



**Center for Wealth
Management**

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Beneficiary Designation



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Why is the beneficiary designation so important?

The beneficiary named in your life insurance policy is the party to receive the money when you die. The beneficiary can be a person, a business entity, a trust or trustee, or your estate. In general, the money received from a life insurance policy is tax free, meaning the recipient does not have to pay income tax on it. There are, however, exceptions to the tax-free treatment that appear later in this discussion.

How does the beneficiary designation relate to policy ownership?

It is entirely possible (though maybe not advisable) that an insurance policy could insure the life of one party, be owned by a second party, and have a third party as the beneficiary. When the owner and beneficiary are two different parties, and neither is the insured, there could be a gift tax consequence. Gift tax requirements dictate that death proceeds payable to someone other than the owner of the policy (or a trustee for the owner) constitute a gift from the policyowner to the beneficiary.

Tip: Make sure the owner and the beneficiary are the same party to avoid the gift tax consequence.

Possible beneficiary designations for buy-sell insurance

There are five beneficiary designations that are often considered for the buy-sell insurance policy. While each may seem to be a good choice, some of the alternatives could result in misunderstandings or unintended tax consequences at the time of the transfer of your interest. When insurance is being used to fund your buy-sell agreement, it is generally suggested that the party responsible for paying for your business interest be the party named as beneficiary on the funding insurance policy.

Seller's surviving spouse or heir as policy beneficiary

Seller's surviving spouse or heir as policy beneficiary

When this makes sense

Your buy-sell is a Section 303 redemption or a reverse Section 303 redemption--If your business is a C corporation, S corporation, or family corporation, and you expect your family or estate to be redeeming your stock under the rules for a Section 303 stock redemption, you might want your surviving spouse or heir to be the named beneficiary in the policy. Here's why: The proceeds from the life insurance policy can be loaned to the corporation. The corporation uses the loan to buy your share of the business from your estate or family. The corporation shows a loan on the books and gets a tax deduction for the interest portion. Your family receives a stream of payments plus interest for your business, and the business doesn't have to wipe out its cash to make the purchase. This is a reverse Section 303 redemption.

When this might not make sense

Any instance other than the above--Naming your surviving spouse or heir as the beneficiary to the life insurance policy funding any other type of buy-sell agreement could result in a delay, a dispute, and the possible failure of the sale of your business interest.

For instance, let's say you have a buy-sell agreement and your surviving spouse or heir is the beneficiary of the life insurance funding the agreement but is not the buyer of your business interest named in the agreement. The proceeds of a life insurance policy are paid directly to the named beneficiary--in this case, your spouse or heir. This seems fine because you wanted the money to end up there after the sale of your stock, right? Well, there

could be a problem. It is possible that your surviving spouse or heir might claim ownership of both the insurance proceeds and your stock--despite the provisions of your buy-sell agreement--as a result of misinformation or misunderstanding. If your buy-sell agreement is not absolutely clear, your spouse or heir may succeed in collecting both the insurance proceeds and your stock, defeating the intent of your buy-sell agreement. The buyer could be left with nothing more than a contractual right to purchase your stock. If your estate transfers the stock to the buyer and is left with insufficient funds to pay creditors, the transfer could be considered fraudulent by law. The creditors, which include the IRS, can interfere with the buyer's full ownership of the interest.

The business as policy beneficiary

When this makes sense

Your buy-sell agreement obligates the business itself to buy your interest--If your buy-sell agreement obligates the business itself to buy your interest, such as with an entity purchase agreement, it is very logical for the business to be named the beneficiary on the life insurance policy funding the agreement. When you die, the business receives the proceeds from the policy and pays your family or estate for your business interest.

When this might not make sense

Your buy-sell agreement obligates a party other than the business itself to buy your interest--If your buy-sell agreement does not obligate the business itself to buy your stock, there could be problems if the business is the beneficiary of the insurance policy. Once the business receives the proceeds from the insurance policy, the money is considered company funds. If your buy-sell agreement obligates another shareholder to personally buy your stock, the use of company funds (directly or indirectly) would constitute a taxable dividend to the individual in the amount of the purchase. The corporation would be considered to have relieved the individual buyer of the obligation to pay for your interest.

Tip: The company could loan the insurance proceeds to the individual buyers. As long as the transaction is properly documented and an appropriate rate of interest is charged, the transaction should avoid dividend treatment.

Business is a corporation subject to alternative minimum tax--If your business is a C corporation, the receipt of the proceeds by the corporation could trigger the alternative minimum tax (AMT). As a result of the tax liability, the after-tax amount of the proceeds could be insufficient for the purchase.

Tip: It still might make sense to name the business as the beneficiary of the life insurance proceeds, however. The potential AMT liability can be calculated in advance and is shown in the Worksheet: Calculate Effect of AMT on Corporate-Owned Life Insurance.

Tip: One way to cover the tax is to buy enough insurance to cover the amount of the alternative minimum tax liability on the proceeds. See the Worksheet: Calculate the Target Amount of Insurance to Offset AMT.

The buyer(s) of the business interest as policy beneficiary

When this makes sense

Generally good idea for buyer to be policy beneficiary--The buyer named in the buy-sell agreement has the obligation to pay your family or estate in exchange for your business interest. Naming the buyer as the beneficiary to the insurance policy being used to fund the buy-sell agreement is considered the "classic" approach. The buyer under an entity purchase agreement or stock redemption would be the business itself. Under a cross purchase agreement or a one-way buy-sell, the buyer is an individual.

When this might not make sense

It is generally considered the best idea for the buyer under the buy-sell agreement to be the beneficiary of the funding life insurance policy.

Seller's estate as policy beneficiary

When this makes sense

Almost never--Generally not advisable for estate to be beneficiary on buy-sell insurance. Naming the seller's estate as the policy beneficiary generally leads to several problems and is not advisable for the following reasons:

- Proceeds must be included in gross estate value--Insurance proceeds payable to the insured's estate must be included in the gross taxable estate. It is possible the IRS could try to collect tax on the business interest and the insurance proceeds paid to the estate. The IRS has not succeeded with this type of claim yet, but this has not stopped them from trying.
- Proceeds could be subject to estate creditors including claims of heirs--The insurance proceeds paid to the estate become part of the estate with the stock. The stock and the insurance proceeds would both be subject to claims by the creditors of the estate.
- Proceeds could be subject to estate or inheritance tax--In some states, insurance proceeds payable to the estate of the insured are subject to state estate or inheritance taxes. This is a completely avoidable tax on the proceeds because in most states, insurance proceeds payable directly to a beneficiary other than the estate are partially or fully exempt from the taxes.
- Eliminates important benefit of cross purchase agreement--If the buy-sell is a cross purchase agreement and the insurance proceeds are payable to the estate directly, the IRS could argue that the surviving owners are not entitled to the basis step-up for federal income tax purposes. The IRS's argument would be based on the technical point that the insurance proceeds were not used by the surviving owners to buy the stock. The IRS may refuse to recognize the insurance as part of the purchase price. To add to the IRS's argument, the buyer would not be able to produce a canceled check as evidence of the amount or date of payment for the stock.

The trustee under a trust agreement as policy beneficiary

When this makes sense

Buy-sell agreement uses trust--When a trustee is used to oversee your buy-sell agreement, it is logical to name the trustee as the beneficiary on the funding life insurance policy. Payment of the life insurance proceeds to the trustee allows for a complete segregation of your business and personal assets, thus avoiding all the problems related to naming your estate or your spouse/heir as the beneficiary. The trustee will receive the policy proceeds directly, allowing it to pay your estate quickly for the sale of your interest while sparing your family or estate the tasks of transferring your stock to the buyer and dealing with the insurance company. For more on using a trustee with your buy-sell agreement, see [Using a Trustee with Your Insurance-Funded Buy-Sell Agreement](#).

When this might not make sense

Buy-sell agreement doesn't use trust arrangement--It doesn't make sense to name a trustee as the beneficiary on the buy-sell agreement life insurance if you don't have a trust agreement in place with your buy-sell agreement.

Options for wait and see buy-sell agreement

When your buy-sell agreement is a wait and see agreement, you don't know for certain if the buyer of your business interest will be the business itself, an individual buyer, or a combination until the transactions actually occur. This presents a challenge in the funding arrangements but not an impossible situation. There are actually several alternatives for insurance funding under the wait and see buy-sell agreement.

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Business as beneficiary--The business itself can be the beneficiary on the insurance policies covering the lives of each shareholder. If, at the time of purchase of a deceased shareholder's stock, it is decided that the business will be the buyer, it simply uses the proceeds from the policy to pay for the purchase. If circumstances dictate that the individual shareholders should make the purchase instead of the business, the business can loan the insurance proceeds to the individuals. The loan should be secured either by the stock being purchased or by personal assets of the buying shareholders. The loan should carry the same terms and conditions as a bank loan and should be fully documented.

Caution: Remember, any time a corporation receives insurance proceeds, it could trigger the alternative minimum tax or increase an existing alternative minimum tax liability.

- Shareholders as beneficiary--Another possible beneficiary arrangement is for the shareholders to be the beneficiaries on the buy-sell funding life insurance (ideally, they should be the owners and premium payers as well). If it is decided that the business should make the purchase of a deceased shareholder's interest, the individual shareholders can lend the money to the business. Another possibility is for the shareholders to make capital contributions to the business, which would allow them to increase their cost basis by the amount contributed.
- Trustee as beneficiary--A third-party trustee can hold the insurance policies as owner and beneficiary. The trustee would receive the insurance proceeds at the death of a shareholder and lend the funds to the purchaser, whether it is the business or the individual shareholders. The loan should be documented and carry an interest rate comparable to that of the average loan rate in the area.



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