



A New Spin on Buy-Sell Agreements

By Damon E. Coombs

USING A PROPERLY DESIGNED LIMITED LIABILITY COMPANY (a *Buy-Sell LLC*) to own life insurance that funds a buy-sell arrangement can produce dramatic tax savings for a small business owner and make the life insurance more useful.

If you are a co-owner of a business entity such as a corporation, partnership or limited liability company, you know that you need a buy-sell agreement. A buy-sell agreement lets you buy your co-owner's interest in the business if he or she tries to sell his or her interest, quits working with you, becomes bankrupt or dies. If you don't have a buy-sell agreement, you could end up trying to run a business with someone you don't know, don't trust, don't like or who can't help with the business.

Life insurance is a good way to fund the purchase of the interest of a deceased co-owner. It saves the business' cash and gets cash to the co-owner's heirs. Term insurance is often used to fund a buy-

out on death. Often, the business buys the insurance and is the beneficiary of the insurance for the sake of simplicity, deductibility of premiums and low cost.

This structure misses two important opportunities: (1) the opportunity to "step up" the tax basis of the surviving co-owner upon the death of another co-owner, and (2) the opportunity to use some or all of the premium dollars for the purchase of whole life insurance or other permanent product to accumulate cash for retirement purposes, estate planning or funding a buy-out for events other than death (such as disability).

In the event that a co-owner dies and the business owns the insurance, the business gets the death benefit and typically uses the insurance proceeds to *redeem* the interest of the deceased co-owner. By contrast, a *cross purchase* buy-sell provides for the purchase of the terminating co-owner's interest by the remaining co-owner.



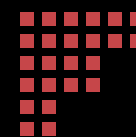
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A *cross purchase* can give the surviving co-owner a boost in his or her tax basis, whereas a *redemption* cannot.

If you buy a deceased co-owner's interest in a *cross purchase*, your basis for tax purposes in that interest will be, generally speaking, what you pay. When you sell that interest in the future, your taxable gain on that sale is, generally speaking, the difference between what you get for it at that time and what you paid for it when you bought it from your co-owner. If, on the other hand, your business buys your terminating co-owner's interest in a *redemption*, your co-owner's interest and its tax basis vanish. Either way, you end up with the exact same interest in the business (if there were only two co-owners, you are now the sole owner; if there were three co-owners, there are now two). But with the *cross purchase*, your tax basis receives a boost. That boost means that you will pay less tax upon a profitable disposition or liquidation of your business.

A *cross purchase* works reasonably well for a business owned by two people. Each owns the insurance on the life of the other, pays the premiums, etc. However, if the business has three owners, the situation becomes dramatically more complex. Each owner needs two policies — one for each of the two other co-owners. Six policies are needed for three co-owners, 12 for four co-owners, etc. This factor is the primary impediment to *cross purchase* arrangements. An additional concern in a *cross purchase* is that younger, healthier co-owners pay higher premiums because the policies they own are on the lives of the older, less healthy co-owners.

There have been many attempts to solve these problems. Classic arrangements have included the "one policy per owner" trust (aka the "escrowed" buy-sell), the "triple split dollar" arrangement and the "business irrevocable life insurance trust." These arrangements have various problems, including a likely prospect that the death benefit of one or more of the policies involved may be taxable because a "transfer for value" will occur at some point in the operation of the arrangement. The best thing about life insurance is that the death benefit is nontaxable, and a "transfer for value" destroys that benefit.

This problem can be avoided by using

an entity taxed as a partnership (like a *Buy-Sell LLC*) to hold the life insurance policies. A partnership in which the insured is a partner enjoys an exception to the "transfer for value" rule. Because the insured members under the policies held by the LLC are also members of the *Buy-Sell LLC*, the tax-exempt status of the death benefits is preserved.

A death benefit paid to a *Buy-Sell LLC* can be *specialy allocated*. This means that the income and the distribution of the death benefit can be directed exclusively or primarily to the surviving members. If properly structured, the surviving members can withdraw that money tax-free and use it to buy the deceased co-owner's business interest. The small business owner thus gets the benefit of a *cross purchase* without the complexity of multiple policies and without losing the tax benefit of life insurance.

A *Buy-Sell LLC* provides its members with incentive to accumulate cash values in their respective policies. They can withdraw these policies upon retirement without taxation of cash value gains. They can get the benefit of tax-deferred growth offered by universal and whole life products on the insurance policies used to fund the buy-sell. This is a significant benefit for people who have used tax deferred retirement planning (such as their 401(k) plan) to the maximum desired and have either maximized use of their Roth IRA or do not qualify for a Roth IRA.

In addition, using irrevocable trusts to hold some of a co-owner's interest in a *Buy-Sell LLC* can deflect the value of a business interest acquired from a deceased co-owner away from the estate of surviving co-owners. Also, the value of policies held by a *Buy-Sell LLC* can be protected from the creditors of the business enterprise and the separate creditors of the other co-owners.

A *Buy-Sell LLC* may be just the right spin for your business succession planning. ■

Damon E. Coombs is a shareholder in the law firm of Callister Nebeker & McCullough, where he serves the diverse legal needs of business organizations and their owners, including tax and estate planning, and organizational, governance, transactional and financing matters.