



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Volume 3, Issue 1

Exciting New Developments in Buy-Sell Planning

This issue of The Wealth Counselor examines exciting new developments in business succession planning - specifically, the use of LLCs or partnerships to own life insurance for buy-sell planning purposes. Such a structure obtains the advantages of cross-purchase and stock redemption buy-sell agreements without many of the disadvantages of either traditional structure. This development is significant to all wealth planning professionals and their business-owner clients.

Background

For many business owners, the business itself is their primary source of income both during working years and in retirement. Thus, buy-sell planning is critical for not only death planning but also disability and retirement planning during lifetime.

Unfortunately, the two traditional types of buy-sell agreements ((1) stock redemption (aka entity purchase) and (2) cross-purchase agreements), have significant limitations and disadvantages that often prevent business owners from adequately preparing for many business succession issues.

Stock Redemption (Entity Purchase)

With a Stock Redemption arrangement, the corporation owns the life insurance and agrees to redeem the shares of a deceased shareholder at that shareholder's death. The shareholder in turn agrees that his estate will transfer the shares back to the corporation for an agreed-upon price.

The advantages of this arrangement are:

1. The simplicity of only one life insurance policy per shareholder;
2. The shareholders allocate premium costs according to their percentage ownership in the corporation; and
3. This arrangement ensures compliance with the terms of the buy-sell agreement.

The disadvantages of stock redemption arrangements are many:

1. The loss of the step-up basis at the owner's death, such that the surviving shareholders will incur larger capital gain tax upon a lifetime disposition;
2. The insurance policies are subject to attachment by the corporation's creditors;
3. If the corporation is a C corporation, the death proceeds may also be subject to the alternative minimum tax (AMT);
4. If corporate-owned buy-sell policies are over-funded to provide non-qualified retirement benefits to the owners, the benefits are generally subject to income tax; and
5. Potential taxation on redemption of the stock to the extent of earnings and profits where the attribution rules of IRC Sec. 318 apply.

If the corporation is an S corporation, the results of a stock redemption arrangement are better, because the AMT and attribution rules do not apply where the business has always been an S corporation. Also, the life insurance cash value and death proceeds give the shareholder some stock basis adjustment, reducing the amount of capital gain tax that may be triggered on a sale during life or at death.

Planning Tip: Stock redemption arrangements require only one policy per shareholder and thus cost less to implement, but have significant disadvantages as compared to cross-purchase arrangements.

Cross-Purchase

Under a cross-purchase arrangement, each owner/shareholder owns a policy on every other owner, and each surviving owner agrees to buy the deceased owner's interest directly from the deceased owner's estate.

The advantages of this structure are:

1. Because individuals own the policies and receive the income tax-free death benefit, they can obtain a full basis step-up by buying the stock directly from the decedent's estate;
2. The common "wait and see" approach allows surviving shareholders to keep the insurance proceeds for themselves and use any retained corporate earnings to effectuate a redemption; and
3. Policies are protected from the corporation's creditors.

The disadvantages of cross-purchase arrangements are:

1. The number of policies required to accomplish funding - each owner must own a policy on each other owner;
2. Policies are subject to attachment by the owner's creditors;
3. An owner may fail to pay premiums or refuse to pay death benefits pursuant to the buy-sell agreement;
4. The premium burden is allocated based on the cost of insurance of each other owner; and
5. Application of the transfer-for-value rule (when surviving owners purchase from the deceased owner policies on the other survivors).

Planning Tip: Cross-purchase arrangements also have significant disadvantages. For many clients, the number of policies required for funding - and the resulting cost - is simply too big of a hurdle for implementation.

Use of LLCs to Structure and Fund Buy-Sell Agreements

In a recent Private Letter Ruling, PLR 200747002, the IRS authorized a strategy that has the advantages of both cross-purchase and redemption agreements without the disadvantages of either. With this structure, the shareholders execute a cross-purchase agreement and form an LLC, taxed as a partnership, to own the life insurance. The cross-purchase agreement and LLC operating agreement have provisions that reference each other.

Special provisions of the LLC include:

1. The LLC manager is a corporate trustee, and any replacement must be a corporate trustee;
2. Members cannot vote on life insurance matters;
3. The manager must use life insurance proceeds as required in the buy-sell agreement; and

4. The LLC must maintain a capital account for each member, with special allocations of premiums and proceeds.

Upon examination of this structure, the IRS ruled that the life insurance death proceeds would not be includible in the respective estates of the LLC members. Thus, this structure contains the advantage of the traditional buy-sell structures without the disadvantages.

Planning Tip: Using an LLC to own life insurance for buy-sell funding purposes accomplishes the buy-sell objectives without causing many of the adverse income tax consequences and without causing estate tax inclusion.

"LifeCycle" Buy-Sells

This ruling adopts an approach similar to the "LifeCycle" Buy-Sell Agreement, first written about in "Using a General Partnership to Structure and Fund Buy-Sell Arrangements," by James C. Peterson and William S. White, from the January 2000 issue of the *Journal of Financial Service Professionals*.

There are some differences, however, between the PLR and "LifeCycle" structures, in particular:

1. The PLR uses term insurance - LifeCycle uses cash value insurance to also accomplish retirement planning objectives;
2. The PLR limited its ruling to funding a death buyout - LifeCycle can also be used for non-qualified retirement benefits; and
3. The PLR LLC has a more restrictive operating agreement - for example, LifeCycle does not require a corporate trustee as manager (only requires an independent trustee) and restricts a member against voting only on policies on that member's life. Counsel who submitted the PLR believes that these more restrictive provisions are only necessary for those seeking a letter ruling.

Planning Tip: Using an LLC or partnership to own insurance for buy-sell funding purposes eliminates the tax and other disadvantages of both cross-purchase and stock redemption agreements. Further, this structure requires only one policy per owner, making it a more attractive structure from the business owners' perspective.

Conclusion

Buy-sell planning is critical for business owners, but many defer implementation of a business succession agreement because of either the cost or tax disadvantages, or both, of the traditional buy-sell structures and common alternative. Use of an LLC or partnership to own the life insurance for a buy-sell arrangement eliminates both of these impediments and thus is much more attractive to business owners.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.