NexGen
INSURANCE STRATEGIES

Tax Issues in Buy-Sell Agreements for LLCs with Unequal Ownership

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For LLCs taxed as partnerships, buy-sell agreements involving unequal ownership interests create heightened income tax, basis, and valuation risks. These risks are often magnified when life insurance is used as the funding mechanism, making CPA involvement critical at the design stage.

Key CPA Considerations

1. Transaction Structure. The choice between a cross-purchase and an entity redemption directly impacts basis outcomes and long-term tax efficiency—particularly when ownership is unequal.

2. Life Insurance Funding. Policy ownership, premium payments, and beneficiary designations must reflect economic reality to avoid constructive distributions, compensation income, or gift exposure.

3. Valuation Discipline. Buy-sell pricing mechanisms should be reviewed regularly to ensure alignment with fair market value and capital accounts.

Redemption vs. Cross-Purchase: Tax Comparison

Feature	Cross-Purchase	Entity Redemption
Who Buys Interest	Remaining Member	LLC
Basis Step-Up	Yes (Outside Basis)	No (Absent §754)
§754 Election Impact	Often Less Critical	Frequently Essential
Life Insurance Proceeds	Received Tax-Free by Member	Increase LLC Capital
Unequal Ownership Risk	Lower	Higher (Value Shifts)

§754 Watch-Out
When an LLC redemption is funded with life insurance and no §754 election is in place, remaining members may inherit built-in gain attributable to the departing member—even though insurance proceeds were received income-tax free. This mismatch frequently surprises clients and undermines the perceived benefit of the buy-sell plan.

Illustrative Life Insurance Funding (Cross-Purchase)

Member A (70%)	Pays Premiums	Owns Policy on Member B
	↓	
Life Insurance Policy	Death Benefit	Tax-Free Proceeds
	↓	
Purchase of LLC Interest	Basis Step-Up	Economic Alignment

CPA Takeaway

For LLCs with unequal ownership interests, buy-sell agreements should be reviewed as integrated tax and risk-management arrangements. Early CPA involvement—particularly around §754 elections, valuation methodology, and insurance funding—can prevent economically sound plans from producing unintended tax outcomes.