

## M INTELLIGENCE

### ADVISOR'S GUIDE: BUY-SELL LIFE INSURANCE LLC

The Buy-Sell Life Insurance Limited Liability Company can be an effective way to manage a Buy-Sell between 3+ parties.

Buy-Sell arrangements using life insurance have traditionally taken three approaches: cross-purchase, stock redemption, and a hybrid, also commonly known as a “trusteed Buy-Sell”.<sup>1</sup> While each of these approaches has distinct advantages, increasingly a fourth approach is providing an operating company with greater efficiency and protection: an LLC that owns and manages life insurance within a Buy-Sell arrangement.

The Buy-Sell Life Insurance LLC is designed to provide central ownership, administration, and maintenance of the necessary life insurance policies funding the Buy-Sell need. With this structure, it becomes simpler to allocate premiums and death benefits among parties to the agreement. It can also reduce exposure of the policies to the operating company’s creditors and help ease the distribution of policies to the members should they no longer be required to fund the agreement.

#### TRADITIONAL APPROACHES

##### CROSS-PURCHASE BUY-SELL ARRANGEMENTS

In a cross-purchase arrangement, each shareholder owns a life insurance policy on each of the other shareholders. At a shareholder’s death, the life insurance policy proceeds are paid to the other shareholders

who then use the proceeds to buy the deceased shareholder’s interest from their estate. The estate has a capital gains event on the sale of the shares. However, as capital assets held by the decedent at death, the shares receive a basis adjustment, and the subsequent sale by the estate should not result in a capital gains liability if the purchase price equals the new basis. The purchaser(s) receive(s) an income tax basis in their “new” shares equal to the purchase price. The advantage to using a cross-purchase arrangement is this ability to receive a new “stepped-up” basis in the transferred shares. The disadvantage is the number of policies that are required where more than two people are involved. For example, two shareholders require two policies; three shareholders require six policies (each shareholder would buy two policies—one for each other shareholder); four shareholders would require 12 policies, and so forth. The total number of policies required to fund a cross-purchase arrangement can be expressed by the equation  $N*(N-1)$ , where N equals the number of shareholders.

##### STOCK REDEMPTION BUY-SELL ARRANGEMENTS

In contrast to the cross-purchase, the operating entity in a stock redemption arrangement using life

<sup>1</sup> Buy-Sell agreements can either stand alone or be integrated into the company’s operating agreement. The company’s counsel will often draft the buy-sell agreement to be flexible enough for the parties to elect the “type” of buy-sell (cross-purchase or stock redemption) at a future point or a triggering event. These more flexible “wait and see” Buy-Sell agreements include both the cross-purchase and stock redemption terms and outline how the parties can elect and act under either arrangement.

insurance owns a single life insurance policy on each of the shareholders. This advantage is offset by the disadvantage of not receiving a tax basis adjustment for the remaining shareholders of the repurchased shares. At the shareholder's death, the policy proceeds are paid to the operating entity and used to repurchase the shares from the decedent's estate. The purchase is a capital gains event for the decedent's estate but, considering that the basis in the decedent's shares should be adjusted to the date of death value (or alternate valuation date), there should be no capital gains liability if the sale price equals the stepped-up basis. Unlike a cross purchase, the remaining shareholders usually do not see a step-up in the basis of their shares. Instead, when the decedent's shares are retired, the share concentration is generally increased among the remaining shareholders, and the price per share is increased proportionately.

## TRUSTEED BUY-SELL ARRANGEMENTS

The Trusteed Buy-Sell arrangement functions in a similar way to the Buy-Sell Life Insurance LLC. Specifically, a single entity can hold just one life insurance policy per insured rather than multiple policies, and the use of policy proceeds can be structured to obtain a new basis in purchased shares. However, the trusteed arrangement can present challenges such as potential estate tax inclusion by indirect incidents of ownership when a subordinate party to a grantor or beneficiary is the trustee.<sup>2</sup> Additionally, the arrangement can cause transfer-for-value issues at the death of each shareholder.

The Buy-Sell Life Insurance LLC provides a new approach to buy-sell arrangements. It combines the benefits of both the traditional plans and minimizes their deficiencies.

## SPECIAL PURPOSE LIMITED LIABILITY COMPANIES AND THE "BUY-SELL" LLC<sup>3</sup>

The Buy-Sell Life Insurance LLC is a special purpose limited liability company (SPLLC) duly formed and operated under state law for the specific business purpose of holding, managing, funding, and distributing proceeds from life insurance policies used in a

buy-sell arrangement. The LLC ensures the business owners' buyout obligations are satisfied and ensures the operating business' continuity.

Generally, the LLC, taxed as a partnership, is a separate entity from the operating company and is used to facilitate the Buy-Sell provisions governing the operating company. The LLC is the applicant, owner, premium payor, and beneficiary of the life policies funding the arrangement. The LLC members mirror the shareholders who are party to the Buy-Sell arrangement and generally are the insureds on the LLC-owned policies.

Like a stock redemption or trusteed arrangement, the LLC requires only one policy per shareholder and allows for centralized management and collection of the policies funding the arrangement.

Upon a shareholder's death, the LLC will redeem the decedent's membership interest in the LLC. The proceeds from the life insurance policies are paid to the LLC income tax-free and are either distributed directly to the decedent's estate in consideration for their shares or distributed to the surviving members of the LLC who will then use the proceeds to buy the deceased shareholder's interest in the operating company.

## BENEFITS OF THE BUY-SELL LIFE INSURANCE LLC

- Properly structured and operated, the LLC gives the surviving operating company shareholders a new basis in their acquired shares equal to the share purchase price. This mirrors the benefits of a traditional cross-purchase arrangement.
- The life insurance proceeds paid to the LLC are income tax-free and are allocated to the surviving LLC members. This increases the members basis in the LLC membership interests.<sup>4</sup>
- Distribution of the policy proceeds to the surviving members is also generally income tax-free.<sup>5</sup>
- When the LLC receives the tax-exempt income, it increases the partner's adjusted basis in their membership interest.<sup>6,7</sup>

<sup>2</sup> See PLR 9349002.

<sup>3</sup> See PLR 200747002.

<sup>4</sup> IRC §§ 101(a)(1) and 705(a)(1)(B).

<sup>5</sup> IRC §§ 705(a)(2), 731(a), and 733.

<sup>6</sup> IRC § 705(a)(1)(B).

<sup>7</sup> If an LLC member receives the tax-free distribution, the member's adjusted basis is accordingly reduced for the distribution. IRC §§ 705(a)(2) and 733.

<sup>8</sup> IRC § 1012(a).

<sup>9</sup> IRC § 101(b).



- When the surviving members purchase the deceased shareholder's operating company interest, the buyer receives basis in the shares of the operating company equal to the purchase price.<sup>8</sup>
- If the policies are no longer needed, the policies can be distributed out to the insureds or a company in which the insured is a shareholder, meeting the exceptions to the transfer for value rules.<sup>9</sup> This is particularly useful if the business is sold to a third party or shut down at retirement.<sup>10,11</sup>
- Because the LLC is taxed as a partnership, a policy distributed to an insured member should not result in any recognition of gain for either the LLC or the member.<sup>12</sup>
- Generally, the LLC can provide creditor protection under state law where the LLC assets are not subject to attachment by a member's creditors.

### PRIVATE LETTER RULING 200747002<sup>13</sup>

This guide reflects the content of a 2007 IRS Private Letter Ruling (PLR) ([www.irs.gov/pub/irs-wd/0747002.pdf](http://www.irs.gov/pub/irs-wd/0747002.pdf)) describing an IRS-approved approach to using a stand-alone LLC to manage the life insurance funding of an operating company's Buy-Sell arrangement. Key elements of the PLR to consider when structuring the arrangement include:

- establishing a valid LLC business purpose. The LLC operating agreement authorizes establishing an "Insurance LLC" which is defined as an LLC or other entity designated to hold life insurance on the life of one or more shareholders to satisfy the obligation of one or more shareholders to purchase company stock.
- ensuring the agreement specifies that the LLC will be used to distribute life insurance proceeds to fulfill any obligations.
- ensuring that the LLC maintains a separate capital account for each member.

<sup>10</sup>IRC § 1001(a) could cause life insurance policies swapped by co-owners following the shutdown of a business to realize a gain on the exchanged policies.

<sup>11</sup>Under IRC § 311(b), if a corporation distributes a corporate-owned life insurance policy to the insured shareholder, the shareholder will recognize taxable income on the gain in the policy. See also IRC § 1371(a) governing subchapter S corporations.

<sup>12</sup>IRC § 731(a-b).

<sup>13</sup>PLRs apply only to the party which requested the ruling and can't be relied upon as definitive guidance for other taxpayers.

- ensuring the management of the company is vested in an independent or corporate manager and not the members or a party subordinate to any member (if estate taxes are a concern).

The PLR also provides guidance on an approved contribution and capital allocation plan: The LLC operating agreement requires member contributions equal to the premium on any insurance policies contributed by the member.

At an insured's death, the proceeds of the insurance policy are allocated to the capital account of the member who contributed the policy, and the company distributes the policy proceeds proportionally to the member(s)' respective capital account(s).

### STRUCTURING THE LLC

The LLC should be taxed as a partnership. Generally, the operating company shareholders should own the same percentage of the LLC as they do the operating company. However, if a shareholder is uninsurable, it might make sense to limit LLC members to insurable shareholders. It is also common for a non-shareholder to be an LLC member to accomplish a firm's succession plan. This can include employees, family members such as a spouse or child, and trusts which could own the LLC interests.

A member or chosen manager can operate the LLC. For instance, if a client has any estate tax concerns, the LLC can be set up to have an independent manager, such as a corporate trustee, manage the LLC.<sup>14</sup> The LLC should also elect to be a cash basis taxpayer.<sup>15</sup>

### ALLOCATING POLICY PREMIUMS

Generally, the operating company is the source for premium payments. The operating company can pay the premiums on behalf of the LLC, and the payment is considered either a distribution or compensation to the participating members. If a premium is paid directly

<sup>14</sup>Under IRC § 2042, if an insured member of the LLC has any incidents of ownership over the life insurance policy, the death benefit will be includable in the insured's gross estate. If this is a concern, consider prohibiting any insured member from acting as a manager and exercising any power or right over any life insurance policy of which they are the insured.

<sup>15</sup>Upon the death of a member, as long as the decedent's taxable year ends at their death, any death benefit proceeds will be allocated to the surviving members' capital accounts rather than allocated to the decedent's capital account. (IRC 706(c)(2)(A)).

by the operating company on behalf of LLC members, the payment results in a deemed capital contribution to the LLC. If the LLC owns income-producing assets, the income can also be used to pay the premiums.

Allocating premium payments among members is important because it affects the members' capital accounts. Generally, there are three ways to allocate the premiums:

1. Allocate all premiums as contributed by the members on a pro-rata basis, mirroring the member's ownership percentage in the LLC.
2. Allocate the premium as paid by the insured (pay your own premium), resulting in a contribution by the insured.
3. Allocate the premium similarly to a Cross-Purchase arrangement wherein the noninsured pays the premium, and the payment is considered a contribution to the LLC.

### **PRO RATA TREATMENT CONSIDERATIONS**

The operating company's advance of the premium is allocated equally among each of the members resulting in equal income recognition and capital accounts. This approach, while seemingly fair, does not resolve any issues caused by higher or lower premiums due for each insured. It simply equalizes the policy basis among the members.

### **PAY YOUR OWN PREMIUM CONSIDERATIONS**

This approach favors younger or healthier insureds because a lower premium results in less taxable income. This arrangement also is useful if there is any need to distribute the policy out to the insured because the capital contributions and distribution costs aren't materially different.

### **CROSS-PURCHASE ALLOCATION CONSIDERATIONS**

The insured's policy is paid for by the other members resulting in a zero basis in the policy by the insured. Rather, the other members receive a basis equal to the premiums they have paid. If a policy needs to be distributed out to the insured, the policy cost may exceed the insured's capital account. This also can cause issues where the parties have substantially different policy costs due to health, age, or other reasons.

## **ALLOCATING DEATH BENEFIT PROCEEDS**

Death benefits are generally allocated based on the method used to allocate premiums.

### **PRO RATA TREATMENT CONSIDERATIONS**

Generally death benefits are allocated pro rata among LLC members.

### **PAY YOUR OWN PREMIUM CONSIDERATIONS**

In the pay-your-own-premium treatment, it makes sense to allocate the death benefit to the deceased's capital account. However, under IRC 706(c)(2)(A), this may not be the proper outcome: "The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation or otherwise.)"

- Practice Consideration: To take advantage of IRC 706, consider adding language to the operating agreement that an interest of a deceased member either be terminated or deemed purchased on the date of death. This would terminate the member's taxable year in the LLC upon death. Additionally, the members may want to add language to the operating agreement that any death benefits received by the LLC be extraordinary income allocable to the remaining members of the LLC.

### **CROSS-PURCHASE CONSIDERATIONS**

With a cross-purchase allocation, the death benefit is allocated among the non-insured's separate account(s).

## **CONCLUSION**

A buy-sell agreement can be instrumental in ensuring a business continues after the exit of a business owner. Traditional approaches to a buy-sell have provided effective options for putting a plan in place, but the increasingly popular option of the Buy-Sell Life Insurance LLC offers many benefits as our Guide has tried to illustrate. It should be given serious consideration when buy-sell planning is initiated.



## FAQ

### Is the LLC's payment of the life insurance premiums income tax deductible?

No, pursuant to IRC § 264(a)(1), the premium payments are not tax deductible because the taxpayer is directly or indirectly a beneficiary of the policy.

### Is there a requirement that the LLC taxed as a partnership be a for-profit business?

Generally, no, under the Uniform Limited Liability Company Act, there is no "for profit" requirement. Instead, the Act allows the LLC to be formed for any lawful purpose, such as being part of a company's succession plan.

### Does the situs of the LLC need to be the same as the operating company?

No, the LLC need not be situated in the same state as the operating company. Factors informing the formation state of the LLC include creditor protections, favorable laws and courts, privacy, and state income taxes.

### Must the insured members of the LLC comply with the notice and consent requirements of IRC § 101(j)?

Generally, yes. It is advisable that all of the insureds comply with the notice and consent requirements of 101(j).

### Does the transfer-for-value exception for transfers to partnerships apply?

With approval of a client's counsel, it appears that the transfer to partnership exception applies.<sup>16</sup>

### How do you value the LLC membership at the death of an insured member?

This depends entirely upon how prior contributions are allocated to the member's capital account. The LLC agreement should explicitly value the deceased member's interest exclusive of the policy's death benefit.<sup>17</sup> It may also be advisable to seek a valuation by an independent qualified appraiser.

<sup>16</sup> But see Rev. Proc. 2019-3. The IRS presently has stated that it will not rule on whether or not the transfer of a life insurance policy to an unincorporated organization will result in the organization's treatment as a partnership or will be exempt from the transfer-for-value rules when substantially all of the organization's assets consist, or will consist, of life insurance policies on the lives of its members.

<sup>17</sup> See *Cartwright v. Comm'r* 183 F3d 1034 (9th Cir. 1999) and *Estate of Blount v. Comm'r*, U.S. Court of Appeals for the Eleventh Circuit, No. 04-15013, Oct. 31, 2005. But also see *Connelly v. Comm'r*, United States District Court Eastern District of Missouri Eastern Division Case No. 4:19-cv-01410-SRC.

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