Unlike a will, which takes effect only when the business owner dies, a buy-sell can cover a number of lifetime triggering events, including retirement, an asset sale, or disability.

Here's a strategy to guarantee the sale of your business in advance—with some added benefits!

Special Report

The LLC Buy-Sell Strategy

A Simple 4-Step Process!

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4 Simple Steps

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Acknowledgement

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For most business owners, business ownership represents their single largest asset. Virtually all will insure their business against loss from fire, theft, even earthquakes and floods.

Likewise, most business owners count on the value of their ownership interest to be the source of a successful and secure retirement; yet, relatively few may have taken the steps to ensure that this happens.

A buy-sell agreement can be considered analogous to a last will and testament, which is part of an estate plan to control the disposition of a probate estate. However, a buy-sell agreement isn't limited to death as being the only triggering event. Triggering events can also include retirement, an asset sale, or even disability.

One thing a buy-sell does is "lock-in" the sale of a business in advance—at a fair price.   The owner not only has a buyer, but a fair price with the funding locked-in in advance!

Who is the buyer? It can be a partner, a key employee, an outsider—it can even be someone from your competition! It can be virtually anyone who would like to buy your business but may not have the money, at least not yet.

A Quick Primer:

A buy-sell is a legally-enforceable agreement under which the owner of a business interest agrees to sell that interest for a specified amount upon the occurrence of a triggering event—i.e., death, retirement, or disability—to another party. The other party is legally obligated to purchase.

Most common is the situation where there are two or more partners of a business who want to avoid dealing with a deceased partner's spouse as the deceased partner's replacement . The arrangement removes the spouse from the picture but also provides the deceased partner's spouse with a buy-out of the ownership shares. The family of the deceased has sold the business and the remaining partners can move ahead. The funding mechanism is typically a life insurance policy simply because it provides liquidity when needed without having to sell other assets, take out an interest-bearing loan, or deplete cash reserves.

There are two basic types of buy-sell agreements: (1) stock redemption or 'entity', and (2) cross-purchase. There are many variations, but it comes down to these two types.

1. **The entity agreement:** ABC Inc.. Owns policies on owners A, B, and C. If A should die or become disabled, the insurance company pays ABC who receives the money and pays the money to the family of A in exchange for A's ownership interest.

2. **Cross-purchase agreement:** A, B, and C each own policies on each other.   B, for example, has policies on A and C. Upon a triggering event affecting A, B and C receive money from the insurance company and pay A's family, each receiving half (for example) of A's ownership shares.

That's an oversimplified overview; but, it should give you an idea of what we're talking about.

While both have their advantages, there are some issues worth considering for each:

Stock redemption issues

- When a business redeems the stock from the deceased's family, the remaining owners do not receive a stepped-up basis in their ownership interest.
- Business owned life insurance, being an asset of the business, is potentially subject to the claims of creditors. Properly designed, the cash values can become significant.
- Business owned life insurance is an Alternative Minimum Tax (AMT) preference item for large C corporations. Both the accumulated cash value and death benefit may contribute to AMT exposure.
- The transfer-for-value (TVF) rule may apply in some cases. IRC Section 101(a)(2) applies when life insurance is transferred for valuable consideration—it makes no difference if the policies are term or permanent—and could result in a taxable death benefit. The rules are strict.

Cross-purchase issues

Whenever legal or tax issues arise, you should consult with the appropriate licensed professionals possessing appropriate experience.

- If there are a number of players, the number of policies can be unmanageable. Where n = the number of players, the number of policies required is n * (n-1). So, if there are four partners, 12 policies would be required.
- Cross-purchase policies are personally owned and may be subject to the claims of personal creditors and ex-spouses.
- Plan regulatory compliance issues may arise. All the parties would be relying on each other to pay premiums on time and maintain the proper beneficiary designations. Further, they would be trusting each other not to raid policy cash values.
- Transfer for value issues could arise if a new shareholder is added to an existing agreement.
- Premium inequality may be an issue where two players are of different ages. The young healthy owner may be faced with paying higher premiums on the life of an older, unhealthy owner… and may not be able to afford keeping it up.

What to do?

The LLC Buy-Sell

Yes, Virginia, it is possible to deliver the benefits of stock redemption and cross-purchase buy-sells while eliminating most of the hurdles.

The LLC buy-sell strategy combines two business planning techniques: a limited liability company (LLC) and a cross purchase; and, it's not that difficult.

The Simple 4-Step Process

1. Form the LLC

This is a separate LLC you and the other players form set up to oversee and administer the buy-sell agreement. It must be a valid LLC under state law and separate from the underlying business.

2. Attorney drafts a cross-purchase buy-sell agreement

The agreement should be tailored to the needs of the LLC owners to cover the LLC and the underlying business. The buy-sell cross purchase can be either a separate document or made part of the LLC operating agreement. The parties to the agreement are the owners.

3. The LLC purchases life insurance policies on each of the business owners.

Here, the key to funding lifetime triggering events—retirement and/or disability, for example—means the policy must have cash value; so, cash value permanent insurance would be preferred as term has no cash value. Again, other options include purchasing ownership shares with business cash or taking out interest-bearing loans; however, both of those options come with contingencies that may not provide much security for the family of the survivors.

4. The triggering event takes place

If the triggering event is death, the LLC receives the policy proceeds and allocates the proceeds to each LLC member who use the funds to purchase the deceased member's interest in both the LLC and the business, according to the terms of the agreement. Each purchaser is generally able to increase his or her basis in the business based on the purchase price.

Funding the Buy-Sell Purchase

Term Insurance: Short-term protection at lowest cost. Appropriate for short-term needs (presumably not including retirement) or for start-up businesses strapped for cash.

Universal Life Insurance: Maximum flexibility of premium and crediting choices. Good fit for cyclical businesses or where cash flow is unpredictable.

Whole Life Insurance: Strongest guarantees and most predictable cash accumulation. Little to no flexibility.

Disability Buy-Sell Insurance: Not to be overlooked.

Paying the Premium

The most common strategy is to have the business use earnings to fund the LLC as capital contributions. This means that the funds are taxable to the business owners before they even go to the LLC; however, the LLC capital contributions increase each owner's LLC basis.

Sometimes, owners can contribute existing insurance policies to the LLC as a capital contribution. This can happen when an owner is no longer insurable but owns some life insurance already.

Consult your tax specialist regarding the funding methods since the method selected will depend on a variety of tax and accounting issues.

The LLC Buy Sell advantages

- **Simple.** Just one policy per owner.
- **Stepped-up basis**. Because it's built on a cross-purchase structure, each owner may increase his/her cost basis by his or her share of the purchase price.
- **Transfer for value**. Adding new owners to the agreement or transferring policies among LLC members does not trigger a TFV trap. Under current law, transferring a life insurance policy, or portion thereof, to an LLC co-owner is an exception to the TFV rule.
- **No AMT**. The corporate AMT does not apply to an LLC
- **Creditor protection.** Creditors of the business generally cannot attack LLC assets and creditors of individual owners generally cannot attack LLC-owned life insurance.
- **Plan compliance.** The LLC owns the insurance and pays the premiums.

Exit Strategies

Retirement Buyout: The life insurance policy is transferred to the existing owner as part of the purchase price for his/her shares. The existing owner can then access the policy's cash value in retirement. If cash flow is properly structured, the policy remains in force while the income is received tax-free. If the cash values in the policy are insufficient to cover the full purchase price, the shortfall is often paid in installments from earnings or from a bank loan. In some cases, if the exiting owner is the majority owner and the purchase price is high, the purchasers may access cash value from multiple policies. After the buyout, the remaining LLC owners can either go forward with the existing LLC agreement or the LLC can be wrapped-up and terminated, in which case the policies are distributed to each insured and should not result in any immediate taxation.

Death

Life insurance proceeds are paid to the LLC, which owns the policy, income tax-free. The LLC distributes the proceeds to the surviving owners income tax-free. The LLC members then complete the purchase of both the LLC and underlying business interests from the deceased owner's heirs.

Afterwards, the LLC can be continued, new owners may be added, or the LLC can be terminated. If terminated, existing policies are distributed to the insureds as a tax-free return of basis and not considered a transfer-for-value.

There's more to know, of course; but a good, experienced, and qualified independent advisor can bring all the right resources and advanced experts to the table in helping you craft the solution that's right for your business.

For more information

Visit the IFG website at **indfin.com/business.**

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Jim has been providing independent private client wealth management services since 1991.

Jim founded, built, and sold five successful businesses in the 1970s and has been a headline speaker at more than 500 conventions throughout the United States, Canada, and the U.K. for companies like Hearst, CapCities/ABC, Media General, Foster Grant, Hobie Cat, and scores of others. Articles by or about Jim have appeared in more than twenty-five publications nationally and he's also been interviewed for American Airlines' *Sky Radio*.

Jim is a *CERTIFIED FINANCIAL PLANNER®* (CFP®) professional and has also been awarded the *ACCREDITED INVESTMENT FIDUCIARY®* designation from the Center for Fiduciary Studies in association with the Joseph M. Katz Graduate School of Business at the University of Pittsburgh. His articles on fiduciary issues have also appeared in The Profit Sharing Council of America's *Insights* and *The Journal of Compensation & Benefits.*

Jim grew up in Chillicothe, Ohio and Alexandria, Virginia; graduated from Emory & Henry College (Virginia) with a degree in economics; and served in Vietnam with the U.S. Army before beginning his business career in California. He makes his home in the Mountain Meadows section of Moorpark.

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