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Plan for your business transition and your life

Using permanent life insurance to fund a retirement buy-sell arrangement

As a partner or co-owner of a business, you've poured your energy (and probably a lot of cash) into making your company a success. You may have even put your business needs ahead of your personal ones. Now it's time to make sure that you, your family and your business are set up for the future, even if you or one of your co-owners:

- Passes away unexpectedly
- Becomes disabled
- Decides to get out of the business
- Retires

Who's an ideal candidate for a retirement buy-sell?

- Co-owner of a business
- Wants to plan for business transition
- Needs retirement income as well

Flexibility to meet your changing needs

Many businesses utilize buy-sell arrangements, funded by term life insurance, to ensure that they'll have the funds to transition a business to the other owners if one of them passes away. Term is often used because it is inexpensive. However, an arrangement like that limits how the funds can be used.

On the other hand, a retirement buy-sell arrangement funded by permanent life insurance gives you flexibility as your priorities evolve, no matter what direction your business takes or what the future may bring. Permanent life insurance can let you:

- Fund a business transfer to the other co-owners if one of them passes away
- Transition the business to the other co-owners if one becomes disabled
- Sell the business during the co-owners' lifetime
- Fund your own retirement

What is a retirement buy-sell arrangement?

In this arrangement, the business owners each own life insurance policies on themselves, unlike a standard buy-sell where the business owns the policies or the owners purchase policies to cover the other owners. This gives the business owners access to their policies' cash surrender to fund a lifetime buy-out of the business or to use as supplementary retirement income if the business is sold and the buy-sell is no longer needed. In addition, because the policy is owned by the insured, the policy can include a long-term care rider to provide the insured and his or her family with financial protection against a long-term care event.

How does it work?

1

Life insurance policy

Each business owner purchases and owns a life insurance policy on his or her own life.

- The face amount of the policy is at least equal to that insured's proportionate interest in the business.
- The life insurance premium is paid by the individual insured — often times through a bonus from the business.

2

Endorse death benefit to each other

Although the policy is owned by the insured, or sometimes, a trust created by the insured, some or all of the death benefit will be "endorsed" or "rented" to the other business owners as a way for them to temporarily "own" a piece of the death benefit, giving them the ability to collect that money if the insured passes away. This could satisfy their obligations under the buy-sell agreement.

- The rental of the death benefit is year-to-year and ends if the business is sold or otherwise terminates.
- The amount of the death benefit rented each year can be adjusted if the ownership percentages change or the value of the business changes.

3

Payments for the policy death benefit endorsement made to each other

The rental charge is based on the economic benefit cost of the death benefit, which is the value of the portion of the death benefit that you temporarily "own." For most insureds, the economic benefit cost of the death benefit represents only a fraction of the policy's total premium. That's because a policy's premium includes ownership in not just the death benefit, but the cash value, as well as the other benefits of the policy. The economic benefit cost is measured annually using either the IRS Table 2001-10 rate or the insurance company cost of term insurance.

Benefits and considerations of a retirement buy-sell

Benefits

- **Efficiently transfer the business** — Cash is available from the life insurance proceeds or cash surrender value that you can use to efficiently transfer the business interest to the other co-owners, if one passes away, becomes disabled, retires or wants to sell his or her business interest.
- **Step-up cost basis on the purchase of ownership interest** — When one owner leaves the business, the other owners' cost basis increases by the amount they paid for the interest of the former co-owner. This is a benefit you can typically get with a cross-purchase buy-sell arrangement, but not an entity buy-sell.

  Example: Let's say Jack and Jill start the business by investing nothing but their time and energy, therefore each has zero cost basis. Their business is appraised at $1,000,000, so they put together a retirement buy-sell agreement and "rent" $500,000 of death benefit from each other. If Jack dies, Jill can pay Jack's estate $500,000 and own 100% of the business. By executing the buy-sell like they did, Jill now also has $500,000 of cost basis in the business. If she decides to sell the business for $1,000,000, she'll only have to pay taxes on the capital gains of $500,000 (instead of the whole $1,000,000, if she still had zero cash basis). That could save Jill a lot of money in taxes.
- **Use the cash value to supplement retirement income** — Unlike term insurance, you can use the policy's cash values to do a lifetime buy-out or to supplement your retirement income when the buy-sell obligation is no longer required.
- **Retain the policy if you leave the business** — Since each owner already owns the policy on his or her life, there is no need to purchase the policies from the business or co-owners if the business is terminated or the insured leaves the business.
- **Use the policy for multiple purposes** — Unlike a traditional cross-purchase buy-sell arrangement, where each co-owner purchases a policy on the other co-owners, the retirement buy-sell requires only one policy per owner. And that single policy can fund a buy-sell arrangement and be used to accumulate supplemental income or protect against potential long-term care costs.

Things to consider

- **Having the cash flow to pay the premiums** — In the long run, the accumulation of cash value may make a permanent life insurance policy more cost-effective than term insurance; however, the premium on a permanent policy will be greater than term insurance, at least initially.
- **The "rental" income may be taxable to the recipient** — The amount you receive from the "rental" of the death benefit on your policy may be taxable as ordinary income under IRC Section 61.
- **The "rental" cost will increase** — Although the rental cost of the term insurance element will initially be low, the value of the term insurance increases as the insured ages.
- **How to avoid "transfer of value"** — In arrangements like this, in order for the death benefit to be received free of income taxes, the business owners must plan to avoid the transfer for value. By the business owners having the partnership in place, an exception is provided to the "transfer for value" rule because the rental of the death benefit by the co-owners is then considered a "transfer to a partner of the insured" and therefore, not taxable.

Want to learn more?

Talk to your financial professional to see if a retirement buy-sell agreement, with an Equitable America or Equitable Financial permanent life insurance policy, may be a wise choice for you and your co-owners.

For more information, visit equitable.com.

Under current federal tax rules, you generally may take income tax-free partial withdrawals under a life insurance policy that is not a modified endowment contract (MEC) up to your basis in the contract. Additional amounts are includible in income. The IRS places a limit on how much money can go into life insurance premiums for the policy and how quickly such premiums can be paid in order for the policy to retail all of its tax benefits. If certain limits are exceeded, a MEC results. MEC policyholders may be subject to taxes on distributions on an income-first basis, that is, to the extent there is gain in their policies, and penalties on any taxable amount if they are not age 59½ or older. Loans taken will be free of current income tax as long as the policy remains in effect until the insured's death, does not lapse and is not a MEC. Please note that outstanding loans accrue interest. Income tax-free treatment also assumes the loan will eventually be satisfied from income tax-free death benefit proceeds. Loans and withdrawals reduce the policy's cash value and death benefit, may cause certain policy benefits or riders to become unavailable, and may increase the chance the policy may lapse. If the policy lapses, is surrendered or becomes a MEC, the loan balance at such time would generally be viewed as distributed and taxable under the general rules for distribution of policy cash values. In addition, withdrawals, policy loans and any accrued loan interest may cause your policy to lapse even if you are in a period of coverage under the No-Lapse Guarantee Rider. Speak to your financial professional before taking any withdrawals or policy loans.

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