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. 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.

Disability of a Business Owner

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.
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

Disability of a Business Owner

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.