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Buy–Sell Agreements and Life Insurance—A Primer

By Brian T. Whitlock

A well-crafted Buy–Sell agreement is a prerequisite for all closely held businesses that have two or more owners. Regardless of how an entity is organized and operated, whether it is a general partnership, a limited partnership, a limited liability company, a C Corporation, or a Subchapter S Corporation, the owners should have a means of providing for an orderly succession of ownership in the event of death, disability, divorce, bankruptcy, or termination of employment. The agreement can prohibit transfers to competitors, and limit transfers to certain permitted transferees. The agreement should create a market for an otherwise non-marketable equity interest by setting a transfer price, terms of payment, and a method of transfer. A properly structured agreement can also mitigate disputes between the owners by defining when distributions of income must be made in order to cover income tax obligations, and it can avoid power plays designed to squeeze out minority holders of equity, and by creating a framework for arbitrating disputes between owners.

Many Buy–Sell agreements are funded, in whole or in part, with life insurance on the lives of the equity owners. Some agreements are also funded with disability insurance, or life insurance policies that allow the policyholders to access the cash values growing within the policy during the lifetime of a disabled owner. These agreements help fund a buy out that might be triggered by a disability.

The goal of this column is to provide a general overview of Buy–Sell agreements and some of the issues that may be encountered, especially when the agreements use life insurance as a means of financing the purchase.

The Form of the Agreement

Limited liability companies and limited partnerships generally have a partnership agreement or operating agreement, which is in addition to the state form that is filed in a state agency, in each state in which they are organized or operated. That formal agreement is signed by all of the equity owners. The partnership agreement (in the case of a limited partnership) or operating agreement (in the case of a limited liability company) almost always contains language that restricts the transferability of the equity interests and at the same time provides a framework for the Buy–Sell arrangement.

General partnerships do not require the filing of a formal document with any state agency in order to come into existence. As a result, an additional agreement may be necessary in order to establish a Buy–Sell agreement.

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Corporations are generally created *via* the filing of Articles of Incorporation with some state agency (typically the Secretary of State). In addition to the Articles of Incorporation, all corporations will have By-Laws that explain the governance of the corporation. Neither of these documents will address the transferability of the shareholders' equity, unless the corporation is created under a state statute commonly referred to as a "Close Corporation Act." As a result, an additional agreement will be necessary in order to establish a Buy–Sell agreement.

Entity Purchase Agreements

An Equity Purchase Agreement is a contract among the owners of the business entity to have the business directly purchase the equity interest. An equity purchase by the entity is frequently referred to as a "redemption." In a redemption, the equity interest of the departing owner is transferred to the entity, and the equity interests held by the remaining owners thereby increase proportionately.[1]

If the parties intend to use life insurance as part of the financing, then the entity will generally own an insurance policy on each of the owners, and the entity will pay the premiums. Typically, the agreement requires the benefits under the policy to be paid to the departing owner, with any shortfall payable with an installment note.

Cross Purchase Agreements

A Cross Purchase Agreement is a contract among the owners of the business entity that calls for the remaining owners to directly purchase the equity interest of the departing owner.

If the parties intend to use insurance as part of the financing, then each owner may need to own an insurance policy on the lives of each of the other owners. Each owner will be personally responsible for the payment of the policy's premiums, generally with the owner's after-tax income. Where significant age differences exist among the various owners, the premiums on the lives of older owners will likely be more expensive.

Hybrid Agreements

A Hybrid Agreement contains combinations of both the Cross Purchase and Entity Agreements. In a Hybrid Agreement, the remaining individual owners may be given an option to purchase a proportionate share of the departing shareholder's equity. If the individuals do not elect to purchase all of the departing shareholder's equity, then the entity will either have a secondary option or it may be required to redeem the balance.

Income Tax and Basis Considerations

The sale of the departing owner's equity in each of the three types of agreements will be a capital transaction. If the sale is consummated during the lifetime of the departing owner, then the gain or loss will be measured on the difference between the price paid and the owner's adjusted basis. The gain or loss will be long term or short term depending upon whether the owner held the equity interest for more or less than one year. If the sale is consummated after death, then first the basis of the deceased owner's equity will be increased to fair market value under Code Sec. 1014, and the gain or loss will always be deemed to be long term, since the lifetime holding period is ignored for capital assets held at death.[2]

The form of the agreement that the Buy–Sell utilizes will have a significant impact on the income tax basis of the buyer. If the departing owner's equity is purchased by the entity under either an Entity Purchase Agreement or a Hybrid Agreement consummated by the entity, then the income tax basis of the remaining shareholders will not change if the entity is taxed like a corporation under either Subchapter C or Subchapter S. If the entity is taxed like a partnership, then the entity may elect under Code Sec. 754 to increase the basis of the assets held by the entity and thus provide a tax benefit to the remaining shareholders. The higher basis could result in greater depreciation deductions, and it could reduce any long-term capital gains of the remaining equity owners who subsequently sell their interests during their lifetimes.

If the departing owner's equity is purchased directly by the remaining owners, then the basis of the remaining owners' equity interests will increase by the amount of the purchase price paid directly by that buyer.

Life Insurance as a Funding Vehicle

The payment of premiums on life insurance policies are not deductible, even though there may be a business purpose underlying the expense.[3] The receipt of life insurance death benefits is generally income tax free.[4]

Funding Cross Purchase Agreements with life insurance policies is fairly simple when there are only two equity holders. Each equity owner acquires a single life insurance policy on the life of the other equity owner. However, when there are more than two equity owners, the funding of Cross Purchase Agreements can be cumbersome. For example, A, B, C, and D each own 25% of Acme. If the owners use a Cross Purchase Agreement and try to fund it with life insurance, A could need to own three insurance policies (one on each of B, C, and D). Similarly, B could

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need to own three insurance policies (one on each of A, C, and D), and so on. An insurance salesperson's dream and business owners' nightmares.

Equity Purchase Agreements are the easier "Buy–Sell" solution where there are more than two shareholders, and the primary funding mechanism is life insurance. In an Equity Purchase scenario, the entity will only need to purchase a single life insurance policy on the life of each equity owner. However, there are traps for the unwary when the business entity is the owner of the life insurance policies.

Entity Owned Life Insurance Traps

Where the entity owns life insurance on the life of any employee, Code Sec. 101(j) will only permit the benefits to be received by the company tax-free when the employee has received advance notice of the existence of the policy and has signed a Notice and Consent (Internal Revenue Service (IRS) Form 8925).[5]

If the entity is a corporation taxed under Subchapter S of the Internal Revenue Code, the life insurance proceeds represent non-taxable book income. As non-taxable income, the proceeds do not increase the corporation's Accumulated Adjustment Account (AAA), but rather they become part of the S Corporation "Other Adjustments Account" (OAA). This classification is important in as much as it impacts the ordering of any distribution of earnings from the S Corporation. The equity of S Corporation falls into four classes; from the bottom up the classes of equity are: Paid in Capital (or Capital for short), OAA, Accumulated Earnings and Profits (AE&P), and AAA.[6] Distributions that come out of AAA or OAA are tax-free to the shareholders (provided that they have basis in the amount distributed). However, S Corporation distributions reduce each class of shareholder's equity in order from the top down: AAA, AE&P, OAA, and finally Capital. Before the shareholder can access the tax-free death benefit of a life insurance policy paid to the corporation from OAA, it must first distribute all of the AAA and AE&P first. AE&P represents the earnings of the corporation that were accumulated during any period that the corporation may have operated under Subchapter C of the Internal Revenue Code. The receipt of AE&P represents a taxable dividend to the shareholders.

Code Sec. 2042 can represent a second trap. Code Sec. 2042 can force the inclusions of life insurance benefits into one's estate, if the decedent has "incidents of ownership in the policy, exercisable either alone or in conjunction with any other person."[7] Where an equity owner holds more than 50 percent of the equity of a business that holds a life insurance policy on the life of the same shareholder, the proceeds of that policy that are payable directly to a family member and not the entity will be includable in the Gross Estate of the equity owner under Reg. §20.2042-1(c)(6). The regulation exempts the portion of the death benefits that are payable to the entity,[8] for the simple policy reason that the decedent's equity share of the entity will be included in their Gross Estate for estate tax purposes.[9]

The final question that arises in connection with entity owned life insurance is whether the death benefit payable to the entity for the purpose of servicing the Buy–Sell agreement increases the value of the entity as a whole under Code Sec. 2031. The Eleventh Circuit Court of Appeals addressed this issue in *Estate of Blount* back in 2005.[10] Despite holding that the Buy–Sell agreement did not validly fix the value of the equity interest,[11] the Court nonetheless held that the insurance proceeds were not the type of a non-operating asset[12] that would add to the fair market value of the business. Instead, the Court held that the insurance proceeds were a dollar for dollar offset for the entity's enforceable contractual obligation to redeem the equity interest and thus should not be included in the fair market valuation of the entity. This same issue was revisited recently in *Connelly v. US*[13] to an opposite conclusion. Similar to the Appellate Court decision in *Blount*, the 2021 US District Court decision determined that the Buy–Sell agreement at issue failed to validly fix the value of the equity interest. However, the District Court in Connelly rejected the Eleventh Circuit reasoning that the agreement nevertheless created an enforceable contractual obligation to redeem the equity and thus offset the value of the insurance. If this reasoning is upheld on appeal, it could hinder the future of Equity Purchase Agreements being funded with insurance.

Alternatives for Holding Buy–Sell Life Insurance

Rather than list the entity as the owner of the insurance, planners have always used alternative vehicles for holding the life insurance.

The Trusteed Buy–Sell Agreement

Some planners create a trust to hold each of the life insurance policies on the owners. The trust accomplishes the goal of protecting the cash value of the policies by maintaining them outside of the entity and free from the creditors of the business and the owners, but it exposes the insurance to new risks. First, the trust may not have a business purpose that is recognized by the IRS.[14] Second, it may be difficult to transfer existing policies either into or out of a trust. Code Sec. 101(a)(2) imposes an income tax on the death benefit that results from life insurance

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policies that are transferred in exchange for valuable consideration. The contribution of existing policies to a single trust represent a transfer of the cash value associated with each of those policies. Where there is a difference in cash values among the policies at the time of transfer and future premiums are paid by cash contributions by the various owners, then in the view of the IRS there has been a transfer of the underlying policy value to the trust and the other beneficiaries. Code Sec. 101(a)(2)(B) creates exceptions to the "Transfer for Value" rules where the policy is transferred to (a) the insured; (b) a partner of the insured; (c) a partnership in which the insured is a partner; or (d) a corporation in which the insured is an officer or a shareholder. Trusts and beneficiaries of trusts are not among the lists of exempted transfers. Similarly, after the death of the first shareholder, if the policies of the surviving owners are purchased from the trust or distributed *pro rata* to the remaining owners, a second, non-exempt transfer for value may have occurred. Third, trusteed Buy–Sell agreements must be careful to avoid Code Sec. 2042, incidents of control over the policies where the agreement may be amended or revised. Finally, there may be gift tax implications when there is a substantial disparity in the premium amounts paid for each of the different owners.

The Escrowed Buy–Sell Agreement

Similar to the trust, a formal escrow agreement allows for the centralized ownership of policies on multiple owners. The escrow is ideal when the parties are apprehensive about the performance (or lack thereof) of the parties, after death. The escrow becomes the means by which the parties are reassured that someone does not get "cold feet" after the event has occurred that under the terms of the Buy–Sell Agreement mandates that the transfers occur.

Frequently, while everyone is alive and healthy, each of the equity owners will deposit not only the physical life insurance policies that they own but also the physical stock certificates (in the case of corporations) or member certificates (in the case of limited liability companies (LLCs)) representing the equity owned with the escrow agent. The difference between the escrow and a trust is that legal ownership of the policies and the equity remain with the depositors. The escrow agreement contains the instructions to the escrow agent. While the parties are alive, the escrow agent will verify that the premiums on the policies are being timely paid. In addition, after a death the instructions will direct the agent to collect the death benefits, distribute the payment (cash and installment notes) to the family of the deceased owner, and distribute the stock or member certificates to the remaining owners.

Insurance-Only Partnerships and Special Purpose LLCs

The current popular alternative to using an escrow is the use of a partnership or a LLC for the sole purpose of acquiring, holding, and managing the insurance during the lives of the owners and collecting and transferring the death benefits after death. The insurance-only partnership or LLC operates as a brother–sister entity with similar owners to each of the operating businesses covered under the Buy–Sell Agreement.

Similar to a trust, the LLC can offer a certain level of asset protection for the cash values of the insurance policies, against charging orders, that the general partnership and escrow cannot provide. The special purpose partnership or LLC can be more flexible than a trust, in so much as it can receive and account for the capital contributions of each of the partners/members; it can allow for special allocations that address how premiums are paid and the disparities in the amounts of premiums on owners of differing ages or with underlying health issues; and it can compensate each of the partners for any inequities that might occur during the funding of the insurance. Under Code Sec. 704(a), the partnership/LLC agreement can specifically allocate the death benefit to the capital accounts of the survivors, and thus avoid inclusion under either Code Sec. 2031, and *Connelly*, or Code Sec. 2042.

Under the separate partnership/LLC method for funding Buy–Sell Agreements, each of the partners/members personally contributes after-tax to their respective capital accounts. In this way, their capital contributions directly increase their basis. Pre-death buy-outs could be based upon each partner's capital account. Post-death, the death benefit is collected, the partnership/LLC redeems the interest of the separate partnership/LLC, and then the separate partnership/LLC distributes the remaining proceeds to the remaining partners/members. Finally, the remaining partners/members use their share of the proceeds to effectuate their purchase of the deceased owner's equity under the Cross Purchase Agreement covering the operating business or if they can lend their share of the proceeds to the operating business and permit the business to redeem the equity of the deceased owner under the terms of the Stock Purchase Agreement or the Hybrid Agreement. Even though the redemption does not impact the basis of the remaining equity owners, the loans that are made to the entity to provide the cash necessary to fund the redemption effectively increase each of the buyers' basis in the operating business.

The disadvantages of using the separate partnership/LLC structure are: (a) the insurance partnership/LLC must file an annual Partnership income tax return (IRS Form 1065); (b) it involves multiple sets of books, in order to track the

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capital accounts; and (c) it involves the creation of multiple Buy–Sell and operating agreements.

Summary

A well-crafted Buy–Sell agreement should be created for all businesses with two or more equity owners. When the owners are unrelated, the agreement is critical in making sure that there are restrictions on transferability and establishing a market for the future transfer of the owner's interest. When the equity owners are related, additional caution must be exercised in crafting a *bona fide* business arrangement that will satisfy Code Sec. 2703 and not cause the death benefits to be included in the Gross Estate of a deceased family member for estate tax purposes. In either case, when the agreements are funded in part with life insurance special care and coordination is necessary.

ENDNOTES

[1] For example, A, B, and C are all equal 1/3 owners of Acme. If Acme redeems the interest of A, then B and C indirectly increase their percentage ownership and each own 1/2 of the outstanding equity.

[2] Code Sec. 1223(9).

[3] Code Sec. 246(a)(1).

[4] Code Sec. 101(a)(1).

[5] Code Sec. 101(j) was added the Internal Revenue Code in recognition of the fact that insurance companies generally limit the amount of insurance that can be issued by all carriers on the life of any one person. An individual's insurability limit is based upon their net worth and the amount of income that they generate annually. If an entity exhausts the employee's insurability limit, without the employee's permission, then individual employees may not be able to personally purchase enough insurance protection for their family.

[6] Code Sec. 1368.

[7] LTR 9349002 (August 25, 1993).

[8] Reg. §20.2042-1(c)(6) provides that, if the death benefits of a life insurance policy are payable to the entity, then the policy would not be includable in the Gross Estate of the decedent under Code Sec. 2042.

[9] As a result, the agreement should not be structured to require the death benefit to be paid directly to the family of the deceased owner. The proceeds should be paid to the entity, which can then pay them to the family in exchange for the deceased owner's equity. There is a similar rule for partnerships (including limited liability companies that are taxed as partnerships). Rev. Rul. 83-147, 1983-2 CB 158, LTR 200214028.

[10] *Estate of Blount*, CA-11, 2005-2 USTC ¶60,509, 428 F3d 1338 (2005).

[11] In order for a Buy–Sell agreement to validly fix the value of an equity interest among family members, it must be a *bona fide* business arrangement and satisfy Code Sec. 2703 and case law. The agreement must: (i) not be a device to transfer property family members for less than full and adequate consideration, (ii) contain terms that are comparable to similar arrangements entered into by persons in arm's-length transactions, (iii) contain a purchase price that is fixed and determinable, (iv) be legally binding both during life and after death, and (v) not be a substitute for a testamentary disposition.

[12] Reg. §20.2031-2(f)(2) generally requires the value of non-operating assets to be added to and thus increase the value of the business held within the same entity.

[13] *Connelly*, DC-MI, 2021-2 USTC ¶60,729 (2021).

[14] LTR 9349002 (August 25, 1993).

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