The cross-purchase buy-sell agreement is one of the foundations of business continuation planning. It has one flaw; more business owners require exponentially more life insurance policies. Many solve this dilemma with the use of trusteed cross-purchase agreements. While a mainstay in buy-sell planning, the trusteed cross-purchase agreement is not without its challenges. This Advisor Update will discuss the merits and challenges of using trusteed cross-purchase agreements.

Background

Cross-purchase agreements coordinate a simple transfer structure in a business. Each shareholder is obligated to purchase the business interest of other shareholders. If life insurance is used to fund the obligation, each shareholder owns a life policy on the other. The cross-purchase agreement has a number of advantages over an entity purchase arrangement. Reasons include a step-up in basis for surviving owners, the ability to convert to an entity agreement without violating the transfer for value rule, avoidance of family attribution rules and prevention of the corporate Alternative Minimum Tax.

This plan has one primary weakness. Each business owner is both the purchaser and owner of the life insurance on each of his or her co-owner’s life. The more owners involved in a business, the more life policies required. If a company has four owners, they would need twelve life policies.

Trusted cross-purchase agreement

A trusteed buy-sell agreement is used many times to get the best of both worlds — tax benefits of a cross-purchase agreement structure, with a minimal amount of life policies as in the entity purchase. In this type of arrangement, the parties use a third party to effectively act as a trustee or escrow agent to carry out the mutual obligations to each other as created in a cross-purchase agreement. Let’s review how this structure works.

Assume the company has four shareholders. The shareholders enter into a buy-sell agreement that provides for the sale and purchase of their each respective business interest in the event of death, disability, retirement or involuntary transfer. This arrangement may require the transfer of stock to a trust. The trustee would purchase one insurance policy on each shareholder. The trust would be the owner and beneficiary of the policy with each shareholder accountable for the premium.
Upon death, the insurance company pays a tax-free death benefit to the trust. Acting like an escrow agent, the trustee transfers the decedent’s stock to the surviving shareholders in return for the payment of life insurance to the decedent’s estate. The surviving owners are entitled to a step-up in basis and retain the other benefits of a cross-purchase agreement.

So far, so good (or not?)

This properly executed trusteed cross-purchase agreement has given the owners the benefits of a cross-purchase agreement, with the minimum number of insurance policies as in an entity purchase agreement.

There are potential disadvantages with this approach. While the transaction seems to have worked great up to the first death, potential “transfer for value” problems are created. Upon the death of the first shareholder, his or her beneficial interest in the remaining life policies is automatically transferred to the remaining shareholders. This could result in the unwanted taxation of subsequent death proceeds. In addition to the unwanted taxation of the death proceeds, the death benefits could be included in the deceased owner’s estate (second deceased owner) as the owner had control over the revocable trust. At the second death, the death benefits could be income taxable to the trust, and the death proceeds could be estate taxable to the deceased shareholder’s estate.

Summary

The trusteed cross-purchase agreement is still a viable tool in business continuation planning. Advisors using such a tool need to be aware of the potential ramifications, as the application of this agreement continues beyond the death of the first business owner. Another option frequently used is having the agreement provisions and the insurance inside a partnership. This partnership approach provides the advantages of a cross-purchase without the “transfer for value” issues that are in the trusteed approach. A partnership used solely to facilitate buy-sell agreement may not be considered a legitimate business purpose by the IRS. Many practitioners establish partnerships for other business reasons and include such buy-sell language.

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