Life Insurance Funding of Stock Purchase Agreements

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LIFE INSURANCE FUNDING OF STOCK PURCHASE AGREEMENTS

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The closely held corporation occupies a special place in the fields of corporate law and estate planning. Although the corporate form of doing business grants a theoretical perpetual life, the experienced attorney knows that the closely held corporation is often nearly as "mortal" as a partnership. Disagreements among the relatively small number of shareholders of the closely held corporation can lead to a disruption of the business and an eventual dissolution of the corporation. While no form of business can protect against the hazards caused by disagreements among its owners during their lifetimes, it is possible to protect the corporation against the problems caused by the death of a shareholder.

Attorneys who spend a considerable amount of their time in the practice of corporate law and estate planning readily acknowledge that the death of a closely held corporation shareholder may place stock in the hands of undesirable new shareholders. Usually the surviving shareholders do not want just anyone to assume ownership of stock held by a deceased shareholder, since they may foresee a potential conflict of personalities and objectives.

The use of corporate surplus for dividends instead of expansion or extra salaries is a prime example of a business decision that may create conflict. Most closely held corporation stock is held by "active" shareholders who derive income from the corporation as officers or key employees. Inactive shareholders may find their shares of little value, since these corporations rarely either pay dividends, or intend to make such payments. Corporate earnings are either distributed as deductible salaries and bonuses to the active shareholders, or reinvested within the business. Dividend payments represent non-deductible payments to the corporation, which would have to go through two levels of taxation before ending up as spendable income to the active shareholders. In this day of tax-orientated business management, dividends are usually paid by the closely held corporation only as a last resort.

When the heirs of the deceased shareholder assume a majority position, the uncertainties for the surviving shareholders are obvi-

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1 The term "heirs" is used in the non-technical sense in this article to mean anyone who would acquire property rights upon death.
ous. A transfer of even a minority interest by reason of death can be traumatic, since minority stockholders suits can result in harassment of the majority stockholders, or even dissolution of the corporation.

Often the surviving shareholders will want to purchase the interest of the deceased shareholder, but the heirs may either refuse to sell, or hold out for an unreasonable price. On the other hand, the executor or the heirs of the deceased minor shareholder may want to sell the corporate shares to pay death taxes and expenses, or to get into a less risky investment and receive greater income from that portion of the estate. But there may be no market for a minority interest, or the surviving majority shareholders may purchase it at only a bargain price.

When these potential problems are analyzed, closely held corporation shareholders often agree that the sale of shares by the estate of the deceased shareholder and a purchase by either the corporation itself or the surviving shareholders is the most realistic means of planning for both the preservation of the business and the well-being of the heirs. This is usually accomplished by entering into a formal stock purchase agreement. A corporate purchase of the deceased shareholder's stock is usually called a stock redemption. When stock is to be purchased by the surviving shareholders, it is usually called a cross-purchase arrangement.

In order to be effective, any agreement must provide restrictions on the sale of the stock during the lifetime of the shareholder, and limit the ability to transfer the stock upon death. Since stock is personal property, any restriction on its alienation must be reasonable in the light of applicable state law. Usually there is a "right of first refusal" given to the prospective purchaser of the stock, and the price is set by either a specified formula, or by agreement between the concerned parties. The right to make a gift of the stock during the lifetime of a shareholder, or to encumber it in any way, should also be considered. The ability to restrict the transfer of stock upon death will usually depend upon the ability of the surviving party to the stock purchase agreement to obtain specific performance of that agreement. It is desirable to mention the restrictive stock purchase agreement in the shareholder's will, requesting that the executor promptly perform according to the agreement. In most cases a restrictive endorsement on the face of the stock certificates is specified as part of the purchase agreement.²

A well drafted stock purchase agreement will usually also provide for a purchase if the shareholder incurs a long term disability, as well as a lifetime sale. A detailed discussion of those portions of the agreement is beyond the scope of this article, but they are worthy of considerable attention by the shareholders and their attorneys. A buy-out in either of those circumstances may take place over a longer period of time, or provide for limited use of promissory notes at a specified rate of interest, since the full purchase price may not be as readily available as it would be if death prompted the buy-out.

The stock purchase agreement provides both a means to assure that the control of the business rests with the surviving shareholders, and a guaranteed market for the stock of the deceased shareholder. However the proper financing of the purchase is the critical element that is too often ignored. With the hazard of premature death as a major motivation behind the agreement, that particular contingency can only be effectively provided for by some form of life insurance funding. Term insurance is rarely used in these situations, since there is often no intention that any active shareholders will sell-out before death occurs. If the shareholder lives until his life expectancy the high cost of term insurance in the later years of the agreement, if available at all, must be considered. Careful consideration of the cost involved usually results in a decision that permanent insurance is the only guaranteed way to fund the buy-out and still provide for an early death. While a sinking fund can be used to fund a buy-out that will occur at normal retirement ages of 65 or 70, and disability income insurance can help fund a buy-out that takes place when a shareholder becomes inactive in the business for medical reasons, permanent life insurance can help fund all three possibilities. If a disability or a lifetime buy-out is required, the cash values of permanent life insurance can be used to provide a substantial initial payment. Often the policy itself is transferred to the selling shareholder as part of the purchase price.

The method used to purchase a shareholder's interest will depend on a number of practical, legal, and tax factors. Life insurance fits naturally into either the stock redemption or the cross-purchase plan. In each case the premiums paid on the insurance will rarely equal the total death proceeds. There is usually a substantial "discount," or inflation" in value in excess of the total premium. This large potential gain is inherent in the nature of the insurance funding vehicle. If this method of advanced funding is not used, a premature death may require heavy borrowing in order to fund a stock purchase, and the ability of either the corporation or the
surviving shareholders to obtain a loan may be seriously affected if the deceased shareholder was a "key man" in the business.

In practice, the choice of either a stock redemption or a cross purchase plan will usually depend on non-insurance factors. The federal income tax invariably enters into the decision. If all other things are favorable, the owners of a closely held corporation will often find the stock redemption plan most to their liking, since the purchase will be made with corporate, rather than personal funds. If the business is successful and the shareholders are active as key employees, the corporate tax bracket may be lower than the respective tax brackets of the individual shareholders. If this is the case, the accumulation of funds in the form of insurance cash values is made easier through the use of a stock redemption plan, especially if the active shareholders are already taking salary and bonuses that are near the limits set by the Internal Revenue Service for compensation that is deductible by their corporation. For that reason alone, the corporate stock redemption will often be considered first.

THE INSURANCE FUNDED STOCK REDEMPTION AGREEMENT

Most states now permit a corporation to purchase its own stock if that purchase does not either render it insolvent or impair the rights of other shareholders. The shareholders and the corporation contract that the stock of the deceased shareholder will be purchased, or redeemed, by the corporation, upon death. The agreement should be authorized by the corporation, and it may require approval by the board of directors, or the shareholders. The agreement binds the shareholder’s estate and executor. Disability and lifetime sales are usually also covered in the agreement, and there are always some restrictions on the lifetime sale of the stock.

When death occurs and the redemption takes places, the surviving shareholders continue to own stock in the same ratio as each survivor’s interest had to the other survivor’s stockholdings prior to the redemption. Since the survivors do not change their relative shareholdings, this agreement is not suitable if some proportionate change in shareholding is desired. If that is the intention, at least a limited cross-purchase arrangement is required. The usual goal is equality among the survivors, and this makes the redemption method practical only if the survivors already hold equal numbers

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of shares. If not, the person desiring to increase his proportionate shareholdings must enter into one or more cross-purchase agreements, and the nature of those agreements may vary with the parties involved. The drafting attorney will have to spend some time with the exact mathematics of each buy-out in order to be sure that the agreement meets his client's needs in every eventuality.

In a family held corporation involving related parties, the federal income tax laws may effectively prohibit the use of a stock redemption agreement. A redemption of stock by a family held corporation is potentially taxable at ordinary income rates to the deceased shareholder's estate.\(^5\) Consideration of the provisions of the Internal Revenue Code applying to the actual and constructive ownership of stock and the possibilities of a tax free redemption by a corporation owned by closely related shareholders are beyond the scope of this article. If the planned redemption would be considered to be a taxable dividend to the shareholder's estate, the only alternatives are a partial stock redemption,\(^6\) a cross-purchase agreement, or a combination of the two.

As part of the redemption agreement, the corporation provides that liquid funds or surplus will be available to make the stock purchase, and it agrees to purchase, pay premiums, and maintain insurance on the life of each potential selling shareholder, usually in an amount sufficient to cover the entire purchase price. The agreement may further provide for additional purchases of insurance if the value of the stock increases. The corporation applies for and names itself owner of the insurance, retaining all incidents of ownership, such as: a) The right to name and change the beneficiary; b) The right to assign the contract, or to revoke an assignment; c) The right to use dividends; d) The right to borrow on the cash value, or to surrender the policy for the cash value.

The corporation then names itself as sole direct beneficiary. The insurance contract may also allow for a substitute or “additional” direct beneficiary to be named by the corporation after the death of the shareholder. The additional direct beneficiary method of paying policy proceeds grants the heirs of the insured shareholder the use of the settlement options provided in the insurance policy. The right of the corporate owner to name such a beneficiary may exist for a limited time, often only a year or two. If the settlement

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\(^6\) IRC § 303 deals with partial stock redemptions for estate liquidity. The estate of a deceased shareholder must include sufficient stock in the redeeming corporation to meet certain percentage tests. IRC § 302 (b) (2) may also be of help in rare cases.
options are not of interest, the corporation takes the full policy proceeds and uses those proceeds to effect the redemption of the stock. The purchased stock normally becomes treasury stock, available for any valid corporate purpose.

With any type of advance funding for stock redemptions, including life insurance, the shareholder with the greatest amount of stock may feel that his share of the corporate surplus is, in effect, bearing the greatest burden of the total costs of funding, and that he is "buying himself out." This might be better illustrated if the large shareholder is also older than the other shareholders, in which case the premiums on the insurance on his life owned by the corporation may represent a substantial outlay. If the objections are serious, the value of the corporate shares is sometimes increased to help make up for the extra costs during his lifetime. But a substantial shareholder should also remember that the agreement also guarantees him a market for his stock, and at a fair price. In fact, sometimes the shareholders will agree to a redemption, rather than a cross-purchase plan, because it is the only way younger, minority shareholders will agree to a buy-out. The cost might otherwise be prohibitive under a cross-purchase arrangement, where the funding must be provided with personal dollars.

One practical problem that arises when a stock redemption is planned is the correlation between the amount of insurance purchased and the price specified for the stock. The difficulty lies in both maintaining the insurance funding at a level sufficient to effect the purchase, and in satisfying the heirs of the deceased shareholder that the use of corporate dollars to pay insurance premiums did not work in favor of only the surviving shareholders. The agreement should provide for the purchase of additional insurance if the stock appreciates in value. That value is normally specified by mutual agreement of the shareholders, or pursuant to a specified formula. If a shareholder becomes uninsurable, the lack of complete insurance funding can be corrected by the use of other forms of corporate surplus, or by corporate borrowing.

The fact that the active shareholders as a group may abstain from an increase in their compensation in order to allow the corporate insurance purchase might cause them to be interested in whether the insurance values will be reflected in the selling price of their shares. Any price set by mutual agreement can specifically take those values into consideration. Formula type valuation is another matter, and the use of "book value" in any portion of the formula requires a decision whether that value is to include only the cash values of the insurance contracts, or the cash value of the policies on the lives of the survivors plus the entire death proceeds
of the policy on the life of the deceased shareholder. In either case an initial amount of "over insurance" may be required in order to provide full funding, but in the latter instance much more coverage may be required in order to take the death proceeds into consideration. If the value is to include a pro-rata portion of the death proceeds, the formula may provide that the valuation date is to be the date of death, or shortly thereafter. If not, the valuation date will be made any time up to a year prior to death. Similar problems might also occur if some multiple of corporate earnings is used in the valuation formula.

FEDERAL INCOME TAX ASPECTS OF THE INSURANCE FUNDED STOCK REDEMPTION AGREEMENT

The effect of the federal taxes weighs heavily on any corporate decision-making process. Fortunately, there are favorable tax results available through the use of insurance funding.

Payment of the insurance premiums by the corporation is not a deductible business expense, nor is the premium payment a constructive dividend to the shareholders. The cash value of permanent life insurance owned by the corporation should not, by itself, create an accumulated earnings tax problem. On the contrary, an argument can be made that life insurance provides the most economical way to fund a redemption of stock upon death, and that it should be favored over other methods of providing advanced funding when there is a potential accumulated earnings tax problem.

If the corporation, either directly or indirectly, borrows money to pay premiums on the policy used to fund the redemption agreement there is a possibility that the interest deduction will be disallowed. The "financed insurance" restrictions of the Internal Revenue Code and the applicable regulations make it clear that the systematic borrowing in order to pay such premiums will deny

7 IRC § 264(a) (1).
8 Rev. Rul. 59-184, 1959-1 CUM. BULL. 65. Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958).
9 IRC § 531. Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1957) is a favorable case on the question of accumulating earnings for the redemption of a minority interest. For a favorable view of life insurance and the excess-profits tax, see Emeloid Co., Inc. v. Commissioner, 189 F.2d 230 (3d Cir. 1951). For a negative view of accumulating earnings to redeem the stock of a majority stockholder, see Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958). Herwitz, Stock Redemptions and the Accumulated Earnings Tax, 74 HARV. L. REV. 866 (1961) contains some interesting thoughts on this subject.
the corporation a deduction for the interest paid on such borrowed funds.\textsuperscript{10} No mention is made of accrual basis taxpayers in the Internal Revenue Code Regulations, but the intention of the Code is clear. If the corporation plans to use borrowing in order to pay insurance premiums, at least four of the first seven premiums should be paid with non-borrowed funds in order to assure the right to deduct the interest payments in the future.\textsuperscript{11}

Dividends received on participating insurance purchased to fund a redemption are treated in the same manner as personal life insurance dividends. A policyholder is entitled to receive dividends on a non-taxable basis until the total value of the dividends received exceeds the value of the premiums paid.\textsuperscript{12} Dividends accumulated at interest result in ordinary income to the corporation each year, in the amount of the interest received or credited, so long as it can be withdrawn by the policyowner.\textsuperscript{13}

If the insurance contract should be surrendered, sold, or transferred prior to its maturity, any gain over premium cost that is actually or constructively received is taxable as ordinary income.\textsuperscript{14} If properly arranged, a policy will rarely be surrendered, but the redemption agreement may provide that it be distributed to the selling shareholder, the insured, if there is a lifetime or disability redemption. A policy exchanged by the corporation for another type of insurance policy from the insurer may also give rise to an ordinary income tax liability on the gain over the corporation's cost if any cash is received, or if the exchange is essentially for a policy with a smaller reserve value and greater insurance protection.\textsuperscript{15} A policy that matures prior to the death of the insured will also give rise to taxable income on the gain element if the corporation surrenders the policy for a lump sum.\textsuperscript{16} If the proceeds are timely placed under a disbursing settlement option, the gain is spread out over the term of the option.\textsuperscript{17} Death benefits used by

\textsuperscript{10} IRC § 264(a)(3). Treas. Reg. § 1.264-4(d)(4) states that the "trade or business" exception of this section of the code does not apply to insurance purchased to fund a stock retirement plan. If the insurance plan was purchased by the corporation prior to August 7, 1963, these restrictions do not apply.

\textsuperscript{11} This is the general exception of IRC § 264(c)(1).

\textsuperscript{12} IRC § 72(e)(1)(B); Treas. Reg. § 1.72-1(b)(1) (1956).

\textsuperscript{13} Treas. Reg. §§ 1.451-2, 1.61-7 (1967).

\textsuperscript{14} IRC § 72(e); Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964).

\textsuperscript{15} IRC § 1035.

\textsuperscript{16} IRC § 72(e)(1)(B).

\textsuperscript{17} IRC § 72(h) provides that the gain will not be constructively received if, within 60 days of maturity, and before receiving any payment in cash, the policyholder elects an option that disburses principal and income. The "interest only" option does not qualify.
either the corporation or by the additional direct beneficiary named by the corporation, such as the family of the insured, may also give rise to ordinary income on the interest element credited by the insurer on the death proceeds placed under option settlement.\textsuperscript{18}

An important advantage of any insurance funded stock purchase plan is the fact that the "gain" element of insurance proceeds received upon death is exempt from income tax if properly arranged.\textsuperscript{19} This is true even though the corporate balance sheet and earnings statement may reflect this appreciation in value. This tax free element of gain may not be available if the policy has been the subject of a sale or other "transfer for value" prior to the death of the insured.\textsuperscript{20} Fortunately, that is rarely a problem if the insured is a corporate shareholder or officer, and where the corporation has been the last purchaser of the policy.\textsuperscript{21}

The death proceeds of insurance may indirectly lead to taxation problems, as outlined earlier, if the redemption does not meet the strict tests established by the Internal Revenue Code for a corporation owned by closely-related shareholders. However, the nature of the funding vehicle has no effect on the problem of qualifying for a tax-free redemption, and the same results would occur if the corporation used a sinking fund, or borrowed to effect the redemption. If properly arranged, no adverse tax effects occur for either the surviving shareholders,\textsuperscript{22} or the estate of the deceased shareholder. The surviving shareholders maintain the same cost basis for their shares after the redemption as they had before the redemption. The deceased shareholder's estate receives an increased basis for the stock upon death.\textsuperscript{23} The agreement usually sets the value for

\textsuperscript{18} IRC § § 101(d), 101(a). An important exception applies to the surviving spouse of an insured, who is entitled to receive up to $1,000 in interest each year if a disbursing option is elected. See IRC § 101(d) (2) (B). It is uncertain whether this exception is available to a surviving spouse who receives settlement option proceeds under the provisions of a stock-purchase plan that grants her the right to use an "additional direct beneficiary" provision in the insurance contract.\textsuperscript{19} IRC § 101(a) (1).\textsuperscript{20} IRC § 101(a) (2).\textsuperscript{21} IRC § 101(a) (2) (B); Treas. Reg. § § 101-1(b) (3), 1.101-1(b)(5) (1957).\textsuperscript{22} Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. However, the surviving shareholders should have no personal obligation to purchase the deceased shareholders stock. See Rev. Rul. 59-286, 1959-2 Cum. Bull. 103.\textsuperscript{23} IRC § 1014.
both estate and income tax purposes, and the redemption of the deceased shareholder's stock should result in no taxable gain to his estate.24

THE INSURANCE FUNDED CROSS-PURCHASE AGREEMENT

The cross-purchase agreement involves individual shareholders, and not the corporation. It is used if there is to be a proportionate change in the respective equity positions of the shareholders, such as where a shareholder with a small amount of stock wishes to acquire enough shares to provide equality with the other surviving shareholders. Whenever the actual or constructive ownership rules of the Internal Revenue Code would treat a stock redemption as a taxable dividend, closely related shareholders will be normally required to use the cross-purchase method of stock purchase. These agreements are often more complicated than those used for a stock redemption, especially if there is to be an unequal purchase of shares in order to change the relative holdings of the surviving shareholders.

The agreement provides that the individual shareholders are obligated to purchase a proportionate part of the stock of any contracting party who may die while the agreement is in force. If only two shareholders are involved in the agreement, the survivor agrees to purchase all of the deceased shareholder's interest. The agreement binds the shareholder's estate and executor. Disability and lifetime sales should also be covered, and there should be restrictions on the sale of the stock during each shareholder's lifetime.

Because the funding of a purchase by an individual is often more difficult than the funding of a corporate purchase, life insurance is virtually a necessity in most agreements of this type. The cross-purchase agreement provides that each shareholder shall apply for and own a separate policy on the life of each of the other parties to the agreement, in an amount sufficient to fund the purchase. Each will name himself as beneficiary of the policy he owns, and pay all of the premiums. When a shareholder dies, the agreement requires that the survivor or survivors collect the insurance proceeds and use those proceeds to purchase stock from the deceased shareholder's estate.

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24 The ability of the stock purchase agreement to set both the price of the shares to the survivors and the estate tax value of those shares is important to the deceased shareholder's estate. The date of death basis established by IRC § 1014 is then identical to the sales price, so no capital gain is reportable by the estate.
One slight drawback of the cross-purchase arrangement is the number of insurance policies required if there are several parties to the agreement. With the stock redemption, one life policy is purchased on each shareholder. With the cross-purchase arrangement, each shareholder owns a separate policy on the life of each other shareholder. If only two parties are involved the result is the same whether a cross-purchase or a stock redemption plan is used, only two policies are needed. But if four shareholders are parties to a cross-purchase agreement, a total of twelve policies must be issued, as compared with a total of four policies in a stock redemption plan.

A more critical problem occurs if there are disparate ages or shareholdings. Since the cost of insurance increases with age, a young shareholder may have difficulty paying premiums on the policy or policies he owns on his older associates. Sometimes the plan is changed to a corporate stock redemption if the parties are unrelated, because of the inability of the younger man to pay a large premium. Another possibility is to provide only partial funding, or to combine a partial redemption with a cross-purchase arrangement. Occasionally, the younger, active shareholders may be able to arrange for higher compensation, within the limits of corporate deductibility, so that they can better afford the higher premiums. Another alternative is to have the older shareholders agree to a price or formula that is somewhat less generous than might be used in a stock redemption agreement.

Fortunately, the question of evaluating the shares does not present the same complications in a cross-purchase plan, when compared with a stock redemption. Because the corporation and its assets play no part in the funding, it is often easier to arrive at a value. That value may also increase more slowly, since funds for the stock purchase are accumulated outside the corporation. The cash values and the appreciation of the life insurance at death are not part of the price negotiations, and this may help reduce both the value of the stock and the amount of the insurance required to provide full funding.

**FEDERAL INCOME TAX ASPECTS OF THE INSURANCE FUNDED CROSS-PURCHASE AGREEMENT**

There may be a cost advantage providing funding of a cross purchase arrangement, rather than a stock redemption, if shareholders are in a lower tax bracket than their corporation. However,

\[25 \text{ See note 6 supra.}\]
generally one of the practical considerations already mentioned prompts the choice of a cross-purchase plan. There is one income tax reason for using this plan, and it concerns the tax status of the surviving shareholders after the purchase. If the surviving shareholder sells his stock interest during his lifetime, he would have a higher overall cost basis, when compared with the cost basis he would have if a stock redemption had been utilized.

Under a cross-purchase plan, the purchase of the deceased shareholder's stock increases the survivor's overall total cost basis. In a stock redemption plan it does not, because the corporation makes the purchase, and the individual shareholders who survive do not in fact increase their shareholdings. Assuming the market value of the survivor's interest is identical in either case, a lifetime sale of his interest would yield a larger capital gains tax liability if the redemption method were utilized. This is one of the hazards of using the corporate, rather than the personal dollar, to provide the funding. The fact that many closely held corporation shareholders intend to hold all their stock until death, when it will receive a tax free increase in basis, makes this less of a problem than it might appear. Of course, this discussion assumes that there will always be a potential gain over the shareholder's cost basis, but the fact that the stock is subject to a purchase agreement ordinarily makes that assumption valid. If the stock is not likely to increase in value, there may be no market anywhere.

Payment of the insurance premiums by the shareholder is not a deductible business or personal expense. The cash value of permanent life insurance is a personal asset, and this investment may even provide a potential gain over costs after a period of years. A shareholder who, either directly or indirectly, borrows to pay premiums on a policy or policies used to fund a cross-purchase agreement also has a potential problem with the deductibility of interest paid on the borrowed funds. If there is an intention to borrow to pay premiums over a long period of time, a deduction for the interest is guaranteed only if the policyowner pays at least four of the first seven premiums with non-borrowed funds.

IRC § 1012.
IRC § 264(a) (1) prohibits the deduction if the policyholder is directly or indirectly a beneficiary.
IRC § 264(a) (3). Although Treas. Reg. § 1.264-4(d) (4) (1959) discusses only “stock retirement” plans in connection with its view that such use of life insurance does not fall within the “trade or business” exception of IRC § 264 (c) (4), it is likely that the attitude of the Internal Revenue Service would be the same if the insurance were purchased to fund a cross-purchase agreement.
See note 11 supra.
Dividends received on participating insurance purchased to fund the cross-purchase agreement are received tax-free until the total value of the dividends exceeds the value of the premiums paid. Interest paid on accumulated dividends is taxable at ordinary income rates. It is includable in the policyowner's gross income in the first taxable year it can be withdrawn by him, whether or not it is actually withdrawn.

If the insurance policy or policies should be surrendered, transferred or sold prior to their maturity, any gain over premium cost that is actually or constructively received is taxable as ordinary income. Policies used to fund a cross-purchase plan are rarely surrendered, but they may be transferred to the insured-shareholder who sells his interest during his lifetime. An exchange of policies with the insurer may also produce income if there is a gain over premium cost. This would result if any cash were received by the policyowner, or if the exchange is for a policy with lower reserves and greater insurance protection.

A policy that matures prior to the death of the insured will also result in taxable income on the gain element. If the proceeds are placed under a disbursing option within 60 days after maturity, the gain is spread out over the term of the option. Any interest paid on death benefit settlement options is also ordinary income. The family of the insured may be granted the right to use the policy settlement options under the additional direct beneficiary provisions, and the recipient of option payments would have the obligation to report the interest element provided by the insurer.

When the insured dies, the policyowner usually receives the entire death proceeds free of any income tax liability. This is a major advantage of the life insurance funding vehicle. However, if the policy had been subject to a “transfer for value” prior to the insured's death, the proceeds in excess of the policyowner's cost basis could be taxable at ordinary income rates, if the purchase of the insurance did not fall within the allowable exceptions of the Internal Revenue Code. If the insurance is purchased by each shareholder and never transferred, the tax-free nature of the death

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30 See note 12 supra.
31 See note 13 supra.
32 See note 14 supra.
33 See note 15 supra.
34 See note 16 supra.
35 See note 17 supra.
36 See note 18 supra.
37 See note 19 supra.
38 See note 20 supra.
benefit is assured. But the cross-purchase agreement may eventually create a number of transfer for value problems whenever a shareholder dies owning policies on the lives of two or more shareholders. In that case the surviving shareholders are often tempted to purchase the policies for their cash values and continue them on a cross-ownership basis. This might be especially important if one or more shareholders have become uninsurable. In any event, the value of each of the survivor's holdings will have increased by his purchase of stock from the deceased shareholder. If full funding is to be continued, the situation would ordinarily prompt many transfers for value, with potential serious income tax problems.

No satisfactory solution has ever been devised to avoid the transfer for value problems outlined above if there are three or more shareholders who are parties to the agreement. The usual result is that the insured buys the policy from the estate of the deceased shareholder and uses it for his personal benefit. The survivors then purchase additional coverage on each other's life to maintain proper funding. Most cross-purchase agreements provide that the insured will have the initial right to purchase the policy on his life, and that right would almost certainly be exercised if the insured had become uninsurable.

The deceased shareholder's estate receives an increased basis for the stock upon death. The agreement usually sets the value for both estate and income tax purposes, and the sale of the deceased shareholder's stock should result in no taxable gain to his estate.

TRUSTEED CROSS-PURCHASE PLANS

In some cases the shareholders may doubt the ultimate effectiveness of the cross-purchase arrangement. They may worry about the intentions of the other shareholders to maintain the insurance funding, or their ability to avoid borrowing on the cash values of the policy. Additional doubts may apply to the family of the deceased shareholder and the potential trouble they might cause the estate, with the possibility that the transfer of shares will be held up by litigation.

39 Unfortunately, the general business exceptions to the transfer for value rule, established in IRC § 101(a)(2), have never provided relief for the sale of a policy to a shareholder who is not the insured. Legislation to allow such a transfer has been suggested several times, but with no results thus far.

40 IRC § 1014, see note 23 supra.
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If the performance of the agreement is in doubt and the shareholders still want to go through with the cross-purchase plan, it can be trusteed. The use of a trustee helps guarantee the performance of the agreement. Its value is readily apparent, and it may be the only way for the shareholders to agree to utilize the cross-purchase plan.

Under this plan the shareholder will deposit his stock with the trustee. The shareholder then purchases the insurance on the lives of the other shareholders and deposits the policies with the trustee. The shareholders usually continue to pay the premiums directly to the insurer, although the trustee can also do this after receiving the funds from the shareholder. The trustee is named beneficiary of the policies. When the stockholder dies, the trustee receives the insurance proceeds, pays the proceeds to the estate of the deceased shareholder, and delivers the deceased shareholder's stock to the survivors. Any funds required in excess of the insurance proceeds are secured from the survivors prior to the transfer of the stock. If the insurance proceeds exceed the value of the stock, the excess is returned to the surviving shareholders.

The tax results of the trusteed arrangement should be identical to those of the basic cross-purchase arrangement, since legal title in the stock and in the insurance contract remains in each shareholder.

FEDERAL ESTATE TAXES AND THE STOCK PURCHASE AGREEMENT

If properly arranged, these agreements have a distinct advantage. That is, they may establish the value of the stock in the deceased shareholder's estate for federal estate tax purposes. This simplifies planning for estate liquidity needs, and it eliminates the long delays required to litigate valuation questions in the federal courts. The following are generally required in order for the stock purchase agreement to determine the federal estate tax value: a) Evidence that the agreement was the result of arm's length bargaining and provided a reasonable price at the time the agreement was signed. b) The stock cannot be sold during the shareholder's lifetime for more than the price set in the agreement, and the other shareholders or the corporation have a right of first refusal. c) The deceased shareholder's estate must actually sell the stock in accordance with the mandatory provisions of the agreement, or pursuant to an option to purchase granted the survivors or the corporation.

41 A stock redemption plan can also be trusteed, but it is less common.
The total effect of these requirements is to add one more favorable attribute, that of determining the estate tax value, to the stock purchase agreement. When this occurs, the sale of the stock by the estate should result in no taxable gain, since the price is identical to the new cost basis of the stock. When the agreement is between unrelated parties, no difficulty should arise. Agreements among closely related shareholders are carefully scrutinized to uncover any possibility that there may have been some donative or testamentary intent that would not meet the requirement of arms-length bargaining.

A special life insurance section of the Internal Revenue Code\(^4\) makes it especially important that the life insurance used to fund the buy-out does not fall under that section and possibly cause both the value of the insurance and the value of the stock to be included in the insured-shareholder's estate. This might occur if the insured held an incident of ownership in the policy,\(^4\) or if the proceeds were payable to or for the benefit of his estate.\(^5\) If the stock purchase agreement and the funding are properly arranged, there should be no problem.\(^6\) The insured's estate should never be made the direct beneficiary of the policy on his life. If a policy owned by the insured is sold to the corporation in order to help fund the stock redemption agreement, care must be taken to assure that no incident of ownership remains with the insured. Because of the transfer for value rule, such a sale would rarely take place between shareholders in order to fund a cross-purchase agreement.

**DISABILITY AND SIMULTANEOUS DEATH**

Because the closely held corporation often involves only shareholders who are active as employees of a corporation, the possibility of an active shareholder incurring a long term or permanent disability should be considered. The corporation may have to hire a replacement for the disabled employee-shareholder. This may make it difficult to continue the shareholder's salary. Even if no replacement is required, the shareholders who remain healthy and active may not want to continue paying disability benefits indefinitely. If no salary or disability benefits are available, the disabled shareholder may have to sell his stock in order to maintain his family. The alternative is to negotiate for the payment of dividends on the stock, and dividend payments are rarely desired by the healthy shareholders.

\(^4\) IRC § 2042.
\(^5\) IRC § 2042 (2).
\(^6\) IRC § 2042 (1).
\(^7\) Rev. Rul. 56-397, 1956-2 CUM. BULL. 599.
Because long-term disability is a problem, stock purchase agreements may contain disability buy-out provisions. The following is a checklist of points that should be considered: a) The definition of disability that will result in a buy-out. If disability insurance is used to protect against this possibility, the definition used in the policy may be used, or incorporated by reference. b) The length of disability that will be required before the buy-out becomes mandatory. c) The possibility of requiring disability insurance as a funding vehicle. d) Because the disability purchase will rarely be made with a lump-sum payment, the length of time allowed for the payment of the purchase price should be defined. e) The possibility of death during the period that disability stock purchase payments are being made. f) The disposition of any life insurance on the disabled shareholder. g) The possibility of complete or partial recovery of the shareholder during the period the stock purchase payments are being made.

The possibility of death of several shareholders occurring simultaneously, or within a short period of time, should also be considered. In such an event the shareholders may not want the stock purchase to take place. If all of the key shareholders die within a short time the business may still have to be sold to outsiders, or liquidated. In such a case, it may be a needless burden to require the estate of the first to die to go through the sale of its stock to either the corporation or to the estate of the shareholder who died in close succession. A clause in the agreement can provide that the purchase agreement become void in that event. The estate of each deceased shareholder would then be free to use the insurance values and the corporate stock as it deems best.

CONCLUSION

The insurance funded stock purchase agreement is often a vital part of any plan for continued business success. It also can be an essential part of a family's estate plan. The shareholders usually agree that death is a major uncertainty, and that they intend to remain active in the business as long as possible. Funding the purchase agreement is almost a necessity and life insurance admirably takes care of the major uncertainty, the premature death. Properly arranged, the insurance funded stock purchase agreement adds planning certainty where none previously existed.47

47 A number of estate planning treatises cover the intricacies of stock purchase plans and their place in the overall estate plan. The following periodicals may also be of help. 71 HARV. L. REV. 687 (1958); 17 J. OF AM. SOC. OF C.L.U. 212 (1963); 57 MICH. L. REV. 655 (1959); 47 MINN. L. REV. 625 (1963); 35 FORDHAM L. REV. 625 (1967).
The appendixes that follow are reprinted in an abridged form from Northwestern Mutual Life Insurance Company's Document 1320, "Business Agreements for Use With Life Insurance." Appendix A illustrates some basic clauses used in a stock redemption agreement. Appendix B illustrates a cross-purchase agreement.
AGREEMENT BETWEEN STOCKHOLDERS AND COMPANY TO PURCHASE STOCK

In many corporations where the stock is closely held, it is important upon the death of a stockholder that the corporation and its surviving stockholders be able to control the disposition of all or part of the deceased's stock. This will tend to limit the stockholders to those who are actively engaged in the management of the business. In addition, if a corporation is able to purchase the stock of a deceased stockholder, it may be in a position to make an attractive proposal to an outsider who possesses the energy and ability that the corporation needs.

However, some states do not permit a corporation to purchase its own stock. In other states, such right is specifically allowed by statute or court decision. There is still a third class where there is neither statute nor court decision on the question. Local counsel must advise whether, in his opinion, this type of agreement is valid in his state. Also, in several states a corporation is permitted to purchase its stock only out of surplus. If an agreement is drafted in a state where such a rule is followed, the limitation should appear in the agreement.

There probably is no state where the right of a corporation to purchase its own stock is absolute in all events. Corporate creditors have equities in the corporate assets superior to those of the stockholders. If the corporation is insolvent or if the use of corporate assets to purchase stock jeopardizes the rights of creditors, the agreement will not be enforced. Furthermore, if the corporation has become insolvent or its solvency is impaired, the right of a corporation to purchase stock of a deceased stockholder may be of little importance to anyone since the stock will have little or no value.

The agreement should be authorized by proper corporate action. Counsel for the parties will determine what is “proper corporate action” in view of the local law governing the contract. In most situations the corporate officers cannot enter this form without the approval of either the board of directors or the stockholders.

Finally, the stock certificates should be stamped in accordance with section 1 of the agreement. This will constitute notice to a purchaser that the stock is transferable only upon compliance with the provisions of a stock purchase agreement, and is apparently required by Section 15 of the Uniform Stock Transfer Act.

FORM OF AGREEMENT BETWEEN STOCKHOLDERS AND COMPANY TO PURCHASE STOCK

AGREEMENT made ..........................................., 19........, among John Doe, William Smith and Thomas Jones, hereinafter called the Stockholders, of City, State, and the John Doe Company, a corporation organized under the laws of the State of ........................................., hereinafter called the Company.

Whereas the Stockholders are collectively the owners of all the capital stock of the Company, each Stockholder owning 150 shares in the Company, and

Whereas the Stockholders believe it to be for their best interests and for the best interest of the Company that the stock of a deceased Stockholder be acquired by the Company, and

Whereas the Company has arranged to provide the necessary funds to acquire the stock of a deceased Stockholder through life insurance,

It is therefore agreed:

1. Upon the execution of this agreement, the certificates of stock subject hereto shall be surrendered to the Company for endorsement as follows:
"This certificate is transferable only upon compliance with the provisions of an agreement dated ................................, 19........, between John Doe, William Smith, Thomas Jones and the John Doe Company, a copy of which is on file in the office of the Secretary of the Company."

After endorsement the certificates shall be returned to the Stockholders. All stock hereafter issued to any Stockholder shall bear the same endorsement.

2. The Company shall take out insurance on the life of each Stockholder for $50,000 and name itself as beneficiary of the policies. All policies are listed in Schedule A attached to and made a part of this agreement. The policies and any proceeds received thereunder shall be held by the Company in trust for the purposes of this agreement. The Company shall have the right to take out additional insurance on the life of any Stockholder whenever, in the opinion of the Company, additional insurance may be reasonably required to carry out its obligations under this agreement. Any additional policies shall be listed in Schedule A and shall otherwise be subject to the terms of this agreement.

The Company shall pay all premiums on insurance policies taken out by it pursuant to this agreement and shall exhibit proof of payment to the respective Stockholders within 15 days after the due date of each premium. The Company shall be the sole owner of the policies issued to it, but shall not, during the term of this agreement, modify or impair any of the rights or values under such policies.

3. The purchase price of each share of stock shall be its book value at the end of the month in which the death of the Stockholder occurs. Book value shall include the cash surrender values of life insurance policies taken out by the Company pursuant to this agreement, and the proceeds of policies insuring the life of a deceased Stockholder in excess of their cash surrender values. The determination of book value shall be made by the accountant then servicing the Company, and such determination shall be conclusive on all parties.

4. Upon the death of any Stockholder, the Company shall purchase the decedent's stock from his estate, and the estate shall sell such stock to the Company. The personal representative of the deceased Stockholder shall proceed with the probate of the estate and shall promptly transfer title to the decedent's stock to the Company.

The Company shall collect the proceeds of the insurance policies on the life of the deceased Stockholder, and upon receipt of title to decedent's stock, shall pay such proceeds, or so much thereof as may be necessary, to the deceased Stockholder's personal representative in payment for the decedent's stock. In the event the purchase price exceeds the insurance proceeds, the Company shall pay to the decedent's personal representative any additional amount necessary to pay the purchase price in full.

5. In the event any Stockholder desires to sell all or part of his stock, he shall give written notice of such election to the Company, and the Company shall then have the right, exercisable within .................. days, to purchase such stock. The purchase price of all stock so purchased shall be determined in accordance with the terms of section 3 of this agreement.

6. All shares of stock offered pursuant to section 5 and not purchased by the Company within the time provided therein, shall be free from the terms of this agreement (and new certificates shall be issued without the section 1 endorsement) if within an additional .................. days such shares shall have been transferred on the books of the Company to a third person. If and when all of the stock of a Stockholder shall have been transferred, he shall cease to be a party to this agreement.
7. If by operation of section 6 any Stockholder's participation in this agreement shall terminate, then for 30 days thereafter he shall have the right to purchase the policies on his own life owned by the Company. The purchase price of the policies shall be the interpolated terminal reserve as of the date the retiring Stockholder ceased to be a party to this agreement, plus the proportional part of the gross premiums last paid before said date which covers the period extending beyond that date. In the event any permanent form policy to be transferred shall not have been in force for a period sufficient to obtain a value, as stated above, then the purchase price shall be an amount equal to all net premiums paid.

8. This agreement shall terminate in the event of the bankruptcy, receivership, or dissolution of the Company.

9. No insurance company shall be under any obligation in respect to the performance of the terms and conditions of this agreement. Payment by the insurance company pursuant to the terms of any policy shall be a complete discharge of the said insurance company from all claims, suits and demands of all persons whatsoever.

10. This agreement shall bind the Stockholders and their respective heirs, executors, administrators, and assigns, but nothing herein shall be construed as an authorization to any Stockholder to assign his rights or obligations hereunder. Each Stockholder in furtherance hereof shall execute a Will directing his executor to perform this agreement and to execute all documents necessary to effectuate the purposes of this agreement, but the failure to execute such Will shall not affect the rights of any of the Stockholders or the obligations of any estate as provided in this agreement.

In witness whereof the parties have signed and sealed this agreement.

.................................................................L.S.
John Doe

.................................................................L.S.
William Smith

.................................................................L.S.
Thomas Jones

Corporate Seal John Doe Company

by.................................................................L.S.
President

Attest:

.................................................................
Secretary
APPENDIX B

FORM OF AGREEMENT AMONG STOCKHOLDERS TO PURCHASE STOCK

AGREEMENT made .............................................., 19........, among Joe Doe, William Smith and Thomas Jones, hereinafter called the Stockholders, of City, State.

Whereas the Stockholders are collectively the owners of all of the capital stock of the John Doe Company, a corporation organized under the laws of the State of ................................, hereinafter called the Company, each stockholder owning shares in the Company as follows:

John Doe............................. 200 shares
William Smith.................... 120 shares
Thomas Jones..................... 100 shares

and

Whereas the Stockholders believe it to be for their best interests and for the best interests of the Company that the stock of a deceased Stockholder be acquired by the surviving Stockholders, and

Whereas the Stockholders have arranged to provide the necessary funds to acquire the stock of a deceased Stockholder through life insurance,

It is therefore agreed:

1. Upon the execution of this agreement, the certificates of stock subject hereto shall be surrendered to the Company for endorsement as follows:

"This certificate is transferable only upon compliance with the provisions of an agreement dated ................................., 19........, between John Doe, William Smith and Thomas Jones, a copy of which is on file in the office of the Secretary of the John Doe Company."

After endorsement the certificates shall be returned to the Stockholders. All stock hereafter issued to any Stockholder shall bear the same endorsement.

2. Each Stockholder shall take out insurance on the life of each of the other Stockholders in the amounts specified in Schedule A attached to and made a part of this agreement. Each Stockholder shall have the right to take out additional insurance on the lives of the other Stockholders, whenever additional insurance may be reasonably required to carry out his obligations under this agreement. Any additional policies shall be listed in Schedule A and shall otherwise be subject to the terms of this agreement. Each Stockholder shall name himself as the direct beneficiary under the policies for which he is the applicant, and he shall be the sole owner of the policies taken out by him.

Each Stockholder shall pay all premiums due on the policies taken out by him on the lives of the other Stockholders and shall exhibit proof of payment to each respective Stockholder within 15 days after the due date of each premium. If any Stockholder fails to pay a premium within 15 days after the premium due date, the Stockholder who is the Insured under the policy whose premium is due may pay such premium. Such payment shall be considered a loan to the Stockholder in default, and the Stockholder making the payment shall be entitled to recover such amount with interest from the date of payment at ...........% per annum.

No Stockholder shall during the term of this agreement revoke or change the beneficiary designation or modify or impair any of the rights or values under his policies.

3. The purchase price of the stock of a deceased Stockholder shall be $................. per share. The Stockholders may from time to time change this price by amendment of this agreement.
4. Upon the death of any Stockholder, the surviving Stockholders shall purchase the decedent's stock from his estate, and the estate shall sell such stock to the surviving Stockholders. The personal representative of the deceased Stockholder shall proceed with the probate of the estate and shall promptly transfer title to decedent's stock to the surviving Stockholders.

The surviving Stockholders shall collect the proceeds of the insurance policies on the life of the deceased Stockholder, and upon receipt of title to decedent's stock, shall pay such proceeds, or so much thereof as may be necessary, to the deceased Stockholder's personal representative in payment for the decedent's stock. In the event the purchase price exceeds the insurance proceeds, the surviving Stockholders shall pay to the decedent's personal representative any additional amount necessary to pay the purchase price in full.

All stock purchased by the surviving Stockholders shall be divided between themselves in the same proportion that their share holdings bear to each other at the date of death of the deceased Stockholder.

5. Upon the death of any Stockholder, each of the surviving Stockholders shall have the right to purchase from the personal representative of the deceased Stockholder the policy or policies on his own life. The purchase price shall be the interpolated terminal reserve as of the date of death, plus the proportionate part of the gross premiums last paid before the date of death which covers the period extending beyond that date. In the event any permanent form policy to be transferred to a surviving Stockholder shall not have been in force for a period sufficient to obtain a value, as stated above, then the purchase price shall be an amount equal to all net premiums paid. This right shall be exercised within ................. days after the qualification of the personal representative of the deceased Stockholder: otherwise, it shall lapse.

6. In the event any Stockholder desires to sell all or part of his stock, he shall give written notice of such election to the other Stockholders who shall then have the right, exercisable within ................. days, to purchase such stock in the same proportion that their share holdings bear to each other at date of the written notice.

The purchase price of all stock so purchased shall be $................ per share, payable in cash upon delivery of the shares duly endorsed. The Stockholders may from time to time change this price by amendment of this agreement.

7. All shares of stock offered pursuant to section 6 and not purchased by the other Stockholders within the time provided therein, shall be free from the terms of this agreement (and new certificates representing such shares shall be issued without the section 1 endorsement) if within an additional ................. days such shares shall have been transferred on the books of the company to a third person. If and when all of the stock of a Stockholder shall have been transferred, he shall cease to be a party to this agreement.

8. If by operation of section 7 any Stockholder's participation in this agreement shall terminate, then for 30 days thereafter the policies owned by the terminated Stockholder and the policies owned by the remaining Stockholders on the life of the terminated Stockholder shall each be subject to purchase by the respective Insureds. The purchase price of the policies shall be determined as set forth in section 5, substituting date of withdrawal for date of death.

9. This agreement shall terminate in the event of the bankruptcy, receivership or dissolution of the Company.
10. No insurance company shall be under any obligation in respect to the performance of the terms and conditions of this agreement. Payment by the insurance company pursuant to the terms of any policy shall be a complete discharge of the said insurance company from all claims, suits and demands of all persons whatsoever.

11. This agreement shall bind the Stockholders and their respective heirs, executors, administrators, and assigns, but nothing herein shall be construed as an authorization to any Stockholder to assign his rights or obligations hereunder. Each Stockholder in furtherance hereof shall execute a Will directing his executor to perform this agreement and to execute all necessary documents in implementation thereof, but the failure to execute such Will shall not affect the rights of any of the Stockholders or the obligations of any estate as provided in this agreement.

In witness whereof the parties have signed and sealed this agreement.

........................................................................... L.S.

John Doe

........................................................................... L.S.

William Smith

........................................................................... L.S.

Thomas Jones

SCHEDULE A

The amounts of life insurance to be carried on the life of each Stockholder by the parties to this agreement are as follows:

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<th>Name of Insured</th>
<th>Total</th>
<th>Doe</th>
<th>Smith</th>
<th>Jones</th>
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</thead>
<tbody>
<tr>
<td>John Doe</td>
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<td></td>
<td>$10,909</td>
<td>$9,091</td>
</tr>
<tr>
<td>William Smith</td>
<td>12,000</td>
<td>8,000</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>Thomas Jones</td>
<td>10,000</td>
<td>6,250</td>
<td>3,750</td>
<td>...</td>
</tr>
</tbody>
</table>