ADVANCED MARKETS INSIGHT

ATLAS
ADVISORY GROUP, LLC
Grow Protect Preserve

M Financial Group's Advanced Markets Insights are designed to help clients understand sophisticated planning strategies and their applications.

M Financial Group continues to lead the industry in insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

Using Life Insurance to Protect a Business Installment Sale

Borrowing Funds to Buy a Business

An important option for financing the purchase of a business interest under a buy-sell plan is the use of debt instruments. Often, the buyer has insufficient cash reserves for an outright purchase. As an alternative, the buyer may finance the purchase by giving the seller a promissory note or similar instrument representing the buyer's obligation to make a series of payments.

Selling for Periodic Payments

In an installment sale, a buyer agrees to pay the purchase price in periodic installments of principal and interest over a specified period of time. The IRS has mandated that the minimum interest rate on a bona-fide installment sale is the Applicable Federal Rate (AFR).[1] However, a higher rate of interest can be used.

The buyer and the seller negotiate the parameters of the installment sale, including the duration of the note, the frequency and structure of the payments, and the composition of principal and interest.

Taxation of Interest

Interest paid to the seller on an installment obligation is generally taxed to the seller as ordinary income.

Deductibility of Interest

Interest payments may be deductible (subject to certain limitations) as a business or investment interest expense by the buyer.

Eligibility for Installment Reporting

Generally, the seller may report any gain recognized on the installment sale of a business interest on an installment basis.[2] The seller recognizes a share of the total gain recognized on the sale in each taxable year. The key exceptions applicable to installment reporting treatment of installment sales are:

1. Sales of publicly traded shares or securities.
2. Sales of property subject to depreciation recapture.[3]
3. Sales with more than $5 million of installment debt.

In these situations, the seller may be required to report all or a portion of the gain immediately.

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1 IRC Sections 163, 483, & 1272.
2 IRC Section 453.
3 IRC Sections 751, 1245, & 1250.

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Planning for Contingencies

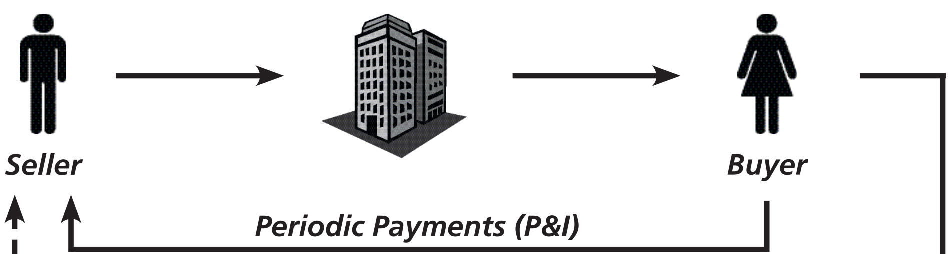
The buyer may die before all of the installment payments have been made. Life insurance offers a way to ensure that the buyer's full debt obligation will be met, and is required by many buy-sell plans.

Considerations

- Intra-family Installment Sales have come under scrutiny by the IRS. In some instances, the IRS has disqualified the sale of a business interest to a family member when it did not believe the transaction to be valid under Section 302.
- The unpaid balance of the note the seller holds is includable in his/her taxable estate. A self-cancelling installment note (SCIN) is a specialized debt instrument that can solve this problem. A SCIN terminates either at the date of full satisfaction or at the date of the seller's death.

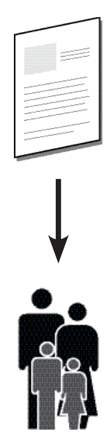
Installment Sale of a Business

1. The seller and buyer enter into a purchase agreement in which the business is transferred to the buyer.



2. In exchange, the buyer agrees to make periodic payments to the seller for a specified period of time. These payments include principal and interest.

3. The buyer purchases a life insurance contract to protect his/her heirs from the burden of continued payments in the event the buyer dies before completing the payments.



For More Information

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