

Cross endorsement funding for cross purchase buy-sell agreements

The Tax Cuts and Jobs Act of 2017 and the increased Federal Estate Tax threshold have led to renewed interest in an existing funding method for cross purchase buy-sell agreements: the cross endorsement of life insurance policies. Like traditional cross ownership of policies, the cross endorsement option facilitates the purchase by a surviving business owner of a deceased or departing owner's interest and provides the surviving business owner with an increase in cost basis.

The cross endorsement vs. traditional cross purchase funding

Traditionally, policies funding a cross purchase arrangement are cross-owned, meaning that each business owner is the owner and beneficiary of a policy on the other business owner's life. The "cross" occurs in the ownership structure.

By contrast, when a cross endorsement option is used, each business owner owns the policy on his or her own life, and endorses part, or all, of the death benefit to the other business owner (i.e. the "endorsee"). In other words, the "cross" occurs in the beneficiary designation.

	Traditional cross ownership		Cross endorsement	
Policy owner	Owner A	Owner B	Owner A	Owner B
Insured	Owner B	Owner A	Owner A	Owner B
Beneficiary	Owner A	Owner B	Owner B	Owner A
Economic benefit	None	None	Owner B	Owner A

These two funding options are designed to accomplish the same primary goal – providing funds to allow one owner to buy out the other. At first glance, owning your own policy seems simpler than cross ownership: each owner owns and controls his or her own policy and there is no taxable transfer when the agreement terminates. However, the appropriateness, ancillary benefits, and taxation outcomes can be very different. It's important to consider the following aspects of the cross endorsement option.

Transfer for value

Unless certain exceptions apply, the cross endorsement of the death benefit can create a “transfer for value” of an interest in a life policy, causing the death benefit to be taxable to the endorsee. If the business subject to the buy-sell is taxed as a partnership, or the owners are partners in another entity taxed as a partnership, the “transfer to a partner of the insured” exception would apply, allowing the death benefit to be received by the beneficiary income tax free. If the business is not taxed as a partnership and the owners are not partners in another entity, the transfer for value issue might defeat the goals of the cross endorsement option. The owners could either change to a different funding strategy, such as an entity or cross purchase, or they could create a partnership to facilitate the business continuation.

Estate taxation

If a business owner owns the policy being used to fund a buyout, then generally both the value of the business interest and the policy death benefit would be includable in his or her estate. In the past, this discouraged use of the cross endorsement option. However, recent tax reform increased the lifetime exemption amount to a point where this is a concern for only a small number of business owners.¹

Split dollar

The ownership/beneficiary structure of cross endorsement creates a split-dollar arrangement by definition.² In order to avoid the resulting taxable death benefit, the parties would be well-advised to execute a separate written split dollar agreement and the endorsee should compensate the insured for the “value of the economic benefit” of the death benefit protection endorsed to him or her each year. (Consider it analogous to a rental fee that the endorsee pays for the right to receive a portion of the policy death benefit.) The economic benefit amounts received by each owner will be taxed as ordinary income to the recipient.

Benefits of cross endorsement

Assuming the transfer for value issue can be addressed, the cross endorsement offers several benefits:

- The policy is controlled by the owner/insured, with premiums based on his or her own age and health.
- Cash values can be tapped for a lifetime buy-out or retained for retirement if the buy-sell agreement is terminated.
- For owners with unequal ownership percentages, this option could be perceived as a more equitable solution. No policy gains are recognized upon the termination of the buy-sell agreement because no exchange of the policies is necessary.
- It provides flexibility to change beneficiaries if business ownership changes.

Considerations of cross endorsement

The cross endorsement has its own set of risks and considerations:

- There is risk of a transfer for value violation, making the death benefit taxable income.
- The endorsee lacks control over the policy and death benefit. For example, if the policy owner borrows against the cash value, the death benefit could be reduced.
- The value of the economic benefit will increase as policy owner/insured ages.

Discuss with your local CPA or attorney whether using cross endorsement of policies to fund your cross-purchase buy-sell arrangement is right for your business.

¹ The exemption amount is \$11.18 million per person in 2018 and is scheduled to sunset after 2025 and revert to its 2017 numbers, adjusted for inflation.

² Treas. Reg. §1.61-22(b)(1).



principal.com

Principal National Life Insurance Company and Principal Life Insurance Company, Des Moines, Iowa 50392-0002.

The subject matter in this communication is provided with the understanding that Principal® is not rendering legal, accounting, or tax advice. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.

Insurance products issued by Principal National Life Insurance Co (except in NY) and Principal Life Insurance Co. Plan administrative services offered by Principal Life. Principal National, Principal Life are members of the Principal Financial Group®, Des Moines, IA 50392.

Principal, Principal and symbol design and Principal Financial Group are trademarks and service marks of Principal Financial Services, Inc., a member of the Principal Financial Group.

BB12188 | 08/2018 | 572933-08272018 | © 2018 Principal Financial Services, Inc.