Buy-Sell Review

Plan for the future of your business.

Presented to

Sample Company

Des Moines, IA

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 Sample Company ("Company"):

- **Sample Agreement, dated 01/01/2010, ("Agreement")**

- **Business Planning Fact Finder**

- **Combination of Tax Returns and Financials from 2020 to 2022**

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.

Some Agreements include language that structures the financial and working relationship among co-owners of the business, with buy-sell provisions being only a part of the entire agreement. This Buy-Sell Review is limited to only the buy-sell provisions found in the Agreement.

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	entity purchase
Business owners	Owner A (50%) Owner B (50%)

Comments:

- An S corporation is generally a pass-through entity for income tax purposes.
- The owners are urged to follow the procedures outlined in the Agreement closely. Ignoring valuation and other procedures dictated by the Agreement could undermine the validity of the Agreement.
- Given the age of the Agreement, this may be a particularly good time to review all current provisions and to discuss with local counsel and the business owners whether any additional terms should be added.

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 an entity 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 an annual determination that may be out of date.
  - 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 $3,855,000 to $5,048,000. The Highlighted Value in the Informal Business Valuation is $5,048,000.
  - Consider the impact to the business of installment payments to buy the interest of a deceased or disabled owner. For example, the cost of purchasing a $2,500,000 business holding over 5 years is $500,000 per year (not factoring interest). Given that the buyer is generally using after-tax dollars to purchase, the cost is approximately $793,651 per year when factoring taxes at 37%.

- **Life Insurance paid to a company** - 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 reconsider the 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.

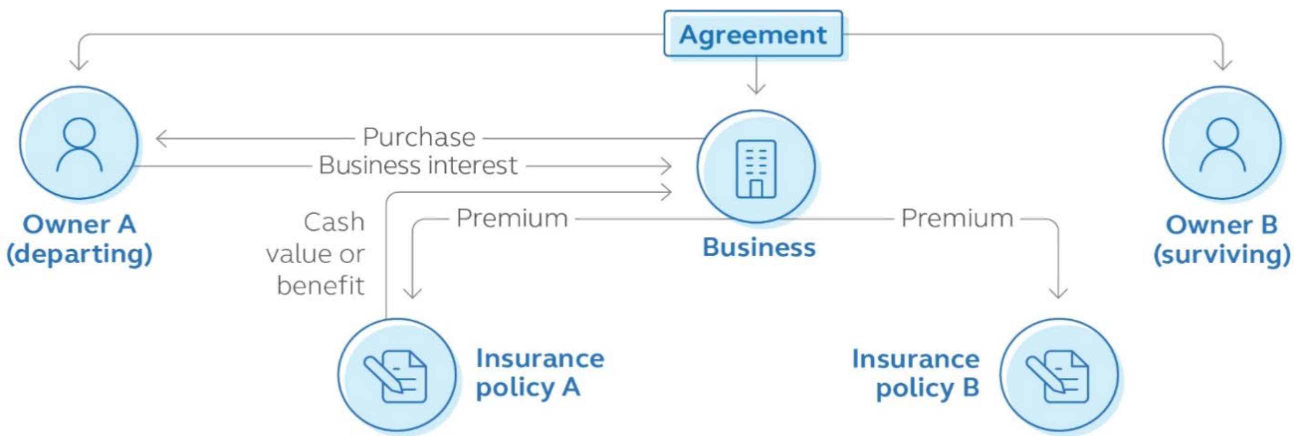
- **Priority considerations:**
  An unsigned Agreement is without legally binding effect. Before signing the Agreement, ensure that the owners are satisfied it contains the needed buy-sell provisions after discussing with local counsel.

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

Your agreement structure:

Entity purchase

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



Comments:

- An entity purchase buy-sell arrangement provides the simplicity of only one life insurance and/or disability buy-out policy on each business owner. This may be an advantage over a cross purchase buy-sell design when there are multiple business owners.
- Under an entity purchase arrangement, life insurance policies are owned by the business entity, and the policy owner is also the beneficiary. Entity-owned policies would be subject to the claims of creditors of the business. However, the policies would not be subject to the claims of personal creditors of the business owners.
- If company-owned life insurance will be used to provide funding for the Agreement, it is important the Agreement explicitly state how the cash values and death benefits will be treated in the valuation of the company, and that the valuation procedures dictated by the Agreement be followed closely.
- 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 reconsider the 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.

Your agreement structure:

Entity purchase

Additional comments:

- Your tax and legal advisors may provide you with a full list of advantages and disadvantages of the different types of buy-sell arrangements.

- Most states have laws that address the conditions under which a corporate redemption may occur. Often, these statutes relate to the level of corporate surplus present at the time a stock redemption is to occur. Since the timing of a stock redemption may be unpredictable, life and disability insurance contracts may be helpful to the business owners in facilitating the redemption.

- The implementation of an entity purchase arrangement can result in an unintended shift of control upon the death of one owner. Business owners should discuss with legal counsel whether an entity purchase will meet the owners' goals under varying scenarios.

Additional information

The business owners might wish to discuss the following with local counsel:

- An unsigned Agreement is without legally binding effect. Before signing the Agreement, ensure that the owners are satisfied it contains the needed buy-sell provisions after discussing with local counsel.

Purchase and sale events

The following summarizes typical purchase and sale triggering events and indicates whether they are addressed in your buy-sell agreement:

Triggering events	Mandatory/optional	Purchasers
Death	mandatory Sec. 7.1.1	company mandatory $0
Disability	optional Secs. 7.1.2	company optional
Retirement	not addressed	not addressed
Termination of employment (voluntary)	not addressed	not addressed
Termination of employment (involuntary)	not addressed	not addressed
Bankruptcy	optional	company optional
Divorce	not addressed	not addressed
Operation of law	not addressed	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.

- 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.

- As the Agreement is currently structured, it's possible that there may be a determination of disability under the Agreement's provisions, but the insurer from whom disability insurance policies have been acquired might not agree. This potential conflict between disability funding and the Agreement's disability provisions may create a cash flow shortage for the purchaser. Generally, when a disability trigger is included and funded in an Agreement, the Agreement utilizes the insurance company's determination of disability for its purposes. Review this important matter with local counsel.

S corporation considerations

Comments:

- 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 termination 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.

- S corporations utilizing an entity redemption buy-sell plan design have sometimes found it advantageous to incorporate the "short-year" election process of IRC Section 1377(a)(2) into their Agreement. In brief, if the S corporation can qualify, this technique can provide a greater increase in ownership cost basis to surviving owners. An entity purchase design requires only one policy per owner (owned by the Company). Qualification for short year election generally requires use of the cash basis accounting method. Review with local counsel the IRC Section 1377(a)(2) election process.

- For pass-through taxation entities, such as S corporations, life insurance death proceeds, as tax-exempt income received by the business entity, may provide the surviving owners with only some cost basis increase for income tax purposes. This outcome occurs because basis increase resulting from receipt of tax-free life insurance death proceeds must be allocated pro rata based on ownership, even to a deceased business owner.

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 determined as indicated below.

Purchase price provisions	Death	Disability
Primary method of determing the purchase price	based on an annual determination that may be out of date	based on an annual determination that may be out of date
Second method of determining the purchase price (if applicable)	determined by an appraisal	determined by an appraisal
Does agreement contain language attempting to exclude insurance death benefits from the business value?	not addressed	not addressed
Other provisions		
Does the Agreement provide for marketability, lack of control, or minority interest discounts?	not addressed	
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 the same as for 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 $3,855,000 to $5,048,000. The Highlighted Value in the Informal Business Valuation is $5,048,000.
- See the "Life insurance paid to a company" page for an overview of how company-owned life insurance may impact the purchase price.
- The Supreme Court ruling in *Connelly v. US* (2024) makes it unclear whether an agreement can successfully set a business value for estate tax purposes that excludes life insurance death proceeds. Note that disability buyout coverage from Principal is designed to reimburse the business for covered expenses after the buyout has occurred.

Purchase price

Additional comments:

- The valuation provisions of buy-sell agreements are one of the most frequently litigated issues in buy-sell disputes. Courts tend to hold owners to the terms of their contract, even if the outcome is not as fair as the owners expect. Owners need to be cognizant of the standards by which the value of their interest will be determined, and whether the terms of the Agreement will permit a minority owner's share to be reduced because of lack of control and/or marketability. Owners are urged to discuss this issue with local counsel, taking care to be certain they understand the pricing provisions of their agreement. If a buy-sell agreement requires ownership valuation to be determined by an outside appraisal, best practice is to instruct the appraiser in the Agreement whether to apply minority interest or marketability discounts.

- 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.

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	not addressed	not addressed
Method for purchasing a departing owner's interest	purchaser's choice of lump sum or installments Sec. 8.4.2	purchaser's choice of lump sum or installments Sec. 8.4.2
Installment period	60 months Sec. 8.4.2	60 months Sec. 8.4.2
Down payment	10% Sec. 8.4.1	10% Sec. 8.4.1
Interest rate	prime plus 2% Sec. 8.4.2	prime plus 2% Sec. 8.4.2

Comments:

- The purchase terms for other triggering events are the same as both death and disability.

- 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.

- The agreement should explicitly require use of available life insurance proceeds and disability buy-out proceeds to complete a sale under the Agreement.

- 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	not discussed
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.

- The agreement does not address disposition of life insurance policies if the buy-sell ceases to apply to a particular insured while alive. There is somewhat inconsistent authority on the question of whether an insured's right to buy a policy insuring himself/herself from another for fair market value constitutes, in and of itself, an incident of ownership in the policy. As such, the drafting attorney should include such a provision only after reviewing the relevant legal authorities, such as Rev. Rul. 79-46 (right to buy is incident of ownership) and Est. of Smith 73 TC 307 (1979) (right to buy is not incident of ownership).

- 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.

Life insurance paid to a company

Whenever life insurance proceeds are paid to a company (most common with entity purchase and wait-and-see buy-sell agreements), the parties will want to discuss with local counsel the effect of the June 2024 US Supreme Court decision in *Connelly v. US* .

Highlights of your agreement:

Concern about value for estate tax purposes?	no
Type of agreement	entity purchase
Primary method of determing the purchase price at death	based on an annual determination that may be out of date

Per *Connelly v. US* , life insurance proceeds paid to a business entity generally increase the value of the company for estate tax purposes, without an offsetting reduction in value due to the entity's purchase obligation. This in turn generally raises the value of the deceased owner's fractional business interest for estate tax purposes.

Despite *Connelly v. US* , there is reason to think that a buy-sell agreement might be able to set a business value for estate tax purposes that excludes life insurance proceeds payable to the business. In theory, this might be done if the buy-sell agreement contains a value that excludes life insurance proceeds, such value is fixed or derived via formula, and if the agreement also meets certain other criteria. Counsel for the parties involved will have to review the relevant law (IRC Section 2703, Reg. §20.2031-2, and Revenue Ruling 59-60) and their clients' situation to see whether this is a viable approach.

If life insurance proceeds paid to the business do have the effect of raising the value of the business and thus also raising the value of the deceased owner's interest for estate tax purposes, resulting effects could include:

- The decedent's estate being estate taxed on a value that is higher than what is being received as a purchase price under the buy-sell agreement.
- The buyer (likely, the business) potentially having to pay a higher price under the agreement (that takes into account a fraction of the life insurance proceeds), particularly if the purchase price is simply based upon "fair market value" upon death.

To avoid the issue, the parties might want to instead have any life insurance proceeds paid to the other business owners (rather than paid to the Company), as would be common in a cross-purchase arrangement.

Ultimately, the course of action taken by the parties should be done after careful consultation with their own legal and tax counsel.

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 Sec. 2
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	yes Sec. 6.1
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 Sec. 6.2
Right of first refusal (2nd option)	company 2nd optional Sec. 6.3
Option price	lesser of agreement or 3rd party offer price Secs. 6.2, 6.3

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	no
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.
- An unsigned Agreement is without legally binding effect. Before signing the Agreement, ensure that the owners are satisfied it contains the needed buy-sell provisions after discussing with local counsel. Once the Agreement is in final form, it will be important for all intended parties to sign 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		
Estate tax exposure		
Structure and adequacy of any life and disability buy-out insurance		

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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 experience, solutions, and services to consult with you on financial solutions that help address specific needs.

- No. 1 provider for nonqualified deferred compensation (409A) clients*
- Provider of complimentary business market administrative services for more than 30 unique program designs and over 24,000 plans
- Preparer of thousands of informal business valuations since 2011
- Reviewer of more than 2,500 buy-sell agreements since 2011

* 2024 *PLANSPONSOR* NQDC Market Survey, July 2024 (1,970 clients).