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Funding Your Buy-Sell Agreement with Life Insurance

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If you are within 10 years of retirement, let me help you understand how the retirement landscape has changed and how these changes can impact your current and future financial decisions.

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Funding Your Buy-Sell Agreement with Life Insurance

What does it mean to fund a buy-sell agreement with insurance?

The general function of life insurance is to create a sum of money payable at the death of the insured in order to replace the economic loss resulting from the person's death. When used to fund your buy-sell agreement, life insurance will create a sum of money at your death that will be used to buy your business interest from your family or estate. Using life insurance in a buy-sell agreement requires all the procedures involved in buying personal life insurance. An application must be completed, including a completed medical history, and life insurance underwriting procedures must take place.

When can it be used?

You are a party to a buy-sell agreement

You can use life insurance funding if you are one of the parties specified in a buy-sell agreement and are obligated by the terms of the agreement to purchase all or a part of the business interest held by another buy-sell participant at the other person's death. This obligation provides an insurable interest, one of the requirements for an insurance company to issue a policy.

You are insurable

For insurance funding to work with your buy-sell agreement, you must be able to get life insurance, which often involves a physical examination. If you are in poor health, you might be considered uninsurable by the insurance companies. If this applies to you, see Alternatives for the Uninsurable for some optional funding methods. You can still use insurance with your buy-sell agreement even if some of the parties are uninsurable. You would need to structure alternate financing for the uninsurable shareholders.

Who owns the life insurance policy?

Although certainly not an ironclad rule, the general arrangement is for the partners, partnership, stockholders, or corporation (whoever is the purchaser specified in the agreement) to pay the premiums. The party paying the premiums is also generally the owner of the policy and receives the proceeds of the policy at the death of the insured, whose interest in the business is to be purchased. There are many possible variations to this scenario. See the discussions Premium Payment, Beneficiary Designation, and Choosing the Policyowner for more information.

Strengths and tradeoffs of life insurance in a buy-sell agreement

There are strengths and tradeoffs that apply to the use of life insurance in funding a buy-sell agreement in general. These are discussed in this section. There are also some considerations specific to the type of buy-sell agreement, which are addressed separately in paragraphs below.

Strengths

Low-cost alternative

The total cost of the annual premiums on a life insurance policy is generally far less than the amount of cash that would need to be reserved and held aside to fully fund the purchase of a share of the business. The use of life insurance allows full funding of the buy-sell agreement, using an amount of cash that is less than the full purchase obligation.

Only means of guaranteeing event that creates need for cash (death) also provides cash for it

The death of a shareholder can cause a strain for the company resulting from the loss of talent, disruption of business, and the accompanying loss of revenue. Such an event could lead to temporary difficulty in getting loans or other funding. The use of life insurance funding with the buy-sell agreement will likely assure that cash will be available to purchase the deceased owner's share of the business, eliminating the need to find financing at the time of the event.

Policy cash values can be used to fund lifetime sale

When your buy-sell is funded with a permanent (cash value) life insurance policy, the accumulated cash values can be accessed and used to fund a lifetime sale resulting from retirement or disability. The policy can remain in force or be surrendered when the cash is needed.

> **Caution:** There may be tax consequences and fees associated with a policy surrender. See Tradeoffs.

Life insurance proceeds paid quickly after death--possible to close buy-sell deal quickly

Life insurance is designed so that the proceeds are paid quickly after your death. This characteristic ensures that the buy-sell transaction can be settled quickly. The use of life insurance proceeds to fund the buy-sell agreement can provide your estate with the cash needed to fulfill state and federal estate tax obligations.

Life insurance proceeds received income-tax free.

The proceeds received from the policy generally do not constitute taxable income to the beneficiary of the policy when the beneficiary is an S corporation, the shareholders, or a third party.

> **Caution:** A C corporation may be subject to the alternative minimum tax (AMT) when it receives proceeds from a life insurance policy.

Simple to explain and implement

Most people have some understanding of the concept of insurance. The process of getting life insurance for a buy-sell agreement is the same as that for any other life insurance. Even if someone has never had insurance before, it is still not difficult to explain the concept and put the policies in place.

Tradeoffs

Life insurance premiums not deductible expense

In general, policy premiums are paid with after-tax dollars and are not a deductible expense. This applies regardless of who pays the premiums--the corporation, the shareholders, or a third party.

Uninsurable shareholders present a problem

It is possible that a shareholder may be deemed uninsurable, although few individuals are actually refused insurance because of age or physical health. Most insurers may agree to cover almost any age up to the mid-70s (and even 80 with some policy types). People with illnesses may be insured with the application of a rating (or a flat extra premium, depending upon the severity of the illness). The rating that may apply to a high-risk insured will raise the cost of the premiums on that individual and equates the premium to the total level of risk for the insurance company. The additional cost of insurance for a high-risk shareholder may make other options more appealing. For more information on funding for uninsurable shareholders, see Alternatives for the Uninsurable.

Payment of policy premiums represents ongoing expense

Policy premiums represent an ongoing expense. In an entity purchase buy-sell with several shareholder participants, the annual policy premiums could, in some cases, even result in cash flow problems for the corporation. Not only is cash needed for the payments, but the premiums are not a deductible expense.

> **Tip:** Even though the payment of policy premiums can result in a cash drain, it is not anything like the cash outflow that would result at the time of an obligation to purchase the entity under a buy-sell agreement if no insurance was used! In addition, if a shareholder dies soon after a policy is issued, the purchase will have been funded with minimal cash outlay.

Could create transfer-for-value problem

If life insurance policies are used to fund the agreement, the death of one owner could cause a transfer-for-value problem with the policies insuring the remaining owners. When a shareholder dies, the estate becomes the owner of the policies covering the other shareholders under the agreement. If these policies are transferred to the remaining shareholders to fund future obligations under a cross purchase buy-sell agreement, a transfer-for-value may occur. If a transfer-for-value is deemed to occur, any proceeds received from the transferred policy will be taxable.

Policy cancellation may be taxable

If the policy is canceled (surrendered) for cash (for instance, to fund a lifetime buyout under the buy-sell), the gain on the policy is subject to federal income tax. The gain on a canceled policy is calculated by adding the net cash value and the balance of any outstanding loans and subtracting the policy basis.

> **Caution:** The policy may also carry surrender charges. Check your policy.

> **Caution:** Policy fees and expenses are usually charged against the policy in the first few years. As a result, policy surrenders during the first few years of the policy may provide little cash value.

> **Caution:** If the policy is surrendered while there is a policy loan balance outstanding, the transaction could be subject to income tax on the amount of the loan.

Considerations by type of buy-sell agreement: entity purchase agreement

The alternative minimum tax (AMT) may apply when policy owned by C corporation

The proceeds received by a C corporation under an entity purchase (stock redemption) buy-sell agreement may be subject to the alternative minimum tax (AMT). In addition, any buildup in cash surrender value of life insurance policies held by a C corporation may also subject the corporation to--or increase its existing exposure to--the AMT. The corporate AMT is not an issue when the proceeds are received by an S corporation, a partnership, or the co-shareholders or partners of the insured.

Value of insurance proceeds increase value of business

When the business is the beneficiary of the insurance policy, the value of the proceeds received becomes company property and increases the value of the business. This scenario, which is sometimes referred to as the "ballooning" problem, could result in inequity in the treatment of the deceased and the surviving shareholders. If the purchase price does not include the value of the insurance proceeds, the family of the deceased shareholder does not benefit from the increase in the value of the business resulting from receipt of the insurance proceeds and the cash values of the company-owned policies on the other shareholders.

> **Example(s):** Wayne, Bruce, and Robin are equal shareholders in a business valued at $300,000, with an entity purchase agreement fully funded by life insurance. Wayne dies. The company owns a $100,000 policy on Wayne's life and collects the proceeds as beneficiary, increasing the value of the business to $400,000. The $100,000 proceeds are transferred to Wayne's estate in exchange

for his stock. Bruce and Robin now each hold 50 percent interests in the company, which is valued at $300,000 plus the cash values on the existing policies on their own lives. Wayne's estate doesn't receive any benefit from the increase in the value of the business due to the receipt of the proceeds on Wayne's life or the cash values in the policies on the lives of Bruce and Robin.

Tip: A practical solution might be for the sale price in the entity purchase agreement to reflect the cash values of all policies funding the buy-sell. The deceased shareholder would then receive a benefit (through the sale price) from cash value accumulations in the policies.

Considerations by type of buy-sell agreement: cross purchase agreement

Life insurance has no adverse effect on working capital or credit position of the company

The company is generally not a buyer under a cross purchase agreement, which is an agreement between the individual shareholders. As a result, the company will not have to reserve large amounts of cash in a sinking fund in advance of a stock purchase, nor will it need to use company funds or take on debt to fund the buy-sell transaction.

Can require large number of policies

Under the cross purchase (crisscross) form of buy-sell agreement, each participant holds a policy on the life of every other participant under the buy-sell agreement. If there are a large number of participants, many policies will be needed. For more information on the number of policies required, see Calculate the Number of Policies Needed with Cross Purchase Buy-Sell Agreement.

Disparity in ages or ownership percentages can cause inequities in premium payments

Under a cross purchase buy-sell agreement, each owner pays the premiums on the policies owned on the other shareholder's lives. If the ages of the shareholders vary widely, younger shareholders will have to pay higher premiums on the lives of the older shareholders. The younger owner may find it difficult or impossible to pay the higher premiums. (The counterargument is that younger shareholders may have a shorter payment period. Of course, there is no guarantee that this will be the case.) Likewise, if the ownership percentages are not equal, more insurance will be needed to cover the buyout cost of the larger interests, resulting in higher premium costs for those who hold smaller ownership interests.

Can we use our group life insurance to fund the buy-sell?

This is not advisable for several reasons:

1. Generally, group life insurance premiums are deductible to the company. However, an employer may not deduct premiums it pays for group insurance coverage on an employee when the employer is a beneficiary either directly or indirectly.

2. Many states have group insurance statutes that prohibit an employer from being the beneficiary of group insurance on its employees.

3. If group life insurance is used for funding a cross purchase agreement, the corporation cannot deduct the group life premiums. The premiums could be considered constructive dividends to the shareholders.

4. The reciprocal transfers of policies between the shareholders could be considered a transfer-for-value by the IRS. The proceeds from the group insurance would be taxed as ordinary income to the surviving shareholders.

5. It is possible that the shareholders might agree collectively that the amount received from the group policy by the beneficiary spouse or family of a deceased shareholder would be the consideration for the stock. In this case, the surviving shareholders would not receive an increase in the stock's basis,

resulting in a larger gain if the business interest is sold in a lifetime transfer.

6. If the policy ownership is not transferred, and the shareholders simply name each other as beneficiaries, then both the business interest and the insurance proceeds would be included in a stockholder's gross estate.

How much insurance is needed?

Ideally, the buy-sell agreement should be fully funded. The insurance coverage should be arranged so that your life is insured for an amount equal to the value of your ownership interest. When you die, there will be enough cash from the policy proceeds to pay your estate in full for your share of the business. It is important to note, however, that even partial funding of the agreement is far better than no funding at all. If all that is affordable is insurance coverage for part of the value of your interest, you might want to go ahead and fund that amount. You may be able to get more insurance or take on additional funding methods later. For additional types of funding, see Funding Your Buy-Sell Agreement with Tools other than Insurance.

What happens if the insurance proceeds differ from the value of the business interest?

Proceeds less than value of interest

The insurance proceeds could be less than the value of your business interest due to growth of the business (or other reasons). Your buy-sell agreement should specify what will happen when the value of the business is larger than the amount of the proceeds from the insurance company. One possible option is for the buyer to make installment payments for the difference. Your buy-sell agreement should specify how the proceeds/valuation difference will be handled.

Proceeds greater than value of interest

The proceeds from the life insurance policy funding your buy-sell agreement could exceed the value of your business interest when you die, as a result of cash value buildup in the policy. Often, it is specified within a buy-sell agreement that the insurance proceeds represent the minimum price for the business interest and that the full amount of the insurance will be paid to the deceased's family or estate. Another option is to provide that any proceeds in excess of the value of your interest at death belong to the party who paid the premiums on the insurance. Your buy-sell agreement should address this potential situation up front and should specify whether the funds would be used by the business, the surviving shareholders, or to provide an additional benefit to the family or estate of the deceased.

How to do it

After the buy-sell agreement stating the purchase price, terms, and funding arrangements is drafted, the following steps should occur:

Obtain the life insurance policies

For an entity purchase (stock redemption) buy-sell agreement, the business should apply for separate life insurance policies on each of the shareholders. A common arrangement is for the business to pay the annual premiums and be the owner and beneficiary of the policies.

For a cross purchase (crisscross) buy-sell agreement, each shareholder applies for individual life insurance policies on each of the other shareholders. Each shareholder pays the annual premiums on the policies on the other shareholders and is the owner and beneficiary of the policies. For a wait and see buy-sell, there are three purchase options available for the life insurance policies: The business can buy the policy on each of the shareholders, as in the stock redemption; the individual shareholders can buy the policies, like in the cross purchase plan; or a combination of these can be used. When the time comes to make the purchase, the individuals who own the policies can loan the proceeds to the company for the purchase, if a purchase by the company is desired at that time.

> **Tip:** Include a schedule of the insurance policies as part of the buy-sell agreement. List the names of all buy-sell participants, the insurance company, policy numbers and face amounts, and the policyowners, beneficiaries, and premium payers.

Monitor annual policy premium payments

Each year, the premiums on the policies must be paid, or the insurance will lapse. Your buy-sell agreement should include a feature requiring proof of policy premium payment.

Review amount of insurance regularly

The insurance coverage may have to be increased periodically to reflect increases in the value of the business. It might be a good idea to include the insurance review as part of the annual year-end closing of the company's books. If additional insurance is not possible, another funding method, such as a cash reserve, could be established to help cover the increase in the business value.

Monitor insurance company

Periodically check on your insurance company. Is the company maintaining its ratings, or has it suffered from a financial downturn? There are several ways you can easily check out how your insurance company is performing. Financial and ratings information is available from several reputable sources and is often available at your local library, by subscription, or on the Internet.

Income tax considerations

Policy premiums are not deductible expenses

Amounts paid for life insurance premiums are not deductible. It makes no difference if the policy you own under the buy-sell is on the life of another shareholder or your own life.

> **Caution:** If the stockholders attempt to use company-paid group life insurance to fund the buy-sell agreement, the company may be denied a deduction for its premium payments. If the stockholders reciprocally name each other as beneficiaries of their insurance or reciprocally agree to apply the proceeds to the purchase of their stock, the proceeds may be taxable under the transfer-for-value rule.

> **Tip:** It is possible, however, to pay the cost of the premium to the policyowner in the form of a bonus. This would make the amount of the premium deductible by the business as compensation to the policyowner, but the amount of this bonus together with the policyowner's other compensation must not exceed reasonable compensation. The bonus may need to be "grossed up" so that the after-tax bonus amount is sufficient for the premium payment.

Premiums could be considered taxable dividends

Premiums paid by an associate shareholder are not taxable to the insured. However, if the corporation pays the premiums on life insurance to fund a buy-sell agreement between the individual shareholders (cross purchase buy-sell agreement), the premium payments may be treated as taxable dividends to the stockholders.

> **Tip:** It is possible, however, to pay the cost of the premium to the policyowner in the form of a bonus. This would make the amount of the premium deductible by the business as compensation to the policyowner, but the amount of this bonus plus any other compensation paid to the policyowner must not exceed "reasonable compensation." The bonus may need to be "grossed up" so that the after-tax bonus amount is sufficient for the premium payment.

Death proceeds are generally received income-tax free (except C corporation)

Proceeds received at the death of the insured are generally not subject to income tax for the beneficiary. The notable exception to this treatment is when the proceeds are received by a C corporation, which could face an alternative minimum tax (AMT) liability when it receives insurance proceeds.

Questions & Answers

How many policies are needed to fund a buy-sell with life insurance?

It depends upon the type of buy-sell agreement and the number of participants under the agreement. With an entity purchase agreement, the general arrangement is for the business itself to own the insurance policies. One policy would be required for each shareholder under the agreement, so if there are 6 participants, the company would buy 6 policies. With a cross purchase agreement, the shareholders buy policies on each other. Six participants under a cross purchase agreement would need a total of 30 policies. Each shareholder would buy 5 policies, one on each of the other 5 participants. See Calculate the Number of Policies Needed with Cross Purchase Buy-Sell Agreement for the calculations. If you use a trustee with the buy-sell agreement, the trustee could buy one policy for each participant.

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