

## Life Insurance Funded Buy-Sell Arrangements: Comparison of Entity Purchase and Cross Purchase Arrangements

Note: This chart is intended to be a general discussion of the issues pertinent to the choice of a buy-sell approach funded with life insurance. It does not attempt to address issues related to the taxation of a specific tax entity except where noted. For additional information on this topic please reference Prudential Financial's discussion in: IFS-A024767: Chart-Comparison of Business Entities.

	Entity Purchase (Redemptions, Liquidations)	Cross Purchase
<b>The Plan</b>	A buy-sell agreement that obligates the business to purchase, at an agreed on price, the interest of a business owner on the occurrence of a specified event – generally the owner's death, disability, or termination of employment.	A buy-sell agreement where business owners agree among themselves that the remaining/surviving owner(s) are obligated to purchase (or have the option to purchase), at an agreed on price, a departing owner's interest on the occurrence of a specified event – generally an owner's death, disability, or termination of employment.
<b>The Purchaser</b>	The business.	The remaining/surviving business owner(s).
<b>Seller</b>	The owner or his/her estate.	The owner or his/her estate.
<b>Seller: Basis in Business Interest</b>	Lifetime Sale: Basis remains unchanged.  Sale at Death: The business interest receives a "step-up" in basis to fair market value at the death of an owner. <sup>1</sup>	Lifetime Sale: Basis remains unchanged.  Sale at Death: The business interest receives a "step-up" in basis to fair market value at the death of an owner. <sup>1</sup>
<b>Purchaser: Basis in Business Interest</b>	The remaining/surviving owners do not receive any cost basis adjustment in their business interest after the buy-out. Subsequent sales may trigger additional taxable gain. (Note: Where a stock redemption is funded with life insurance in a pass-through entity, the life insurance will cause the owners to receive an increase in basis.)  The percentage ownership of the remaining/surviving owners is increased pro-rata, by the amount repurchased (i.e., redeemed/liquidated). This can sometimes realign voting power, shifting the control of the business in an undesirable way.	The remaining/surviving owner(s) receive a new basis in the purchased interest(s) – the fair market market value paid. This new basis is used to measure taxable gain for subsequent sales.  The surviving/remaining owners' percentage of ownership can remain the same or change depending upon the agreement and the amount of the deceased/departing owner's interest purchased by each survivor/remaining owner.
<b>Estate Tax Valuation</b>	The price at which a deceased owner's business interest must be sold under a buy-sell agreement will generally be binding as the estate tax value of the business interest, where the buy-sell agreement provides: <ul style="list-style-type: none"> <li>■ That the estate is obligated to sell the business interest at the death of the owner;</li> <li>■ For a reasonable and ascertainable price;</li> <li>■ For a lifetime restriction on the disposition of the business interest; and</li> <li>■ The agreement is bona fide, not a device to transfer the business for less than adequate consideration.</li> </ul>	

<sup>1</sup> Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax is repealed for the year 2010. For deaths occurring in that year only, a modified step-up in basis will be available. This is limited to a step-up of \$1.3 million in total for all beneficiaries and an additional \$3 million step-up in basis is available for property passing to a surviving spouse.

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<b>Family Attribution Rules</b>	<p>Only apply to corporate redemptions. (However, in an S corporation with no C corporation accumulated earnings and profits, the attribution rules do not result in dividend treatment).</p> <p>Consequences of the rule: When “related” persons own the stock, a redemption may be subject to taxable dividend treatment (ordinary income) instead of sale or exchange treatment through the application of the IRC § 318 attribution/constructive ownership rules.</p> <p>These rules can be waived if the conditions in IRC § 302(c)(2)(A) are met.</p> <p>The attribution rule does not apply if the redemption qualifies under IRC § 303 as a payment of estate administrative expenses or taxes.</p>	<p>There are no problems of constructive ownership or attribution under IRC § 318 when a cross purchase arrangement is used.</p>
<b>Life Insurance Funding</b>	<p>The business is the owner, premium payer and the beneficiary of a policy on the life of each owner in an amount sufficient to assure the performance of its repurchase obligation under the agreement.</p>	<p>Each owner applies for, owns and is the beneficiary of a policy on the life of each of the other owners in an amount equal to his/her share of the purchase obligation.</p>
<b>Policies Needed</b>	<p>Only one policy per owner is required.</p>	<p>As the number of owners increase, multiple policies are required. The number of policies needed is: <math>n \times (n-1)</math>, where <math>n</math> = the number of owners.</p>
<b>Policy Management</b>	<p>Fewer policies owned and administered by the business entity will increase the likelihood that premiums will be paid, policy performance will be monitored, and death benefit proceeds will be used for the intended buy-sell purpose.</p>	<p>Multiple personally owned policies add additional complexity to the management process and the successful outcome of the plan.</p> <p>In addition, where a trust is used as a policy management tool, “transfer for value” problems can result leading to partial or full taxation of the death benefit proceeds.</p>
<b>Policy Premiums</b>	<p>Premiums are a nondeductible business expense for income tax purposes.</p> <p>Age discrepancies, underwriting ratings, and percentage ownership that can result in insurance costs that are radically different among the multiple owners become less of an issue where business dollars pay premiums.</p> <p>S corporations, partnerships, and limited liability companies: Depending on the type of pass-through entity, the accounting methods used, and the nature of the buy-sell arrangement, nondeductible premiums reduce the value of an owner’s interest in the entity (basis reduction).</p>	<p>Premiums on personally owned life insurance policies are a nondeductible expense for income tax purposes.</p> <p>Premium discrepancies become more of an issue where personal dollars are used to purchase policies.</p> <p>To defray personal premium cost, business dollars are often put to use through the implementation of executive benefit strategies such as a bonus agreement or a split dollar plan. As the result of these strategies, additional compensation may result to the business owners. Care must be taken that these additional dollars can be justified as “reasonable compensation.”</p>

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<b>Tax Bracket Considerations</b>	<p>Consideration must be given to the taxation of the entity and the effect of nondeductible premium on the entity and its owners.</p> <p>For example, when funding a cross purchase arrangement, premium payments made by a corporation in a high tax bracket may be more costly than a deductible bonus paid to the owners in lower tax brackets.</p>	
<b>Policy Cash Values</b>	<p>When permanent policies are used, policy cash values are corporate assets.</p> <p>Cash values can be accessed by the business for use in a lifetime purchase resulting from an owner's disability or withdrawal from the business.<sup>2</sup></p> <p>C Corporations: See alternative minimum tax (AMT).</p> <p>S corporations, partnerships and limited liability companies: Depending on the type of flow-through entity, the accounting methods used and the nature of the buy-sell arrangement, cash value increases flow through and increase the value of an owner's interest in the entity (basis increase).</p>	<p>Where permanent policies are used, cash values can be accessed by the policy owner for use in a lifetime purchase resulting from an owner's disability or withdrawal from the business.<sup>2</sup></p>
<b>Policy Proceeds: Income Taxation</b>	<p>The policy proceeds are generally received free of income taxes under IRC § 101(a).</p> <p>See "Transfer of Policies."</p> <p>C Corporations: See Alternative Minimum Tax (AMT).</p>	<p>The policy proceeds are generally received free of income taxes under IRC § 101(a).</p> <p>See "Transfer of Policies."</p>
<b>Policy Proceeds: Effect on Business Value</b>	<p>Term insurance: At the death of an insured owner, term insurance increases the value of the business by the face amount of the policy.</p> <p>Permanent insurance: At the death of an insured owner, the entity's books are adjusted for the difference between the cash value and death benefit proceeds (generally a gain) resulting in an increase in business value.</p> <p>S corporations, partnerships, and limited liability companies: Depending on the type of pass-through entity, the accounting methods used and the nature of the buy-sell arrangement, death benefit proceeds flow through and increase the value of an owner's interest in the entity (basis increase).</p>	<p>The business value is not affected by personal receipt of policy proceeds by an owner.</p>

<sup>2</sup> Life insurance policy cash values are accessed through withdrawals and policy loans. Loans are at interest. Unpaid loans and withdrawals cause a reduction in cash values and death benefits and may affect any guarantee against lapse. In general, loans are not taxable, but withdrawals are taxable to the extent they exceed basis in the contract. Loans outstanding at policy lapse or surrender prior to the death of the insured will cause immediate taxation to the extent of gain in the contract. For policies that are Modified Endowment Contracts, distributions (including loans) are taxable to the extent of income in the contract, and an additional 10% federal income tax penalty may apply. Consult your own tax advisor for advice regarding your particular situation.

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<b>Policy Proceeds: Estate Includibility</b>	<p>Corporations: If all of the incidents of ownership for the policy are held by the corporation, only the value of the stock, not the policy proceeds, will be includible in the decedent's gross estate for estate tax purposes.</p> <p>Partnerships and Limited liability companies: there are no direct regulations that deal with incidents of ownership held by a partner/member.</p> <p>The general belief is that where the entity is both the owner and the beneficiary of a policy on a partner/member's life, the partner's/member's gross estate should include just his/her proportionate share of the business value, which reflects a proportionate share of the policy proceeds.</p>	<p>The cash value of the policies owned by the decedent on the other owners' lives are includible in the decedent's gross estate.</p>
<b>Transfer of Policies</b>	<p>Since the business is the owner of the life insurance policies, at the death of an owner there is no need to transfer ownership.</p> <p>Accordingly, this limits the possibility of incurring a "transfer for value" problem resulting in partial or full taxation of the death benefit proceeds.</p> <p>Care must be taken when decisions are made to change the form of the buy-sell agreement (e.g., from entity purchase to cross purchase or vice versa) so that the "transfer for value" rules are not violated.</p>	<p>Transfer for value problems are more likely since the estate of the deceased owner will own policies on the lives of the surviving owners. At the death of a business owner, the deceased owner's estate and the surviving owners may choose to shift ownership to provide for full funding at a subsequent death.</p> <p>Unless an exception to the transfer for value rule applies, taxation could result. To avoid a transfer for value problem for the surviving owners, the estate can only sell the policies to: the respective insureds; a corporation where the insured is an officer or stockholder; a partnership in which the insured is a partner; or a partner of the insured.</p>
<b>Alternative Minimum Tax (AMT)</b>	<p>Where life insurance is used as a funding tool for an entity purchase, death benefit proceeds and cash value build-up may affect the "adjusted current earnings" (ACE) calculation and trigger AMT tax.</p> <p>Only applicable to C corporations: An exemption applies to qualifying small corporations.</p>	<p>Alternative minimum tax is not applicable to personally owned life insurance policies.</p>

This material contains general information to help you understand some basic buy-sell agreements. It also contains references to concepts that have legal, accounting or tax implications. It is not intended to be legal, accounting or tax advice. Neither Prudential nor its licensed sales professionals provide legal or tax advice. Consult your own attorney and/or accountant for advice regarding your particular situation.

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