Buy-Sell Planning Using Life Insurance



Cross Purchase Arrangements

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Cross Purchase Arrangements Using Life Insurance

As a successful business owner you do not like surprises – especially when it comes to money.

That's why it is important to plan for unexpected events that may affect your business. Have you thought about what would happen if one of your co-owners were to die unexpectedly? Where would you get the money to buy out his or her share of the business?

Cross Purchase Arrangements are one way you can help ensure the continued success of your business so that you can focus on what you do best – taking care of business.

In a cross purchase arrangement, business owners agree among themselves to collectively purchase the interest of any owner who dies. Using life insurance policies to fund the buyout, each business owner purchases a life insurance policy on all the other owners. At the death of an owner, the surviving owners receive the policy proceeds and then purchase a pro rata share of the deceased owner's business interest from his or her estate. The result is that the estate's non-liquid business interest is converted into cash and the surviving owners now own 100 percent of the business.

Some Potential Advantages

- **Income tax-free death benefit:** Life insurance proceeds can be received income tax-free (IRC § 101 (a)). This assumes there are no transfer-for-value issues.
- **Policies generally are not subject to the entity's creditors:** Because the policies are not owned by the entity, the policies are not business assets and therefore are not subject to claims of the business' creditors.
- **Basis increase:** In a cross purchase plan, the purchasers (surviving owners) will receive full basis credit for the purchase price.
- **No corporate Alternative Minimum Tax (AMT):** Corporate AMT applies only to C-corporations. Because the owners (rather than the corporation) own the policies, the policy proceeds are not subject to the corporate AMT.
- **Capital gains treatment:** Sale of the deceased owner's interest by an owner's estate normally will be considered the sale of a capital asset and receive capital gains tax treatment. Even better, there usually is little or no capital gains to be recognized because of the step-up in basis of the business interest to its fair market value at the death of an owner (IRC § 1014).[1]

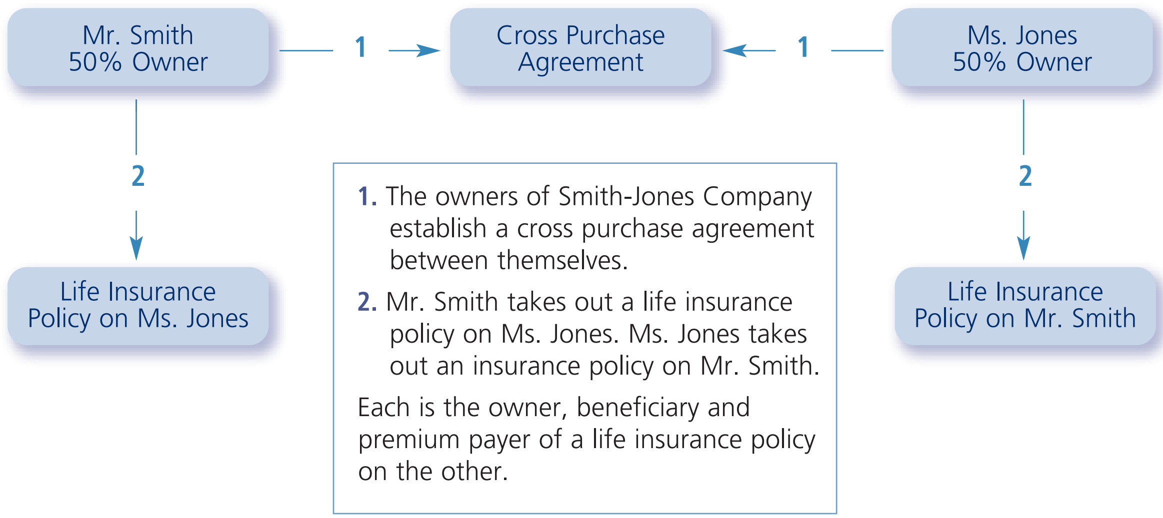
[1] The availability of step-up-in-basis is affected by the provisions of the Economic Growth & Tax Relief Reconciliation Act of 2001.

Some Potential Disadvantages

- **Use of personal income:** Personal after-tax funds are used to purchase the insurance policies and the premiums are not deductible.
- **Possible disproportional premium payments:** In a cross purchase arrangement, the policies are cross-owned. This means that the youngest owner (presumably the one who can least afford to pay) will own and pay for the policy on an older, and perhaps rated owner.
- **The company cannot record the policies as assets:** The business does not own the insurance policies and therefore cannot book them as assets.
- **Administrative complexities:** In the case of more than two owners, multiple policies must be purchased and held by each owner. The formula is N x (N-1), where N = the number of owners. In the case of five owners, for example, 20 policies (5 x 4) need to be purchased.
- **Additional life insurance may be needed:** After the remaining owners have purchased their respective shares of the deceased owner's interest, their interest in the business will increase. In order to fully fund their purchase obligations at the next death, each remaining owner may need to increase the amount of death benefit coverage on the other owners. Additional life insurance may have to be purchased.
- **Deceased's estate owns policies on the remaining owners:** The estate of a deceased owner will likely own one or more policies on the surviving owners. Unless there is a provision to the contrary, the remaining owners may not be able to gain ownership of the policies the estate owns on their lives.

How it Works

Establishing and Funding the Plan

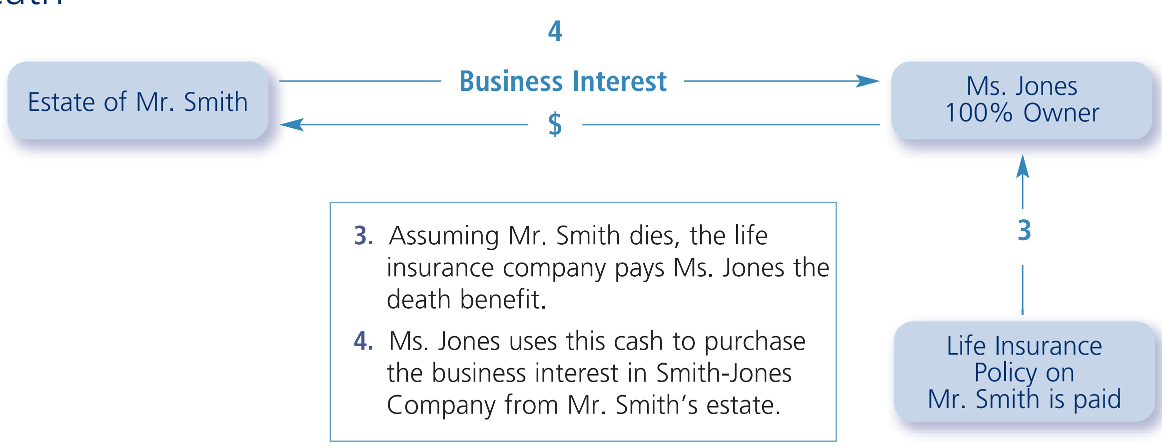


1. The owners of Smith-Jones Company establish a cross purchase agreement between themselves.

2. Mr. Smith takes out a life insurance policy on Ms. Jones. Ms. Jones takes out an insurance policy on Mr. Smith.

Each is the owner, beneficiary and premium payer of a life insurance policy on the other.

At Death



3. Assuming Mr. Smith dies, the life insurance company pays Ms. Jones the death benefit.

4. Ms. Jones uses this cash to purchase the business interest in Smith-Jones Company from Mr. Smith's estate.

Result

Surviving owner, Ms. Jones obtains full control of Smith-Jones Company and Mr. Smith's estate gets cash in exchange for the business interest.

Next Step

Designing a business continuation plan is a crucial step to ensure your business remains intact at your retirement, death or other triggering event. Whether you leave your business by choice or by chance, you'll leave your business on track and help provide for your family's future. With a cross purchase arrangement, you can help protect the financial security of yourself, your business, co-owners and your family.

Talk to your tax and legal advisors to determine if a cross purchase arrangement may meet your specific needs.

For more information please call your ING Financial Professional.

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