BUY-SELL AGREEMENTS:

INSURANCE FUNDING FOR C AND S CORPORATIONS

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USING LIFE INSURANCE TO FUND BUY-SELL AGREEMENTS

- It is possible that the shareholders might all live to their actuarial life expectancies or longer, and they might achieve the same after-tax return on their investments (in their business or in other investments) as an insurance company achieves before taxes. *If* that could be assured, they would not need life insurance to fund their buy-sell agreement.

  ⇒ The primary reason to use life insurance is to shift to the insurance company the risk that one or more shareholders will die before their actuarial life expectancy.

  ⇒ Other reasons are to establish a forced investment regime and to benefit from the insurance company's professional asset management and tax-free build-up of invested funds. [2]

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[1] *This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

[2] As a supplement or alternative to using life insurance, the purchase price for the shares can be paid with a down payment and installment payments over several years. If life insurance is used to fund only a portion of the buy-out under the buy-sell agreement, the unfunded portion of the purchase price is usually paid out in installments

(footnote continued on next page)

- When life insurance is used to fund the buy-sell agreement, the "entity purchase vs. cross purchase" issue must be addressed when the agreement is drafted. This outline discusses that issue.[3]

- When a life insurance policy is "**transferred for value**" to someone other than the insured or a partner of the insured, the proceeds become taxable.[4]

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(footnote continues from previous page)

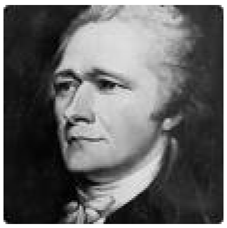
over several years. As another alternative, the shareholders can pre-fund a reserve for the buy-outs, possibly creating a holding company to retain the liquid assets and making an S corp election to avoid accumulated earnings tax penalties.

3 If the buy-sell agreement is not funded by life and/or disability insurance, the agreement can be drafted to defer the issue until a triggering event occurs.

4 The Service has ruled privately that the partnership does not need to do anything else. PLR 93-09-021, December 3, 1992.

BACKGROUND OF EXAMPLES

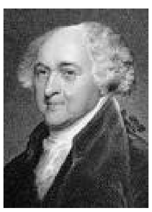
Five shareholders: Alex (Hamilton), Ben (Franklin), George (Washington), John (Adams) and Tom (Jefferson) each with 20 shares of S Corp. All live in California.



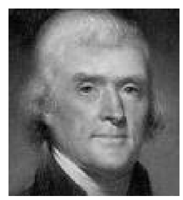

Alex and Elizabeth
(Hancock Park)

Ben
(Marina del Rey)

George and Martha
(San Marino)




John and Abigail
(Santa Barbara)



Tom
(Marin)

[5]

Amelia
(Encino)

Tax basis of each shareholder in his 20 shares at the end of 2007: $20,000.

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[5] Author makes no claim to copyright in any photo or artwork.

Value of a block of 20 shares in 2008: $400,000

Value of S Corp. at the end of 2008: $3 million[6]

1. EXAMPLE 1: ENTITY PURCHASE

1.1 S Corp. owns a $400,000 life insurance policy on each shareholder.[7]

1.2 George dies at end of 2008. His wife Martha estate gets a new basis of $400,000 in the 20 shares.

1.3 S Corp. receives life insurance proceeds of $400,000, which increases the basis of each of the five shareholders by $80,000 each.8 So the new basis of Alex, Ben, John and Tom's 20 shares each is $100,000 each ($20,000 initial basis + $80,000 from the life insurance proceeds).[9] The new basis of Martha is $480,000 ($400,000 stepped-up basis + $80,000 from the life insurance proceeds).

1.4 S Corp. buys the 20 shares from Martha for $400,000 (their value), so Martha has a capital loss of $80,000 (the amount realized

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6 In valuing each block of shares, they used a 20% discount for lack of a liquid market for the shares and a 16% discount because no block carried or bestowed control of S Corp.

7 Because each block of 20 shares is worth $400,000, S Corp. is fully funding each purchase.

8 Note that S Corp.'s accumulated adjustment account does *not* increase.

9 Should the value of the corporation increase by the amount of the life insurance proceeds? No, because the corporation has an obligation to use all of the proceeds to buy back Martha's shares. We assume that the eliminating the cash value of the policy on George's life from the S Corp. balance sheet will not affect the value of S Corp. (that is, it is not valued at book value).

is $400,000, the basis is $480,000). Because all of Martha's community property assets were adjusted to their value at the date of George's death, Martha has no capital gain to offset the capital loss, and the loss is permanently *wasted*.

- **Observation**: *Entity purchases always waste basis.*

1.5 Alex, Ben, John and Tom then sell all of their shares to BigCo for $3 million, or $750,000 each.[10] They each have a $650,000 gain and, at a combined federal and California 24% tax rate, pay income tax of $156,000 each.

1.6 Alex and Ben each buys from S Corp. the policies on his life, taking it as separate property, not community property, to avoid "transfer for value" problems. John and Tom do not need additional life insurance, so S Corp. surrenders their policies to the insurance company and receives their cash value.[11]

2. EXAMPLE 2: CROSS PURCHASE

2.1 Alex, Ben, George, John and Tom each owns a $100,000 policy on each other. So Alex owns four $100,000 policies: on Alex, Ben, John and Tom. There are 20 policies,[12] providing $2 million in coverage (20 x $100,000). S Corp. does not own any life insurance.

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[10] This assumes no appreciation in value, only that the purchaser of all of the outstanding shares does not impose discounts for lack of control and lack of a ready market for the shares.

[11] S Corp. might also be able to sell the unwanted policies in the "secondary market."

[12] The number of policies = N × (N - 1), where N = the number of shareholders.

2.2 George dies at the end of 2008. His wife Martha gets a new basis of $400,000 in the 20 shares.

2.3 Alex, Ben, John and Tom each receives insurance proceeds of $100,000.

2.4 Alex, Ben, John and Tom each uses the proceeds to buy a block of five shares from Martha for $100,000 per block. Martha receives $400,000 for the 20 shares, so she has no gain or loss.

2.5 Alex, Ben, John and Tom each now has his original 20-share block with a basis of $20,000 and a new five-share block with a basis of $100,000.

2.6 Alex, Ben, John and Tom then sell all of their shares to BigCo for $3 million, or $750,000 each. They each have a $630,000 gain ($750,000 - $120,000) and, at a 24% tax rate, pay tax of <u>$151,000</u>.

2.7 **Observations**:

2.7(a) Alex, Ben, John and Tom *each* saves <u>$5,000</u> on the sale of their S Corp. stock as a result of using the cross-purchase arrangement rather than the entity purchase. They save taxes because the $80,000 tax basis allocated to F's estate in Example 1 is *wasted* in the entity purchase, but there is *no wasted basis* in Example 2.

2.7(b) In Example 1 S Corp. was 100% insured. (That is, it expects to pay $400,000 to buy out a shareholder and it carries life insurance with a face value of $400,000 on each shareholder.) **The lower the portion of the purchase price that S Corp. insures, the greater the relative benefit of the cross purchase.** This is because the less insurance S Corp. carries, the less basis the shareholders receive when S Corp. receives the insurance proceeds, so the greater the shareholder's tax on an eventual sale of the company.

2.7(c) The difference between cross-purchase and entity purchase is even more dramatic for C corporations:

- o The shareholders do not get any basis increase when the C corporation receives the policy proceeds.

- o The C corporation is subject to alternative minimum tax on its receipt of the life insurance proceeds (and on increases in the cash value of the policy over the cumulative premiums paid). Neither S corporations nor individuals are subject to the adjustment that triggers this tax.

2.8 The above results are the same whether the policy is term or permanent life insurance.

3. **EXAMPLE 3: GIFT OF SHARES**

3.1 John's daughter Amelia is an officer of S Corp. After George's death and buy-out, John wants to give to Amelia S Corp. shares representing a 5% interest in S Corp.[13] Alex, Ben and Tom consent to the transfer.

3.2 Amelia will take a tax basis in the shares equal the lower of (a) John's basis or (b) the value of the shares on the date of the gift.

3.3 If George's shares had been acquired by S Corp. in an entity purchase, John would give to Amelia four shares (5% x 80 shares

[13] John started with a 20% interest in S Corp., than acquired another 5% interest when George died bring John's interest to 25% before the gift to Amelia.

outstanding) with a total basis of $20,000 ($100,000/20 shares x 4 shares).

3.4 In contrast, if George's shares had been acquired in a cross-purchase, John would give to Amelia five shares (5% x 100 shares outstanding) and John could give to Amelia John's high-basis shares that John acquired from Martha. So Amelia would have a basis of $100,000 in her five shares. John would do this if John expected to hold his original shares until John or his wife Abigail died, resulting in a basis adjustment to fair market value at the date of each death.

3.5 **Observations**:

- The higher basis in *gifted shares* is an incidental benefit of the cross-purchase arrangement.
- Even better: Instead of John buying shares from Martha, John gets the permission of the other shareholders for Amelia to buy the shares directly from Martha. This way, there is no gift made by John (unless he needs to give Amelia the cash to fund the purchase).

4. EXAMPLE 4: TRANSFERRING POLICIES IN THE CROSS-PURCHASE ARRANGEMENT

4.1 As in Example 2, Alex, Ben, George, John and Tom each own a $100,000 policy on each other and S Corp. does not own any life insurance. (In other words, this is a cross-purchase arrangement.) There is $2 million (5 x 4 x $100,000) in coverage.

4.2 George dies at the end of 2008. Alex, Ben, John and Tom each uses the proceeds of his policy on George's life to buy a block of five shares from Martha.

4.3 Alex, Ben, John and Tom each has his original 20-share block with a basis of $20,000 and a new five-share block with a basis of $100,000.

4.4 So far, all the same facts as Example 2.

4.5 The value of S Corp. is still $3 million and the value of each 25-share block is $500,000 (≈ ($3M/4 x (1-25%) x (1-15%)). If one of the four shareholders dies, the purchase price will be spread among the three surviving shareholders, so the purchase price will be $166,667 each ($500,000/3). However, each shareholder still has only $100,000 of life insurance on each other shareholder.

4.6 Martha still has four $100,000 policies: one each on Alex, Ben, John and Tom. Ben, John and Tom each would like to buy $33,333 of coverage on Alex. The insurance company will allow a transfer from Martha to Ben, John and Tom because they have insurable interests in Alex's life under their buy-sell agreement.[14]

4.7 However, if Ben, John and Tom acquire that life insurance coverage from Martha, the "transfer for value" rule will trigger gain on the proceeds when the proceeds are received. So the $33,333 of coverage would yield only $25,000 after a 24% tax.

- The way to avoid this income tax hit is to form a *partnership* (or an LLC taxed as a partnership) among Alex, Ben, George, John and Tom before George dies. The partnership must have a real business, like leasing equipment and/or real property to S Corp., or owning and operating an apartment building.

[14] New policies could be purchased by Alex, Ben, John and Tom, but they might be more expensive than the permanent or guaranteed renewable term that was originally purchased, or one of the shareholders might not be insurable in 2009.

- The advantage of the partnership is that life insurance can be transferred among partners without a "transfer for value" problem.[15]

4.8 Assume for purposes of this example 4 that the partnership is in place before George dies and (b) that Ben, John and Tom each acquires a 1/3 interest in George's policy on Alex. Then Alex Ben, John and Tom buy the policies from Martha at the same time as they buy the S Corp. stock.[16]

4.9 Alex, Ben, John and Tom are still under-insured, because they each now have only $133,333 of coverage for a $166,667 risk.[17]

4.10 **Observations**:

- The problem of transferring policies does not arise in the entity purchase.[18] Whether the additional complexity of transferring policies and establishing a partnership is worthwhile depends on the estimated amount and present value of the benefit anticipated from the cross-purchase arrangement – and the parties' tolerance for complexity.

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15 There is no corresponding exception for transfers among shareholders.

16 The buy-sell agreement can require George's estate to sell its interest in the partnership also, but this is not necessary.

The partnership agreement should allow the partners to compete with the partnership, because if Martha is not bought out, the surviving shareholders might want to form a new partnership to make any new joint investments.

17 The shareholders had $2M of coverage and used $400,000 of it on George's death. Their remaining coverage on the $2M risk is $1.6M and they have 80% coverage.

18 The problem *does* arise when a shareholder walks away from the business.

- The cross-purchase arrangement, by itself, does not fill in the coverage gap left as the shareholders die.

5. EXAMPLE 5: POLICIES HELD IN ESCROW

5.1 Alex, Ben, George, John and Tom decide to use a cross-purchase arrangement and to anticipate the need to transfer policies as shareholders are bought out over time. They create a partnership soon after they acquire their life insurance and sign their buy-sell agreement.

5.2 They also create an escrow at S Corp.'s bank. The bank, as escrow holder, holds one $400,000 policy on each of Alex, Ben, George, John and Tom, providing $2 million ($400,000 x 5) in coverage. Each shareholder owns 25% of the policy on each other shareholder for tax purposes. S Corp. pays the premiums on the policies on behalf of the shareholders and treats the payments as additional compensation to the shareholders (who are also employees).

5.3 George dies in 2008. The bank receives $400,000 into the escrow and pays that amount to Martha for George's 20 shares. The payment is treated as $100,000 paid by each of Alex, Ben, John and Tom.

5.4 The bank now has a $100,000 policy on each of Alex, Ben, John and Tom. Martha is still treated as owning 25% of each policy.

5.5 Each shareholder buys 1/3 of Martha's interest in the policy on each other shareholder.[19] The payments for the policies are made through the escrow.

5.5(a) There is no "transfer for value" problem because the shareholders are all also partners.

5.5(b) As a result of these transfers, Alex, Ben, John and Tom each increases his interest in the bank's $400,000 policy on the other three shareholders by 8.33% to 33.33%.

5.5(c) Consequently, each shareholder has $133,333 of coverage on each other shareholder.

5.6 **Observations**:

5.6(a) Because the value of each shareholder's interest is now $500,000, the buy-out price for each of the three surviving shareholders will be $166,667, so each shareholder is now under-insured by $33,333.

5.6(b) If one of the shareholders have become uninsurable, the shareholders must self-insure that amount. If insurance rates have increased, the shareholders will bear that additional cost.

5.6(c) The escrow arrangement is more convenient than owning and transferring several policies on each shareholder. However, it involves finding an escrow holder and additional documentation when the arrangement is put in

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[19] Ben, John and Tom each buys 1/3 of Martha's interest in the policy on Alex. Alex, John and Tom each buys 1/3 of Martha's interest in the policy on Ben. Alex, Ben and Tom each buys 1/3 of Martha's interest in the policy on John. Alex, Ben and John each buys 1/3 of Martha's interest in the policy on Tom.

place. It does not solve the problem of declining coverage as shareholders are bought out.

6. EXAMPLE 6: THE "MULTI-LIFE" POLICY

6.1 The bank, as escrow holder, acquires one policy with an automatic increase rider ("AIR") for each of the four other shareholders. The policy pays as follows:

- $400,000 when the first shareholder dies;
- $500,000 when the second shareholder dies;
- $666,667 when the third shareholder dies; and
- $1 million when the fourth shareholder dies.

6.2 The proceeds are treated as paid on behalf of the surviving shareholders. Because the surviving shareholders may be treated as acquiring the interest of each decedent in the policy, the partnership is necessary to avoid the "transfer for value" problem.

6.3 **Observations**:

- The multi-life policy solves the problem of declining insurance coverage as shareholders are bought out.
- This type of policy can be used in either an entity-purchase or a cross-purchase arrangement, and with an S or C corporation or a partnership.
- Does the decedent retain incidents of ownership in the policy, thereby retaining it in his estate and paying unnecessary estate tax? See Finnegan, *Low-Cost Buy-Sell Funding With Joint Life First-to-Die*, J. AM. SOC. CLUS & CFCS 42 (July 1992), for arguments against this unfavorable result.

7. EXAMPLE 7: THE "GUARANTEED ANNUAL INCREASE" POLICY

7.1 In all of the above examples, we assumed that the value of S Corp. remained constant. However, the shareholders might be confident that the value of S Corp. will increase over time (for example, as it pays down its debt to buy the company).

7.2 If they are unwilling to over-insure initially and do not want to bear the risk that one or more of them will become uninsurable or that the cost of coverage will increase substantially, they can acquire a policy with an **automatic increase rider** that increases the coverage over time (for example, at 7% per year).

8. EXAMPLE 8: AN INSURED SHAREHOLDER WALKS AWAY FROM THE BUSINESS

8.1 Alex loses his taste for the business and quits in 2008 (before George dies). Ben, George, John and Tome buy Alex's shares for promissory notes, payable over seven years. Alex receives a total of $400,000, resulting in a gain of $380,000 and a total tax of $91,000. Alex uses the installment method to report the gain.

8.1(a) Ben, George, John and Tom's insurance on Alex's life: If the remaining shareholders own permanent insurance on Alex's life, they can transfer it to Alex in partial payment for Alex's shares and Alex can cash it in or keep it, as Alex chooses. If Alex keeps it, Alex should take it as Alex's separate property to come within the "transfer for value" exception for insurance on the life of the person who acquires the policy. If the other shareholders own term insurance on Alex's life, they would let it lapse. If their term insurance on Alex's life has a valuable guaranteed renewal feature, they could sell it to Alex.

8.1(b) Alex's insurance on the lives of Ben, George, John and Tom: Alex sells the policies to them, surrenders the policies for their cash values (if permanent insurance) or (if term insurance) lets the policies lapse. See 4.6 above.

8.2 Alex dies in 2009 with unpaid balances on his promissory notes from Ben, George, John and Tom. Elizabeth, Alex's surviving wife, does not get a basis step-up in the notes because the installment notes generate "income in respect of a decedent." As the notes are paid, Elizabeth will continue to report gain on the 2008 sale of Alex's shares.

OBSERVATIONS ABOUT THE OVERALL PROCESS

- It takes clients time to get comfortable with the many issues involved in their buy-sell agreement.

- A buy-sell agreement that is 80% perfect is often much better for the clients than no buy-sell agreement at all.

- So … Few companies will start with a cross-purchase buy-sell agreement.

- Most will start with an entity-purchase arrangement. The advisor will want to note the possible tax benefits of a cross-purchase arrangement. It is OK to allow clients to walk before they run.

- The second version of the buy-sell agreement, when they purchase more insurance coverage because the business has been a success, is a good time to switch to a cross-purchase arrangement.

- When, as a result of the number of shareholders, the number of policies in a cross-purchase arrangement becomes awkward, it is time to consider escrowed policies.

[End of outline.]

Additional Information

To receive more information from Bill Staley about these issues, please check the box(es) below, provide your address (or business card) and return this page to Bill Staley -- or FAX it to Susan Rognlie at (818) 936-2990.

1. ☐ **Buy-Sell Agreement Checklist**. For those considering adopting or revising a buy-sell agreement.*

2. ☐ "**Buy-Sell Agreements for Owners of Closely-Held Businesses: An Overview**."*

3. ☐ "**Incentive Compensation Arrangements**." A discussion of the alternatives, including the problems with using stock.*

4. ☐ "**Succession Planning: Transferring a Business to the Next Generation**." Case studies.*

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