Nationwide®
is on your side

The Advanced Consulting Group

Business succession series

Entity v. cross purchase arrangement

Jake Bosacki, JD, FSRI
Director, Advanced Consulting Group

This chart highlights some of the differences between an entity and a cross purchase arrangement.

Buy/Sell Type	Entity/Redemption	Cross Purchase
	Business agrees to buy departing or deceased owner's interest and departing or deceased owner is obligated to sell the interest.	**Co-owners reciprocally agree to buy departing or deceased owner's interest and departing or deceased owner is obligated to sell the interest.**
Shifting Control	When the business purchases the departing or deceased owner's interest, the interest is typically cancelled or retired and can shift the controlling interest to an unintended group of owners.	When the agreement is formed the seller identifies how much of the seller's interest the specific purchaser will buy and no unintended shift in control results.
Life Insurance Funding	The business applies for, owns, pays premiums, and is the beneficiary of a policy insuring each seller's life. Only one policy per insured is needed. Policy values can be used to facilitate the lifetime buy out of a departing owner and at death the business receives tax free death benefits.	Each owner applies for, owns, pays premiums, and is the beneficiary of a policy insuring each seller's life. Multiple policies per owner may be required, break points can be missed. Determine the number of policies needed using this equation, where N equals the number of owners: (N x (N - 1)) Policy values can be used to facilitate the lifetime buy out of a departing owner and at death the policy beneficiary receives tax free death benefits.

Buy/Sell Type	Entity/Redemption	Cross Purchase
Premium Payment	Premium payments are not deductible. The business will use current cash flows or business assets to pay premiums. Premium payments on term policies owned by S corporations and partnerships may reduce the business owner's basis in the stock or partnership,[1] whereas premium payments on permanent policies will not reduce the business owner's outside basis to the extent the premium amounts will be capitalized. Businesses may experience a better internal rate of return on policy cash values than other invested assets.[2] Business paid premiums mitigate psychological impact of a premium disparity that might exist between two owners.	Premium payments are not deductible. Each owner can use individual assets to pay premiums (e.g. personal checking). The following are methods that can be used by the owners to get funds from the entity to make the payments. Partners in a partnership may take capital withdrawals tax free up to partnership basis and pay premiums. Partners in a partnership may be eligible to receive a taxable bonus (guaranteed payment) and pay premium. Shareholders of an S corporation (with no accumulated earnings and profit) may receive distributions tax free up to shareholder basis and pay premiums (distributions must be pro rata). Shareholders of an S corporation may be eligible to receive a taxable bonus and pay premiums (bonus amounts will increase recipient shareholder's overall payroll tax liability and should be considered when pro rata distributions are not available). Shareholders of a C corporation may receive dividend distributions and pay premiums (capital gains rates apply to most dividends received from domestic corporations). Shareholders of a C corporation may be eligible to receive a taxable bonus and pay premiums (bonus amounts will avoid the C corporation "double taxation").
Purchaser's Basis	At the lifetime departure of an owner, the remaining owners do not receive an increase in outside basis. At the death of an owner, the surviving C corporation owners do not receive an increase in outside basis. At the death of an owner, the surviving S corporation owners receive an increase in outside basis equal to the death benefits received by the S corporation divided by the shareholders pro rata ownership interest (this may result in wasted basis, but can be remedied by making a short year election). At the death of an owner, the surviving partners in a partnership receive an increase in outside basis equal to the death benefits received by the partnership divided by the partners pro rata ownership interest (this may result in wasted basis but can be remedied by making a special allocation).	At the lifetime departure or death of an owner, the purchaser will receive basis in the acquired interest equal to the purchase price.

Buy/Sell Type	Entity/Redemption	Cross Purchase
Seller's Basis	At lifetime departure, taxable gain is the excess of the purchase price over the basis. At the death of an owner, the owner's estate receives an adjustment to outside basis of the business interest (that's included in the seller's gross estate) equal to the fair market value at the date of death or special valuation, except for items that constitute income in respect of decedent.	At the lifetime departure, where the seller receives capital gain treatment the seller will first recover outside basis tax free. At the death of an owner, the owner's estate receives an adjustment to outside basis of the business interest (that's included in the seller's gross estate) equal to the fair market value at the date of death or special valuation, except for items that constitute income in respect of decedent.
Seller's Tax	Sellers of C corporation or S corporation shares will receive "sale or exchange" treatment (amounts received minus outside basis equals capital gain) if the sale constitutes a redemption (1) that is not essentially equivalent to a dividend, (2) is substantially disproportionate, (3) completely terminates the shareholder's interest, (4) is a redemption in partial liquidation of the corporation, or (5) is the result of a redemption of stock to pay estate taxes. (attribution can cause the seller to fail to receive "sale or exchange" treatment, but can be remedied using "waiver"). Sales of C corporation shares not receiving "sale or exchange" treatment will be treated as a dividend to the extent of corporate earnings and profits, then as a return of basis, then capital gain (capital gains rates apply to most dividends received from domestic corporations, but the seller will not recover outside basis to the extent the distribution is a dividend). Sales of S corporation shares not receiving "sale or exchange" treatment will be treated differently depending on whether the S corporation has any accumulated earnings and profits from prior years as a C corporation. If the S corporation has accumulated earnings and profits from prior years as a C corporation, the distribution shall not be included in the gross income of the seller to the extent that it does not exceed the adjusted basis of the stock. To the extent that it does exceed the adjusted basis of the stock it will be treated as a gain from the sale or exchange of property (until AAA is reduced to zero), then as a dividend (to the extent of retained earnings and profits), then as the tax free return of shareholder basis, and then capital gain from the deemed "sale or exchange" of stock.	Sellers of C corporation or S corporation shares will receive "sales or exchange" treatment (amounts received minus outside basis equals capital gain) and the seller will be able to recover outside basis. Sellers of a partnership interest will receive "sales or exchange" treatment (amounts received minus outside basis equals capital gain) and the seller will be able to recover outside basis, except to the extent the interest sold is comprised of "hot assets," which will be treated as ordinary income to the seller.

Buy/Sell Type	Entity/Redemption	Cross Purchase
Seller's Tax (continued)	If the S corporation does not have retained earnings and profits (which is usually the case) the distribution shall not be included in the gross income of the seller to the extent that that it does not exceed the adjusted basis of the stock. To the extent that it does exceed the adjusted basis of the stock it will be treated as a gain from the sale or exchange of property. Sales of a partnership interest are generally treated differently depending on the apportioned character of the partnership interest being sold (goodwill, substantially appreciated inventory, unrealized receivables, and other partnership assets) and the seller will be taxed on the sale of his partnership interest at ordinary income or capital gain rates (with a return of basis) depending on which partnership property the sale is attributable to and whether the partnership was a service or non-service partnership.	

Conclusion

The decision between an entity and a cross purchase arrangement is propelled by several factors depending on the specific situation. There are fairly obvious reasons to consider either. Ultimately, the needs of the entity and the individual owners should be assessed to determine the most suitable course of action.

Nationwide®
is on your side

[1] IRC sec. 705(a)(2)(B) and Treas. Reg. sec. 1.705-1(a)(3)(ii) and for S corps. is IRC sec. 1367(a)(2)(D).

[2] Intended to highlight that on some policies the internal rate of return is capable of outperforming other types of investments.

This material is not a recommendation to buy, sell, hold or rollover any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition, or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

Federal income tax laws are complex and subject to change. The information in this paper is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.

NFM-15424AO.2 (03/18)