Buy-sell agreements

Prepare today for the unknown future of your business.

Quick reference guide

Buy-sell agreement comparison

Do you and your co-owners have a strategy in place to transfer your business to the right people, at the right time, for the right amount of money? Having a buy-sell agreement in place can help protect the future of your business.

A buy-sell agreement is key to your exit strategy. It creates a market for the business when an owner dies, becomes disabled, or leaves. When structured correctly and funded with life and disability insurance from Principal®, a buy-sell agreement can help provide a solid start to your exit plan — and the people who depend on the future of your business.

Some of the protection benefits of buy-sell agreements can include:

Family. You and your family can be protected by having co-owners buy your interest in the business for a set price and providing them the funding to do that if you die, become disabled, or leave the business.

Co-owner. Co-owners get protection by providing them the opportunity and funding to purchase the business interest of a deceased, disabled, or departing owner.

Continuation. Minimize conflicts among owners by setting the price and terms of a sale when an owner leaves the business.

Business. Help protect the business by preventing and/or limiting transfers to parties that might be unqualified or undesirable by requiring certain restrictions.

Estate. It may be possible to fix the value of your business interest for estate tax purposes as long as the price meets IRS guidelines at the time the agreement was signed.

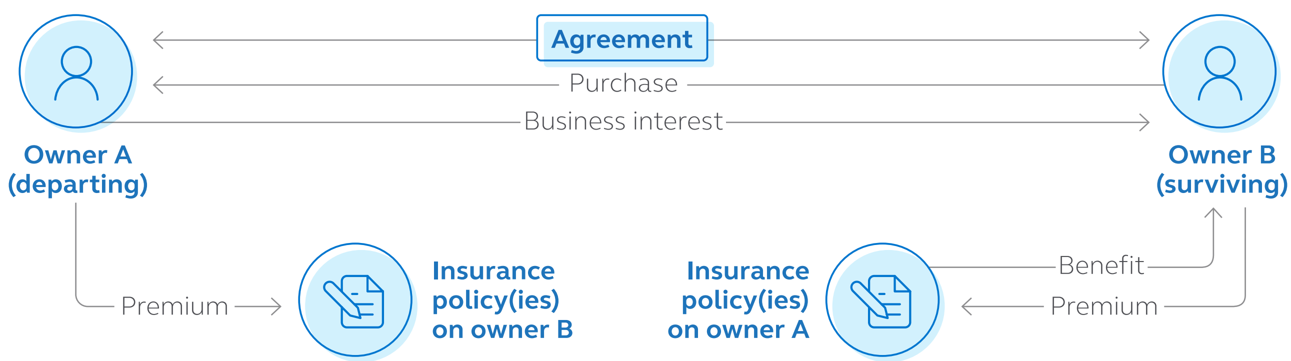
Buy-sell options

The most common buy-sell agreement types are cross purchase, entity purchase, and wait and see. It might be helpful for you to understand the basics and how each type works.

Cross purchase buy-sell

Here's how it works

Once the agreement is in place, each owner purchases a life and/or disability insurance policy on each of the other owners. Each owner is the premium payer and beneficiary of the policies they own. Upon a triggering event, the remaining owners purchase the departing owner's business interest using policy cash values or benefits from the policy.



What you need to know

Taxes could be minimized upon a subsequent sale. Insurance proceeds are received income tax -free. Remaining owners receive an increased cost basis as a result of the purchase price paid to the departing owner.

Business may pay premiums. Dollars used to pay premiums may be taxable as a bonus to the policy owner and in that scenario are generally deductible to the business.

Multiple policies may be necessary on each owner. If there are more than two business owners, multiple policies on each owner are required. Each business owner is the owner, premium payer, and beneficiary of policies on each of the other owners. So, if there are multiple business owners, this may become cumbersome.

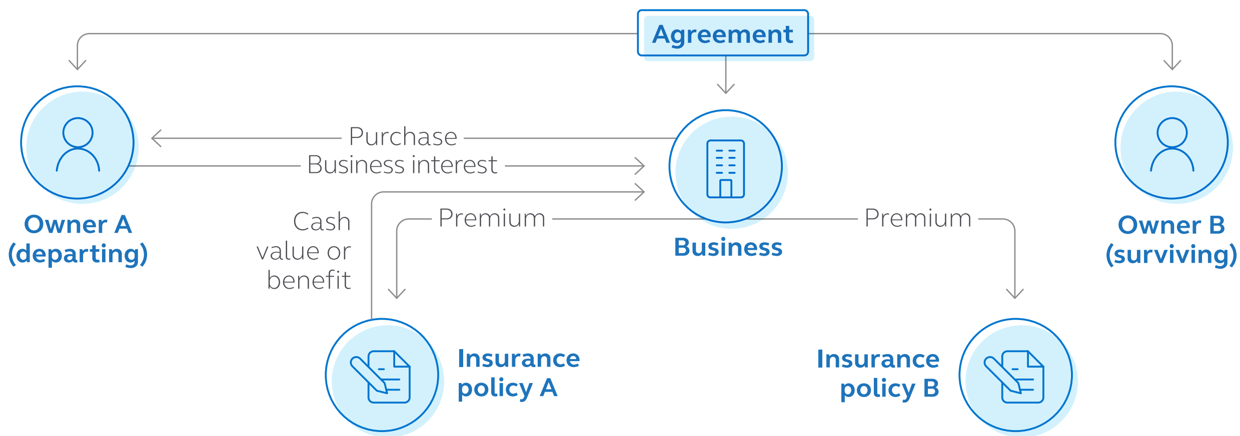
Tax implications can vary by triggering event. Family members generally receive an adjusted basis following an owner's death. For disability or other lifetime triggering events, the selling owner may recognize capital gain.

Death benefit received does not increase the value of the business or the estate. Life insurance proceeds are paid to the surviving owner, so there is no impact to the value of the business or the value of the deceased owner's estate.

Entity purchase buy-sell

Here's how it works

Once the agreement is in place, the business purchases a life/and or disability insurance policy on each owner. The business is the owner, premium payer, and beneficiary of those policies. Upon the triggering event, the business purchases the departing owner's business interest using policy cash values or benefits from the policy.



What you need to know

Fewer policies are needed. The business owns and pays premium on one policy per owner.

Remaining owners may pay higher taxes later. Since the remaining owners don't purchase the departing owner's shares directly, they might not receive a full increase in basis, depending on the structure of the business.

Family-owned businesses may require additional planning. If the departing owner's family members remain owners, special planning may be necessary.

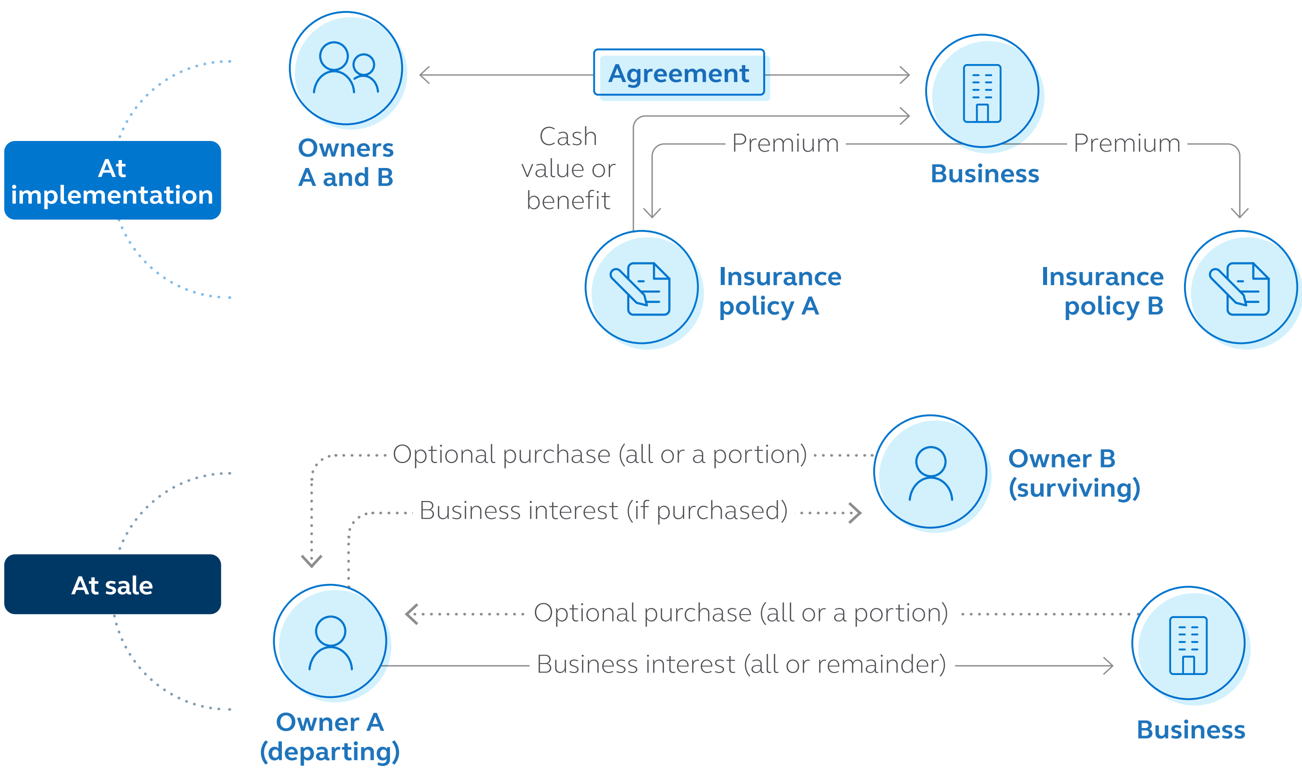
Tax implications can vary by triggering event. Family members generally receive an adjusted basis following an owner's death. For disability or other lifetime triggering events, the selling owner may recognize capital gain.

Possible impact on value of business. The U.S. Supreme Court in Connelly v. US (2024) held that if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation. If any owner anticipates being subject to the federal estate tax, the owners might wish to consider a different buy-sell design. Alternatively, additional life insurance (likely owned in an irrevocable trust) may be needed to provide liquidity to pay any estate tax that may be due.

Wait and see buy-sell

Here's how it works

Once the agreement is in place, the business purchases life insurance on each owner. Upon any triggering event, the business has the option to purchase all or a portion of the departing owner's interest. If the business chooses not to purchase all of the departing owner's interest, the remaining owner(s) can choose to purchase all or some of the remaining interest. If any business interest remains, the business is obligated to complete the purchase, assuring 100% of the departing owner's interest will be acquired.



What you need to know

Flexibility for remaining owners. Remaining owners have the flexibility to select the desired buyer for the purchase of the departing owner's business interest.

Tax implications for remaining owners. Added flexibility may create additional tax complications for remaining owners.

Possible impact on value of business if insurance is owned by the business. The U.S. Supreme Court in Connelly v. US (2024) held that if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation. If any owner anticipates being subject to the federal estate tax, the owners might need to carefully consider how to structure the funding. Alternatively, additional life insurance (likely owned in an irrevocable trust) may be needed to provide liquidity to pay any estate tax that may be due.

		Cross purchase Co-owners purchase departing owner's business interest	Entity purchase Business purchases departing owner's business interest	Wait and see Purchase of departing owner's business interest by either remaining owner(s) or business
Insurance arrangement	**Premium payer**	Each owner pays premium on policies they own	Business	Remaining owner(s) or business
Insurance arrangement	**Owner**	Each owner owns policy on life of each other owner	Business[1]	Remaining owner(s) or business
Insurance arrangement	**Beneficiary**	Each owner is beneficiary of policies they own	Business	Remaining owner(s) or business
Income tax impact	**Business**	Not a party to the agreement	Premiums not deductible Proceeds received tax-free	Depends on the owner and beneficiary arrangements
Income tax impact	**Purchasing owner**	Premiums not deductible Proceeds received tax-free Basis increased by amount paid to deceased's family	C corporations — no basis increase to surviving owners S corporations and other pass-through entities — with planning, surviving owners may be able to obtain some basis increase	Depends on the identity of purchasing owner (either remaining owner or business) made at time of death
Income tax impact	**Seller upon death**	Purchase price received generally doesn't cause taxable event[1]	Purchase price received generally doesn't cause taxable event[2]	Purchase price received generally doesn't cause taxable event[2]
Income tax impact	**Seller upon disability**	Seller recognizes capital gain to the extent proceeds exceed basis	Seller recognizes capital gain to the extent proceeds exceed basis	Seller recognizes capital gain to the extent proceeds exceed basis
Estate tax impact	**Estate value**	Value of business interest and cash value of policies on other owners included in gross estate	Value of business interest included in gross estate and risk that death benefit might inflate value[3]	Value of business interest and possibly value of policies on other owners depending on ownership structure. Also, risk that death benefit might inflate value of business.[3]

(1) The tax deduction for interest expense on general borrowing may be reduced if the business owns life insurance contracts issued after June 8, 1997, on the lives of certain insureds.

(2) If purchase price received is equal to value of business interest at death, there will be no capital gain tax payable upon sale.

(3) Connelly v. US, No. 23-146, 602 U.S.___ (June 6, 2024).

What might work for me?

Here are some common scenarios and possible solutions based on entity type and number of owners involved.*

If owners are likely to face federal or state estate tax:

For businesses with fewer owners, a cross purchase agreement might be advantageous. This is true whether the business is taxed as a partnership, S corporation, or C corporation (or a limited liability company taxed as a partnership, S corporation, or C corporation). This is because Connelly v. US (2024) generally affects business owners subject to estate tax. Cross-ownership is a primary means of avoiding the impact of Connelly, however, a cross purchase arrangement often requires each owner to have a policy on each other owner.

For businesses with many owners, some might still decide to use a cross purchase agreement. However, if the number of owners facing an estate tax makes a cross purchase unwieldy, the owners may wish to consider creating a new entity to hold the policies, such as a business continuation general partnership (BCGP). Such an arrangement can be funded with one policy per owner and may still avoid the estate tax effects of Connelly.

If owners are not expected to be subject to federal or state estate tax (even after the scheduled sunset Jan. 1, 2026):

Businesses with fewer owners may benefit from a cross purchase arrangement, due to the increased cost basis it offers to surviving owners. This is true whether the business is taxed as a partnership, S corporation, or C corporation (or a limited liability company taxed as a partnership, S corporation, or C corporation).

For businesses with many owners, some might still decide to use a cross purchase agreement. However, if the number of owners makes a cross purchase unwieldy, the owners may wish to consider an entity purchase arrangement. An entity purchase provides the advantage of needing only one policy per owner. An entity purchase arrangement does not avoid the impact of Connelly, but the estate tax value is less likely to matter if the estate tax threshold is not reached. Furthermore, in many cases, the surviving owners may still be able to receive an increased cost basis after a death occurs.

For single-owner businesses:

For sole proprietorships (single-owner corporations), a one-way buy-sell can be the primary buy-sell option. Ask your financial professional or tax/legal advisors for information on the various one-way buy-sell designs (e.g., one-way buy-sell, sole-owner transition, or no-sell buy-sell).

* This is for discussion purposes only. You should consult tax and legal advisors regarding your specific situation.

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