Buy-Sell Review

Plan for the future of your business

Presented to

Company Name

City, State

Presented by

Producer Name

Taking steps now to protect the future of your business is important. That's why having a buy-sell agreement in place is such a good idea. We appreciate the opportunity to look at your current plan and hope that this Buy-Sell Review ("Review") will be helpful to you as you continue your planning.

We received the following documents for Company Name ("Company"):

- **Document Name, dated October 1, 2012 ("Agreement")**

- **Business Planning Fact Finder**

- **Tax Returns from 2016 to 2018**

Important information

Please note this Review is based on our review of these documents and is intended to be used as a basis for discussions with your tax and legal advisors. If these documents are invalid in any way or other pertinent documents exist that we're not aware of, the observations, recommendations and analysis contained in this Review may be inaccurate. Principal® does not provide tax or legal advice.

This Review does not provide you with a legal opinion as to the legal or tax implications of your agreement or the appropriateness of any funding strategies. Principal cannot provide you with any legal document or revise existing legal documents. If an informal valuation is provided, it is not a substitute for a formal valuation, nor does it establish a value for tax purposes. The Review is intended to help identify your objectives for the buy-sell agreement and any issues that must be addressed to help ensure your objectives are being met.

Prepared by: Advanced Solutions Reviewer
Reviewed by: Advanced Solutions Reviewer

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Background information

Entity type	S corporation
Entity taxation	S corporation
Type of agreement	cross purchase
Business owners	Owner A (50%) Owner B (50%)

Comments:

- An S corporation is generally a pass-through entity for income tax purposes.

Executive summary

Our goal in providing this Review is to help you make sure that if interests in this business should need to be sold or transferred you have:

- enough funds
- in the right place
- at the right time

Highlights of your Agreement:

- **Death -** In the event of a business owner's death, the Agreement is structured as a cross purchase buy-sell arrangement. The buy-out at death is mandatory.

- **Disability** - In the event of a disability, the purchase of an owner's interest is optional. The definition of "disability" for purposes of the buy-sell does not align with the definition in a disability buy-out policy.

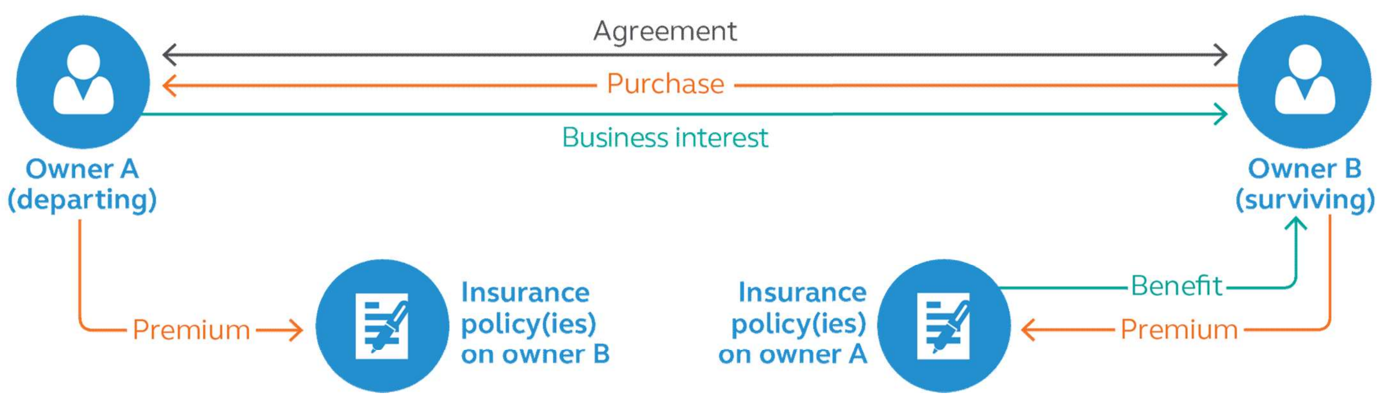
- **Purchase Price** - The Agreement states that the price for a business owner's interest at death will be based on Agreement provisions. The Agreement provisions are blank.

- **Action items:**
    - Review and update (if needed) any life and disability buy-out coverage associated with this Agreement.
    - Discuss this report with your tax and legal advisors.

We appreciate this opportunity to help you uncover planning solutions that may improve your fiscal well-being.

Your agreement structure:
Cross purchase

The Agreement is drafted as a cross purchase buy-sell arrangement upon the death of a business owner. Under this cross purchase buy-sell plan design, the surviving business owners, as opposed to the business entity, are the purchasers of a deceased owner's interest.



Comments:

- A cross purchase buy-sell arrangement is often used with two or three business owners. Under such arrangement, the surviving business owners will generally use income tax free life insurance death proceeds to purchase the business interest of a deceased owner. This permits the surviving owners to receive an increase in ownership cost basis for income tax purposes. This increase in cost basis in the Company will lessen the amount of capital gain tax paid if a subsequent sale should occur.

- Under a cross purchase arrangement, life insurance policies are generally cross owned by the business owners and would be subject to the personal creditors of the business owners. However, the policies would not be subject to the creditors of the business. "Cross owned" means the policy owner is also the beneficiary, but not the insured. Unwelcome income and/or estate tax consequences may result if different policy ownership/beneficiary structure is followed.

- The number of life or disability buy-out policies owned by the business owners will increase significantly as the number of business owners increases under a cross purchase arrangement.

Purchase and sale events

The following purchase and sale triggering events appear in your buy-sell agreement:

Triggering events	Mandatory/optional	Purchasers
Death	mandatory	other owner(s) mandatory
Disability	optional	other owner(s) optional
Retirement	not addressed	not addressed
Termination of employment (voluntary)	not addressed	not addressed
Termination of employment (involuntary)	not addressed	not addressed
Bankruptcy	not addressed	not addressed
Divorce	not addressed	not addressed
Operation of law	optional	not addressed
Deadlock provision	not applicable	

Purchase and sale events

Comments:

- Purchase rights or options arising from the occurrence of buy-sell event triggers are typically subject to time limits. If a potential buy-sell triggering event occurs, the parties should pay close attention to the time limit provided to exercise a purchase right or option.

- Including death as a mandatory buy-sell provision for buyer and seller is common in buy-sell agreements.

- Disability of an active owner may be disruptive to a business and is often a mandatory buy-sell triggering event. Consider including disability as a mandatory buy-sell triggering event.

- Personal bankruptcy of a business owner, or other assignment of the business interest to creditors, is often a buy-sell triggering event. Review with local counsel whether personal bankruptcy, or assignment of the business interest to creditors, should be added as buy-sell triggering event.

- The divorce of a business owner is often a buy-sell trigger if the spouse of a business owner is awarded an ownership interest in the Company pursuant to the divorce. Often the divorcing business owner is provided the initial option to purchase. The Company and other business owners may be given secondary purchase options. The parties may wish to consider adding divorce as a buy-sell triggering event.

- Termination of employment for any reason other than one of the enumerated event triggers, whether voluntary or involuntary, is often a buy-sell triggering event. Consider the advantages and disadvantages of including termination of employment as a purchase option.

- Retirement is an important mandatory triggering event often overlooked under a buy-sell agreement. Consider amending the Agreement to include retirement of a business owner as a mandatory purchase event.

- Using a disability definition based on being eligible to receive benefits under “any disability policy” may not be consistent with the definition and timing of disability buy-out insurance coverage.

Purchase and sale events

Additional comments:

- Discuss with local counsel which buy-sell triggering events should be mandatory and which ones should be optional.

S corporation considerations

Comments:

- Premiums paid by an S corporation for Company-owned policies may be considered a non-deductible item at the Company tax reporting level, as an expense not properly chargeable to a capital account. Non-deductible expenses generally reduce the owners' cost basis in their Company ownership interest. Annual increases in policy cash value, if present, may ineffect, be "netted" against decreases in cost basis.

- All oustanding shares of S corporation stock must confer identical rights to distribution and liquidation to shareholders pro-rata according to their stock ownership. If identical rights to distribution and liquidation proceeds are not conferred pro-rata according to stock ownership, an impermissible second class of stock will result, which would cause a loss of the S corporation election. Review with local counsel any provision in the Agreement that may create an impermissible second class of stock. Discuss this matter with local counsel.

Purchase price

In the events of death and disability, the purchase price of a business owner's interest is a pro rata portion of the value of the Company as determined below.

Purchase price provisions	Death	Disability
Primary method of determing the purchase price	based on Agreement provisions that are blank	the same as for death
Second method of determining the purchase price (if applicable)	determined by an appraisal	the same as for death
Is insurance excluded from the valuation of the business?	not addressed	not addressed
Other provisions		
Does the Agreement provide for minority interest discounts?	no	
For certain triggering events, is the purchase price subject to a "haircut"?	no	
Did Principal prepare an informal business valuation?	yes	

Comments:

- The purchase price for other triggering events is same as death.
- We completed an informal business valuation of the Company based on Company financials. Using several formulas (but excluding book value), the business value ranged from $3,000,000 to $3,500,000.
- The risk of using a stated or agreed upon business value in a buy-sell agreement is that it may become out of date, particularly if it has been a number of years since the Agreement was signed. Consider whether an alternative methodology, such as a formula or appraisal approach, might be simpler, as well as fairer to both the purchasers and the sellers.

Purchase price

Additional comments:

- Discuss with local counsel whether the valuation provisions should specify whether control premiums, and discounts for lack of marketability and/or lack of control/minority interest are to be taken into account.

- Key employee life and disability coverage may be helpful to the business owners in protecting the value of the business from the unexpected loss of a key employee's services. Typically, the business is the owner, premium payer, and beneficiary of key employee policies. Policy proceeds may be income tax free, while premium payments are generally non-deductible to the Company.

- Businesses with two or more owners should fully fund their buy-sell Agreement with life and disability buy-out insurance. Review the purchase price provisions of your Agreement and ensure the Agreement is funded with the appropriate amount of insurance.

- In general, a reduction in purchase price (or "haircut") based on the occurrence of a potential transfer event may be enforceable, if the resulting purchase price still represents a reasonable value of the business interest. Consider with local counsel whether adding a haircut for specific triggering events is appropriate and would result in a reasonable purchase price.

- Since the Agreement includes an appraisal process to determine overall Company value, the business owners may want to consider if the Agreement should direct the appraiser to include or not include control premiums or minority discounts. The Agreement may also be used to instruct the appraiser regarding the desired treatment of life insurance death proceeds from Company-owned policies. Other potential valuation adjustments, such as the proper valuation standard for assets, may also be considered.

Purchase terms

Life insurance and disability buy-out coverage may be very helpful in matching cash needs with cash flow.

Purchase term provisions	Death	Disability
Required to apply insurance proceeds towards purchase price	all insurance proceeds received by Company required to be applied	not addressed
Method for purchasing a departing owner's interest	purchaser's choice of lump sum or installments	same as for death
Installment period	20 quarters	same as for death
Down payment	25%	same as for death
Interest rate	prime	same as for death

Comments:

- The purchase terms for other triggering events are the same as for death.
- If installment payments are for a period of less than 10 years, the parties may wish to compare the likely cash needs of the Company to cash flow upon the occurrence of a buy-sell trigger. If the cash needs are substantial and cash flow limited, the parties may wish to consider provisions for payments over a longer period of time.
- Requiring all life insurance proceeds received by the Company to be used for buy-sell purposes could interfere with intended key person coverage.
- Since installment payments to a business owner may be scheduled beyond the unexpected death of a business owner, it may be advisable for policy owners to retain ownership of any life insurance policies on the life of the selling business owner. As the term of the note nears completion, the policy may be transferred for its fair market value as final payment.

Funding

The ownership and beneficiary structure of life and disability insurance policies acquired for purposes of a buy-sell agreement should be aligned with the Agreement's purchase obligations.

Life insurance on business owners	permitted
Disability buy-out insurance on business owners	not discussed
Schedule of life and disability policies included	no
Life insurance ownership and beneficiary designations aligned with Agreement	unknown
Disability buy-out ownership and beneficiary designations aligned with Agreement	unknown
Agreement discusses distribution of excess life insurance proceeds	no
Option for business owners to purchase policies when Agreement completed or terminated	no

Comments:

- The parties may wish to review insurance coverage. It's important to periodically update the amount of insurance in force to a level that's roughly consistent with the value of the business. The amount of insurance available to purchase depends upon the value of the business. Underwriting standards for life insurance and disability coverage are different.

- Life insurance death proceeds are income tax free to an employer only if the insurance is properly structured and the employer complies with IRC Section 101(j). Section 101(j) applies to employer-owned life insuance issued or materially changed after August 17, 2006. To preserve the favorable income tax treatment of life insurance death proceeds, Section 101(j) compliance requires written notice and signed consent by the insured employee to the placement of life insurance coverage owned by the employer. In addition, annual information reporting (Form 8925) on employer-owned policies is required by IRC Section 6039I. Cross-owned policies do not appear to be subject to these rules since they are not employer-owned.

Funding

Additional comments:

- Many business owners find it advantageous to list all life and disability insurance policies acquired for purposes of the buy-sell agreement, including ownership and beneficiary arrangements, on a separate schedule attached to the agreement. Where life insurance policies are concerned, this practice has the advantage of not confusing whether death proceeds are to be used for key person needs of the business or to complete the purchase of a deceased owner's business interest.

- If the Agreement includes a disability trigger, or one is added, it may be helpful to review with local counsel whether the disability terms of purchase procedures in the Agreement are consistent with the claims payment procedures in the disability buy-out policy. Some disability buy-out policies may be structured by insurers as expense reimbursement policies. Therefore, a disability buy-out claim may not be payable until the buy-out of a disabled owner's interest has occurred.

- A new owner purchasing the Company on an installment sale basis may find it helpful to acquire business loan protection disability coverage to ensure a source of future payments if the purchaser should become disabled.

- The Agreement does not provide business owners an option to purchase any policies owned by the Company and/or other business owners upon termination or completion of the Agreement.

- Consider adding provisions to the Agreement that address future ownership of life insurance policies acquired for purposes of the buy-sell arrangement as circumstances change. Many agreements include provisions for the following circumstances: (1) termination of the buy-sell agreement; (2) sale of the company; (3) termination of the business owner's relationship with the company. If any of the preceding events occur, the business owner may be given the option to purchase the policy on his or her life. In addition, if the departing business owner holds a policy on the remaining business owners, the remaining owners should also be provided with the right to purchase the policies from the departing owner.

- Revenue Procedure 2005-25 generally provides valuation safe harbors for the transfer of life insurance policies from a business to an employee (including an owner-employee). The general standard of valuation is a policy's "fair market value." Generally speaking, fair market value is measured differently for different types of life insurance products and might not be respresented by a policy's cash surrender value. The insurance company providing the product is in the best position to provide the measure of fair market value for its products. Transactions between or among business owners are generally not bound by the valuation guidelines.

Transfer restrictions

A provision limiting transfer of ownership interests is common and useful in a buy-sell agreement. Oftentimes, a business owner may not sell, assign, transfer, pledge, dispose of or otherwise encumber any of his or her interest in the Company, except as provided in the Agreement.

The Agreement includes provisions to limit the transfer of ownership	yes
Any transfer of interests in violation of the Agreement will be treated as null and void	not addressed
Transferees are treated as receiving purely an economic interest (non-voting) unless the remaining business owners agree otherwise	no
Permitted transferrees include certain family members	not addressed
Permitted transferees include certain trusts for the benefit of family members and/or for estate planning	not addressed
Any transfer that endangers an S corporation election is prohibited	not addressed
Any transfer by operation of law is prohibited under the Agreement	yes

Comments:

- Transfer restrictions prohibiting the transfer of interests by operation of law often have no binding legal effect.

Right of first refusal

A right of first refusal provision is typically included in buy-sell agreements. Such a provision may be helpful to a business owner wishing to exit the business but may also serve to protect the business owners from being forced to accept an outside party as a new business owner, without recourse.

The Agreement includes a right of first refusal provision	yes
Right of first refusal (1st option)	other owner(s) optional
Option price	3rd party offer price

Comments:

- A right of first refusal price is generally based on (a) the Agreement price; (b) the third party offer price; or (c) the lesser of the Agreement price or the third party offer price.

- Purchase rights or options arising from the occurrence of a right of first refusal provision are typically subject to time limits. If a right of first refusal is triggered, the parties should pay close attention to the time limit provided to exercise a purchase right or option.

Signatures

It's important that the Agreement is signed by all parties.

Signed by all named business owners	yes
Company is party to the Agreement	yes
Signed by a representative of the Company	no
Spousal consent provisions included in the Agreement	no
Signed by spouses of all business owners	no

Comments:

- The inclusion of spousal consent provisions and obtaining the signatures of spouses may be helpful in establishing the value of a divorcing owner's interest in the business. This could also help prevent a divorce court from using its own valuation of the business for marital property settlement purposes.

- Often, a surviving spouse may be named as executor of the estate of a business owner. A smooth transfer of shares at death may be facilitated by prior notice of the Agreement and consent by the surviving spouse.

- The parties may wish to consider adding spousal consent provisions and asking any spouses to sign the Agreement.

- A buy-sell Agreement not signed by a representative of the Company, does not bind the the Company to the Agreement's terms. Once the Agreement is in final form, discuss with local counsel if it would be helpful for the Company to be added as a signatory to the Agreement.

Your action plan

The following are discussion points based on the results of this report:

Discussion points	Do I want to make a change?	Priority
The terms of the Agreement if a business owner dies		
The terms of the Agreement if a business owner becomes disabled		
Other buy-sell triggering events		
The Agreement purchase price		
The Agreement purchase terms		
Structure and adequacy of any life and disability buy-out insurance		

You benefit from a partner who knows business

As the owner of a business, your financial needs are different than those of other individuals. So, it only makes sense to work with a company that understands the financial needs of businesses and their owners. We at Principal help business owners like you every day. This means we have the expertise, solutions and services to consult with you on financial solutions that help address specific needs.

- No. 1 provider of nonqualified deferred compensation plans*
- Provider of complimentary business market administrative services for more than 30 unique program designs and over 16,000 plans.
- Preparer of thousands of informal business valuations since 2011.
- Reviewer of more than 1,500 buy-sell agreements since 2011.

* Based on total number of Section 409A plans, *PLANSPONSOR* 2018 NQDC Recordkeeping Survey, June 2018.