Buy/Sell Disability Financial Planning

Presented by:

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A Lloyd's Coverholder

Odds of Becoming Disabled

Are you willing to gamble your financial security and that of your family on these odds?

Consider the Odds of a Business Owner Becoming Disabled for 90 Days or Longer Prior to Age 65:

Age	Number of Business Owners				
	1	2	3	4	5
30	54%	79%	90%	96%	98%
35	50%	75%	88%	94%	97%
40	45%	70%	84%	91%	95%
45	40%	64%	78%	87%	92%
50	33%	55%	70%	80%	86%
55	25%	43%	57%	68%	76%

Source: Commissioners Individual Disability Table A (NOTE: The 1985 CIDA is the most current morbidity table available for individual disability claim experience and is in use by many State Insurance Departments.)

It's also important to know that a disability lasting for more than 90 days is likely to continue for:

Age When Disabled	Average Duration of Disability
30	2.2 years
35	2.5 years
40	2.7 years
45	2.9 years
50	2.8 years
55	2.5 years

Source: Commissioners Individual Disability Table A (NOTE: The 1985 CIDA is the most current morbidity table available for individual disability claim experience and is in use by many State Insurance Departments.)

DISABILITY BUY/SELL AGREEMENTS

OVERVIEW OF THE NEEDS

Small businesses and large businesses are affected by the loss of a business owner's expertise, talents, prestige, and leadership. The loss may come as a result of withdrawal from the firm due to retirement or personal reasons, or due to death or disablement. Whatever the cause of the withdrawal, the survivors in the firm will face financial and emotional consequences of substantial proportions.

The U.S. Chamber of Commerce and the U.S. Department of Labor advise us that small businesses in total exceed the labor force of big business. Small business is big business because there are so many of them! In appraising the size of the small business market as to the use of Buy/Sell Disability Insurance, our reliable sources estimated that fewer than fifteen percent have equipped themselves to adequately handle the challenge of a forced buy-out due to disability.

Large business is not to be ignored. The owners of large businesses face problems similar to those of the owners of small businesses. The size of the firm and its financial capability may require much greater sums; percentage wise, the loss may be little different than to a small firm.

Do large companies buy disability buy/sell insurance? Yes! Premiums of $200,000 - $800,000 are not uncommon because amounts of $10,000,000 - $20,000,000 or more are needed to maintain financial stability in the firm.

THE EMOTIONAL FACTOR - A PRIMARY CONCERN

Mr. Outside, the world's greatest salesperson, and Ms. Inside, a superb administrator, have teamed up to build a business. It is working. Business is fine until Mr. Outside is disabled in an auto accident, or Ms. Inside suffers a brain tumor. Can either adequately carry the load of their duties and also the duties of the disabled business owner? NO! And it could be worse; both owners could be disabled simultaneously. Statistically, when two owners aged 40-45 are involved in a business, there is a 72.7% chance that, before age 65, one of them will sustain a disability that will last at least ninety days. If it lasts longer than 90 days, the chances are that it will last 5.8 years before death claims the disabled partner.

Can adequate "temporary help" be employed as a substitute for the disabled owner? NO! Can permanent help be found and justified? Perhaps. The most likely thing to happen will be a weakening of the firm, whether it is through loss of sales or loss of administrative effectiveness.

The disabled owner expects his or her salary and all benefits to continue at the same level as prior to the disability, even though the company's financial strength is weakening. The non-disabled owner, frustrated and frightened, rapidly develops a huge anger block because of the disabled owner's demands for equal pay and lack of understanding of the horrendous work and worry heaped upon him/her. The non-disabled owner no longer sees the disabled partner as a human being deserving of sympathy, but as an enemy due to the costly impairment of the firm. He/She is siphoning off reserves and assets while not contributing to the firm's well-being.

In such a case the non-disabled owner may have a desire to "crush the enemy," but murder is illegal! As long as the disabled person is alive, his or her full voice is legal in all decisions and must be heard.

The only solution to saving the firm is to quiet the voice of the enemy. Quieting the disabled owner's voice must be agreed to in advance of the disability. A modern Buy/Sell Agreement funded with an adequate amount of disability insurance to fulfill the terms of the agreement is the simple and affordable solution to this very difficult situation.

THE AGREEMENT – THE FIRM'S STABILIZER

The broker may become a Hero to the business owners by guiding them and their advisors in the creation of a comprehensive and a modern agreement that takes into consideration the devilish problems that can develop due to the withdrawal of an owner from a firm for any reason, but particularly on the solutions to the difficult matter of disability.

Voluntary withdrawal and retirement withdrawal are usually known in advance so the financial aspects can be contemplated and negotiated. Withdrawal by death is absolute and quick unless it is preceded by a lengthy disability. A quick solution to an immediate, forced buy-out because of a disability is unfair to the disabled partner, for he/she should be given time to recover and maintain business ownership. A prolonged disability can destroy the firm unless there is a reasonable buy/sell trigger date. Studies over many years indicate a 12-month buy/sell waiting period or trigger date is reasonable to all parties. Longer trigger dates are available and may be agreed to, requiring reduced premiums.

THE PERIL AND THE ODDS

The Problem

A major hazard facing a business firm is the emotional and financial impact of a disabled owner on the non-disabled owners. When an active owner suffers a long-term disability, without advanced planning, the business faces these difficult alternatives:

Continuation

Continuing the disabled owner's income would be a serious financial drain on the business. Because the disabled owner is no longer making a significant contribution to the business the business profits suffer. In addition, it may be necessary to hire a replacement for the disabled owner, adding to the ever-weakening conditions of the firm.

Liquidation

Liquidation means selling the business because it is failing and must be sold. Overhead continues because the owners want to maintain the firm's intent of selling it as a viable business. Creditors must be paid and employees must be paid. The value of business goodwill may be lost due to diminished service, lack of customer contact and slow payment of obligations

Reorganization

The disabled owner may sell to an outsider or to active owners. Generally, active owners prefer purchasing the disabled owner's business interest to avoid potential conflicts with a new owner. The remaining owners may not have the funds necessary to buy at an acceptable price. The best hope for saving the firm is a Buy/Sell Agreement appropriately funded by disability insurance.

FUNDING THE BUSINESS DISABILITY BUY/SELL AGREEMENT

Intelligently planned business buy/sell agreements anticipate the contingencies of the voluntary withdrawal, death, or disablement of a business owner.

In the case of voluntary withdrawal, the buy-out procedure is usually set out in the buy/sell agreement. If it is not, then the matter has to be negotiated at the time of decision. It is not uncommon for the buy-out, on a withdrawal basis, to be on a structured installment basis.

Death is certain, but the time of the death is uncertain. Therefore, it could happen while the agreement is in force and has to be contemplated. The solution to the funding of the buy-sell agreement is simple with the purchase of life insurance on the parties to the agreement. A lump sum settlement is the usual funding design.

Disability presents different considerations. Typically, a buy-sell agreement contains an elimination period of twelve months or longer, to give the disabled person time to recover and return to work and not be forced to prematurely sell his/her business interest. Once the elimination period has been completed the funding by disability insurance can be handled on an installment basis or on a lump sum basis.

The Installment Sales basis is frequently chosen as the plan design for a disability funding plan. There are some disadvantages to this design which should be weighed carefully. Among them is the requirement that a reasonable interest rate be charged on any installment sale. If interest is not charged, the IRS will impute a rate of interest as high as 10% compounded and the recipient of the interest will be required to declare this as taxable income.

Monthly Benefit Disability Plans typically pay an amount equal to the principal payment, but not the interest. Simple interest of 6% of a million dollars is $60,000 per year, which is uninsured and requires cash to cover the cost.

A Lump Sum Benefit eliminates the interest cost. A further advantage of the Lump Sum Benefit is that it eliminates the need to continue life insurance on the disabled business owner. The Monthly Benefit Installment purchase basis needs ongoing life insurance to protect against the disabled owner dying during the buy-out period.

If for some reason the seller wants an installment buy-out basis, the Lump Sum Benefit can be paid to a trustee to hold and then to release the funds on an installment basis. This eliminates the tax on interest received and the need for continuing the life insurance.

When all factors are combined, the Lump Sum Benefit is as economical, or perhaps more so, than the Monthly Benefit plan design.

Other Factors

Recovery – Installment buy-out policies may not guarantee continuation of the monthly benefits should the Insured recover. Because the buy-sell agreement is usually binding and final on the trigger date, this could leave the purchaser with the obligation to pay for his acquired share, but with no funds available to make the payments, if the disabled partner recovers.

Death – Installment buy-out policies will typically not continue the benefit payments if the Insured dies within the installment period. This means that the life insurance policy purchased to fund the death portion of the buy-sell agreement cannot be transferred to the disabled owner, or dropped, until the end of the installment period, because the death benefit will be needed to complete the transaction in the event of death during the buy-out period.

With the Lump Sum plan, the life insurance policy can safely be transferred, or dropped. With this approach, the disabled business owner not only receives a fair market value for the business, but the buyer(s) may transfer or drop the life insurance policy that was put in force to provide buy-sell funding in the event of death.

PROTOTYPE OF A MODERN DISABILITY BUY/SELL AGREEMENT

Buy/Sell Disability Insurance is a mover and a shaker when it comes to generating very big premiums and big commissions. Frequently, the by-product sales or tangential sales generate more commissions than the disability buy/sell plan!

The disability buy/sell spotlights the need for Salary Continuation, Key Person, and Bank Loan Disability, as well as an increase in the Buy/Sell Life Insurance, which in a successful company falls to an inadequate level each year.

If there is a Buy/Sell Agreement in existence, it is typically funded for the contingency of death with life insurance. It is axiomatic. In most cases, there is a missing page in the agreement; the page that contemplates the aspects of disability, a more likely peril the firm will encounter and one that is fraught with unrealistic emotions of the disabled owner.

We were reminded of this fact by a brochure mailed to us by a large, old CPA firm. In the brochure entitled "An Introduction to Business Valuation Services," an impressive digest of services and credentials of the firm are listed. This is followed by a statement of the firm's high expertise which reads, "to determine the adequacy of LIFE INSURANCE, for the value of a company, a shareholder's interest in the company, or loss of a key person." No mention is made about disability insurance. Astute brokers have an excellent opportunity to introduce the peril of disability and demonstrate their knowledge about the comprehensive approach to Buy/Sell funding.

A modern Buy/Sell Agreement between business owners must include the aspects of a long-term disability of a business owner. Disability statistically is the most likely factor that will disrupt a business. Disability is the most devilish contingency business owners will face.

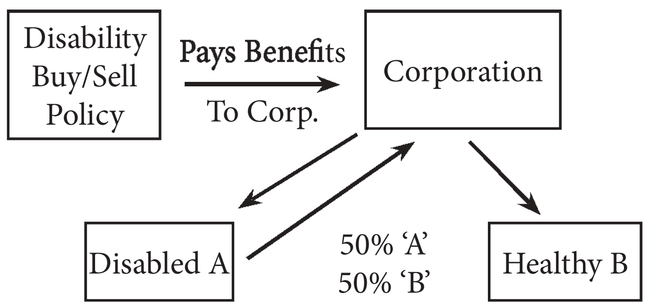
Many businesses do not have Buy/Sell Agreements in force, and of those that do, the page on disability contingencies is missing on 85% of them. Many business owners' consultants have overlooked the peril of disability because the subject has only received modest promotion. Insurance professionals provide a great service to their clients in helping create a modern Buy/Sell Agreement that includes the importance and value of dealing with disability in the Buy/Sell Agreement.

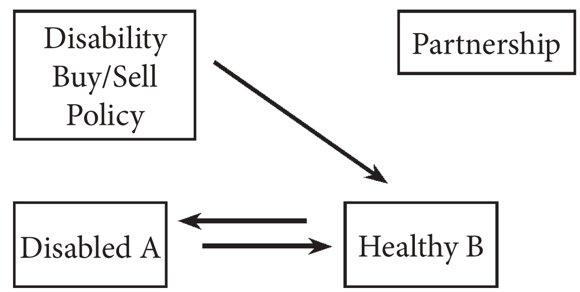
Our prototype Disability Buy/Sell Agreement is available to help prospective insureds and their advisors create a modern and comprehensive agreement that integrates a disability Buy/Sell with their life insurance Buy/Sell plan. Attorneys will be happy to have this instrument, for they can quietly and easily develop a good agreement by following this prototype. They are not left out and they will earn their customary fee while producing a better agreement.

Subjects to be addressed:

- Owners and percentage of interest in the firm
- Types of business
- Business valuation
- Disability definition and trigger date
- Transfer of interest
- Delivery of payment
- Disposition of life insurance policies
- Death during installment period
- Control of business organization during disability
- Fringe benefit of a disabled owner
- Termination or amendment of agreement

Stock Redemption or Cross Purchase





After one year of disability, the disabled stockholder is obligated to sell this stock at the current value of the corporation, and the corporation is obligated to buy it and redeem the stock.

After one year of disability, the disabled partner is obligated to sell his interest to his partner and his partner is obligated to buy this interest at current value of the corporation.

Buy-Out/ Tax Facts

1. Corporation purchases a disability income policy for an employee with benefits payable to corporation. (rev. rul. 66-262, 1966-2 CB 105)

- Premiums are not deductible by the corporation. (IRC 265 (1)).
- Premiums are not taxable to the employee. (IRC 106).
- Benefits are tax exempt to the corporation. (IRC104 (1) (3)).

2.An owner's interest is a capitol asset. Hence, whether purchased by the business or by a third-party, the purchaser of the interest cannot deduct his payment for Federal Income Tax purposes.

3.Where there is a total redemption of a shareholder's shares, the payment he or she receives will be treated as a capitol gain or loss. If the redemption value is less than total, the payments may be deemed to be dividends and hence ordinary income to the shareholders even though they are not deductible by the corporation. (IRC 302)

4. Installment Buy-Out when at least one payment of the purchase price is paid after the close of a taxable year, the gain on the sale will be taxed only as it is received. (IRC 453 as amended by the installment Sales Revision Act of 1980) Where an installment buy-out takes more than one year, interest must be paid by the purchaser on the declining balance of the payments or interest will be imputed. (IRC 483)

Advantages to Active Partners

1. Guarantee that the business interest of a disabled partner can be obtained in the event of his disability at a definite price.

2. Guarantee that the active partner(s) can keep voting control of the business.

3. Guarantee that the active partner(s) can keep the disabled partner's family out of the business.

Advantages to Disabled Partner

1. A definite market for his or her business interest at a fair price.

2. Family members do not need to become involved in the business to protect their interest.

3. Money received for shares can be protected by investing it:
   - In conservative income producing investments.
   - In several different investments instead of just one.

Probability of Disability

(Long term disability is defined as disability that lasts at least 90 days.)

Age	Years to Age 65	Number of Persons in the Group					
		1	2	3	4	5	6
25	40	53.7%	78.6%	90.1%	95.4%	97.9%	99.0%
30	35	52.2%	77.1%	89.1%	94.8%	97.5%	98.8%
35	30	50.3%	75.3%	87.7%	93.9%	97.0%	98.5%
40	25	47.7%	72.7%	85.7%	92.5%	96.1%	98.0%
45	20	44.3%	69.0%	82.7%	90.4%	94.6%	97.0%
50	15	39.4%	63.2%	77.7%	86.5%	91.8%	95.0%
55	10	32.1%	53.8%	68.6%	78.7%	85.8%	90.2%
60	5	20.4%	36.6%	49.5%	59.8%	68.0%	74.5%

Average duration of a disability that lasts 3 months or longer:

Age	Duration	Age	Duration	Age	Duration	Age	Duration
25	4.3 Years	35	5.1 Years	45	5.8 Years	55	6.6 Years
30	4.7 Years	40	5.5 Years	50	6.2 Years		