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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—typically 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 a cross-purchase type of buy-sell agreement, each business owner individually agrees to buy part of a deceased owner's interest. Under another type—the entity buy-sell agreement—the business itself, not the individual owners, agrees to buy the interest.
- To fund a cross-purchase buyout, each owner purchases a life insurance policy covering the life of every other owner. Added together, the policies insuring each owner total the purchase price for that owner's share of the business.
- The buy-sell agreement either specifies a fixed purchase price or provides a formula for establishing the price. Example: Three partners own equal shares in a business valued at $300,000, with each owner's share worth $100,000. To fund a cross-purchase agreement, Owners 1 and 2 each purchase a $50,000 policy covering Owner 3. Owners 2 and 3 each purchase a $50,000 policy covering Owner 1. And Owners 1 and 3 each purchase a $50,000 policy covering Owner 2. The result is two policies covering each owner, for a total of six policies.
- In a cross-purchase agreement, each owner/partner buys and owns policies covering the lives of the others, and is the beneficiary of those policies.
- If an owner dies, the surviving owners use the life insurance proceeds to purchase a share of the deceased owner's interest.

The Result…

- Cross-purchase agreements generally provide that each surviving owner's interest in the business remains the same in relation to the other owners. If the relationships are unequal, they will remain unequal after the death.

Example: Ash owns 60%, Birch owns 20% and Cedar owns 20% of their company. If Cedar dies, Ash's interest is still three times that of Birch. With Cedar's 20% interest divided pro-rata between the two survivors, Ash's ownership grows from 60% to 70%, and Birch's from 20% to 30%.

The Tax Consequences...

- The life insurance premiums paid by each owner personally are not tax-deductible.
- If a corporation pays the premiums on behalf of shareholder-employees, the corporation may be able to deduct the premiums as a reasonable and necessary business expense—but only if the payments are treated as salary. If they are treated as dividends, the business can't deduct them. Either way, the shareholder employee must report these amounts as income.
- The surviving owners receive an increase in basis under a cross-purchase agreement that isn't available in an entity or stock redemption agreement. A basis increase is desirable because it reduces the amount of taxable capital gain upon a future sale of the business interest.
- Any cash value in policies the deceased person owned covering the other business owners is included in the deceased owner's estate, which could affect the estate tax payable.
- The purchase price established 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.

Potential Downsides...

- In a business with many owners, a cross-purchase agreement can be cumbersome because of the number of policies required. For example, with six owners, each owner purchases five policies, for a total of 30 life insurance policies needed to fund the agreement.
- If there's a wide disparity in the owners' ages, the younger owners carry the greater premium-payment burden since the older owners' policies cost more. The business itself

can't use any cash values that may accumulate in the policies since the individuals own the policies, not the business.

The Multiple-Policy Solution...

- To avoid the multiple-policy problem, owners may use a "trusteed" cross-purchase agreement.
- In this situation, the trustee purchases and owns life insurance on each owner, reducing the number of policies to the number of owners. The trustee collects the policy proceeds when an owner dies, pays the proceeds to the deceased owner's estate, and transfers the deceased owner's shares to the surviving owners in the agreed-upon proportions.
- The trusteed arrangement works only if the owners are partners in a partnership. Otherwise, the transfer-for-value rule will apply to taint the death benefits after the first death.

The Bottom Line...

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

Summary

What Is a Cross-Purchase Buy-Sell Agreement?

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

The cross-purchase type of buy-sell agreement provides that each surviving owner individually purchase a portion of the deceased owner's interest. In another type—the entity buy-sell agreement—the business itself purchases the deceased's interest.

Why Is It Needed?

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

How Does It Work?

To provide funding, each owner buys a life insurance policy covering the life of every other owner. Each person owns the policies he or she buys and is the beneficiary of those policies.

Assume a partnership valued at $750,000 is owned by three equal partners—Risley, Radford and Wisman. With a cross-purchase agreement, each partner buys policies on the lives of the other two in the amount of $125,000 each, so that each partner is insured for a total of $250,000.

Assume further that Wisman dies. The death benefits on the two policies insuring his life—one owned by Risley and one by Radford—are paid to the two surviving partners as beneficiaries of the policies. Result: the surviving partners have a total of $250,000 to purchase Wisman's business interest from his heirs.

What's the Tax Picture?

The premiums individual owners pay are not tax-deductible. If, on the other hand, a corporation pays the premiums, they may be deductible if they are treated as compensation to the shareholder-employees on whose behalf they are paid. If the corporation's premium payments are treated as dividends to the shareholders, the premiums would not be deductible by the corporation and the shareholder receiving the dividend would be taxed at the "15 or 20%" rate on corporate dividends applicable to the shareholder.

Life insurance death proceeds are generally received federal income tax free.

What Are Some Other Benefits?

With a cross-purchase buy-sell agreement in place, surviving owners are assured of having the funds to buy out a deceased owner's heirs and maintain control of the business.

While all the terms of the sale are decided in advance, the agreement should provide a mechanism—such as a periodic stock revaluation clause—so that the heirs receive a fair price for the deceased's interest.

The surviving owners receive an increase in basis that can reduce the capital gains taxes on any future sale of the business interest.

Finally, a properly drawn buy-sell agreement can fix the value of the business interest for federal estate tax purposes.

What Are Some Potential Downsides?

A cross-purchase arrangement may be cumbersome when there are many owners, since multiple life insurance policies are required. For example, a business with six owners would require a total of 30 policies to fund the agreement (unless the business uses a trusteed approach).

When there is a wide age disparity among the owners, younger owners bear a greater premium burden to insure older owners.

Because the policies in a cross-purchase agreement are individually owned, cash values accumulating in the policies aren't available to the business.

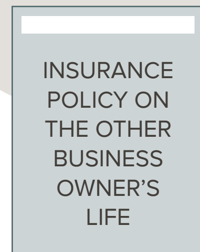
Both the benefits and drawbacks should be considered in determining what type of agreement to put in place. The important thing is that, with any type of properly drawn-up and funded buy-sell agreement, owners of small businesses know that they are establishing a fair price for their business interest, and assuring that the people and the money to purchase that interest will be there when the situation arises.

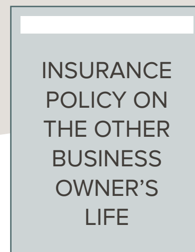
1

The owners execute a buy-sell agreement in which they agree to buy—and commit their estates to sell—the business interest for an agreed-upon price.

2

To fund the agreement, each owner buys a life insurance policy on every other owner.





3

When an owner dies, the family/estate receives the deceased owner's share of the business.

4

The surviving owners use the insurance proceeds to purchase the deceased owner's business interest from the estate under the terms of the agreement.

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