Advanced Sales

White Paper: The "Own Your Own Policy" Buy-Sell

Number 11-1 June 1, 2011

Contact us: AdvancedSales@us.ing.com

Buy-sell and business continuation agreements are important business planning documents. Because every business owner will voluntarily or involuntarily leave their business someday, these agreements are critical in determining both the ownership and decision-making structure of the business after an owner leaves. A smooth transition of business ownership is important for both the remaining owners and the departing owner and his/her family. Owners who don't have a buy-sell plan in place before it is needed may create difficult problems for their families and co-owners.

Just as it is important to have a binding agreement, it is equally important that funds are available to carry out the promises made in the agreement. Even a perfectly drafted buy-sell agreement can't be carried out unless the buyer(s) have the money to follow through on his/her/their purchase obligation. Ownership transitions won't happen without a concrete plan for financing the agreement. This publication will offer a new strategy for funding ownership transfers necessitated by an owner's death.

The Importance of Life Insurance

Most buy-sell agreements include death as one of the triggering events. When this is the case, an owner's death activates the legal obligations to buy and sell the deceased owner's interest. Because death is nearly always a triggering event, life insurance policies are often used in the funding of the agreement. Some potential advantages life insurance provides include:

(1) The policy death benefit is generally payable in full as soon as the policy has been issued and a premium has been paid, even if the insured owner dies shortly thereafter.

(2) Policy death benefits may be paid relatively quickly after proof of death so the buyer will have some or all of the funds necessary for the purchase.

(3) Policy death benefits are generally paid to the policy beneficiary income tax free under IRC Section 101.

Common Varieties of Buy-Sell Arrangements

Different varieties of buy-sell arrangements have been developed over time. The two most common varieties are the entity purchase arrangement (in which the business buys back/redeems a departing owner's interest) and the cross purchase arrangement (in which the remaining owners purchase their pro rata shares of the departing owner's interest). Both arrangements have their respective potential advantages and disadvantages.

Who Owns the Policies?

Nearly all buy-sell agreements that use life insurance as a funding mechanism have one thing in common: **The insured business owners do not own the life insurance policies that insure their lives.** In an entity purchase arrangement the business typically owns the policies. In a cross purchase arrangement the other owners or another entity (e.g. a trust or a general partnership) own the policies. Life insurance policies can be very valuable assets. The fact that owners don't own their own life insurance policies can result in a number of real problems, including:

(1) The person/entity owning the policy may not pay the premiums or may mismanage the policy so that it is not in force at the insured owner's death; in these instances no death benefits are paid.

(2) The insured business owner has no ability to make decisions concerning the policy on his/her life.

(3) "Surplus" death benefits (those in excess of the amount needed to purchase a deceased owner's interest) are retained by the policy owner and can't be used to meet the deceased owner's personal financial objectives.

Additional problems may arise when the purchase obligation is triggered before the departing owner's death. Many buy-sells are activated when a triggering event occurs prior to an insured owner's death. In lifetime buy-outs, there aren't any policy death benefits available to fund the purchase of the departing owner's interest. In these situations:

(1) If an owner's health deteriorates, he/she may become uninsurable and be unable to purchase other life insurance coverage.

(2) Even when a departing owner is insurable, the cost of purchasing new coverage could be prohibitive because of age, health or other conditions.

(3) The insured may not have the legal right to acquire ownership of the policy if he/she leaves the business before death.

(4) Even when a departing owner does have the right to acquire ownership of the policy(ies) insuring his/her life, the cost of acquiring those policies could be too high.

Some buy-sell agreements have provisions which give departing owners a limited opportunity to acquire ownership of their policies. For example, when they leave, the agreement may give them the option to purchase their policy from its current owner for its fair market value. Or, the agreement may give the purchaser(s) the option to transfer the policy back to the departing owner and treat the policy's value as part of their payment.

In some cases these provisions can be helpful. Much of the time, however, they may be ineffective for a number of reasons. For some policies, it can be difficult to establish their fair market value. Some policies include various guaranteed features/components which can be hard to value. It is quite possible that the owners may disagree over a policy's fair market value. If the insurance company is asked to value it (as it is sometimes asked to do for the filing of 712 form), the remaining owners may not find the value acceptable. Other times the policy may not provide much in the way of long term value. For example, when term life insurance is used to fund a buy-sell agreement, the policy may terminate at a specified age (e.g. age 70 or age 80) or the premiums may increase substantially after age 65, the approximate age when many owners hope to retire.

Personal Ownership of Buy-Sell Life Insurance Policies

Despite potential valuation difficulties and disagreements, a departing owner's life insurance policy is an asset which could possibly be quite useful in his/her personal retirement planning or wealth transfer planning. Personal ownership of the policy would give the departing owner control of the death benefit; he/she could change the beneficiary designation so the death benefits could be used to meet personal financial objectives.

The "Own Your Own Policy Buy-Sell" strategy is a new alternative for structuring the ownership of life insurance policies designed to fund either an entity purchase or a cross purchase buy-sell agreement. This strategy separates the ownership of the life insurance policies from the obligation to purchase created under the agreement.

Why Is Personal Ownership Rarely Used?

In spite of the potential advantages of personal life insurance ownership to fund buy-sell agreements, this alternative is not widely used. There are at least three main reasons:

(1) Someone else (either another owner, entity or the business itself) has the legal obligation to purchase their interest. Because potential purchasers need to make sure they have sufficient funds to satisfy their purchase obligations under the agreement, it can make sense for them to own and control the policies.

(2) The entity purchase and cross purchase methods are well known and provide business owners and their tax and legal advisors with workable and predictable results.

(3) The transfer for value rule of IRC Section 101. One of the biggest advantages of using life insurance in buy-sell funding is that policy death benefits are generally federal income tax free to the policy beneficiary when the insured owner dies. This valuable income tax benefit may be lost if the business owners own their own policies because they may violate the "transfer for value rule." A transfer for value occurs when the owner of a life insurance policy transfers an interest in the policy to someone else and receives something of value in return. Under IRC Section 101 a transfer for value isn't limited to just cash or tangible assets; "value" can also include a legally enforceable promise which could potentially benefit the transferor (such as a promise to purchase the owner's interest). The result of violating the transfer for value rule is that the policy death benefit less the combined total of the consideration paid and total premiums paid after the transfer become taxable income to the policy beneficiaries.

Here's an example to illustrate the point. A and B are each 50% owners of a business. Each purchases a $1,000,000 life insurance policy on his own life and names the other owner as the policy beneficiary. Under normal circumstances neither A nor B would name each other as policy beneficiaries. Reciprocal promises to name each other as beneficiaries can be implied from their respective actions (or from the terms of the agreement). These reciprocal promises are the "value" that triggers the transfer for value rule. Thus, if A dies, part or all of the $1,000,000 death benefit B receives as the beneficiary of A's policy may be taxable income to B.

The Partnership Exception

Fortunately, it is possible to avoid the harsh income tax consequences of the transfer for value rule. In IRC Section 101(a)(2) Congress created a number of exceptions to the rule; if one of those exceptions applies, then it is possible the policy beneficiary may still receive the life insurance death benefits free of federal income taxes. An exception likely to apply to many buy-sell arrangements is the "partnership exception." This exception shields transfers for value from federal income taxes if the transfer is to a partner of the insured or to a partnership in which the insured is a partner. There are some fine points to this exception which should be kept in mind, including:

- The partnership must actually be operated as a partnership and not merely exist in form only.
- Members of a limited liability company (LLC) that has elected to be taxed as a partnership are considered to be "partners" for purposes of the transfer for value rule. (Private Letter Ruling (PLR) 9625013).
- A transfer for value from a corporation to a partnership in which an insured shareholder is a partner comes within the exception (PLR 9042023).
- Transfers to shareholders who are partners, even though in an unrelated partnership, fall within the exception (PLR 9347016, PLR 9045004).
- The transfer of policies insuring shareholders / partners from a corporation to a partnership established specifically to receive and manage the policies comes within the exception (PLR 9309021).

- The IRS has ruled that it will not issue rulings concerning whether or not the 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 its members (Rev. Proc. 20063, 2006-1 IRB 122). Thus, it may advisable for the partnership to have other assets in addition to life insurance policies on the lives of the partners in the partnership.

The "Own Your Own Policy Buy-Sell"

The ability to use the partnership exception to avoid the transfer for value creates an opportunity for a new type for life insurance-funded buy-sell arrangement—the "Own Your Own Policy (OYOP) Buy-Sell." In this approach each owner owns his/her own policy and names other owners (or the business in an entity purchase agreement) as beneficiaries of part of the death benefit so they have the ability to meet their purchase obligations. If these owners are in a partner/partnership relationship, the transfer for value rule should be avoided.

The Own Your Own Policy Buy-Sell—Cross Purchase

Assuming there is valid partnership in place or the business is organized and taxed as an LLC, LLP or a partnership, these steps may be taken:

(1) The owners enter into a cross purchase arrangement; each owner agrees to purchase his/her pro rata share of the interest of the other shareholders when they die.

(2) Each owner purchases and pays the premiums on a policy on his/her own life with a face amount at least as large as the value of his/her interest in the business; an option B death benefit approach (death benefit payable is the face amount plus premiums paid) may be appropriate because the insured's estate will then recover premiums paid into the policy.

(3) Each owner names the other owners as partial beneficiaries of the policy death benefit according to their pro rata shares of the business; the necessary forms are filed with the insurance company.

(4) At an insured owner's death, the death benefits are paid out according to the policy beneficiary designation; each surviving owner uses his/her share of the death benefit to purchase part of the deceased owner's share of the business from his/her estate under the terms of the agreement.

(5) If an owner retires or otherwise leaves the business before death, the remaining owners may use the cash values in the policies they own on themselves and/or other personal assets to purchase their respective shares of the departing owner's interest.

(6) Both the departing and remaining owners file the forms needed to change the beneficiary designations on all the life insurance policies.

The Own Your Own Policy Buy-Sell—Stock Redemption

If the business is organized as a C corporation or Subchapter S corporation and the parties wish to establish an entity purchase or stock redemption buy-sell format, the life insurance policies may still be owned by the insured owners. Although the partnership exception may not be available to shield the death benefit from the transfer for value rule, a different exception to this rule may apply—the corporation exception. This exception can be used when the transfer for value is to a corporation in which the insured is a shareholder or director. See IRC Section 101(a)(2)(b).

The shareholders could potentially use the Own Your Own Policy strategy to implement a corporate entity purchase/stock redemption plan with these steps:

(1) The owners and the corporation enter into a stock redemption buy-sell agreement; the corporation agrees to purchase the interests of shareholders when they leave or die.

(2) Each owner purchases and pays the premiums on a policy on his/her own life with a face amount at least as large as the value of his/her interest in the business.

(3) Each owner names the corporation as one of the policy beneficiaries as required in the agreement; the agreement may establish standards for the owners regarding paying premiums and administering the life insurance policies.

(4) Assignment forms or beneficiary forms are filed with the insurance company.

(5) At an insured owner's death, the death benefits are paid to the corporation per the beneficiary designation; the corporation uses these death benefits to redeem the deceased owner's stock.

(6) If an owner retires or otherwise leaves the business before death, the corporation will use other assets to redeem the departing owner's stock; the beneficiary forms are changed.

Possible Advantages When Owners Own Their Own Policies

Upon close examination, there may be a number of potential advantages when business owners own their own buy-sell life insurance policies. They include:

(1) **Personal Ownership and Control**—Each owner makes the decisions concerning his/her own policy (however, if the agreement sets standards for the policies, each owner would have to satisfy those standards / requirements).

(2) **One Policy Per Owner**—There is no need for multiple policies on each owner.

(3) **Ability to Include Personal Death Benefit Coverage**—An owner may want more death benefits than the amount needed under the agreement; he/she may decide to increase the death benefits to accomplish personal protection and wealth transfer planning objectives in addition to the buy-sell funding objective.

(4) **Each Owner Pays His/Her Own Way**—Each owner is responsible for his her own premiums; younger or healthier owners aren't forced to pay premiums on older or less healthy owners.

(5) **Choose Own Policy and Set Own Premium Level**—Within the terms of the agreement, each owner may decide what type of policy to purchase and how much premium to pay; they may choose to pay in more than the minimum in order to increase cash values potentially available to fund the purchase of another owner's interest or to create supplemental retirement income for themselves.

(6) **Business Dollars For Premiums Potentially Available**—The business may assist with paying premiums; time-tested premium funding techniques like Section 162 bonus plans, split dollar, and split dollar loans may potentially be used.

(7) **The Policies Are Portable**—Every owner who leaves the business before death takes the policy with him; there is no need to attempt to acquire the policy from another owner or from the business.

(8) **Wealth Transfer Planning**—After an owner leaves, he/she may reposition the policy to meet personal needs without going back through the underwriting process to purchase new coverage; problems with increased premiums and decreased insurability can potentially be avoided.

What Type of Coverage Is Appropriate?

Many business owners consider the need for buy-sell life insurance to be temporary. That's because they often expect to sell their interests when they retire (usually between ages 60-70). As a result, they often use term insurance to fund their purchase obligation. Owners who leave at retirement are usually bought out with cash, debt (notes) or future earnings (through installment payments) or a combination thereof. The perception that owners are likely to sell out when they retire encourages the use of term insurance for buy-sell funding.

In the Own Your Own Policy Buy-Sell structure cash value life insurance may be appropriate because the policy must be in force at the insured's death. This means it may have to be in force for a longer period of time. Owners who like the OYOB approach and want their death benefit coverage to stay in force after they leave will likely have other uses for the policy. For the policy to be viable for some years after the owner's departure, cash value insurance may be needed. Cash value insurance may also be attractive because of its potential to provide some degree of supplemental income after the owner leaves the business. The fact that the policy can be used for other purposes after the insured owner's interest in the business has been purchased makes cash value life insurance appropriate.

Managing the Policies

The business owners may be able to combine both their business life insurance planning and their personal life insurance planning in one personally owned policy. The total death benefit could include components for buy-sell funding, spousal support, mortgage and personal debt repayment, and estate liquidity. Of course, the personal portion of the death benefits will be included in their taxable estates for estate tax purposes. If this is a problem, then it may be possible for the insured owner to establish an irrevocable life insurance trust (ILIT) and have it own the policy. The portion of the death benefit needed to fund the buy-sell arrangement could be handled by naming the other owners or the business as beneficiaries of the ILIT to the extent of ownership in the business. The ILIT could be drafted so that their status as beneficiaries would end if they die or leave the business before the insured or if the insured ILIT grantor leaves the business before death.

The insured is responsible for paying policy premiums. He/she can use personal funds or may enter into a premium sharing arrangement with the business or an outside entity. If it makes financial sense, the business may be able to supply some of the premium dollars through an economic benefit split dollar arrangement or a split dollar loan. It is also possible that some assets from the business could be distributed to the owners as compensation, dividends or (depending on the business' tax structure) return of basis.

Wise owners will want to make sure the death benefits they need from another owner's policy will be available to help them meet their purchase obligations at the owner's death. Thus, their status as beneficiaries entitled to receive a portion of the death benefit must be formalized in the buy-sell agreement. Their rights can potentially be secured through an irrevocable beneficiary designation, a written assignment or a policy endorsement. They should consult with their tax and legal advisors to determine which strategy is best suited to their needs.

Potential Tax Consequences of the OYOP Buy-Sell

The year-to-year income tax treatment of on OYOP buy-sell arrangement is not known with certainty. The transfer for value issue should only arise when an insured owner dies, not while he/she is alive. It does not create any year-to-year income tax consequences during an insured's lifetime. Also, it is possible to "cure" a transfer for value before the insured's death by transferring the policy back to the insured. Are there any year-to-year tax consequences when a policy owner names a business partner as a temporary beneficiary of all or part of the death benefit of his policy in return for a business partner doing the same for him?

The authors are not aware of any regulations, rulings or cases which have directly addressed an OYOP buy-sell arrangement. Because the business is not involved in the arrangement, we believe that income taxation under the following internal revenue code sections is not applicable:

- Section 162—no compensation from the business
- Section 79—no plan of group insurance
- Section 264—no benefit provided from the business to the owners.

We believe the income taxation of OYOP arrangements could potentially be viewed in at least three different ways:

No Taxation

An OYOP arrangement may be compared to how life insurance is sometimes used in divorce/marital dissolution situations. In addition to alimony and child support, divorce decrees may require one spouse to purchase and maintain life insurance coverage on his/her life for the benefit of an ex-spouse for a specified term of years. After the specified term expires, the insured ex-spouse is entitled to do anything he/she wishes with the policy. When a provision like this is included in a divorce decree, a binding legal obligation on the part of the ex-spouse to provide life insurance protection is created. If the spouse receiving the life insurance protection does not own the policy, then the premium payments are not considered alimony and the value of the life insurance coverage is not taxable income (Temp. Treasury Reg. 1.71-1T, A-6).

It is possible that the taxation of the temporary year-to-year life insurance protection in an OYOP buy-sell arrangement could be handled in a similar way. For this argument to be effective, it is likely that the buy-sell agreement must create an obligation on the part of each owner to provide the other owners with a specific dollar amount of life insurance death benefits. Accordingly, it may make sense for the agreement to have a provision requiring each owner to secure life insurance coverage on his/her life and to name the other owners as beneficiaries for stated amounts or percentages of that coverage.

Taxation Under the Split Dollar Rules

Could the split dollar regulations apply to the temporary assignment of policy death benefits? An analysis of the split dollar regulations creates doubt as to whether an OYOP arrangement qualifies as a split dollar arrangement. 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 any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract." See Reg. 1.61-22. In the OYOP strategy the insured owner (who is also the sole premium payor) temporarily names the other owners as beneficiaries of the death benefit and does not retain a right to recover any portion of the premiums he/she has paid from the death benefits provided.

Should the IRS decide to apply the split dollar rules to an OYOP buy-sell arrangement, it could possibly conclude that the arrangement should be treated as a private split dollar plan. In this event, an owner who names another owner as a beneficiary of part or all of his policy death benefit could be deemed to be making a gift to the other owners. The value of the gift could be the economic benefit value of the death benefit provided. The economic benefit value is determined by multiplying the IRS Table 2001 rate for the insured's current age by the number of $1,000 units of death benefit that would be paid to that owner if the insured died during the current year. If the necessary requirements are met, it is possible the rates of an insurance company's qualifying term policy could be used in place of the IRS Table 2001 rates. If a donee has a "present interest" in the gift, then it may qualify for the gift tax annual exclusion. If no "present interest" exists, then the gift would reduce the donor's lifetime gift tax exemption. These would be "cashless" gifts since nothing tangible is actually transferred.

Split Dollar example: Suppose A, B & C are equal owners of Wacky Widgets LLC. The business is appraised to be worth $3,000,000 and the owners decide to use the OYOP Buy-Sell. Their respective ages are A-55, B-45 and C-35. Each purchases a $1,000,000 policy on his own life. Each names the other two owners as equal beneficiaries of $1,000,000 of the life insurance coverage ($500,000 each). Based on the IRS Table 2001 rates, over the next five years each could be deemed to make economic benefit gifts under the private split dollar rules in these amounts:

	A's Annual Gift (55)	B's Annual Gift (45)	C's Annual Gift (35)
Year 1	$4,150	$1,530	$ 990
Year 2	4,680	1,670	1,010
Year 3	5,200	1,830	1,040
Year 4	5,660	1,980	1,060
Year 5	6,060	2,130	1,070

No Taxation as a Fair-Market Value Sale

It may be possible to avoid taxation on the assignment of the life insurance benefits if each owner annually pays the other owners fair market value for his/her share of the policy death benefit. What is that value? A good argument could be made that it is the economic benefit value determined under the split dollar rules.

This alternative could be compared to old-style "reverse" split dollar plans which were sometimes used in the 1990's before the IRS revised the split dollar rules. In these old reverse split dollar plans, an owner had a personal life insurance policy on his/her own life. The corporation "rented" some or all of the death benefits from that policy to meet its need for key person life insurance. It paid the owner-insured an annual rental fee for the annual use of the owner's personal life insurance death benefit protection. The amount of the rent paid annually was the economic benefit value.

A fair market rental payment for temporary use of the death benefit coverage could be considered to negate any potential gift from the policy owner. If the value of the death benefit protection is equal in value to the rent paid, then it can be argued that the assignment of the death benefit creates no tax consequences because items of equal value are exchanged. Under this reasoning, the assignment of the death benefit may not create any taxable income to the policy owner, but the rental income each owner receives in return for assigning his/her policy death benefits to other owners could be treated as taxable income.

This strategy presents a new transfer for value issue because an interest in the policy death benefit is being transferred for valuable consideration. However, an exception to the transfer for value rule may apply to prevent potential adverse income taxation. The applicable exception is that the transfer goes back to the insured. See IRC 101(a)(2).

If this is the tax approach the IRS adopts, what would be the economic impact to the shareholders? Simply stated, the out-of-pocket cost to each shareholder would have three components:

(1) The cost of the premium on his/her own life insurance policy, LESS

(2) The total "rental" payment received from each of the other owners for the assignment of their share of the policy death benefit, PLUS

(3) The potential income tax on the total of the "rental" payments received from the other owners.

Some Potential Disadvantages

Some possible disadvantages to an OYOP Buy-Sell arrangement include:

(1) A procedure for monitoring the policies should be implemented and enforced. The buy-sell agreement could require each owner to present a quarterly, semi-annual or annual report of the status of their life insurance policy. The business could hire a life insurance expert to review the policy information and make an annual report.

(2) The policy beneficiary designations should be confirmed with the insurance company and reviewed regularly.

(3) If applicable, economic benefit calculations would need to be performed annually and any taxable gifts should be reported to the IRS; to the extent economic benefit gifts don't qualify for the gift tax annual exclusion, a portion of an owner's lifetime gift tax exemption would be used.

(4) Taxable gifts that reduce an owner's lifetime gift tax exemption may also reduce the amount of the estate tax unified credit available at the owner's death; as a result, the amount of property an owner may be able to transfer federal estate tax free at death may be reduced.

OYOP Applications

The OYOP Buy-Sell concept could potentially apply to a large number of businesses. That's because many existing businesses are currently structured as limited liability companies (LLCs), limited liability partnerships (LLPs), professional limited liability partnerships (PLLPs) and general partnerships. The LLC form of business is a legal structure that is being adopted by many new businesses. Owners of C corporations and Subchapter S corporations often have assets that are used in the business but are owned outside the corporation in a partnership. C corporation and Subchapter S corporation owners may choose to create a partnership by contributing personal assets and/or taking distributions from the corporation and funneling the after-tax portion of those distributions into a new partnership. In the alternative, C corporation and S corporation owners could structure their life insurance buy-sell funding to use the corporation exception to the transfer for value rule.

Conclusion

For many years advisors to business owners have avoided having owners personally own the life insurance policies that fund their buy-sell arrangements. This may no longer need to be the case. The Own Your Own Policy Buy-Sell is a strategy which has the potential to provide many business owners with the ability to own and control their life insurance policies while still maintaining policy death benefits to fund buy-sell obligations triggered by death. Because the OYOP strategy has the potential to combine buy-sell funding with personal life insurance needs, it gives them the opportunity to combine all their life insurance needs in a single policy. It also gives business owners who leave their businesses during their lifetimes more opportunity to customize, structure and manage their policies to provide ongoing benefits after they leave the business.

These materials are not intended to and cannot be used to avoid tax penalties. They were prepared to support the promotion or marketing of the matters addressed in this document. Each taxpayer should seek advice from an independent tax advisor.

The ING Life Companies and their agents and representatives do not give tax or legal advice. This information is general in nature and not comprehensive, the applicable laws change frequently and the strategies suggested may not be suitable for everyone. You should seek advice from your tax and legal advisors regarding your individual situation.

Life insurance products are issued by ReliaStar Life Insurance Company (Minneapolis, MN), ReliaStar Life Insurance Company of New York (Woodbury, NY), and Security Life of Denver Insurance Company (Denver, CO). Within the state of New York, only ReliaStar Life Insurance Company of New York is admitted and its products issued. All are members of the ING family of companies.

© 2011 ING North America Insurance Corporation cn67400052014

160112 06/1/2011