Funding Your Buy-Sell Agreement: Life Insurance or Installment Payments?

Most business owners realize the need for a buy sell agreement but are reluctant to fund the contract with life and disability insurance. Understandably, business owners may not want to spend the money needed on insurance premiums and believe that if the contract gives the buyer an option of paying the buy-out price over a period of years, then that is the better solution. They're usually wrong.

Solution

A buy-sell agreement generally requires the Company or surviving owner to purchase the deceased owner's interest in the business at a specified price, and requires the deceased owner to sell that interest. The contract protects both the Company and the family of the deceased owner. The surviving owner maintains continuity of management and ownership. The decedent's estate converts a non-liquid asset into cash to fulfill the financial needs of the surviving family. The buy-sell agreement will also contain other triggering factors, such as disability of an owner, retirement, criminal conviction, and more.

Business owners are sometimes reluctant to buy the life and disability insurance to fund the payout provisions of the buy-sell agreement. Unfortunately, this is often a result of the failure of some business owners to fully understand the cash flow drain placed on the company or surviving owner to pay the installment obligation. The surviving owner or the business will rarely have the cash to pay the deceased owner's estate (or disabled owner) in one lump sum, and will seldom have the cash flow to pay in installments, particularly if the payment term is long.

The solution is to purchase the life insurance and disability insurance that will pay out the policy benefits exactly when it is needed – at the death or disability of one of the owners triggering the buy-sell agreement.

Case Study

Bill and Diane are equals owners of Acme Watch Company. Acme is a profitable S Corporation that pushes Bill and Diane into a 40% marginal federal and state income tax bracket. The Company has been valued at $2 million. Bill and Diane have a buy-sell contract that requires the surviving owner to purchase the deceased owner's interest for $1 million under an installment contract payable over 10 years at 8% interest. Neither Bill nor Diane has $1 million in cash to pay in lump sum. Therefore, the surviving owner will have to generate sufficient business profit to pay the installment obligation. The Company operates on profit margin of 10% for every dollar of sale.

For purposes of simplicity, let's assume the annual installment obligation is about $150,000. Since payment of the obligation is not deductible, the surviving owner has to earn $250,000 in income to net $150,000 in a 40% marginal federal and state tax bracket. To earn $250,000 the survivor has to generate annual sales of $2,500,000 or $25,000,000 over the 10- year installment period.

- Could either surviving owner generate enough profit to pay the installment obligation and still earn a good income for his or her personal needs?
- Will the death of an owner have an adverse impact on sales? How is that going to be made up?
- Will the survivor have to hire someone to take over some of the responsibilities of the deceased owner? Where is the cash flow coming from for this? How much more is needed?

- Will the installment obligation affect the ability of the Company to pay salaries, or borrow money, expand or fulfill any other business purposes?
- What happens to existing company debt when one owner is deceased or out of the business from a disability?
- What happens when the Company or the surviving owner becomes insolvent?
- What happens when the surviving owner becomes disabled or dies?

Solution

It makes business and financial sense for business owners, like Bill and Diane, to own life and disability insurance on each other's lives so that the survivor has the cash to pay the buy-out price in one lump sum. In addition, cash value life insurance can accumulate a reserve so that one owner can use the money to help fund a lifetime sale from the other owner's disability or retirement. Yes, there may be an immediate impact on current business cash flow but premiums on insurance are at a substantial discount relative to the benefits that may be paid. As the deceased or disabled owner, you will want to ensure that your family is financially protected and not have to worry about collecting on debts from your former business partners.

Purchasing life and disability insurance to fund a buy-sell agreement is the way to go.

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