FAQS

Life Insurance Funded Buy-Sell Arrangements

COMPARISON OF ENTITY PURCHASE AND CROSS PURCHASE ARRANGEMENTS

Please note that this chart presents a general discussion of issues relating to choosing a buy-sell arrangement funded with life insurance. It does not attempt to address issues related to the taxation of a specific tax entity except where noted.

	ENTITY PURCHASE (REDEMPTIONS, LIQUIDATIONS)	CROSS PURCHASE
The Plan	A buy-sell agreement that obligates the business to purchase, at an agreed-on price, the interest of a business owner on the occurrence of a specified event—generally the owner's death, disability, or termination of employment.	A buy-sell agreement where business owners agree among themselves that the remaining/surviving owner(s) are obligated to purchase (or have the option to purchase), at an agreed-on price, a departing owner's interest on the occurrence of a specified event—generally an owner's death, disability, or termination of employment.
The Purchaser	The business.	The remaining/surviving business owner(s).
Seller	The owner or his or her estate.	
Seller: Basis in Business Interest	Lifetime sale: Basis remains adjusted cost basis. Sale at death: The business interest receives a "step-up" in basis to fair market value at the death of an owner.	
Purchaser: Basis in Business Interest	The remaining/surviving owners do not receive any cost basis adjustment in their business interest after the buy-out. Subsequent sales may trigger additional taxable gain. (Note: Where a stock redemption is funded with life insurance in a pass-through entity, the life insurance will cause the owners to receive an increase in basis.) The percentage ownership of the remaining/surviving owners is increased pro rata, by the amount repurchased (i.e., redeemed/liquidated). This can sometimes realign voting power, shifting the control of the business in an undesirable way.	The remaining/surviving business owner(s) receive a new basis in the purchased interest(s)—the fair market value paid. This new basis is used to measure taxable gain for subsequent sales. The surviving/remaining owners' percentage of ownership can remain the same or change depending upon the agreement and the amount of the deceased/departing owner's interest purchased by each survivor/remaining owner.
Estate Tax Valuation	The price at which a deceased owner's business interest must be sold under a buy-sell agreement will generally be binding as the estate tax value of the business interest where the buy-sell agreement: ‣ Provides that the arrangement is binding on the parties during the life and at the death of the owners for a price that is determinable from the agreement. ‣ Provides that it's entered into for a bona fide business reason. ‣ Is not a testamentary device to transfer the business to members of decedent's family for less than adequate consideration. ▪ In family situations, has terms comparable to similar arrangements entered into by persons in arm's length transactions.	

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	ENTITY PURCHASE (REDEMPTIONS, LIQUIDATIONS)	CROSS PURCHASE
Family Attribution Rules	Apply only to corporate redemptions. Consequences of the rule: When "related" persons own the stock, a redemption may be subject to taxable dividend treatment (ordinary income) instead of sale or exchange treatment through the application of the IRC §318 attribution/constructive ownership rules. (However, in an S corporation with no C corporation accumulated earnings and profits, the attribution rules do not result in dividend treatment.) These rules can be waived if the conditions in IRC §302(c)(2)(A) are met. The attribution rule does not apply if the redemption qualifies under IRC §303 as a payment of estate administrative expenses or taxes.	There are no problems of constructive ownership or attribution under IRC §318 when a cross purchase arrangement is used.
Life Insurance Funding	The business is the owner, premium payer, and the beneficiary of a policy on the life of each owner in an amount sufficient to help assure the performance of its repurchase obligation under the agreement.	Each owner applies for, owns, and is the beneficiary of a policy on the life of each of the other owners in an amount equal to his or her share of the purchase obligation.
Policies Needed	Only one policy per owner is required.	As the number of owners increases, multiple policies are required. The number of policies needed is: n x (n -1), where n = the number of owners.
Policy Management	Fewer policies owned and administered by the business entity will increase the likelihood that premiums will be paid, policy performance will be monitored, and death benefit proceeds will be used for the intended buy-sell purpose.	Multiple personally owned policies add additional complexity to the management process and the successful outcome of the plan. In addition, where a trust is used as a policy management tool, "transfer-for-value" problems can result, leading to partial or full taxation of the death benefit proceeds.
Policy Premiums	Premiums are a nondeductible business expense for income tax purposes. Age discrepancies, underwriting ratings, and percentage ownership that can result in insurance costs that are radically different among the multiple owners become less of an issue where business dollars pay premiums. S corporations, partnerships, and limited liability companies: Depending on the type of pass-through entity, the accounting methods used, and the nature of the buy-sell arrangement, nondeductible premiums reduce the value of an owner's interest in the entity (basis reduction).	Premiums on personally owned life insurance policies are a nondeductible expense for income tax purposes. Premium discrepancies become more of an issue where personal dollars are used to purchase policies. To defray personal premium cost, business dollars are often put to use through the implementation of executive benefit strategies such as a bonus agreement or a split dollar plan. As the result of these strategies, additional compensation may result to the business owners. Care must be taken that these additional dollars can be justified as "reasonable compensation."

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	ENTITY PURCHASE (REDEMPTIONS, LIQUIDATIONS)	CROSS PURCHASE
Tax Bracket Considerations	Consideration must be given to the taxation of the entity and the effect of nondeductible premiums on the entity and its owners. For example, when funding a cross purchase arrangement, premium payments made by a corporation in a high tax bracket may be more costly than a deductible bonus paid to the owners in lower tax brackets.	
Policy Cash Values	When permanent policies are used, policy cash values are corporate assets. Cash values can be accessed by the business for use in a lifetime purchase resulting from an owner's disability or withdrawal from the business.* C corporations: See "Alternative Minimum Tax (AMT)." S corporations, partnerships, and limited liability companies: Depending on the type of flow-through entity, the accounting methods used, and the nature of the buy-sell arrangement, cash value increases the owner's basis.	Where permanent policies are used, cash values can be accessed by the policy owner for use in a lifetime purchase resulting from an owner's disability or withdrawal from the business.*
Policy Proceeds: Income Taxation	For "employer-owned" policies issued after August 17, 2006, IRC §101(j) provides that the death benefit in excess of premiums and other amounts paid will be taxed as ordinary income. However, if specific employee notice and consent requirements are met and certain safe harbor exceptions apply, the death benefit can be received income tax-free under IRC §101(a). See "Transfer of Policies." C corporations: See "Alternative Minimum Tax (AMT)."	For "employer-owned" policies issued after August 17, 2006, IRC §101(j) provides that the death benefit in excess of premiums and other amounts paid will be taxed as ordinary income. However, if specific employee notice and consent requirements are met and certain safe harbor exceptions apply, the death benefit can be received income tax-free under IRC §101(a). IRS Revenue Bulletin 2009-24 Notice 2009-48 provides additional interpretation of IRC § 101 (j) and its application to a cross purchase arrangement. See "Transfer of Policies."
Policy Proceeds: Effect on Business Value	The death benefit received by the business may increase the value of the business.	The business value is not affected by receipt of policy proceeds by an owner.
Policy Proceeds: Estate Includibility	Corporations: If all of the incidents of ownership in the policy are held by the corporation, only the value of the stock, not the policy proceeds, will be includible in the decedent's gross estate for estate tax purposes. Partnerships and limited liability companies: There are no direct regulations that deal with incidents of ownership held by a partner/member. The general belief is that, where the entity is both the owner and the beneficiary of a policy on a partner's/member's life, the partner's/member's gross estate should include just his or her proportionate share of the business value, which reflects a proportionate share of the policy proceeds.	The cash value of the policies owned by the decedent on the other owners' lives is includible in the decedent's gross estate.

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	ENTITY PURCHASE (REDEMPTIONS, LIQUIDATIONS)	CROSS PURCHASE
Transfer of Policies	Since the business is the owner of the life insurance policies, there is no need to transfer ownership at the death of an owner. Accordingly, this limits the possibility of incurring a "transfer-for-value" problem resulting in partial or full taxation of the death benefit proceeds. Care must be taken when decisions are made to change the form of the buy-sell agreement (e.g., from entity purchase to cross purchase) so that the "transfer-for-value" rule is not violated.	Transfer-for-value problems are more likely since the estate of the deceased owner will own policies on the lives of the surviving owners. At the death of a business owner, the deceased owner's estate and the surviving owners may choose to shift ownership to provide for full funding at a subsequent death. Unless an exception to the transfer-for-value rule applies, all or a portion of the death benefit could be subject to income taxation. To avoid a transfer-for-value problem for the surviving owners, the estate can sell the policies only to the respective insureds, a corporation where the insured is an officer or stockholder, a partnership in which the insured is a partner, or a partner of the insured.
Alternative Minimum Tax (AMT)	Where life insurance is used as a funding tool for an entity purchase, death benefit proceeds and cash value build-up may affect the "adjusted current earnings" (ACE) calculation and trigger alternative minumum tax. Only applicable to C corporations: An exemption applies to qualifying small corporations.	Alternative minimum tax is not applicable to personally owned life insurance policies.

*Life insurance policy cash values are accessed through withdrawals and policy loans. Loans are charged interest. Unpaid loans and withdrawals reduce cash values and death benefits and may affect any guarantee against lapse. In general, loans are not taxable, but withdrawals are taxable to the extent they exceed basis in the contract. Loans outstanding at policy lapse or surrender before the insured's death will cause immediate taxation to the extent of gain in the contract. For policies that are Modified Endowment Contracts, distributions (including loans) are taxable to the extent of income in the contract, and an additional 10% federal income tax penalty may apply. Consult your own tax advisor for advice regarding your particular situation.

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