

Success Strategy Cross-Purchase Buy-Sell Arrangement



WHAT IS A CROSS-PURCHASE BUY-SELL ARRANGEMENT?

A cross-purchase buy-sell arrangement is an agreement in which each business owner agrees to buy the interest of the others in the case of death, disability, or retirement.

HOW DOES A CROSS-PURCHASE BUY-SELL ARRANGEMENT WORK?

In a cross-purchase buy-sell arrangement, the owners agree amongst themselves on a business continuation plan. Each owner agrees to buy the others' shares in the event of death, retirement or disability.

FUNDING WITH LIFE INSURANCE

In a cross-purchase buy-sell arrangement funded with life insurance, the business owners each buy a policy on the others. For example, if there are three owners then there will typically be six policies. The formula for determining this is the number of owners (n) multiplied by the number of owners subtracted by one [$n \times (n-1)$]. Each owner will pay the premiums out of his or her personal funds. The premium payments are not tax deductible. Another option is for the corporation to pay bonuses to the owners or to enter into a split dollar arrangement to pay the premiums.

WHY USE LIFE INSURANCE?

Life insurance is an excellent choice to fund a cross-purchase buy-sell arrangement because the death benefit proceeds will be received by the individual income tax free¹. Life insurance also has the potential for tax-deferred accumulations. When using life insurance in a cross-purchase buy-sell arrangement, the value of the entity does not increase, because the individual owners and not the business own the policy.

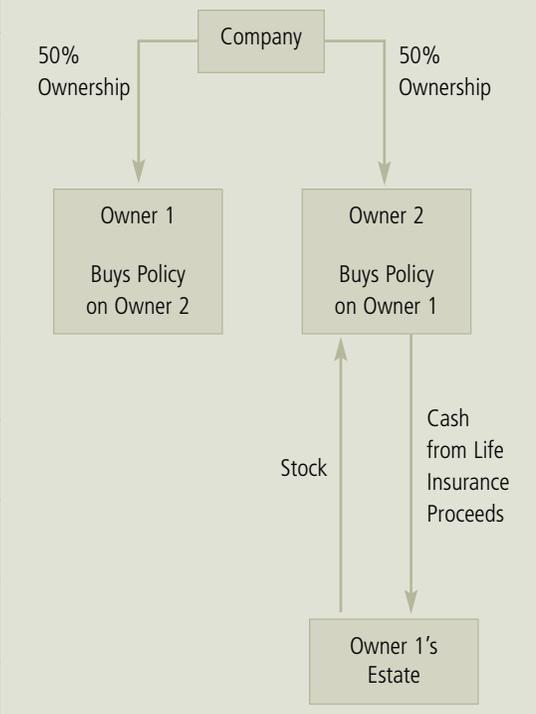
ADVANTAGES OF CROSS-PURCHASE BUY-SELL ARRANGEMENTS

- The purchasing owners receive a step-up in cost basis in the acquired business interest, which reduces any future taxable gain.
- The business does not reflect the value of the life insurance policy on its balance sheet. Thus, the value of the business does not increase.
- The business is not a party to the cross-purchase buy-sell arrangement, thus the life insurance is not subject to Alternative Minimum Tax (AMT).

DISADVANTAGES OF CROSS-PURCHASE BUY-SELL ARRANGEMENTS

- The plan may require several different policies and does not work well if the business has more than five owners.
- The owners may be in a higher income tax bracket than the business, thus resulting in higher insurance costs.
- Life insurance premiums are not tax deductible.

| CROSS-PURCHASE ¹ | |
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| What it is | An arrangement in which each owner agrees to buy the business interest of another owner. |
| How it works | Owners enter into a business continuation arrangement among themselves. |
| Funding Methods | Life insurance, sinking fund, borrowed funds, installment purchase. |
| Funding with Life Insurance | Each owner purchases a life insurance policy on the others. For example, if there are three owners, then there will be six policies. [Formula: Owners x (owners – 1) = number of policies] |
| Premium Payments | The owners pay the premiums. The premiums can be funded by the corporation through a bonus plan. |
| Corporate Creditors and Insurance | The life insurance is not subject to corporate creditors |
| Alternative Minimum Tax | No potential corporate alternative minimum tax (AMT) or accumulated earnings tax. |
| Business Valuation when insurance is used | The life insurance policy does not increase the value of the business |
| Optimal Scenarios for Cross Purchase Plan | Businesses with five or fewer owners. |



1. Life insurance death proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions, such as when a life insurance policy has been transferred for valuable consideration. No legal, tax or accounting advice can be given by John Hancock, its agents, employees, or registered representatives. Prospective purchasers should consult their professional tax advisor for details.

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