



COMBINATION BUY-SELL STRATEGY

Producer Guide



 **TRANSAMERICA**
INSURANCE & INVESTMENT GROUP

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Overview

The death of a principal owner of a closely held business can create serious financial problems for the estate, the business, and the survivors of the decedent. Upon his/her death, the heirs may be faced with significant problems that can affect the continuation and orderly transfer of the business. Therefore, a buy-sell agreement can be crucial for business owners who want to assure the trouble-free transfer and continuing vitality of their businesses.

Traditionally, business owners setting up a buy-sell agreement had to choose between two options: a cross-purchase or an entity purchase. While the proper use of either arrangement will help ensure the transfer of business interests according to the wishes of the owners, there are disadvantages associated with either strategy. There are, however, several benefits of a combination buy-sell strategy that are not available in either a cross-purchase or an entity purchase.



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Buy-Sell Agreement Basics

While actual contracts may differ in wording, most buy-sell agreements generally state that each owner agrees:

- Not to dispose of his/her ownership interest during his/her lifetime without first offering it for sale to the other owners and/or to the business entity
- That the surviving owners or the business entity will purchase—and the decedent’s estate will sell—the decedent’s ownership interests
- That a purchase price based on a pre-established formula will be used at the time of death in order to determine a definitive value for the ownership interests

Financing the Buy-Sell Agreement with Life Insurance

Acquiring the funds to complete a buyout can be difficult, especially when the business owner has died and the business could be adversely affected by the loss of his/her services. The surviving business owner(s) could raise the necessary funds by borrowing, selling business assets, or using cash reserves, but all of these approaches are inherently uncertain. Alternatively, life insurance offers a viable option for financing a buy-sell agreement.

A life insurance policy can provide the proper amount of liquidity at a time when it is needed most: after the death of a business owner. Funds received from the death benefit proceeds of the policy can be used by the business or surviving owner(s) to purchase the decedent’s interest. The cash values may also serve as a source of funds for a buyout at dissolution, or when a business owner becomes disabled, is incapacitated, or decides to retire.

What Is a Combination Buy-Sell Arrangement?

The combination buy-sell is a nontraditional arrangement in which a general partnership is used to structure and fund a business buy-sell. This special arrangement combines the benefits of both a cross-purchase and an entity purchase, while avoiding their negative aspects. With this arrangement—in addition to establishing a traditional buy-sell agreement for the business—the owners establish a separate general partnership. The partnership owns and names itself beneficiary of life insurance policies insuring the lives of the owners.

At the death of one of the owners, and according to the terms of the buy-sell arrangement, the death benefit proceeds can be distributed by the partnership to the surviving owner(s)/partner(s) to fund a cross-purchase-type buyout, loaned to the business to fund an entity purchase, or used by the partnership itself to buy the deceased owner’s interest.

In order to understand the benefits of using the combination buy-sell arrangement, it is necessary to have an understanding of the benefits and drawbacks of traditional buy-sell arrangements. Following is a brief discussion of the entity purchase and cross-purchase buy-sell arrangements.

Entity Purchase

An entity purchase is different from a cross-purchase in that the business itself agrees to purchase the business interest from the decedent's estate. The business owns and is the beneficiary of a life insurance policy on each owner, and at the owner's death, the business uses the death benefit proceeds for the buyout.

Advantages:

- Easier to administer than a cross-purchase, since only one policy is needed for each owner
- The premium cost is spread among the owners according to their percentages of ownership interests
- Business funds are used to pay premiums on the policies
- Policies are controlled by the business, and cash values of the policies are considered business assets

Disadvantages:

- Due to family attribution rules, if other owners are family members and the redeemed business interests are C corporation stock, the redemption may be treated and taxed as a dividend, resulting in the entire sale amount being taxed as ordinary income
- Surviving owners' bases remain the same, possibly causing large taxable gains if the corporation is sold in the future
- If the corporation is a C corporation, death proceeds may be subject to alternative minimum tax (AMT)
- No corporate income tax deduction is available for premium payments
- Ownership interest of surviving owners changes on a pro rata basis following redemption, which could result in an unintentional shifting of power
- Policies are subject to the creditors of the business
- Corporation must follow notice, consent, and annual reporting requirements for corporate-owned policies per IRC §§ 101(j) and 6039I

Cross-Purchase

A cross-purchase buy-sell arrangement is an agreement between and among the individual owners of business. Each owner agrees to purchase the other owner's/owners' interest in the business if that owner dies or becomes disabled. Commonly, this type of arrangement will be funded with life insurance policies, with each individual owner owning and being named beneficiary on the policies insuring the other owner(s).

Advantages:

- Each owner's basis in the business is increased by an amount equal to the purchase price. If the business is sold in the future, this higher basis can reduce the taxable gain from the sale.
- If the arrangement is properly structured, funds paid by the business as a bonus/compensation to the owner(s) to pay premiums are deductible by the business
- A cross-purchase avoids corporate AMT and family attribution issues

Disadvantages:

- Multiple policies are required. The formula for the number of policies is $n(n - 1)$, where "n" equals the number of owners.
- There is a greater premium burden on younger and/or healthier owner(s), since they will need to purchase policies on owners who are older and/or in poor health, increasing premium costs
- Corporate-owned life insurance policy notice, consent, and reporting requirements of IRC §§ 101(j) and 6039I may apply

Benefits of Using a Combination Buy-Sell

As stated previously, a properly structured combination buy-sell provides the benefits of an entity purchase and a cross-purchase agreement by:

- Requiring only one insurance policy per owner
- Avoiding possible AMT on life insurance proceeds that could occur for C corporations that use an entity purchase buy-sell arrangement
- Providing full cost basis for the purchased shares to all surviving business owners, likely reducing the taxable gain if the business interest is sold in the future
- Reconfiguring policy ownership to achieve protection from the business's creditors
- Allowing the business to deduct amounts that are paid as bonuses to owners who will ultimately contribute these funds to the partnership to purchase life insurance policies, if properly structured

Additionally, the combination buy-sell arrangement includes benefits not obtained with an entity-purchase or cross-purchase arrangement. These benefits include:

- Giving owners the ability and flexibility to allocate the premium burden among themselves in any percentage desired
- The ability of the owner/insured to accumulate significant dollars in the life insurance policies on a tax-favored basis and safe from the business's creditors, and that can then be used for retirement



How Does the Combination Buy-Sell Strategy Generally Work?

- The business and the owners establish a corporate buy-sell agreement for the sale of the business. For added flexibility, the buy-sell can be structured as a “wait-and-see” arrangement, in which the actual purchaser of the decedent's interest in the business is not determined until the death of one of the owners.
- The individual owners of the business then establish a separate general partnership.
- The business pays an annual deductible bonus to the individual owners, as well as additional funds to pay the income taxes due on the bonus.
- Each owner contributes the after-tax bonus received to the partnership. These payments are treated as capital contributions to the partnership by the individual partners.
- The amounts that are contributed to the partnership will determine the partner's/owner's percentage of ownership and original basis in the partnership.
- The partnership purchases one policy per owner, which eliminates the need for numerous policies under a cross-purchase agreement. The partnership is both the owner and beneficiary of the policies.
- The total death benefit should be enough for the partner(s)/owner(s) to purchase the decedent's interest in both the partnership and the business.
- Corporate-owned life insurance policy notice, consent, and reporting requirements of IRC §§ 101(j) and 6039I may apply.

What Happens When an Owner Dies?

- As the owner of the life insurance policy, the partnership receives the life insurance death benefit federal income tax-free.
- Each partner's basis in the partnership is increased pro rata by the partner's percentage interest in the partnership when the partnership receives the death benefit. If special allocation provisions are used, the bases of the surviving partners can be increased by the entire amount of the death benefit proceeds, thus avoiding any "wasted" basis that would otherwise be allocated to the decedent.
- The death proceeds are first used to purchase the decedent's interest in the partnership. The remaining amounts are then distributed to the partners. These amounts will not be taxable as long as they do not exceed the partners' bases in the partnership.
- With the distributions received from the partnership, the partner/owner can either purchase the decedent's interest in the business directly from his/her estate in a cross-purchase arrangement, or contribute the funds to the business so that the business can redeem the decedent's interest through a stock redemption.

The Importance of "Business Purpose"

In order to establish a valid partnership, there must be an adequate business purpose for the partnership. There has been debate as to whether a partnership formed solely to hold life insurance to facilitate a buy-sell agreement is enough of a business purpose to constitute a validly formed partnership.

In Private Letter Ruling 9309021, the Internal Revenue Service (IRS) ruled that a partnership formed for the specific purpose of facilitating a corporate cross-purchase buy-sell agreement, and therefore engaged in the acquisition and management of life insurance policies on the lives of the partners, is a valid partnership for income tax purposes. Subsequently, in Rev. Proc. 96-12, the IRS has taken a no-ruling position as to the use of partnerships to fund a buy-sell agreement.

Specifically, the IRS will not give advance rulings or determination letters as to whether an entity in which almost all the assets are the policies on the lives of the members is a valid partnership.

As a result, those considering using a combination buy-sell arrangement may want to consider contributing or having the partnership own or manage other assets in addition to the life insurance contracts.

Example: Bow Wow Kennel Supplies Corporation

Jim (60 years old), Bob (40 years old), and Joe (40 years old)—three unrelated individuals—are equal shareholders of Bow Wow Kennel Supplies Corporation, a C corporation. All three shareholders decide to establish a general partnership—the JBJ Partnership—in order to fund and structure a buy-sell arrangement for the corporation. The JBJ Partnership will also manage additional properties owned by Bow Wow. This should help establish a legitimate business purpose for the partnership.

Jim, Bob, and Joe each invest \$100,000 in the JBJ Partnership and, as a result, each has a one-third interest in the partnership and an initial basis of \$100,000. The amount of basis is extremely important, because as long as Jim, Bob, and Joe receive distributions that do not exceed their respective bases in the partnership, the distributions will not be taxable.

The JBJ Partnership purchases life insurance policies, each with a \$1 million death benefit on each of the three partners. Given their various ages—premiums on the policy for Jim are likely to be substantially higher than the premiums for Bob and Joe—however, the actual outlay from each partner can be the same: \$100,000. In addition, only three policies—one on each partner—need to be purchased. If a cross-purchase arrangement were used, a total of six policies would have had to be purchased.

The Bow Wow Kennel Supplies Corporation provides an executive bonus to the individual partners to pay the insurance premiums, as well as extra funds to cover the tax on the bonus—a double bonus. These executive bonus payments should be tax-deductible by the corporation, provided the bonuses are considered reasonable compensation. The bonuses received by Jim, Bob, and Joe are then contributed to the partnership. Each contribution made by them will increase their basis in the partnership.

Five years later, Jim dies, and each of the surviving two partners receive an increase in his partnership basis of \$333,333, or one-third of the \$1 million death benefit. As a result, Bob and Joe can each receive a \$333,333 distribution from the partnership federal income tax-free and use these funds to purchase Jim's shares in the corporation. Both Bob's and Joe's basis in the shares purchased from Jim's estate will equal the purchase price for these shares. This increased basis in the corporation shares purchased from Jim's estate will likely be higher than Jim's basis in his original shares due to appreciation of the corporation's value over the years, and will increase Bob's and Joe's bases in their interest in the corporation. As a result, this higher basis will reduce the taxable gain if Bob and Joe decide to sell their interest in Bow Wow Kennel Supplies Corporation in the future.

So far in this scenario, the two surviving partners will not benefit from the \$333,333 increase in the partnership basis attributed to Jim. However, if the partnership has special allocation provisions, it can allocate the entire death benefit to just Bob and Joe. Doing this will provide a partnership basis increase to Bob and Joe, the surviving partners, of \$500,000 each. Therefore, \$500,000 can be distributed to each partner federal income tax-free, which they can then use to buy Jim's interest in the corporation.

Who Can Benefit from the Combination Buy-Sell Strategy?

- Businesses, particularly family businesses
- Business owners who want to ensure who assumes control over the business if one of the owners dies
- Business owners who want to ensure that funds are available to purchase a deceased owner's share in the business
- Business owners who want all of the benefits of a cross-purchase and entity purchase without the drawbacks associated with each arrangement

Ensuring Business Continuity

Most business owners spend a lot of time and energy building their companies. By developing a long-term financial strategy using life insurance that protects the business, provides tax advantages, and helps plan for the future through a combination buy-sell, business owners can ensure that their assets are protected.

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