Wait and See Buy-Sell Arrangement

As a business owner you may not know how you want to deal with the succession issues arising from the death of a co-owner in the business: with a cross purchase agreement or with an entity purchase agreement. A wait and see buy-sell agreement lets you defer the choice to when the business interest is transferred, instead of committing you in advance.

A buy-sell agreement is a contract that identifies a buyer for your business interest in the event of your death, disability or retirement and establishes a fair price for your heirs. When taking the form of a cross purchase agreement, each owner becomes contractually obligated to buy the interest of the deceased or departing owner and the departing owner (or the estate) becomes obligated to sell the interest to the remaining owner(s). When taking the form of an entity purchase agreement, the business is a party to the agreement and contractually obligated to buy the interest of the deceased or departing owner, and the departing owner (or the estate) becomes obligated to sell the interest to the business. When funded with life insurance, the purchasing party(s) can be confident that some or all of the funds needed to complete the purchase will be available at the death of an owner.

A wait and see buy-sell agreement combines the cross purchase and entity purchase buy-sell agreements into one. At the death of a business owner, the company has an option to redeem the deceased’s shares (the agreement resembles an entity purchase). If the company does not redeem the shares within a time specified in the agreement, the right to purchase the deceased owner’s shares passes to the surviving shareholders (where it resembles a cross purchase). To the extent the surviving shareholders do not exercise their option, the company is required to redeem the remaining shares.

If the company is publicly traded it may not be able to lend money to an owner because of the Sarbanes-Oxley Act of 2002 making loans from public companies to directors and certain executive employees a criminal act.

In the agreement illustrated below, the company owns a life insurance policy on the lives of each owner. It can use the proceeds of the life insurance to redeem a deceased owner’s shares from the owner’s estate, or it can lend money to the surviving owners to allow them to purchase the shares from the estate themselves.
PRIOR TO DEATH OR RETIREMENT

Business Owners \[\rightarrow\] Wait and See Contract to Buy & Sell \[\rightarrow\] Business Entity

\[\downarrow\]
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\[\uparrow\]
Life Insurance Policies on Owners

\[\rightarrow\]
Premium Payments

AT DEATH

Step 1: The business entity receives the death benefit from a Genworth Financial company. The business may choose to redeem the deceased’s shares. If it chooses not to do so, step 2 applies.

Step 2: The business entity lends the death proceeds to the surviving owners to allow them to purchase the deceased owner’s business interest from his or her estate. If the surviving owners choose not to purchase the decedent’s business interest (or if only some of them do so), step 3 applies.

Step 3: To the extent there are shares remaining in the decedent’s estate, the business entity is required to redeem those shares.

OPTIONS 1 AND 3

Decedent’s Estate \[\rightarrow\] Cash and Notes \[\rightarrow\] Business Interest \[\rightarrow\] Business Entity

\[\downarrow\]
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Death Benefit
ADVANTAGES:

- Gives the business a choice of buy-sell methods, cross purchase or entity purchase, depending on the business needs at the time the transfer of the business interest is effected.

- Eliminates the need for a new agreement if business needs change to favor a different type of agreement.

- Identifies a ready buyer for the business and establishes a method of determining the purchase price for the business interest.

- Provides surviving owners with the assurance that they will be able to continue the operation of the business without interference from an unwelcome outside party or inexperienced heir.

- Gives both creditors and employees some assurance that the business will continue beyond the death, disability or retirement of one of the owners.

- Creditors may be more willing to extend credit to a business with a funded business continuation arrangement in place.

- When funded with life insurance policies, owners can feel more confident that some or all of the money needed to complete the buyout will be available at the death of an owner.

- If cash value life insurance policies are used to fund the arrangement, the business may opt to utilize any available cash value to assist in the purchase of the business interest at the retirement or withdrawal of one of the owners.

- Cash value within a life insurance policy may be accessed by the policyowners via policy loans, partial surrenders and withdrawals, subject to policy limitations or restrictions.
TAX CONSIDERATIONS:

- Death benefits paid under the policy to the business are received income tax free.
- Premiums paid by the business on any life insurance policy funding the buy-sell arrangement are not income tax deductible.
- Any growth in the cash value in a life insurance policy is income tax deferred until removed from the policy.
- Cash value within a life insurance policy may be accessed by the business on a tax-favored basis provided the policy is not a modified endowment contract.
- If the life insurance policy is a modified endowment contract, any policy loans, partial surrenders and withdrawals will be subject to income tax to the extent there is gain in the policy values. Further, if the insured is less than age 59½, the taxable portion of the distribution may be subject to an additional 10% IRS penalty tax unless the distribution meets one of the allowable exceptions. Modified endowments are created when the premiums of cash value type policies exceed certain limits.
- The IRS attribution rules may make it impossible for a C corporation to use a stock redemption agreement if the C corporation is family owned.
- If the surviving shareholders exercise their right to purchase the deceased’s shares, they receive those shares at fair market value on the date of the deceased’s death (or alternate valuation date). If the value of the “new” shares is greater than the value of the shares as originally issued, then, on any subsequent sale of a surviving owner’s business interest, the “new” shares will be sold for a smaller capital gain (and smaller tax liability) than the shares the owner already held. This favorable tax treatment is not available when the business entity redeems the deceased owner’s shares.
- The agreement should not obligate the owners to purchase stock. If it does, and if they refuse to purchase the stock, and the entity redeems the stock, the redemption will be considered a taxable dividend to the estate of the deceased owner.
- Death benefits received by the business as beneficiary under the policy are not included in the insured owner’s estate provided the insured did not possess any incidents of ownership in the policy within three years of death. Majority ownership in the business may result in the insured possessing an incident of ownership in the policy.

DISCLAIMER

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1Policy loans, partial surrenders and withdrawals have the effect of reducing the death benefit and cash value. A policy loan is generally not taxable unless the policy is surrendered with an outstanding loan balance. In certain highly funded cases, life insurance policies may be considered Modified Endowment Contracts (MECs). In such cases, distributions will be taxable income to the extent that there is gain in the contract. In addition, a 10% IRS penalty tax may be due on any taxable income received prior to age 59½.