The Buy-Sell Wizard

Producer Guide

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LIFE INSURANCE

ING

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The Business "Will"

A buy-sell agreement is a written agreement which establishes what will happen to a business owner's ownership interest when he/she leaves the business. Because every business owner must leave their business someday, these agreements are important tools for controlling the future ownership of the business. It's not a question of "if" an owner is going to leave; rather it is a question of "when." Owners who don't leave during their lifetimes will leave when they die. Effective buy-sell agreements establish the terms, price and procedures for transferring a departing owner's interest. A smooth ownership transition is important to the departing owner, his/her family and the remaining owners. When an owner dies and there isn't a buy-sell agreement in place, control over the deceased owner's interest can be lost; state law will likely determine who will own it in the future.

Business Succession Planning Can Be Complicated

Over the years many different varieties of buy-sell agreements have been developed and not all of them are suitable for every business. It can be difficult to determine which one will deliver the best results. Because there are many potential strategies, owners should discuss the issue with their tax and legal advisors. Once a buy-sell strategy has been selected, the life insurance policies funding it need to be properly owned and managed so the death benefits will be delivered to the right person at the right time.

LIFE INSURANCE FUNDING

In most buy-sell agreements the death of an owner is a triggering event. When this is the case, life insurance may be used as part of the funding because:

- Policy death benefits may supply some or all of the funds the buyer will need to satisfy his/her/its purchase obligation under the agreement.
- Policy death benefits may potentially be an efficient source of funds because they are generally paid to beneficiaries income tax free under IRC Section 101.
- If the purchase takes place before an owner dies, policy cash values may be available to pay some or all of the purchase price.

The ING Life Companies' (ING) Buy-Sell Wizard May Be Able To Help

The ING Buy-Sell Wizard has been developed to make it easier to identify which buy-sell alternatives may potentially be suitable for a business. Based on answers to several questions, this Wizard may assist in making three important decisions:

1. ***Which Types of Buy-Sell Arrangements Should Be Considered?***
   The Wizard considers nine commonly used varieties of buy-sell arrangements and suggests which of them may potentially be suitable for the business.
2. ***Who Should Own the Life Insurance Policies Funding the Arrangement?***
   It is critical that the funds to complete the purchase are in the right hands; the Wizard makes it easier to coordinate the policy ownership with the buy-sell arrangement suggested.
3. ***Who Should Pay the Policy Premiums?***
   If the life insurance policies are to provide the necessary funding, the premiums must be paid; the Wizard considers the ownership of the policies and who should pay the premiums.

How the Wizard Works

Based on information the owner provides, the Wizard evaluates nine different types of commonly used buy-sell arrangements. Its suggestions flow from three pieces of information the owner shares with you. First, the owner must identify how the business is structured for tax and legal purposes: C corporation, S corporation, partnership, limited liability company (LLC) or limited liability partnership (LLP). This piece of information is critical because some buy-sell alternatives don't work with every legal structure.

Second, the owner needs to review a set of three or four factors and indicate which one is most important. Buy-sell arrangements tend to fall into one of three general classes: entity purchase, cross purchase and flexible buy-sell. The most important factor selected in this step indicates which one of these general classes is most likely to meet his/her objectives. *Note the <u>letter</u> of the factor selected.*

Third, depending on the factor selected in Step 2, the owner needs to review a different set of factors. Again, the owner chooses the one he/she feels is most important. This selection identifies a specific type of buy-sell arrangement within the general classification. The appropriate life insurance ownership decision and identity of the premium payor flow logically from the selected type of buy-sell agreement. *Note the <u>number</u> of the factor selected.*

The Wizard's Results

After the owner has made his/her selections, you need to suggest which buy-sell arrangement(s) they should consider. Each possible selection from the first set of factors has a LETTER in front of it. Also, each possible selection from the second set of factors has a NUMBER in front of it. You need to put the letter and number together to create an identification code.

You take this identification code to the Wizard Results section. Each of the nine available buy-sell arrangements has a letter and number in front of it. You simply take the selection code and match it to the code in front of one of the buy-sell arrangements. The buy-sell arrangement code that matches the owner's selection code is the buy-sell arrangement that you could suggest. Read the summary for it. If you have previously printed out each of the nine extended summaries, you can share the appropriate one with the owner. The policy ownership and premium payment information are included in the Wizard Results page summary.

Of course, you should strongly encourage the owner to discuss the Wizard's suggestion with the business' tax and legal advisors. If these advisors agree with the Wizard's suggestion, they can begin drafting /updating the buy-sell documents. In the meantime you can work with the owners to determine if life insurance coverage is available and if so what it might cost.

Who Should Own the Life Insurance Policies?

The specific buy-sell arrangement identified should help determine the proper ownership of the life insurance policies which will fund the strategy. Several general rules may help guide the choice of policy owner:

- In Entity Purchase arrangements, the business will likely be the policy owner;
- In Cross Purchase arrangements, the owners (or entities they create) will likely be the policy owners;
- In a flexible buy-sell arrangement, the policies could potentially be owned by either the entity or the owners; in most cases, however, the owners will own the policies in a cross purchase-style format.

Who Should Pay the Policy Premiums?

There are really only two potential sources of funds for paying policy premiums: the individual owners or the business itself. In most cases, the policy owner will pay the premiums. If the business owns the policies, it usually pays the premiums. If the owners (or an entity established by the owners) own the policies, they usually pay the premiums.

There is one notable situation in which someone other than the policy owner may pay the premiums. That situation involves owners of C corporations participating in cross purchase buy-sell arrangements. C corporation owners in cross purchase buy-sells may wish to use business dollars to pay their policy premiums for either of two reasons:

1. It may be more financially efficient for the business to pay the premiums if the C corporation's marginal income tax bracket is lower than the owners' personal income tax brackets, or
2. The owners may not have the funds needed to pay premiums or, if they do, they may wish to retain these funds for other purposes.

Dollars in a C corporation may be used to help the owners pay the policy premiums through a number of executive benefit strategies: 162 Bonus Plans, Restricted Bonus Arrangements (REBAs), salary increases, or split dollar economic benefit arrangements or split dollar loan arrangements. Although these strategies involve additional costs and complexity, they may have the potential to shift some of the cost of paying the premiums to the business.

This opportunity doesn't exist for businesses with other legal structures because in all of them the business is not a separate taxable entity. Their earnings pass through the entity directly to the owners. Thus the only dollars which can be used to pay premiums are the owners' dollars. The business doesn't really have any of its own; its dollars belong to the owners according to their respective ownership percentages. Consequently, 162 bonus plans, REBAs and split dollar loans generally aren't efficient when it comes to funding buy-sell arrangements in Sub S corps, LLCs, LLPs and partnerships.

9 The **Nine** Different Buy-Sell Strategies Used in the Wizard

The Wizard has nine different buy-sell strategies that it has the potential to recommend. These strategies fall into these classes:

Entity Purchase
Traditional
Section 303 Redemption
Short Tax Year (S corp only)

Cross Purchase
Traditional
ILIT Buy-Sell
Trusteed Cross Purchase Buy-Sell
General Partnership Buy-Sell

Flexible Buy-Sell Strategies
Wait & See Buy-Sell
Own Your Own Policy Buy-Sell

A short summary of each buy-sell strategy is provided. For additional information, feel free to consult the ING Life Companies' other materials relating to each buy-sell strategy.

Traditional Entity Purchase
The business purchases the ownership interest of a deceased or departing owner.

Section 303 Redemption
This is a purchase of part of a deceased owner's interest under IRC Section 303 which permits the business to redeem some stock from the owner's estate to provide estate liquidity. The value of the ownership interest redeemed may not exceed the total of the deceased owner's funeral costs, medical expenses of last illness, estate administration costs and federal and state estate taxes. In order to use this option, the value of the deceased's business interest must constitute at least 35% of the adjusted gross estate.

Short Tax Year Election (S corp only)
This strategy is designed to help the surviving owners receive the full basis increase for life insurance death benefits that are paid to a Subchapter S corporation when it receives life insurance death benefits as the policy beneficiary.

Traditional Cross Purchase
The remaining owners purchase their pro rata share of the business interest of a deceased or departing owner.

The ILIT Buy-Sell
It may not be wise for owners wealthy enough to have federal estate tax problems to personally purchase any of the business interest owned by a deceased or departing owner. Such a purchase could increase their federal estate tax liability. As an alternative, they can establish an Irrevocable Life Insurance Trust (ILIT) to purchase their pro rata share of that interest. The ILIT trustee enters into the buy-sell agreement with the other owners.

The Trusteed Cross Purchase Buy-Sell
In this buy-sell structure the owners enter into a cross purchase agreement and establish a trust to own the life insurance policies funding it. The trustee collects the funds needed to pay premiums and purchases/owns the policies. The trustee receives the death benefits when an insured owner dies. It is most often used when there are three or more owners so only one policy is needed on the life of each owner.

General Partnership Buy-Sell
In this buy-sell structure the owners enter into a cross purchase arrangement and establish a general partnership to own the life insurance policies funding it. The owners contribute the funds the partnership needs to pay the premiums. At an owner's death the partnership receives the death benefits and distributes them to surviving partners so they can purchase their pro rata shares of the deceased's interest from his/her estate. This buy-sell structure appears to avoid potential transfer for value problems after the first owner's death.

Wait & See Buy-Sell
This is an extremely flexible buy-sell structure because it does not dictate who will purchase a departing owner's interest. When a triggering event occurs, a series of purchase options is activated so the remaining owners can customize the ownership of the departing owner's interest to meet their needs going forward. If some of the departing owner's interest remains available after the purchase options have expired, then the business will purchase the remaining interest.

The Own Your Own Policy Buy-Sell
Rather than purchasing a policy on the other owners, it may be advantageous for each owner to purchase a policy on his/her own life and assign part of the death benefit to the other participating owners so they can purchase his/her interest if he/she dies. Each owner controls his/her own life insurance policy (within the terms of the buy-sell agreement) and may take it with him/her if he/she retires or leaves the business for other reasons during his/her lifetime.

The OYOP Buy-Sell—A New Buy-Sell Arrangement

This is a new addition to the list of flexible buy-sell arrangements. You may not be familiar with the OYOP buy-sell strategy, so we'd like to summarize its advantages and how it works. In the traditional cross purchase arrangement, each owner is the owner and beneficiary of a policy on each of the other owners. When one owner dies, the other owners receive death benefits from the policies they own on his life and use them to purchase a pro rata share of the deceased owner's business interest.

The traditional approach works well when an owner dies, but in many cases an owner chooses to leave the business while he/she is living. When an owner leaves because of retirement, disability, divorce, boredom or other lifetime event, there is no life insurance death benefit to fund the purchase of his/her interest. In fact, a departing owner would probably want to take the life insurance policies on his/her life with him/her when he/she goes and use the death benefits for personal/family purposes. Unfortunately, this may not be possible under the terms of the agreement.

If each owner owned his/her own life insurance policy and temporarily assigned part or all of the death benefit to the other owners, there could be a number of potential advantages:

- One Policy Per Owner—There is no need for multiple policies on each owner.
- Personal Ownership and Control—Every owner owns and makes the decisions concerning his/her own policy (although each owner must manage the policy to satisfy any standards or requirements set in the buy-sell agreement).
- Include Personal Death Benefit Coverage—An owner may want more death benefits than the amount needed under the buy-sell agreement; he/she may wish to combine the coverage required under the buy-sell agreement with the coverage they need for personal protection and wealth transfer planning.
- Personal Responsibility—Each owner is responsible for his/her own premiums; younger or healthier owners aren't forced to pay premiums on older or less healthy owners.
- Set Own Premium Level—Owners decide how much premium to pay; they may choose to pay in more than the minimum in order to increase cash values that can potentially be used to supplement their retirement income.
- Policy Is Portable—Every owner who leaves the business before death takes the policy with him/her; there is no need to attempt to acquire the policy from another owner or from the business.
- Personal & Wealth Transfer Planning—After an owner leaves, he/she has the option to reposition the death benefits to meet personal needs without going back through underwriting to purchase new coverage; problems with increased premiums and decreased insurability can potentially be avoided.

Some of the disadvantages include:

- If the value of the business increases, the amount of death benefits assigned to other owners may need to be increased; also, when an owner leaves the business and sells his/her interest while alive, death benefit assignments will have to be released or beneficiary designations will have to be changed.
- Some tax/legal advisors may not be familiar with OYOP buy-sell arrangements; they may need more information in order to provide objective advice and draft the buy-sell document properly.

The major objection to the OYOP approach to buy-sell planning is the possible application of the transfer for value rule. Unbeknownst to many people, the transfer for value rule isn't likely to apply in situations where the business is organized as an LLC, LLP, or partnership. And it may not apply in C corporation situations where the owners are also partners in a separate partnership.

This isn't the place to go into a detailed discussion of the OYOP buy-sell. Suffice it to say that this new strategy merits close examination and may be useful to owners who could benefit from owning their buy-sell life insurance policies. If you are interested in learning more about this strategy, feel free to read the other materials the ING Life Companies have made available.

Conclusion

There are many different buy-sell arrangements and it can be difficult to determine which one is most likely to meet the objectives of individual business owners. The ING Buy-Sell Wizard is a tool which may be able to help. It arranges different buy-sell strategies according to the income tax structure of the business and the primary objective of the owners. In addition to helping identify workable buy-sell options, it can assist in selecting the life insurance policy owner and the source of funds for paying policy premiums. The Buy-Sell Wizard may be a tool that could help you close more business succession sales.

For more information on the Buy-Sell Wizard or Buy-Sell strategies, call your ING Life Companies' representative or ING Insurance Sales Support at 866-ING-SELL (866-464-7355).

Appendix
The Selection Pages for C Corporations, S Corporations & Partnerships, LLCs or LLPs

C Corporations

Assuming the ownership interest of one of your co-owners becomes available for purchase in the future, choose which of the following is most important to you in your buy-sell planning:

A. Have the flexibility to decide who will purchase different percentages of that interest after a triggering event occurs (avoid being locked into a purchase procedure established years earlier).

B. Retain your current ownership percentage relative to other remaining owners.

C. Increase the tax basis of your new ownership position (your current interest plus your share of the departing owner's interest) and thereby potentially reduce capital gains taxes should you decide to sell at a later time.

D. Avoid additional corporate taxes (e.g. the Alternative Minimum Tax).

If you selected either C or D, which one of these factors is most important to you?

1. Prevent your purchase of a departing owner's interest from increasing your taxable estate (and thus your federal estate taxes).

2. Control and manage the life insurance coverage on your life (which may provide funds for your co-owners to purchase your interest) and allow your co-owners to control and manage the life insurance policies on their lives.

3. Ensure that the life insurance policies funding the buy-sell agreement are properly managed by creating a separate entity (a trust or partnership) to administer them.

4. None of these factors is important.

If you selected B, which one of these factors is most important to you?

5. The corporation will purchase the entire interest of a departing owner.

6. The corporation will purchase only a portion of a deceased owner's interest to provide liquidity for his/her estate; the maximum value of the shares purchased can't exceed the total of the estate's "qualified costs" under IRC Section 303.

C Corporation Results

A - Wait & See Buy-Sell
B5 - Traditional Entity Purchase
B6 - Section 303 Redemption
C1 or D1 - ILIT Buy-Sell
C2 or D2 - Own Your Own Policy Buy-Sell
C3 or D3 - Trusteed Cross Purchase or General Partnership Buy-Sell
C4 or D4 - Traditional Cross Purchase

Subchapter S Corporations

Assuming the ownership interest of one of your co-owners becomes available for purchase in the future, choose which of the following is most important to you in your buy-sell planning:

A. Have the flexibility to decide who will purchase different percentages of that interest after a triggering event occurs (avoid being locked into a purchase procedure established years earlier).

B. Retain your current ownership percentage relative to other remaining owners.

C. Increase the tax basis of your new ownership position (your current interest plus your share of the departing owner's interest) and thereby potentially reduce capital gains taxes should you decide to sell at a later time).

If you selected C, which one of these factors is most important to you?

1. Prevent your purchase of a departing owner's interest from increasing your taxable estate (and thus your federal estate taxes).
2. Control and manage the life insurance coverage on your life (which may provide funds for your co-owners to purchase your interest) and allow your co-owners to control and manage the life insurance policies on their lives.
3. Ensure that the life insurance policies funding the buy-sell agreement are properly managed by creating a separate entity (a trust or partnership) to administer them.
4. None of these factors is important.

If you selected B, which of these factors is most important to you?

5. The corporation will purchase the entire interest of a departing owner.
6. Short Year Tax Election (S corporation must be a cash basis taxpayer)—The corporation will purchase the entire interest of deceased owner; however, in order for the surviving owners to receive the full basis increase from the life insurance death benefits, the corporation will elect to complete the purchase and end its income tax year before receiving the life insurance death benefits.

Subchapter S Corporation Results

A - Wait & See Buy-Sell
B5 - Traditional Entity Purchase
B6 - Short Tax Year Entity Purchase
C1 - ILIT Buy-Sell
C2 - Own Your Own Policy Buy-Sell
C3 - Trusteed Cross Purchase or General Partnership Buy-Sell
C4 - Traditional Cross Purchase

Partnership, LLC or LLP

Assuming the ownership interest of one of your co-owners becomes available for purchase in the future, choose which of the following is most important to you in your buy-sell planning:

A. Have the flexibility to decide who will purchase different percentages of that interest after a triggering event occurs (avoid being locked in to a purchase procedure established years earlier).

B. Retain your current ownership percentage relative to other remaining owners.

C. Increase the tax basis of your new ownership position (your current interest plus your share of the departing owner's interest) and thereby potentially reduce capital gains taxes should you decide to sell at a later time).

If you selected C, which one of these factors is most important to you?

1. Prevent your purchase of a departing owner's interest from increasing your taxable estate (and thus your federal estate taxes).

2. Control and manage the life insurance coverage on your life (which may provide funds for your co-owners to purchase your interest) and allow your co-owners to control and manage the life insurance policies on their lives.

3. Ensure that the life insurance policies funding the buy-sell agreement are properly managed by creating a separate entity (a trust or partnership) to administer them.

4. None of these factors is important.

If you selected B, the only choice is traditional entity purchase.

Partnership, LLC or LLP Results

A - Wait & See Buy-Sell

B - Traditional Entity Purchase

C1 - ILIT Buy sell

C2 - Own Your Own Policy Buy-Sell

C3 - Trusteed Cross Purchase or General Partnership Buy-Sell

C4 - Traditional Cross Purchase

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