FOR BUSINESS OWNERS

Disability Buy-Out Insurance

Business Succession Planning

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

Preparing for a permanent disability is critical to ensuring business succession. If you or one of your business partners became too sick or hurt to work and could not return to the business, would you have a plan or the means to buy out the disabled partner?

Protect your business from a permanent disability by funding a buy-sell agreement with Disability Buy-Out insurance from Principal Life Insurance Company. Disability Buy-Out 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.

Regardless of the buy-sell agreement type in place, funding with a Disability Buy-Out insurance policy from Principal Life allows 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

Cross Purchase

Each business owner purchases and owns a Disability Buy-Out insurance policy on each of the other business owners. The primary benefit of this arrangement is that the 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. Plus, creditors are not eligible to receive the policy benefits.

Entity Purchase

The business purchases and owns the Disability Buy-Out 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.

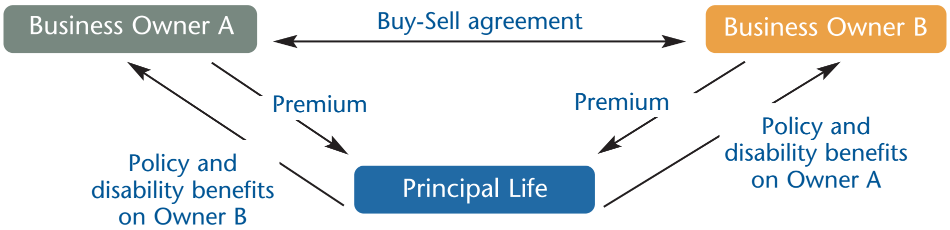
Hypothetical case scenario

In the following scenario you'll see how important it is to properly fund a buy-sell agreement with Disability Buy-Out insurance and how the two different agreement types work. Scenario assumptions:

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

Cross Purchase agreement

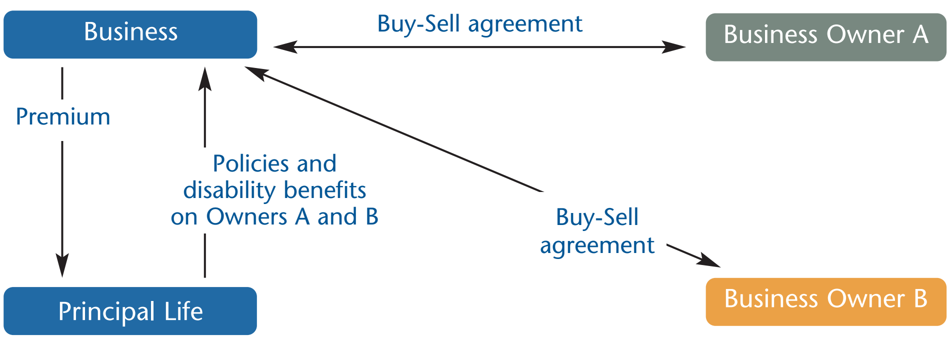
If a Cross Purchase agreement is in place and funded with Disability Buy-Out insurance, the business can continue with minimal risk. In this example, each owner would own a $1 million policy on each other.



- 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) as a reimbursement.
- The non-disabled owner then owns the business, and the disabled owner has been paid the agreed-upon price.

Entity Purchase agreement

If an Entity Purchase agreement is in place and funded with Disability Buy-Out insurance, the business can continue with minimal risk. In this example, the business purchases $1 million Disability Buy-Out insurance policies 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) as a reimbursement.
- The non-disabled owner owns the business, and the disabled owner has been paid the agreed-upon price.

Buy-sell arrangement benefits

For Active Business Owner(s)

- 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
- Assures smooth and complete transition of management
- Competitors cannot buy the disabled owner's business interest in the firm
- Retains control of the business rather than the disabled owner's family members

For Disabled Business Owner(s)

- Assures a price under mutually agreed upon terms (avoids disagreements in the negotiation of the sale price)
- Allows family members to focus on meeting the needs of the disabled owner rather than protecting the business
- Provides money the disabled partner needs to pay living costs and bills that a disabling condition may generate
- 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 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 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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