Buy-Sell Entity Purchase

Essentials 2018

In an entity purchase plan (AKA stock redemption plan), the company agrees in advance to buy the interest of a withdrawing/deceased owner while the withdrawing/deceased owner agrees to sell his or her ownership interests to the company. A properly structured entity purchase plan may allow for the business continuing past an owner's death and a source of income for the decedent's family.

Buy/Sell Planning is a Critical Element of Any Successful Business

All businesses can benefit from buy-sell planning – sole proprietorship, C Corporation, S Corporation, Partnerships, LLCs, etc.

- Provides a definite market for transferring the ownership interest. In a cross-purchase buy-sell, the co-owners must purchase the interest
- Specifies a set or determinable price. This price may also set the value used for estate tax calculation
- Provides some or all of the funds necessary to execute the agreement – when properly funded with life insurance
- Maintains "closeness" of the business by restricting and planning who/what can receive the business interests
- Provides liquidity to pay estate taxes (due to nine months from date of death)

How Entity Purchase Works With a C Corporation

1. At an owner's death, disability, or departure, the company agrees to purchase the business interest from the owner – this is documented in a formal agreement between the company and the owners.
2. The company applies for (and is beneficiary of) a life insurance policy on each owner. The business will pay the premiums and will be the owner and beneficiary of the policy.
3. At death, the company receives the policy death proceeds.
    a. If departure is for reasons other than death (i.e. disability) the policy's cash values can be accessed to partially or totally fund the purchase.
4. The company purchases (redeems) the agreed business interest from the decedent's estate.

How a Cash Basis S-Corporation Would Vary

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2. The company applies for (and is the beneficiary of) a life insurance policy on each owner. The business will pay the premiums and will be the owner and beneficiary of the policy.
3. At death, the corporation redeems the deceased shareholder's interest for a promissory note. This eliminates the deceased shareholder's estate as a shareholder of the S corporation.
4. The corporation then elects a short tax year under IRC §1377 (a)(2).
5. The corporation then receives the policy's death benefit after the start of the new tax year. Receipt of policy death benefit increases the basis in current shareholder's stock. "Current shareholder" includes the surviving shareholders and does not include the deceased shareholder or his/her estate.
6. The corporation pays off the note with the policy death benefit.

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Why Life Insurance

- Cash value inside a policy grows tax-free (subject to potential AMT if C Corporation).
- Death proceeds are received income tax-free (subject to potential AMT if C Corporation) and received at just the right time to fulfill the agreement.

In order for the death proceeds to receive income tax-free treatment, the Pension Protection Act of 2006 requires that two items are met:

- The notice and consent requirements are met
- The insured is an employer or a key person[1] or the ultimate payee (not beneficiary) is:
    - A member of the insured's family
    - The designated beneficiary (other than employer)
    - A trust established for the benefit of any such person
    - The insured's estate

Considerations

- Policy cash value is potentially subject to corporation's creditors.
- Premium payments are not a deductible expense.
- Remaining business owners do not receive a basis increase in their ownership interest. (S Corporation remaining owners may be able to receive a stepped-up basis with proper redemption planning.)
- Possible dividend treatment in family situations. In a family-owned corporation, the redemption may be treated as a dividend instead of a capital gain.
- C Corporations may be subject to Alternative Minimum Tax (AMT) on the policy growth and the death benefit.

Essentially

Estate's non-liquid asset (i.e. the business interest) is sold to the company at an agreed upon price (little or no gain should be taxable due to step-up in basis at date of death). Company provides premium payments thus avoiding any inequity/unfairness associated with individual premium payments with cross-purchase planning. The policy's cash value is an asset on the business' balance sheet offsetting the redemption obligation. A minimal amount of administration is required since only one policy per owner needs to be purchased and maintained. The business interest does not pass to any unintended parties.

[1] As defined by the tax law, the proceeds are used to purchase the decedent's interest in the business from one of the persons listed below. (See the Key Person Agent Guide #14524 for the tax law definition of a key person.) Aviva requires Form 15996, Notice and Consent for Employer Owned Life Insurance, to be completed and included with all new employer-owned life applications.

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