qualify under IRC § 302 as a complete termination, resulting in capital gains tax treatment.

³ *Corporations in their first year or having average annual gross receipts less than \$7.5 million for the preceding three-year period (average annual gross receipts of \$5 million for initial qualification) are not subject to AMT.*

⁴ *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Rev. Rul. 54-458*, 1954-2 CB 167; *Rev. Rul. 55-745*, 1955-2 CB 223; *Rev. Rul. 75-447*, 1975-2 CB 113; *Niedemeyer v. Comm.*, 62 TC 280 (1974); *Monson v. Comm.*, 79 TC 827 (1982); *Est. of Durkin v. Comm.*, 99 TC 561 (1992).

- ◆ The wait-and-see buy-sell arrangement can be structured to equalize corporate ownership or allow ownership in any desired percentages.
- ◆ If the remaining owners are the purchasing parties, each purchaser will receive the benefit of a basis step-up in the purchased ownership interest equal to the price paid.
- ◆ If the corporation redeems stock and the remaining owners contribute funds to accomplish the repurchase, the owners receive the benefit of a basis increase equal to their capital contributions.

Tax Considerations for the Departing Owners or the Heirs:

- ◆ A properly drafted buy-sell agreement can help establish the value of the business interest for estate tax purposes.
- ◆ The sale of the business interest at death should not result in income taxable gains because the basis of the business interest in the estate is stepped-up at death. In contrast, the lifetime sale of the business can result in income taxation.⁵

⁵ Under the Economic Growth and Tax Reconciliation Act of 2001, the estate tax is repealed for the year 2010. For deaths occurring in that year only, a modified step-up in basis will be available. This is limited to a step-up of \$1.3 million in total for all beneficiaries and an additional \$3 million step-up available for property passing to a surviving spouse.

Recommended Action Plan

1. Seek the professional advice of your attorney regarding your personal needs and objectives for the disposition of your business interest in the corporation.
2. Meet with your accountant, attorney, and/or professional appraiser to determine the value of your business interest.
3. Determine the appropriate insurance solution.
4. Have your attorney draft the agreement, corporate resolution, and other appropriate documents.
5. Apply for the life insurance and complete all medical and underwriting requirements.
6. Review the buy-sell arrangement with your licensed financial professional, attorney, and accountant on a regular basis.