Buy-Sell Arrangements

At a glance

The continuity of a business from one generation to another or from one partner to another in case of death, disability or separation is an important factor in the life of a business. Understanding that business entities may be formed in a variety of structures, this overview is meant to assist you in understanding how the various types of Buy-Sell Arrangements operate and how they may be best implemented. The inclusion of life insurance as part of the continuation planning process offers many advantages to all parties of a Buy-Sell Agreement which are outlined below.

Arrangement	Summary	Ownership
Entity – *C Corporation* – *S Corporation* – *Partnership* – *Limited Partnership* – *Limited Liability Company*	The entity agrees to purchase a deceased business owner's interest from the deceased owner's estate.	The entity is the owner, payor, and beneficiary of the policies.
Cross Purchase – *Individual Business Owners*	The individual business owners agree to purchase a deceased business owner's business interest from the deceased owner's estate.	Each shareholder can be the owner, payor, and beneficiary of policies on the lives of the other business owners.
Trusteed – *Trust*	The individual business owners agree to purchase a deceased business owner's interest using a trust to fund and administer the purchase of the interest from the deceased owner's estate.	Typically a revocable trust is the owner, payor, and beneficiary of the policies. An irrevocable trust could own the policies if desired.
Wait and See – *C Corporation*	The C-corporation has the first option to purchase a deceased shareholder's stock. If the option is not exercised, the remaining shareholders have an option to purchase some or all of the stock. If there is any stock not purchased by the shareholders, the C-corporation must purchase it.	The C-corporation can be the owner, payor, or beneficiary of the policies; or each shareholder can be the owner, payor, and beneficiary of policies on the lives of the other business owners.

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The United States Life Insurance Company in the City of New York

AGLC103920

	Number of Policies	Comply with §101(j)[1]	Potential Corporate AMT[2]	Tax Basis After Purchases
Entity – *C Corporation* – *S Corporation* – *Partnership* – *Limited Partnership* – *Limited Liability Company*	One policy is purchased for each insured.	Yes	Yes, for a C-corporation	• In a C-corporation buy-out, the remaining shareholders will not receive a step-up in basis in their existing stock • For a pass-through entity, receipt of life insurance death benefit proceeds increases the basis in the remaining owners' business interests
Cross Purchase – *Individual Business Owners*	N(N-1) policies purchased for the whole arrangement. *N = number of business owners participating in the arrangement [e.g. 4(4-1) = 12 total policies purchased]*	No	No	• All business owners receive a step-up in their business interests upon purchase of the deceased business owner's interest
Trusteed – *Trust*	One policy is purchased for each insured.	No	No	• All business owners receive a step-up in their business interests upon purchase of the deceased business owner's interest
Wait and See – *C Corporation*	One policy is purchased for each insured when the corporation is the owner, payor, and beneficiary of the policies. N(N-1) policies purchased when the shareholders are the owners, payors, and beneficiaries of policies on the lives of the other shareholders.	Yes, if the C-corporation is the owner and beneficiary of the policies. No, if the shareholders are the owners and beneficiaries of the policies.	Yes, if the C-corporation is the owner and beneficiary of the policies. No, if the share-holders are the owners and beneficiaries of the policies.	• If the C-corporation is the owner and beneficiary of the policies, shareholders will: a) not get a step up in the basis of the corporation if it purchases the deceased shareholder's stock; or b) get a step up in the basis of the corporation if the shareholders borrow from the corporation to purchase the deceased shareholder's stock • If the shareholders are the owners and beneficiaries of the policies, then all remaining shareholders will receive a step-up in their basis in the corporation upon purchase of the deceased shareholder's stock

1 Section 101(j) of the Internal Revenue Code requires an employer who is the owner and beneficiary of a life insurance policy on an employee to meet various notice and consent requirements for the employer to receive the death benefit proceeds tax free. See I.R.C. §101(j) for the specific requirements. Your client should consult his/her tax advisor with any questions concerning implementation of a Buy-Sell Arrangement.

Advantages	Disadvantages
• The arrangement is simple • The entity controls the premium payments and the death benefit proceeds • The cash value is an asset on the books of the entity and can be accessed by the entity	• Stock redemptions of C-corporations must meet various requirements to avoid dividend tax treatment of the purchase proceeds • The remaining C-corporation shareholders do not receive a step-up in basis in their stock • The policy cash values are not protected from the entity's creditors
• The remaining shareholders receive a tax basis increase in their respective ownership interest after purchasing the deceased business owner's interest	• Multiple policies must be purchased for each business owner when there are more than two owners • Disparities in the age and health of each business owner may cause large differences in each business owner's premium obligation
• The trustee holds the policies and stock to carry out the purchase • Only one policy is needed per insured • If a revocable trust is used, the owners can revoke the trust and personally own their respective policy if the business is sold or dissolved • The remaining shareholders receive a tax basis increase in their respective ownership interest after purchasing the deceased business owner's interest	• The business owners must meet an exception to the transfer-for-value rule. I.R.C. §101(a)(2) • Exceptions to the rule are: - transfer where basis of transferee is determined by reference to basis of transferor (gift); or - transfer is to the insured, partner of the insured, partnership of insured, or corporation of insured
• It provides flexibility in deciding whether the corporation or the shareholders will purchase the deceased shareholder's stock • Only one policy is needed per insured if the C-corporation purchases the policies • If shareholders purchase the deceased shareholder's stock, they receive a step up in basis	• If the C-corporation purchases the deceased shareholder's stock, the stock redemption must meet various requirements to avoid dividend tax treatment of the purchase proceeds • If the C-corporation receives the death benefit proceeds and the shareholders desire to purchase the deceased shareholder's stock, the company must determine how to pay/loan the proceeds to the remaining shareholders • If shareholders purchase the policies, multiple policies must be purchased on each shareholder

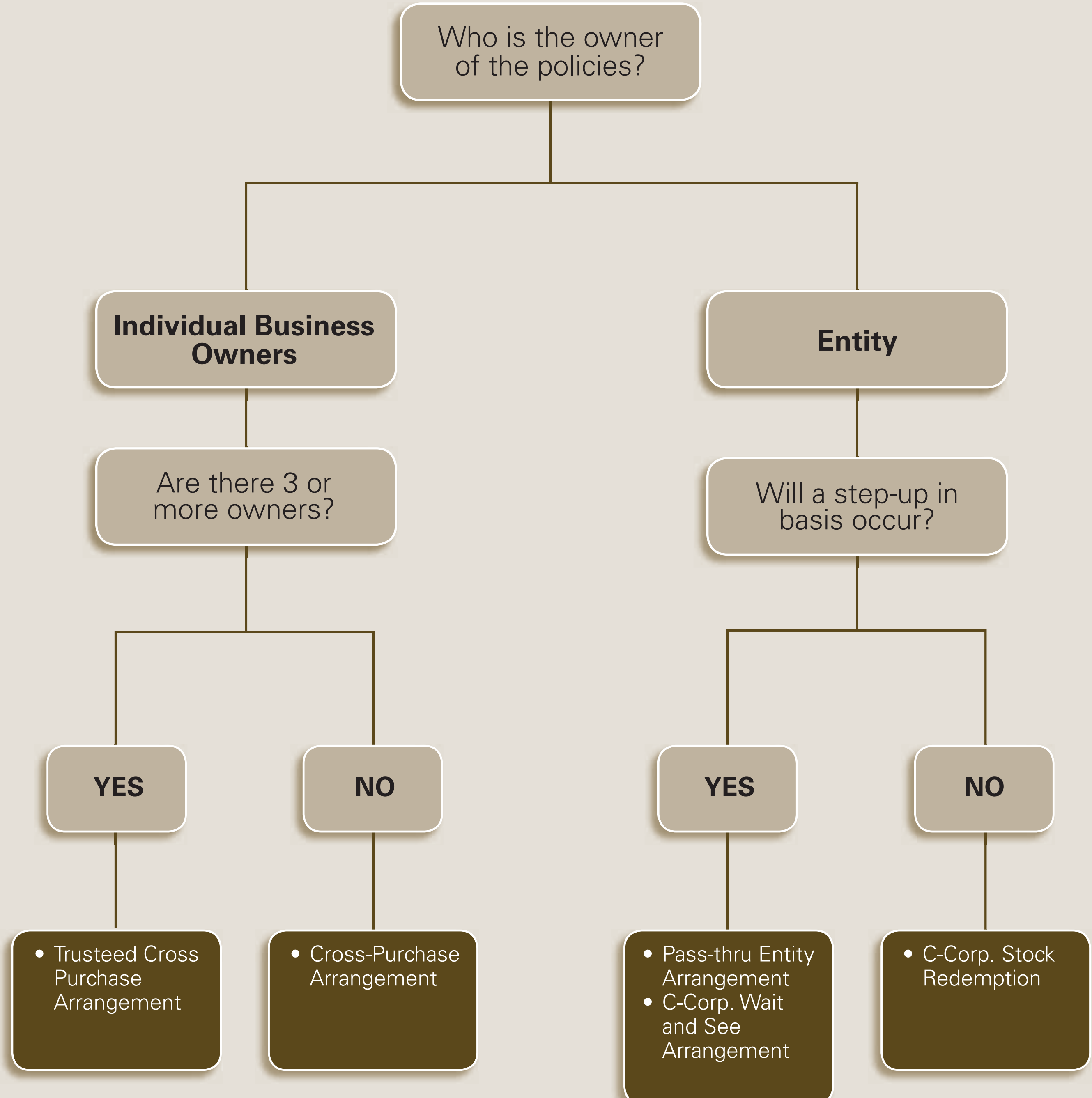
[2] Death benefit proceeds paid to a C-corporation may be included in the corporation's alternative minimum tax (AMT) calculation. Sizeable death benefit proceeds could create an AMT liability for the corporation. For corporations susceptible to a potential AMT tax liability, the death benefit proceeds should be adjusted to account for the potential tax consequences. Your client should consult his/her tax advisor with any questions concerning implementation of a Buy-Sell Arrangement.

Methods of funding Buy-Sell Arrangements

- **Sinking Fund**—Money or property is set aside over time to provide sufficient liquidity for a buy-out in the future (e.g. retirement). Sinking funds do not address the risk of a premature buy-out and the fund may be susceptible to market investment risk creating insufficient funds for a buy-out.
- **Commercial Loan**—Funds are borrowed from a commercial lender (e.g. a bank) to facilitate the buy-out. Commercial loans do not require the purchaser to set aside capital prior to the buy-out. The buyer risks the inability to obtain a loan if there is a disruption in the credit markets and may also be subject to interest rate risk if market rates are high at the time of the buy-out.
- **Installment Sale**—The business interest is purchased with the buyer making periodic payments of principal and interest to the seller for a specified term of years. The seller must wait until the end of the installment sale period until the full principal amount, equal to the value of the business, is received. The advantages to this arrangement are often one-sided. The buyer benefits from a delay of paying the full purchase price, while the seller could be left without sufficient funds to address an immediate estate tax liability or debt obligation.
- **Sale of Business Assets**—The business sells assets to provide sufficient funds for the buy-out. Assets can be set aside prior to a buy-out, or the business can choose which assets will be sold at the time of the buy-out. The business bears the risks related to the market value of the assets at the time of the buy-out and the amount of time needed to sell the assets. The business may have to discount the assets if a quick sale is required. Most likely, the business will recognize taxable gain on the sale of the assets.
- **Life Insurance**—The buyer purchases a life insurance policy on the life of the business owner. Life insurance provides funds precisely when they are needed in a death buy-out scenario and is a cost effective way for a buyer to meet a buy-out obligation, even considering the time value of money. The death benefits may be received income tax free and permanent life insurance provides tax deferral on the cash value accumulation inside the policy. The cash value of permanent life insurance can provide funds to supplement a living buy-out upon retirement or disability.

For questions relating to buy-sell arrangements, contact the American General Advanced Sales Team at (800) 677-3311, prompt 5.

Buy-Sell Arrangement Decision Tree



Buy-Sell Resources	Recommended Products
eStation Only (eStation.americangeneral.com) Wait and See Buy-Sell (Advanced Sales Strategy) Trusteed Buy-Sell (Advanced Sales Strategy) Protecting the Future of Your Business (Consumer Brochure) Employer Fact Finder (Consumer Brochure) ePocket Tax Tables **eStation and Software CD** Advance Markets Online (AMO) AMO Salesmaker AMO Documents **Software CD Only** Tapestry	**Buy Out Upon Death Only** AG Select-a-Term® **Living Buy Out and Buy Out Upon Death** AG ROP Select-a-Term® Elite UL® Elite Index®

Policies issued by:
American General Life Insurance Company
2727-A Allen Parkway, Houston, Texas 77019

Elite UL Policy Form Number 03325; Elite Index IUL Policy Form Number 08327; AG Select-a-Term Policy Form Number 07007; AG ROP Select-a-Term Policy Form Number 06001

The United States Life Insurance Company in the City of New York
70 Pine Street, New York, New York 10270

Elite UL Policy Form Number 03325N; Elite Index IUL Policy Form Number 08327N; AG Select-a-Term Policy Form Number 07007N

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