



INDEPENDENT INVESTOR

Your Guide to Life Planning

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Using Life Insurance to Ensure Business Continuity

The loss of critical personnel can be life threatening to small businesses; however, it's a risk that life insurance can often mitigate. In fact, life insurance policies are frequently used in plans aimed at making it possible for a business to survive a change of ownership or the loss of a partner, the chief executive or an employee whose creative talent, technical knowledge or salesmanship drives the business.

Most commonly, life insurance is employed as the funding mechanism in buy-sell plans-legal agreements that provide for an orderly transfer of ownership interests-and to compensate for the loss of a key person.

Buy-Sell Agreements

A buy-sell agreement allows the remaining owner or owners to acquire the interest of a departing owner due to death or another specified event, such as disability or retirement. The agreement typically restricts an owner's ability to transfer his or her interest and sets out the terms under which another owner or the business entity may acquire the departing owner's interest.

A buy-sell agreement can anticipate situations that could imperil the business or be harmful to owners and employees. For example, it can be used to prevent unwanted outsiders or heirs from obtaining an ownership interest; it can prevent the continued involvement of retired or inactive shareholders or partners; and it can ensure the legal continuation of the entity if an owner becomes bankrupt or loses a required professional license.

Among its benefits, a buy-sell agreement creates a marketplace for the shares of a closely held business, helping ensure that departing owners will receive adequate compensation.

Life insurance is typically used to fund the agreement and may also provide cash to pay other costs. How life insurance is employed depends on the structure of the buy-sell agreement. In the case of a partnership, for example, the agreement may call for each partner to buy and maintain policies on each of the other partners in an amount sufficient to cover the beneficiary's partnership interest. In other types of buy-sell plans, the business entity purchases the insurance policy on each owner and the business is the beneficiary.

Insuring a Key Person

Key person life insurance compensates the business against losses that result from the insured's death. In that event, the company-which has purchased the policy and paid the premiums-immediately receives the policy's tax-free death benefit and applies the proceeds toward the resulting business costs. Examples of costs include those incurred in recruiting and training a replacement, purchasing the decedent's ownership interest and replacing lost revenue.

To provide greater flexibility, the company may arrange an exchange agreement, allowing it to transfer coverage to a successor if the key person leaves the firm prior to retirement. While the insured is employed, the life insurance may provide the firm with additional benefits, such as a potentially higher credit rating and the ability to tap the policy's cash value for emergency funds.

Practical Matters

- Establishing a value (or valuation method) for the business is a necessary step in determining how much funding will be needed for a buy-sell agreement. Likewise, the amount of life insurance to

purchase for a key person should be based on a reasonable estimate of the costs the firm would incur as a result of his or her departure.

- A professional appraisal is usually advisable in preparing a buy-sell agreement. Professional advice is also recommended in key person situations where issues such as a potential reduction in the firm's credit rating or loss of confidence among customers, employees or vendors may be involved.
- Your insurance agent can provide information about life insurance terms and costs. Keep in mind that insurance premiums are not deductible business expenses and that life insurance cash values and death proceeds may result in corporate alternative minimum taxes.
- Owners contemplating a buy-sell agreement should consult legal and tax advisors to discuss how the proposed agreement may affect their personal financial situation and estate planning.¹

¹ Life insurance policies contain exclusions, limitations, reductions of benefits, and terms for keeping them in force. Your financial professional can provide you with costs and complete details. This information is intended to provide general education on the importance of buy/sell agreements. Please note that the LPL Financial Advisor providing this newsletter does not provide business valuations services.

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