**8809. What types of insurance can be used to fund a buy-sell agreement?**

Many business owners who structure a buy-sell agreement prefer to use insurance to fund the agreement.The insurance provides certainty that the purchase price will be funded, as it can be structured to pay out upon the occurrence of the triggering event(s), usually the death, retirement or permanent disability of the seller. A buy-sell agreement funded through insurance can raise several tax and nontax issues, however.

Various types of insurance can be used to fund a buy-sell agreement, including the following:

1. *Term life insurance*. Term life insurance, which provides life insurance coverage for a set amount of time, is a possible funding mechanism, but because the insured may outlive the pre-set term of the policy, it may not present the best option for younger business owners.If the insured outlives the term, the policy may expire and the investment may be lost.

**Planning Point**: This type of approach is best when there is not sufficient cash flow to fund permanent insurance or when there is an intention to sell the business at a certain point.

(2) *Cash value life insurance*.Various types of permanent life insurance that allow for a build-up of cash value within the policy may be used to fund a buy-sell agreement, and may be especially useful where the triggering event is *not* the departing business owner’s death.This type of insurance provides for a build up of cash value over time and permits the policy owner to withdraw a portion of the cash value tax-free.As a result, if the buy-sell agreement is triggered by an event such as the departing owner’s retirement or disagreement over S corporation dividend distributions, for example, the remaining owners can still access the cash value to fund the purchase.

(3) *Disability insurance*.Disability insurance can be used to fund a buy-sell agreement where the triggering event is the disability of the departing business owner.[[1]](#footnote-1)

**Planning Point:** Often times, the sales price is determined by an appraisal or through a formula. Therefore, the amount of the insurance may not equal the sale price. Consideration must be given as to what happens to the excess insurance proceeds; or how a deficit is handled if the insurance proceeds proves to be less than the sales price. Typically, to the extent that there is a gap between the insurance proceeds and the sales price, the deficit is paid through a promisorry note. This note will need to carry interest and consideration under the terms of the note.

Q 8670 through Q 8692 provide an in-depth discussion of the tax treatment of the use of life insurance in a business context.Q 8674 discusses the tax treatment of the policy from the standpoint of the insured-employee, and Q 8672 and Q 8673 outline the deductibility of premiums paid by the employer-business entity.

See Q 8810 for a discussion of some of the various triggers that may be used in the context of a buy-sell agreement.

1. . See *Oak Rd. Family Dentistry, P.C. v. Provident Life & Accident Ins. Co*., 370 F. Supp. 2d 1317(2005). [↑](#footnote-ref-1)