

# Insurance-related best practices guide for buy-sell agreements



All businesses are different. And business owners need their buy-sell agreements to work for their specific situation. We’ve reviewed hundreds of complex buy-sell agreements and have valuable best practice information that can help.

This guide isn’t a complete list of suggestions. But, you can use it when working with your legal counsel to get the most out of your buy-sell agreement and properly coordinate it with any insurance funding.

## Valuation

**1** | When a formula valuation is employed by the buy-sell agreement and company-owned life insurance policies are present with the company listed as beneficiary, the buy-sell agreement should be clear about whether life insurance death proceeds should be considered as cash or cash equivalents for purposes of the valuation formula.

**2** | If an appraisal approach is used to value the business, the buy-sell agreement should instruct the appraiser about the desired treatment of life insurance death proceeds from company-owned policies.

**3** | Company-owned life insurance may be excluded from the value of the business through an effectively drafted buy-sell agreement.

- Buy-sell agreements may be drafted in a way that locks-in the value of the business for estate tax purposes, exclusive of life insurance proceeds acquired for buy-sell funding purposes.

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- The agreement should be clear that certain policies, identified on an attached schedule or exhibit, were obtained for the sole purpose of the buy-sell agreement. These should be excluded from the company's value.

## Taxation

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**1** | A trustee cross-purchase arrangement with trustee-owned policies may cause a portion of the life insurance death proceeds to be treated as taxable income to the beneficiaries. This is due to a violation of the transfer for value rule found in IRC Section 101(a)(2).

- In general, the promise of reciprocal action may be viewed as implied consideration paid for access to death proceeds. This may create a transfer for value problem if life insurance policies are transferred to the trust or if the beneficial interest of the trust beneficiaries changes.
- A trustee cross-purchase buy-sell arrangement can also require inclusion of death proceeds in a deceased business owner's estate.

**2** | Life insurance death proceeds are only income tax free to an employer if the insurance is properly structured and the employer complies with the requirements of IRC Section 101(j).

- Section 101(j) applies to employer-owned life insurance policies issued or materially changed after Aug. 16, 2006.
- A few things need to happen to preserve the favorable income tax treatment of life insurance death proceeds. Section 101(j) compliance requires that the employee/insured:
  - › Is provided written notice meeting the specific requirements of 101(j) and
  - › Provides a signed consent to the placement of life insurance coverage owned by the employer. This notice and consent needs to be obtained prior to the policy being issued.

**3** | Revenue Procedure 2005-25 generally provides valuation safe harbors for the transfer of life insurance policies from a business to an owner/

**4** | Using the value of life insurance death proceeds to establish the value of a deceased owner's business interest is generally inconsistent with IRS estate and gift tax valuation guidelines. This can be found in Revenue Ruling 59-60.

employee. The general standard of valuation found in the Revenue Procedure is that a policy should be valued at its "fair market value" for income tax purposes. This Revenue Procedure is the most recent income tax guidance provided by the IRS on this topic.

- Transactions between or among business owners are generally not bound by the valuation guidelines of Revenue Procedure 2005-25.
- Fair market value is measured differently for different types of life insurance policies. Sometimes a policy's cash surrender value isn't representative of its fair market value. The insurance company that issued the policy is in the best position to provide the measure of fair market value for a policy based upon IRS guidance.

**4** | For entities taxed under the rules for flow-through companies (S corporation or partnership), cash value increases in company-owned life insurance policies help to offset the negative impact on owner cost basis in business interest occurring from payment of a non-deductible expense (a life insurance premium).

- Company-owned policy cash values may also serve as an informal sinking fund to assist with a purchase under any lifetime buy-sell triggering events.

**5** | Buy-sell agreements should include provisions regarding the disposition of life insurance death proceeds in excess of the purchase price set by the agreement.

- Best practice suggests retention of excess death proceeds by the policy owner who paid for the policy. This avoids unexpected and unnecessary taxation.

- If the agreement requires death proceeds in excess of the purchase price to be paid to the estate or personal beneficiary of a deceased owner, then adverse tax consequences may result. If these excess proceeds are paid from the company (policy owner) to the deceased owner's estate or personal beneficiary, the excess proceeds may be taxable ordinary income as undocumented split dollar benefits.
- 6** | If business owners appear likely to have an estate tax liability at death, then best practice suggests that the buy-sell agreement be used to “lock-in” the value of the business for estate tax valuation purposes. The requirements to do this generally include the following factors:
- The price must be fixed or determinable pursuant to a formula under the agreement.
  - The estate must be obligated to sell at death at the agreement price.
  - The agreement must prohibit the owner from disposing of his or her interest during life without first offering it to the other party or parties at no more than the agreement price.
  - The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth.
  - For family transfers, any agreement to acquire property at less than fair market value will be disregarded for federal transfer tax purposes. Unless, under IRC Section 2703(b), the agreement (1) is a bona fide business arrangement; (2) not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and (3) has terms comparable to similar arrangements entered into by persons in an arms-length transaction.

## General considerations

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- 1** | To provide the highest level of assurance that life insurance death proceeds will be used to complete a sale after the death of a business owner using the agreement's terms, the buy-sell agreement should be drafted in a manner that creates a valid, binding contractual obligation to complete a purchase with the death proceeds. The below structure could be incorporated into the buy-sell agreement:
- The agreement should provide that the business owners have agreed to fund death-time purchase obligations through acquisition of life insurance policies.
  - The agreement should require that policies acquired for purposes of funding the buy-sell agreement must be maintained for the life of the agreement.
  - The agreement should identify life insurance policies acquired for the sole purpose of completing a purchase under the agreement in a schedule attached to the agreement.
    - › The schedule should identify the policy owner, the insured, and the beneficiary, in addition to the policy number, insurer, and face amount.
    - › The schedule should be kept up to date as changes in company ownership or policies happen.
  - The agreement should explicitly require that death proceeds from policies identified on the life insurance schedule need to be used to complete a sale upon the death of a business owner.
  - Payment terms of the agreement should be integrated with the availability of life insurance death proceeds from policies identified on the schedule. The scenarios addressed should include: (1) death proceeds in excess of the purchase price, and (2) any amount of the purchase price not covered by death proceeds.
  - As noted in other places in this document, the policy rights of a non-insured policy owner, whether it's the company or a co-owner other than the insured, should be restricted by the buy-sell agreement.

**2** | Cash value policies on the life of a business owner, held by the company or another business owner, should be transferred to the seller as part of the consideration in purchasing such owner's interest in the business upon the occurrence of a lifetime purchase and sale event. Best practice suggests using the policy's fair market value to complete payment under an installment note.

**3** | A buy-sell agreement should include language that addresses the possibilities for future ownership changes of life insurance policies acquired for purposes of the buy-sell arrangement.

- Many buy-sell agreements include dispositive provisions for some or all of the following circumstances: (1) termination of the buy-sell agreement; (2) sale of the company; or, (3) termination of the business owner's relationship with the company. If any of the preceding events occur, best practice suggests the business owner should be given the option (to be exercised within a specified period of time) to purchase his or her policy for its fair market value.
- Plus, if a departing business owner holds a policy on a remaining business owner, the remaining owner should also be provided the option to purchase his or her policy from the departing owner.

**4** | As a general rule, the ownership and beneficiary structure of life and disability insurance acquired for purposes of funding a buy-sell agreement should be aligned with the agreement's purchase obligations.

- If insurance isn't properly structured, the business owner with the purchase obligation may not be the person receiving insurance proceeds.
- Life insurance policies owned by the insured, with other business owners named as beneficiaries, will likely be considered a violation of the "transfer for value" rule (IRC Section 101(a)(2)). This happens because the mutual promises exchanged between policy owners is viewed as consideration exchanged for access to the death proceeds. When this happens, a large portion of the death benefit may be taxable as ordinary income.

**5** | Death, disability, and retirement are the three most common mandatory purchase and sale events found in buy-sell agreements. Funding for mandatory purchase and sale events can ease financial strain when death and disability happen unexpectedly. This can also be helpful for anticipated lifetime exit events, such as retirement.

- If the buy-sell plan design for these events is entity purchase, funding which is provided from a source independent of existing corporate surplus prior to the death of a business owner, may help ease state law requirements governing corporate redemptions.

**6** | The amount of insurance available for purchase generally depends on the value of the business.

- The presence of a formal or informal business valuation, in the absence of a clear valuation method in the agreement supported by financial details, can be very helpful in validating life insurance death benefits, as well as the disability buy-out benefit amount.
- Financial underwriting standards for life insurance and disability coverage may be different.

**7** | A business owner exiting the business under a lifetime triggering event through an installment sale of his or her interest generally shouldn't have an option to purchase the life insurance policy on his or her life until the installment sale is completed.

**8** | Business owners should be provided with an unqualified purchase option regarding any policy on their lives owned by either the company or other business owners for the purposes of the buy-sell agreement before the policy is terminated or sold to a third-party.

**9** | An owner of a life insurance policy, who isn't insured by the policy, should be prohibited by the buy-sell agreement from exercising any rights as policy owner which would reduce the death benefit to an amount less the full face amount of the policy. And also from taking any other action that might otherwise impair the viability of the policy, without first obtaining written permission from the insured business owner.

**10** | Many business owners have found it helpful to list all life and disability insurance policies acquired for purposes of the buy-sell agreement on a separate schedule attached to the agreement.

- Where life insurance policies are concerned, this practice has the advantage of not confusing whether death proceeds should be used to reimburse the company for the loss of a key person, provide survivor income to a spouse, or to complete the purchase of a deceased owner's business interest.

**11** | When life and disability policies are acquired and identified for purposes of the buy-sell agreement, the buy-sell agreement should explicitly require payment of life insurance death benefits or disability buy-out proceeds, up to the purchase price, to complete a sale under the agreement.

**12** | It's important to maintain funding for purchase obligations at a level which is close to the current value of the business.

- Back-up provisions for payment using an installment sale process are typically included to cover payments for any uninsured purchase price.

**13** | Buy-sell funding is easier to manage and plan when there are fewer policies involved in funding purchase obligations under a buy-sell agreement.

**14** | Many business owners who have adopted a wait-and-see buy-sell design where the business owners hold a final, mandatory purchase obligation find it most helpful for insurance policies funding this plan design to have the non-insured business owners as the owners and beneficiaries of these policies.

- When neither the company, nor the business owners, have a mandatory purchase obligation, life insurance funding may generally work best when the company is the owner and beneficiary of any funding policies.

**15** | The life insurance company that issued an insurance policy identified by the agreement as a policy acquired for purposes of that agreement should be authorized and directed to give the insured shareholder, upon receipt of his or her written request, any information on the status of the insurance policy(s) on his or her life.

## Entity purchase buy-sell plans

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**1** | An entity purchase buy-sell arrangement provides the simplicity of only one life insurance and/or disability buy-out policy on the life of each business owner.

**2** | Under an entity purchase arrangement, life insurance policies are generally owned by the business entity with the business as beneficiary for the entire amount of death proceeds. Policies owned in this way would be subject to the creditors of the business, but wouldn't be subject to the personal creditors of the business owners.

**3** | For pass-through taxation entities, life insurance death proceeds from company-owned policies as tax-exempt income received by the business entity may provide the surviving owners with only partial cost basis increase for income tax purposes. This is because some of the basis increase is allocated to the deceased owner. This inefficient basis allocation

may create unnecessary larger capital gains exposure upon a subsequent sale by a surviving business owner.

**4** | S corporations using an entity redemption buy-sell plan design have often found it advantageous to incorporate the "short-year" election process of IRC Section 1377(a)(2) into their agreement. If the S corporation can qualify, this technique can provide a full increase in ownership cost basis to surviving owners and only requires one policy per owner (owned by the company). Qualification generally requires use of the cash basis accounting method by the business entity.

- S corporations with three or more owners that currently have a cross purchase buy-sell plan design have sometimes found it helpful to convert to an entity purchase buy-sell plan design in conjunction with the "short-year" election process of IRC Section 1377(a)(2).

**5** | In general, premiums paid for company-owned policies are non-deductible at the company level. See IRC Section 264(a)(1). Premiums paid by an entity taxed as a flow-through organization for company-owned policies are generally considered a non-deductible item at the company tax reporting level as an expense not properly chargeable to a capital account. Non-deductible expenses generally reduce the owners' cost basis in their company ownership interest, pro rata. Annual increases in policy cash value, if present, may, in effect, be "netted" against decreases in cost basis, since these cash value increases are chargeable to a capital account. See IRC Section 1367(a)(2)(d).

**6** | For entities taxed as partnerships, including LLCs that have chosen to be taxed under the partnership rules, life insurance death proceeds, as tax-exempt income received by the business entity, generally increase all owners' cost basis in the company on a pro rata basis. A special allocation process may be made part of the operating agreement or partnership agreement that allocates all of the basis increase from receipt of life insurance death proceeds only to the surviving owners. Without an allocation process like this in place, a meaningful portion of the cost basis increase from death proceeds is wasted on the deceased owner. It's also generally advisable, in order to support the reasonableness of the death benefit allocation, to also provide for a corresponding similar allocation of premium expense.

## Cross-purchase buy-sell plans

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- 1** | Under a cross-purchase arrangement, life insurance policies are generally cross-owned by the business owners.
- Policies owned in this way are subject to the personal creditors of the business owners. But, cross-owned policies aren't subject to the creditors of the business.
- 2** | The buy-sell agreement should identify cross-owned policies in a schedule attached to the agreement. The agreement should also note that the policies were acquired for the exclusive purpose of buy-sell planning. It's also helpful when the agreement explicitly requires that life insurance death proceeds first must be used to complete a sale under the agreement to the extent possible.
- Business owners want to feel comfortable that if they pass away, the agreement will be enforceable as implemented. Agreements drafted with the above provisions are more likely to be enforceable as written than agreements without these provisions.
- 3** | The transfer of existing life insurance policies from an entity taxed as a corporation to a business owner in order to establish cross-purchase funding may create a "transfer for valuable consideration" as

- defined in Section 101(a)(2) of the Internal Revenue Code. This transfer will most likely jeopardize the income tax free nature of life insurance death proceeds. One important exception is that transfers to "partners" of the insured aren't subject to the transfer for value rule.
- If practical, a cross-purchase buy-sell plan may be funded with policies owned by a general partnership or an LLC tax as a partnership. If the owners of both entities are the same, then the partnership exception to the transfer for value rule would likely apply. New policies may also be an option.
- 4** | The number of life or disability buy-out policies owned by the business owners will increase as the number of business owners increases under a cross-purchase arrangement.
- 5** | A corporate cross-purchase buy-sell arrangement informally funded with partnership-owned life insurance policies offers the simplicity of one policy per business owner, while also providing owners with a full increase in corporate ownership cost basis. Also, if the partnership is properly structured, life insurance death proceeds on a deceased business owner may be excluded from the deceased's owner's estate for estate tax purposes.

## Disability buy-out considerations

**1** | It's typically most helpful to adopt a definition of disability in the agreement that's directly linked to the determination of disability by the insurer under the disability buy-out policy.

- This will ensure that funds are available from the disability buy-out policy to complete a purchase under the disability trigger.

**2** | It's important to review an agreement's payment terms for consistency with the claims payment procedures in the disability buy-out policy.

- Many disability buy-out policies are structured by insurers as expense reimbursement policies. Therefore, a disability buy-out claim will not be payable until the buy-out of a disabled owner's interest has occurred.

**3** | It's generally advisable for the company to retain ownership of any life insurance policies on the life of a disabled owner until an installment purchase of the disabled owner's interest is completed.

- This helps to ensure continued funding if a disabled owner should die before his or her interest is fully purchased under a disability purchase and sale trigger.



# Life insurance funding considerations

Plan type	Structure	Tax issue	Alternatives
Cross-purchase buy-sell plan design funding	Each insured owns a policy on his or her own life naming the other owner(s) as beneficiary.	Likely a “transfer for value” when death occurs, causing taxation of death benefit in excess of cost basis. Mutual promises have been viewed as “consideration” paid for access to death proceeds. Estate may argue not a payment under buy-sell plan.	Policies should generally be owned by the party holding the purchase obligation, not the insured. For multiple owners, possibly consider a business continuation general partnership approach for cross-purchase funding.
Trusteed cross-purchase buy-sell plan design	A trust owns policies on the business owners. Trustee uses death proceeds to complete the sale transaction.	Same transfer for value issue as above. In addition, there may also be an estate tax issue (either through an incident of ownership or a transfer with a retained interest).	With multiple owners and a corporation, possibly consider a business continuation general partnership or an IRC Section 1377(a)(2) short-year election (if a full S corp). Both allow one policy per owner and a full increase in the survivors’ cost basis. If a partnership, consider use of the partnership special allocation process for a similar outcome.
Entity purchase buy-sell plan design funding	Entity owns a policy on each business owner. Spouse of the business owner is named as beneficiary.	Likely an undocumented endorsement split dollar plan or a dividend causing the death benefit to be taxable as ordinary income. It may also be possible for the spouse to argue the death benefit isn’t a payment for the deceased owners’ interest.	If the entity holds the purchase obligation, then the entity should be the beneficiary of any policy it owns for purposes of the buy-sell agreement.
Converting from an entity purchase plan design to a cross-purchase plan design	Company-owned policies are transferred to business owners to implement cross-owned funding structure.	Unless the entity is taxed as a partnership, this is a violation of the transfer for value rule causing taxation of death proceeds since there isn’t an exception governing such a transfer.	Either transfer to a funding entity taxed as a partnership, or acquire new coverage. Existing policies could be retained for key person needs or sold to the insured.



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