# An Overview of Buy-Sell Arrangements

Every business is unique and has its own particular needs when it comes to setting up a succession plan among the business' owners. Luckily, there are many ways to solve the buy-sell dilemma. The trick is sorting through the myriad options to find the right one. In order to make that process simpler, it's important to know where a particular type of buy-sell arrangement is best suited, the positives of each arrangement and what needs to be considered when implementing a buy-sell arrangement.

Buy-sell arrangements are used by owners of closely held business entities, including C corporations, subchapter S corporations, sole proprietorships, limited liability companies and partnerships, in order to facilitate an orderly transfer of ownership interests upon the death, retirement or disability of a business owner. Buy-sell agreements are designed to ensure that the business will continue and that the business owners will receive a fair value for their business interests.

## BENEFITS OF IMPLEMENTING A BUY-SELL AGREEMENT

- There's continuity of management and control for the remaining business owners.
- Owners of non-marketable business interests are assured of a fair price for their interest.
- A buy-sell agreement negotiated at arm's length may help establish the business' value for estate tax purposes.

## BENEFITS OF USING LIFE INSURANCE IN A BUY-SELL AGREEMENT

- Life insurance proceeds are generally received on a tax-favored basis.
- Cash values generally accumulate on a tax-deferred basis.
- Cash values may be used as a down payment in the event of disability or retirement.
- Cash is made immediately available to purchase a deceased owner's interest.
- Life insurance proceeds provide liquidity for ordinary living expenses and estate tax liability.

## TYPES OF BUY-SELL AGREEMENTS

Buy-sell agreements can be structured under various forms, including 1) entity redemption, 2) cross purchase, 3) cross endorsement, 4) wait-and-see and 5) a one-way agreement. The plan structure will depend on the type of business, the number of business owners, the stage of the company (e.g., growth or mature stage) and the owners' goals. The type of insurance funding – whether life, disability or both – will depend on the age, duration and health of the business owners and the business owners' ultimate goals for their business.

## Entity Redemption Plan

With an entity redemption plan, the business owners enter into an agreement with the business entity in which the entity agrees to purchase a business owner's interest. This type of buy-sell agreement obligates the business owners or their estates to sell the owner's interest in the business to the business entity. At the same time, the business entity is obligated to purchase the departing owner's interest, thereby ensuring that a departing owner will have a market for their business interest. The entity redemption plan will either establish the purchase price for the business interest or will outline a method for determining that purchase price.

With the entity redemption plan, the business entity is the applicant, owner and beneficiary of a life insurance policy on the life of each business owner. At the insured's death, the business entity receives the life insurance death benefit, usually income-tax-free, and then uses the death benefit proceeds to purchase the business interest from the owner's estate.

If the owner is departing due to retirement or disability, the business can access the policy's cash values as a source of liquidity for the down payment on an installment note for the purchase of the departing owner's business interest. In either situation, the result is that the departing owner's interest is now owned by the entity, which means that the remaining owners have a proportionally increased interest in the business entity.

An entity redemption agreement is often used in situations where there are multiple business owners because of the simplicity in requiring just one policy per owner. A business will also use entity redemption if there is a disparity among the business owners' ages or health or if the business has a need for the cash value inside the policy.

### *Considerations*

When the policy is owned by the business entity, it's important to keep in mind that life insurance premiums aren't tax deductible.

In addition, for federal income tax purposes, life insurance death benefits are generally paid income-tax-free to beneficiaries pursuant to IRC Section 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to, the transfer of a life insurance policy for valuable consideration, unless the transfer qualifies for an exception under IRC Section 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy, unless the policy qualifies for an exception under IRC Section 101(j) and the employer has a "Notice and Consent" agreement on file prior to the policy's issue.

Policies and cash values are subject to creditors of the business.

Life insurance proceeds may increase the value of the business for estate tax purposes.

If the business is a pass-through organization, a properly structured entity-redemption agreement may allow for remaining owners to receive a step-up in basis when the departing owner's interest is redeemed by the business entity.

## Cross Purchase

In a cross purchase buy-sell agreement, the business owners agree to purchase the departing owner's business interest in the event of death, retirement or disability. Each business owner is the applicant, owner, beneficiary and premium payor for insurance policies on the lives of every other business owner. At death, each surviving owner/beneficiary normally would receive the policy proceeds income-tax-free. Each surviving owner uses the proceeds to pay the deceased owner's estate, and in return the estate transfers a *pro rata* portion of the deceased owner's business interest. The result is that the estate's non-liquid business interest has been transformed into cash (and installments notes to cover any shortfall) and the remaining owners own 100% of the business.

If the owner is departing due to retirement or disability, the remaining owners can access the cash value of the policy they own on the departing owner as a down payment toward their obligation to buy out the departing owner. Another option is that the remaining owners can transfer the policy insuring the departing owner to the departing owner in partial payment for the departing owner's interest in the business entity.

### *Considerations*

A cross purchase agreement is generally used where there are no more than three owners of similar age and/or health and when it's anticipated that there will be a long-term need for the buy-sell agreement. The cross purchase arrangement is used in business entities without many owners because this structure requires several different policies for each business owner. The formula for determining the number of policies needed under a cross purchase arrangement is N x (N-1), where N equals the number of owners. For example, in the case of four owners, 12 policies would need to be purchased (4 x 3 = 12).

With the cross purchase arrangement, the owners may violate the transfer-for-value rule when, in order to provide additional funds for a subsequent buyout, the decedent's estate transfers policies owned by the decedent to the remaining business owners. The violation of the transfer-for-value rule can be avoided if the business owners, or their business entity, meet one of the exceptions to the rule.

The owners may be in a higher income tax bracket than the business, thus resulting in higher insurance costs. Also, individual owners pay premiums with personal after-tax dollars rather than with the business checkbook.

Possible disproportional premium payments among owners are due to disparities in age or health.

Policies and cash values are subject to the individual owner's creditors.

In a cross-purchase agreement, remaining owners receive a step-up in basis equal to the purchase price.

## Cross Endorsement

In a cross endorsement agreement, each business owner buys and is the owner of an insurance policy on their own life. To provide the death benefit, the other business owners need to purchase the departing owner's business interest at death; the insured/owner of the policy will endorse a portion of the policy's death benefit to the other business owners, making them "renters" of the death benefit.

This endorsement is done in proportion to the other business owners' ownership percentage in the business. The owner of the policy will pay the premiums while the other business owners will pay the policy's owner an annual "rental charge" for the death benefit. This rental charge is equal to the economic benefit cost for the amount of death benefit endorsed to the "renter." The annual rental charge can be used to offset the premiums that the policy's owner must pay. At the insured's death, the death benefit is paid to the other business owners according to the amount endorsed to them, and they can use that death benefit to purchase the business interests from the deceased's estate.

Often, business owners will choose to utilize a cross endorsement method when they have identified a short-term need for the buy-sell coverage, such as when a sale of the business entity is anticipated. Since each business owner, or their irrevocable life insurance trust (ILIT), is the owner and beneficiary of the policy on their own life, when there is no longer a buy-sell need, the endorsement to the other business owners is dropped and the existing policy can be used for the insured's other needs, such as estate planning or supplemental retirement income.

### *Considerations*

Payment of the economic benefit amount under the "rental agreement" that accompanies a cross endorsement agreement is taxable as ordinary income to the policy's owner. The economic benefit amount needs to be paid annually, in addition to the required premium payments, although the policy's owner can use the economic benefit amount received as an offset against the amount they have to pay as the premium.

A cross endorsement arrangement can also trigger a violation of the transfer-for-value rule. This happens when the insured/policyowner endorses the death benefit to the other business owners. The violation of the transfer-for-value rule can be avoided if the business owners or their business entity meet one of the exceptions to the rule.

The owners may be in a higher income tax bracket than the business, resulting in higher insurance costs. Also, individual owners pay premiums with personal after-tax dollars rather than with the business checkbook.

Business owners with disparities in age or health are responsible for the increased costs of their own policies.

Policies and cash values are subject to the individual owner's creditors.

In a cross purchase agreement, remaining owners receive a step-up in basis equal to the purchase price.

## Wait-And-See

The wait-and-see agreement allows business owners to postpone the choice between an entity redemption and a cross purchase until the death of a business owner. The wait-and-see buy-sell requires that both the business entity and the business owners agree to purchase the business interests of a departing business owner pursuant to the terms and conditions of the agreement. Typically, in a wait-and-see plan, the business has the first option to purchase a business owner's interest. If the business fails to exercise its option, then the remaining business owners have a second option to purchase the business interest. If the business owners fail to purchase all or a portion of the departing owner's interest, then the entity is required to purchase the remainder.

A wait-and-see arrangement provides flexibility. Where it's determined that a cross purchase arrangement is more advantageous to the remaining business owners, the business entity will not exercise its first option. However, if entity redemption would be more advantageous and the insurance policies are owned by and payable to the remaining business owners, the surviving owners may contribute their proceeds either to the entity as a capital contribution or as a loan.

### *Considerations*

When the policy is owned by the business entity, it's important to keep in mind that life insurance premiums aren't tax deductible.

In addition, for federal income tax purposes, life insurance death benefits generally pay income-tax-free to beneficiaries pursuant to IRC Section 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to, the transfer of a life insurance policy for valuable consideration, unless the transfer qualifies for an exception under IRC Section 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy, unless the policy qualifies for an exception under IRC Section 101(j) and the employer has a "Notice and Consent" agreement on file prior to the policy's issue.

This is the most flexible type of buy-sell agreement, because the purchase can be done at either the entity or owner level. The choice is made at the time of the triggering event rather than on the date the agreement was signed.

If the funding is at the owner level and there are multiple owners, the administrative complexity of each owner owning a policy on every other owner is the same as with a cross-purchase agreement.

## One-Way

A one-way buy-sell is an agreement that is appropriate for either 1) a sole business owner who wants to sell their interest to someone who doesn't have an ownership interest (such as a key employee, family member or third party) or 2) a business owner who wants to arrange for the sale of their interest to one or more co-owners who have no reciprocal desire to sell. The one-way cross-purchase arrangement requires the buyer to purchase the business owner's interest upon the occurrence of the triggering event.

The buyer purchases a life insurance policy on the business owner's life. The buyer will pay the premiums and will be the policy beneficiary. Where the buyer is a key employee or a family member, the business may provide the source of premiums through a taxable bonus. At the business owner's death or departure, the buyer uses the death proceeds or cash values to purchase the business owner's interest.

### *Considerations*

Policies and cash values are subject to the individual owner's creditors.

Policyowners have access to policy values. Where the premiums are funded with employer bonuses, the business may put a restrictive endorsement on the policy, limiting access to cash values. The restriction could be released upon the business owner's retirement or disability to allow access to cash values for a down payment on a buyout.

The new owners receive a step-up in basis equal to the purchase price.

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