John Hancock
LIFE INSURANCE

Success Strategy
One-Way Buy-Sell Arrangements

Many business owners do not make formal plans to transfer the business to a successor in the event of retirement, disability or death of the owner. However, lack of succession planning can cause a business to fail because of the significant changes that follow these triggering events. A well drafted and properly funded buy-sell arrangement can clarify who will own and run your business in the event of your death, disability or retirement. For situations where there are multiple business owners, there are several buy-sell options such as cross-purchase, entity redemption or cross-endorsement arrangements. In some cases there may be only one business owner, and one valued employee may have been identified as a potential successor.

WHAT IS A ONE-WAY BUY-SELL ARRANGEMENT?

A "one-way" buy-sell arrangement is a succession planning arrangement in which a key employee agrees to buy the business in the event of your death, disability or retirement. The arrangement can be funded with a permanent life insurance policy on your life to provide the flexibility needed to accommodate changing needs over the life span of the business.

HOW DOES IT WORK?

In accordance with the terms of the buy-sell agreement, your intended successor will purchase and own a permanent life insurance policy on your life. The valued employee, who may be a family member or a key person in the business, will also be the beneficiary of the life insurance policy. Your company will pay a bonus annually to your key employee in the amount of the premium payment due, to minimize the out-of pocket expense of the arrangement. The bonus payments may be tax-deductible to the corporation, but the payment will also be taxable to the key employee.[1] Your company may also choose to make a double bonus which is equivalent to the premiums due plus the income tax due on the bonus.

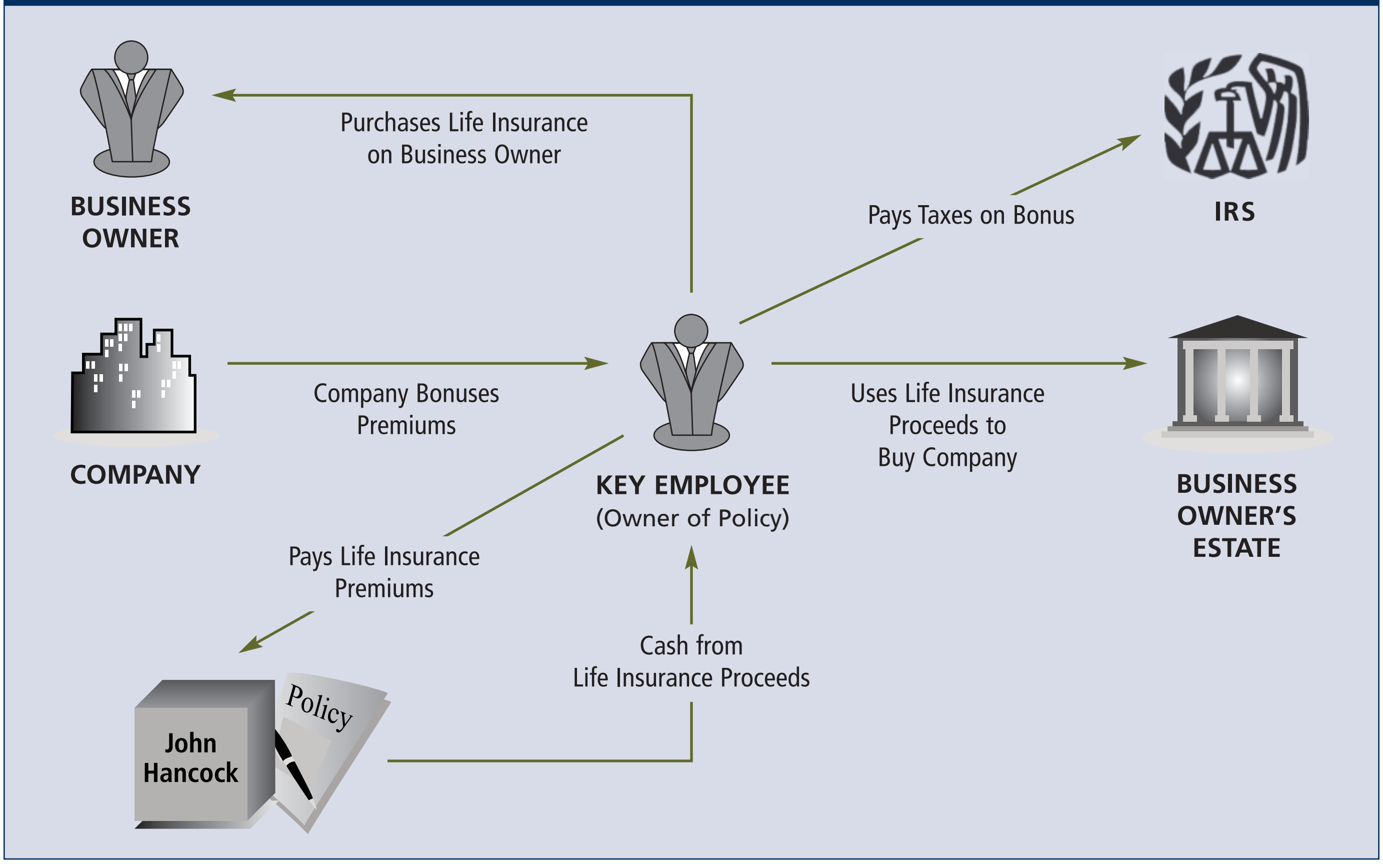
BENEFITS

- The life insurance proceeds should not be subject to income taxes.[2]
- The company will receive a tax deduction for the bonus payments.
- The successor/employee should receive a full basis step-up for the purchase of the business interest.
- The life insurance policy does not increase the value of the business.
- Since the business entity is not a party to the buy-sell agreement, the corporate alternative minimum tax (AMT) and accumulated earnings tax do not apply to the policy proceeds.
- The value of the business may be fixed for estate tax purposes.

CONSIDERATIONS

- The successor/employee will have to recognize the bonus amount received for life insurance premium payments as taxable income.
- Since the successor/employee owns the life insurance policy, the policy cash value will be includable in his/her estate, if he/she predeceases the business owner.[3]
- Access to the policy's potential cash values may lower the death benefit needed to satisfy the buy-sell obligation.[4]

Here’s an example:



1. The use of a bonus arrangement creates additional compensation to the recipient and must fall within the reasonable compensation guidelines of the Internal Revenue Code Section 162 in order to be deductible by the corporation.
2. See IRC Section 101(a)(1) and Treas. Reg. Section 1.101-1(a)(1). Life insurance death benefit proceeds are generally excludable from the beneficiary’s gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration.
3. The successor’s estate may receive a corresponding tax deduction for the liability associated with the buy-sell agreement.
4. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested. Withdrawals are available in the 2nd policy year.

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IM1489 02/09 MLINY01280910563

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