MassMutual

STRATEGY SPOTLIGHT*

Trusteed Cross-Purchase Arrangement

A trusteed cross-purchase arrangement is a legal agreement between a third party and the stockholders that provides for the planned disposition at an agreed upon price of their ownership interests in the event of a death, disability, or retirement. The trustee acts to carry out the obligations of the stockholders.

A Trusteed Cross-Purchase Arrangement and Life Insurance Funding

To fund a cross-purchase agreement with life insurance requires each shareholder to own a policy on every other shareholder. This means, for example, that six policies would be required to fund a cross-purchase buy-sell involving three shareholders. The formula for calculating the required number of policies is the number of shareholders times that number minus one (x times x- 1). The need for so many policies is a major disadvantage of the cross-purchase approach whenever there are more than two or three shareholders involved.

In a trusteed plan, the shareholders establish a revocable trust naming a third party as trustee. The trustee is the owner and beneficiary of one policy on the life of each shareholder. This reduces the number of policies needed. On the death of a shareholder, the trustee is obligated to collect the insurance proceeds and distribute them to the surviving shareholders as beneficiaries of the revocable trust. The shareholders then have the funds with which to purchase the stock of the deceased shareholder, required by a separate cross-purchase buy-sell agreement. The trustee will then distribute the deceased shareholder's shares equally to the surviving shareholders.

The agreement may provide that the trustee collects the premiums from the insureds. Each shareholder insured would contribute funds to the trust, which would allow the trustee to pay the premiums as they come due. Alternatively, the corporation can pay the premiums and treat those payments as bonuses (tax deductible assuming no reasonable compensation problems exist). The premiums on each policy are treated as income to the shareholders other than the insured (since the insurance proceeds are for the benefit of the shareholders other than the insured).

* The information provided is not written or intended as specific tax or legal advice. MassMutual, its subsidiaries, employees, and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

Disadvantages of Using a Trusteed Cross-Purchase Arrangement

The trust concept makes the shareholders, other than the insured of each policy, co-beneficial owners of each policy. On the death of a shareholder, therefore, the deceased shareholder's beneficial interests in the policies on the lives of the other shareholders pass to the other surviving shareholders. Arguably this arrangement amounts to a transfer of that beneficial interest by the deceased shareholder to the surviving shareholders other than the insured of each policy. This could constitute a transfer-for-value (TFV). In light of the TFV issue,[1] it is recommended that the shareholders are also partners of each other in a bona fide partnership. This partnership relationship, which can be satisfied either by an existing partnership relationship or by a bona fide partnership formed for this purpose, in most cases makes a TFV that might occur eligible for the exception to the TFV rule for transfers to "partners of the insured."

[1] Certain transfers of life insurance contracts may jeopardize the income tax free payment of the death proceeds (above basis in the contract). The client should always consult their tax and legal advisors prior to making any changes to ensure that the transfer either is not a transfer-for-value or meets one of the exceptions to the transfer-for-value rule and thus the death benefit will still be received income tax free.

Advantages of Using a Trusteed Cross-Purchase Arrangement

In addition to minimizing the number of life insurance policies needed to fund a cross-purchase arrangement, the trusteed arrangement can also ensure that there is specific performance of the buy-sell agreement and the proceeds from the insurance policy are distributed to the decedent's estate in exchange for the ownership interest.

Please work with your financial professional, tax advisor, and legal advisor. They can assist you with any questions you may have.

Additional Resources

Trusteed Cross Purchase Snapshot

Buy-Sell Planning

Participating whole life insurance policies are issued by Massachusetts Mutual Life Insurance Company (MassMutual), Springfield, MA 01111-0001.

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