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BUSINESS SOLUTIONS

Buy-Sell Agreements Using Life Insurance

Life Insurance

Prudential

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A Guide to Buy-Sell Agreements Using Life Insurance

Buy-Sell Agreements Using Life Insurance

What Is a Business Continuation Strategy?

In a larger sense, the business continuation strategy begins with the inception of the business and continues throughout the business life cycle. It involves building the business, increasing its value, and transitioning the business to new owners at the retirement, death, or disability of its founders.

The different stages of a business offer financial professionals a myriad of opportunities to work with a business owner over a span of years. A business in the infant stages is dependent on its founder and often needs the protection provided by key person life insurance. As the business grows and management staff is added, what better way is there to create and build business value than through executive benefit plans? Finally, as the owner ages and the transition stage begins, there is a great need for retirement, estate, and exit strategies.

It's important to remember that business continuation is much more than just a formal Buy-Sell Agreement. It is an ongoing process that starts years before the transfer event. The Buy-Sell Agreement is only one part of the business continuation process.

Why Is a Buy-Sell Agreement Needed?

For many business owners, the business is the major source of family income, a personal investment vehicle, and a significant portion of the owner's estate. Without a proper strategy in place for the owners, financial hardships can result for the remaining owners as well as for the family of a disabled or deceased owner. A properly structured Buy-Sell Agreement is one of the most powerful tools for managing the transition of a company's ownership. It allows the business owner(s) to design and structure the business before a transition event to ensure business continuity for the surviving owners and financial security for the departing/deceased/disabled owner and their family and heirs.

A properly structured Buy-Sell Agreement can:

- Create a market for a departing owner's stock.
- Help maintain ownership control within the desired channels.
- Establish a fair price or valuation method in advance of a triggering event.
- Possibly set the value of the business interest for purposes of federal estate tax.
- Reduce the chance of valuation disputes with the Internal Revenue Service.*
- Contain directives that help avoid conflicts among family members.
- Provide needed liquidity to handle estate expenses.
- Preserve the business' tax status.
- Improve the credit risk of the business.

*Please consult your own tax or legal advisor.

BUY-SELL AGREEMENTS

The Buy-Sell Agreement is structured as a legal contract that addresses issues such as:

- Which events will trigger a sale.
- Who has the right or obligation to purchase a business interest.
- How the purchase price will be determined.
- How payments will be made.
- How the buyout will be funded (perhaps most important).

Funding the Buy-Sell Agreement

A Buy-Sell Agreement creates a contractual obligation to purchase a departing/deceased/disabled owner's business interest. To be effective, funds need to be available to make the prescribed purchase.

Basically, there are four ways to fund a Buy-Sell Agreement: from cash flow, through the use of a sinking fund, borrowing the money, and with insurance proceeds.

Cash Flow

The business owner who believes that the business can generate enough dollars to fund the Buy-Sell Agreement is taking a risk. Economic downturns or other market conditions beyond the owner's control may reduce cash flow and make it difficult, or impossible, for the business to support the buyout. A business faces the crisis of losing a leader when a business owner dies. How will this affect future cash flow? At the owner's retirement, can the business generate enough cash flow to support new management salaries as well as pay the departing owner?

Sinking Fund

Preparing for a future event is not a bad idea. However, death, disability, or an owner's withdrawal can occur without notice and sooner than expected. Where will the funds come from? Premature death or unexpected disability can wreak financial havoc if the funds put aside fail to match the need.

Borrowing

The loss of a key player may impair the creditworthiness of both the business and the remaining owners. Banks and loan institutions may be reluctant to lend money to the business or the remaining owners. In addition, interest costs may be excessive. For these reasons, borrowing the funds may be impractical and expensive.

Life Insurance

A Buy-Sell Agreement funded with life insurance is often the most economical and practical solution, especially when the business owner plans to "die with their boots on." Life insurance provides a specific payout at death, regardless of when death occurs. When cash-value life insurance is used, the policy may serve double duty, providing both an income tax-free death benefit and potential cash value accumulation on an income tax-deferred basis.[1]

Life insurance can be a cost-effective method of prepaying the purchase price of a business because premium costs are usually lower than the death proceeds, and the death proceeds are generally received income tax-free under IRC §101(a). However, it should be noted that, for employer-owned contracts issued after August 17, 2006, the death proceeds in excess of the cost basis are subject to income tax, except where employee notice and consent requirements are met and certain exceptions apply.[2] In addition, businesses must fulfill annual information reporting requirements.

The starting point to understanding when the death proceeds are subject to income taxes is to recognize what the Pension Protection Act, which added IRC §101(j), calls an employer-owned contract. An employer-owned contract is defined as a life insurance contract:

- That is owned by a person engaged in a trade or business (applicable policyholder, as defined by the law).
- Under which such person, or related person (as defined by the law), is directly or indirectly a beneficiary.
- That covers an insured who is an employee of the trade or business of the applicable policyholder on the date the contract is issued.

Clearly, this definition includes policies where a business is the owner and beneficiary, such as policies funding a stock redemption or entity purchase Buy-Sell Agreement. What is not so obvious is that, under the applicable policyholder and related party definitions, the legislation expands its reach to a broad group of individuals and entities and, consequently, may apply to cross-purchase and trusteed Buy-Sell Agreements.

Congress apparently was aware that this broad definition could negatively impact many valid business uses, so IRC §101(j) includes a number of exceptions. However, the exceptions apply only where the employee receives notice of, and consents to, the following in writing prior to policy issue:

- The applicable policyholder intends to insure the employee's life and specifies the maximum face amount for which the employee will be insured at time of issue.
- The employee consents to being insured and agrees that such coverage may continue after they terminate employment.
- The applicable policyholder will be the beneficiary of the death proceeds paid.

Meeting the notice and consent requirements is a critical first step to death benefits.

However, notice and consent are not the only requirement. Employer-owned contracts must also fall within one of the following exceptions:

Insured's status. This exception provides that the income taxation rule will not apply to employer-owned contracts provided the insured was either:

- An employee at any time during the 12-month period prior to death, or
- A director, a highly compensated employee,[3] or a highly compensated individual[4] at the time the contract was issued.

[1] Based on sufficient death benefit and/or cash value availability. Loans and withdrawals may reduce policy cash values and death benefits, may affect any policy guarantees against lapse, and may have tax consequences.

[2] IRC §101(j). To assist business owners, Prudential Financial has developed a sample notice and consent. See: *Attention Employers: Employer-Owned Life Insurance Rules Have Changed.*

[3] *Highly compensated employees* include employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year ($150,000/$155,000 if the look-back year is 2023/2024, indexed for inflation in future years and, if you so choose, was in the top 20% of employees when ranked by compensation).

[4] *Highly compensated individuals* include the five highest-paid officers or individuals who are among the highest-paid 35% of all employees.

Who receives the death proceeds. This exception states that the income taxation rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured.
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured.
- To a trust established for the benefit of a family member or designated beneficiary.
- To the estate of the insured.
- Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

Mandated annual reporting of employer-owned contracts for each year the contracts are owned. The following information must be reported on Form 8925, "Report of Employer-Owned Life Insurance Contracts," which should then be attached to the business' federal income tax return:

- The number of employees at the end of the year.
- The number of employees insured under such contracts.
- The total amount of insurance in force under such contracts.
- The name, address, and taxpayer identification number of the applicable policyholder as well as the type of business.
- An attestation that valid consent has been obtained from each insured, or where all consents have not been obtained, the number of insured for whom such consent was not obtained.

In light of these reporting rules, it is extremely important that a business maintains documentation that proves it has met the notice and consent requirements in a timely manner.

Disability Insurance

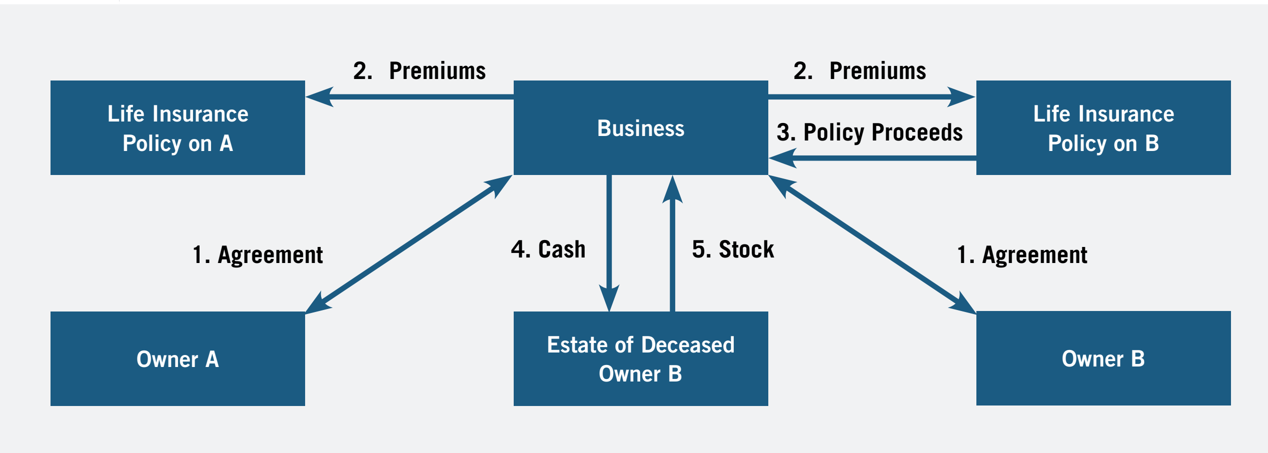
Although life insurance is frequently used to provide funds at death to complete the obligations created in a Buy-Sell Agreement, disability provisions are often neglected. Disability buy-out policies are available to many types of businesses and can help reduce the need to fund the entire purchase out of cash flow.

Common Forms of Buy-Sell Agreements

In its simplest form, a Buy-Sell Agreement is generally structured in one of the following ways:

Entity Purchase Agreement/Stock Redemption Agreement. Under this purchase format, the Buy-Sell Agreement is between the business and the owners. Following the terms of the agreement, the business promises to buy back the ownership interest of the departing, disabled, or deceased owner. The business bears the cost of financing the agreement. When the Buy-Sell Agreement is funded with life insurance, the business is the owner, beneficiary, and premium payer on the lives of its owners.

STRUCTURE OF AN ENTITY PURCHASE/STOCK REDEMPTION AGREEMENT



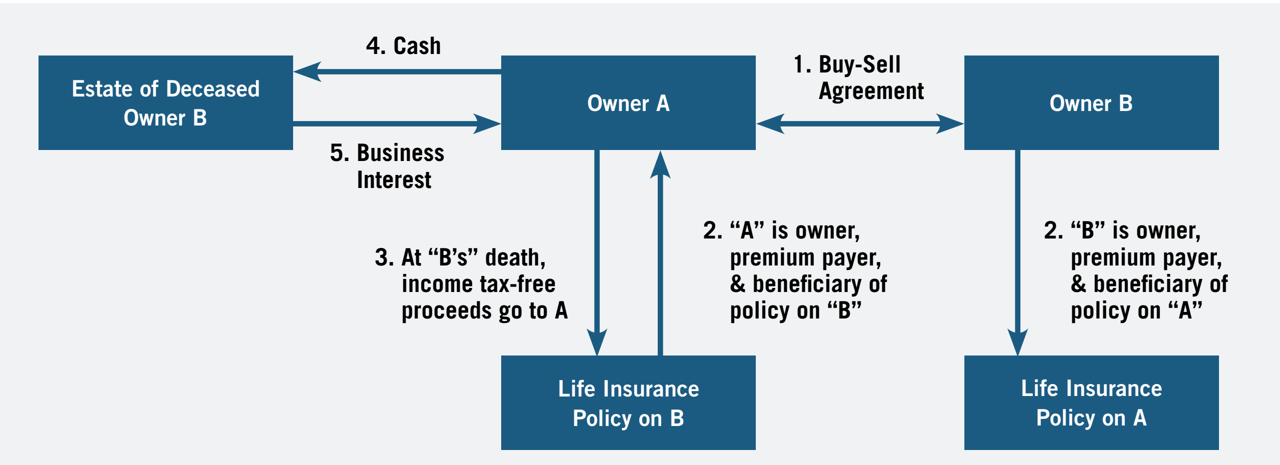
1	The business enters into a stock redemption agreement with each owner obligating the business to purchase a deceased owner's stock in the business and obligating the decedent's estate to sell
2	The business purchases life insurance protection on the life of each owner equal to at least the value of the owner's interest. The business is the policyowner, the premium payer, and the beneficiary of each policy. Clients should consult with legal counsel to determine whether notice and consent under IRC §101(j) is required before the policies are issued.[5]
3	At the death of an owner, the business collects the proceeds from the life insurance policy.
4	The business pays the agreed-upon amount, determined by the terms of the entity purchase/stock redemption agreement, to the owner's estate.
5	The owner's estate releases the stock to the business.

[5] For employer-owned life insurance policies issued after Aug. 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally income tax-free under IRC §101(a).

Cross-Purchase Agreements. Under the cross-purchase format, the agreement is between the co-owners of the business. The remaining/surviving owners are contractually obligated to purchase the interest of a departing/deceased/disabled owner. The business is not a party to the agreement. Under a cross-purchase agreement, the financing obligation is shifted to the remaining/surviving owners.

When the Buy-Sell Agreement is funded with life insurance, each owner is the owner, beneficiary, and premium payer of an appropriate amount of life insurance on the other owners.

STRUCTURE OF A CROSS-PURCHASE BUY-SELL AGREEMENT



1	All owners enter into an agreement obligating the survivor(s) to purchase a decedent's interest and obligating the decedent's estate to sell.
2	Each business owner purchases and is the owner, premium payer, and beneficiary of a life insurance policy on each of the other owners. Clients should consult with legal counsel to determine whether notice and consent under IRC §101(j) are required before the policies are issued.[5]
3	At the death of one of the owners, the surviving owner(s) receives the policy proceeds.
4	The surviving owner(s) pays the proceeds of the policy to the estate of the decedent according to the provisions of the Buy-Sell Agreement.
5	The estate of the deceased owner transfers the business interest to the purchasing party(ies).

A third approach, a hybrid agreement combining the features of both the entity and cross-purchase approaches, is sometimes employed:

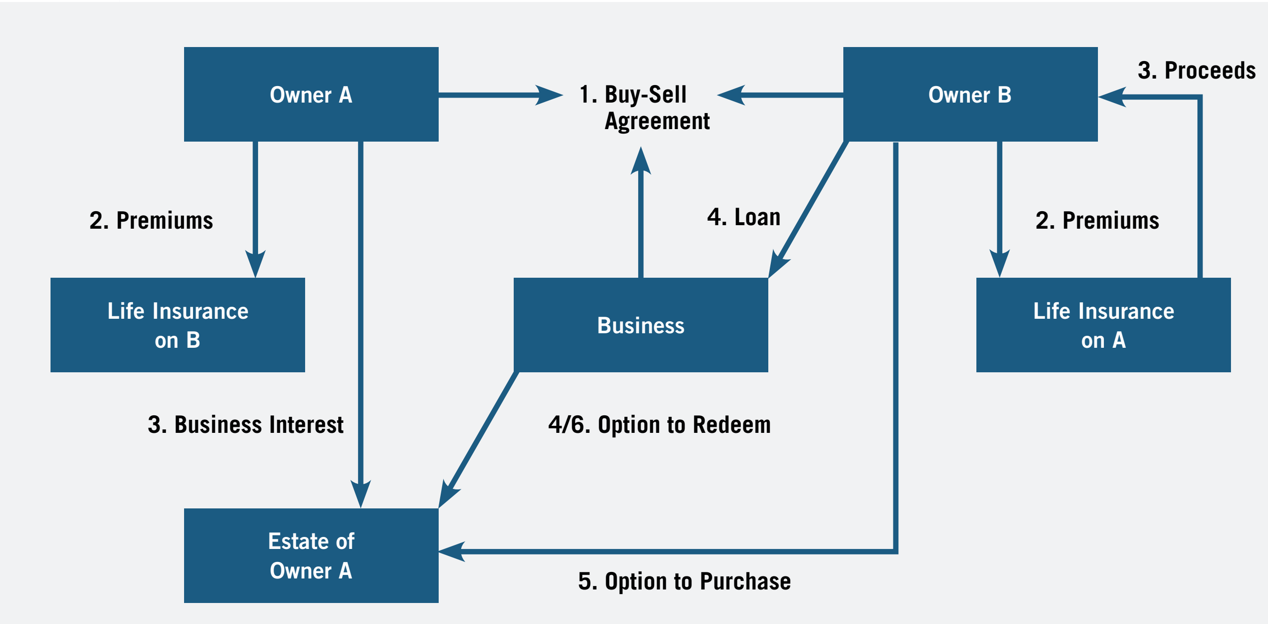
Wait-and-See Buy-Sell Agreements. The wait-and-see format allows the owners to defer the choice between an entity purchase and a cross-purchase format until a triggering event occurs. This approach allows for unexpected contingencies by allowing the parties to the agreement to "wait and see" the best course of action, and then take it, even many years after the agreement is put in place.

Under this approach, the business is given the first option to purchase all or a portion of a departing/deceased/disabled owner's interest. If the business fails to purchase the interest, then the remaining/surviving owners have a second option to purchase the available interest. If the remaining/surviving owners fail to purchase the ownership interest or only purchase a portion of it, then the business is required to purchase the remainder.

BUY-SELL AGREEMENTS

Under the wait-and-see approach, when the Buy-Sell Agreement is funded with life insurance, the business owners generally are the owners, premium payers, and beneficiaries of the policies. If the ultimate decision is to have the business purchase the departing/deceased/disabled owner's interest, the remaining/surviving owners can lend the money to the business or make additional capital contributions to the business entity upon the triggering event.

STRUCTURE OF A WAIT-AND-SEE BUY-SELL AGREEMENT



1	The owners and the business enter into a binding, but flexible, Buy-Sell contract that doesn't specifically identify the purchaser (business or business owner) until an owner's death.
2	Life insurance is purchased on the life of each business owner. Generally, the business owners are the owners, premium payers, and beneficiaries of the policies. Clients should consult with legal counsel to determine whether notice and consent under IRC §101(j) is required before the policies are issued.[5]
3	At owner A's death, the estate receives the business interest and owner B receives the life insurance proceeds.
4	Under the Buy-Sell Agreement, the business is given the first option to purchase/redeem all or a portion of A's business interest at a price or formula specified in the agreement. If the redemption option is exercised, the surviving shareholder B can help finance the repurchase by lending policy proceeds to the business or making an additional capital contribution.
5	If the business fails to purchase the stock, or purchases only a portion of it, then B's cross-purchase option is exercised, and the insurance proceeds can be used to finance the purchase of the business interest from A's estate.
6	If B (and other owners, if any) fails to purchase all of the business interest, the business is required to complete the purchase/redemption of any remaining interest.

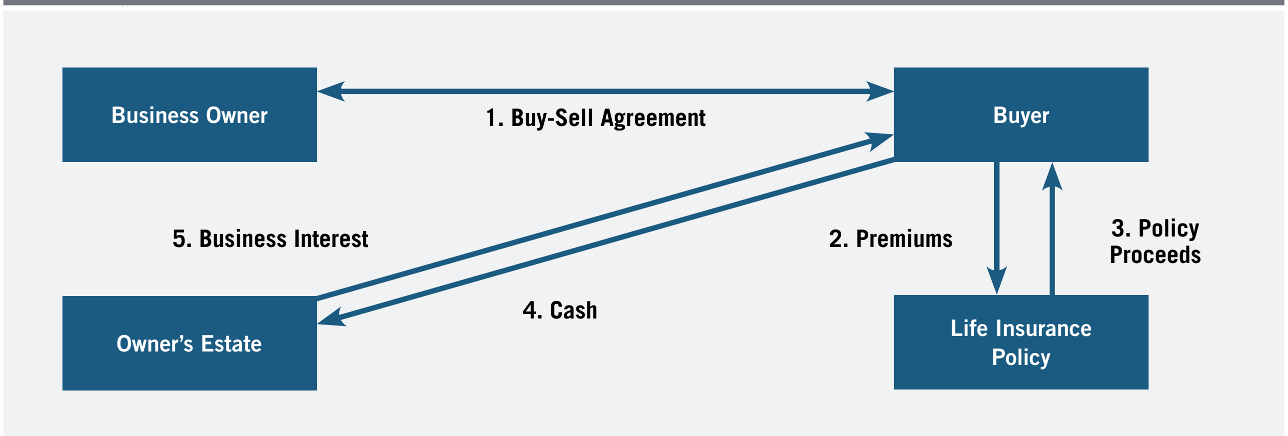
Sole Ownership

One other common Buy-Sell Agreement is used in sole ownership situations.

Unilateral Buy-Sell Agreement. The unilateral approach is frequently used where the sole owner is selling the entire business to one or more key employees, family members, or other interested parties. It is simply a one-way buyout between an owner and a purchasing party.

When life insurance is used to fund the unilateral Buy-Sell Agreement, the purchasing party obtains insurance on the life of the business owner, pays the premium, and is named as the beneficiary. At the death of the selling owner, the policy proceeds are paid to the purchasing party and may be used to assist in meeting the purchase obligation spelled out in the Buy-Sell Agreement.

STRUCTURE OF A UNILATERAL BUY-SELL AGREEMENT



1	The business owner and the buyer enter into a binding Buy-Sell Agreement obligating the business owner's estate to sell and the buyer to purchase the owner's business interest at their death. Where desired, additional language can be added to the Buy-Sell Agreement to cover a proposed lifetime sale due to disability or retirement.
2	The buyer obtains life insurance on the life of the business owner. The buyer is the owner, beneficiary, and premium payer of the policy. Clients should consult with legal counsel to determine whether notice and consent under IRC §101(j) is required before the policies are issued.[5]
3	At the death of the business owner, the buyer receives the policy proceeds.
4	The buyer uses the life insurance proceeds to fulfill their purchase obligation according to the terms of the Buy-Sell Agreement.
5	The business owner's estate releases the business interest and/or assets to the buyer.

Structuring the Buy-Sell Agreement Funded with Life Insurance

Once the decision is made as to the basic format and approach of the Buy-Sell Agreement, the agreement can be drafted and customized in many different ways to meet the specific needs of the parties involved.

When choosing the appropriate Buy-Sell structure, a fundamental concern is the income tax consequences of the transaction. The tax consequences will be determined by the interaction of the type of Buy-Sell format chosen (entity, cross-purchase, or hybrid) and the type of business entity (C corporation, S corporation, partnership, or limited liability company) involved in the transaction. In addition, the transaction must be structured to minimize the application of the transfer taxes (i.e., gift, generation skipping, and estate taxes).

As with any transaction involving legal and/or tax considerations, no steps should be taken without legal, tax, and insurance counsel.

Working with Cross-Purchase Agreements

Tax problems tend to be fewer with a cross-purchase agreement and most complex with a C corporation redemption involving family members.

Under the cross-purchase approach, the business owner or their estate simply sells the business interest to the remaining/surviving owners according to the terms of the agreement. Because the business interest is treated as a capital asset, any gain on the sale is generally treated as capital gain taxed at the more favorable capital gains rates. There is generally no gain or loss to be recognized because the owner's basis in the business is stepped up to the fair market value on the date of death. This should be the sales price set by the formula in the agreement.

C Corporations and S Corporation Considerations. The purchasing shareholder's income tax basis in their total stock interests is increased (i.e., stepped up) by the purchase price. When the remaining/surviving shareholder will retain their business interests until death, this may not be important because their heirs receive a step-up in basis upon their death. However, the need for increased basis may be much stronger with S corporation shareholders where future distributions will be made or future losses are anticipated because basis protects distributions from taxation and losses can be deducted only to the extent of a shareholder's basis in the S corporation.

A word of caution on S corporations—whether the Buy-Sell Agreement is structured as a cross-purchase agreement or as a stock redemption, if the purchasers are not qualified S shareholders, the corporation will lose its S status and be taxed as a C corporation. Generally, S status cannot be re-elected for five years after a terminating event. Thus, it is important to ensure that individuals, trusts, or other entities inheriting or purchasing the stock are qualified shareholders.

Partnership and Limited Liability Company (LLC) Considerations.[6] The selling partner (or member) recognizes gain/loss on the sale of a partnership or LLC interest. Such gain/loss is typically treated as capital gain/loss unless the selling partner's (member's) share of the underlying partnership asset includes "hot assets" (i.e., substantially appreciated inventory and unrealized receivables) that are treated as ordinary income for tax purposes.

The price set in a partnership cross-purchase agreement often becomes a strong point of negotiation in structuring the Buy-Sell Agreement when hot assets are involved.[7] The IRS regulations allow arm's-length agreements allocating the selling price between capital assets and the hot assets. The buyer and the seller generally have opposing positions. The seller typically wants to minimize ordinary income taxation and wants very little of the purchase price to reflect the value of the hot assets. On the other hand, the buyers, anticipating the possibility that a Section 754 step-up election will be made to adjust the partnership's (LLC's) inside basis in its assets to reflect the increased fair market value of the partnership's (LLC's) units, often push for the opposite result in order to reduce their future ordinary income when the receivables are collected or the inventory is sold.[8] The actual allocation of these hot assets depends on the bargaining strength and goals of the various owners and determines who carries the tax burden.

[6] The assumption is made that this is a multi-owner LLC taxed as a partnership for income tax purposes.

[7] Often, the Buy-Sell Agreement is actually part of the original partnership (LLC) operating agreement itself.

[8] IRC §743(b) permits a partnership to elect to adjust its basis (under IRC §754) in assets to reflect a purchase or other increase in the basis of a partner's interest, often referred to as a Section 754 step-up. Once the election is made, it cannot be revoked and applies to all subsequent taxable years of the partnership.

Insurance Considerations

- **Premium Expense.** Because each owner personally owns policies on the other owners, the first issue is the use of personal dollars to finance premiums. If the business provides the needed dollars, there are income tax consequences to the policyowners (e.g., compensation, dividends, distributions).

  Additional premium issues arise where the ages of the owners differ greatly or one of the owners is in poor health because the younger/healthier owners will be paying significantly higher premiums than the older/unhealthy owners.

  Where switching to an entity agreement is not a feasible solution, objections may be overcome if the business implements an IRC §162 bonus arrangement to reimburse the owners for lost premium dollars, making adjustments for tax costs and premium discrepancies.

- **Premium Deductibility.** Premiums paid by the policyowners to purchase the life insurance funding the Buy-Sell Agreement are not tax-deductible. However, when the business provides the needed dollars by implementing an IRC §162 bonus arrangement, the bonus is generally deductible as compensation by the business (as long as the bonus is considered reasonable compensation) and taxable as income to the policyowner.

- **Transfer-for-Value Issues.** Care must be taken to avoid transfer-for-value issues when circumstances change and policies personally owned by departing or deceased owners are transferred. To not do so could result in death benefit proceeds being subject to income taxation.

- **Managing Multiple Policies.** Cross-purchase agreements funded with life insurance require each owner to own policies on all of the other owners.[9] For the funding to be effective, policies must be maintained and managed to avoid lapse, a task that becomes complicated with numerous owners and personal ownership. In addition, with multiple policies and owners, it is more difficult to ensure that the remaining/surviving owners will honor the Buy-Sell Agreement and exchange death benefit proceeds for the deceased's ownership interest. For this reason, an entity purchase approach may be the preferred method if the number of policies is too large.

  Where an entity purchase approach is not suitable, another proposed solution is the use of a trust, holding one policy on each owner. However, this technique can create transfer-for-value problems at the death of one owner. To circumvent this problem, tax and legal advisors often make use of the partnership transfer-for-value safe harbor (i.e., all the shareholders who are beneficiaries of the trust are also partners in a bona fide partnership or the trust itself is a partner in the partnership). Another approach is to substitute a partnership for the trust (i.e., a bona fide partnership will be the owner and beneficiary of the policies and will complete the buy-out terms at the death of a shareholder).

  When using the partnership approach to avoid transfer-for-value issues, it is important to remember that a partnership is not an eligible S corporation shareholder.

[9] The number of policies needed is calculated using the formula: n x (n-1), where "n" equals the number of owners.

Working with Entity Purchase/Stock Redemption Agreements

As with a cross-purchase agreement, the tax consequences of an entity purchase/stock redemption agreement depend on the type of business entity involved.

C Corporation and S Corporation Considerations. Generally, any payment made by a corporation to a shareholder is taxed as ordinary income to the extent of earnings and profits. However, by structuring a redemption to meet the requirements of IRC §302(b) or IRC §303, an exception to this general rule is made that allows the redemption payment to be treated as a sale or exchange taxed at the more favorable capital gains rates.

- **IRC §302(b) Capital Gains Treatment.** One frequently used exception under IRC §302(b) is to structure the redemption as a complete termination of the shareholder's interest at his death so that the resulting sales or exchange treatment, combined with the step-up in basis at death, should result in no tax to the selling heirs.

  However, where family members are shareholders, rules under IRC §318 complicate the ability to achieve sales or exchange treatment by attributing stock that is owned by another family member (spouse, children, grandchildren, and parents) or by various entities involving family members (trusts and other related business entities) to a redeeming shareholder. Where IRC §318 attribution rules apply to prevent a complete or substantially disproportionate termination of business interest from meeting the requirements of IRC §310(b), the corporate redemption of stock will be taxed as ordinary income to the extent of corporate earnings in profits. It should be noted that a corporation that has always been taxed as an S corporation does not have earnings and profits; thus, the attribution rules are not a concern for these business entities (See discussion below). To avoid the attribution rules in a C corporation (or S corporation with retained earnings from when it was a C corporation), the Buy-Sell can be structured as a cross-purchase agreement.

  Where an S corporation has always been taxed as an S corporation, a redemption of a shareholder's interest will be income tax-free to the extent of the owner's basis and then will result in capital gains treatment, similar to a cross-purchase agreement. However, if the S corporation was previously a C corporation, there is a potential for ordinary income taxation if the S corporation has earnings and profits (E&P) remaining from its C corporation years, and the family attribution rules under IRC §318 apply.

- **IRC §303 Capital Gains Treatment.** When a large percentage of a decedent's estate is composed of a business interest and there is a desire to retain the business within the family, the estate may be faced with a lack of liquid assets to pay estate liabilities and other settlement costs. To raise the cash necessary to meet these obligations, the heirs may be forced to sell assets. One possible solution may be a partial redemption of the corporate stock.

  Recognizing this need, IRC §303 was added to the Internal Revenue Code to create an exception that would allow an estate to do a partial redemption of a decedent's stock without it being considered a dividend (i.e., to be treated as a sale or exchange, thus receiving capital gains treatment).

  Generally, IRC §303 applies only to a distribution by a corporation where the value of the stock included in the decedent's gross estate exceeds 35% of the value of the adjusted gross estate. An IRC §303 redemption is limited to the amount needed to pay estate, inheritance, legacy, and succession taxes, along with any funeral and administration expenses allowed as a deduction from the estate.

Partnership and Limited Liability Company (LLC) Considerations. Entity buyouts involving a partnership or an LLC are generally referred to as liquidations when the partner's (member's) entire interest is repurchased by the partnership (LLC).

Liquidations do not have many of the problems that complicate corporate redemptions because the family attribution rules do not apply to these tax entities. In addition, unlike S corporations, distributions to partners (members) do not have to be made pro rata if a "substantial economic effect" can be established. Nor do partnerships and LLCs have restrictions on who can be a partner or member. However, the trade-off for this flexibility is that the tax rules governing these entities are complex.

Payments for a partner's (member's) share of partnership (LLC) property are generally treated as distributions with the partner recognizing capital gain to the extent any cash received exceeds the partner's (member's) basis in the entity. However, the potential for ordinary income treatment exists if the following items are distributed: unrealized receivables; substantially appreciated inventory; and goodwill. The possibility of ordinary income treatment on liquidation exists primarily for service-oriented partnerships.

If a Section 754 election is in effect at the time of the liquidation, the basis of the partnership (LLC) property will be adjusted upward or downward to reflect any recognized gain/loss from the liquidation. An upward Section 754 election can be effective when the intent is to hold the partnership or LLC until death because higher basis results in lower taxable gain on future distributions.

Insurance Considerations

- **Premium Expense.** The entity applies for and owns the life insurance on the lives of its owners. Only a single policy is needed on each owner, which is an advantage over the cross-purchase approach when there are more than two owners. Where there are large age or health discrepancies, using an entity for the source of premium dollars allows for more equalization of premium cost differences between the owners.

- **Premium Deductibility.** Premium dollars paid for by a C corporation are nondeductible for tax purposes and do not affect the shareholders' basis in their stock. All the shareholders share proportionately in the cost of the insurance.

  Like in C corporations, premiums paid by a pass-through entity (S corporations, partnerships, and LLCs) are nondeductible for tax purposes. However, unlike in a C corporation, premium dollars reduce the owners' basis. The amount of basis reduction depends on whether the business has purchased term or permanent insurance. In an S corporation, this premium expense will be allocated to shareholders pro rata (i.e., reflecting their ownership percentages). Using the substantial economic effect argument under partnership/LLC tax law, it may be possible to allocate this expense to just the owners who will benefit from the policy proceeds.

  When cash-value life insurance is used in a pass-through entity, additional adjustments are made to the owners' basis to reflect the investment element of the premium cost (i.e., upward adjustments for cash value increases). Because this cash value increase (and the resulting higher basis) shields the owners from taxation, it is an important consideration when a pass-through entity makes distributions or the business generates losses.

- **Policy Proceeds.** The proceeds of life insurance policies received by a business are generally not subject to income tax assuming the requirements of IRC §101(j) have been met. The proceeds will not be included in the business owner's estate; however, the value of the business interest may be increased by the proceeds, depending on the terms of the Buy-Sell Agreement. This could have the effect of increasing the value of the owner's estate.

  Life insurance proceeds received by an S corporation, partnership, or LLC increase the basis of an owner's business interest. Consequently, a deathtime redemption arrangement funded with life insurance in an S corporation, partnership, or LLC will result in the surviving owners receiving an increase in basis. In contrast, the stock of the surviving shareholders of a C corporation does not receive an increase in basis.

- **Transfer-for-Value Issue.** Often, when the decision is made to switch from an entity purchase to a cross-purchase approach in a C corporation, the corporation may distribute the policy on the life of owner B to owner A. This is clearly a transfer-for-value and may result in the income taxation of all or part of the death benefit proceeds. One solution to this cross-transfer problem is to make certain that the shareholders are also all partners in a bona fide partnership. Where this exception to the transfer-for-value rule is not available, new policies purchased and owned by the individual shareholders should be considered, and, where appropriate, the corporation can maintain the original policies to provide key person insurance.

Gift Tax and Buy-Sell Agreements

The implementation of a Buy-Sell Agreement and the required sale under the agreement should not be taxable gifts where the transaction is a bona fide business arrangement and adequate consideration is given to all parties through their mutual promises.

Estate Taxes and Buy-Sell Agreements

A Buy-Sell Agreement may be effective in setting the business value for estate tax purposes if:

- The estate is obligated to sell the business interest at the price set forth in the agreement.
- The agreement places certain lifetime restrictions on transfers of the business interest.
- The value of the business interest is fixed by or determinable from the agreements.
- The agreement represents a bona fide business arrangement and is not merely a device to transfer the business interest for less-than-adequate consideration.

The IRS especially scrutinizes family transactions and will use the valuation rules found in IRC §2703 to ignore valuations that provide for a sale at less than the business' fair market value. However, the IRS will honor valuations established in a Buy-Sell Agreement if three requirements found in IRC §2703(b) are met: (1) the agreement must be a bona fide business arrangement; (2) it cannot be a device to transfer property to members of the decedent's family for less than full and adequate consideration; and (3) it must have terms comparable to similar arrangements entered into by a person in an arm's-length transaction.

Business Valuation

One of the most important components in a Buy-Sell Agreement is establishing the price of the business interest. The Buy-Sell Agreement includes a purchase price for the business interest, generally expressed as fixed-price-per-unit-of-interest or set by a formula, and generally requires an expert appraisal or business valuation.

An accurate valuation is a major component of a successful Buy-Sell Agreement. An expert appraisal helps:

- Avoid or minimize IRS challenges regarding valuation for estate tax purposes.
- Minimize the chance of disputes between the selling and purchasing parties.
- Assure that the family will receive a fair price for the business interest.

There is no one method of determining a business' value, and different methods may be used for different purposes. It is important that a business owner seeks the advice of their legal and tax counsel to ascertain the best method for arriving at the business' fair market value for Buy-Sell purposes.

Techniques and Tools for the Disposition of a Business Interest

When a closely held business is transferred, various strategies and financing alternatives are used to pass the business to a younger generation family member or a third-party purchaser with income, gift, and estate tax efficiency. Which tools or techniques should be chosen depends on a variety of factors: the relative income and marginal tax brackets of the parties to the agreements, the need for a flexible payment schedule, the seller's continuing income requirements, the relationship between the parties, and the degree of trust between the parties.

The discussion that follows is an overview of some of the common techniques and tools employed when transferring a business interest.

Overview of Common Techniques and Tools Employed when Transferring a Business Interest

Installment Sale. Technically, an installment sale is a method of selling a business for other than a lump-sum cash payment (i.e., at least one payment is received after the close of the tax year in which the sale occurs). Generally, the business owner sells the business, taking back an installment note that specifies payment amounts, payment dates, and an interest factor. Installment sales are commonly used in the business world because they allow the seller to defer the reporting of gain until the receipt of each installment payment and may allow a cash-poor buyer to finance the majority of the purchase price through future business income. In addition, the moment the sale occurs, the installment payments the buyer is obligated to make become part of his/her basis for resale and depreciation.

Installment sales are used both where the business is sold to an unrelated third party and where there is an intra-family sale.

Self-Canceling Installment Note (SCIN). With a traditional installment note, if the seller dies while the note is outstanding, the unpaid principal and interest is typically included in his/her gross estate. In addition, any remaining installment payments are treated as income in respect of the decedent (IRD) and are taxed to the recipient-beneficiary when received. To avoid these tax problems in intra-family sales, a SCIN is often used as the financing vehicle.

A SCIN is a contingent installment note that expires upon a certain cancellation event. In a business sale, that event is typically the seller's death. The goals are to exclude the unpaid balance of the note from the seller's estate and to minimize any gift tax. Under a SCIN, the buyer will never pay more than a certain maximum amount and may pay less if the seller dies prematurely.

However, to avoid the implication of a gift, the SCIN cancellation provision in the contract must be bargained for as part of the consideration for the sale. Either the purchase price or the interest rate must reflect a premium (increase) that accounts for the value of the cancellation feature.

The SCIN is a "hybrid" approach. It uses the installment method to determine the maximum amount the buyer will pay and the private annuity approach should the seller die prior to the end of the payment term. The SCIN is generally chosen where the seller wants to retain a security interest or when the buyer wants to be certain that his basis in the business will be equal to its fair market value on the date of the sale.

Family Limited Partnerships (FLPs). Structured properly, a family limited partnership is an important succession tool for closely held businesses allowing ownership interests and other assets to be transferred to family members at substantially discounted values while allowing the senior generation to retain control.

In a typical family limited partnership, the parent(s) hold a general partnership interest and transfer limited partnership interests to the children via gifts. As general partners, the parents retain the ability to manage the partnership. As limited partners, the children have the right to participate in the profits of the partnership and receive protection from personal liability; however, they lack any voice in the operational affairs of the partnership.

A family limited partnership is an effective estate and financial strategy tool that can accomplish some or all of the following:

- Create a tool for successor ownership of the family business.
- Protect the family business and other assets from creditor attack.
- Help pass family wealth to the younger generation with income, gift, and estate tax efficiency.
- Provide flexibility allowing for future changes.
- Utilize life insurance policies to fund estate and business needs.

Because the IRS scrutinizes the implementation and operation of FLPs for abusive practices, business owners considering the implementation of a family limited partnership (FLP) should seek the advice of experienced legal and tax counsel.

Grantor Retained Annuity Trusts and Unitrusts (GRATs, GRUTs). Grantor retained interest trusts are special irrevocable trusts that allow the grantor (trust maker) to make gifts of property while retaining an income interest in the property for a term of years. At the end of the term of years, the property (the remainder interest) passes to the beneficiaries of the trust.

In a GRAT, the grantor receives a fixed dollar amount each year for the specified term of years. In a GRUT, the amount received equals a fixed percentage of the value of the property held in the trust, as valued annually.

These special trusts are used to substantially reduce the gift tax value of the remainder interest passing to the beneficiaries of the trust. Basically, the higher the value of the income interest retained by the grantor and the longer the term of the trust, the less the value of the remainder interest; consequently, the gift amount and the resulting gift tax will be lower. As long as the grantor outlives the income term, the present value and all future appreciation of the trust property are removed from the grantor's estate at a lower gift tax cost. If the grantor dies before the expiration of the term of years, the value of the asset at the grantor's date of death is included in their estate.

Business stock, such as S corporation stock that generates sufficient income, can be placed in a GRAT or GRUT. The grantors, generally the parents, receive income from the trust and, at their deaths, the stock passes to the next generation. If the grantor outlives the term of years, the stock will pass to the children at a discounted gift tax value. In addition, the value of the stock and its appreciation is eliminated from the grantor's taxable estate.

Life insurance on the grantor may be used to offset the estate tax liability that may occur if the grantor dies before the term has expired.

Charitable Remainder Trusts (CRTs). A charitable remainder trust is an irrevocable trust that has both charitable and non-charitable beneficiaries. Typically a CRT is designed to pay income to one or more non-charitable beneficiaries (generally the donor and the donor's spouse) for their lives or for a term of years, after which the remainder of the trust assets are paid to a charity. The CRT can be structured to provide a fixed amount (charitable remainder annuity trust, CRAT) or a fixed percentage of assets as valued annually (charitable remainder unitrust, CRUT).

The best assets to give to a CRT are highly appreciated assets in which the donor has a low basis. If an individual sells these assets without using a CRT, the gain on the sale will be subject to capital gains tax and future investment dollars are lost to the IRS. However, if the appreciated assets are transferred to the CRT and then sold, because the CRT is a qualifying exempt charitable trust, it pays no capital gains tax at the time of the sale.

Accordingly, a business owner holding most of the family wealth in highly appreciated stock with little income stream could use a CRT to ensure that maximum dollars would be invested in diversified assets, producing the needed funds for their retirement years.

To replace the value of the assets transferred to the CRT and to provide for the owner's heirs, a wealth replacement irrevocable life insurance trust (ILIT) could be established. With a proper strategy, the needed premium dollars could be paid from the income generated by the CRT.

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