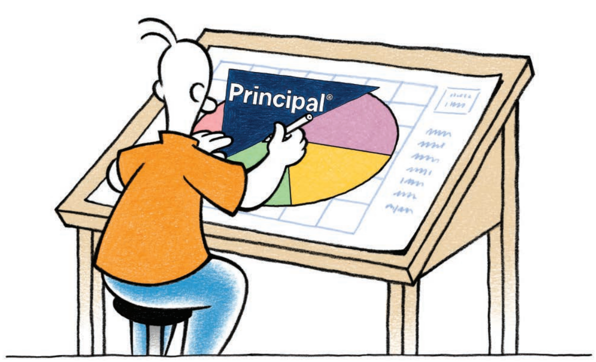
FOR BUSINESS OWNERS

Disability Buy-Out Insurance

Business Succession Planning



Do you have a plan for the future of your business?

If you or one of your business partners became too sick or hurt to work and could not return to the business, what would happen? Do you have a succession plan or the means to buy out the disabled partner?

Protect your business from the risk of a disability by funding a buy-sell agreement with **Disability Buy-Out (DBO) insurance** from Principal Life Insurance Company. A buy-sell agreement stipulates how a business owner's interest is transferred following a triggering event such as a total disability.

A DBO insurance policy funds the buy-sell agreement, allowing the remaining owners to continue the business without:

- Using business cash flow
- Obtaining loans from financial institutions
- Selling shares of the business to get working capital

DBO insurance may be used to fund two types of buy-sell agreements – Cross Purchase and Entity Purchase. (A buy-sell agreement must be in force when the disability begins or no benefit is payable.)

Cross Purchase

How it works – Each business owner purchases and owns a DBO insurance policy on each of the other business owners.

- Healthy owners receive a step-up in basis when they buy out the disabled owner.
- Their additional investment into the business helps offset their profit and tax liability if they eventually sell the business for a gain.
- Creditors are not eligible to receive the policy benefits.

Entity Purchase

How it works – The business purchases and owns the DBO insurance policies and pays the premiums (which are not tax deductible). If a total disability occurs, the business purchases the disabled owner's business interest and receives tax-free reimbursement.

- This type of arrangement is often preferred when multiple owners are involved.
- Entity Purchase agreements are not recommended if any of the business owners expect to sell shares of the business during their lifetimes because no one will receive a step-up in basis.

Complimentary planning services for your business

Principal Life has a team of experts who can:

- Review your buy-sell agreement to ensure it's effective and properly funded
- Provide an informal valution of your business that helps identify the next steps in business continuation planning

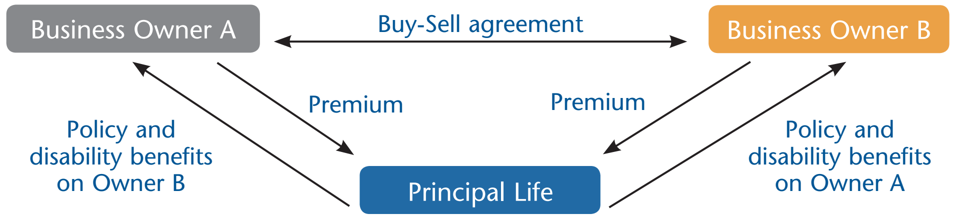
Hypothetical case scenario

In the following scenario, you'll see how important it is to properly fund a buy-sell agreement with DBO insurance and how the two agreement types work. The scenario assumptions include:

- Two-owner architectural firm worth $2 million
- Many fixed business expenses, including high rent
- One owner becoming totally disabled

CROSS PURCHASE AGREEMENT

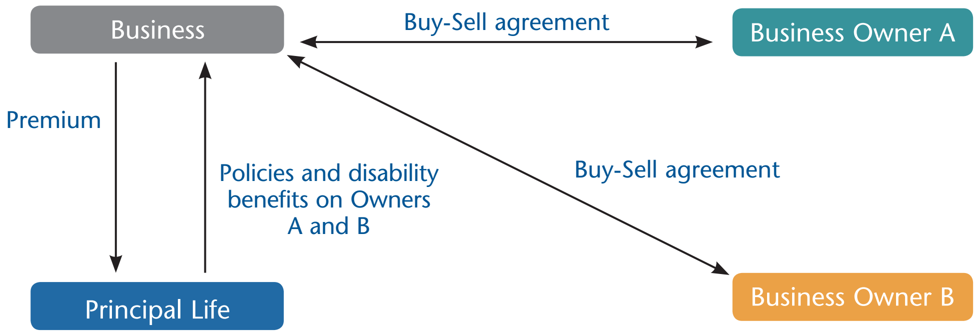
A Cross Purchase agreement is in place and funded with DBO insurance. In this example, each owner owns a $1 million policy on each other.



- After the disability, the non-disabled owner purchases the disabled owner's share in accordance with the agreement and receives policy benefits (up to the maximum policy limit).
- The non-disabled owner then owns the business, and the disabled owner has been paid the agreed-upon price.

ENTITY PURCHASE AGREEMENT

An Entity Purchase agreement is in place and funded with DBO insurance. In this example, the business purchases a $1 million DBO insurance policy on each business owner.



- After the disability, the business purchases the disabled owner's share in accordance with the agreement and receives the policy benefits (up to the maximum policy limit).
- The non-disabled owner then owns the business, and the disabled owner has been paid the agreed-upon price.

Buy-sell arrangement advantages

For Active Business Owner(s)

- It assures that the disabled owner can be bought out at a predetermined price and time after a disability occurs.
- Customers, creditors and employees are assured of business continuity.
- It assures a smooth and complete transition of management.
- Competitors cannot buy the disabled owner's business interest in the firm.
- Current owner(s) retain control of the business rather than the disabled owner's family members.

For Disabled Business Owner(s)

- It assures a price under mutually agreed-upon terms (avoiding disagreements in the negotiation of the sale price).
- It allows family members to focus on meeting the needs of the disabled owner rather than protecting the business.
- It provides money to the disabled partner to pay living costs and bills that a disabling condition may generate.
- It assures the disabled partner's financial future is no longer contingent on the business.

Tax consequences

- Premiums are not deductible. (IRC Section 264(a)(1) and Rev. Rul. 66-266)
- Disability benefits paid to the business (Entity Purchase) or to the non-disabled business owner(s) (Cross Purchase) are received income tax-free. (IRC Section 104(a)(3))
- Sale proceeds equal to the excess of sale price over basis are usually taxed to the disabled business owner at capital gain rates in the year payments are received. No step-up in basis is available.
- Sale proceeds represented by unrealized receivables, substantially appreciated inventory and depreciation recapture (partnerships), or by an incomplete redemption of a shareholder's stock (corporations) are usually taxed to the disabled business owner as ordinary income.

FOR MORE INFORMATION

Contact your local representative.

Principal® Financial Group

WE'LL GIVE YOU AN EDGE®

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