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THE *Concept...*

- ◆ A buy-sell agreement obligates one party to purchase a deceased business owner's interest at a certain price, and another party—the deceased owner's estate or heirs—to sell the interest at that price.
- ◆ The agreement gives business owners assurance about who will purchase a deceased owner's interest, what the price will be, when the sale will take place, and where the funds will come from.

THE *Process...*

- ◆ Under an entity type of buy-sell agreement, the business entity agrees to buy the deceased owner's interest.
- ◆ The entity buy-sell agreement is funded by life insurance purchased by the business and covering the life of each owner. The amount of insurance approximates the purchase price for each insured's share of the business.
- ◆ The business gives the employee notice that it intends to buy life insurance on the employee and obtains the employee's written consent.

- ◆ The purchase price is either specified as a certain fixed amount, or the agreement includes a formula for establishing the price.
- ◆ The business entity owns and is the beneficiary of the policies. If an owner dies, the business receives the life insurance proceeds, which it uses to purchase the deceased owner's interest.


THE *Choice...*

- ◆ There is another type of buy-sell agreement—the cross-purchase agreement—under which each business owner individually agrees to buy a portion of the deceased's interest.
- ◆ An entity agreement is often preferred over a cross-purchase agreement when there are many owners. The business owns just one policy for each owner, unlike a cross-purchase agreement where each owner owns a policy on every other owner.
- ◆ Entity agreements are also preferred when there is a wide disparity in the owners' ages. With a cross-purchase agreement, younger owners bear a greater premium burden for policies on older owners.
- ◆ A business may also choose the entity type agreement in order to gain access to policy cash values. Such access is generally not available under a cross-purchase agreement.



THE *Tax Consequences...*

- ◆ Premiums paid for life insurance to fund a buy-sell agreement are not tax-deductible, but the death proceeds are generally excluded from federal income tax if the notice and consent requirements have been met.
- ◆ C corporations may be subject to corporate alternative minimum tax on part of the death proceeds. The inside buildup (in excess of the cost of insurance) is included in the AMT calculation.
- ◆ If a corporate stock redemption agreement is used, there generally is no increase in basis for a surviving owner's interest (as there is with a cross-purchase agreement).
- ◆ Distributions from a corporation to a shareholder are taxed as dividends unless the stock redemption qualifies as an exempted transaction—such as a Section 303 redemption or a complete termination of the shareholder's interest.
- ◆ The price established for a business interest in a buy-sell agreement can fix the value for federal estate tax purposes if strict legal requirements are met.
- ◆ The agreement can base the price on a professional appraisal or a formula that considers such things as the company's earnings history and future earnings potential; the book value of the company's



assets; the general financial condition of the business; any prior sales of business interests; goodwill; and the outlook for the specific industry and the economy in general.

THE *Bottom Line...*

A buy-sell agreement funded by life insurance can be an invaluable tool in helping business owners solve three pressing problems: establishing a price for their business interest, securing a buyer, and assuring that the money to purchase that interest will be there when the need arises. Choosing the type of agreement—entity or cross-purchase—depends on the characteristics of the business and the owners' wishes.



SUMMARY

What Is a Buy-Sell Agreement?

A buy-sell agreement provides that, if one of the owners of a business dies, a buyer will be available to purchase the deceased owner's interest. Equally important, it obligates the deceased's heirs to sell the interest to the buyer named in the agreement.

The entity type of buy-sell agreement provides that the business entity, rather than the surviving individual owners, will buy a deceased owner's interest. Another type of buyout—a cross-purchase agreement—provides that each surviving owner purchase a portion of the deceased owner's interest.

Why Is It Needed?

A buy-sell agreement helps ensure that a business can continue after an owner dies. When funded by life insurance, the agreement provides both the financing and the mechanism to ensure that control of the business will remain with the surviving owners and that the heirs will receive a fair price for their inherited interest.



How Does It Work?


To provide funding for the buyout, the business purchases a life insurance policy covering each owner, with the business entity as the owner and beneficiary. The business must first give notice that it intends to buy insurance on the owner-employee and obtain the owner-employee's written consent.

The amount of insurance approximates the agreed-upon purchase price for each owner's interest. The agreement stipulates either a specific purchase price or a formula for determining that amount. When an owner dies, the life insurance proceeds provide the funds to buy the interest from heirs.

Premiums paid for the insurance aren't tax-deductible, but the death proceeds are generally excluded from federal income tax if the notice and consent requirements have been met. However, C corporations may be subject to the corporate alternative minimum tax on part of the death proceeds. Redemptions that meet certain requirements can avoid being taxed as dividend distributions.

When Is an Entity Agreement Preferred?

The entity buy-sell agreement may be preferable when there are many owners, since it requires the business to purchase only one policy for each owner. A cross-purchase agreement requires every owner to buy a policy covering every other owner.



An entity agreement may also be the preferred choice if there is a wide age disparity among the owners. Under a cross-purchase agreement, younger owners bear a greater premium burden to insure older owners.

If the business wants policy cash values to be available as reserve funds, it must be the owner of the policy. Access to cash values would not be possible in a cross-purchase agreement where the individual business owners are the policyowners.

What Are the Benefits?

With an entity buy-sell agreement funded by life insurance, the business is assured of having the funds to buy out a deceased owner's heirs. The surviving business owners will maintain control of the business and the heirs will receive a fair value for the deceased owner's interest. All the terms of the sale—including the purchase price, when the purchase will occur and where the funds will come from—are decided in advance. In addition, a properly drawn agreement can fix the value of the business interest for federal estate tax purposes.

The benefits are substantial when agreements are made in advance—and in writing—and the apparatus to fund the agreement is in place. The important thing is that owners of small businesses know that they are establishing a fair price for their business interest, and assuring that a willing buyer and a willing seller will be there when the situation arises.



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1. Each business owner is party to a buy-sell agreement with the business.
2. The business gives the employee notice that it intends to buy life insurance on the employee and obtains the employee's written consent. The business pays premiums to the insurance company for life insurance policies insuring each owner.



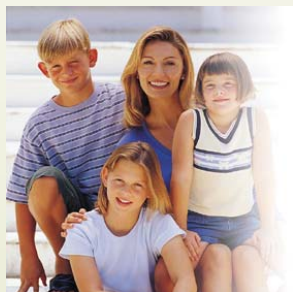
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3. When an owner dies, the business, as owner and beneficiary of the policy on the deceased owner's life, receives the death benefits.
4. The business uses the life insurance proceeds to help purchase the deceased owner's business interest from his or her estate.





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