



Structuring and Funding the Buy-Sell Agreement

This article surveys the principal forms of the buy-sell agreement and the proper coordination of life insurance ownership and beneficiary designations. It is essential to work with professional advisors to select and implement the right form of buy-sell agreement based on the specific facts and circumstances of each case. One size does not fit all!¹

A well-drafted and carefully administered buy-sell agreement provides a number of important benefits. It creates a ready market for an illiquid asset; controls who the remaining partners are in business with; ensures a fair price for both the buyer and the seller; and fixes the value for estate tax purposes (but see discussion of the Connelly case below).^{2,3} Life insurance provides income tax-free funds to the surviving owners exactly when needed to purchase a decedent's interest in the business.

Buy-sell arrangements have traditionally taken two primary forms: cross-purchase or stock redemption. The cross-purchase agreement has two important variations - the wait-and-see buy-sell agreement (a hybrid of the two) and the trustee cross-purchase buy-sell agreement. While each of these approaches has distinct advantages and disadvantages, the Buy-Sell LLC brings the best of all worlds together. Selecting the right form to fit the business owners' needs and circumstances is essential.

Traditional Approaches

THE STOCK REDEMPTION BUY-SELL AGREEMENT

In a stock redemption agreement, the operating business is obligated to redeem, that is, purchase, a deceased owner's interest. As a result, the operating business will be the owner, beneficiary, and premium payor on a single policy insuring each owner. Upon an owner's death, the policy proceeds are paid to the operating business and used to redeem the interests from the decedent's estate.

- From the estate's point-of-view, under the current estate tax law, assets included in the decedent's estate (including the business interest, regardless of the form) receive a stepped-up cost basis. As a result, to the extent that the buy-sell price is less than or equal to the estate tax value, the sale of the decedent's business interest does not trigger gain.⁴
- However, from the surviving business owners' point-of-view, where the operating business is a flow through entity⁵, life insurance proceeds

payable to the business increase the cost basis of all owners (including the estate) pro rata. Since the estate has already received a stepped-up cost basis under the estate tax law, the basis increase due to the life insurance is wasted.⁶

Importantly, in the recent *Connelly* case, the United States Supreme Court turned a well-established precedent on its head ruling unanimously that life insurance owned by and payable to a corporation to fund a stock redemption agreement increased the value of a decedent's interest.⁷ Although the scope of the holding is unclear (the Supreme Court failed to give much of an explanation for its decision), this places a cloud of uncertainty over redemption agreements and caution is advised. It is the opinion of some that the *Connelly* decision applies narrowly, only to family situations and it may merely be a "bad facts" case; it is, however, up to the client's legal and tax advisors to make the call.⁸

The Cross-Purchase Buy-Sell Agreement

In a **cross-purchase arrangement**, the individual owners are obligated to purchase a decedent's interest. Each business owner owns and pays for a life insurance policy insuring the other owners. Upon an

owner's death, the life insurance policy proceeds are paid to the surviving owners who then purchase the deceased owner's interest. As with the redemption agreement, the sale by the decedent's estate does not trigger gain and the surviving owners now control 100% of the business. In contrast to the redemption, however, the survivors receive a full fair market value (FMV) cost basis in the just-purchased interests equal to the purchase price.

Where greater than two business owners are involved, one disadvantage of the traditional cross-purchase agreement is the required number of policies. While two owners require only one policy on each, three owners require two policies on each owner for a total of six policies. If there are four owners, 12 policies are required.⁹

CROSS-PURCHASE EXAMPLE

Three equal shareholders own an 'S' corporation valued at \$6 million (\$2 million each). They enter into a cross-purchase buy-sell agreement. On the death of a shareholder, each surviving shareholder is personally obligated to purchase $\frac{1}{2}$ of the deceased owner's shares in the business (\$1 million each). \$6 million of death benefit is needed so that each shareholder purchases and pays the premiums on a \$1 million policy insuring each of their two partners:

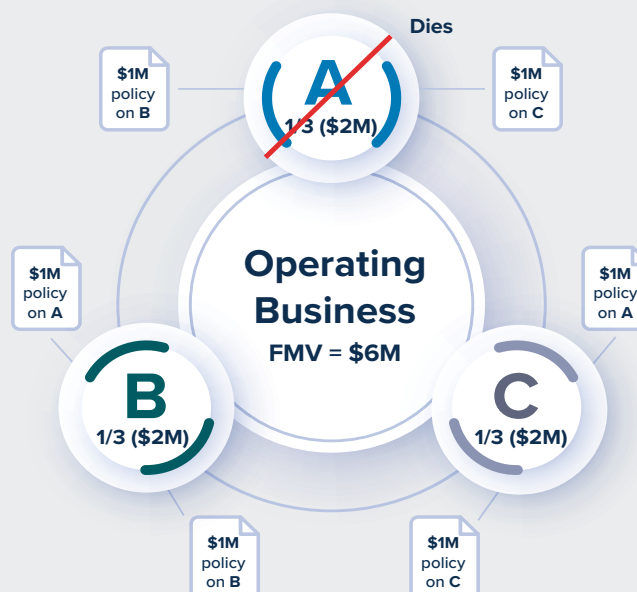
\$6M Life Insurance to Fund Cross-Purchase

Each shareholder owns **$\frac{1}{3}$ (\$2M)** of an 'S' corporation with a total FMV = \$6M and purchases \$1M life insurance policies on each of his co-shareholders (for a total of 2):

- **A** buys \$1M policies insuring **B & C**
- **B** buys \$1M policies insuring **A & C**
- **C** buys \$1M policies insuring **A & B**

On A's death, B & C each

- Uses the \$1M income tax-free proceeds to purchase A's shares
- Receives a \$1M cost basis in those purchased shares
- Owns $\frac{1}{2}$ the \$6 million business (\$3 million each)



ESSENTIAL FINAL STEP IN CROSS-PURCHASE EXAMPLE

After A's death, A's estate still owns the \$1 million policies insuring B and C. B and C each now has a \$3 million purchase obligation but own only \$1 million of coverage on their partner. A's policies are, therefore, needed by the survivors. Since A has paid the premiums to date on those policies, best practice is for B to purchase the policy insuring C from A's estate and C to purchase the policy insuring B. Even then, they are still each short \$1 million and new coverage, if available, is advisable.¹⁰ However, an equally important issue must be addressed: the potential transfer-for-value violation.

THE TRANSFER-FOR-VALUE RULE

Unless within an exception to the transfer-for-value rule, the transfer of a life insurance policy for valuable consideration violates the rule and the policy loses its income tax-free character. In the preceding example, without more, B and C's purchases of the policies from A's estate violates the rule.

The most commonly available exception is the transfer of the policy to a partner of the insured or to a partnership in which the insured is a partner.¹¹ This exception is met if the operating business itself is a partnership (or an LLC that is taxed as a partnership for federal tax purposes). For example, if the operating business is a 'C' or 'S' corporation and if shareholders are all partners in a separate partnership that holds business real estate, the exception will be met.¹²

The Wait-and-See Buy-Sell Agreement

The wait-and see buy-sell agreement is a hybrid between a cross-purchase and a redemption agreement where, first, the surviving owners have the option to purchase the decedent's business interest (the cross-purchase) and, second, the business has the obligation to redeem the decedent's interest (the redemption) if the surviving owners' options are not exercised. This provides a great deal of flexibility in allowing the parties to choose the best form of buy-sell to suit their goals at the time a buyout is triggered.

WAIT-AND-SEE EXAMPLE

Suppose that, when the corporation was worth \$6 million, three equal shareholders in an 'S' corporation (\$2 million each) enter into a wait-and-see buy-sell agreement and each purchased \$1 million of coverage on the other two shareholders. For example, B and C each purchases \$1 million of coverage insuring A and so on. When A dies five years later, the business has doubled in value to \$12 million and A's interest to \$4 million. Unfortunately, the shareholders never increased their coverage.

The wait-and-see buy-sell agreement allows

1. B and C to each use their \$1 million life insurance proceeds to each purchase ½ A's interest; and
2. The company to redeem the balance funding the \$2 million shortfall with a promissory note issued by the company.

The Trusteed Cross-Purchase Buy-Sell Agreement

With the trusteed cross-purchase agreement, an escrow agent (the trustee) owns the policies and acts on behalf of each individual owner exactly as they would have acted in a traditional cross-purchase arrangement.

The benefit of the trusteed cross-purchase agreement is that it

1. Simplifies ownership of and administration of the policies;
2. Provides the exact same results as the traditional cross-purchase arrangement the for all of the parties; and
3. Ensures that terms of the buy-sell agreement will in fact be honored by both the buyers and, where the trustee also holds the business interests, sellers.

In effect, the trustee stands in the shoes of each owner and, as their agent, is empowered to act on their behalf. That is, legally, the acts of the trustee are the acts of the individual owners. The trustee should be a third party such as the owners' attorney or accountant, or they could hire a trust company to fill that role.

It is important to note that, unless the owners are partners in the state law or federal tax context, the trustee cross-purchase is not optimal for more than two business owners. As discussed above, following the first death, when each surviving non-insured purchases the policy from the decedent's estate, the policy death benefit loses its income tax-free character unless it is within an exception to the transfer-for-value rule.

A Strategic Approach

THE BUY-SELL LLC

The Buy-Sell LLC is an LLC formed under state law and taxed as a partnership for federal tax purposes. It is operated exclusively to hold life insurance policies to fund the buy-sell arrangement. The Buy-Sell LLC is the owner, premium payor, and beneficiary of the policies on behalf of the non-insured owners.

The Buy-Sell LLC can be managed by the members or, if the members have estate tax exposure, by a professional manager, who could be the members' attorney or accountant.

The Buy-Sell LLC structure provides a number of important benefits.

1. It provides centralized management of the buy-sell agreement and, like the trustee cross-purchase arrangement, ensures that the terms of the agreement will be honored.
2. As with the traditional cross-purchase agreement, the surviving owners receive a FMV cost basis equal to the purchase price of the deceased owner's stock.
3. Unlike a traditional cross-purchase agreement with three or more policies, it only requires one policy per owner.
4. Because the LLC is operated as a partnership, a transfer of the policy to the non-insured owners is within the partnership exceptions to the transfer-for-value rule.
5. Properly structured (and depending on state law and absent a fraudulent conveyance), the LLC may protect the policies from the business and the business owners' creditors.
6. If the operating business is sold or if the buy-sell agreement is no longer needed, each policy may be

distributed to the insured and repurposed for their own personal insurance needs including estate planning.^{13,14}

The main disadvantage of the structure is the additional cost and complexity of the plan.

Regarding premium payments, having each party responsible for the premiums exactly as they would be if they owned the policies personally to fund a cross-purchase seems to be the fairest. In that case, based on a carrier's pricing and medical underwriting at the time of issue, each non-insured policyowner is paying premiums based on the insured's probability of passing. Premiums could also be allocated based on the percentage ownership of the operating business essentially the same way they would be allocated with business owned policies funding a redemption agreement.

Upon a shareholder's death, the Buy-Sell LLC will apply the income tax free death proceeds to either

1. Pay the decedent's estate directly with the decedent's interests retitled in the surviving owners' names, provided that the operating business is a 'C' corporation, an LLC or a partnership (that is, not operated as an 'S' corporation), and purchase the decedent's interest in the operating business;¹⁵ or
2. Distribute the income tax-free cash to the surviving owners to purchase the decedent's interest.

In either case, the decedent's interest is purchased on behalf of the surviving owners, who receive a cost basis in the purchased stock equal to the purchase price (the FMV) – the same result as a cross-purchase buy-sell agreement.

THE BUY-SELL LLC EXAMPLE

Our three equal shareholders who own an 'S' corporation valued at \$6 million (\$2 million each) enter into a cross-purchase buy-sell agreement. On the death of a shareholder, each surviving shareholder is personally obligated to purchase ½ of the deceased owner's shares in the business. To fund the agreement, they form a Buy-Sell LLC, separate from the operating company, that is also a party to the buy-sell agreement. The Buy-Sell LLC is the owner, beneficiary, and premium payor on a policy insuring each shareholder with a face amount of \$2 million.

The Buy-Sell LLC will own

- ½ the \$2 million policy insuring A for the benefit of B and C (\$1 million each). B and C will each contribute ½ the premium to the Buy-Sell LLC.
- ½ the \$2 million policy insuring B for the benefit of A and C, each of whom will contribute ½ the premium to the Buy-Sell LLC.
- ½ the \$2 million policy insuring C for the benefit of A and B, each of whom will contribute ½ the premium to the Buy-Sell LLC.

Upon A's death, the Buy-Sell LLC receives the \$2 million income tax free proceeds on behalf of the survivors B and C and pays the \$2 million to A's estate.¹⁶

- One-half of A's 1/3rd interest in the operating business is re-titled in each of B and C's names so that they now each own 50% of the business.
- They each have a \$1 million cost basis in the new shares (worth \$1 million each).

B and C also contribute funds to the Buy-Sell LLC to purchase A's interest in the policies insuring B and C from A's estate on behalf of the non-insured.

As a result, they each now own

- ½ the Buy-Sell LLC;
- The \$2 million policy insuring his partner; and
- Going forward, each will contribute the premium on the policy insuring their partner.

Because they each now own 50% of a \$6 million business, the buy-sell agreement is underfunded, and they immediately apply for \$1 million more insurance.

Conclusion

A buy-sell agreement can be instrumental in ensuring a business continues after the death of a business owner. It is important to work with professional advisors to select the optimal form of the agreement for the case at hand. In many cases, the Buy-Sell LLC matches the advantages and overcomes the disadvantages of traditional buy-sell plans. It is important to recognize that buy-sell planning is a highly specialized and complex area of the law where it is critical to work with qualified legal, tax and insurance advisors with expertise in this important area.

FOOTNOTES

¹ By the author's permission, short excerpts have been reproduced here that were originally published in *Responding to Connelly* by Robert W. Finnegan, April 2025 Trust & Estates magazine

² While this article focuses on the death of a business owner, a carefully crafted buy-sell agreement will also address other triggers including disability or retirement of an owner.

³ With any life insurance funded buy-sell agreement, the policy owner and beneficiary aligns with the buy-sell purchase obligation. For example, if the business is obligated to redeem a decedent's interest (the redemption agreement), then the business is the owner, beneficiary, and premium payor; if the individual owners are obligated to redeem a decedent's interest (the cross-purchase agreement), then the non-insureds will be the owners, beneficiaries, and premium payors.

⁴ The decedent's business interest is potentially subject to estate taxes, a topic beyond the scope of this article.

⁵ Flow through entities are those businesses that are not taxed as a separate entity, including an 'S' corporation, partnership or LLC. A 'C' corporation is not a flow through entity.

⁶ Cash basis taxpayers of flow through entities should be able to split the tax year, thus allocating the entire stepped-up cost basis to the surviving owners.

⁷ *Connelly v. United States*, Supreme Court of the United States, No. 23-146 (June 6, 2024)

⁸ Based on regulations applicable to buy-sell agreements, unrelated business owners are given greater latitude in setting the price for the business if (1) combined they own greater than 50% of the value of the business and (2) their respective interests are each subject to the same valuation restrictions. Code Sec. 2703 and Treas. Reg. Sec.

25.2703-1(b)(3). Connelly did not explicitly address or invalidate these authorities.

⁹ The formula for the number of policies in a cross-purchase agreement = $N \times (N-1)$, where N represents the number of business owners.

¹⁰ The agreement could be overfunded to purchase the deceased owner's interest in the LLC or it could be redeemed with a promissory note.

¹¹ Other exceptions include the basis exception, a transfer to the insured, or a transfer to a corporation in which the insured is a shareholder or an officer (however, a transfer to a co-shareholder or co-officer of the insured is not).

¹² Importantly, the transfer-for-value rule is not an issue with a redemption agreement because, on the death of an owner, the business remains the owner of the policies before and after the redemption so that there is never a transfer of the policies.

¹³ Cash may need to change hands because the policies may be for different amounts and have greater or lesser premiums.

¹⁴ In the case of permanent cash value life insurance, because the Buy-Sell LLC is taxed as a partnership, a policy distributed to an insured member should not result in any recognition of gain for either the Buy-Sell LLC or the member.

¹⁵ The Buy-Sell LLC is not a permissible 'S' corporation shareholder. Consequently, the LLC may only continue to own the deceased owner's interest in the operating business provided it is operated as a 'C' corporation, an LLC or a partnership.

¹⁶ Special partnership allocations are used to allocate death benefit to the non-insured partners of the Buy-Sell LLC.



This material and the opinions voiced are for general information only and are not intended to provide specific advice or recommendations for any individual or entity. To determine what is appropriate for you, please contact your M Financial Professional. Information obtained from third-party sources is believed to be reliable but not guaranteed.

The tax and legal references attached herein are provided with the understanding that neither M Financial Group, nor its Member Firms are engaged in rendering tax, legal, or actuarial services. If tax, legal, or actuarial advice is required, you should consult your accountant, attorney, or actuary. Neither M Financial Group, nor its Member Firms should replace those advisors.

Securities and Investment Advisory Services Offered Through M Holdings Securities, Inc. A Registered Broker/Dealer and Investment Advisor, Member FINRA/SIPC.

© Copyright 2025 M Financial Group. All rights reserved. #4980051 Expires 11/2027

M Financial Group | 1125 NW Couch Street, Suite 900 | Portland, OR 97209 | 800.656.6960 | fax 503.238.1815 | mfin.com