Life Insurance in Buy-Sell Agreements

Life insurance often is used as a means of funding the purchase of a shareholder's stock or a partner's partnership interest pursuant to the terms of a buy-sell agreement. If the transaction is properly structured, the life insurance can be excluded from the insured's estate. In a typical buy-sell arrangement, each shareholder owns and is the beneficiary of life insurance on the life or lives of the other shareholders.

> **EXAMPLE:** A and B form a corporation and enter into a buy-sell agreement, which, in part, provides that upon the death of one of the other shareholders, the surviving shareholder may purchase the deceased shareholder's stock at fair value, which is to be determined by an appraiser. In order to ensure that each shareholder will have sufficient liquidity to purchase the other shareholder's interest in the corporation, A takes out an insurance policy on B's life, while B takes out an insurance policy on A's life.

In the preceding example, because neither A nor B has an ownership interest in the policy on their own life, the proceeds will not be includible in either of their estates, even though the policies were purchased pursuant to a reciprocal agreement (See Rev. Rul. 56-397, 1956 C.B. 599).

➔ **Planning Point:** Should you come across a situation where the insured, rather than the other shareholder, was named as owner of the insurance policy, you may be able to prevent the insurance proceeds from being included in the insured's gross estate if you can establish that the insured's retention of incidents of ownership was due to a mistake by the agent who sold the policy (See *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950), and *Watson v. Comm'r*, 36 T.C. Memo 1084 (1977)). Alternatively, if the proceeds are included in the insured's estate, the value of the decedent's interest in the entity should be reduced by the amount of the insurance proceeds (See *Mitchell Est. v. Comm'r*, 37 B.T.A. 1 (1938) and *Tompkins Est. v. Comm'r*, 13 T.C. 1054 (1949), *acq.* 1950 C.B. 5).

Buy-sell agreements also may be structured so that the corporation, rather than the shareholders, will own insurance on the lives of the shareholders. Upon a shareholder's death, the proceeds will be payable to the corporation to fund the redemption of the deceased shareholder's stock. In this situation, even if the deceased shareholder is a "controlling" shareholder, the corporation's incidents of ownership will not be attributed to the insured, because the proceeds are payable to the corporation (although the insurance will be reflected in the value of the decedent's stock interest when it is valued for estate tax purposes). The same result should obtain in the partnership context (*see Knipp Est. v. Comm'r*, 25 T.C. 153 (1955), *acq. in result* 1959-1 C.B. 4).