Protecting Your Business With Insurance

By Michael J. Fischer, CLU, ChFC

The three "Ds" – death, disability and divorce – may be the biggest risks for any privately owned business.

If a business has more than one owner, any one of these three can put all owners at risk. If a business owner dies, his or her share of the business may go to heirs that the other owners would rather not have involved with the business. In case of divorce, partial ownership may go to an embittered spouse. A disability may keep an owner from contributing to a business while continuing to benefit from ownership.

A buy-sell agreement, which creates a means for transferring ownership shares in a business, is typically used not only to protect against these risks, but to provide an exit strategy for whatever reason an owner leaves the business. The buy-sell agreement dictates when owners can sell their interest, who can buy it and what price they will pay.

Financing the purchase of an owner's business interest is, of course, key to the success of any buy-sell agreement. Even if a business has sufficient cash flow to purchase an owner's shares, it is probably not the best use of capital, which could instead be used to help the business grow. Borrowing the money is also an option, but the business may not qualify for a loan and, even if it can, its borrowing capabilities may be put to better use helping the business grow.

Many businesses choose to fund buy-sell agreements with life insurance. Other than the cost of annual premiums, life insurance has no impact on business finances. When an owner dies, the death benefit can be used to purchase the owner's interest from his or her heirs. When cash-value life insurance is used, the cash value may also fund the buyout in a divorce settlement. Disability insurance can similarly be used to fund a buyout in case an owner becomes disabled.

Cash value can also be used to fund a buyout if an owner retires or leaves the business for other reasons.

Types of Agreements

Two types of buy-sell agreement are available – a cross-purchase agreement and a redemption agreement. Using a cross-purchase agreement, owners take out life insurance polices on each other's lives. Using a redemption agreement, the business purchases life insurance on the lives of its owners and is named as the beneficiary of the policies.

Cross-purchase agreements. The cross-purchase agreement is most commonly used because of its tax advantages. It allows the family of the deceased owner to have a tax basis equal to the fair market value of the deceased owner's stock at the time of death, which eliminates income taxes that would otherwise result from the sale. The stepped-up basis can also reduce future income taxes if surviving shareholders later sell their interests.

In addition, because the deceased is not the owner of the life insurance, the death benefit is not included in the estate of the deceased business owner. Because proceeds are paid directly to surviving shareholders, the death benefit is not subject to the corporate alternative minimum tax (AMT) or to claims of corporate creditors.

Stock redemption agreement. When a business has many owners, a cross-purchase plan can be difficult to administer, since each owner buys insurance on the other owners. It would take 20 policies, for example, to fund a buy-sell agreement for five business owners.

A cross-purchase plan also creates inequities because young, healthy owners may have to pay higher premiums to insure older owners.

The stock redemption agreement is easier to administer because the business owns all of the policies, so only one policy is needed per owner. In addition, the corporation absorbs the differences in premium costs among shareholders.

Conversely, the stock redemption agreement is not as advantageous for tax purposes. While the corporation does not have to recognize income from insurance proceeds, it must record the impact of the transaction on earnings. In addition, when an owner's shares are purchased by the business, the remaining shareholders do not get the benefit of a step-up in basis. As a result, when their shares are sold, taxable capital gains will be greater.

Practically any multi-owner business can benefit from a buy-sell agreement funded with life insurance. Before determining which agreement is best for your business, though, it may be best to consult with your financial and tax advisors.

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