by Terri Getman, J.D.*, CLU, ChFC, RICP, AEP (Distinguished)

Is it Possible to Fund a Buy-Sell Agreement with a Personally Owned Policy?

Situation: Nearly all buy-sell agreements that use life insurance as a funding vehicle do not have the business owner owning their own policy. In an entity purchase arrangement (where the business buys back/redeems a departing owner's interest), the business is the owner and beneficiary. In a cross purchase arrangement (where the remaining owners purchase interest of the departing owner), the other owners of the business own the policy. The entity purchase and cross purchase buy-sell methods are well known and provide business owners and their tax and legal advisors with predictable results. Furthermore, since the potential purchasers need to make sure they have the funds to satisfy their legal obligations to purchase the business, it makes sense for them to own and control the life insurance policy.

In spite of the fact that the above classic buy-sell life insurance structures provide predictable results, it's not unusual to find business owners wanting control over their policies in order to avoid some of the following real problems:

- The person or entity that owns the policy may not pay the premiums or may mismanage the policy.
- Death benefit in excess of the amount needed to purchase a deceased owner's interest, if any, is retained by the policy owner and is not available to meet the needs of the deceased owner's family.
- The insured may not have the right to acquire the policy if he/she leaves the business and the cost of acquiring new coverage could be prohibitive because of age, health, or other conditions.
- Even if the insured has the right to acquire the policy, the cost to acquire ownership may be too high.

In addition to avoiding some real problems, personal ownership provides some potential advantages. Personal ownership of a policy gives a retiring owner control of the cash value and death benefit so that it can be used to meet personal objectives. For example, personal ownership could be used by a retiring owner as a supplement to their personal retirement or personal wealth transfer plan.

This author has seen a number of out-of-the-ordinary owner/beneficiary structures in buy-sell arrangements. One such structure is the cross endorsement buy-sell arrangement. This arrangement provides the business owner ownership of the policy while providing the purchasing business owner funds to help satisfy their purchase obligations. Like many uncommon structures, there are some legal and tax issues that must be considered. This Counselor's Corner discusses the key issues associated with this structure.

Solution: Before addressing the issues associated with the cross endorsement buy-sell arrangement, let's first focus on how the arrangement is structured.

5501 Excelsior Boulevard | Minneapolis, MN 55416

* Not in the practice of law

Under a cross endorsement buy-sell arrangement, the business owners enter into a cross-purchase agreement where each owner agrees to purchase their pro rata share of the other business owner's interest. However, instead of each business owner purchasing a policy on the other owner's life, each business owner purchases and owns a life insurance policy on their life. The company may make annual bonus payments to each business owner in the amount of the premium to minimize their cash outlay.

The face amount of the policy will be based on at least his or her proportionate projected value in the business. The arrangement is structured as a non-equity endorsement split-dollar agreement (normally using a return of premium death benefit option so the insured's estate can recover the premiums paid) with the death benefit endorsed to the other business owner(s) to satisfy the obligation under the buy-sell agreement. So, legal counsel must also draft a non-equity endorsement split dollar agreement. The necessary endorsement forms are filed with the insurance carrier.

During the term of the arrangement, each business owner that owns his or her policy has access to the policy's potential cash values. However, parties to the buy-sell agreement may want to restrict access to the policy during the term of the agreement so it doesn't impair the death benefit. Furthermore, since the arrangement is structured as an endorsement split dollar, each business owner will pay the economic benefit amount based on the insured's age. The insured will recognize this amount as ordinary income. Basically, the business owner recognizes income on the economic benefit of their policy.

At an insured business owner's death, the death benefit is paid to the surviving owners according to the terms of the endorsement. Each surviving owner uses their share of the death benefit to purchase the deceased's business interest from the estate, which is required under the terms of the buy-sell agreement. Alternatively, if the business owner retires or otherwise leaves the business, the remaining owners release the endorsement on the departing owner and the departing owner releases his/her interest in the remaining owners. The departing business owner is now able to use the entire policy on his or her life for personal purposes.

This brings us to the reason for this Counselor's Corner: a discussion of the issues associated with structuring a cross endorsement buy-sell arrangement.

Application of the Transfer-for Value to the Transaction

One of the biggest benefits to using life insurance in a buy-sell arrangement is that policy death benefits are generally received income tax-free by the beneficiary. However, there are a number of ways this benefit can be lost. One way that the income tax-free death benefit can be frequently lost in out-of-the-ordinary buy-sell structures is by violating the transfer-for-value rule under IRC §101.

In general, a transfer for value occurs when the owner of a life insurance policy transfers an interest in a policy to someone else and receives something of value in return. The policy does not need to have cash value for the transfer-for-value rule to apply. In fact, every type of policy (term, whole life, universal, indexed, and variable, etc.) is covered under the transfer-for-value rule. The term transfer is broadly defined to include any transfer of a right to receive all, or any part, of a life insurance policy. An outright transfer of the ownership of a policy does not have to occur for a transfer to take place. A transfer can be triggered by the creation of any enforceable contractual right to receive all or part of the insurance proceeds. Furthermore, value isn't limited to just cash or tangible assets. Value can also include an enforceable promise which could potentially benefit the transferor. For example, naming someone as the beneficiary of a policy in exchange for a promise to purchase the owner's business interest is a transfer for value.

Fortunately, there are exceptions to the transfer-for-value rule. If a transfer falls under one of these exceptions, even though the transfer is for valuable consideration, the death benefit proceeds will not be subject to income tax. IRC §§ 101(a)(2)(A) and (B) list five safe harbor exceptions. These exceptions include transfers made to the following exempt transferees:

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

An exception likely to apply to many buy-sell arrangements is the partner/partnership exception. There are some fine points that should be kept in mind, including:

- The partnership must not merely exist in form only.
- Members of an limited liability company (LLC) that have elected to be taxed as a partnership are considered to be partners for purposes of the transfer-for-value rule.[1]
- Transfer from a corporation to a partnership in which an insured shareholder is a partner comes within the exception.[2]
- Transfers to co-shareholders who are also partners in a partnership with the insured falls within the exception, even though the relationship is an unrelated partnership.[3]
- The transfer of policies insuring shareholders/partners from a corporation to a partnership established specifically to manage the policies comes within the exception.[4] However, the IRS has ruled that it will not issue rulings concerning whether or not the transfer-for-value exception applies to a transfer of a policy to an unincorporated organization where substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members.[5] Thus, the partnership should have other assets in addition to life insurance.

The ability to use the partner/partnership exception to avoid taxation under the transfer-for-value rule creates an opportunity to use the cross endorsement buy-sell arrangement where the business owners have a partnership relationship during the term the buy-sell is applicable. Of course, when the co-owners release their interest in the policy back to the insured, this re-transfer also falls within the exception.

Prior to the Tax Cuts and Jobs Act of 2017, if the transfer was covered by one of the exceptions, no further consideration was required under the transfer-for-value rules. However, the 2017 legislation added a new provision (IRC §101(a)(3) under the transfer-for-value regulations which impose additional steps to the analysis. Under the new provision, it's also necessary to determine whether the transfer is a "reportable policy sale" or if the policy was ever previously transferred in a reportable policy sale. A reportable policy sale is defined generally as the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. It's worth noting that a reportable policy sale does not require a sale of the policy, but merely the acquisition of an interest in a policy.

Furthermore, it should be noted that a transfer of a policy interest may constitute a reportable policy sale, even though the individual or entity receiving the policy interest falls under one of the exceptions of the traditional transfer-for-value rules. If the transfer is a reportable policy sale, none of the current transfer-for-value exceptions apply. If the transfer is not a reportable policy sale and the transfer is also to a transferee who is exempt under the traditional transfer-for-value rules, the death benefit is income tax-free under the general tax rules.

Fortunately, buy-sell relationships should usually qualify as a substantial financial relationship under the regulations. Specifically, the regulations provide that a substantial financial relationship exists where:

- The acquirer or the owners of the acquirer have a common investment with the insured (other than the policy) and a buy-out of the insured's interest in the common investment by the co-investor after the insured's death is reasonably foreseeable.
- The acquirer maintains the life insurance policy to provide funds to purchase assets of or satisfy liabilities of the insured, or to satisfy liabilities arising at the insured's death.
- The acquirer is a charitable organization that has previously received substantial financial support or significant volunteer support from the insured.

The first two points should cover policy transfers for buy-sell purposes. Consequently, it's possible for the cross-endorsement buy-sell arrangement to qualify for an exception under the traditional transfer-for-value rules and the new reportable policy sale regulations.

Application of the Split Dollar Rules to the Transaction

Some take the position that the split dollar rules do not apply because the policy owner does not retain a right to recover premiums paid and the regulations state that in a split dollar life insurance arrangement, "at least one of the parties to the arrangement paying premiums...is entitled to recover (either conditionally or unconditionally) all or a portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract."[6] While it may be possible to establish the arrangement so the policy owner does not recover premiums paid, it's more likely that the owner will want to recover all or some portion of the premiums. Furthermore, in the business context, the special split dollar rules that apply to compensatory and shareholder arrangements do not require the service provider/shareholder to have an interest in the policy cash value.[7] All that is required is for the beneficiary of all or any portion of the death benefit be designated by the service provider/shareholder or be a person reasonably expected to be designated as beneficiary. Consequently, it's very likely that the split dollar rules will apply to the cross endorsement buy-sell arrangement.

Even if one believes that it should not be subject to the split dollar rules, it may still be prudent to treat this buy-sell structure as a split dollar arrangement because of the tax risks. Specifically, if it's determined that the arrangement is governed by the split dollar rules; it should be treated as an endorsement split dollar arrangement subject to economic benefit tax treatment.[8] Under the economic benefit tax structure, failure to pay or report the economic benefit cost will cause the death benefit to be taxable.[9]

Assuming the buy-sell arrangement is subject to the split dollar rules, each year the other business owners will need to pay or report the economic benefit amount and the insured will need to report this amount as income. The economic benefit cost is measured each year using either the government Table 2001 or the insurer's alternative term rates. The term rate takes into account the insured's attained age, as well as the amount of the death benefit being endorsed. The insurer's alternative term rate can be used only if the insurance company issuing the policy meets certain requirements.[10] Finally, when the cross endorsement arrangement is terminated and the endorsements released, the taxable economic benefit amount stops and the insured business owner retains his or her policy.

Managing the Life Insurance Policies

One of the practical concerns with the insured business owner owning his or her own policy is that the co-owners of the business will want to make sure they will receive the death proceeds to help satisfy their legal obligations to purchase the business. Thus, it's important that their rights in the policy death benefit be formalized. Furthermore, parties to the buy-sell agreement may want to restrict access to the policy during the term of the agreement so not to impair the death benefit. Another practical question that arises with this structure is whether the business can help pay the premiums. As the owner of the policy, the insured business owner is responsible for paying the premiums. However, if it makes sense, he or she can enter into an arrangement where the business is the source of some or all the premium. Finally, the business owner may want to know if it is possible to combine both their personal and business needs for insurance into one policy. Thus, the total death benefit could include components for buy-sell funding and personal needs such as spousal support and mortgage/debt liquidation.

In Summary

The cross endorsement buy-sell life insurance policy structure gives business owners the opportunity to own and control their own policy. For business owners who plan on leaving their business during their lifetime, the arrangement allows them to manage their policies to provide ongoing benefits after they leave the business. It also gives the owner the opportunity to combine their personal life insurance needs with buy-sell funding.

---

[1] *PLR 9625013*
[2] *PLR 9042023*
[3] *PLR 9347016, PLR 9045004*
[4] *PLR 9309021*
[5] *Rev. Proc. 20063, 2006-1 IRB 122*
[6] *Treas. Reg. §1.61-22.*
[7] *Treas. Reg. §1.61-22(b)(2)*
[8] *Treas. Reg. §1.61-22(b)(3)*
[9] *Treas. Reg. §1.61-22(f)(3)*
[10] *Notice 2002-8.*

5501 Excelsior Boulevard | Minneapolis, MN 55416