



Situation: For many business owners, the focus is on today- running the business, managing day-to-day operations and expenses, and growing revenues. Most business owners can't imagine a day when they will be unable to participate in their business. However, that day will arrive, and business owners need to plan for the continuation and control of the business. Without proper planning, death, disability, or retirement can create chaos for all parties involved. However, a well-written buy-sell agreement paired with life and disability insurance policies can help make the transition smoother.

While buy-sell agreements are a cornerstone of business continuity planning, many owners approach them with uncertainty. Financial advisors play a key role in helping owners navigate legal, tax, and funding considerations. In this *Counselor's Corner*, we will review some of the most common – and important – questions business owners tend to ask, including:

- Do I really need a buy-sell agreement? What are the benefits of a buy-sell agreement?
- What are the types of buy-sell agreements, and which is the best for my business?
- How will the buyout be funded?

Solution: Buy-sell agreements are foundational to sound business succession planning; yet the first question a business owner is likely to ask a financial advisor is, ***“Do I really need a buy-sell agreement? What are the benefits of establishing an agreement?”*** For most closely held businesses, the answer is almost always “yes”, you should have a buy-sell agreement because of the following benefits:

For the Deceased Owner's Estate/Heirs A Buy-Sell:

- *Creates a market for the deceased owner's interest.* Closely held business owners often have a difficult time locating a willing buyer for their interest. An enforceable buy-sell agreement ensures that a buyer is available and that the “price is right.”
- *Avoids negotiating price and terms when the estate may be in a weak bargaining position.* The lack of a valid buy-sell agreement at an owner's death alters the negotiation playing field. When an estate is facing administrative and tax costs and has few liquid assets, a “fire sale” may be the result.
- *Provides for increased efficiency in the administration of the owner's estate.* A buy-sell arrangement can help prevent delays in the administration of the estate and alleviate disputes between the deceased owner's heirs and the surviving business owners.
- *Relieves the heirs of the estate from the affairs of the business.* Heirs who are not participating in the business generally will not want to be exposed to the on-going risks of operating a business. A funded buy-sell arrangement can ensure that disinterested heirs are bought out and protected from any business risks.
- *Ensures that the estate receives cash for estate liquidity, survivors' income, or other family needs.* Often, the bulk of an owner's estate is tied up in non-liquid business assets. Without a buy-sell arrangement in place, the personal representative may have to sell assets under less than favorable conditions to pay estate taxes or provide a living allowance for a surviving spouse.
- *Establishes the value of the interest for federal estate tax purposes.* A properly structured “arms-length” buy-sell agreement helps to establish business value at an owner's death, reducing the possibility of IRS challenge.¹

For the Surviving Owners A Buy-Sell:

- *Helps to prevent disputes between the heirs of the deceased owners.* Disputes commonly occur from the clash between passive owners' short-term goals, which favor return on investment and frequent distributions, and the long-term goals of active owners who are typically more interested in retaining funds to grow the business. Both parties' objectives can be met if a funded buy-sell arrangement is in place and inactive heirs are bought out.



- *Enables the execution of a smooth transition in the control and ownership of the entity, allowing the business to remain in good standing with clients, creditors, and employees.* At an owner's death, incapacity, or retirement, a business is often thrown into turmoil because the person who was the driving force in the business is no longer there. A carefully structured buy-sell arrangement permits the owner to begin the process of transferring ownership and control before the triggering event – allowing for a smoother transition.
- *Prevents unwanted parties from acquiring an ownership interest.* A properly drafted agreement will help prevent meddling family members from becoming involved in the daily decision-making of the business or third-party competitors from acquiring the business.
- *Provides an independent mechanism for determining a price or pricing formula for the business interest, decreasing the potential for disputes.* It is simpler for all parties involved to negotiate payment terms before the fact, when presumably no party is operating from a position of weakness and emotions are not at a high. Not only does a buy-sell agreement set pricing parameters prior to the event, but flexible drafting can also give "first rights of purchase" to family members, ensuring that they are given priority over third-party buyers.
- *Helps avoid transfers that could have a negative impact on the business entity's formation or tax status.* For example, tax rules exist that dictate what types of individuals or entities can have an ownership interest in a business structured as an S corporation. Shares transferred to a prohibited shareholder terminate the S corporation tax status, causing the business to be taxed as a regular C corporation. A buy-sell agreement can prevent this from happening by requiring that stock be transferred only to eligible S corporation shareholders.

What are the Most Common Forms of Buy-Sell Agreements

Once the business owner is convinced of the need to have a buy-sell agreement, the next logical question is, ***"What are the types of buy-sell agreements, and which is the best for my business?"***

There are several forms of buy-sell agreements, each tailored to the ownership structure, financial goals, and long-term vision of the business. The most common forms include cross-purchase agreements, entity purchase/stock redemption agreements, hybrid/wait-and-see agreements that combine elements of both, and one-way agreements. Each type differs in how ownership interests are transferred, who is responsible for purchasing those interests, and how the transaction is funded. The financial advisor may be the first person to explain in general terms the distinctions among these agreement types, but the business owner's legal and tax advisors should be the ones helping the owners make the determination which is the "best" for their specific situation.

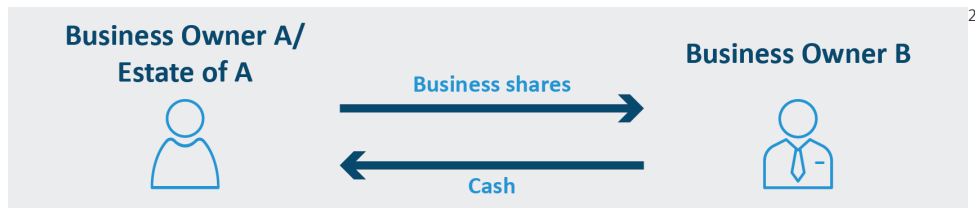
Understanding the distinctions among the types of buy-sell agreements is essential for business owners and financial advisors. The right structure can help minimize tax consequences and reduce the risk of disputes during transitions. Furthermore, as the business evolves, maintaining an appropriate buy-sell framework becomes critical in protecting both the business and its stakeholders. Thus, it's important to have the buy-sell agreement regularly reviewed.

The following are the key features of the most common forms of buy-sell agreements, their life insurance structure, and the advantages and disadvantages of each:

Cross-Purchase Agreement:

In a cross-purchase agreement, each business owner agrees to buy the departing business owner's interest. With this buy-sell form each business owner is the owner and beneficiary of a life insurance policy on the other business owners, resulting in multiple policies on each business owner. While each business owner is responsible for the premium payment on the policy(s) s/he owns, the business can pay the premiums as a taxable bonus.

Upon the death of an owner, the surviving business owners receive the life insurance proceeds to buy the deceased owner's business interest. The insurance proceeds should generally be received income tax-free by the survivors, and the business interest received by the estate of the deceased owner will usually receive a step-up in basis equal to the date of death value of the business. As long as the purchase amount paid by the surviving owners is equal to the date of death step-up basis value, the heirs do not recognize income tax on the sale.



Advantages of Cross-Purchase Agreement:

- Provides the surviving business owners a step-up in basis for the business interest purchased
- Avoids constructive dividend treatment, which can result in adverse income tax to the estate of the deceased in family-owned C corporations (and S corporations which were once C corporations with retained earnings).³
- Avoids the risk that life insurance proceeds will increase the value of the business for estate tax purposes.⁴

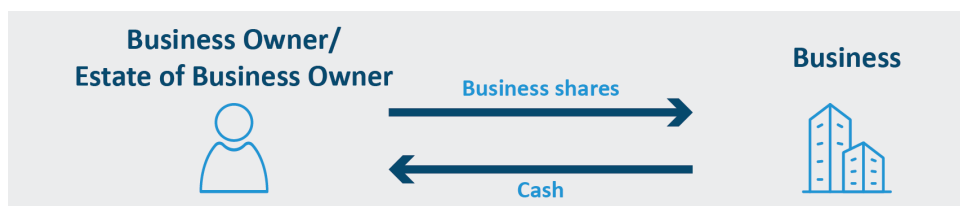
Disadvantages of Cross-Purchase Agreement:

- Becomes complex with many business owners (multiple policies)
- Premium payments may become burdensome when there is a difference in age, health, and percentage ownership between owners such as where a younger minority owner must purchase coverage on an older, less healthy majority owner.
- Changing policy ownership after the death of a business owner can have income tax ramifications. For example, if on the death of a business owner the surviving business owners acquire the policies the decedent owned to help fund the ongoing obligation of the buy-sell agreement, the change of owner/beneficiary may cause the subsequent receipt of death proceeds to be subject to income tax under the transfer-for-value rule.⁵

Entity-Purchase/ Stock Redemption Agreement:

In an entity purchase agreement, the business itself agrees to buy back the departing business owner’s interest. With this buy-sell form the business is the owner, beneficiary, and premium payer of a life insurance policy on each business owner equal to each owner’s proportionate interest in the business. This results in one policy for each business owner.

Upon death of an owner, the business receives the life insurance proceeds to buy the deceased owner’s business interest. Assuming the employer notice and consent requirements of IRC §101J have been met, the business should generally receive the insurance proceeds income tax-free⁶ and the business interest received by the estate of the deceased owner will usually receive a step-up in basis equal to the date of death value of the business. Generally, as long as the purchase amount paid by the business is equal to the date of death step-up basis value, the heirs do not recognize income tax on the sale.



Advantages of Entity-Purchase Agreement:

- Simpler administration – fewer insurance policies (one per business owner) and less complexities of premium payment.
- Since the business owns the policies, there may be a stronger sense of security that the buyout will be performed in contrast to the cross-purchase arrangement.
- After the death of a business owner, the business may continue to own the insurance policies on the surviving business owners, avoiding the complex issues of changing policy ownership that occur in a cross-purchase arrangement.
- Works well for businesses with multiple owners.

Disadvantages of Entity-Purchase Agreement:

- After the redemption, the remaining business owners may not get an increase in basis even though they own a larger interest in the company. (NOTE: When business-owned life insurance funds the arrangement, the life insurance death proceeds increases the basis of the owners in a pass-through business entity, such as an LLC, partnership, and S corporation).
- The surviving owners interest in the business increases in proportion to their current interest. For example, if you have three owners with 20%, 30%, and 50% interests in the business, at the death of the 20% owner, the survivors' interest will increase to 37.5% and 62.5%. If the desire is to have a 50/50 interest the entity structure will not accomplish this objective. In contrast, if the three owners each own 33.3% interest in the business at the death of one, the survivors will have a 50/50% interest with an entity arrangement.
- The purchase of the deceased owner's interest by the business may be treated as a constructive dividend, which can result in adverse income tax to the estate of the deceased in family-owned C corporations (and S corporations which were once C corporations with retained earnings).³
- The life insurance proceeds received by the business may increase the value of the decedent's interest in the business for estate tax purposes.⁴
- Business-owned life insurance proceeds may be subject to income taxation if the notice and consent requirements of IRC101J have not been followed.⁶

Wait-and-See Agreement:

This form of buy-sell agreement combines elements of both cross-purchase and entity-purchase agreements. With this agreement, the business has the first option to purchase the departing owner's interest. If the business declines, the remaining owners can purchase the departing owner's interest. If neither acts, a mandatory purchase provision may apply. With this form of buy-sell each business owner is the owner and beneficiary of a life insurance policy on the other business owners, like a cross-purchase, resulting in multiple policies on each business owner.

Upon the death of an owner, the surviving business owners receive the life insurance proceeds which should generally be received income tax-free, and the business interest is received by the estate of the deceased owner and will usually receive a step-up in basis equal to the date of death value of the business. If at this point it is determined that the business should purchase some or all of the deceased owner's business interest, the surviving owners can make a capital contribution to the business using the insurance proceeds, increasing their basis in the business by the amount of the capital contribution. The business, in turn, can use the proceeds to purchase the interest of the deceased. Alternatively, the surviving owners can use the proceeds to acquire the interest of the deceased. Again, the survivors get a basis adjustment equal to their purchase price. Finally, assuming the purchase amount paid to the estate of the deceased is equal to the date of death step-up basis value, the heirs will generally not recognize income tax on the sale.

Advantages of a Wait-and-See Agreement:

- This structure provides maximum flexibility. Instead of committing to a particular arrangement, the business owners can adopt the arrangement determined to be the most advantages after the death of an owner.

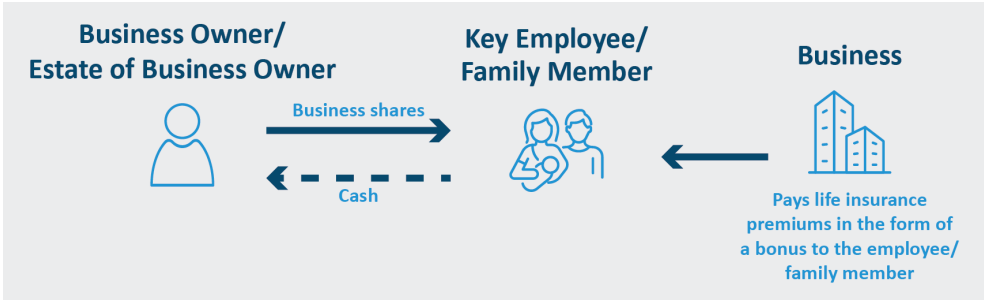
Disadvantages of a Wait-and-See Agreement:

- Becomes complex with many business owners (multiple policies)
- Premium payments may become burdensome when there is a difference in age, health, and percentage ownership between owners.
- In the corporate context, care must be taken to avoid constructive dividend treatment.

One-Way Buy-Sell Agreement:

This arrangement is typically used where there is only one business owner. A one-way buy-sell agreement is one in which an individual, such as a key employee or possible family business heir, agrees to buyout the interest of a "selling" business owner (typically a senior generation sole/majority owner) upon a triggering event. Accordingly, the key employee will be the owner and beneficiary of a policy on the life of the "selling" business owner. Typically, the business will pay a bonus to the policy owner in the amount of the premium payments to minimize the out-of-pocket expense of the arrangement.

Upon the death of the business owner, the key employee receives the life insurance proceeds to buy the deceased owner's business interest. The insurance proceeds should generally be received income tax-free by the key employee and the business interest received by the estate of the deceased owner will usually receive a step-up in basis equal to the date of death value of the business. Assuming the purchase amount paid by the key employee is equal to the date of death step-up basis value, the heirs do not recognize income tax on the sale.



Advantages of a One-Way Buy-Sell Agreement:

- Provides the key employee a step up in basis for the business interest purchased.
- Avoids the risk that life insurance proceeds will increase the value of the deceased business owner's interest in the business for estate tax purposes.⁴

Disadvantages of a One-Way Buy-Sell Agreement:

- There is the danger that the key employee terminates employment prior to the triggering event. Consequently, the agreement should include provisions concerning what happens to the policy on the business owner's life.
- Premium payments may become burdensome.

Factors in Choosing the Appropriate Buy-Sell Structure:

Selecting the right buy-sell structure is a critical decision that affects policy ownership, tax outcomes, and long-term business structure. The following factors consistently guide the decision.

- *Number of owners.* The size of the ownership group is often the starting point. In businesses with only two or three owners, a cross-purchase agreement is manageable. However, as the number of owners increases the complexity of maintaining multiple life insurance policies grows. In these cases, an entity purchase structure (trusteed or business continuation LLC) is often more practical.
- *Estate tax considerations of the owners.* After the Supreme Court's Connelly decision, a cross-purchase arrangement is favored in situations where business owners' net worth will cause them to be subject to state or federal death taxes because this form of buyout avoids the risk that life insurance proceeds will increase the value of the business for estate tax purposes.⁴
- *Ownership goals.* The owners must consider how they want control of the business to evolve over time. An entity-purchase arrangement will result in the surviving owner's interest increasing in proportion to their ownership interest. In contrast, a cross-purchase arrangement allows for more flexibility in future ownership interest.
- *Business entity form, relationship of the business owners to each other, and the resulting tax considerations.* Tax treatment is one of the most important considerations in deciding on a buy-sell structure. Cross-purchase arrangements allow surviving owners to receive a step-up in basis, while entity-purchase agreements alone do not provide this benefit. However, entity-purchase arrangements funded with life insurance in pass-through business entities can provide surviving owners with a basis adjustment. On the other hand, entity purchase arrangements can cause adverse dividend taxation in C corporations (and S corporations which were once C corporations with carried-over retained earnings) where shareholders have family relationships (e.g., parent/child).



- *Administrative complexity.* Ease of implementation and maintenance is often overlooked. Entity arrangements are often simpler to administer. Cross-purchase arrangements can become cumbersome due to the number of required life insurance policies.

Bottom line: the selection of the “best” buy-sell arrangement for a business requires careful coordination among financial, tax, and legal advisors is essential to ensure the agreement is both effective and sustainable over time.

How Will the Buyout be Funded?

A buy-sell agreement is only as effective as its funding mechanism. While the agreement outlines who will buy, when, and at what price the funding strategy determines whether the transaction can occur without financial strain.

Key funding options include:

- *Installment payments/seller financing* is the most common method of funding a buy-out triggered by the lifetime departure of an owner. This approach may also be used in combination with insurance where the insurance funding alone is not sufficient to cover the entire value of the business interest of the deceased owner. With this form of funding the remaining owners or business agree to purchase the departing owner’s interest over time using installment payments. It should be noted that with this approach key person coverage in the amount of the note is often acquired on both the departing owner as well as the purchaser to cover the risk of either individual’s death during the term of the note. The benefits and considerations to using seller financing as a funding option include:
 - Payments can be tailored to the cash flow of the business
 - Risk to the departing owner or heirs if business performance declines
 - Ongoing financial burden on the business
 - Delayed liquidity for the departing owner or their estate
- *Third-party financing* is often mentioned as a funding option, but the ability to borrow money from a bank or other third-party lender may not be available with smaller or newer businesses. With this approach the business and the owner obtain loans to fund a buyout at the time of the triggering event. The third-party lender will typically want collateral which in most cases results in both the business and the owner signing the note and becoming personally responsible for the debt. The benefits and considerations to using third-party financing as a funding option include:
 - Preserves internal cash reserves
 - Loan approval is uncertain at the time of need
 - Adds debt to the business
 - Interest costs increase total buyout price

Life insurance is the most widely used and often the most efficient way to fund buy-sell agreements triggered by an owner’s death. Life insurance is particularly valuable because it solves the liquidity problem at the exact moment it arises. Under this approach, policies are purchased on the lives of each owner, and the death benefit provides immediate liquidity to fund the buyout. The benefits and considerations to using life insurance as a funding option include:

- Immediate cash availability upon death
- Generally income tax-free death benefit
- Predictable funding mechanism
- Premium costs increase with age or health issues
- Policy ownership and beneficiary design must align with the agreement
- Complexity grows with multiple business owners

- *Disability buyout insurance* provides funds if an owner becomes permanently disabled. While death is a common trigger event, the disability of an owner can be more financially disruptive and prolonged. Thus, it is common to have disability as a triggering event and some form of disability coverage (buyout, overhead expense, key person or personal disability income) is often purchased to help provide some financial support to the disabled owner so that a business can transition ownership smoothly even when an owner is alive, but no longer contributing to the business. Disability buyout coverage typically includes an elimination period of 12 to 24 months and the benefit can be structured to pay as a lump sum or installment. The benefits and considerations to having disability buyout coverage as a funding option include:
 - Protects against long-term uncertainty
 - Prevents strained relationships caused by inactive owners retaining equity
 - Policies can be expensive
 - Definition of disability should be aligned with the buy-sell agreement triggering event

Choosing the right funding method is critical to preserving business continuity, maintaining fairness among owners, and protecting stakeholders. No single method fits every situation. The optimal solution often reflects a combination of funding options.

In Summary

Buy-sell agreements are essential for protecting both the business and its owners. Whether structured as an entity purchase/stock redemption, cross-purchase or some hybrid arrangement, the key is aligning the agreement with the company's ownership structure, tax strategy, and succession plan. A carefully structured buy-sell agreement not only can help to ensure a smooth transition during unexpected events, it can also preserve business stability and value over time.

However, without adequate funding to ensure that the buy-sell can be implemented as documented, the arrangement may fall by the wayside. The solution – life insurance. Not only can life insurance help provide the needed funds at death, regardless of when death occurs, life insurance can be the most cost-effective method for the purchase of the business as small premium dollars can generate lump sum, income tax-free death benefits.

¹*Under case law that developed around Treas. Reg. § 20.2031-2(h), the purchase price determined under a buy-sell agreement was held to fix the value of an interest in a closely held business if the following four requirements were satisfied:*

- *The price must be fixed by, or determinable from, the agreement.*
 - *The agreement must be binding on the parties during life and after death.*
 - *The agreement must have been entered into for bona fide business reasons.*
 - *The agreement must not be a substitute for a testamentary disposition to transfer the business interest for less than adequate consideration.*
- However, because of perceived abuses in connection with agreements among owners of closely held businesses and their families for agreements entered into, or substantially modified, after October 8, 1990, IRC § 2703 provides that for transfer-tax purposes the agreement must also meet the following three-part test:*

- *It is a **bona fide** business arrangement.*
- *It is **not a device** to transfer property to members of the decedent's family for less than full and adequate consideration.*
- *It has **terms comparable** to similar arrangements entered into by a person in arms-length transactions.*

²*Pictures of buy-sell structures are from John Hancock*

³*Where the buy-sell arrangement involves the sale of a closely held family corporation, the attribution rules of IRC § 318 add additional complexity if the sale is structured as a repurchase by the corporation (a redemption). Where the attribution rules of IRC §318 apply and the transaction fails to qualify for safe harbor treatment, distributions as part of a buyout will be taxed as ordinary income to the extent of accumulated E&P.*

⁴*See Connelly v. US., 602 U.S. 257 (2024) where the Connelly brothers established a stock redemption buy-sell agreement which provided if one died, the shares would be purchased at the annually agreed value or in default of an agreed value, the appraised value. At the majority owner's death the brothers did not have an agreed value, nor did they secure an appraisal. The business used \$3 million from the business owned life insurance policy to redeem the deceased brother's shares based on an "amicable" agreed value arrived at between the estate and surviving brother. The estate reported the value of decedent's interest as \$3 million. The IRS disagreed and valued his shares at \$5.3 million, including the life insurance proceeds in the business's value. The estate paid the additional tax and sued for refund. In a unanimous decision the Supreme Court held that a stock redemption obligation to redeem shares at fair market value does not create a liability that offsets the life insurance proceeds received by the business to fund the obligation. Thus, the value of the business was increased by the amount of the proceeds on the business owned life insurance policy.*



⁵IRC § 101(a)(2) provides that all or part of the death benefit proceeds under a policy transferred for valuable consideration will be taxed as ordinary income – unless the transfer falls within an exception to this general rule.

IRC §101(j) provides that for employer-owned life insurance (EOLI) contracts issued after August 17, 2006, death benefits will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer. However, if certain notice and consent requirements are met and if certain “safe harbor” exceptions apply, the death benefits can pass income tax-free.

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