Buy-Sell Planning Using Life Insurance

Producer Guide

These materials are not intended to be used to avoid tax penalties and were prepared to support the promotion or marketing of the matter addressed in this document. Neither ING nor its affiliated companies or representatives give tax or legal advice. Clients should consult with their tax and legal advisors regarding their individual situation.

For agent/registered representative use only. Not for public distribution.

ING

The Opportunity

The Need

Any closely held business faces the possibility of an owner dying, retiring or becoming disabled. A business owner's death or disability can create major problems, jeopardizing a lifetime of hard work and investment, leaving beneficiaries in the difficult position of sorting things out. The remaining business owners are faced with difficult questions:

- How will the business continue?
- Who will control the business?
- Can/will family members of the deceased or disabled owner get involved?
- How will the continuing owners finance the buyout of the owner who is no longer there?

A properly structured and funded buy-sell agreement permits an orderly transfer of the business when the owners retire, divorce, become disabled, or die.

Consider the probabilities of death or disability of a business owner.

Chances that a business owner will die prior to age 65

The Life Insurance Marketing Research Association's (LIMRA) 1996 report, "The U.S. Small Business Market: Opportunities and Challenges," indicates that the odds of becoming disabled for 90 days or longer are much greater than dying during one's working years. Studies also suggest that as the number of business owners increase, so do the odds that one of them will suffer long-term disability.

Owner(s)	Business Owners Under Age 65[1]	Probability (Percent) of a Death
Sole Proprietorship	30	23.5
	40	21.8
	50	18.3
Two Business Partners	30-30	41.5
	35-35	40.4
	40-40	38.8
	45-45	36.3
	50-50	33.3
Three Business Partners	30-30-30	55.2
	35-35-35	54.0
	40-40-40	52.2
	45-45-45	49.6
	50-50-50	45.5
	55-55-55	40.8

1 Based on 1980 C.S.O. mortality

For agent/registered representative use only. Not for public distribution.

Probability of at Least One Owner in a Group Suffering a Long-term Disability Before age 65

	Number of Owners in the Age Group[2]					
Age	1	2	3	4	5	6
25	58%	82%	92%	97%	99%	99%
30	54%	79%	90%	96%	98%	99%
35	50%	75%	88%	94%	97%	98%
40	45%	70%	84%	91%	95%	97%
45	40%	64%	78%	87%	92%	95%
50	33%	55%	70%	80%	86%	91%
55	25%	43%	57%	68%	76%	82%

[2] Source: Based on 1985 Commissioner's Individual Disability Table

Market Size

Why should life insurance professionals consider the buy-sell market? According to the LIMRA report previously cited:

- 34 percent of all corporations lack plans for a formal transfer of ownership
- 40 percent of non-corporate businesses lack such plans
- 50 percent of firms with transfer plans do not have life or disability insurance to fund their continuation plans

In addition, the LIMRA study found that "a service approach centering around setting up or servicing formal business transfer plans will frequently uncover additional needs."

Benefits

The benefits of talking with your prospects about a buy-sell agreement funded with life insurance include:

- Creating a market for a shareholder's closely held stock when it is needed (frequently at the owner's death).
- Establishing the purchase price of the deceased owner's interest and possibly the value of the stock for estate tax purposes.
- Maintaining closeness of the business by restricting transfer of stock to other owners, family members, or a preapproved group of non-owners.
- Providing liquidity to pay estate taxes to the IRS and pay other estate settlement costs.
- Providing funds for a down payment on a buyout at the retirement of an owner.
- Possibly making the business a better credit risk because the probability of continuation is enhanced.
- Preventing transfer of S-corporation stock to an ineligible shareholder.
- Providing for an owner's family in the event of death or disability.

For agent/registered representative use only. Not for public distribution.

Target Market

- Any business can benefit from a buy-sell arrangement including sole proprietorships, partnerships, and closely-held corporations.
- The prospect for a buy-sell opportunity is someone who runs a business in which he or she has invested, and from which he or she earns a living. In many cases, the investment in the business represents that person's only significant asset besides their home.

It's not unusual for the business owner to take on an uncomfortable amount of debt to finance the growth of the business. So death or disability can jeopardize a lifetime of hard work and leave the business owner's heirs in the unenviable position of trying to negotiate with creditors as well as meet the needs of customers.

Implementing a buy-sell agreement, or "business will," for these individuals may provide a cost-effective means of assuring both business continuity and family security.

How It Works

Designing a business continuation plan is a crucial step to ensure your business remains in-tact at your retirement, death or other triggering event. Whether you leave your business by choice or by chance, you'll leave your business on track and help provide for your family's future. By arranging a buy-sell agreement using life insurance, you can help protect yourself, your business co-owners and your family.

When a buy-sell agreement is funded with life insurance, the policyowner (usually a co-owner of the business or the business itself) uses the policy proceeds to buy out the business interest of another owner who retires, becomes disabled, or dies.

Or, if your client chooses to retire, the cash value of the life insurance policy can be accessed by the use of partial withdrawals and policy loans to provide a down payment to help fund the buyout of his or her share of the business. Cash values may be accessed by taking loans and withdrawals from the policy. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse.

A well-constructed buy-sell agreement anticipates how the value of a business may change over time and provides for appropriate adjustments in the amount of the buyout price. The amount of life insurance can be designed to vary with the buyout price, so your client is always properly covered.

For agent/registered representative use only. Not for public distribution.

Funding a Buy-Sell Agreement

Buy-sell agreements need a funding mechanism to make sure money is available to carry out the agreement if a triggering event occurs, without causing financial hardship to the parties involved.

Without the proper funding, even the most carefully drafted buy-sell agreement may prove useless if there are no funds to purchase the deceased owner's interest. Several funding methods besides life insurance are available, but all have disadvantages:

- Using funds from current working capital to fund an installment buyout may limit the company's ability to function and can be costly because each dollar paid for the business interest is a nondeductible after-tax dollar. In addition, these payments would stop if the business were to fail.
- Borrowing funds from a third party will result in the total amount paid for the business being much greater than the purchase price, with the final cost depending on the interest rate and length of the loan. In addition, a lender may not be willing to lend funds to the business at the very time those funds are needed - when an owner dies.
- A sinking fund is a viable solution when a business owner is uninsurable. The problem with this approach is that it may take years to build the necessary funds, but the death of the owner or other triggering events may occur at any time. Also, a sinking fund is expensive because deposits are made with personal or business after-tax dollars. Earnings on the fund may also be reduced by income taxes.

Using Life Insurance to Fund a Buy-Sell Agreement

Life insurance is potentially the least costly method of funding a buy-sell agreement. It is also the only method that makes the necessary dollars available at the exact time funds are most needed (at the death of an owner). The advantages of funding a buy-sell agreement with life insurance include:

- Cash immediately available to the entity or its surviving owners to purchase the deceased owner's interest. This also potentially generates supplemental income to the deceased owner's family or may help pay estate settlement taxes.
- Death benefit proceeds from the life insurance policy are typically received income-tax free. Proceeds from an insurance policy are generally income tax free (e.g. absent a transfer for value), and if properly structured, may also be free from estate taxes. It is important to note that the beneficiary may be subject to state income taxes and the federal alternative minimum tax.

For agent/registered representative use only. Not for public distribution.

- No financial strain on the buyer at the time of purchase. Receipt of the death benefit proceeds allows the satisfaction of the obligation under a buy-sell agreement while freeing up business cash flow and personal funds for other endeavors.
- Cash value accumulations can be used as a substantial down payment in the event of other triggering events, such as disability or retirement.
- Choice of a wide variety of life insurance products to meet the funding need.
- A review process must be in place to assure that coverages adjust to changes in the value of the business. Contingency plans must be in place in the event an owner becomes uninsurable and coverage cannot be increased as needed.

Split dollar funding of a buy-sell agreement can allow the company to share in the cost of the premiums for the life insurance policies used in a cross purchase, wait-and-see, or no-sell buy-sell agreement. This funding method may provide some purchasing leverage subject to the income and gift tax consequences set forth in the Split Dollar Final Regulations issued by the Treasury and IRS.

In addition to the buy-sell agreement, if the company enters into a split-dollar arrangement with each owner in which the company agrees to pay most or all of the insurance premiums, the company can reflect its security interest in the policy's cash value as an asset on its balance sheet. The company also recovers the greater of its net premium outlay or policy cash value, either at death or during life, from the policy's cash values. The surviving owners receive an increased basis on the purchase of a deceased owner's interest funded by the life insurance death benefit.

Important Product Features

The life insurance product you choose to fund a particular buy-sell agreement will depend on the needs and circumstances of each client. The following product features can maximize the benefits of using life insurance to fund a buy-sell agreement:

Long-Term Performance

A product with good long-term performance may provide high death benefit IRRs, which minimize the cost of providing the buyout at death, compared to other funding alternatives. In addition, the potential cash buildup can provide the dollars at retirement to help fund a living buyout.

Flexibility

Many policyowners want the ability to start, stop, or adjust premiums as their needs change, for example, giving them additional control when cash is needed for business purposes. Also, they want to be able to adjust or schedule the death benefit for protection that keeps pace with the projected growth of the business value.

For agent/registered representative use only. Not for public distribution.

Zero or Near Zero Net-Cost Loan

To fund a buyout at retirement, a near-zero net-cost loan reduces the cost of using the policy's cash value as the source of funds. The purchasing party withdraws to basis and then borrows cash from the policy. When the interest rate credited on borrowed funds is close to the interest rate charged for the loan, the interest earned covers the majority of the loan interest to be paid, and the policyowner gets a near-zero net-cost loan.

Potential for Cash Value Buildup in Early Years

When a business is paying the premiums, as in a stock redemption agreement or in a cross purchase with split-dollar arrangement, the premiums are an expense on the business' books. If a policy has a high cash value, the company's security interest in the cash value is recorded as an asset on the company's books, offsetting the premium liability. This can be extremely important in industries such as construction, where working capital is needed for bonding.

No Maturity/Extended Maturity

This feature makes certain that the owner doesn't outlive the death benefit. Although it may be rare for a business owner to remain active in the business past age 100, many times the policy used for the buy-sell agreement is transferred to the insured as part of the living buy out at retirement. The policy is then used for retirement income and/or estate liquidity. A no-maturity feature allows for maximum supplemental income to be drawn from the cash values or for the death benefit to remain in force past age 100 if necessary.

Adjustable Term Rider/Scheduled Term Rider

These riders can help assure that a buy-sell agreement is adequately funded, for example, when the value of a business has appreciated.

Buy-Sell Agreements in Detail

A buy-sell agreement is a legal contract between business owners that restricts the right of an owner to transfer his or her interest in the business to certain parties under specified terms. Such agreements may compel the parties to buy and/or sell the business interest under certain terms if a triggering event occurs. The events that may trigger a buy out include death, disability, retirement, termination of employment, divorce, bankruptcy, creditors' judgment against an owner, a third-party offer to purchase or loss of license in a professional practice.

Types of Buy-Sell Agreements

There are five basic variations of buy-sell arrangements discussed in this guide:

- Entity purchase or stock redemption
- Cross purchase
- Trusteed cross purchase
- Wait-and-see buy-sell
- No-sell buy-sell

Each type of agreement has advantages and disadvantages in any given situation. It is important for you as a valued financial professional to understand which agreements best fit your client's particular situation.

For agent/registered representative use only. Not for public distribution.

Please note, while it is important to consider several possible triggering events such as the disability of a business owner, this guide will concentrate on buy-sell agreements triggered by the death of an owner, funded with life insurance.

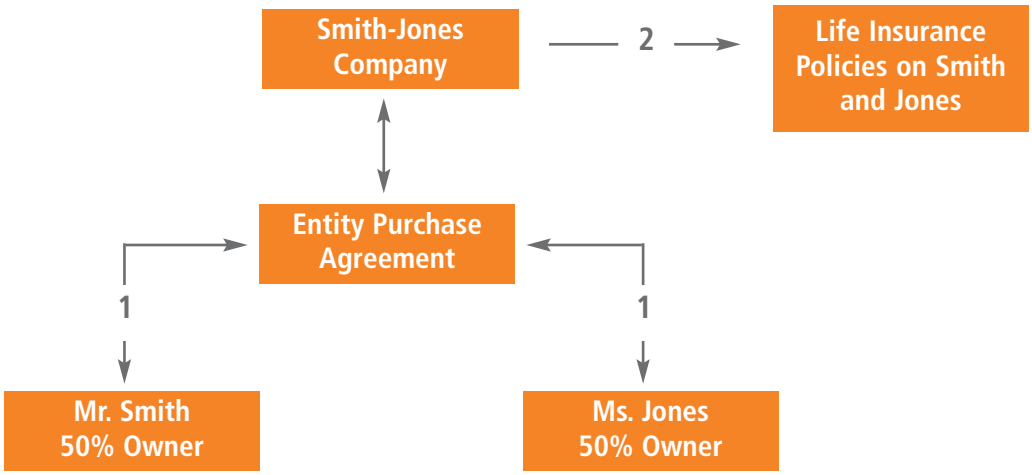
Entity Purchase (Stock Redemption) Agreements

In an entity purchase agreement, the business will purchase the owner's interest when a triggering event occurs. The business is the applicant, owner, beneficiary, and premium payer for life insurance on the lives of the owners. At the death of an owner, death benefit proceeds are paid to the business. The business then purchases the deceased owner's interest in the business from his or her estate, and the surviving owners' percentage of ownership of the business increases proportionately.

The the following charts depict an entity purchase agreement.

Entity purchase agreement funded by life insurance

Establishing and Funding the Plan

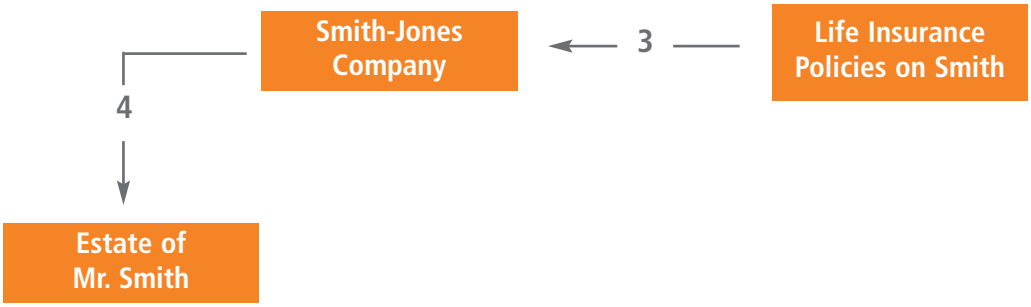


1. The Smith-Jones Company establishes an entity purchase agreement with Mr. Smith and Ms. Jones. Mr. Smith and Ms. Jones each agree to sell their interest to the business at death or other triggering event such as disability or retirement.
2. Smith-Jones Company purchases a life insurance policy on each owner equal to the owner's share of the business. Smith-Jones Company is the beneficiary of the policy.

Smith-Jones Company is the owner, beneficiary and premium payer for the insurance.

For agent/registered representative use only. Not for public distribution.

At Death or Other Triggering Event



3. Assuming Mr. Smith dies, the insurer pays income-tax death benefit free proceeds to Smith-Jones Company. It is important to note that the beneficiary may be subject to state income taxes and federal alternative minimum tax.

4. Smith-Jones Company continues to pay cash to Mr. Smith's estate in exchange for the estate's interest in the business.

Result

Smith-Jones Company continues with the surviving owner in control of the business. The estate of the deceased has cash from the sale of the business interest.

Advantages

- Administrative ease: The number of policies that need to be purchased is limited to one policy for each owner.
- Equalization of payments: Because the business is paying all insurance premiums, there is equalization of premium costs among owners. Factors such as age, smoker status, and health ratings may be less of an issue.
- Business pays the premiums: It is usually psychologically easier for business owners to pay premiums from the business account than from a personal account.
- Cash value is a business asset: The insurance policies' cash value buildup is shown as a business asset on the balance sheet.

Disadvantages

- Policies and cash value are subject to creditors of the business: Because the policies are owned by the business, they are assets that business creditors can attach.
- Payment system may not be fair: The equalization of payment may not be fair because of age or health status differences among owners. For example: two 50 percent owners, one owner who is 30 years old with a life insurance premium of $1,000; the other owner who is 65 years old with a premium of $7,500. The business will pay the total premiums of $8,500 per year. The owners may feel that another payment scheme is more appropriate.

For agent/registered representative use only. Not for public distribution.

- Inequality of total benefits received: Depending on the timing of an owner's death, the total benefits received by each owner may not be equal.
- Nondeductibility of premiums: The life insurance premiums are not deductible under IRC §264(a).
- Increase in value of entity: The life insurance proceeds may increase the value of the entity for estate tax purposes because the death proceeds flow into the business.

Specific issues regarding C-corporations

- Alternative minimum tax: Both the cash value buildup and death benefits greater than basis are subject to the corporate Alternative Minimum Tax (AMT). This is a tax of up to 20 percent on the annual increase in cash value and up to 20 percent of life insurance death benefit greater than basis. (Note that the Taxpayer Relief Act of 1997 repeals the corporate AMT for "small business corporations" after 1997. IRC §55e generally defines a small business corporation as having annual gross receipts of less than $5 million.)
- No basis credit for corporate redemption: The surviving owners' basis in their shares will not change because no credit is given for the corporation's redemption of stock from a selling shareholder. This is important if any of the surviving owners sell stock before his or her death, since the capital gains tax will be paid on all proceeds greater than the shareholder's basis.
- Possible dividend treatment in a family situation: In a family-owned corporation, the redemption may be treated as a dividend, which is taxed as ordinary income, rather than a sale, which is taxed at capital gains rates. This can be disastrous since in most cases where a shareholder has died, there will be little if any capital gain because of the death step-up in basis. One possible solution is to draft the agreement so that the sale is between actual family members rather than the estate, qualifying for the friendlier family attribution rules.
- Possible loss of net operating loss carryover: If a corporation has a net operating loss (NOL), entering into a buy-sell agreement may trigger the immediate loss of some or all the NOL. Any company that has an NOL should consult a competent tax advisor when considering entering into a Buy-sell agreement.
- Possible large charge to earnings in early years of the policy: This can occur when the policy selection results in a large premium payment and little or no cash value. This can adversely affect the corporation's bottom line, which is important in public companies or in industries such as construction where bonding is important.

Specific issues regarding S-corporations

- Step-up in basis: Only a partial step-up in basis can be obtained by the remaining owners from life insurance death proceeds payable to an S-corporation.
- Possible dividend treatment: If an S-corporation has ever been a C-corporation, it may have the same dividends (ordinary income) vs. sale (capital gains) issues as a C-corporation, at least to the extent of locked-in earnings and profits.
- No corporate Alternative Minimum Tax (AMT) exposure.

For agent/registered representative use only. Not for public distribution.

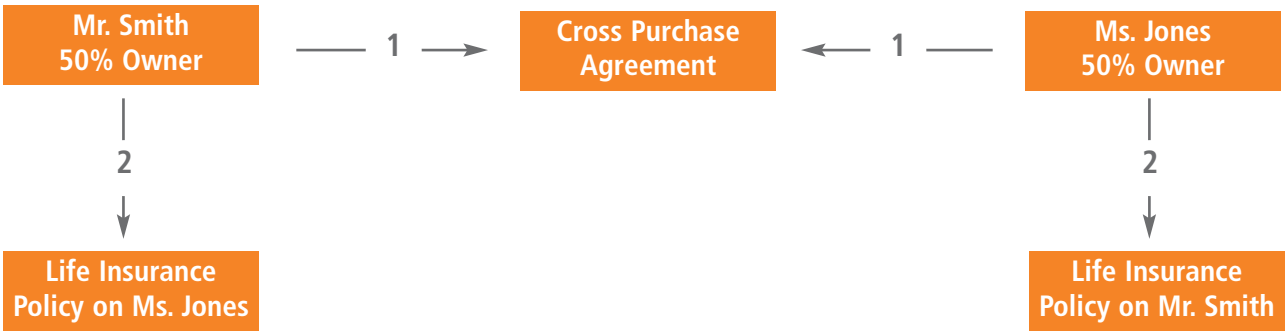
Cross Purchase Agreements

In a cross purchase agreement, when an owner dies, the surviving business owners agree to purchase the deceased owner's business interest. Each business owner is applicant, owner, beneficiary and premium payer for insurance policies on the lives of every other business owner. At death, each surviving owner/beneficiary will normally receive the policy proceeds income-tax-free. Each surviving owner pays cash to the deceased owner's estate and in return the estate transfers a pro rata portion of the deceased owner's business interest. The result is that the estate's nonliquid business interest has been transformed into cash and the surviving owners own 100 percent of the business.

The following charts depict a cross purchase agreement.

Cross Purchase Agreement Funded with Life Insurance

Establishing and Funding the Plan

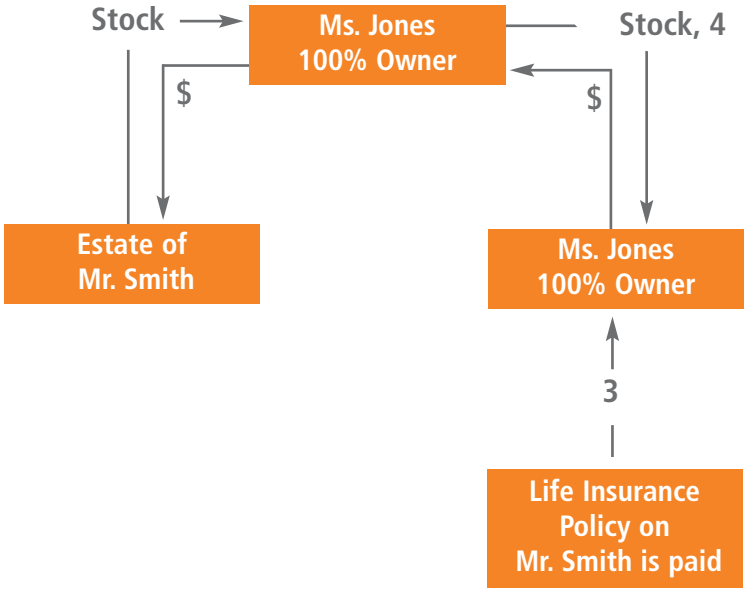


1. The owners of Smith-Jones Company establish a cross purchase agreement between themselves.
2. Mr. Smith takes out a life insurance policy on Ms. Jones. Ms. Jones takes out an insurance policy on Mr. Smith.

Each is the owner, beneficiary and premium payer of a life insurance policy on each of the other business owners.

For agent/registered representative use only. Not for public distribution.

At Death or Other Triggering Event



3. Assuming Mr. Smith dies, the life insurance company pays Ms. Jones the death benefit.

4. Ms. Jones uses this cash to purchase the business interest in Smith-Jones Company now belonging to Mr. Smith's estate.

Result

Surviving owner, Ms. Jones retains control of Smith-Jones Company and Mr. Smith's estate has cash in exchange for the business interest.

Advantages

- Income-tax-free death benefit: Life insurance proceeds normally will be received income-tax-free (IRC § 101 (a)). This assumes there are no transfer-for-value issues.
- Policies and cash values generally are not subject to the entity's creditors: Because the policies are not owned by the entity, the policies are not business assets and therefore are not subject to claims of the business' creditors.
- Basis increase: In a corporate cross purchase plan, the purchaser (surviving shareholder) will receive full basis credit for the purchase of the stock.
- No corporate AMT: Corporate AMT applies only to C-corporations. Because the owners (rather than the corporation) own the policies, the policy proceeds are not subject to the corporate AMT.
- Capital gains treatment: The sale of stock by an owner's estate normally will be a sale of a capital asset and will receive capital gains tax treatment. Even better, there usually is little or no capital gain to be recognized because of the step-up in basis of the business interest to its fair market value at the death of an owner (IRC § 1014).

For agent/registered representative use only. Not for public distribution.

Disadvantages

- Use of personal income: Personal after-tax funds are used to purchase the insurance policies and the premiums are not deductible. A split-dollar agreement between the company and each owner means that the company will pay the majority of the insurance premiums. See the *Funding* section of this guide for more information on split-dollar funding of a buy-sell agreement.
- Possible disproportional premium payments: In a cross purchase agreement, the policies are cross-owned. This means that the youngest owner (and presumably the one who can least afford to pay) will own and pay for the policy on an older and perhaps rated owner. Again, a split-dollar arrangement can be used to help equalize the premium payments. (See the *Funding* section of this guide for more information on split-dollar.)
- The timing of a triggering event can result in inequality of total benefits received between shareholders.
- The company cannot record the policies as assets: The business does not own the insurance policies and therefore cannot book them as assets. However, if the policy is a split-dollar arrangement, the company's security interest in the cash value is a business asset.
- Policies are subject to the individual owners' creditors.
- Administrative complexities: In the case of more than two owners, multiple policies must be purchased and held by each owner. The formula is N x (N-1), where N equals the number of owners. For example, in the case of five owners, 20 policies need to be purchased (5 x 4 = 20).

Trusteed Cross Purchase

When a cross purchase buy-sell arrangement is desired, but the number of owners and the number of policies required to fund the arrangement makes this too complex, one solution is a trusteed cross purchase agreement. This arrangement is sometimes known as an escrowed or custodian buy-sell.

In a trusteed cross purchase, an independent trustee takes out a life insurance policy on the life of each owner, limiting the number of life insurance policies needed to the number of owners participating in the cross purchase agreement.

In a trusteed cross purchase agreement, each party agrees to do the following:

- Endorse his or her stock certificates in blank and deliver them to the trustee.
- Allow the trustee to take out an insurance contract on his or her life.
- Periodically contribute funds to allow the trustee to pay the life insurance premiums on the policies of the other owners.

When an owner later dies, the trustee collects the policy proceeds and pays the deceased owner's estate, in exchange for the business interest owned. The trustee then credits each surviving shareholder's account with the appropriate pro rata ownership of the purchased shares. By agreement, the deceased owner's escrowed interest in the policies insuring the surviving owners is also reallocated to the surviving owners.

For agent/registered representative use only. Not for public distribution.

Transfer-For Value Issues

There may be transfer-for-value issues in a trusteed plan with more than two owners. Where an owner sells his or her business interest to the trustee, the trustee normally buys not only the business interest but the life insurance policies owned by the seller on the other owners' lives. Since the policies are being "transferred for value," this normally will subject the death benefit that is greater than basis to ordinary income tax treatment.

Instead of using a trust to hold the life insurance policies, a partnership can be looked at as an alternative. Partnerships and partners are both exceptions to the transfer-for-value rules. Many attorneys believe that partnerships need to be "real" partnerships, with other assets besides life insurance policies. Please have your client check with knowledgeable tax counsel on this issue.

Advantages

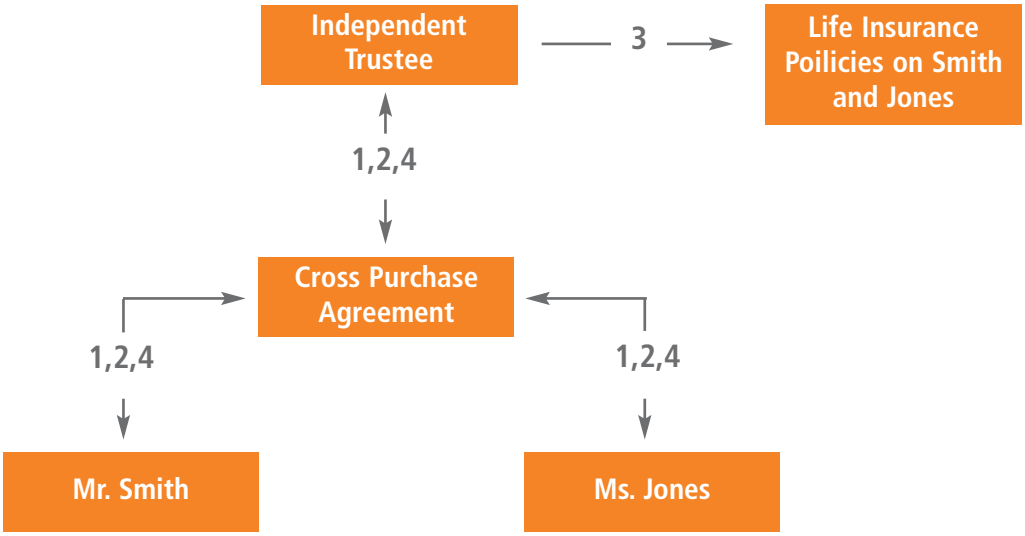
- Reduced number of policies required: In most cases this arrangement is used with a cross purchase agreement, but only one policy per owner is required to fund the plan.
- Income-tax-free death benefit: Life insurance proceeds normally will be received income-tax-free (IRC § 101 (a)). This assumes there are no transfer-for-value issues.
- Policies and cash values generally are not subject to the entity's creditors: Because the policies are not owned by the entity, they are not business assets and therefore are not subject to claims of the business' creditors.
- Basis increase: In a corporate cross purchase plan, the purchaser (surviving shareholder) will receive full basis credit for the purchase of the stock.
- No corporate AMT: Corporate AMT applies only to C-corporations. Because the owners (rather than the corporation) own the policies, the policy proceeds are not subject to the corporate AMT.
- Capital gains treatment: Sale of stock by an owner's estate normally will be considered a sale of a capital asset and receive capital gains tax treatment. Even better, there usually is little or no capital gain to be recognized because of the step-up in basis of the business interest to its fair market value at the death of an owner (IRC § 1014).

For agent/registered representative use only. Not for public distribution.

Disadvantages

- Hidden tax liability: When the policy interest is reallocated after the death of an owner, there is a transfer-for-value issue that could jeopardize the income-tax-free nature of the insurance death benefit. There are several exceptions to the transfer-for-value rule and anyone considering this method of funding should consult with legal and tax advisors.
- Use of personal income: Personal after-tax funds are used to purchase the insurance policies and the premiums are not deductible. A split-dollar arrangement between the company and each owner may allow the company to share in the cost of the premiums, subject to the income and gift tax consequences set forth in the Split Dollar Final Regulations issued by Treasury and the IRS.
- Possible disproportional premium payments: This means that the youngest owner (and presumably the one who can least afford to pay) will pay for the policy on older and perhaps rated owners.
- The timing of a triggering event can result in inequality of total benefits received between shareholders.
- The company cannot record the policies as assets: The entity does not own the insurance policies and therefore cannot book them as assets. However, if the policy is a split-dollar arrangement, the company's security interest in the cash value is a business asset.

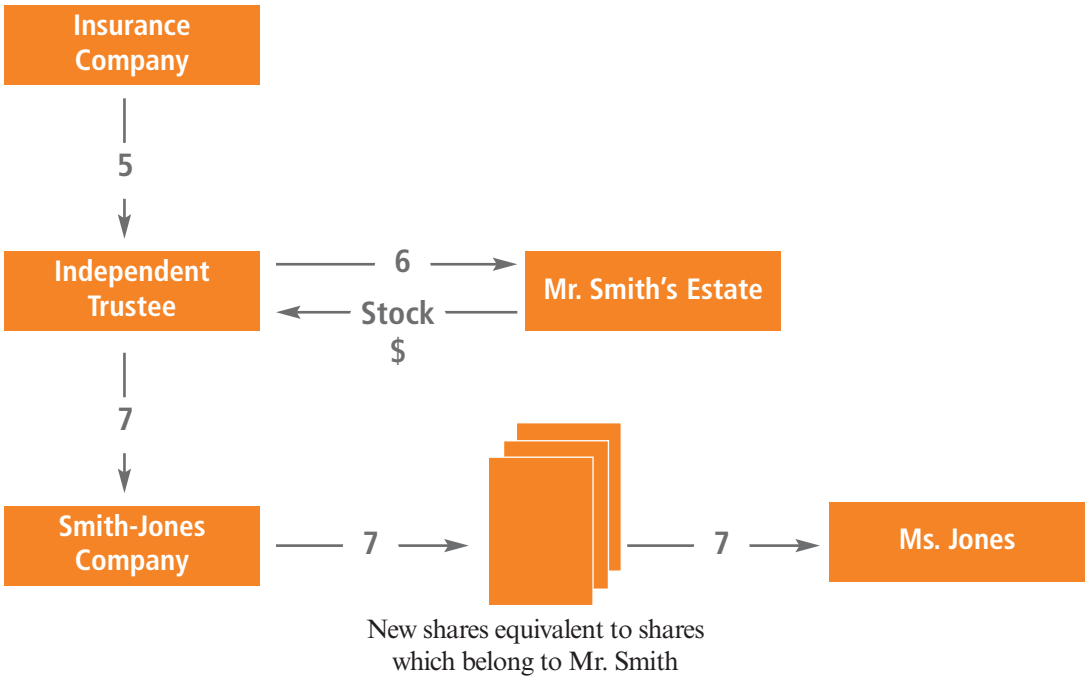
Establishing and Funding the Plan



1. Mr. Smith and Ms. Jones each sign a cross purchase agreement with an independent trustee.
2. Each endorses their stock certificates in blank and delivers them to the trustee.
3. Each agrees to allow the trustee to take out an insurance policy on his or her life.
4. Each periodically contributes funds to allow the trustee to pay the premiums on the policies.

For agent/registered representative use only. Not for public distribution.

At Death or Other Triggering Event



5. Assuming Mr. Smith dies, the insurance company pays the death benefit to the trustee.
6. The trustee pays Mr. Smith's estate in exchange for his business interest.
7. The trustee then sees that Smith-Jones Company issues new shares to the surviving owner, equal to the shares that belonged to Mr. Smith.

Results

The surviving owner retains control of the business and the estate of the deceased owner receives cash for the business interest.

For agent/registered representative use only. Not for public distribution.

Wait-and-See Buy-Sell Agreements

The decision as to whether a cross purchase buy-sell arrangement or a stock redemption plan is better may be difficult to determine at the time the plan is adopted. A wait-and-see agreement lets the business owners wait until the first death or other triggering event occurs to decide whether the business or the owners should purchase the business interest. This flexibility is useful because the best results often cannot be determined until a triggering event actually occurs. The wait-and-see agreement allows the purchaser to be the entity, the owners, or both.

With the typical wait-and-see plan, the business has the first option to purchase the stock at the price or formula set in the agreement. If the business fails to exercise its option, the surviving business owners have a second option to purchase the stock. Finally, if the business owners fail to purchase the stock, or only purchase a portion of it, then the entity is required to purchase the remainder.

A wait-and-see arrangement adds flexibility because if a cross purchase plan is more advantageous than a stock redemption, the business will not exercise its first option to buy the stock. On the other hand, if a stock redemption plan would be the most advantageous, and the insurance policies are owned by and payable to the shareholders, the surviving shareholders may decide to lend the proceeds to the entity after a death occurs. When the entity pays back the loan, it will not be considered income to the owners, except for any interest that is paid on the loan.

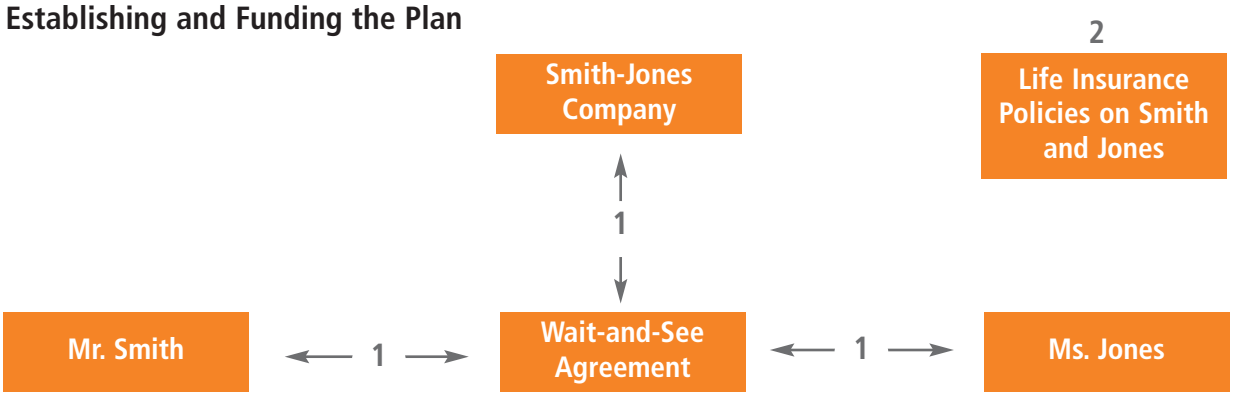
Generally, the funding for a wait-and-see agreement should be at the owner level for two reasons:

1. If the agreement is funded at the entity level, all the potential problems of an entity purchase agreement apply.
2. If the life insurance is cross-owned, the owners will receive basis credit for their purchase of the interest or they could make a capital contribution to the entity and receive a basis step-up for the capital contribution.

The following charts depict a wait-and-see agreement.

Wait-and-See Agreement Funded with Life Insurance

Establishing and Funding the Plan



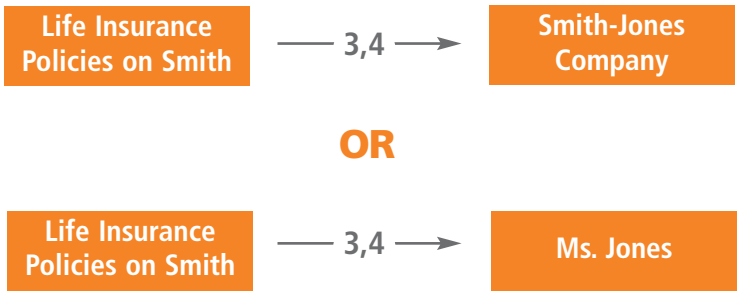
1. Smith-Jones Company establishes a wait-and-see purchase agreement with Mr. Smith and Ms. Jones.
2. Funding can be at the entity level (Smith-Jones Company buys life insurance on Mr. Smith and Ms. Jones)

OR

Funding can be at the individual level (Mr. Smith and Ms. Jones buy life insurance policies on each other.).

For agent/registered representative use only. Not for public distribution.

At Death or Other Triggering Event



3. Assuming Mr. Smith dies, his interest passes to his family or his estate.
4. Depending on whether the corporation or the individual owners purchased the life insurance policies, they are paid the proceeds from Mr. Smith's policy.
5. First, Smith-Jones Company may exercise its option to purchase any or all of the decedent's (Mr. Smith's) interest.
6. If Smith-Jones Company does not buy all of the deceased owner's interest, the surviving shareholder(s) has the option to purchase it.
7. Smith-Jones Company must then redeem any remaining shares. Any entity redemption is usually funded with capital contributed by the surviving shareholders from the insurance proceeds.

Results

Either the business or surviving owner purchase the business interest from the deceased owner's estate, depending on which is most advantageous to Smith-Jones Company and the surviving owner.

Advantage

- Flexibility: This is the most flexible type of buy-sell agreement because the purchase can be done at either the entity or owner level. The choice is made at the time of the triggering event, rather than on the date on which the agreement was signed.

Disadvantages

- Life insurance and multiple owners: If the funding is at the owner level and there are multiple owners, the administrative complexity of each owner owning a policy on every other owner is the same as with a cross purchase agreement.
- Inequality of total benefits received: Depending on the timing of a triggering event, the total benefits received by each shareholder may not be equal (see No-Sell Buy-Sell Planning Agreements, 117675).

For agent/registered representative use only. Not for public distribution.

No-Sell Buy-Sell Agreements

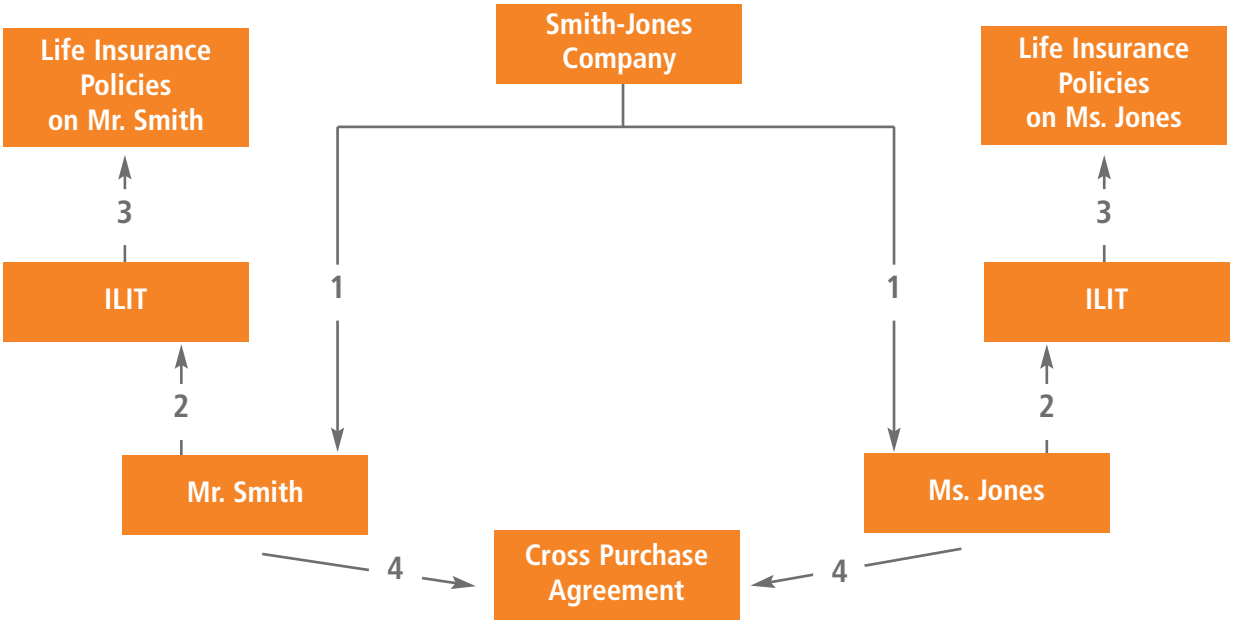
A no-sell buy-sell agreement is similar to other buy-sell agreements in that management and/or voting interest will pass to the surviving owners. It is dissimilar in that the nonvoting interest in the company will remain with the deceased owner's family or estate. A no-sell buy-sell agreement can be a good choice if the owners want the deceased owner's heirs to benefit from appreciation in the company's value over time and from the equalization of benefits between the first and last owners to die. A no-sell buy-sell agreement is particularly attractive in situations where substantial future appreciation is expected, for example, a dairy farm that is close to city limits and will be incorporated into the city within a few years.

The essence of a no-sell buy-sell agreement is to have each owner's interest divided into a voting (management) interest and a nonvoting (nonmanagement) interest. For example, a partnership interest can be divided into a general partnership interest and a limited partnership interest. In a corporation (including S-corporations), the owner's interest can be divided into voting and nonvoting shares. In the case of a limited liability company, the owner's interest can be divided into a management interest and a nonmanagement interest. The owner's management or voting interest is subject to a normal buy-sell agreement and so will pass to the surviving owners at the deceased owner's death. The remaining (nonmanagement) interest will remain with the deceased owner's family. Each owner sets up an Irrevocable Life Insurance Trust (ILIT) with life insurance in the amount of the value of his or her business interest. At the owner's death, the life insurance in the trust will be used to support the family.

The charts on the following pages depict a no-sell buy-sell agreement.

No-Sell Buy-Sell Agreement

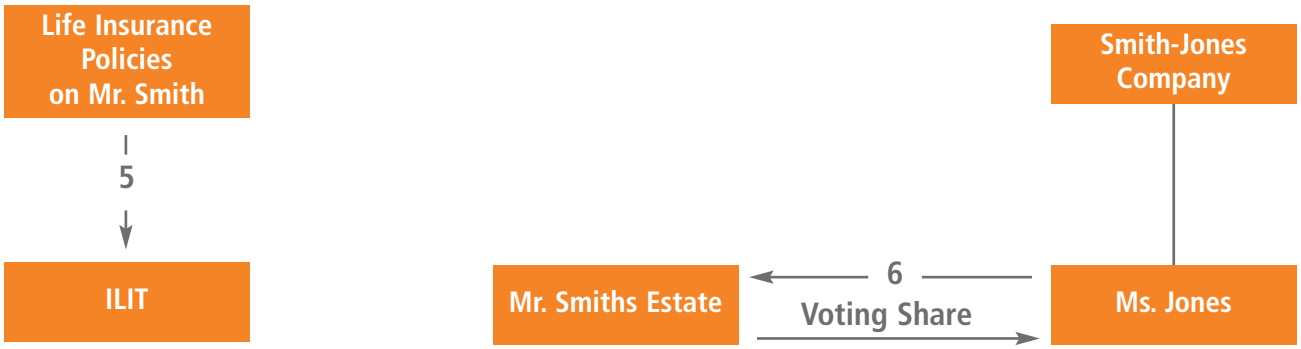
Establishing and Funding the Plan



1. Smith-Jones Company re-capitalizes into two voting shares and 198 non-voting shares. Owners, Mr. Smith and Ms. Jones each receive one voting share and 99 non-voting shares.
2. Mr. Smith and Ms. Jones each establish an Irrevocable Life Insurance Trust (ILIT).
3. Their ILITs purchase life insurance policies on them.
4. Mr. Smith and Ms. Jones enter into a cross purchase agreement to purchase voting shares at each other's death.

For agent/registered representative use only. Not for public distribution.

At Death or Other Triggering Event



5. Mr. Smith dies and the insurance company pays the death benefit to his ILIT.
6. Ms. Jones buys the Smith-Jones Company voting stock from Mr. Smith's estate using personal, after-tax funds.
7. The estate of Mr. Smith retains the non-voting stock.

Result

Ms. Jones owns 100 percent of voting and 50 percent of non-voting stock in the Smith-Jones Company. Mr. Smith's estate owns 50 percent of the non-voting stock. Mr. Smith's estate has access to the cash in his ILIT for estate liquidity purposes, through asset sale or a loan from the ILIT.

Advantages

- The deceased owner's heirs can share in the future upside of the business.
- Control of the business remains in the hands of the surviving owner(s).
- Income-tax-free and estate tax-free life insurance proceeds (when properly structured) are available to the family in the amount equal to the death benefit of the policy.
- Avoidance of corporate Alternative Minimum Tax (AMT) issues.
- The premiums are deductible by the company if paid as compensation to the owner.
- The policy can be a split-dollar arrangement between the trust and the business.

Disadvantages

- The premiums are paid with owner after-tax dollars.
- A method of valuing the voting interests needs to be determined.
- The surviving owners do not own 100 percent of the business (but do own 100 percent of the voting interest).
- The agreement needs to have a procedure for buying out the non-voting interests or else there is no assurance that the non-voting interest is ever purchased.

Summary and Comparison

The following pages summarize and compare key features of cross purchase and stock redemption agreements for partnerships and corporations.

For agent/registered representative use only. Not for public distribution.

Cross Purchase versus Entity Purchase (Stock Redepmtion)

	Partnership		C-Corporation		S-Corporation	
Purchaser	**Cross Purchase The Partners**	**Entity The Partnership**	**Cross Purchase The Shareholders**	**Stock Redemption The Corporation**	**Cross Purchase The Sharholders**	**Stock Redemption The Corporation**
Number of Purchasers	Each partner buys one policy on each of the other partners in order to buy a portion of the deceased partner's interest.	One policy is purchased on each partner. As the number of partners increases, the entity plan becomes more attractive	Each shareholder buys one policy on each co-shareholder in order to buy a portion of his or her stock.	The corporation buys one policy on each shareholder. As the number of shareholders increases, the stock redemption plan becomes more attractive.	Each shareholder buys one policy on each co-shareholder in order to buy a portion of his or her stock.	The corporation buys one policy on each shareholder. As the number of shareholders increases, the stock redemption plan becomes more attractive.
Relative Interests	A partner can increase or decrease his relative interest in the partnership by committing to buy a larger or smaller proportion of the deceased partner's interest.	Each partner will hold the same relative interest after the buyout.	A shareholder can increase or decrease his or her relative interest in the corporation by committing to buy a larger or smaller proportion of the deceased owner's stock.	Each shareholder will hold the same relative interest after the buyout.	A shareholder can increase or decrease his or her relative interest in the corporation by committing to buy a larger or smaller proportion of the deceased owner's stock. Surviving shareholder's percentage of ownership increases proportionately.	Each shareholder will hold the same relative interest after the buyout.

Funding the Policies

	Partnership		C-Corporation		S-Corporation	
Purchaser	**Cross Purchase**	**Entity**	**Cross Purchase**	**Stock Redemption**	**Cross Purchase**	**Stock Redemption**
Funding the Policies	Individual partners pay the premium on the policies they own on the other partners. Younger partners pay larger premiums on the lives of older or unhealthy partners. An escrow arrangement can hold the policies, collect the premiums and pay the insurance company.	The partnership pays the premium. Each partner shares in the total premiums paid in proportion to his or her partnership interest. An entity plan can assure the partners that the premiums will be paid and that the policies stay in force.	The individual shareholders pay the premium on the policies they own on the other shareholders. A split-dollar or executive bonus arrangement can assist the shareholder.	The corporation pays the premiums. If the shareholders are in a higher tax bracket, it can make good business sense for the corporation to pay the premiums.	The individual shareholders pay the premiums on the policies on the other shareholders.	The corporation pays the premiums. The corporate income used to pay the premiums is taxed pro rata to the shareholders.

For agent/registered representative use only. Not for public distribution.

Value and Basic Effects

	Partnership		C-Corporation		S-Corporation	
Purchaser	**Cross Purchase**	**Entity**	**Cross Purchase**	**Stock Redemption**	**Cross Purchase**	**Stock Redemption**
Valuation	The insurance proceeds do not increase the value of the business.	The policy cash values and death proceeds increase the value of the partnership unless the Buy-sell agreement allocates the death proceeds to the surviving partners.	The insurance does not increase the value of the stock.	Cash value affects the value of the stock. At redemption, the value of the stock increases if the corporation retires stock.	The insurance does not increase the value of the stock.	The cash value affects the value of the stock.
Relative Interests	The purchasing partner receives an increase in basis equal to the purchase price. While the entity plan can also increase a partner's basis, the cross purchase plan results in a higher basis.	When the insurance is paid to the partnership, the death proceeds in excess of the cash value increase each partner's basis proportionately, including the deceased partner's interest.	The surviving shareholders receive an increase in basis equal to the purchase price of the stock.	The surviving shareholders do not receive an increase in basis when the corporation buys the deceased's stock.	The surviving shareholders receive an increase in basis equal to the purchase price of the stock.	The surviving shareholders can receive an increase in basis by electing a short tax year (cash basis tax payer only).

Creditors, Attribution & Taxes

	Partnership		C-Corporation		S-Corporation	
Purchaser	**Cross Purchase**	**Entity**	**Cross Purchase**	**Stock Redemption**	**Cross Purchase**	**Stock Redemption**
Creditors	The policy values are not subject to the firm's creditors unless the firm is insolvent.	The policy values are subject to the firm's creditors.	The corporate creditors cannot reach the policy values. State law dictates whether personal creditors can attach policy values.	The policy values are subject to corporate creditors.	The corporate creditors cannot reach the policy values. State law dictates whether personal creditors can attach policy values.	The policy values are subject to corporate creditors.
Family Attribution	N/A	N/A	No	Redemption is subject to the family attribution rules.	No	S-Corporations with E&P are subject to the family attribution rules
Section 302 Regs	N/A	N/A	N/A	N/A	No	S-Corporations with E&P must qualify as a redemption under IRS §302
Taxation of Deceased Sharholder's Heirs	N/A	N/A	Basis is stepped up at the death of shareholder and no gain is recognized.	Basis is stepped up at death and no gain is recognized, provided redemption meets either IRC §302 or §303 requirements.	Basis is stepped up at the death of shareholder and no gain is recognized.	Basis is stepped up at death and no gain is recognized if redemption qualifies for IRC §302 or §303 treatment.
Alternative Minimum Tax	N/A	N/A	No	Yes	No	No

A Limited Liability Company (LLC), Limited Partnership (LP) and Family Limited Partnership (FLP) buy-sell agreement should be similar to a partnership arrangement.

For agent/registered representative use only. Not for public distribution.

Selling Buy-Sell Planning Using Life Insurance

All Types of Businesses

Virtually any owner of a closely held business is a prospect for a buy-sell agreement funded by life insurance. Sole proprietorships, partnerships, limited liability companies, and corporations all are prospects for the solutions offered by buy-sell agreements.

Helping business owners set up and service buy-sell plans frequently provides the opportunity to uncover other needs that you can assist them with, for example, key person insurance, disability insurance, group life and health insurance, qualified and nonqualified plans, or estate planning.

Financial Risks Without a Buy-Sell

The business provides the majority of the owner's income and usually is the largest asset in the business owner's estate.

The business owner often has taken on an uncomfortable amount of debt to finance the growth of the business, for which he or she is personally responsible.

Death or disability can jeopardize a lifetime of hard work and leave the business owner's heirs in a precarious financial position. A buy-sell agreement funded by life insurance can provide a cost-effective means of assuring both business continuity and family security.

Additionally, the death of a business owner can lead to conflicts among his or her survivors. For example, a spouse might want continuing income (dividends or distributions), children involved in the business might want growth (profits invested back in the business rather than to pay dividends), and children not involved in the business might want cash (dividends, distributions, and/or liquidation of the business).

Key employees who are not family members want job security (how will they work together with the children who want to run or liquidate the business). Other owners may not want the deceased owner's family to remain as owners at all.

A properly designed buy-sell agreement can anticipate these conflicts and provide a plan to avoid them.

Advantages

- Liquidity to purchase a deceased owner's interest is provided by life insurance, normally on an income-tax-free basis. Death benefits from the life insurance policy are generally income-tax-free.
- The selling owner's estate or family converts a non-liquid asset to cash.
- The surviving owners are not burdened with the deceased owner's family as continuing owners.

Disadvantages

- The deceased owner's family will not share in any upside of the business (unless the no-sell buy-sell plan is implemented).
- Normally there will be an inequality as to what each owner's family will receive, based on the owners' order of death. (Generally, the earlier an owner dies, the less his or her family will receive.)

Each type of closely held business has its own issues and concerns arising from an owner's death as well as the funding of a buy-sell plan. A buy-sell arrangement can be tailored to provide solutions to each of those needs.

For agent/registered representative use only. Not for public distribution.

Sole Proprietorships

Needs/Motivating Factors	Buy-Sell Solution
Executor or heirs without the needed experience or expertise to run the business.	A buy-sell agreement assures that a willing and knowledgeable person will purchase the business after the owner's death.
Liquidation may provide only a fraction of the "going concern" value.	A buy-sell agreement allows the heirs to get a fair price for the business and helps in the quick settlement of the estate.
Stability of the business is threatened, with loss of goodwill, creditors wanting immediate payment, and difficulties collecting accounts receivable.	The security of a planned transition to a competent owner can ease the concerns of the owner, creditors, and difficulties collecting accounts receivable.

Partnerships and Limited Liability Companies

Needs/Motivating Factors	Buy-Sell Solution
The partnership must be dissolved upon the death of the partner.	A buy-sell agreement can assure business continuation upon the death of a partner.
The deceased partner's family may not understand why income has stopped.	A buy-sell agreement can mean a quicker settlement of the estate and a fair price for the deceased partner's business interest, which can offset the family's loss of income.
The remaining partners may not be able to continue the business because of lack of liquidity.	A buy-sell agreement can assure continued operation of the business because additional liquidity is available through life insurance proceeds.

Corporations

Needs/Motivating Factors	Buy-Sell Solution
Possible lack of a ready market for the shares of the deceased stockholder.	A buy-sell agreement provides a buyer and a fair price for the deceased stockholder's shares.
Remaining stockholders may not work well with deceased owner's spouse or children, or a third party who buys the deceased owner's shares.	A buy-sell agreement specifies who can own the deceased owner's shares and on what terms.
Remaining stockholders may not have the money to buy the deceased owner's shares.	A buy-sell agreement funded by life insurance provides the necessary cash at the precise time it is needed, for example., at the death of an owner.

For agent/registered representative use only. Not for public distribution.

Corporate Distributions to Redeem Stock

There are two tax questions calling for special consideration when a buy-sell agreement provides for the redemption of stock by a corporation. If the following questions cannot be resolved satisfactorily, the scales may be tipped in favor of a cross purchase agreement among owners:

- Is the corporate distribution in payment for the stock taxable as a dividend under the general rule of I.R.C. Sec. 301?
- How does the accumulated earnings tax affect the stock redemption plan?

The income tax treatment of distributions in redemption of stock is dealt with in I.R.C section 302 that contains two safe harbors under which payments made by a corporation in redemption of its stock will be treated as a sale or exchange of a capital asset and not as a distribution of dividends. In addition, the "not essentially equivalent to a dividend" test provides a third, but not very reliable, alternative.

The following are brief explanations of the safe harbors that will allow a redemption to be treated as a sale:

- Redemption is not essentially equivalent to a dividend (I.R.C. Sec. 302(b)(1)): This first exception to the dividend treatment of stock redemptions is perhaps the most difficult for which to qualify. The IRS must be convinced to use this first test on the basis of facts and circumstances of each situation. This section should be relied on only if others are not available. Clients may wish to obtain a private letter ruling to use this exception and certainly should consult their own tax advisor.
- Redemption is substantially disproportionate (IRC Sec. 302(b)(2)): A redemption will receive capital gains treatment if immediately after the redemption the following mathematical tests are met:
  - The stockholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.
  - The stockholder's percentage of voting stock is less than 80 percent of the voting stock, prior to redemption.
  - The stockholder's percentage of common stock (voting and nonvoting) must be less than 80 percent of the percentage of voting stock owned prior to redemption.
- Complete redemption of all the stockholder's interest in the corporation (I.R.C. Sec. 302(b)(3)): If all of a stockholder's shares (voting, nonvoting, preferred and common) are redeemed, the redemption will qualify for capital gains treatment. In determining how many shares the stockholder owns, add up the shares actually owned and those constructively owned under I.R.C. Sec. 318 attribution rules (which are discussed later in this guide).

The attribution rules of I.R.C. Secs. 302(c) and 318 apply to both complete redemptions and substantially disproportionate redemptions. These provisions are meant to give capital gain treatment only when there is a substantial change in the ownership of the corporation. Some redemptions do not, in reality, change the control or ownership and therefore are treated as dividends.The attribution rules can be divided into the two categories of family attribution and other entities, which are discussed below.

For agent/registered representative use only. Not for public distribution.

I.R.C. Section 303 Redemption

I.R.C. Sec. 303 permits a corporation to redeem a portion of a decedent's stock without it being considered a dividend and so use a corporate surplus to meet the deceased shareholder's estate costs. An I.R.C. Section 303 partial redemption can provide cash and/or other property from the corporation for the decedent's executor to pay estate taxes and other expenses. An I.R.C. Section 303 redemption is specifically exempt from the attribution requirements (see below), helping family corporations to make redemptions possible without the threat of dividend treatment.

The major advantage of a 303 redemption is that the amount paid to the estate is usually not treated as a dividend distribution. Instead, it will be treated as the "exchange price" for the stock and will generally result in no gain being recognized at all by the estate, if the basis for the stock has been "stepped-up" by reason of being included in the decedent's estate.

For a business owner's stock to qualify for favorable tax treatment, the value of the stock must exceed 35 percent of the adjusted gross estate. Also, if the decedent owns 20 percent or more of the value of each of two or more corporations, they can be combined to meet the 35 percent requirement.

Attribution Rules

For the purposes of I.R.C. Sec. 302, the rules of constructive stock ownership (I.R.C. Sec. 318) apply, under which a stockholder will be treated as owning the stock in a corporation that is owned directly or indirectly by:

- A spouse, children, grandchildren, and parents (the family attribution rule discussed below).
- A partnership, in proportion to the stockholder's interest in the firm.
- An estate or trust (except an exempt employees' trust), in proportion to the taxpayer's actuarial interest as beneficiary; or, for a trust, to the extent the taxpayer is treated under I.R.C. Secs. 671-678 (relating to grantor and other substantial owners) as the owner of any portion of the trust.
- A corporation, in proportion to stock interests, if the taxpayer owns 50 percent or more of the value of the stock.

In addition, stock owned (directly or indirectly) by or for a partner or a beneficiary of an estate is considered as being owned by the partnership or the estate. Stock owned directly or indirectly by or for a beneficiary of a trust is considered as being owned by the trust (except an exempt employee's trust), unless the beneficiary has only a remote contingent interest and the actuarial value of which does not exceed five percent of the trust property. Stock owned directly or indirectly by a person who owns 50 percent or more in value of the stock of a corporation is considered as being owned by the corporation, but this rule does not apply to the corporation's own stock. Constructively-owned stock counts in determining the 50 percent requirement. An option to acquire stock, or an option to acquire such an option, is also treated as ownership of the stock subject to the option.

For agent/registered representative use only. Not for public distribution.

Sidewise Attribution

Once stock is attributed from an individual to an entity (partnership, estate, trust or corporation), it will not again be attributed sidewise from the entity to another partner, beneficiary or shareholder whose shares are redeemed. I.R.C. Sec. 318(a)(5)(C).

For example, if A and B are shareholders in Corporation X, and also are partners in Partnership Z (which owns no X stock), their shares of X stock will not be attributed to each other through the corporation or partnership.

Double Attribution

Stock constructively owned by an individual under the family attribution rule cannot be treated as owned by him or her for the purpose of again applying the family attribution rule in order to make another person the constructive owner of the stock. I.R.C. Sec. 318(a)(5)(B). In all other cases, including cases involving stock options, there can be a chain of constructive ownership.

For example, stock owned by a son-in-law is considered constructively owned by his wife, but will not, in turn, be considered constructively owned by her father. However, such stock would be considered owned by her father's estate if she were an estate beneficiary. If the daughter has an option to acquire her husband's stock, such stock will be considered owned by her father as well as by the father's estate in the event of his death.

Family Attribution

As mentioned earlier, under I.R.C. Sec. 318(a)(1), a redeeming stockholder constructively owns stock directly owned by or for his spouse, children, grandchildren, or parents. A stockholder is not deemed to own stock of his brothers, sisters, or grandparents. The family attribution rules can be waived if, after a complete redemption, the following conditions are satisfied:

- Immediately after the redemption, the redeeming stockholder can have no interest in the corporation as either an officer, director, employee, or independent contractor (although interest as a creditor is fine). Also, the redeeming stockholder cannot serve as custodian of stock held under the Uniform Gifts to Minors Act, or have an interest in a trust that owns stock of the redeeming corporation.
- The stockholder must not acquire an interest in the corporation within 10 years after the redemption, except by inheritance.
- An agreement must be filed by the redeeming stockholder or his executor agreeing to notify the IRS of any stock acquisitions which would violate the above rule and agreeing to maintain necessary records.
- The redeeming stockholder did not acquire the redeemed stock within 10 years before the redemption from a family member whose stock ownership would be attributed to him under the attribution rules.
- At the time of the redemption there is no stockholder related under the attribution rules who has acquired stock from the redeeming stockholder in the prior 10 years.

For agent/registered representative use only. Not for public distribution.

Actually, the last two bullets may not apply if the IRS can be convinced that tax avoidance was not a principal purpose of the transaction or that the redeeming stockholder inherited the stock.

In addition to the family attribution rules, the redeeming stockholder is also treated as owning a proportionate part of the stock that is actually owned by the following entities:

- A partnership in which he or she is a partner
- An estate of which he or she is a beneficiary
- A trust of which he or she is a beneficiary
- A corporation in which he or she owns 50 percent or more of the outstanding stock

Obviously, the attribution rules are highly complex and should be dealt with only with the assistance of appropriate tax and legal advisors.That is, the buyer must agree to buy for the specific price and the seller must agree to sell at the specific price to affirmatively establish a price for Buy-sell purposes.

Want to Hear More?

For top notch sales support from leading industry professionals dedicated to helping you grow your life business, call the ING National Sales Support Team at:

866.ING.SELL
866.464.7355

ING. Your future. Made easier.℠

For agent/registered representative use only. Not for public distribution.

ReliaStar Life Insurance Company
20 Washington Avenue South
Minneapolis, MN 55401

ReliaStar Life Insurance Company of New York
1000 Woodbury Road, Suite 208
Woodbury, NY 11797

Security Life of Denver Insurance Company
1290 Broadway
Denver, CO 80203

www.ing.com/us

These materials are not intended to be used to avoid tax penalties, and were prepared to support the promotion or marketing of the matter addressed in this document. The taxpayer should seek advice from an independent tax advisor.

Neither ING nor its affiliated companies or its representatives give tax or legal advice. The strategies suggested may not be suitable for everyone. Each individual should consult with his or her own tax advisor and legal counsel before implementing any of the strategies discussed here.

Life insurance products are issued by the ReliaStar Life Insurance Company, ReliaStar Life Insurance Company of New York, and Security Life of Denver Insurance Company. Variable universal life insurance products are distributed by ING America Equities, Inc., 1290 Broadway, Denver, Colorado 80203. Only ReliaStar Life Insurance Company of New York is admitted, and its products issued, within the state of New York. All are members of the ING family of companies.

Variable insurance products are offered by prospectus only. To solicit variable insurance products you must maintain a variable insurance license and be a registered representative of a broker-dealer that has a current selling agreement with the issuing company.

For agent/registered representative use only. Not for public distribution.

117671

cn36175082008
© 2006 ING North America Insurance Corporation
09/01/2006