Advanced Buy/Sell Disability Planning

*A modern Buy/Sell Agreement funded with adequate **lump-sum disability insurance** to fulfill the terms of the agreement is the simple, affordable solution to a difficult situation.*

Disability Buy/Sell Agreements

Overview of The Needs

Small businesses and large businesses alike are affected by the loss of a business owner's expertise, talents, prestige, and leadership. The loss may come as a result of withdrawal from the firm due to retirement or personal reasons, or due to death or disablement. Whatever the cause of the withdrawal, the survivors in the firm often face significant financial and emotional consequences.

The Emotional Factor

Mr. Outside, the world's greatest salesperson, and Ms. Inside, a superb administrator, have teamed up to build a business. It is working. Business is fine until Mr. Outside is disabled in an auto accident, or Ms. Inside suffers a brain tumor. Can either adequately carry the load of their duties and also the duties of the disabled business owner? NO! And it could be worse; both owners could be disabled simultaneously. Statistically, when two owners aged 40-45 are involved in a business, **there is a 72.7% chance that, before age 65, one of them will sustain a disability that will last at least ninety days**. If it lasts longer than 90 days, the chances are that it will last 5.8 years before death claims the disabled partner.

Can adequate "temporary help" be employed as a substitute for the disabled owner? NO! Can permanent help be found and justified? Perhaps. The most likely outcome will be a weakening of the firm, whether through loss of sales or loss of administrative effectiveness.

The disabled owner expects his or her salary and all benefits to continue at the same level as prior to the disability; even as the company's financial strength deteriorates. The non-disabled owner, frustrated and frightened, rapidly develops animosity because of the disabled owner's demands for equal pay and due to the lack of understanding of the increasingly untenable work load and anxiety thrust upon him/her. The non-disabled owner no longer sees the disabled partner as a human being deserving of sympathy, but as an enemy due to the costly impairment of the firm. He/She is depleting reserves and assets while not contributing to the firm's well-being.

In such a case the non-disabled owner may even subconsciously wish for the disabled partner to die, so that the life insurance funded buy-sell plan can solve the difficult dilemma. As long as the disabled person is alive, his or her full voice is legal in all decisions and must be heard.

The only solution to saving the firm is to quiet the voice of the enemy. Quieting the disabled owner's voice must be agreed to in advance of the disability. **A modern Buy/Sell Agreement funded with adequate disability insurance to fulfill the terms of the agreement is the simple, affordable solution to this challenging situation.**

The Agreement – The Firm's Stabilizer

Proactive advisors can become a Hero to the business owners by guiding them in the creation of a comprehensive and a modern agreement that considers the devilish problems arising with the withdrawal of an owner from a firm for any reason, but particularly concerning the difficult matter of disability.

Voluntary withdrawal and retirement withdrawal are usually known in advance so the financial aspects can be contemplated and negotiated. Withdrawal by death is absolute and quick unless it is preceded by a lengthy disability. A quick solution to an immediate, forced disability buy-out is unfair to the disabled partner, for he/she should be given time to recover and maintain business ownership. A prolonged disability can destroy the firm unless there is a reasonable buy/sell trigger date. Studies over many years indicate a 12-month buy/sell waiting period or trigger date is reasonable to both parties. Longer trigger dates are available and may be agreed to, requiring smaller insurance premiums.

The Peril and the Dynamics

The Problem: A major hazard facing a business firm is the emotional and financial impact of a disabled owner on the non-disabled owners. When an active owner suffers a long-term disability, without advanced planning, the business faces the following difficult alternatives.

Continuation: Continuing the disabled owner's income would be a serious financial drain on the business. With the disabled owner no longer making a significant contribution to the business, profits suffer. In addition, it may be necessary to hire a replacement for the disabled owner, further weakening the firm. Beyond Buy/Sell disability benefits, "Key Man" insurance programs such as to cover "Business Overhead Expense" help compensate the company for loss of a key contributor.

Liquidation: Liquidation means selling the business because it is failing and must be sold. Overhead continues because the owners want to maintain the firm's value and viability. Creditors and employees must be paid. Business value / goodwill may be lost due to diminished service, lack of customer contact (revenue falloff) and slow payment of obligations.

Reorganization: The disabled owner may sell to an outsider or to active owners. Generally, active owners prefer purchasing the disabled owner's business interest to avoid potential conflicts with a new owner. **The remaining owners may not have the funds necessary to buy at an acceptable price.** The best hope for saving the firm is a Buy/Sell Agreement appropriately funded by disability insurance.

Funding the Business Disability Buy/Sell Agreement

Intelligently planned business buy/sell agreements anticipate the contingencies of the voluntary withdrawal, death, or disablement of a business owner.

In the case of voluntary withdrawal, the buy-out procedure is usually set out in the buy/sell agreement. If it is not, then the matter has to be negotiated at the time of decision. It is not uncommon for the buy-out, on a withdrawal basis, to be on a structured installment basis.

Death is certain, but its timing is uncertain. Therefore, it could happen while the agreement is in force and has to be contemplated. The solution to the funding of the buy-sell agreement is simple with the purchase of life insurance on the parties to the agreement. A lump sum settlement is the usual funding design.

Disability presents different considerations. Typically, a buy-sell agreement contains an elimination period of twelve months or longer, to give the disabled person time to recover and return to work and not be forced to prematurely sell his/her business interest. Once the elimination period has been completed the funding by disability insurance can be handled on either an installment basis or on a lump sum basis.

The Installment Sales basis is frequently chosen as the plan design for a disability funding plan. There are some disadvantages to this design which should be weighed carefully. Among them is the requirement that a reasonable interest rate be charged on any installment sale. If interest is not charged, the IRS will impute a rate of interest as high as 10% with the recipient required to report the interest as taxable income.

Monthly Benefit Disability Plans typically pay an amount equal to the principal payment, but not the interest. Simple interest of 5% of a million dollars is $50,000 per year, which is uninsured and requires cash to cover the cost.

A Lump Sum Benefit eliminates the interest cost. A further advantage of the Lump Sum Benefit is that it may eliminate or reduce the need to continue life insurance on the disabled business owner. The Monthly Benefit Installment purchase basis needs ongoing life insurance to protect against the disabled owner dying during the buy-out period.

If for some reason the seller wants an installment buy-out basis, the Lump Sum Benefit can be paid to a trustee to hold and then release funds on an installment basis. This eliminates the tax on interest received and the need for continuing the life insurance. [*This could be useful given today's permanent life insurance's ability to provide tax-advantaged retirement income in the absence of untimely death*.]

When all factors are combined, the Lump Sum Benefit is as economical, or perhaps more so, than the Monthly Benefit plan design.

Other Factors

Recovery – Installment buy-out policies may not guarantee continuation of the monthly benefits should the Insured recover. Because the buy-sell agreement is usually binding and final on the trigger date, this could leave the purchaser with the obligation to pay for his acquired share, but with no funds available to make the payments, if the disabled partner recovers.

Death – Installment buy-out policies will typically not continue the benefit payments if the Insured dies within the installment period. This means that the life insurance policy purchased to fund the death portion of the buy-sell agreement cannot be transferred to the disabled owner, or dropped, until the end of the installment period, because the death benefit will be needed to complete the transaction in the event of death during the buy-out period.

With the Lump Sum plan, the life insurance policy can safely be transferred, or dropped. With this approach, the disabled business owner not only receives a fair market value for the business, but the buyer(s) enjoys the option of transferring or dropping the life policy put in force to provide buy-sell funding in the event of death.

Prototype of a Modern Disability Buy/Sell Agreement

The disability buy/sell spotlights the need for Salary Continuation, Key Person, and Bank Loan Disability, as well as the need for increased Buy/Sell Life Insurance which, in a successful company, tends to fall to an inadequate level each year.

If there is a Buy/Sell Agreement in existence, it is typically funded for the contingency of death with life insurance. **It is axiomatic. In most cases, there is a missing page in the agreement; the page contemplating the aspects of disability, a more likely peril the firm will encounter and one fraught with unrealistic frustration and raw emotions of the disabled owner . . . or his/her co-owners.**

I was recently reminded of this fact by a brochure mailed to us by a CPA firm. The firm's brochure entitled "An Introduction to Business Valuation Services," listed an impressive digest of services and CVA credentials. This was followed by a statement of the firm's expertise which reads, "To determine the adequacy of LIFE INSURANCE, for the value of a company, a shareholder's interest in the company, or loss of a key person." No mention is made of disability insurance. Astute advisors have an excellent opportunity to help clients immeasurably by introducing the peril of disability and leading a comprehensive approach to Buy/Sell funding.

A modern Buy/Sell Agreement between business owners must include the aspects of a long-term disability of an owner. Not only is disability statistically the most likely factor to disrupt a business. It is also the most devilish contingency business owners will face.
Many businesses do not have Buy/Sell Agreements in force, and of those that do, the page on disability contingencies is missing on 85% of them. Many business owners' consultants have overlooked the peril of disability because the subject has only received modest promotion. True insurance professionals provide a great service to their clients in helping craft a modern Buy/Sell Agreement correctly addressing disability in the Buy/Sell Agreement.

My firm and certain of our carriers provide prototype Disability Buy/Sell Agreements to help business owners and their legal advisors create a modern and comprehensive approach integrating a disability Buy/Sell with their life insurance Buy/Sell plan.

Subjects to be addressed:

- Owners and percentage of interest in the firm
- Types of business
- Business valuation
- Disability definition and trigger date
- Transfer of interest
- Delivery of payment
- Disposition of life insurance policies
- Death during installment period
- Control of business organization during disability
- Fringe benefit of a disabled owner
- Termination or amendment of agreement

As with life Insurance Buy / Sell Plans, lump sum disability Buy / Sell Plans can be designed as Stock Redemption or Cross Purchase plans, including trusteed arrangements where there are several owners.

Stock Redemption
After one year of disability, the disabled stockholder is obligated to sell this stock at the current value of the corporation, and the corporation is obligated to buy it and redeem the stock.

Cross Purchase
After one year of disability, the disabled partner is obligated to sell his interest to his partner and his partner is obligated to buy this interest at current value of the corporation.

Advantages to Active Partner(s)

1. Guarantee that the business interest of a disabled partner can be obtained a definite price in the event of his/her disability.
2. Guarantee that the active partner(s) can keep voting control of the business.
3. Guarantee that the active partner(s) can keep the disabled partner's family out of the business.

Advantages to Disabled Partner(s)

1. A definite market for his or her business interest at a fair price.
2. Family members do not need to become involved in the business to protect their interest.
3. Money received for shares can be protected by investing it:
    - In conservative income producing investments.
    - In several different investments instead of just one.
    - Other hedged approaches.

Buy-Out Tax Facts

1. Corporation purchases a disability income policy for an employee with benefits payable to corporation. (rev. rul. 66-262, 1966-2 CB 105).
    - Premiums are not deductible by the corporation. (IRC 265 (1)).
    - Premiums are not taxable to the employee. (IRC 106).
    - Benefits are tax exempt to the corporation. (IRC104 (1) (3)).
2. An owner's interest is a capital asset. Hence, whether purchased by the business or by a third-party, the purchaser of the interest cannot deduct his payment for Federal Income Tax purposes.

3. Where there is a total redemption of a shareholder's shares, the payment he or she receives will be treated as a capital gain or loss. If the redemption value is less than total, the payments may be deemed to be dividends and hence ordinary income to the shareholders even though they are not deductible by the corporation. (IRC 302).

4. Installment Buy-Out when at least one payment of the purchase price is paid after the close of a taxable year, the gain on the sale will be taxed only as it is received. (IRC 453 as amended by the installment Sales Revision Act of 1980). Where an installment buy-out takes more than one year, interest must be paid by the purchaser on the declining balance of the payments or interest will be imputed. (IRC 483).

Probability of Disability

Age	*Years to age 65*	*Number of Persons in the Group*					
		1	**2**	**3**	**4**	**5**	**6**
25	40	53.7%	78.6%	90.1%	95.4%	97.9%	99.0%
30	35	52.2%	77.1%	89.1%	94.8%	97.5%	98.8%
35	30	50.3%	75.3%	87.7%	93.9%	97.0%	98.5%
40	25	47.7%	72.7%	85.7%	92.5%	96.1%	98.0%
45	20	44.3%	69.0%	82.7%	90.4%	94.6%	97.0%
50	15	39.4%	63.2%	77.7%	86.5%	91.8%	95.0%
55	10	32.1%	55.8%	68.6%	78.7%	85.8%	90.2%
60	5	20.4%	36.6%	49.5%	59.8%	68.0%	74.5%

Average Duration of a Disability that lasts 3 months or longer

Age	*duration*
25	4.3 years
30	4.7 years
35	5.1 years
40	5.5 years
45	5.8 years
50	6.2 years
55	6.6 years

Table data based on the Commissioners Individual Disability Table.

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