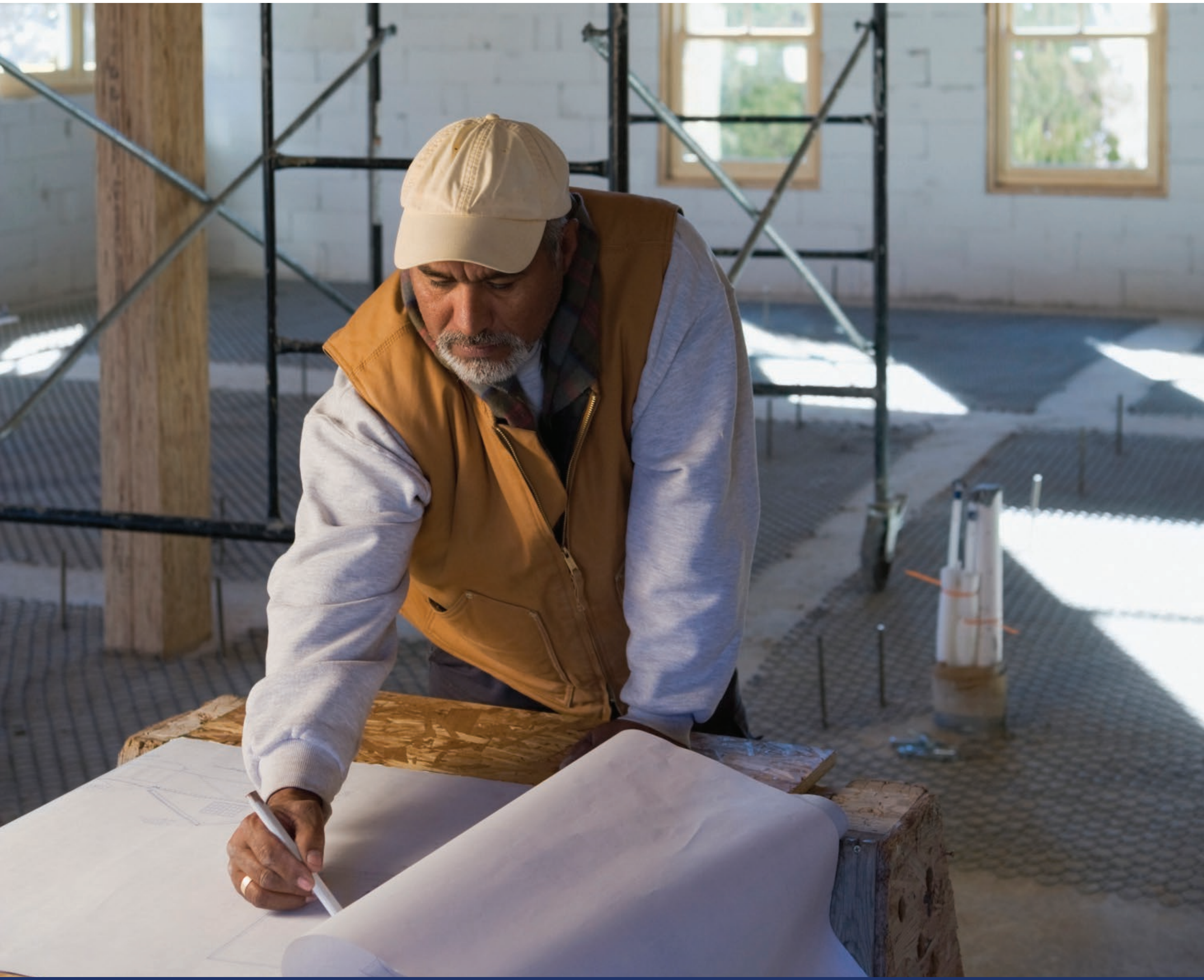


# Protect your most valued asset

A closer look at buy-sell agreements


## The business interest is often the single largest asset of a closely-held business owner's estate.

**Often it is used to provide the majority of current income and support to the family and will be looked to as a source of income and wealth at retirement.**

Understanding, and ultimately realizing, the value of the business, and developing and implementing a succession plan for the entity, whether because of death, disability or retirement, is critical to the continued well-being of the family.

The information provided is not written or intended as specific tax or legal advice. MassMutual, its subsidiaries, employees and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.

Businesses can transition expectedly or unexpectedly. That's why it's important to plot a course toward protecting your business and minimizing the impact a change in ownership could have on those who depend on the business most. Proper planning requires a comprehensive analysis, which would include addressing a number of concerns such as:

1. **What is the value of the business in the event it has to be sold under less than favorable circumstances?**
   What value can be truly realized in the event of a "fire sale"?

2. **What is the short-and long-term financial impact on the family?**
   How will the family survive without the income?
   How will the family continue to maintain its standard of living?

3. **What is the short-term impact on the business?**
   Can the business meet its short-and long-term cash needs?
   Can the business even survive?

4. **What is the long-term impact on the business?**
   Can the business be transferred to a successor without negatively impacting business operations and employees?
   Will the transferring shareholder realize full value for the transfer?

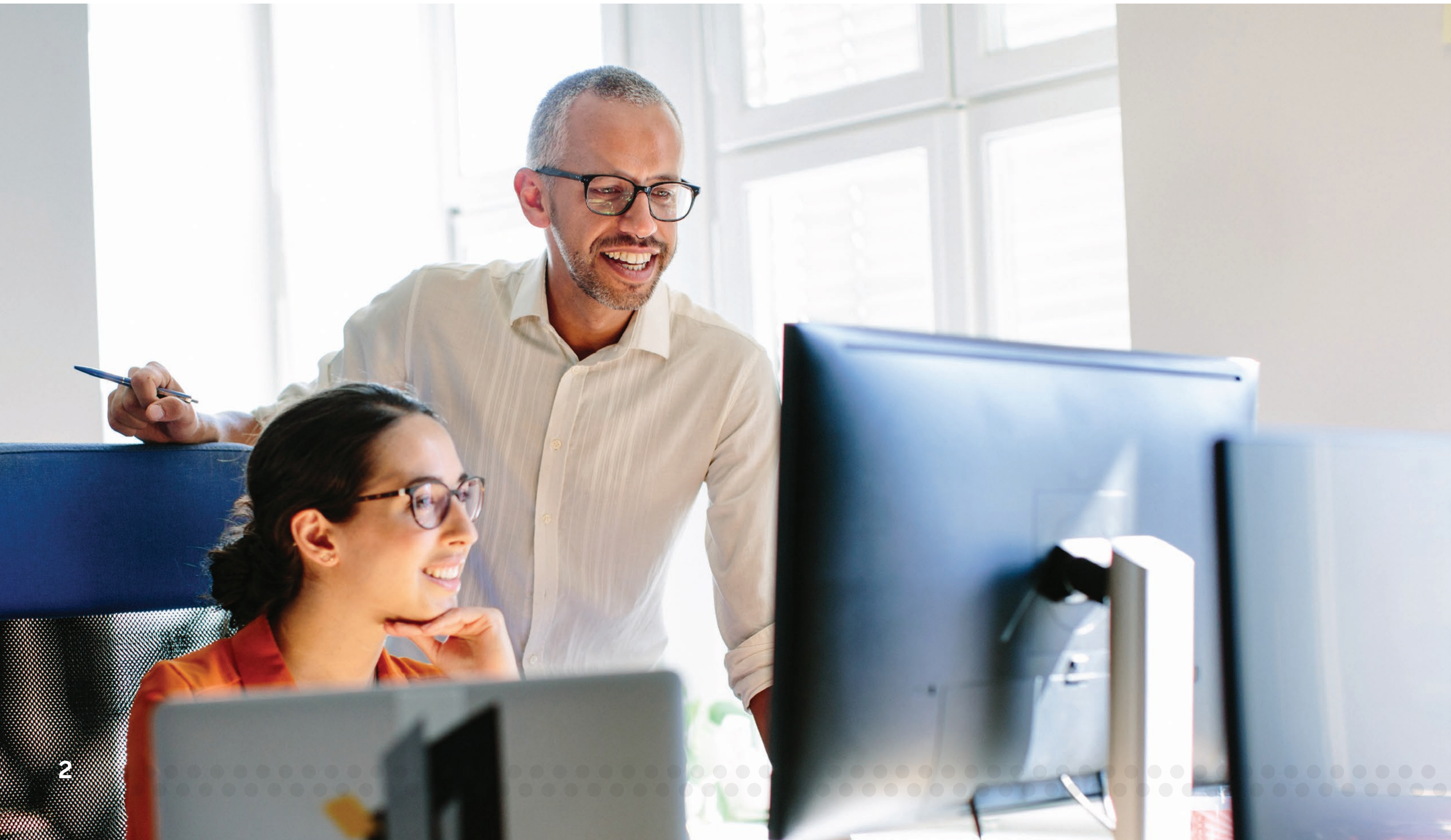
MassMutual does not provide qualified business valuations. For a qualified or certified business valuation, consult a properly credentialed appraiser.

# Establishing an effective business continuation plan

## Ultimately, realizing the full value of the business requires a plan.

### Part of that plan may involve the establishment of a buy-sell agreement.

A buy-sell agreement is a legally binding agreement that requires one party to sell and another party to buy a particular ownership interest in a business in the event of the death, disability or retirement of a partner or shareholder or upon certain other triggering events as specified in the contract. These agreements may be used by any type of business entity — sole-proprietor, corporation, partnership, limited liability company (LLC), etc.



## Why do you need a buy-sell agreement?

If the agreement guarantees the continuity of the business upon the death of an owner, it will provide that the deceased owner's estate will receive a fair price.

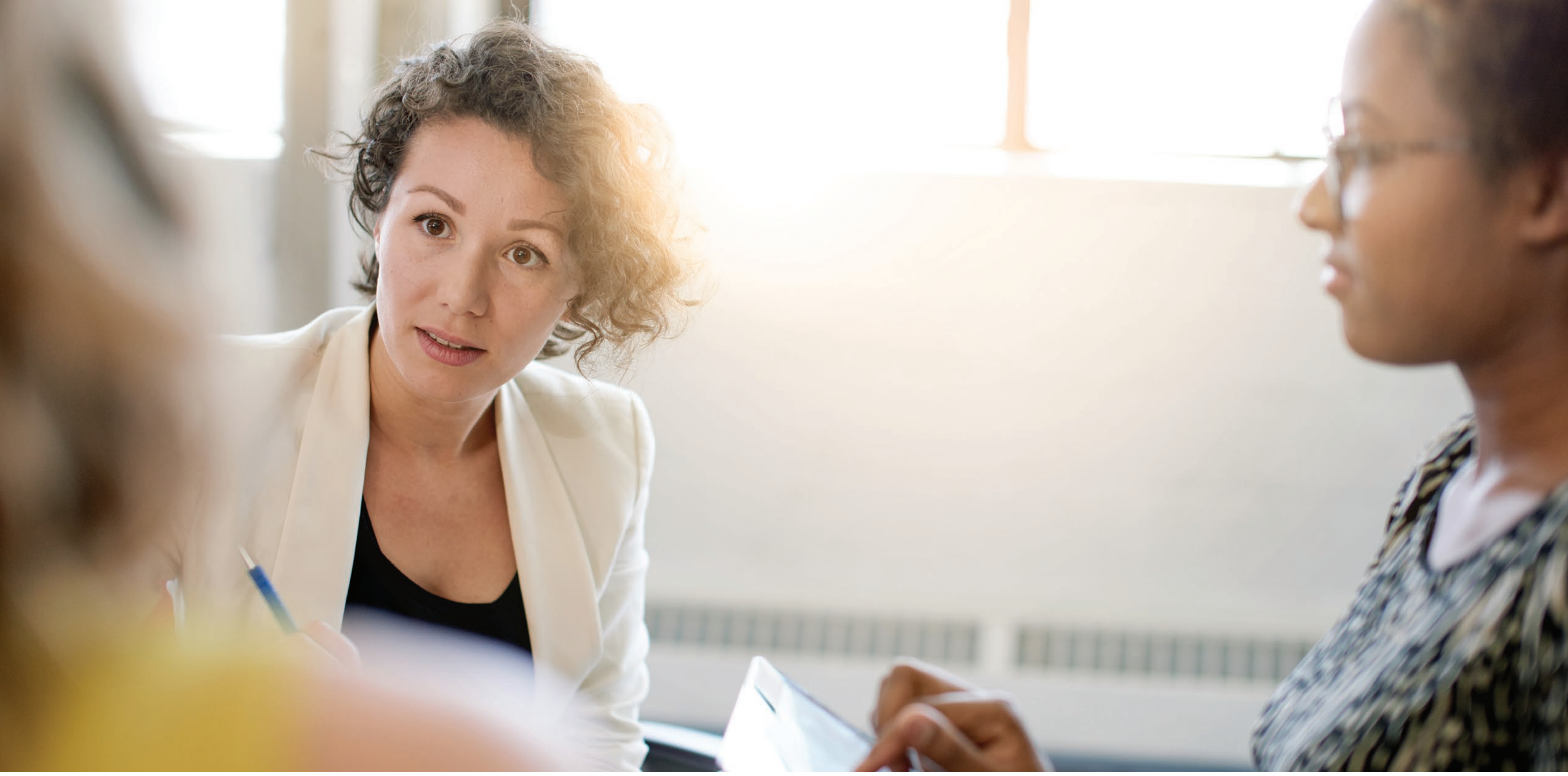
Under this arrangement, when an owner dies, if the provisions are carried out, the plan will assure the prompt and orderly sale of his or her business interests. This benefits the family and the surviving owners of the business. The agreement also helps to stabilize the business and provide financial assurances for the employees and creditors of the business.

While the buy-sell agreement legally requires the survivors to buy and the estate to sell, the arrangement could fail if the survivors do not have the financial capacity to make the purchase following an owner's death. Life insurance can be an excellent way to fund a buy-sell agreement because it provides liquid funds at the exact moment that they are needed.

## How do you establish a buy-sell agreement?

The beginning of the process usually involves establishing a value for the business. This value is typically only an approximation and should not be used as a substitute for a qualified appraisal issued by an attorney, accountant or other qualified business valuator. The approximate value may be determined by a review of financial statements and the application of a number of standard calculations, or by comparison with sales of similar businesses in the industry.

Establishing the buy-sell agreement should be supervised and executed by an attorney. There are also various types of agreements that the attorney may discuss.



## There are three basic forms of buy-sell agreements:

1. **Entity (stock redemption) Plan**
   Under this plan, the business purchases an owner's entire interest at an agreed upon price upon death, disability or retirement. If the business is a corporation, the plan is referred to as a stock redemption agreement. In a partnership context, the plan is called a liquidation of interest.

   If life insurance is used to fund the agreement, the corporation would own life insurance on the lives of the shareholders and use the proceeds to purchase (redeem) their stock at death. This method is fairly simple and straight-forward since the corporation is the owner, premium payer and beneficiary of the policy and the cash value is recorded as an asset of the corporation on the balance sheet.

   However, a number of drawbacks exist. For example, the basis of the deceased shareholder's stock of a corporation is not increased when it is distributed to the surviving shareholders, although in certain S Corporations, it may be possible to achieve a step-up in basis. Also, the death benefit may not be free of income taxes for certain large corporations or if the provisions of IRC Section 101(j), covering employer-owned insurance policies are not followed. Finally, if the corporation is family-owned, the redemption of the deceased shareholder's stock may be considered a taxable dividend under the attribution rules of IRC Section 318.

# Entity buy-sell agreements

## HOW IT WORKS[1]

BUSINESS applies for a life insurance policy covering each owner.

BUSINESS pays the premiums.

Massachusetts Mutual Life Insurance Company underwrites the policy application and, if approved, issues the life insurance policy.

- The business entity is the policyowner
- The business entity is the beneficiary

## TAX CONSIDERATIONS

### BUSINESS

- Premiums are not tax deductible, but the death proceeds are generally exempt from federal income tax. (Note: Some C Corporations may be subject to corporate alternative minimum tax on a portion of the proceeds.)
- If a corporate stock redemption agreement is used, there is generally no increase in basis for a surviving owner's interest (surviving owners of S Corporations, partnerships and LLCs can obtain a partial or full step-up). This differs from a cross purchase buy-sell agreement.

### INSURED

- There is no tax implication.
- Generally, the redemption of the decedent's business interest is income tax-free to his/her estate or heirs. However, redemption of stock may be taxed as a dividend in certain family-owned cases.

## ADVANTAGES

### BUSINESS

- Cash values in life insurance policies are available as reserve funds for the business entity.[2]
- This type of buy-sell agreement may be preferable when there are many business owners (business owns just one policy for each owner) or when there is a wide range of ages among business owners (in other types of buy-sell agreements, younger owners pay higher premiums on the policy of an older owner).
- The price established for a business interest in a buy-sell agreement among unrelated parties, may fix the value for federal estate tax purposes.
- If the death of a partner occurs, the policy proceeds are paid to the business and are generally income tax-free.

2. **Cross Purchase Plan**
   Under this plan, the remaining owners purchase the withdrawing owner's entire interest at an agreed upon price. It is also possible that individuals who are not currently owners (such as employees, outsiders or family members) may be parties to the agreement.

This plan avoids many of the issues associated with a stock redemption plan although it may become cumbersome if there are more than two shareholders. To address this issue, the owners could use a "trusteed" cross-purchase arrangement where a trust would own one policy on each shareholder and represent the shareholders in the transaction, eventually distributing the deceased shareholder's stock to the surviving shareholders.

# Cross purchase buy-sell agreements

## HOW IT WORKS

EACH OWNER applies for a life insurance policy covering the life of every other owner.

EACH OWNER pays the premium on the policies.

Massachusetts Mutual Life Insurance Company underwrites the policy application and, if approved, issues the life insurance policy.

- Each business owner owns a policy on the life of the other business owners.
- The policy owner is the beneficiary.

## TAX CONSIDERATIONS

### BUSINESS

- Premiums paid personally by each individual owner are not tax deductible.
- A Split Dollar plan might be used for the business to pay the premiums.

### DECEASED OWNER'S ESTATE

- Generally, the proceeds from a life insurance policy paid to a deceased business owner's estate for his/ her interest will be income tax-free.
- The policy owned by the decedent on the lives of the other owners may be purchased or surrendered.

### SURVIVING OWNERS

- Policy proceeds are generally received income tax-free, subject to rules regarding transfer of policies for a valuable consideration.

## ADVANTAGES

### BUSINESS

- Owners may use a "trusteed" cross purchase agreement.[3]
  - The trustee acquires and owns life insurance on each owner, reducing the number of policies to the number of owners.
  - In the event of death, the trustee collects the life insurance policy proceeds when an owner dies, pays the proceeds to the deceased owners estate, and transfers the deceased owners shares to the surviving owners in the appropriate proportions.

3. **One-Way Buy-Sell**
This type of agreement can be used when there is a sole owner of a business and there are no co-owners to buy out the owner's interest when a triggering event, such as death or retirement, occurs. If a potential buyer of the business can be identified, perhaps a family member or a key employee, this version of the buy-sell agreement can be adapted for the soleowner situation. It is called the "one-way" buy-sell because only one party (a non-owner) is obligated to purchase the business when a triggering event occurs. The benefit of using a one-way buy-sell is it allows the sole owner to exit the business and still receive fair market value for the business from another party looking to assume ownership in the future.

## Disability income buy-sell benefits

Many business owners overlook Disability Income insurance as a key tool for business planning strategies. Yet, just over one in four of today's 20-year-olds will become disabled before reaching age 67.[4]

When a business owner purchases a disability buy-sell policy, it can help provide the critical funds necessary to facilitate the orderly transfer of ownership. The concept of disability as it relates to a partner's active participation in a business is often far more difficult to define and describe than most other buy-sell triggering events. For purposes of the buy-sell agreement, a disability buy-sell policy can provide, not only the funding for a partner buy-out, but the definition of total disability as well. This allows the insurance issuer, acting as an objective third party, to determine if a disability has occurred.

## Where should you start?

You have built your business with the hopes that it will withstand the test of time. Unfortunately, there are a lot of elements out of your control that can affect the success of your business, such as an unstable economy, lack of consumer spending, and increased competition.

There are also some factors that can impact both the business and the continued well-being of your family, such as death, disability or retirement. It is possible to plan for some of these contingencies. A properly executed and funded buy-sell agreement may be the first step towards ensuring that both your business and family are able to survive one of these unforeseen events.

Begin working with your financial professional to outline your long-term personal and business financial goals. Planning for the unexpected is just as important as planning for your expected growth, diversification or even the sale of your business.

[1] Death proceeds from life insurance contracts owned directly or indirectly by an employer insuring the lives of its employees are taxable to the employer unless certain notice and consent requirements are met. See IRC Section 101(j).

[2] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10 percent tax penalty. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

[3] Transfer-for-value problems may occur at the death of the second shareholder when a trusteed cross purchase arrangement is used.

[4] Source: Social Security Administration Fact Sheet, 2020

Insurance products issued by Massachusetts Mutual Life Insurance Company (MassMutual) (Springfield, MA 01111) and its subsidiaries, C.M. Life Insurance Co. and MML Bay State Life Insurance Co. (Enfield, CT 06082). C.M. Life Insurance Co. and MML Bay State Life Insurance Co., are non-admitted in New York.



SB10216 921 CRN202309-284144