

Buy-Sell LLC

Helping Business Owners Become Independent of Their Business

Most seasoned advisors recognize that the principal share of an owner's net worth is tied up in their business. These same assets represent the sole resource an owner can access to attain their personal retirement objectives. The key to success is unlocking this business wealth and redeploying it to help owners become financially independent of their business. However, the sheer number of potential opportunities tempts an uninitiated advisor to offer poorly coordinated and overly complex strategies, for which most business owners have little patience. A comprehensive approach provides a more viable strategy.

Traditional Approaches

A buy-sell agreement is vital to the continuation of a business. Traditional buy-sell techniques possess inherent risks that must be disclosed to the client. There are generally two types.

Entity purchase plans are insurance policy efficient - only one policy is needed per owner. The business is the premium payer and beneficiary and policy cash values are listed as assets on the corporate balance sheet. However, these types of plans have drawbacks:

- These arrangements often fail to allocate a full basis increase to the survivors. The higher the basis, the more cash is shielded from income in a subsequent disposal of the business interest.
- The Corporate Alternative Minimum Tax (AMT) may subject the otherwise tax-free death proceeds of a C Corporation to adverse taxation¹

- The transfer of policies may present adverse income taxes on the death benefit to corporate shareholders under the transfer for value rule²
- Keeping the policies in place until death may inadvertently cause inclusion of a portion of the proceeds in the insured's estate
- The insured may face difficulty in acquiring ownership of their policies without facing significant tax consequences after they exit the business

Cross purchase arrangements are basis efficient - the surviving owners receive an income-tax basis step-up equal to the purchase price of the deceased owner's stock. The owners of the business are the owners and beneficiaries of life insurance on their co-owners. Unfortunately, there are drawbacks with these arrangements as well:

- Younger and healthier owners subsidize premiums on older and less healthy owners
- These arrangements quickly become unwieldy if there are multiple owners of the business³
- Each insured may also face tax dilemmas when trying to acquire ownership of their own policy when the company disbands, as the cash values are invariably different at rollout

Trusteed arrangements resolve the conflicts between the two techniques. Under this arrangement, the owners utilize a third party (often an irrevocable life insurance trust) to act as premium payer, owner and beneficiary of the life insurance policies on each owner and to carry out the buy-sell agreement.

While this technique offers the simplicity of one life insurance policy per owner and the fairer allocation of premium costs, the death benefit may be subject to the transfer for value rule, since the beneficial interests in the policies on the surviving shareholders owned by the decedent transfer to the other surviving owners. The transfer for value violation may greatly reduce the amount of death proceeds received tax free. This may come as an unwelcome surprise to owners who believed the trustee arrangement was solving one problem, only for another problem to be created.

While these traditional strategies offer certain benefits, they are often outweighed by disadvantages. The challenge is to provide a strategy that meets a business owner's need to become financially independent of their business and to ensure a smooth business continuation in the event of their death or early departure. The Buy-Sell LLC may be just such a strategy.

The Buy-Sell LLC

The Buy-Sell LLC preserves the best traits of traditional techniques while offering a new way forward for contemporary business owners seeking a more tailored strategy.

Assembling the LLC

The structure of the Buy-Sell LLC is straightforward. First, a Limited Liability Company (LLC), organized as a partnership for tax purposes, is formed. For purposes of this discussion, assume the corporation and the Buy-Sell LLC are separate entities. Each shareholder of the corporation is a member of the LLC and owns an equal percentage. However, an existing, stand-alone LLC taxed as a general partnership can facilitate the entire transaction.

The LLC acts as owner, premium payer and beneficiary of one policy for each owner. The owners fund the LLC from personal funds or through a tax deductible I.R.C. 162 bonus from the primary operating entity.⁴ In either case, transfers to the LLC are characterized as capital contributions. Each owner will contribute amounts sufficient to pay the life insurance premiums on the policy that insures their life. These contributions increase the member's ownership interest and serve to shield from taxation a subsequent policy distribution from the LLC to the insured.

Upon the death of an owner, the membership agreement will specify that the LLC, as beneficiary of the life policy, will pay the deceased owner's estate an amount equal to the deceased ownership interest.⁵ The deceased owner's estate will then transfer ownership shares to the surviving owners. Most of the proceeds will be available for the survivors to effectuate a buy-out of the operating business. A closer scrutiny of three facets of the Buy-Sell LLC should provide greater clarity.

1. Equal or Equitable Allocation of Premium Burden?

An issue identified earlier in traditional cross purchase agreements is the disproportionate premium owners often pay to subsidize higher premiums of their fellow owners. This problem is somewhat mitigated in

entity arrangements where the corporation pays all premiums. Nonetheless, advisors should be cognizant of a more meaningful way to allocate the premiums to maximize the economic effect for their clients.

A Buy-Sell LLC offers just such a way. Keep in mind that capital contribution to the LLC to pay premiums will increase the respective basis of each owner. A Buy-Sell LLC allows the membership agreement to control the allocation of premium dollars even if the allocation is disproportionate to the capital contributions of the owners. Provided this special allocation has substantial economic effect, the agreement may provide accounting flexibility among separate items of business income, gain, deductions and credits.

Assume three owners A, B and C each possess a one-third interest in the primary business and the Buy-Sell LLC. The premiums necessary to insure A, B and C are \$20,000, \$17,000 and \$23,000 respectively, due to age and health differences. In this case, the Buy-Sell LLC membership agreement can direct the allocation of the total \$60,000 premium equally (\$20,000 to each partner) to their capital accounts, though the actual contributions vary. This can easily be defended, as the substantial economic effect is to create premium equity among the LLC members who might otherwise be economically disadvantaged by receiving a larger or smaller basis increase due to age or health disparities between otherwise equal owners. Allocations are considered insubstantial if they simply shift tax consequences or are offset by other allocations in subsequent tax years.⁶ This is one of many ways the Buy-Sell LLC can resolve the inevitable premium disparity.

2. Tax Advantaged Distribution of the Policy at Retirement

A significant advantage of the Buy-Sell LLC and often the primary motivation behind its recent popularity with professional advisors is the tax efficiency of the life insurance rollout. A distribution of a policy from a traditional arrangement involving a corporate operating entity would trigger immediate taxation of gain to the corporation and subject the receiving shareholders to income taxation of the fair market value of the policy.⁷ However, when appreciated property is distributed from a partnership through a Buy-Sell LLC rollout, the gain is not recognized by either the business or the recipient. Rather, a life insurance distribution due to retirement or withdrawal is simply treated as an exchange for the member's interest in the LLC.⁸ In fact, the entire rollout is unrecognized to the extent of the recipient's basis in the LLC.⁹

Upon obtaining ownership of the policy, the retiring owner can then use it to supplement retirement income through loans and withdrawals.¹⁰ This is a major benefit of using permanent cash value life insurance to fund a business succession agreement. The death proceeds effectuate a buy-out and, if unused, the same policy may be leveraged for the owner's retirements needs. Since transfers are exempt from the transfer for value rule, the distribution to the retiring owner will preserve the death proceeds from income taxation.

3. Death of an Owner

The Buy-Sell LLC continues to be a dynamic planning tool even upon the death of an owner. A common disadvantage of many entity agreements is the lack of basis step-up at death. Even S Corporation entity agreements only allow a limited basis step-up under the pro rata rules governing such entities.¹¹ However, a noteworthy advantage of this strategy is that it permits the surviving partners to fully allocate the tax-exempt proceeds amongst themselves. This allows them to obtain a full basis increase without "wasting" a basis increase on a deceased owner who otherwise obtains a basis increase under existing tax provisions.¹²

For example, assume an accrual basis S corporation has five shareholders with each shareholder's interest equal to \$1 million. In a typical stock redemption agreement, upon the death of one owner, the cost basis of each owner (including the deceased owner) would increase by \$200,000. However, using a Buy-Sell LLC, the membership agreement can once again capitalize on the special allocation rules to allow increases in basis in a manner other than directly proportionate to each owner's respective ownership interests in the LLC. This allows the death benefit to be allocated in a targeted way to allow a full increase for the survivors alone. In this example, the remaining four partners would now each receive a \$250,000 basis increase. The higher the basis, the less income taxation a member will be exposed to as all the owners of the business will be the members or owners of the LLC.¹³ In our example, as the Buy-Sell LLC is not the initial primary entity, the LLC would enter into a cross purchase agreement with the original entity to effectuate the buy-out. The LLC operating agreement and cross purchase agreement will reference one another to properly consummate the sale.

Avoiding Tax Traps

The bane of many contemporary entity arrangements is the partial or full inclusion of death proceeds in the insured's estate through attribution rules. In short, the ownership of the death proceeds would be included in an insured's estate in proportion to their respective ownership in the entity. However, PLR 200214028 addressed this in stating that a member/partner does not possess an incident of ownership in a policy, provided the death benefit proceeds are payable to or for the benefit of the LLC.¹⁴ Consequently since there is no incident of ownership, the death proceeds are excluded from the decedent's estate under I.R.C. 2042(2).

Another consideration is if the Buy-Sell LLC passes the "business purpose" rule. This rule states a partnership is valid only if it has a legitimate business purpose.¹⁵ Although the IRS has indicated it will not issue an advance ruling on this issue, there is guidance to support a partnership venture whereby a general partnership was formed to purchase and own life insurance to facilitate a cross purchase agreement with the owners' primary corporation.¹⁶ Though there appears to be support for an entity with a sole asset of life insurance, the lack of a higher level of legal clarity makes it advisable to err on the side of safety and form a structure with an otherwise valid business purpose. Fortunately, many business owners already use these LLC's for unquestioned business purposes such as lease back arrangements and real estate ventures.

The Six Attributes of the Buy-Sell LLC

A Buy-Sell LLC avoids the seemingly unavoidable tradeoffs between traditional buy-sell techniques while accentuating their best attributes. The attributes of the Buy-Sell LLC can be summarized as follows:

1. Premium Equity
2. LLC Tax Basis Maximization
3. Policy Minimization
4. Tax Advantaged Policy Rollout
5. Policy Flexibility
6. Avoidance of Unnecessary Tax Inclusion

A technique with this many advantages cannot be ignored by the modern advisor seeking to place the best interest of the client first, especially those business owner clients seeking to become truly independent of their business.



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- ¹ Life insurance proceeds may be subject to alternative minimum tax when the policies are owned by a C Corporation. But a C corporation will be subject to the AMT only if its average Annual Gross Receipts are in excess of \$5m for its first three years in business and the three-year average is more than \$7.5 million thereafter.
- ² IRC 101(a)(2). If a policy is transferred for valuable consideration, the death proceeds will be taxable as ordinary income, except to the extent of the consideration received and net premiums.
- ³ The Cross Purchase formula is $n(n-1)$, where n is the number of owners. Thus, three owners would require the purchase of six policies: $3(3-1)=6$. This compares with three policies for an entity purchase arrangement.
- ⁴ I.R.C. 264(a)(1). The LLC and the member may not deduct the premiums for life insurance to fund this arrangement although a bonus under I.R.C. 162 (so long as its deemed reasonable) is deductible.
- ⁵ Including his or her share of the value of the life insurance policies on the survivors. This will avoid a potential taxable transfer for value as a transfer to a LLC taxed as a partnership in which the insured is a member is a specified exception under this rule.
- ⁶ Reg. §1.704-1(b)(2).
- ⁷ Transfers of Business-Owned Life Insurance Can Trigger a Tax Hit, Michael Geeraerts and Bryan Davis, 10-9-15. If the transfer is to a non-shareholder employee, it is treated as compensation and the employee will have to include the policy's fair market value in his or her gross income.
- ⁸ I.R.C. 731(a). A distribution of property rather than money generally results in no gain or loss recognition or the distribute partners.
- ⁹ If the value of the life insurance is not equal to the share of the owner's interest in the LLC, withdrawals or additions from other business assets can also be made prior to distribution.
- ¹⁰ Loans and withdrawals will decrease the cash value and the death benefit. Tax-free distributions assume the life insurance policy is properly structured so that it is not a Modified Endowment Contract (MEC). Should the policy lapse or be surrendered prior to the death of the insured, there may be tax consequences.
- ¹¹ Under I.R.C. 1377(a)(2)(Short Year Election) there is guidance allowing an S Corporation using a cash basis accounting to make a short year election and allocate death proceeds solely among the surviving owners.
- ¹² I.R.C. 1014-Taxpayers are permitted a basis step up to fair market value at time of death for items of capital property
- ¹³ Zell, Wayne M. The National Law Review: Buy-Sell Agreements re: Business Succession, Oct 13, 2014
- ¹⁴ PLR 200214028. Keep in mind a PLR is binding authority solely for the requesting party, though such rulings often give the taxpayer a sense of the Service's general view on tax matters.
- ¹⁵ Treas. Reg. §301.7701-1(a)(2). An important factor in distinguishing a mere tenancy in common, or co-ownership is the active pursuit of business.
- ¹⁶ PLR 9309021.

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