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Funding Your Buy-Sell with Insurance- Premium Payments

Funding Your Buy-Sell with Insurance: Premium Payments

What is it?

Included in the decisions needed to set up and fund your buy-sell agreement with life insurance is the question of who should make the premium payments: the business itself, the individual owners of the business, or a combination of the two. Regardless of which party makes the payments, they are generally not a tax-deductible expense. The form of the buy-sell agreement will often indicate which is the logical party to pay the premiums. Usually, the party responsible for the premium payments is the same party who is the policyowner .

Corporation pays outright--how it works

The corporation sends payments from the company bank account to the insurance company. The payments are not tax deductible.

Makes sense when the business has obligation (or option) to buy an owner's interest under the buy-sell agreement

When the business itself is the buyer under an entity purchase agreement or has an option to buy an owner's interest under a wait and see buy-sell agreement , it makes sense for the business itself to pay for the premiums on the insurance funding the agreement. When the business is in a lower tax bracket than the individual owners, this payment arrangement can be cost effective. The premiums are paid using money that has been taxed only to the corporation.

Doesn't make sense when the buyer under the buy-sell agreement is an individual

If the business pays the premiums but is not the owner of the policy or the party responsible for making the purchase under the buy-sell agreement, the premium payments could be considered a form of dividend payment from the company to the individual who owns the policy. The amount paid by the company on behalf of the individual could be taxed to the individual as a dividend.

Corporation pays premiums as part of compensation for employee/buyer--how it works

The corporation pays the insurance premiums to the insurance company. The payments are charged against the salary accounts of the individuals. The company may be able to take a tax deduction for the premium payments if the combined premium and compensation amounts are reasonable. The individual employee/buyer must include the premium amounts paid by the company in his or her taxable income.

Makes sense when buy-sell is cross purchase agreement

For the premiums to be paid by the corporation and charged to compensation, the buy-sell should be a cross purchase agreement , obligating the individual shareholders to buy each other's shares. The business cannot be a designated beneficiary on the policies, either directly or indirectly.

Don't do this if your buy-sell agreement obligates the business to buy an owner's interest--potential tax disaster

By definition, insurance premiums are paid with after-tax dollars, and the proceeds are generally received tax free. If the business pays the policy premiums and charges them to the shareholder's compensation accounts and takes a tax deduction when the payment obligation actually belongs to the company, there could be big trouble! The business would be relieving itself of a payment obligation and attempting to receive a tax deduction for a nondeductible expense.

Don't do this if the total of premiums and compensation could be deemed unreasonable--potential dividend problem

When the shareholders are already receiving reasonable levels of compensation, the inclusion of the policy premiums could cause the amounts to be deemed excessive by the IRS. If the IRS determines that the combined compensation and premium payments are unreasonable, this method could be viewed as a way to get money out of the company free of corporate-level tax. If this is the case, premium payments will likely be deemed dividend payments and taxed to the individuals as such. In addition, the corporation could find itself in violation of local corporate laws governing dividend payments, which are generally allowed only under certain conditions.

Split dollar payment of premium--how it works

A split dollar life insurance plan is an agreement between an employer and an employee to share the costs and benefits of the life insurance policy on the life of the employee. Split dollar is a method of premium payment for the life insurance; it is not a type of policy.

Types of split dollar arrangements

These are not the only possible ways to set up a split dollar arrangement. The arrangement can be as flexible as the parties require and can use a variety of policy types and splits.

Business/individual split--two forms

Split dollar arrangements usually take one of two forms: (1) the endorsement form, in which the employer is formally designated as the owner of the insurance contract and endorses the contract to specify the portion of the insurance proceeds payable to the employee's beneficiary, or (2) the collateral assignment form, in which the employee is formally designated as the owner of the contract, the employer's premium payments are characterized as loans from the employer to the employee, and the employer's interest in the insurance proceeds is designated as security for its loans.

The Sarbanes-Oxley Act of 2002 makes it a criminal offense for a public company to lend money to its executives or directors. This may prohibit the use of the collateral assignment form in these companies.

Individual split dollar arrangement

There is also a split dollar arrangement between individuals. This arrangement is not as commonly used as the types of business/individual splits.

Split-designation method--two individuals split the premium payment, the cash values, and death benefit of the insured party.

When split dollar arrangements make sense

Individuals are obligated under cross purchase buy-sell agreement

Split dollar insurance funding makes sense when the individual shareholders are responsible for carrying out the obligations of the buy-sell agreement, such as in a cross purchase buy-sell agreement . Use of split dollar funding can be especially helpful when there are younger shareholders who must pay for the policies on older shareholders or when the shareholders hold varying interests in the business.

Business is in significantly lower tax bracket than individual

When the business is in a much lower tax bracket than the individual, the business can pay the same premium with fewer taxable dollars than the individual.

Seller under buy-sell pays policy premiums--how it works

The seller pays the premiums on the policy covering the seller's own life, using personal funds. The payments are not tax deductible.

When this makes sense--almost never

This arrangement almost never makes sense. It is not very common for the life insurance to be arranged so that the seller pays for the insurance on his or her own life. Essentially, this arrangement obligates the shareholders to finance the purchase price on the shares they already own instead of the shares they would be buying. When a shareholder dies, this arrangement would require a reimbursement of the premiums paid by the individual on his or her own policy. If the deceased shareholder is older and held a large percentage of the stock, the reimbursement could pose a financial problem.

Buyer named in buy-sell pays--how it works

The buyer under the buy-sell agreement pays for insurance on the seller's life, using personal funds. The insurance purchased and the premium payments represent the shares to be bought under the agreement. The payments are not tax deductible.

Makes sense when buy-sell agreement is a cross purchase agreement

This arrangement works well when a cross purchase agreement is used between a small number of shareholders. It is generally considered the preferred method for the buyer to pay the premiums on the policies covering the lives of the individual co-owners. Each shareholder would pay the premium on the policies they own on the lives of the other shareholders.

Can also work when buy-sell agreement is a wait and see agreement

Having the individuals pay the insurance premiums can work with the wait and see buy-sell, even though the actual buyer is unknown until the transaction occurs. If the individual pays the premiums and receives the policy proceeds, the money could be loaned to the business if a stock redemption is chosen at the death of a shareholder.

May not make sense when individual buyer is in higher tax bracket than corporation

When an individual shareholder pays the premiums, the money may have been taxed at both the corporate and shareholder levels. The premium payments are not tax deductible to the business or the individual. If the individual is in a higher tax bracket than the business, the after-tax cost of the insurance would be more expensive than if the business had paid the premiums.

Pool into which buyer contributes--how it works

There are two ways in which the premium contribution pool is usually done:

- All shareholders contribute a proportion of the total of all premiums equal to their ownership interests. Those owning a larger interest of the business would pay a larger proportionate share of the total premiums.
- All shareholders contribute an equal proportion of the premiums, which is derived by dividing the total of all premiums due by the number of participants under the agreement.

If the owners all hold equal interests, these options would have the same result. With either arrangement, the estate of the deceased should be reimbursed for the proportionate amount of premiums paid on the policy covering that shareholder's own life.

Makes sense when buy-sell is cross purchase agreement and there is wide difference in ages of owners

If there is a wide difference in the ages of the shareholders--or if one (or more) of the shareholders is rated, resulting in a wide difference in the premiums--it may be more affordable to engage in a pooling arrangement. Use of a pooling method would make the premium payments more affordable under a cross purchase agreement. Without such an arrangement, the younger shareholders could find it impossible to pay the premiums on policies of the older shareholders. Likewise, those who hold smaller ownership interests could have difficulty paying premiums on the larger policies covering the owners with larger interests.

The trustee under a trust agreement--how it works

The trustee has custody of--and pays--the premiums on the policies. The individual shareholders under a trusteed cross purchase agreement--or the business under an entity purchase agreement--contribute funds to the trust so that the payments can be made.

Makes sense when trustee is part of buy-sell agreement

If a trustee is being used as part of the buy-sell agreement, it makes sense for the trustee to pay the premiums on the insurance policies.

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