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TAX & TRANSACTIONS BULLETIN

Volume 19 Winter, 2008

Properly Structured Buy-Sell Agreement Can Minimize Income and Estate Taxes

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- The state-of-the-art technique is a Cross Purchase using a limited liability company (LLC)
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Properly Structured Buy-Sell Agreement Can Minimize Income and Estate Taxes

Business owners typically use a Buy-Sell Agreement to accomplish several important goals. First, upon the death of an owner the Buy-Sell Arrangement will provide the surviving owners with continued control of the business. Second, the Agreement is often funded with life insurance to create a liquid cash payout for the family of the deceased owner. Third, the Agreement may assist in creating a ceiling in the value of the business for estate tax purposes.

A Buy-Sell Agreement is often structured as a Cross Purchase (rather than as a Redemption). In a Cross Purchase the surviving owners buy the corporate Stock from the deceased owner's estate. The Cross Purchase Buyout enables the surviving owners to: (1) receive the insurance proceeds income tax free; (2) take a stepped-up Tax Basis in their purchased Stock; and (3) avoid estate tax on the insurance proceeds.[1]

To obtain the best possible economic and tax result, careful planning is essential to a proper Buy-Sell Agreement. The state-of-the-art technique is a Cross Purchase using a limited liability company (LLC).[2] In Private Letter Ruling (PLR) 200747002, the IRS approved a Cross-Purchase Arrangement using an LLC. The Ruling involved three (3) individuals who were shareholders of an S corporation. Each shareholder owned term life insurance policies on the lives of the other shareholders. Each shareholder contributed her policies to the LLC.[3] Each shareholder became of a Member of the LLC.

The LLC had special provisions to facilitate the Cross Purchase. First, the Buy-Sell Agreement specifically authorized creation of the LLC. Second, each shareholder was required to sign an agreement instructing the LLC Manager to disburse the policy proceeds according to the Buy-Sell Agreement. Third, the LLC was formally designated as owner and beneficiary of each policy. Fourth, management of the LLC was vested in the Managers (and not in the members).[4] Fifth, a national Bank acted as

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[1]Contrarily, a Redemption Agreement, where the business entity effects the buyout, has distinct disadvantages including: (a) the Redemption structure may trigger the "Transfer for Value" rules, resulting in income taxation of the life insurance proceeds; (b) Life Insurance proceeds owned by the business entity may be subject to Estate Tax at the owner's death due to attribution; (c) C Corporations are subject to an additional Alternative Minimum Tax on their receipt of life insurance proceeds; (d) the Redemption distribution impairs the entity's capital pool, especially if the insurance proceeds only represent a down payment on the buyout; (e) a Redemption can be recast by the IRS and taxed as a dividend at ordinary income rates instead of favorable capital gains (although the 15% tax on qualified dividends may reduce this last risk).
[2]The LLC is treated as a partnership for federal tax purposes.
[3]Prior to the transfer of the policies to LLC, each shareholder did not have any incidents of ownership in the policies that insured his life (since these policies were owned by the other shareholders).
[4]Thus, the LLC was "Manager-managed."

initial Manager of LLC.[5] Sixth, the LLC Operating Agreement stated that in no event may a Member whose life is insured under any of the policies have any right to vote on the LLC's exercise of incidents of ownership with respect to any of the polices.[6] Seventh, each Member was required to make contributions to the LLC equal to the premium on the insurance policies contributed by the Member (i.e. equal to the premiums on the lives of the other Members). Each contribution was allocated to the Member's capital account. Each Member had a separate capital account for each policy.[7] Eighth, on the death of an insured Member, the proceeds of the policies are allocated to the capital account of the Member who contributed the policy (or that Member's assignee).[8] The LLC then distributes the proceeds of the policy to the Members in proportion to their respective capital accounts maintained with respect to that policy. However, such distribution will be made only if the Manager determines that all obligations have been satisfied or are assured to be satisfied with respect to the policy under the Buy-Sell Agreement.

In PLR 200747002, the IRS ruled that the Shareholders (i.e. the Members) do not possess any incidents of ownership under Code Section 2042 with respect to any of the LLC policies.[9] Thus, PLR 200747002 (together with prior Rulings) provides a method for structuring a Cross Purchase that has the following Major Advantages:

1. The LLC Arrangement is exempt from the "Transfer for Value" rules.[10]

2. The LLC Arrangement allows the surviving Shareholders to receive the insurance proceeds income-tax free.[11]

3. The LLC Arrangement allows a deceased Shareholder to exclude from his taxable estate the proceeds of the policies on his life.

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[5]By naming a Bank as Manager of the LLC, the arrangement effectively resembled an irrevocable life insurance trust with a corporate trustee. The members had the ability to remove or select a replacement Manager by majority vote of the members, provided that any replacement must be a corporate trustee or an individual who is bonded and who is not a related or subordinate party (as defined under section 672(e) of the Internal Revenue Code) with respect to the members or their assignees.

[6]Thus, the LLC Operating Agreement prohibited the Members from voting on any matter relating to any life insurance policy.

[7]Each Member also had a separate Percentage Interest for each policy.

[8]Thus, on the death of an insured Member, the proceeds of the policies are allocated to the capital accounts of the other Members. (This occurs because each Member originally contributed solely policies on the lives of the other Members. The LLC thus functioned as a continuation of the prior arrangement in which each Shareholder owned a policy on the life of all other Shareholders).

[9]A deceased Member would therefore exclude from his taxable estate the proceeds of the policies on his life. However, that deceased Member must include the value of his LLC Interest in his taxable estate. Although PLR 200747002 does not address this issue, the value of a deceased Member's LLC Interest appears to be his capital account in the policies on the other Member's lives. In the case of the first (1st) Member to die, his capital account in the policies on the other Member's lives would be merely the unexpired value of prepaid term insurance (i.e. typically a nominal value). In the case of the second (2nd) Member (or any subsequent Member) to die, his capital account in the policies on the other Member's lives would be (i) the unexpired value of prepaid term insurance on the surviving Members plus (ii) either the cash proceeds allocable to or received by that 2nd Member from the earlier death of a prior (1st) Member, or the corporate stock received by that 2nd Member pursuant to his purchase thereof pursuant to the Buy-Sell Agreement. In summary, PLR 200747002 appears to exclude from each Shareholder's taxable estate all life insurance proceeds, except for (i) the nominal value of existing term policies and (ii) the cash proceeds received (or corporate stock purchased) under the Buy-Sell Agreement due to the prior death of a Shareholder. **Note:** With further planning, it may be possible to also exclude from each Shareholder's taxable estate both (i) the nominal value of existing term policies and (ii) the cash proceeds received (or corporate stock purchased) under the Buy-Sell Agreement due to the prior death of a Shareholder. To exclude both of these amounts, a Parent (or possibly a Spouse) of a Shareholder establishes an Irrevocable GST Exempt Trust f/b/o that Shareholder. The Shareholder is Trustee and a Beneficiary of Trust, may make distributions pursuant to an ascertainable "support" standard, and has a limited power of appointment. Therefore, the Trust is permanently excluded from estate tax. The Trust is structured so that Shareholder is treated as "owner" of the Trust under the Grantor Trust rules. The Trust becomes a Member of the LLC and makes premium contributions to LLC. Upon the death of an insured Member, Trust receives its prorata portion of the insurance death benefits, which Trust uses to purchase corporate stock. The Trust permanently excludes from estate tax that purchased stock and Trust's capital account in LLC. Although the Shareholder/Trustee/Beneficiary has relinquished outright control and ownership of the purchased stock, he still exercises a good degree of control over that purchased stock in his capacity as Trustee of Trust. PLR 200747002 describes this technique.

[10]See Private Letter Ruling (PLR) 9309021.

[11]See Private Letter Ruling (PLR) 9309021.

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4. The LLC Arrangement, when combined with an Irrevocable GST Exempt Grantor Trust f/b/o Shareholder,[12] allows a deceased Shareholder to also exclude from his taxable estate both (i) the nominal value of existing term policies and (ii) the cash proceeds received (or corporate stock purchased) under the Buy-Sell Agreement due to the prior death of another Shareholder.

5. The LLC Arrangement permits the surviving Shareholders to obtain a Stepped-Up Tax Basis in their purchased Stock.

6. The LLC Arrangement protects the Insurance Proceeds from creditors, since creditors of a Shareholder generally cannot pierce the LLC and prevent monies from being distributed to the estate of the deceased Shareholder.

7. The LLC Arrangement protects the Insurance Proceeds from intra-Shareholder disputes, since the Corporate Manager acts impartially.

8. The LLC Arrangement may reduce administrative costs in situations where the LLC initially applies for the policies, since only one (1) policy is needed for each Shareholder.

9. The LLC Arrangement avoids the potential pitfalls inherent in a Redemption Agreement.

Ultimately, these IRS Rulings help Business Owners to implement a Buy-Sell Agreement with minimal income tax liability, minimal estate tax liability, and minimal creditor liability. The LLC is currently the entity-of-choice to accomplish these Goals. Upon the death of an Owner, the cash insurance proceeds are collected by the LLC. The LLC then distributes the cash proceeds to the surviving Owners, who are required to use that cash to purchase the Stock in the business from the estate of the deceased owner at an agreed price. The Final Result is that the deceased owner's family receives a cash buyout, and the surviving Owners control and own all Stock in the business.

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[12] The mechanics of establishing this Irrevocable GST Exempt Grantor Trust f/b/o Shareholder are as follows: The Shareholder's Parent, acting as Grantor, creates an irrevocable trust for the benefit of Shareholder/Child. The Shareholder/Child is trustee of trust and, in his capacity as trustee, may distribute trust income and principal to himself, his spouse, and his descendants, based on an ascertainable "support" standard. Shareholder/Child has the right to withdraw the full amount of each direct or indirect transfer to trust that constitutes a completed gift under Code Section 2511, provided that Shareholder/Child's withdrawal power lapses at the end of each year to the extent that the lapse would not constitute the release of a general power of appointment under Code Section 2514. At Shareholder/Child's death, the trust assets are distributed pursuant to Shareholder/Child's exercise of a limited power of appointment. In PLR 200747002, the IRS held that Shareholder/Child will be treated as the owner of trust for federal income tax purposes, under the Grantor Trust rules of Code Sections 678 and 677. Thus, trust is a Grantor Trust owned by Shareholder/Child. For a trust which is a member of the LLC, Grantor Trust treatment is essential to (i) avoid the "Transfer for Value rules," and (ii) allow trust to receive the insurance proceeds income-tax free upon the death of another Shareholder. *See PLR 9309021.* This planning technique, which utilizes the Irrevocable GST Exempt Grantor Trust f/b/o Shareholder, permanently excludes from such Shareholder's taxable estate all of the following: (i) the proceeds of the policies on such Shareholder's life; (ii) the nominal value of existing term policies on the remaining Shareholder's lives; and (iii) the cash proceeds received (or corporate stock purchased) under the Buy-Sell Agreement due to the prior death of other Shareholders. By using this planning technique, the *only* item included in Shareholder's taxable estate would be the corporate stock he originally owned when the Buy-Sell Agreement was established. The Shareholder would have to establish a Gift Program to remove this stock from his taxable estate. **Note:** In the event Shareholder's Parent is unavailable, then it is possible that Shareholder's Spouse could (as Grantor) establish the Irrevocable GST Exempt Grantor Trust f/b/o Shareholder.

IRS Disallows Loss Where Individual Sells Stock and Causes her IRA to Purchase Identical Stock

The IRS has applied the Wash Sale Rules[13] to a situation where an individual taxpayer sells depreciated securities for a loss, and then causes her Traditional IRA (or Roth IRA) to purchase identical securities within thirty (30)[14] days. Effectively, the IRS is treating an individual and her IRA as the same taxpayer for purposes of the Wash Sale Rules. The IRS took this position in Revenue Ruling 2008-5, issued on December 20, 2007.

The Wash Sale Rules prevent the tax deduction of a paper loss, where there is no corresponding economic loss. For example, assume an individual owns 10 shares of Company A Stock which she purchased for $100 and which has a current value of $40. If she sells her 10 shares for $40, and immediately repurchases 10 new shares of Company A Stock for $40, then, in the absence of the Wash Sale Rules, she would be entitled to a capital loss of $60 *even though she has no economic loss.*

Under the Wash Sale Rules, the cost basis of the purchased securities is the sum of their cost and the loss barred by Section 1091 on the sale.[15] The disallowed loss can therefore be deducted when the taxpayer's investment ultimately is closed by selling the purchased securities. Thus, the Wash Sale Rules merely defer recognition of losses, rather than permanently disallowing them.

In Revenue Ruling 2008-5, however, the IRS both disallowed the loss on the sale of stock, and stated that the taxpayer's basis in her IRA Account was not increased by the disallowed loss. Thus, the individual taxpayer in Revenue Ruling 2008-5 suffered permanent disallowance of the tax loss. The IRS is likely concerned that in a situation involving a Wash Sale with an IRA, the practical effect of permitting an increased basis in the IRA is to eliminate future ordinary income tax when the IRA makes a distribution. Elimination of ordinary income tax may provide significantly greater benefits to a Taxpayer than mere deferral of a capital loss, which is the result in a Wash Sale not involving an IRA. In the absence of the IRS' position in Revenue Ruling 2008-5, a taxpayer might intentionally engage in a Wash Sale and reinvest in her IRA, in order to convert a capital loss into tax-exempt income.[16]

Example 1: Application of the Wash Sale Rules to an Individual's IRA. *An Individual owns 100 shares of X Company stock with a basis of $1,000. On December 20, 2007, the Individual sells the 100 shares of X Company stock for $600 (the "Sale"). On December 21, 2007, the Individual causes a Traditional IRA (or a Roth IRA), established for the exclusive benefit of that Individual (or her beneficiaries), to purchase 100 shares of X Company stock for its then fair market value (the "Purchase"). The Individual executes the Sale and the Purchase with different, unrelated market participants. The Individual is not a dealer in stock or securities. Held: The loss on the Sale of stock is disallowed under Code Section 1091. The Individual's basis in the Traditional IRA (or Roth IRA) is not increased by virtue of Code Section 1091(d).*

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[13] See Code Section 1091.
[14] The Wash Sale Rules of Code Section 1091 provide that loss on a sale of securities may not be deducted if the taxpayer acquires, or enters into a contract or option to acquire, substantially identical securities within the period beginning 30 days before the sale and ending 30 days after the sale.
[15] See Code Section 1091(d).
[16] Possibly the Tax Court would disagree with the IRS' position in Revenue Ruling 2008-5 that cost basis in the IRA is not increased by the disallowed loss. By permanently disallowing the loss, IRS appears to "punish" the taxpayer and to create an inequity in the tax measurement system.

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