Exit Planning

Buy-Sell Agreements Quick Reference Guide

Principal® Financial Group

A buy-sell agreement increases the stability of a small business by providing a buyer for the owner's interest in the business. A buy-sell agreement also protects the remaining owners by preventing a disruptive or unqualified individual from acquiring an interest in the business. Funding the agreement with life and disability buy-out insurance reduces the financial strain on remaining owners.

This guide provides a starting point for you to help business owners decide the best form of buy-sell agreement. However, that determination depends on a wide variety of factors. Because agreement type and policy ownership have significant tax implications clients must consult their tax and legal advisors. This information applies primarily to entity purchase and cross purchase buy-sell agreements for C corporations. Other flow-through entities, due to their nature and related tax complexities, may be able to obtain many of the advantages of cross purchase even when an entity purchase agreement is used.

Common Scenarios

Following are some commonly encountered situations and generic recommendations based on entity type and the number of owners involved. This is for discussion purposes only. Clients must consult their tax and legal advisors regarding their specific situation.

For sole proprietorships (and one-owner C corporations), a one-way buy sell is the primary buy-sell option.

For partnerships (and limited liability corporations taxed as partnerships), entity purchase is often the best choice because only one policy per owner is needed to fund the agreement, yet remaining owners can obtain increased basis for death proceeds paid to the partnership.

For C corporations with three or fewer shareholders, cross purchase will generally be the most advantageous approach.

For C corporations with three or more shareholders, entity purchase will often be the most practical approach, despite the disadvantages mentioned on the next page. Tax complications can arise with entity purchase in the case of family-owned businesses.

Also consider using a business continuation general partnership (BCGP). A BCGP provides remaining owners an increase in basis, permits the agreement to be funded with one policy per owner and provides an efficient method to accumulate for retirement. For details on BCGP, please refer to the Advanced Solutions section of Workbench.

For any business where the owners are interested in an efficient method to accumulate cash for retirement, the BCGP should be considered.

For S corporations with three or fewer shareholders, cross purchase will generally be the most advantageous approach.

For S corporations with three or more shareholders, entity purchase will often be the most practical approach.

FOR MORE INFORMATION

Go to **www.principal.com/exitplanning** or contact the National Sales Desk at 800-654-4278.

Quick Reference Guide

		CROSS PURCHASE	ENTITY PURCHASE
	DESCRIPTION	Co-owners purchase departing owner's business interest	Business purchases departing owner's business interest
INSURANCE ARRANGEMENT	PREMIUM PAYOR	Each owner pays premium on policies he or she owns	Business
INSURANCE ARRANGEMENT	OWNER	Each owner owns policy on life of each other owner	Business[1]
INSURANCE ARRANGEMENT	BENEFICIARY	Each owner is beneficiary of policies he/she owns	Business
INCOME TAX ASPECTS	BUSINESS	Not a party to the agreement	• Premiums not deductible • Proceeds received tax-free[2]
INCOME TAX ASPECTS	PURCHASING OWNER	• Premiums not deductible • Proceeds received tax-free • Basis increased by amount paid to deceased's family	• C corporations – no basis increase to surviving owners • S corporations and other pass-through entities – with planning, surviving owners may be able to obtain some basis increase
INCOME TAX ASPECTS	SELLER UPON DEATH	Purchase price received generally doesn't cause taxable event[3]	Purchase price received generally doesn't cause taxable event[3]
INCOME TAX ASPECTS	SELLER UPON DISABILITY	Seller recognizes capital gain to the extent proceeds exceed basis	Seller recognizes capital gain to the extent proceeds exceed basis
	ESTATE TAX ASPECTS	Value of business interest and cash value of policies on other owners included in gross estate	Value of a business interest included in gross estate
ADVANTAGES		• Surviving owners receive an increase in the basis of their business interests equal to the purchase price paid to the departing owner. • Insurance proceeds are not included in the deceased owner's estate. • Insurance proceeds and cash value are not subject to AMT. • Insurance policies and proceeds generally are not subject to creditors of the corporation. • Family attribution rules do not apply.	• Only one policy per owner is needed to fund the agreement. • Premiums paid by the business. Owners share premiums in proportion to their interest in the business. • Creates an asset that enhances the business balance sheet. Source of cash for business contingencies, including lifetime buy-outs of departing owners. • Offers administrative simplicity. Business owns all policies and pays all premiums.
DISADVANTAGES		• If three or more owners are involved, multiple policies are required on each owner. • Where owners differ in age and/or health, premium burden on owners can be unequal.	• Remaining owners do not receive a basis increase in their stock for the purchase price paid to a departing owner. • Life insurance proceeds indirectly increase the value of the deceased owner's taxable estate. • Life insurance proceeds and policy cash values may be subject to the alternative minimum tax (AMT). • Life insurance policies and proceeds are subject to creditors of the business. • The family attribution rules for constructive ownership of stock usually make entity purchase unattractive for family businesses.

[1] The tax deduction for interest expense on general borrowing may be reduced if the business owns life insurance contracts issued after June 8, 1997 on the lives of certain insureds.

[2] Proceeds may be subject to corporate alternative minimum tax. Generally, the alternative minimum tax applies to corporations with average annual gross receipts in excess of $7.5 million for the prior three-year period.

[3] If purchase price received is equal to value of business interest at death, there will be no income tax payable upon sale because the basis in the business interest is stepped up to the fair market value at death.

Principal® Financial Group

WE'LL GIVE YOU AN EDGE®

Principal National Life Insurance Company and Principal Life Insurance Company, Des Moines, Iowa 50392-0001, www.principal.com

BB9093-06 | 09/2015 | t15081301um