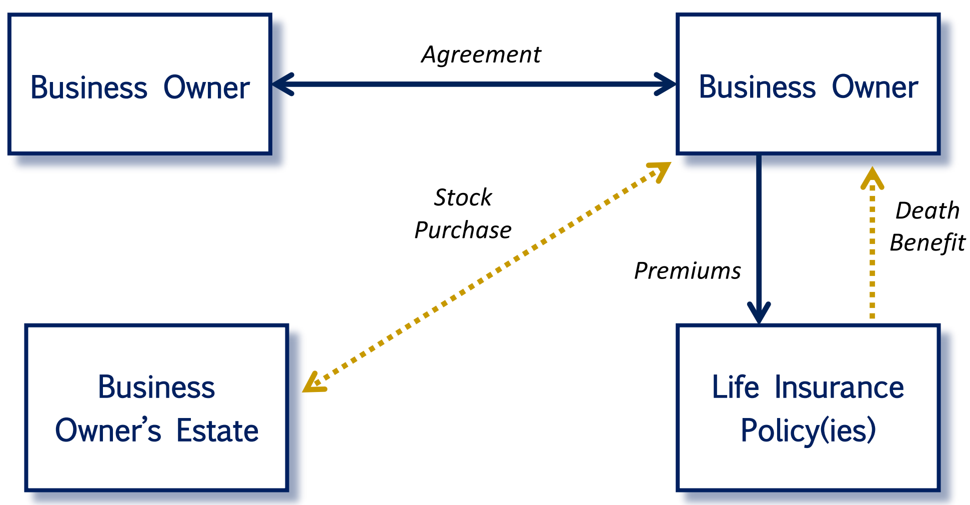
The Cross Purchase Buy/Sell Arrangement

In a cross purchase agreement, when an owner dies or becomes totally disabled, the surviving business owners agree to purchase the deceased or disabled owner's business interest. Each business owner is applicant, owner, beneficiary and premium payer for insurance policies on the lives of every other business owner. At death or total disability, each surviving owner/beneficiary normally receives the policy proceeds income tax free. Each surviving owner pays cash to the disabled owner or deceased owner's estate and in return the disabled owner or deceased owner's estate transfers a pro rata portion of the disabled or deceased owner's business interest. The result is that the disabled owner or the deceased owner's non-liquid business interest has been transformed into cash and the surviving owners own 100 percent of the business.



1. Working with the business' legal, tax and financial advisors, the business owners enter into a cross purchase agreement. The agreement requires the business owners to purchase the decedent departing or disabled business owner's interest in the business for an agreed upon price upon a triggering event (e.g. death, retirement or disability).
2. To fund its purchase obligation, the business owners purchase a life insurance (and/or disability) policy on the lives of the other participating business owners. The policyowner pays the policy premiums and is the policy beneficiary.
3. Upon the death (or disability) of an insured business owner, the surviving business owners receive the insurance proceeds income-tax-free*.
4. The surviving business owners apply the proceeds towards the purchase of the disabled or decedent business owner's interest in the business from the disabled business owner or from his or her estate.

* *For federal income tax purposes, life insurance death benefits are generally income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owed policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

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Advantages

- Life insurance proceeds normally will be received income-tax-free (IRC § 101(a)). This assumes there are no transfer-for-value issues.
- The policies are not owned by the entity; therefore, the policies are not business assets and are not subject to claims of the business' creditors.
- In a corporate cross purchase plan, the purchaser (surviving shareholder) will receive full basis credit for the purchase of the stock.
- The owners (rather than the corporation) own the policies; therefore, the policy proceeds are not subject to the corporate AMT.
- The sale of stock by an owner's estate normally will be a sale of a capital asset and will receive capital gains tax treatment. Even better, there usually is little or no capital gain to be recognized because of the step-up in basis of the business interest to its fair market value at the death of an owner (IRC § 1014).

Disadvantages

- Personal after-tax funds are used to purchase the insurance policies and the premiums are not deductible.
- In a cross purchase agreement, the policies are cross-owned. This means that the youngest owner (and presumably the one who can least afford to pay) will own and pay for the policy on an older and perhaps rated owner.
- The business does not own the insurance policies and therefore cannot book them as assets.
- Policies are subject to the individual owners' creditors.
- Administrative complexities - In the case of more than two owners, multiple policies must be purchased and held by each owner. The formula is N x (N-1), where N equals the number of owners. For example, in the case of five owners, 20 policies need to be purchased (5 x 4 = 20).