

**BUY-SELL AGREEMENTS USING LIFE INSURANCE**





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## **Producer Marketing Guide**

The purpose of this guide is to present an overview of buy-sell agreements using life insurance as a funding vehicle. This guide is not intended to provide detailed information on these topics. For additional information on these and other buy-sell topics, please refer to the resource list found at the end of this guide.

### **The Importance of a Business Continuation Plan**

How many “businesses” are there in the United States? In 2004, according to the Office of Advocacy estimates there were approximately 24.7 million businesses in the United States.

The vast majority of businesses are small, closely held companies. These businesses are the backbone of the U.S. economy. Yet a LIMRA report, U.S. Small Businesses in 2000, indicated that only 58% of small businesses had formal written continuation plans. And, of those that do, one has to wonder — How many of these plans are properly funded?

Opportunities abound for the financial professional who understands the problem and presents a solution.

### **What is Business Continuation Planning?**

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

The growth and maturity 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 then through executive benefit plans? And 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 planning is much more than a formal buy-sell agreement. Rather, it is an ongoing process that starts years before the transfer event. The buy-sell agreement is only one piece of the business continuation process.



## Why is a Buy-Sell Agreement Needed?

For many business owners, the business is often the major source of family income; a personal investment vehicle; and a major portion of the owner's estate. Without proper planning by the owners, financial hardships can result for the remaining owners as well as 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 plan and structure the business prior to a transition event to ensure business continuity for the surviving owners as well as financial security for the departing/deceased owner's 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's tax status
- Improve the credit risk of the business

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; and perhaps most important,
- How the buyout will be funded.



## Funding the Buy-Sell Agreement

A buy-sell agreement creates a contractual obligation to purchase a departing/deceased 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, or 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

Planning 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 credit worthiness of 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 when a business owner dies. Life insurance guarantees a specific payout at death, regardless of when death occurs. Because premium costs are lower than the proceeds, and death benefit proceeds are generally received income-tax free, life insurance can be the most economical method of prepaying the purchase price of the business.

When cash value life insurance is used, the policy may serve double duty, providing both an income-tax-free death benefit and cash value that accumulates on an income-tax-deferred basis.<sup>1</sup> When needed, this cash accumulation can be used to fund the down payment for the buyout at an owner's retirement.<sup>2</sup> Where the buy-sell agreement includes disability provisions, disability insurance can be purchased to help provide the needed funds.

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<sup>1</sup> IRC § 101(a)

<sup>2</sup> Based on sufficient death benefit and/or cash value availability. Loans and withdrawals may cause a reduction in policy cash values/death benefits, may affect policy guarantees, and may have tax consequences.



## 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. A disability buyout policy is available to many types of businesses and can help reduce the need to fund the entire purchase price out of cash flow.

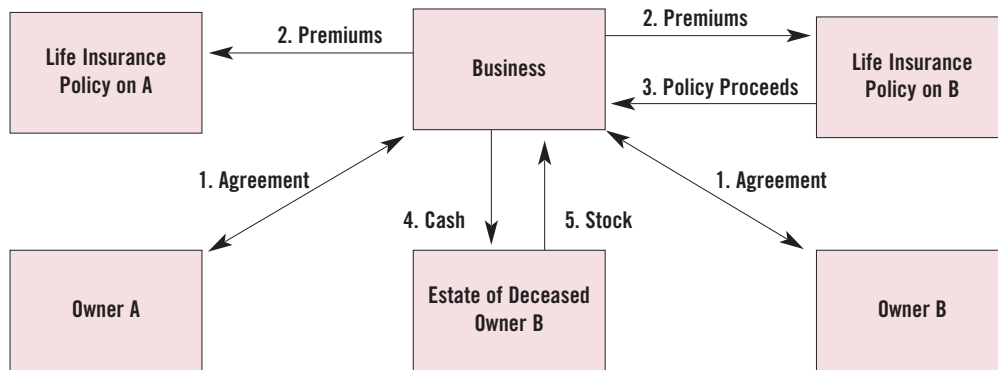
## Common Forms of Buy-Sell Agreements

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 arrangement is funded with life insurance, the business is the owner, beneficiary, and premium payer of policies on the lives of its owners.

### Structure of an Entity Purchase Arrangement/Stock Redemption Arrangement



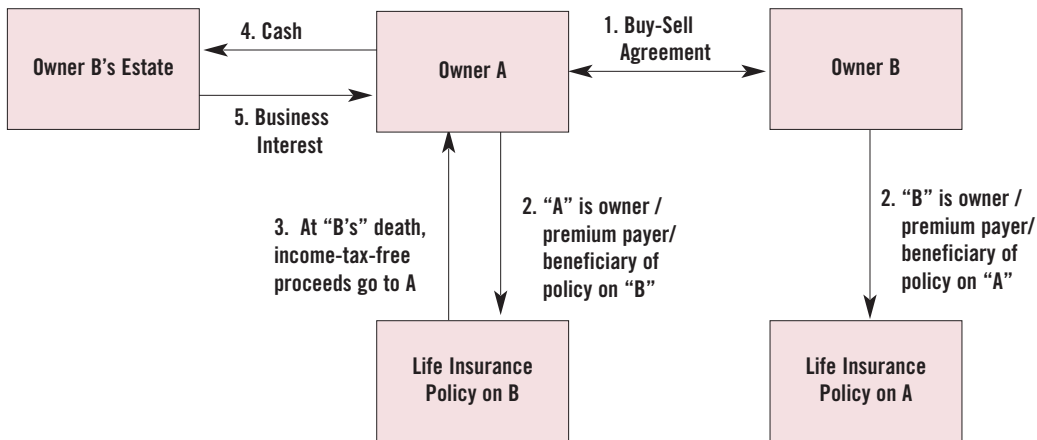
1. The business enters into a stock redemption agreement with each owner obligating the business to purchase a deceased owner's stock in the business and obligating the decedent's estate to sell.
2. The business purchases life insurance protection on the life of each owner equal to at least the value of the owner's interest. The business is the policy owner, the premium payer, and beneficiary of each policy.
3. At 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.



- **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 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-Out 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 the other owners.
3. At the death of one of the owners, the surviving owner(s) receive the policy proceeds — generally income-tax free under IRC § 101(a).
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:

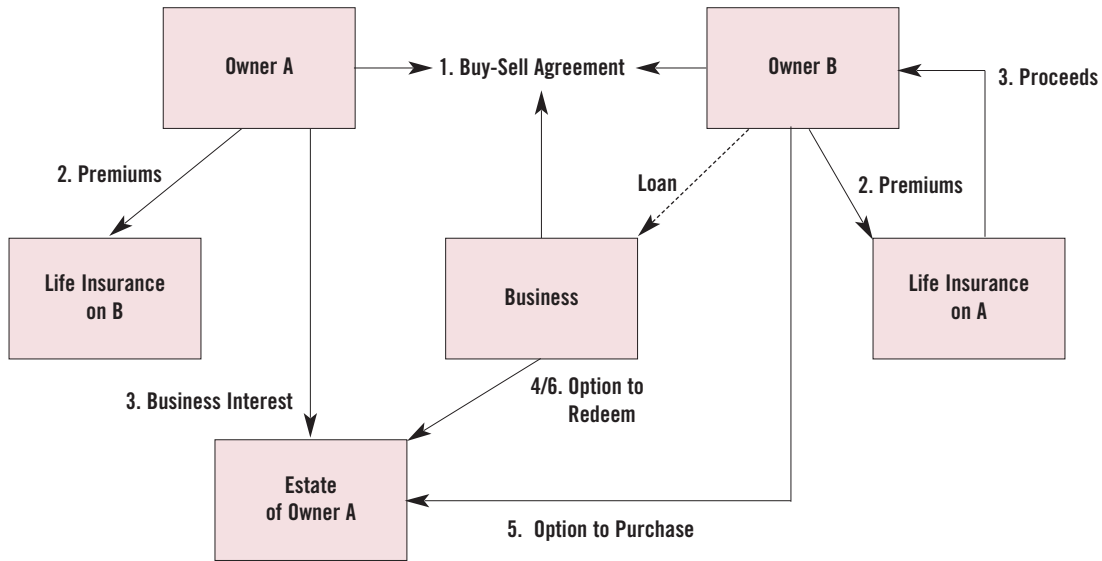
- **Wait-and-See Buy-Sell Agreements.** The wait-and-see format allows the owners to defer the choice between an entity repurchase and a cross purchase format until a triggering event occurs. This approach allows for unexpected contingencies by allowing the parties to the agreement to “wait and see”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

Under this approach, the business is given the first option to purchase all, or a portion of, a departing/deceased 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.

Under the wait-and-see approach, when the buy-sell arrangement is funded with life insurance, generally the business owners are the owners, premium payers, and beneficiaries of the policies. If the ultimate decision is to have the business purchase the departing/deceased 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 Arrangement**



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.
3. At owner "A's" death the estate receives the interest and owner B receives the life insurance proceeds.
4. Pursuant to the buy-sell agreement, the business is given the first option to purchase/redeem all or a portion of "A's" 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 only purchases 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.

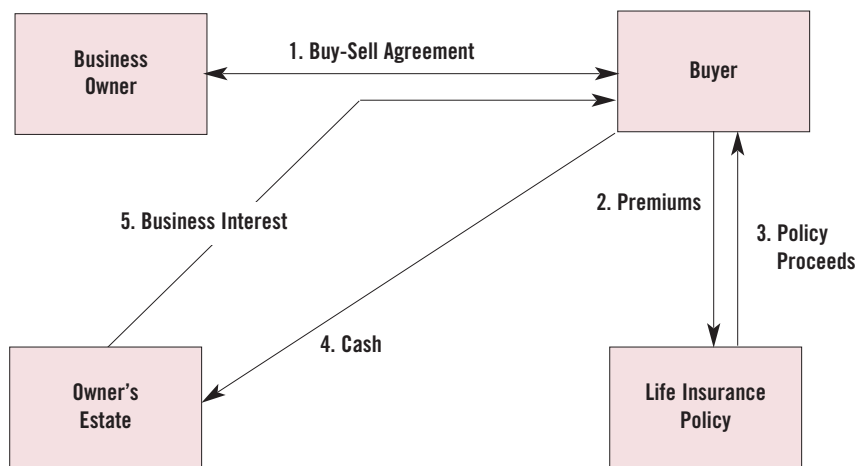


One other common buy-sell arrangement is used in sole ownership situations:

- **Unilateral Buy-Sell Agreement.** The unilateral approach is frequently used where the 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 his/her 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.

3. At the death of the business owner, the buyer receives income-tax-free policy proceeds under IRC § 101(a).

4. The buyer uses the life insurance proceeds to fulfill his/her 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 Arrangement Funded with Life Insurance

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

In choosing the appropriate buy-sell structure, a fundamental concern will be 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 or avoid 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 arrangement and most complex with a C Corporation redemption involving family members.

Under the cross purchase approach, the business owner or his/her 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. Further tax efficiency is gained where the business owner's estate sells the business interest shortly after his/her death, as there is generally no gain to be recognized because the estate's basis in the business interest is the fair market value on the date of death, which due to the step-up in basis, should be the sales price set by the agreement.<sup>3</sup>

**C Corporations and S Corporation Considerations.** The purchasing shareholders increase their income tax basis in their total stock interests (i.e., step-up in basis) by the purchase price. Where the remaining/surviving shareholders will retain their business interests until death, this may not be important, as their estate receives a step-up in basis upon their death.<sup>4</sup> 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, as basis protects distributions from

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<sup>3</sup> Under the Economic Growth and Tax Relief Reconciliation Act of 2001, for the year 2010, the estate tax is repealed. 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 available for property passing to a surviving spouse.

<sup>4</sup> Id.



taxation and losses can only be deducted 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.**<sup>5</sup> The selling partner (or member) also recognizes gain/loss on the sale of a partnership (LLC) interest. Such gain/loss is typically treated as capital gain/loss unless the selling partner’s (member’s) share of the underlying partnership assets 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.<sup>6</sup> 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 avoid 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.<sup>7</sup> 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.

**Insurance Considerations.**

- **Premium Expense.** Since 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 business dollars, there are income tax consequences to the policy owners (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, since the younger/healthier owners will be paying significantly higher premiums than the older/unhealthy owners.

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<sup>5</sup> The assumption is made that this is a multi-owner LLC taxed as a partnership for income tax purposes.

<sup>6</sup> Often the buy-sell agreement is actually part of the original partnership (LLC) agreement itself.

<sup>7</sup> 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.



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 policy owners 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 policy owner.
- **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 losing all or part of the exclusion from income taxation under IRC § 101(a).
- **Managing Multiple Policies.** Cross purchase agreements funded with life insurance require each owner to own policies on all of the other owners.<sup>8</sup> 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 arrangement and exchange death benefit proceeds for the deceased's ownership interest. For this reason, if the number of policies becomes too large, an entity purchase approach may be the preferred method.

Where an entity purchase approach is not suitable, another proposed solution is the use of a trust, holding one policy on each owner. However, the “one trust one policy per shareholder” cross-purchase technique can create transfer-for-value problems. To circumvent this problem, planners 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 buyout terms upon 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.

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<sup>8</sup> The number of policies needed is calculated using the formula:  $n \times (n-1)$ , 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 entity involved.

**C Corporations and S Corporation Considerations.** Generally, any payment made by a corporation to a shareholder is taxed as a dividend (i.e., as ordinary income). However, by structuring a redemption to meet the requirements of IRC § 302(b) or IRC § 303, an exception to this general rule is made which 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.<sup>9</sup>

However, where family members are shareholders, rules under IRC § 318 complicate the ability to achieve sales or exchange treatment by attributing to a redeeming shareholder stock that is owned by another family member (spouse, children, grandchildren and parents) or by various entities involving family members (trusts, other related business entities). To avoid these attribution rules and ordinary income taxation in situations involving family members, the buy-sell agreement can be structured as a cross purchase arrangement.

- **IRC § 303 Capital Gains Treatment.** When a large percentage of a decedent's estate is comprised 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.

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<sup>9</sup> Under the Economic Growth and Tax Relief Reconciliation Act of 2001, for the year 2010, the estate tax is repealed. 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 available for property passing to a surviving spouse.



- **Special Considerations, S Corporations.** 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 the capital gains treatment seen under the C Corporation rules. 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.

**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 since neither the AMT rules nor the family attribution rules 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 since 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 — an advantage over the cross purchase approach when there are multiple 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 C Corporations, premiums paid by a pass-through entity (S Corporations, partnerships and LLCs) are nondeductible for tax purposes. However, unlike in C Corporations, premium dollars do affect the owners' basis, reducing it dollar for dollar. In an S Corporation, this premium expense will be allocated to shareholders pro-rata (i.e., reflecting their ownership percentage). Under partnership/LLC tax law, using the substantial economic effect argument, 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 owner's basis to reflect the investment element of the premium cost (i.e., upward adjustments for cash value increases). When a pass-through entity will make distributions in the future, or the business will generate losses, this cash value increase and the resulting higher basis is an important consideration since it shields the owner from taxation.

- **Policy Proceeds.** Proceeds of life insurance policies received by the business are generally not subject to income tax, but do increase the earnings and profits of a C Corporation. Where the shareholder holds a controlling interest in the C Corporation (greater than 50% ownership), the proceeds will not be included in the controlling shareholder's estate to the extent they are paid to the corporation, although the purchase price of the shares under the agreement may be affected by the additional cash, depending on the method of determining the purchase price.

Life insurance proceeds received by an S Corporation, partnership, or LLC are not subject to income tax at either the entity or owner level. However, such proceeds increase the basis of an owner in his or her ownership 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, surviving shareholders of a C Corporation do 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.
- **Alternative Minimum Tax.** If the corporation is a C Corporation, policy cash values and



death proceeds will affect the adjusted current earnings (ACE) calculation and may result in alternative minimum taxation (AMT). S Corporations, partnerships, and LLCs are not subject to AMT.<sup>10</sup>

## **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 agreement, and
- 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 special valuation rules found in IRC § 2703 to ignore valuations that provide for a sale at less than the business's fair market value. However the Service will honor below market valuations if three additional 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 member's 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 arms' length transaction.

A proper independent valuation is especially critical when buy-sell arrangements involve related parties.

## **Business Valuation**

One of the more important components in a buy-sell arrangement 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.

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<sup>10</sup> For tax years after December 31, 1997, corporations with average annual gross receipts less than \$7.5 million for the preceding three-year period (average annual gross receipts of \$5 million for initial qualification) are no longer subject to AMT.



An accurate valuation is a major component of a successful buy-sell arrangement. 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, and
- Assure that the family will receive a fair price for the business interest.

There is no one method of determining a business's value and different methods may be used for different purposes. It is important that a business owner seek the advice of his/her legal and tax counsel to ascertain the best method for arriving at the business's 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 planning techniques 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 including: 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; the degree of trust between the parties, etc.

The discussion that follows is an overview of some of the 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, SCINs are 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 goal is to exclude the unpaid balance of the note from the seller's estate and to avoid 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 over a private annuity 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.

**Private Annuities.** Where a private annuity is used in a buy-sell agreement, the business owner transfers ownership in exchange for an unsecured promise to a stream of income (an annuity) for life.

Private annuities are typically used when the sale involves an elderly individual (often in poor health, but death is not imminent) selling to a younger generation family member.

Similar to the SCIN, the goal of a private annuity is to exclude the asset and future appreciation from the seller's estate and to avoid gift tax. However, the life payout meets an additional cash need since the seller receives the assurance of a lifetime income stream.

The major risk is that the transferor/annuitant may live longer than his/her actuarial life span. For the buyer, this means that there is the possibility that he/she will pay more than the business is worth.

**Family Limited Partnerships (FLPs).** Structured properly, family limited partnerships are 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, via gifts, limited partnership interests to the children. 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 planning 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 planning needs

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

**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 his or her estate.

Business stock, such as S Corporation stock that generates sufficient income, can be placed in a GRAT or GRUT with children as beneficiaries while paying income to the senior generation. And 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 noncharitable beneficiaries. Typically a CRT is designed to pay income to one or more noncharitable beneficiaries (generally the donor and the donor’s spouse) for life 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 gain tax and future investment dollars are lost to the IRS. However, if the appreciated assets are transferred to the CRT and then sold, since the CRT is a qualifying exempt charitable trust, it pays no capital gain tax on 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 his/her 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 proper planning, the needed premium dollars could be paid from the income generated by the CRT.

## Resources for Buy-Sell Arrangements Using Life Insurance

The following materials have been created by Prudential Financial to help you recognize and close the life insurance sale. Materials are grouped by topic areas and presentation focus (producer seminar, chart, consumer brochure, etc.) for your convenience.

### **Comprehensive Guides**

- IFS-A082204: Producer Marketing Guide: Buy-Sell Agreements Using Life Insurance
- IFS-A071522: Producer Marketing Guide: Employee Stock Option Plans (ESOPs)
- IFS-A005418: Technical Guide: Life Insurance Planning for the Subchapter S Corporation
- IFS-A074815: Leimberg’s: Why Entity Planning is Important to You
- IFS-A084055: Leimberg’s: Valuing a Closely Held Business
- IFS-A071291: Booklet (National Center for Employee Ownership): An Introduction to ESOPs

### **Producer Seminars**

- IFS-A103496: Understanding the Business Life Cycle
- IFS-A089525: Exit Strategies for the Closely Held Business
- IFS-A092118: Entity Considerations and Life Insurance Sales



IFS-A095517: Understanding Financial Statements

IFS-A095514: Exhibits for Seminar “Understanding Financial Statements”

IFS-A085352: Valuation of a Closely Held Business

IFS-A005420: Business Continuation Considerations for the S Shareholder

IFS-A076515: Buy-Sell Arrangements: Focus on S Corporations

IFS-A076532: Buy-Sell Arrangements: Focus on Partnerships and LLCs

IFS-A016638: Family Limited Partnerships: Foundation and Benefits

IFS-A071688: Employee Stock Ownership Plans (ESOPs) Planning and Strategies

**PruPower Minutes (aka Brainsharks)**

IFS-A113709: Buy-Sell Arrangements Using Life Insurance

IFS-A115240: Employee Stock Option Plans (ESOPs)

**Charts**

IFS-A024767: Comparison of Business Entities

IFS-A088143: Business Life Insurance at a Glance

IFS-A079154: Comparison of Entity Purchase and Cross Purchase Arrangements

IFS-A082190: Comparison: Financing Alternatives for Transferring a Business Interest

IFS-A077676: Comparison: Estate Payment Strategies for Transferring a Business Interest

IFS-A080953: IRC § 318 Rules of Attribution

**Frequently Asked Questions (FAQs)**

IFS-A082347: The Benefits of Establishing a Buy-Sell Arrangement

IFS-A079805: Buy-Sell Arrangements and Transfer-for-Value Issues

IFS-A079860: Buy-Sell Arrangements and Estate Valuation: IRC § 2703

IFS-A080954: How the Attribution Rules Affect Stock Redemption Buy-Sell Arrangements

IFS-A089036: Life Insurance and Corporate Alternative Minimum Tax (AMT)

IFS-A077771: Tax Treatment of Stock Redemptions Incident to Divorce

IFS-A080958: Buy-Sell Arrangements: Partnerships, LLCs and the IRC § 754 Election

IFS-A096724: S Corporation ESOPs: Planning or Abuse?

**Sales Ideas and Solutions**

IFS-A035870: Using Target Term Rider to Enhance Funding for a Buy-Sell Arrangement

IFS-A105581: Case Profile: Buy-Sell Arrangements

IFS-A035871: Estate Equalization Using Life Insurance for Heirs of a Business Owner



IFS-A081510: No-Sell Buy-Sell Arrangement

IFS-A081468: Closely Held Business Sale Using a CRT

IFS-A069649: ESOP Plans - A Tax-Advantaged Technique

IFS-A071585: ESOP Plans - A Tax-Favored Exit Strategy for Business Owners

IFS-A071506: ESOP Sales Opportunities

#### **Fact Finders and Questionnaires**

IFS-A069748: Confidential Business Fact Finder

IFS-A081979: Business Continuation Supplement

IFS-A071590: Profile Questionnaire: Can an ESOP Meet Your Client's Needs?

#### **Client Approach Materials**

IFS-A075564: Statistics Talk: The Importance of Small Business Succession Planning

IFS-A015760: Prospecting Letter: General Business Approach

IFS-A071496: Business Postcard: General Business Postcard

IFS-A074833: Prospecting Letter: Business Valuation

IFS-A073392: Prospecting Letter: Business Exit Strategies

IFS-A069845: Seminar Invitation: General Business Strategies

#### **Client Brochures**

IFS-A006833: Business Strategies

IFS-A006206: Business Continuation Planning

IFS-A049256: Helping to Protect the Future of Your Business

IFS-A004807: Valuation of a Closely Held Business

IFS-A087893: Transfer Your Business Using the "No-Sell Buy-Sell" Arrangement

IFS-A090965: ESOP – A Succession, Finance and Estate Tool

#### **Consumer Presentations and Seminars**

IFS-A012892: Corporate Cross Purchase Buy-Sell Arrangement

IFS-A012896: Stock Redemption for Shareholders of Closely Held Corporations

IFS-A025295: Section 303 Stock Redemption

IFS-A012899: Unilateral Buy-Sell Arrangement

IFS-A006164: Wait-and-See Buy-Sell Arrangement

IFS-A078281: Cross Purchase Arrangement For Owners of Partnerships and LLCs



IFS-A074542: Corporate Buy-Sell Funded with Partnership-Owned Life Insurance

IFS-A012894: Entity Purchase Arrangement for Owners of Partnerships & LLCs

IFS-A022395: Business Continuation Using a Family Limited Partnership

IFS-A022394: Business Continuation Using a Charitable Remainder Trust

IFS-A022393: Business Continuation Using the S Corporation GRAT

IFS-A083809: Understanding Business Succession Strategies for the Closely Held Business

**P R O D U C E R   M A R K E T I N G   G U I D E**



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