



Buy-Sell Review

Plan for the future of your business

Presented to
SoftTek - Sample 1
Dallas, TX

Presented by
Tahitta Diaz
diaz.tahitta@principal.com
214-417-4479



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 SoftTek - Sample 1 ("Company"):

- SoftTek Buy-Sell Agreement, dated 01/01/2019, ("Agreement")
- Business Planning Fact Finder
- Tax Returns from 2018 to 2020

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.

State LLC law generally includes default provisions that will come into play if the subject matter is not addressed by the operating agreement. These default provisions may impact buy-sell issues. In some cases, state law may restrict operating agreement and/or buy-sell provisions altogether. This report does not include a review of state LLC law and/or default provisions.

Prepared by: Polina Engel, J.D., CLU®
Reviewed by: April Caudill, J.D., CLU®, ChFC®, AEP®

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Background information

Entity type	limited liability company
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Entity taxation	partnership
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Type of agreement	cross purchase
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Business owners	Andrew Jackson (50%) Alex Hamilton (50%)
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Comments:

- A partnership 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

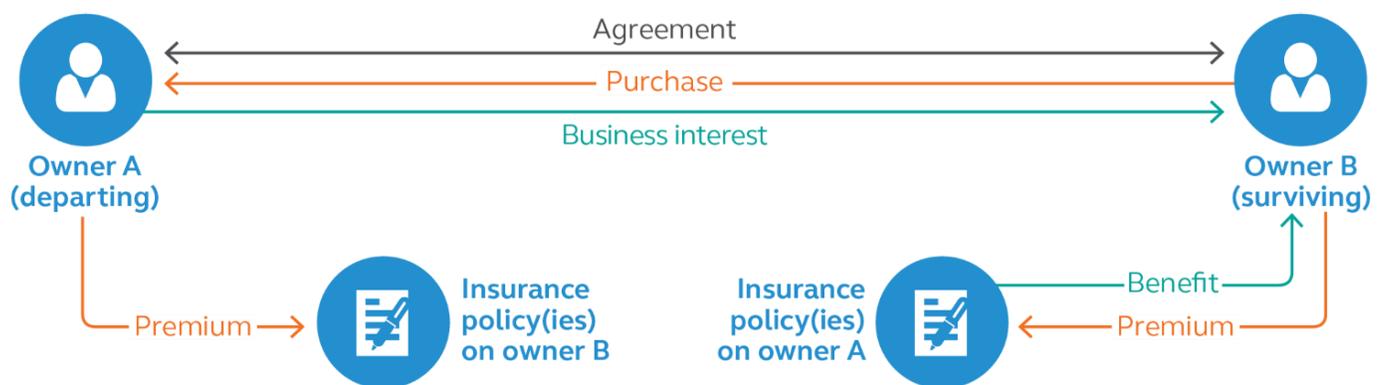
Highlights of your Agreement:

- 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 not addressed.
- Purchase Price - The Agreement states that the price for a business owner's interest at death will be determined annually.
- 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.

Additional information

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

- The Agreement does not include spousal consent provisions or signatures of each of the spouses. Business owners should discuss with local counsel whether these provisions should be included for signature.
- The divorce of a business owner is often a buy-sell optional trigger if the spouse of a business owner is awarded an ownership interest in the Company pursuant to the divorce. The Agreement provides the Company the option to purchase the interest of the ex-spouse of a business owner. Often, the divorcing business owner is provided the initial option to purchase such interest. The Company and other business owners may be given secondary purchase options. The parties may wish to consider updating the Agreement to provide the divorcing business owner the initial option.
- When business owners reside in a community property state, such as Texas, the death of a spouse is often included as an optional purchase and sale event for the community property interest of a deceased spouse if the stock is passed to someone other than the surviving business owner spouse. Discuss with local counsel if this circumstance should be addressed by the Agreement.
- The Agreement requires business owners to annually establish the value of the business. Our experience indicates that compliance with annual updating of the stated value method of valuation is at best inconvenient for business owners. Changing to a third party appraisal or formula driven valuation might be more suitable. In any case, consider adding a back-up valuation process.
- The Agreement requires that the business own life insurance on the business owners. Generally, with a cross purchase agreement, such as the one here, it is the other owner, rather than the business, that should be the owner and beneficiary on life insurance policy of their partner.
- Although the Agreement requires the purchase of life insurance to fund the buy-sell obligation, it does not require that such death benefit be applied to the purchase price. Consult with local counsel to make sure the Agreement aligns with the business owners' intent.

Purchase and sale events

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

Triggering events	Mandatory/optional	Purchasers
Death	mandatory	company mandatory
Disability	not addressed	not addressed
Retirement	optional	company optional
Termination of employment (voluntary)	not addressed	not addressed
Termination of employment (involuntary)	not addressed	not addressed
Bankruptcy	not addressed	not addressed
Divorce	optional see p. 6	company optional
Operation of law	not addressed	not addressed
Deadlock provision	no	

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.
- 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.

Purchase and sale events

Additional comments:

- Discuss with local counsel which buy-sell triggering events should be mandatory and which ones should be optional.
- A deadlock provision may be helpful to avoid irreconcilable differences between owners. It is most often included in buy-sell agreements where there are only two business owners. Under this provision, a business owner who receives a purchase offer from a co-owner must either sell to the co-owner, or purchase the co-owner's interest at the price and terms contained in the offer.

Partnership considerations

Comments:

- Premiums paid by an entity taxed as a partnership on life insurance policies it owns 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, in effect, be "netted" against decreases in cost basis.
- Key employee life and disability coverage may be helpful to the business owner 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.

Purchase price

In the event of death, 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 determining the purchase price	determined annually	not addressed
Is insurance excluded from the valuation of the business?	not addressed	not addressed
Other provisions		
Does the Agreement provide for 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 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 \$755,000 to \$832,000.

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	no	not addressed
Method for purchasing a departing owner's interest	purchaser's choice of lump sum or installments	not addressed
Installment period	5 years	not addressed
Down payment	250,000	not addressed
Interest rate	prime rate	not addressed

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.
- 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	required see p. 6
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 insurance 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 represented 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	yes
Transferees are treated as receiving purely an economic interest (non-voting) unless the remaining business owners agree otherwise	no
Permitted transferees 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 applicable
Any transfer by operation of law is prohibited under the Agreement	no

Comments:

- The ability to make transfers to family members or certain trusts can be particularly helpful for family-owned businesses or estate planning purposes.

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
Right of first refusal (2nd option)	company 2nd optional
Option price	not included

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.

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