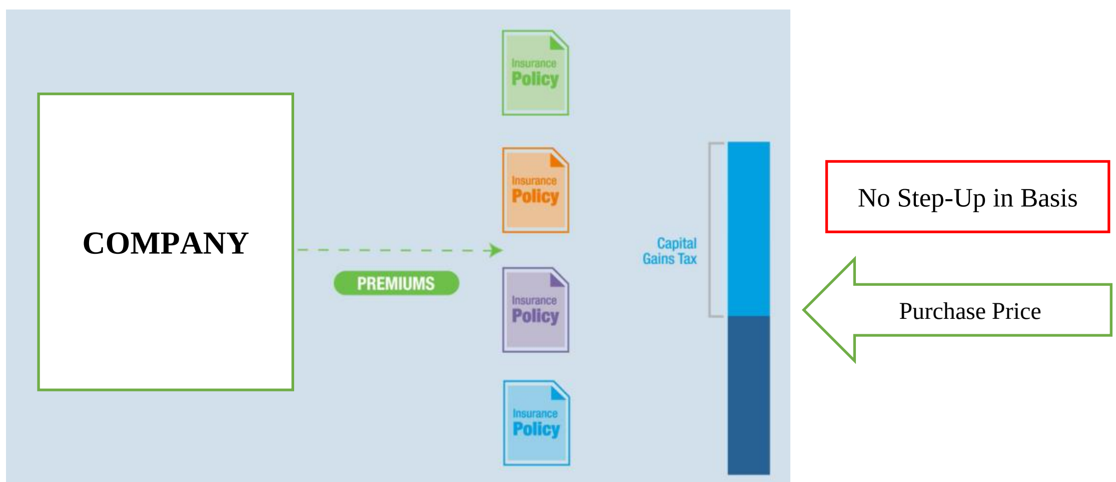
LIFE INSURANCE POLICIES COVERING MEMBERS

Life insurance covering Members provides liquidity upon the passing of a Member and benefits the Company and the Member's family. The Membership Interest of a deceased Member may be purchased in one of the following manners, which may be established in the Operating Agreement or in separate Buy-Sell Agreements with each Member.

1) REDEMPTION AGREEMENT
2) CROSS-PURCHASE AGREEMENT
3) INSURANCE LIMITED LIABILITY COMPANY

1) **REDEMPTION AGREEMENT** (Also known as a Company Buy-Back Agreement or an Entity Purchase Agreement)



<u>Characteristics of a Redemption Agreement</u>

- The Company owns and is the beneficiary of life insurance policies covering Members
- Life Insurance proceeds fund the Company's purchase of the available Membership Interest
- If a Member passes, the Company redeems the Membership Interest directly from the estate
- Members agree in advance that their estate will transfer their interest back to the Company
- If there is coverage above the value of the Membership Interest, proceeds go to the family

<u>Advantages of a Redemption Agreement</u>

1) Only one policy per Member is needed so costs less to implement.

2) Premium costs are allocated among Members in relation to their pro-rata share of Membership Interest.

3) Since life insurance policies are owned by the Company, benefits are beyond the reach of the deceased's creditors and are not includible in the Member's estate.

4) If a Member leaves the Company, policies on the remaining Members are not disrupted, as is the case in a cross-purchase.

<u>Disadvantages of a Redemption Agreement</u>

1) There is no step-up in cost basis to the surviving Member's Membership Interest upon the owner's death, so surviving Members will incur larger capital gain taxes.

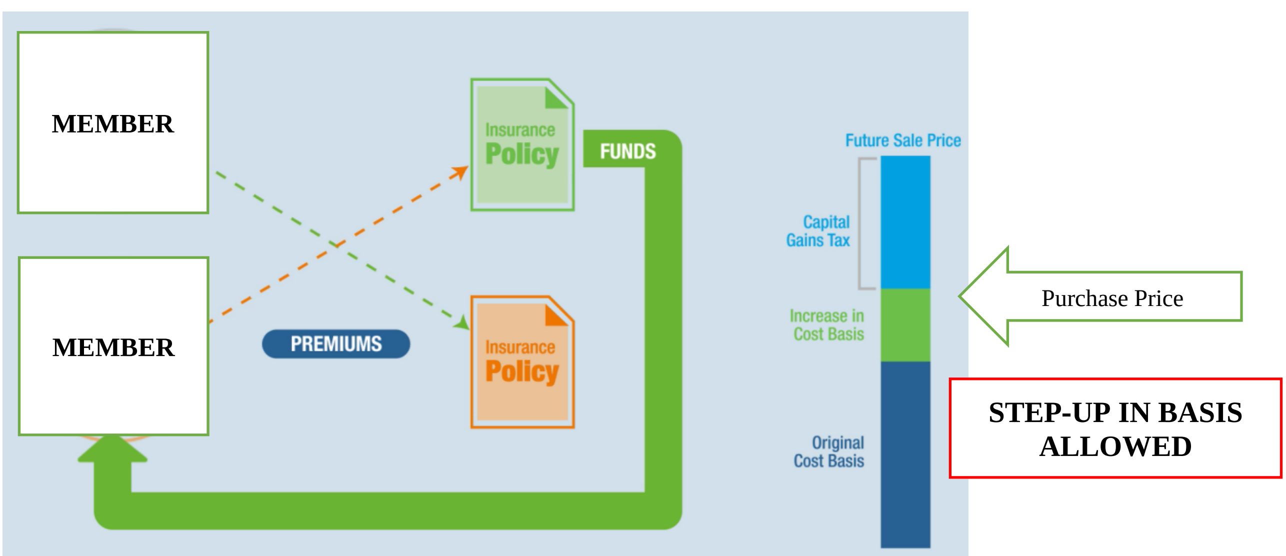
2) Insurance policies are subject to attachment by the Company's creditors.

3) If Company-owned insurance policies are over-funded to provide non-qualified retirement benefits to Members, the benefits are generally subject to income tax.

4) Company must obtain consent from the Member before the issuance on any policy. Failing to obtain consents could cause insurance proceeds to be subject to income tax, including proceeds that are otherwise received income tax free. Additional reporting is also required.

- <u>Step-Up in Basis Defined</u>: The increase of the value of an appreciated asset for tax purposes, to the higher market value of the asset at the time of the inheritance. When a beneficiary receives an asset, the value is generally higher than when the owner acquired the asset. The asset receives a step-up in basis causing the capital gains taxes for the beneficiary to be minimized.

2) CROSS-PURCHASE AGREEMENT



<u>Characteristics of a Cross-Purchase Agreement</u>

- Each Member owns a life insurance policy on each of the other owners
- The Members own and are the beneficiary of life insurance policies covering Members
- Life Insurance proceeds fund the Members' purchase of the available Membership Interest
- If a Member passes, the Members redeem the Membership Interest directly from the estate
- Members agree in advance that their estate will transfer their interest back to other Members
- If there is coverage above the value of the Membership Interest, proceeds go to the family

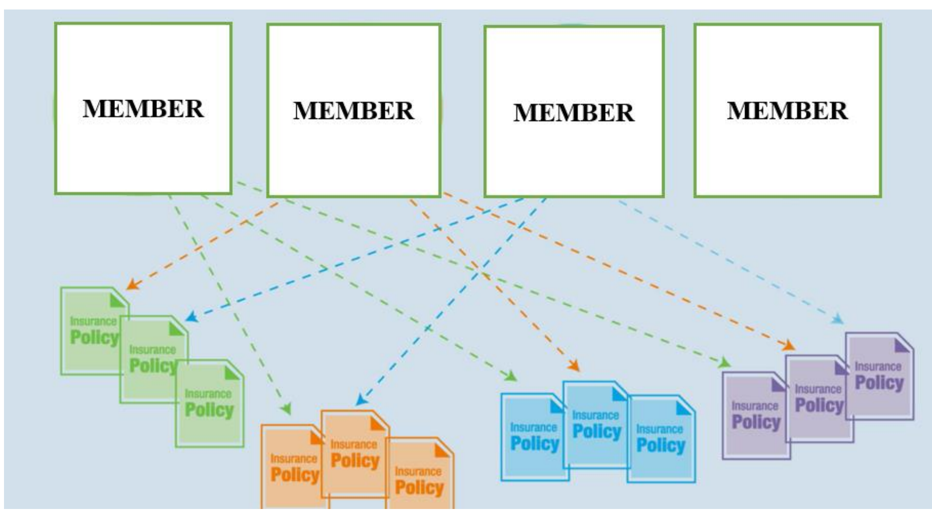
<u>Advantages of a Cross-Purchase Agreement</u>

1) Purchaser received a "step-up" in basis for amount of purchase price.

2) Capital gains tax due only on the increase from a sales price above the purchase price.

<u>Disadvantages</u>

1) Each Member must own a policy on each other Member, which becomes unwieldy if there are numerous Members.

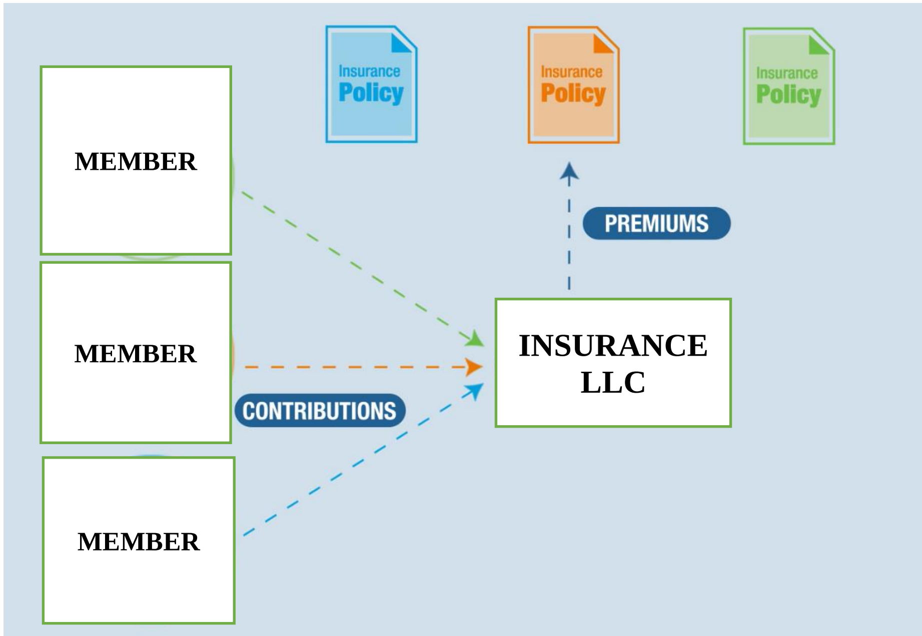


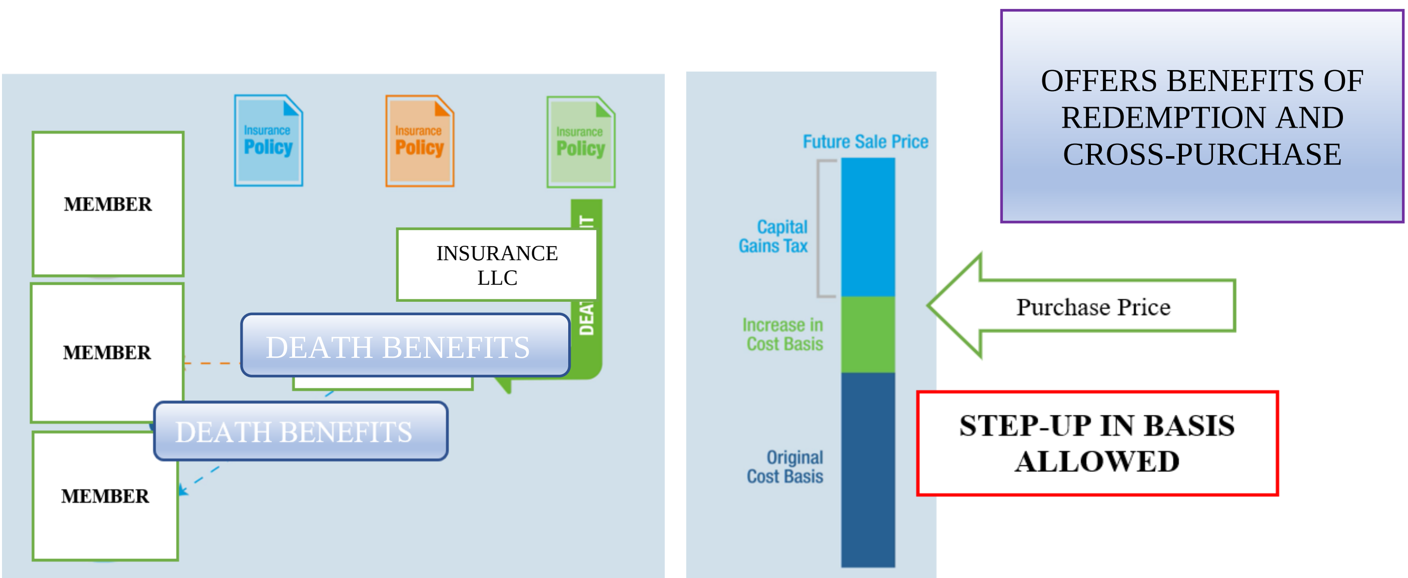
TOO MANY POLICIES

2) A Member may fail to pay premiums or refuse to pay death benefits.

3) Life insurance policies are included in the deceased Member's estate for estate tax purposes.

3) BUY-SELL AGREEMENT USING AN INSURANCE LLC





Using an Insurance Limited Liability Company to own life insurance covering Members was recently approved by the IRS and offers the advantages of a Redemption Agreement and a Cross-Purchase Agreement without many of the disadvantages. Since all the policies will be held by the insurance LLC and not the individual owners, the insurance LLC provides centralized management and creditor protection for the policies and avoids estate tax inclusion for its owners.

Characteristics of an Insurance LLC

1) Ownership of an Insurance LLC should mirror the ownership of the Company.

2) The Insurance LLC must be managed by an independent Manager that is not a Member to ensure that Members are not deemed to have retained incidents of ownership, which would cause estate tax inclusion of death benefits upon a Member's death.

3) Members must make annual capital contributions to the LLC sufficient to enable the LLC to pay premiums.

4) Capital contributions made by a Member are credited to that Member's Capital Account.

5) Capital contributions are not required to be equal between the Members.

6) The contribution amount of each Member may be determined by the amount of death benefit required by each Member to satisfy their purchase obligations under the Buy-Sell Agreement.

7) The Members' operating Company can make the capital contribution payments directly to the LLC and allocate the contributions to each Member as income.

8) The LLC will not have any income tax liability if all contributions are used to make premium payments.

9) If a Member passes, the Manager allocates proceeds to the Members to fund the purchase of available Membership Interest.

10) If a Member passes, proceeds are allocated to the Capital Accounts of the surviving Members in the proportions necessary to allow each Member to fulfill his/her purchase obligation under the terms of the Buy-Sell Agreement.

Advantages of an Insurance LLC

1) Requires only one policy per owner.

2) Purchaser receives a step-up in cost basis.

3) Common ownership of insurance policies makes premium payments easier.

4) Ensures all policies are kept in force and avoids the possibility of one Member dropping coverage on another Member.

5) Creditors of one Member cannot reach the assets of the LLC.

6) Life insurance ownership is separate from the Company.

7) Members cannot vote on life insurance matters.

8) Manager must use life insurance proceeds as required in the Buy-Sell Agreement.

9) The LLC must maintain a capital account for each Member, with special allocations of premiums and proceeds.

10) The IRS ruled that the life insurance death proceeds are not part of the estate of the deceased Member subject to estate tax inclusion.

11) An unused death benefit can be distributed income tax free to the Members.

12) If a Members wants to retire or sell their Membership Interest, their life insurance policy may be transferred tax free to the remaining Members as part of the purchase price. Remaining Members can access the cash value of policy.