Trusteed Cross-Purchase Buy-Sell Agreements

Options for businesses with multiple shareholders

Cross-Purchase Buy-Sell Agreements are one of the cornerstones of business continuity planning for shareholders or partners of privately-owned businesses. Traditional buy sell agreements are used by businesses when there are multiple shareholders. At the death of a shareholder, adding a cross-purchase component to the agreement requires the deceased shareholder's heirs to sell the business interest to the surviving shareholders. A key advantage of using the cross-purchase method of a buy sell is that surviving shareholders will receive a full step-up in cost basis on a deceased shareholder's interest. The step-up in cost basis also provides favorable and valuable tax advantages in the future when the surviving shareholders sell their interests.

The cross-purchase method, unlike a typical buy-sell agreement, requires that each shareholder obtain a life insurance policy on each of the other shareholders or partners. This ensures the business continues uninterrupted in the event of the death of one or more of the shareholders.

A well drafted standard buy-sell agreement offers an attractive option in the event of a shareholder's death, disability, divorce or retirement. In conjunction with adequate funding, it may accomplish some of the following:

1. Create a market for an illiquid asset, converting it into cash
2. Avoid the forced sale of an asset to raise cash for final expenses and estate taxes
3. Ensure both a fair sale and purchase price of an asset
4. Control ownership – for example, preventing surviving shareholders being in business with a deceased shareholder's surviving spouse or other family members
5. Fix the value of the business for estate tax purposes

However, the cross-purchase buy-sell structure does come with a wrinkle. Multiple shareholders require multiple life insurance policies. If, for example, there are four shareholders, then twelve insurance policies would be required: N(N-1).

To address this shortcoming, many business advisors suggest a specific type of cross purchase structure known as a Trusteed Cross Purchase Agreement as an alternative to buying numerous insurance policies. In this arrangement,

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the shareholders use a third party to effectively act as a trustee, or escrow agent, to carry out the mutual obligations for each individual shareholder as specified in the cross-purchase agreement.

Using our original scenario of four shareholders: The Trusteed Cross Purchase Agreement still provides for the sale and purchase of business interests in the event of a shareholder's death, disability, divorce or retirement. This agreement may also require the transfer of stock to a trust. However, the Trustee would purchase just one insurance policy on each shareholder. The Trust would be the owner and beneficiary for each insurance policy insuring the four shareholders. Each shareholder, individually, would be accountable for the premium payments. Only four (4) insurance policies would be needed using the trusteed approach compared to twelve (12) insurance policies under the traditional structure.

In the event of the death of one of the shareholders, the insurance company would pay a tax-free death benefit to the Trust. Acting as an escrow agent, the Trustee transfers the decedent's stock to the surviving shareholders in return for the payment of the life insurance cash proceeds that are paid to the deceased shareholder's estate. The surviving shareholders are entitled to the favorable step-up in cost basis and retain the other benefits of the Cross-Purchase Buy-Sell Agreement.

Business owners and their advisors using this method need to be aware of potential future ramifications beyond the death of the first shareholder. For example, possible "transfer for value" problems could be created for the remaining policies in the Trust. That is why all possible options should be reviewed in evaluating the needs and objectives of the shareholders.

BLBB Risk Services, led by Director Bob Flood, works in tandem with our financial planning department to help our clients evaluate their current risk and insurance postures and analyze how insurance might be a key tool to help limit risk and transfer or preserve accumulated business assets. Contact Bob, or your BLBB financial advisor, at 215-643-9100 to discuss if a Trusteed Cross-Purchase Buy-Sell Agreement is right for your business.

Tax and legal counsel should be consulted in the drafting of these documents.

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