THOMPSON COBURN LLP

insights

TYPES NOT MAPPED YET September 16, 2019 | TTR not mapped yet | Georgia Loukas Demeros, Sarah J. Chang

Strategies for buy-sell agreements using insurance

A version of this article originally appeared in the September 2019 issue of Thomson Reuters' Estate Planning journal.

Buy-sell agreements are critical when dealing with a closely held business and yet often ignored or given short shrift by business owners. Life insurance is an effective tool that business owners can use to implement the provisions of a buy-sell agreement by providing liquidity at the death of an owner to both his or her business and family. Having a properly drafted buy-sell agreement is key in avoiding conflict and memorializing how life insurance proceeds are to be used at the death of a business owner. The creation of a separate entity to hold life insurance is increasingly being used by practitioners in buy-sell agreement planning to avoid tax traps and other pitfalls.

What is a buy-sell agreement?

In very general terms, a buy-sell agreement (which may be part of a shareholders' agreement, an operating agreement, a partnership agreement, or other agreement) is an agreement among owners of a closely held business that restricts the rights of the owners to transfer their interests in the entity. It also usually gives the other owners and the entity, in some combination, the right (and sometimes the obligation) to purchase the interests of an owner when the owner dies or wishes to make a lifetime transfer of his or her interests. Accordingly, a properly drafted buy-sell agreement can prevent the interests of a deceased business owner from passing to others whom the remaining owners would not want to have interests in the entity, and it can also provide liquidity to the estate of a deceased owner.

The triggering events for a buy-sell agreement can go beyond death and voluntary lifetime transfers. A possible involuntary transfer, such as one that could result from a divorce or bankruptcy, can also trigger purchase rights or obligations. Other events might include the owner's permanent disability or the termination of an owner's employment with the entity.

The buy-sell agreement sets forth how the value of a transferring owner's interests are to be determined. In some situations, the buy-sell agreement simply may provide that an appraisal of the interests will be done at the time in question. In other cases, a valuation formula may be specified. In the latter case, it is especially important that the buy-sell agreement be reviewed periodically to ensure that the formula still generates an appropriate value for interests in the entity.[1]

Using life insurance to fund a buy-sell agreement

A buy-sell agreement does not need a funding mechanism to be valid. The entity and its owners may have sufficient resources to pay for any interests that may be bought pursuant to the terms of the agreement. However, it is very common to fund the obligations to purchase interests upon the owners' deaths with life insurance.[2] The life insurance proceeds are used to purchase the deceased owner's interest, or at least as much of it as can be covered by the insurance. This can ease the financial strain on the entity and the remaining owners.

As discussed immediately below, the use of life insurance can complicate a buy-sell agreement depending on the structure of the agreement. However, those complications can usually be managed, and the benefit of having the life insurance proceeds available to purchase the interests generally outweigh any potential detriments.

Redemption or cross-purchase agreement?

A buy-sell agreement can be structured as a redemption agreement or a cross-purchase agreement by the surviving owners. In some cases, the agreement might be a hybrid of

the two. In addition, an insurance limited liability company, discussed later in this article, can also be used to maximize creditor protection and other tax benefits.

Example. Three individuals, A, B, and C, create a corporation and are the initial sole shareholders. What factors should they consider in structuring their buy-sell agreement?

With a redemption agreement, at the death of an owner, the entity will be the buyer (or at least the primary buyer) of the decedent's interests in the entity. Therefore, the entity will own the life insurance policies insuring the lives of its owners. At an owner's death, the proceeds are paid to the entity, and the entity uses the proceeds to buy the interests of the deceased owner from his or her personal representative. Once the entity buys the shares, the shares are no longer outstanding and the interests of the remaining owners in the entity are increased proportionately. A redemption is simple and provides centralized management to administer the policies and collect the death benefits. Because the policies are owned by the entity, the policies are not subject to reach by the owner's creditors, or includable in his or her estate. In addition, if an owner leaves the business, policies on the remaining owners would not be disrupted the way they would with a cross-purchase agreement.

With a cross-purchase agreement, the surviving business owners (not the entity) purchase (or at least have the first option to purchase) the deceased owner's interest in the entity. The business owners individually own the policies insuring each other's lives. When a business owner dies, the proceeds are paid to those surviving owners who hold one or more policies on the deceased owner, and these surviving owners buy the shares from the deceased owner's personal representative. Any shares the surviving owners buy from the deceased owner will have a basis equal to what the surviving owners paid for the shares. Thus, if these shares are later sold at an amount greater than their basis, the surviving owners will recognize lower capital gains tax than the other shares they hold.

Note that basis in S corporation stock or a partnership interest fluctuates from year to year, based on the entity's operations and distributions. A cross purchase agreement may also avoid lender or creditor restrictions imposed on an entity's cash flow, as sales of ownership interests occur between owners without involving the entity.

The owner(s) of the insurance policies should be the first purchaser (s), i.e., "follow the money." With a redemption agreement, the entity owns and pays for all of the life insurance policies and is also the beneficiary of the policies. In the above example, if A dies, the life insurance proceeds are paid directly to the corporation, which then uses the funds to redeem the shares held by A's personal representative. B and C would not be directly involved in the purchase.

With a cross purchase agreement, A, B, and C own policies on each other, and they each name the others of them as the beneficiaries. So if A dies, B and C would receive the policy proceeds directly and they would individually purchase A's shares from A's personal representative. The corporation would not be involved. Note that the number of policies required under a cross-purchase agreement will be higher than that for a redemption agreement if more than two owners are involved. If there are three owners, six policies will be needed. With four owners, that number jumps to 12.

A hybrid approach is often used where the owners want the flexibility for either the entity or the surviving owners to buy a deceased owner's interest, while requiring those receiving insurance proceeds at the death of an owner to be obligated to purchase the deceased owner's interest. In the example above, if the corporation receives insurance proceeds at A's death, the corporation would first be required to purchase those shares with a value equal to the insurance proceeds received, and any remaining shares could be purchased by the surviving owners or by the corporation. The agreement should always require the owner(s) of the insurance to buy first and then, if there are interests remaining, give the entity, then the other owners, the option to purchase any remaining interests. By giving the entity the first purchase option, it allows the entity to decide at the owner's death whether it is better for the entity or the other owners to purchase the remaining interests and avoids any argument that the entity is discharging the remaining owners' obligation to purchase. Three primary issues are notable with a redemption agreement:

1. If the entity is a C corporation and the corporation wants to distribute any excess life insurance policy proceeds to the remaining shareholders, such distributions could be treated as a taxable dividend to the remaining shareholders.

2. Even though the corporation collects the proceeds, lender or creditor restrictions could preclude the corporation from using the proceeds to buy a deceased shareholder's shares. For instance, the corporation may have loan documents restricting its ability to use the corporation's resources to buy the shares; tort creditors could present similar obstacles. In such circumstances, the other owners could purchase the interest, but the insurance proceeds would not be available to them to do so.

3. Because the corporation owns the policy and will receive the proceeds of the policy, typically the remaining owners will not receive a step-up in basis when an owner dies. This result would be different if the entity is (a) a cash-method S corporation and the redemption is structured properly, or (b) a partnership with special provisions.

On the other hand, a redemption agreement has two primary benefits. First, it is simple and fair. The entity simply buys the deceased owner's interest and the remaining owners do not have to worry about coming up with the money to do so. Second, if an owner leaves the entity, it is relatively easy to administer the policies. This differs from a cross-purchase agreement, which is subject to transfer-for-value issues discussed further below.

The cross-purchase agreement does solve all of the major problems raised by the redemption agreement. When owners purchase a deceased owner's interest, they receive a basis equal to the purchase price for that interest, which can reduce capital gains taxes in the future if the entity is sold. As the entity is not doing the purchasing, any restrictions on the entity as a result of loans would not prevent the remaining owners from using the insurance proceeds to purchase the deceased owner's interest. Cross-purchase agreements also have issues that need to be considered:

1. Estate tax inclusion and creditor claims are potential risks. The policies that an owner owns on the other owners will likely be includable in the owner's estate. If an owner has creditor issues, including a divorce, the policies owned on the lives of the other owners might be subject to those creditors' claims.

2. Cross-purchase agreements also are more complicated to administer than redemption agreements. Besides the multiplicity of policies, the entity needs to make sure that the policy owners (the owners of the business) actually pay the required premiums. As the owners are likely to be of different ages and health, the costs of the various policies are likely to be different, meaning the owners will owe differing amounts each year. The entity may have to gross-up distributions to the owners by different amounts to account for this and to allow the owners to pay for the policies.

3. Cross-purchase agreements for corporations raise the issue of transfer-for-value if a remaining shareholder purchases a policy from a deceased shareholder on the life of a third shareholder. In most cases, receipt of life insurance proceeds is not a taxable event.[3] However, if a life insurance policy is transferred for valuable consideration, the net proceeds of sale are treated as ordinary income when received.[4] So a purchase of a deceased shareholder's interest in a policy on the life of a third shareholder might trigger income tax when that policy pays off. This would result in any proceeds the remaining shareholder later receives in excess of the purchase price plus any premiums he or she has paid since the purchase to be subject to income tax.

Insurance LLCs

Where multiple owners in a business seek the benefits of a cross-purchase agreement but at the same time want to avoid the risks associated with a cross purchase, consideration should be given to forming a separate manager-managed limited liability company ("Insurance LLC") to hold and administer the insurance policies insuring the lives of the business owners. Existing policies held by the owners may be transferred to the Insurance LLC, or new policies can be purchased by the Insurance LLC. Each member of the Insurance LLC is designated as a beneficial owner of the life insurance policies insuring the other members whose ownership interests in the operating entity such member is obligated to purchase at death under the operating entity's buy-sell agreement. The life insurance policies must also name the
Insurance LLC as the beneficiary.

Having the Insurance LLC hold title to all the policies provides centralized management and creditor protection for the policies it holds and avoids estate tax inclusion for its owners, benefits that are not otherwise available when the individual owners hold the policies. It also avoids bad tax results when an owner leaves the business and policy ownership needs to be adjusted. While integrating an Insurance LLC into a buy-sell agreement can add cost and complexity, an Insurance LLC's benefits can often outweigh these costs.

The Insurance LLC's ownership mirrors that of the operating entity, and an independent person or corporate trustee should serve as the manager. Each member of the Insurance LLC must make capital contributions equal to the premiums on the life insurance policy with respect to which that member is designated as the beneficial owner, consistent with the member's purchase obligation under the operating entity's buy-sell agreement. Where a policy has more than one beneficial owner, each member's contribution for policy premiums should be proportionate to the member's overall percentage interest in the operating entity (if the buy-sell provides for a proportionate purchase).

Example. A holds a 35% overall percentage interest in the operating entity, and B holds a 5% overall percentage interest in the operating entity. A and B are the beneficial owners of a policy insuring C's life, with the annual premium being $1,000. A would make an annual contribution of $875 (35% / 40% x $1,000), and B would make a contribution of $125 (5% / 40% x $1,000).

Typically, the operating entity will pay the life insurance premiums on behalf of its owners so as to ensure the premiums are paid. Provisions can be included in the operating entity's buy-sell agreement requiring the entity to make contributions to the Insurance LLC on behalf of its members, and the entity is to treat those contributions as deemed distributions to its owners, who as noted above, are also the owners of the Insurance LLC. A separate capital account is maintained for each policy of which a member is designated as beneficial owner and credited for the contribution made to pay the insurance premium. Assuming the policy held by the Insurance LLC is a term policy, over the course of the year the contribution expires as the policy will lapse without further payments. Each time a new contribution is made by the members to pay the premium, the ownership of the death benefit is reallocated. This accounting is done separately for the policy on each owner. Note that if a policy held by the Insurance LLC is a policy with cash value, the contributions will not expire and will remain reflected in the capital account for that policy. Separate capital account maintenance allows insurance proceeds received by the Insurance LLC to be allocated only to those surviving members who have the obligation to purchase the deceased member's interests in the operating entity.

The members of the Insurance LLC also need to make contributions to fund the Insurance LLC's administrative expenses (such as annual filing and professional fees). A separate operating capital account is maintained for each

member reflecting the member's contributions to fund the annual administrative expenses and the member's allocated administrative expenses.

At a business owner's death, the Insurance LLC's manager collects the insurance proceeds. The manager first uses those proceeds to redeem the deceased member's Insurance LLC interest for fair market value, which is equal to the deceased member's capital account (which at the time of redemption needs to be adjusted for any value in the policies allocated to such deceased member). When all purchase arrangements for the deceased owner's interest in the operating entity have been finalized, the manager then distributes the remaining insurance proceeds to those surviving Insurance LLC members designated as the beneficial owners of the policy(ies), who are also the same business owners required to purchase the deceased owner's interests under the operating entity's buy-sell agreement. These surviving owners immediately use the proceeds to purchase the deceased owner's interest.

Thus, the manager's role is similar to a combination of being a trustee of a life insurance trust (but with less liability) and an escrow agent. In this manner, the parties are assured that the life insurance proceeds will be used for the intended purpose. In addition, the insurance policies insuring the surviving members continue to be owned by the Insurance LLC, which is now owned by the surviving members, and any cross-purchase obligations between them under the operating entity's buy-sell agreement remain intact.

Ltr. Rul. 200747002 approved use of an Insurance LLC. It held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC. However, the IRS requested some modifications be made to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy.

Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation. The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. These additional restrictions should be placed in the operating agreement only if seeking a letter ruling, or when the client is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.
The letter ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment. It also did not address any transfer-for-value issues. Formation of the LLC should not implicate these rules because formation is a nontaxable (substituted basis) transfer; [5] however, the attorney should make sure that the transfer is not a "reportable policy sale" that could permanently contaminate a policy.[6] Also, a member receiving an increased ownership percentage of a policy due to an increased contribution is not a transfer of the policy but rather a tax-free contribution to the LLC.[7]

Taxation of entity-owned life insurance

In addition to income tax issues arising from transfer-for-value situations, when an entity owns life insurance on certain of its owners or employees, the proceeds received from those polices at the deaths of the insureds may also be taxed upon receipt. The proceeds received from any entity-owned life insurance policy issued or materially changed after 8/17/2006 will be taxable unless certain requirements are met.[8] This applies to owners with a 5% or greater interest and highly compensated employees. If an Insurance LLC is used, this would include any person who is at least a 5% owner of the Insurance LLC. This is true regardless of whether the insurance is purchased by the Insurance LLC initially or later transferred to the Insurance LLC.

Notice to and consent of the insured must be obtained on or before the issuance of the policy. The notice and consent requirements are met if, before the issuance of the contract, the insured:

1. Is notified in writing that the entity intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued.

2. Provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment (or the ownership that makes the insured treated as an employee under Section 101(j)).

3. Is informed in writing that the policy owner will be a beneficiary of any proceeds payable upon the insured's death.

The notice can be integrated into a buy-sell agreement or a separate document. The authors suggest incorporating the notice in the buy-sell agreement and using a separate notice and consent for each policy to provide simple proof of compliance with the notice and consent requirement. (Exhibits 1 and 2 provide sample notice and consent forms.) If a separate document, it can be drafted by a third party, such as an attorney, or provided by an insurance agent, but a qualified tax advisor should review any notice prepared by an agent or other third party. The notice must include the policy's maximum face amount. The authors recommend erring in favor of a very high amount in the consent to provide a cushion that includes increased death benefits due to investing the cash value, if any. Sample notices are included at the end of this article. Integrating the notice into the buy-sell agreement can solve the problem of the separate notice and consent not being done timely.[9]

An entity or other employer that owns one or more employer-owned life insurance policies also must file Form 8925 with its federal income tax return annually.

If policies were issued before notice was given and consent obtained, the best option is to get new policies, when possible. If that is not possible, the entity may be able to distribute the policies to the insured owners, who could later transfer the policies back to the entity. As this might be considered a step transaction, another possibility would be for the owners to transfer the policies to an Insurance LLC.

If the entity is a corporation, a distribution of a policy to one or more of its shareholders is a deemed sale of the policy for fair market value at the corporate level, as well as a potentially taxable distribution to the recipient(s). If the entity is taxed as a partnership, relevant capital accounts must reflect the distributed policy's fair market value. While the valuation of insurance policies is outside the scope of this article, note that a term policy's valuation is not necessarily just the unearned policy premium.[10]

Impact of insurance on purchase price

If the buy-sell agreement is structured as a redemption agreement, the parties need to be clear in the agreement how the life insurance proceeds will affect the purchase price. This is important for financial and tax reasons. Many practitioners provide that the purchase price at death is the greater of the insurance proceeds received and the value of the deceased owner's interest. From an estate tax perspective, such a provision may increase the value of the interest in the owner's estate and related estate taxes.

Alternatively, the excess proceeds (that would be reduced by estate taxes if added to the purchase price) could stay with the entity and help replace the business loss caused by the insured's death. If the agreement uses a formula to set the purchase price, the agreement should clearly identify whether the formula includes or excludes the death benefit in determining the price. Also consider the formula's valuation date and whether it should precede the death of the owner.

Cost of life insurance

If insurance is being relied on to fund a buy-sell agreement, the planning might implode due to high mortality expenses as an owner ages. If the cost is not prohibitive, the parties should consider buying permanent life insurance and not term, where costs will be higher early, but much lower in later years. Decisions will also need to be made as to how long the policies should be viable. Is age 90 or 95 adequate? Is age 120 really necessary or just adding cost? Lastly, is there a back-up plan if the insurance expires? Many agreements provide for a payout over time of any portion of the purchase price not covered by insurance. A provision such as that should be considered in any agreement that is drafted.

Insurance premiums paid by an entity in connection with a buy-sell agreement are not deductible by the entity.[11] This, in essence, adds to the cost of the insurance and should be considered when structuring the agreement.

Conclusion

The death of an owner of a closely held business is a difficult time for both the business and the decedent's family. Proper planning in advance of an owner's death with a buy-sell agreement and insurance, will help provide a smooth transition of the entity to its surviving owners, and at the same time provide liquidity to a deceased owner's family when they may need it most.

Georgia Loukas Demeros serves as an estate planning advisor and personal general counsel to closely-held businesses, business leaders, and other individuals.

Sarah J. Chang counsels individuals, families, and business owners in developing comprehensive estate plans through the use of wills, trusts, powers of attorney, and gifting strategies.

1. Under Reg.20.2031-2(h) or Section 2703, a price set in a buy-sell agreement may not be binding on the IRS for federal estate tax purposes. Thus, a deceased owner's estate will be bound under the agreement to sell its interest in the entity at the agreement price but may have to report a higher value for federal estate tax purposes and therefore pay estate tax on this phantom extra value. As a practical matter, the parties need to be able to prove that the agreement was intended to provide a fair price in every event (which may require updating from time to time) and not game the estate tax system. A detailed discussion of the actual requirements of Reg. 20.2031-2(h) and Section 2703 is beyond the scope of this article. ↩
2. If permanent disability is also a trigger event, that too could be funded with (disability) insurance. ↩
3. Section 101(a)(1). ↩
4. Section 101(a)(2). Exceptions for certain transfers include a substituted basis transfer or a transfer to the insured, a partner of the insured, a partnership of which the insured is a partner, or a corporation of which the insured is an officer or shareholder. These exceptions do not apply if the policy has ever been subject to a "reportable policy sale." ↩
5. Sections 101(a)(2)(a) and 721(a). ↩

6. Section 101(a)(3). ↩

7. Section 721(a). ↩

8. Section 101(j). ↩

9. Ltr. Rul. 201217017. ↩

10. Rev. Proc 2005-25, 2005-1 CB 962, applies generally in valuing life insurance contracts for income tax purposes. ↩

11. Section 264(a)(1). ↩

authorsTest

georgia

Georgia Loukas Demeros

sarah

Sarah J. Chang