Principal®

Buy-sell agreements

Prepare today for the unknown future of your business

Quick reference guide

Buy-sell agreement comparison

Do you and your co-owners have a strategy in place to transfer your business to the right people, at the right time, for the right amount of money? Having a buy-sell agreement in place can help protect the future of your business.

A buy-sell agreement is key to your exit strategy. It creates a market for the business when an owner dies, becomes disabled, or leaves. When structured correctly and funded with life and disability insurance from Principal®, a buy-sell agreement can help provide a solid start to your exit plan — and the people who depend on the future of your business.

Some of the protection benefits of buy-sell agreements include:

Family. You and your family can be protected by having co-owners buy your interest in the business for a set price and providing them the funding to do that if you die, become disabled, or leave the business.

Co-owner. Co-owners get protection by providing them the opportunity and funding to purchase the business interest of a deceased, disabled, or departing owner.

Continuation. Minimize conflicts among owners by setting the price and terms of a sale when an owner leaves the business.

Business. Protect the business by preventing and/or limiting transfers to parties that might be unqualified or undesirable, by requiring certain restrictions.

Estate. Fix the value of your business interest for estate tax purposes as long as the price meets IRS guidelines at the time the agreement was signed.

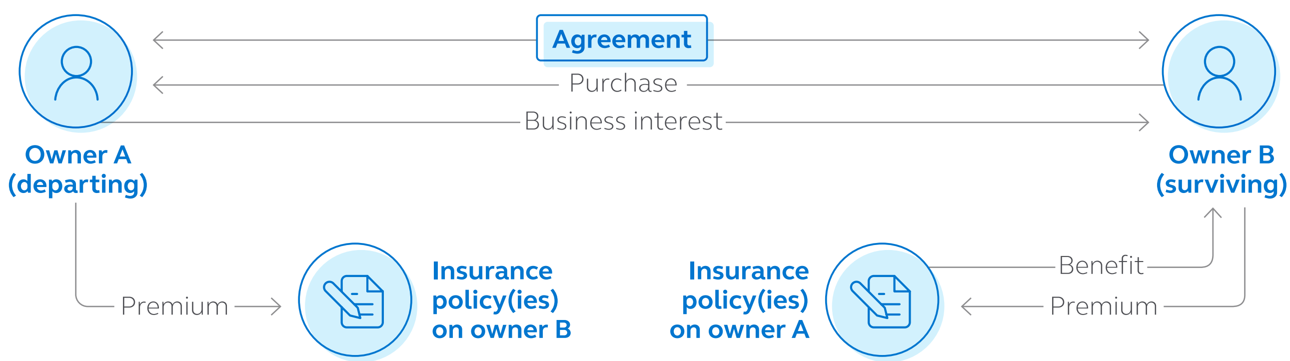
Buy-sell options

The most common buy-sell agreement types are cross purchase, entity purchase, and wait and see. It might be helpful for you to understand the basics and how each type works.

Cross purchase buy-sell

Here's how it works

Once the agreement is in place, each owner purchases a life and/or disability insurance policy on each of the other owners. Each owner is the premium payer and beneficiary of the policies they own. Upon a triggering event, the remaining owners purchase the departing owner's business interest using policy cash values or benefits from the policy.



What you need to know

Taxes could be minimized upon a subsequent sale. Insurance proceeds are received income tax -free. Remaining owners receive an increased cost basis as a result of the purchase price paid to the departing owner.

Business may pay premiums. Dollars used to pay premiums may be taxable as a bonus to the policy owner and in that scenario are generally deductible to the business.

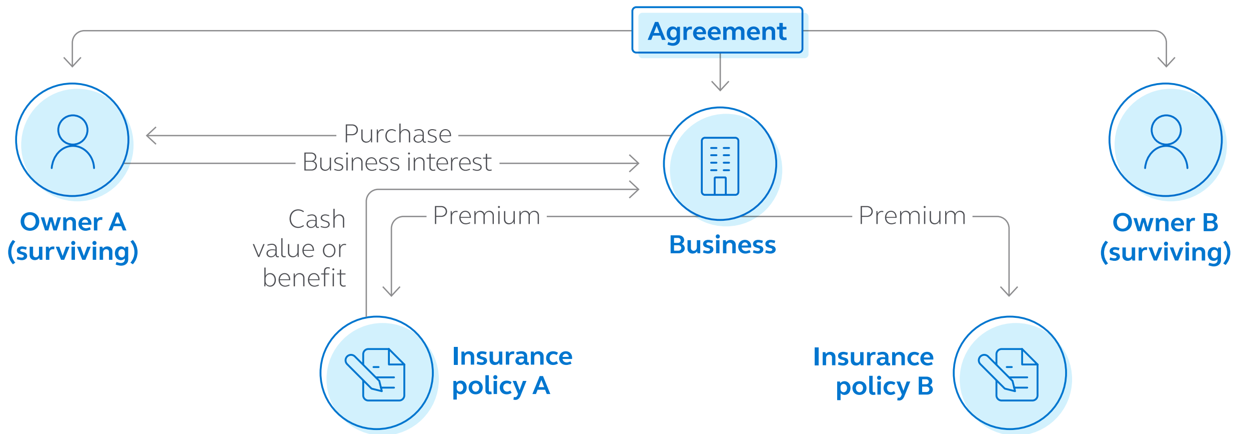
Multiple policies may be necessary on each owner. If there are more than two business owners, multiple policies on each owner are required. Each business owner is the owner, premium payer, and the beneficiary of policies on each of the other owners. So, if there are multiple business owners, this may become cumbersome.

Tax implications can vary by triggering event. Family members generally receive an adjusted basis following an owner's death. For disability or other lifetime triggering events, the selling owner may recognize capital gain.

Entity purchase buy-sell

Here’s how it works

Once the agreement is in place, the business purchases a life/and or disability insurance policy on each owner. The business is the owner, premium payer, and beneficiary of those policies. Upon the triggering event, the business purchases the departing owner’s business interest using policy cash values or benefits from the policy.



What you need to know

Fewer policies are needed. The business owns and pays premium on one policy per owner.

Remaining owners may pay higher taxes later. Since the remaining owners don’t purchase the departing owner’s shares directly, they might not receive a full increase in basis, depending on the structure of the business.

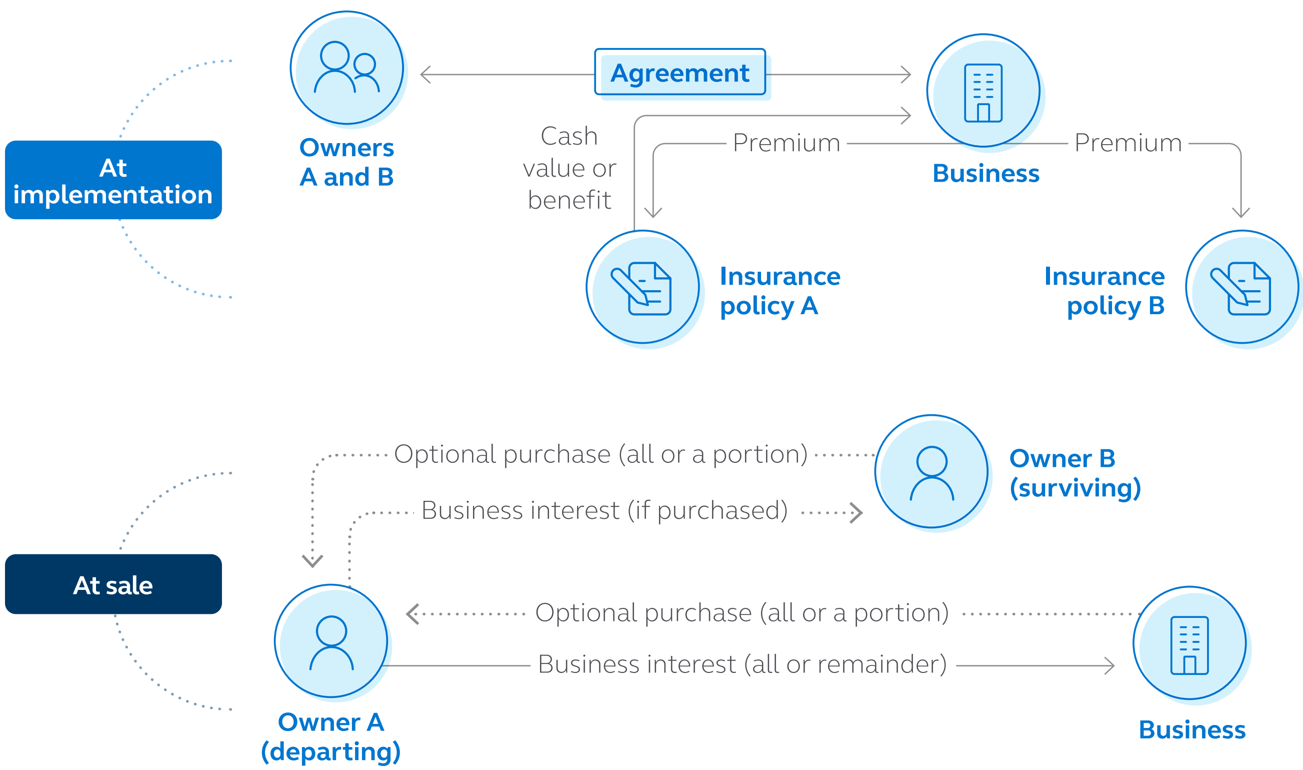
Family-owned businesses may require additional planning. If departing owner’s family members remain owners, special planning may be necessary.

Tax implications can vary by triggering event. Family members generally receive an adjusted basis following an owner’s death. For disability or other lifetime triggering events, the selling owner may recognize capital gain.

Wait and see buy-sell

Here's how it works

Once the agreement is in place, the business purchases life insurance on each owner. Upon any triggering event, the business has the option to purchase all or a portion of the departing owner's interest. If the business chooses not to purchase all of the departing owner's interest, the remaining owner(s) can choose to purchase all or some of the remaining interest. If any business interest remains, the business is obligated to complete the purchase, assuring 100% of the departing owner's interest will be acquired.



What you need to know

Flexibility for remaining owners. Remaining owners have the flexibility to select the desired buyer for the purchase of the departing owner's business interest.

Tax implications for remaining owners. Added flexibility may create additional tax complications for remaining owners.

		Cross purchase	Entity purchase	Wait and see
		Co-owners purchase departing owner's business interest	Business purchases departing owner's business interest	Purchase of departing owner's business interest by either remaining owner(s) or business
Insurance arrangement	**Premium payer**	Each owner pays premium on policies they own	Business	Remaining owner(s) or business
	Owner	Each owner owns policy on life of each other owner	Business[1]	Remaining owner(s) or business
	Beneficiary	Each owner is beneficiary of policies they own	Business	Remaining owner(s) or business
Income tax impact	**Business**	Not a party to the agreement	• Premiums not deductible • Proceeds received tax-free	Depends on the owner and beneficiary arrangements
	Purchasing owner	• Premiums not deductible • Proceeds received tax-free • Basis increased by amount paid to deceased's family	• C corporations — no basis increase to surviving owners • S corporations and other pass-through entities — with planning, surviving owners may be able to obtain some basis increase	Depends on the identity of purchasing owner (either remaining owner or business) made at time of death
	Seller upon death	Purchase price received generally doesn't cause taxable event[1]	Purchase price received generally doesn't cause taxable event[2]	Purchase price received generally doesn't cause taxable event[2]
	Seller upon disability	Seller recognizes capital gain to the extent proceeds exceed basis	Seller recognizes capital gain to the extent proceeds exceed basis	Seller recognizes capital gain to the extent proceeds exceed basis
Estate tax impact		Value of business interest and cash value of policies on other owners included in gross estate	Value of business interest included in gross estate	Value of business interest and possibly value of policies on other owners depending on ownership structure

[1] The tax deduction for interest expense on general borrowing may be reduced if the business owners life insurance contracts issued after June 8, 1997, on the lives of certain insureds.

[2] If purchase price received is equal to value of business interest at death, there will be no income tax payable upon sale. Under the current law, basis step up at death is replaced by a modified carryover basis rule in 2010 only.

What might work for me?

Here are some common scenarios and possible solutions based on entity type and number of owners involved.*

For **partnerships (and limited liability corporations taxed as partnerships),** entity purchase may often be a good choice because only one policy per owner is needed to fund the agreement. And remaining owners can obtain increased basis for death proceeds paid to the partnership.

For **C corporations with three or fewer shareholders,** cross purchase can often be the most advantageous approach.

For **C corporations with three or more shareholders,** entity purchase can often be the most practical approach. Tax complications can arise with entity purchase in the case of family-owned businesses. Also consider using a business continuation general partnership (BCGP) or a limited liability corporation (LLC). A BCGP or an LLC provides remaining owners an increase in basis, permits the agreement to be funded with one policy per owner, and provides an efficient method to accumulate for retirement.

For **any business** where the owners are interested in an efficient method to accumulate cash for retirement, the BCGP or an LLC can be considered.

For **multi-owner, professional service firms with substantial liquidity needs,** you may want to consider a multi-owner buy-sell strategy that matches cash flow needs and takes into consideration triggering events that happen both at death and during the owners' lifetimes.

For **S corporations with three or fewer shareholders,** cross purchase may generally be the most advantageous approach.

For **S corporations with three or more shareholders,** entity purchase can often be the most practical approach.

For **sole proprietorships (single-owner corporations),** a one-way buy-sell can be the primary buy-sell option. Ask your financial professional or tax/legal advisors for information on the various one-way buy-sell designs (e.g. one-way buy-sell, sole-owner transition, no-sell buy-sell).

* This is for discussion purposes only. You should consult tax and legal advisors regarding your specific situation.

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