# BUY-SELL AGREEMENTS FUNDED WITH LIFE INSURANCE

*in brief*

22-3893 (0318)

Northwestern Mutual®

# Buy-Sell Agreements Funded with Life Insurance

## WHY ENTER INTO A BUY-SELL AGREEMENT?

- Create a market for the owner's business interest.
- Provide for mutually agreeable price and terms.
- Facilitate smooth transition of management and control of the business interest.
- Assure owner that future of surviving family members is not dependent upon the business.
- Provide liquidity to pay estate taxes and settlement costs.
- Often can help establish the value of the business interest for estate tax purposes.
- Reduce potential for discord and litigation.

## WHY FUND WITH LIFE INSURANCE?

- Assure that funding is available to purchase the business interest in the event of the business owner's death.
- Provide funds to purchase the business interest for the cost of premiums paid on the policy.
- Avoid negative impact on working capital and credit position of the business.
- Is a simple and effective funding method when compared to other methods, such as a taxable sinking fund or paying "out-of-pocket" for the business interest.
- If purchase of business interest occurs before insured's death, a permanent life insurance policy with cash value can be used to provide a down payment for the purchase price.

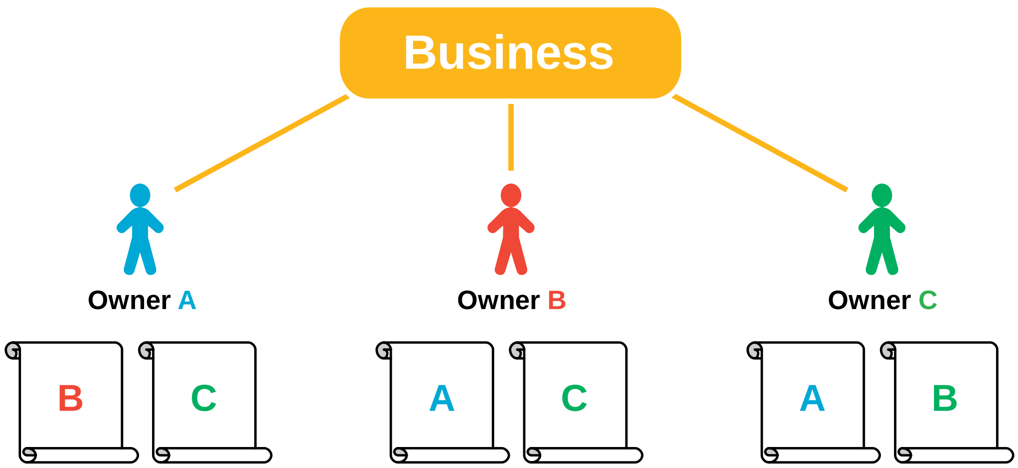
## HOW MUCH LIFE INSURANCE?

- The amount of life insurance in place should be reviewed periodically to ensure that it is sufficient to cover the value of the business interest to be purchased.
- The purchase price of any business interest generally should be based on a formula that takes into account the growth (or decline) of the business while the agreement is in place.

# How It Works – *Cross Purchase*

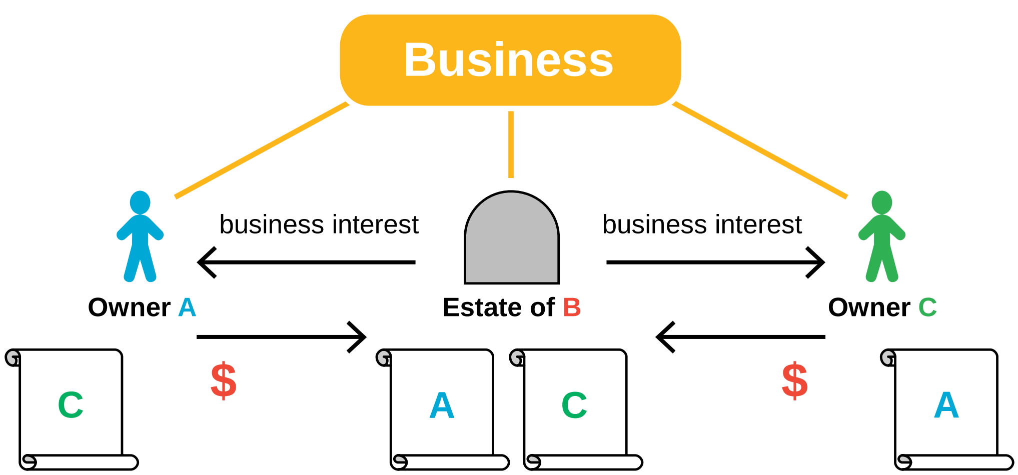
## DURING LIFE OF OWNERS

- Business owners enter into an agreement that provides that each surviving owner will purchase the business interest of a deceased owner.
- Each business owner is applicant, owner, and beneficiary of a life insurance policy on the other owners (so A owns policies on B and C; B owns policies on A and C; etc.).




## AFTER DEATH OF AN OWNER (E.G., OWNER B DIES)

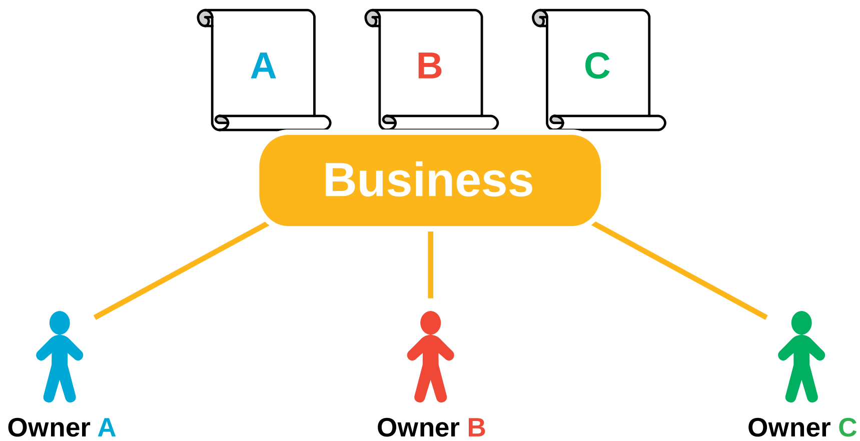
- Owners A and C receive death proceeds from policies they own on B.
- Owners A and C use these proceeds to buy the business interest from the estate of Owner B.
- Result: Owners A and C together own 100% of business, and B's estate/heirs have funds.
- Afterwards, B's estate could sell the policy it owns on Owner A to Owner C, and the policy on Owner C to Owner A (these will be transfers-for-value, unless exception is met).



# How It Works – *Entity Purchase*

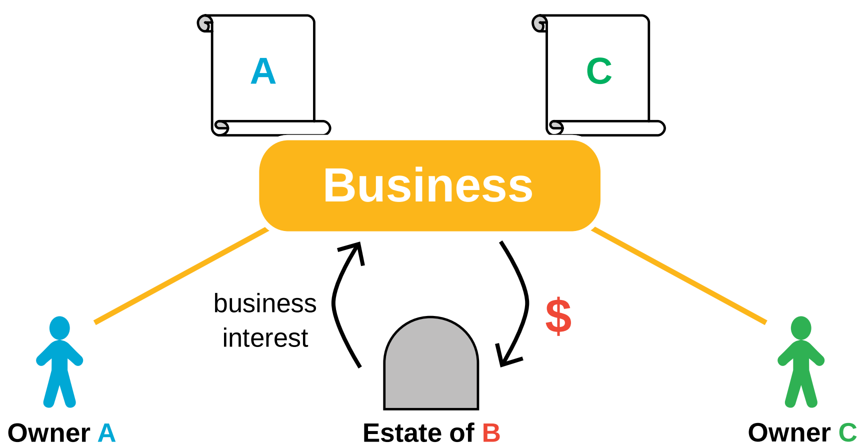
## DURING LIFE OF OWNERS

- The business owners and the business entity enter into an agreement that provides that the business entity will purchase the business interest of a deceased owner.
- The business entity is applicant, owner, and beneficiary of a life insurance policy on each of the business owners (so the business owns a policy on A, on B, and on C).




## AFTER DEATH OF AN OWNER (E.G., OWNER B DIES)

- The business receives death proceeds from the policy it owns on B.
- The business uses these proceeds to buy the business interest from the estate of Owner B.
- Result: Owners A and C together own 100% of business, and B's estate/heirs have funds.



# Comparing Plans

## CROSS PURCHASE

| Advantages | Disadvantages |
|---|---|
| • Surviving purchasers obtain increased basis in the acquired business interest (can result in tax savings if purchaser later sells that interest).<br>• Individually-owned policies are generally not subject to the claims of business creditors if no flow-through liability (e.g., corporation or LLC).<br>• Allows surviving owners to buy deceased owner's business interest in unequal amounts. | • Can be difficult to administer if there are multiple owners.<br>• Insured plans generally require multiple policies on each owner.<br>Number of policies needed = Number of Owners x [Number of Owners – 1].<br>• Perceived inequity if large differences in premiums due to age/health.<br>• If policies are owned and paid for by individual owners, generally cannot take advantage of a business with a lower tax bracket than individuals (C corporation only). |

## ENTITY PURCHASE

| Advantages | Disadvantages |
|---|---|
| • Funding is provided by the business rather than by the individual owners.<br>• Requires only one insurance policy on each business owner.<br>Number of policies needed = Number of Owners.<br>• Potential tax leverage when business pays for policies it owns if business has lower tax bracket than the individuals (C corporation only).<br>• Discrepancies in premiums due to age/health are indirectly spread out among all owners, and are less of a perceived problem. | • More difficult for surviving owners to obtain increased basis in business interests that each acquires.<br>• Stock attribution rules could cause payment from the corporation to be taxed to selling shareholder as dividend (generally limited to family-owned corporations).<br>• Business-owned insurance policies are generally subject to the claims of business creditors.<br>• Does not allow owners to designate percentage of ownership acquired – may result in unintended shift of control.<br>• If buy-sell is terminated while insured is alive, a transfer of the policy from the business can be a taxable event (more likely true with transfers from corporations). |

# Buy-Sell Variations

## UNILATERAL BUY-OUT PLAN

- An agreement where a business owner agrees to sell (but not buy) a business interest, and another party agrees to buy (but not sell) a business interest.
- Often occurs where a sole owner of a business agrees to sell to a key employee.
- Can be arranged so that the key employee owns and is beneficiary of a life insurance policy insuring the sole owner, and at the death of sole owner, key person receives the death benefit and buys business from the sole owner's estate – but other arrangements are possible as well.
- Unilateral buy-outs also occur where an owner agrees to buy the business interest of other owners, but intends to transfer gratuitously – not sell – his/her own business interest to family members.

## WAIT-AND-SEE BUY-SELL PLAN

- There are several ways to arrange this, but frequently the business has first option to buy all or a portion of a deceased owner's interest.
- The surviving owners then have option to buy any of the ownership interest not purchased by the business. Sometimes any interest not purchased by the remaining owners must then be purchased by the business.
- Insurance policies to fund the wait-and-see plan can be held by either the owners or the business. Often they are held by the owners. If the business decides to purchase the decedent's interest, the surviving owners lend or contribute the funds to the business.

## ESCROWED BUY-SELL PLAN

- A cross purchase buy-sell plan that requires only one policy per business owner.
- Tax-wise, it mimics non-insured business owners being joint owners and joint beneficiaries of one policy.
- An escrow agent holds the insurance policies on each owner (and often holds their business interests too).
- Premiums are paid by the owners.

## DISABILITY BUY-OUT PLAN

- Any type of buy-sell agreement can also provide that the disability of an owner is an event that triggers buy-sell obligations.
- The party that is required to purchase the business interest from disabled insured is owner and loss payee on a disability buy-out insurance policy.

# Tax Considerations

## GENERAL

- Premium payments are not deductible. See Internal Revenue Code ("I.R.C.") § 264(a)(1).
- Proceeds paid on death are generally received free of income tax. I.R.C. § 101.
- Transferring or trading policies can trigger taxable income (whether at start or termination of buy-sell plan). I.R.C. § 1001. *United States v. Davis, 370 US 65 (1962); and International Freighting Corp. v. Commissioner,* 135 F2d 310 (2d Cir. 1943).
- When policies or interests in policies are transferred (whether at start or termination of buy-sell plan), the transfer-for-value rule could cause the death benefit to be income taxable. Exceptions include transfers to: (i) the insured; (ii) a partner of the insured; (iii) a partnership in which the insured is a partner; or (iv) a corporation in which the insured is an officer or shareholder. There's also an exception if the transferee's basis in the policy is determined by the transferor's basis (carry-over basis). These exceptions do not apply if the new policy owner has no substantial family, business, or financial relationship with the insured. I.R.C. §101(a).
- The value of the business interest for estate tax purposes will generally be measured by the value specified in the buy-sell agreement, although the IRS is not bound by values specified in agreements, particularly between family members. I.R.C. §§ 2031 and 2703, and Treasury Regulation § 25.2703-1(b).

## TAX CONSEQUENCE TO SELLER

- On the sale of a business interest by a deceased owner's estate, the estate generally recognizes no gain because its basis is "stepped up" to fair market value at death. I.R.C. § 1014.
- A portion of the payment to the estate may be taxed as ordinary income if the business is a partnership with accounts receivable, appreciated inventory, or goodwill. I.R.C. § 736.
- Stock attribution rules may cause the payment to the selling shareholder of a family owned corporation to be taxed as a dividend. I.R.C. §§ 302 and 318.

## BASIS OF SURVIVING OWNERS

- In a cross purchase buy-sell plan, a purchasing owner's basis in the business interest is increased by the purchase price. I.R.C. § 1012.
- In an entity buy-sell plan, the basis of the surviving owners might be increased when the insurance proceeds are paid to the business entity, depending on the type of entity (note: LLCs can elect to be taxed as any of these, but usually are taxed as Partnerships or S corporations):
  - *C corporation:* Stock basis of remaining shareholders is not increased.
  - *S corporation:* Insurance proceeds received by entity increase basis of each owner (including deceased) proportionate to ownership percentage, unless a § 1377 election is made (with cash basis S corporation) to allocate all basis increase to surviving owners.
  - *Partnership:* Insurance proceeds received by entity increase basis of each owner (including deceased) proportionate to ownership percentage, unless special allocations are made to allocate all basis increase to surviving owners. I.R.C. § 705.

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