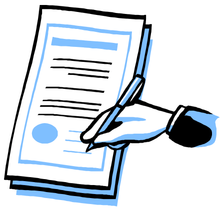


Business Buy Out Plan

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

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. This price can be based on a professional appraisal or formula that takes into account, among other things:

- The earnings history and future earnings potential of the business
- The book value of the company's assets and the general financial condition of the business
- Any prior sales of interests in the business
- Goodwill
- The outlook for the economy in general and for the specific industry

There are two common variations of buy and sell agreements; the ***entity*** agreemen*t* and the ***cross purchase*** agreement.

Bob Rhodes & Small Business Insurance Agency do not provide legal or tax advice. This provided as an overview of potential strategies to address a business interest transfer. Clients should always consult with their own qualified legal and tax advisors.

Entity agreement

Under an entity type of buy-sell agreement, **the business entity, not the individual owners,** agrees to buy the interest. The entity buy-sell agreement is funded by life insurance covering the life of each owner. The amount of insurance approximates the purchase price for the insured's share for the business. The purchase price is either specified as a certain fixed amount, or the agreement includes a formula to be used to establish the price. The business entity owns the policies and is the beneficiary of each. If an owner dies, the business receives the life insurance proceeds, which it uses to buy out the deceased owner's interest.

1. Each business owner is party to a properly drafted buy-sell agreement with business
2. The business pays to the insurance company the premium for life insurance policies insuring each owner.
3. When an owner dies, policy proceeds are paid to the business.
4. The business uses the life insurance proceeds to help purchase the deceased owner's business interest from his or her estate.
5. The premiums are not deductible by business

Although premiums paid for life insurance to fund the buy-sell agreement are not tax-deductible; the death proceeds are generally exempt from federal income tax. Some C corporations may be subject to corporate alternative minimum tax on part of the proceeds. If a corporate stock redemption agreement is used, there 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 generally taxed as dividends, but dividend treatment can be avoided if the stock redemption qualifies as one of certain exempted transactions (e.g., a section 303 redemption, or a complete termination of the shareholder's interest).

An entity agreement is preferred over a cross-purchase agreement when:

- There are many owners. The business owns just one policy for each owner.
- There is a wide disparity in ages of the owners.
- The business wants policy cash values to be available as reserve funds for the business entity

Cross-purchase agreement

Under a cross purchase type of buy-sell agreement, **each business owner individually** agrees to buy a portion of a deceased owner's interest.

To fund a cross-purchase buyout, each owner purchases a life insurance policy covering the life of every owner. The total amount of insurance approximates the purchase price of the insured's share of the business. The purchase price is either specified as a certain, fixed amount, or the agreement includes a formula to be used to establish the price.

1. The individual owners agree to buy and commit their estates to sell the business interest for an agreed-upon price. Each owner buys a policy on the life of every other owner.
2. 2. The agreement is funded with life insurance, with each owner paying premiums to the insurance company
3. 3. When an owner dies, surviving owners receive insurance proceeds.
4. 4. Insurance proceeds are used to help buy the deceased owner's business interest from the estate under the terms of the agreement.

Example: Assume three partners own equal shares in a business. Each owner's share is valued at $1,000,000.

- Owner #1 and Owner #2 each purchase a $500,000 policy covering Owner #3.
- Owner #2 and Owner #3 each purchase a $500,000 policy covering Owner #1.
- Owner #3 and Owner #1 each purchase a $500,000 policy covering Owner #2.

Each business owner/partner owns the policies he or she buys 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. Cross-purchase agreements generally provide that the ownership interest of each surviving business owner remains the same in relation to the other owners. So if the relationships are unequal, they remain unequal after the death.

For example, Ash owns 60%, Birch owns 30% and Cedar owns 10%. If Cedar dies, Ash's interest is still twice that of Birch:

Present Position		Position after Cedar's Death
Ash 60%		66-2/3%
Birch 30%		33-13%
Cedar 10%		-------

Premiums paid personally by each owner are not tax-deductible. Policy proceeds are generally received federal income tax free, subject to rules regarding transfer of policies for a valuable consideration. Surviving owners receive a step-up in basis under a cross-purchase agreement that is not available in an entity or stock redemption agreement. A step-up 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 owns covering the other business owners is included in the deceased owner’s estate, and thus could affect the estate tax payable.

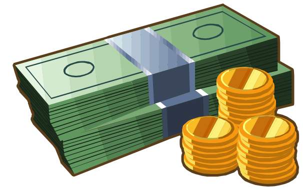
Some reasons why a cross-purchase agreement may not be attractive include:

- If a business has many owners, a cross-purchase agreement can be cumbersome. For example with six owners, each owner purchases a policy covering the other five, for a total of 30 life insurance policies to fund the agreement.
- If there is 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, not the business entity, own the policies.

To avoid the multiple policy concerns, owners may use a "trusted” cross-purchase agreement.

The trustee acquires and owns life insurance to each owner, reducing the number of policies to the number of owners such that offers the simplicity of administration of an entity buy-sell arrangement.

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 appropriate proportions. There are benefits to adopting these arrangements especially regarding administration and implementation. A well crafted plan can avoid the primary concern surrounding violations of IRS Sec. 101 (a) pertaining to transfer for value. Often this can pitfall can be avoided by making use of the “partnership” exempt transfer wherein the policies used to fund the buy-sell agreement are owned by a separate partnership and each insured beneficiary is also a partner. In addition, the partnership “interest” can reflect the proportional value of the business for premium payments.



Insured Funding

Term Insurance

- Term insurance is life insurance that remains in effect for a specified period of time (term) or with a level premium for a specified period of time.
- After initial term, the coverage expires or premiums increase.
- Different periods are available, but most insurers offer terms of either one, five, ten, fifteen or twenty years, some out to thirty years.
- Initially, more insurance coverage is affordable for a lower premium cost.
- Term can be combined with permanent insurance for to meet budgeting concerns.
- Term may convertible to a permanent policy without proving insurability.
- Unlike permanent insurance, most term insurance plans do not build cash values-there is no "savings" element
- Premiums increase each time the policy term ends rising sharply as the insured person grows older

Permanent Insurance

- Protection continues for the insured person's lifetime with no requirement for renewal, as long as the premiums are paid.
- Premiums are typically payable as long as the insured lives, except for a variation called "limited pay" policies
- Premiums are established at policy inception and remain level throughout the payment period. They do not increase as the insured ages.
- Part of each premium is allocated in a cash value account that may gradually increases over the life of the policy.
- Cash value accumulations are available to the policy owner at any time during the life of the policy in the form of policy loans or withdrawals.
- The two most common forms of permanent insurance are whole life and universal life plans.
- ***Policies may be continued or utilized to provide added "select" retirement benefits for owners.***