Modern Buy-Sell Planning

Using LLC and Life Insurance

A Limited Liability Company (LLC) is an entity that offers business owners the liability protection of a corporation and the flexible tax characteristics of a partnership. Planners are putting LLCs to ever-greater use to help their clients address a wide variety of needs, from asset protection to estate planning. One area in which LLCs have shown themselves to be particularly useful is buy-sell planning for business owners in a manner that not only addresses the potential death of an owner, but retirement as well, in a tax-efficient manner. This paper will describe how businesses can utilize an LLC and cash value life insurance to formulate a comprehensive buy-sell plan.

The Need for Buy-Sell Planning

In a buy-sell agreement, business owners agree to transfer their interests in the event of death, retirement, disability or other designated events. Without such an arrangement, departure of a principal can result in economic and emotional uncertainty. For example, if an owner dies and leaves his interest to someone currently outside the business, a substantial question exists as to whether that individual has the skill, energy, and experience to carry the necessary load. Even if co-owners have an informal buy-out understanding, the deceased's family may not be willing to sell the business interest to remaining owners at a reasonable price. An owner might also simply leave, selling his interest to an outside buyer, who might disrupt operations by seeking more salary, higher dividends, or other changes.

Traditional Buy-Sell Formats and Funding

Traditionally, two of the most common formats for addressing these concerns have been (1) the **entity buy-sell plan**, in which the business agrees to buy the interests of a departing or deceased owner, and (2) the **cross purchase buy-sell plan**, in which each business owner agrees to buy the business interests of a departing or deceased owner. Both types are frequently funded with life insurance, assuring that in the event of an owner's death:

- *Remaining owners maintain control.*
- *Outsiders are prevented from buying into the business.*
- *Conflicting interests and unrealistic price expectations are overridden.*
- *The deceased owner's family receives what it needs most: income tax-free cash.*
- *The deceased owner's family is protected from the worries and risks of continued business operations.*

Shortcomings of Traditional Plans

As effective as insurance-funded entity and cross purchase plans can be, they are not a cure-all for business owners. Potential problem areas include the following:

- **Unnecessary capital gains taxes**. Under entity plans for businesses organized as C corporations, surviving shareholders do not receive basis increases upon an owner's death, resulting in greater taxable gain if and when they later sell the company. For S corporations, results sometimes can be at least a little better, due to the company's pass-through income taxation, but even then there may be inefficiencies. Owners wishing to achieve the greatest tax efficiency often gravitate toward cross purchase plans, which generally can be relied upon to efficiently direct basis increases to surviving owners.

- **Administrative complexity**.

  Unfortunately, cross purchase plans are not always a good fit for businesses due to the administrative complexity that may arise from each owner holding a policy insuring the life of every other owner. For example, if a business has three shareholders, a total of six policies would be required; if a business has four shareholders, twelve policies would be required. One method that has been developed to address this problem is the "trusteed cross purchase," in which trusts are established to hold one policy on the life of each shareholder, and to make death proceeds available to remaining shareholders in order to accomplish a cross purchase buy-sell.

- **Transfers for value**. When a life insurance policy is transferred for valuable consideration, policy death proceeds in excess of the purchaser's basis become subject to income tax. Fortunately, there are some exceptions to this rule, such as transfers to the insured, transfers to a partner of the insured, or transfers to a partnership in which the insured is a partner. There is no exception, however, for a transfer to a co-shareholder of the insured. Thus, a corporation with a stock redemption plan in place may find it difficult to convert existing policies to a cross purchase plan without triggering income taxable death proceeds. Similarly, trusteed plans may result in transfers for value upon the death of an owner.

- **Policy design limitations**. The use of cash value life insurance to fund traditional entity and cross purchase plans is often desired by owners to partially fund living buyouts at retirement. However, under either format, policy distribution may trigger taxation of policy gains to the policy owner, in addition to the gain typically realized by the retiring owner on the appreciated value of his interest in the business. Exceptions are made when owners liquidate their interests in a business taxed as a partnership.

Buy-Sell Agreements Utilizing LLCs

An alternative to traditional entity and cross purchase plans is for business owners to utilize an LLC taxed as a partnership to own one policy on the life of each owner. Although conceptually similar to a trusteed cross purchase plan, the key difference arises from the fact that partnership taxation, which is not available for trusts, can result in greater flexibility and potentially favorable economics, as detailed below.

Ideal Client Profile

The best candidates for this technique are the same business owners who are candidates for a traditional buy-sell plan, but who, in addition:

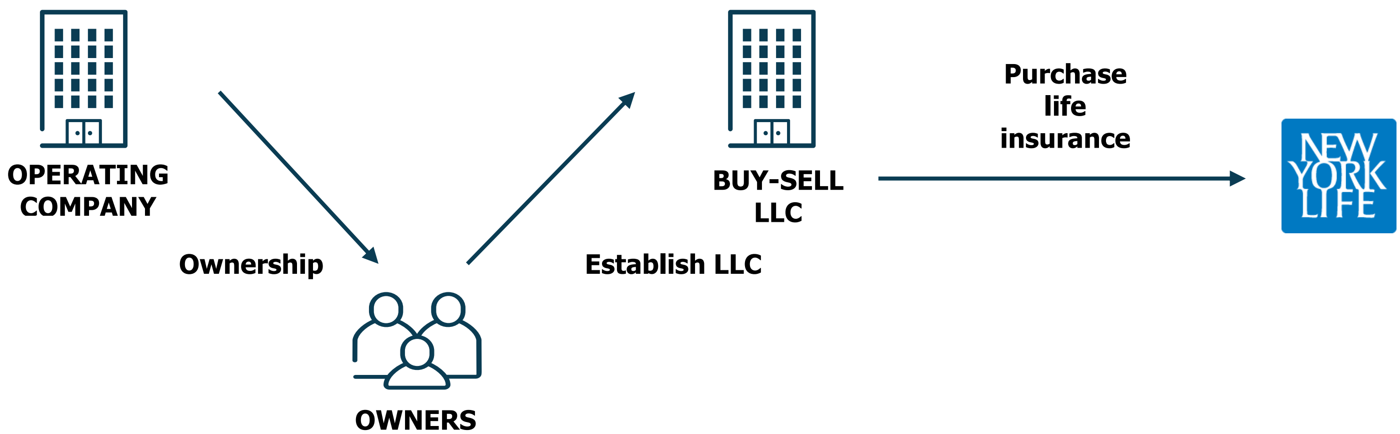
- Wish for their plan to be more comprehensive than traditional buy-sell plans, by addressing, in a tax-efficient manner, living buyouts at retirement.
- Are concerned that their plan be tax efficient in other respects, as well (such as avoiding unnecessary capital gains taxes).
- Are capable of funding the plan in a manner likely to generate policy cash value accumulations suitable for supplementing other retirement income sources.

Note: Although it is becoming increasingly common to encounter businesses that are organized as LLCs, many businesses are still organized as corporations. Therefore, it is important to remember that a business not already organized as an LLC may utilize an LLC buy-sell plan as long as the owners first set up a separate LLC that is taxed as a partnership, in addition to their already existing operating company. One possibility is for the new LLC to hold some other business assets, such as commercial realty, which it could lease back to the operating company, and which would give the LLC a business purpose independent of the buy-sell arrangement. This may provide the additional benefits of shielding such assets from creditors of the operating company, as well as creating a source of funding for policy premiums. Of course, setting up such a plan may be relatively simpler for those businesses already organized as an LLC.

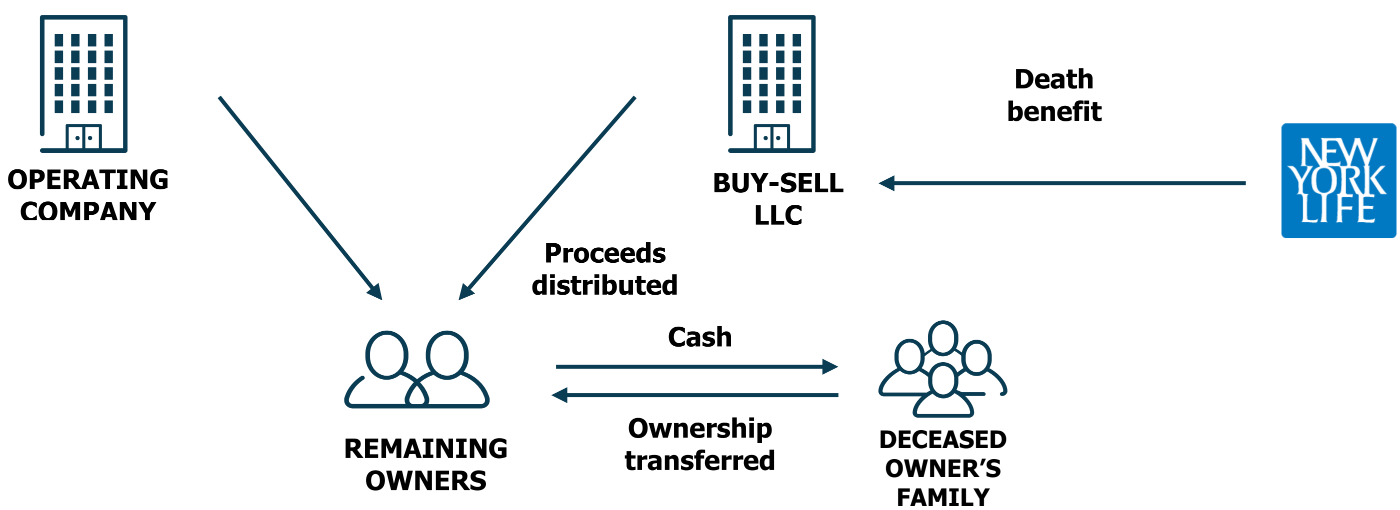
Basics of Plan Operation

1. **Initial Setup.** If the operating company is not already organized as an LLC, the owners must first set up an LLC that is taxed as a partnership. The LLC then applies for a single policy on each owner's life. Owners transfer cash to the LLC to fund premium payments.
2. **Upon the Death of an Owner.** When an owner dies, the policy proceeds are received by the LLC as tax-exempt income. Through special allocation of the proceeds, the surviving owners' capital accounts receive a distributive share that will increase their basis in the LLC. The LLC distributes the life insurance proceeds to the surviving owners. The surviving owners directly purchase proportionate shares of the deceased owner's interests in both the operating company and the LLC.
3. **Upon the Retirement of an Owner.** When an owner retires, he could terminate his LLC interest, with the policy insuring his life distributed to him in exchange for his interest in the LLC, and his interest in the operating company acquired by the remaining owners in exchange for a note. If the policy has been adequately funded, cash values may be available to the retiring owner, reducing his reliance on large note payments for retirement income. This may result in the retirement buyout being a more affordable component of the overall plan.

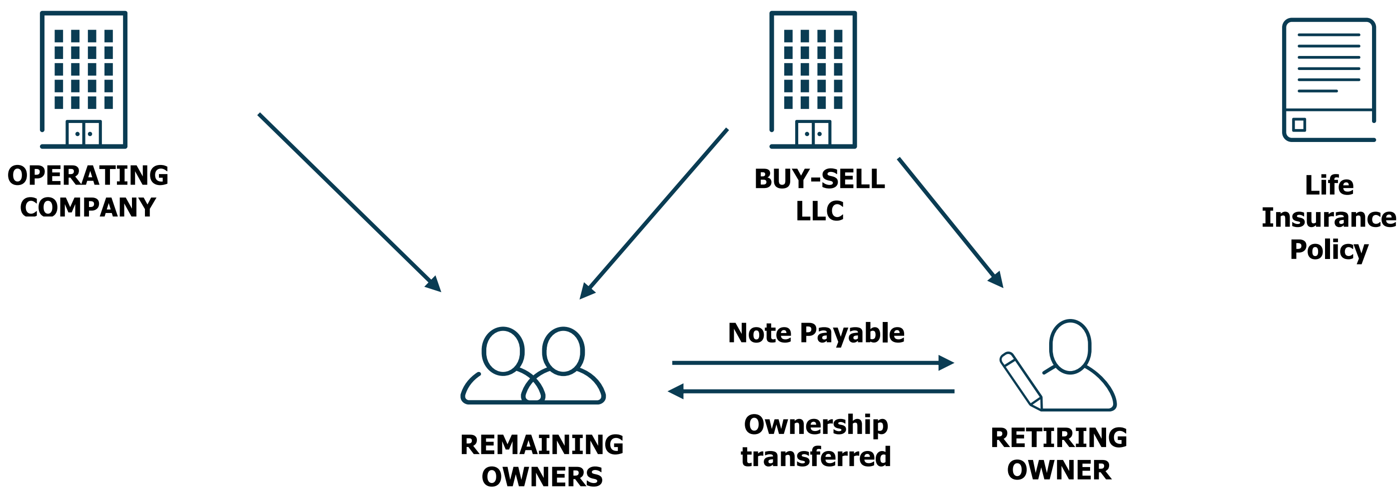
1. Initial Set Up



2. Death



3. Retirement



Potential Benefits of Utilizing an LLC

- **Retention of Control.** As with entity and cross purchase plans funded with life insurance, upon the death of an owner, surviving owners are able to maintain control of the company without concern for sharing ownership with the deceased owner's heirs.
- **Creditor Protection.** During the term of the arrangement, cash values in the LLC-owned life insurance policies are generally protected from creditors of the operating company, as well as the creditors of the respective owners. Upon a distribution of a policy to a retiree, his policy remains protected from creditors under the exemption laws of the state of residency.
- **Efficient Basis Increases in the Event of an Owner's Death.** Unlike entity plans for C corporations and many S corporations, surviving owners may receive all of the basis increases resulting from funding the buyout with life insurance.
- **One Policy Per Owner.** In contrast to traditional cross purchase plans, only one policy is needed per owner.
- **Avoiding Transfers for Value.** Exceptions to the transfer-for-value rule include transfers to the insured, transfers to a partner of the insured, and transfers to a partnership in which the insured is a partner. An LLC taxed as a partnership would qualify as a partnership for purposes of these exceptions.
- **Use of Policies After Retirement.** The cash value life insurance policy insuring the life of an owner can be distributed to him at retirement. In contrast to cross purchase plans, and entity plans for corporations, such a distribution by an LLC taxed as a partnership generally does not trigger taxation of policy gains to the original policy owner. In addition, there would generally be no gain or loss to the retiring owner, who could then access policy cash values on a tax preferred basis through surrenders to basis and policy loans.[1]
- **Centralized policy management.** The LLC provides formality and structure for the management of policies funding the agreement. For example, the LLC Operating Agreement can specify the purpose of the life insurance policies, and all of the restrictions that apply to the arrangement. Unlike traditional cross purchase arrangements, there is no concern that individual owners will fail to adequately fund policies, or take prohibited actions such as borrowing against the policies.
- **Managing Premium Disparities.** In any company for which a buy-sell plan is developed, it is possible that the cost of insuring one owner may be greater than the costs of insuring other owners, for various reasons such as age, health,

[1] Loans accrue interest and are generally not taxable. Withdrawals may be taxable under some circumstances. Loans and withdrawals will reduce policy cash values and death benefit.

and majority ownership status. In such cases, designing a buy-sell plan acceptable to all parties can be challenging. For example, traditional entity plans funded with term life insurance policies may lack appeal to older/majority shareholders, who feel that sharing term insurance costs amounts to subsidizing their own buyouts. Alternatively, an objection may arise from the owners who will have to pay more to insure their older/majority partners under a cross purchase plan. However, if plan funding is expanded to include permanent policies that may eventually be distributed to retiring owners in a tax efficient manner, greater flexibility may be available to allocate total plan costs in a manner suitable to all parties.

Issues & Considerations

- The LLC must have an adequate business purpose in order to achieve these tax benefits. Some commentators feel providing the mechanism and funding for the operating company's buy-sell plan is itself sufficient for these purposes.
- The LLC should be owner and beneficiary of the insurance policies used to fund the arrangement, and each policy's death proceeds should be specially allocated to the non-insured owners. The life insurance death benefit must be sufficient to purchase the deceased's LLC interest *and* share of the operating company.
- Premium allocation must be carefully considered, especially when policies will be used to provide additional retirement income at a future date. Premiums are typically characterized as bonuses paid by the operating company for the benefit of owners, and are considered capital contributions by the owners to the LLC. The amount allocated to a particular owner does not have to correspond to the premiums on the policy insuring that owner; in fact, many commentators suggest policy premiums should be allocated to non-insureds in order to facilitate efficient basis step-ups for surviving owners.

LLC Buy-Sell arrangements require careful drafting and can involve complex accounting. Clients should consult with their legal and professional advisors before structuring any buy-sell arrangement to ensure that their goals and objectives are met

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies.