

## Business Continuation for the Closely Held Business

The Time to Prepare for the Future Is Now.

Do you worry that your business would be at risk if you or your business partner were to die today?

Do you dream of retirement and passing the business to family members?

Do you find yourself anticipating your golden retirement years but are fearful that you can't make ends meet without the income generated by your business?

If so, it's time you stop worrying, roll-up your sleeves, and work with your tax, legal, and licensed financial professionals to develop an exit strategy that includes the expected as well as the unexpected to help assure that your "dreams do come true."

The place to start is the buy-sell agreement.

### A Buy-Sell Agreement

The buy-sell agreement, drafted by your attorney, assures a market for your business should you die, become disabled, or leave the business.

It does this by providing a method of determining the value of the business, identifying the future buyer(s), and creating a legal obligation between you and the buyer(s).

When it's time to leave your business, a properly designed buy-sell agreement can:

- Guarantee a "pre-selected" buyer for your business interest, preventing outsiders from gaining control of the family business.

- Identify the events that trigger a buyout, set the purchase price, and establish the terms of purchase, thereby removing uncertainty and providing a sense of security for your family.
- Help set the value of your business interest for federal estate tax purposes, which can reduce the risk of IRS challenge.
- Provide reassurance to business creditors and employees that the business will continue without you.
- Help your family by providing liquidity for estate settlement costs.
- Prevent the loss of pass-through taxation by ensuring that S corporation stock remains with qualified owners.

### Funding the Buy-Sell Agreement

While the buy-sell agreement creates a contractual obligation for you to sell and the purchaser to buy, its successful completion requires that the needed funds be in place at a triggering event.

There are a number of ways to fund a buy-sell agreement. Let's take a closer look.

### Cash Flow

Often, when the buyer is a family member or a key employee, the expectation is that the dollars needed for the buyout will be generated by the business. But if you were to die today, how would the loss of your leadership or your credit relationships affect cash flow? At your retirement, is it realistic to believe that the business's cash flow can support new management salaries and pay you what you feel you are owed?

Either you must build your business to a point where it can produce the additional funds needed or search for another funding source.

### Borrowing

Many business purchases are financed with debt, but banks and loan institutions may be reluctant to lend money to a smaller, closely held business that has just lost a key player. Even if the lender agrees to take a credit risk, the interest costs may be excessive. For this reason, third-party loans may be impractical and expensive.

### Installment Sales

Because third-party loans may be difficult to acquire, business owners often agree to self-finance the buyout.

Once again, the cash flow from the business is expected to be the source of future principal and interest payments.

It's important to realize that you carry the risk of loan default if the buyer cannot sustain the needed cash flow. Worse yet, your "golden years" may be interrupted if you are forced to take the business back.

### Insurance

A buy-sell agreement funded with life insurance may be the most economical and practical solution for funding your buyout agreement.

Life insurance covers the risk of premature death by providing an immediate death benefit

that is generally received free of federal income tax at the death of the insured owner.<sup>1</sup>

Where cash value life insurance is used, the policy serves double duty, providing both a death benefit and cash value that accumulates on an income tax-deferred basis and that can be accessed through withdrawals and loans.<sup>2</sup>

Where the buyout agreement includes disability provisions, disability insurance<sup>3</sup> can be purchased to help provide the needed funds.

Your licensed financial professional can provide you with costs and more details on products designed to meet your specific needs.

## Structuring Your Buy-Sell Arrangement Funded with Life Insurance

Buy-sell arrangements funded with life insurance can be customized to meet the specific needs of the parties to the agreement. In general, buy-sell arrangements take one of three basic approaches: entity purchase, cross purchase, or the wait-and-see format.

### Entity Purchase Arrangement

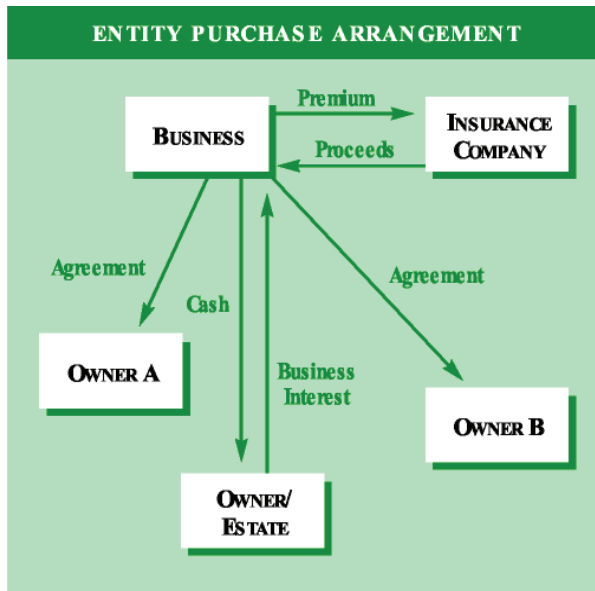
In an entity purchase approach, (also known as a stock redemption where the business entity is a corporation), the buy-sell contract is between the business and the individual owners. Following the specific terms of the agreement, the business promises to buy back the ownership interest of the departing or deceased owner.

<sup>1</sup>Under IRC §101(a), death benefit proceeds received by a C corporation may be subject to alternative minimum tax. In addition, for employer-owned 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 income tax-free under IRC §101(a).

<sup>2</sup>Loans and withdrawals cause a reduction in cash values and death benefits, may affect the guarantees against lapse, and may have tax consequences.

<sup>3</sup>The availability of disability insurance varies by carrier and state.

To fund the buyout, the business buys a life insurance policy on each of the owners in an amount equal to their respective ownership interest. The business is the owner, beneficiary, and premium payer on these policies.



### Advantages

- **Policy control.** Because the policies are owned by the business, the business has more control over the administration and maintenance of the buy-sell arrangement.
- **Cash value.** Where cash value policies are used, the cash value is an asset on the business's balance sheet.<sup>4</sup>
- **Income tax-free death benefit.** Policy proceeds are generally received income tax-free under IRC § 101(a)<sup>5</sup>
- **Owner equality.** Because the business is responsible for premium payments,

individual owners are less concerned about premium disparities that result from age and other underwriting factors.

### Disadvantages

- **Creditor risk.** Where the policies are owned by the business, they are subject to the claims of the business's creditors.
- **Nondeductible premiums.** Life insurance premiums paid by the business are not deductible for income tax purposes.<sup>5</sup>
- **Family Attribution rules.** When a family-owned business is structured as a C corporation, an entity purchase arrangement may not be the best tax strategy. In family run corporations, the redemption of an owner's stock may be treated as a dividend rather than a capital transaction if certain other family members or family run entities also own stock in the entity.
- **Basis Increase.** Entity purchase buybacks increase the surviving owners' percentage interests in the business but do not increase their cost basis. Where there are lifetime buyouts, this may result in the recognition of capital gains resulting in capital gains tax. In addition, increasing percentages may alter voting power unfavorably.

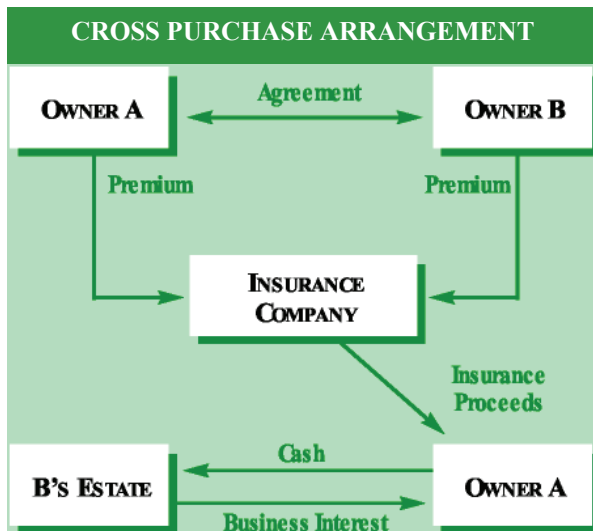
<sup>4</sup>Where the business is a C Corporation cash value increases in excess of premiums paid may result in alternative minimum tax (AMT).

<sup>5</sup>Under IRC §101(a), death benefit proceeds received by a C corporation may be subject to alternative minimum tax. In addition, for employer-owned 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 income tax-free under IRC §101(a).

## Cross Purchase Arrangement

Under the cross purchase approach, the agreement is between the co-owners of the business. The remaining/surviving owners are obligated to purchase the interest of a departing/deceased owner. The business is not a party to the agreement.

When the buy-sell arrangement is structured as a cross purchase buyout, each business owner is the owner, beneficiary, and premium payer of an appropriate amount of life insurance on the other owners.



### Advantages

- **Income-tax-free death benefit.** Policy proceeds paid to the owners upon the death

of an insured are generally received income tax-free under IRC 101(a)<sup>6</sup>.

- **Cash value.** If cash value life insurance is used to fund the arrangement, cash values accumulate on a tax-deferred basis and are available to help finance lifetime buyouts.<sup>7</sup>
- **Basis increase.** Purchasing owners receive an increase in their ownership interest equal to the fair market price they paid.
- **Capital gains taxation.** The sale of an owner's stock is treated as the sale of a capital asset, thus it receives capital gains tax treatment. A lifetime sale may result in taxation where the sales price exceeds the seller's basis in the stock, but the sale of a business interest at death generally does not result in taxable gain due to the step-up in basis received by the estate.<sup>8</sup>
- **No AMT.** Alternative minimum tax only applies when a C Corporation owns the policies.
- **Creditor risk.** Policies are no longer subject to business creditor risk, but may be attached by the business owner's personal creditors.

### Disadvantages

- **Policy administration and maintenance.** Where there are more than two owners, multiple policies must be purchased and held by each owner.<sup>9</sup> Personal ownership and numerous policies make control over the buy-sell arrangement more difficult.

<sup>6</sup>Under IRC §101(a), death benefit proceeds received by a C corporation may be subject to alternative minimum tax. In addition, for employer-owned 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 income tax-free under IRC §101(a).

<sup>7</sup>Loans and withdrawals cause a reduction in cash values and death benefits, may affect guarantees against lapse, and may have tax consequences.

<sup>8</sup>Under the Economic Growth and Tax Relief 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 for property passing to a surviving spouse.

<sup>9</sup>The number of policies needed is provided by the formula  $N \times (N-1)$ , where  $N$  is the number of business owners.

- **Personally owned policies.** Premiums paid for personally owned life insurance policies are not income tax deductible by the business owners.

Premium payments are likely to be borne disproportionately between owners due to age differences, ratings, etc. — often with younger owners paying higher premiums on older owners.

If the business provides the needed premium dollars, there are income tax consequences to the owners (e.g., compensation, dividends, distributions, split dollar arrangements).

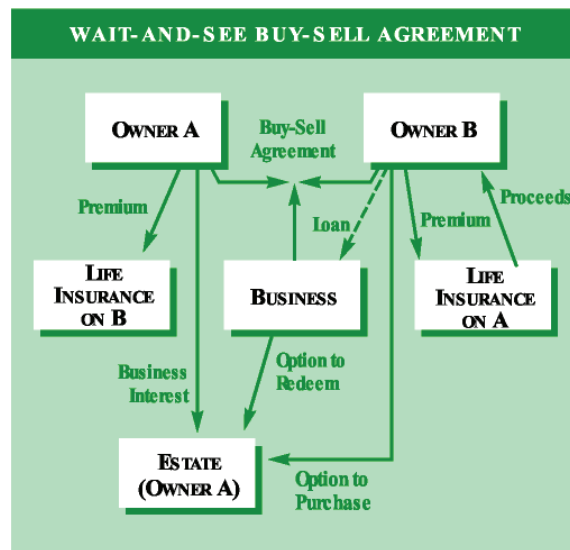
- **Transfer-for-value issues.** Where the cross purchase arrangement requires multiple policies, care must be taken that any management techniques used, such as trusts, family limited partnerships, or limited liability companies, are structured to avoid estate tax inclusion and the transfer-for-value rule that could result in death benefit proceeds being subject to income taxation.

### Wait-and-See Arrangement

The decision as to which format the buy-sell arrangement should follow is often difficult to determine at the time the arrangement is put in place.

The wait-and-see approach allows the owners to defer the choice between an entity repurchase and a cross purchase format until a triggering event occurs.

A wait-and-see buy-sell agreement is generally drafted to provide the business with a first option to purchase the departing/deceased owner's interest. If this option is not exercised within a stated time, the remaining owners are given the option to purchase the business interest. Finally, if the business owners fail to purchase the stock or only purchase a portion of it, the business is then required to purchase the remainder.



Generally, the wait-and-see approach is similar to the funding under the cross purchase approach in that each business owner is the owner, beneficiary, and premium payer of an appropriate amount of life insurance on the other owners. If the ultimate decision is made to have the business purchase the departing/deceased owner's interest, the remaining/surviving owners can lend the money to the business or make additional capital contributions using the death benefit.

## Advantages/Disadvantages

The major advantage of the wait-and-see arrangement is the flexibility to delay the choice of how to structure the buy-sell arrangement until a triggering event occurs.

The other “advantages” and “disadvantages” of the wait-and-see arrangement are determined by the ultimate choices made as to the buy-sell structure and policy ownership (entity versus cross-purchase).

## The Power of Planning

Preparing your business plan, managing change, and coping with emergencies are all part of your ongoing responsibility as a business owner. You plan your market strategy, project

budgets and profitability, estimate expenses, and predict industry trends and customer demands.

You know the power of planning. It has helped you grow and shape your business. Now put the power of planning to work in a business continuation arrangement.

Make sure your company continues to prosper and provide for your family, even after you are no longer at the helm, whether by choice or by chance.

Working with your tax and legal advisors, Prudential can help you put the funding in place to help ensure the financial future of your business and your family.

*This material is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that we are not rendering legal, accounting or tax advice. Your own advisors should provide such services. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under Internal Revenue Code.*

*Life insurance is issued by The Prudential Insurance Company of America, Newark, NJ, and its affiliates. All are Prudential Financial companies and each is solely responsible for its own financial conditions and contractual obligations. The availability of other products and services varies by carrier and state.*

*Life insurance policies contain exclusions, limitations, reductions of benefits and terms for keeping them in force. Your licensed financial professional can provide you with costs and complete details.*

**Securities and Insurance Products:  
Not Insured by FDIC or Any Federal Government Agency. May Lose Value.  
Not a Deposit of or Guaranteed by Any Bank or Bank Affiliate.**

Prudential, Prudential Financial, the Rock logo and the Rock Prudential logo are registered service marks of The Prudential Insurance Company of America and its affiliates.

©2008 The Prudential Insurance Company of America  
751 Broad Street, Newark, NJ 07102-3777.  
www.prudential.com

ALL RIGHTS RESERVED

IFS-A006206 Ed 11/08 EXP 12/10

