Insurance Funding and Alternatives in Buy-Sell Planning

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Society of FSP
Rocky Mtn. Chapter
January 18, 2022

Types of Buy-Sell Agreements

- Redemption-Entity is buyer (Corporation or LLC)
- Cross-Purchase-Shareholder/Members are buyer/seller
- Hybrid Method-Wait and See

Redemption-Entity

A. Insurance should be owned by and payable to entity

B. Guaranty by other members

C. Impact upon balance sheet of entity

Redemption-Entity owns insurance

- Shareholder/member is most often an employee
  - **Cash accumulation vehicles owned by the entity can be utilized for SERP/similar funding**
  - Down-payment upon lifetime disposition due to disability, departure or discord
  - May fund cost recovery upon lifetime disposition

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Redemption-Guaranty

- May not be enough insurance to fully fund buyout
- Entity will need to issue promissory note for balance
- Seller’s estate is ultimately a lender; there should be loan covenants (see June 10 presentation) and **personal guaranty of survivors**

Redemption-other factors

- Bank covenants-unless a specific carveout in loan documents

  - Entity receipt and subsequent use of life insurance proceeds may be restricted/prohibited if entity is outside its loan covenants

  - Death of key player may require proceeds to be used for debt reduction/working capital/any number of reasons “other than a buyout”.

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Redemption-other factors

- Buy as much insurance initially as carrier will provide to:
  - Address future insurability issues.
  - Valuation of underlying entity is expected in increase.
  - Insurance funding at death will assure stability for deceased member's family.

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Redemption-other factors

- Excess funding; who gets the excess:
  - Does it remain working capital of entity?
  - If a “C” corp. distribution to remaining shareholders could be a dividend ?
  - If distributed to decedent’s estate and in excess of legal obligation for stock buyout, is it a bonus-ordinary income in respect of a decedent?

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Redemption-other factors

- **NO step up in basis to survivors**
- Disposition of life insurance owned by entity when the entity goes away has complications.
- Transfer from C corporation to insured is taxable event to insured/separate ownership as C corporation

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Redemption-Disposition/winding up of entity owning life insurance

- Transfer from C corporation to insured is taxable event (valuation?).

- Mechanics require transfer to insured to avoid transfer for value concerns.

- Transfer to insured puts insurance “back into” the shareholder’s estate for 3 years.

Redemption-Sale of Entity owing life insurance

- Most sales of closely held businesses are “asset sales”
- Life insurance on the principals of the selling entity (corporation/LLC without regard to income tax status) is generally an excluded asset
- Entity eventually goes away or should?

Redemption-Sale of entity owning life insurance

- Review of policies status;
- Surrender (only option…..)
- Continue premium payment; maintain death benefit (as entity asset or transfer to insured and from there…to an ILIT?)

Redemption-Sale of entity owning life insurance

- Transfer by insured to ILIT
- Value ITRV, or
- Consider life settlement option;
- **Investigate disposition as early in sale transaction as possible**

Cross Purchase-Fundamentals

- Ownership by shareholders/members on each other.
- If 4 shareholders/members 12 policies as each owns a policy on the other 3
- Premium paid by or taxed to owner of policy
- Accounting for Premium/assurance its paid

Cross Purchase-fundamentals

- Member who dies owns policies on other members:
  - Value of the policies owned by decedent part of decedent's taxable estate and subject to creditors of shareholder/member
  - Transfer of policies from decedent of the policies owned by decedent to survivors' possible transfer for value

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Cross Purchase considerations

- May consider escrow/trust/partnership arrangement to eliminate multiple policies

- Must be cognizant of possible transfer for value considerations upon transfer of a deceased owner's policies to the survivors

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Cross Purchase considerations

- If owner of policy has creditor issues policy may be subject to lien/claim

- The exemptions that normally apply to life insurance under state law don't apply if the owner and insured are not related per se.

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Cross Purchase considerations

- What is done with policies owned by a shareholder/member who leaves the entity
  - Voluntary departure.
  - Disability departure
  - Termination of Employment
  - Life-time buyout.

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Cross Purchase considertions

- Lifetime departure:
  - Should owner who leaves be required to give insured first right to acquire policy at it ITRV?
  - Should the owner who leaves be required to transfer the policy to the insured gratuitously
  - Should the owner who leaves be required to transfer the policy proportionately to the remaining shareholders/members

Cross Purchase considerations

- Using an Insurance LLC
- Essentially makes a cross purchase arrangement into a redemption as the LLC owns one policy on each member
- The proceeds are used to acquire the deceased interest and allocated proportionately to the survivors

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Cross Purchase considerations

- Insurance LLC
  - Death of owner of policies which insure the lives of remaining shareholders/members …need to avoid transfer for value
  - Exception to transfer for value is partners and partnerships
  - LLC taxed as partnership

Cross Purchase considerations

- Insurance LLC
  - Avoids lending covenants
  - Should assure use of proceeds for intended purpose
  - Charging order restrictions should insulate policy from creditors of a member of LLC

Hybrid-Wait & See

3. Hybrid Method

   A. Whom do we want to have the preference; entity or members?

   B. Do we want entity to have mandatory obligation

   C. Where is the funding done?

   D. Force out the insurance

One-way Buy-Sell

- Key employee or family member
- Is generally considered designated successor
- Today/who knows tomorrow; we want step in basis at death
  - Generally, not concerned about removing appreciation from owners' estate.

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One-way Buy-Sell

- Key Employee/family member
  - Purchases life insurance policy on owner(s)
  - The premiums are paid through bonus to key employee
  - Death of owner(s) step up in basis received by Key employee/family member

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One-Way Buy-Sell

- Insurance proceeds received tax free by owner
- Proceeds paid by owner to decedents estate in exchange for units/shares
- Key employee/family member acquires company for price of a premium
- Family not involved in business get $$ equivalent

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Cross-Endorsement Buy-Sell

- Each owner of the business has a policy on their own life
- Generally, the entity will bonus funds to maintain the policy
- Each owner names their own beneficiary
- Each owner allows an endorsement on the policy

Cross-Endorsement Buy-Sell

- The endorsement is in favor of the other owner of the business who “rents” the death benefit for purposes of buyout
- The “rent” is calculated as is “split-dollar benefits”

Cross-Endorsement Buy-Sell

- Provides flexibility to owner of policy who can have greater coverage then needed for buy-sell
- Can take policy with them at departure without complications
- Owner continues to have access to cash surrender value

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Cross-Endorsement Buy-Sell

- Need to address transfer for value upon death.
- Generally, done through partnership exception under Section 101 of IRC
- Rent paid by other shareholder/member is income to insured/owner

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Funding Methods Life Insurance

Hybrid Plans

A. The option is first to Members in proportion to their ownership

B. Default is mandatory purchase by the entity (a redemption)

C. Where will the insurance be owned

Funding Methods Life Insurance

General provisions

A. Require the proceeds of life insurance to be used 100% for purchase as down payment

B. Balance of purchase price paid in installments

C. Installments must bear interest to avoid imputed interest rules

Lifetime Funding Methods

1. Disabled Shareholder
2. Departing Shareholder
3. Discord Among Shareholders/Members
4. Puts & Calls
5. Modification of Mandatory Terms to Facilitate Funding if the Buy-out Upon a "Put" Exercised Early.

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Lifetime Funding Methods

Disabled Shareholder

A. Disability Insurance paid by entity ordinary income to recipient

B. Disability insurance or <u>wage continuation plan</u> designed to facilitate transition with credit after some period applied to purchase price

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Lifetime Funding Methods

Disabled Shareholder

C. Wage continuation plan <u>(must be in writing)</u> funded from cash flow

D. Life Insurance on disabled member/shareholder used as cost replacement

E. Portion of payment (after certain number of months) applied to purchase price and disabled

F. Member must relinquish ownership with perhaps a stock pledge agreement as collateral

Lifetime Funding Methods

Departing Shareholder

A. May use cash surrender value of policy as down-payment

B. May use the value of the policy transferred to the departing Shareholder;

C. Must be willing to abandon the death benefit (transfer to insured an exception to transfer for value concern)

Lifetime Funding Methods

Departing Shareholder

D. Installment payments bearing interest; usually the Applicable Federal Rate at minimum

E. Collateral for installment payments

F. Restrictions on management activities during installment period to incentivize accelerated payoff of installment note

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Lifetime Funding Methods

Discord Among Shareholders/Members

A. May use cash surrender value as down-payment

B. May transfer policy to departing shareholder/member/agreement on value

Lifetime Funding Methods

Discord Among Shareholders/Members

C. Provide mandatory terms for lifetime buy-out

i. Percent of down payment
ii. Number of installments
iii. Interest rate on installments
iv. Non-compete from selling Shareholders/Members
v. Personal guaranty from remaining Members

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Funding with Life Insurance

- C corporations subject to 21% tax
- Life insurance premium not deductible …looks better at 21%
- Life insurance proceeds received by C corporation as of 2017 no longer subject to alternative minimum tax "AMT"

Funding with Life Insurance

- Addressing discrepancies in insurability
  - Cash flow as sinking fund if not used for premiums
- Addressing cost of insurance based upon underwriting example;
  - owner is charged with the premium cost attributable to the expensive to insure “insured”.
  - Bonus to cover discrepancies….cognizant of 2 classes of stock if an “S”

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Funding with Life Insurance

- Entity payment to assure policies remain in force
- Use of Escrow/Trust arrangement to receive policy proceeds at death and assure used for buy-sell purposes

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