covr® Strategy Snapshot

Buy-Sell Planning— Trusted Cross-Purchase

SITUATION

For most business owners, a buy-sell agreement is critical to ensure an effective transfer of the business to existing or new owners. This arrangement is commonly referred to as buy-sell planning. But there's a lot more involved than simply having a written buy-sell agreement in place. Some questions that should be asked, and answered:

1. What type of buy-sell agreement (there are five common agreements) will work best for this client and the business?
2. What buy-sell arrangement will get the best income tax results?
3. Does the agreement include the right buy-sell triggering events?
4. Does the agreement have a solid valuation amount or formula?

PROBLEM

There are five common types of buy-sell arrangements. Most advisors are only familiar the "cross-purchase" plan and the "stock redemption" plan. Unfortunately, the potential income tax consequences of an event triggering a buy-sale is often overlooked. It is important that the right buy-sell arrangement is utilized to help minimize or eliminate unwanted tax consequences. The "problem" to solve is determining which arrangement is best for a client's situation – there is no one-size-fits-all solution.

The five common arrangements (more or less in order of popularity) are:

1. Cross-Purchase
2. Entity Purchase (also known by the term Stock Redemption)
3. Wait & See Buy-Sell
4. Trusteed Cross-Purchase
5. One-Way Buy-Sell

This piece focuses on the Trusteed Cross-Purchase arrangement, which includes trust provisions in the actual buy-sell agreement to simplify the arrangement when there are four or more owners.

STRATEGY

A cross-purchase agreement is an agreement between two or more owners of a business, whereby remaining owners are obligated to buy, and the departing owner is obligated to sell, when a "triggering event" occurs. The agreement will prohibit the sale or gift of a business interest to anyone who is not a current owner. The business itself is not a party to a cross-purchase agreement.

Common buy-sell events:

1. Death
2. Disability
3. Departure (from employment – termination, retirement, resignation)
4. Divorce
5. Bankruptcy

Funding the buy-out

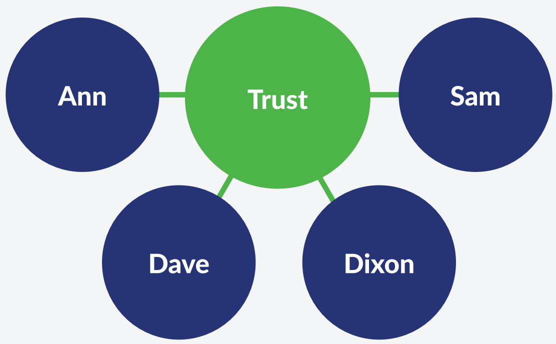
For each one of these events, it is important to ask "how are we going to pay for this particular buy-out?" For some events, such as death and disability, insurance is often the best solution. For other events, no insurance is available so an installment payment plan may be the only viable option.

Implementing a buy-sell agreement to incorporate these events is straight-forward enough. Where many agreements run into "trouble" is the lack or insufficient understanding of the income tax consequences.

Basis concerns

Take for example the issue of basis. When one buys a stock, that is the cost basis. In a cross-purchase arrangement, when one (or more) owner buys stock from a departing owner, that is basis. A cross-purchase arrangement allows each owner to increase basis, so that any capital gain upon the eventual sale of the business is lower. It is important to remember, however, this basis treatment is not necessarily the case with an entity purchase plan. In that situation, the business buys the stock, and, depending upon the type of tax entity the business is, there may be no basis increase for the business owners. This is not something that most business owners want to happen.

How it works



Trusteed Cross Purchase

- Trust, created by Dave, Dixon, and Sam purchase life insurance policy one each of their lives = one policy per owner
- Dave, Dixon and Sam contribute premium $$ into the trust each year
- At death of an owner, the trust uses the death benefit to buy business from the deceased owner's estate
- Achieve tax basis increase not available threw stock redemption plan

Example

Air & Supply, Inc. (ASI), worth $16,000,000, is owned 25% each by Ann, age 50, Dave, age 57, Dixon, 52, and Sam, age 55. They all work at ASI (taxed as a C corporation). They plan to eventually sell the company to fund their retirement, but in the meantime, they'll continue to work. None of their children work (or will work) in the business so leaving the business to their family is not a concern. What is a concern, however, is that they all receive fair and adequate value should they leave the company before it is sold to a third party.

Initially, an entity purchase plan was considered because it offered the simplicity of only purchasing four life insurance policies to cover a buy-out at death – one on each owner, with the business owning the policies. However, their tax advisor advised them that there would be no basis increase to the shareholders if the company bought the stock. Not a good tax result. A traditional cross-purchase buy-sell was then discussed, but that would have meant that each owner would have to buy three life insurance policies – one on each of the other owners, meaning there'd be 12 policies. That was not appealing either. They asked their advisor if there were any other options. And indeed there was.

A Solution

Enter the Trusteed Buy-Sell plan. All four owners sign a cross-purchase agreement that includes trust provisions that will effectively get them the basis increase they want and limit the number of insurance policies to four, not twelve. In effect this plan takes "the best of both worlds" and combines them into a third approach. The owners contribute their share of the premiums to the trust of which they are each 25% beneficiaries. The trustee holds the policies and pays the premiums to the insurance carrier. Upon the death of an owner, the trustee receives the death benefit and uses it to purchase the deceased owner's interest in the business. The surviving owners become 33% beneficiaries of the trust, which now holds three policies.

Results

- The three surviving owners will increase their respective basis in the company by their pro rate share of the purchase price.
- Only four, not twelve, life insurance policies were needed.

CLIENT PROFILE

- Owns a business
- Has a business "partner"
- Has a buy-sell agreement that may need reviewing/updating
- Have insurance funding death and disability buy-outs that may need reviewing/updating
- Wants to sell business, or leave to family