Cross endorsement funding for cross purchase buy-sell agreements

The traditional funding method for cross purchase buy-sell agreements is cross ownership of life insurance policies. However, another option to consider may be to use cross endorsement of the death benefit instead. Both of these methods facilitate the purchase of a deceased or departing owner's interest and provide the remaining owner with an increase in cost basis.

The cross endorsement vs. traditional cross purchase funding

Traditionally, policies funding a cross purchase arrangement are cross-owned, meaning that each business owner is the owner and beneficiary of a policy on the other business owner's life. The "cross" occurs in the ownership structure.

By contrast, when a cross endorsement option is used, each business owner owns the policy on his or her own life, and endorses part, or all, of the death benefit to the other business owner (i.e., the "endorsee"). In other words, the "cross" occurs in the beneficiary designation.

These two funding options are designed to accomplish the same primary goal—providing funds to allow the remaining owner to buy out the departing owner. At first glance, owning your own policy seems simpler than cross ownership: each owns and controls his or her own policy, and there's no need to exchange policies when the agreement terminates (avoiding a possible taxable event). However, in each case, the appropriateness, ancillary benefits, and taxation outcomes must be carefully considered.

Transfer for value

Unless certain exceptions apply, the cross endorsement of the death benefit can create a "transfer for value" of an interest in a life insurance policy, possibly causing the death benefit to be taxable to the endorsee. See Transfer for value/reportable policy sale regulations overview and Transfer for value/reportable policy sale regulations Q&A. If the business subject to the buy-sell is taxed as a partnership, or the owners are partners in another entity taxed as a partnership, the "transfer to a partner of the insured" exception would apply, allowing the death benefit to be received by the beneficiary income tax free. If the business is not taxed as a partnership and the owners are not partners in another entity, the transfer for value issue and the resulting taxable death benefit might defeat the goals of the cross-endorsement option.

Estate taxation

With cross endorsement, because the business owner owns the policy being used to fund a buyout, generally both the value of the business interest and the policy death benefit would be includable in his or her estate. However, the large lifetime exemption amount may make this a concern for only a small number of business owners.[1]

Split dollar

The ownership/beneficiary structure of cross endorsement creates a split-dollar arrangement.[2] In order to avoid the resulting taxable death benefit, the parties would be well-advised to execute a separate written split dollar agreement and the endorsee should compensate the insured for the "value of the economic benefit" of the death benefit protection endorsed to him or her each year. (Consider it analogous to a rental fee that the endorsee pays for the right to receive a portion of the policy death benefit.) The economic benefit payment (rental fee) received by each owner will be taxed as ordinary income to the recipient.

	Traditional cross ownership		Cross endorsement	
Overview Ann and Bill own a business together and want to make sure they have buy-sell funding in place.	**Ann** owns and is a beneficiary of a policy where Bill is the insured (and Bill owns and is a beneficiary of a policy where **Ann** is the insured). Upon Bill's death, **Ann** receives the death benefit and uses it to purchase Bill's interest in the business.		Bill owns and is a beneficiary of a policy where he is the insured. Bill endorses the death benefit of this policy to **Ann** (and **Ann** owns and is a beneficiary of a policy where she is the insured. **Ann** endorses the death benefit to Bill). Upon Bill's death, **Ann** receives the endorsed death benefit and uses it to purchase Bill's interest in the business.	
Policy owner	**Ann**	Bill	**Ann**	Bill
Insured	Bill	**Ann**	**Ann**	Bill
Beneficiary	**Ann**	Bill	Bill	**Ann**
Economic benefit (rental fee)	None	None	Bill	**Ann**

Benefits of cross endorsement

The cross-endorsement structure offers several benefits:

- The policy is controlled by the owner/insured, with premiums based on his or her own age and health.
- Cash values can be tapped for a lifetime buy-out or retained for retirement if the buy-sell agreement is terminated.
- No policy gains are recognized upon the termination of the buy-sell agreement because no exchange of the policies is necessary.
- It provides flexibility to change beneficiaries (endorsees) if business ownership changes.

Considerations of cross endorsement

The cross endorsement has its own set of considerations:

- If no transfer for value exception applies, the death benefit may be taxable to the endorsee.
- The endorsee lacks control over the policy and death benefit. For example, if the policy owner borrows against the cash value, the death benefit could be reduced.
- The value of the economic benefit that needs to be paid (rental fee) will increase as the policy owner/insured ages.

Discuss with your tax or legal advisor whether using cross endorsement of policies to fund your cross-purchase buy-sell arrangement is right for your business.

[1] The exemption amount is $12,060,000 per person in 2022 and is scheduled to sunset after 2025 and revert to its 2017 numbers, adjusted for inflation.
[2] Treas. Reg. §1.61-22(b)(1).

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