Structuring Life Insurance Correctly to Fit into a Buy-Sell Agreement

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It is no secret that proper planning must be done to ensure that all assets find their way to the intended beneficiaries in the event of a person's death, but when a partnership interest in a business is among those assets, additional complexities arise. Many business partners establish buy-sell agreements, which they fund with life insurance, to be certain that the company will remain in the right hands in the event of a partner's death and to safeguard the financial security of the decedent's heirs. Good planning can prevent the death of a partner from halting business operations, avoid having an unintended business partner and can allow the decedent's beneficiaries to convert their stake in the company into liquid assets.

How a funded buy-sell agreement can protect the business and the family. Through a "cross purchase" arrangement, each partner agrees to purchase the other partners' share of the business in the event that one of them passes away or if another provision of the agreement is triggered. The life insurance policy for each partner gives the survivors designated in the agreement access to the liquidity needed to buy out the decedent's interest. After the sale, the heirs of the deceased partner receive the capital from the buy-out, often enabling a spouse or other heir to continue funding living expenses.

Properly utilizing life insurance to fund the purchase. While it is tempting to utilize company capital to fund the life insurance premiums, to be most effective, the policies must be held by the individuals, outside of the business, and the beneficiaries should be clearly designated as the partners themselves. To help fund the policies, partners sometimes grant themselves a year-end bonus to pay for premiums.

Ownership and beneficiary designations are not always aligned with intentions. It is common for these policies to be set up to benefit the business instead of the partners themselves. Having the insurance owned by the company or having the company designated as the beneficiary causes the policy proceeds to be paid to the company, inflating the value of the company and resulting in the cash coming into the wrong hands. In this case, the surviving partner will have access to only a percentage of the cash intended for the buy-out.

There are additional factors that must be considered when putting plans in place to protect the interest of businesses, their owners and their heirs in the event that a business partner should pass away. It is essential to implement such plans in coordination with trusted advisors that have the necessary experience and expertise in this area.

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