# Funding a Buy-Sell Agreement with Disability Insurance

You may have a great buy-sell agreement in place at the company where you are a partner or co-owner--one that clearly stipulates how much your family will be paid for your share of the business interest in the event of your death. It may also cover early retirement and the buyout terms under those circumstances. But what if you become disabled long before you are likely to die or retire? Insurance industry statistics show that the chance of you or one of your co-owners sustaining a long-term illness or injury (over one year) before age 65 is much greater than the odds of any one of you dying prematurely. Disability income insurance may provide a solution.

## How disability income insurance works

If you were to suffer a severe injury or develop some type of long-term illness, you would probably be unable to earn a paycheck during that time. Disability income insurance is a salary-continuation agreement that replaces a portion of your income while you are injured or ill. Disability insurance with your buy-sell agreement provides the funds to allow your company to continue paying your salary or to completely buy your share of the business if your disability is permanent.

Keep in mind that disability insurance is designed to protect you in the event of a long-term illness or injury. So, a disability insurance policy includes an elimination period (i.e., a waiting period between the time you become sick or injured and the time any benefits are paid). Some policies call for waiting periods as long as one or two years, so you will need to depend on your savings and other investments for a considerable period of time. Depending on the type of policy, you can receive benefit payments in either a lump sum, installment payments, or a combination of the two. Disability insurance should generally be used in addition to the funding method you have chosen for the purchase of your business interest at your death or retirement.

## Coordinate the disability policy with your buy-sell agreement

You should make sure that any conflict between the provisions of your disability income insurance policy and your buy-sell agreement is eliminated at the outset. The buy-sell agreement should contain the same definition of disability as your disability policy. Determine when the agreement requires a complete buyout after you become sick or injured. Also, coordinate the waiting period, how benefits are paid, and how you may be able to buy your shares back if you recover from your illness or injury.

## Different types of buy-sell agreements

If your buy-sell agreement is an entity purchase (stock redemption) plan, the company itself buys disability policies for each of the shareholders or partners. The company is the owner, premium payer, and beneficiary of the policies. With a cross purchase (crisscross) agreement, you and your co-owners agree as individuals to purchase the business interest of any co-owner who becomes disabled. Under the terms of the agreement, you buy a separate disability policy on each of the other co-owners; in turn, each co-owner buys a policy on you. Each of you is the owner, premium payer, and beneficiary of the policies you have purchased. Be aware that tax consequences may arise if the company pays the premiums on policies under a cross purchase agreement. A wait and see (hybrid) buy-sell agreement allows you to combine features of both an entity purchase and cross purchase agreement.

## Disability income funding can ensure you a fair price

The greatest advantage offered by using disability insurance with your buy-sell agreement is that you can receive the full value of your business interest if you become disabled before your death or normal retirement. For example, say you become permanently disabled in an auto accident. You are unable to work and want to sell your interest in the business you helped establish, but the company doesn't have the cash to pay you right now. Without disability coverage in this circumstance, you might be forced to go outside the company to sell your business interest. You could end up selling the interest for less than it is worth.

Funding your buy-sell agreement with disability insurance assures that the other co-owners will buy your interest, names the conditions under which they will purchase your interest, and provides the money to pay you a fair price. If your injury is not permanent, disability insurance will provide income protection for your family while you are recovering.

## What are the drawbacks of using disability insurance?

- Insurance premiums are not tax deductible. It makes no difference if the payments are made by the business itself or the individual owners.
- Insurance companies may consider you uninsurable--ineligible for disability insurance--due to factors such as your age, health problems, high-risk hobbies, or employment in certain occupations.
- Disability insurance can be used only if you're sick or injured. There is no policy benefit available if you die or retire from the business when you're healthy.

## What happens if you recover from your disability?

It's possible that you could recover from your illness or injury after you've already sold your business interest under your buy-sell agreement's disability clause. If this happens, you could find yourself without a business, career, or income. Make sure that your buy-sell agreement addresses whether you'll be eligible to buy your shares back if you recover after the waiting period. The agreement should contain a schedule specifying how your interest will be transferred back to you. Because it is possible that you'll recover from your disability, it is generally advisable to set up a long waiting period before the policy pays salary continuation benefits or triggers the purchase of your share of the company. This reduces the chance that you may recover from your disability after having sold your business interest. In addition, longer waiting periods reduce the policy premiums.

## Monitoring your buy-sell agreement

Remember that the disability insurance with your buy-sell agreement will provide you with no benefit if the policy is allowed to lapse. Make sure that all required premiums are regularly paid. You don't want to leave yourself and your family unprotected at a time when you're sick or injured. While you're at it, check up on the other funding components of your buy-sell agreement. And if the agreement is not fully funded, push to have this done as soon as it is financially feasible for the company. Finally, as the company grows, it's important to periodically review the buy-sell document and the funding vehicles to ensure that they're keeping pace with the current value of your business.

Wealth Management Group, LLC
2000 Winton Rd. So.
Building 4A
Rochester, NY 14618
585-241-5900