Cross-Purchase Buy-Sell Agreement

The Concept…

- A buy-sell agreement is a legally binding contract that establishes under what conditions, to whom and at what price an owner, partner or shareholder can or must sell a business interest.
- The agreement gives business owners assurance about who will purchase a deceased owner's interest, what price will be paid, when the sale will take place and how the purchase will be funded.

The Process…

- A buy-sell agreement specifies a fixed purchase price or provides a formula for establishing the price.
- Under a cross-purchase buy-sell agreement, each business owner individually agrees to buy a part of a deceased owner's interest. This is in contrast to the entity-purchase buy-sell agreement, in which the business itself agrees to buy the interest..
- To fund a cross-purchase buyout, each owner purchases a life insurance policy on the life of every other owner. Added together, the proceeds from the policies on a deceased owner will equal the purchase price for that owner's share of the business.
- Each owner buys, owns and is the beneficiary of individual policies covering the life of each owner.
- **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.
- If an owner dies, each of the surviving owners uses the life insurance proceeds to purchase a share of the deceased owner's interest.

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No Bank or Credit Union Guarantee	Not FDIC/NCUA Insured	May Lose Value

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The Result…

- Cross-purchase agreements generally provide an equitable way to divide a surviving owner's business interest so that post-death ownership interests remain relatively the same in relation to other owners. If the relationships are unequal to begin with, they will remain unequal.
- **Example:** Alma owns 60%, Betty 20% and Catherine 20% of their company. The cross-purchase agreement states that if one owner dies, her interest is divided equally between the survivors. Therefore, if Betty dies, Alma's ownership interest grows from 60% to 70%, while Catherine's interest grows from 20% to 30%.

The Tax Consequences...

- Life insurance premiums paid by each individual owner are not tax-deductible.
- If a corporation pays the premiums on behalf of shareholder-employees, the corporation can deduct the premiums as a reasonable and necessary business expense as long as the premiums paid are reported as salary. If treated as dividends, the business cannot deduct the premiums paid. 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 attractive because it reduces the amount of capital gains tax due when and if a sale of the business interest occurs.
- Any cash value in policies owned by the deceased business owner (covering the other business owners) is included in the deceased owner's estate, which could affect estate tax liability.
- The purchase price established in a buy-sell agreement can fix the value for federal estate tax purposes when strict legal requirements are met. The agreement can base the price on a professional appraisal or a formula that considers factors such as:
    - the company's earnings history
    - 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
    - the outlook for the industry
    - 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 involved. 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, younger owners carry a greater premium-payment burden since policies on older owners cost more.
- The business cannot use any cash values that may accumulate in the policies since the business does not own the policies.

The Multiple-Policy Solution for Partners…

- To avoid the multiple-policy problem, owners may use a "trusteed" cross-purchase agreement.
- The trusteed arrangement works only if the owners are partners in a partnership. Otherwise, the transfer-for-value rule will taint the death benefits after the first death.
- With a trusteed agreement, 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 Bottom Line…

A buy-sell agreement fully funded with life insurance can be an invaluable tool in helping business owners establish a price for their share of the business, secure a buyer and ensure that the money to purchase the interest is 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 business owners dies, the remaining owners will purchase the deceased owner's interest. Equally important, it obligates the deceased owner's heirs to sell the interest to the other owners.

A cross-purchase type of buy-sell agreement provides that each surviving owner purchase a portion of the deceased owner's interest. This is in contrast to the entity buy-sell agreement, where the business entity purchases the deceased owner's interest.

Why Is It Needed?

A buy-sell agreement helps ensure that a business will continue after an owner dies. When the buy-out is fully funded with life insurance, the agreement provides:

- Financing and the mechanism to ensure that control of the business remains with the surviving owners
- Assurance that heirs will receive immediate cash 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 and is the beneficiary of each individual policy.

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.

If 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. Together, the surviving partners have a total of $250,000 to purchase Wisman's business interest from his heirs.

What's the Tax Picture?

Premiums paid by individual owners are not tax-deductible. If, on the other hand, a corporation pays the premiums, they are deductible when payments are treated as compensation to the shareholder-employee on whose behalf premiums are paid. Premium payments treated as dividends to shareholders are not deductible by the corporation. Either way, premiums paid by a corporation are treated as income to the shareholder-employee and taxed as such. Life insurance death benefits, however, 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 (a periodic stock revaluation clause, for example) so that heirs receive a fair price for the deceased's interest. Surviving owners receive an increase in basis that can reduce the capital gains tax on a 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.

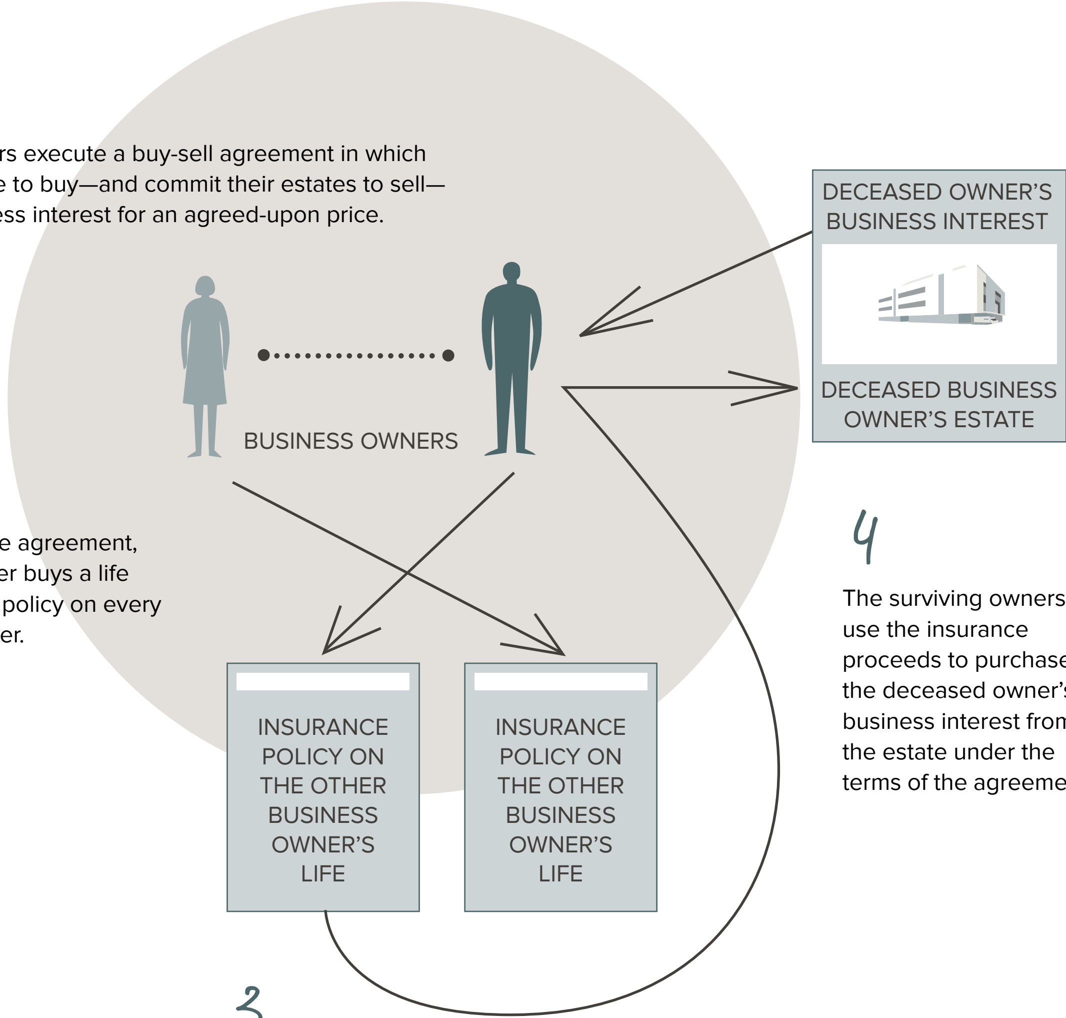
What Are the Potential Downsides?

A cross-purchase arrangement can be cumbersome when there are many owners, since multiple life insurance policies are required. In addition, when there is a wide age disparity among the owners, younger owners bear a greater premium burden to insure older owners. Finally, because the policies in a cross-purchase agreement are individually owned, cash values accumulating in the policies are not available to the business.

Both the benefits and the drawbacks should be considered in determining what type of agreement to put in place. It is important to note that, with any properly drawn and fully funded agreement, owners of small businesses know that they are establishing a fair price for their interest. They can further rest assured that willing buyers with the financial ability to purchase the business interest will be there when needed.

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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CLC.963399.08.19