Buy-Sell Agreements:

Why and How to Fund Them

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Executive Summary

- Once a closely-held business attains a meaningful value, its owners should implement a buy-sell agreement to assure a market for a partial interest in it and to provide a smooth transition to its future owners.

- Without adequate and regular funding -- with life and disability insurance funding wherever possible -- the purchase obligations of a buy-sell agreement are often empty and unenforceable.
  - The funding of the agreement is more important than identifying the future buyer with certainty. With a "wait-and-see" buy-sell agreement, life and disability insurance can be purchased on the owner who will be expected to sell, and the buyer can be determined later. Without funding, however, it may not be possible to control this decision.

- Ownership of the insurance policies funding the buy-sell agreement should be structured to minimize taxation. Issues to plan for or around include:
  - The possible imposition of the corporate alternative minimum tax on the insurance proceeds received by a C corporation;
  - Increasing the capital gains tax cost basis for the surviving owners by the amount of the insurance proceeds;
  - Structuring any C corporation stock redemption to assure, if possible, its treatment as a sale of a capital interest rather than the distribution of a dividend;
  - Avoiding extra taxes on excess accumulations of retained earnings by a C corporation that are not justified by reasonable business needs;
  - Arranging any changes in the ownership of policies to avoid "transfers-for-value" that subject otherwise tax-free insurance proceeds to income taxation; and
  - Considering the eventual ownership and use of the insurance policies so as to reduce both income and estate taxes.

- Disability buy-sell provisions relating to the eligibility and timing of payments for a disability-related buyout should follow the language of the insurance policies funding them. Because it is not possible to insure the full amount of the purchase required upon disability, payments from other sources -- including the cash value of life insurance policies and life insurance premiums saved by life insurance policy provisions waiving premiums upon disability -- should be identified.

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Buy-Sell Agreements: Why and How to Fund Them

by
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Buy-sell agreements among co-owners or present and future owners of a closely-held business are intended to assure the smooth future transition of its ownership. They provide the mechanism, and, if properly funded, the means, to effect a change in control and a transfer of interests upon the occurrence of a number of events, beginning with death, disability and retirement. Yet, for some reason, there is widespread confusion among professional advisors on the questions of whether and how to fund these agreements, even though, without such funding, they may contain little more than empty, unenforceable promises. Consequently, most existing agreements need much improvement.

This is not intended as a comprehensive treatise on all aspects of buy-sell agreements. Rather, it focuses on their insurance funding, first outlining the compelling reasons for doing so and then reviewing in some detail the tax and non-tax consequences of placing the insurance policy ownership with the individual co-owners (a cross-purchase plan), with the business (a redemption or entity arrangement), or in a hybrid form.

Whether and When to Implement a Buy-Sell Agreement: There is a surprising lack of recognition of the circumstances calling for a buy-sell agreement. They are not limited to the classic case of two co-owners, each owning half of a successful, mature business. They should also be considered:

(1) Where a company with little or no value can expect to appreciate in the near future.

(2) Where a majority, and perhaps older, owner ought to provide an incentive, in the form of helping to fund a buy-sell agreement, for one or more younger owners and key employees to stay with the business.

(3) Where a sole owner wants to assure the future market for a business by identifying a buyer in advance from among the following: children, key employees, competitors, suppliers, or customers.

(4) Where it is unclear whether one or more children will or should be future owners, but having insurance in a trust for their benefit enables such children and the trustee to make this choice at the proper time in the future.

Reasons for Buy-Sell Agreements: Before addressing the question of funding, it may be worthwhile to review some of the major reasons for a buy-sell agreement in the first place:

(1) To provide a market for the business interest of a deceased, disabled, or retired owner. Closely-held enterprises do not have a ready exchange for their sale, especially of partial interests in them. In most cases, only co-owners, those already in the business, or the business itself would want to or be in a position to buy them. Note that this market-creating purpose for a buy-sell agreement may be especially important for a sole proprietorship, the sale of which might be arranged to a similar business or to one or more key employees who are not currently owners.

(2) To restrict transferability, both during life and at death, of ownership interests by defining and limiting those who may acquire or receive them. Regardless of who might be willing to buy into the business, the existing owners are logically interested in keeping ownership amongst themselves or others already involved in the business. More than likely, they do not want to go into business with the surviving spouse or children of a co-owner, or even, for any length of time, with the executor of a co-owner's estate. Nor, in the absence of an agreement to the contrary, do they likely relish the idea of bringing in any outside investors, even assuming they could attract them. What lender or investor would want to put money in the business after the death of the key executive anyway?

(3) To effect a transfer of the business to the right family members. This is especially important when it is intended that the business will pass to certain family members and not to others. For example, perhaps the business will be purchased by one or more children and a surviving spouse will be provided for with non-business assets. Or, very often, some but not all children will be involved in the business, and it is important to assure that the business go to those who are actually working in it.

Even when it is unclear which family members, if any, will take over the business, having a funded buy-sell agreement in place, with insurance enabling children to buy the business, if it is appropriate and that is their choice at that time, will provide the most future flexibility.

(4) To fix the value of, or at least the method of valuing, the business during life and at death. Under current tax law, it is very difficult, if not impossible, to fix the value of a family business for purposes of transfers to natural heirs, as the IRS suspects attempts at undervaluation for estate and gift tax purposes. Between other co-owners and even to some extent with family businesses, however, establishing a fair valuation methodology remains a primary reason for a buy-sell agreement.

In any case, the recognition that the business has a meaningful value usually triggers awareness of the need for a buy-sell agreement. This is followed by a further acknowledgment of the necessity of an orderly and mutually understood procedure to determine and make ongoing adjustments to the valuation and the requirement of a funding source to put the business and its co-owners in a position to honor the purchase obligations of the agreement.

(5) To define the events that trigger the right or obligation to buy or sell. These typically include death, disability, and retirement. They may also address voluntary or involuntary separation from the business, a desire to sell an interest in the business coupled with a right-of-first-refusal (perhaps at a discounted price) by remaining co-owners, bankruptcy, and divorce.

(6) To give incentives to one or more younger or minority owners or key executives to join or remain with the business. The promise of future ownership to the younger key executive through a buy-sell agreement funded with the help of a majority, older owner may well be the reason that the younger individual, who is increasingly crucial to the success of the business, decides to remain with it instead of seeking out better opportunities.

(7) To protect the status of an S corporation by prohibiting ineligible shareholders. An S corporation can only have certain types of owners. It is common for buy-sell agreements involving them to provide a non-qualifying individual or entity from becoming an owner.

Reasons to Fund Buy-Sell Agreements with Life and Disability Insurance: While it may not be possible to fund a buy-sell agreement to cover every contingency, it should be possible to do for at least the possibilities of death and disability and, cash flow permitting, to use permanent life insurance as a tax-advantaged vehicle in the right situations to build up at least a portion of the funds anticipated to be needed for a lifetime buyout when an owner retires.

Especially because of the need to back up the promises of a buy-sell agreement with the funding of it, let's spend a minute focusing on the importance of doing so.

(1) Insurance funding is required to make a buy-sell agreement enforceable upon death or disability: Without it, the agreement may not be worth the paper on which it is written. Most businesses will be unable to generate or borrow the necessary cash from other sources. Even if possible, those alternatives would likely be much more expensive.

(a) Insurance on the expected seller should be put in place just as soon as the business has a meaningful value, even if it is unclear just who the buyer will be -- whether it will be a current co-owner, one or more family members, one or more key managers, or perhaps even another business. The ownership of the policy or the planned use of its proceeds can be changed after the insurance is acquired with a "wait-and see" buy-sell agreement. Without the funding already in place, however, this future flexibilty will be sacrificed.

(2) The odds of pre-retirement death or disability are very high: Death or disability before retirement is likely enough and its financial consequence grave enough, both to deceased or disabled co-owners and those needing money to buy them out, that insurance for these purposes is essential, unless it cannot be obtained. Consider the high odds of death or disability before age 65, as shown below. As should be readily apparent from the table on the next page, the chances are so great as to make foolhardy the failure to insure against these possibilities by anyone able to do so.

The High Odds of Death and Disability Before Age 65

Odds of One or More Deaths Before Age 65 (Number of Chances Out of 100)				Odds of at least One Permanent Disability (90 Days or Longer) Before Age 65 (Number of Chances Out of 100)			
Two Owners		**Three Owners**		**Two Owners**		**Three Owners**	
Age	**Chances**	**Age**	**Chances**	**Age**	**Chances**	**Age**	**Chances**
35-35	47.4	35-35-35	61.8	35-35	84.2	35-35-35	93.7
40-40	45.8	40-40-40	60.2	40-40	80.4	40-40-40	91.3
45-45	43.5	45-45-45	57.6	45-45	75.0	45-45-45	87.5
50-50	39.8	50-50-50	53.3	50-50	67.1	50-50-50	81.1
35-40	46.6	35-40-45	59.9	35-40	82.4	35-40-45	91.2
40-45	44.7	40-45-50	57.1	40-45	77.8	40-45-50	87.3
45-50	41.7			45-50	71.3		

(3) Permanent life insurance can be the most effective means of funding lifetime retirement buyouts and retirement savings: Life insurance with a strong-performing, low commission policy is nearly as effective a funding vehicle for lifetime buyouts and for retirement income for a co-owner as it is for purchases at death. That is why, where businesses produce an adequate cash flow and the co-ownership is likely to last a long time, the owners should consider a form of permanent life insurance. Insurance is needed in the first place to cover the possibility of a buyout at death. Assuming, however, that the owners live long and healthy lives, the cash value in these policies can be used to finance a portion of a lifetime buyout, or the policies can be transferred to the insureds for them to use either as a source of retirement income or to provide estate liquidity at death. As in other areas, life insurance serves multiple, flexible purposes, providing the necessary coverage in the short-run and a tax-advantaged source of accumulating cash for the longer term.

If the owners are interested in a policy where the cash value accumulation might more closely track the rate of appreciation that they expect for their business, they may want to consider "variable" life. These policies allow the underlying policy investments to be made in a 401(k)-like menu of mutual funds, including equities. Given the long-term rate of return from equity investments, it might be expected, although there are certainly no guarantees, that the long-range performance of a variable policy will be a little better than an insurance company's traditional and more conservative investment portfolio. Variable policies have somewhat higher expenses, however, so the investments in them should be in equities in order to have a good chance of outperforming the traditional policy after these extra costs are deducted. (For additional information on evaluating life insurance, see "What Professional Advisors Should Know and Ask about Life Insurance").

(4) The business entity or co-owners might not be able to afford the future installment payments required with an unfunded agreement: There is no assurance or likelihood that extra future after-tax cash flow would be adequate to afford installment payments. Most co-owners do not have and could not easily borrow the cash necessary to fund a buyout. It might also be hard for the business to borrow the money. What lender is going to extend credit just after the key executive and owner of the business has died. Even if the business could borrow, it would be forced to incur the expense of debt and interest payments and to forgo other demands for capital. More likely, the agreement's promise of installment payments would go unfulfilled and would be unenforceable.

(5) Even if installment payments might be affordable, their cost would likely be much greater than the price of the insurance premiums. Both insurance premiums and the principal portion of installment payments are, in most cases, not deductible. The exception would be for premiums on policies owned by employees and paid for by the business as compensation. The main cost advantage of insurance is the fact that insurance proceeds are income tax-free (except for a possible 15% tax in the case of C corporations, which expense can be recouped against corporate income taxes in future years) and that the cash value builds up on a tax-deferred basis. Not only is the insurance expense cheaper than installments; it is also more predictable.

(a) Maximizing returns from the life insurance investment: The advantages of insurance funding over the expense of future installment payments are especially great where care is taken to maximize the risk-adjusted rate of return from the life insurance investment. This is accomplished by selecting a life insurance company that has achieved a consistently superior rate of return on premium dollars and also provides the highest level of financial safety. In addition, any permanent insurance product should be funded in a way that minimizes the commission cost. The money funding buy-sell agreements will go farther and be safer if placed with a policy of this kind.

(For additional information on this point, see “How to Make Permanent Life Insurance A Good Investment”).

(6) If the agreement’s buyout requirement is unenforceable, the heirs of a co-owner could force a sale or liquidation. Funding the agreement is essential not just to treat any deceased co-owner fairly but to assure the survival of the business.

(7) The promised installment payments upon the death, disability, or retirement of co-owners create an enormous unfunded liability. The liability will be a drag on the corporate balance sheet and will make the business less credit worthy for other possible borrowing. Even if additional borrowing is possible, the interest rate and terms for such loans will be less favorable than if the balance sheet is cleaner. The unfunded liability will have the greatest impact if many co-owners will be owed installment payments at the same time. The ability to pay them may depend on unrealistic expectations of future growth in revenues.

(8) Insureds may often be substituted on the same policy if one owner leaves the business and another joins it. This is less a reason to fund the agreement than it is an answer to a the possible objection to insurance funding based on the questions of about possible policy options if a shareholder/insured leaves the business. Although those departing insureds can be given the option of taking their policies with them and continuing to pay premiums, they will often choose not to, leaving the business wondering what to do with a policy on which it may have been paying the premiums. In some cases, it may hang on to the policy and continue to pay the premiums. Especially if the policy is held until the insured’s death, thus taking advantage of the income tax-free treatment of the death proceeds, the rate of return can be quite attractive, and the policy’s cash value is otherwise a valuable asset. More often, the business will be interested in the opportunity to substitute a new insured for the previous one without incurring the additional expenses normally associated with taking out a new policy. The premium and policy values may have to be adjusted in light of differences in ages and health between the previous and new insured, but the transaction is otherwise smooth and cost-effective.

(9) With entity purchases (redemptions) involving partnerships and S corporations, life insurance funding is the only means to increase the cost basis of the survivors’ interests by the amount of the purchase price. As will be discussed in more detail below, one of the objectives of a buy-sell arrangement is to increase the cost basis of the remaining owners by the amount of the purchase price, so that when their interests are later sold, their capital gains tax exposure is reduced.
This is the result under all circumstances with a cross-purchase made by the remaining owners individually of the deceased or departing owner’s interest. With life insurance funding, it is also possible when an S corporation or partnership makes the purchase.

As we will also see, it may be desirable to structure an S corporation buy-sell agreement as a redemption, rather than a cross-purchase, where it formally was a C corporation and has leftover retained earnings (“accumulated earnings and profits”). In most cases, this cash cannot be distributed by the corporation in a redemption without being treated as ordinary income. Life insurance funding of the redemption, however, reduces this accumulated earnings and profits by the same percentage that the amount redeemed bears to the total value of the enterprise. The life insurance funded redemption, thereby, not only increases the cost basis of the survivors’ interest but also better positions the remaining interest for a favorable tax treatment upon a subsequent redemption. Neither of these benefits would be obtainable from a redemption carried out without insurance.

(10) Unfunded buy-sell agreement are as hazardous to professional advisors as they are to their business clients. Businesses are not likely to survive the inability to make promised payments to deceased, disabled, and retired co-owners as the result of an unfunded agreement. When that occurs, they will probably be sold or liquidated, and the lawyer's, accountant's, and banker's existing client will disappear at the same time. Properly structured buy-sell agreements that enable an enterprise to stay in the hands of a family or key executives working in the business will enhance the persistency of the professional advisor's current client base. Advisors should take an inventory of their existing clients with either no agreement or an unfunded agreement and motivate them to remedy the problem.

Questions about Possible Inequities in Insurance Funding: In most buy-sell funding arrangements, it is difficult to arrange for amounts of insurance and a premium cost that appear to treat everyone equally. There are two situations that might be viewed as inequitable.

(1) The heirs of a deceased co-owner normally receive less than surviving owners. The heirs receive the insurance proceeds in exchange for the deceased owner's share of the business. They also have the any cash value in a policy or policies other than the surviving owner(s). The surviving owners have both their share plus the deceased owner's share that has been acquired with the insurance proceeds.

As a simple example, with two equal owners, the survivor will end up with twice as much. This difference may be narrowed somewhat by any cash value in a policy on the survivor in the estate of the deceased owner.

There is no ready-made solution to this situation. Increasing the amount of insurance to compensate for these unequal amounts works when there are several co-owners. To do this, the coverage on each owner should be raised by the original amount of insurance divided by the number of remaining owners. For example, a 20 percent owner with four other owners would be equally compensated if the amount of insurance is increased from 20 percent to 25 percent of the business' value. This is not nearly as practical a solution, however, if there are only two equal co-owners. The amount of insurance would need to be doubled, and this remedy may be viewed as too expensive.

Compromise approaches include increasing the amount of insurance by a portion of the original coverage to provide some additional compensation to the family of a deceased co-owner, requiring an additional series of installment payments from the survivors, or, at a minimum, requiring the survivors to pay the equivalent of any cash value in policies on their lives in buying them from the estate of a deceased co-owner.

(2) Differences in the ages, health, and ownership percentages of the owners can lead to wide disparities in premium costs. The younger, minority owner making less money may not be able to afford insurance on the older, majority owner. It may have to be purchased either with substantial, additional bonused compensation to the younger owner, or it will need to be acquired by the business. A "split dollar" ownership and payment arrangement (discussed further below), where the business pays all or most of the premium but the younger co-owner owns it, is another possibility. So is mixing the policies with varying combinations of term and whole life insurance so as to equalize, or at least narrow the difference in, the costs of premiums on the different policies. These questions may seem especially problematic when there is a majority, older owner and a younger, minority owner who is not at all in a position to afford all of the insurance required to fund the buyout of the senior partner.

(a) Why should older, majority owners not simply buy their own insurance and let younger, minority owners fend for themselves? After all, the majority owners might ask, what reasons are there for them, either themselves or through the business which they mostly own, to be funding the buyout of their own interests for the benefit of the younger minority owner? In these situations, there is likely one or more reason for the older owner, through the business and perhaps with a split dollar ownership arrangement to be helping to pay for the insurance that will acquire his own interest rather than, if insurance is to be taken out at all, simply acquiring his own policy and perhaps owning it in an irrevocable trust.

(i) The business may not be marketable to anyone else. The fundamental purpose of the buy-sell agreement is to assure a market for the business that may not otherwise exist. Unless the younger, minority owner has the wherewithal to buy the business, perhaps no one else will, certainly not for the same price, and the majority owner and the heirs will lose much of their investment. The business may not survive and will have to be liquidated or sold at a firesale price.

(ii) Just as importantly, the younger, minority owner may not stick around without the expectation of the future ownership of the business. If the younger owner, who is increasingly important to the success of the business, departs, the business is likely to lose much of its value. The buy-sell agreement largely funded by the older, majority owner gives the younger partner and key executive reason to stay and helps to maintain and enhance the value of the business.

<u>Types of Buy-Sell Agreements and Insurance Policy Ownership Arrangements</u>

With an understanding of the many reasons why the funding of buy-sell agreements is essential, we are ready to discuss the types of buy-sell agreements and policy ownership and payment arrangements.

General Background: To review the basics, there are two essential types of agreements -- the **cross-purchase**, which has co-owners purchasing from and selling to each other, and the **redemption** (a term which applies to corporations purchasing a shareholders interests) or **entity** (a more generic term, which can also apply to partnerships) agreement.

Sometimes these arrangements are in **hybrid** form where interests are partially acquired by other owners and partially by the business, for example where insurance proceeds used to fund a buyout are paid in part to surviving owners and in part to the business. This might occur where an agreement starts out in cross-purchase form but insurance policies belonging to a deceased or departed owner are subsequently transferred to the business rather than to co-owners.

Where there is some uncertainty as to whether an individual will be in or remain involved in the business in the future, a **"wait-and-see"** agreement allows that decision to be deferred. If, for example, there are two children and child #1 is already involved in the business, but it is unknown whether child #2 will be, an insurance policy owned by child #2 could be used either to fund a partial acquisition of the business or to compensate that child for the fact that the business will go to child #1. In the latter case, the proceeds from child #2's policy might be loaned to the business to fund a partial redemption of the parents' stock.

General Principles in Choosing the Type of Agreement: The main rule is that, in the case of C corporations, and, to a lesser extent, S corporations, a cross-purchase arrangement is preferable to a redemption for a variety of tax reasons. This is true even though the cross-purchase agreement may seem more administratively complex. Although we will cover each of these tax issues in more detail, they should be introduced here.

At the same time, it should be stated at the outset that, where the business is a partnership or limited liability company, the choice between the cross-purchase and redemption agreement does not generally matter because of the advantageous partnership taxation rules that apply to both entities. This extended review of the choices between the two types of agreements will therefore generally only pertain to the context of C corporations and S corporations, except where otherwise noted.

(1) Whether or not the tax or cost basis of surviving owners, used to calculate their eventual capital gains, is increased by the purchase price of the buy-out. The answer is yes with a cross-purchase arrangement, no with a redemption and C corporation, and, with special additional foresight and planning, yes with an S corporation and partnership.

(2) Whether the purchase price received by the estate of a deceased owner will be treated as the payment in a sale and exchange after its capital gains tax basis has been stepped up at death, or whether it will be treated as a dividend. This is not an issue in the case of a cross-purchase, but only when the payment is coming from the business in a redemption. It is really only problematic for C corporations that are family businesses and family-owned S corporations which still have accumulated earnings and profits from their days as S corporations.

(3) Whether the insurance proceeds are income tax-free. Insurance proceeds are most always income tax-free, and that is one of the main tax advantages of the product. However, there are two circumstances which can prove the exception.

(a) Policies owned by a C corporation face a possible corporate alternative minimum tax at an effective 15 percent rate. This is not an issue for policies owned by other types of business entities or by individuals. Even where the tax must be paid, it can be recovered as a credit against the liability for corporate income taxes in future years.

(b) The transfer of the ownership of, or the interest in, a policy, in exchange for value (rather than as a gift) can trigger the "transfer-for-value" rule and make all of the policy's death proceeds received by the beneficiary subject to income taxes. In the context of a buy-sell agreement, this can occur when policies are transferred between shareholders, and it is most apt to happen in cross-purchase arrangements after the death or departure of one of several shareholders when the policies owned by that individual are acquired by or transferred to other shareholders who are not the insureds on those policies. This is the tax reason to favor a redemption over a cross-purchase agreement, but, as we will see, the transfer-for-value problem can be avoided with a cross-purchase arrangement if its potential is spotted in advance.

Reasons for a Redemption Agreement: Before dealing at greater length with the above-mentioned arguments for cross-purchase arrangements, it would be well to have an understanding of the reasons why most buy-sell agreements are, often inadvertently and wrongly, structured as redemptions.

(1) They are simpler to administer. This appears to be true from the standpoints of the smaller number of insurance policies required, the assurance of premiums being paid, and the reduced likelihood that the ownership of policies will have to be changed in the future when owners die or otherwise leave the business. There are ways, however, for cross-purchase agreements to minimize these advantages that redemptions appear to have.

(a) Fewer policies required: With the policies owned by the business entity, only one policy is required for each owner. With a pure cross-purchase arrangement, each owner must have a policy on each other owner, such that the total number of policies required is n (n-1), where n is the number of owners. With more than three owners, it is fairly cumbersome.

The best way to avoid the need for a multitude of policies where there are several co-owners is not through a redemption arrangement, but rather with either a trust-like escrow agreement or with a partnership (partnership-owned policies avoid the tax traps of policies owned by C corporations) that is set up with a bona fide business relationship with the corporation. In either case, the entity -- the trust or the partnership -- is generally the owner, payor, and beneficiary of the policies. With the trust arrangement, a transfer-for-value income tax problem is still possible when beneficial interests in the policies change hands, but, as is explained below, a partnership overcomes this problem. With a trust, care should also be taken in its drafting to avoid giving the co-owners any “incidents of ownership” in policies on their own lives, which can make the proceeds includable in their estates. Co-owners should be specifically denied the right to participate in such decisions as borrowing from or surrendering policies on their lives.

(b) Greater assurance that premiums will be paid and that insurance proceeds will be applied to effect a buy-out. Any concern about the reliability of individual owners to pay the premiums for policies which they own themselves on the lives of the other owners in a cross-purchase arrangement can be answered in one of several ways: a trust or partnership ownership, as just described; a loan arrangement, where the individuals own the policies, the corporation pays all or most of the premium, and the corporation has a secured interest in recovering its premium payments from the policy’s cash value or death proceeds; or a bonus plan, where the individuals own the policies, the company pays the premiums, and the premium cost is taxable compensation to the policy owner and a deductible expense for the business (the company might also pay (“gross up”) the tax cost to the policy owners of the bonus/premium payments).

As for any worry that a policy’s death proceeds payable to an individual owner will not be applied to make the required purchase, that is, of course, an enforceable contractual promise. Further security against possible non-compliance is available with an entity -- the escrow trust or partnership -- as beneficiary.

(2) One or more individual owners could not afford the required purchase price or the insurance premiums. This is especially true in the case of the younger, minority owner whose potential inability to afford a buyout of the older, majority owner and whose all-important role in the business was presented earlier as a key reason for having the business, and indirectly the majority owner, help fund the buyout. It is not necessarily an argument, however, for a redemption arrangement. The majority owner can help fund the buyout by the younger, minority owner without making the business the owner of the policy. This can again be done with either a loan or bonus plan, where the individual owns the policy that is completely or mostly paid for by the business.

(3) The possible transfer-for-value of policy ownership with a cross-purchase arrangement is difficult to avoid and argues for a redemption agreement instead. The transfer-for-value rule, partially explained above, relating to the possible income taxation of otherwise tax-free life insurance death proceeds seems at first a needlessly confusing provision of the tax code. It is designed to discourage wagering-related sales of policies among non-insureds. Overlooking its impact can subject otherwise income tax-free life insurance proceeds to taxation instead.

A redemption agreement with a corporation owning the policies is not necessary to avoid a transfer for value. There are several exceptions to the transfer for value rule that can avoid the dire consequence of the taxation of the death proceeds in a cross-purchase context. These include transfers to the insured, to a corporation in which the insured is a shareholder or officer, to a partner of the insured or a partnership of which the insured is a partner, and transfers in which the cost basis of the policy is carried over in whole or in part after the transfer (this is paraphrasing; it means an exception when a policy is gifted, or when the transfer is part gift and part sale but more gift than sale). The major non-exception, and the most frequent potential cause of a transfer-for-value exposure to the possible threat of income taxation of policy death proceeds, is the transfer of a policy from one shareholder, who has died or otherwise left a business, to another. Again, there is an exception for a transfer to a corporation of which the insured is an officer or shareholder, but not to another shareholder of that corporation.

Consider the example of a $3 million business with three equal owners, each holding a $500,000 life insurance policy on the lives of the other two owners to enable them to buy out each other's interest pursuant to a cross-purchase agreement. If one of them dies or leaves the business, the remaining owners should each want to, or perhaps would be required to, acquire the $500,000 policy on the life of the other remaining co-owner, so that they would then have $1 million, instead of $500,000, on each other's life (they would still need an additional $500,000 each on the life of the other in order to still have an agreement insured for the full $3 million of the business). If they acquire those policies themselves, these transactions would amount to transfers for value to fellow shareholders that would trigger the eventual income taxation of the policy's death proceeds -- obviously, a disastrous result.

The way around this potential trap, without giving up the generally more tax-advantageous cross-purchase arrangement in favor of a redemption agreement, is to use the partner/partnership exception to the transfer -for-value rule. A partnership between the remaining shareholders could be created, and the policies could then be acquired either by this new partnership or by the individuals as partners rather than merely as shareholders. Although a 1993 private letter ruling (9309021) suggests that such a partnership could legitimately be established only for the purpose of acquiring and holding life insurance policies on the lives of its partners, this seems, quite possibly, to run counter to the accepted rule that a partnership must have more of a business purpose. Partnerships that own items of business equipment and real estate that are leased to the corporation are, therefore, frequently suggested as the vehicle for insurance policy ownership which avoids both the transfer-for-value potential and the misplaced tendency to opt for a redemption arrangement in the first place in order to dodge this tax risk.

If the policies to be transferred have been held directly by co-owners of the business, the partnership designed to avoid the transfer-for-value could be created after their death or departure. If, however, all of the policies are held by a trust in which the co-owners have a beneficial interest and, upon the death of a co-owner, the trust provisions operate automatically to shift the beneficial interests of the remaining policies among the remaining co-owners, a transfer-for-value would occur. Instead, the partnership should be created at the outset either to own the policies from the beginning or to receive the beneficial interests in policies on the surviving owners that have been attributed to the deceased owner.

(4) A lower corporate than individual tax bracket makes it less expensive to pay non-deductible insurance premiums with corporate dollars, and corporate ownership and a redemption agreement therefore makes sense. Because insurance premiums are non-deductible to the individual and to the corporation, if the business has any interest in the policies, they are least expensive to the taxpayer in the lowest bracket. There may be a tendency to think that where a lower corporate tax bracket (perhaps as low as 15 percent) is a reason to have the business pay the premiums, this necessarily also means that the business should own and be the beneficiary of the policies and use the proceeds to redeem a deceased owner's interest. This is not the case.

Because a cross-purchase agreement may likely be preferable for other tax reasons, it is possible to combine individual policy ownership in a cross-purchase arrangement with the loan arrangement discussed above using the corporation to pay the premiums at its lower tax cost.

Reasons to Favor a Cross-Purchase Agreement: These were outlined above, but, for those still awake and looking for more detail, they are explained further here. These are all tax reasons, and, it should be emphasized again, they apply to the choice to be made between cross-purchase and redemption agreements when the business entity is a C corporation and, to some extent, when it is an S corporation. When the enterprise is a partnership or limited liability company, however, the choice between the two does not matter nearly so much. The following observations will mainly apply just to C and S corporations, noting the differences in impact between the two.

(1) Avoid the corporate alternative minimum tax at an effective 15 percent rate that applies to life insurance death proceeds payable to a C corporation. As noted previously, this tax is worse than it sounds, since it can be recovered as a credit against future corporate income taxes. To the extent, the corporation has continuing income taxes against which to claim this credit, the business is really only out the cost of money. However, the insurance proceeds may be very substantial in relation to the corporation's likely future income tax liability. In any event, if the tax can be easily avoided by a decision in favor of a cross-purchase over a redemption agreement, it should be.

(2) Increase the cost basis of the interests of the acquiring shareholders by the amount of the purchase price paid to complete the buy-sell agreement. With a cross-purchase, the amounts paid by individual owners to acquire other interests in the business, whether or not the purchases are funded with insurance, will always increase their capital gains cost basis by a like amount. As a result, their eventual liability for capital gains taxes if and when their own stake in the business is sold, will be reduced. If the buyout occurs through a redemption rather than a cross-purchase, the impact on the basis of the survivors will depend on the type of entity and certain provisions in the buy-sell agreement. The treatment with limited liability companies (LLC's) will be similar to that of partnerships discussed below.

(a) C Corporations: With a C corporation, a redemption, whether or not funded with insurance, will not increase the cost basis of the remaining owners.

(b) S Corporations: The situation with an S corporation is more complicated. A redemption not funded by insurance will not increase the cost basis of the remaining owners. To the extent the purchase is funded by insurance, the basis of the remaining owners will normally go up in an amount proportionate to the interest each of them had in the business before the insured died. For example, a younger, minority owner with a only a 10 percent interest in the business would experience a basis increase for 10 percent of the amount of the insurance proceeds used to buy out a deceased owner's interest even though, after the insured's death, this individual may become a 50 percent owner of the business.

However, in the above example, it may be possible to secure a basis increase for an amount of the insurance proceeds proportionate to the remaining shareholders' respective shares of the business after the insured's death, rather than before -- in other words, 50 percent in this example, rather than 15. To accomplish that requires: (a) a corporation which is a cash basis taxpayer; (b) an election by all taxpayers in conjunction with the buy-sell agreement to consent to a shortened tax year under Code Section 1377(a)(2) in any taxable year that a shareholder ceases to be a shareholder, (c) a redemption by means of giving a short-term note to the estate of the deceased shareholder before the insurance proceeds are received; (d) the receipt of the policy proceeds during a new tax year when only the survivors are shareholders, thus allowing the tax-free S corporation income to increase the cost basis of only the remaining shareholders in proportion to the percentages of their interests in the company; and (e) the use of the proceeds to pay off the note that was given, in the previous tax year, to redeem the interest of the deceased shareholder.

Thus, in a S corporation redemption, a step-up in basis for the full amount of the insurance proceeds is possible for the surviving shareholders of a cash-basis S corporation, but it requires advance planning in the form of a signed consent to the shortened tax year as part of the buy-sell agreement. What are the odds that this opportunity to increase the cost basis of the survivors by the full value of the insurance proceeds will be overlooked? A cross-purchase agreement might be easier in the first place. As we will see, however, S corporations which were formally C corporations and which have leftover accumulated earnings and profits that can only be distributed as ordinary income may be better off combining an insurance-funded redemption with this shortened tax year strategy.

(c) Partnerships and LLC's: In a cross-purchase situation, partners receive a basis step-up for the amount of the purchase price, although they will have to make an election under Section 754 to also have the basis in the partnership's assets adjusted upwards by a like amount.

Where the partnership makes the purchase, whether the partners' basis is increased depends on whether the purchase is made is made with life insurance proceeds and how those proceeds are allocated as between the deceased and surviving partners. With an uninsured agreement, there is no basis increase for the partners. With insurance, as we saw in the S corporation context, the tax-free income from the insurance proceeds increases the basis of the partnership assets by a similar amount and is passed through to the partners. With a special allocation in the partnership agreement to allocate this income all to the surviving partners, they receive the full benefit of the basis increase, which is also equivalent to the purchase price paid for the interest of the deceased partner.

(3) Avoid the possible treatment of a buyout payment as a fully taxable dividend or ordinary income, rather than as a completely or mostly tax-free payment in exchange for a capital interest. Just as the previous issue of increasing the cost basis for a purchased interest is an issue for a buyer in a buy-sell transaction, this issue affects the seller either during lifetime or the estate of a deceased owner. Note that with a redemption agreement, especially involving a C corporation, there is a major tax issue to address for both buyers and sellers -- basis for the buyers and possible dividend treatment for the sellers.

(a) C Corporations: Concerning the question of possible dividend treatment, this is only an issue in the case of redemptions of C corporation stock, but, in those situations, it can be devilishly complex. For other kinds of entity purchases and for cross purchases, the transaction is automatically treated, with some exceptions in the case of certain assets of partnerships and sole proprietorships, as the sale of an interest in the capital of the enterprise. Because it normally occurs shortly after death, when the cost basis of the owner has been stepped up to its date of death value under Section 1014, the sale by the estate will generally not produce a gain or loss. That may also be the case with a redemption of an interest in a C corporation. But to qualify these redemptions as the purchase of a capital interest with little or no capital gains tax consequence, rather than a dividend fully taxable as ordinary income, may either not be possible, especially in many family business situations, or will require the observance of an elaborate set of tax rules. We will try to cover them, but that discussion should be prefaced with an emphasis of the basic point that the potential dividend treatment of a redemption can be avoided either with a cross-purchase arrangement or with a business entity that is not a C corporation and, if it has been one, which no longer has accumulated earnings and profits left over from its C corporation days.

Qualifying as a Capital Transaction under Sections 302 and 303: Without attempting an exhaustive analysis of the unusually complicated method for determining whether a redemption can qualify as a the sale of a capital interest rather than a dividend, let's at least summarize the basic rules so that the issues can be spotted. Beginning with the Section 301 presumption that corporate distributions are dividends, Section 302 and 303 each provide for ways that they may qualify as a sales and exchange of a capital interest. It should first be determined whether the redemption can so qualify under Section 302, which is most likely to occur if it is either "substantially disproportionate" or a complete redemption of a shareholder's interest. If not, it may still be treated as a sale and exchange under Section 303 to the extent of deductions for estate taxes and administrative expenses.

Looking first at Section 302, a redemption is substantially disproportionate if the percentage of the ownership of the redeeming shareholder after the redemption, figured by excluding the shares that have been redeemed, is less than 80 percent what it was before the redemption. This percentage reduction must apply to both voting stock and common stock, and the resulting total percentage of ownership must be less than 50 percent. A redemption is otherwise most apt to qualify if it entails a complete transfer of all of the seller's interest.

The complicating factor is that the "family attribution rules" of Section 318 attribute to the redeeming shareholder shares that are owned by related individuals (other than siblings) and entities (estates, trusts, corporations, and partnerships). These attribution rules may, in some cases, be waived with a redeeming shareholder's tax return, or, in the case of potential estate attribution which cannot be waived, by making full distributions to beneficiaries with their disclaimer of any further interest in the estate prior to the redemption. Even so, qualifying for these exceptions can be impractical or impossible.

Section 303 offers another possible way for a redemption to secure treatment as a capital transaction. If a business comprises 35 percent of the taxpayer's adjusted gross estate (two or more businesses may be combined to reach this percentage if the taxpayer owns at least 20 percent of each business that is used), the redemption will receive sale and exchange treatment to the extent of the all estate and inheritance taxes, including interest, and funeral and administration expenses.

While this section can be very helpful, it can only benefit estate beneficiaries who owe estate taxes. For example, a surviving spouse who seeks to redeem but who owes no estate taxes because of the marital deduction can only use this provision to the modest extent of funeral and administration expenses. Also, where estate taxes are due, the estate must have the liquidity with which to pay them, which is, of course, another argument for insurance.

(b) S Corporations which were formally C corporations: The possible treatment of an S corporation redemption payment as ordinary income is only a problem for those which were formally C corporations and which still have retained earnings from that period, known as "accumulated earnings and profits." It helps to have some basic understanding of S corporation accounting and the rules governing the pass-through and distributions of income, particularly for those which were previously C corporations.

The undistributed net income of an S corporation (which is income already received by the S corporation and passed through to the shareholders with taxes paid by them) is identified as its "Accumulated Adjustment Account" or "AAA." Because an S corporation pays no separate taxes and the shareholders' taxes have already been paid on this income, it is distributed tax-free. However, if it was retained earnings at a time when it was a C corporation, and ten years have not elapsed since then, it is separately treated as "accumulated earnings and profits" ("AE&P"). Distributions of it are taxed as ordinary income.

When the retained cash of an S corporation and former C corporation is distributed, whether in a redemption or otherwise, the normal rule is that AAA comes out first, which is tax-free to the extent of the recipient's basis (part of basis is the undistributed net income on which the shareholder has already paid taxes). Once AAA is consumed, AE&P is distributed, which is fully taxable. Until an S corporation has been in existence for 10 years, at which point the segregated status and unfavorable tax treatment of the AE&P account ends, the inability to take this money out without subjecting it to additional taxes poses the same problem as those experienced by C corporations. Here is where a redemption funded by life insurance can help.

Life insurance funding of a redemption reduces the accumulated earnings and profits by the same percentage that the amount redeemed bears to the total value of the enterprise. For example, a redemption of half of the stock of the company would shrink the outstanding AE&P by the same amount. For that reason, where an S corporation has AE&P, a redemption, if funded by life insurance, can be preferable to a cross-purchase, contrary to the general rule. A cross-purchase would leave the same amount of tax-exposed AE&P for the successor owners. The life insurance-funded redemption, however, gets rid of a proportionate amount of it and better positions the company for a subsequent redemption. At the same time, the 1377(a)(2) shortened tax year election, described above, also enables the surviving shareholders to obtain the full benefit of the basis increase from the tax-free life insurance, equivalent to the purchase price, that they would receive with a cross-purchase. In this situation at least, notwithstanding the normal reasons to opt for the cross-purchase arrangement, the dual advantage of the life insurance-funded redemption makes it the preferred strategy.

(c) Partnerships (and LLC's): Whether transferred in a cross-purchase or an entity purchase, the payment for certain partnership assets will be treated as ordinary income to the recipient. Even though this does not have any insurance funding implications, it should be understood in the context of how payments to deceased and departing owners are taxed.

The payments that are characterized as ordinary income are for the so-called "hot assets" -- the accounts receivable of a cash basis partnership and "substantially appreciated inventory" -- and potentially also goodwill if it is not assigned a separate value in the partnership agreement. "Substantially appreciated inventory" includes those items which account for at least ten percent of all partnership property other than cash and which exceed 120 percent of the adjusted basis of this inventory to the partnership.

The IRS limits the extent to which the purchase price can be allocated to items not characterized as ordinary income. However, the partnership agreement can somewhat minimize this problem by identifying a distinct value for goodwill, which can be a very substantial part of the worth of a professional partnership.

The partners should also be aware that, to the extent these items are treated as ordinary income to the departing or deceased partner, the money paid for them decreases the income tax liability of those remaining. Conversely, treating goodwill as a capital asset in the partnership agreement lowers the tax burden for the selling partner or estate, while letting it be an ordinary income item instead would help the buyers by reducing their shares of taxable income.

(4) Beware of the "Accumulated Earnings Tax" on accumulations of retained earnings which are not deemed to be for reasonable business needs. This is an issue for C corporations accumulating retained earnings rather than paying taxable dividends. If the amount exceeds $250,000 ($150,000 for professional corporations) plus the amounts needed for the reasonably anticipated needs of the business, the excess is taxed at the top 39.6 percent individual rate.

Accumulations to pay for life insurance-funded redemptions may be suspect if maintained primarily for the estate planning needs of the majority shareholder rather than for the welfare of the business. On the other hand, accumulations for redemptions designed to maintain the continuity of the business, keep the business in the hands of those currently working in it, or increase the interests of non-family key employees are examples of purposes which have been deemed legitimate. Clear statements in corporate resolutions and buy-sell agreements of the business necessity of a life insurance-funded redemption can help to support a successful contention of business need.

Alternatively, the corporation can increase compensation to those owning insurance policies in a cross-purchase arrangement to put them in a position to buy out the interest of a retiring or deceased owner. The cost of the premiums on an annual basis should not be so great, in addition to the policy owner's regular salary, as to violate the rules against unreasonable compensation, which are designed to limit deductible compensation and force the taxation of excess compensation as dividends. Given the general advantages of a cross-purchase agreement over a redemption, a split dollar or bonus funded cross-purchase plan may be the best approach.

The Disposition of Life Insurance Policies No Longer Needed to Fund a Buy-Sell Agreement

If there is insufficient understanding of the reasons and ways to fund a buy-sell agreement with life insurance, there is even less attention given to the disposition of these policies when they are no longer needed for that purpose. As with the initial funding issues, there are a number of tax ramifications to consider, and it is important to recognize both the income and potential estate tax consequences of policy transfers.

(1) Income Tax Issues: Because policies can be replaced on the same insured without recognition of any gain under a Section 1035 exchange, it is easy to lose sight of the fact that the purchasing, bonusing, distribution in liquidation, and trading of policies on different insureds are not tax-free events. The tax impact of each of these should be understood.

If a policy is acquired, for example by an insured from a co-owner when the agreement is terminated or by an insured owner who is leaving the business, the seller of the policy will be taxed on the difference if any between the purchase price (which will normally be the policy's cash value) and the seller's tax basis in the policy. The seller's basis will normally be the premiums the seller has paid, but if there is an outstanding loan that the buyer is assuming, or the seller has taken any distributions from dividends or the surrender of cash value additions, the seller's basis will be reduced accordingly. The purchaser's new basis in the policy will be the price paid, plus any outstanding loan of the seller assumed by the purchaser.

In the first several years of a new policy, the cash value -- the price the buyer will normally pay -- will usually not exceed the premiums that the seller has paid, and the seller will have no taxable gain. Policies that have been in existence for a long period of time probably will.

If a policy is transferred by the business entity to the insured, it is compensation to an employee in the approximate amount of the cash value and a deductible business expense to the business in that case. In the case of a sale or other distribution of a policy by the business, a corporation must recognize any gain over the tax basis, as described above. In the event of a distribution to a non-employee shareholder, the policy's value will be a dividend.. For that reason, care should be taken not to violate the one class of stock requirement by a disproportionate distribution to an S corporation shareholder. If the distribution is from an S corporation in a liquidation, the policy's gain will be passed through to the shareholders in proportion to their respective interests. If it is from a partnership or a limited liability company, because of the somewhat more favorable method for computing an owner's basis in these entities, the distribution in liquidation will be tax-free.

If policies are exchanged between co-owners of a business, so that, for example, the policies which two co-owners have owned on each other's lives end up with each insured for their own retirement or estate planning purposes, each policy owner will recognize gain on the transfer to the extent of the cash value in the policy received in excess of premiums paid on the policy given up. Any money or other value received or given as part of this exchange (sometimes called "boot") will increase or reduce the amount of the gain. This method for calculating gain also applies to a shareholder trading stock to a corporation in exchange for a policy on the shareholder that has been owned by the business to fund a redemption. Both the business and the shareholder will have to recognize any gain in the policy, on the one hand, and the stock, on the other.

Transfer-for-Value Questions: The transfer of a policy when it is no longer needed to fund a buy-sell agreement will not normally violate the transfer-for-value rule, making its eventual death proceeds subject to income taxation, because the policy will normally go to the insured, which transfer is exempt from this rule. However, if the policy will still be used after its owner has died or left the business, a transfer-for-value will occur if the ownership of, or any beneficial interest in, the policy shifts to one or more co-owners who are not the insured. A partnership involving the insured should be in place so that it or a partner will take over the ownership of the policy and, because of the partnership/partner exception, prevent a transfer-for-value from occurring.

(2) Estate Tax Issues: The estate tax concern apt to arise when a policy on an insured co-owner is ultimately transferred to an irrevocable trust for the benefit of the insured's family is Section 2035's 3-year rule. It causes the proceeds of policies to be included in the insured's taxable estate if the insured has held "incidents of ownership" within three years of death.

It may be possible to avoid this possibility by having the irrevocable trust acquire the policy directly from the non-insured owner, rather than having the insured gift it to the trust after first acquiring the policy from the business entity or co-owner. By keeping the policy from first passing through the hands of the insured before going to the trust, the 3-year rule is avoided.

An additional question is whether the direct acquisition by the trust is a transfer-for-value, since the trust might not be an exempt transferee. However, it is generally thought that if the irrevocable trust acquiring the policy is a "grantor trust," meaning both that any income from the trust is attributable and taxable to the trust's grantor, who is the insured, and that, for income tax purposes, the trust and the insured are therefore considered to be the same, then the transfer to such a trust should be deemed a transfer to the insured and thus exempt from the transfer-for-value rule. As with other questions of this kind, however, tax counsel should be consulted before undertaking such a transfer.

The owners may also want to begin the buy-sell transaction by having policies on the lives of the other co-owners held in an irrevocable life insurance trust. This will enable the value of the stock that is purchased from a deceased, insured co-owner with insurance proceeds to accrue outside of the taxable estate of the surviving owners. The remaining policies on the lives of the surviving owners that are held in the trust of the deceased owner should then be purchased by the irrevocable trusts of the survivors.

Additional Life Insurance Funding Issues

Certain life insurance funding issues deserve attention in addition to those relating to the type of buy-sell agreement, the ownership arrangements for the policies, and the impact of these decisions on taxation.

The Pros and Cons of First-to-Die Policies: First-to-die policies, which involves life insurance on two or more lives paying a benefit only on the first death, are now available as a means of funding buy-sell agreements. The rationale for the policy is that the death benefit is only or mostly needed to fund a one-time buyout. Some policies allow the option of purchasing more insurance without additional underwriting to provide additional insurance proceeds for buyout purposes upon subsequent deaths.

The advantage of first-to-die policies is a 15-20 percent premium savings over two separate policies for the same amount of insurance. The arguments against it are that the premium savings are not sufficient to offset the extra benefits and flexibility of having additional policies to fund continuing buy-sell, and possibly eventual estate tax liquidity, needs. Also, first-to-die policies with extra policy features and options are likely expensive enough to administer that their long-term rates of return will compare unfavorably with the best traditional policies.

Permanent vs. Term Insurance for Buy-Sell Funding: The choice of term vs. permanent insurance to fund a buy-sell agreement depends on the likely duration of the business ownership and cash flow.

For start-up companies holding down their expenses or for enterprises that will clearly be sold within short periods of time, term insurance is preferable. If the logical choice is term insurance, there are several basic issues to address, including the length of time that the policy will remain effective without further evidence of insurability. (See additional article, "How to Shop for Term Insurance").

For successful companies with adequate cash flow where the ownership will likely remain in place for ten years or more, permanent insurance may be a wise investment and offer versatile applications. Rather than only funding an owner's buyout in the early years, it can still be in place at older ages. Most importantly, its cash value can be applied to a lifetime buyout at retirement or otherwise. Alternatively, the policies can be transferred to the insureds, where the cash values can be used as a source of retirement income or estate liquidity, or portions of a policy can be applied to each purpose.

The case for permanent insurance to fund buy-sell agreements will be much stronger if policies are selected that have the most competitive internal insurance charges and the lowest sales commissions. (See "How to Make Permanent Life Insurance A Good Investment" for a discussion of how these factors can enhance internal rates of return from investments in permanent life insurance by 200 basis points (2 percent) or more).

Distinguishing the Need for Key Person Insurance from Buy-Sell Coverage: Because key person insurance, which protects the business entity from the potential financial loss from that person's death or disability, is owned by the business entity, and buy-sell coverage is often similarly owned, the purposes for the life insurance are sometimes confused. Often, those who have purchased life insurance for one of these two purposes will mistakenly think that they have coverage for the other need as well. Sometimes, the insurance will be acquired, but co-owners will forget and fail to document the purpose for which it was obtained.

Those who are insured for buy-sell purposes will usually be key people whose loss to the enterprise from death or disability would cause a major financial hole in its operations. Except when those insured by a buy-sell agreement are not active, key employees, key person insurance should also be maintained. Where a business entity acquires life insurance for either of these reasons, its purpose should be well documented in a buy-sell agreement and otherwise in a corporate resolution or partnership agreement.

Most closely-held businesses need life and disability insurance for both key person and buy-sell purposes. Their importance and their differences should be understood.

The Funding Needs of ESOPs: Employee Stock Ownership Plans are a very tax-effective means for owners of C corporations to sell and diversify at least a 30 percent ownership interest without recognizing capital gains. Most owners who sell to an ESOP give up less than all of their interest. A buy-sell agreement is needed to arrange for the purchase of the balance of their interests at death. They cannot count on being able to sell the remainder of their stock to the ESOP on terms as favorable as a buy-sell agreement might permit, as the trustee of the ESOP has a fiduciary duty not to act in a way that will devalue the shares already owned by the ESOP and its participants. A funded buy-sell agreement is necessary to assure a favorable market for the balance of the owner's interest retained after the initial sale to the ESOP.

The Funding Needs of Public Companies with Lightly Traded Stock: Where the stock of a publicly-held company is lightly traded, a buy-sell agreement can help to provide a more favorable market for shares than may exist on the open market and avoid the risk that a board of directors, in agreeing to a future redemption of a substantial outstanding block of stock, might violate its duty to the corporation and its shareholders.

The fact that a company is partially publicly-held does not assure a ready market for an especially large holding of stock when the shareholder wants or needs to sell. For a board of directors to agree to such a redemption could drive down the value of the other shares and use up badly-needed corporate cash. Such potential effects on the company could preclude substantial owners, who are officers and directors, from unloading their shares for fear of breaching their fiduciary duty to the company. Also, boards of directors may not approve a redemption if it is not in the best interests of the company. However, if it is funded in advance with life insurance for the purpose of maintaining the value of the company's stock upon a redemption of the interest of a large shareholder, the redemption will be permissible.

Funding Disability-related Buyouts

Since pre-retirement disability is substantially more likely than death, the buy-sell agreement should clearly cover that contingency, and, to the extent possible, disability insurance should be obtained to fund the buyout for the same reasons life insurance is needed at death. Business owners and their professional advisors should therefore be aware of the separate item relating to this necessary part of the agreement and the funding of it. Here are at least some of these issues.

(1) The medical and financial underwriting for disability insurance is more difficult than the process for obtaining life insurance. In the first place, the most well-known disability carriers limit their buyout coverage to about $1 million, and this assumes that the payout does not begin for two years and is made in installments over two years. In addition, medical conditions, such as bad backs and treatment for clinical depression, which may have no or only a slight impact on life insurance underwriting, may result in the denial of disability buyout insurance. Lloyd's of London and other markets specializing in the most difficult risks may need to be explored in certain cases in order to obtain the necessary coverage.

(2) The definition of disability and the timing of the buyout should mirror the terms of any disability policy. The definition of disability of disability in the buyout agreement should not be more generous than that in an insurance policy, and there would be no need to make it more restrictive. In addition, the payments should not be required to begin sooner than they will be made by the insurer. Unlike individual disability income insurance, where coverage may begin 30 or 90 days after a disability begins, disability buyout coverage is only extended after a long enough period of time, usually a year or two, in which it can be determined whether the co-owner can continue in the business. Which waiting period is chosen should depend on how long the business can do without the services of the disabled owner.

(3) With both life and disability buyout valuations, the agreement should specify whether the buyout amount will be based on a valuation of the business with or without the deceased or disabled key person co-owner. The choice will normally be, and should fairly be, the pre-death or disability valuation. This will increase the importance to the business of also having key person life and disability coverage to assure, to the extent possible, that the business does not lose value because of the loss of a key person. As is noted below, the insurance needed to fund a buy-sell agreement should not be confused with the coverage necessary to protect the business against the death or disability of a key person. Both needs should be separately valued and insured against.

(4) Disability insurers will not issue buyout coverage to cover the full value of the business, and separate plans will have to be made to finance the uninsured portion of the purchase. Just as individual disability insurance will only cover 60-70 percent of income, disability buyout coverage will generally provide no more than 80 percent of the value of an owner's interest, less if the insured is a majority owner. Buyout plans will have to identify other sources of payments. The cash value from life insurance policies on the disabled owner can provide some of the funds. If the policy has the "waiver of premium" feature attached to it, no premiums will be due on the life policy while the insured is disabled, and the premium savings can also be applied in installment fashion to the disability buyout price. Beyond that, uninsured installment payments will need to finance the purchase.

Conclusion

Buy-sell agreements are essential for successful and stable closely-held businesses with multiple owners and for sole proprietorships which seek to assure a buyer for their enterprises. The particulars of the agreement, as complex as they can be, especially from a tax standpoint, and as much careful professional attention as they require, are less important than the funding of them. Generally, only life and disability insurance can provide the predictable source of liquidity to assure the transfer of business interests envisioned by buy-sell agreements. Those who recognize the need for adequate, long-term coverage can enjoy the security that there will be a ready market for those selling a business interest and sufficient cash for those expecting to buy one.

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