

**Buy-Sell Agreements:
Why and How to Fund Them**

David N. Barkhausen
Life Insurance Advisors, Inc.
Fee-Only Insurance Consulting
714 E. Prospect Avenue
Lake Bluff, Illinois 60044
(847) 482-1605

Buy-Sell Agreements: Why and How to Fund Them

Executive Summary

- Once a closely-held business attains a meaningful value, its owners should implement a buy-sell agreement to assure a market for a partial interest in it and to provide a smooth transition to its future owners.
- Without adequate and regular funding -- with life and disability insurance funding wherever possible -- the purchase obligations of a buy-sell agreement are often empty and unenforceable.
 - The funding of the agreement is more important than identifying the future buyer with certainty. With a “wait-and-see” buy-sell agreement, life and disability insurance can be purchased on the owner who will be expected to sell, and the buyer can be determined later. Without funding, however, it may not be possible to control this decision.
- Ownership of the insurance policies funding the buy-sell agreement should be structured to minimize taxation. Issues to plan for or around include:
 - The possible imposition of the corporate alternative minimum tax on the insurance proceeds received by a C corporation;
 - Increasing the capital gains tax cost basis for the surviving owners by the amount of the insurance proceeds;
 - Structuring any C corporation stock redemption to assure, if possible, its treatment as a sale of a capital interest rather than the distribution of a dividend;
 - Avoiding extra taxes on excess accumulations of retained earnings by a C corporation that are not justified by reasonable business needs;
 - Arranging any changes in the ownership of policies to avoid “transfers-for-value” that subject otherwise tax-free insurance proceeds to income taxation; and
 - Considering the eventual ownership and use of the insurance policies so as to reduce both income and estate taxes.
- Disability buy-sell provisions relating to the eligibility and timing of payments for a disability-related buyout should follow the language of the insurance policies funding them. Because it is not possible to insure the full amount of the purchase required upon disability, payments from other sources -- including the cash value of life insurance policies and life insurance premiums saved by life insurance policy provisions waiving premiums upon disability -- should be identified.

Buy-Sell Agreements: Why and How to Fund Them

Table of Contents

	<u>Page</u>
Whether and When to Implement a Buy-Sell Agreement	4
Reasons for Buy-Sell Agreements	5
Reasons to Fund Buy-Sell Agreements	6
Permanent Life Insurance to Fund Lifetime Buyouts	7
Installment Payments vs. Life Insurance as a Funding Source	7
Questions about Possible Inequities in Insurance Funding	9
Types of Buy-Sell Agreements and Insurance Policy Ownership	10
Reasons for a Redemption Agreement	11
Reasons to Favor a Cross-purchase Agreement	13
Avoiding the Corporate Alternative Minimum Tax	13
Increasing the Cost Basis for Surviving Shareholders	13
Avoiding Dividend Treatment of a Redemption	14
The Disposition of Policies No Longer Needed to Fund the Agreement	14
Additional Life Insurance Funding Issues	15
The Pros and Cons of First-to-Die Policies	16
Permanent vs. Term Insurance for Buy-Sell Funding	16
Distinguishing the Need for Key Person Insurance from Buy-Sell Coverage	16
The Funding Needs of ESOPs	17
The Funding Needs of Public Companies with Lightly Traded Stock	17
Funding Disability-related Buyouts	17
Conclusion	18

LIFE INSURANCE ADVISORS, INC.
FEE-ONLY INSURANCE CONSULTING
714 E. PROSPECT AVENUE • LAKE BLUFF, ILLINOIS 60044
PHONE (847) 482-1605 • FAX (847) 234-9973
david@lifeinsuranceadvisorsinc.com

Buy-Sell Agreements: Why and How to Fund Them

by
David N. Barkhausen

Buy-sell agreements among co-owners or present and future owners of a closely-held business are intended to assure the smooth future transition of its ownership. They provide the mechanism, and, if properly funded, the means, to effect a change in control and a transfer of interests upon the occurrence of a number of events, beginning with death, disability and retirement. Yet, for some reason, there is widespread confusion among business owners and their professional advisors on the questions of whether and how to fund these agreements, even though, without such funding, they may contain little more than empty, unenforceable promises. Consequently, most existing agreements need much improvement.

This is not intended as a comprehensive discussion of buy-sell agreements. Rather, it focuses on their insurance funding, first outlining the compelling reasons for doing so and then reviewing in some detail the tax and non-tax consequences of placing the insurance policy ownership with the individual co-owners (a cross-purchase plan), with the business (a redemption or entity arrangement), or in a hybrid form. For a preliminary outline of these questions, and a checklist that will enable you to determine if you have addressed them, see [“Buy-Sell Agreements – An Owner’s Checklist.”](#)

Whether and When to Implement a Buy-Sell Agreement: There is a surprising lack of recognition of the circumstances calling for a buy-sell agreement. They are not limited to the classic case of two co-owners, each owning half of a successful, mature business. They should also be considered:

- (1) Where a company with little or no value can expect to appreciate in the near future.
- (2) Where a majority, and perhaps older, owner ought to provide an incentive, in the form of helping to fund a buy-sell agreement, for one or more younger owners and key employees to stay with the business.
- (3) Where a sole owner wants to assure the future market for a business by identifying a buyer in advance from among the following: children, key employees, competitors, suppliers, or customers.
- (4) Where it is unclear whether one or more children will or should be future owners, but having insurance in a trust for their benefit enables such children and the trustee to make this choice at the proper time in the future.

Reasons for Buy-Sell Agreements: Before addressing the question of funding, it may be worthwhile to review some of the major reasons for a buy-sell agreement in the first place:

(1) To provide a market for the business interest of a deceased, disabled, or retired owner. Closely-held enterprises do not have a ready exchange for their sale, especially of partial interests in them. In most cases, only co-owners, those already in the business, or the business itself would want to or be in a position to buy them. Note that this market-creating purpose for a buy-sell agreement may be especially important for a sole proprietorship, the sale of which might be arranged to a similar business or to one or more key employees who are not currently owners.

(2) To restrict transferability, both during life and at death, of ownership interests by defining and limiting those who may acquire or receive them. Regardless of who might be willing to buy into the business, the existing owners are logically interested in keeping ownership amongst themselves or others already involved in the business. More than likely, they do not want to go into business with the surviving spouse or children of a co-owner, or even, for any length of time, with the executor of a co-owner's estate. Nor, in the absence of an agreement to the contrary, do they likely relish the idea of bringing in any outside investors, even assuming they could attract them. What lender or investor would want to put money in the business after the death of the key executive anyway?

(3) To effect a transfer of the business to the right family members. This is especially important when it is intended that the business will pass to certain family members and not to others. For example, perhaps the business will be purchased by one or more children and a surviving spouse will be provided for with non-business assets. Or, very often, some but not all children will be involved in the business, and it is important to assure that the business go to those who are actually working in it.

Even when it is unclear which family members, if any, will take over the business, having a funded buy-sell agreement in place, with insurance enabling children to buy the business, if it is appropriate and that is their choice at that time, will provide the most future flexibility.

(4) To fix the value of, or at least the method of valuing, the business during life and at death. Under current tax law, it is very difficult, if not impossible, to fix the value of a family business for purposes of transfers to natural heirs, as the IRS suspects attempts at undervaluation for estate and gift tax purposes. Between other co-owners and even to some extent with family businesses, however, establishing a fair valuation methodology remains a primary reason for a buy-sell agreement.

In any case, the recognition that the business has a meaningful value usually triggers awareness of the need for a buy-sell agreement. This is followed by a further acknowledgment of the necessity of an orderly and mutually understood procedure to determine and make ongoing adjustments to the valuation and the requirement of a funding source to put the business and its co-owners in a position to honor the purchase obligations of the agreement.

(5) To define the events that trigger the right or obligation to buy or sell. These typically include death, disability, and retirement. They may also address voluntary or involuntary separation from the business, a desire to sell an interest in the business coupled with a right-of-first-refusal (perhaps at a discounted price) by remaining co-owners, bankruptcy, and divorce.

(6) To give incentives to one or more younger or minority owners or key executives to join or remain with the business. The promise of future ownership to the younger key executive

through a buy-sell agreement funded with the help of a majority, older owner may well be the reason that the younger individual, who is increasingly crucial to the success of the business, decides to remain with it instead of seeking out better opportunities.

(7) To protect the status of an S corporation by prohibiting ineligible shareholders.

An S corporation can only have certain types of owners. It is common for buy-sell agreements involving them to provide a non-qualifying individual or entity from becoming an owner.

Reasons to Fund Buy-Sell Agreements with Life and Disability Insurance: While it may not be possible to fund a buy-sell agreement to cover every contingency, it should be possible to do for at least the possibilities of death and disability and, cash flow permitting, to use permanent life insurance as a tax-advantaged vehicle in the right situations to build up at least a portion of the funds anticipated to be needed for a lifetime buyout when an owner retires.

Especially because of the need to back up the promises of a buy-sell agreement with the funding of it, let's spend a minute focusing on the importance of doing so.

(1) Insurance funding is required to make a buy-sell agreement enforceable upon death or disability: Without it, the agreement may not be worth the paper on which it is written. Most businesses will be unable to generate or borrow the necessary cash from other sources. Even if possible, those alternatives would likely be much more expensive.

(a) Insurance on the expected seller should be put in place just as soon as the business has a meaningful value, even if it is unclear just who the buyer will be -- whether it will be a current co-owner, one or more family members, one or more key managers, or perhaps even another business. The ownership of the policy or the planned use of its proceeds can be changed after the insurance is acquired with a "wait-and see" buy-sell agreement. Without the funding already in place, however, this future flexibility will be sacrificed.

(2) The odds of pre-retirement death or disability are very high: Death or disability before retirement is likely enough and its financial consequence grave enough, both to deceased or disabled co-owners and those needing money to buy them out, that insurance for these purposes is essential, unless it cannot be obtained. Consider the high odds of death or disability before age 65, as shown below. As should be readily apparent from the table on the next page, the chances are so great as to make foolhardy the failure to insure against these possibilities by anyone able to do so.

The High Odds of Death and Disability Before Age 65

Odds of One or More Deaths Before Age 65

(Number of Chances Out of 100)

<u>Two Owners</u>		<u>Three Owners</u>	
<u>Age</u>	<u>Chances</u>	<u>Age</u>	<u>Chances</u>
35-35	47.4	35-35-35	61.8
40-40	45.8	40-40-40	60.2
45-45	43.5	45-45-45	57.6
50-50	39.8	50-50-50	53.3
35-40	46.6	35-40-45	59.9
40-45	44.7	40-45-50	57.1
45-50	41.7		

Odds of at least One Permanent Disability (90 Days or Longer) Before Age 65

(Number of Chances Out of 100)

<u>Two Owners</u>		<u>Three Owners</u>	
<u>Age</u>	<u>Chances</u>	<u>Age</u>	<u>Chances</u>
35-35	84.2	35-35-35	93.7
40-40	80.4	40-40-40	91.3
45-45	75.0	45-45-45	87.5
50-50	67.1	50-50-50	81.1
35-40	82.4	35-40-45	91.2
40-45	77.8	40-45-50	87.3
45-50	71.3		

(3) Permanent life insurance can be the most effective means of funding lifetime retirement buyouts and retirement savings: Life insurance with a strong-performing, low commission policy is nearly as effective a funding vehicle for lifetime buyouts and for retirement income for a co-owner as it is for purchases at death. That is why, where businesses produce an adequate cash flow and the co-ownership is likely to last a long time, the owners should consider a form of permanent life insurance. Insurance is needed in the first place to cover the possibility of a buyout at death. Assuming, however, that the owners live long and healthy lives, the cash value in these policies can be used to finance a portion of a lifetime buyout, or the policies can be transferred to the insureds for them to use either as a source of retirement income or to provide estate liquidity at death. As in other areas, life insurance serves multiple, flexible purposes, providing the necessary coverage in the short-run and a tax-advantaged source of accumulating cash for the longer term.

If the owners are interested in a policy where the cash value accumulation might more closely track the rate of appreciation that they expect for their business, they may want to consider “variable” life. These policies allow the underlying policy investments to be made in a 401(k)-like menu of mutual funds, including equities. Given the long-term rate of return from equity investments, it might be expected, although there are certainly no guarantees, that the long-range performance of a variable policy will be a little better than an insurance company’s traditional and more conservative investment portfolio. Variable policies have somewhat higher expenses, however, so the investments in them should be in equities in order to have a good chance of outperforming the traditional policy after these extra costs are deducted. (For additional information on evaluating life insurance, see [“What Business Owners Should Know and Ask about Life Insurance”](#)).

(4) The business entity or co-owners might not be able to afford the future installment payments required with an unfunded agreement: There is no assurance or likelihood that extra future after-tax cash flow would be adequate to afford installment payments. Most co-owners do not have and could not easily borrow the cash necessary to fund a buyout. It might also be hard for the business to borrow the money. What lender is going to extend credit just after the key executive and owner of the business has died. Even if the business could borrow, it would be forced to incur the expense of debt and interest payments and to forgo other demands for capital. More likely, the agreement’s promise of installment payments would go unfulfilled and would be unenforceable.

(5) Even if installment payments might be affordable, their cost would likely be much greater than the price of the insurance premiums. Both insurance premiums and the principal portion of installment payments are, in most cases, not deductible. The exception would be for premiums on policies owned by employees and paid for by the business as compensation. The main cost advantage of insurance is the fact that insurance proceeds are income tax-free (except for a possible 15% tax in the case of C corporations, which expense can be recouped against corporate income taxes in future years) and that the cash value builds up on a tax-deferred basis. Not only is the insurance expense cheaper than installments; it is also more predictable.

(a) Maximizing returns from the life insurance investment: The advantages of insurance funding over the expense of future installment payments are especially great where care is taken to maximize the risk-adjusted rate of return from the life insurance investment. This is accomplished by selecting a life insurance company that has achieved a consistently superior rate of return on premium dollars and also provides the highest level of financial safety. In addition, any

permanent insurance product should be funded in a way that minimizes the commission cost. The money funding buy-sell agreements will go farther and be safer if placed with a policy of this kind. (For additional information on this point, see [“How to Make Permanent Life Insurance A Good Investment”](#)).

(6) If the agreement’s buyout requirement is unenforceable, the heirs of a co-owner could force a sale or liquidation. Funding the agreement is essential not just to treat any deceased co-owner fairly but to assure the survival of the business.

(7) The promised installment payments upon the death, disability, or retirement of co-owners create an enormous unfunded liability. The liability will be a drag on the corporate balance sheet and will make the business less credit worthy for other possible borrowing. Even if additional borrowing is possible, the interest rate and terms for such loans will be less favorable than if the balance sheet is cleaner. The unfunded liability will have the greatest impact if many co-owners will be owed installment payments at the same time. The ability to pay them may depend on unrealistic expectations of future growth in revenues.

(8) Insureds may often be substituted on the same policy if one owner leaves the business and another joins it. This is less a reason to fund the agreement than it is an answer to the possible objection to insurance funding based on the questions of about possible policy options if a shareholder/insured leaves the business. Although those departing insureds can be given the option of taking their policies with them and continuing to pay premiums, they will often choose not to, leaving the business wondering what to do with a policy on which it may have been paying the premiums. In some cases, it may hang on to the policy and continue to pay the premiums. Especially if the policy is held until the insured’s death, thus taking advantage of the income tax-free treatment of the death proceeds, the rate of return can be quite attractive, and the policy’s cash value is otherwise a valuable asset. More often, the business will be interested in the opportunity to substitute a new insured for the previous one without incurring the additional expenses normally associated with taking out a new policy. The premium and policy values may have to be adjusted in light of differences in ages and health between the previous and new insured, but the transaction is otherwise smooth and cost-effective.

(9) With entity purchases (redemptions) involving partnerships and S corporations, life insurance funding is the only means to increase the cost basis of the survivors’ interests by the amount of the purchase price. As will be discussed in more detail below, one of the objectives of a buy-sell arrangement is to increase the cost basis of the remaining owners by the amount of the purchase price, so that when their interests are later sold, their capital gains tax exposure is reduced. This is the result under all circumstances with a cross-purchase made by the remaining owners individually of the deceased or departing owner’s interest. With life insurance funding, it is also possible when an S corporation or partnership makes the purchase.

As we will also see, it may be desirable to structure an S corporation buy-sell agreement as a redemption, rather than a cross-purchase, where it formally was a C corporation and has leftover retained earnings (“accumulated earnings and profits”). In most cases, this cash cannot be distributed by the corporation in a redemption without being treated as ordinary income. Life insurance funding of the redemption, however, reduces this accumulated earnings and profits by the same percentage that the amount redeemed bears to the total value of the enterprise. The life insurance funded redemption, thereby, not only increases the cost basis of the survivors’ interests but also better positions the remaining interests for a favorable tax treatment upon a subsequent

redemption. Neither of these benefits would be obtainable from a redemption carried out without insurance.

Questions about Possible Inequities in Insurance Funding: In most buy-sell funding arrangements, it is difficult to arrange for amounts of insurance and a premium cost that appear to treat everyone equally. There are two situations that might be viewed as inequitable.

(1) The heirs of a deceased co-owner normally receive less than surviving owners. The deceased owner's heirs receive the insurance proceeds in exchange for the deceased's share of the business. In a cross-purchase, they also retain, at least initially, any cash value in policies on the lives of the surviving owner(s). The surviving owners, on the other hand, have both their share plus the deceased owner's share that has been acquired with the insurance proceeds.

As a simple example, with two equal owners, the survivor will end up with twice as much. This difference may be narrowed somewhat by any cash value in a policy on the survivor in the estate of the deceased owner.

There is no ready-made solution to this situation. Increasing the amount of insurance to compensate for these unequal amounts works when there are several co-owners. To do this, the coverage on each owner should be raised by the original amount of insurance divided by the number of remaining owners. For example, a 20 percent owner with four other owners would be equally compensated if the amount of insurance is increased from 20 percent to 25 percent of the business' value. This is not nearly as practical a solution, however, if there are only two equal co-owners. The amount of insurance would need to be doubled, and this remedy may be viewed as too expensive.

Compromise approaches include increasing the amount of insurance by a portion of the original coverage to provide some additional compensation to the family of a deceased co-owner, requiring an additional series of installment payments from the survivors, or, at a minimum, requiring the survivors to pay the equivalent of any cash value in policies on their lives in buying them from the estate of a deceased co-owner.

(2) Differences in the ages, health, and ownership percentages of the owners can lead to wide disparities in premium costs. The younger, minority owner making less money may not be able to afford insurance on the older, majority owner. It may have to be purchased either with substantial, additional bonused compensation to the younger owner, or it will need to be acquired by the business. A "split dollar" ownership and payment arrangement (discussed further below), where the business pays all or most of the premium but the younger co-owner owns it, is another possibility. So is mixing the policies with varying combinations of term and whole life insurance so as to equalize, or at least narrow the difference in, the costs of premiums on the different policies. These questions may seem especially problematic when there is a majority, older owner and a younger, minority owner who is not at all in a position to afford all of the insurance required to fund the buyout of the senior partner.

(a) Why should older, majority owners not simply buy their own insurance and let younger, minority owners fend for themselves? After all, the majority owners might ask, what reasons are there for them, either themselves or through the business which they mostly own, to be funding the buyout of their own interests for the benefit of the younger minority owner? In these situations, there is likely one or more reason for the older owner, through the business and perhaps with a split dollar ownership arrangement to be helping to pay for the insurance that will

acquire his own interest rather than, if insurance is to be taken out at all, simply acquiring his own policy and perhaps owning it in an irrevocable trust.

(i) **The business may not be marketable to anyone else.** The fundamental purpose of the buy-sell agreement is to assure a market for the business that may not otherwise exist. Unless the younger, minority owner has the wherewithal to buy the business, perhaps no one else will, certainly not for the same price, and the majority owner and the heirs will lose much of their investment. The business may not survive and will have to be liquidated or sold at a firesale price.

(ii) **Just as importantly, the younger, minority owner may not stick around without the expectation of the future ownership of the business.** If the younger owner, who is increasingly important to the success of the business, departs, the business is likely to lose much of its value. The buy-sell agreement largely funded by the older, majority owner gives the younger partner and key executive reason to stay and helps to maintain and enhance the value of the business.

Types of Buy-Sell Agreements and Insurance Policy Ownership Arrangements

With an understanding of the many reasons why the funding of buy-sell agreements is essential, we are ready to discuss the types of buy-sell agreements and policy ownership and payment arrangements.

General Background: To review the basics, there are two essential types of agreements -- the **cross-purchase**, which has co-owners purchasing from and selling to each other, and the **redemption** (a term which applies to corporations purchasing a shareholders interests) or **entity** (a more generic term, which can also apply to partnerships) agreement.

Sometimes these arrangements are in **hybrid** form where interests are partially acquired by other owners and partially by the business, for example where insurance proceeds used to fund a buyout are paid in part to surviving owners and in part to the business. This might occur where an agreement starts out in cross-purchase form but insurance policies belonging to a deceased or departed owner are subsequently transferred to the business rather than to co-owners.

Where there is some uncertainty as to whether an individual will be in or remain involved in the business in the future, a **“wait-and-see”** agreement allows that decision to be deferred. If, for example, there are two children and child #1 is already involved in the business, but it is unknown whether child #2 will be, an insurance policy owned by child #2 could be used either to fund a partial acquisition of the business or to compensate that child for the fact that the business will go to child #1. In the latter case, the proceeds from child #2’s policy might be loaned to the business to fund a partial redemption of the parents’ stock.

General Principles in Choosing the Type of Agreement: The main rule is that, in the case of C corporations, and, to a lesser extent, S corporations, a cross-purchase arrangement is preferable to a redemption for a variety of tax reasons. This is true even though the cross-purchase agreement may seem more administratively complex.

At the same time, it should be noted that, where the business is a partnership or limited liability company, the choice between the cross-purchase and redemption agreement does not generally matter because of the advantageous partnership taxation rules that apply to both entities.

This review of the choices between the two types of agreements will therefore generally only pertain to the context of C corporations and S corporations, except where otherwise noted.

For a more technically complete discussion of the often arcane and confusing tax issues that influence the structure of insurance-funded buy-sell agreements, you may want to review the version of this [article for professional advisors](#).

(1) Whether or not the tax or cost basis of surviving owners, used to calculate their eventual capital gains, is increased by the purchase price of the buy-out. The answer is yes with a cross-purchase arrangement, no with a redemption and C corporation, and, with special additional foresight and planning, yes with an S corporation and partnership.

(2) Whether the purchase price received by the estate of a deceased owner will be treated as the payment in a sale and exchange after its capital gains tax basis has been stepped up at death, or whether it will be treated as a dividend. This is not an issue in the case of a cross-purchase, but only when the payment is coming from the business in a redemption. It is really only problematic for C corporations that are family businesses and family-owned S corporations which still have accumulated earnings and profits from their days as S corporations.

(3) Whether the insurance proceeds are income tax-free. Insurance proceeds are most always income tax-free, and that is one of the main tax advantages of the product. However, there are two circumstances that can prove the exception.

(a) Policies owned by a C corporation face a possible corporate alternative minimum tax at an effective 15 percent rate. This is not an issue for policies owned by other types of business entities or by individuals. Even where the tax must be paid, it can be recovered as a credit against the liability for corporate income taxes in future years.

(b) The transfer of the ownership of, or the interest in, a policy, in exchange for value (rather than as a gift) can trigger the “transfer-for-value” rule and make all of the policy’s death proceeds received by the beneficiary subject to income taxes. In the context of a buy-sell agreement, this can occur when policies are transferred between shareholders, and it is most apt to happen in cross-purchase arrangements after the death or departure of one of several shareholders when the policies owned by that individual are acquired by or transferred to other shareholders who are not the insureds on those policies. This is the tax reason to favor a redemption over a cross-purchase agreement, but, as we will see, the transfer-for-value problem can be avoided with a cross-purchase arrangement if its potential is spotted in advance.

Reasons for a Redemption Agreement: Before dealing at greater length with the above-mentioned arguments for cross-purchase arrangements, it would be well to have an understanding of the reasons why most buy-sell agreements are, often inadvertently and wrongly, structured as redemptions.

(1) They are simpler to administer. This appears to be true from the standpoints of the smaller number of insurance policies required, the assurance of premiums being paid, and the reduced likelihood that the ownership of policies will have to be changed in the future when owners die or otherwise leave the business. There are ways, however, for cross-purchase agreements to minimize these advantages that redemptions appear to have.

(a) Fewer policies required: With the policies owned by the business entity, only one policy is required for each owner. With a pure cross-purchase arrangement, each owner must

have a policy on each other owner, such that the total number of policies required is $n(n-1)$, where n is the number of owners. With more than three owners, it is fairly cumbersome.

The best way to avoid the need for a multitude of policies where there are several co-owners is not through a redemption arrangement, but rather with either a trust-like escrow agreement or with a partnership. Partnership-owned policies avoid the tax traps of policies owned by C corporations, and a partnership can be created that has a bona fide business relationship with the corporation. In either case, the entity -- the trust or the partnership -- is generally the owner, payor, and beneficiary of the policies. With the trust arrangement, a transfer-for-value income tax problem is still possible when beneficial interests in the policies change hands. A partnership overcomes this problem. With a trust, care should also be taken in its drafting to avoid giving the co-owners any "incidents of ownership" in policies on their own lives, which can make the proceeds includable in their estates. Co-owners should be specifically denied the right to participate in such decisions as borrowing from or surrendering policies on their lives.

(b) Greater assurance that premiums will be paid and that insurance proceeds will be applied to effect a buy-out. Any concern about the reliability of individual owners to pay the premiums for policies which they own themselves on the lives of the other owners in a cross-purchase arrangement can be answered in one of several ways: a trust or partnership ownership, as just described; a loan arrangement where the individuals own the policies, the corporation pays all or most of the premium, and the corporation has a secured interest in recovering its premium payments from the policy's cash value or death proceeds; or a bonus plan, where the individuals own the policies, the company pays the premiums, and the premium cost is taxable compensation to the policy owner and a deductible expense for the business (the company might also pay ("gross up") the tax cost to the policy owners of the bonus/premium payments).

(2) One or more individual owners could not afford the required purchase price or the insurance premiums. This is especially true in the case of the younger, minority owner whose potential inability to afford a buyout of the older, majority owner and whose all-important role in the business was presented earlier as a key reason for having the business, and indirectly the majority owner, help fund the buyout. It is not necessarily an argument, however, for a redemption arrangement. The majority owner can help fund the buyout by the younger, minority owner without making the business the owner of the policy. This can again be done with either a loan or bonus plan, where the individual owns the policy that is completely or mostly paid for by the business.

(3) The possible transfer-for-value of policy ownership with a cross-purchase arrangement is difficult to avoid and argues for a redemption agreement instead. The transfer-for-value rule, partially explained above, relating to the possible income taxation of otherwise tax-free life insurance death proceeds seems at first a needlessly confusing provision of the tax code. It is designed to discourage wagering-related sales of policies among non-insureds. Overlooking its impact can subject otherwise income tax-free life insurance proceeds to taxation instead.

A redemption agreement with a corporation owning the policies is not necessary to avoid a transfer for value. There are several exceptions to the transfer for value rule that can avoid the dire

consequence of the taxation of the death proceeds in a cross-purchase context. Generally, the most effective planning to avoid this tax trap involves the use of a partnership.

(4) A lower corporate than individual tax bracket makes it less expensive to pay non-deductible insurance premiums with corporate dollars, and corporate ownership and a redemption agreement therefore makes sense. Because insurance premiums are non-deductible to the individual and to the corporation, if the business has any interest in the policies, they are least expensive to the taxpayer in the lowest bracket. There may be a tendency to think that where a lower corporate tax bracket (perhaps as low as 15 percent) is a reason to have the business pay the premiums, this necessarily also means that the business should own and be the beneficiary of the policies and use the proceeds to redeem a deceased owner's interest. This is not the case.

Because a cross-purchase agreement may likely be preferable for other tax reasons, it is possible to combine individual policy ownership in a cross-purchase arrangement with the loan arrangement discussed above using the corporation to pay the premiums at its lower tax cost.

Reasons to Favor a Cross-Purchase Agreement: These are all tax reasons briefly explained above. They are covered in much greater detail in the [version of this article for professional advisors](#). It should be emphasized again that they apply to the choice to be made between cross-purchase and redemption agreements when the business entity is a C corporation and, to some extent, when it is an S corporation. When the enterprise is a partnership or limited liability company, however, the choice between the two does not matter nearly so much. The following observations mainly apply just to C and S corporations, noting the differences in impact between the two.

(1) Avoid the corporate alternative minimum tax at an effective 15 percent rate that applies to life insurance death proceeds payable to a C corporation. As noted previously, this tax is worse than it sounds, since it can be recovered as a credit against future corporate income taxes. To the extent, the corporation has continuing income taxes against which to claim this credit, the business is really only out the cost of money. However, the insurance proceeds may be very substantial in relation to the corporation's likely future income tax liability. In any event, if the tax can be easily avoided by a decision in favor of a cross-purchase over a redemption agreement, it should be.

(2) Increase the cost basis of the interests of the acquiring shareholders by the amount of the purchase price paid to complete the buy-sell agreement. With a cross-purchase, the amounts paid by individual owners to acquire other interests in the business, whether or not the purchases are funded with insurance, will always increase their capital gains cost basis by a like amount. As a result, their eventual liability for capital gains taxes if and when their own stake in the business is sold, will be reduced.

If the buyout occurs through a redemption rather than a cross-purchase, the impact on the basis of the survivors will depend on the type of entity and certain provisions in the buy-sell agreement. With a C corporation redemption, there is never a basis step up. With S corporations, partnerships and LLC's, it is sometimes possible, depending on certain factors.

(3) Avoid the possible treatment of a buyout payment as a fully taxable dividend or ordinary income, rather than as a completely or mostly tax-free payment in exchange for a capital interest. Just as the previous issue of increasing the cost basis for a purchased interest is an issue for a buyer in a buy-sell transaction, this issue affects the seller either during lifetime or the estate of a deceased owner.

(a) C Corporations: Concerning the question of possible dividend treatment, this is generally only an issue in the case of redemptions of C corporation stock, but, in those situations, it can be devilishly complex. To qualify these redemptions as the purchase of a capital interest with little or no capital gains tax consequence, rather than a dividend fully taxable as ordinary income, may either not be possible, especially in many family business situations, or will require the observance of an elaborate set of tax rules that is beyond the scope of this version of this article (see [professional advisors' article](#) for greater detail).

(4) Beware of the “Accumulated Earnings Tax” on accumulations of retained earnings which are not deemed to be for reasonable business needs. This is an issue for C corporations accumulating retained earnings rather than paying taxable dividends. If the amount exceeds \$250,000 (\$150,000 for professional corporations) plus the amounts needed for the reasonably anticipated needs of the business, the excess is taxed at the top individual income tax rate.

Accumulations to pay for life insurance-funded redemptions may be suspect if maintained primarily for the estate planning needs of the majority shareholder rather than for the welfare of the business. On the other hand, accumulations for redemptions designed to maintain the continuity of the business, keep the business in the hands of those currently working in it, or increase the interests of non-family key employees are examples of purposes which have been deemed legitimate. Clear statements in corporate resolutions and buy-sell agreements of the business necessity of a life insurance-funded redemption can help to support a successful contention of business need.

Alternatively, the corporation can increase compensation to those owning insurance policies in a cross-purchase arrangement to put them in a position to buy out the interest of a retiring or deceased owner. The cost of the premiums on an annual basis should not be so great, in addition to the policy owner's regular salary, as to violate the rules against unreasonable compensation, which are designed to limit deductible compensation and force the taxation of excess compensation as dividends. Given the general advantages of a cross-purchase agreement over a redemption, a bonus or loan arrangement funding a cross-purchase plan may be the best approach.

The Disposition of Life Insurance Policies No Longer Needed to Fund a Buy-Sell Agreement

If there is insufficient understanding of the reasons and ways to fund a buy-sell agreement with life insurance, there is even less attention given to the disposition of these policies when they are no longer needed for that purpose. As with the initial funding issues, there are a number of tax ramifications to consider, and it is important to recognize both the income and potential estate tax consequences of policy transfers.

(1) Income Tax Issues: It is easy to lose sight of the fact that the purchasing, bonus, distribution in liquidation, and trading of policies on different insureds are not tax-free events. The tax impact of each of these transactions should be understood.

If a policy is acquired, for example, by an insured from a co-owner when the agreement is terminated or by an insured owner who is leaving the business, the seller of the policy will be taxed on the difference if any between the purchase price (which will normally be the policy's cash value) and the seller's tax basis in the policy. The seller's basis will normally be the premiums the seller has paid, but if there is an outstanding loan that the buyer is assuming, or the seller has taken any distributions from dividends or the surrender of cash value additions, the seller's basis will be reduced accordingly. The purchaser's new basis in the policy will be the price paid, plus any outstanding loan of the seller assumed by the purchaser.

If a policy is transferred by the business entity to the insured, it is compensation to an employee in the approximate amount of the cash value and a deductible business expense to the business in that case. In the case of a sale or other distribution of a policy by the business, a corporation must recognize any gain over the tax basis, as described above. In the event of a distribution to a non-employee shareholder, the policy's value will be a dividend.

If policies are exchanged between co-owners of a business, so that, for example, the policies which two co-owners have owned on each other's lives end up with each insured for their own retirement or estate planning purposes, each policy owner will recognize gain on the transfer to the extent of the cash value in the policy received in excess of premiums paid on the policy given up.

(2) Estate Tax Issues: The estate tax concern apt to arise when a policy on an insured co-owner is ultimately transferred to an irrevocable trust for the benefit of the insured's family is known as the "3-year rule." It causes the proceeds of policies to be included in the insured's taxable estate if the insured has held "incidents of ownership" within three years of death.

It may be possible to avoid this result by having the irrevocable trust acquire the policy directly from the non-insured owner, rather than having the insured gift it to the trust after first acquiring the policy from the business entity or co-owner. By keeping the policy from first passing through the hands of the insured before going to the trust, the 3-year rule is avoided.

The owners may also want to begin the buy-sell transaction by having policies on the lives of the other co-owners held in an irrevocable life insurance trust. This will enable the value of the stock that is purchased from a deceased, insured co-owner with insurance proceeds to accrue outside of the taxable estate of the surviving owners. The remaining policies on the lives of the surviving owners that are held in the trust of the deceased owner should then be purchased by the irrevocable trusts of the survivors.

Additional Life Insurance Funding Issues

Certain life insurance funding issues deserve attention in addition to those relating to the type of buy-sell agreement, the ownership arrangements for the policies, and the impact of these decisions on taxation.

The Pros and Cons of First-to-Die Policies: First-to-die policies, which involves life insurance on two or more lives paying a benefit only on the first death, are now available as a means

of funding buy-sell agreements. The rationale for the policy is that the death benefit is only or mostly needed to fund a one-time buyout. Some policies allow the option of purchasing more insurance without additional underwriting to provide additional insurance proceeds for buyout purposes upon subsequent deaths.

The advantage of first-to-die policies is a 15-20 percent premium savings over two separate policies for the same amount of insurance. The arguments against it are that the premium savings are not sufficient to offset the extra benefits and flexibility of having additional policies to fund continuing buy-sell, and possibly eventual estate tax liquidity, needs. Also, first-to-die policies with extra policy features and options are likely expensive enough to administer that their long-term rates of return will compare unfavorably with the best traditional policies.

Permanent vs. Term Insurance for Buy-Sell Funding: The choice of term vs. permanent insurance to fund a buy-sell agreement depends on the likely duration of the business ownership and cash flow.

For start-up companies holding down their expenses or for enterprises that will clearly be sold within short periods of time, term insurance is preferable. If the logical choice is term insurance, there are several basic issues to address, including the length of time that the policy will remain effective without further evidence of insurability. (See additional article, [“How to Shop for Term Insurance”](#)).

For successful companies with adequate cash flow where the ownership will likely remain in place for ten years or more, permanent insurance may be a wise investment and offer versatile applications. Rather than only funding an owner’s buyout in the early years, it can still be in place at older ages. Most importantly, its cash value can be applied to a lifetime buyout at retirement or otherwise. Alternatively, the policies can be transferred to the insureds, where the cash values can be used as a source of retirement income or estate liquidity, or portions of a policy can be applied to each purpose.

The case for permanent insurance to fund buy-sell agreements will be much stronger if policies are selected that have the most competitive internal insurance charges and the lowest sales commissions. (See [“How to Make Permanent Life Insurance A Good Investment”](#) for a discussion of how these factors can enhance internal rates of return from investments in permanent life insurance by 200 basis points (2 percent) or more).

Distinguishing the Need for Key Person Insurance from Buy-Sell Coverage: Because key person insurance, which protects the business entity from the potential financial loss from that person’s death or disability, is owned by the business entity, and buy-sell coverage is often similarly owned, the purposes for the life insurance are sometimes confused. Often, those who have purchased life insurance for one of these two purposes will mistakenly think that they have coverage for the other need as well. Sometimes, the insurance will be acquired, but co-owners will forget and fail to document the purpose for which it was obtained.

Those who are insured for buy-sell purposes will usually be key people whose loss to the enterprise from death or disability would cause a major financial hole in its operations. Except when those insured by a buy-sell agreement are not active key employees, key person insurance should also be maintained. Where a business entity acquires life insurance for either of these reasons, its

purpose should be well documented in a buy-sell agreement and otherwise in a corporate resolution or partnership agreement.

Most closely-held businesses need life and disability insurance for both key person and buy-sell purposes. Their importance and their differences should be understood.

The Funding Needs of ESOPs: Employee Stock Ownership Plans are a very tax-effective means for owners of C corporations to sell and diversify at least a 30 percent ownership interest without recognizing capital gains. Most owners who sell to an ESOP give up less than all of their interest. A buy-sell agreement is needed to arrange for the purchase of the balance of their interests at death. They cannot count on being able to sell the remainder of their stock to the ESOP on terms as favorable as a buy-sell agreement might permit, as the trustee of the ESOP has a fiduciary duty not to act in a way that will devalue the shares already owned by the ESOP and its participants. A funded buy-sell agreement is necessary to assure a favorable market for the balance of the owner's interest retained after the initial sale to the ESOP.

The Funding Needs of Public Companies with Lightly Traded Stock: Where the stock of a publicly-held company is lightly traded, a buy-sell agreement can help to provide a more favorable market for shares than may exist on the open market and avoid the risk that a board of directors, in agreeing to a future redemption of a substantial outstanding block of stock, might violate its duty to the corporation and its shareholders.

The fact that a company is partially publicly-held does not assure a ready market for an especially large holding of stock when the shareholder wants or needs to sell. For a board of directors to agree to such a redemption could drive down the value of the other shares and use up badly-needed corporate cash. Such potential effects on the company could preclude substantial owners, who are officers and directors, from unloading their shares for fear of breaching their fiduciary duty to the company. Also, boards of directors may not approve a redemption if it is not in the best interests of the company. However, if it is funded in advance with life insurance for the purpose of maintaining the value of the company's stock upon a redemption of the interest of a large shareholder, the redemption will be permissible.

Funding Disability-related Buyouts

Since pre-retirement disability is substantially more likely than death, the buy-sell agreement should clearly cover that contingency, and, to the extent possible, disability insurance should be obtained to fund the buyout for the same reasons life insurance is needed at death. Business owners and their professional advisors should therefore be aware of the separate item relating to this necessary part of the agreement and the funding of it. Here are at least some of these issues.

(1) The medical and financial underwriting for disability insurance is more difficult than the process for obtaining life insurance. In the first place, the most well-known disability carriers limit their buyout coverage to about \$1 million, and this assumes that the payout does not begin for two years and is made in installments over two years. In addition, medical conditions, such as bad backs and treatment for clinical depression, which may have no or only a slight impact on life insurance underwriting, may result in the denial of disability buyout insurance. Lloyd's of London and other markets specializing in the most difficult risks may need to be explored in certain cases in order to obtain the necessary coverage.

(2) The definition of disability and the timing of the buyout should mirror the terms of any disability policy. The definition of disability in the buyout agreement should not be more generous than that in an insurance policy, and there would be no need to make it more restrictive. In addition, the payments should not be required to begin sooner than they will be made by the insurer. Unlike individual disability income insurance, where coverage may begin 30 or 90 days after a disability begins, disability buyout coverage is only extended after a long enough period of time, usually a year or two, in which it can be determined whether the co-owner can continue in the business. Which waiting period is chosen should depend on how long the business can do without the services of the disabled owner.

(3) With both life and disability buyout valuations, the agreement should specify whether the buyout amount will be based on a valuation of the business with or without the deceased or disabled key person co-owner. The choice will normally be, and should fairly be, the pre-death or disability valuation. This will increase the importance to the business of also having key person life and disability coverage to assure, to the extent possible, that the business does not lose value because of the loss of a key person. As is noted below, the insurance needed to fund a buy-sell agreement should not be confused with the coverage necessary to protect the business against the death or disability of a key person. Both needs should be separately valued and insured against.

(4) Disability insurers will not issue buyout coverage to cover the full value of the business, and separate plans will have to be made to finance the uninsured portion of the purchase. Just as individual disability insurance will only cover 60-70 percent of income, disability buyout coverage will generally provide no more than 80 percent of the value of an owner's interest, less if the insured is a majority owner. Buyout plans will have to identify other sources of payments. The cash value from life insurance policies on the disabled owner can provide some of the funds. If the policy has the "waiver of premium" feature attached to it, no premiums will be due on the life policy while the insured is disabled, and the premium savings can also be applied in installment fashion to the disability buyout price. Beyond that, uninsured installment payments will need to finance the purchase.

Conclusion

Buy-sell agreements are essential for successful and stable closely-held businesses with multiple owners and for sole proprietorships which seek to assure a buyer for their enterprises. The particulars of the agreement, as complex as they can be, especially from a tax standpoint, and as much careful professional attention as they require, are less important than the funding of them. Generally, only life and disability insurance can provide the predictable source of liquidity to assure the transfer of business interests envisioned by buy-sell agreements. Those who recognize the need for adequate, long-term coverage can enjoy the security that there will be a ready market for those selling a business interest and sufficient cash for those expecting to buy one.

David N. Barkhausen is President of Life Insurance Advisors, Inc., a fee-only life insurance consulting firm. He was previously an agent with Northwestern Mutual Life from 1991-1998 and was the company's top first-year agent in 1991-92.

An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also

conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.