



Advanced Markets

Planning Risks and Solutions for Today's Business Owners

Focusing on traditional buy-sell planning and alternatives after *Connelly*

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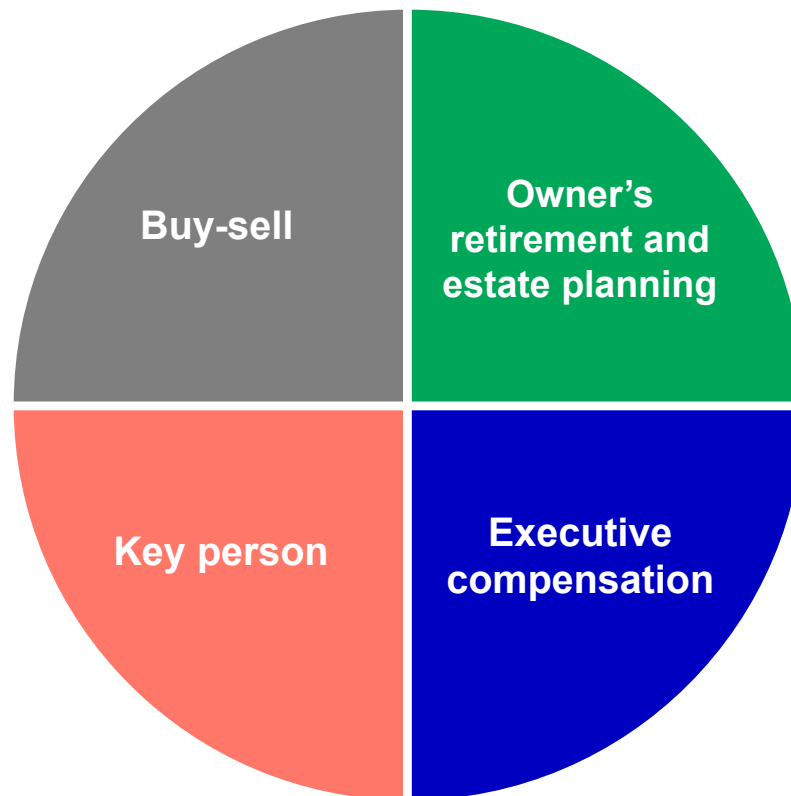
Challenges for small business owners

-  **The value of the business is distinctly tied to the owner**
Potential for economic turmoil for family if something happens to the owner
-  **Finding a Successor can be a challenge**
Most owners will look to family or employee as successor, but this may not be a reality for all owners
-  **Planning for key employees can be difficult**
 - Loss of a key employee can be detrimental
 - Finding ways to attract, retain, and reward key employees can be a challenge
-  **They plan to sell their business to fund most or all of their retirement**
Multitude of issues when selling to family members
 - Equalizing the estate to non-employee children
 - Distributing executive control among family members
 - Uncertainty with their ability to run the business
 - Customers willingness to work with the successors

Life insurance for business owners



Many uses of Life Insurance for business owners...



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Buy-Sell Planning Discussion

1

Buy-Sell Planning

Succession planning is critically important to business owners who must rely on that planning to be accepted and respected by tax and other legal authority.

2

Connelly v. U.S.

A recent case where the Court included life insurance proceeds owned by the business on a shareholder in the business value for estate tax purposes.

3

What does it mean?

This decision may change the business succession planning landscape as we knew it..

4

Planning Opportunities

The Connelly case presents opportunities for buy-sell review and a shift to alternative buy-sell arrangements

Importance of Planning

- ✓ Nearly **66%** of business owners do not have documented and communicated succession plan for their business.¹
- ✓ But **78%** of business owners say that the business is their most important asset and protecting it is their top long-term goal.¹
- ✓ And with **51%** of US businesses owned by baby-boomers who are set to transition in the next 10 years.²
- ✓ It's estimated that only **30%** of small businesses successfully sell.²

Sources:

¹ PwC's 2023 U.S. Family Business Survey, pwc.com, May 16, 2023

² 2023 State of Owner Readiness Report, Exit Planning Institute, <https://exit-planning-institute.org/state-of-owner-readiness>



Business owner concern

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Will my business partner's spouse or children, or some unknown third party, end up being my business partner?

In the event of my death, disability or retirement, how can I:

- Provide cash for my spouse and children
- Secure a buyer for my ownership interest
- Establish a value for my business interest
- Transfer the business to the next generation
- Provide liquidity for estate tax payments
- Equalize inheritance among siblings
- Entice key employees to remain with the business



Potential solution: A buy-sell agreement

Legally binding contract that provides for transfer of ownership and continuation of business at death, disability, retirement or other triggering event



May assist with:

- Providing cash for owner's spouse and heirs
- Establishing a value for the business
- Transferring the business to the next generation
- Providing liquidity for estate tax payments
- Equalizing inheritances among siblings
- Enticing key employees to remain with the business



Variety of types:

- Entity purchase/stock redemption
- Cross-purchase
- One way
- Wait and see
- Cross endorsement



Traditional buy-sell options

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Cross-Purchase

Agreement between *owners*

- Each owner has the right/obligation to buy the business interests directly from a departing business owner (or owner's estate)
- Each business owner purchases life insurance on the lives of the other owners

Entity Purchase/Stock Redemption

Agreement between *entity* and *owners*

- Business has right/obligation to buy the business interests directly from departing business owner (or owner's estate)
- The business purchases life insurance policies on the lives of the business owners

Common Drawbacks

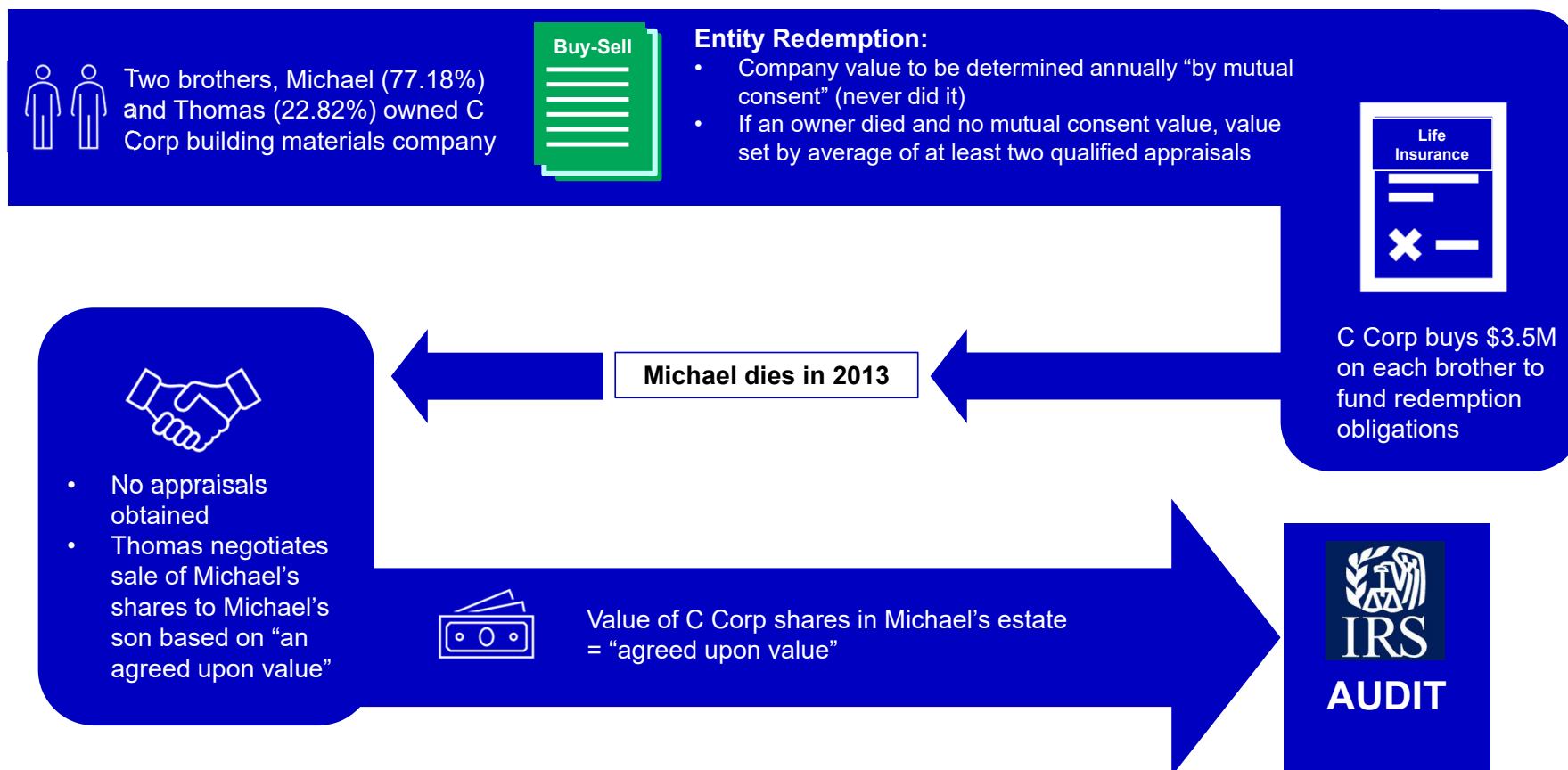
Cross-Purchase

- Too many owners
- Different ages and health
- Premium payment source
- Mistrust

Entity Purchase/Stock Redemption

- Loss in basis “step up” for survivors
- Owners not looking for pro-rata increase
- Concerns post-*Connelly*

The Case Facts





8th Circuit Decision

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IRS had valued decedent's shares almost double what the estate claimed:

- The IRS included the \$3.5M death benefit in the value of C Corp
- The estate had offset the grossed-up value by the contractual obligation to redeem

The Court agreed and ignored the owners' entity redemption agreement

- IRC §2703: property value for tax purposes determined without regard to any agreement unless it requires FMV price or method for determining it
 - In addition, the owners ignored the agreement requirements, so IRS is not bound by it
-
- Without the agreement to consider, the death benefit could not be offset by any obligation under the agreement to use the death benefit to redeem the decedent's shares

SCOTUS Decision

Question presented

- Should the proceeds of a life insurance policy taken out on a shareholder's life to facilitate a stock redemption be considered a corporate asset when calculating the value of the SH's shares for estate taxes?

SCOTUS affirmed the 8th Circuit's decision

- Contractual obligation to redeem is not necessarily a liability that reduces the corporation's value for estate tax purposes
- Contractual obligation to redeem does not offset value of the proceeds



What's next?

The future of entity redemptions at stake?

- *Connelly* decision means insurance proceeds received by the corporation will increase the value of the business
- SCOTUS noted (in a footnote) that there could be circumstances where a redemption agreement would reduce the value of a corporation, but suggests a narrow exception

Planning need

- Redemption agreements should be reevaluated
- Consider offering to review existing buy-sell agreements for problem areas
- When does a redemption agreement still make sense?
- Explore migrating from an entity-agreement to an alternate structure:
 - Cross-purchase
 - Cross-endorsement
 - Cross-purchase, facilitated by a special-purpose Insurance LLC



Unwinding an entity-redemption buy-sell

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Existing Entity-Redemptions

- Discuss with attorney
- When should entity redemption agreements be used?
 - Small ownership percentage
 - When estate taxation is not a concern
- Unwinding to cross-purchase/CEBS/Insurance LLC
 - Watch out for potential transfer-for-value issues
 - IRS has issued a “no rule” notice on transferring a policy from a corporation directly to an LLC taxed as a partnership in which the owner is a member
- Replacing coverage?



Helping with a review

Key questions to ask:

- How is the business structured (C-corp, S-corp, LLC, etc.)?
- Are the owners or successors related to one another?
- Is the agreement between all of the owners or just some of the owners?
- What are the triggering events for the buy-sell obligations?
- Is the buy-sell obligation voluntary or mandatory?
- For family-owned businesses in particular, what is the management succession plan?
- **Who is designated as the buyer of a deceased owner's interest – the company or other owners?**
- **How is the price of a departing owner's interest determined?**
- **Is the buy-sell adequately funded?**
- **What is the process for ongoing compliance with the agreement?**



Alternative #1: CEBS

Cross-endorsement buy-sell



Each owner owns a policy on his/her life and *endorses* death benefit to the other owners

- Rental fee for endorsement = “economic benefit”
- When owner dies, death benefit endorsed to co-owners is received income-tax free and those funds are used to purchase business interests of deceased owner
- Any death benefit exceeding endorsed amount will be paid to the insured’s designated beneficiaries (spouse/children)
 - Potential policy cash values can also be used to supplement owner’s retirement income or to fund lifetime buyout of business



Cross-Endorsement Buy-Sell (CEBS)



Benefits:

- Multiple policies not required for cross purchase obligations
- Endorsement can cover multiple owners and be changed/updated regularly
- Policies can be customized by each owner
- Owners can combine business, retirement and estate planning needs into one policy



Considerations:

- Transfer-for-value:
 - May not be appropriate for strictly corporate owners
- Potential income and estate tax implications:
 - Compliance with split dollar regs



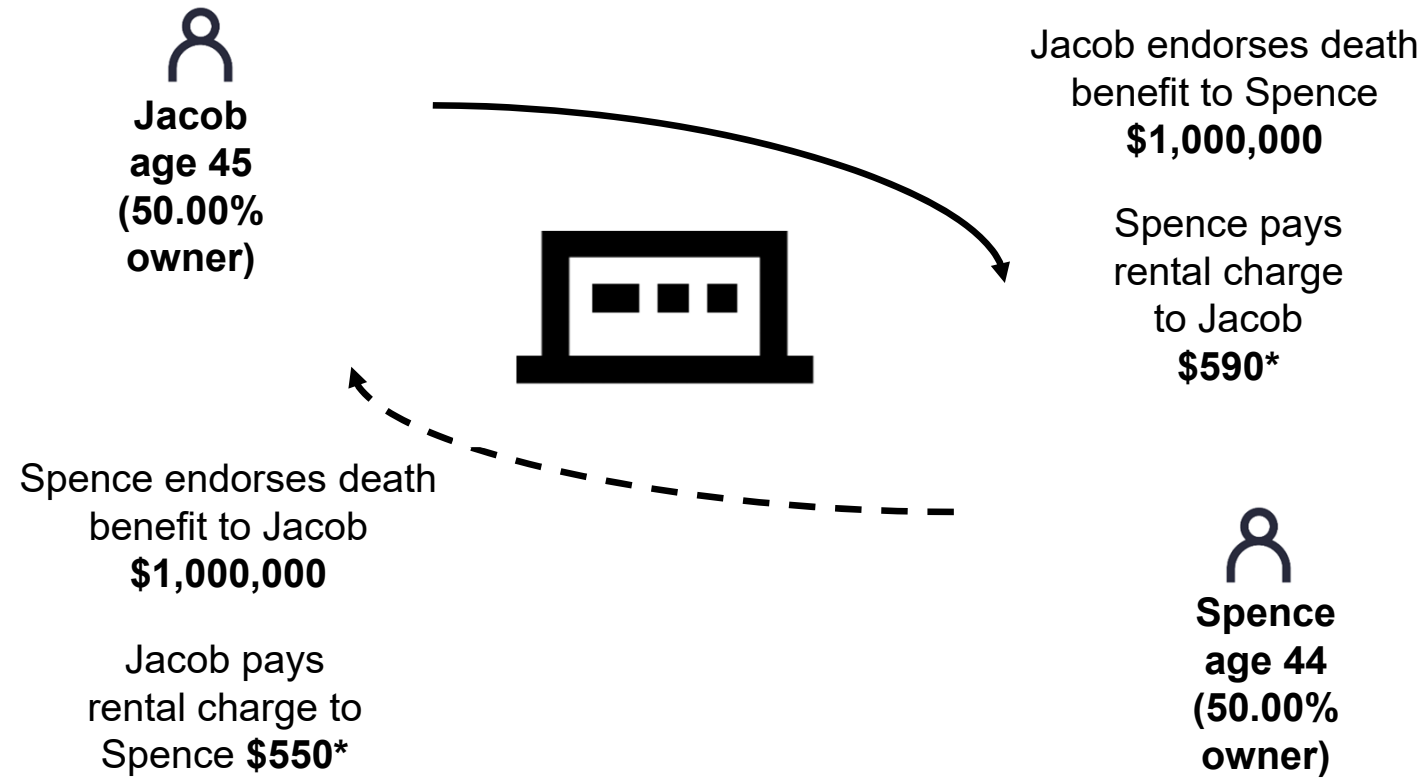
Client Profile:

- Multi owner businesses
- Owners who want more control over their policy
- Owners who are also looking for personal coverage, supplemental income, and/or LTC coverage
- Business owners with a partnership relationship to avoid transfer-for-value
- Ownership interests will be sold or transferred before economic benefit costs become too high



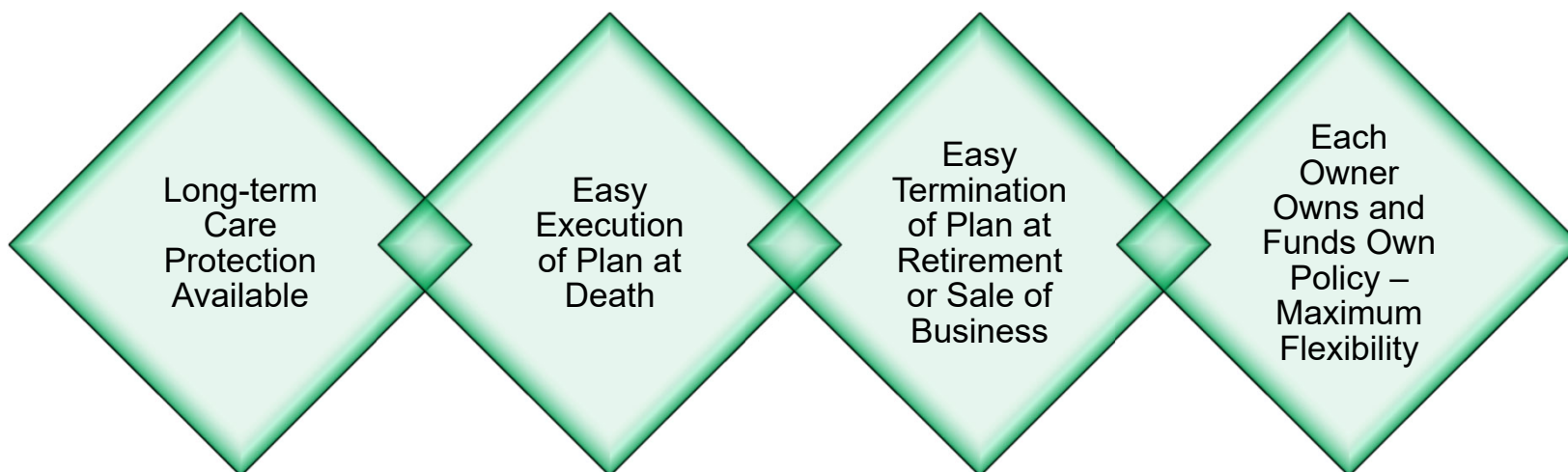
CEBS

“Renting” death benefit



*Based on leading insurer's alternative term rate table

Advantages of CEBS





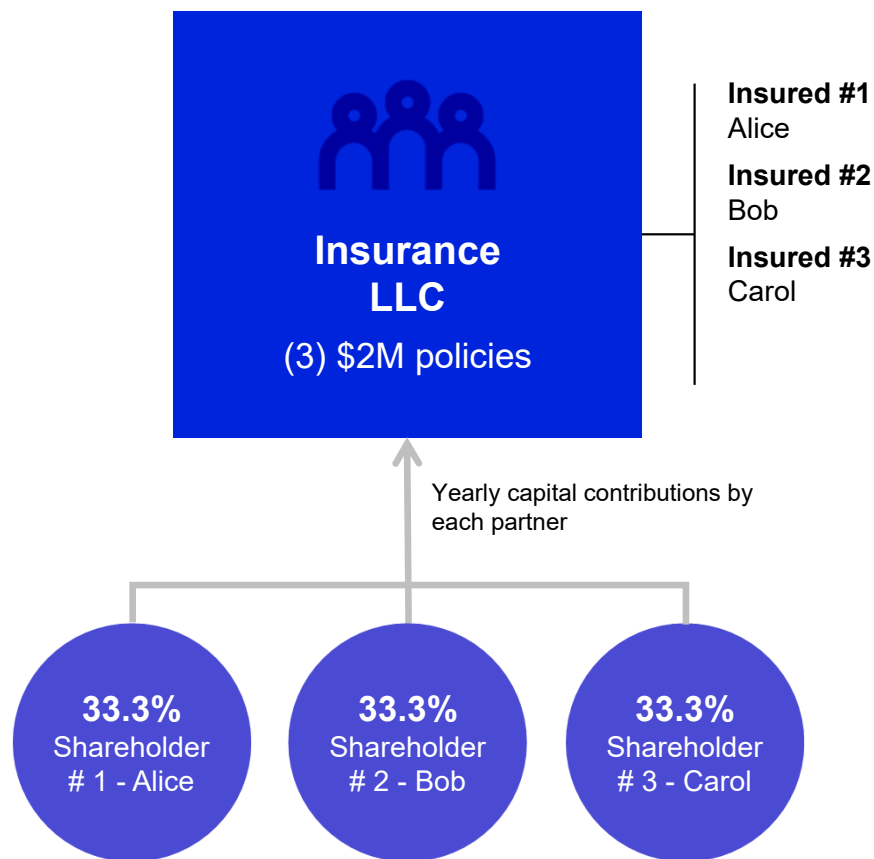
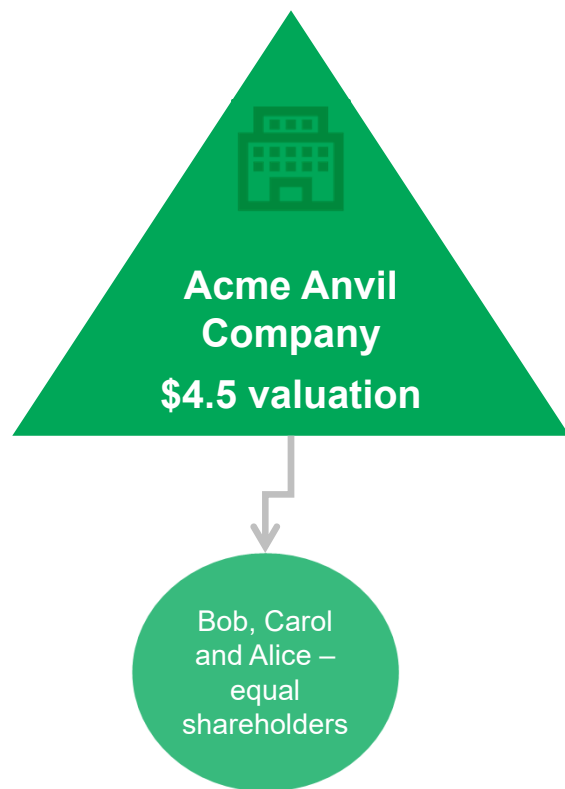
Alternative #2: Insurance LLC

Insurance LLCs

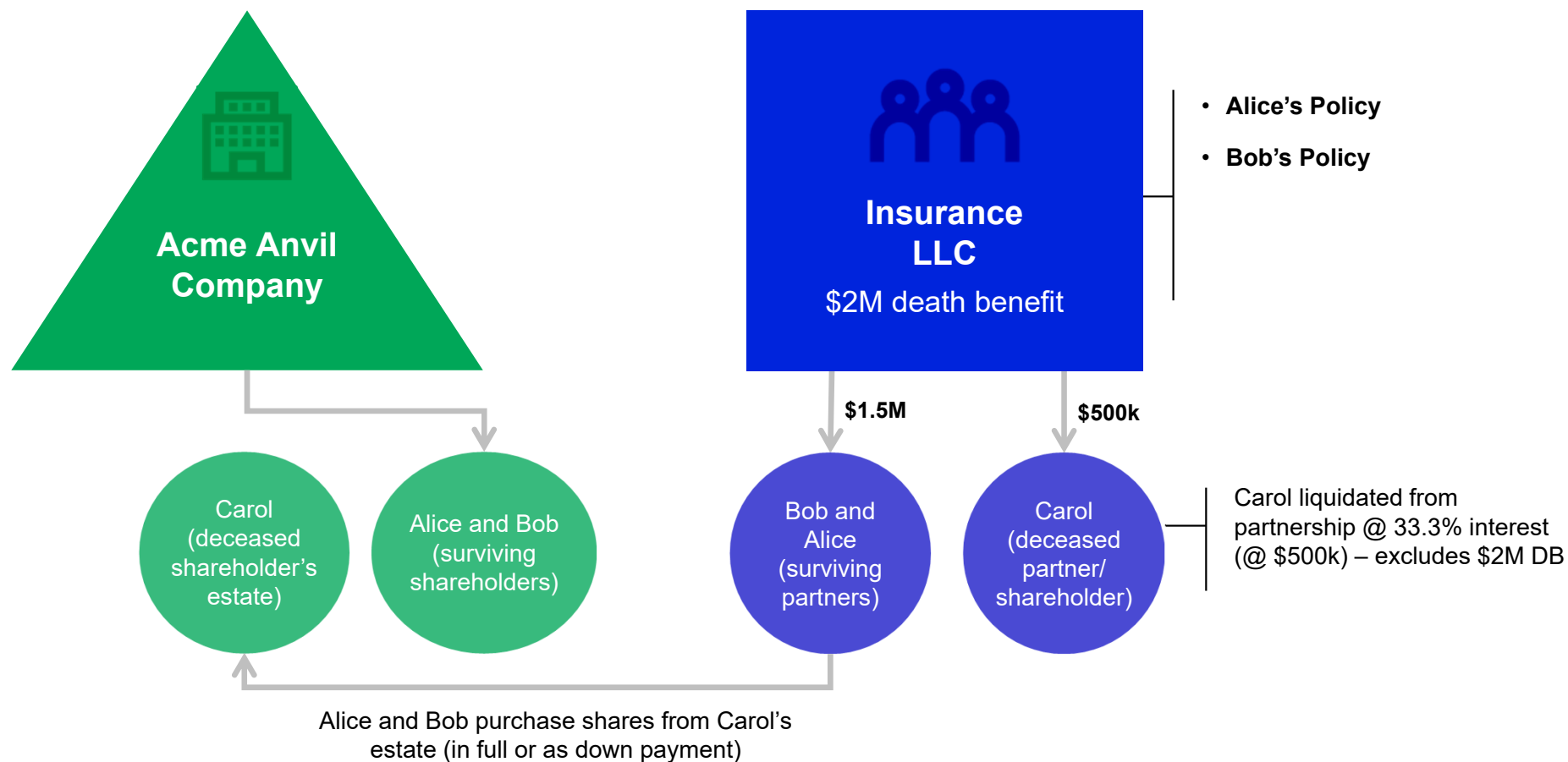
How it works

- Form an LLC taxed as a partnership
- Draft a buy-sell agreement
- Purchase insurance on each owner
- Make ongoing payments of life insurance premiums
- Leverage insurance on death or departure from business

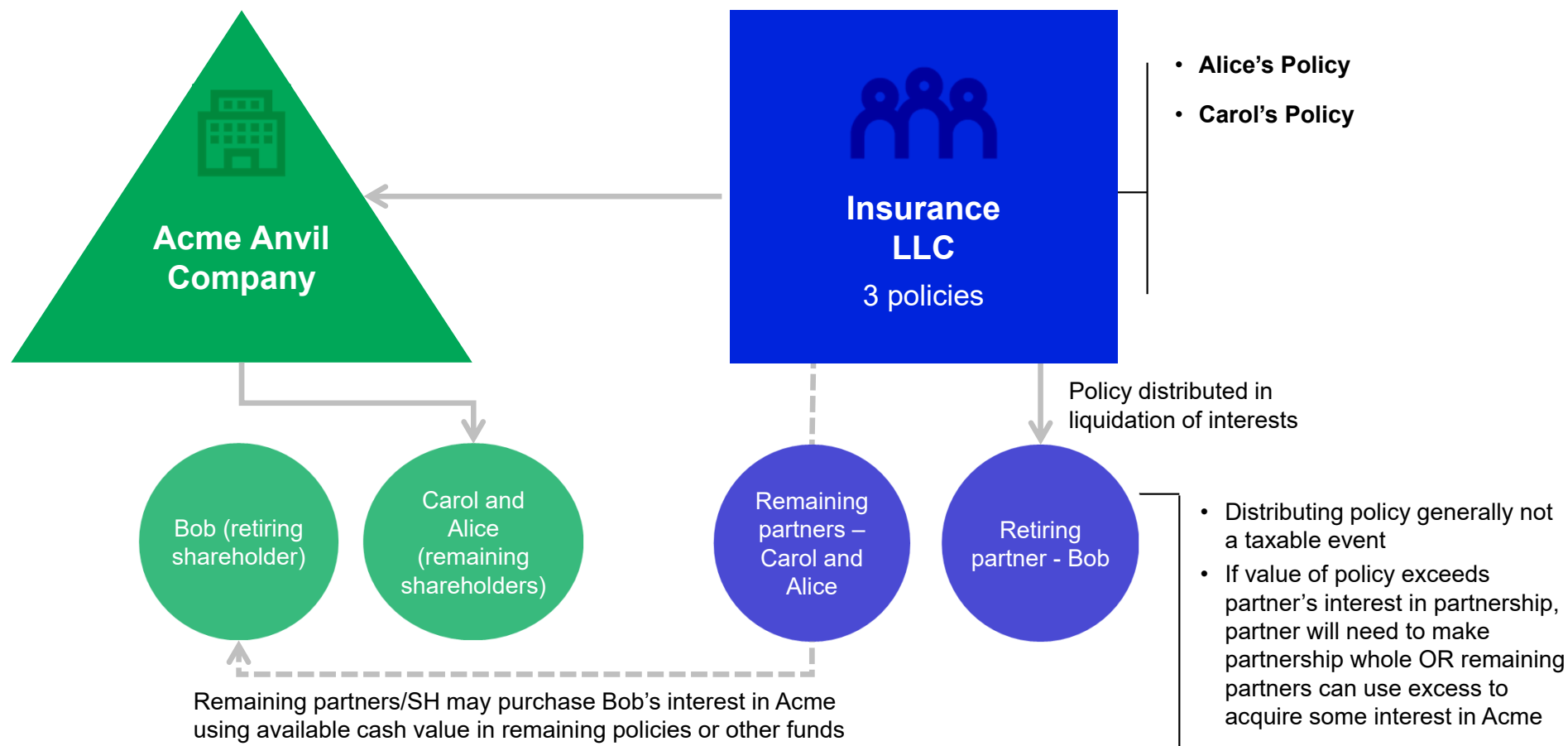
Insurance LLC as an alternative



At Carol's death



At Bob's retirement





Key Person Insurance

Protecting the business with life insurance on a key person

Key person life insurance

Key person coverage



- Insurance policy taken out on the life of a key employee
- Key person could be an owner, partner, or employee whose knowledge and contributions to the company are invaluable

Purpose: Protect the business from financial hardship due to the death, disability or retirement of a key person.

Structure: Business is the owner, premium payor, and beneficiary of a life insurance policy on the life of the key employee.

- Premiums are not tax deductible
- §101(j) applies.

Amount of coverage





Employer Owned Life Insurance

Application of §101(j) to policies issued or materially changed after August 17th, 2006

Employer-owned life insurance

IRC §101(j) applies

Must comply with §101(j) or else proceeds of employer-owned insurance may be subject to ordinary income taxes

Employee signed notice and consent prior to issue



- DB paid to insured's immediate family, designated beneficiary (or trust for their benefit) or
- Employed within 12 months of death, or
- DB used to purchase equity interest, or
- Director/highly compensated



Form 8925 each year there is EOLI

Ask your business owner clients if the business owns any life insurance and if so, whether the business is in compliance with §101(j).





Retaining & Rewarding Key Employees

Breadth of Business Planning Options Using Life Insurance - Rewarding & Retaining Key Employees

Rewarding & Retaining Key Employees

- Executive Bonus (162 Bonus)
- REBA
- SERP
- Salary Deferral
- Business Split Dollar
 - Endorsement
 - Non-equity collateral assignment
 - Loan regime collateral assignment





Retirement and Estate Planning for Business Owners

Breadth of Business Planning Options Using Life Insurance - Retirement\Estate Planning for the Business Owner

Retirement\Estate Planning

- Executive Bonus
- Estate Equalization
- Personal Key Person
- Planning with trusts
 - Gifting
 - Business Split Dollar
 - Financing techniques
 - Private Finance
 - Dual Loan
 - Premium Finance
 - Private Split Dollar
 - Sale of an Asset to a Grantor Trust (SAGT)





Insurance policies and/or associated riders and features may not be available in all states.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 ½. Withdrawals are available after the first policy year.

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