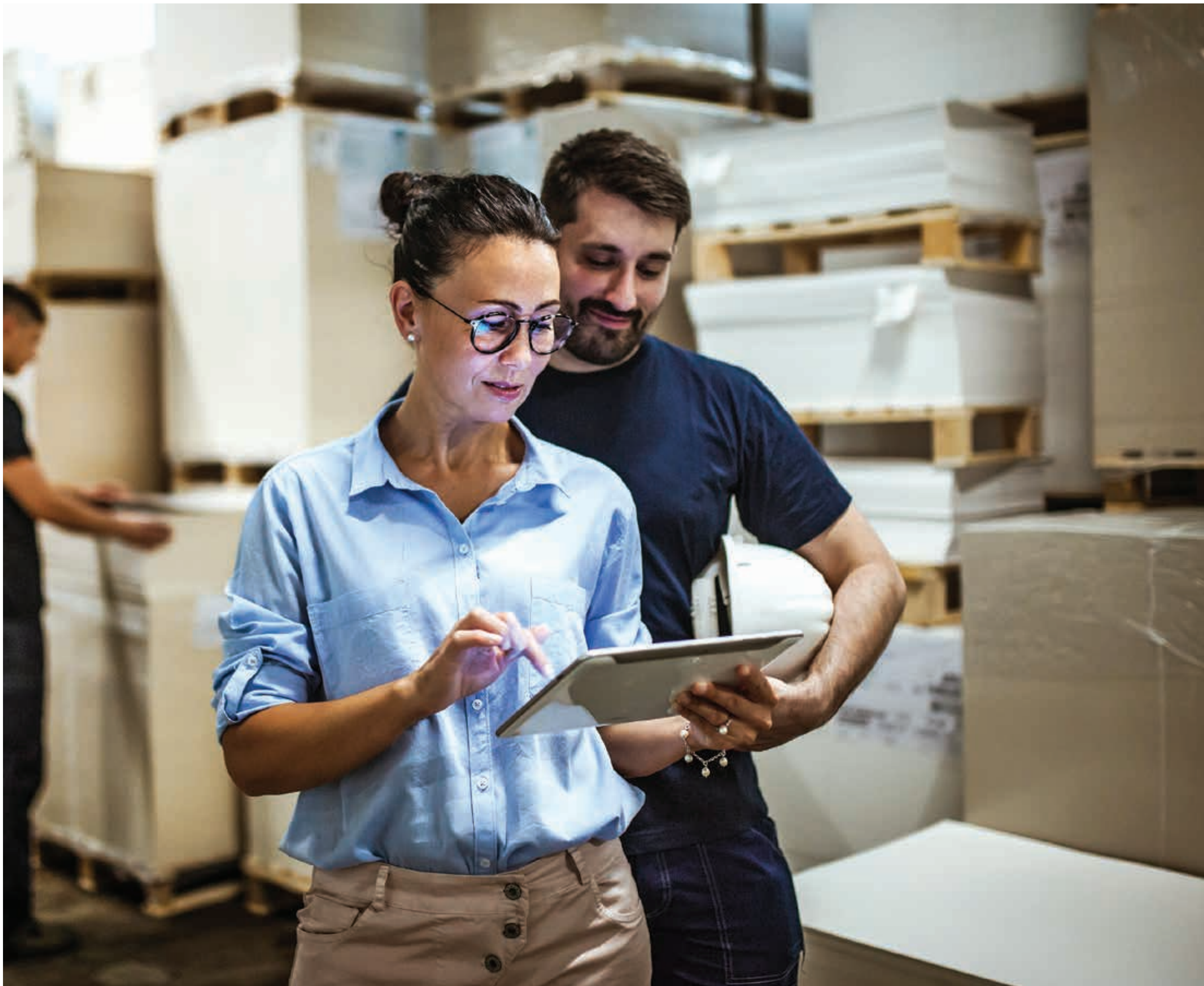
Allianz Life Insurance Company of North America

WHITE PAPER

Strategic exit: A financial professional's guide to helping clients sell their small businesses



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Introduction

Small-business owners typically spend most of their time running the day-to-day operations of their businesses, rather than thinking about what will happen to their business when they are no longer there. One-third of U.S. private business owners said they have no long-term plan or are unsure of the future of their business, according to a recent Gallup survey.[1]

However, just as individuals formulate estate plans to handle their affairs, business owners must also plan for the inevitable. A business exit strategy can accomplish many of the same goals as an estate plan, including protecting the interests of the surviving owners and their heirs. Financial professionals can have an important role in this, helping their small-business-owner clients to prepare an effective written business exit or succession strategy that seeks to meet their goals.

A buy-sell agreement can be an integral part of a business succession plan. These agreements spell out the terms and legal details of what happens to the business interest of an owner when they leave the business, whether upon their retirement, death, or other event.

This guide offers financial professionals six key steps to assist their clients with preparing and implementing life insurance as a funding vehicle for a buy-sell agreement. It includes examples of how buy-sell agreements can be structured to achieve specific results and identifies small details that can create a big impact. It will also discuss the value and implementation of various life insurance options that can be used to fund the plan.

[1] Source: Gallup Pathways to Wealth Survey, March 2025

STEP

1

Fundamental questions

Begin with an initial client conversation. One good starting point may be asking a client what keeps them awake at night when thinking about their business, says Robert Richert, an Advanced Markets Senior Director at Allianz Life Insurance Company of North America (Allianz), who has more than three decades experience in business succession planning.

Posing some "what-if" scenarios can also help clients consider their future planning options and intentions. Questions to consider include:

- *Have you thought about what will happen to your business when you die?*
- *What would happen if one of your key employees or a partner died or became disabled?*
- *If you found yourself operating your business with your partner's spouse or children, would that be a desired solution? Would that work?*

Then, ask if they have a business succession plan in place. If they do, ask for a copy of the agreement to read and review. Next, ask them to explain how they believe the agreement will operate in various scenarios or circumstances, such as if they or another owner dies, becomes disabled and unable to work, decides to retire early, or even goes through a divorce. Some owners may correctly understand how their existing plan will work, but others may find that the existing agreement does not work as they intended, Richert notes.

STEP

2

Consider the advantages of succession planning and buy-sell agreements

Explaining the benefits of succession planning and having a buy-sell agreement in place may help educate your clients about why such plans are critical to their future intentions.

First, succession plans help ensure that the owner's specific wishes and intentions are met in the event of their death, instead of the succession of the business being controlled by certain statutory legal defaults. Much like when a person dies intestate (without a will), when there is no clear succession plan in place, state statutes provide defaults for a business to be terminated or sold in the event of the owner's death, but these results may not be what the owner wants. Clients should consult with an attorney to discuss their specific situation.

Next, succession plans which include a buy-sell agreement can be an effective means of handling conflicts and disputes that frequently arise between surviving owners and heirs of the deceased owner, such as spouses, children and other family members, or even creditors of the owner or the business.

Buy-sell agreements can help ensure that the client's heirs that are entitled to the proceeds of the sale of the business are receiving a fair price in exchange for the deceased owner's share.

In addition, while some clients may be confident that their children or other family members will want to continue their legacy, it may turn out that subsequent generations either aren't interested in, or qualified in, taking over a family business. In many cases, no one will be more passionate about running that business than the original owners. This is a scenario where securing the sale of the business may be the best option, Richert says.

A buy-sell agreement can also establish a market for the deceased owner's interest in the business. The selling owner will be assured that their interest will be purchased, and they'll know in advance how it's going to be valued and how it's going to be paid for. Likewise, the remaining shareholders know exactly what they will pay, and that it will be a fair price, using a valuation method that they've already agreed upon in advance. In this way, a buy-sell avoids the risk that the interest would transfer to an outsider or possibly be undervalued.

A succession plan which includes a buy-sell agreement can make the difference between a smooth and confident transition and one filled with obstacles and conflict.

STEP

3

Deciding how to structure a buy-sell agreement

Depending on the type of business or goals, there are several buy-sell agreement options for businesses to consider. Various factors may determine which type of buy-sell agreement and structure will be suitable for the needs of the business. (See chart at the end of this section.) Some key questions to consider include:

How is the business organized? The business structure itself – whether it's a sole proprietorship, a partnership, a C-corporation, a pass-through (S Corporation), or a Limited Liability Company – often determines what type of buy-sell agreement may be appropriate.

How much is the business worth? What will be the agreed-upon method for valuing an exiting shareholder's interest?

How well is the business doing? Is it growing? What is the cash flow like?

Are there restrictions on who can acquire ownership interest? Is the business a professional association or professional corporation where only licensed professionals in the same field as the corporation are allowed to be owners? For example, in many states, only licensed attorneys can own or control a private law firm.

Is there a fixed number of owners? Who are the owners? You need to be certain that the agreement is updated correctly and all current owners have signed the buy-sell agreement.

Are other family members involved in running the business? Do your wishes include having your spouse or children continue to operate your business? Do you want future generations of your family to continue your legacy business?

Once these factors are determined, financial and legal professionals can help decide which of the following three types of buy-sell agreements may be appropriate for the needs of the business and owners.

Cross-purchase agreement: This type of agreement involves each owner having an obligation to purchase the interest of the other owner in the event of death, disability, or other triggering event. Each owner would own a policy of insurance on each of the other owners. A cross-purchase agreement is more manageable with a small number of owners. For instance, for a two-owner business, each owner owns a life insurance policy on the other. Cross-purchase agreements tend to become expensive and complex when more than three or four owners are involved. For example, if there are five business owners, each would be required to take out a policy on four other owners, adding up to 20 life insurance policies overall. Use the simple formula to determine the number of life insurance policies needed: $N * (N - 1)$, where N represents the number of business owners.

Redemption agreement: In this agreement, the owner's interest is redeemed by the company itself upon the occurrence of a triggering event, such as the death of a shareholder or owner. The company owns a policy of life insurance on each of the owners. This agreement is more commonly used as the number of owners, shareholders, or shares increases. A redemption agreement can make sense from a cash-flow standpoint as well, if the business itself has more cash flow for buying the insurance policies than each individual owner.

Hybrid agreement (wait and see): This agreement often starts as a cross-purchase agreement but allows flexibility. In some instances, the shareholders have the right but not the obligation to purchase the shares and/or interest of the deceased shareholder. If they elect not to purchase, the business then has a mandatory obligation to purchase (i.e., redeem) the shares so that the deceased shareholder's estate can be paid and the interest can come back to the business. A hybrid agreement allows flexibility for shareholders to make the decision whether or not to purchase the deceased owner's interest until the agreement is invoked, which may be years after the agreement is drafted.

Buy-sell agreement comparison

Cross-purchase agreement	Redemption agreement:	Hybrid agreement (wait and see):
Each shareholder has an obligation to purchase the interest of the other shareholder in the event of death, disability, or other triggering events. Each shareholder would own a policy of insurance on each of the other shareholders. More complex when three or more owners are involved. **Business structures:** Partnership, S-Corp, C-Corp, LLC	Owner's interest is redeemed by the company itself upon the occurrence of a triggering event, such as the death of a shareholder or owner. The company owns a policy of life insurance on each of the owners. Common with larger number of owners or shareholders. **Business structures:** Partnership, S-Corp, C-Corp, LLC	A cross-purchase agreement with more flexibility. Shareholders may have the right but not the obligation to purchase the shares and/ or interest of the deceased shareholder. If they elect not to purchase, the business then has a mandatory obligation to purchase the shares. **Business structures:** C-Corp, S-Corp, Partnership, LLC

This information is provided as a general overview and is not intended to be a comprehensive comparison of all aspects, features, and considerations of the options available. Clients should consult with their attorney and tax advisor to discuss their specific situation.

STEP

4

Consult professionals for details of buy-sell agreements

It's never too early for your clients to start mapping out an exit or succession strategy. A team of professionals with different areas of expertise are likely to be involved in stages of succession planning, typically including an attorney, a tax professional, and a financial professional.

A buy-sell agreement may be included as an item on the attorney's business formation checklist, which, for example, if the business is a corporation, includes filing articles of incorporation, writing the bylaws, and corporate resolutions.

Where the buy-sell agreement is included depends on the business formation. For example, in the case of a corporation, the buy-sell may be part of the shareholder agreement. In the case of a limited liability company (LLC), it may be included as part the operating agreement, or in the case of a partnership, as part of the partnership agreement. In any case, a buy-sell agreement can also be a standalone document.

For a corporation, the stock certificates issued should include a restrictive legend on the certificate itself that refers to the buy-sell agreement, Richert explains. If someone tries to transfer the stock, the restrictive legend provides notice to others that there is a buy-sell agreement governing the transfer of the stock that may restrict or even void the transfer.

Meanwhile, in any state with community property jurisdiction, (such as Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), you may need a spousal consent to enter a buy-sell agreement, as the interest in the business may be a community property asset. In that case, a spouse may need to consent in order to transfer the interest in the business to someone other than the surviving spouse.

It's also important for your client to have an attorney looking after his or her interests, which may differ from those of the business. The company, as well as each individual owner, should have their own separate legal representation to review and advise them on the agreement. Likewise, each owner should also have their individual tax professional review the agreement as well.

Since attorneys and tax accountants may not always be knowledgeable in life insurance, those professionals will rely on the financial professional or insurance agent to recommend a life insurance product or products, run appropriate illustrations, and complete the applications to fund the buy-sell agreement.

STEP

5

Determine how the buy-sell will be funded

Funding is a crucial part of the buy-sell agreement. Regardless of what the agreement states, including whether surviving owners have the ability, right, or obligation to purchase the business after the death of one owner, the agreement must include where that funding will come from. If the agreement isn't fully funded, it may not function as effectively as intended or desired.

There are various ways to fund a buy-sell agreement, each with their own advantages and disadvantages. Funding mechanisms may include cash payments, or a sinking fund, which is a pool of money set aside over time by the business owner to fund the buy-out. Another method is installment payments, but this may be restrictive and less beneficial to various parties involved.

Life insurance is a common solution and can be an efficient method for funding a buy-sell agreement as the funds become available upon the occurrence or triggering event, such as the death of an owner.

Connolly v. United States: 2024 U.S. Supreme Court Decision

When using life insurance to fund buy-sell agreements, one important consideration is how the company's receipt of life insurance proceeds from a policy on the life of a deceased owner may affect the valuation of the company and may result in additional estate tax for the family of the deceased shareholder.

In the past, where a company had an obligation to redeem the interest of a deceased owner, the life insurance proceeds received by the company were not considered to increase the value of the company because of the corresponding redemption obligation. But in a Supreme Court case from June 2024, *Connolly vs United States*, the Court determined that the life insurance proceeds increase the value of the company and therefore the value of the ownership interest owned by the deceased owner. This decision may effectively increase the federal estate tax a deceased owner's estate must pay and may also affect the way some buy-sell agreements are structured in the future.

The *Connolly* case involved a company owned by two brothers. A hybrid buy-sell agreement was in place, giving the surviving brother the right to purchase the shares and was backed up by a corporate obligation to redeem the shares.

The company owned a $3.5 million life insurance policy on each of the two brothers. One of the brothers died in 2013, and his surviving brother declined to purchase the shares. The company then was obligated to redeem the shares from the deceased brother's estate and used $3 million from the life insurance proceeds to do so. However, the IRS argued that the deceased's business interest was actually worth $5.3 million, which included the value of life insurance proceeds. The IRS argued that the deceased brother's estate failed to pay the correct amount of estate tax.

This case changed a long-standing assumption that in a redemption agreement, the insurance proceeds do not need to be added to the value of the company when determining the value of the shares. In this case, the IRS decided that the company was getting $3.5 million in life insurance, making the company worth more when valuing the shares in terms of the estate of the deceased shareholder.

A key takeaway from *Connolly* is that business owners may want to re-evaluate their current buy-sell agreements, particularly if they have a redemption agreement in place. Businesses may want to explore with their insurance and legal teams alternative structures, such as a cross-purchase arrangement. They may also consider having their life insurance policies managed by a trust or escrow agent, or even forming a special purpose LLC to own the life insurance policies.

STEP 5 ... continued

Deciding which insurance policies or products may be appropriate to fund the buy-sell will depend on several factors. "Premium costs are often the driving factor on whether funding will be based on term insurance, permanent insurance, or some combination of the two," says Richert.

Like any other type of life insurance strategy, products should be selected based on the need. For instance, if life insurance is intended to fund the buy-sell agreement only in the event of the owner's death, but the owner's interest will not extend past their retirement at age 65, term insurance may be sufficient to meet that need. But if the owner decides that they want to work past their 65th birthday, and the initial term expires, it might be too costly or not possible to renew that initial term policy. In that case, permanent – or cash value – insurance may be a more suitable option.

There can be other advantages to using permanent insurance. Premiums generally remain level over the life of the policy and, unlike term insurance, the available cash value of permanent insurance can be used, through policy loans and/or withdrawals,[1] to meet short-term liquidity needs or to help fund a down payment of a buyout.

Permanent insurance is also more flexible than other life insurance products in terms of premium payments, which, for instance, might help business owners with cash-flow challenges. Payments on these policies gain flexibility once enough premium is paid into the policy to ensure they remain in force. Products such as indexed universal life policies may be more attractive and affordable to business owners, as they carry guaranteed fees and charges, and guaranteed death benefits, Richert says. (Policy guarantees are backed by the issuing insurance company.)

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change, and you should consult a tax professional.

STEP

6

Schedule regular reviews of buy-sell agreements

Financial professionals should schedule periodic reviews of their clients' buy-sell agreements on a regular basis and work with their clients' team of professionals so that the funding can be evaluated, maintained, and updated as needs change. For example, consider a fictional company with a 10-year-old buy-sell agreement. The value of the business has gone up exponentially, but if the business owners haven't commensurately increased the life insurance policies, the buy-sell agreement may no longer be fully funded.

Many aspects of any business can evolve and change over time, with varying degrees of frequency. These changes can be connected to business growth and increased valuations, or changes to the number of owners or shareholders. Every time a new owner or key individual enters the business, the agreement must be updated to reflect these changes, and new owners need to sign and abide by the agreement. Clients should consult with their attorney and/or tax advisor periodically to discuss.[1]

Periodic meetings can be opportunities for agents or financial professionals to review the current insurance policies in place to help make sure they are adequate for funding. The amount of life insurance needed may change at various points over time, and the insurance professional can be proactive in addressing these changes.

Buy-sell agreements are not "set it and forget it" documents.

Walk-through of an event illustrating how life insurance can be an efficient choice for funding a buy-sell agreement

When a business owner dies and a buy-sell agreement is in place, life insurance can provide a valuable funding mechanism to help ensure a smooth process. Life insurance provides the liquidity needed, upon the insured owner's death, so that the company or surviving owners have the ability to buy out the deceased owner's interest in the business. Survivors, such as a spouse, don't need to worry about how they're going to get paid for that interest as the life insurance policy, as a funding vehicle for the agreement, will allow them to receive the full value of that business interest in one payment. Other funding mechanisms, such as the business paying installment payments or a promissory note, may be less attractive as the spouse or other heirs to the deceased owner's estate will have to wait to receive their funds.
This scenario is also better for the company or shareholders, as it helps ensure that they can pay for the buyout and regain control of the business interest of the deceased owner.

[1] This content is for general educational purposes only. It is not intended to provide fiduciary, tax, or legal advice and cannot be used to avoid tax penalties; nor is it intended to market, promote, or recommend any tax plan or arrangement. Allianz Life Insurance Company of North America, its affiliates, and their employees and representatives do not give legal or tax advice. Customers are encouraged to consult with their own legal, tax, and financial professionals for specific advice or product recommendations.

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