Northwestern Mutual®

Cross Purchase vs. Entity Purchase

Introduction

Buy-sell planning is an important consideration for any business owner who wants to facilitate a smooth transfer of a business interest. There are two primary ways to structure a buy-sell: a cross-purchase or an entity purchase arrangement. Each arrangement has advantages and disadvantages which should be considered when determining which type of arrangement will be implemented.

Types of buy-sell arrangements and funding options

1. **Cross-purchase.** In a cross-purchase arrangement, the business owners agree to purchase each other's interests upon certain triggering events such as death, disability, or retirement. Traditionally, in a cross-purchase arrangement funded with life insurance, each business owner owns and is the beneficiary of a life insurance policy insuring the other owner(s).

2. **Entity Purchase**. In an entity purchase arrangement, the entity will purchase an owner's interest upon the triggering event. If the purchase obligation is funded with life insurance, the business is the owner and beneficiary of life insurance policies on the business owners.

	CROSS-PURCHASE ARRANGEMENTS	ENTITY PURCHASE ARRANGEMENTS
Who is the seller?	Departing owner.	Departing owner.
Who is the buyer?	Co-owner(s).	Business entity.
Is it simpler to administer with more than two owners?	No, because if funded with life insurance, multiple policies are needed for each owner. Formula is **[n*(n-1)]** where n = number of owners.	Yes, because only one policy per owner is needed.
Is it feasible where the buyout is between an owner and a non-owner?	Yes.	No, but can get creative by having a key person own a small amount of stock so that entity purchase can be accomplished at death. This would technically make key person an owner.
Are assets funding buyout protected from business creditors?	Generally, yes, because owners are personally responsible for funding buyout, so any assets set aside for this purpose are owned personally.	No, because assets funding entity purchase are owned by the business.
Are assets funding buyout protected from personal creditors?	No, but some states have statutes that protect life insurance in certain situations. Any state	Generally, yes.

	CROSS-PURCHASE ARRANGEMENTS	ENTITY PURCHASE ARRANGEMENTS
	statute needs to be read closely to determine applicability.	
Is there increased assurance that the assets funding the buyout won't be used improperly?	No, assets funding buyout are held personally. Holding assets in escrow can alleviate these concerns.	Yes, because it's easier for all owners to check the status of the asset if owned by the business.
Are there possible transfer-for-value[1] issues when unwinding buy-sell arrangement funded with life insurance?	Yes, unless an exception[2] applies.	Yes, unless an exception applies.
Are there possible transfer-for-value issues when transferring existing policies to fund a new buy sell arrangement?	Yes, unless an exception applies.	Yes, unless an exception applies.
Are there possible transfer-for value issues when transferring policies on surviving owners from a deceased owner's estate to surviving owners?	Yes, unless an exception applies.	No, because policies on surviving owners are owned by entity and don't need to be transferred at the death of an owner.
Is the fair market value of a life insurance policy income taxable to insured at unwinding of buy-sell arrangement during life?	No. However, there are potential income tax consequences on the transfer of the policy.	Generally, yes.
Does the arrangement allow surviving owners to buy deceased owner's interest in unequal amounts?	Yes.	No, remaining shareholders will have pro-rata increases in their ownership percentages. This may result in an unintended shift of control.
Are perceived discrepancies in premium due to age or health spread out among all owners?	No. Healthy owner who owns policy on unhealthy owner will pay more in premiums.	Yes, because funding is provided for the business rather than by the individual owners.
What if co-owners are related and business is a corporation?	Non-issue.	Stock attribution rules could cause payment from corporation to be taxed to selling shareholder as a dividend rather than a capital transaction.
Is there estate inclusion of assets funding buy-sell?	Assets are included in the asset owners' estates (e.g., if an owner of a life insurance policy dies, the fair market value of the policies (s)he owns on the others' lives will	Policies used to fund buyout may be indirectly included in decedent owner's estate by increasing value of business interest.

[1] Makes death benefit income taxable to beneficiary at insured's death unless exception applies. IRC § 101(a)(2).
[2] Exceptions include transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is a shareholder or officer, or any transfer in which the transferee's basis is determined by reference to the transferors. *Id*.

	CROSS-PURCHASE ARRANGEMENTS	ENTITY PURCHASE ARRANGEMENTS
	be included in the decedent's estate).	
Is there potential for tax leverage when business owns/pays for assets to fund buyout if business is in a lower tax bracket than individuals?	No.	Yes (C-corp only).

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