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Buy-Sell Agreements & Disability Insurance:
The Disability Buy-Out

A healthy buy-sell agreement should contain provisions that anticipate the future needs of a business. Although most buy-sell agreements make provision for the death of a business owner, many buy-sell agreements are silent when it comes to the disability of a business owner. The reality is that a business owner is more likely to become disabled - than to die - while leading a business entity. The crippling effects of a business owner's disability are far-reaching: aside from the business owner's own health and well-being, an accident or unexpected illness threatens the livelihood of the business owners' families, the business, and its employees. The antidote to this eventuality is smart, simple, and sound: Disability Buy-Out Insurance.

The Disability Buy-Out is a *Mandatory* Business Strategy for Handling a Business Owner's Disability

If an injury or illness prevents a business owner from returning to the business, Disability Buy-Out (DBO) insurance helps fund a buy-sell agreement. It enables the remaining owners, or the business entity itself, to buy-out the disabled owner's share of the business.

A disability buy-out provision in a buy-sell agreement will direct the disabled business owner, after a certain period of total disability – typically 12 months, to sell his/her portion of the business to the remaining owners or to the business entity itself. The remaining owners (or the business entity) obtain the funds to complete the buy-out from the DBO insurance.

DBO insurance is an economical and well-thought out approach to implementing the disability buyout – it is the superior business strategy when compared with the uncertainty of other options such as depleting savings, drawing from future earnings, or taking out business loans. DBO insurance premiums are guaranteed, predictable, and planned. At this critical time in the life of the business and its owners, DBO insurance shifts the burden of funding the buy-out from the individual business owners and the business to the insurance company.

Disability Buy-Out Insurance: One Product, Many Solutions

Besides providing financial stability to the owners and the business, DBO insurance resolves several of the conflicting concerns that will confront the remaining owners and the disabled owner in the event of an owner's disability.

- Where will we get the money to buy-out the disabled owner?
- Will the disabled owner sell his/her interest to a competitor?
- How long can the business operate without the disabled owner's help?

Besides the security of preserving vital financial resources for medical or other expenses, DBO insurance proceeds give the disabled owner peace of mind that his/her investment in the business will be recovered:

- Where is my return for starting and growing the business?
- Why should I let others run my business, using my money?
- How can I recover my investment?

Incorporating the Disability Buy-Out into Cross Purchase Buy-Sell Agreements

In a cross purchase buy-sell agreement each business owner agrees, upon the total disability of a business owner, to sell his/her ownership interest to the remaining business owners in return for the value of his/her ownership interest. Each business owner owns, and is the loss payee of, a DBO insurance policy on the other business owners.

In a trusteed cross purchase buy-sell agreement, the business owners use a third party ("trustee") to carry out their cross purchase agreement. The business owners transfer their stock certificates to the "trustee" and the "trustee" purchases a DBO insurance policy on each business owner. The "trustee" is both the owner and loss payee of the policies.

Upon the total disability of a business owner the insurance company pays the disability benefit to the "trustee." The disabled owner transfers his/her interest in the business to the "trustee," who then transfers the disabled owner's interest in the business to the remaining business owners and pays the disability benefit to the disabled business owner.

Incorporating the Disability Buy-Out into Entity Purchase Buy-Sell Agreements

In an entity purchase buy-sell agreement, all business owners enter into an agreement with the business, providing that the business will buy, and the disabled owner will sell, his/her interest in the business to the business in the event of a total disability. The business owns and is the loss payee of a DBO insurance policy on each business owner.

Tax Implications

Regardless of the form of the buy-sell agreement, premiums paid for Disability Buy-Out Insurance by the business owner or by the business are not deductible, but the benefits are received tax-free. However, unique to the cross purchase agreement and trusteed cross purchase agreement, if the business bonuses the premium amount to the business owners as additional compensation, the premium *is* deductible to the business as a compensation expense, but the premium must be included in the business owner's income.

The disabled owner may recognize a capital gain on the difference between his/her basis in the business and the price he/she is paid upon the sale of his/her interest. Because tax considerations are an integral part of sound business and personal planning, business owners are encouraged to consult their own tax and legal advisors to fully understand their coverage needs and tax status.

Just What the Doctor Ordered

Business owners have the ability to tailor the DBO insurance policy to fit their personal and business needs. Upon a business owner's total disability, the DBO insurance policy may cover expenses related to programs for occupational rehabilitation or the costs of modifications or other access benefits (i.e. the installation of a wheelchair ramp) that assist the business owner's return to gainful employment in his/her occupation.

Business owners have the flexibility to choose the manner in which premiums will be paid: Annually, semiannually, quarterly, or monthly. And to choose between three different funding methods for the receipt of Disability Buy-Out Insurance proceeds: (1) Lump Sum; (2) Monthly Installment; or (3) Down Payment.

A Conversion Option is available which allows the business owners to convert their DBO insurance policies to individual disability income insurance policies. Business owners may also select a Future Increase Option which gives the business owners the opportunity to purchase additional DBO insurance in the future, without furnishing proof of health; this option is essential in the event the value of the business increases.

Conclusion

As a business owner, you probably already have a buy-sell agreement. Consult with your advisors and review the agreement to ensure that it incorporates a disability buy-out, and that the agreement is properly funded with DBO insurance.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

GEAR # 2012-10984 Expiration: 12/31/2014

Guardian Financial Representatives may call the Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, for additional information.