CROSS ENDORSEMENT BUY-SELL AGREEMENT

The trusteed cross purchase agreement is one flexible means of providing for the complete disposition of a business interest.1 However, the cross endorsement buy-sell agreement is an alternative which can provide the benefit of basis-step up typically found in a cross purchase agreement with the simplicity and flexibility of individual policy ownership by the insured shareholders. Unlike the trusteed cross purchase agreement and the escrow and partnership versions of that structure, each shareholder simply purchases a permanent policy on his or her own life. 2 No third party is required to own or facilitate the arrangement.

**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation owned by four stockholders, A, B, C, and D. They enter into a buy-sell agreement providing for the purchase and sale of their respective interests. 3 Typically, this agreement is *binding* and obligates all stockholders, or their representatives, to either buy or sell upon their death, disability, or retirement.

To fund the agreement the stockholders simply endorse some or all of the death benefit on a policy (or policies) insuring their own life to the other shareholders. For example, A would endorse a portion of the death benefit on his or her life insurance policy (equal to the purchase obligation of that shareholder) to each of B, C, and D. 4 Likewise, B would endorse his or her death benefit to A, C, and D. C and D would do the same with the result that each of A, B, C, and D could own a single permanent policy on his or her life that would be partially endorsed to each of the other three shareholders. A, B, C, and D can continue to own their own life insurance policy and their own shares of stock without the need to make a transfer. Like a trusteed cross purchase agreement, a cross-endorsement arrangement can substantially reduce the number of policies required to fund a cross-purchase buy-sell agreement. 5

**UPON DEATH.** Assuming that A dies first, the insurance company pays the death benefit to the shareholders as provided for under the split dollar endorsement agreements. Assuming A, B, C, and D were equal shareholders – the death benefit would be paid (tax-free) one-third to each of B, C, and D. 6 Pursuant to the buy-sell agreement, A’s estate would transfer A’s entire stock interest (one-third each) to B, C, and D in exchange for the cash received from the insurance company. 7 The fully funded agreement can *assure* that A’s surviving family receives a fair price for his or her interest in the business. But such an agreement can also serve to establish, or “peg,” the value of the stock.8 Most importantly, under this structure, if the business is sold or otherwise terminated during the insureds’ lifetimes, the life insurance policies are owned by the individual insured. All that is required is that the parties cease the annual rental of the death benefit under the endorsement split dollar arrangement. 9

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DIAGRAM GOES HERE

INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Names of owners to be insured.

2. Sex.

3. Dates of birth.

4. Smoker/nonsmoker.

5. Value of ownership interests.

6. Form of organization (C corporation, S corporation, partnership, or sole proprietorship).

7. Identity of purchaser.

8. Identity of policyowner (insured or an entity created by insured such as an ILIT).

CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

Income Tax

**Q 61**. For death proceeds to be excludable from income, a life insurance policy must meet certain requirements.

Corporation

**Q 241**. Stockholder cannot deduct premiums paid on policy purchased on life of another stockholder.

**Q 245**. Premiums paid by corporation on policies owned by stockholders are taxable income to stockholders.

**Q 272**. Sale of deceased’s stock will usually not result in income tax liability to deceased’s estate.

**Q 273**. Income tax effects of funding stock purchase agreement with life insurance.

Partnership

**Q 249**. Premiums paid by partner for insurance on his own life are not deductible by him if proceeds payable to copartner.

**Q 284**. Income tax results when deceased partner’s interest sold or liquidated under a business purchase agreement.

**Q 286**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

Footnotes

1. See discussion of the Trusteed Cross Purchase Agreement on pages 134 to 137. A common alternative to the Trusteed Cross Purchase Agreement is the Partnership Cross Purchase Agreement in which a partnership is used rather than a trust or escrow arrangement. The partnership arrangement is used to void what some tax professionals consider a possible transfer for value issue created when beneficial ownership of the policies is transferred in the Trusteed Cross Purchase Agreement structure. See a discussion of Transfer for Value on pages 562-563.
2. Sometimes the policy is owned by a trust created by the insured rather than by the insured individually. Use of a trust brings with it the advantages and disadvantages of trust ownership discussed in various places throughout the text including pages 50 to 53)
3. See footnote 2, page 133, for an explanation of the various means that can be used in the agreement to determine a purchase price.

4 The arrangement between the shareholders is a simple endorsement split dollar agreement whereby the policy owner simply “rents” the death benefit to the other shareholders using the IRS 2001-10 rates or the carrier cost of term insurance. See a discussion of endorsement split dollar at pages 216 to 219.

5. With multiple stockholders the typical cross purchase agreement has the disadvantage of requiring that each stockholder be the owner and beneficiary of a policy on each of the other stockholders. Example 1, below, requires twelve policies to fund a cross purchase agreement involving just four stockholders (i.e., A must own policies insuring B, C, and D, etc.). Example 2 uses a cross-endorsement arrangement to reduce the number of policies to the number of insured stockholders.

6 Each of B, C, and D would receive the death benefit free of all income taxes since they are received as the death benefit of a life insurance contract.

7With a trusteed buy-sell agreement there is a potential transfer for value problem after the first death upon the transfer of the deceased stockholder’s ownership interests in the remaining policies insuring the surviving stockholders (pages 562-563). With the cross-endorsement arrangement no such problem exists at that time since no policy is transferred. Rather, the endorsement split dollar agreement in future years is merely modified to accommodate the new ownership percentages. Some tax advisors have expressed concern that the cross-endorsement itself is a transfer for value. To avoid this concern, a common strategy is to create a partnership between the partners to hold a piece of business property such as land, building, or vehicles.

8To help “peg” the value, the parties must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A’s estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 125 and pages 414-415).

9 This avoids potential conflict among shareholders upon sale or liquidation of the business. In most instances, once the business is sold or terminated, the parties to the buy-sell arrangement want to acquire the policies on their own life. Traditional entity purchase, cross purchase, and trusteed cross purchase arrangements require complicated planning to insure that this can be done and that a fair price for the policy is set. With the cross-endorsement buy sell arrangement no transfer is required. Each surviving shareholder simply stops endorsing his or her policy to the other shareholders when the buy-sell agreement ceases to exist.