Guardian

Using a partnership or LLC to complete a Corporate Business Continuation Plan

You and your business partners realize the importance of planning for the successful continuation of your business. Through the years, the business you originally started as a corporation has grown. Additional legal entities may have been created to further insulate assets from creditors and to more effectively manage your business. For instance, you may have a partnership or limited liability company that owns the real estate or equipment used in your corporate business. With this additional degree of complexity, you now need to address business succession planning. What do you need to know?

One solution – using a partnership or LLC to complete the Corporate Business Continuation Plan

There are two commonly used methods to structure a business continuation plan. The first is known as an entity purchase plan. For corporations, it is commonly referred to as a stock redemption plan. The second is known as a cross purchase plan. Each has its advantages and disadvantages. By combining the business continuation planning for the partnership or LLC with the corporation's, you can get the best of both.

Background

With a stock redemption plan, the corporation agrees to purchase the shares of a deceased or disabled shareholder, and the shareholder (or his or her estate) agrees to sell the shares back to the corporation. Typically, permanent life insurance and disability insurance are used to fund the buyout. The death benefits of the life insurance can fund a buyout based upon the death of a shareholder, and the cash values can help to fund a lifetime buyout. In the case of a disability, disability buy-out insurance provides the funding to complete the buy-sell agreement. The corporation is the owner and beneficiary of a life insurance or disability policy on each shareholder. Where there are many shareholders, stock redemption plans are somewhat easier to fund compared to a cross purchase plan.

However, stock redemptions are not without disadvantages.

- In a death situation, surviving shareholders do not receive an increase in cost basis. Therefore, significant additional capital gains taxes could result if the remaining shareholders later decide to sell their shares during their lifetime.
- There are tax issues known as "transfer-for-value" if the agreement is terminated and a decision needs to be made about the disposition of the life insurance policies. Transfers-for-value may result in subjecting the death proceeds of the insurance to income taxes.

The cross purchase arrangement, on the other hand, avoids most of these concerns. In this type of arrangement, each shareholder owns a policy on the other shareholders. The shareholders are purchasing the stock directly from a deceased shareholder's estate, presumably for fair market value, and they get additions to basis for the amount they pay.

But, like stock redemption plans, cross purchase arrangements also have disadvantages.

- They are more difficult to set up when there are more than two business owners: unless a trust is used, the number of policies needed is determined by using the formula N x (N-1) where N equals the number of owners.
- There may still be possible transfer-for-value issues if the arrangement is unwound, particularly for corporate cross purchase plans.
- Younger (and presumably healthier) owners wind up paying more for policies they purchase on the lives of older, and possibly, less healthy owners.

The partnership or LLC, like the corporation, is a business that also needs a business continuation plan. However, combining the partnership or LLC plan with the corporate plan to help fund the buy-sell obligation can help you avoid many of the pitfalls of both arrangements, such as the transfer-for-value issues, yet reap many of the benefits, such as an increase in cost basis and owning only one policy per owner. The reason is because of the nature of partnerships and LLCs taxed as partnerships (as most are) for income tax purposes. Partnerships and LLCs are not subject to AMT.

In addition, if a business continuation plan is terminated and insurance policies need to be transferred, these transfers may be exempt from the transfer-for-value rules. The statutory exemptions that do not subject insurance policies transferred for value to adverse tax consequences are broader in partnership situations than with corporations.

Note that if the partnership or LLC is not already in existence, one can be created. Legal counsel should be consulted here. Some tax and legal advisors do not feel comfortable establishing a separate entity just to own life or disability insurance on the individual owners because they feel it does not have a legitimate business purpose. However, some legal and tax advisors feel the creation of an entity whose purpose for creation is the continuance of the operating (main) company, in and of itself, is a legitimate business purpose for establishing the entity (either a separate partnership or LLC.) There is limited guidance here. Note that there is precedent with the IRS for establishing partnerships solely for this purpose. (See Private Letter Rulings 9042023 and 9309021.) However, subsequent to these private rulings, the IRS has stated it will no longer rule privately on:

1. whether the entity will be treated as a partnership; or
2. whether existing policies transferred to the new entity will be exempt from the transfer-for-value rules of IRC Section §101 if substantially all of the organization's assets consist, or will consist, of life insurance policies on the lives of the partners/members. (See Rev. Proc. 2003-3.).

Also, it may be possible that state law might not recognize a partnership or LLC created solely for buy-sell purposes, so input from legal counsel is critical. Finally, note also that if an LLC is used, the LLC must elect to be taxed as a partnership in order for this arrangement to work in the manner described.

How does it work?

A group of four contractors operate as a C corporation. They also have a partnership (or LLC taxed as a partnership) that owns the construction equipment that it leases to the corporation. As they begin to discuss their business continuity plan, they would like to minimize the number of policies needed to fund the agreement, so are considering an entity plan. However, they are attracted by the positive tax benefits associated with a cross purchase agreement, since they hope to ultimately sell the business in the future.

To fund their buy-sell agreement, the partnership acquires four life insurance and disability policies and is the owner and beneficiary of each policy. At the death of a shareholder/partner, the partnership receives the death benefit and uses a portion of the proceeds to purchase the decedent's interest in the partnership. The partnership then distributes the balance of the proceeds to the surviving owners, who use that money to purchase the deceased owner's interest in the corporation from the decedent's estate, similar to the cross purchase arrangement. Similarly, if one partner becomes disabled, the partnership receives the disability benefits and uses them to purchase the disabled owner's share of the business.

Other considerations

- An attorney must be consulted to draft the buy-sell agreements as well as to create the partnership or LLC, if necessary.
- Legal counsel should discuss with the client its opinion on whether the partnership or LLC must have a legitimate business purpose beyond holding the life or disability insurance policies (e.g., a real estate or equipment leasing business).
- Disability buy-out insurance should always be used in conjunction with life insurance to adequately fund the business continuation arrangement. Having both types of insurance in place assures funds will be available to address either buy-sell contingency.
- The Pension Protection Act of 2006 enacted rules relating to life insurance policies owned by businesses on the lives of "employees" (defined very broadly in the law) that are issued after August 17, 2006. For life insurance death benefits to be income tax free to the business, the "employer-owned life insurance" rules of IRC §101(j) and §6039I must be met. There are four general requirements: (1) notice must be given to the insured, and her or his consent obtained; (2) either the insured must fit into certain categories or the proceeds must be used for certain purposes; (3) there must be record-keeping; and (4) there must be reporting to the IRS concerning these policies. IRS reporting is done on IRS Form 8925.
  - With respect to item (2), employer-owned life insurance for business continuation buy-sell planning purposes falls within the rules.
- IRC Sec. 265 and Rev. Ruling 66-262 address the tax treatment of disability buy-out policies. Premiums paid for these policies are never deductible, regardless of who pays the premiums (i.e., the business itself or the owners). Benefits are paid to reimburse amounts paid by the business or other owners to purchase a disabled owner's business interest and are received tax-free. The disabled owner, however, is subject to taxation on any capital gain resulting from the sale of his or her ownership share. In a cross purchase arrangement, the business can bonus the premium amount to the policy owner. The bonus is deductible to the business, but it must be included in the policy owner's income.

Please consult with your Guardian financial professional if you have any questions concerning this document.

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