Harmony Wealth Strategies
William F. McAllister, Jr., CLU®
22 Morgan Farms Drive, Suite 4
South Windsor, CT 06074
860-836-9314
Bill@HarmonyWealthStrategies.com
www.HarmonyWealthStrategies.com

Harmony Wealth Strategies
BUILDING AND SAFEGUARDING YOUR FINANCIAL WORLD

Funding Your Buy-Sell Agreement with Disability Insurance

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What is disability insurance?

Disability insurance is an insurance policy that pays a benefit in the event of a long-term illness or injury. The policy contains specific definitions of what constitutes a disability and the time frame (waiting period) between the disabling event and the first benefit payment.

How can disability affect your business?

Higher likelihood of owner disability than death for given period

The scary fact is, the likelihood of you or one of your co-owners becoming sick or injured for 12 months or longer before age 65 is much higher than the likelihood of any one of you dying. This means a higher likelihood of the buy-sell agreement being triggered by disability than death for any given year.

Disabled owner still needs income and the business may be unable to continue paying salary

If you become sick or hurt, you would still need income to cover your living expenses. Health insurance may cover all or most of your medical needs, but it can't do much for your mortgage, your car payment, shoes for your kids, or your grocery bill. The business may not be able to pay you a salary for not working without the payments being considered dividends. Generally, companies are allowed to pay dividends only under certain circumstances, and the money must come from surplus funds.

Tip: *A disability salary continuation agreement established before an event of disability would allow the company to continue paying salary to a disabled owner for a specific period of time. The agreement can be structured to apply to certain individuals or groups, without covering all employees.*

Co-owners may be unhappy paying nonproductive owner

Your co-owners will probably be reluctant to continue paying you if you cannot work. Even if the company is able to do it, continuing to pay out your salary will probably cause a cash drain on the company as well as extra work for the remaining co-owners who are trying to fill your duties while you are out of work.

Business may be directly affected by your absence

Your business may be adversely affected by your sudden absence due to disability. Depending upon your role within the business, your absence due to disability could result in a slowdown or even a loss of sales; replacement costs incurred in attempting to find and train a replacement; possible slowdowns in production; and the possible loss of goodwill with customers and trading partners.

How can you use disability insurance with your buy-sell agreement?

Disability insurance can be used in addition to the funding method you have decided on for the purchase of a business interest at an owner's death or retirement. It provides the buyer with money to pay for your interest when you become sick or injured for a long time. If the buy-sell agreement is an entity purchase plan, the business generally owns, pays for, and is the beneficiary on the disability policy. With a cross purchase agreement, the individuals bound under the agreement generally own, pay for, and are the beneficiaries on the policies on each other. When you become sick or hurt, a waiting period (usually 12 to 24 months) begins. At the end of the waiting period, the policy pays the benefit in either a lump sum, installment payments, or a combination of the two.

What are the benefits of using disability insurance with your buy-sell agreement?

Income protection for you and your family

The disability clause in your buy-sell agreement and disability insurance funding provide income protection for your family. Your buy-sell agreement establishes the buyer for your interest as well as the conditions under which they must buy. When you become sick or hurt, the disability insurance provides the buyer with the money to pay for your share of the business.

Increase chances of receiving fair price if you have to sell

If you become sick or injured and are unable to participate in your business, you may be forced to sell your interest. If your buy-sell agreement is funded for a purchase only at your death but you are alive and disabled, the buyer under your buy-sell agreement may not have all the cash to pay for your interest (for instance, if funding was arranged for a buyout at death). You could be at a negotiating disadvantage if you are allowed to try to find a buyer outside the buy-sell agreement. Chances are high that you will not be able to get a fair price for your share of the business if you are forced to sell quickly due to disability.

Disability defined

Disability insurance policies contain a definition of disability (which can vary between policies), an explanation of what happens in the event of a recurring disability, and the time period before benefit payments begin. This frees the company or shareholders from trying to define the conditions of disability. It frees the sick or injured person (maybe you?) from having to prove to co-owners an inability to work. It becomes the responsibility of the insurance company to monitor the disability.

Tip: *Coordinate the terms of your buy-sell agreement disability clause with the policy definition of disability. When your buy-sell has the same definition of disability as your insurance policy, any potential for confusion or disagreement is eliminated.*

What are the drawbacks to using disability insurance with your buy-sell agreement?

You may be uninsurable

If insurance companies consider you uninsurable, you will not be able to get disability insurance. Factors that could make someone ineligible for disability insurance include a history of certain health problems, high-risk hobbies such as skydiving or auto racing, or employment in certain occupations.

Can't be used to fund buy-out of retiring or withdrawing healthy owner

Although disability insurance can be used effectively to fund the purchase of your business interest when you are sick or injured, there is no policy benefit available if you are retiring or withdrawing from the business when you are healthy. Unlike life insurance, a disability policy can't be surrendered in exchange for a payment from accumulated cash values.

Benefits payable to corporation could trigger alternative minimum tax (AMT)

If your business is a C corporation, disability policy benefits paid to the corporation under an entity purchase agreement could trigger the AMT. When the company receives disability insurance proceeds, the amount received will increase an existing AMT liability or create a new exposure to the (very complicated) tax. If the business is subject to additional tax as a result of receiving disability proceeds, there will be less cash available to pay you.

Insurance premiums not tax deductible

The premiums for disability insurance to fund your buy-sell agreement are not deductible. It makes no difference if the payments are made by the business itself or the individual owners.

What could go wrong using disability insurance with your buy-sell agreement?

You could recover after the sale of your business interest

It is possible (though maybe not probable) that you could recover from your illness or injury after you sold your business interest under the disability clause of your buy-sell agreement. If this happened, you would find yourself without your business and possibly forced to start all over again in a new business or career.

Tip: *Disability insurance policies contain a waiting period before benefits are paid. It is generally advisable to use a long waiting period (e.g., 24 months) for the disability insurance and trigger date for the buy-sell agreement. By using a long waiting period, you reduce the chances that you will recover after you have sold your interest. In addition, longer waiting periods reduce the policy premiums.*

Tip: *Make sure that your buy-sell agreement and your disability policy address what will happen if you do recover after the transfer of your interest has taken place or begun. It should specify whether you would be eligible to get your interest back should you recover after the waiting period.*

Conflict between policy terms and buy-sell agreement terms

Perhaps the biggest (but completely avoidable) problem you could run into using disability insurance with your buy-sell agreement is a conflict between the terms of the insurance policy and the terms of your agreement.

For example, your buy-sell agreement might state that the waiting period between the time you become disabled and the time your interest is bought is 12 months, but the disability insurance policy might have a waiting period of 24 months. You may be under the assumption that you will be able to sell your interest to the buyer named in the buy-sell agreement after a full year of sickness or injury, only to find out that you have another year to wait before there is any money.

It is important to make sure that the terms of the disability policy and the buy-sell agreement disability clause are the same. The following table shows the areas to pay particular attention to when setting up the disability clause and the policy:

Coordinate Disability Insurance Policy Terms with Buy-Sell Agreement	
Disability definition	**What is disabled? Unable to perform own job, or any job?**
Waiting period	**How long after disability occurs before benefit is paid?**
Trigger date	**When does sale of the interest become mandatory?**
Recovery	**If you recover after the buy-sell transaction has begun, can you get your shares back?**
Recurring disability	**What if your disability returns when you appeared to have recovered?**
Payment terms	**Will the payment be made in a lump sum, installments, or a combination of the two?**

Policy allowed to lapse--no benefit when needed

It is an unfortunate possibility that the premiums on the disability policy may not be paid, causing the policy to lapse. If this happens, there will be no insurance benefit when you become sick or disabled.

Tip: *Monitor the premium payments, and make sure they are paid. This way, you can avoid the unpleasant surprise of discovering there is no disability insurance to pay for your business interest after you have sustained a major illness or injury.*

Are there any alternatives to fund a disability buy-out under your buy-sell agreement?

Alternatives for funding the disability clause of your buy-sell agreement, along with the benefits to you as the seller, are shown in the following table:

Funding Alternatives for Disability Buyout		
Funding Method	**Seller Advantages**	**Seller Disadvantages**

Lump-Sum Cash	**Seller gets money up front**	**Seller may not get money if buyer doesn't have it**
Private Annuity	**Often used in family transfers when business owner in poor health**	**Seller becomes unsecured creditor of buyer**
Borrowings	**Seller gets money up front**	**Seller may not get money if buyer doesn't have access to credit**
Installment Payments	**Seller can set favorable interest rate Gain can be spread over time**	**Seller becomes creditor of buyer**
Sale-Leaseback	**Seller gets money up front**	**No guarantee sale-leaseback transaction will occur**
Life Insurance	**Seller gets money up front from policy accumulated cash value**	**Cash value may not be large enough for total buyout Cash value may not be available**
Disability Insurance	**Seller can "cash out" of business after disability**	**Seller could recover from disability, no longer have a business**

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