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Insurance related best practices guide for buy-sell agreements

No two businesses are exactly alike. Business owners need their buy-sell agreement to consider their specific situation and needs. We've reviewed thousands of buy-sell agreements and have valuable best practice suggestions that can help.

For many business owners, buy-sell planning has been significantly affected by the U.S. Supreme Court decision in *Connelly v. US* (June 6, 2024). The Court held that if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation.

This guide isn't an exhaustive list of best practices. But, you can use it when working with your attorney to review your buy-sell agreement (particularly in light of the *Connelly* decision), and to properly coordinate it with any insurance funding.

General considerations

1 | As a general rule, the ownership and beneficiary structure of life and disability insurance acquired for purposes of funding a buy-sell agreement should be aligned with the agreement's purchase obligations.

- This means that the party that has the obligation to buy should be the owner and beneficiary of the contract that insures the person being bought out. For example, if Owner A has to buy from Owner B upon the death of Owner B, then Owner A should own and be the beneficiary of a life insurance policy on Owner B.
- If insurance isn't properly structured, the person with the purchase obligation might not be the person receiving insurance proceeds.
- If life insurance is owned by the insured, the other business owners should not be named as beneficiaries, without a split dollar agreement, for two reasons:
  - (a) unless the owners are partners in a partnership, the beneficiary designation could be considered a violation of the "transfer for value" rule (IRC Section 101(a)(2)), making the death benefit income taxable to the recipient, and
  - (b) fact that the insured owns the policy would put the death benefit in the insured's estate for estate tax purposes.

2 | It's important to maintain funding for purchase obligations at a level close to the current value of the business.

- Back-up provisions for payment using an installment sale process are typically included to cover payments for any uninsured purchase price.

3 | To provide the highest level of assurance that life insurance death proceeds will be used to complete a sale after the death of a business owner using the agreement's terms, the buy-sell agreement should be drafted in a manner that creates a valid, binding contractual obligation to complete a purchase with the death proceeds. The following structure could be incorporated into the buy-sell agreement.

- The agreement should provide that the business owners have agreed to fund purchase obligations following a death through acquisition of life insurance policies.
- The agreement should state that policies acquired for purposes of funding the buy-sell agreement must be maintained for the life of the agreement.

- The agreement should identify life insurance policies acquired for the sole purpose of completing a purchase under the agreement in a schedule attached to the agreement.
  - The schedule should identify the policy owner, the insured, and the beneficiary, in addition to the policy number, insurer, and face amount.
  - The schedule should be kept up to date as changes in company ownership or policies happen.
- Where life insurance policies are concerned, this practice has the advantage of not confusing whether death proceeds should be used to reimburse the company for the loss of a key person, provide survivor income to a spouse, or to complete the purchase of a deceased owner's business interest.
- The agreement should note that funding vehicles include, but are not necessarily limited to, the policies listed on the schedule. The agreement should explicitly require that death proceeds from policies identified on the life insurance schedule be used to complete a sale upon the death of a business owner. Business owners want to feel comfortable that if they pass away, the agreement will be enforceable as implemented.

- When life policies are acquired and identified for purposes of the buy-sell agreement, the buy-sell agreement should explicitly require payment of life insurance death benefits, up to the purchase price, to complete a sale under the agreement.

- Payment terms of the agreement should be integrated with the availability of life insurance death proceeds from policies identified on the schedule. The scenarios addressed should include:
  - death proceeds in excess of the purchase price, and
  - any amount of the purchase price not covered by death proceeds.

4 | Cash value policies on the life of a business owner, held by the company or another business owner, often should be transferred to the seller as part of the consideration in purchasing such owner's interest in the business upon the occurrence of a lifetime purchase and sale event. Best practices suggest transferring the policy as part of the final payment under an installment note.

5 | A buy-sell agreement should include language that addresses the possibilities for future ownership changes of life insurance policies acquired for purposes of the buy-sell arrangement.

- Many buy-sell agreements include dispositive provisions for some or all of the following circumstances: (a) termination of the buy-sell agreement; (b) sale of the company; or, (c) termination of the business owner's relationship with the company for a reason other than death. Discuss with local counsel whether the agreement should provide an option for each owner to purchase his or her policy for its fair market value.
- Business owners exiting the business under a lifetime triggering event through an installment sale of their interest generally shouldn't have an option to purchase the life insurance policy on his or her life until the installment sale is completed.

6 | Death, disability, and retirement are the three most common mandatory purchase and sale events found in buy-sell agreements. Funding for mandatory purchase and sale events can ease financial strain when death and disability happen unexpectedly. This can also be helpful for anticipated lifetime exit events, such as retirement.

- If the buy-sell plan design for these events is entity purchase, funding provided from a source independent of existing corporate surplus, prior to the death of a business owner, may help ease state law requirements governing corporate redemptions.

7 | The amount of insurance available for purchase generally depends on the value of the business. The presence of a formal or informal business valuation, in the absence of a clear valuation method in the agreement supported by financial details, can be very helpful in validating the need for life insurance death benefits, as well as the disability buy-out benefit amount.

8 | An owner of a life insurance policy, who isn't insured by the policy, can be prohibited by the buy-sell agreement from exercising any rights as policy owner that would reduce the death benefit to an amount less than the full face amount of the policy. The owner can also be prohibited from taking any other action that might otherwise impair the viability of the policy.

9 | Many business owners who have adopted a wait-and-see buy-sell design where the business owners hold a final, mandatory purchase obligation find it most helpful for insurance policies funding this plan design to have the non-insured business owners as the owners and beneficiaries of these policies.

- When neither the company, nor the business owners, have a mandatory purchase obligation, life insurance funding may generally work best when the company is the owner and beneficiary of any funding policies. However, if the owners are subject to an estate tax, personal or cross ownership may be more desirable, given the potential impact of *Connelly* on the value of the company.

10 | The life insurance company that issued an insurance policy identified by the agreement as a policy acquired for purposes of that agreement should be authorized and directed to give the insured owners, upon receipt of their written request, any information on the status of the insurance policies on their lives.

Cross-purchase buy-sell plans

1 | Under a cross-purchase arrangement, life insurance policies are generally cross-owned by the business owners.

- Cross ownership of policies, with the death benefit paid to the non-insured surviving owner(s), was mentioned by the U.S. Supreme Court in *Connelly* as a means of avoiding the inclusion of the death benefit in the value of a company.

2 | Under a cross-purchase arrangement with cross-owned policies, the number of life or disability buy-out policies owned by the business owners will increase as the number of business owners increases.

3 | Under a cross purchase, the persons doing the buying (e.g., surviving owners) receive a basis increase equal to the amount they paid. That is, the increase in their basis in the business equals the increase in the value of the business they acquired.

4 | The transfer of existing life insurance policies from an entity taxed as a corporation to a business owner in order to establish cross-purchase funding may create a "transfer for valuable consideration" as defined in Section 101(a)(2) of the Internal Revenue Code. This transfer will most likely jeopardize the income tax free nature of life insurance death proceeds. Important exceptions to the transfer for value rule are for transfers (i) to the insured, (ii) to partners of the insured, and (iii) to a partnership where the insured is a partner.

- The exception for transfers to a partner of the insured may be met if, when the policy is transferred from the corporation to the non-insured owner, the owners are also partners in an entity taxed as a partnership elsewhere.
- The exception for transfers to a partnership where the insured is a partner may be met if the policies are transferred to an entity taxed as a partnership where one of its partners is the insured. This may occur if policies are transferred from the corporation to a Business Continuation Limited Liability Company (BCLLC) or Business Continuation General Partnership (BCGP), which is used to carry out a cross purchase.

5 | A cross-purchase buy-sell arrangement funded with partnership-owned or LLC-owned life insurance policies – as occurs with a Business Continuation General Partnership (BCGP) or Business Continuation Limited Liability Company (BCLLC) – offers the simplicity of one policy per business owner, while also providing owners with a full increase in corporate ownership cost basis. Also, if the partnership (or LLC taxed as a partnership) is properly structured, it may be possible for the life insurance death proceeds to be excluded from the deceased owner's estate.

Entity purchase buy-sell plans

1 | Under an entity purchase arrangement, life insurance policies are generally owned by the business entity with the business as beneficiary for the entire amount of death proceeds.

2 | An entity purchase buy-sell arrangement provides the simplicity of only one life insurance and/or disability buy-out policy on the life of each business owner.

3 | Under an entity purchase, the remaining business owners are not paying funds to buy from the departing owner (the business is doing the paying). As such, the remaining owners may have an increase in their business value (due to there then being fewer owners) but they do not receive an increase in their basis in the business *solely* due to the buy-out.

4 | For entities taxed as partnerships and S corporations (including LLCs taxed as either), life insurance death proceeds generally increase all owners' cost basis in the company on a pro rata basis.

- With partnerships, a special allocation can be made part of the operating agreement or partnership agreement, allocating the basis increase from receipt of life insurance death proceeds only to the surviving owners. Without an allocation process like this in place, a meaningful portion of the cost basis increase from death proceeds would be wasted on the decreased owner. It's also generally advisable, in order to support the reasonableness of the death benefit allocation, to also provide for a corresponding similar allocation of premium expense.

- S corporations using an entity redemption buy-sell plan design have often found it advantageous to incorporate the "short-year" election process of IRC Section 1377(a)(2) into their agreement. If the S corporation can qualify, this technique can provide a full increase in cost basis to the surviving owners – up to the amount of the death proceeds received by the S corporation – and requires only one policy per owner (owned by the company). Qualification generally requires use of the cash basis accounting method by the business entity. It is unclear whether a Section 1377 election would mitigate the impact of *Connelly* on the company value.

Valuation

1 | When a formula valuation is employed by the buy-sell agreement and company-owned life insurance policies are used, with the company listed as beneficiary, the buy-sell agreement should be clear about whether life insurance death proceeds should be considered as cash or cash equivalents for purposes of the valuation formula. If certain requirements are met, the agreement may be able to exclude death proceeds from the calculation of the value of the company. Under *Connelly*, such proceeds would generally increase the value of the company for estate tax purposes unless the agreement successfully locks in a value for estate tax purposes.

2 | If an appraisal approach is used to value the business, the agreement should include language designed to exclude death proceeds from the value of the company. Under *Connelly,* such proceeds would generally increase the value of the company for estate tax purposes. The buy-sell agreement should instruct the appraiser about the desired treatment of life insurance death proceeds that are paid to the company.

3 | Despite the *Connelly* decision, it may be possible to exclude company-owned life insurance from the value of the business if the agreement meets certain requirements.

- Buy-sell agreements are often drafted in a way that is intended to lock-in the value of the business for estate tax purposes, exclusive of life insurance proceeds acquired for buy-sell funding purposes. It is not entirely clear whether this process remains possible after *Connelly*.
- The agreement should be clear that certain policies, identified on an attached schedule or exhibit, were obtained for the sole purpose of the buy-sell agreement.

4 | Using the value of life insurance death proceeds to establish the value of a deceased owner's business interest is generally inconsistent with IRS estate and gift tax valuation guidelines. These can be found in Revenue Ruling 59-60.

Taxation

1| Life insurance death proceeds are income tax free to an employer only if the parties comply with the requirements of IRC Section 101(j).

- Section 101(j) applies to employer-owned life insurance policies issued or materially changed after August 16, 2006.
- Section 101(j) requires that the employee/insured:

  › Is provided written notice meeting the specific requirements of 101(j) and
  › Provides a signed consent to the placement of life insurance coverage owned by the employer. This notice and consent needs to be obtained prior to the policy being issued.

2 | In general, premiums paid for life insurance and disability buyout policies are non-deductible.

3 | Revenue Procedure 2005-25 generally provides valuation safe harbors for the transfer of life insurance policies from a business to an employee. The general standard of valuation found in the Revenue Procedure is that a policy should be valued at its "fair market value" (FMV) for income tax purposes.

- Transactions between or among business owners are technically not governed by the valuation guidelines of Revenue Procedure 2005-25; however, owners may find it helpful to use these guidelines. Revenue Procedure 2005-25 generally provides a safe harbor for determining a policy's fair market value, defining it as the higher of (i) premiums plus earnings minus reasonable charges (PERC) or (ii) interpolated terminal reserve plus unearned premiums plus pro-rata expected dividends.

- Fair market value is measured differently for different types of life insurance policies. Sometimes a policy's cash surrender value isn't representative of its fair market value. The insurance company that issued the policy is in the best position to provide the measure of fair market value for a policy based upon IRS guidance.

4 | For pass-through taxation entities, life insurance death proceeds from company-owned policies as tax-exempt income received by the business entity may provide the surviving owners with only a partial cost basis increase for income tax purposes. This is because some of the basis increase is allocated to the deceased owner.

5 | Cash value life insurance policies may serve as an informal sinking fund to assist with a purchase under any lifetime buy-sell triggering events.

6 | Buy-sell agreements should include provisions regarding the disposition of life insurance death proceeds in excess of the purchase price set by the agreement.

- Best practice suggests retention of excess death proceeds by the policy owner who paid for the policy. This avoids unexpected and unnecessary taxation.

- If the agreement requires death proceeds in excess of the purchase price to be paid to the estate or personal beneficiary of a deceased owner, then adverse tax consequences may result. For example, if these excess proceeds are paid from the company (policy owner) to the deceased owner's estate or personal beneficiary, the excess proceeds may be taxed as additional compensation or as additional dividends.

7 | If business owners appear likely to have an estate tax liability at death, it may be possible to “lock-in” the value of the business for estate tax valuation purposes. Guidance preceding the *Connelly* decision included the following requirements for doing so:

- The price must be fixed or determinable pursuant to a formula under the agreement.
- The estate must be obligated to sell at death at the agreement price.
- The agreement must prohibit the owner from disposing of his or her interest during life without first offering it to the other party or parties at no more than the agreement price.
- The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner’s bounty without full and adequate consideration in money or money’s worth.
- For family transfers, any agreement to acquire property at less than fair market value will be disregarded for federal transfer tax purposes unless, under IRC Section 2703(b), the agreement (1) is a bona fide business arrangement; (2) is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration; and (3) has terms comparable to similar arrangements entered into by persons in an arms-length transaction.

8 **|** A trusteed cross-purchase arrangement with trustee-owned policies may cause a portion of the life insurance death proceeds to be treated as taxable income to the beneficiaries if the arrangement creates a violation of the transfer for value rule (found in IRC Section 101(a)(2)):

- If existing policies are transferred to the trust (e.g., because of *Connelly*);
- If the policies are initially issued inside the trust, but then a shift of ownership takes place following the first death;
- In general, the promise of reciprocal action could be viewed as implied consideration paid for access to death proceeds. This may create a transfer for value problem if life insurance policies are transferred to the trust or if the beneficial interest of the trust beneficiaries changes.

The transfer for value issue can be addressed by making certain the insured/owners are also co-owners of an entity taxed as a partnership.

Disability buy-out considerations

1 | It’s typically most helpful to adopt a definition of disability in the agreement that’s directly linked to the determination of disability by the insurer under the disability buy-out policy.

- This may help ensure that funds are available from the disability buy-out policy to complete a purchase under the disability trigger, and that the obligation to buy does not occur earlier than the completion of the policy's elimination period.

- If there is more than one disability buyout policy on an owner, it may be helpful to specify which policy’s definition will be used to determine whether the insured is disabled for purposes of the buyout.

2 | It’s important to review an agreement’s payment terms for consistency with the claims payment procedures in the disability buy-out policy.

- Many disability buy-out policies are structured by insurers as expense reimbursement policies. Therefore, a disability buy-out claim will not be payable until the buy-out obligation of a disabled owner’s interest has been incurred.

3 | It’s generally advisable for the company to retain ownership of any life insurance policies on the life of a disabled owner until an installment purchase of the disabled owner’s interest is completed. This helps to ensure continued funding if a disabled owner should die before his or her interest is fully purchased under a disability purchase and sale trigger.

4 | If the insured owner under a disability buyout policy is no longer active full time in the business due to reasons other than disability, the disability buy-out policy should be terminated, since it will no longer pay out.

Common potential life insurance pitfalls

Plan type	Potential pitfall	Tax issues	Alternatives
Cross-purchase buy-sell plan design funding	Each insured owns a policy on his or her own life naming the other owner(s) as beneficiary.	May be a "transfer for value" causing taxation of death benefit. Also, death benefit may be subject to inclusion in deceased insured's estate.	Policies should generally be owned by the party holding the purchase obligation.
Trusteed cross-purchase buy-sell plan design	A trust owns policies on the business owners. Trustee uses death proceeds to complete the sale transaction.	After death of business owner, the policies owned by deceased are generally transferred to the surviving non-insured owners, causing a transfer-for-value and taxable death benefit.	If using a trusteed buy-sell, make sure the insured/owners are also co-owners of an entity taxed as a partnership.
Entity purchase buy-sell plan design funding	Entity owns a policy on each business owner. Spouse of the business owner is named as beneficiary.	Without split dollar accounting for one-year term rates, death benefit may be taxable to spouse as additional compensation or dividend or additional purchase price. It may also be possible for the spouse to argue the death benefit isn't a payment for the deceased owners' interest.	If the entity holds the purchase obligation, then the entity should be the beneficiary of any policy it owns for purposes of the buy-sell agreement. An endorsement split dollar arrangement can be used to pay a portion of the death benefit to the spouse of the insured endorsee, relating to the portion of the death benefit that *exceeds* the business' buy-out obligation.
Converting from an entity purchase plan design to a cross-purchase plan design	Company-owned policies are transferred to business owners to implement cross-owned funding structure.	Unless the entity is taxed as a partnership, this is a violation of the transfer for value rule causing taxation of death proceeds since there isn't an exception governing such a transfer.	Either transfer to an entity taxed as a partnership, create a new entity taxed as partnership and make all the owners partners in this new partnership, or acquire new coverage. Existing policies could be retained for key person needs or sold to the insured.

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