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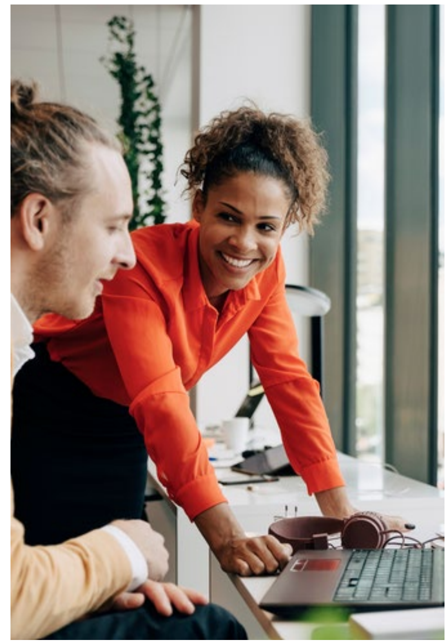
Four common mistakes to avoid in buy-sell agreement funded with life insurance



You know about Redemption (or Entity) buy-sell agreements, Cross Purchase agreements and "Wait-and-See" agreements. Yet sometimes in our zest to help clients decide upon the best arrangement, we sometimes forget some of the basics in business continuity planning. The intent of this article is to address four basic planning issues to remember when working with clients on their business exit strategy.

C Corporations - Recommending a Stock Redemption Plan

A stock redemption buy-sell plan is a contract between the corporation and the shareholders. The agreement obligates the corporation to purchase from the estate of a deceased shareholder, or from a disabled or departing shareholder, his or her interest at the agreed upon price in the agreement. If life insurance is used to fund the agreement at a shareholder's death, the corporation is the owner, premium payor and beneficiary of the policy.

While redemption plans do have the advantage of requiring only one policy per business owner, unlike a cross purchase arrangement, the remaining shareholders do not receive an increase in cost basis upon the corporation purchasing a deceased or departing shareholder's interest. This is because the remaining shareholders are not a party to the agreement. This can result in negative tax consequences if the business is later sold or liquidated.

There may be other tax consequences as well. For example, corporate owned life insurance policies are subject to the claims of corporate creditors (unlike personally owned life insurance which may be afforded a level of creditor protection based upon state law). In addition, the transfer-for-value rule may rear its ugly head (more on this in a moment) if the corporation decides to change the redemption arrangement to a cross purchase arrangement and transfers the policies to the shareholders. This may result in the death benefit, less the consideration paid for the policy, being subject to income taxes. Finally, in family owned businesses, the family "attribution" rules may apply causing the redemption to be treated as a dividend and not as a capital transaction resulting in unintended, adverse tax consequences.

The family attribution rules deem certain shares owned by other family members to be constructively owned by the seller.

So, if you have clients operating their business as a C corporation, it is important that they fully understand all of the implications a redemption plan can present.

S Corporations - *Not* Recommending a Redemption Plan

Does that mean a redemption plan for an S corporation should be avoided? Not necessarily. Some of the issues seen with C corporations, such as potential business creditors' claims and transfer-for-value concerns still exist, but surviving shareholders in an S corporation can receive an increase in cost basis when the corporation redeems a deceased shareholder's interest if the funds for the redemption come from life insurance proceeds. This is a result of the way tax-free life insurance benefits are accounted for in a pass-through entity such as an S corporation. It also involves an accounting procedure commonly referred to as "closing out the tax year" or a "short year election" pursuant to IRC Section 1377(a)(2). Assuming the S corporation is a cash basis taxpayer (of which the majority are), the surviving shareholders can receive a basis step-up if the corporate tax year is terminated shortly after the death of a shareholder, *but before receipt of the tax-free life insurance proceeds are paid to the corporation.* This allows the full amount of the proceeds to increase the basis of the surviving shareholders' interests.

So, by having a redemption plan in an S corporation, you can still minimize the number of policies needed to fund the agreement, but also enjoy some of the tax advantages associated with traditional cross purchase agreements. Note, however, that for a life time buy-out, and for an "at death" buy-out *not* funded by life insurance, a stock redemption will not result in an increase in basis for the remaining shareholders. That is identical to the treatment in C corporations.

Funding Formula - Failing to Monitor Buy-Sell Arrangements and Insurance Funding

There are a multitude of issues that must be addressed in a well drafted buy-sell agreement, but one of the most important is the method chosen to determine the value of a departing owner's interest. Many different valuation methods exist. It can be as simple as setting forth a fixed value in the agreement or more sophisticated techniques like capitalized or discounted future earnings formulas. What is important to remember is that the IRS will focus on the technique that is most appropriate based upon the type of business involved when determining the value of an interest for estate tax purposes. The IRS will be especially vigilant when close family members are involved. This underscores the importance of closely monitoring the manner of valuation used to ensure that a major discrepancy does not exist between the value proposed by the IRS, and the amount set forth in the agreement. This also impacts the amount of life and disability buy-out insurance protection needed to fund the buy-sell agreement. Accordingly, buy-sell arrangements, as well as the insurance used to fund those arrangements, must be reviewed on a regular basis to ensure that there is sufficient funding to complete a buy-out.

Transfer-for-Value Rule - Forgetting Its Application

Generally, life insurance proceeds are not subject to income taxation, unless the policy itself (or an interest in the policy) is transferred for valuable consideration. Violation of the rule would cause the death benefit, minus whatever consideration was given in return for the policy (or interest in the policy), to be subject to income taxes.

Where the transfer-for-value problems are typically seen is with a stock redemption plan. For example, it is not uncommon for shareholders to want to change their redemption plan to a cross purchase arrangement at the death or departure of a shareholder. Generally, they would like to use the same corporate owned policies to fund the agreement. However, this seemingly innocuous transaction will invoke the transfer-for-value rule.

It is not an exception to the rule to transfer a policy from a corporation to a *co-shareholder* of an insured shareholder. If the shareholders have a partnership or a limited liability company taxed as a partnership, a transfer to a co-partner (or member) would be an exception and prevent the proceeds from being subject to income taxes.

Conclusion

Finally, don't forget the application of the employer owned life insurance rules set forth in IRC Section 101(j) when helping clients with their business continuation concerns. The rule basically states that in certain situations, an employer must provide written notice to an employee that life insurance will be taken out on that employee's life. The employee must also provide written consent of that application. There are other requirements as well. (The word "employee" here is defined broadly: it could be a shareholder, partner, or member of an LLC, even if he or she doesn't work as a "W-2 employee"). Therefore, redemption agreements, entity buy-sell arrangements, and even some cross purchase agreements, may require meeting the strict requirements of the employer owned life insurance rules. Failure to comply may result in the taxation of the life insurance proceeds.

There are many moving parts when planning for the disposition of a business interest. While things can get technical pretty fast, having an understanding of the basics will go a long way when planning for business owners.

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