StatonWalsh

Financial Clarity Through Transparency

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Buy-Sell Agreement

In order to guarantee a buyer for the interest in a business (particularly a minority interest which may be of very little value to one's heirs), consideration should be given to a lifetime agreement among the business owners as to how to dispose of the business.

Entity Plan

Under an entity plan the organization buys the interest of the deceased business owner. This type of arrangement is often used when there are several owners.

Cross-Purchase Plan

Under this plan each surviving owner agrees to buy the interest of any deceased owner.

An attorney should be consulted in deciding which plan is better.

Advantages of Buy-Sell Agreements

- Guarantees a buyer for an asset that probably will not pay dividends to one's heirs.
- Can establish a value for federal estate tax purposes that is binding on the IRS. See IRC Sec. 2703.
- Spells out the terms of payment and is easily funded with life insurance and disability insurance.
- Provides a smooth transition of complete ownership, management, and control to those who are going to keep the business going.

Funding a Buy-Sell Agreement

Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement - Corporation

When a stockholder dies, the disposition of his stock depends upon several key factors:

- Is the decedent a majority or minority stockholder?
- Is retention or sale of stock desired?
- Will death costs or the needs of the heirs force the sale?
- Is there a market for the stock?

Ownership Situation	Additional Considerations
Decedent was minority owner	A minority interest in a corporation has little value to an owner who is not an employee. Close corporations rarely pay dividends. Without an agreement the estate is in a poor bargaining position. Minority stockholders can cause problems.
Decedent was equal owner	Decedent's spouse or children may have a vote equal to the shareholder who is running the business.
Decedent was majority owner	Can a minority stockholder afford the buyout? Are the payments tied to the success of the business? Can a minority stockholder keep the business successful?
Decedent was sole owner	Who will buy the stock? Child? Key employee? Competitor? How will he or she pay for it if the business fails?

A Buy-Sell Agreement Brings Certainty

One way to bring certainty to these unanswered questions is a binding buy-sell agreement which benefits all parties:

- **Benefits to the deceased's family.**
  - They receive a fair price for the stock.
  - They are free from business worries.
- **Benefits to the buyer of business.**
  - He or she has control of business and its future earning potential.
- **Price and terms.**
  - These are established prior to the crisis.

- **Additional lifetime benefits.**
  - Prospective owners may work harder if the business may someday be theirs.
  - The agreement can cover a buyout at retirement, disability or disagreement.

Funding a Buy-Sell Agreement

Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement – Cross-Purchase vs. Stock Redemption

	Cross-Purchase Buy-Sell	Corporate Stock Redemption
Parties to the plan	A cross-purchase plan is between the shareholders themselves.	A stock redemption plan is between the corporation and the stockholders.
Income tax treatment at a later sale of stock by the surviving shareholders	Purchasing stockholders get a new basis in acquired stock, which is used to measure taxable gain at a later sale of the stock.	The surviving stockholders own a larger percentage of the outstanding shares, but their basis in the stock does not change, causing a higher capital gain at a later sale of the stock.
State laws restricting stock redemptions	Only applies to redemptions by the corporation.	State laws may require that redemptions of stock can be made only from company surplus.
Family attribution rules IRC Sec. 318	Only applies to redemptions by the corporation.	These rules may cause what appears to be a total redemption of a decedent's stock, to be treated as a taxable dividend.
Are life insurance policies available to corporate creditors?	Not generally. It is possible, if for some reason, the life policy is not insulated from the corporation's creditors.	The cash values and the proceeds would generally be available to the creditors of the corporation.
Who pays the premiums on insured plans?	The shareholders. If corporation pays, it must be treated as additional compensation.[1]	Corporation is the policy owner, beneficiary, and the premium payer.[1]
Are there problems when transferring the policies which the decedent owned on other shareholders?	A purchase of these policies by a surviving shareholder will create a transfer for value which may cause the proceeds to be partially subject to income taxation.	Policies are owned by the corporation. No need to make a transfer when one shareholder dies.
What if the corporation needs the proceeds?	Available only if the surviving shareholders are willing to lend the proceeds to the corporation.	Corporation has the right to collect the proceeds at date of death.

[1] Both cross-purchase and stock-redemption agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income. If certain regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

	Cross-Purchase Buy-Sell	Corporate Stock Redemption
Which is easier to understand?	At death, there may be multiple buyers of the decedent's shares. In an insured plan this also means multiple policies on each shareholder.	Generally thought to be easier to understand. At time of death, only one buyer (the corporation) and one seller (the deceased shareholder's estate).
What's wrong with multiple insurance policies?	The plan may require many policies. The formula is: (number of shareholders) times (number of shareholders - 1). For example, if there were 5 shareholders, you would need 20 life insurance policies, i.e., 5 x (5-1)	Need only one policy for each shareholder.
Other considerations	• If a stockholder is having trouble paying the premium, he or she may allow the policy to lapse. • Insurance may cost more if the corporation is in a lower tax bracket than the individuals.	• It permits the pooling of premium obligations.[1] • No question arises as to unreasonable compensation. This often occurs when salaries are increased to pay the premiums for life insurance used to fund a cross-purchase agreement. • The voting power could be altered in an undesirable way.[2]

Wait-and-See Buy-Sell Agreement

If it seems difficult to make the decision as to which plan to use, one may consider what is called a wait-and-see buy-sell agreement.

- Stockholders and corporation agree to the following:

[1] When one stockholder is older and/or the majority owner and the other is younger and/or a minority owner, the insurance premiums may be vastly different.

[2] Example: Father owns 30%, son owns 30% and unrelated key man owns 40%. A combined vote of father and son controls the business. If father's stock is redeemed at his death, the unrelated key man would own a majority of the outstanding stock and control the business.

- The surviving shareholders have the option[1] to purchase the shares of the deceased shareholder, and
- The corporation has the obligation to redeem the shares to the extent they are not purchased by the shareholders.

- Funding should be as in a cross-purchase plan.
- When a shareholder dies, the survivors elect one of two options:
    - Option one.

      Collect insurance proceeds.
      Buy the shares individually.

    - Option two.

      Collect insurance proceeds.
      Lend proceeds to the corporation.
      Cause the corporation to redeem the shares.
      Corporation issues interest-bearing notes to repay loans.

- An alternative arrangement.
    - The corporation has the first option to purchase the stock at the price or formula set in the agreement.
    - If the corporation fails to exercise its option, the surviving shareholders have a second option to purchase the stock.
    - If the survivors fail to purchase the stock, or only purchase a portion of it, then the corporation is required to purchase the remainder.

[1] The wait-and-see plan is generally most desirable. However, if a shareholder is obligated to purchase stock and doesn't, a later purchase by the corporation would likely be a dividend.

Buy-Sell Agreement – Limited Liability Company

Manager-Managed LLC

At death, the disposition of a member's interest in a limited liability company (LLC) depends on how the company is structured.

Like a partnership, an LLC can have two or more members. A "manager-managed" LLC, is actively managed by a designated manager, with the members having only an ownership interest in the company.

Death of a Member

At the death of a member in a manager-managed LLC, the executor may have several choices, depending on the terms of the Operating Agreement for the LLC:

- The executor may sell the interest.
  - Potential buyers may be restricted to existing LLC members.
  - The value of the deceased member's interest may be limited by the terms of the LLC Operating Agreement or by a limited market for the interest.
  - The growth in the value of the business interest may not be realized.
  - Family income may be eliminated.
- The executor may transfer the interest to the heirs.
  - Any transfer to heirs may be restricted by the LLC Operating Agreement.
  - The heirs often have conflicting interests and needs.

Death of a Manager

If the manager of this type of LLC dies, the surviving members of the LLC can generally either elect a new manager to continue the business of the LLC or dissolve the LLC. Often, the deceased manager is also a member of the LLC and the deceased's membership interest must be sold or transferred as part of continuing the business of the LLC or dissolving it.

The untimely death of a manager can have a disastrous effect on the LLC:

- Creditors may become worried and may want to be paid immediately.
- Operating the business may be difficult without the deceased manager's skills.

- Debtors may not pay.
- The remaining member(s) may be forced to sell assets at “fire sale” prices.
- Good will may be lost.
- The deceased member’s family may not understand why the income has stopped.

A Potential Solution: A Binding Buy-Sell Agreement[1]

- **Entity plan:** Under this arrangement, the LLC purchases the deceased or withdrawing member’s interest.

- **Cross-purchase plan:** Under this arrangement, the surviving member purchases the deceased or withdrawing member’s interest.

A Buy-Sell Agreement Benefits All Parties[2]

BENEFITS TO DECEASED’S FAMILY	BENEFITS TO BUYER OF BUSINESS	ADDITIONAL LIFETIME BENEFITS
• Freed of business worries. • Not forced to sell assets. • Family gets a fair price for business interest. • Estate is settled more quickly.	• The owner has full control of the business and its future earning potential. • May alleviate concerns of creditors or suppliers.	• The agreement can cover a buy out at retirement, disability, or a disagreement. • It produces a sense of security that heirs are protected and that the business will continue.

[1] An attorney should be consulted in deciding which plan is better and in preparing the agreement.

[2] Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement – Limited Liability Company

Member-Managed LLC

At death, the disposition of a member's interest in a limited liability company (LLC) depends on how the company is structured.

Like a partnership, an LLC can have two or more members. A "member-managed" LLC, as the name implies, is managed by the members themselves.

When a member of a member-managed LLC dies, the disposition of the deceased member's interest depends upon several key factors:

- Does the deceased member want his or her interest sold or retained by the heirs?
- Will death costs or the needs of the heirs force the sale of the business?
- Can the remaining members afford to buy the deceased member's interest?
- Can the members operate the business without each other?

In the absence of a continuation agreement, an LLC is dissolved at the death of a member. The surviving members become the liquidation trustees, responsible by law for dissolving and terminating the business.

Common Problems During Dissolution

If the LLC is dissolved, the liquidating trustee can expect problems:

- Creditors may become worried and may want to be paid immediately.
- Operating the business may be difficult without the deceased member's skills.
- Debtors may not pay.
- The remaining member(s) may be forced to sell assets at "fire sale" prices.
- Good will may be lost.
- The deceased member's family may not understand why the income has stopped.

Buy-Sell Agreement – Limited Liability Company

A Potential Solution: A Binding Buy-Sell Agreement[1]

- **Entity plan:** Under this arrangement, the LLC purchases the deceased or withdrawing member's interest.

- **Cross-purchase plan:** Under this arrangement, the surviving member purchases the deceased or withdrawing member's interest.

A Buy-Sell Agreement Benefits All Parties[2]

BENEFITS TO DECEASED'S FAMILY	BENEFITS TO BUYER OF BUSINESS	ADDITIONAL LIFETIME BENEFITS
• Freed of business worries. • Not forced to sell assets. • Family gets a fair price for business interest. • Estate is settled more quickly.	• The owner has full control of the business and its future earning potential. • May alleviate concerns of creditors or suppliers.	• The agreement can cover a buyout at retirement, disability, or a disagreement. • It produces a sense of security that heirs are protected and that the business will continue.

[1] An attorney should be consulted in deciding which plan is better and in preparing the agreement.

[2] Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement – Limited Liability Company

Single-Member LLC

At death, the disposition of a member's interest in a limited liability company (LLC) depends on how the company is structured.

An LLC can be owned and managed by a single member. If the owner of a single-member LLC dies, his or her executor is generally faced with the same situation as if the decedent had been a sole proprietor. The executor can:

- Temporarily continue the business; or
- Close down the business; or
- Transfer the business to the heirs; or
- Sell the business.

Each of these options can present issues with regard to loss of business value, creditor problems, conflicts with heirs, and loss of business income.

A Potential Solution

One potential solution is a binding buy-sell agreement, benefiting all parties involved:

- **Benefits to the deceased's family.**
  - Freed from business and creditor worries.
  - Not forced to sell assets at "fire sale" prices.
  - Family gets a fair price for the business.
  - Estate is more quickly settled.
- **Benefits to the buyer of the business (usually a key employee).**
  - He or she still has a job and his or her income continues.
  - He or she owns the business and controls its future success.

- **Other advantages of buy-sell agreements.**
  - Guarantees a buyer for an asset that probably will not pay dividends to one's heirs.
  - Can establish a value for federal estate tax purposes that is binding on the IRS. IRC. Sec. 2703
  - Spells out the terms of payment. If desired, payment may be funded with life and disability insurance.[1]
  - Provides a smooth transition of complete ownership, management, and control to those who will continue the business.

[1] Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local income tax law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement - Partnership

At death, the disposition of a partner's interest depends upon several key factors:

- Does the partner want his/her interest sold or retained by the heirs?
- Will death costs or the needs of the heirs force the sale of the business?
- Can the remaining partners afford to buy the deceased partner's interest?
- Can the partners operate without each other?

In the absence of a continuation agreement, a partnership is dissolved at the death of a partner. The surviving partner(s) becomes the liquidation trustee, who is responsible by law for dissolving and terminating the business.

Common Problems During Dissolution

During the dissolution process, the liquidating trustee partner can expect problems:

- Creditors may become worried and may want to be paid immediately.
- Operating the business may be difficult without the deceased partner's skills.
- Debtors may not pay.
- The remaining partner may be forced to sell assets.
- Good will may be lost.
- Deceased partner's family may not understand why the income has stopped.

A Better Solution Is a Binding Buy-Sell Agreement

- **Entity plan:** Under this arrangement, the partnership purchases the deceased or withdrawing partner's interest.

- **Cross-purchase plan:** Under this arrangement, the surviving partners purchase the deceased or withdrawing partner's interest.

Note: An attorney should be consulted in deciding which plan is better and in preparing the agreement.

A Buy-Sell Agreement Benefits All Parties

BENEFITS TO DECEASED'S FAMILY	BENEFITS TO BUYER OF SMALL BUSINESS	ADDITIONAL LIFETIME BENEFITS
• Freed of business worries. • Not forced to sell assets. • Family gets a fair price for business interest. • Estate is settled more quickly.	• The owner has full control of the business and its future earning potential. • May alleviate concerns of creditors or suppliers.	• The agreement can cover a buy out at retirement, disability or disagreement. • It produces a sense of security that heirs are protected and that the business will continue.

Funding a Buy-Sell Agreement

Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement - S Corporation

Cross-Purchase

A cross-purchase buy-sell agreement would be basically the same in an S corporation as with a regular C corporation.

Stock Redemption

Because of the tax treatment of the S corporation, the stock redemption plan has a few different considerations:

- Since most income passes through to the shareholders, there is little opportunity to manipulate the corporate and individual tax brackets.
- Accumulation of funds by the S corporation would be taxed at the shareholders' top marginal tax brackets. Life insurance would lessen this problem because the premiums are often times less than the amount needed for the buyout. Applicable state insurance laws must be reviewed to make sure shareholders have an "insurable interest" in the other shareholders.
- If stock passes to too many persons in addition to the existing shareholders, currently limited to 100 persons, the S corporation election may be lost.
- A beneficiary who inherits S corporation stock (so that he or she then owns more than 50% of the shares) could possibly revoke the election, contrary to the wishes of the other shareholders.
- Life insurance proceeds may be income tax exempt to both the S corporation and individual shareholders; the basis of stock held by each shareholder is increased by his or her share of the proceeds. Income from a stock redemption may be treated as a mix of taxable dividend and capital gain, or it may be treated solely as a capital gain transaction.

Funding a Buy-Sell Agreement

Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Buy-Sell Agreement - Sole Ownership

The Death of a Sole Owner

When the sole owner of a business dies, his or her executor has several choices, some of which have potential problems:

- **The executor can temporarily continue the business.**
    - The executor may be unfamiliar with the business.
    - There can be some loss in good will.
    - The executor may be liable for any business losses.
    - Creditors will typically want to be paid immediately.
    - Subsequent sale may bring less than the value determined for federal estate tax purposes.
- **The executor can close down the business.**
    - Loyal employees are out of work.
    - Family income ceases.
    - Accounts receivable may be very difficult to collect.
    - The estate may receive only minimal value for the business.
- **The business can be transferred by will to the heirs.**
    - Heirs may not have the desire or ability to run business.
    - The heirs often have conflicting interests and needs.
    - There can be some loss of good will.
    - The business may have to be sold to pay the taxes and expenses.
    - Creditors will typically want to be paid immediately.
    - Accounts receivable may be very difficult to collect.

The executor can sell the business.

- Buyers may pay only a fraction of the going-concern value.
- Creditors will typically want to be paid immediately.
- Accounts receivable may be very difficult to collect.
- Family income is eliminated.

A Better Solution

There is a better solution - a binding buy-sell agreement which benefits all parties.

- **Benefits to the deceased's family.**
  - Freed from business and creditor worries.
  - Not forced to sell assets.
  - Family gets a fair price.
  - Estate is more quickly settled.
- **Benefits to the buyer of business** (usually a key employee).
  - He or she still has a job and his or her income continues.
  - He or she owns the business and controls its future success.

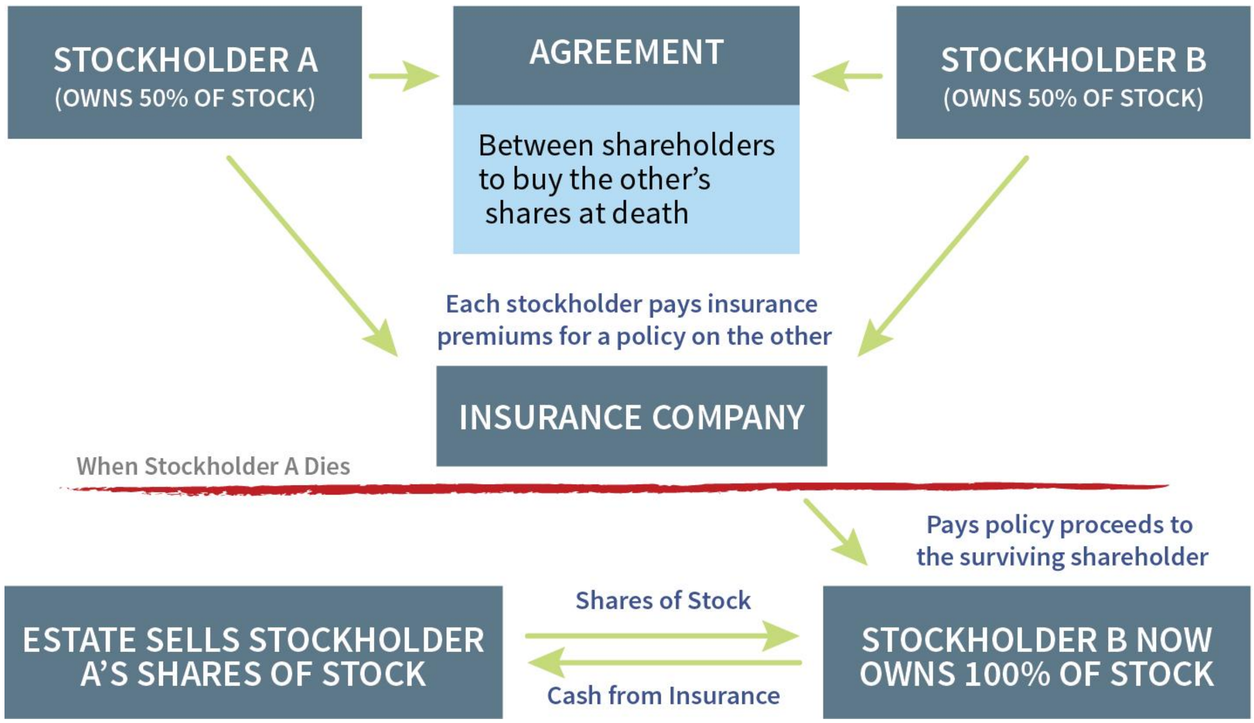
Lifetime Benefits

In addition to the benefits explained above, there are also various benefits which occur during the lifetime of the owner.

- Knowing the business will continue gives employees stability.
- Knowing that he or she may someday own the business, the prospective buyer can assume more responsibility and work harder.
- Key employee can be put in charge when owner retires.

Cross-Purchase Buy-Sell Agreement

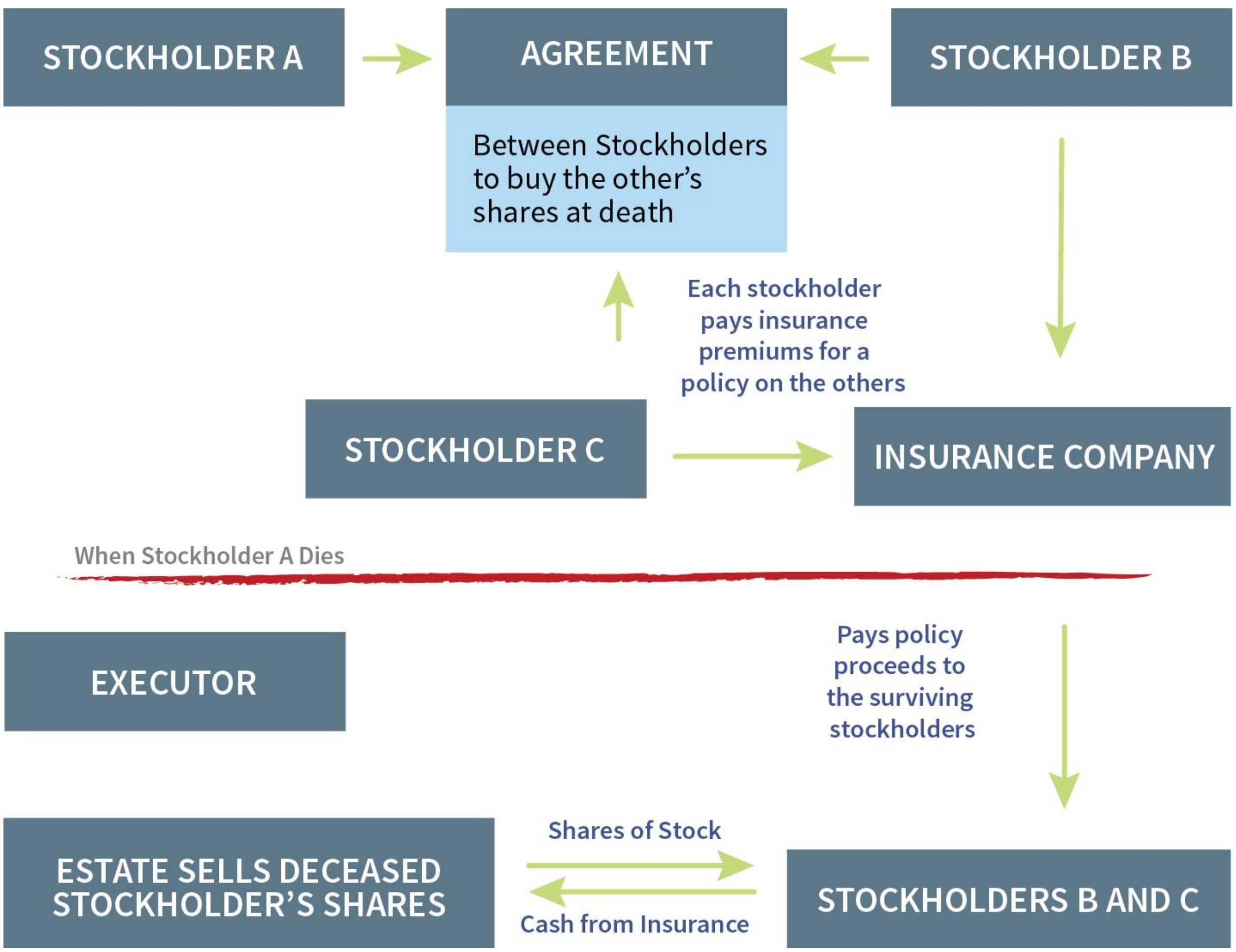
A cross-purchase buy-sell agreement involves shareholders entering into an agreement with each other, rather than with the corporation, to insure an orderly disposition of their stock in the event of an untimely death or disability.



Advantages	Disadvantages
The transferred shares receive a new income tax basis equal to the price paid. This will mean a tax savings, if the stock is later sold at a higher price.	Plan is more difficult to administer if more than two or three shareholders.
No problem with state laws restricting redemptions.	Requires more policies, e.g., 12 policies for 4 shareholders, 20 policies for 5 shareholders, etc.
No problem with IRC Sec. 318 attribution rules.	Some policies may lapse if owner doesn't make the payments.
Life policies may be insulated from the corporation's creditors.	Life insurance proceeds may be taxable if the provisions of IRC Sec. 101(j) apply.

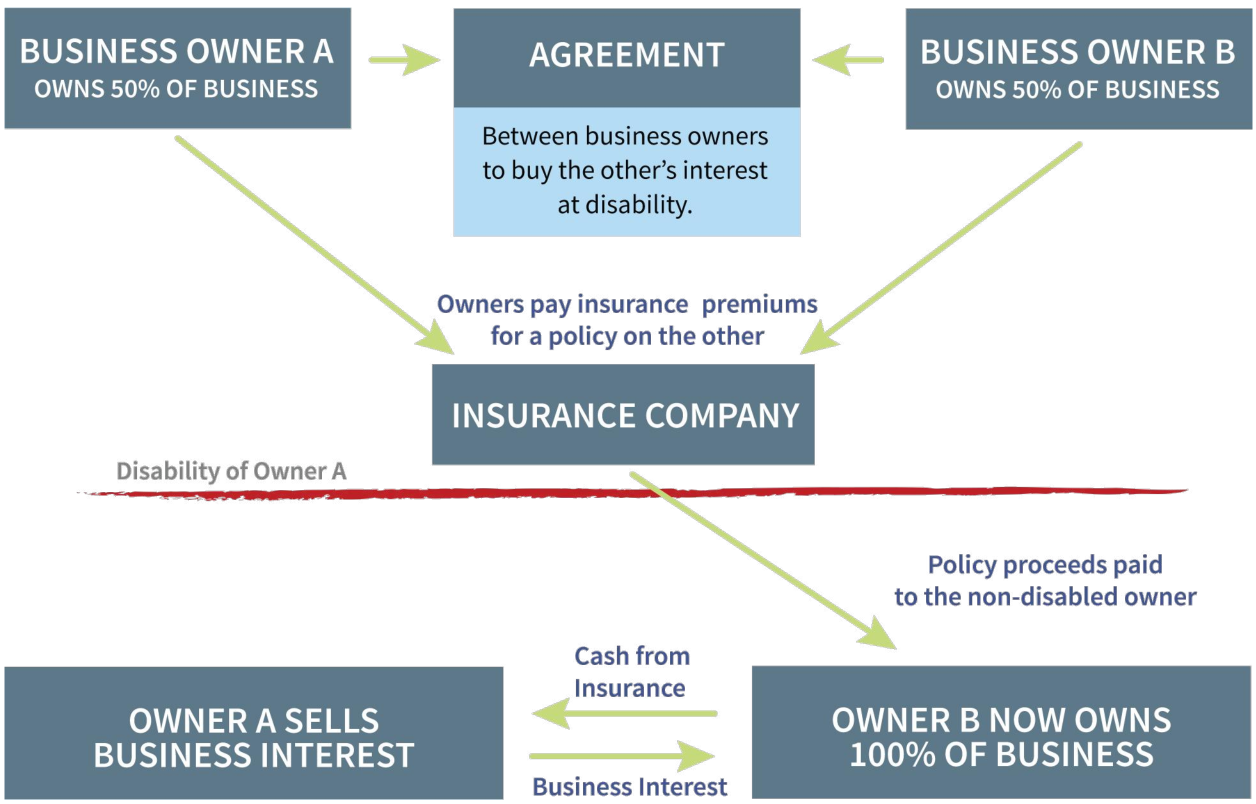
Cross-Purchase Buy-Sell Agreement with Three or More Owners

A cross-purchase buy-sell agreement involves stockholders entering into an agreement with each other, rather than the corporation, to insure an orderly disposition of their stock in the event of an untimely death or disability.



Disability Buy-Out Cross-Purchase Agreement

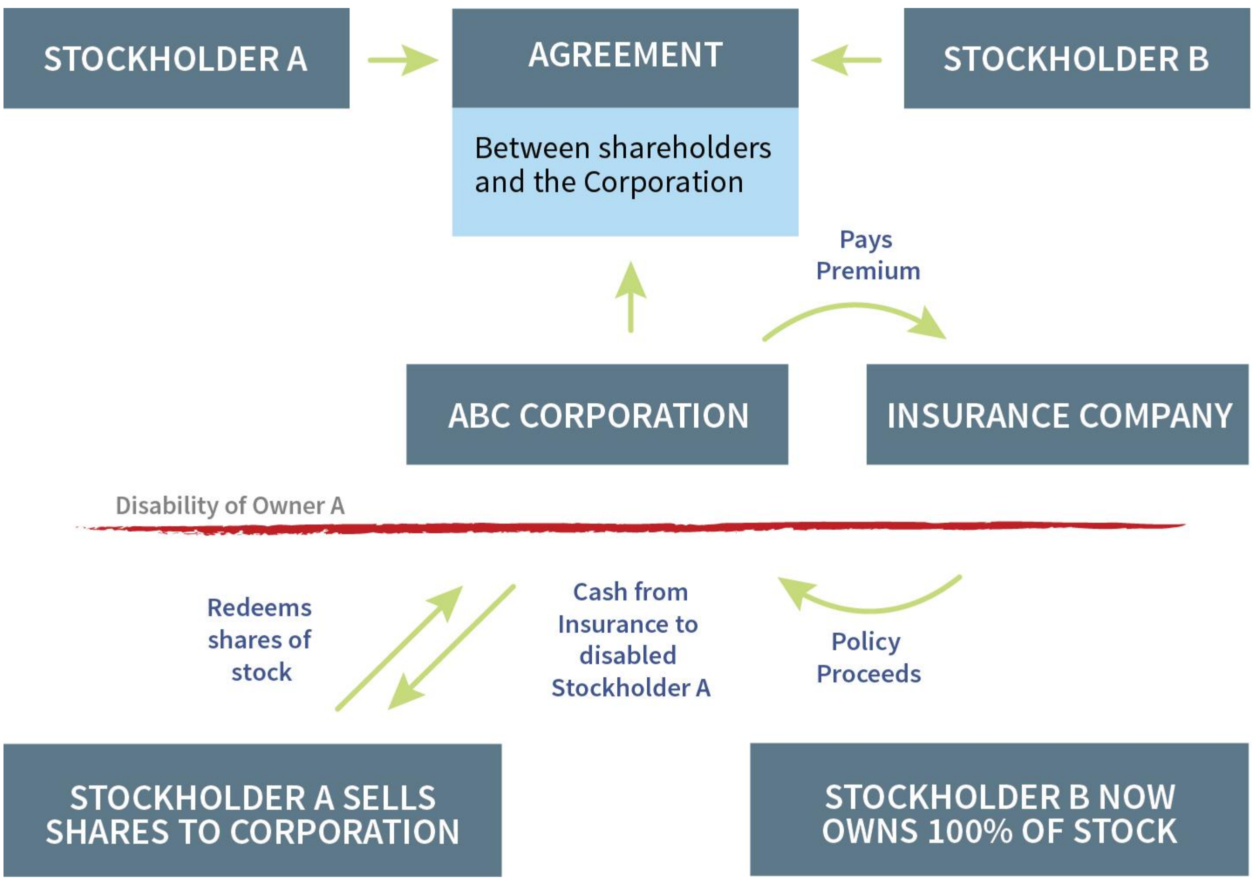
A cross-purchase buy-sell agreement involves business owners entering into an agreement with each other to assure an orderly disposition of their business interest in the event of disability.



Advantages	Disadvantages
The transferred interests receive a new income tax basis equal to the price paid. This will mean a tax savings, if the interest is later sold at a higher price.	Plan is more difficult to administer if more than two or three business owners.
No problem with state laws restricting redemptions.	Requires more policies, e.g., 12 policies for 4 owners, 20 policies for 5 owners, etc.
Disability policies may be insulated from the company's creditors.	Policies may lapse if owner doesn't make the payments.

Disability Buy-Out Stock Redemption Plan

A stock redemption plan involves stockholders entering into an agreement with the corporation to insure an orderly disposition of their stock in the event of disability.



Advantages	Disadvantages
Usually easier to understand than the cross-purchase plan.	Voting power may be altered unfavorably.
Fewer policies in insured plans.	Strict state redemption laws must be followed.
No questions as to unreasonable compensation issues when agreement is properly written.	Value of non-disabled owner's shares increase but not basis.

Making Buy-Sell Agreements Acceptable to the IRS

When a business owner dies, there is a risk that the IRS will include his or her business interest in the gross estate at a value that exceeds the price at which it is actually sold to a new buyer. To reduce the possibility of such a hardship, many business owners enter into a buy-sell agreement, while they are still living.

If the new buyer happens to be the business owner's son or daughter, it is easy to imagine the parent directing his executor to sell the business to that child at a value which is far below fair market value. This would cause the estate to have a lower value and thus the government would collect a smaller federal estate tax. Therefore, buy-sell agreements between family members are generally subject to very close scrutiny by the IRS.

The government recognizes the use of buy-sell agreements to peg the value of a business for estate tax purposes, so long as there is no abuse in the area of valuing the business.

Rules for Business Valuation

The Internal Revenue Code provides these rules for business valuation in IRC Sec. 2703.

- The agreement must be a bona fide business arrangement.
- It must not be merely a device to transfer the business interest to family members[1] for less than full and adequate consideration.
- The terms of the agreement must be comparable to those found in similar arrangements entered into by persons in an arm's length transaction.

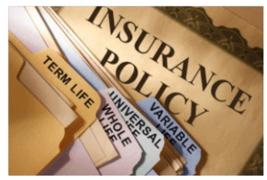
If the parties to the agreement are not related to one another and are not the natural objects of each other's bounty, they can set the value of their stock for federal estate tax purposes with a buy-sell agreement using a formula, a fixed price, or provision for an independent appraisal.

If the parties to the agreement are related,[1] they must use a reasonable formula in the agreement or agree to the use of independent appraisals after death occurs in order to establish a binding value. An experienced professional business appraiser who is familiar with the industry should choose the formula.

[1] Family members are defined in the regulations to include one's spouse, parents of either spouse and their lineal descendants (and their spouses), and other individuals who would be the natural objects of the transferor's bounty. See Reg. Sec. 25.2701-1, 25.2701-2.

Methods of Funding a Buy-Sell Agreement

In the event of a business owner's death, there are several options to consider for funding a Buy-Sell agreement:

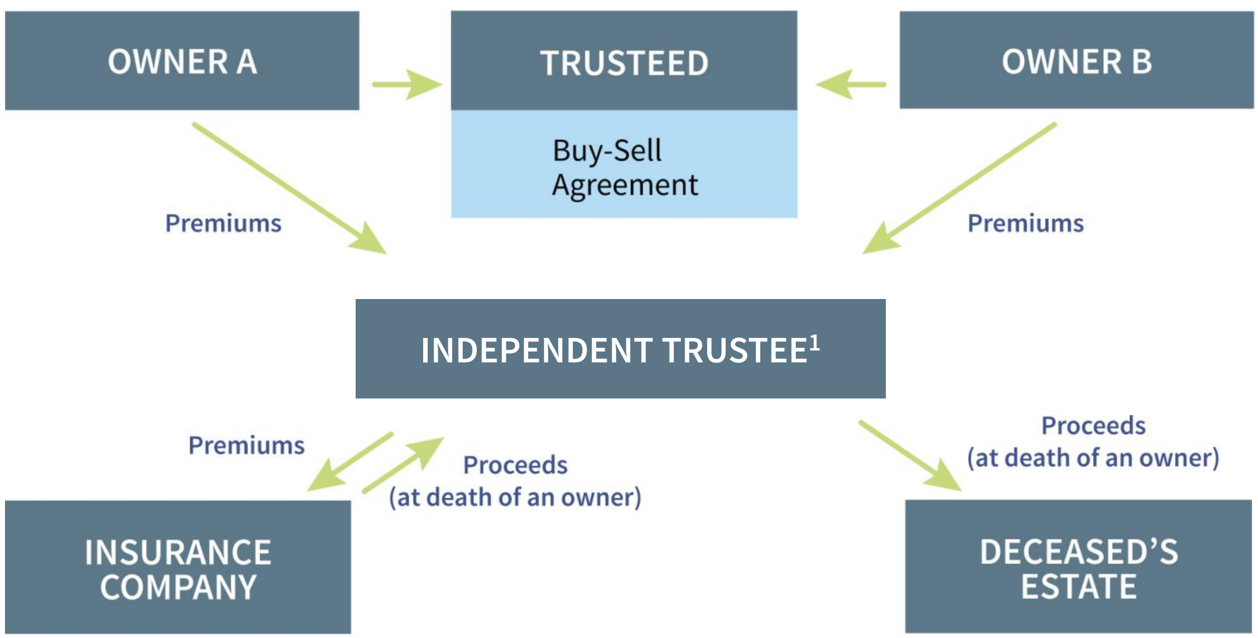



- **Personal funds of buyers:** Most successful business people do not keep large sums of liquid assets on hand. They have their money working in their businesses.
- **Sinking fund in the business:** Such a fund will be inadequate if death is premature and the time of need is uncertain. A corporation may develop an accumulated earnings tax problem.
- **Borrowed funds:** Loss of a key person (such as an owner) may impair the credit worthiness of the business and other partners or shareholders. Interest costs may be excessive, and the interest expense of shareholders or partners may not be deductible.
- **Installment payments to heirs by buyer:** The business may fail and the payments stop. The principal and interest payments may be too burdensome.
- **Life insurance owned by the buyer:**
  - Complete funding from policy proceeds may be available from the beginning.
  - Proceeds may be free from income tax; see IRC Sec. 101(j).
  - Cash values can be used for a buyout due to retirement or disability.
  - It is generally the most economical method.
  - Credit position is strengthened.

Trusteed Corporate Buy-Sell Agreement

One of the advantages of a cross-purchase buy-sell agreement is that each surviving stockholder gets a new income tax basis on the stock which he or she purchases from the deceased (or departing) shareholder. The new basis would be equal to the amount paid for the stock. This will reduce income taxes if the business is later sold for a higher amount.

One disadvantage to insurance-funded cross-purchase buy-sell plans becomes apparent when there are several owners. For example, if there were five owners, each of them would have to own a policy on each of the other four owners. This would mean that a total of 20 different policies would be required. To get the benefits of the increased tax basis and a fewer number of polices, one should consider a trusteed buy-sell agreement.



[1] Unless certain requirements are met, life insurance proceeds may be includable in income. See IRC Sec. 101(j).

Trusteed Corporate Buy-Sell Agreement

DURING LIFE	AT DEATH
Each owner signs an agreement with an independent trustee to do the following: • Endorse their stock certificates in blank and deliver them to the trustee. • Agree to allow the trustee to take out an insurance contract on his or her life. • Contribute funds to pay the premiums on the policies on the lives of the other owners.	• The trustee collects the insurance proceeds on the decedent's life and delivers them to his or her estate. • The trustee, under the terms of the agreement, sees that the corporation issues new shares to each of the surviving owners in exchange for the shares which belonged to the deceased owner.

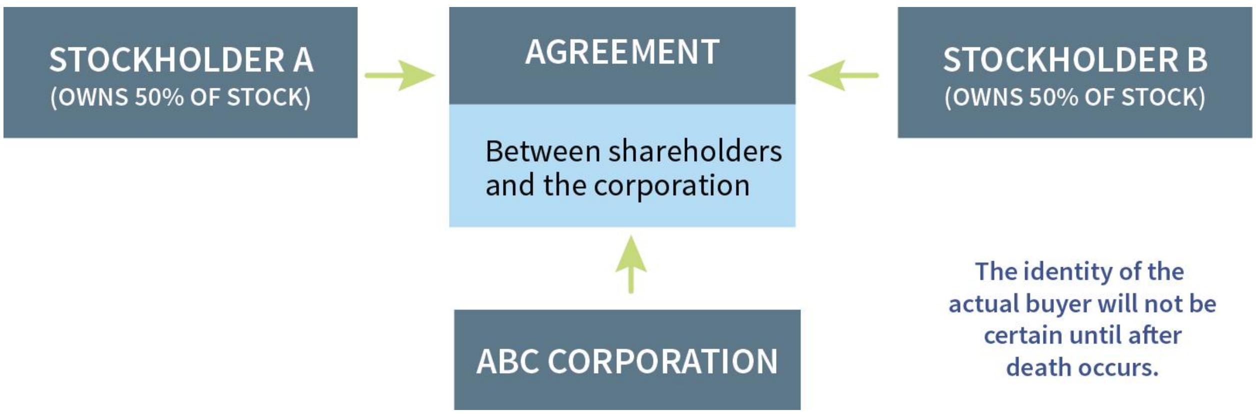
Note: In situations involving three or more co-stockholders, the death of the first stockholder to die can create a "transfer for value" problem for the surviving stockholders under IRC Sec. 101(a)(2)(B).

Seek Professional Guidance

In setting up a trusteed corporate buy-sell agreement, the advice and guidance of trained legal, tax, and insurance professionals is highly recommended.

Wait-And-See Buy-Sell Agreement

The decision as to whether a cross purchase buy-sell agreement or a stock redemption plan is better may be difficult at the time it is drafted. Many business owners use the wait-and-see approach to defer this choice until after a death occurs.



Typical Plan

- The corporation has the first option to purchase the stock at the price or formula set in the agreement.
- If the corporation fails to exercise its option, the surviving shareholders have a second option to purchase the stock.
- If they fail to purchase the stock, or only purchase a portion of it, then the corporation is required to purchase the remainder.
- If the insurance policies[1] are owned by and payable to the shareholders, the surviving shareholders may decide to lend the proceeds to the corporation after a death occurs, if they determine that a stock redemption would be most advantageous.
- When the corporation pays back the loan, it will not be considered income to the shareholder, except for interest which is paid on the loan.
- On the other hand, if a cross purchase plan is more advantageous the corporation will not exercise its first option to buy the stock.

In setting-up a wait-and-see buy-sell agreement, the advice and guidance of trained legal, tax, and insurance professionals is highly recommended.

[1] Unless certain requirements are met, life insurance proceeds may be includable in income. See IRC Sec. 101(j).

Who Should Own the Policy?

Improper ownership of insurance policies that are used to fund buy-sell agreements can cause serious problems for the survivors. The following hypothetical situation illustrates the proper ownership of policies:

Assumptions:

Owners: A, B and C
Ownership: 60%, 30%, 10%
Business value: $2,000,000
Funding vehicle: Life insurance

Cross-Purchase Plan		
Insured	Owner, Beneficiary and Premium Payer	Amount and Number of Policies
A (60%)	B C	$600,000 $600,000
B (30%)	A C	$300,000 $300,000
C (10%)	A B	$100,000 $100,000

Entity Plan		
Insured	Owner, Beneficiary and Premium Payer	Amount and Number of Policies
A (60%)	The Business	$1,200,000
B (30%)	The Business	$600,000
C (10%)	The Business	$200,000

Premiums for life insurance (or disability insurance to fund a buyout) are not deductible to the individuals or to the business entity. However, the policy proceeds are generally received income-tax-free by the beneficiary. If the corporation pays the premiums on policies used by the stockholders to fund a cross-purchase plan, there will likely be constructive dividend problems.

Also, under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance on this issue is strongly recommended.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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