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Abstract: *The use of a general partnership to fund a buy-sell arrangement (i.e., a LifeCycle buy-sell) combines the benefits of the traditional stock redemption and cross purchase methods of planning for business continuation. It requires only one life insurance policy per owner, avoids the corporate alternative minimum tax, and provides a full basis increase to surviving owners. In addition, the use of a general partnership provides several other benefits that cannot be had from either the standard cross purchase or stock redemption type buy-sell arrangements.*

Small businesses are the principal source of income for their owners and their families during working years and in retirement. The businesses are usually illiquid and often make up the majority of the taxable estates of the owners. Consequently, a business continuation plan or buy-sell agreement is critical for the owners' retirement and estate planning. It is equally critical that the buy-sell agreement be funded to provide the intended results. Life insurance is considered one of the most effective funding vehicles because a relatively small sum of money—the premium—provides the full amount necessary to fulfill a buyout obligation under the buy-sell agreement tax free to the surviving owners. Starting with this premise, this article focuses on the issues and planning alternatives surrounding the use of life insurance as a funding vehicle for buy-sell agreements. The issues considered include whether the life insurance policies that fund the buy-sell agreement can also provide additional nonqualified retirement benefits for owners and how the various planning alternatives affect this combined use of the policies.

Traditional Planning Techniques

Corporate Funding

Traditional buy-sell planning involves choosing to purchase either corporate-owned life insurance to fund a stock redemption buy-sell agreement or individually owned policies to fund a cross purchase or wait-and-see type buy-sell agreement.

Stock Redemption or Entity Purchase. With the stock redemption buy-sell (or entity purchase if not for a corporation), the corporation agrees to redeem the shares of a deceased shareholder, and the shareholder agrees that he or she (or his or her estate) will transfer the shares back to the corporation in return for an agreed price or for a price based on a formula. This arrangement has the advantage of just one life insurance policy per owner, all owned and controlled by the corporation. The premium costs are allocated to the owners according to their respective percentage ownership interests. Corporate ownership of the policies means that any policy cash values are subject to attachment by the corporation's creditors. Upon the death of an owner, the complete redemption of the decedent's shares eliminates his or her pro rata share of corporate earnings and profits.[1]

The redemption causes the percentage ownership interest of the surviving shareholders to increase pro rata, which could result in an unintended party gaining control of the business. In addition, with C corporations, the death proceeds may also be subject to the alternative minimum tax (AMT).[2] The surviving owners will not see any increase in their income tax bases as a result of the buy-out of a deceased shareholder because it is the corporation that actually purchases the shares. Even with a flow through entity, this approach can result in a less than full basis step-up for the surviving owners to the extent that part of the insurance proceeds are allocated to the deceased shareholder's interest in the entity. Note that the deceased shareholder does not need the basis step-up because the estate will receive a basis step-up to full fair market value as property acquired from a decedent.[3]

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Finally, if corporate-owned buy-sell policies are over-funded to provide nonqualified retirement benefits to the owners, the benefits are generally taxable as salary continuation payments. Consequently, any tax-deferred gains within the policies — cash value in excess of premiums paid —are converted to taxable income when paid out to a retired owner.

Cross Purchase. Largely because of the AMT and loss of basis step-up issues, many advisers now recommend cross purchase buy-sell agreements, particularly for C corporations. With a cross purchase or wait-and-see buy-sell agreement, each owner owns a policy on each of the other owners. This avoids corporate AMT because the policies are not owned by the corporation. Furthermore, since the individuals own the policies and receive the tax-free death benefit, they are in a position to get a full basis step-up either by buying the stock directly from the decedent's estate or by contributing it as capital to the corporation if the stock redemption alternative is chosen under a wait-and-see buy-sell agreement.

Cross purchase buy-sell agreements are not without their drawbacks, however. With cross purchase funding, the premium burden is allocated based on the cost of insurance on the other owners. The result is that the youngest and healthiest owners will pay more than their proportionate share of the premiums since they own the policies on the older, less healthy owners. Conversely, the older, less healthy owners will pay proportionately less for the policies they own covering the younger, healthier owners. This situation is often a point of contention because the younger, healthier owners often believe paying proportionately more is unfair while the older, less healthy owners may believe it is fair because the younger, healthier owners are more likely to get the death benefit and end up owning the company. Since each owner must own a policy on all other owners, multiple policies are required if there are more than two owners. The number of policies required can be computed by multiplying the number of owners by the number of owners minus one. For example, a company with four owners requires 12 policies [4 x (4 - 1) = 12]. If cross purchase policies are over-funded for the purpose of retirement accumulations, then the exchange of policies (so the insured owns his or her own policy in retirement) triggers the recognition of gain in the policies — the amount of the tax-deferred build-up within the life insurance policies gets converted into taxable income.

Special Alternatives

OPPO Trust. Some planners have suggested that a trust could be used to avoid the drawbacks of cross purchase funding. The so-called OPPO trust (One Policy Per Owner) is intriguing because it eliminates the problems of multiple policies and unequal premium burdens. However, the OPPO trust poses potential problems under the transfer-for-value rule.[4] One potential transfer-for-value rule violation flows from the recognition that the owners, as beneficiaries of the trust, are the beneficial owners of the life insurance policies owned by the trust. Obviously, cross purchase buy-sell funding cannot be accomplished by having each owner purchase a life insurance policy on himself or herself with the other owner or owners named as beneficiaries of the policy. Because this would represent a transfer of an interest in the policies (i.e., the death benefit) in exchange for the other owners entering into the buy-sell agreement, it would clearly violate the transfer-for-value rule and cause the death benefit to be taxed as ordinary income. With an OPPO trust, each owner is a beneficial owner of a proportionate share of his or her own policy and effectively, through the trust agreement, names the other owners as beneficiaries of the policy.

The second and perhaps greater potential transfer-for-value rule violation comes where there are more than two owners and one owner dies. In that case, through the trust agreement, the beneficial interests in the policies on the survivors — which were owned by the decedent through the trust—transfer to just the surviving owners. It is this transfer that may make the death benefits taxable under the transfer-for-value rule.

Triple Split Dollar. As an alternative to the OPPO trust, some commentators have proposed what is referred to as triple split dollar.[5] It is pitched as a simpler alternative to the OPPO trust. Like the OPPO trust, the idea is to position ownership of the life insurance policies in a manner that will avoid AMT and secure a basis step-up for the surviving shareholders. With triple split dollar, each shareholder owns the policy that insures his or her life. Each shareholder enters into a collateral assignment agreement with the company. In addition, to make the policy's death benefit available to the surviving shareholders to effectuate the buy-sell agreement, each shareholder endorses the death benefit of his or her policy to the other shareholders. The problem: this endorsement is a transfer-for-value, and a co-shareholder is not an exception to the transfer-for-value rule. Thus, before the surviving co-owners can use the death benefit to buy the deceased shareholder's shares, a significant amount of the proceeds will be subject to income tax.[6] Accordingly, triple split dollar will work only when the business entity is either a partnership or an LLC.

LifeCycle Buy-Sell. The LifeCycle buy-sell introduces a general partnership into an otherwise standard corporate buy-sell arrangement. It avoids the transfer-for-value rule by utilizing

...the partnership-funded buy-sell provides several other benefits that the corporate cross purchase and stock redemption type buy-sell plans do not...

a general partnership to hold the policies that insure the lives of the co-shareholders. Each shareholder is a partner in the partnership. On the death of a shareholder, the death benefit is received income tax free. It is specially allocated to the surviving shareholders, which increases their basis in the partnership. This type of allocation allows for an income tax-free withdrawal of the proceeds by the surviving shareholders, so they can buy the decedent's shares.

One of the most positive attributes of the LifeCycle buy-sell is the ability of the partnership to distribute the policy insuring the life of a retiring shareholder. The retired partner can use the policy in any manner he or she chooses as though he or she had owned the policy from the start and paid the premium with after-tax dollars. The retiring shareholder will have a basis in his or her share of the partnership. They can take income tax-free withdrawals to this basis and then switch to loans to supplement their retirement income.

The LifeCycle buy-sell provides all these benefits without the complexity of multiple split dollar agreements and without subjecting the death benefit proceeds to the income tax. For these reasons, the LifeCycle buy-sell is a planning device that is superior to the OPPO trust and triple split dollar.

Partnership Funding

As stated above, using partnerships to own life insurance to fund corporate buy-sell agreements resolves the problems raised by the OPPO trust and triple split dollar. With a partnership, the benefits of both stock redemption and cross purchase methods are available, without the drawbacks of either method. In addition, the partnership-funded buy-sell provides several other benefits that the corporate cross purchase and stock redemption type buy-sell plans do not, including:

1. The ability to transfer life insurance policies funding the arrangement to a departing owner/insured without the receipt being taxable income to the owner/insured and without recognizing any gain within the policy from cash values exceeding the sum of the premiums;
2. Complete flexibility in allocating the premium burden among the owners;
3. Allowing surviving owners to effectively distribute corporate surplus to themselves tax-free as part of the buyout; and
4. Allowing owners/insureds to accumulate significant dollars on a tax-favored basis, safe from corporate creditors, to supplement their retirement incomes.

The Benefits of Partnership Funding

Using a partnership to own the life insurance has many advantages. Only one policy is required per owner. Because a partnership in which the insured is a partner is a statutory exemption to the transfer-for-value rule,[7] the OPPO trust and triple split dollar concerns explained above are eliminated. A partnership is not subject to the corporate AMT. Policy cash values are outside the reach of corporate creditors. The partnership entity also provides a certain amount of protection from the individual owners' creditors, depending upon state law. Creditor protection makes the partnership an attractive vehicle for accumulating additional dollars toward retirement. The policies can be removed from the partnership tax-free,[8] which means tax-deferred build-up in the life insurance can be provided to a retiring owner tax-free. These benefits to the individual business owners can motivate them to actually execute and fund the buy-sell agreement.

These added benefits also typically spur the business owners to adequately fund the policies relative to the death benefit. Adequately funded policies are beneficial because they are less likely to lapse; they also provide more flexibility in that premiums in many policies can be skipped during bad years or premiums may be stopped altogether at some point in time. An adequately funded policy often will have an increasing death benefit in the future, potentially matching growth in business value.

Also, since mortality charges in life insurance policies are assessed only on the net amount at risk — that is, the difference between the cash value and the death benefit — more cash value actually reduces the total mortality charges within level death benefit policies. Since the policies can be given to a retiring owner, he or she can access the cash value of the policy, tax-free, during retirement. This benefit presents tax-planning opportunities during retirement by making tax-free funds available for high tax years, which allows balancing between taxable and tax-free retirement income to reach the maximum tax planning efficiency.

Additional benefits to using the partnership are that one partnership can fund for several other entities and that the premium burden can be allocated among the business owners as desired. The death benefit is received as tax-exempt income under Internal Revenue Code Section 702. It can be specially allocated, affording only the capital accounts of the surviving owners a distributive share, which increases each surviving owner's basis to the same extent under Code Section 705(a)(1)(B). The partnership can also be used to hold other business assets outside of the corporation for additional flexibility and creditor protection. For example, real estate expected to appreciate in value is often held outside of C corporations.

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Importance of Business Purpose

Some commentators have questioned whether a partnership created solely for the purpose of owning life insurance to fund a buy-sell agreement for another entity is a partnership for tax purposes.[9] The issue is whether the purpose of facilitating a business continuation plan for a related entity constitutes an adequate business purpose under partnership law. Although currently the IRS will not issue advance rulings on this issue,[10] a review of the statutory and case law defining partnerships for tax purposes, as well as the non-tax business reasons for utilizing a partnership leads to the conclusion that such a partnership does meet the business purpose requirement.

A partnership for federal tax purposes is "broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships."[11] It does not matter whether state law does or does not classify a venture as a partnership.[12] Accordingly, for federal tax purposes, the appropriate analysis begins with reviewing the applicable sections of the Internal Revenue Code. Under Code Sections 7701(a)(2) and 761(a), a partnership is defined as "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title a trust or estate or a corporation."[13]

It is well settled that the mere conjunction of co-ownership and the derivation of income from property will not be enough to establish partnership status. Treasury Regulation § 301.7701-1(a)(2) indicates that the crucial factor distinguishing a mere tenancy in common from a partnership is the active pursuit of a business. The Regulation states: "[M]ere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for tax purposes." Tenants in common, however, may be partners if they actively "carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent."[14] Accordingly, the extent to which co-ownership is merely passive, as opposed to active, is a critical fact. The most prominent distinction between passive and active co-ownership is whether individuals, or their appointed agent, undertake all of the duties and responsibilities of managing and handling the entity's assets.

In Revenue Ruling 75-374,[15] the Service ruled that taxpayers were passive co-owners of property when the taxpayers — a life insurance company and a real estate investment trust, each with an undivided one-half interest in an apartment project — hired an unrelated management corporation to provide all tenant services, customary and non-customary. The management company provided the tenant services and retained the profits earned thereby, with no obligation to share the profits with the taxpayers. There was no indication that the management company shared the risk of gain or loss in the development.

This Revenue Ruling stands for the proposition that co-owners who do not actively handle and manage the assets and affairs of their entity, either in their own capacity or through an agent, but instead hire an unrelated person or entity that does not share in the risk of gain or loss, have not formed a bona fide partnership. The IRS noted that if the owners had rendered the tenant services themselves, or through a management company acting as their appointed agent, their co-ownership would have been classified as a partnership.

Such was the case in *Bergford v. Commissioner*.[16] Several individuals invested in an arrangement that owned and leased computer equipment. They attempted to *avoid* partnership classification by analogizing their ownership of the computers to that of co-tenants as described in Revenue Ruling 75-374. Like the taxpayers in 75-374, they had hired a management company to handle and manage all assets and affairs of the entity. In rejecting the analogy, the Ninth Circuit Court of Appeals aptly pointed out that, although a management company was technically hired, it was not simply an unrelated independent contractor, but in fact a partner. Under the "management agreement," the manager clearly shared the risk of gain or loss in the entity, and none of the individuals could withdraw from the entity, or assign their interest in it, without the manager's consent. Accordingly, the Ninth Circuit Court of Appeals concluded that the manager was, in fact, a managing co-partner.

Accordingly, actively carrying on a trade, business, or financial operation means that the participants either take it upon themselves, or appoint a co-partner, to manage and handle the assets and affairs of the entity. This is true even if the business or financial operation does not engage in selling or leasing products, or in providing services to outside parties. It is also true if the entity only holds intangible financial assets as opposed to tangible personal property or real property.

For example, in *Wadel v. Commissioner*,[17] five individuals contributed funds for the purpose of investing in securities pursuant to the recommendations of a specified investment service. They executed a document setting out the terms of their arrangement

...an organization engaged solely in investment activities that does not make the election under the Regulations would be considered a partnership.

and naming one of the individuals as "trustee" to operate and manage the venture. The *only* activity was buying and selling securities and collecting dividends and interest on the securities. A partnership return was filed reporting ordinary income and capital gains from the venture, but capital losses were reported separately by the individuals. The court applied the exact same definition of "partnership" as was subsequently applied in Revenue Ruling 75-374, *Bergford*, and certain private letter rulings (discussed next): "The term 'partnership' includes a syndicate, group, pool, joint venture, or other incorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation."[18] The court held that the arrangement was a valid partnership, noting that all participants had made capital contributions of cash for the purpose of buying, selling, and dealing in securities, and that all management responsibilities would be undertaken by one of the participants. *Wadel* is not the only case where individuals that formed investment clubs *solely* to invest in securities — and whose income was derived solely from dividends, interest, and gains from security sales — were deemed to have formed a valid partnership.[19]

Additional support for the proposition that an entity formed only for investment purposes may constitute a valid partnership is found in Internal Revenue Code Section 761(a), in which a partnership is defined as an unincorporated organization through which a business or financial operation is carried on. Significantly, this Code Section also states that such an organization "availed of for investment purposes only and not for the active conduct of a business" can elect, under the provisions of the Regulations, to be excluded from the application of the partnership provisions of the Code. The clear implication of the provision is that an organization engaged solely in investment activities that does not make the election under the Regulations[20] would be considered a partnership. If this were not so, there would be no need to provide for its "election out" of the partnership provisions.[21]

The final version of Treasury Regulation § 1.701-2[22] also supports the position that holding an investment portfolio constitutes a business. This anti-abuse provision provides that each partnership transaction must be entered into for a "substantial business purpose" but gives no specific indication of the meaning of that phrase. The Regulation, however, provides that the intent of Subchapter K is to permit taxpayers to "conduct joint business (including investment) activities." Significantly, the parenthetical phrase was not included in the Proposed Regulations, but was included in the final version.

Finally, two private rulings are — or appear to be — directly on point.[23] In Private Letter Ruling 90-42-023, a majority shareholder formed a general partnership under the state's Uniform Partnership Act, and the shareholder's corporation transferred its life insurance policies on the shareholder's life to the newly formed partnership for valuable consideration. Although the Service noted that the partnership "has associates and an objective to carry on business and divide gains therefrom," the facts only indicate that the partnership was newly formed and simply funded with life insurance. The Service ruled that a valid partnership existed under Code Section 7701(a)(2). The ruling did not elaborate on the partnership's business activity, beyond the limited remarks cited above. In another ruling, however, the Service did elaborate on the business purpose of a remarkably similar arrangement.

In Private Letter Ruling 93-09-021, the Service reviewed a set of facts in which a partnership was formed under the state's Uniform Partnership Act for the purpose of funding a cross purchase buy-sell arrangement. The ruling involved two taxpayers who planned to create a partnership to purchase corporate-owned life insurance policies on their lives. After the purchase, the partnership would own the policies, make itself the beneficiary, and pay all the premiums. The taxpayer stated that the business purpose of the arrangement was to facilitate a cross-purchase agreement for the corporate stock in the event of death. The purpose of the partnership was to "engage in the purchase and acquisition of life insurance policies on the lives of the partners." The handling and management of the life insurance policies was not delegated to an unrelated party for hire, as the taxpayers did in Revenue Ruling 75-374. The Service specifically noted that "...the management and authority of [the partnership] is equally vested in each of the partners" and the "[p]artnership will have ownership rights in the Policies and will manage a portfolio of insurance policies."[24] Based on these facts, the Service held that the entity constituted a partnership for tax purposes under Code Section 7701(a)(2).

Accordingly, the applicable regulations, code sections, and case law give ample support to individuals who utilize a general partnership to manage and handle variable life insurance policies to fund a business succession plan. Business owners who use a partnership to hold policies that fund a business succession plan do not merely create a simple trust arrangement, joint venture, or cotenancy. Unlike a trust,[25] it is contemplated that they will undertake the duties of managing and handling the assets of the partnership and not delegate such duties to a trustee. Unlike a simple joint venture or co-tenancy, theirs is a long-term venture not lim-

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ited to a single event.[26] Like the taxpayer in Bergford, "...the economic benefits to the individual participants [are] not derivative of their co-ownership of the [partnership's assets], but rather come from their joint relationship toward a common goal."[27] To the extent the partnership is established to hold the policies that are the centerpiece of the co-partners' business continuation plan, they are unmistakably engaged in a long-term venture.

To reinforce these points, a written partnership agreement should clearly note the purpose of the life insurance policies and state the partners' profit motive as it relates to the investment features of the life insurance policies. The agreement should articulate the partners' intent to join their assets and to generate and share the partnership's profits in order to, among other things, ensure the continuous operation and continuity of their corporation and to provide retirement accumulations similar to an investment partnership. The partnership agreement should also include the various restrictions that are customary in partnerships: all participants should agree to relinquish their right to deal with the policy on their life, or any other policy owned by the partnership, as a separate owner by waiving partition rights and agreeing not to encumber the policies without the unanimous consent of the co-partners. Assuming these measures are taken and the formalities of the partnership entity are observed, clients and tax planners may employ this technique with minimal tax risk.

Structuring the Partnership-Funded Buy-Sell

The Corporate Buy-Sell. The corporate buy-sell agreement that controls the transfer of corporate shares is the starting point. For maximum flexibility, the agreement should give the surviving owners the option of using either stock redemption or cross purchase, depending on which is most advantageous when a death occurs. The parties to the agreement are the corporation itself and all shareholders. The agreement restricts the transfer of stock in the corporation and requires a restrictive legend on the share certificates. The agreement is written to postpone the decision of whether an actual buy-out will be done through cross purchase or stock redemption until the death of a shareholder. This agreement is accomplished by giving the first option to purchase shares of a deceased shareholder to the surviving shareholders. If, or to the extent that, the surviving shareholders do not purchase all the stock of a deceased shareholder, the corporation is obligated to redeem such shares.

The order of the purchase options is extremely important for tax purposes. The ultimate obligation to purchase shares of a deceased shareholder must fall on the corporation to avoid having the stock redemption option be treated as a dividend to the surviving shareholders. If the agreement instead provides that the ultimate burden to purchase the shares of a deceased shareholder falls on the surviving shareholders, and the stock redemption option is chosen, the redemption by the corporation would fulfill an obligation of the shareholders to purchase the shares. In that case, the IRS could successfully argue that the payment of the proceeds to the deceased shareholder's estate by the corporation is on behalf of the surviving shareholders who have the obligation to purchase the shares, making the payment a dividend distribution to the surviving shareholders.[28] This result is avoided as long as the ultimate liability to purchase the shares falls on the corporation.

At the death of a shareholder, the surviving shareholders can accomplish the stock redemption buy-out by loaning or contributing the life insurance proceeds to the corporation instead of purchasing the shares directly from the estate of a deceased shareholder. The corporation can then use the proceeds to redeem the decedent's shares. The redemption option should be chosen only if it will be treated as a complete redemption of all shares owned by the decedent's estate or if the redemption qualifies under Code Section 303.[29] If the decedent's estate is considered to own any stock other than the deceased shareholder's shares under the attribution rules,[30] then the stock redemption option should be utilized only if, and to the extent that, the distribution is treated as a payment in exchange for the stock under Section 303. If, or to the extent that, Section 303 does not apply, then the cross purchase option will be utilized when the attribution rules present a problem.

The option to use the stock redemption approach is included for those situations in which there are earnings and profits to be eliminated or the surviving shareholders wish to remove surplus from the corporation. In the case of earnings and profits, the complete redemption of a decedent's shares eliminates his or her pro rata share of the corporate earnings and profits.[31] Cash surplus can be removed from the corporation by simply using the surplus to effect the stock redemption, allowing the surviving shareholders to keep all or part of the life insurance death benefits. The effect is that corporate surplus is utilized, and the surviving shareholders end up with more cash from the retained death benefits. Since the surviving shareholders receive their cash from the life insurance, there is no distribution of surplus to the surviving shareholders that could be taxed as dividends. In effect, a tax-free distribution of surplus is accomplished.

The Partnership Buy-Sell. The next step is for the shareholders to form a partnership to be the owner and beneficiary of life insurance on each shareholder. The partnership

...the amount of the premium bonus allocated to a partner is also the amount of the deemed contribution of capital to the partnership.

agreement states that its business purpose is to provide corporate business continuation and also accumulate additional money to enhance the partners' retirement income. The partnership agreement should further provide that upon the death of a partner, his or her interest is transferred to the partnership. In exchange, the partnership will pay the deceased partner's estate or heirs an amount equal to the deceased partner's share of the total partnership value, including his or her share of the total cash value of all policies, immediately before his or her death. Finally, the partnership agreement must provide that any life insurance death benefit received by the partnership will be "specially allocated" to just the surviving partners.[32]

The Amount of Life Insurance. There are two factors to consider when determining how much life insurance to buy; how much is needed to fund the corporate buy-sell agreement; and whether the cash value represented by a particular partner's partnership interest will grow into a significant asset. This determination is important because, at death, the partnership needs to have sufficient cash to buy the deceased partner's partnership interest (consisting of his or her share of the total cash value immediately before death) and to distribute enough out to the survivors to fulfill the obligations under the corporate buy-sell agreement. Consequently, the death benefit should increase approximately as fast as the cash value.

The Premiums. The premiums on the life insurance will usually be paid by the corporation for the benefit of the shareholder/employees. The payments are typically characterized as bonuses, similar to a Code Section 162 executive bonus arrangement. Since the policies are owned by the partnership, the premiums are treated as contributions of capital by the partner to the partnership. The amount of the total premium bonus allocated to each individual partner is determined by the partnership agreement. The amount allocated to any particular partner does not need to correspond to the premium on the policy insuring that partner. In fact, it is usually tied to the amount of premium the particular partner would have to pay if he or she owned policies on the other shareholders under a cross purchase arrangement or a percentage of the total premium equal to the partner's percentage interest in the corporation.

The allocation of the premium burden among the partners is important if they intend to accumulate cash values for retirement in the life insurance. This allocation is important because the amount of the premium bonus allocated to a partner is also the amount of the deemed contribution of capital to the partnership. The partners' capital contribution is the basis for determining what portion of the total partnership value — basically the cash value of all policies owned by the partnership — will be paid for a partner's partnership interest at death or retirement. The "special allocation" only affects the death benefit received by the partnership and not the ownership of the cash values or any other assets owned by the partnership.

For example, assume A, B, and C each own one-third of a corporation and are equal partners in the funding partnership. Assume further that the premiums necessary to insure A, B, and C are $14,000, $9,000, and $7,000, respectively. The partners may agree to allocate the total $30,000 premium equally — $10,000 to each. If the corporation pays the premium, each owner will have $10,000 of taxable income, and the corporation will have a $30,000 income tax deduction. The partners will each have a $10,000 deemed contribution of capital to the partnership each year. If, at the end of ten years, the policies have $130,000, $110,000, and $90,000, respectively, of cash value (for a total of $330,000), each partner will have an interest in the partnership worth $110,000.

The Death Benefits. Life insurance death benefits received by the partnership are income tax-free.[33] The proceeds are part of the partners' distributive share as tax-exempt income.[34] The partners' basis in their partnership interest increases by their distributive share of the tax-exempt income.[35] Distributions from the partnership to a partner are generally nontaxable as long as the cash distributed does not exceed the partner's basis in his or her partnership interest.[36] Consequently, it is important that the death benefit be allocated only to the surviving partners so that they get the full basis increase under Section 705(a)(1)(B). This allocation will enable the surviving partners to distribute the death benefit to themselves tax-free, providing the funds necessary to effect the corporate buyout provisions. It will also keep any fraction of the death benefit out of the insured's estate, provided the partnership agreement strictly prohibits any partner from exercising any control over the policy insuring his or her life, or from retaining any negative powers over the policy.[37] The deceased partner's basis is stepped up to fair market value at death so his or her estate has no need for the basis increase.[38]

When the life insurance proceeds come into the partnership, the deceased partner's interest in the partnership will first be purchased by the partnership in accordance with the partnership buy-sell provisions. Then the remaining proceeds are paid to the surviving partners/shareholders so the obligation to purchase or redeem the decedent's corporate shares under the buy-sell agreement can be fulfilled.

Retirement of a Partner. Upon the termination of a partner's interest in the partnership, the policy insuring the partner may be distributed to him or

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her in exchange for the partner's interest in the partnership. If the cash value of the policy does not equal the partner's share of the total partnership cash value, adjustments may be made prior to the distribution. The adjustment can be accomplished by withdrawing cash from the policy or policies with excess cash and depositing it into the policy or policies short on cash value. Such transfers are not taxable (assuming no policies are modified endowment contracts) and do not affect the partners' basis or "outside" partnership basis.

The transfer of the policy to the departing partner is exempt from the transfer-for-value rule because the transfer is to the insured.[39] There will be no gain or loss to the departing partner regardless of whether the value of the policy is more or less than the departing partner's adjusted basis in his or her partnership interest.[40] Similarly, there will be no gain or loss recognized by the partnership regardless of the relationship of the sum of the premiums to the cash value.[41]

The departing partner will take the policy with a basis equal to the departing partner's adjusted basis in his or her partnership interest immediately before the distribution.[42] This amount will most likely be different from the sum of the premiums paid on the policy. Usually, the basis will be the sum of the premium bonuses allocated to the departing partner over the period in which he or she was a partner.

Conclusion

Using a partnership to fund a corporate buy-sell arrangement avoids having to make the tradeoffs inherent between the cross purchase and the stock redemption buy-sell arrangements while providing additional benefits. It allows flexibility to customize the design to fit the particular business situation as well as enabling the policies to be used to accumulate additional retirement dollars, safe from corporate creditors. The purposes of providing business continuity and planning for retirement of the owners should be considered sufficient to provide substance to the partnership. Consequently, planners should feel safe in availing themselves of the benefits of a partnership-funded buy-sell knowing that many of the reasons for doing so are not exclusively tax motivated.
(I/R Code No. 1400.00/1450.00)

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(1) I.R.C. §312.
(2) I.R.C. §55.
(3) I.R.C. §1014.
(4) I.R.C. §101(a)(2).
(5) *See* B. D. Schneider and D. E. Steichen, *Triple Spilt Dollar Buy-Sell: A New Funding Alternative for Corporations,* J. Am. Soc'y CLU & ChFC, Mar. 1998, at 86.
(6) Treas. Reg. §1.101-1(b)(4) supports this conclusion.
(7) I.R.C. §101(a)(2)(B).
(8) I.R.C. §731.
(9) *See* A. Kupferberg and R. M. Wolf, *Transferring Life Insurance Policies to a New Partnership*, Est. Plan., Nov./Dec./1993, at 340; V. S. Levy, *The Life Insurance Partnership: A Promising Solution to Transferring Life Insurance Policies from a Corporation*, J. Am. Soc'y CLU & ChFC, Jan. 1994, at 64.
(10) Rev. Proc. 96-12, 1996-1 C.B. 616. This revenue procedure, published January 12, 1996, says the Service will currently not issue any further advance rulings on whether, in connection with a transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership or (ii) the transfer of a life insurance policy to the organization will be exempt from the transfer-for-value rule, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the partners. The revenue procedure does not say that the IRS finds the practice abusive or that the entities should not be considered partnerships. In private conversations with IRS officials about the revenue procedure that one of the authors is aware of, IRS officials stated that they had been receiving too many requests and that they wanted to review the matter further before issuing any further rulings. The fact that the IRS was about to publish the proposed "check-the-box" regulations (published May 13, 1996, PS-43-95, 61 Fed. Reg. 21989), which ultimately became final, may be part of the reason the Service decided to suspend issuance of advance rulings on the subject.
(11) Treas. Reg. §1.761-1(a); see also McManus v. Commissioner, 583 F.2d 443, 447 (9th Cir. 1978), cert. denied, 440 U.S. 959, 99 S.Ct. 1501, 59 L.Ed.2d 773 (1979).
(12) Estate of Kahn v. Commissioner, 499 F.2d 1186, 1189 (2d Cir. 1974).
(13) I.R.C. §7701(a)(2). Entity classification regulations that were finalized in December 1996 add a degree of certainty to this area. Generally, the regulations permit an unincorporated entity (an "eligible entity") to elect how it wants to be classified for federal tax purposes. An organization will generally be considered an entity separate from its owners if the participants carry on a trade or business from which they divide the profits. Treas. Reg. §301.7701-1(a)(2). If the organization is considered separate from its owners and has at least two owners, Treas. Reg. §301.7701-3(a) provides that it can elect to be classified as either a partnership or an association taxable as a corporation. If it does not make an election, it will automatically be classified as a partnership.

(14) Treas. Reg. §301-7701-1(a)(2).
(15) 1975-2 C.B. 261 (1975).
(16) 12 F.3d 166 (9th Cir. 1993).
(17) 44 B.T.A. 1042 (1941).
(18) *Id.*, at 1045.
(19) *See* Rev. Rul. 75-523, 1975-2 C.B. 257 ("Under §761 of the Code a partnership may be availed for investment purposes only, and need not be engaged in the active conduct of a business"); *see also* Rev. Rul. 75-525, 1975-2 C.B.350.
(20) Treas. Reg. §1.761-2
(21) *See*, Madison Gas and Elec. v. Commissioner, 72 TC 521 (1979), *aff'd*, 633 F2d 512 (7th Cir. 1980).
(22) Issued Dec. 10, 1994, published in the Fed. Reg., Jan. 3, 1995.
(23) While a private letter ruling cannot be relied upon as precedent by anyone other than the taxpayer who applied for it, it does indicate that the IRS considers funding of a buy-sell arrangement to be a valid business purpose.
(24) Priv. Ltr. Rul. 93-09-021 (Mar. 5, 1993). Accordingly, parties should avoid funding the partnership with term or fixed products because these carry no responsibility to manage or handle subaccounts. The same is true if the partnership is funded with split dollar life insurance and the sponsoring corporation receives a "full policy rights" collateral assignment as opposed to a "no-policy rights" collateral assignment.
(25) Trust beneficiaries do not control, manage, and handle the assets of a trust, a trustee does. If beneficiaries did exercise such control, the entity would be treated as a partnership. *See*, Wadel v. Commissioner, 44 B.T.A. 1042 (1941); *see also*, Morrissey v. Commissioner, 296 U.S. 344 (1935) (holding that a trust that carried on a business and divided the profits among its "beneficiaries" was in fact an "association" taxable as a corporation under the predecessor to §7701(a)(3)). The fact that the court deemed the association to be a corporation as opposed to a partnership is of no moment because the requirement that an entity carry on business and divide gains therefrom is a prerequisite for treatment as a corporation or partnership. Treas. Regs. §301.7701-2(a); *see also*, Priv. Ltr. Rul. 93-09-021, *supra* note 22.
(26) The sole distinction between a "joint venture" and a "partnership" is that the former usually relates to a single project rather than the kind of continuing business relationship typical of a partnership. *See* Long v. Commissioner, 77 T.C. 1045 (1981); Podell v. Commissioner, 55 T.C. 429, 431 (1970).
(27) *Bergford*, 12 F.3d 166, 169 (9th Cir. 1993).
(28) *See* Daniel Gerson v. Commissioner, 56 T.C.M. (CCH) 1202 (1989).
(29) *See* I.R.C. §303, dealing with corporate distributions in partial or full redemption of stock to pay death taxes.
(30) I.R.C. §318.
(31) I.R.C. §312.
(32) I.R.C. §704(a)
(33) I.R.C. §101(a)
(34) I.R.C. §702.
(35) I.R.C. §705(a)(1)(B).
(36) I.R.C. §731.
(37) *See* Rev. Rul. 75-70, 1975-1, C.B. 301; see also Estate of Frank H. Knipp, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. (in buy-sell arrangement where partnership owns a life insurance policy on a decedent-partner, partnership's incidents of ownership not attributed to insured partner).
(38) I.R.C. §1014.
(39) I.R.C. §101(a)(2)(B).
(40) I.R.C. §731(a). Under 731(a) gain is recognized to the extent the amount of *money* distributed exceeds the partner's basis in his partnership interest. A distribution of *property* from a partnership to its partners, however, generally results in no gain or loss recognition to the partnership or to the distributee partners.
(41) I.R.C. §731(b).
(42) I.R.C. §732(b).

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