



What Common Buy-Sell Situations Give Rise to Transfer-for-Value Concerns?

by Terri Getman, JD, CLU, ChFC, RICP AEP(Distinguished)



Situation: Using life insurance as a funding vehicle for a buy-sell arrangement gives rise to a number of potential tax traps, especially in out-of-the-ordinary owner/beneficiary structures. To this author, it seems that more than almost any other area, buy-sell agreement funding, modification, and termination give rise to potential transfer-for-value traps. This *Counselor's Corner* discusses some of the most frequent buy-sell situations that result in adverse taxation under the transfer-for-value rule.

Solution: Let's first review how the transfer-for-value rule works and why it can be so detrimental to a buy-sell situation.

Life insurance proceeds are generally excluded from the income of the beneficiary, even if the policy is used to fund a buy-sell agreement and even if the buyer uses the proceeds to complete the buyout.¹ However, IRC § 101(a) provides that all or part of the death benefit proceeds under a policy *transferred for valuable consideration will be taxed as ordinary income* – unless the transfer falls within an exception to this general rule. Death benefit proceeds from life insurance policies transferred for valuable consideration are generally income taxable to the extent that the proceeds exceed the policy owner's cost basis (basis).

Consideration is defined broadly and does not need to be cash or property. A mutual or reciprocal promise can trigger the transfer-for-value rule. Herein lies the problem for many buy-sell scenarios.

Before discussing that problem, we'll look at the exceptions to the transfer-for-value rule.

Death benefit proceeds will not be subject to taxation under the transfer-for-value rule where the transfers are made to the following exempt transferees:

1. The insured
2. A partner of the insured
3. A partnership in which the insured is a partner
4. A corporation in which the insured is an officer or shareholder
5. Any person where the transferee's basis in the policy is determined in whole or in part by reference to the basis of the transferor (i.e., carryover basis transferees).

With the basics in place, let's take a look at why the transfer-for-value rule so clearly needs to be avoided in a buy-sell arrangement.

The unexpected taxation of a large lump-sum payment of policy proceeds raises financing problems for the buy-sell arrangement. If only the after-tax proceeds are available to buy the deceased's business interest, under-funding of the purchase obligation may result, and the buyer may not be able to affect the purchase for cash or may be forced to seek funds elsewhere.

With the basics in place, let's take a look at why the transfer-for-value rule so clearly needs to be avoided in a buy-sell arrangement.

¹ For employer-owned life insurance policies issued after August 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally income tax-free under IRC § 101(a).



The unexpected taxation of a large lump-sum payment of policy proceeds raises financing problems for the buy-sell arrangement. If only the after-tax proceeds are available to buy the deceased's business interest, under-funding of the purchase obligation may result, and the buyer may not be able to affect the purchase for cash or may be forced to seek funds elsewhere.

The following are several common situations that often give rise to transfer-for-value problems in buy-sell arrangements:

Shifting Policy Ownership. Circumstances change, and business owners may discover that the original structure of their buy-sell was not the best strategy, so they restructure it, changing from a stock redemption to a cross purchase or vice versa. If a wait-and-see buy-sell is used, when the ultimate decision is made as to who will be the buyer (entity vs. individual), policies may have to be shifted to place the financing where it is needed to affect the buyout. When the ownership on existing policies is shifted to accommodate a change in the format of a buy-sell agreement, beware of transfer-for-value problems.

For example, suppose that ABC, Inc. owns a \$2 million life insurance policy on each of two stockholders. The policies fund a stock redemption agreement. The stockholders decide to end this agreement and to fund a new cross purchase agreement. To fund the new agreement, owner "A" intends to buy the policy on owner "B's" life from ABC, Inc. and owner "B" will buy the policy on "A." As structured, this scenario does not fit into one of the safe-harbor exceptions to the transfer-for-value rule.

Let's assume that "A" pays \$40,000 to purchase the policy on "B" from ABC, Inc., and then pays an additional premium of \$50,000. At this point, "B" dies. "A" receives \$2 million in proceeds, but \$1,910,000 (\$2,000,000 – (\$40,000 + \$50,000)) will be taxable as ordinary income. Furthermore, assuming a tax rate of 35 percent, "A" will have only \$1,241,500 left to pay the \$2 million purchase price. The result is an under-funded buy-sell.

One solution: The corporation can retain the policies,

using the coverage to provide key person protection, and "A" and "B" can purchase new policies. A bonus plan or a split-dollar agreement may be used in order to help minimize personal costs.

Another solution: They can choose to take a safe-harbor route. If "A" and "B" are partners in a bona fide partnership when the policies are transferred from ABC, Inc. to the partners, there will be no ordinary income taxation since the policies qualify for the transfer-for-value exemption for a transfer to a partner.

When shifting policies from individual ownership to corporate ownership, transfer-for-value issues are avoided only if the insured is a shareholder or officer in the corporation – another transfer exemption.

Using Existing Policies to Fund a Cross-Purchase Agreement. Often, when business owners want to create a cross purchase buy-sell, they attempt to use existing policies as the financing vehicle. This might not be the best decision, as the Internal Revenue Service (IRS), relying on the Internal Revenue Code's (IRC) broad definition of "value," has repeatedly taken the position that reciprocal promises under a buy-sell arrangement is "consideration."

For example, in *Monroe v. Patterson*, where a corporate-owned policy was transferred to a trust established to administer a cross purchase buy-sell and the shareholders were required to pay continuing premiums on the policy, the U.S. district court held that there had been a transfer-for-value.² Here, the court found two forms of consideration: the mutuality of the agreed upon obligations (the agreement to buy) and the actual cash consideration paid (as premiums) by the surviving beneficiary shareholder.

In *Private Letter Ruling (PLR) 7734048*, the IRS reached a similar adverse conclusion where policies were simultaneously transferred from the insureds to their co-shareholders to fund a cross purchase arrangement. Here, two shareholders each owned a policy on their own life. After they established a cross

² *Monroe v. Patterson*, 197 F. Supp. 146 (ND Ala. 1961).



purchase agreement, they transferred the policies to each other. At the time of the transfer, the policies were in their first year and had no cash value.

Once again, the IRS held that there was consideration even though no cash changed hands. The reason: the reciprocal transfer of the policies. **Note that it made no difference that the policies had no value at the time of the transfer. Under this reasoning, even if the policies were term policies, they would be subject to the transfer-for-value rule.**

The unwary often suggest that a corporation give a policy to a shareholder to avoid the transfer-for-value rules. However, the IRS is not likely to view this transaction as a gift when done in a business context. Rather, it will be treated as a policy distribution (i.e., as a dividend or as compensation to the receiving shareholder), and the transfer-for-value rule will apply.

It is also unlikely that the transfer-for-value problem can be avoided if the insured buys the policy from the corporation and then gives it to the other shareholder. The IRS could contend that the two transfers should be treated as a single transfer (i.e., a collapsible step transaction). In addition, the IRS might argue that reciprocal promises (promises by each shareholder to acquire the policy on his/her life and then to give it away) create valuable consideration. *See the discussion of the "Estate of Rath v. United States" that follows.*

Death of a Shareholder. In a cross-purchase arrangement, a transfer-for-value issue may occur where a shareholder dies owning policies on the surviving shareholders, and the policies are subsequently sold to shareholders who are not the insured. One solution for selling to a shareholder who is not the insured is to make certain that he/she is also a partner in a bona fide partnership.

Other potential solutions: Sell the policies to the corporation for a stock redemption, surrender them for cash, or have survivors purchase the policies on their own lives and keep them as personal insurance.

Terminating a Buy-Sell Agreement. When a stock redemption agreement is terminated, the corporation may wish to distribute the policies to the respective insureds if the policies are no longer needed for a business purpose. A distribution of a policy to the insured qualifies as one of the five safe harbors, and the transfer-for-value rule will not apply.

Problems arise when a shareholder does not want to own the policy personally because of estate inclusion issues and the resulting estate tax. Is there a way to avoid the transfer-for-value rule and still escape estate inclusion? Can a transfer be made to the insured's trust, and does this qualify for the safe harbor exemption as a transfer to the insured?

The *Estate of Rath v. United States* is a lesson on what not to do.³ Under the buy-sell agreement, the shareholder-insured had the right to have the policy assigned to himself or his nominee if the corporation decided to terminate the agreement. At the termination of the redemption agreement, the corporation sold the policy to the shareholder's wife.

When the IRS held that there was a transfer-for-value, the wife argued that, in reality, her husband had exercised his option to have the policy transferred to him (a protected party) and then he had given the policy to her (an exception to the transfer-for-value rule). The court ignored the argument that a two-step process had been utilized, holding that the fact that the insured could have acquired the policy himself and then transferred it to his spouse, retaining the exclusion of the proceeds at his death, did not warrant the court recharacterizing what had actually occurred.

It is important to note that even if a taxpayer could convince the IRS that he/she had acquired the policy directly and then transferred it as a gift to a spouse, the risk of estate inclusion of the policy proceeds still exists for three years after the transfer. It may be possible for a shareholder to avoid both estate inclusion and the transfer-for-value rule by distributing the policy to a grantor trust where the insured is treated as the owner of the trust under the grantor trust rules in IRC §§ 671-677.⁴

³ *Estate of Rath v. United States*, 608 F.2d 254 (6th Cir. 1979)

⁴ *Swanson v Comm.*, 518 F.2d 59 (8th Cir. 1975). See also *Rev. Rul. 2007-13, I.R.B. 2007-11.*



Another solution to potential transfer-for-value problems when distributing the policy to an irrevocable life insurance trust (ILIT) is to use the partnership exemption (i.e., have the ILIT and the insured both be partners in a partnership that has a valid business purpose).

Trusted Buy-Sell. While transfer-for-value problems can arise in many buy-sell scenarios, problems often occur in cross purchase agreements where multiple policies are required. Remember that each owner purchases a policy on the life of each of the other owners.⁵

For the funding to be effective in a cross-purchase buy-sell arrangement, the policies must be maintained and managed — a task that becomes complicated with numerous policies and personal ownership. In addition, with multiple policies and owners, it is more difficult to ensure that the surviving owners will honor the buy-sell arrangement and exchange death benefit proceeds for the deceased's ownership interest. One proposed solution to this dilemma is to use a trusted buy-sell for management purposes.

Under a trusted arrangement, a trust is used to hold the stock of the various shareholders as well as the life insurance policies. Typically, the trustee purchases just one policy on each owner. This one-policy-per-shareholder scenario has potential transfer-for-value problems and is clouded with tax uncertainty.

The problems begin at the first shareholder's death. Although there is no physical transfer of the policies within the trust, the beneficial interest in the decedent's share of the policies on the lives of his co-shareholders has essentially been shifted to the surviving shareholders. The shift of this beneficial interest will more than likely be seen by the IRS as valuable consideration tied to reciprocal promises. That is, it can be assumed that a policy owner would not allow the interest in a policy he/she owned on another shareholder to pass through the trust's ownership to the other shareholders unless the other shareholders agreed to do the same.

The solution to this dilemma is to make use of the partnership transfer-for-value safe harbor (i.e., make

certain that the shareholders who are beneficiaries of the trust are also partners in a bona fide partnership or LLC taxed as a partnership). It is important to note that several private letter rulings have confirmed that the partnership does not have to have a connection with the corporation whose shares are subject to the buy-sell arrangement.

Another approach is to substitute a LLC taxed as a partnership for the trust where a bona fide LLC/partnership will be the owner and beneficiary of the policies and will complete the buyout terms at the death of a shareholder. Again, by using the partnership safe-harbor exception, transfer-for-value issues can be avoided.

As with any advanced strategy, other considerations arise. When a LLC/partnership holds life insurance policies, one concern is the potential for inclusion of the policy proceeds in the insured's estate. There are no regulations dealing with incidents of ownership held by a partner through a partnership. The general belief is that where the partnership is both the owner and beneficiary of a policy on the partner's life, the partner's estate includes just his/her proportionate share of the partnership interest (i.e., the value that reflects a proportionate share of the death proceeds).

In Summary. In any buy-sell scenario, ensure financing is available at a shareholder's death without triggering the transfer-for-value rule. Pay close attention when existing policies are included or ownership shifts. Many issues can be resolved using safe-harbor exemptions. Remember, the IRS has treated reciprocal promises as valuable consideration, causing unwanted tax results. Finally, the partnership exemption may offer flexibility where solutions seem limited.

⁵ The formula for determining the number of policies is: $N \times (N-1)$ where "N" equals the number of business owners.



This material has been prepared to assist our licensed financial professionals and clients' advisors. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that we are not rendering legal, accounting or tax advice. Such services must be provided by the client's own advisors. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code. Insurance policies contain exclusions, limitations, reductions of benefits and terms for keeping them in force. Policies and or features may not be available in all states.

**Securities and Insurance Products:
Not Insured by FDIC or Any Federal Government Agency. May Lose Value.
Not a Deposit of or Guaranteed by Any Bank or Bank Affiliate.**

For the Education of Financial Advisors & Financial Professionals. Not for use with the General Public.

www.dbs-lifemark.com

5501 Excelsior Boulevard | Minneapolis, MN 55416