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Business Insurance Basics

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TABLE OF CONTENTS

SECTION I
FORMS OF DOING BUSINESS

The laws of the United States and the various states allow businesses to conduct their affairs under any of several different forms. These include doing business as a sole proprietorship, as a partnership, as a corporation or in other forms which have been authorized by statute, such as the relatively new Limited Liability Corporation, joint venture, association or other forms.

This chapter reviews the traditional primary forms of doing business, and analyzes some of the advantages and disadvantages of each

Sole Proprietorships

The traditional, and probably one of the first, ways in which Americans have done business is the sole proprietorship. Arguably, it is the simplest form of business entity.

Creation Analysis

The sole proprietorship is a business which is owned by one person, who is its manager and employee. It can be started without formalities. It is the simplest business entity form to create. The proprietor merely opens for business. The only requirements are that he obtain whatever licenses are necessary. Otherwise, there are no formal requirements. Once the doors open, the proprietor can begin to conduct business.

Advantages

This *simplicity* of formation is a primary advantage of the sole proprietorship. Simplicity of operation is another. The proprietor is in complete charge of the business. It is the simplest possible management structure, since theowner/proprietor/manager or employee is responsible to no other person. He makes all the decisions, and reaps either the benefit or the disadvantage of those decisions.

Quite literally, the proprietor *is* the business. His assets and liabilities are those of the business, and vice-versa. There is no distinction or separation for legal purposes.

Thus, tax treatment of the sole proprietorship is simplified--the entire profits of the business are taxed to the individual owner as income in the year earned. The business does not qualify for any special deductions, and must meet the same rules for deductions that any other business must meet. In terms of income and deductions, there is nothing special about it. This simple tax treatment also contributes to the popularity of this form of doing business.

Disadvantages

The very simplicity of operation as a proprietorship, which is its greatest advantage, indirectly results in its greatest disadvantage--the unlimited liability to which the proprietor may be personally subject as a result of

actions taken in the normal course of business. As stated above, the proprietor himself is exposed to all losses and indebtedness. Business capital is personal capital. The business' debts are his, as are his liabilities. Business creditors can obtain personal judgments against the proprietor. Those judgments can be enforced by attaching the personal assets of the proprietor, if necessary.

Such exposure is a significant risk, which must be considered by all who intend to and operate businesses.

Dissolving the Sole Proprietorship

As can any business, the proprietorship can cease doing business for any of a number of reasons. These may include the death of the proprietor, sale or other transfer of the business or insolvency. Proprietorship terminations raise some special issues in law and finance. This section examines a few of those issues.

Death of the Proprietor

When the proprietor of a sole proprietorship dies, the business typically dies with him. Since the business has no legal identity apart from the owner, its affairs terminate simultaneously with his death, and its assets and liabilities become part of the owner's estate. Even extremely profitable businesses will terminate. There is no provision for the existence of the business apart from its proprietor.

The assets of the proprietor are commingled (in fact, are) the assets of the business. Upon the death of the proprietor, business activities cease until and administrator is appointed. During this cessation of business activities, there is likely to be very little income. However, several of the business' fixed expenses, such as rent, light and heat, may continue to grow. The waiting period for the appointment of the administrator can be extremely expensive unless planned for.

Ownership Transfer or Closure

If the proprietor decides to terminate a sole proprietorship voluntarily, there are very few formalities to observe. Termination of a sole proprietorship is as simple as opening one. The owner merely winds up the financial affairs of the business by paying the debts and collecting the accounts receivable, and then closes the doors.

If the owner of the business decides to sell it, some special aspects of tax laws come into play. Since the business has no legal existence aside from the owner, the owner is precluded from claiming that he sold a single capital asset--the business. Rather, the tax laws consider that he has sold all of the assets of the business, individually. All income is allocated to the sale of the assets.

Asset transactions require that the purchase price be allocated to those individual assets on the books. The proprietor therefore recognizes ordinary income on some assets, rather than report the entire transaction as a capital gain on the sale of the entire business. This appears to be disadvantageous to the owner, but it must be recalled that the proprietorship itself pays no tax at all apart from the owner.

Financial Insolvency

Of course any business, regardless of its form, may end because of insolvency of the business. Bankruptcy ultimately benefits no one, since both owners and creditors usually take a loss. If the business produced goods or services that were in demand, consumers or customers also are hurt by bankruptcies.

In the case of insolvent proprietorships, as in the case of death of the proprietor, the assets of the business and the owner are commingled. Creditors may claim against the personal assets of the owner to satisfy debts of the business. The process can be quite complicated and expensive. In the end, unless there are substantial assets, few will benefit.

In the cases both of death and bankruptcy, it is the responsibility of the administrator to wind of the affairs of the deceased. Recognizing the problem of the accumulation of fixed expenses, courts will closely supervise liquidations of proprietorships due to either death or bankruptcy, and will often appoint temporary administrators in an attempt to speed the process and minimize the losses.

Consequences of Dissolution

When a proprietorship terminates, the effects of that termination ripple through a large universe. When any business terminates, the local community and its economy are affected by the loss of the business. While it is true that the degree of the effect varies based on the size and type of the business which has terminated, as well as the size of the community and the nature of the businesses within it, it is safe to assume that <u>any</u> business termination will affect the surrounding community.

Loss of Jobs

When a proprietorship is terminated, employment is inevitably affected. The proprietorship bought supplies and raw material, if it was a manufacturing concern, or softer supplies if it was a service provider. Employees at local business provided those supplies. Employees at the bank handled the financial matters for the proprietorship. Local lawyers and accountants likely provided services to it. All of those personnel will now have less to do because of the loss of the proprietorship.

Moreover, if the proprietorship itself has any employees, it is unlikely that they can wait for the business to reopen. Their jobs will have been effectively lost.

When jobs are lost, more personnel appear on the unemployment and welfare rolls. Services to the unemployed cost money, and must be paid for with new tax dollars. Eventually the local community, and eventually society itself, pays.

Family Income Adjustments

The owner's *family income* also terminates when the proprietorship business terminates. Moreover, the income of the business very likely provided all, or a good portion of, the family's income. Likewise, the assets of the business likely represented a substantial portion of the family's net worth. Those assets and income flows can be reached by creditors of the business, and are not available to the family until the business affairs and the decedent's estate are concluded. Once these processes are complete, the family may have few resources left.

Estate Administration

Delays in the administration and settlement of the decedent's estate can arise from many factors, and may have the effects discussed above. Delay may arise merely from the overloaded condition of the probate court, which may cause a delay in the appointment of an administrator. Likewise, the administrator himself may be overburdened by the accounting requirements involved in terminating the affairs of the business. For example, ongoing work contracted for by the proprietor may have to be completed.

Moreover, the decedent, or his family, may themselves cause delays in estate administration. For example, if the decedent's will is contested for some reason, the contest itself normally causes a delay in administration. Likewise, if the decedent left no will, the time required to appoint court personnel to oversee the affairs of the estate will tend to slow administration down.

Each such delay keeps the assets out of reach of the decedent's family for that much longer. In busy jurisdictions, delays in administration can be substantial, with the inevitable result that some families suffer.

Asset Reduction

As discussed above, the family of the proprietor will suffer a loss of assets in most instances in which the proprietorship is terminated. This occurs because the assets of the proprietor are by definition available to creditors for business expenses and debts. Whether the termination is voluntary or due to the failure of the business or death of the proprietor, use of assets for

this purpose results in an inevitable shrinking or reduction in the total amount of assets available after the proprietorship ceases operation.

The estate administration process requires the administrator or executor to convert assets of the estate into liquid assets which can be allocated to the expenses of administration and estate settlement. This includes the personal and business debts of the proprietor.

The administrator has no duty under law to attempt to maximize the value of the assets by selling the business. Sales of sole proprietorships are usually difficult to achieve equitably, because the market for the business may be illiquid or nonexistent. Under such circumstances it is difficult to obtain a satisfactory, or fair, price.

Issues on termination of proprietorships are real and substantial enough that proprietors must have a business continuation plan if they desire that the business be passed along. The concept of business continuation will be examined elsewhere in these materials.

Partnerships

Creation Analysis

Partnerships are nearly as simple as sole proprietorships to form and operate. Basically, two or more partners open their business, obtaining whatever licenses and permits are necessary in their jurisdiction. There are very few other formalities.

Although not required, experience has taught that partnerships should only be formed and operated pursuant to an agreement between the partners which thoroughly, completely and clearly sets forth their understanding regarding the finances and operation of the partnership business. Otherwise, the partnership will likely be doomed to fail, as the partners will disagree continually with each other over the daily decisions involved in operating the business.

Each partner brings his own skills and experience into the business. Often, partners form partnerships to take advantage of their common, complementary or supplementary skills. Whatever the reasons, partnerships have several *normal* characteristics.

1) Partnerships are unincorporated business entities.

2) They are created by an agreement, understanding or contract between two or more parties acting as partners.

3) The purpose is to carry on a business <u>for profit</u>.

4) Each partner is a principal and owner of the business.

Similarly, each partner has *unlimited personal liability* for the debts of the partnership. Each partner will share equally in the profits or losses of the partnership, unless the partnership agreement specifies differently.

All carefully drawn partnership agreements provide for the allocation of profits and losses between the partners, the allocation of management and operational effort, and the right to deal with partnership property. If the agreement does not cover these issues, it has not been drawn properly.

As can any business, partnerships can be dissolved or terminated for a number of reasons, and with varying consequences. Partnerships come in many forms, but the two most common are: a) Limited Partnerships; and 2) General Partnerships.

Limited Partnerships

A *limited partnership* is a type of partnership which is recognized by the civil law, but was unknown at common law. The Uniform Partnership Act provides for the formation of limited partnerships. The general partners are partners of the entity, with all of the rights and liabilities that entails. The limited partners, on the other hand, are liable to creditors, or for the losses of the partnership, only to the extent of their investment in the assets of the partnership. Generally, as long as a limited partner refrains from participating in the day-to-day operations of the business, he is exempt from liability as a general partner.

In essence, then, the role of the limited partner is to capitalize the business, while the role of the general partner is to operate the partnership business. All of the general partners have the same duties, responsibilities and liabilities. Limited partners have no voice in the operation of the business.

See Table 1-2 for a summary of the roles and duties of general and limited partners. In effect, the limited partnership is one step closer to a corporation, since it has investors who provide capital, have limited liability and do not participate in the operation of the business.

Illinois has adopted the Revised Uniform Partnership Act. The Act governs all limited partnerships formed after 1987. Limited Partnerships formed prior to 1987 are governed by the provisions of the Uniform Partnership Act, which was in effect until that time.

General Partnerships

In a *general partnership*, on the other hand, all of the partners participate in the operation of the business, and have unlimited liability to third parties for acts of partners in the course of doing partnership business. In addition, each partner shares in the profits or losses of the business, in proportions set forth in the partnership agreement.

General partnerships are more common than limited partnerships. One often finds associations of attorneys, accountants or medical service providers doing business in the form of a partnership.

As to third parties, each partner can bind the partnership in business transactions with third parties. In so doing, debts can be created for which all of the partners will be liable.

All of the property originally brought into the partnership or subsequently acquired by the partnership, is partnership property. The share of a deceased partner reverts to the living partners. A partner cannot transfer his interest in specific partnership property.

Every partner, general and limited alike, is permitted to have access to the books and records of the partnership at all times. Partners must account to the partnership for any profits derived, or expenses undertaken. Each individual partner acts as a trustee for the partnership, thus prohibiting the use of funds and profits for personal benefit.

Dissolution of Partnerships

The dissolution of the partnership may occur in various ways. Dissolution itself is not a termination of the partnership, or of the rights and duties of the partners, since many of the rights and duties of the partners persist throughout the dissolution. For purposes of this discussion, the term "dissolution" merely designates that point in time when the partners cease to carry on the business of the partnership together; "winding up", or liquidation, is the process of settling partnership affairs after dissolution; and "termination" is the point in time when all of the partnership affairs are wound up and ended.

The dissolution of a partnership is caused by any event which makes it unlawful for the partnership to carry on its business. Such events can include the death of a partner, or the bankruptcy of any partner. If the partnership was limited by the partnership agreement to a fixed period of operation or to completion of a given task, the expiration of the period or completion of the task can also trigger the dissolution of the partnership. In any event, the onset of dissolution ends the authority of the remaining partners to operate the partnership, except for the winding up activities.

Death of a Partner

When a partner dies, the surviving partners own all of the business assets, and automatically become *liquidating trustees* of the partnership, unless the partnership agreement allows for business to be continued. (See below). The liquidating trustee(s) have a fiduciary responsibility to such parties as creditors, limited partners (investors), and also the estate of the deceased partner. All of these third parties must place their trust in the liquidating trustee to competently and honestly wind up the affairs of the partnership.

Ownership Transfer or Closure

The dissolution of the partnership does not of itself dissolve the *existing liability* of any partner. Under the Uniform Partnership Act, which has been adopted in amended form in Illinois, a partner is discharged from any existing liability upon dissolution by an agreement to that effect between himself, the partnership creditor and the partnership personnel who continues the business of the partnership for dissolution purposes (the liquidating trustee). It should be noted that the

partnership need not terminate its affairs if the agreement provides for the continuation of the business of the partnership. Under §41, et. seq. of the Uniform Partnership Act, partnerships are allowed to continue in business if the agreement so provides. The act dictates the liability of current and former partners when this occurs

Such an agreement need not be express. It can be inferred from the course of dealing between the creditor and the partnership, if the creditor has knowledge of the dissolution.

If a new partner is admitted to the partnership, or if a partner retires having an interest in partnership property and assigns his interest to a third person, and the business continues pursuant to the partnership agreement, creditors of the first partnership are also creditors of the resulting partnership. The retired or deceased partner may have the value of his interest in the property of the partnership.

Creditors of first partnership are creditors of the new partnership. Although it seldom occurs, assumption of partnership liabilities by third persons acts to discharge the liabilities of the partners.

Financial Insolvency

Similarly, if the triggering event is the bankruptcy of either a partner or of the partnership generally, a liquidating trustee is designated to handle the termination activities of the partnership. In the event of a bankruptcy filing, the federal courts will appoint the trustee. In the event of the bankruptcy of a partner, the remaining partners become liquidating trustees.

Consequences of Dissolution

Loss of Jobs

The dissolution of an existing partnership has many of the same effects on the surrounding community as the termination of any business. Depending on the size and scope of the partnership business, the community may suffer *loss of employment.* This occurs because

the cessation of the partnership business results in a lessening of demand for local goods and services to the extent that the partnership utilized them. Thus, in addition to the direct loss of employment positions at the terminated partnership, this overall lessening of demand will work its way through the local economy and may result in loss of jobs at suppliers or service providers which might have been used by the partnership.

Family Income Adjustments

Another economic effect of dissolution is the *loss of family income*. To the extent that the partnership was successful, the partners provided their families with the compensation they earned by contributing their skills and labor to the partnership enterprise. That income consisted of the partner's share of the operating profits. Without the existence of the partnership that income ceases, at least until the ex-partner obtains another source of income.

Because during the dissolution period the liquidating trustee must wind up the affairs of the partnership by collecting the accounts payable and paying the debts of the partnership, the family of the partners are almost certainly deprived of income during the dissolution period, at least

Estate Administration Issues

When the dissolution has occurred as a result of the death of a partner, the *settlement of the estate of a decedent's estate will be delayed* due to the necessary settlement of the partnership's affairs. Obviously, the longer the delay, the more painful it is for the family of the deceased partner. Because the partner's assets are available to the creditors of the partnership, all partnership debts must be cleared and the remaining assets sold before the family can receive the partner's share of the assets.

Asset Reduction

Yet another effect of the dissolution of a partnership is the *loss of business assets* which almost inevitably occurs due to the liquidating trustee's inability to

collect all of the accounts receivable and to the required sale of certain of the partnership assets. This occurs because the liquidating trustee has the responsibility of converting assets to cash in order to meet obligations. When such a conversion occurs within a relatively short time frame, it is difficult to get fair prices for the assets which are sold. In this respect, a net loss occurs.

Corporations

The third major form of business entity is the *corporation*. The corporation differs from the proprietorship and the partnership in one significant respect--it exists as a separate legal entity, whereas proprietorships and partnerships have no independent existence apart from the individual proprietors or partners. Individual identity allows corporations to have a perpetual existence, and to employ more diverse methods of raising capital. A corporation can be sued in its own name, and can buy and sell property in its own name. It is taxed as a separate entity, unlike proprietorships and partnerships. Moreover, the existence of the corporate entity provides a certain amount of protection from liability for management and executive personnel.

Definition and Creation of Corporation

Formation

A corporation is a legal entity created and operated under the corporation law of the state of incorporation. Each state has such a statute. The statute sets out in detail the requirements for the creation, maintenance, operation and dissolution of the corporation. In Illinois, this is the Business Corporation Act of 1983, as amended.

Corporations are formed by one or more incorporators, who select a corporate name and file the *articles of incorporation* in duplicate with the office of the Secretary of State, along with the required fee. The availability of corporate names can be checked on the database maintained by the Secretary's office. The Articles are set forth on a form available from the Secretary. Additional articles can be offered on a separate sheet.

The Articles *may*, but need not, set forth the names and addresses of the incorporators, provisions for managing the business, defining the rights of

shareholders, and an estimate of the value of the corporate property and provisions setting forth or limiting the extent of liability of directors.

The Secretary's office processes the Articles and issues a *Certificate of Incorporation.* The Certificate must be recorded in the county of formation.

The shareholders of the corporation own the corporation. The shareholders may adopt a set of *by-laws*, which set forth a more detailed plan for the operation of the corporation. They may contain any provision for the regulation and management of the affairs of the corporation not inconsistent with law or the Articles.

Typically, the shareholders then hold a *first meeting of shareholders*, at which a Board of Directors is elected to manage the affairs of the corporation. The Board need not consist solely of shareholders. Any competent adult may serve. Once elected, the Board operates the corporation and manages its affairs.

The assets of the shareholders cannot be attached by creditors of the corporation, which is one of the primary reasons for the popularity of this form of doing business.

Taxation of Corporations

The corporation has a separate existence, and in almost every state is taxed as a separate entity. That is, corporations pay a separate income tax, pay property taxes on corporate property, are subject to various other franchise taxes and other miscellaneous taxes such as stock transfer taxes, etc. The extent of local taxation varies from state to state and locality to locality. Therefore location selection is of critical importance to most incorporators.

Ironically, these corporate taxes result in double taxation to shareholders on dividends the corporation pays them on their stock. The corporation first pays income tax on its earnings, and then distributes some of those post-tax earnings to shareholders as dividends. The shareholders then pay income tax on the dividends.

Types of Corporations

There are several types of corporate forms which may be used. Each form has distinct characteristics and offers distinct advantages and disadvantages.

The Subchapter S Corporation

A Subchapter S corporation is a form of closely held corporation which is eligible for special tax treatments under the Internal Revenue Code, Subchapter S.

In many respects the Subchapter S corporation operates similarly to a partnership. The S corporation pays no federal income tax on its business earnings. Rather, such profits as it may generate are considered to be the income of the shareholders for tax purposes. The shareholders receive their income in proportionally to the extent of their holdings. They report the income as personal income for tax purposes.

Subchapter S status is elected at the time of corporate formation, or at any time preceding the taxable year for which the election is to be effective. If the election is not made, it is waived. Only a domestic corporation that is not a member of an affiliated group can elect Subchapter S treatment. It can have no more than 35 shareholders, and can issue only common stock

The S corporation must file an annual return on form 1120S, which is due on or before the 15th day of the third month following the close of the tax year. Generally, for S corporations, this must be the calendar year.

Subchapter S election can be terminated by a vote of the shareholders, unless limited by the Articles or Bylaws. Eligibility for Subchapter S treatment is lost automatically if the corporation is no longer eligible due to its obtaining more than 35 shareholders or more than 25% passive income.

The Professional Corporation

Another type of close corporation is the *professional corporation.* This form is typically formed by service providers such as doctors, attorneys or CPAs. Theoretically, this form of business entity allows the use of special tax treatments and may work to limit personal liability.

The Public Corporation

Although most corporate businesses begin as closely held corporations of one type or another, many are *publicly held.* These corporations have offered stock to some segment of the public, and have been successful in attracting investors. This means that there are many shareholders (some corporations have shareholders numbering in the tens of millions).

The sale of stock is one of the most common ways for corporations to raise capital. Obviously, if more investors can be attracted, more capital can be raised. The disadvantage of this is a dilution of control, as ownership is dispersed. The new shareholders make their influence felt at annual meetings, at which directors are elected. (The directors operate the corporation for the benefit of the shareholders). Often, public ownership results in amendment of the by-laws to increase the number of directors. The new shareholders then use their votes to attain seats on the Board.

The other common method of raising capital for corporations is by issuing debt instruments in the form of bonds. The holder of a bond is a creditor on a note, while a shareholder has an equity ownership position in the corporation.

The Closely Held Corporation

In contrast, closely held corporations are typically formed and owned by only a few shareholders. Their stock has not been offered to the public, although it may be at some time in the future. Rather, the stock is owned privately.

The difference between public and private ownership of corporate stock is profound in one sense. Closely held corporations may have only a few shareholders, who own all of the stock. The stock itself often (usually) is not regularly traded. Therefore, there is no liquid market available for it, at least on short notice. Thus, valuation of close-held stock is difficult or impossible. In situations where the holder of close-held stock is forced to sell his holdings, it is difficult to obtain a price which will be satisfactory to him.

Publicly held stock, on the other hand, is traded regularly and may be listed on an approved and regulated exchange. Typically the members of the exchange will make an instant liquid market for such stock, which makes valuation, not to mention liquidation, of holdings a much simpler task.

The Limited Liability Corporation

Characteristics of Corporate Entities

<u>Insulation from Personal Liability</u>

One of the primary advantages of the corporate form, as stated previously, is that investors in the corporation have *limited personal liability*. This generally means that a shareholder can lose only the amount of his investment, which occurs if the corporation files for bankruptcy, either voluntarily or involuntarily. For example, a huge judgment against a corporation could force a bankruptcy filing, but the only effect on the shareholder would be the loss of his investment to the extent that liquidation of the corporate assets do not reimburse the investor.

Loss of the investment can be painful for the investor. However, it is less painful or damaging than loss of the investor's individual assets would be if the creditor were able to attach them. In the corporate form, the creditors cannot typically attach the individual assets of the investors, despite years of attempts by plaintiff's attorneys.

Rather, the corporation itself is liable, both for its own acts and for the acts of its employees, officers and directors in the course of their duties. The employees themselves are typically protected from liability with regard to contractual disputes, to the extent that their actions were within the scope of their duties. However, with regard to torts, officers, directors and employees may have personal liability to third persons.

Officers, directors and employees are liable to or some of their acts. For example, because liability attaches for torts, these personnel would be liable to the corporation or to outsiders for fraud or for any other tort in which they participate personally.

Similar considerations govern the *criminal* liability of such personnel. Traditionally, they were not liable for offenses committed by the corporation, except where the individual himself participated in it. However, within the past twenty years this doctrine has been eroded by case law, with the result that liability is now more easily found.

In light of the increasingly common piercing of the corporate veil, officers, directors, managers and employees should be well insured for their actions on behalf of the corporation.

Perpetual Existence

Another major difference between the corporate form of doing business and proprietorships and partnerships is that, under law, corporations have a *perpetual existence*. Thus, death of an incorporator, executive, officer or manager will not operate to terminate corporate operations. The deceased will merely be replaced in time, either by action of the shareholders, directors or management, and operations will continue. While success or failure may be operationally affected by the death existence, as such, will not be.

Transfer of Ownership

Corporate stock represents actual *shares of ownership*. The holder of shares has an equity ownership position in the corporation. The relationship between the corporation itself and its shareholders is contractual in nature. The rights and duties of the shareholders are prescribed by their subscription agreements, the Articles of Incorporation, the Bylaws and any special Shareholder's Agreement which may be in effect. In many senses the corporation has a fiduciary duty to its shareholders, and corporate directors and officers are fiduciaries, as well.

Stock ownership is represented by share certificates. The certificates are the personal property of the shareholder. The transferability of corporate stock results from its character as personal property which can be transferred to others under specified conditions. The transfer of stock is regulated by statute (either the Uniform Commercial Code, Article 8 or the Uniform Stock Transfer Act).

Transfers of shares effectively transfers ownership of the corporation to its *investors*. The corporation may repurchase its stock if the stock was issued as callable. Usually this is characteristic only of preferred stock, not common shares.

Transfer of shares is typically completed by delivery of the share certificate. In the case of publicly owned corporations, transfers are accomplished on a regulated market, under the Securities Exchange Act. 1934., 193.

Rights of Shareholders

Generally, shareholders have no right to represent the corporation or act for it in the course of business. The business of the corporation is instead handled by its Board of Directors. Neither do the shareholders have an interest in corporate property, the title to which is held by the corporation itself.

However, by exercising their votes, the shareholders have the power by election of officers and directors, to influence (sometimes control) the operation of the corporation.

Shareholders also have a *preemptive right* to maintain their proportion of ownership in the corporation. Thus, if the amount of shares outstanding is increased, each shareholder must be offered his proportional share. Existing shareholders have first call on a new issue before it is offered to the public.

In the event of liquidation, shareholders become proportional creditors of the corporation, with preferred shareholders having priority over common shareholders.

Corporate Profits

Corporate profits and losses are shared proportionally with the shareholders, as owners of the corporation. Profits are distributed as <u>dividends</u> on the stock held by the shareholders. Dividends must be authorized by the Board of Directors. They are never guaranteed. For example, even if the corporation earns a profit for the operating period the Board may elect not to distribute a dividend. It may wish to use the accumulated earnings for other purposes, such as investment, expansion, reduction of debt, etc. The

directors are only required to use their sound discretion. If a dividend is declared, it may be paid in either cash, stock, scrip or bonds.

Dividends arise from *profits*. They cannot normally be paid out of the capital of the corporation. If a dividend is "passed", for a given time period, the investor-shareholder-owner loses his opportunity to share in the profits for that time period. If a dividend is declared, the corporation generally declares that the right to it goes to shareholders of record as of a specific date. This is for the purpose of avoiding, or minimizing, disputes over the right to the dividends.

<u>Section I Summary</u>

The three primary forms of doing business are proprietorships, partnerships and corporations. Similarities and differences in these forms are set out in Table 1-3, found in the Appendix Section.

SECTION II:

THE IMPACT OF DEATH ON THE BUSINESS ENTITY

Impact of Death on Sole Proprietorships

Business Continuation

Death of proprietor usually terminates generally means the death of the business, with the attendant severe economic consequences discussed above. Without proper planning for continuation, termination and liquidation of the business becomes a virtual necessity. If the business is one which is capable of continuation, proper planning can both provide funds to the family or heirs of the proprietor and provide for continuation of the business.

To review, when the sole proprietor dies, it is the duty of the administrator to wind up the affairs of the proprietorship and settle the decedent's estate. Normally this results in the termination of the proprietorship business. However, if the proprietorship represents a highly profitably endeavor, the administrator may choose to continue its operation. This decision is caused by the fiduciary duty that the administrator has toward the estate of the deceased.

Continuation Without Authority

A problem in this context is that the administrator may make this decision *without proper authority*.

The situation described above often arises because a surviving spouse attempts to continue the business of the deceased. This causes several problems. Often the spouse will have neither the knowledge nor the ability necessary to continue the profitable operation of the business. If the business is ruined in an unauthorized attempt to continue it, litigation with other heirs may result, as the decisions of the unauthorized party are questioned in court actions.

Likewise, the administrator himself may attempt to continue the business on the assumption that continuation is the best way to conserve estate assets. However, this course of action is not without risk, because the probate court will scrutinize every aspect of the decision, and will impose punishment upon the administrator if the unauthorized attempt to continue operation results in losses to the estate.

Likewise, if an heir attempts to continue the business without authorization, the probate court will hold both the heir and the administrator personally responsible for losses which may occur.

Moreover, an administrator receives no reward if his unauthorized continuation of operation is successful. The probate court will allow the estate of the deceased to collect the additional profits, but will not allow the administrator to profit thereby. Thus, administrators have little or no incentive to attempt continuation of the business without authority.

Consent of Heirs

Knowing that a forced sale of the business may bring little or no return (due to the fact that no liquid market exists and the business is difficult to value), the administrator may attempt to avoid a liquidation sale. The heirs may be in agreement with this, since they also do not wish to suffer a forced liquidation sale. If they are in agreement, they may give express permission for the administrator to continue the operation of the business. Usually, the ultimate objective of such a decision would be to accomplish the eventual sale of the business at a "fair" price.

When the heirs have given express permission, *any losses resulting from the attempted continuation of operation are charged to the estate*, not the administrator himself. However, if the heirs withdraw their permission, losses resulting from the operation of the business will be chargeable to the administrator. On the other hand, expenses incurred in the operation of the business are charged to the administrator.

Thus, even with the consent of the heirs there is financial risk to the administrator in attempting to continue the operation of the business. In addition, because the heirs have given their permission, they cannot hold the administrator personally liable for losses as they would otherwise be allowed to do.

Consent of the Creditors

Typically, the administrator is liable to creditors for expenses involved in the continuation of operation. This is true even if the heirs have given their consent. However, if the creditors themselves have also given consent, the administrator is not personally liable for expenses.

When full consent has been given by all interested parties, the administrator may be compensated for his services in the operation of the business. However, without the consent of all involved, the courts will not allow such compensation. Any compensation thus paid will be paid out of profits. If there are no profits, there may be no funds to pay the administrator.

Note that if new creditors are created in the course of continuing the business, the administrator is treated as a sole proprietor for purposes of the new creditor relationships. The new creditors may thus hold the administrator personally liable for trade debts created during the course of the operation.

This represents a very substantial financial risk to the administrator, and is a major disincentive to continue the operation of the business. In addition, the heirs and creditors have created financial risk for themselves by giving the consents and limiting the liability of the administrator. For these reasons, it is unusual for these consents to be given.

Presence of Authority

In order to be fully authorized to continue the business, the administrator must have the authority specified by the common law, and the state statutes. The common law is set forth in court decisions in probate cases.

If the court issues an order allowing an administrator to continue the business of the deceased proprietor for the purposes of winding up the operations of the enterprise, the administrator has received common law authority to do so. Reasons that a court might use for issuing such an order include 1) preparing the business for sale; 2) winding up the affairs of the business in an orderly way; or (rarely) 3) to maximize the income of the estate (and therefore the heirs).

However, even though the administrator has been granted proper common law authority, the courts will typically hold him liable for losses and newly created business indebtedness. This is the same financial risk discussed in the above sections.

Authority may also be granted if the state has a statute allowing administrators to continue a business for the purpose of selling it. In Illinois, unless otherwise provided in the will of the decedent, the representative may continue to operate the (unincorporated) business of the decedent for one month following the issuance of letters of office, and for such further time as the court may grant. The operation is continued under the supervision of the court.

Generally, operation with full authority, although it is not without its risks both to the administrator himself and the estate, it offers a better chance of eventually realizing a fair price for the business at a sale.

Role of Last Will and Testament

Often, a sole proprietor will have given thought to the continuation of his business after his death, and may have discussed the topic with various persons. However, discussion of the topic does not accomplish anything. It is *essential that affirmative steps be taken* if the proprietor wishes his business to continue after his death. Otherwise, it is almost inevitable that the business will be sold, and that the price realized from

the sale will be unsatisfactory to the family of the deceased. Not uncommonly, the proprietor will set forth his plan for continuation in his will.

The will binds the administrator to attempt to follow the plans of the decedent, if the plans fall within statutory guidelines. The statutory guidelines typically provide that the business may be continued for any of the following reasons:

1) The business may be sold as a going concern;

2) The business can be continued until a family member can take it over; and

3) To provide a source of family income; and

4) To continue until a successor can take over.

Setting forth provisions in the will is a distinct improvement over mere authority of the heirs or creditors. However, it is not free of problems.

Future Planning Options

Sale of the Business

Often a proprietor directs in his will that the business should be sold as a going concern. The intent in making such a provision is to avoid a forced sale of assets.

If the provision requires sale as a going concern during the administration of the estate, there will be a problem due to the short time frame in which the administrator must sell the concern. Valuing the concern will of necessity be determined by reference to the inventory and stock on hand. The usual result of such a clause is that the business is sold in a forced liquidation sale, and the heirs are unhappy.

A better provision would allow operation for an indefinite time until the sale can be made. Such a provision at least gives the administrator the opportunity to take a more measured approach to the sale. With good fortune, a more accurate value can be assessed. It is more likely that a willing buyer will be found. A disadvantage is that the business is required

to survive throughout the longer period, risking business downturns, changes in economic conditions and other normal business risks. This also creates an increased risk to the administrator.

Continuation by Heirs

A will provision providing for continuation of the business by the heirs is full authorization for the heirs to do so. However, many aspects of such a will instruction can create problems. For example, the heirs may be minors, incompetents or aged or infirm. Virtually any such condition would render the operation of the business impossible or impractical.

If no specific time period for the continuation of operation is set forth in the instruction, there is no guarantee that the business will survive normal business cycles.

Yet another problem arises if the surviving spouse of the proprietor disagrees with the provision. Surviving spouses have statutory rights in the estate. The will could be challenged by a surviving spouse whose intent differed from that manifested by the will.

Continuation to Provide Family Income

If the business operation is the only source of income for the proprietor's family, the proprietor may direct in his will that the business be continued so that income will continue to be provided. The administrator then must attempt to continue to operate the business profitably.

If the administrator is able to do so, he will be entitled to compensation for his successful efforts. However, operation of a profitable business is not normally possible on a part-time basis. The estate should consider the employment of a professional trustee who possesses the skill to operate the business profitably.

Continuation by Successor

If the will of the proprietor names a new owner, and that owner is capable of operating the business, there is a good chance that the business can continue to be operated successfully. However, the same business risks as in all of the other arrangements exist. Moreover, the heirs, or a surviving spouse, may want the business to be liquidated in order that they may receive the cash, and may challenge the will in court.

In order to implement any of the above plans, the estate must provide adequate cash. This can be accomplished through the use of life insurance, as will be described later. Sufficient operating cash and a competent successor or administrator, may enable the business to be continued successfully.

Impact of Death on Partnerships

Dissolution of the partnership resulting from the death of a partner is normally an unappealing course for the remaining partners. The problems inherent in dissolution of partnerships were examined briefly in Section I. Other alternatives, and other aspects of dissolution, are be considered in this section.

Business Continuation Analysis

The Surviving Partner

Surviving partners who continue to operate the partnership business without proper authority are subject to similar risks as are borne by administrators of proprietor's estates who make similar decisions. This is because the heirs and the estate administrator have recourse against the surviving partners, absent a specific authorization in the partnership agreement.

The liability of the remaining partners to the heirs and administrator runs to the profits which are realized as a result of the continued operation of the business. In addition, use of the partnership assets to generate the profits entitles the estate to compensation for the use thereof, usually in the form of interest. The interest entitlement exists even if no profits are earned as a result of the continuation.

As a result of this entitlement, the surviving partners undertake considerable financial risk if they elect to continue the operation of the partnership business without authority. The Uniform Partnership Act, as adopted in most states, requires that surviving partners become the liquidating trustees of the partnership and begin the process of *dissolution*.

Theoretically, the liquidating trustees are charged with winding up the partnership's affairs and distribute the assets to the remaining partners and the estate of the deceased partner. Once a partnership has been dissolved and the winding up process concluded, the assets of the partnership are distributed in this order:

Creditors other than partners;

- **Loans from partners (other than capital contributions;**
- **Capital contributions of partners; and**
- **Profits of partners.**

Often, if the survivors ignore or refuse this responsibility, the continuation of the business will not earn profits, but will result in losses. Those losses are subject to attack by the estate of the deceased partner.

New Partnership Formation

Moreover, formation of a new partnership with the heirs or family of the deceased may be impossible or impractical. The family of the deceased partner has suffered an emotional shock, as have the remaining partners. The family's shock is obvious and understandable. The remaining partners have just lost a friend and colleague. It is not unknown, under these circumstances, for the surviving partners to offer to form a new partnership which includes the family of the deceased.

However, this presents obstacles to success. At the outset, the heirs do not have a right to the business assets until the estate is settled. (Recall the order in which partnership matters are wound up, above). An accounting must be rendered to the administrator.

Moreover, no partnership can be successful unless there is full agreement between the parties. The surviving partners cannot <u>force</u> the creation of the new partnership upon the family or the heirs, nor can the family force such an arrangement on the surviving partners.

The remaining partners are to some extent at the economic mercy of the heirs of the deceased partner. Those heirs may know nothing about the business. In that event, the remaining partners would be assuming virtually the entire load of continuing the business, regardless of the fact that a "new" partnership was formed.

The concerns of the heirs may be different than that of The surviving partners. Heirs may be interested primarily in continuing their income, while the remaining partners are interested in operating and growing the business. Sometimes these interests conflict. Making partners of the heirs may work out for the best, but only if the heirs have the skill and interests, let alone the ability to get along with the other partners.

Partnership Interest Transfer

It is not uncommon where the existing partners wish to continue the business, for the existing partners to attempt to buy the interest of the deceased partner. Alternatively, sometimes the heirs themselves wish to purchase the partnership interest. In both cases, the idea is an attempt to avoid the disaster of liquidation. In either case, the same problems as those set forth above apply.

Surviving partners may be in a conflict of interest if they act without authority, because their duty under the law is to dissolve the partnership. If a surviving partner is the liquidating trustee, the problem of a trustee selling assets or interests to himself arises. The heirs, on the other hand, may not have the financial wherewithal or technical ability to be partners, even assuming a fair price for the partnership interest can be found.

Transfer By Prior Contract

It has been shown that continuation of the partnership business, in any form, without proper authority is risky for both the surviving partners and the surviving heirs. However, it is possible that the partners may anticipate The eventuality of one of their deaths, and set forth a continuation plan in the partnership agreement itself.

Purchase Offer

If the partnership agreement provides properly for it, The surviving partner or a third party could be offered an option to *purchase the deceased partner's interest*. A problem inherent in this approach is the difficulty of valuing the deceased partner's interest and, typically, the buyer's difficulty of obtaining financing for the purpose. In addition, even if financing can be obtained, going into debt may not be an attractive alternative to the remaining partner.

However, if the partnership agreement provides for such a buyout, the remaining partner may be forced to do so, for his alternative is to allow liquidation of the business.

New Partnership Formation

Often the agreement may call for the surviving partners to form a new partnership This type of arrangement is not uncommon among law firms and accounting firms which do business in the partnership format. The new agreement, as before, may be between the surviving partners and the heirs or surviving family members.

If that is what the partnership agreement provides, the Same problems as outlined above apply, although the New partnership has a measure of authority due to the Provisions of the partnership agreement which implement the continuation plan. However, authority does not guarantee that the new partnership will be successful. As we saw before, the heirs may not have the professional skill to be a productive partnership. However, if the heir is experienced in the partnership business and capable of contributing to its success, the chances of success are increased.

Whether or not any of the requirements for a successful new partnership are present, there is some measure of financial risk for the heirs. As new partners, their assets are available to business creditors of the partnership. It is clear that formation of a new partnership with the heirs is not a perfect alternative.

Role of Last Will and Testament

Purchase Option

Just as a preexisting arrangement set forth in the partnership agreement may Provide for continuation of the partnership business, the deceased partner may set Forth clauses in his will which attempt to implement a continuation plan. However, it is not clear that will clauses provide the same kind of authority. Under law, the surviving partner must become the liquidating trustee. With his will, the deceased partner attempts to providing the surviving partner with the option of continuing the business.

Presumably, the deceased partner intends that by doing so his heirs will benefit from the successful continuation of the business. However, it is not clear that this will occur and, if it does not, the heirs will be subjected to financial risk. If the partnership is a small one, the surviving partner will bear the burden of doing all of the work to continue the business. There is no guarantee of success.

Sale to Existing Partner

If the will provides that the surviving partner may buy the interest of the deceased partner, there may be an authority problem arising, as before, from the problem of the liquidating trustee selling partnership assets or interests to himself. Moreover, in any sale of a partnership interest, there is the problem of valuing the partnership interest, and the difficulty the surviving partner may have in financing such a transaction.

Realistically, the only way to place a value on the partnership interest is for the will clause to specify a price. However, this is rarely satisfactory. Even if the price fairly represented the value of the interest at the time the will was written, that value may have changed in the interim.

However, even if the price is accurate and acceptable, financing the acquisition of the membership remains. We have seen that none of the alternatives are entirely acceptable. Most either subject the heirs or the surviving partners to financial liability or place the heirs in the position of being partners in a business to which they may not be able to

contribute. However, other methods may offer better solutions. See the discussion of buy-sell agreements below.

Death of a Corporate Shareholder

By its very nature, the corporation is perpetual. That is, unless it is terminated deliberately, or as the result of some event or condition (such as insolvency), it continues in existence and operation regardless of the identity of its managers or owners. The death of a shareholder, then, will not normally affect the existence of the corporate entity.

Partnerships, Proprietorships

When either a partner or a sole proprietor dies, the organization dies with him because neither partnerships not proprietorships have an existence which is separate from that of their owners. (See previous discussion). The surviving partner of a partnership, by operation of law, becomes a liquidating trustee charged with the responsibility of wrapping up partnership affairs. Similarly, the administrator of the estate of a sole proprietor may likewise be charged with the same responsibility. Unless very carefully planned, attempts to continue the operation of such entities may result in financial disaster.

Shareholders in corporations, however, merely own portions of the corporation. Death of a shareholder does not necessarily represent a threat to the continuation of the corporation, although it may have consequences depending on whether the shareholder was active in the management of corporate affairs and, if so, the extent of his activity. Typically publicly owned corporations, which may have hundreds, thousands or even millions of shareholders, will be unaffected by the death of a shareholder. Close corporations, on the other hand, may suffer a more profound impact.

Closely Held Corporation

Recall that closely held corporations may merely be partnerships or proprietorships which have adopted a corporate form for one reason or another, but retained the centralization of ownership and management characteristics of their forbear. Often such a business

will function as if it were a partnership or proprietorship instead of with complete corporate formalities. If its operation is similar, so could be the problems faced when one or more of the shareholders dies. If so, the death of a shareholder, if not planned for properly, could create circumstances which would result in the termination of the business.

To a degree, the severity of the problems caused by the death of a shareholder will depend on the proportion of ownership of the deceased shareholder. For obvious reasons, the death of a majority shareholder may have a larger impact than the death of a minority shareholder. However, one important difference remains: the shares owned by the shareholder are personal property, and are treated as such by his administrator.

In the worst possible case, death of the majority shareholder may be analogous to the death of the sole proprietor of a proprietorship.[i] If there is no agreement to the contrary, the administrator may simply be forced to liquidate the assets of the business in order to settle the estate. Otherwise, like a proprietorship, the corporation will simply go out of business because the person principally responsible for whatever degree of success it has enjoyed, is no longer available to operate the business.

However, it is possible for the corporation to continue. Generally, either the remaining shareholders, if any, or new shareholders (possibly) the heirs of the deceased shareholder, will be responsible for the success or failure of such a continuation. If the shareholders have the expertise, time and motivation to operated the company themselves, or to nominate competent management, the effort may succeed. Otherwise, it is likely to fail.

It must be remembered that the shareholder's stock in the corporation was his personal property, and as such is normally distributed to heirs or legatees of the decedent's estate. As seen with the other forms of business operation, the interests of the heirs may be to continue income, or to provide cash infusion to the heirs. Either motivation may clash with the motivation of remaining shareholders who may wish to continue and grow the business. Therefore, many similar problems will be faced by the administrator of the decedent's estate. Proper planning for continuation can assist the administrator in addressing those problems.

Pre-arrangement

If the deceased desired that the business continue after his death, he may have planned for such eventuality by any of several pre-arranged methods.

Buy-Sell

Particularly if there was more than one shareholders, the owners of close corporations may implement a buy-sell plan to address the potential problems raised by the death of one of them. This is a common tactic where the shareholders are working managers of the corporation, as is often the case with close corporations.

The buy-sell agreement anticipates and addresses several common problems, chief among them the problem of valuing the shares of the decedent for purposes of the buyout as well as the authorization and mechanics of continuation. Basically, this type of agreement provides the survivors the opportunity to buy out the decedent's interest according to a *preconceived plan*.

There are several variations of buy-sell agreements, but they all have similar purposes and they all achieve certain goals. These goals include:

. Identifying an acceptable price for the stock

. Setting forth requirements for purchase of the decedent's stock, either by the survivors or by the corporation itself

. Requiring the heirs to sell the decedent's stock at the agreed price.

Overall, the goal of such agreements is to provide the surviving shareholders the right to acquire full control and ownership of the corporation, while assuring that the heirs receive a fair price for the decedent's shares.

The principle danger and the most difficult issue associated with the use of such agreements is the assurance of proper funding to carry out the provisions of the agreement. See the discussion following in chapter.

- **Stock Option Contract**

An alternative pre-arranged scheme that is sometimes used is providing the surviving shareholders with an option to purchase the decedent's shares. The Option, which is basically a *call* option, is set forth in a written *stock option agreement.* A call option allows, but does not require, the holder of the call option to purchase a specific amount of stock at a predetermined price (called the "strike price") within a predetermined time period (referred to as the "maturity").

An option agreement of this type will be successful only in the event that the survivors have access to sufficient capital resources to complete the purchase within the maturity period. If sufficient reserves are not available, the optionholders need not purchase the stock, and may either refuse the option or allow it to expire unexercised. Should such a condition occur, the plans of the decedent (and the shareholders) will not be realized, and the sale will not be completed.

Right of First Refusal

Yet another type of effort to continue the corporation is to offer the surviving shareholders the right of first refusal on the decedent's shares. Often, such a right is set forth either in the By-Laws or in a separate Shareholder's Agreement, which will require that any offer to sell shares in the corporation must be made initially to the shareholders. While such a provision acts to maintain the closed nature of a closed corporation, it may operate to prohibit the heirs from attempting to obtain a fair price for the shares. Another drawback of such an arrangement is that the heirs are not obligated to sell--which may result in the surviving shareholders being faced with interference in the management of the business from the heirs. This is analogous to some problems which may arise when attempts are made to continue the operation of partnerships.

Other Options

Liquidation

Strictly speaking, it is not necessary to transfer ownership of the decedent's shares to the surviving shareholders, even though it is often desirable to do so. Sometimes it is not even desirable. For example, if the decedent operated the corporation and the surviving

shareholders took no part in its operation, the surviving shareholders possess no special expertise or ability to contribute to or continue its operation, and no provision has been made for competent management to continue operation, liquidation may be the best option. This is particularly true if the corporation has substantial assets which may be easily liquidated at fair market value. Liquidation of assets can then be followed by dissolution of the corporation, with the value of the decedent's ownership share being distributed to the decedent's heirs.

Realistically, liquidation and termination is probably the least desirable alternative. If assets are liquidated in a forced sale, it is unlikely that the goodwill of the corporation will be valued fairly, unless it is embodied in intellectual property such as trademarks which can be licensed out for royalties. Although liquidation results in distribution to the heirs of the decedent, it terminates a source of income for both the heirs and the surviving shareholders, and results in the loss of jobs and commerce to the community.

Continuance by Reorganization

Reorganization and continued operation may not be a satisfactory alternative, either. If the heirs merely hold the shares, their goal will be to maintain the business as a source of income, while the surviving shareholders ultimately end up working for the benefit of the decedent's heirs. Not uncommonly, surviving shareholders are displeased by such a turn of events. Friction sufficient to destroy what is left of the corporation's ability to operate is a likely result. It is preferable to allow the surviving shareholders the opportunity to own and build the business.

Sale to New Shareholder

Sale of the decedent' interest to a third party is normally an extremely unsatisfactory alternative. The new shareholder will either be *inactive* in management, in which case he will view his shares an income-providing investment similar to the decedent's heirs in the preceding paragraph. The result is inevitably similar--the surviving working shareholders become dissatisfied. The other possibility is that the

new investor will be an *active* participant in management. Although there is a chance for success depending on the expertise of the investor, the barriers to success are high. They include the difficulty of successfully integrating the work and management style and personality of the new investor with the surviving shareholders. Moreover, the heirs may not be satisfied with the price they received for the decedent's shares.

Section II Summary

Overall, the death of the principal operator of a small business can create several problems for the survivors. Heirs may wish to continue a source of income. Surviving co-owners or operators of the business may wish to succeed to ownership or control. The interests of heirs and co-owners may be in opposition to each other.

The death of a proprietor, for all intents and purposes, means the end of the business. Operation by heirs is usually impractical. Sufficient authority for continuation rarely exists in the estate plan of the owner, nor does the required expertise. Obtaining a fair price is generally a problem. The most practical path is normally to liquidate and terminate the business.

Similarly, partnerships terminate by law upon the death of a partner unless the partnership agreement provides for continuation. Unless the partnership is highly formalized, continuation is usually impractical for the surviving partners to either form a new partnership which includes the heirs of the deceased partner, or to continue to operate the partnership for the benefit of the decedent's heirs.

Similar problems arise in closely held corporations when the deceased was a majority shareholder. The administrator of the decedent's estate has a fiduciary duty to the heirs of the estate, and will look to maximize the value of the decedent's stock for either income or sale purposes. Normally, in a small business, attempts to provide for management participation by the heirs are as likely to fail as they are in the partnership context. Likewise, as in the cases of both partnerships and proprietorships, forced liquidations rarely fair value for the decedent's shares. Corporations, however, are perpetual by their nature.

Often, the owners can provide for their continued operation by mean of buy-sell, or similar, agreements between the shareholders. Buy-sell agreements have the advantages of providing a fair value for the decedent's stock and for providing the surviving shareholders with the opportunity to purchase the entire business. A primary weakness of buy-sell arrangements is the provision of adequate *funding* to implement the arrangement.

Section III

Buy-Sell Agreements

Regardless of the form of business entity, we have seen that survival and continuation can only be achieved by careful planning. If survival is desired, the primary planning tool is the buy-sell agreement. This is true for proprietorships and partnerships as well as for closely held corporations, although it is most commonly used in connection with corporations.

In all buy-sell agreements, regardless of the form of the business entity, successful implementation of the arrangement depends on the availability of financing sufficient to implement the terms of the buy-sell. In most cases, the use of life insurance can provide the funding vehicle on which that success depends.

Elements of the Buy-Sell Agreement

A buy-sell agreement provides sufficient authority to continue the business in all cases following the death of the owner, whether the owner is a sole proprietor, a partner or the shareholder of a corporation (particularly a closely held corporation). It is the most common, and usually the most efficient method of providing for the orderly continuation of operation and transfer of ownership of the business entity. Use of such an agreement minimizes the risks inherent for survivors, heirs and estate administrators, and is preferable for creditors, as well.

General Nature of Buy-Sell Agreements

The buy-sell agreement is a contract which provides that one party will buy, and another party will sell, the outstanding ownership interest of another upon the death (or other triggering event) of the owner.

At the outset, the desire must be present for the business to continue. Assuming that such a desire exists, a preliminary step to creating a buy-sell arrangement, the proper party to continue the business must be identified. If the business is a proprietorship, the proper party may be another individual who will act as successor to the owner. If the proprietorship is operated and owned primarily by a single owner, identification of such a party may be difficult. If the business a partnership, identification of the proper party may be somewhat simpler, because the successor party will usually be the remaining partners. If the business is a closed corporation, the successor may be one or more of the remaining shareholders. In any case, *identification of the proper successor is key to the success* of the buy-sell. If the successor cannot be identified, there is no reason to attempt to implement the agreement.

Most often, the prospective buyer will be employed at the firm or will already be a copartner or shareholder.

Assuming that the desire for continuation exists, and that the successor is identified, a buy-sell agreement is crafted. The terms of such an agreement may vary, but generally will provide that the successor will purchase the interest of the owner upon the

owner's death, retirement or other triggering event (such as disability). The purchase price and terms will be clearly set forth, as well as the time frame in which the purchase is to take place.

Just as the buy-sell agreement is the preferred method of transferring control of a proprietorship to a chosen successor, the *partnership buy-sell agreement* is the best way to continue a partnership. The buy-sell has the advantage of being Pre-arranged and, unlike some other attempts to continue a partnership, legally enforceable. It also removes the possibility of conflicts of interest on the part of the administrator of the decedent's estate.

Like proprietorship buy-sell agreements, partnership buy-sell agreements are in the form of written contracts between partners under which the surviving partners agree to purchase the business interest of the deceased partner at a price set forth in the agreement. Alternatively, the business can be valued at the time of the triggering event according to a calculation set forth in the agreement. As is the case with proprietorships, it is critical that the successor partner be identified and be capable of, and motivated to, continue the business of the partnership.

As with proprietorships and partnerships, the preferred method for transferring control of a corporation is a buy-sell agreement. Normally, such agreements are for the purpose of transferring the stock of a deceased or retiring shareholder. However, similar agreements can be used to transfer title to assets.

In most respects buy-sell arrangements for corporations are similar to those for other types of business organizations. However, the great flexibility of ownership structure provided by the corporate form allows similarly increased flexibility in formation of the agreement.

As mentioned above, corporate buy-sell agreements can be any of several types. These include arrangements under which:

. The corporation (or, if impossible, the surviving shareholders) must buy and the estate of the surviving shareholder must sell.

. The corporation, or the surviving shareholders, have an option to purchase the stock of the deceased shareholder.

. The estate has the right, but not the obligation, to offer the stock to the survivors or to the corporation. Normally, if the stock is offered, the offeree is obligated to purchase.

. There is no obligation to buy or sell, but if a shareholder or his estate wants to sell, the shares must first be offered to the corporation or to the surviving shareholders before it can be offered to third parties.

The possible combinations are nearly without limit. However, as in other buy-sell arrangements, the success of the arrangement may hinge on identification of the successors, their motivation to continue the business, and their financial ability to purchase the stock.

The agreement itself can provide for the necessary funding by specifying the use of life insurance. Use of insurance to fund buy-sell arrangements is generally the most predictable and efficient way to guarantee the availability of funds.

Funded and Non-Funded Approaches

Another requirement for the success of a buy-sell arrangement is provision for funding the agreement. Such provisions are commonly included in the written buy-sell contract. The reason that funding must be provided for is obvious--it would do no good to require the purchase and sale of an ownership interest if, when the time for performance came, the buying party could not perform due to lack of funds. Thus, the contract may attempt to provide funding in advance. Normally, *life insurance* is the vehicle which is used to provide the required funding.

Funding with life insurance is more valuable than unfunded arrangements which may come immediately to mind because it provides the buyer with greater flexibility, and with the assurance of availability of capital. For example, if the buy-sell terms provided that the buyer pay for the seller's interest out of the proceeds generated by the operation of the business, the buyer will be deprived of income during the repayment period. Similarly, payment of loan balances and interest to a bank would impact the employee's income, even assuming he could qualify

(or prequalify) for such a loan. Payment of the price to the owner or his heirs in installments would be unsatisfactory because during the installment period the owner would be deprived not only of ownership, but also of the value of the ownership interest being sold.

Life insurance, if used properly, can provide funding sufficient to meet the purchase price requirements. It will guarantee the delivery of the proper quantity of money at the time it will be required. When used in this way, the buy-sell agreement is said to be funded.

The funded buy-sell agreement between the sole proprietor and one or more of the key employees of the business, benefits all concerned: the employees, since they will succeed to ownership of the business; the family of the deceased sole proprietor, since they will receive a fair price for the business; and the proprietor himself since his creditors of the business and the employees know that there is an orderly plan for continuation of the business.

Typical Provisions

The terms of buy-sell agreements vary depending on the type of business entity, the parties, the price, the timing and the funding and payoff terms. However, certain provisions are typically included in nearly all buy-sell agreements. These terms include identification of the parties, a statement identifying the business by name and location, and the agreement of the parties to purchase and sell the business upon the death of the owner, identification of the assets and liabilities of the business, and the price of the transaction. Not uncommonly, provisions for funding the transaction through the use of life insurance contracts are also included. Such a form is capable of adaptation for use in the case of proprietorships, partnerships or corporations, as well.

Entity Valuation

There are several methods of valuing ownership interests.

The purchase price is usually based on the value of the *assets and the goodwill* less the *liabilities* of the business. Assets are real and personal property, and financial assets such as receivables and cash on hand. Goodwill is the good name and reputation of the business entity. Goodwill is often quite important to the valuation calculation. It is sometimes embodied in intellectual property, such as trademarks, trade names, and trade secrets. Just as often, however, it is the good reputation which the business has earned over time. Liabilities are accounts payable and recurrent expenses.

Typically, in a buy-sell agreement the price of the purchase is clearly stated in the agreement. Because the value could change over time, the agreement normally provides that revisions in the price can be made from time to time. Obviously, for such a revision to become enforceable, it must be documented in a written amendment to the contract document and agreed to by both parties. The price can be arrived at by any of several methods. Most of these employ a *valuation formula*.

One method is simply to state a fixed price per share for the decedent's stock, agreed to by both sides. This is the most common method.

Considerably less security is provided if the valuation formula depends on an appraisal at the time of the death or triggering event.

A more sophisticated valuation formula includes calculation at the time of death of *adjusted book value* of the business. Book value is normally assets less liabilities. However, book value enhances the calculation by taking into account adjustments for asset depreciation and current market values of assets which might otherwise be carried at unrealistically low values.

Another formula is based on *capitalized earnings* of the business. This method is less direct. It involves calculating the earning ability of the business. This is shown by the profit and loss statement, and comparison of the business' earnings to similar businesses. From this comparison, average earnings are calculated. This average earning is then multiplied by a capitalization factor. The capitalization factor

often is a multiplier of between 5 and 15. This calculation requires considerable sophistication in valuation theory and technology, along with knowledge of the industry.

Many other methods of calculating the value of the business can be used. These include calculation of a price based on the straight capitalization method, in which the corporation's average net profits are capitalized at a specific rate, and the result represents the total value of the business including the goodwill. A typical capitalization rate is 10-15%. Combinations of several methods may also be used.

Obviously, any calculation formula may be dynamic over time. Thus, if funding is to be provided with life insurance care must be taken to see that the policy values track the calculated value.

Application of Life Insurance

Using life insurance to fund the buy-sell arrangement is the most efficient and convenient method of assuring funding for the transaction will be available when it is needed. If insurance is used, provisions in the agreement spelling out the plan in detail are critical to its ultimate success. These include:

- Provisions identifying the policies used. Policies must be identified by issuer, policy number, the name of the insured, the face amount of the coverage, and a statement that the proceeds are to be used to purchase the ownership interest.

- Provisions for adding and changing policies. Arrangements to add policies or coverage amounts are necessary. This reflects the dynamic nature of the valuation, as discussed above.

- Provisions covering differences between the amount of insurance and purchase price. If the value of the business changes faster than the coverage can be adapted, there may be a difference between the price and the proceeds available. For example, if the amount of coverage is not equal to the price, the buyer could be required to pay the difference in installments over a time period. Such a schedule should be spelled out.

- Ownership and premium responsibilities. Normally, the prospective buyer will own the policy. The policy will cover the life of the owner, partner or principal shareholder.
- Beneficiary arrangements. The prospective buyer is typically the beneficiary of the policy.
- Disposition of the policies upon termination of the agreement[ii]

Generally term insurance rather than cash value life insurance is used to fund buy-sell agreements. At some point, due to the constantly increasing cost of term life insurance over time, conversion to a level premium policy may be a consideration.

Sole Proprietor Tax Considerations

In the case of a sole proprietorship or partnership, the business entity has no legal existence apart from the owner. Therefore, the value arrived at for purposes of the buy-sell arrangement will be included in the value of the owner's estate after his death. Assuming that the calculation can be supported by reasonable assumptions and methods, the Internal Revenue Service will usually accept it as valid.

Funded Buy-Sell Agreements (Partnerships)

Nearly all of the factors discussed in the preceding section apply to buy-sell agreements for all types of business organizations including partnerships. However, partnership buy-sells may present additional considerations.

There are two types of partnership buy-sell agreements. *Entity purchase* agreements provide for the partnership itself to purchase the interest of the deceased partner. In the case of entity purchase arrangements, the partnership itself owns life insurance contracts on the life of each partner. The partnership,

likewise, would be the beneficiary of the insurance contracts in the event of any partner's death. The funds from the life insurance indemnity are then used to purchase the partner's interest at a price, which is either predetermined or calculated, as set forth above.

Cross-purchase agreements, on the other hand, are more commonly used where there are a only a few partners. The partners arrange to buy each others' interests. The partnership itself is not a participant in this arrangement. Each partner owns and is the beneficiary of life insurance on the other partners. Rather, each partner purchases life insurance on the other partners, pays the premiums and is the beneficiary. The funds are used to fund the purchase of the deceased partner.

To the extent that either arrangement is used and properly funded, the heirs of the deceased partner, the remaining partners, and the creditors and customers of the business are all benefitted by such an arrangement. The heirs are advantaged because they know with surety that they will receive a fair price for the partnership share. The creditors and customers are advantaged by knowing that there is an orderly plan for the continuation of the partnership's business. The remaining partners benefit by the knowledge that their source of income will continue, and by their opportunity to increase their stake in the business. Also, they are not subject to the possibility that they will be forced to take on a family member as a partner, or that any other unusual conditions may ensue from the death of the partner.

Entity Purchase Agreements (Liquidation Plans)

If the entity purchase arrangement is used, the partnership itself will purchase the share of the deceased or retiring partner. In some ways, the entity purchase arrangement is similar to a corporate stock repurchase plan. However, partnership plans present different problems.

Elements of Decision

Assuming that the agreement is funded by life insurance, the partnership itself will own the policies, pay the premiums and be the beneficiary. Obviously, for planning to be complete, there must be life insurance policies on each partner. Therefore, the

number of partners is one of the elements in the decision of what type of arrangement to use. As the number of partners increases, entity purchase arrangements become more attractive due to the cost savings resulting from the smaller number of policies required. (See succeeding discussion on cross purchase agreements).

Similarly, the *age* of the partners is an element in the decision as to which type of arrangement to use. At the early stages of a partnership's existence, when there may be only a few partners and they are likely to be close in age, this may not be an issue. However, if the partners are not close in age, it can become one, even if the entity form of agreement is used. This is because life insurance on older employees has considerably higher premium costs that on employees who are relatively younger. If the individual partners owned and paid the premiums on life insurance covering their co-partners, the younger partners would therefore incur greater premium expense. This would be an argument for use of the cross-purchase style of arrangement.

The *interests of the different partners* are also weighed in making the decision. This analysis is similar to that regarding the age of the partners. If the partners own similar shares of the business, it is not an important element. However, if the partners own disparate percentages of the business, this could become material. The partner who owns the larger percentage would be more expensive to buy out, necessitating more life insurance to be carried on him by his junior copartner. The junior partner then incurs the greater expense. This result may lead the partners to consider the entity purchase type of plan, in which the business itself owns the life insurance.

A consideration in entity arrangements is that when the partnership owns the policies the value of those policies, including any cash value which may accrue (which is unlikely, since most of these agreements are funded with term insurance), is an asset of the business. Although all assets of the business contribute to the value of the business, they are also available to creditors. Avoidance of this situation would be an argument for adoption of a cross-purchase arrangement.

Under the entity arrangement, the business uses the proceeds of life insurance policies on the deceased partner to purchase the deceased partner's interest. The share of the deceased partner is retired into the business. Since the business itself is the buyer, the result is that, somewhat ironically, the sum of the surviving partner's shares following the entity purchase may not equal 100%. For example, if a partnership of three equal partners (each with a 1/3 interest) purchases the share of one of them, the remaining two partners are still left with two equal shares of 1/3 each. Normally, the surviving partners will reorganize the partnership following the buyout.

Tax Considerations

There may also be tax considerations which play a part in the decision of which type of arrangement the partners should use. For example, under Section 708 of the Internal Revenue Code, if more than 50% of the partnership capital and profits are sold within a 12 month period, the partnership must be dissolved. However, if the interest of the partner is liquidated, there is no dissolution even if that interest exceeds 50%. Part of the liquidation payments can be made tax deductible to the remaining partners and payments for goodwill can specifically be made tax deductible to them.

Payments made in liquidation of the decedent's partnership interest are considered distributions by the partnership to the extent that the payments are in exchange for the partner's interest in partnership property. These provisions do not apply if the transaction is between the parties. For this reason, tax considerations may be an element in deciding which form of transaction to use. However, even though the IRS could argue that each partner has incidents of ownership in the insurance used to fund such a transaction because of his management rights as a partner, the Service has never taken this position, and the risk that it will do so is regarded as slight.

Cross Purchase

A cross purchase agreement is used in situations where there are just a few partners. One reason is that such a plan is more expensive to implement because of the number of insurance policies which must be purchased. In essence, each partner insures the life of

all the other partners, with himself as beneficiary. The partnership does not participate in the transaction directly.

Due to the expense, the cross purchase arrangement is usually not workable if there are more than three or four partners. For example, if there are two partners, A owns insurance on B, and B owns insurance on A, so a total of two policies is required. Where there are three partners, A owns policies on B and C, B owns policies on A and C, and C owns policies on A and B. Thus, six policies are required. Generally, the number of policies required is

$$P * (P-1),$$

where P is the number of partners. Thus, in a 4 man partnership, twelve policies would be required, while if there are five partners twenty policies would be used. It is easy to imagine that the cost quickly becomes prohibitive as the number of partners increases. For that reason, the cross purchase arrangement is seldom used for larger partnerships.

Components of the Funded Buy-Sell

The components of the funded buy-sell agreement for partnerships are similar to the components of similar agreements for sole proprietorships and, to a certain extent, for corporate forms. An outline of typical terms follows below.

The agreement binds the partners and the heirs to the purpose of effecting the buy-sell. In addition, it normally binds the partners to a refusal option in the event that a partner decides to leave the partnership during their lifetimes. The purchase price will be set, the use of life insurance to fund the purchase will be provided for, and the disposition of the decedent's interest in the partnership is also set forth in the agreement.

The following is an outline of the principal terms, although the agreement can set forth more, or fewer.

Parties

All of the partners are parties to a cross purchase arrangement, since each partner will end up owning insurance on the life of all the other partners. If the entity purchase arrangement is used, the partnership itself along with the partners, will be an additional party. Generally, each partner is identified by his full name and residence address at the time of the agreement, and the partnership by its formal number, office address and tax identification number. These identifications are normally set forth either in the preamble to the agreement or in a special definitions section.

Identifying the Purpose

The primary purpose of the agreement is to provide for the orderly transfer of the decedent's interest in the partnership, either to the partnership as a redemption, or to the surviving partners. If a redemption-type of transaction is planned, the entity-purchase arrangement is used. Purchase of the decedent's interest by the remaining partner or partners requires use of the cross-purchase style of transaction.

Options at Retirement or Resignation

Just as the partners wish to plan for continuation of their business upon the death of any partner, they also wish to plan for the eventuality that a partner may retire or resign from the partnership. Normally, the partners desire that, in such an event the retiring or resigning partner offer his interest first to the remaining partner. The buy-sell agreement normally contains provisions to this effect. Not uncommonly, this option provides either the remaining partners, or the partnership itself, with a right of first refusal to purchase or redeem the interest of the retiring or resigning partner.

Determining Price and Funding

Price

As in the case of sole proprietorships, and as discussed above, the price of the transaction must be set clearly forth in the agreement. If it is not, the lack of clarity is likely to ultimately defeat the purpose of the transaction. Setting a specific price provides clarity, and all parties to the agreement have the

benefit of that for planning purposes. However, use of a stated price has several disadvantages. Primary among them is that even if the agreement provides for it, the business may not review and update the price with adequate frequency to assure that the price reflects the value of the business at a given point in time.

Likewise, the price must be a fair one, or the heirs of the decedent will be disadvantaged and may be motivated to challenge the legality of the proposed transaction. As set forth above, there are numerous methods of valuation which can be employed to arrive at a price which is perceived as fair. Such concerns may dictate the use of a valuation formula, as discussed above. The formula could provide a value calculation based on appraisal, adjusted book value, capitalization of earnings, or any of the other techniques discussed previously, or a combination of them. If a valuation formula is used to set the price, the agreement should also specify who shall perform the calculation, the method of calculation, and the times at which the calculation will be performed.

An obvious disadvantage of valuation formulas is that, since the value of the business will be established at the time of death, it is not possible to predict with absolute certainty the amount of life insurance which will be necessary to fund the transaction.

Assuming that the transaction will be funded with life insurance contracts (regardless of whether the entity purchase or cross-purchase plan is used), the provisions for obtaining, owning, paying the premiums and designation of beneficiaries should be clearly set forth in the agreement. All insurance policies should be identified by number, owner, amount, date and beneficiary. This is usually done on a schedule attached to the agreement itself, since the schedule is simpler to keep up to date. The insurance provisions of the contract should also lay out plans for the acquisition of additional insurance, substitutions of owners or beneficiaries, and making other changes regarding the insurance contracts.

Professional Services Partnerships

If the partnership is in the business of delivering professional services, such as a law firm or a medical practice partnership, valuation of the business is more difficult, because there are few hard assets upon which the valuation can be based. Thus, valuation formulas based on an assets + goodwill calculation are difficult or impossible to perform. Assets of professional practices largely consist of intellectual property and goodwill.

Here the need for a funded buy-sell agreement may be even more evident than for a normal partnership. The professional partnership will require capital in order to service the client load of the decedent, and the decedent's family will have a requirement for substantial funds to replace the income which would have presumably been earned by the decedent.

The usual solution for a professional partnership is to employ an entity purchase form of arrangement. This is especially so for professional partnerships which have a multiplicity of partners. Some law firms, for instance, have over 500 partners. Use of cross-purchase arrangements would be practically impossible for such a partnership. One provision often employed by professional partnerships in their buy-sell agreements provides continuing income to the family of the deceased partner rather than a lump-sum.

Beneficiaries

As noted above, the beneficiary arrangements must be set forth in the agreement. Typically, in a cross-purchase arrangement, the individual partners are the beneficiaries. In an entity plan, the partnership itself is the beneficiary. (Note that for tax purposes, payments received from insurance policies by the partnership will increase the value of the partners' percentage interests).[iii] If necessary, the beneficiaries of all policies could be a trustee. However, use of a trustee will increase the complexity of administration.

Use of Insurance

Premium Selection and Payment

It was noted above that premiums on life insurance contracts are normally paid (and the policies owned) by the partners, if the contemplated transaction is of the entity purchase type, and by the partnership itself if the cross-purchase arrangement is used. However, other arrangements may be made. How the premium payments are allocated should be spelled out in the agreement, since calculation of the allocation can be somewhat complex.

This is because many of the same factors discussed above may apply. The partners may all have equal interests, or they may not. There may, or may not be great disparity in age. As set forth above, inequities may result if all eventualities are not planned for from the outset.

Consider a three man partnership with a cross purchase arrangement and equal partnership interests where the partners are all equal in age. Each partner owns policies on the other two partners. Each is responsible for two premiums, since he does not pay for the insurance on himself. In such a case, the premium costs would be effectively equal, and the relative burdens would also be equal. However, if one partner is substantially older, the premium cost for policies on him will be proportionally greater. Similarly, if one partner has a proportionally larger share, the insurance required to provide the necessary funding for his share will be proportionally larger, resulting in higher premium costs. The higher costs borne by the other partners result in an imbalance. The best way to deal with such an imbalance is to address it in the buy-sell agreement.

The premiums could be pooled, and then paid in equal shares by the partners. A disadvantage of this approach is that the pooling will cause the more junior partners to pay a disproportionate share of the total premium. For this reason, pooling of premiums, is not normally used where ages or partnership interest shares vary.

Alternatively, the insured partner could pay the premium on the policy covering his own life. This arrangement typically is found only in cross purchase agreements involving only one or two partners.

When the partnership pays the premium, as it would under an entity purchase arrangement, any cash values which accumulate under the policy become assets of the partnership, and therefore or the partners. As such, the cash values are potentially subject to the claims of creditors. This is often reason enough to utilize term insurance for purposes of funding these agreements. Cash value insurance, however, has several uses and can be valuable to a business in any of several applications.

Application to the Partnership

An additional clause relating to insurance may specify what becomes of policies on the lives of the surviving partners if there has been a transaction under the buy-sell agreement caused by the death of one of them. Normally, this occurs only in the context of cross purchase arrangements. For example, suppose in a three person partnership each partner owns and is the beneficiary of insurance contracts on the life of the other two partners. If partner A dies, partners B and C receive benefits which are used to purchase A's interest from the heirs. Thus the heirs are paid the stated price for their forbear's interest, and B and C remain as partners. Each still owns insurance on the life of the other, and *the estate owns policies on each of them*. The agreement may wish to provide that those policies terminate, with the cash values paid to the estate. If the partnership continues in operation, there need be no change in the partner's policies, except that the amounts of insurance may need to be increased. However, if the partnership terminates, the insurance contracts will likely terminate. If this is the case, accumulated cash values on them should be paid to the owners.

Adjustments to the Plan

As mentioned previously, the agreement can, and should provide for amendments and changes as they become necessary, particularly to the value of the business as reflected in the price. The value of the business, and therefore the price, will change over time regardless of the valuation formula used, as will the value of a proprietorship or a corporation. The agreement must be capable of amendment to reflect such changes, including changing the amount and type of insurance policies used, if necessary.

In addition, the agreement should state the procedure to be used for payment of the price if the value exceeds the amount of insurance available at the time of the death of the partner. Normally, the agreement will provide that any unpaid balance will be paid in installments, with reasonable interest, by the surviving partners. Usually the time frame for completion of the payment is relatively short.

Tax Considerations

As noted above, the partnership is not a separate taxpaying entity, although it does file an annual return. Rather, partnership profits are passed directly through to the partners in the proportions of their partnership interests. The partners are taxed on their respective shares of the profits.

The premiums on life insurance to fund buy-sell agreements are not deductible. This is the case whether paid directly by the individual partners pursuant to a cross-purchase agreement, or by the partnership itself to fund an entity purchase. However, the value of the partnership interest of the deceased partner is included in his estate for federal estate tax purposes. As with any business interest, the Internal

Revenue Service usually will accept the valuation set forth in the buy-sell agreement if the assumptions used in the process of valuing the business are reasonable.

Funded Buy-Sell Agreements for Close Corporations

Participants in a new corporate venture should employ a buy-sell agreement to provide for continuation of the business upon the death of one of the participants, and to provide the surviving participants with the opportunity to buy the interest of the decedent. In a corporation, that interest is reflected in the proportion of shares owned by the decedent. Employment of such an agreement benefits the surviving shareholders, whose investment in the business is protected to the extent that the business' opportunity to continue is enhanced. The family of the deceased shareholders is also benefitted by virtue of the fact that they receive a fair price for the value of the investment.

Virtually all of the concerns discussed above with regard to partnerships also apply to buy-sell agreements in the context of closed corporations,

including the form of the transaction, valuation and pricing, funding (usually through the use of insurance contracts), funded/unfunded approaches, tax considerations, and typical provisions. This section investigates those considerations.

Types of Agreements

Typically, corporations will utilize buy-sell agreements structured to:

. Require the corporation to buy, and the estate of the deceased shareholder to sell;

. To provide the corporation or the surviving shareholders with the right, but not the duty, to purchase the shares of the deceased shareholder;

. Provide the estate with the right to sell the stock to the surviving shareholders; or

. Require the estate to offer the shares first to the surviving shareholders.[iv]

In structuring the agreement, a number of forms can be used. Many are similar in nature to the entity purchase or cross-purchase arrangements commonly utilized by partnerships in their business continuation plans. Examples include:

. Agreements between the business itself and the individual owners (similar to a partnership entity plan);

. Agreements between the individual owners (similar to partnership cross-purchases);

. Agreements between individual owners and key persons, such as family members or third persons; or

. **Combinations of the above.**

The determination of which form of plan to use is driven by several factors These include: the number of shareholders; the desire to shelter accumulated cash values from creditors of the corporation; the ages and relative interests of the shareholders; and tax considerations. In the case of closed corporations, the

most commonly used plans are stock redemption plans which act to reduce the number of shares which are issued (although the number approved remains unchanged).

Stock Redemption (Entity Purchase) Agreements

At the death of a shareholder, his stock passes to his estate. Life insurance proceeds from policies on his life are paid to the business. The business pays the cash proceeds to the estate according to the agreement. In response, the executor of the shareholder's estate transfers the stock to the corporation. This form of agreement is similar in nature to the entity purchase agreement commonly used by partnerships and is known as a stock redemption agreement. The number of shares of authorized stock remains unchanged, but the number of shares issued has been reduced. Consequently, the remaining shareholders have an increased percentage of the issued voting stock.

In order for the plan set forth in the agreement to be successful, a definite price for the stock must be arrived at and the transaction must take place at the established price. The price is normally arrived at by any of the established valuation methods discussed previously. The transaction is enabled by the funds provided by the life insurance policies used to fund the transactions. As with partnership arrangements, plans that fit these parameters are known as funded buy-sell agreements.

If the corporation was both the owner and the beneficiary of the policies used to fund the agreement, the value of the insurance on the decedent's life will not be includible as insurance proceeds *per se* in the decedent's gross estate for estate tax purposes. Similarly, premium costs paid by the corporation on insurance used to fund the agreement are not tax deductible to the corporation. Similarly, the proceeds are received by the corporation tax-free. Assuming that all of the shareholder's stock is terminated, the transaction will not be treated by the IRS as a dividend distribution. See the discussion on taxation issues below.

Cross Purchase Agreements

The cross purchase arrangement for closed corporations is similar in nature to that for partnerships. It is used in similar circumstances--that is, where there are few shareholders who are also active in the management of the corporation. In the cross purchase form, each shareholder is insured for the value of his share. The policies are owned and premiums are paid for by the other shareholders. The owners are the beneficiaries of the policies. Upon the death of a shareholder, the proceeds of the life insurance on his life are paid to the shareholder-policyholder-beneficiaries. The money is then used to purchase the interest of the decedent.

As in the case of partnerships, if there are more than very few shareholders, usually two or three, use of this form of agreement becomes expensive and awkward due to the number of insurance policies which must be maintained. Thus, if there are more than just a few shareholders, the entity purchase agreement is normally used.

However, many other elements play a part in the decision of which form to use. Among these are the relative ages and membership interests of the shareholders. Disparity in either would result in inequality of premium payments. If the premiums were being paid by individuals under a cross purchase plan, these inequalities could be a cause of dissatisfaction with the agreement. Therefore, if the shareholders are greatly different in either age or relative ownership, the entity purchase form would be preferable if equalization of premium payment is a concern.

Tax considerations are also present. As with the entity purchase form, life insurance premium payments on policies used to fund the agreement are not deductible by the stockholders. The fact that the stockholders are responsible for the premium payments is, in fact, one of the major drawbacks of this type of agreement. By using *split-dollar insurance*, the corporation can help finance the buy-sell plan.

A final consideration in deciding what type of agreement to use is enforceability of the agreement. Cross purchase agreements are clearly enforceable, while entity purchase plans may not be enforceable if the corporation has insufficient surplus to make the purchase (something that is unlikely to occur if the transaction has been funded with life insurance). Funded agreements are normally enforceable.

Optional Buy-Sell Agreements

Within the past decade, the *optional buy-sell* form has evolved. Under such an arrangement the shareholders elect either the cross purchase (stock purchase) or entity purchase (stock redemption) process at the time of the triggering event. In addition, the plan includes any or all of the following options:

- Corporation's option to purchase part or all of the decedent's shares
- Shareholder's option to cross purchase the decedent's shares
- Corporation's option to purchase any shares not redeemed or cross-purchased.

Flexibility results from the exercise of any of the additional options.

Agreement Analysis

Every agreement is unique in some of its aspects. Nevertheless, there are many elements that are common to most corporation buy-sell agreements, and many of the most common have counterparts in partnership and proprietorship agreements.

Parties to the Agreement

As do agreements respecting partnerships or proprietorships, the buy-sell agreement will always have a clause clearly setting forth and *identifying the parties* to the transaction. Normally, the agreement will be between all of the shareholders. The corporation itself may be a party, particularly if the entity purchase format is used. In addition, a trustee can be designated. Where a trustee is used, his duties normally include holding the insurance policies and stock.

As in all agreements, the parties are identified with particularity, which normally means the names and addresses of individuals (possibly along with their Social Security numbers), and the name and an office address of the corporation.

Purpose of the Agreement

The purpose to the agreement normally is set forth in the preamble. This will be a short, clear statement of what the parties desire to accomplish by entering the agreement, and a statement that they have entered the agreement in order to effect the stated purpose.

Options and Refusal Rights

First refusal rights occur in agreements where distribution of the stock of the decedent is desired to be restricted in such a way that the corporation will remain closed. This would normally mean that, if any shareholder or shareholder's estate, wishes to offer its shares for sale, they must be offered either to the corporation itself or to the remaining shareholders before offering them to any third party. Not uncommonly, the price at which the offer must be made is also stated in such a clause. The operation of this clause offers the shareholders the opportunity to restrict the ownership of the corporation to the universe of shareholders in existence at the time the agreement was written.

The Buy-Sell Commitment

Each party to the agreement, including the individual shareholders, the heirs of the shareholders and the corporation itself, should commit to the purpose of the agreement. In other words, the shareholders (in the event of a cross purchase agreement) or the corporation (in the event of an entity purchase agreement), must commit to purchase the shares of the deceased (or retired) partner. In addition, each shareholder and his heirs must agree to offer the shares for sale in accordance with the purpose of the plan.

Price of the Transaction

As in both partnership and proprietorship agreements, the price of the transaction, or at least the formula for determining it, must be set forth explicitly. Price of the shares can be determined by any of several methods, most of which are available to similar agreements respecting other business forms. Common methods include:

. Stating a fixed price in the agreement and not deviating from it;

. Providing that the price be set by an appraisal to be performed at the time of the triggering event;

. Utilizing a formula valuation such as adjusted book value, straight capitalization or year's purchase method; or

. Any combination of methods.

Each type of provision has advantages and disadvantages. For example, the fixed price method provides a basis for precise planning and funding. However, it may result in an inadequate price being paid for the decedent's stock. Similarly, leaving the price to be set by an appraisal following the triggering event provides a less secure basis for planning. The result of such a clause is that the designated buyer may not have sufficient insurance in place to fund the transaction at the appraised value, resulting in a shortfall which may have to be addressed by installment payments. Similar arguments could be made with regard to every funding method.

Insurance Use Provisions

Where insurance policies are used to provide the funding for the transactions, they are identified (usually on a schedule) by name, carrier, policy number, face amount, insured, owner and beneficiary. Usually, the buy-sell contract provides that the insurance contracts can be changed, added to, canceled, substituted for or otherwise dealt with as required by the buy-sell plan.

Adjustment Provisions

If periodic valuation methods are used, or if the price is based on some valuation to be performed at the time of the triggering event (the death, disability or retirement) of the shareholder, there is a possibility that the funds provided by insurance will not be adequate to fund the entire purchase. The adjustment clause spells out what happens in such a case. Normally, the balance will be paid by the buyer in installments over a fixed period. Normally, the repayment period is quite short.

Other Terms

The parties can include any clauses they wish in their agreement. Not uncommonly, buy-sell agreements include clauses which allow termination or amendment of the agreement under certain conditions (usually, that all parties agree in writing to any such change or amendment). Additionally, the contract may spell out the disposition of the survivors' insurance policies, the requirements for notices sent to the parties, arbitration provisions, and other clauses.

Stock Valuation

Further to the preceding discussion on valuation of stock, it should be noted that valuation of the stock of public companies usually is a simple matter. The stock of public companies is listed for trading on exchanges. The specialist members of the exchanges maintain an orderly market for the stock by making public bids and offers. The bid and offer prices are reported worldwide in real time. The value of a share, therefore, is always known, or easy to discover.

Assessing the value of the stock of closely held corporations presents more problems. This is because, for close corporations, it is unlikely that a liquid market exists. Therefore, the prices are not immediately available.

The market mechanism does not work for closely held corporations partly because the marketplace does not have access to information about them. Therefore, specialists would have nothing on which to base their bids and offers. Moreover, the stock is not listed for trading on an exchange. Therefore, there is no consistently maintained market, and no market makers to maintain it.

It is critically important to the family of the deceased that they receive a fair price for the decedent's stock. Otherwise, the heirs are shortchanged, and the quality of their lives will be negatively affected. Likewise, the remaining shareholders who are the buyers of the shares, have an interest in arriving at a fair price, because they do not wish to overpay for the shares. If they do so, their personal capital (or that of the corporation, in the event of an entity purchase) will be eroded. Obviously, neither is a desirable situation.

Fortunately, the valuation methods described above have been found to do an acceptable job of pegging the value of the stock. Whether based on adjusted book value or a more complex calculation, or any combination of them, these methods have been tested and proved over many years. All parties can be relatively confident that if one of the common formulas is used, a fair price will be identified. This is important to the estate of the decedent. The IRS will typically accept the value of the decedent's interest if that value was found by a generally accepted valuation method, and is

- Fair, reflecting normal business intent;
- Fixed or set forth in the agreement; and
- The agreement <u>requires</u> the parties to transact at the price established within the agreement; or
- The agreement provides an option for transacting the sale at a fair price, and obligates the estate to offer the shares at such price.

Other Tax Considerations

An important question to the families and heirs of deceased shareholders is how the operation of the agreement will impact taxation of the decedent's estate.

Code Section 302

As a general rule, any payment by a corporation (not a Subchapter S corporation) to a shareholder will be treated as ordinary income, or a *dividend*, rather than as a capital gain. This is true even if the payment is made to redeem stock. If a payment is treated as a dividend, the entire amount will be taxed as ordinary income, with no deduction for basis, and earnings and profit of the corporation will be reduced by the amount of money or other property distributed by the corporation. However, there are exceptions, as set forth below.

In the case of an entity purchase in which the corporation itself has bought back the stock at a reasonable price, Section 302 of the Internal Revenue Code sets forth the standards for determining whether the redemption will qualify for capital gains taxation,

or whether the redemption will be taxed as a dividend. One of the requirements is set forth in Code, §302(b)(3). This section provides that if the corporation has redeemed all of a shareholder's remaining shares (both *actually* and *constructively* owned, so that the shareholder's interest is terminated), the amount paid by the corporation will be treated, not as a dividend, but as payment in exchange for the stock. Thus, the redemption will be treated as a capital transaction.

One of the requirements for such treatment is that the entity purchase must be a complete redemption. Thus, the redemption must cover all of the stock actually or constructively owned by the estate. If the transaction accomplishes this, the sale will be treated as a capital transaction, and there will be no taxable dividend.

Family attribution rules may cause the IRS to find that shares owned by family members of the decedent are constructively owned by the estate. The attribution rules may be overcome if the shareholder who owned the stock does not maintain any stock interest in the corporation immediately following the redemption and does not reacquire any shares in the corporation for the 10-year period following the redemption.

Code Section 303

If the corporation has liquidity problems, as close corporations may, the tax code offers means to protect itself from forced sale of assets for the purpose of raising necessary cash upon the death of a shareholder. The tool used for providing this protection is the Section 303 redemption. Within the limits of Section 303, surplus can be withdrawn from the corporation free of income tax.

This section provides that under stipulated conditions, a corporation can redeem part of a deceased shareholder's shares without the redemption price being treated as a dividend (which would be taxable as ordinary income). Instead, the redemption will be treated as payment in exchange for the stock (a capital transaction). It can be safely used in connection with the stock of a family owned corporation because the constructive ownership rules are not applied in a Section 303 redemption.

The stock of any corporation can qualify for a Section 303 redemption. This includes all classes of voting and nonvoting stock.

The following conditions must be met if the stock redemption is to qualify for nondividend treatment under Section 303:

. The stock to be redeemed must be includible in the decedent's estate for federal estate tax purposes;

. The value of all the stock of the redeeming corporation which is includible in decedent's gross estate must comprise more than 35% of the value of the decedent's *adjusted gross estate*.

The dollar amount which can be paid out under a Section 303 redemption is limited to a total of:

. All estate taxes

. Funeral and administrative expenses

. State death taxes

Also, the stock must be redeemed within three years and 90 days from the filing of the estate tax return.

Funded Buy-Sell Agreement Advantages

Generally, all parties benefit from a funded buy-sell agreement. As noted previously, the heirs of the deceased benefit by receiving a fair price for their family member's investment which might be otherwise difficult to value. The remaining shareholders benefit by the continuation of their business and their ownership in it. The active management and participation of the shareholders will continue unabated.

Stock Retention Considerations

In rare instances, the family of the deceased shareholder may benefit from retaining the shares. In order for such an action to benefit the family, the following elements should be present:

. The business should be a *commercial operation*, such as a manufacturing or distribution concern. It is unlikely that a professional corporation designed for the purpose of providing services to clients would lend itself to such a strategy, since the family would not be likely to be able to contribute to its success or continuation.

. The decedent's interest should be controlling.

. Skilled succession of management should be identified.

. The business should be profitable.

The family should not need the capital which would be provided by the purchase of the stock facilitated by the stock buyout agreement.

Even if all of the elements are in place, it is likely that the heirs of the decedent will still benefit more from a properly executed buy-sell agreement than by any plan to retain the stock of the deceased.

Methods for Stock Retention

In the unlikely event that the decedent's family can justify retention of the shares, the normal way to accomplish this goal is by means of the decedent's *will*. The will clause to accomplish this would be either a *specific bequest* or by *establishing a testamentary trust* for the stock.

The specific bequest is used when the stock is to be transferred to a specific heir. For example, if a family member can, in the opinion of the testator, continue to operate the company and provide income for his family, the testator may leave all of his stock to the heir by making a specific gift in his will. . Assuming such gift is made in the will, the testator must remember to include clauses which assure the remaining heirs are treated fairly.

A trust is used as a method of optimizing the payment of federal estate and gift taxes by the estate. In essence, the trust takes title to all the assets of the decedent, and makes such gifts as the decedent directs. Thus, a specific gift of stock can be made from within the trust, just as it can be made from within the will.

Regardless of the method chosen, it is important to recall that the better solution, in almost all cases, is to make use of a funded buy-sell agreement. Such an agreement can be structured to provide continuing income to the family, either directly or indirectly, or to provide a lump-sum payment to the heirs. Meanwhile, the business continues to operate, benefiting the remaining shareholders, employees and the local economy.

Section III Summary

The first chapter introduced the major forms of doing business. The second chapter investigated the impact that death of a proprietor, partner or shareholder can have on the business, absent a cohesive plan for the continuation of the business. The consequences on the heirs of the deceased, the remaining owners, partners or shareholders, and employees of the business were catalogued. Societal effects were listed.

Having recognized the need for a continuation plan, this third chapter has investigated the means of designing and implementing it. For virtually every business type, the optimal form of business continuation is the buy-sell agreement. Buy-sell agreements are either funded or unfunded. Unfunded buy-sell agreements lay out the continuation plan, but do not provide mechanisms to assure that the funds necessary to complete the transaction. Funded agreements, on the other hand, provide for the availability of funds by the use of insurance policies on the life of the owner, partners or shareholders. The proceeds of the policies are used to pay for the ownership interest upon the triggering event (usually the death, but sometimes the retirement or disability of the owner).

Buy-sell plans are typically in one of two forms. In one form, the interest is purchased by another employee of the business. If the business is a proprietorship, the successor in interest is probably an employee who has expertise and the desire to own and operate the business. This employee will own and maintain insurance on the life of the owner, will pay the premiums and be the designated beneficiary. Upon the death of the owner, employee will receive the proceeds, which he will then pay to the heirs, under the terms of the buy-sell agreement. From that point on, subject to the terms of the agreement, he will continue to operate the business.

In the case of a partnership or corporation, two typical arrangements are used: the entity purchase or cross purchase. For corporations, these are usually referred to as stock redemption or stock purchase plans, but they have similar meanings. Under the entity purchase plan, the business organization itself repurchases the interest of the deceased partner or

shareholder. In order to effect the transaction, the corporation or partnership entity itself owns and maintains life insurance on the lives of the partners or shareholders. The business organization pays the premiums on the insurance and is the beneficiary of the policies. Upon the triggering event (the death, disability or retirement of the partner or shareholder). Proceeds from the insurance are paid to the entity, which then pays them to the heirs of the family and receives the decedent's ownership interest in return. The ownership interest is then retired.

In the cross purchase arrangement, the *remaining partners or shareholders* are the purchasers of the ownership interest of the deceased owner or shareholder. The insurance used to fund the transactions is owned and maintained by each partner or shareholders. Therefore, a greater number of policies is required. Administratively, this type of arrangement is difficult to implement if the business organization has more than three owners or partners.

Regardless of the form of the transaction, it is of critical importance to all concerned that the price paid for the ownership interest of the deceased owner, partner or shareholder be reasonable and fair. The heirs of the decedent must receive a fair price which will provide them the best approximation of the value of the investment. The remaining owners, partners or shareholders must not substantially overpay, lest they burden themselves or the business with debt which cripples future operation. In order to avoid disputes and minimize the probability of litigation over the price, the price is normally a term of the buy-sell agreement itself. Within the agreement the price is either set forth directly, or provisions are made for valuating the business, and therefore calculating the value of the ownership share. Commonly used valuation methods include adjusted book value, appraisals, straight capitalization, year's purchase method, or combinations of any of them.

SECTION IV

BUSINESS USES OF LIFE INSURANCE

The complexity of the modern U. S. economy, and of U.S. politics, has made partners of employees, employers and the government when it comes to planning for the future. Individuals have greater difficulty providing all of the funds necessary to provide for their retirement than at various times in the distant past. This is due, at least in some respects, to the tax burdens society places on most citizens, and to the relative increase in the cost of basic goods and services over the course of the twentieth century.

Employers and the government have become partners in the planning process. The federal government provides income for employees who reach retirement age or become disabled through the Social Security program, while employers provide retirement planning packages and insurance options which benefit the families of their employees.

Role of Employee Benefits

Employee benefits are a dynamic area of concern for most employers. The retirement and health benefits provided by employers have become necessities for employees. As such, they are critically important items for management's consideration. Benefit programs have for many years experienced upwardly spiraling costs. Moreover, the burden of government regulation has increased logarithmically.

Besides providing benefits directly to employees, the benefit structure of the organization assists the employer in satisfying its "4-R" needs:

. *Recruiting* employees;

. *Retaining* employees;

. *Rewarding* employees; and

. *Retiring* employees.

Employee benefit plans are employer sponsored plans that provide benefits if employees die, become sick or disabled, or lose their income source as a result of death or retirement. These goals are accomplished through the use of deferred compensation retirement plans, disability income plans and various insurance programs, particularly life and health insurance. For management, benefit planning has become a dynamic and challenging area. For employees, the benefits provided by the plans have become necessities.

As mentioned above, the federal government also provides programs geared to the health and retirement of citizens, chiefly the *Social Security* and *Medicare* programs. Periodically, specific problems are addressed in greater detail by specific legislation. For example, the Employee Retirement Income Security Act (ERISA) was enacted in 1976 to set specific standards for the implementation and maintenance of private deferred compensation retirement plans. Similarly, 1996 has seen the passage into law of the Kennedy-Kassebaum bill providing for the portability of health insurance. Thus, employee benefits are also a dynamic political area.

This book does not cover the government programs of Social Security and Medicare. For further information on those programs, the reader should contact his local Social Security office or any of the excellent publications on the subject by publishers such as Commerce Clearing House, Prentice Hall, Matthew Bender or The National Underwriter.

Deferred compensation benefits typically are either *qualified* or *nonqualified*. If qualified, contributions to the plans are tax deductible to corporations and taxes on contributions are not paid by employees until benefits are received, typically at retirement. If nonqualified, taxes are paid on the contributions, but benefits of any amount can be allowed.

Qualified deferred retirement plans are either *defined contribution* plans or *defined benefit* plans. Defined contribution plans require the employer to make contributions based on performance criteria, while defined benefit plans guarantee a resulting retirement benefit.

Employer sponsored health insurance may be the most dynamic area in the entire field of employee benefit planning. Health insurance provided by employers is frequently viewed by employees as the most critically important benefit which the employer can provide. For many employees, such a plan provides their best, or only, hope of providing access to medical care for themselves or their families.

Principally, employee health benefits are provided by the group purchasing power of employers and associations. This power is delivered by two methods--the prenegotiation of rates and prices for medical services, and the prepurchase of quantities of medical care. The different approaches are evidenced in *Health Maintenance Organization (HMO)* plans, or *Preferred Provider Network* (PPO) plans. HMO's are networks of medical service providers who are employees or members of the HMO. Generally, the HMO contract provides for the provision of specific quantities of specific services to participants or enrollees. The PPO represents independent providers who have agreed to provide services at a reduced rate to enrollees of the plan. In both cases, the purchasing power of the employer is reflected in the group health plan, regardless of form.

The beauty of such plans, from the point of view of the employee, is that the employee is provided with access to quality medical services, and the plan provides either reimbursement for the costs of the services (PPO), or has already paid for the services (HMO).

Group Life Insurance

Moreover, the power of group purchasing carries over into the provision of other types of insurance provided by employers, chief among them life insurance. Substantial life insurance can be provided to employees through group insurance mechanisms. Group insurance plans are arrangements under which groups of persons (employees) who have a specific relationship to the policyholder (the employer or association) are provided with insurance coverage under a single contract.

This group underwriting is the most important single distinguishing characteristic of group insurance plans. The underwriter is mostly unconcerned with the characteristics of any single covered individual. In most cases, no evidence of insurability is required. Instead, what is aimed at is obtaining a group of individual lives, or an aggregation of such groups, the mortality of which can be predicted with some degree of certainty. The point is that the *group* is the underwriting unit. The usual group is the corporation's employees. Normally, such insurance is less expensive due to the cost savings in the underwriting process. Thus employers are able to provide substantial amounts of insurance to their employees at rates which probably are better than those which the employees could achieve individually.

An employer may provide employees with up to $50,000 of group term insurance protection each year without cost to the employees. Generally, the taxable value of group term insurance in excess of the exclusion amount is determined by reference to a table provided by the IRS. Premiums paid by the employer are deductible as long as it qualifies. In order to qualify, the plan must a) provide a general death benefit, excludable from gross income under Code §101(a); and b) provide the benefit to a group of employees on a nondiscriminatory basis.

Group Term Insurance

The basic plan of insurance under which group life insurance is provided is yearly renewable term insurance. The coverage has many of the characteristics of that provided through individual policies. Coverage generally renews automatically without evidence of insurability following each annual expiration. The employee has the insurance protection, which has no cash value.[v] The amount of insurance on each employee is typically a multiple of his salary level. Not uncommonly, this is 200%.

The group term coverage terminates shortly after the employee's tenure with the employer, usually 31 days. However, the employee has a right to convert the group insurance to an individual permanent life insurance contract.

Premium levels are calculated through a multi-step process. These steps include:

. Determination of the total premium payable at each age represented by the covered group.

Addition of a *policy constant* which is some fixed amount per year, but is usually applied only to some fraction of the insurance (for example, a policy constant of $2.50 applied only to the first $50,000 of insurance). The policy constant is an administrative expense adjustment for the covered group.

. Application of any relevant discount or adjustment to the total premium.

. Divide the total premium by the number of $1,000 units. This results in the premium per $1,000 of insurance.

Once the premium per unit is known, payments are allocated between the employee and the employer. Usually, the cost is either borne entirely by the employer or split evenly between the two.

Postretirement Life Insurance Funding

Although the normal style of group life insurance is group term insurance, employers occasionally provide ordinary cash value life insurance in a group plan. Several different types of cash value insurance can be utilized. The basic purpose of these plans is to provide cash for funding post-retirement life insurance.

Three general approaches have been commonly utilized for these purposes. These are:

. Continuation of a portion of group term insurance

. Retired lives reserve (RLR)

.Cash value life insurance.

Flat Value Continuation

Continuation of the term insurance is usually on the basis of a flat value. For example, after retirement an employee who was covered at the level of twice his salary might maintain insurance at the level of $15,000 or some other flat figure.

Retired Lives Reserve (RLR)

An RLR is a group product, the objective of which is the provision of continuing life insurance beyond retirement. It consists of two basic elements: a) term insurance renewable annually (normally until age 100) that qualifies as insurance under Code §79; and b) an accumulating reserve which is used after retirement to pay premiums on the term insurance after retirement. The plan is normally qualified, resulting in tax deductibility of employer contributions and tax deferrals for the employee. The fund is administered by a third party, either a trust or the life insurance company, and never reverts to the employer as long as the employee is employed. If the employee dies or quits prior to retirement age, the accumulations are used to fund future costs for others in the plan.

Use of these plans was greatly curtailed following the adoption of the Tax Reform Act of 1984, which limited the employer's deduction under Code §404(a)(5) to the amount includible in the employee's income, and allowed only if separate accounts were maintained for each employee.

Cash value insurance can also provide funding for postretirement life insurance. These usually fall into one of three categories: a) group paid-up insurance; b) group ordinary life; and c) group universal life.

Group Paid Up Insurance

This approach was at one time the most popular for providing postretirement life insurance coverage. It combines accumulating units of single premium whole life insurance and decreasing units of group term life. The combination provides the same death benefits as regular group term life insurance.

Premium costs are split between the employer and the employee. The employee fraction is used to purchase increments of paid-up single-premium whole life insurance. The amount is dependent on the employee's age and the level of his contribution. However, the employee has the advantage of not being required to be medically approved. The employer contribution is applied to provide an amount of decreasing term insurance. When added to the accumulated face amounts of the paid up single-premium insurance, equals the total amount for which the employee is eligible.

At retirement, the term insurance is discontinued and the paid-up insurance remains in place for the duration of the employee's lifetime. This type of plan is seldom used today.

Group Ordinary Life

This is a misnomer, because in reality there is no "typical" group ordinary life insurance plan. The term broadly refers to any plan which provides cash value life insurance to a group of employees which will qualify for favorable tax treatment under Code, §79. Regardless of form, such plans usually consist of a term portion and a cash value portion. As in the paid-up plan described above, the employee pays the premium for the cash value portion, which remains in effect after the employee's retirement.

Group Universal Life (GULP)

A more common method of providing postretirement life insurance is the group universal life (GULP) plan. Typical of these plans is guaranteed interest rates, death benefit and loan provisions, and the potential for investment returns provided by interest sensitive instruments.

GULP plans work similarly to standard universal life plans. However, there are some differences. Participation in the plan is usually voluntary on the part of the employee. Coverage is usually provided without evidence of insurability only up to specified limits. The employee himself usually determines, at least within limits, the amount of coverage he wishes to purchase. Typically, the employee pays the entire cost of the premium for such a plan. The employee's premiums are applied primarily to the mortality cost of the insurance on his life, for administrative expenses and for an addition to the cash value of the insurance that stands to the employee's credit under the plan.

The use of group underwriting standards limit the flexibility of universal plans. Loans can normally be taken against cash values which accumulate in such policies. Partial withdrawals of cash values during the life of the insured, a feature of some individual universal life policies, may not be offered in GULP's.

There is no direct tax advantage to participating employees in a GULP as compared to simply purchasing their own individual UL policies from an insurance company. However, the group underwriting process is what makes the guaranteed issue possible. For many employees, this is the most valuable aspect of the plan, especially for employees who may be otherwise uninsurable.

Survivor Income Benefits

Survivor income benefits are a form of monthly income that become payable upon the death of an employee who may be covered under either a pension plan or a group life insurance plan. Three characteristics distinguish these from other forms of insurance:

- Proceeds are payable in the form of monthly payments only;

- Covered employees do not name beneficiaries; and

- Benefits are only payable only as long as there is a living survivor beneficiary.

These plans are marketed on the basis of the claim that life insurance coverage typically provides only the equivalent of two or three years of replacement income, while survivor benefits provide a lifetime annuity.

Dependent coverage is not the same thing, although coverage on the lives of dependents is sometimes provided by employers. Normally, the amounts of coverage are relatively small, but employees value this benefit. Therefore, provision of dependent coverage assists the employer with its 4-R requirements.

Funding the Benefits

As has been stated, most of the funding for postretirement benefits comes from the accumulations in the plans resulting from the applications of premium payments made by employees to the cash value portion of the plans. The employer normally makes no contribution to the accumulating portion of the plans.

Section IV Summary

Employers typically provide various insurance coverages to their employees as part of their overall compensation and benefits package. These coverages are integrated into the benefit structure with the purpose of assisting the employer with its 4-R requirements--recruiting, rewarding, retaining and retiring its employees.

The most typical insurance benefits provided are group health coverage, and various forms of group life insurance. Health coverage is perceived by employees as one of the most valuable benefits which can be offered. For some the availability of insurance at group rates, and with no requirement for evidence of insurability, represents their only means of providing access to quality medical care for their families. Health coverage features networks of approved care providers who provide services at prenegotiated rates. In different combinations, medical care is delivered under those policies by either an HMO or a PPO. In both cases, the employee benefits by the group purchasing power of the employer. The lower price is offered because the basic underwriting unit is the group.

Moreover, employers commonly provide life insurance to employees in any of several common forms. Again, employees benefit from the group purchasing power of the employer. The typical form of life insurance benefit is the group term policy. Typically, the employer pays most of the premium for renewable term life insurance on the life of the employee in an amount which is a multiple of the employee's salary. The employer's contribution to the premium cost is tax deductible, and the benefit is received free of tax by the employee. Postretirement life insurance benefits are provided at group cost levels by various plans to which the employee contributes a percentage of the premium. The premium percentage contributed by the employee buys segments of cash value insurance. The accumulations provide for insurance coverage after retirement, when the group term coverage normally terminates.

<u>**SECTION V**</u>
DEFERRED COMPENSATION PLANS, DISABILITY INCOME, KEY PERSON AND SPLIT DOLLAR INSURANCE

The other part of the benefit package consists of plans which provide for the accumulation of retirement income for employees. Qualified plans assist employees in their retirement planning by providing for the tax-free accumulation of funds in a separate retirement account. Taxes on the accumulation are not paid until withdrawals begin, normally at retirement age. Employer contributions to the plan are tax deductible expenses. The operation of such plans, known as qualified plans under ERISA, produces accumulations sufficient to provide for the employee's retirement, something most employees are incapable of accomplishing unaided.

While health and life insurance plans help in *recruiting* employees, a well designed qualified deferred compensation retirement plan can assist the employer in <u>retaining</u> employees, by providing the employee with a powerful incentive to remain a participant in the plan.

Deferred Compensation

Not all deferred compensation plans are retirement plans, although retirement funding is one of the chief reasons for the existence of deferred compensation plans. Deferred compensation plans can also be structured in such a manner as to provide a reward to prized employees.

By definition, deferred compensation plans are those which defer the receipt of a percentage of current compensation, thus deferring taxation upon it as well. If the purpose of the plan is to provide retirement income, withdrawals do not begin until retirement, at which time it is likely that the employee's income level, and therefore taxation level, will be lower. In the meantime, the compensation which has been deferred accumulates in an investment account. If the plan is qualified, the accumulations are tax-free. If not, taxes may be assessed on the accumulations.

Qualified deferred compensation plans are subject to the requirements of the Employee Income and Retirement Security Act (ERISA). The tax advantages provided by qualified plans are more profound than for nonqualified plans, although nonqualified plans also provide certain advantages.

Whether qualified or nonqualified, deferred compensation plans are implemented according to the terms of a written agreement, which clearly sets forth the terms of the plan.

Qualified vs. Nonqualified

Nonqualified plans allow the employer much greater flexibility as to who is covered, what coverage is provided, and how much money can be deferred. The tradeoff for this greater flexibility is that such plans provide fewer tax benefits to employee and employer alike.

However, the nonqualified plan must still be set forth writing and communicated to the covered employees. Accumulations in such a plan are not tax deferred. The plan need not be filed with the IRS or the PBGC, since it is not qualified. However, the greater flexibility granted to employers amounts to the ability to discriminate. Thus, such plans are chiefly used as incentive or reward plans for specific employees. With such a plan, for example, a favored employee can be allowed (or assisted) to place a much larger amount of money in a plan which accumulates until retirement than he would be allowed to do under a qualified plan. This is because the nonqualified plan is not subject to the restrictions and requirement of ERISA.

Qualified plans are also set forth in writing. However, in order to become qualified the plan must be filed with the IRS, which reviews it to assure its compliance with the participation, vesting, funding, level and reporting and communication requirements of ERISA. If qualification is granted, employer deductions will be given for contributions to the plan made by the employer. Once installed, the employer must not discriminate as to participation, eligibility, vesting, or benefit levels. In addition, the employer must file various annual reports and returns regarding the plan, and communicate the plan clearly to covered employees.

The advantages of qualified plans can be summarized as follows:

. The covered employee is not considered to be in receipt of taxable income from the plan until benefits are distributed;

. Lump-sum distributions, subject to certain conditions, are eligible for averaging rules which may operate to further reduce income taxation on the distribution;

. Employer contributions are tax deductible; and

. Investment income on the plan is not subject to taxes as it accumulates.

Funded vs. Unfunded

Deferred compensation plans are basically promises to deliver money to the participant at some later date (usually, but not always, retirement). Most plans are *funded*, but occasionally *unfunded* plans are used.

Unfunded Plans

In unfunded plans, no money is set aside for future delivery to the employee participant. In essence, the plan is an unsecured promise by the employer in which the employee is taking a substantial risk. Occasionally, the employer sets aside a reserve for the purpose of accumulating the necessary cash. No matter what cash or property is held in the reserve, however, to the extent that it is under the control of the employer it is a corporate asset which is available to creditors. The plan is not funded.

Funded Plans

In this context, "funded" refers to actuarially determined funding for the contemplated benefits which the plan will provide. The funding is basically the employee's security for the promise to deliver money to him at some future time or upon the occurrence of some event. The security cannot be under the control of the employer. The usual method of relinquishing control is to allow the fund to be managed by a trustee. Any of several different types of funding vehicles may be used--including cash, annuities, guaranteed interest contracts, life insurance, fixed income securities or combinations.

Advantages and Disadvantages

The most obvious advantage of, and the primary justification and application for, qualified deferred compensation plans is to provide tax free accumulations to be used at retirement. The employee is advantaged by the postponement of taxes. The employer is advantaged directly by the deductibility of his contributions, and indirectly by the use of the benefits provided under the plans to assist the employer in meeting his 4-R requirements.

There are few disadvantages. Primary among them is the restrictions placed on the tax-free accumulation, and on tax deductions, by the requirements of ERISA. However, the framers of the legislation considered that to allow greater tax benefits would be to deprive the federal government of a substantial portion of needed income.

Federal Tax Rules and ERISA

Eligibility and Participation Requirements

Under ERISA, eligibility for the plan must be open to all employees who do not fall into one of the following categories:

. Employees with less than one year of service (1000) hours;

. Employees who are less than 21;

. Part-time employees; and

. Employees covered by collective bargaining units.

The employer may not discriminate against groups of employees for participation on the plan. In order to insure nondiscrimination, the plan must satisfy either the a) Ratio Test; or b) the Average Benefit Test along with the "50-40" test. The Ratio test is satisfied if the percentage of lower paid employees benefiting from the plan is at least 70% of the percentage of the percentage of highly compensated employees who benefit from the plan. The Average Benefit Test requires that the employer establish a classification of employees if the percentage of lower paid employees who benefit from the plan is at least 50% of the percentage of highly paid employees who benefit from the plan. The plan must not adversely affect the average benefit provided to lower paid employees. The 50-40 test is satisfied if the plan benefits the lesser of 50 employees or 40% of the workforce.

Vesting Requirements

Once eligible and participating, the employee's benefits must vest at least as fast as set forth in a schedule in the statute. Normally, benefits in defined contribution plans vest more quickly than do benefits in defined benefit plans. Regardless, the employee's interest in the plan accumulations must vest according to the following rules:

. Employee contributions, if any, are always 100% vested;

. If eligibility requirements exceed one year, vesting must be 100% vested upon becoming eligible;

. Employees must be vested 100% at normal retirement age (which is defined in the plan);

- The plan must vest according to the 3/7 schedule or over the five year schedule (The 3/7 schedule does not require any vesting through the first two years, and then 20 per cent per year through the 7th year. Otherwise, the participant must be 100% vested after 5 years of participation in the plan).

Limits on Contributions and Benefits

For defined benefit plans, the annual normal retirement benefit for any participant may not exceed the lesser of an indexed dollar amount of 100% of the participant's average compensation (not exceeding $150,000 for benefits accruing in years beginning in 1994) for his three highest years of compensation. The benefit limit is adjusted annually by the IRS, if necessary. (The maximum allowable in 1995 is $118,500). The minimum benefit allowable is $10,000 annually.

For defined contribution plans, the annual contribution limit may not exceed the lesser of 1) 25% of compensation (not exceeding $150,000 for years beginning in 1994) or 2) $30,000. At such time as the benefit limit under a defined benefit plan exceeds $120,000, the $30,000 limitation will be increased to 25% of the benefit limitation.

Compensation Taken Into Account

The plan can only consider the first $150,000 of compensation.

Joint and Survivor Annuities

Qualified plans must provide for joint and survivor annuity options for the participant and surviving spouse. Employees may elect out of this option.

Commencement of Benefits

The plan must provide for payment of benefits to begin not later than the 60th day after the **latest** of: (1) the close of the plan year in which the participant attains the earlier of age 65 or normal retirement age as defined in the plan; 2) the close of the plan year in which the participant marks the 10th anniversary of his enrollment in the plan; or 3) the close of the plan year in which the participant terminates service with the employer.

Minimum Funding Standards

In the case of defined benefit plans, employer contributions must meet a minimum funding standard which includes amortization of past service liability as well as current plan costs.

Returns Which Must be Filed

The plan must file an annual return (IRS Form 5500) each year.[vi] In addition, PBGC-1 forms must be filed with the Pension Benefit Guaranty Corporation each year. These returns provide extensive information on each plan, including verification of its actuarial funding standards.

Basic Types of Deferred Compensation Plans

There are two primary classifications of deferred compensation plans: *defined benefit* plans and *defined contribution* plans. Defined benefit plans are plans in which the benefits are expressed as a specified, definite benefit at retirement. The employee does not take any risk with such an agreement. Consequently, such plans are very attractive to older employees for whom retirement is nearer. The benefit, therefore, is the fixed factor in such a plan, while the funding required for it is the variable. Since the funding sufficiency must be actuarially reviewed on an annual basis and the funding brought up to date, the benefit will always be capable of delivery at the time of retirement.

A defined contribution plan does not specify or guarantee that a benefit will be available to the employee at retirement. Rather, it requires the employer to make contributions according to a certain formula. As an example, contributions could be based on the profitability of the business. The participant's final benefit is dependent on the accumulation from these contributions. However, there is no requirement that contributions even be made at all. They are made only if the conditions set forth in the plan occur. Typically, defined contribution plans are more popular with younger employees who are more willing and ready to accept some risk in return for the possibility of higher eventual returns.

The classical type of defined benefit plan is the pension plan, while the best known form of defined contribution plan is the profit sharing plan. For a comparison of the characteristics of these types of plans, see Table V-1 in the Appendix Section at the end of this book.

Split Dollar Insurance

Split dollar insurance plans, in the context of employee compensation and benefits, refers to a method of purchasing insurance. In this sense, the plan is a funding mechanism, not a life insurance policy. Such plans are commonly used by businesses. The arrangement divides, or "splits" the death benefit, living benefits and premiums between the employee and the employer. The objective is to join the needs of the employee with the employer's capability of premium payment.

Advantages and Uses

Basic Form of Plan

An obvious advantage of sharing the premium with the employer is that the employee can thereby afford a relatively greater amount of insurance. It is particularly valuable to the successor employee in a proprietorship, partners of a partnership or shareholders of a close corporation who must own and maintain insurance subject to a cross purchase arrangement set forth in a buy-sell agreement. If, for example, one of the participants in the plan is more difficult or expensive to insure due to health, age or ownership share, split dollar may provide the ideal purchasing vehicle to facilitate implementation of the plan. It can also be used to provide a desirable benefit to a key employee.

In the normal plan, the corporation and employee jointly purchase whole life, universal life or another form of cash-value insurance on the employee's life. The employer provides the funds to pay the portion of each annual premium equal to the annual increase in cash value of the policy. The employee pays the balance. In the event of the employee's death, the employer is entitled to the proceeds of the policy up to the level of the cash value, or of the portion equal to its total premium contributions.

The employee's share of the premium is reduced each year as the value of the accumulated cash in the policy increases. It is possible for the employee's share to eventually reach zero in the later years that the policy is in effect. Therefore, the employer's portion increases each year, in proportion to the increase in the cash value. Offsetting this, the employer's entitlement to policy proceeds increases as the cash value accumulates.

Other Approaches

In order to offset this, a *level premium method* of paying the premiums can be calculated, under which the employee pays the same dollar amount of premium throughout the effective period of the plan. Although it is seldom used, it is possible to structure a split dollar plan in which the employer pays the entire premium.

Tax Considerations

The employee does receive economic benefits under a split dollar arrangement, since the employer is contributing to the purchase of the insurance. The economic value received by the employee is subject to income tax.

At all times the insurance has an economic value which can be calculated. The economic value of the benefit the employee receives is calculated by use of the government's one-year term ("P.S. 58") premium rates. The applicable rate for the insured's age in the taxable year is applied to the difference between the employer's share of the death benefit (if death were to occur in the current year) and the full death benefit payable under the basic policy. Basically, the value of the benefit to be included in the employee's taxable income is equal to the one year term cost of the life insurance protection less the employer's contribution. This is not normally an extraordinarily large amount.

However, the entire value of the policy is includible in the insured's gross estate for federal estate tax purposes. This would include the entire death benefit if the employee has any of the incidents of ownership, such as the right to appoint beneficiaries or borrow against the cash value.

The business does not receive a tax deduction for the premiums it pays. Employers do not receive a tax deduction for premiums they pay for insurance on the life of an employee under which the employer is a beneficiary.

Split Dollar Methods

Two major methods of implementing split dollar plans are the *endorsement method* and the *collateral assignment method.*

Endorsement Method

Where the endorsement method is used to implement a split dollar plan, the insurance on the life of the employee is applied for and owned by the employer, who also is responsible for the premium payments. In the normal arrangement, the employee then reimburses the employer for the employee's share of the premiums. The employer is named the beneficiary of the portion of the proceeds which equals the cash value of the policy. In the early years of the plan the cash value of the policy is small, although it increases in later years. The employee designates a

beneficiary for the remainder of the proceeds. An endorsement to the policy modifies the employer's rights as policyowner, thereby protecting the employee's ability to deal with the policy, by providing that the beneficiary designation cannot be changed without the consent of the employee.

Some vendors of life insurance policies permit the ownership rights to be split between the owner and the employee. The covered employee is owner of the portion of the policy in excess of the cash value, and the employer is designated as owner of all the other rights and benefits under the policy.

If the plan is terminated prior to the employee's death, the employer recovers its premium outlay directly from the cash value of the policy. The owner can then surrender the policy or give the employee the right to purchase it for an amount equal to the cash value.

Collateral Assignment System

Under a collateral plan, the employee is the policyowner. As such, premiums are paid by the employee. The employer agrees, in a side agreement, to "lend" the employee the cash value increase each year. Not uncommonly, the loan is made on an interest free basis. The employee assigns the policy to the employer as security for the loans. At the death of the employee, the employer recovers the amounts lent from the death proceeds, since it is the assignee. The policy then reverts back to the employee, whose designated beneficiary receives the balance of the proceeds.

Reverse Split Dollar

In the reverse variation, the usual ownership arrangement is reversed. The employee and the employer pay the premiums but the cash value is controlled or owned by the employee. Rather than the cash value being controlled by the employer, it is controlled by the employee. The death benefit is paid to the employer to the extent that it exceeds the cash value of the policy.

Basically, the entire program is the reverse of the typical arrangement. It is used when the employer requires large amounts of cash. For example, the large death benefit proceeds might be used by an employer to pay for the purchase of stock in a stock redemption or entity purchase plan.

Key Person Insurance

By definition, a key employee is an employee whose death, termination or disability will have an adverse economic impact on the business. The adverse impact will be manifested through loss of net profits, credit impairment or additional expenses relating to the acquisition and training of new personnel. In other words, a key employee is one who would be very difficult to replace and whose loss might result in a loss of business.

The importance of the key person to the operation and success of the enterprise mandates indemnification of such persons. The funds provided by the proceeds of such an indemnity policy can be used to hire and train a replacement, and cover (somewhat) expenses resulting from the reduction of efficiency which is the likely result of the loss of the key person.

Typically the employer is the owner of the policy and the beneficiary of its proceeds. Since the corporation is both owner and beneficiary, it is not allowed a tax deduction for the expense of the premiums. However, life insurance proceeds or disability payments received under such a policy are not subject to income tax.

The typical form of key person insurance is life insurance. Normally, a new policy is purchased, although existing policies can be transferred. When the key person terminates his position, the corporation may continue to keep the policy in force, and eventually receive the death benefit. Alternatively, the policy can be offered by the employer to the employee at a stated price. The corporation also has the option of lapsing the policy, after which coverage will be discontinued. Upon lapse or surrender, the employer can recover the cash value which has accumulated, if any.

It usually the case that the size of the financial impact which would result from the loss of the key employee is difficult or impossible to estimate. Therefore, there is always a question as to the size of the policy which should be purchased. Any of several methods may be used to estimate the size of the financial impact, and therefore the required insurance.

At the outset, the determination of whether the expected loss will be permanent or temporary must be made. The degree of accuracy which can be achieved will vary depending on the type of business, the duties of the individual and several other elements. Certainly, the face amount of the policy should be sufficient to cover the retention and training of replacement personnel should the worst occur.

Once a determination has been made, the insurance can be purchased. Normally, cash value insurance is used, since the accumulated values can be used for other purposes (for instance, they can be borrowed). Whole life and universal life products are often used for these purposes. The corporation owns the policies, pays the premiums and collects the proceeds if the triggering event occurs. As long as the key employee has no incidents of ownership in the policy, the proceeds will not be includible in his estate for federal death tax purposes.

Disability Income

The case of death or disability of a proprietor, partner or shareholder affects the other owners as has been seen. For that reason, plans to continue the business, particularly upon the death of the proprietor, partner or shareholder, are of critical importance. However, other conditions could economically affect the fortunes of the enterprise. Besides the impact of changes in the dynamic business environment, the disability of a key employee could have such an effect.

The usual result of a disability is the loss of income. This occurs because the disabled employee is no longer able to work during the period of his disability, whereas it is his work that supplies his income. An indirect result is that the business enterprise loses the contribution that the disabled employee makes to its success by virtue of his labor and expertise. Therefore, the goal of disability insurance plans is to provide replacement income during the period of the disability.

Disability benefits are very important to the corporation in attracting and retaining desirable employees. Employees view disability coverage as a very valuable benefit. Therefore, careful design of a plan to provide replacement income should be a critical element of the enterprise's benefit structure.

Buyouts

If a proprietor, partner or shareholder of a closed corporation becomes disabled, the problem of providing replacement income for him is augmented by the requirement that the business continue. If the disabled person has not died, there will be no triggering event for the buy-sell agreements discussed previously in Chapter III. Thus, insurance on the life of the disabled person will not have paid its proceeds to anyone, so no funds will be available for effecting the transfer of ownership interest. It is clear that the buy-sell agreement, as previously investigated, did not provide for such a contingency as disability. What is needed is a *disability buy-sell agreement*.

The easiest way to create such an agreement is to insert a clause in the buy-sell agreement making disability a triggering event, obligating the entity purchase or cross purchase arrangements of the buy-sell agreement. Once triggered, the parties would be subject to the same obligations to buy and sell as are contained in the death buy-sell.

The primary difference in operation will be in the timing of the transaction. In the case of death, the transfer of ownership interest can be effected within a relatively short time, which is defined by the period required for processing and payment of the claim against the life insurance policy. Once the policy pays its proceeds to the beneficiary--either the enterprise itself or the remaining partners or shareholders--the cash is available for the transaction, and the transfer of the ownership interest can be closed.

In the case of disability the disabled person may not be judged to be disabled until substantial time has elapsed. Normally, it is not known whether recovery will occur at all or, if it does, when recovery will be complete. The need for income commences at the time of the disability.

Assume that the disability buy-sell triggers after a specific period of time, and the buyout proceeds. Unexpectedly, a few months later, the employee's disability ends and the employee is able to return. However, due to the buyout, the employee has no ownership interest to return to. To avoid the risk of such an occurrence, the disability buyout normally does not trigger until a continuous disability of at least a couple of years in length has been experienced. With such an arrangement in place, the disabled person has a reasonable opportunity to recover, and if the reasonable period has expired the transaction can go forward.

Funded Buy-Sell Agreements

As with any buy-sell agreement, in order to be sure that the purpose of the agreement will be effected the availability of funds must be assured. In the case of disability, not only transaction funds but also funds to provide replacement income to the disabled worker must be provided during the period between the onset of the disability and the closing of the transaction.

The usual vehicle which is used for both purposes is *disability insurance*. Thus, disability buyout provisions are funded with disability insurance policies. If sufficient disability insurance on each partner or shareholder is in place, the necessary funding for the transaction will be present, and there will be no danger of having to use corporate funds to facilitate the transfer of the ownership interest.

The agreement itself may provide for a lump sum payment or a series of installments. The type of payout required by the agreement can be matched to the form of benefit provided by the policy.

Another advantage is that the determination of total disability (which will trigger the buyout) is made by the disability carrier rather than any of the parties to the agreement, thus avoiding a potential source of disagreement and disruption. The form of definition used to make the determination depends on the policy. The most liberal definition of disability would find the person disabled and pay benefits if there was an inability on the part of the disabled person to perform the requirements of his job. More typical is a provision that finds disability in the event that the disabled person is unable to perform any work at all. Most policies fall somewhere between the two extremes.

Business Overhead Expense Insurance

In the event that a key employee suffers a short term disability, such as may result from a debilitating disease or medical condition which renders him temporarily unable to work, careful planning can help the business stay afloat. The situation arises most often in the cases of proprietorships and small corporations or partnerships.

Even though the business is temporarily closed or slowed down, it continues to incur expenses. These "fixed" expenses include such things as rent, power, salaries of clerical personnel, insurance premiums, subscriptions and other items of a similar nature. The problem is that the temporary inability of the proprietor or partner to work may have decreased or stopped the entity's ability to earn income out of which the expenses normally would be paid.

Business overhead insurance can provide funds to cover some of the overhead expenses. This type of policy normally has an elimination period of 60-90 days, and a benefit period which runs for a fixed time, perhaps as long as a year or two. Typical overhead items are covered by such a policy, although such items as the owner's salary expense are not covered. Various options are available under such a policy, including allowing the policyholder to utilize benefit dollars not paid in one month to be accumulated and applied to expenses incurred in a later month.

Premium payments on Business Overhead policies are tax deductible to the business as a necessary business expense.

Salary Continuation

Another use of disability policies is to fund salary continuation for key employees. Usually, these include proprietors, senior partners and founding shareholders. The plan must be funded, or continuation income would have to be provided from normal income. The ideal funding vehicle is disability insurance.

The plan must be established in accord with the requirements of Code §105 or risk losing the deductibility of premiums. These requirements are that the plan must:

. Be in effect before the onset of the disability;

. Be set forth in writing;

. Be communicated in writing to employees; and

. Be formalized in writing as part of the corporation's minutes.

If installed correctly, the premiums of the plan are tax deductible to the corporation, and payments provided thereunder are tax free. Such a plan is an effective tool to build employee liability, and is usually viewed by employees as having great value. As do all good benefit plans, sick pay plans can help employers with their 4-R requirements.

Section V Summary

Deferred compensation is a valuable part of a corporation's (or other business entity's) compensation and benefit structure. All benefit plans benefit both the employer and the employee. The employee is benefited by the benefits that the plans provide. The employer is benefited because the plans assist the employer with its requirements for the 4-R's--recruitment, reward, retention and retirement of its employees.

Deferred compensation plans are written arrangements wherein portions of an employee's current income are deposited into accounts in which they accumulate for withdrawal at a later time, typically at a lower tax rate. Contributions by the employer to qualified deferred compensation plans are tax deductible, and employee income tax on the contributions is deferred until they are withdrawn.

For a plan to become qualified, it must meet the requirements of ERISA regarding eligibility, participation, vesting, funding and communication. If the plan does so, the favorable tax treatment is received.

Qualified deferred compensation plans are of two principal types: defined contribution and defined benefit. Under a defined benefit plan, the employee is guaranteed a certain level of benefit at the time of the triggering event (typically retirement). The employee takes no risk under a defined benefit plan. In defined contribution plans, the employee is not guaranteed a benefit. The employer makes contributions at a specified level, usually based on a function of the business entity's performance such as profitability. The employee takes the risk that a smaller, or no, benefit may result in return for the possibility that the contribution by the employer will be huge if performance is high.

Split dollar life insurance is a method of purchasing cash value insurance under which the employer's ability to pay premiums is optimized with the employee's requirement for the insurance. Typically, such plans are used when cash value insurance is necessary to fund buy-sell agreements. Under the endorsement method, the employer owns the policy and makes the premium payments. The employer is the beneficiary of such percentage of the benefit as will reimburse it for the cash value which has accumulated in the policy. The employee is the beneficiary of the remainder. Under the collateral assignment method, the employee owns the policy and is responsible for payment of the premiums. The employer arranges to loan the employee funds sufficient to cover premiums on the cash value portion of the insurance. The policy is pledged to the employer as security for the loans.

Often the death or disability of a key employee will have a measurable adverse financial impact on the enterprise. Such an adverse impact can be guarded against by the use of insurance on the life of the key employee. The corporation owns the policy, pays the premiums and receives the benefits, which may be used to allay the expenses resulting from the loss of the key employee.

Disability policies can be used both to provide replacement income to the disabled employee and to provide funding for a buy-sell agreement which is triggered upon a determination of total disability.

	Advantages	Disadvantages
Form of Business	. Simple organization . Simple operation . Owner receives profits . Owner makes decisions	. Potential unlimited personal liability . Owner bears brunt of management and labor pressures . Limited capital (owner's personal capital)
Voluntary Termination	Business can be sold at a fair price if there is a liquid market	At death or financial termination, difficulty of finding fair price
Bankruptcy	None	. Personal and business assets commingled . Business creditors claim personal and family assets . Loss of assets and income
Death	None	. Personal and business assets are commingled . Business dies -- no continuation . Economy affected . Jobs are lost . Family income lost . Estate settlement delays . Estate shrinkage

Table 1-1: **Summary of Sole Proprietorship Characteristics**

	General Partnership	**Limited Partnership**
Purpose	To operate the business of the partnership	To operate the business of the partnership
Partners	Tow or more partners. All are involved in management and operation of the partnership business.	Two or more partners. The limited partner is not involved in management, but is similar to an investor.
Liability	Unlimited personal liability with regard to business. Personal assets are liable for partnership debts.	Limited partner has limited liability--can only lose his investment.
Management Decisions	All partners share in management decisions.	Limited partner does not share in management decisions.
Profits and Losses	All partners share equally.	Shares in profits and losses proportionally to business investment.
Life and Death	Partnership terminates on death of partner unless agreement provides for continuation.	Death of a limited partner has no effect.

Table 1-2

Comparison of Characteristics
of
General and Limited Partnerships

	Proprietorship	Partnership	Corporation
Number of Owners	Usually 1	One or more	Any number
Capital-ization	Owner funds	Partners capital contribution	Investors (Shareholders)
Management	By owner	By partners, subject to agreement	Shareholders elect Board of Directors Directors appoint management
Profits	To proprietor	To partners	Can be dispersed to shareholders as dividends
Liability	Unlimited to owner	Unlimited to partners	Officers and employees immune from liability on contracts May be liable on torts
Duration	Dies with death of owner; otherwise, at owner's option	Dies at death or bankruptcy of partner unless specified differently in partnership agreement	Perpetual
Taxation	Profits taxed directly to proprietor	Profits taxed directly to partners No taxation of partnership	S Corporations pass profits through to shareholders Otherwise, corporation taxed as separate entity (Double taxation of dividends)

Table 1-3

Comparison of Forms of Doing Business

	Profit Sharing Plan	Pension Plan
Contributions	Cannot exceed lesser of $30,000 or 25% of compensation	May not exceed smaller of $118,800 (indexed) or 100% of highest 3 year average income
Source of Employer Contributions	Profits	Contributions are actuarially determined and are from any source available to the employer.
Benefit	Share of company profits	Income after retirement, independent of profitability
Allocations	To individual accounts, usually independent of age and years of service	Actuarially computed installments, based on age and years of service
Payability of Benefits	Cash disbursements at any time under certain conditions	Payable at retirement, death or disability
Normal Distribution	Normally lump sum	Normally installments
Benefit Amount	The amount in the individual employee's account at time benefits begin	The amount fixed by the plan's benefit scale
Severance	Normally in cash	Normally deferred
Vesting	Relatively fast	Relatively slow
Insurance	Not required	PBGC insurance is required
Matching Contributions	Employee contributions often allowed	Employee contributions not normally allowed

Table V-1: Comparison of Pensions and Profit Sharing