A Corporate Insured Stock Redemption Buy-Sell Plan

While the death of a shareholder may have no legal effect on a closely-held corporation, without advance planning there are some very real practical consequences that can have an adverse impact on the ability of the corporation to continue as a viable business.

Table of Contents	Page
What Happens When a Shareholder Dies?	2
Problems When the Heirs Become Active Shareholders	2 - 3
Problems When the Heirs Become Inactive Shareholders	3
Problems Faced by the Heirs	4
A Potential Solution Using Life Insurance	4 - 5
How Can a Buy-Sell Plan Be Funded?	5
The Mechanics of an Insured Stock Redemption Buy-Sell Plan	6 - 7
Other Features of an Insured Stock Redemption Buy-Sell Plan	8
Summary of Insured Stock Redemption Buy-Sell Plan Tax Results	9
Estate Planning Considerations	10
Insured Stock Redemption Buy-Sell Plan Action Checklist	11
Important Information	12

What Happens When a Shareholder Dies?

The death of a shareholder in a closely-held corporation may have no *legal* effect on the life of the business.

The deceased shareholder's interest in the corporation may pass to the shareholder's heirs or beneficiaries. The corporation itself may still be legally intact and able to carry on its business affairs.

While the death of a shareholder may have no legal effect on a closely-held corporation, there are some very real **practical** consequences that can have a serious impact.

For starters, an important member of the management team has probably been lost, which can be a serious blow to the business.

Then there is the issue of the deceased shareholder's heirs, who now own an interest in the business. In the absence of advance planning, the heirs:

1. can become active in the business, even through they may be unqualified;
2. they can remain inactive but look to the business for income; or
3. they can sell their stock...to anyone with the purchase price.

Problems When the Heirs Become Active Shareholders

Heirs who were not active in the corporation prior to a shareholder's death may not be qualified to take an active role in managing the business. They will likely contribute very little, but will expect their share of the profits. This situation can lead to serious problems, depending on the heirs' ownership interest:

Heirs as Active Majority Shareholders

As owners of a controlling interest, the heirs may be in a position to dictate corporate policy. Will the surviving minority shareholders be willing to do a majority of the work for a minority of the profits?

Heirs as Active Minority Shareholders

Even if they own a minority interest, the heirs have certain legal rights that cannot be ignored. Will the heirs exercise those rights to receive more liberal treatment from the surviving majority shareholders than sound business judgment might otherwise indicate?

Heirs as Active Equal Shareholders

A surviving equal shareholder is faced with the prospect of running the business with an equal, but unqualified, owner. Since each owner votes one-half of the stock, will decisions still be reached quickly and harmoniously, or will conflicts lead to stalemates and, ultimately, liquidation of the corporation?

Problems When the Heirs Become Inactive Shareholders

While the heirs of a deceased shareholder may not be active in actually running the corporation, this does not prevent them from demanding a voice in corporate policy. Inactive heirs can create a variety of problems, depending on their ownership interest:

Heirs as Inactive Majority Shareholders

As owners of a controlling interest, inactive heirs may determine corporate policy and even declare financially-unsound dividends through their power to select the board of directors. For how long will the surviving minority shareholders be willing to shoulder full responsibility for managing the corporation, while dividing profits with a deceased shareholder's heirs, who make no contribution to the business? On the other hand, if the corporation does not declare sufficient dividends, how will the heirs satisfy their need for income?

Heirs as Inactive Minority Shareholders

The needs and objectives of heirs who own a minority interest may not be consistent with the actions taken by the surviving majority shareholders in managing the corporation. Will this lead to constant bickering and dissension that, at best, impairs business progress or, at worst, leads to a potentially devastating shareholders' suit?

Heirs as Inactive Equal Shareholders

A corporation with two equal shareholders is usually operated like a partnership, with both the workload and the profits split equally. Will the surviving equal shareholder be able to run the business alone, while still satisfying the equal, but inactive, heirs' need for income?

Problems Faced by the Heirs

When a shareholder dies, the heirs may be faced with a number of problems, including:

Need for Income

The heirs may need income, which can only come in the form of dividends from the corporation. Will this need for income conflict with the surviving shareholders' salary expectations and desire to reinvest in the business?

Estate Liquidity

Will there be sufficient liquidity in the deceased shareholder's estate to pay estate taxes and other administrative costs without selling some portion of the stock, which may make up the majority of the estate?

Market

Will there be a ready market for closely-held stock?

In many closely-held corporations, the most sensible course of action is for the surviving shareholders to buy the deceased shareholder's stock from the heirs. While the surviving shareholders are the ideal market for the stock, additional problems can arise in the absence of advance planning:

Will the heirs and surviving shareholders be able to agree on a price?
How will the surviving shareholders fund the purchase?

Without advance planning, the surviving shareholders may find themselves in business with outside buyers, or in a bidding competition with outsiders who want to acquire an interest in a successful, established business.

There is, however, another alternative…

A Potential Solution Using Life Insurance

In many corporations, the best answer to the problems arising at the death of a shareholder may be for the corporation to acquire the deceased shareholder's interest in the business for its fair market value.

When the corporation and its shareholders enter into a binding stock redemption buy-sell plan that is funded with life insurance, the corporation will have the cash to purchase a deceased shareholder's interest for a previously agreed-upon price that is fair to the heirs.

With advance planning, an insured stock redemption buy-sell plan can accomplish the following:

- The surviving shareholders avoid the business problems associated with active or inactive heirs, while the heirs receive cash instead of the generally poor investment potential of closely-held stock.
- The corporation is committed to buy and the deceased shareholder's estate is committed to sell the business interest for a price that is agreed upon in advance.
- The funds to complete the sale are available exactly when needed at a shareholder's death.
- The value of the business interest may be fixed for federal estate tax purposes.
- The deceased shareholder's heirs are guaranteed a full and fair cash price for the business.
- Cash becomes available to settle the deceased shareholder's estate promptly and to replace family income.

How Can a Buy-Sell Plan Be Funded?

There are **FOUR** ways a corporation can fund a stock redemption buy-sell plan:

1. Cash Method

The corporation could accumulate sufficient cash to buy the stock at a shareholder’s death. Unfortunately, it could take many years to save the necessary funds, while the full amount may be needed in just a few months or years. In addition, accumulated earnings tax problems might arise.

2. Installment Method

The purchase price could be paid in installments after a shareholder’s death. For the surviving shareholders, this could mean a drain on business income for years. In addition, payments to the surviving family would be dependent on future business performance after the shareholder’s death.

3. Loan Method

Assuming that the corporation could obtain a business loan, borrowing the purchase price requires that future business income be used to repay the loan PLUS interest.

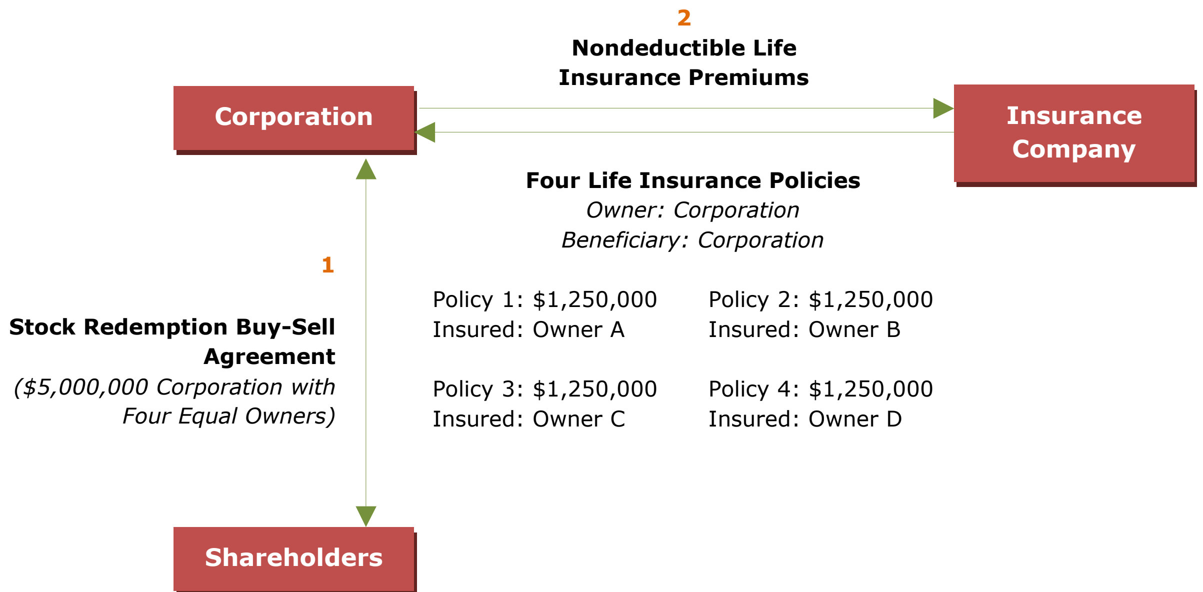
4. Insured Method

Only life insurance can guarantee that the cash needed to complete the sale will be available exactly when needed, assuming that the corporation has been accurately valued (guarantee is based on the continued claims-paying ability of the insurer).

The Mechanics of an Insured Stock Redemption Buy-Sell Plan

The bottom line is that a stock redemption buy-sell plan funded with life insurance is an economical and efficient method of providing the cash necessary to purchase a deceased shareholder's business interest.

Here's how an insured stock redemption buy-sell plan could work for your corporation today...

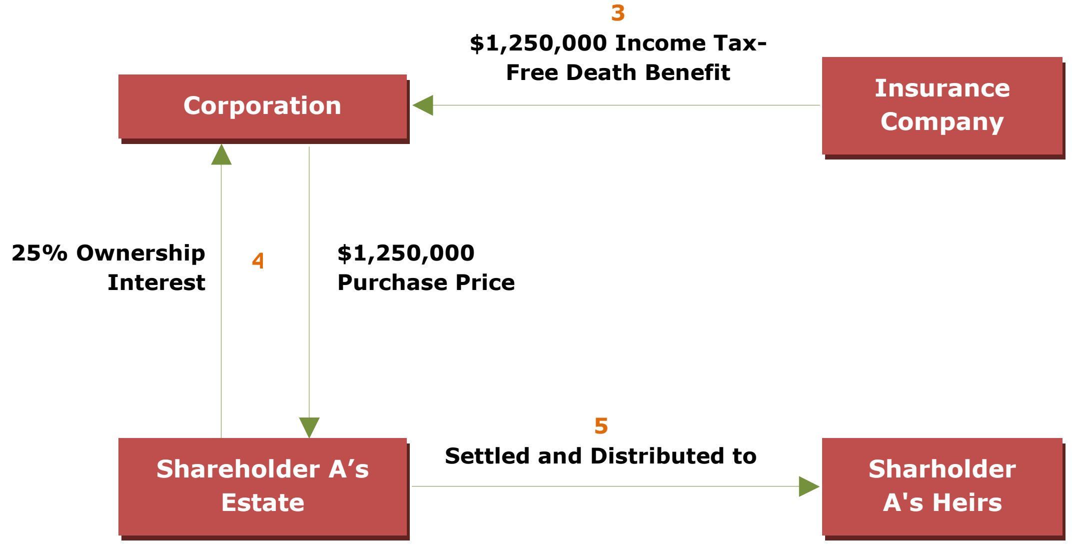


1. The corporation and its owners enter into a stock redemption buy-sell agreement under which the corporation agrees to buy a deceased shareholder's stock and the deceased shareholder's executor is directed to sell that stock to the corporation for an agreed-upon price.

2. The corporation owns, is the beneficiary of and pays the nondeductible premiums for insurance on each shareholder's life in an amount approximately equal to each shareholder's interest in the business.

The Mechanics of an Insured Stock Redemption Buy-Sell Plan

Here's how an insured stock redemption buy-sell plan could work at Shareholder A's death...



3. At a shareholder's death, the corporation receives the income-tax-free death benefit from the life insurance policy it owns on the deceased shareholder.
4. The corporation uses the proceeds of the life insurance to buy the stock from the deceased shareholder's estate for the purchase price agreed upon in the buy-sell agreement.
5. After settling the estate, the executor distributes the balance of the estate to the deceased shareholder's heirs.

What Are the Other Features of an Insured Stock Redemption Buy-Sell Plan?

In addition to serving as a source of funding, an insured stock redemption buy-sell plan can provide a variety of other features:

- **Payment is prompt and certain.** Life insurance proceeds are not subject to the time and expense of the probate process, making them immediately available to complete the purchase of the deceased shareholder's interest.
- **The event creating the need for cash** – a shareholder's death -- **also creates a source of cash** -- the life insurance death benefit. The life insurance policy provides the dollars for a certain need -- purchase of the corporate stock -- that arises at an uncertain time -- death.
- **If the death benefit exceeds the total premiums paid, this gain generally is received free of income tax.** For example, if only 20 cents of each death benefit dollar received has been paid in premiums, the 80 cent gain is received income tax free.
- **Life insurance avoids the problems associated with the other methods** for financing the purchase of a corporate business interest at a shareholder's death.
- **Any cash value in the life insurance policy could be used to help purchase the business interest at a shareholder's disability or retirement** (withdrawals and loans will reduce the policy's death benefit and cash value available for use).

Summary of Insured Stock Redemption Buy-Sell Plan Tax Results

- Premium payments for life insurance to fund an insured stock redemption buy-sell plan are not tax deductible by the corporation.

- While life insurance proceeds received by the corporation at a shareholder's death generally are not subject to federal income tax, they may be subject to the corporate alternative minimum tax.

- The transfer of the deceased shareholder's stock in exchange for the death proceeds is normally treated as the sale of a capital asset. The basis of this capital asset is adjusted to its fair market value on the date of the shareholder's death. Thus, if the amount received by the deceased shareholder's estate -- the purchase price -- equals the fair market value of the stock at death, no gain for federal income tax purposes will result. In a family corporation, however, family attribution rules can result in a partial redemption that is treated as a dividend for which the "step up" in basis is not available. In this situation, a professional tax advisor should be consulted.

- While the surviving shareholders receive an increased ownership share of the corporation, there is no increase in their tax basis.

- Assuming the policies are properly arranged, with each shareholder holding no incidents of ownership in the policy on his or her life, the death proceeds will not be included in the deceased shareholder's estate.

- If the purchase price established in the buy-sell agreement is made at "arm's length" and realistically represents the value of the deceased shareholder's stock, that purchase price may set the value of the stock for federal estate tax purposes, assuming that the agreement prohibits the shareholders from disposing of their stock during life without first offering it to the corporation for the same price.

Estate planning provisions, reviewed on the next page, should be taken into consideration in planning for the disposition of a closely-held corporate interest at a shareholder's death.

Estate Planning Considerations

The federal estate tax is a **progressive tax on the right to transfer property at death**. In 2019, federal estate tax rates begin at 18% and increase to as much as 40% of the taxable value of an estate.

The **federal estate tax** is a transfer tax imposed on the privilege of transferring property at death, while the **federal gift tax** is imposed on the transfer of property during the property owner's lifetime. Both taxes are levied on the **right to transfer property**, and not on the property itself. The amount of tax payable, however, is measured by the **value** of the transferred property.

Once the tentative federal estate or gift tax is determined, it is then reduced by an **estate and gift tax unified credit**. This means that **taxable estates with a value equal to or less than the unified credit equivalent** will not be liable for federal estate tax. The same is true of **cumulative lifetime taxable gifts** which, however, will be brought back into the owner's estate for federal estate tax calculation purposes. **The unified credit equivalent is equal to $11,400,000 in 2019, as adjusted for inflation**, meaning that an individual currently can transfer property valued up to $11,400,000, whether during life and/or at death, without incurring a tax liability.

In addition, **"portability" of the maximum estate tax unified credit between spouses** is available, meaning that a surviving spouse can elect to take advantage of any unused portion of the estate tax unified credit of his or her predeceased spouse (the equivalent of $11,400,000 in 2019). As a result, with this election and careful estate planning, married couples can effectively shield up to $22 million plus (as adjusted for inflation) from the federal estate and gift tax.

Finally, **estate tax deferral** allows payment of estate tax attributable to the value of a closely-held business included in the estate to be deferred for up to five years.

No discussion of estate planning considerations in regard to business continuation would be complete without mention of the **generation-skipping transfer tax** (GSTT). An objective of the federal government is to collect taxes on the transfer of property from one generation to the next generation. If, however, an estate owner is able to skip the members of the immediately lower next generation and transfer property to someone two or more generations removed, the government is deprived of the estate tax that would have been collected on that property at the death of members in the immediately lower next generation. As a result, a generation-skipping transfer in excess of available exemptions is subject to the maximum federal estate and gift tax rate of 40% in 2019. The GSTT is **in addition to** any federal estate or gift tax due and is payable by the transferor, the transferor's estate or by the trustee of a trust making a generation-skipping transfer.

Your professional tax advisor can assist you in developing business and estate plans with the flexibility needed to adjust to an uncertain tax future.

Insured Stock Redemption Buy-Sell Plan Action Checklist

Now...

- ☐ Establish the value of the corporation.
- ☐ Select the appropriate life insurance funding vehicle(s).
- ☐ Establish each shareholder's insurability.
- ☐ Arrange for payment of premiums.

Short-Term...

- ☐ Draft and execute a stock redemption buy-sell agreement.
- ☐ Review the issued policies.
- ☐ Evaluate funding options for the purchase of stock at each shareholder’s disability or retirement.

Longer-Term...

- ☐ An annual review can help ensure that the plan and its funding remain current.
- ☐ Consider the purchase of key employee indemnification insurance on active shareholder-employees.

Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

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