Business Continuation Planning
with Life Insurance

Maintaining Business Continuity After the Death or Retirement of a Business Owner

PACIFIC LIFE

AD-OC-745C

Business Continuation Planning

Using Life Insurance

FUTURES CHANGE WHEN A BUSINESS OWNER DIES

Without proper planning, the sudden death of a small business owner may have a devastating impact on the business, the business' employees, and the other owners of the business. It may also have a significant financial impact on his or her family. A properly structured business continuation plan (i.e. a buy-sell agreement) funded with life insurance may help to minimize the impact caused by the loss of a business owner for both the business and the business owner's family.

FAILING TO PLAN CAN HAVE UNINTENDED RESULTS

The sudden death of the business owner lacking a properly structured business continuation plan may:

- Leave the business' operations severely hampered.
- Leave the business owner's family without its primary source of income.
- Leave the business owner's shares without a resale market.
- Create a conflict between the remaining business owners and the decedent business owner's estate regarding the future direction and ownership of the business.
- Leave the business or remaining shareholders with the desire to buy the decedent's shares but lacking an agreed upon price or the available funds to complete the transaction.

WAITING TO PLAN CAN PROVE PROBLEMATIC

Many business owners put off implementing a business continuation plan largely because they do not want to face their own mortality. Postponing the needs for a business continuation plan can have unintended results:

- A change in the insurability of one or more of the business owners, making the life insurance premiums more expensive, or worse, making life insurance unobtainable.
- A change in the business which may make implementation of a business continuation plan at that point impractical.
- A change in the business owner's personal life which may keep him or her from entering into a business continuation plan.

OUTLINING THE BUSINESS OWNER'S GOALS

A properly structured business continuation plan may help answer the question of what happens to a business after the death of a business owner before it is asked. A business continuation plan generally will require a decedent business owner's estate to sell, and either the business or a co-business owner(s) to buy the decedent's interest in the business at an agreed upon price. A business continuation plan may allow for continuity in business management, a source of income for the decedent owner's family, and a clear direction for future ownership of the business. Additionally, a business continuation plan may establish the value of the business for the purposes of both the buy-sell agreement and for estate taxes.[1]

A business continuation plan is usually structured in one of three ways: a stock redemption, a cross purchase or a wait-and-see buy-sell. The basic difference between these three structures is who purchases the shares. In a stock redemption, the business purchases the shares; in a cross purchase, an individual, usually a co-business owner, purchases the shares; and in a wait-and-see buy-sell both the business and the co-business owners may have the opportunity to purchase the shares (please see the following pages in this brochure for more information regarding these structures).

USING LIFE INSURANCE AS THE FUNDING MEDIUM FOR A BUSINESS CONTINUATION PLAN

The implementation of a business continuation plan using life insurance is often quite simple. With the assistance of the business' tax, legal and financial advisors, the business owners will choose which buy-sell structure is most appropriate for their needs. The attorney then drafts a buy-sell agreement which contains the parameters for the arrangement, including, but not limited to; the possible triggering events for the buy-sell (e.g. death, disability, retirement, etc.) and how the purchase price will be determined. The parties involved in the buy-sell agreement will then purchase life insurance through a life insurance producer on the business owner's life. If the arrangement is structured as a stock redemption, the business will generally be the owner and beneficiary of the life insurance policies. If the arrangement is structured as a cross purchase or a wait-and-see buy-sell, the co-business owners will generally be the owner and beneficiary of the life insurance policies. When the business owner dies, the beneficiary of the life insurance policy receives the policy's death benefit. The beneficiary can use the death benefit proceeds to purchase the decedent's shares of the business as outlined in the business continuation plan.

Note that due to existing and pending state insurable interest laws the client may not have an insurable interest in the insured unless certain conditions are met. Failure to satisfy state insurable interest requirements may result in disqualification of the policy as "life insurance" under IRC Section 7702, and also may among other things void the policy.

[1] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

FEATURES

A properly structured business continuation plan that includes life insurance may provide the parties with the following features:

- Continuity of management and control for the remaining owners.
- A source of income for the decedent business owner's family.
- A captive market for often non-marketable business interests.
- Liquidity to the decedent's estate for estate taxes and administration costs.
- A fair valuation of the business interest for federal estate tax purposes.[1]
- A fair return to the decedent's estate for his or her business interest.

IMPORTANT NOTE ON IRC SECTION 101(j)

IRC Section 101(j) places certain requirements on employer-owned life insurance policies for the policies to retain their tax-free* death benefit. Most, if not all, of the policies purchased to fund a business continuation plan will be required to meet these requirements. It is the employer's responsibility to determine whether life insurance policies will be subject to IRC Section 101(j), and ensure compliance with its requirements. Of particular concern when structuring a business continuation plan is IRC Section 101(j)'s notice and consent requirement. Prior to the issuance of the policy, the business must provide the proposed insured with a written notice containing the following information:

- The business will be the beneficiary of the policy and may remain so even after the proposed insured is no longer with the business.
- The maximum amount of life insurance that the business will purchase on the proposed insured.

The proposed insured must then consent in writing that the employer may purchase life insurance on his or her life. Please note that unless the notice and consent requirement is met prior to the policy issuance date, the majority, if not all, of the policy's death benefit will be subject to income tax.

CASH VALUE LIFE INSURANCE PROVIDES ADDED BENEFITS

Some business owners may initially consider term insurance to fund their business continuation plan. While using term life insurance may suffice in some arrangements, in many cases cash value life insurance policies are a more appropriate funding mechanism for a buy-sell agreement. While a term policy may be less expensive in the early years of the arrangement, cash value life insurance policies may provide the parties in a buy-sell agreement with the following benefits when compared to term life insurance:

- The cash value of the policy may be used as part of a lifetime buyout. Often, a buy-sell occurs for a reason other than the death of a business owner (e.g. retirement, disability, or a specified date). The policyowner may use any available cash value in the life insurance policy to pay for part of the buyout price at a business owner's retirement.
- The insured(s) may not have to re-qualify for insurance. At the end of a fixed duration term life insurance policy, rates may increase dramatically. At this point the purchase of a new term life insurance policy may be cost prohibitive.
- If the arrangement is a stock redemption, the business may book the policy cash value as an asset and may access any available policy cash value for emergencies or other financial needs.
- If the arrangement is a cross purchase or wait-and-see buy-sell, the policyowners/business owners may access any available cash value for emergencies or other financial needs.

[1] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

* *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

Stock Redemption

Funded with
Life Insurance

1 **Agreement:** Working with the business' legal, tax and financial advisors, the business owner(s) and the business enter into a stock redemption agreement. The agreement will require the business to purchase the business owner's interest in the business for an agreed upon price upon the occurrence of a triggering event (e.g. death, retirement or disability).

2 **Premium:** To fund its purchase obligation, the business will purchase a life insurance policy through a life insurance producer on the business owner's life. Prior to the issuance of the life insurance policy, the business must provide written notice to the business owner that it intends to buy life insurance on the business owner's life. The notice must state that the business will be the beneficiary of the policy and may remain so even after the business owner is no longer with the business. Additionally, the notice will state the maximum amount of life insurance that the business will purchase on the business owner. After the business owner receives the notice, he or she will provide the business with written consent to purchase the life insurance. The business will pay the policy premiums and will be the policy beneficiary.

3 **Death Benefit:** At the business owner's death, the business will receive the life insurance death benefit income tax-free.*

4 **Stock Purchase:** The business will apply the death benefit proceeds towards the purchase of the decedent business owner's interest in the business from his or her estate.

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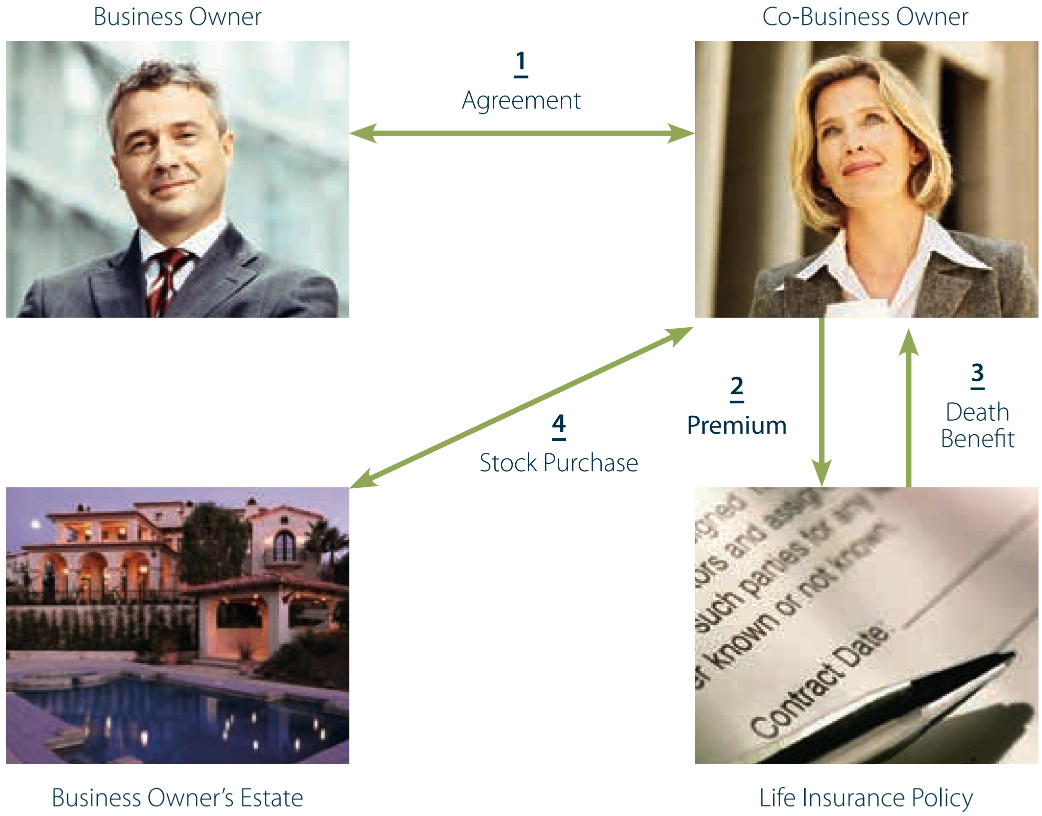
Cross Purchase

Funded with Life Insurance



1 **Agreement:** Working with the business' legal, tax and financial advisors, the business owner and his or her co-business owner(s) enter into a cross purchase agreement. The agreement will require the business owners to purchase a decedent or departing business owner's interest in the business for an agreed upon price upon the occurrence of a triggering event (e.g. death, retirement or disability).

2 **Premium:** To fund their purchase obligation, the business owners will purchase a life insurance policy (or life insurance policies) through a life insurance producer on the lives of the other participating business owners. The policyowner will pay the policy premiums and will be the policy beneficiary.

3 **Death Benefit:** At the first business owner's death, the co-business owners will receive the life insurance death benefit income tax-free.*

4 **Stock Purchase:** The co-business owners will apply the death benefit proceeds towards the purchase of the decedent business owner's interest in the business from his or her estate.

* *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

Wait-and-See Buy-Sell

Funded with Life Insurance

1 **Agreement:** Working with the business' legal, tax and financial advisors, the business and the business owners enter into a wait-and-see buy-sell agreement. The agreement will give the business the first option to purchase a business owner's interest in a business upon the occurrence of a triggering event (e.g. death, retirement or disability). If the business does not exercise its option, the co-business owners will have an option to purchase the departing or decedent business owner's interest. If the co-business owners do not exercise their option, generally the business will be required to purchase the departing or decedent business owner's interest in the business.

2 **Premium:** To fund the purchase obligation, the business owners will purchase a life insurance policy (or life insurance policies) through a life insurance producer on the lives of the other participating business owners. The policyowner will pay the policy premiums and will be the policy beneficiary.

3 **Death Benefit:** At a business owner's death, the co-business owners will receive the life insurance death benefit income tax-free.*

4A **Capital Contribution or Loan:** If the business decides to exercise its option to purchase the shares, the co-business owners may contribute the death benefit proceeds they received to the business as a capital contribution or a loan.

4B **Stock Purchase:** The business will apply the business owner's contributions towards the purchase of the decedent business owner's interest in the business from his or her estate.

5 **Stock Purchase:** If the business decides not to exercise its purchase option, the co-business owner may exercise his or hers. If so, he or she will apply the death benefit proceeds towards the purchase of the decedent business owner's interest in the business from his or her estate.

* *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

Stock Redemption

ADVANTAGES INCLUDE

- This is a simple design because only one policy is required per business owner.
- The business pays the life insurance premiums.
- The business may carry the life insurance cash value on its books as an asset.
- The business may access any available policy cash value through loans and withdrawals up to basis potentially income tax-free.[2]

DISADVANTAGES INCLUDE

- A stock redemption may not provide a step-up in basis for the remaining business owners.
- Creditors of the business may make claims against the life insurance policy cash value.
- The life insurance premiums are not a deductible expense.
- Life insurance cash value increases and death benefit proceeds may result in corporate alternative minimum tax if the business is a C-Corporation.

Cross Purchase

ADVANTAGES INCLUDE

- The purchasing business owner(s) may receive an increase in his or her basis in the business equal to the purchase price of the shares.
- Creditors of the business may not have the ability to make claims against the cash value of the policies.
- The life insurance cash value increases and death benefit proceeds will not result in corporate alternative minimum tax.

DISADVANTAGES INCLUDE

- A cross purchase will generally require that a business owner buy a policy on all the other business owners participating in the cross purchase.
- The business owners will make the premium payments.
- The cash value of policies owned on other business owners may be included in a decedent business owner's estate.

Wait-and-See Buy-Sell

ADVANTAGES INCLUDE

- Allows flexibility in the structure of the buyout.
- May provide the remaining business owners with an increase in their basis in the business.

DISADVANTAGES INCLUDE

- The implementation of a wait-and-see buy-sell is more complex than a stock redemption or a cross purchase.

[2] Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 72, 7702(f)(7)(B), 7702A.Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

Vital Information

This fact finder is provided to help you and your life insurance producer better understand your goals and objectives. Please return the information to your life insurance producer and not to Pacific Life as we cannot and do not provide financial, legal or tax advice.

Name of Business:____________________

Address: ____________________

Nature of Business or Profession: __________ Year Organized: __________

Earnings (net before taxes, last four years) 20____ $________ 20____ $________ 20____ $________ 20____ $________

Book Value (assets minus liabilities):____________________

Value of Business as Going Concern: ____________________

(based on projected earnings of business): __________ $:__________

Liquidation Value (estimated):__________ $:__________

Business Tax Bracket: ____________________

Is there a buy-sell agreement in effect? ________ If so, specify:

Type of Agreement: ____________________

Parties:____________________

____

Dated: ____________________

Purchase Price: $____________________

Funding Mechanism: ____________________

When was the last time the agreement was reviewed? __________

What do you want to accomplish with the agreement? __________

Events Triggering Buyout:

Death: ____________________

Disability: ____________________

Retirement: ____________________

Bankruptcy: ____________________

Business Owners:

Name	Shares/Class	Tax Bracket	Smoker/NonSmoker	Date of Birth	Life Insurance In-Force
				/ /	
				/ /	
				/ /	
				/ /	

Financial Advisor Name: ____________________ Phone Number: __________

Attorney Name: ____________________ Phone Number: __________

Accountant Name: ____________________ Phone Number: __________

Notes

PACIFIC LIFE

Pacific Life Insurance Company
Newport Beach, CA
(800) 800-7681 • www.PacificLife.com

Pacific Life & Annuity Company
Newport Beach, CA
(888) 595-6996 • www.PacificLife.com

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Please Note: This brochure is designed to provide introductory information in regard to the subject matter covered. Neither Pacific Life nor its representatives offer legal or tax advice. Consult your attorney or tax advisor for complete up-to-date information concerning federal and state tax laws in this area.

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