LLC Buy-Sell Agreements

Using Life Insurance to Fund Buy-Sell Agreements for LLCs

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The tax consequences of a buy-sell agreement for a limited liability company are very different from the tax results of a corporate buy-sell agreement, and the treatment of life insurance differs greatly when the insurance is owned by an LLC.

[pg. 460]

Limited liability companies (LLCs) are now the entity of choice for closely held operating businesses in many jurisdictions. Taxed as flow-through entities like partnerships, but offering the limited liability protection of a corporation for owners, LLCs are being used for every kind of business. It should come as no surprise that many corporate business planning tools are adaptable to LLCs. Key tools are the buy-sell agreement [1] and life insurance to fund it. However, applying the buy-sell concept to LLCs can produce significantly different tax results for the seller, the purchaser, and the company.

The special valuation rules of Chapter 14 also apply to LLCs. If a buy-sell agreement is among family members, the owners must take into consideration the impact of Sections 2703 and 2704 . The purchase price set by an agreement among family members will receive greater scrutiny than an arrangement among unrelated parties.

There are two main types of buy-sell agreements: cross purchases and redemptions. Redemptions in the LLC context are referred to as "liquidations" under the Code instead of "stock redemptions" because an LLC does not issue shares of stock. [2] A buy-sell agreement can take the form of a combination of a cross purchase and entity arrangement-commonly referred to as a "wait-and-see" buy-sell agreement. [3]

Cross purchase

The purchasers in an LLC cross purchase agreement are the other owners. Each purchaser acquires part or all of the seller's LLC interest. The seller can own both a capital interest and a profits interest in the LLC, and both kinds of interests are sold to the purchaser(s).

In the case of a corporate cross purchase, the sale of the stock to the buyer determines the tax consequences. The assets the company owns are not affected. If the purchase price for the stock exceeds the seller's cost basis in the shares, the seller has income. The stock sale is treated as a single, unitary "sale or exchange" transaction, subject to capital gain taxation. Gain or loss is generally determined by the difference between the purchase price paid to the seller and the seller's cost basis in his shares. [4]

The tax results differ in an LLC cross purchase. The seller may receive capital gain treatment for only a portion of the interest being sold. Another significant tax consequence of an LLC cross purchase may be an adjustment to the cost basis of the LLC assets; such an adjustment never occurs in a corporate cross purchase.

[pg. 461]

Impact on the purchaser. When the purchase price reflects the current value of the LLCs assets, the purchaser can request an adjustment to the cost basis of the LLC's assets (the "inside basis") on the company's books and records to reflect current market value. The basis of each asset will then be changed by a percentage equal to the portion of the LLC being acquired by the purchaser. [5]

These "inside basis adjustments" can be made only if a " Section 754 election" is made by the tax matters member of the LLC. Once made, the election applies to all future Section 754 -type transactions. The right to require the LLC to make a Section 754 election can be a negotiated provision in a buy-sell agreement, and the purchaser may want a Section 754 election to be a condition of the sale. In addition, if a Section 754 election already is in effect, a purchaser should evaluate the LLC's assets prior to making the acquisition because there can be a downward basis adjustment if assets have declined in value.

The Regulations require the capital account of the seller to be transferred to the purchaser. [6] Further, when a Section 754 election is in effect, the capital accounts of all the members should be adjusted to reflect the fair market value (FMV) of the assets in accordance with the members' respective profit-sharing allocations. [7] Adjusting the capital accounts properly is important, because an LLC's operating agreement may not have substantial economic effect if liquidation of the LLC and distributions of income and capital do not take positive and negative capital accounts into account when taxable income is allocated or distributions of capital are calculated. [8]

The cost basis of an owner of an LLC interest generally includes a proportionate share of the LLC's liabilities. [9] The purchaser will receive an increase in his cost basis in the entity for the proportionate share of the LLC's debt allocable to the interest being acquired.

Impact on the seller. In contrast to a corporate sale, the seller of an LLC interest may have a capital gain for only a portion of the interest being sold. The seller recognizes ordinary income for his share of the LLC's appreciated ordinary income assets (referred to as "hot assets"). Hot assets include unrealized receivables and inventory. Usually, unrealized receivables have a zero cost basis. [10] The seller is deemed to sell his interest in the hot assets for FMV. Moreover, payments for the seller's share of hot assets cannot be reported on the installment method. [11] This means the seller may recognize income from the deemed sale of hot assets before receiving payment in an installment sale.

Because an owner of an LLC interest probably will have basis for his share of the LLC's liabilities, the purchase price is deemed to include an amount equal to the reduction in liabilities allocable to the seller. This is true even though LLC owners generally are not personally responsible for the LLC's liabilities. [12] A reduction in liabilities is treated as the receipt of cash from the LLC.

If the seller is an estate, there is a step-up in basis for the capital portion of the transaction. The estate's LLC interest receives a new cost basis equal to the FMV at the date of death. [13] This portion of the sale is income tax-free if the price equals the date of death value. There is no step-up in basis, though, for the portion of the sale price allocable to the hot assets, which is treated as income in respect of a decedent (IRD). [14] Nevertheless, the estate receives an income tax deduction for the estate tax attributable to this IRD. [15]

Sale of an owner's entire interest in the LLC ends the tax year of the LLC with respect to the selling member. [16] It does not end the LLC's tax year unless at least 50% of the LLC's capital and profits interests are sold during a 12-month period (a "technical termination"). [17]

The result of the sale of an LLC interest is that a proportionate share of the LLC's income

[pg. 462]

will be recognized by the seller on the seller's income tax return for his tax year within or with which his membership in the LLC ends. The Regulations give the LLC the choice of (1) closing its books on the date of sale and allocating its income earned up to the date of the sale, or (2) keeping its books open and making income allocations based on the number of days in the fiscal year the seller owned an interest in the LLC. [18] This choice can have a significant impact on the seller, as well as on the purchaser, and is a factor that must be considered in a buy-sell agreement or as a condition of a purchase.

If the LLC's tax year ends due to a technical termination, there is a deemed liquidation and recontribution of the assets and liabilities to a new LLC. [19] A technical termination created tax problems under prior law, but now rarely results in any income being recognized by the remaining owners. The owners have to make new tax elections for the LLC, except for the Section 754 election, which continues. Income will be recognized only if the cash deemed distributed in the liquidation exceeds the owners adjusted basis in his LLC interest. [20] Because marketable securities are treated as cash in a distribution, an LLC that has significant amounts of marketable securities should build defenses against a technical termination.

If the owners believe there will be taxable income on a technical termination, the owners can plan to avoid this event. For example, an LLC could be owned 49.5% by each of its two owners, and 1% could be owned by an S corporation. Then, upon the death of one of the owners, only 49.5% of the LLC will be purchased under the buy-sell agreement. Another method for avoiding a technical termination is to require a 50% owner to retain a de minimis portion of his interest for a year and a day. [21] Yet another alternative could be to implement a part sale-part liquidation of the 50% owner's interest, because a liquidation is not considered a sale for these purposes. [22]

Impact on the LLC. The LLC receives an income tax deduction for the value of ordinary income items paid to the selling owner (offsetting the income the LLC would recognize on collection of the accounts receivable or on the sale of the inventory) if that payment is treated as a guaranteed payment under Sections 736(a) and 707(c) . Similarly, Section 736(b)(2) excludes such payments from the scope of payments received in exchange for an interest in the LLC. [23]

Liquidations of LLC interests (aka redemption agreements)

A redemption of an LLC interest also receives different tax treatment from a corporate stock redemption. With a C corporation, the company redeems the shareholder's stock. If the redemption qualifies as a complete termination of the owner's interest in the corporation, the entire redemption is treated as an exchange, taxable at favorable capital gains rates. [24] In the case of an LLC, there frequently will be ordinary income for a portion of the liquidating distribution.

Impact on the seller. Payments in liquidation of an LLC interest are treated as capital transactions and receive sale or exchange treatment under Section 736(b) . Any gain is capital gain. [25] Actual recognition of gain is deferred until the payee receives cash or sells property received in liquidation. [26] Marketable securities are deemed to be cash. None of the complex attribution and dividend bailout rules encountered in corporate redemptions apply to LLCs. [27] If an extended payout is made in a liquidation of an LLC interest, gain is not recognized until the owner's entire cost basis in the entity is recovered. This can yield more favorable results than typical installment reporting of income. If there is a loss on the liquidation, the loss is not recognized until the final liquidating payment is made. [28]

There are ordinary income tax implications in a liquidation, too. Under Section 736(a) , payments made in liquidation of an LLC interest are deemed to be either (1) guaranteed payments or (2) a distributive share of future LLC income; both types of payments are taxed as ordinary income. Payments for the owner's share of unrealized receivables are treated

[pg. 463]

as Section 736(a) payments. If paid to an estate on account of the liquidation of a deceased member's LLC interest, the Section 736(a) payments are IRD. [29] As noted earlier, IRD items do not receive a step-up in basis under Section 1014 .

As with the sale of an owner's entire interest, the liquidation of an owner's LLC interest causes the tax year of the LLC to close with respect to that owner. All the deceased owner's share of the income of the LLC will be reported on his final income tax return. [30] However, the tax year for the owner will not close if Section 736(a) payments remain to be made. Therefore, in such situations, to avoid all the deceased owner's share of income in the year of death being taxed to the decedent's estate, the owner can name a "successor in interest," or his estate can distribute the LLC interest to the surviving spouse who can file a joint income tax return with the decedent. [31]

Goodwill that is expressly stated as part of the purchase price is taxed as a capital item in the liquidation. Payments for goodwill not called "goodwill" in the buy-sell agreement are taxed like unrealized receivables. This distinction presents a planning opportunity for the remaining owners of the LLC. LLCs receive an income tax deduction for guaranteed payments to a retiring owner, [32] and the distributive share of the LLC's future income payable to the retiring member is allocated to the retiring member-and not to the other owners. [33] In effect, there is an income tax deduction for Section 736(a) payments.

There is no income tax deduction for Section 736(b) payments (i.e., as a distribution for the LLC interest), although the company can amortize stated goodwill paid. [34] The remaining owners can often justify paying a higher price for the retiring member's LLC interest if a higher percentage of the liquidating payments is allocated to Section 736(a) payments. After income tax deductions, overall net cost may be lower than in a transaction with fewer Section 736(a) payments. This is the reason many planners prefer redemption agreements for LLCs instead of cross purchases.

Impact on the LLC. In a liquidation, the LLC can adjust the basis of capital assets in an amount equal to the capital gain that the retiring owner recognizes on the liquidation, if a Section 754 election is in effect. [35] Alternatively, if a Section 754 election previously was made and the seller will recognize a loss, the LLC must make a negative adjustment to the basis of its capital assets on its books. The LLC will be able to amortize stated goodwill in the liquidation. [36]

The capital account remaining after reduction for the distribution of capital to the retiring owner is reallocated among the remaining owners in accordance with the operating agreement.

Complete liquidation of an owner's interest ends the LLC tax year with respect to that owner just as a complete sale of the owner's interest does. [37] The same issues regarding allocation of income must be dealt with by the parties, and the buy-sell agreement should focus on the pros and cons of closing the LLC's books versus making a pro-rata allocation at the end of the tax year. However, if there still will be Section 736(a) payments that are based on future profits of the LLC, the liquidation technically is not a complete liquidation of the owner's entire interest, and the liquidated owner's tax year for the LLC does not end. If the liquidation is on account of the death of an owner and if the liquidation is not complete, then all the income for the final year of the decedent's life will be recognized as IRD on the estate's income tax return. [38]

Life insurance for the LLC buy-sell agreement

Life insurance is an important component of buy-sell agreements. Insuring the obligation protects the selling owner's family, and eliminates both the burden of paying the obligation for the remaining owners and its impact on future business operations. There are a number

[pg. 464]

of issues concerning life insurance which are unique to LLCs and partnerships. Moreover, the tax results for the surviving owners can be nearly the same regardless of the type of buy-sell agreement selected.

Cross purchase agreements

Under a cross purchase agreement, the owners (and not the LLC) purchase the life insurance. If there are two owners (A and B), A owns and is beneficiary of the policy on B's life, and B owns and is beneficiary of A's policy. Each owner is responsible for paying the premiums for the policy he owns. If the ages of the owners differ, each owner will be responsible for a different amount of premium, and basis adjustments will be unequal.

If the owners want the LLC to pay the premiums, the LLC can classify the premium payments as guaranteed payments to the owners taxable under Section 707 . Otherwise, the payments will be treated as distributions. Distributions to or for the benefit of an LLC owner reduce that owner's basis in his LLC interest. [39] If the owners want guaranteed payment tax results, specific provisions should be included in their agreement.

If it is not practical to use the guaranteed payment method of premium equalization and if there is a significant age difference among the owners or one owner is a substandard risk, then the split-dollar premium payment method can be used. Under this premium financing method, the entity typically pays most of the premium and has an interest in the policy equal to its premium advances or the cash surrender value. The policyowner (i.e., owner of an LLC interest) pays a portion of the premium equal to the economic benefit of the death benefit payable to him at the insured LLC owner's death. [40]

When an insured LLC owner dies, the death benefit is received by the beneficiary/LLC owner income tax-free, and is used to pay for the LLC interest being acquired. [41] The death benefit should be excluded from the insured's estate because the insured does not have an interest in the policy. [42]

If a split-dollar payment plan is used, the cash value of all the insurance policies will be an asset of the LLC, and may be included in the purchase price of the LLC interest. If none of the cash value is allocable to the deceased LLC owner's capital interest, the allocation may not have substantial economic effect as required by Section 704 . The implication of this analysis is that, to be effective, the special allocation needs to emphasize the business purposes being accomplished, and must cover both cash value for purposes of Section 704(b) as well as "incidents of ownership" and death benefits (discussed later).

LLC cross purchases have the same multiplier effect as do corporate cross purchase agreements with respect to the number of policies needed if there are more than two owners of the entity. For example, if there are three owners, six policies must be purchased. Each owner owns a policy on each other owner. The formula to determine how many policies are needed is [number of policies = number of owners × (number of owners - 1)].

The multiplier effect creates administrative problems for cross purchase agreements. When one owner dies, the surviving owners often will acquire from the deceased owner's estate the policies that the decedent owned on the other shareholders. In the corporate setting, purchases of these policies may run afoul of the transfer-for-value rule. [43] There is no exception under Section 101(a)(2) for transfers of a policy for value to a shareholder who is not the insured. And when there are three or more owners, invariably one of the purchasers will be a different person from the insured. If a transfer for value occurs and the insured later dies, the death benefit will be taxable income to the extent it exceeds the purchaser's cost basis in the policy.

The transfer-for-value rule is not a problem when an LLC is used because life insurance transfers to a partner of the insured are an exception to the rule under Section 101(a)(2)(B) . The IRS has ruled privately that a transfer of a policy to an owner of an LLC interest is treated the same as a transfer to a partner for purposes of Section 101(a)(2) . [44]

The exception to the transfer-for-value rule permits LLCs to

[pg. 465]

use trusteed cross purchase plans for three or more owners, an option that is not available to shareholders in a corporate cross purchase because there will be a transfer for value after one of them dies. In a trusteed cross purchase plan, a single policy can be purchased on each owner, using a trust to own the policies. (In a typical cross purchase, the owners acquire multiple policies on the life of each other owner.)

Under the trusteed approach, a single trust can be used, or the owners can opt to form a separate trust to own each policy. If a separate trust is used, all the owners but the insured are grantors and beneficiaries of the trust. If a single trust is used, the trust must be divided into separate shares, and the insured must not be deemed a grantor or beneficiary of the share owning the policy on his life. If the trust is set up improperly, the IRS may attempt to include the insurance in the decedent's estate along with the business interest.

The ability to use a trust to own the policies can be very advantageous. Besides reducing the number of policies needed, a trustee will consummate the sale of the LLC interest, assuring the intended result for the deceased LLC owner's family and the surviving owners. Despite its no-ruling policy, the IRS has ruled privately that the exception to the transfer-for-value rule applied when the owners transferred policies to a trust under which they were treated as the grantors under Section 671 . [45]

The fact that insurance is used to fund a buy-sell agreement does not change the income tax consequences to the seller of the LLC interest. There still will be income tax owed for the portion of the purchase price allocable to ordinary income items that will be classified as IRD for the estate.

Life insurance in a liquidation

There is no alternative minimum tax on life insurance when an LLC (rather than a C corporation) is used. [46] Accordingly, the receipt of death benefits by an LLC will be tax-free.

Ordinarily, the LLC will be the owner and beneficiary of the insurance. [47] The tax impact of this arrangement is quite different from the tax consequences of corporate ownership of life insurance. For C corporations that own life insurance, premium payments are nondeductible expenses. In effect, all shareholders share proportionately in the cost of the insurance. The death benefit is paid to the corporation, and the owners cannot provide in the shareholder's agreement that the cash value be excluded from a determination of the price to be paid for the deceased owner's stock. The issues are much more complex in an LLC. [48]

Premium impact on owners' basis. In the case of an LLC, the premium payments for term insurance are a nondeductible expense not properly chargeable to the capital accounts of the owners. [49] This kind of expense lowers the basis of the LLC owners to whom the expense is allocable. The basis adjustments can be charged to the owners who will benefit from the payment of the death benefits. If there are three owners, A, B and C, the basis reduction for payment of premiums for insurance on A's life can be allocated to B and C. The payments for insurance on B's life can be allocated to A and C, and so forth. The impact on the owners' capital accounts also will reflect this special allocation.

This special allocation appears to conform with the Regulations, and some commentators believe that any other kind of allocation may lack substantial economic effect, and can be challenged by the IRS. [50] The impact of this special allocation of premium cost is that the younger and healthier owners can bear the burden for the higher premiums paid on older or

[pg. 466]

substandard risk owners, just as in the case of a cross purchase agreement.

Cash value insurance is much more complicated. The investment element of the annual premium for cash value insurance usually is treated as a nondeductible expense *chargeable to capital accounts.* [51] When treated in this manner, there are two methods to allocate the investment element of the premium: (1) decrease the basis and capital of the owners for the entire premium and then increase the basis and capital for the investment element, or (2) just decrease the basis and capital by the pure insurance element of the premium, making no change in basis or capital for the investment element. If the first method is used, one must decide how to allocate the increase in basis and capital among the owners for the investment element. If the second method is used, it would appear that all the owners have an interest in the capital asset being acquired (the cash value of the insurance).

Giving each owner credit for a share of the cash value is consistent with tax treatment for the LLC's other assets. However, this allocation may produce unexpected results when an owner dies. At death, a portion of the death benefit may have to be allocated to the deceased owner's capital account instead of to the surviving owners, if the arrangement is to have substantial economic effect. Yet, if all owners do not share ratably in the capital being acquired by the LLC, there can be real economic consequences if the company terminates prior to the redemption. At termination, distributions are made first to owners in accordance with their capital accounts. [52]

Two other uncertain issues concerning cash value insurance are: (1) what to do when total cash value exceeds total premiums paid, and (2) what to do if cash value declines. The first possibility nearly always occurs with policies that have been in effect for at least ten years, and the second possibility easily can happen with variable life policies. While there are no clear answers to these issues, consider treating the entire premium as a nondeductible expense *not chargeable to capital accounts.* Then, there will be no allocation of cash value to anyone and no basis increase or decrease for the investment element. At death, the effect will be the same positive result for the surviving owners as with term insurance (described below).

When an insured owner dies, the tax results can be surprisingly complex, too. Death benefits from insurance are classified as tax-exempt income which increases the basis and capital accounts of owners. [53] The basis allocation may be different, depending on the kind of insurance and the accounting methodology.

Term insurance death benefits should be allocated solely to the owners who survive the insured. Assuming all the cost was allocated to these owners, then the entire positive basis and capital adjustment should be allocated to the survivors. Furthermore, the purchase price to be paid for the decedent's LLC interest should exclude the death benefit from any formula price. This is the preferred result for the survivors, because they want to increase their basis and capital accounts. Higher basis and capital accounts can result in lower income taxable gain on future distributions, and better results on dissolution. If death benefits are paid on cash value insurance, there may be a different result.

If the investment element of every policy is allocated to the non-insured owners, it will be consistent to allocate the entire death benefit to the surviving owners. But if all owners share ratably in the investment element of each policy, it seems questionable whether there can be substantial economic effect unless a portion of the death benefit equal to the portion of investment element of the premium payments is allocated to the decedent. This latter approach is suggested by many commentators, but it may produce unexpected consequences for the survivors. [54]

If the face amount of the cash value insurance does not change from year to year, the decedent LLC owner receives an allocation of an increasing share of the total basis and capital adjustment, and there will be an impact on the price to be paid for his interest in the LLC. This basis adjustment is probably wasted on a deceased owner *because the basis in those assets will be stepped up* under Section 1014 . So, too, is the capital account adjustment allocable to the decedent LLC owner because that capital account is reduced by the redemption price paid. While these undesirable effects may be mitigated if all owners are insured under similar policies, it seems more appropriate to allocate all the impact of a policy to the non-insured owners who will receive the death benefit when a claim is paid. [55]

[pg. 467]

Further complicating the tax consequences is the possibility that the tax matters member of the LLC may elect to close the LLC's books when the decedent LLC owner's interest is liquidated. The result with an operating agreement that allocates profits and losses to the owners in accordance with their percentage interests in the LLC can be significantly different, depending on whether the entity is a cash basis or an accrual basis taxpayer. Issues arise concerning when the insurance claim is filed-before or after the liquidation-and whether allocating basis and capital only to the surviving owners instead of in accordance with the operating agreement lacks substantial economic effect.

Many LLC agreements fail to contemplate the tax impact of life insurance premium payments and death benefits. Instead, there may be reference to the special allocations required on account of Sections 704(c) , 707(b) , or 737 or Reg. 1.704-2(b) regarding negative capital accounts. Otherwise, allocations typically are made in accordance with the percentage interest of each owner in the LLC.

An LLC operating agreement should reflect the needs of the owners and the impact of the buy-sell agreement. If the owners desire all the basis and capital adjustments to be allocated to the non-insured owner(s), the agreement should expressly so state, and the LLC's accountants should be made aware of this special allocation. In addition, any formula price needs to address the issue of whether any portion of the cash value of the insurance on the life of the decedent is includable in the price. It seems that cash value should not be included in the buyout price, although it is clear that the formula must include a ratable share of the cash value of all other policies owned by the LLC under which the decedent was not the insured.

Estate tax issues for LLC-owned life insurance

Death benefits paid to the LLC for a redemption should not be included in the taxable estate of the decedent insured. Instead, they should be included only indirectly in the insured's estate as part of the business valuation-the same result that occurs in the case of corporate-owned life insurance. [56] But LLC tax rules may produce a different outcome.

First, there is the IRS-imposed requirement that the insurance must be for an LLC business purpose. [57] Second is the issue of control by the insured owner. If the insured owner is the sole managing member of the LLC or if he controls a majority of the votes in a manager-managed or a member-managed LLC, the insured will be classified in the same manner as a majority shareholder. [58] Any portion of the death benefit paid for any purpose other than an LLC purpose will be included in the insured owner's taxable estate. If the LLC operating agreement allocates the death benefit to the surviving owners, it is questionable whether this allocation meets the business purpose requirement. Special drafting is necessary to address this.

Allocations deemed by the IRS to be for non-LLC purposes could result in double inclusion in the decedent's estate-the business value plus the insurance death benefit. On the other hand, a buy-sell agreement is so critical to the economic survival of a closely held business that a redemption plan funded with insurance using the suggested allocation methodology should meet the business purpose test created by the IRS, and the Service has recently so held. [59]

Nevertheless, to avoid a challenge by the IRS, the operating agreement should clearly state that the insured LLC owner does not have any control over the administration of the insurance policy; such a provision treats the insured like a nonvoting member of the LLC. All decisions regarding the policy, including the right to make loans, would be made by the non-insured owners of the LLC. A more conservative

[pg. 468]

approach would limit the LLC from making any policy loans to avoid any attempt by the IRS to apply a reciprocity theory to the arrangement when all other owners are similarly insured. [60]

The same issues are faced with split-dollar life insurance. The insured owner cannot have control over the insurance policies insuring his life. The agreement must contain special drafting to deny the insured control over the insurance. [61] While death benefits payable directly to third parties (like non-purchaser insurance trusts) may well not be payable for a business purpose, those death benefits are not being allocated by the special allocation in the LLC operating agreement, but rather by the split-dollar agreements and therefore do not need to be valid under Section 704(b) . Only death benefits payable to the LLC for the buyout need to have substantial economic effect.

Additional considerations

Price for an LLC owner's interest and estate tax issues relating to price. The price for an LLC owner's interest can be either a fixed price or a formula price. This is no different from a corporate buy-sell agreement. Key elements in determining a price are that the price be at arm's length and that the method for calculating the price assure the intended result.

Because one of the goals of any death buyout is to fix the value of the business interest for federal estate tax purposes, the owners will want to make sure that the buy-sell agreement meets the requirements of Reg. 20.2031-1(b) and Section 2703 . If it does, the price selected by the owners will be respected by the IRS for this purpose. In general, the agreement must be in writing and at arm's length, and must be binding at death for the seller. In addition, the agreement must provide for an offer of first refusal during life at a price no higher than the death price, and must not be testamentary in nature. If the parties are related, there is also a comparability test applied to the price and terms.

If insurance is used, frequently there is a provision in corporate buy-sell agreements that the price will be the greater of the price (as determined by the buy-sell agreement) or the insurance death benefit. This concept can be adapted to an LLC buy-sell agreement with some modification. In a redemption, the excess *of the life insurance death benefits over the buyout price* could be used to make guaranteed payments, which are tax deductible by the LLC. The buy-sell agreement should address this issue.

Disability buyout insurance. A discussion of buy-sell agreements should not ignore the need for a buyout in the event of the permanent or long-term total disability of an owner. Disability buyout insurance can be purchased to insure the obligation. The income tax results with respect to premium payments, receipt of claim proceeds under the policy, and basis allocation of the tax-free benefit should be the same as for term life insurance.

Conclusion

The tax consequences of a buy-sell agreement for an LLC are quite different from those resulting from a corporate buy-sell agreement, and the treatment of life insurance differs greatly when the insurance is owned by an LLC. As LLCs become the entity of choice for business arrangements, it is important for advisors to understand how LLCs differ, and how buy-sell agreements and life insurance arrangements should be structured. In particular, the traditional differences between entity and cross purchase agreements may have evaporated except for the somewhat more complicated accounting in an entity buyout-and perhaps the additional opportunity to make some payments deductible for income tax purposes.

PRACTICE NOTES

There is no alternative minimum tax on life insurance when an LLC (rather than a C corporation) is used. Accordingly, the receipt of death benefits by an LLC will be tax-free.

[1] See, e.g., Zuckerman and Grall, "Corporate Buy-Sell Agreements as Estate and Business Planning Tools," 28 ETPL 599 (Dec. 2001) .

[2] See Section 736 . LLCs generally are taxed the same as partnerships under the "check the box" Regulations. Reg. 301.7701-3(b)(1) .

[3] See Leimberg and Rosenbloom, *The Wait and See Buy Sell* (Leimberg Associates, 1999).

[4] Section 1001 . Section 318 attribution is an exception.

[5] Sections 743 and 754 .

[6] Reg. 1.704-1(b)(2)(iv)(l) .

[7] Reg. 1.704-1(b)(2)(iv)(m) .

[8] Section 704 and Reg. 1.704-2(b) .

[9] Section 742 . In an LLC, all debt is nonrecourse debt unless personally guaranteed by an owner, and nonrecourse debt is allocated among all the owners in accordance with their interests in the LLC.

[10] Sections 741 and 751 .

[11] Rev. Rul. 89-108, 1989-2 CB 100 .

[12] The result will be different if one or more owners have assumed personal liability for LLC debt and the seller has not.

[13] Section 1014 .

[14] Section 1014(c) . See 54 TC 1336 27 AFTR 2d 71-1581 444 F2d 90 71-1 USTC ¶9489 , and TC Memo 1969-279 PH TCM ¶69279 28 CCH TCM 1438 29 AFTR 2d 72-394 454 F2d 226 72-1 USTC ¶9176 .

[15] Section 691(c) .

[16] Section 706(c)(2) .

[17] Section 708(b) .

[18] Reg. 1.706-1(c)(2)(ii) .

[19] Reg. 1.708-1(b) .

[20] Section 731(c) . For this purpose, cash includes marketable securities.

[21] See, e.g., Ltr. Ruls. 9805017 , 9529037 , 9440017 , and 8517022 .

[22] Reg 1.708-1(b)(1)(ii).

[23] See Rev. Ruls. 83-155, 1983-2 CB 38 , and 75-174, 1975-1 CB 186 . See also 2 McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶22.06[2][b] (RIA) (hereinafter, "FTPP").

[24] Section 302 . Family attribution under Section 318 and transactions deemed to be bailouts of corporate earnings receive dividend tax treatment, instead.

[25] Section 736(b) .

[26] Section 737 trumps Section 731 , and can cause acceleration of the income recognition on a distribution.

[27] Sections 302 , 306 , and 318 .

[28] Reg. 1.761-1(d) .

[29] Section 753 .

[30] Section 706(c)(2) .

[31] Reg. 1.706-1 .

[32] Reg. 1.736-1(a)(4) .

[33] FTPP, *supra* note 23, at ¶22.01[4][b] and n. 20.

[34] Section 197 .

[35] Section 734 .

[36] Section 197 .

[37] Section 706(c)(2)(A) .

[38] Regs. 1.736-1(a)(6) and 1.708-1(b)(1) .

[39] Section 705 .

[40] The IRS has issued Proposed Regulations that would tax split-dollar life insurance arrangements under an economic benefit regime or under a loan regime. See REG-16475-01 (7/9/02).

[41] Section 101(a)(1) .

[42] Section 2042 .

[43] Section 101(a)(2) . The exceptions to the transfer-for-value rule include a transfer for value to the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is an officer.

[44] Ltr. Ruls. 9625013 and 9625019 . But see Rev. Proc. 96-12, 1996-1 CB 616 (establishing a no-ruling policy with respect to whether a partnership, LLC, or LLP is a partnership for transfer-for-value purposes).

[45] Ltr. Rul. 200120007 .

[46] Sections 55 and 56 .

[47] In a wait-and-see buy-sell agreement, it is possible that the owners may own the insurance outside the LLC.

[48] In an S corporation stock redemption, the results often can mimic a cross purchase arrangement for cost basis adjustments due to the short year option when there is a redemption. Section 1367 .

[49] Section 705 .

[50] Reg. 1.704-2(b) ; Pollack, Amdur, and Bellows, *Partnership Buy/Sell Agreements,* §603 (Little, Brown and Co., 1995).

[51] An insurance premium for a cash value policy has two components: (1) the portion allocable to the cost of term insurance for the year and (2) the balance which is invested (the "investment element").

[52] Reg. 1.704-1(b) .

[53] Sections 101 and 705 .

[54] See 2 Willis, Pennell, and Postlewaite, *Partnership Taxation*, §22.04[2] (Warren, Gorham & Lamont, 6th ed., 2001); contra, Pollack, Amdur, and Bellows, *supra* note 50.

[55] The IRS generally will respect the economic arrangement of the owners if the allocations are consistent, are at arm's length, and are not considered an abuse under the Anti-Abuse Regulation (Reg. 1.701-2).

[56] Rev. Rul. 83-147, 1983-2 CB 145 ; Reg. 20.2042-1(c)(2) .

[57] Rev. Rul. 83-147 deals with partnerships, but the result should be analogous for LLCs that are taxed as partnerships. See also 25 TC 153 51 AFTR 409 244 F2d 436 57-1 USTC ¶9586 57-1 USTC ¶11693 .

[58] See generally Reg. 20.2042-1(c)(6) .

[59] Ltr. Rul. 200214028 .

[60] See generally 23 AFTR 2d 69-1954 395 US 316 23 L Ed 2d 332 69-1 USTC ¶12609 ; and compare 76 AFTR 2d 95-7094 68 F3d 151 95-2 USTC ¶60216 , and 51 AFTR 2d 83-1317 694 F2d 1261 82-2 USTC ¶13505 ; and see 69 TC 32 .

[61] See Ltr. Ruls. 9843024 (limited partner), 200017051 , and 200111038 (both regarding general partner restricted by agreement).