StatonWalsh

Financial Clarity Through Transparency

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December 31, 2021

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Disability of a Business Owner

Many business owners have created buy-sell agreements to protect themselves and their businesses in case of an untimely death. These agreements are often funded with life insurance to ensure that the cash to purchase the business is available when needed.

Permanent disability is another threat faced by business owners. Disability of an owner can create immediate issues as to who will operate and manage the business. Often, the risk of a permanent disability is not provided for in a buy-sell agreement in spite of the fact that the probability of a long-term disability prior to age 65 is greater than the probability of death.

To provide for this risk, business owners can amend existing buy-sell agreements or create separate agreements. Special disability insurance policies can be used to fund a disability buy-sell agreement. These policies can be set up to pay a lump sum, a series of payments, or a combination of the two.

Key Elements to Consider

- **Definition of disability:** How disability is defined in the agreement is very important and should probably be tied to the definition in the disability insurance policy.
- **Elimination period:** The period of time between the first day of the disability and the trigger date, e.g., 12 months to 24 months are frequent options.
- **Trigger date:** This is the date at the end of the elimination period when the buyout begins and the insurance company begins paying on the policy.
- **Successive disability:** A disabled person may temporarily return to work but thereafter have a recurrence of the disability. In many plans, successive disability periods can be tied together to meet the elimination period.
- **Funding period:** The period over which the buyout payments are made. It can be an immediate lump sum or spread out over a period of months, or a combination of both. The funding period set in the policy should match the terms of the buy-sell agreement.
- **Recover from disability:** The recovery of a disabled person after the buyout has begun can raise several questions, among them: Does the funding stop? Can the person return to work with the same company? Lump sum settlement plans, in some cases, can remove some of the uncertainty.

- **Buy-sell agreement:** The buy-sell agreement must be in force at the time of disability in order for payments to be made from the policy.
- **Converting to individual coverage:** Sometimes the disability plan will be convertible to individual coverage if the business has no further need for the coverage, the owner needs additional individual coverage, and he or she meets certain requirements.
- **Involvement in the business:** Many insurers require that the business owner be actively involved in the business.

Tax Basics for Disability Buyouts

	Corporation		Partnership	
	Stock Redemption by the Corporation	Cross Purchase by the Stockholders	Entity Buy-Sell by the Partnership	Cross Purchase by the Partners
Are premiums for a disability policy to fund a buyout deductible?	No IRC Sec. 265(a)(1)	No IRC Sec. 265(a)(1)	No IRC Sec. 265(a)(1)	No IRC Sec. 265(a)(1)
Are the proceeds from a disability policy taxable income?	No IRC Sec. 104(a)(3)	No IRC Sec. 104(a)(3)	No IRC Sec. 104(a)(3)	No IRC Sec. 104(a)(3)
Are payments from the corporation or partnership to individual owner deductible to the entity?	No	N/A	No	N/A
How are benefits taxed to the individual receiving them?	If a complete redemption, it is treated as a sale or exchange. IRC Sec. 302(b)(3)	Capital gain on excess of purchase price over his or her basis in the stock. IRC Secs. 1001; 1221; 1222	Return of basis is nontaxable. Excess is generally taxed as ordinary income. IRC Sec. 736(b)	Capital gain on excess of purchase price over his or her basis in the partnership.

	Corporation		Partnership	
	Stock Redemption by the Corporation	Cross Purchase by the Stockholders	Entity Buy-Sell by the Partnership	Cross Purchase by the Partners
Can the sale qualify as an installment sale to prorate the gains over the years in which payments are received?	Yes IRC Sec. 453	Yes IRC Sec. 453	Yes IRC Sec. 453	Yes IRC Sec. 453

Business Overhead Expense

Another form of disability insurance specially suited to the business owner is Business Overhead Expense (BOE). BOE policies are designed to reimburse certain business expenses of the owner while he or she is totally or partially disabled. The funds provided by the BOE policy help the business survive during the period of the owner's disability. Often, the BOE policy is the reason the owner has a business to return to after the disability. Should the disability appear permanent, the owner usually has additional time to make decisions regarding the future of the business.

Generally speaking, there are only certain types of business owners who qualify for BOE coverage. These include owners of closely held businesses, owners of small businesses and professionals with their own practices.

Some of the expenses typically covered by a BOE policy include the following:

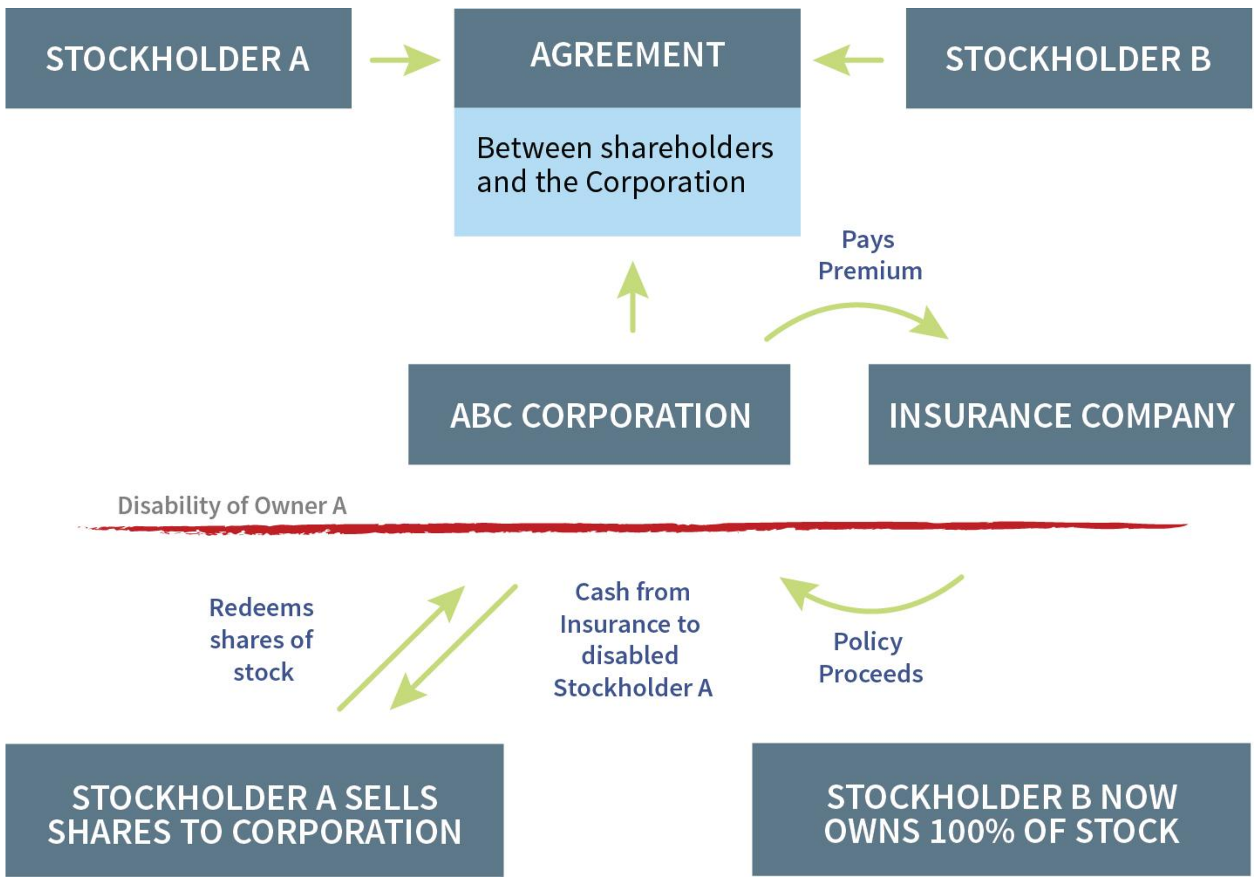
- Legal and accounting fees.
- Utilities.
- Principal payments on debt.
- Leased equipment.
- Business insurance premiums.
- Office supplies.

- Salaries of non-owner, non-family employees.
- Professional dues.
- Business taxes.
- Rent.
- Workers compensation.

In no instance is there any payment from a BOE policy to the business owner. Instead, these funds must come from his or her own disability plan.

Disability Buy-Out Stock Redemption Plan

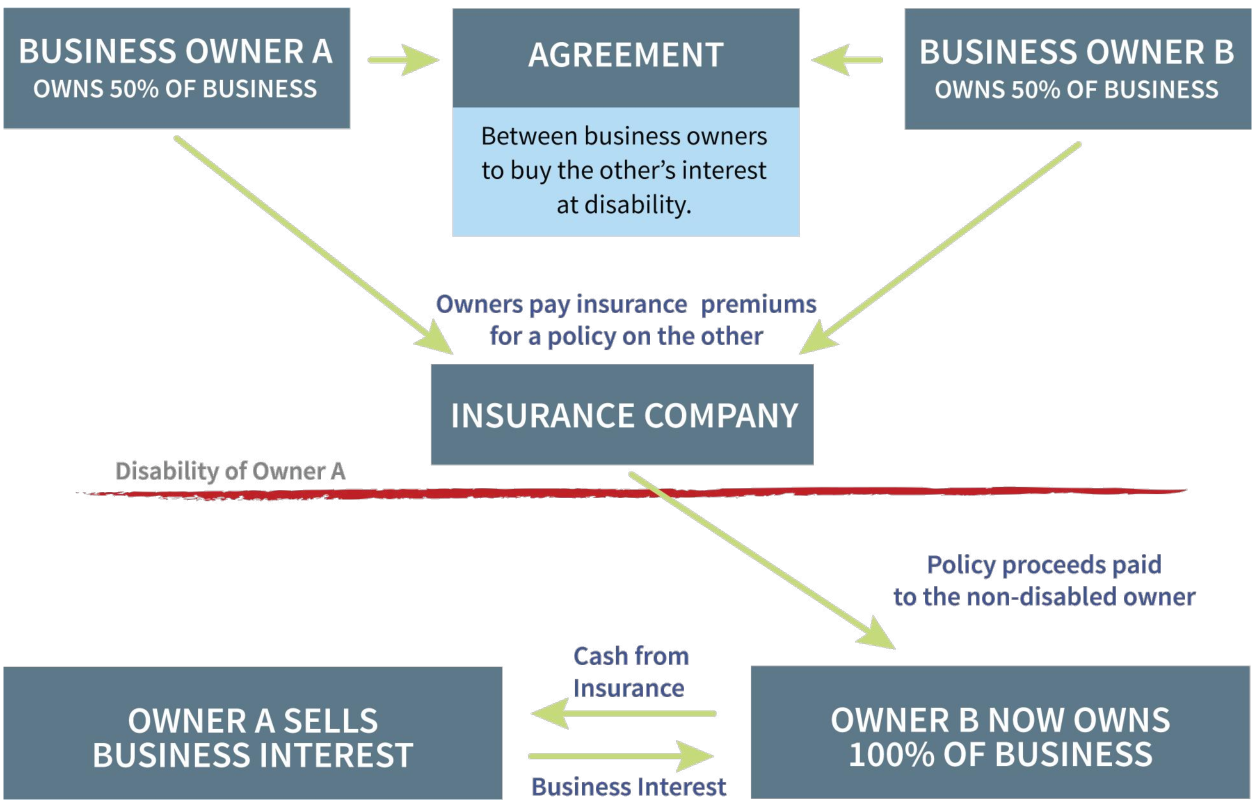
A stock redemption plan involves stockholders entering into an agreement with the corporation to insure an orderly disposition of their stock in the event of disability.



Advantages	Disadvantages
Usually easier to understand than the cross-purchase plan.	Voting power may be altered unfavorably.
Fewer policies in insured plans.	Strict state redemption laws must be followed.
No questions as to unreasonable compensation issues when agreement is properly written.	Value of non-disabled owner's shares increase but not basis.

Disability Buy-Out Cross-Purchase Agreement

A cross-purchase buy-sell agreement involves business owners entering into an agreement with each other to assure an orderly disposition of their business interest in the event of disability.



Advantages	Disadvantages
The transferred interests receive a new income tax basis equal to the price paid. This will mean a tax savings, if the interest is later sold at a higher price.	Plan is more difficult to administer if more than two or three business owners.
No problem with state laws restricting redemptions.	Requires more policies, e.g., 12 policies for 4 owners, 20 policies for 5 owners, etc.
Disability policies may be insulated from the company's creditors.	Policies may lapse if owner doesn't make the payments.

Business Need for Disability Insurance

Self-motivated individuals frequently play a crucial role in the success of a business. This is particularly true of small businesses in which one or two talented people possess highly specialized skills or knowledge that other employees do not have. If such a "key" person were to suffer a long-term disability, not only would the individual face substantial financial risk, but the very survival of the company could be in jeopardy.

Although sole-proprietorships and partnerships are generally the most vulnerable, corporations, particularly corporations built around one or two individuals, are also at significant risk. However the business is organized, when you consider the likelihood that you or one of your key employees may become disabled, there is a clear need to protect both your personal income and the financial well-being of the company.

Options to Consider

There is no single strategy or policy to protect your business from the risks posed by a key employee's disability. Like a puzzle, a number of pieces are needed to complete the picture:

- **Adequate cash reserves:** Liquid funds can cover a short-term disability.
- **Key employee disability insurance:** Pays income to a disabled key employee. If the employer pays any portion of the premium, then a proportionate amount of the benefit is taxable income to the employee. If the employer pays the entire premium, the entire benefit is taxable.
- **Business overhead expense insurance:** This type of insurance covers normal operating expenses such as employee salaries, equipment leases, utilities, rent, advertising, maintenance, etc.
- **Qualified sick pay plan:** The federal tax code prohibits a business owner from paying himself (or herself) a salary while disabled, and then deducting the payments as an allowable business expense. A formal, written qualified sick pay plan (also known as a salary continuation plan), established in advance, can provide for funding the disability benefits as well as maximizing the tax benefits.
- **Disability buy-out:** In the event that you or another owner of the business suffers a permanent disability, disability insurance can be used to fund a buy-sell agreement.

Seek Professional Guidance

The guidance of knowledgeable tax and insurance professionals is essential in preparing for the potential impact of disability on a business.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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