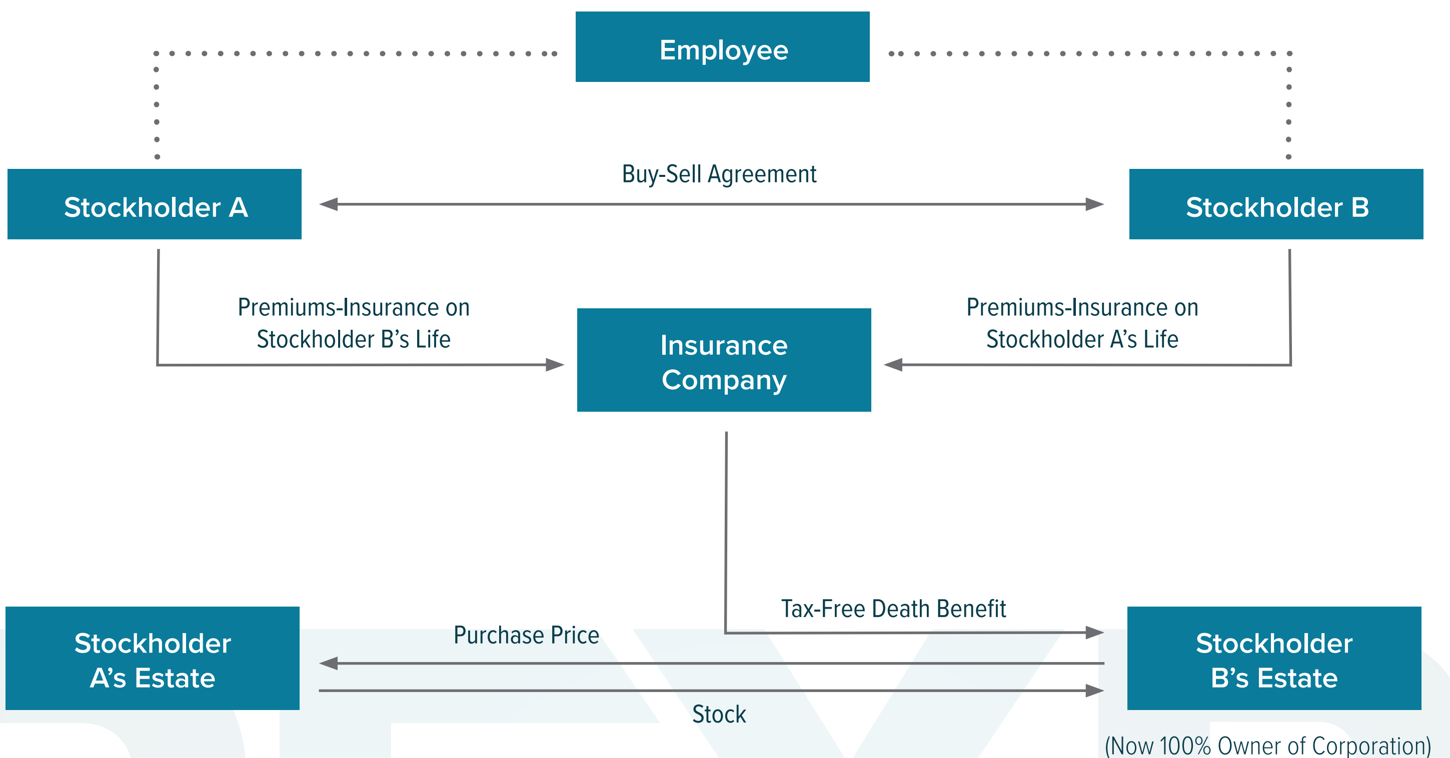
CROSS PURCHASE BUY-SELL AGREEMENT

Under a properly funded cross purchase buy-sell agreement, an owner agrees to purchase all or a portion of the business interest of the other owners. The agreement stipulates that the deceased owner's estate must sell the business interest and that the surviving owners will buy that business. The agreement also establishes the price to be paid either based on a fixed amount or a formula. In general, current tax law has made the formula method the more prudent choice.

Under this type of agreement, each owner buys a life insurance policy on the life of every other owner to fund the buyout. In successful businesses, additional insurance would be purchased as the value of the business continued to increase in value.

If a permanent life insurance policy is used for the funding, there can be sufficient flexibility to assist in a living buyout at retirement or disability if that is an event specified in the buy-sell agreement. The policy's accumulated values can be used as a down payment for an installment sale.

How It Works:



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CROSS PURCHASE BUY-SELL AGREEMENT
Continued

Advantages

- Creates a market and establishes a fair price for the business interest.
- Provides the funds to make the purchase.
- Avoids a forced sale of assets.
- Can provide liquidity to the estate of the deceased owner.
- At owner's death, surviving owners receive the proceeds from the life insurance policy they own on the deceased owner's life income tax free.
- Surviving owner gets a new basis for the business interest.
- Surviving stockholders are given the opportunity to run the business without conflicting interests of heirs.
- The estate is assured prompt and full payment.

Other Considerations

- When there are more than 3 or 4 owners, the number of life insurance policies required may become difficult to manage. At inception, the number of policies required is equal to the number of owners multiplied by that number minus 1. So, if there are 3 owners, you would need 6 policies (3 times 2 (3-1)). If there were 4 owners, 12 policies would initially be required (4 times 3 (4-1))
- If the surviving owners plan on selling their share of the business during their lifetime, the use of a cross purchase arrangement allows them to increase their tax basis in the business by the amount they use to individually buy the deceased shareholder's business interest. This is not always the case when an entity purchase buy-sell arrangement is used.
- If there is a wide disparity in the ages of the owners, the younger owners are paying the greater share of premiums on the life insurance policies they buy on the lives of the older owners. This can be mitigated by having a bonus arrangement for the younger owners to assist in the purchase.
- The cash values of policies owned on other owner's lives are includible in the decedent owner's estate. In disposing of the insurance policies of the survivors that were owned by the deceased, care should be given to avoid the "transfer for value" rules that may subject the life insurance proceeds to income tax to the extent the proceeds exceed the purchase price and any subsequent premiums paid. Generally, these policies should only be sold to the insured or to the business interest to avoid the "transfer for value" rules unless all other surviving owners are partners in a partnership (a permissible exception to the "transfer for value" rule).

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