A Partnership Insured Entity Purchase Buy-Sell Plan

For a partnership to continue after a partner's death, both the surviving partners and the deceased partner's heirs must consent to a reorganization of the partnership. This consent may be dependent on the ability of all parties to overcome a variety of problems. If reorganization isn't possible, the only other option available may be liquidation of the partnership.

Prepared for:

Brought to you by:

Terica Pearson
Pearson Consulting Group
108 Atlanta Street
Suite B
McDonough, GA 30253
Office: (770) 472-1800
terica.pearson@american-national.com
https://finsecurity.com/TPearson

September 22, 2021

Table of Contents	**Page**

What Happens When a Partner Dies?

At the death of a partner, the partnership is dissolved.

In the absence of an agreement to the contrary, the partnership no longer exists. The surviving partners have no authority to act for the partnership, except for purposes of winding up its business affairs.

When a partner dies and there is no plan to dispose of the business interest, the only options available to the survivors are **reorganization** or **liquidation** of the partnership.

Problems in Reorganizing a Partnership

Both the surviving partners and the deceased partner's heirs must consent to a reorganization of the partnership. This consent may be dependent on the ability of all parties to overcome problems such as:

Estate Settlement Costs

Will there be sufficient liquidity in the deceased partner's estate to pay estate taxes and the other estate administrative costs required to settle the estate without liquidating the partnership?

Heirs as Active Partners

Is one or more of the heirs qualified and willing to assume an active role in managing the business? Do the surviving partners want to be in business with the deceased partner's family?

Heirs as Inactive Partners

Will the surviving partners be willing and able to support the deceased partner's family, as well as their own? Will the interests of the surviving partners and the heirs in running the business be compatible?

Sell to Outsiders

Will the surviving partners want to work with outsiders selected by the deceased partner's family?

Sell to Heirs

Will the heirs be both willing and able to buy the business? Will the surviving partners be willing and able to start another business from scratch?

Buy from Heirs

Will the heirs be willing to sell? Will the heirs and the surviving partners be able to agree on a price? How will the surviving partners fund the purchase?

Problems in Liquidating a Partnership

If the attempt to reorganize the partnership fails, as it frequently does without advance planning, the only other alternative is to liquidate the partnership and distribute the proceeds to the surviving partners and the heirs.

The unplanned liquidation of a partnership can produce unfortunate results, both for the surviving partners and for the deceased partner's heirs:

Shrinkage in Value

Can the partnership be liquidated for its market value, or will a financially-disastrous forced liquidation be the result?

Survivor Income

How will the deceased partner's dependents replace the income previously received from the partnership?

Job Loss

How difficult will the surviving partners find it to start again from scratch?

In addition, if a partnership is liquidated and a deficit results (liabilities exceed the liquidation value of assets), surviving partners are liable for their share of the deficit. To make matters worse, they may be liable for the entire deficit if the deceased partner's estate is insolvent!

Without advance planning, a partnership reorganization may not be feasible, while an unplanned liquidation can be financially disastrous for the surviving partners and the heirs.

There is, however, another alternative...

A Potential Solution Using Life Insurance

In many partnerships, the best answer to the problems arising at the death of a partner may be for the surviving partners to acquire the deceased partner's share of the business for its fair market value.

When the partnership and its owners enter into a binding entity purchase buy-sell plan funded with life insurance, the partnership will have the cash to purchase a deceased partner's interest for a previously agreed-upon price that is fair to the heirs.

With advance planning, an insured entity purchase buy-sell plan can accomplish the following:

- Both a forced liquidation and an undesirable reorganization are prevented.
- The partnership is committed to buy and the deceased partner's estate is committed to sell the partnership interest for a price that is agreed upon in advance.
- The funds to complete the sale are available exactly when needed at a partner's death.
- The value of the partnership interest may be fixed for federal estate tax purposes.
- The deceased partner's heirs are guaranteed a full and fair cash price for the business.
- Cash becomes available to settle the deceased partner's estate promptly and to replace family income.

How Can a Buy-Sell Plan Be Funded?

There are **FOUR** ways the partnership can fund an entity purchase buy-sell plan:

1. Cash Method

The partnership could accumulate sufficient cash to buy the business interest at a partner's death. Unfortunately, it could take many years to save the necessary funds, while the full amount may be needed in just a few months or years.

2. Installment Method

The purchase price could be paid in installments after a partner's death. For the surviving partners, this could mean a drain on business income for years. In addition, payments to the surviving family would be dependent on future business performance after the partner's death.

3. Loan Method

Assuming that the partnership could obtain a business loan, borrowing the purchase price requires that future business income be used to repay the loan PLUS interest.

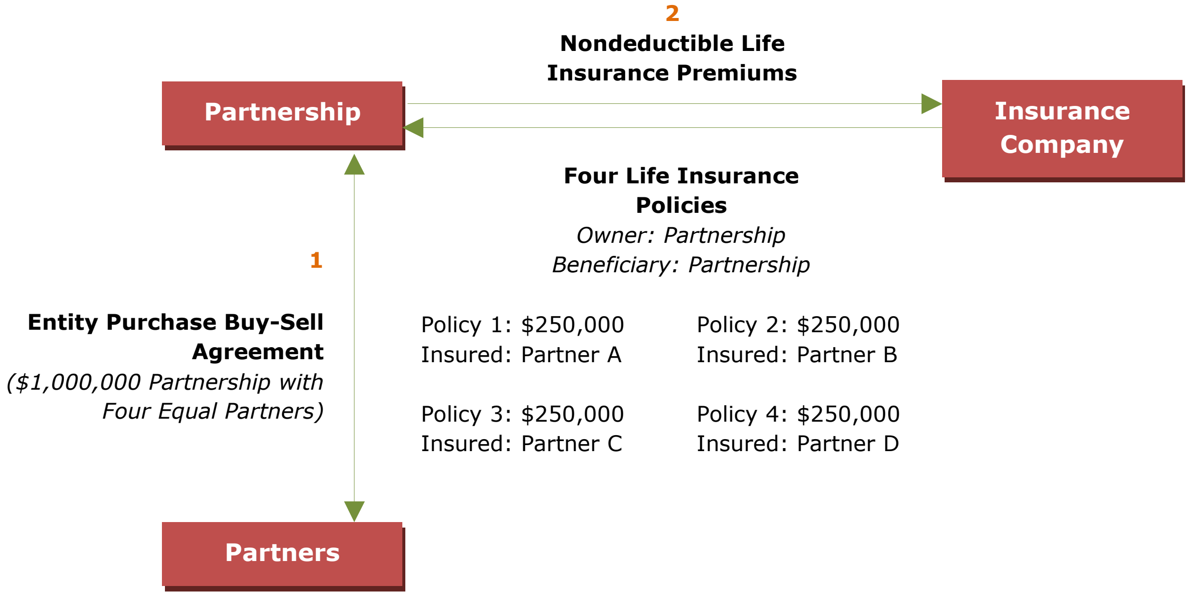
4. Insured Method

Only life insurance can guarantee that the cash needed to complete the sale will be available exactly when needed, assuming that the partnership has been accurately valued (guarantee is based on the continued claims-paying ability of the insurer).

The Mechanics of an Insured Entity Purchase Buy-Sell Plan

The bottom line is that an entity purchase buy-sell plan funded with life insurance is an economical and efficient method of providing the cash necessary to purchase a deceased partner's business interest.

Here's how an insured entity purchase buy-sell plan could work for your partnership today...

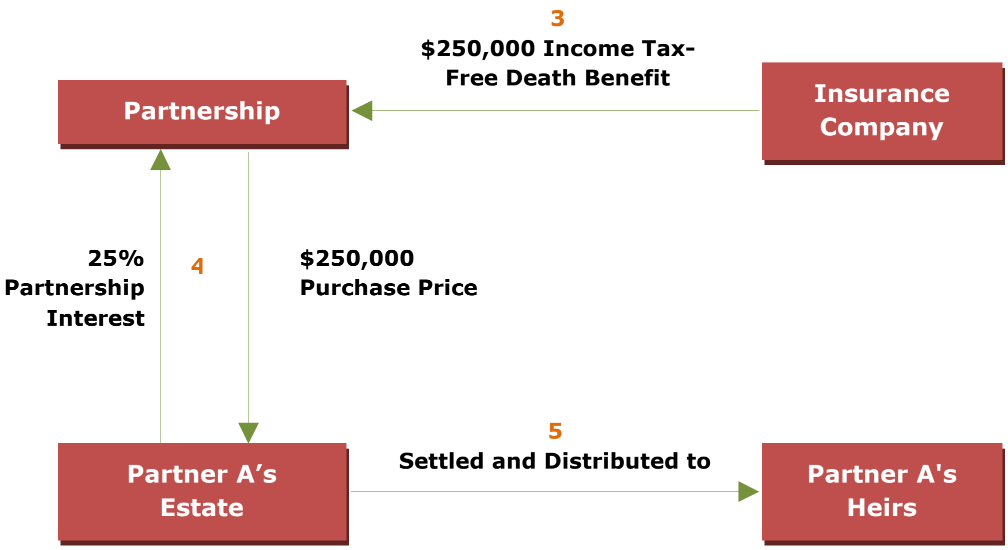


1. The partnership and its owners enter into en entity purchase buy-sell agreement under which the partnership agrees to buy a deceased partner's interest and the deceased partner's executor is directed to sell that interest to the partnership for an agreed-upon price.

2. The partnership owns, is the beneficiary of and pays the nondeductible premiums for life insurance on each partner's life in an amount approximately equal to each partner's share of the purchase price.

The Mechanics of an Insured Entity Purchase Buy-Sell Plan

Here's how an insured entity purchase buy-sell plan could work at Partner A's death...



3. At a partner's death, the partnership receives the income tax-free death benefit from the life insurance policy it owns on the deceased partner.
4. The partnership uses the proceeds of the life insurance to buy the partnership interest from the deceased partner's estate for the purchase price agreed-upon in the buy-sell agreement.
5. After settling the estate, the executor distributes the balance of the estate to the deceased partner's heirs.

What Are the Other Features of an Insured Entity Purchase Buy-Sell Plan?

In addition to serving as a source of funding, an insured entity purchase buy-sell plan can provide a variety of other features:

- **Payment is prompt and certain.** Life insurance proceeds are not subject to the time and expense of the probate process, making them immediately available to the partnership to complete the purchase of the deceased partner's interest.
- **The event creating the need for cash** – a partner's death -- **also creates a source of cash** -- the life insurance death benefit. The life insurance policy provides the dollars for a certain need -- purchase of the partnership interest -- that arises at an uncertain time -- death.
- **If the death benefit exceeds the total premiums paid, this gain generally is received free of income tax.** For example, if only 20 cents of each death benefit dollar received has been paid in premiums, the 80 cent gain is received income tax free.
- **Life insurance avoids the problems associated with the other methods** for financing the purchase of a partnership interest at a partner's death.
- **Any cash value in the life insurance policy could be used to help purchase the partnership interest at a partner's disability or retirement** (withdrawals and loans will reduce the policy's death benefit and cash value available for use).

Summary of Insured Entity Purchase Buy-Sell Plan Tax Results

- Premium payments for life insurance to fund an insured entity purchase buy-sell plan are not tax deductible by the partnership, meaning that amounts paid for premiums are taxed to the individual partners in proportion to their ownership interest.

- Generally, life insurance proceeds received by the partnership at a partner's death are not subject to federal income tax.

- The transfer of the deceased partner's business interest in exchange for the death proceeds is treated as the sale of a capital asset. The basis of this capital asset is adjusted to its fair market value on the date of the partner's death. Thus, if the amount received by the deceased partner's estate -- the purchase price -- equals the fair market value of the business interest at death, no gain for federal income tax purposes will result.

- While the surviving partners receive an increased ownership share of the partnership, there is no increase in their tax basis.

- Assuming the policies are properly arranged, with each partner holding no incidents of ownership in the policy on his or her life, the death proceeds will not be included in the deceased partner's estate.

- If the purchase price established in the buy-sell agreement is made at "arm's length" and realistically represents the value of the deceased partner's interest, that purchase price may set the value of the partnership interest for federal estate tax purposes, assuming that the agreement prohibits the partners from disposing of their partnership interest during life without first offering it to the partnership for the same price.

Estate planning provisions, reviewed on the next page, should be taken into consideration in planning for the disposition of a partnership interest at a partner’s death.

Estate Planning Considerations

The federal estate tax is a **progressive tax on the right to transfer property at death**. In 2021, federal estate tax rates begin at 18% and increase to as much as 40% of the taxable value of an estate.

The **federal estate tax** is a transfer tax imposed on the privilege of transferring property at death, while the **federal gift tax** is imposed on the transfer of property during the property owner's lifetime. Both taxes are levied on the **right to transfer property**, and not on the property itself. The amount of tax payable, however, is measured by the **value** of the transferred property.

Once the tentative federal estate or gift tax is determined, it is then reduced by an **estate and gift tax unified credit**. This means that **taxable estates with a value equal to or less than the unified credit equivalent** will not be liable for federal estate tax. The same is true of **cumulative lifetime taxable gifts** which, however, will be brought back into the owner's estate for federal estate tax calculation purposes. **The unified credit equivalent is equal to $11,700,000 in 2021, as adjusted for inflation**, meaning that an individual currently can transfer property valued up to $11,700,000, whether during life and/or at death, without incurring a tax liability.

In addition, **"portability" of the maximum estate tax unified credit between spouses** is available, meaning that a surviving spouse can elect to take advantage of any unused portion of the estate tax unified credit of his or her predeceased spouse (the equivalent of $11,700,000 in 2021). As a result, with this election and careful estate planning, married couples can effectively shield in excess of $23 million plus (as adjusted for inflation) from the federal estate and gift tax.

Finally, **estate tax deferral** allows payment of estate tax attributable to the value of a closely-held business included in the estate to be deferred for up to five years.

No discussion of estate planning considerations in regard to business continuation would be complete without mention of the **generation-skipping transfer tax** (GSTT). An objective of the federal government is to collect taxes on the transfer of property from one generation to the next generation. If, however, an estate owner is able to skip the members of the immediately lower next generation and transfer property to someone two or more generations removed, the government is deprived of the estate tax that would have been collected on that property at the death of members in the immediately lower next generation. As a result, a generation-skipping transfer in excess of available exemptions is subject to the maximum federal estate and gift tax rate of 40% in 2021. The GSTT is **in addition to** any federal estate or gift tax due and is payable by the transferor, the transferor's estate or by the trustee of a trust making a generation-skipping transfer.

Your professional tax advisor can assist you in developing business and estate plans with the flexibility needed to adjust to an uncertain tax future.

Insured Entity Purchase Buy-Sell Plan Action Checklist

Now...

- ☐ Establish the value of the partnership.
- ☐ Select the appropriate life insurance funding vehicle(s).
- ☐ Establish each partner's insurability.
- ☐ Arrange for payment of premiums.

Short-Term...

- ☐ Draft and execute an entity purchase buy-sell agreement.
- ☐ Review the issued policy.
- ☐ Evaluate funding options for the purchase of partnership interests at each partner's disability or retirement.

Longer-Term...

- ☐ An annual review can help ensure that the plan and its funding remain current.
- ☐ Consider the purchase of key employee indemnification insurance on the partners.

Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

U.S. Treasury Circular 230 may require us to advise you that "any tax information provided in this document is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The tax information was written to support the promotion or marketing of the transaction(s) or matter(s) addressed and you should seek advice based on your particular circumstances from an independent tax advisor."

© VSA, LP All rights reserved (VSA 1b1-05 ed. 01-21)