The LifeCycle Buy-Sell Harmonizes Owners' Diverse Objectives

Funding a buy-sell arrangement via a general partnership avoids choosing between a cross purchase and a redemption agreement. This strategy also harmonizes the owners' business continuation, retirement, and estate planning goals.

WILLIAM S. WHITE, JAMES C. PETERSON, AND RICHARD S. LEVITZ, ATTORNEYS

The primary source of income for many small business owners and their families during working years and in retirement is the business itself. In addition, a small business is usually illiquid and often constitutes most of the owner's taxable estate. Designing a business continuation plan that considers these estate and retirement planning realities is a difficult task. Limitations posed by the traditional "cross-purchase" vs. "redemption" analysis don't make this planning any easier. This article analyzes a business continuation strategy that attempts to get beyond these limitations by using a general partnership as the centerpiece of a buy-sell arrangement (i.e., the LifeCycle buy-sell). This strategy enables advisors to:

- Structure a buy-sell arrangement to achieve maximum tax benefits and flexibility, and
- Extend the life insurance products that customarily fund buy-sells from one dimensional "death benefit" tools to valuable multidimensional assets that can also be used to provide a non-qualified retirement benefit to the insured owners, and be efficiently re-deployed in the future to complement and promote their estate planning objectives.

Traditional business continuation planning techniques

Traditional buy-sell planning typically involves choosing between a stock redemption, using life insurance owned by the corporation, or a cross purchase, using insurance owned by the business owners. Both techniques have advantages and disadvantages.

Stock redemption (entity purchase). Under a redemption arrangement, the corporation agrees to redeem the shares of a deceased shareholder at his death, and the shareholder agrees that his estate will transfer the shares back to the corporation for an agreed-upon price. An advantage of this arrangement is the simplicity of only one life insurance policy per owner. Premium costs are allocated to the owners according to their percentage ownership in the corporation.

The primary disadvantage of a redemption is the loss of the step-up in basis.[1] Thus, upon a lifetime liquidation of their interests, the surviving owners will owe a larger capital gains tax.

There are other disadvantages as well. Corporate ownership of the insurance policies means that any policy cash values are subject to attachment by the corporation's creditors. In addition, if the corporation is a C corporation, the death proceeds may also be subject

WILLIAM S. WHITE is an attorney with Securian Financial Network, Inc., a Minnesota Mutual Company, in St. Paul. He focuses on estate, business, and employee benefit planning. He is also a CLU. JAMES C. PETERSON is an attorney and President of WorthMark Financial Services, LLC, in St. Paul. His firm is a broker/dealer that specializes in helping non-insurance professional firms enter the financial products and services marketplace. He is also a CPA, CLU, and ChFC. RICHARD S. LEVITZ is an attorney and Executive Vice President in the Chicago office of GCG Financial, a full-service financial services firm. He is also a CLU and ChFC, and specializes in estate planning, retirement planning, business succession planning and executive compensation strategies.

to the alternative minimum tax (AMT).[2] Finally, if corporate-owned buy-sell policies are over-funded to provide non-qualified retirement benefits to the owners, the benefits are generally taxable. For the owner of a C corporation, distribution of the policy to the owner would be 100% taxable to the extent of the cash value. If the policy is not distributed and salary continuation payments are simply made from the cash value to the owner, those amounts would also be 100% taxable to the owner.

For an S corporation owner, the results are slightly better because the owner has some basis in the policy. Nevertheless, any tax-deferred gains within the policies (cash value in excess of premiums paid) would be converted to taxable income when paid to a retired owner or upon the distribution of the policy from the corporation to the owner.

Cross purchase. Due to the AMT exposure and loss of basis step-up that result from a redemption buy-sell, many advisors opt for a cross purchase buy-sell arrangement—particularly in the case of C corporations. Under a cross purchase arrangement, each surviving owner buys the deceased owner's stock directly from his estate. To fund this obligation, each owner typically owns an insurance policy on the life of each of the other owners, avoiding corporate AMT.

Because individuals own the policies and receive the income tax-free death benefit, they can obtain a full basis step-up by buying the stock directly from the decedent's estate. Hence, upon the ultimate liquidation of their ownership interest, they will have a higher basis that will reduce the resulting capital gains tax. Additionally, the common "wait-and-see" approach allows surviving owners to keep the insurance proceeds for themselves and use any retained corporate earnings to effectuate a redemption.

Like a redemption, a cross purchase also has drawbacks. The most obvious disadvantage is the number of policies required to accomplish the funding. Since each owner must own a policy on each other owner, multiple policies are required if there are more than two owners. The complexity of the paperwork and ongoing administration required as the number of policies increases can be daunting to business owners.

Another possible negative to a cross purchase is that the premium burden is allocated based on the cost of insurance of each other owner. The result is that the youngest and healthiest owners will pay more than their proportionate share of the premiums because they own the policies on the older, less healthy owners. Finally, if cross purchase policies are over-funded for the purpose of retirement accumulations, the exchange of policies—while avoiding the transfer-for-value rule—triggers the recognition of any built-in gain in the policies, making what would otherwise be tax-deferred income taxable.[3]

The OPPO trust. The "one policy per owner" (OPPO) trust (a.k.a. "escrowed" buy-sell) attempts to avoid the cross purchase drawbacks of unequal premium burdens and multiple policies by having the policies owned in a trust arrangement. The OPPO trust, however, poses potential problems under the transfer-for-value rule.[4] The first violation of the transfer-for-value rule emerges when 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 surviving owners (which were owned by the decedent through the trust) transfer to the other (uninsured) surviving owners. This transfer may cause the death benefits to be taxable under the transfer-for-value rule.

The second transfer-for-value problem stems from the fact that the business owners, as beneficiaries of the trust, are the beneficial owners of the insurance policies owned by the trust. Cross purchase buy-sell funding cannot be accomplished by having each owner purchase a life insurance policy on himself, with the other owner(s) named as beneficiaries of the policy, because that would be 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. This is clearly a violation of the transfer-for-value rule, and causes 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 own policy and effectively, through the trust agreement, names the other owners as beneficiaries of the policy. This presents yet another potential problem with respect to the transfer-for-value rule.

Triple split-dollar. As a simpler alternative to the OPPO trust, some practitioners have proposed what is referred to as "triple split-dollar."[5] Like the OPPO trust,

[1] Cash basis S corporations may, however, achieve significant basis step-up under a redemption arrangement, if the surviving shareholders agree to a "books and records" allocation and terminate the taxable year. See Section 1377(a)(2).

[2] Section 55.

[3] Sections 1001(a) and 1001(c).

[4] Section 101(a)(2).

[5] See "Triple Split Dollar Buy-Sell: A New Funding Alternative for Corporations," J. Am. Soc'y CLU & ChFC 86 (Mar. 1998).

the goal of triple split-dollar is to situate ownership of the insurance policies in a manner that will avoid the AMT and will secure a basis step-up for the surviving shareholders.

Under triple split-dollar, each shareholder owns the policy insuring his life. Each shareholder enters into a collateral assignment agreement with the corporation. Furthermore, to make the policy's death benefit available to the surviving shareholders to fulfill the buy-sell, each shareholder endorses the death benefit of his policy to the other shareholders. This endorsement is a transfer for value, and a transfer to a co-shareholder is not an exception to the transfer-for-value rule. Accordingly, a significant amount of the proceeds will be subject to income tax before the surviving co-owners can use the proceeds to buy the deceased shareholder's shares.[6] Consequently, triple split-dollar will work only when the business entity is a partnership or a limited liability company (LLC). Triple split-dollar, like every arrangement reviewed so far, is not capable of meeting the estate planning objective of deflecting the death benefit out of the owners' estates. This is something the BILIT attempts to facilitate.

The 'BILIT.' The BILIT (business irrevocable life insurance trust) uses irrevocable life insurance trusts (ILITs) as the centerpiece of the buy-sell arrangement.[7] This strategy calls for a cross purchase arrangement whereby the policies each owner maintains on the other owners are held in their own respective ILITs. This has the advantage of deflecting the death benefit payable on one owner's death into the surviving owners' irrevocable trust. The trustees then use the proceeds to purchase the decedent's stock. Each surviving owner's irrevocable trust becomes a co-owner of the business. On the next owner's death, however, the decedent will be required to sell to the survivor not only the stock he held personally at death, but also the stock that his irrevocable trust had previously purchased. The advantage of this approach is that it allows the owners to benefit from certain estate planning measures without frustrating their business continuation objectives.

There are three key disadvantages, though. First, the administrative inefficiency caused by the need for multiple policies on each owner is not avoided. Second, the policies may not be withdrawn from the arrangement without triggering taxation on cash value gains. Third, as in the case of any cross purchase arrangement, a deceased owner leaves a transfer-for-value problem in his wake. The BILIT is no exception. It calls for the policies owned by the deceased owner's irrevocable trust that insure the surviving owners to be "purchased" by each surviving owner's irrevocable trust. For example, assume there are three owners, A, B and C, and A dies. B's irrevocable trust, which already owns one policy on C, will buy another one from A's irrevocable trust, and C's irrevocable trust will similarly buy another policy on B's life. The death benefit on these two policies will then be taxed as ordinary income under the transfer-for-value rule.

Summary. When structuring a buy-sell arrangement—particularly one funded with life insurance—an advisor attempts to ensure that it encompasses as many positive features as possible. Chief among these are:

- Achieving a basis step-up for surviving owners.
- Allowing custom allocation of ownership among surviving owners.
- Avoiding AMT on the death benefit.
- Shielding the policy from business creditors.
- Shielding the policy from creditors of the individual owners.[8]
- Funding the arrangement with only one policy per owner.
- Avoiding income taxation of the death benefit under the transfer-for-value rule.

Neither the basic cross purchase or redemption arrangements, nor any enhancements under the OPPO trust, triple split-dollar or BILIT, offer every feature.

LifeCycle buy-sell

The LifeCycle buy-sell, however, embodies each of the above attributes, so that the dilemma of choosing between cross-purchase and redemption is avoided. The LifeCycle buy-sell simply involves establishing a general partnership to own and maintain the policies that fund the buy-sell arrangement. Each shareholder is a partner in the partnership. A partnership in which the insured is a partner is an exception to the transfer-for-value rule,[9] so the deficiency of the OPPO trust, triple split-dollar, and BILIT is avoided.

The death benefit is received as tax-exempt income under Section 702. It can be specially allocated, affording only the capital accounts of the surviving owners a distrib-

[6] Reg. 1.101-1(b)(4) supports this conclusion.

[7] See "Business Irrevocable Life Insurance Trust and Solving Inequities in Business Continuation Agreements," 140 Tr. & Est. 22 (July 2001).

utive share, which increases each surviving owner's basis to the same extent under Section 705(a)(1)(B). This allows an income tax-free withdrawal of the proceeds by the surviving shareholders (because they are deemed to be recovering basis) so they can buy the decedent's stock.

Moreover, interposing a general partnership permits a buy-sell arrangement to complement two other goals of a business owner—retirement planning and estate planning. As to retirement planning, the partnership gives the owners the incentive to accumulate cash values in their respective policies because the non-recognition rule of Section 731(a) allows them to withdraw their policies upon retirement without triggering taxation of cash value gains. With regard to estate planning, the partnership structure enables each owner to:

- Deflect from the survivor's estate the death benefit payable on a co-owner's death,
- Re-deploy the policy on the owner's life to an irrevocable trust upon retirement without concern about the three-year rule,[10] and
- Avoid estate inclusion of the death benefit payable on the owner's death under Section 2042.

The following analysis examines these retirement and estate planning opportunities.

Non-qualified benefits for the retiring owner

The non-qualified benefit stems from the fact that if an owner lives until retirement, he may withdraw his policy from the buy-sell arrangement (i.e., the partnership) and not trigger taxation of any gain in the policy's cash value due to the non-recognition rule that applies when appreciated property is withdrawn from a partnership.[11] Withdrawing a policy from a traditional cross-owned or redemption arrangement will trigger taxation of cash value exceeding basis under Sections 1001(a), 1001(c), and 311(b).

The transfer of the policy to the departing partner is exempt from the transfer-for-value rule because the transfer is to the insured.[12] In addition, 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 partnership interest (i.e., the policy can be distributed to the partner income tax-free).[13] Similarly, no gain or loss will be recognized by the partnership regardless of the relationship of the total premiums paid to the cash value.[14] If the cash value of the policy insuring the partner's life is less than his pro rata share of the total partnership cash value, adjustments may be made prior to the distribution of the policy.

The departing partner will take the policy with a basis equal to his adjusted basis in his partnership interest immediately before the distribution.[15] This amount will most likely be different from the sum of the premiums paid on that policy. Usually, the basis will be the sum of the premium bonuses allocated to the departing partner over the period he was a partner. Using withdrawals to basis and then loans, the partner can enjoy the typical tax treatment afforded a cash value life insurance policy. Hence, the policies inside the partnership can easily serve as accumulation vehicles for non-qualified benefits for the owners.

This non-qualified retirement benefit aspect of the LifeCycle buy-sell is not a substitute for a living buyout of the underlying corporation. The retiring shareholder/employee must still have his interest bought out under the corporate buy-sell. However, the LifeCycle buy-sell mitigates these circumstances in two important ways. First, the remaining partners have cash value in the remaining policies inside the partnership which they can tap for a living buyout (or at least a significant down payment). Second, if the shareholders agree up-front, the corporate buy-sell can provide for an extended payout on a living buyout.

Estate planning for surviving owner upon co-owner's death

Deflecting the death benefit out of the surviving owner's taxable estate results from the fact that a surviving owner can have the death benefit, which would otherwise be payable to him directly, be paid to an irrevocable trust he has established.[16] Assume there are three equal owners of a $3 million company—A, B, and C. A, B, and C establish a general partnership that owns a $1,100,000 life insurance policy on each of them, and each policy has $100,000 of cash surrender value. The owners each have 1,000 general partnership units. They each own 1,000 shares of the company (40 voting shares valued at $100,000, and 960 nonvoting shares valued at $900,000). On A's death, $550,000 of the $1,100,000 death benefit on his life will be specially allocated to B's capital account, and $550,000 will be specially allocated to C's

[8] If the partnership is structured as an LLC or limited partnership, each owner is afforded protection from the "charging order" regime.

[9] Section 101(a)(2)(B).

[10] Section 2035(a).

[11] See Section 731(a).

[12] Section 101(a)(2)(B).

[13] Section 731(a).

capital account. Allocation of this death benefit to their capital accounts will increase their basis in the partnership dollar-for-dollar. Thus, after the death benefit is paid, B and C would each use $50,000 of their allocable share of the death benefit to redeem A's partnership interest for $100,000, which is the date of death value of his 1,000 partnership units.

Thereafter, B and C would each withdraw from the partnership the $500,000 that remains in their capital accounts. Such a withdrawal would be deemed a recovery of their basis. Collectively, B and C would use this $1 million to purchase the 1,000 shares of company stock from A's estate. Afterward, B and C will each have acquired 20 additional voting shares from A (valued at $50,000) and 480 additional non-voting shares from A (valued at $450,000). The value of the business interests (i.e., in the company and the partnership) in B and C's estates will have increased by 50% from $1,100,000 to almost $1,600,000.

Assume, however, that one or both of them would have preferred to deflect their acquisition of the additional 480 non-voting shares from A out of their estates. With the partnership as the centerpiece of the buy-sell arrangement, B or C can easily accomplish this. Suppose that only B wants to take this estate planning measure. B has three options.

Option 1. B would establish a non-grantor, non-defective ILIT (a "complex" trust) for his heirs, and would give one general partnership unit to it. The trustee would become a party to the buy-sell agreement and would assume an obligation to buy the 480 non-voting shares of A or C.[17] Thereafter, A, B, and C—as general partners of the partnership—would cause the partnership to endorse $450,000 of the death benefit on the policy insuring A and C's lives to the irrevocable trust that B has established. This would be done using a simple endorsement split-dollar agreement.[18] Each year, B would need to make a gift to his trust equal to the term cost of the death benefit the trust will receive from the partnership on the lives of A and C under what amounts to a simple non-equity endorsement split-dollar arrangement.

Although endorsing the death benefit from the partnership to the irrevocable trust constitutes a transfer of life insurance for valuable consideration, the death benefit ultimately received by B's trust on A or C's deaths will not be taxed as ordinary income because it is a transfer for value to a partner of the insured—namely, B's trust.[19] The trust would use the proceeds to purchase the non-voting shares. On B's death, the trust would have an obligation to sell its shares. Those shares would be subject to the buy-sell agreement as evidenced by a recital on the face of each stock certificate. Consequently, the other owners would have the satisfaction of knowing that, although for estate planning reasons the shares of stock may be in places other than each owner's hands, the surviving owner(s) will be able to require all owners to sell the stock in accordance with the buy-sell. If A and C live to retirement and want to withdraw from the arrangement with their policies, the partnership will simply terminate the endorsement split-dollar agreement with B's ILIT.

Option 2. B would establish an irrevocable trust for his heirs. The trustee would become a party to the buy-sell agreement and would assume an obligation to buy the 480 non-voting shares from A or C. Thereafter, B would give 818 of his 1,000 general partnership units to this trust. The value of this gift will be $81,800. (The value of the assets of the partnership is $300,000 (the cash value of the three policies), and 818 units of the 3,000 units outstanding equals approximately 27% of this $300,000.) B would arguably be entitled to a discount. Each year, B would need to make a cash gift to his trust so that the trustee will be able to contribute its pro rata share of annual premiums.

Upon A or C's death, the death benefit would be specially allocated to the surviving partners in proportion to their ownership interests. For example, if A were to die, the $1,100,000 death benefit would be specially allocated as follows: C's 1,000 partnership units would entitle his capital account to $550,000, the trust's 818 units would entitle its capital account to $449,900, and B's 182 units would entitle his capital account to $100,100. After the allocations are made, the parties would use the proceeds to carry out their respective buyout obligations, and B achieves the estate planning goal of deflecting roughly $450,000 out of his estate with a gift of only $81,800.

---

[14] Section 731(b).

[15] Section 732(b).

[16] This avoids inclusion of the insurance proceeds in the survivor's estate, which allows the surviving owner's irrevocable trust to use the proceeds to buy out the decedent's interest.

[17] When dealing with an S corporation, the trust should contain special "qualified Subchapter S trust" or "electing small business trust" provisions. See Sections 1361(d)(3), 1361(c)(2)(A)(v), and 1361(e).

[18] This split-dollar arrangement, and any others referred to in this article, are non-equity type arrangements.

The main difference between Options 1 and 2 is the gift B must make to his trust to cover its required contribution. Under Option 1, the gift equals the term cost of the $450,000 death benefit on A and C's lives respectively. Under Option 2, the trust owes much more than this mere term cost. The trust owes approximately 27% of the partnership's annual premium payments. In return, however, B's trust will own a 27% share of the policies' cash values. The trust's ownership of this percentage of the partnership will, of course, hamper B's ability in the future to exit the arrangement and to acquire the policy on his life for retirement purposes. If this is a concern, B should consider Option 1 or, alternatively, Option 3.

Option 3. Option 3 is identical to Option 2 except that the partnership gives each partner a "limited policy rights" collateral assignment over the cash value of the policy on the partner's life. This accomplishes three things. First, it prevents the partner from acquiring incidents of ownership under Section 2042.[20] Second, it preserves as much as possible the partnership's management authority over the cash values of the policies, so the partnership's business purpose is not unnecessarily diminished, as would arguably be the case if all it owned was term insurance. Third, this strategy significantly reduces the value of the 818 partnership units B gives to his trust (which will result in deflecting $450,000 out of his estate on A or C's death) to approximately 27% of the mere term cost of the death benefit on the policies owned inside the partnership (assuming A and C are both 50, the approximate term cost would be only $810).

This also means that B's ability to exit the partnership upon retirement and to acquire the policy on his life for retirement purposes will not be hampered. Upon retirement, the partnership would simply distribute ownership of the policy on his life to him in satisfaction of his collateral assignment. Alternatively, if B wanted to redeploy the policy to serve estate planning needs, he could establish an ILIT and have the ILIT purchase the policy on his life from the partnership for the term cost of the existing coverage. B's trust, as purchaser, would take the policy subject to the limited policy rights collateral assignment that was in place in his favor. If the trust is a grantor trust, this measure would avoid any issues concerning transfer for value or the three-year rule.[21]

Estate planning issues for the deceased owner

The death benefit payable upon A's death will not be included in his estate because he does not have incidents of ownership in the policy under Section 2042.[22] Moreover, because none of the death benefit is allocated to the deceased partner's capital account, the value of his partnership interest will not reflect any of the death benefit. But let's consider why, under each of the three options above, the death benefit will not be included in the decedent's estate.

Continuing the example from above, assume A dies. Under Option 2 or 3 above, the policy on his life is clearly owned by and payable to the partnership. Accordingly, the $1,100,000 in proceeds will not be included in his estate under Section 2042, even if none of the death benefit payable on A's death is allocated to his capital account. Nevertheless, under Option 2, A's estate will receive $100,000 from the partnership liquidation of his 1,000 general partnership units. Under Option 3, his estate will receive a much smaller amount in liquidation of his 1,000 partnership units, as they represent only the term cost of the coverage on B and C. But this small amount received upon liquidation will be offset when A's estate receives approximately $100,000 in satisfaction of A's collateral assignment interest.

A would also avoid estate inclusion under Option 1. If life insurance owned by a partnership is payable to—or for the benefit of—the partnership, estate inclusion will not result under Section 2042. If the death benefit is payable to—or for the benefit of—the partnership, the deceased insured's allocable share of the death benefit will be included his estate to the extent it increases the value of his partnership interest. Forcing inclusion under Section 2042 would thus result in unwarranted double inclusion to this extent.[23]

Accordingly, if the partners agree to have the proceeds specially allocated or transferred so that the proceeds would not increase the value of the insured's interest (but rather have all the proceeds go to the objects of the insured's bounty), requiring estate inclusion under Section 2042 will not result in double inclusion. In this situation, estate inclusion under Section 2042 is clearly appropriate. However, a recent letter ruling recognized one situation where the part-

---

[19] See Section 101(a)(2)(B) and Ltr. Rul. 200120007 (focus on sale of Policy X2 to Trust 5).

[20] See, e.g., Ltr. Ruls. 9511046 and 9745019.

[21] See Ltr. Rul. 200120007.

ners may agree to direct the death proceeds so the proceeds will not increase the value of the decedent's estate, and estate inclusion will *not* result.

In Rev. Rul. 83-147,[24] proceeds of a life insurance policy owned by a partnership, but payable other than to or for the benefit of the partnership, were included in the deceased insured partner's estate. In this Ruling, the decedent's child was the beneficiary of the policy.

In Ltr. Rul. 200214028, the death benefit was not directed toward the object of the insured's bounty (as was the case in Rev. Rul. 83-147), but rather toward a purpose related to the partnership's business—namely, to the insured's surviving co-partners to help them fulfill a contractual obligation under a buy-sell agreement to purchase the insured's (1) partnership interest and (2) his stock in a company they also owned together. As a result, the Service ruled that Section 2042 inclusion would *not* result.

In Ltr. Rul. 200214028, the entire death benefit was directed toward the surviving co-partners indirectly through the amount their respective capital accounts received, and not directly to their trusts as transferees under an endorsement split-dollar agreement (as Option 1 entails). Nevertheless, the result of avoiding estate inclusion should be the same, because in either case the death benefit is being directed to advance the partnership's purpose of business succession (rather than being directed toward the insured's personal beneficiary).

So the mere fact that under Option 1, the partnership will not be the sole beneficiary of the proceeds shouldn't pose a problem. This is clearly a matter of substance over form—a maxim consistently observed by the Service. If merely naming the partnership as sole beneficiary of the proceeds avoided Section 2042, then the taxpayer in Rev. Rul. 83-147 could have avoided inclusion by changing the beneficiary to the partnership, gifting a small partnership interest to his son, and causing the partnership to specially allocate the death benefit to his son's capital account. Although the technical *form* in which the death benefit is directed would have changed, *substantively* it would still be directed in a manner unrelated to any partnership purpose.

Estate planning for the retiring owner

The absence of incidents of ownership under Section 2042 also gives a retiring owner the ability to re-deploy the policy on his life from the partnership to an ILIT he establishes without running afoul of the three-year rule under Section 2035. This is accomplished by having the ILIT purchase the policy from the partnership for "full consideration in money or money's worth."[25] (The three-year rule does not apply to a sale for "full consideration.") The trust will likely acquire the proceeds to purchase a policy via a gift to the trust from the insured.

If Option 1 or 2 is used, the purchase price may be high because the entire value of the policy would be in the partnership. In this event, the trust could simply buy the term element of the policy and offer a "limited policy rights" or "full policy rights" collateral assignment back to the partnership equal to the unpaid balance.[26] The partnership may then distribute its collateral assignment by reassigning it to the insured retiring partner. A full policy rights collateral assignment should be distributed from the partnership directly to the partner's spouse, resulting in a private split-dollar arrangement.[27] A limited policy rights collateral assignment may be distributed from the partnership directly to the insured retiring partner, also resulting in a private split-dollar arrangement.[28] This strategy has the advantage of giving the couple access to cash value for retirement, while carving out the death benefit and re-deploying it from the partnership to a trust outside the couple's estate in a manner that falls under the "full consideration" exception to the three-year rule.

The BILIT approach addresses, to some extent, the retiring owner's estate planning, but its method of doing so is arguably inferior for two reasons. First, the BILIT requires more than one policy per owner. Second, because the policies are owned outright by irrevocable trusts, withdrawing them from the buy-sell arrangement for additional retirement accumulations becomes virtually impossible due to each trust's irrevocable nature. And although all six policies could conceivably be "uncrossed" so that the two policies on each owner's life end up in each owner's irrevocable trust, this series of exchanges would trigger immediate taxation of any cash value gains that had accumulated. This result defeats a key purpose of the cash value life insurance—namely, additional retirement accumulations available on a tax-preferred basis.

Options 1 and 3 of the LifeCycle approach avoid this quagmire entirely. Upon retirement under

---

22 See Ltr. Rul. 200214028; Rev. Rul. 83-147, 1983-2 CB 158; and Estate of Knipp, 25 TC 153 (1953), *aff'd on other grounds* 244 F.2d 436, 51 AFTR 409 (CA-4, 1957).

23 See Knipp, *supra* note 22, and Ltr. Rul. 9623024.

24 1983-2 CB 158.

Option 1, the partnership simply quits "renting" (i.e., endorsing) the death benefit to the various owners' irrevocable trusts. The endorsement split-dollar arrangements that are put in place for the owner(s) who wanted to take this estate planning measure would simply be terminated.

Under Option 3, the partnership simply distributes the policy to the retiring partner to satisfy the collateral assignment. None of the options requires the policies to be "uncrossed" via a series of taxable exchanges under Section 1001: The partnership has always owned one policy per owner. Any cash value gains the owners managed to achieve would be preserved (1) by the non-recognition rule of Section 731(a) (under Options 1 and 2), or (2) by virtue of the fact that each partner held a collateral assignee's interest over the cash value from inception. Based on the earlier example, B may:

- Re-deploy the policy to meet retirement planning needs by withdrawing the policy on his life from the partnership without triggering taxation of cash value gains;
- Re-deploy the policy to meet estate planning needs by having A and C cause the partnership to sell the policy on B's life to B's ILIT. B would need to make a gift to his ILIT equal to the cash value of the policy so that the trustee could afford the purchase price; or
- Re-deploy the policy to meet retirement and estate planning needs by having A and C cause the partnership to sell the policy on B's life to B's irrevocable trust, and take a collateral assignment back for an amount equal to the cash value. B would need to make a gift to his trust equal to only the term cost of the unearned premium because the rest of the value of the policy would remain in the partnership. The partnership's collateral assignee interest in this split-dollar arrangement with B's irrevocable trust could be distributed to him directly[29] or to his spouse.[30] This allows B to split dollar the policy for estate planning and retirement planning needs.

The LifeCycle buy-sell provides all these benefits without the complexity of multiple policies on each owner, without multiple split-dollar agreements between the entity and the shareholders, and without subjecting the death benefit to income tax due to an unintended violation of the transfer-for-value rule (the common deficiency of the OPPO trust, triple split-dollar, and the BILIT).

Remedying the transfer-for-value problem

Ironically, the transfer-for-value solution often suggested by proponents of the OPPO trust, triple split-dollar, and the BILIT is for A, B, and C to form a partnership to lease equipment from, so that the exception under Section 101(a)(2)(A) applies. The problem with this is that many small businesses either don't own the type of equipment customarily leased under such an arrangement, or don't have a bona fide need for this arrangement. Therefore, overcoming concerns about whether a partnership formed under such circumstances has an adequate "business purpose" becomes difficult, especially when the true purpose of the partnership is managing life insurance policies. Although the transfer-for-value rule is avoided whether the purpose of the partnership is connected[31] or unconnected[32] to the owner's business, the issue here is whether the claimed purpose of forming the partnership is, in fact, related to the partnership itself.

In each of the private rulings cited above, this was undoubtedly the case. But simply forming a "leasing" partnership to avoid the transfer-for-value rule in the context of a buy-sell arrangement leaves you with only one motive—tax avoidance. The IRS has stated that a transaction that has no purpose other than the avoidance or reduction of taxes will be ignored for tax purposes.[33]

When parties to a buy-sell have been forthright about their motives, and their characterization of the purpose of the partnership matches the reality, the Service has ruled favorably.[34] Consequently, the LifeCycle buy-sell puts the partnership at the center, and has the partnership own the policies that fund the buy-sell so it can truly be said that the taxpayer's characterization of the transaction matches reality. This treatment of the partnership also enriches the partnership's business purpose.

For example, the non-tax motive of reducing administrative fees and inefficiencies caused by multiple policies (under a traditional cross purchase) enhances the owners' ability to build cash value. This results in a healthier portfolio of permanent policies

---

25 See Section 2035(d). The purchase price will depend on whether the policy was just recently purchased, is paid up, or is existing and not paid up. See Reg. 25.2512-6. Appraisers should err on the side of over-valuation because under-valuing by even 1% negates 100% of the benefit. Section 2043(a).

26 See Ltr. Rul. 9639053.

27 See Ltr. Rul. 9636033.

28 See Ltr. Rul. 9745019.

29 See Ltr. Rul. 9745019.

30 See Ltr. Rul. 9636033.

(as opposed to mere term insurance) that may then be used to provide owners with additional non-qualified retirement accumulations on a tax-favored basis, or trust-owned life insurance for future transfer tax liquidity needs. This investment dimension creates a much stronger business purpose for the partnership.

Of course, the owners could also use the partnership as a bona fide leasing partnership. But this would simply add weight to the partnership's business purpose. More than adequate grounds for business purpose exist without this additional use. Efficiently providing liquidity for future business succession may be more vital to a business than leasing property to it.

Business purpose

A number of commentators have analyzed 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.[35] The issue is whether the purpose of structuring a business continuation plan for a related entity constitutes an adequate business purpose under partnership law.[36] A review of the statutes and case law suggests that such a partnership does meet the business purpose requirement.

Under 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. It is clear that the mere conjunction of co-ownership and the derivation of income from property does not constitute a partnership. Reg. 301.7701-1(a)(2) explains that the key factor distinguishing a mere tenancy in common from a partnership is the active pursuit of a business. The most important distinction between passive and active co-ownership is whether individuals, or their appointed agent, undertake all the responsibilities and duties of handling and managing the entity's assets.

In Rev. Rul. 75-374,[37] the Service ruled that the taxpayers (a real estate investment trust and a life insurance company, each with an undivided one-half interest in an apartment project) were passive co-owners of property because they had hired an unrelated management corporation to perform all tenant services. The Service made clear that co-owners who do not actively manage and handle the affairs and assets of their entity, 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.

Accordingly, actively carrying on a trade, business, or financial operation means that the partners either take it upon themselves, or appoint a co-partner, to handle and manage the affairs and assets of the entity. This is true even if the entity holds only intangible financial assets.[38]

Section 761(a), also supports the business purpose argument. This section states that an organization "availed of for investment purposes only and not for the active conduct of a business" can elect to be excluded from the application of the partnership provisions of the Code. The clear implication is that an organization engaged solely in investment activities, which does not make such an election,[39] would be considered a partnership. Otherwise, there would be no need to provide for its "election out" of the partnership provisions.[40]

The notion that holding an investment portfolio constitutes a valid business purpose is also supported by the final version of Reg. 1.701-2. This Regulation provides that a partnership must have a "substantial business purpose," but does not define this phrase. The Regulation explains, however, that the intent of Subchapter K is to allow taxpayers to "conduct joint business (including investment) activities." Significantly, the parenthetical phrase, which is in the final version of the Reg., was not included in the Proposed Regs.

Finally, two private rulings are very instructive. In Ltr. Rul. 9042023, a majority shareholder of a corporation and other individuals formed a general partnership. The shareholder's corporation sold its insurance policies on the shareholder's life to the newly-formed partnership. The Service ruled that a valid partnership existed under Section 7701(a)(2).

In Ltr. Rul. 9309021, a general partnership was formed to purchase and own life insurance policies that funded a cross purchase arrangement involving the partners' corporation. The partnership

---

31 See Ltr. Ruls. 9012063, 9328010, 9328012, 9328019, and 9328020.

32 See Ltr. Rul. 9045004.

33 1960-2 CB at 191.

34 See Ltr. Rul. 9309021.

35 See Kupferberg and Wolf, "Transferring Life Insurance Policies to a New Partnership," 20 ETPL 340 (Nov./Dec. 1993); "The Life Insurance Partnership: A Promising Solution to Transferring Life Insurance Policies from a Corporation," J. Am. Soc'y CLU & ChFC 64 (Jan. 1994).

36 In Rev. Proc. 96-12, 1996-1 CB 616, the Service declined to issue any further advance rulings on whether an unincorporated organization will be treated as a partnership when substantially all its assets consist of life insurance policies. In Kerr, 292 F.3d 490, 89 AFTR2d 2002-2838 (CA-5, 2002), a recent taxpayer victory, substantially all the assets of a partnership were life insurance policies. The partnership successfully withstood a host of challenges by the Service.

37 1975-2 CB 261.

would own the policies, pay all the premiums, and be the beneficiary. The Service concluded that the entity was a valid partnership for tax purposes. Here, the management and handling of the insurance policies was *not* delegated to an unrelated party, as was the case in Rev. Rul. 75-374.

Thus, there is clearly ample support to suggest that a legitimate business purpose exists for those who use a general partnership to manage and handle cash value life insurance policies to fund a business continuation arrangement. To the extent the partnership under the LifeCycle buy-sell is established to hold the policies that are the centerpiece of a business succession arrangement, the co-partners are undoubtedly engaged in a joint relationship towards a common goal. If the formalities of the partnership are observed and the partnership agreement is properly drafted (including prohibiting a partner from handling his own policy[41]), advisors should be able to recommend the LifeCycle buy-sell as a technique with minimal tax risk.

Components of the LifeCycle arrangement

Everything starts with the buy-sell arrangement for the underlying business entity (e.g., the corporation). For maximum flexibility, a "wait-and-see" buy-sell agreement should be used to permit the surviving owners to choose between a stock redemption or a cross purchase approach at the time of a business owner's death—depending on which is more advantageous at that time.

Under the wait-and-see approach, there will be a specified order of purchase upon the death of a shareholder. The surviving shareholders have the first option to purchase shares of a deceased shareholder. If the surviving owners do not purchase all the decedent's stock, the corporation is *obligated* to redeem the shares.

If the ultimate burden to purchase the shares of a deceased shareholder is the responsibility of the surviving shareholders (and not the corporation), the redemption of the shares by the corporation would fulfill the shareholders' obligation to buy the shares. In that situation, the IRS could successfully argue that the redemption payment is a dividend to the surviving shareholders.[42] This undesirable result is avoided if the ultimate liability to purchase the shares falls on the corporation.

The life insurance proceeds will be received by the partnership upon the death of a shareholder. The partners will make a distribution to the surviving partners (shareholders) in order to effect the buyout. At that time, the surviving shareholders can choose to pay the proceeds to the estate of the deceased shareholder through the cross purchase arrangement, or instead, contribute the proceeds to the corporation to accomplish a stock redemption. A redemption should be chosen only if it will be treated as a *complete* redemption of all shares owned by the estate or if the redemption qualifies under Section 303. If the estate is considered to own any stock other than the deceased shareholder's shares under the attribution rules,[43] then a redemption should be done only if the distribution is treated as a payment in exchange for the stock under Section 303. If Section 303 does not apply, a cross purchase should be chosen.

The stock redemption approach is an alternative for those situations when there are earnings and profits to be eliminated in the corporation or the surviving shareholders wish to remove surplus from the corporation. The complete redemption of a decedent's shares eliminates his pro rata share of the corporate earnings and profits.[44] Cash surplus can be removed from the corporation by using the surplus to fund the redemption. This allows the surviving shareholders to keep all or part of the life insurance proceeds, essentially accomplishing a tax-free distribution of surplus.

The partnership will be the owner and beneficiary of life insurance policies on each shareholder. The partnership agreement will provide that upon the death of a partner, his *partnership* interest will be redeemed by the partnership for an amount equal to the deceased partner's pro rata share of the aggregate cash value of all the policies immediately before his death.[45] Therefore, in addition to the corporate buy-sell agreement which controls the buyout of the underlying corporate stock, the partnership agreement will provide for a buyout of the *partnership* interest. In essence, there will be two buyouts.

The partnership must be in a position to distribute enough cash to the surviving owners to fulfill the obligations under both the *corporate* buy-sell agreement and the *partnership* agreement. Accordingly, the life insurance death benefit should increase approximately at least as fast as the cash

38 See Wadel, 44 BTA 1042 (1941) (an investment club formed *solely* to invest in securities was a valid partnership). See also Rev. Ruls. 75-523, 1975-2 CB 257, and 75-525, 1975-2 CB 350.

39 See Reg. 1.761-2.

40 See Madison Gas & Elec. Co., 72 TC 521 (1979), *aff'd* 633 F.2d 512, 46 AFTR2d 80-5955 (CA-7, 1980).

41 See Bussing, 89 TC 1050 (1987).

42 See Gerson, TCM 1989-52.

value (or more if the underlying entity is appreciating rapidly).[46]

The underlying corporation will usually pay the insurance premiums for the shareholder/employees. The payments are generally treated as bonuses under Section 162. Each premium payment (which is made directly by the corporation to the insurance company) is treated as a contribution of capital on behalf of the partners to the partnership since the policies are owned by the partnership.

If the partners intend to accumulate significant cash values in the policies for purposes of retirement, the allocation of the premium burden is extremely important. The amount of the premium bonus allocated to a partner is also the amount of the deemed contribution of capital to the partnership, which is the measuring stick for determining what percentage of the total cash value of all the policies owned by the partnership will be paid for a partner's interest at death or retirement. The "special allocation" referred to earlier affects only the death benefit, not the ownership of the cash values or any other assets owned by the partnership.

The partnership will receive the death proceeds income tax-free. The proceeds are part of the partners' distributive share as tax-exempt income,[47] which increases the partners' basis dollar-for-dollar.[48] As long as the cash distributed does not exceed the partner's basis in his partnership interest, distributions from the partnership to a partner are generally nontaxable. To ensure that the surviving partners receive the full basis increase under Section 705(a)(1)(B), it is vital to specially allocate the death benefit only to their capital accounts. This will allow the surviving partners to distribute any insurance proceeds to themselves income tax-free, giving them the cash required for the corporate buyout. Assuming the partnership agreement strictly prohibits any partner from exercising any control over the policy insuring his life, it will also keep any fraction of the death benefit out of the insured's estate.

Conclusion

Funding a buy-sell arrangement via a general partnership avoids the dilemma of choosing between a cross purchase and a stock redemption while providing additional benefits. This technique enables the policies to be used to accumulate additional retirement dollars or to satisfy estate liquidity needs. ■

43 Section 318.

44 Section 312.

45 See Ltr. Rul. 200214028.

46 Some policies offer special riders that allow surviving owners to increase the death benefit of their policies up to four times the original face amount on the death of a co-owner.

47 Section 702.

48 Section 705(a)(1)(B).

REPRINTED FROM ESTATE PLANNING 2/03 WITH PERMISSION
WARREN GORHAM & LAMONT RIA