An educational guide for business owners

Guardian®

Succession planning strategies

Designed to help protect a business owner’s most valuable asset

If you own a small- or medium-sized business, protecting your ability to sell your company when you're ready is important — particularly if you have no relatives or partners who wish to take over someday.

While you may not be ready to sell your business today, perhaps you're concerned about the future — all while dealing with the operational demands of the present. You may also have top performers you need to retain while you remain at the helm.

If your company has one or more key employees, there's an option that you may want to consider, since one or more of them could have some interest in owning your business someday. If that's the case, a two-pronged approach could help you: A Retention Bonus Agreement, used in tandem with a One-Way Buy-Sell Agreement, can provide you with a well-developed business succession plan and give your key employee the funds needed to purchase your business.

What is a One-Way Buy-Sell Agreement?

A one-way, or unilateral, buy-sell agreement is a legal contract between the business owner and some third party addressing the disposition of the owner's business interest upon his or her death, disability, retirement, or other departure. It obligates the purchaser to buy out the interest of the deceased or departing owner. The departing owner, or estate of the deceased owner, is obligated to sell that ownership interest to the third party.

An executive benefit strategy that can benefit you and your key employee(s)

The first part of this strategy involves the Retention Bonus Agreement. It provides incentive to your key employee to stay with your company for a specified period of time — and is often funded with permanent life insurance. At the same time, the second part of the strategy is executed: You enter into a buy-sell agreement to establish the opportunity for your key employee to buy your business interest from you when you're ready to retire, or upon your death or disability. It, too, is commonly funded with life insurance. The third part of the strategy, executing the sale of the business, doesn't take place until the triggering event in the buy-sell agreement (such as your retirement, disability, or death) occurs.

The key to this strategy: The coordination of the executive benefit payout period with the triggering of the buy-sell, and adequate funding of the buy-sell.

What is a Retention Bonus Agreement?

In a Retention Bonus Agreement, the business agrees to pay the specified employee a bonus if the employee stays for an agreed-upon period of time or until a triggering event, such as the retirement, disability, or death of the owner. The employee will have more incentive to stay until the end of the period because otherwise, the employee will forfeit the bonus.

How it works

Let's take a look at the plan in action with a visual to help you understand how to implement the concept under this scenario. A small family business has a key employee who is very important to the success of the firm — and the business owner has no family members willing or able to buy or continue the business after the current owner's death or retirement. The business owner decides that one way that could help to both retain the key executive over a specified period of time, and put that individual in the position to eventually buy the business, is through a strategy that leverages a Retention Bonus Agreement and a One-Way Buy-Sell Agreement.

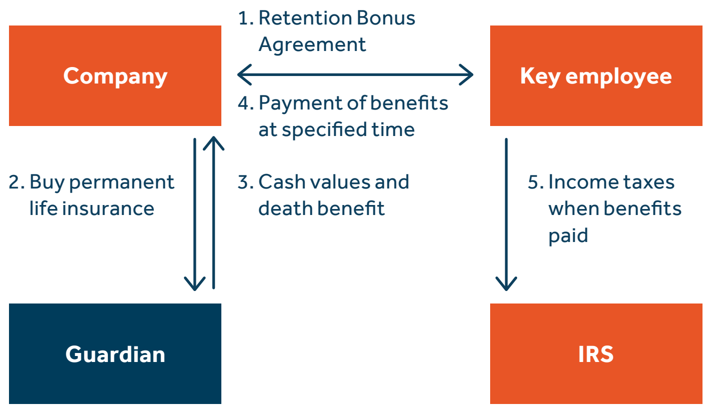
Under this arrangement, if the key employee is still with the company after 10 years (the agreed-upon time in our Retention Bonus Agreement example), they will receive a $1 million bonus, which aligns with the percentage of the business that the executive will buy at the end of year 10. At the end of 10 years, the company uses the first policy to fund the retention bonus for the executive. A few days later, the executive buys the owner's shares, as agreed. If there's not enough money for the full purchase price, a promissory note is used for the rest.

Executive benefit strategy in action: Retention Bonus Agreement + One-Way Buy-Sell Agreement

Step 1a: Enter into the Retention/Stay Bonus Agreement

How the Retention Bonus Agreement works

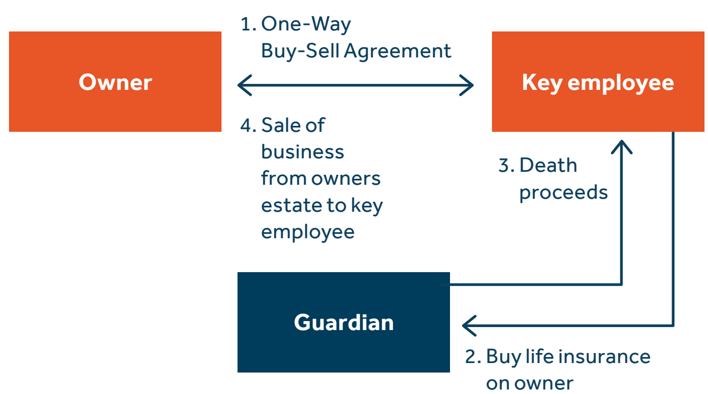
1. The business and key employee enter into an agreement where the business agrees to pay a bonus if the employee stays for a specified period of time or until a triggering event.
2. The business provides the employee with proper notice and obtains the employee's written consent to take out a life insurance policy on his/her life.
3. The business may informally fund the future bonus obligation with life insurance. The business is the applicant, owner, beneficiary, and premium payer of a life insurance policy on the employee's life.
4. Upon the employee's death, the business receives the death benefit income tax-free.[1]
5. If the employee stays throughout the specified period, the business will pay them a lump-sum bonus within 2½ months after the close of the tax year in which the employee was obligated to stay.



Step 1b: Enter into Buy-Sell Agreement

How the One-Way Buy-Sell Agreement works upon the owners death

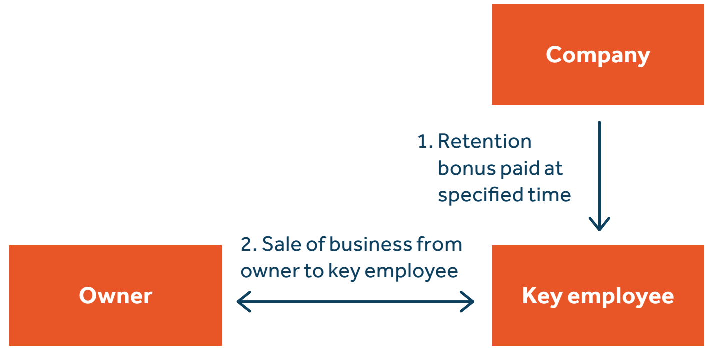
1. The business owner and the buyer (e.g., key employee, child, or third party) work with their financial and legal advisors to create the One-Way Buy-Sell Agreement. Under the terms of the agreement, owner and buyer agree that buyer would be obligated to purchase the business interest of the deceased, disabled, or departing owner for a pre-determined value or a value based upon a formula, and the owner or his/her estate would be obligated to sell.
2. The buyer purchases, and is the owner and beneficiary of, a life insurance policy on the owner's life. The employer may help out by providing a bonus to help cover the cost of the premium.
3. Upon the death of the owner, the buyer will receive the life insurance policy's death benefit, income tax-free.
4. The buyer uses the insurance proceeds to purchase the business interest from the owner or his/her estate.



What happens when the One-Way Buy-Sell Agreement is triggered during owners lifetime

1 The retention bonus is triggered upon reaching the date set forth in the agreement.

2 Immediately thereafter (but not necessarily on the same day because of tax implications, depending upon the number of owners selling, key employees buying, and the type of business entity) the buy-sell is triggered on the date that the business owner and the key employee agreed upon (e.g., 10 years from the execution of the agreement).



Advantages and considerations

Retention Bonus Agreement

- A retention or "stay" bonus for a key employee can be an effective tool in overall succession planning.
- The business owner has the flexibility to decide which employees should be offered a retention bonus.
- A Retention Bonus Agreement can help the business retain key employees during a transition period.
- The owner and employee can negotiate the bonus amount and the "stay" period. For example, a bonus amount can be a set dollar amount (e.g., $1,000,000) or some multiple (e.g., 2 times) of salary. The retention period can be one or two years, or some other time frame. (Generally speaking, going beyond year 10 may be too far into the future to be a meaningful benefit.)
- When the Retention Bonus Agreement is funded with permanent life insurance, the business has access to the policy's cash values.[2,3]
- The bonus is generally paid within 2½ months[4] after the close of the company's tax year in which the employee is required to stay. (Once the employee fulfills his obligation by staying with the company for the requisite period, the employee is generally vested in his or her bonus.)
- Upon an owner's retirement, disability, or other lifetime departure, the cash values of the permanent policy can be used to pay the bonus.
- The business may also use the cash values of a permanent life insurance policy on the life of the key employee to pay the retention bonus. A business may also choose to use a key employee policy to:
  1 informally fund a nonqualified deferred compensation agreement; and
  2 help cover expenses and/or lost revenue upon a key employee's death.

Tax considerations[5]

- Life insurance premiums are not tax-deductible by the business.
- The bonus is tax-deductible by the business when paid as long as the employee's total compensation is reasonable. The bonus would be taxable income to the employee.
- The death benefit is received income tax-free by the business, provided the employer-owned life insurance rules are met.
- For pass-through entities, such as partnerships, limited liability companies, and S corporations, the death benefit received increases an owner's basis in his/her business interest. Premium payments and policy cash values may also affect an owner's basis.

One-Way Buy-Sell Agreement

- The buy-sell agreement provides the business owner and his or her family with assurance that a fair price will be paid for the business.
- The insurance funding provides the necessary cash to execute the buyout, without having to rely upon personal resources, credit, or cash flow.
- If permanent life insurance is used, the cash values can accumulate a reserve so that the buyer has a source of funding for a lifetime purchase due to the owner's disability or retirement.[6]
- The business owner may wish to assist the buyer, particularly if the buyer is a key employee, by providing the life insurance premiums via a deductible bonus to the executive.
- A program such as this may be a way to establish "golden handcuffs" that can help retain key employees.
- The agreement creates a sense of stability for customers, suppliers, bankers, and company employees.

Tax considerations[5]

- Upon the owner's death, the agreement may establish a fixed value for the business for federal estate tax purposes.
- The buyer's "cost basis" in the business interest purchased from the owner would equal the amount paid for the business, which may lower the buyer's capital gains tax bill if he or she decides to sell the business at some point.

Protect your business today — and your bottom line tomorrow

Discover a strategy that can help you retain the key employees who are so important to the ongoing success of your business now, and in the years to come — while securing a buyer for your business when the time is right. Your Guardian financial professional can help you develop a strategy that can help you achieve both objectives, with funding strategies that won't strain your company's finances.

Contact your Guardian financial professional to start your strategy today.

1 The notice and consent requirements for employer-owned life insurance, set forth in IRC § 101(j), should be followed prior to the policy being issued so that the death benefit is not subject to income tax.

2 Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses or is surrendered, any loans considered to be gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first subject to ordinary income taxes. If the policy owner is under age 59½, any taxable withdrawal is also subject to a 10% penalty tax.

3 Some whole life policies do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial representative and refer to your individual whole life policy illustration for more information.

4 Payment within 2½ months of the company's tax year is important, otherwise the agreement may be considered a nonqualified deferred compensation agreement subject to stringent rules and regulations, which could cause unfavorable tax consequences if certain requirements are not met. If IRC § 409A requirements are not complied with, which include having a formalized written plan, the employee may have to recognize all of the deferred compensation, whether received or not as taxable ordinary income, in addition to paying a 20% excise tax and interest in the year there is noncompliance.

5 Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

6 Dividends are not guaranteed. They are declared annually by Guardian's Board of Directors.

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