An educational guide for business owners

Guardian®

Funding your Buy-Sell Agreement

Ensuring financial obligations are met with life insurance

You’ve spent years …

creating a significant financial interest in your business and a Buy-Sell Agreement is an important fundamental step to help protect its financial future.

While you may recognize the need for an agreement, it is equally important to determine how to effectively fund the agreement to ensure that your legal obligations can be fulfilled when a triggering event in your agreement occurs.

This guide has been designed to help you learn about some of the funding methods you can consider for your Buy-Sell Agreement — including how your agreement can be funded through the use of whole life insurance and disability insurance.

How a Buy-Sell Agreement works — and why it needs to be funded

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’s estate 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 (the business) into cash to fulfill the financial needs of the surviving family. Most buy-sell agreements will ordinarily contain other triggering factors, such as the disability of an owner, retirement, criminal conviction, and more.

Buy-Sell Agreement funding options

Some common ways of funding Buy-Sell Agreements include:

- Business cash flow
- Cash reserves
- Borrowing (including the installment sale approach)
- Life insurance and disability buy-out insurance[1,2]

Business cash flow

In most situations, it is unrealistic to expect that a business will have sufficient cash flow to pay the purchase price stipulated in the Buy-Sell Agreement, and still have enough to support new salaries, recruiting, and training expenses. And that assumes there is no reduction in business revenues and profits after an owner dies or departs from the business.

Cash reserves

Most businesses use their cash reserves to fund the growth-related activities of the business, not to pay off debt that has no positive impact on future revenue and profits.

Borrowing

Borrowing may be even tougher to obtain in the wake of the death, disability or departure of an owner. Interest expense may also be excessive and drain the cash flow of the business.

Installment sale

An installment sale approach is another funding method, but that, too, can lead to insufficient and expensive funding because business cash flow is typically the source of the funds used.

Installment sales carry additional risk due to the time required to pay off the debt. Time increases the risk of default on payments, insolvency of the business in the future, and the possibility that the deceased or departing owner or his/her family will need to take back the business — which is contrary to the reason the Buy-Sell Agreement was implemented in the first place.

Life insurance and disability insurance

Insurance, on the other hand, provides the funds needed at the appropriate time — at death or upon disability.

In addition, by using permanent life insurance, the business is also building a balance sheet asset (i.e., the policy cash values) that can be used to fund a Buy-Sell Agreement on account of the voluntary departure of an owner, supplemented by some of the other funding methods discussed above.[3,4]

Questions for you to consider

If one of the owners of your business should die or become disabled:

- Would this have an adverse impact on sales? How is that going to be made up?
- Would the survivor(s) have to hire someone to take over some of the responsibilities of the deceased owner? Where would the cash flow come from for this?
- What happens to your existing company debt?
- What happens when your company or the surviving owner becomes insolvent?

If your business uses an installment obligation to fund the Buy-Sell Agreement:

- Could any of the surviving owners generate enough profit to pay the installment obligation and still earn a good income for their own needs?
- Would the installment obligation affect the ability of the company to pay salaries, borrow money, expand or fulfill other business needs?

Buy-Sell Agreement funding in action: a case study

The following case study can help you see how various funding options may work — and how the various funding methods compare from a cost perspective.

Roger Thornhill is a 48-year-old advertising executive. He founded the Thornhill advertising agency and over the years, brought in a younger associate, George Kaplan, as a partner. Roger and George now each own 50% of the business and are concerned about the continued success of that business should something happen to either of them. Their Guardian Financial Professional suggests a Cross Purchase Buy-Sell Arrangement funded with life insurance. The business is currently worth about $7M, so each of them will buy a $3.5M policy on the other partner. Roger and George like the approach, but the premium for the policy on Roger is about $80K. When George hears this, he asks about different approaches that might reduce the cost. So their Guardian Financial Professional provides an analysis for them to help them compare some common alternatives.

Whole life provides a ready source of funds necessary to make a Buy-Sell Agreement effective.

In this case study, the alternatives for funding are:

- Permanent life insurance
- Using a sinking fund in tandem with loan funding
- All (100%) loan funding
- Installment sale

Life insurance funding approach

First, the Guardian Financial Professional examines the true cost* of the life insurance. The premium of the proposed policy is $80K, and based on current dividend rates will "offset" (meaning premiums will no longer need to be paid) by year 15. So the total premium cost is $1.2M over the 15 years. Assuming Roger dies at age 65 (year 18), the policy death benefit will be about $4.3M. After buying Roger's portion of the business from his heirs, George will have about $800K left over. So the premium outlay of $1.2M is reduced by the $825K George receives, for an actual cost of about $375K.

The example shown here is based on a hypothetical policy not available for sale from Guardian. This hypothetical illustration is intended to show, in general terms, how a typical participating whole life insurance policy might work. This illustration reflects a Male/Female Blend, age **48, Preferred NT, Whole Life 99 and Whole Life 121** and Guardian's **2023** dividend scale. A full illustration, showing both guaranteed* and non-guaranteed values, must be provided by a Guardian Financial Representative to an individual applying for a Guardian whole life insurance policy. For any illustration of a Guardian Whole Life product, the values depending on dividends can be more or less than those shown.

* All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

Sinking fund and loan funding approach

Since George had suggested investing the money they might have spent on premiums (i.e., in a "sinking fund") and then borrowing the rest when needed, their Guardian Financial Professional adds a sinking fund to the comparison. Assuming an interest rate of 5%, at retirement, the fund will have about $1.8M dollars in it.

Year	Business interest	Net after-tax outlay	Sinking fund increase	Sinking fund taxes	Sinking fund balance	Loan amount needed	Interest paid	Total loan cost	Total cost
1	$3,500,000	$76,873	$3,844	$1,076	$79,640	$3,420,360	$1,136,401	$4,556,761	$4,633,634
2	$3,500,000	$76,873	$7,826	$2,191	$162,148	$3,337,853	$1,108,988	$4,446,841	$4,600,586
3	$3,500,000	$76,873	$11,951	$3,346	$247,625	$3,252,375	$1,080,589	$4,332,964	$4,563,582
4	$3,500,000	$76,873	$16,225	$4,543	$336,180	$3,163,821	$1,051,167	$4,214,987	$4,522,478
5	$3,500,000	$76,873	$20,653	$5,783	$427,922	$3,072,078	$1,020,686	$4,092,764	$4,477,127
6	$3,500,000	$76,873	$25,240	$7,067	$522,968	$2,977,033	$989,107	$3,966,140	$4,427,376
7	$3,500,000	$76,873	$29,992	$8,398	$621,435	$2,878,566	$956,392	$3,834,958	$4,373,067
8	$3,500,000	$76,873	$34,915	$9,776	$723,446	$2,776,554	$922,499	$3,699,053	$4,314,035
9	$3,500,000	$76,873	$40,016	$11,205	$829,131	$2,670,870	$887,386	$3,558,255	$4,250,110
10	$3,500,000	$76,873	$45,300	$12,684	$938,620	$2,561,381	$851,009	$3,412,389	$4,181,117
11	$3,500,000	$76,873	$50,775	$14,217	$1,052,050	$2,447,950	$813,322	$3,261,272	$4,106,872
12	$3,500,000	$76,873	$56,446	$15,805	$1,169,564	$2,330,436	$774,278	$3,104,714	$4,027,187
13	$3,500,000	$76,873	$62,322	$17,450	$1,291,308	$2,208,692	$733,829	$2,942,521	$3,941,867
14	$3,500,000	$76,873	$68,409	$19,155	$1,417,436	$2,082,565	$691,924	$2,774,488	$3,850,707
15	$3,500,000	$76,873	$74,716	$20,920	$1,548,104	$1,951,897	$648,510	$2,600,407	$3,753,498
16	$3,500,000	$0	$77,405	$21,674	$1,603,835	$1,896,165	$629,993	$2,526,158	$3,679,249
17	$3,500,000	$0	$80,192	$22,454	$1,661,573	$1,838,427	$610,810	$2,449,237	$3,602,328
18	$3,500,000	$0	$83,079	$23,262	**$1,721,390**	$1,778,610	$590,936	$2,369,546	$3,522,638

George would need to borrow an additional $1.7M to fully buy out Roger's heirs. Assuming he borrows $1.7M at a 6% interest rate and pays the loan off monthly over 10 years, he would pay $560K of interest for a **total cost of $3.5M**. This total cost includes the $80K invested for 15 years, the loan principal, and the loan interest.

Whole life is a versatile financial instrument that can help protect businesses.

100% loan funding approach

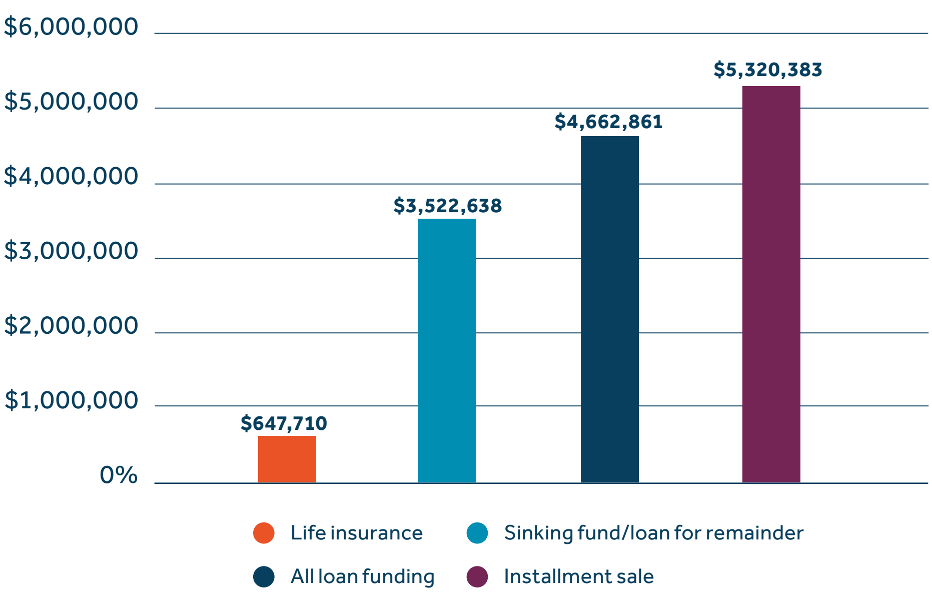
Another option open to George would be to postpone funding the agreement now, and borrow $3.5M when Roger dies. Their Guardian Financial Professional calculates that George would need to make a monthly payment of $38,857 to pay off a loan of $3.5M at 6% interest over 10 years. That represents a **total cost of about $4.6M**.

Installment sale approach

Finally, George speculates that it might make more sense for him to buy the business from Roger's heirs on an installment basis. Their Guardian Financial Professional points out that, under those circumstances, Roger's heirs will most likely want a higher interest rate than a bank would. After all, Roger's heirs are not in the business of lending money and it would be more convenient for them to be bought out all at once. Using the same 10-year time period but a loan interest rate of 9%, their Guardian Financial Professional calculates it would take a monthly payment of about $44K to pay off the installment sale, for a **total cost of $5.3M**.

Each of these funding methods is represented in the chart below. **Note the lower net cost of life insurance when compared to all other funding methods** — on both a net cost and monthly cost basis. In the final analysis, permanent life insurance was able to fund the Buy-Sell Agreement at a fraction of the cost of any of the other three methods.

Comparison of alternatives



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Discover how you can use permanent life insurance to help fund your Buy-Sell Agreement

Contact a Guardian Financial Professional to learn more about the benefits this funding approach can offer your business.

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1 All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

2 Disability provisions, including disability buy-out insurance should also be considered to fund the Buy-Sell Arrangement in the event that it is triggered by the disability of one of the participating owners. Individual disability income products underwritten and issued by Berkshire Life Insurance Company of America, Pittsfield, MA, a wholly owned stock subsidiary of The Guardian Life Insurance Company of America (Guardian), New York, or provided by Guardian. Product provisions and availability may vary by state.

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 professional and refer to your individual whole life policy illustration for more information.

4 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 outstanding loans considered 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 may also be subject to a 10% federal tax penalty.

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