# A Partnership Insured Cross 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.**

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# 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:

**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 partners enter into a binding cross purchase buy-sell plan that is funded with life insurance, the surviving partners 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 cross purchase buy-sell plan can accomplish the following:**

- Both a forced liquidation and an undesirable reorganization are prevented.
- The surviving partners are 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 partners can fund a cross purchase buy-sell plan:

### 1. Cash Method

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

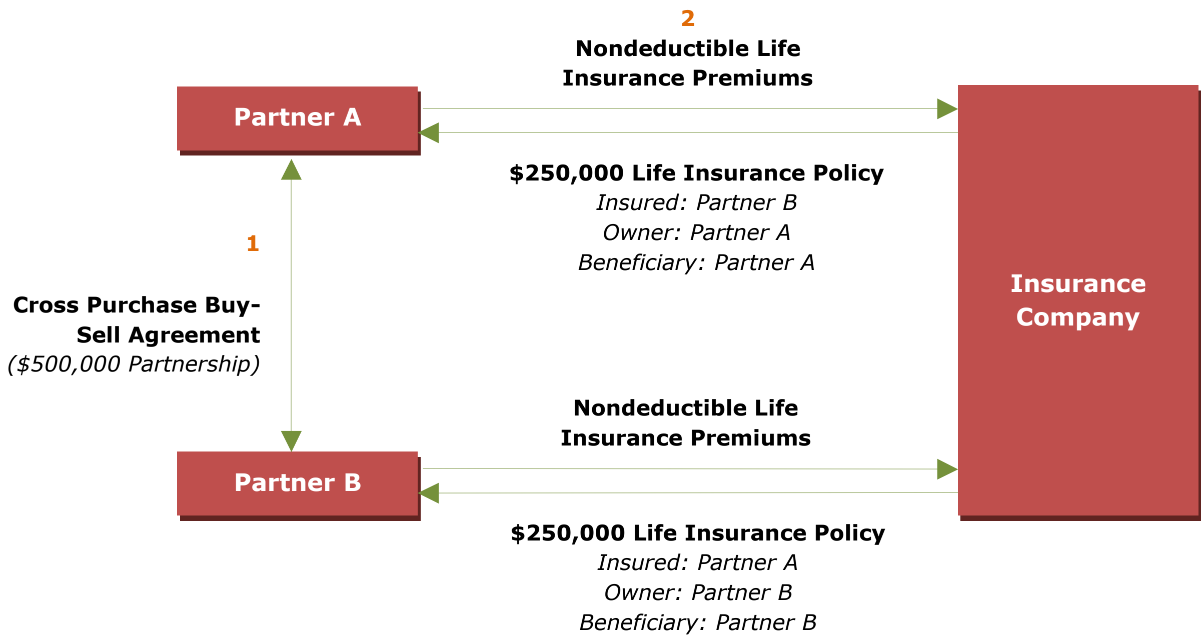
### 4. Insured Method

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 Cross Purchase Buy-Sell Plan

The bottom line is that a cross 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 cross purchase buy-sell plan could work for your partnership today...**

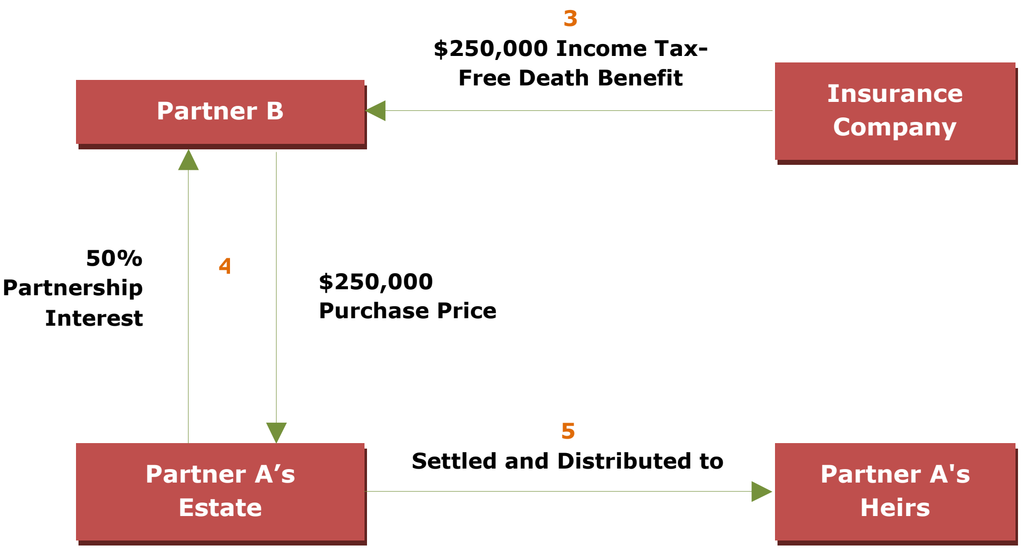



1. The partners enter into a cross purchase buy-sell agreement under which they agree to buy a deceased partner's interest and the deceased partner's executor is directed to sell that interest to the surviving partner(s) for an agreed-upon price. The partnership itself is not part of the agreement.

2. Each partner owns, is the beneficiary of and pays the nondeductible premiums for life insurance on the other partner(s) in an amount approximately equal to that partner's share of the purchase price.

# The Mechanics of an Insured Cross Purchase Buy-Sell Plan

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




3. At a partner's death, each surviving partner receives the income tax-free death benefit from the life insurance policy owned on the deceased partner.

4. The surviving partner(s) then use 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 Cross Purchase Buy-Sell Plan?

In addition to serving as a source of funding, an insured cross 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 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 Cross Purchase Buy-Sell Plan Tax Results

- Premium payments for life insurance to fund an insured cross purchase buy-sell plan are considered a personal expense of each partner and, as such, are not tax deductible.

- Generally, life insurance proceeds received by the surviving partner(s) 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.

- The tax basis of the surviving partner(s) in the partnership increases by the amount of the purchase price.

- 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 other partner(s) 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 2019, 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 $11,400,000 in 2019, as adjusted for inflation**, meaning that an individual currently can transfer property valued up to $11,400,000, 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 $11,400,000 in 2019). As a result, with this election and careful estate planning, married couples can effectively shield up to $22 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 2019. 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 Cross Purchase Buy-Sell Plan Action Checklist

**Now…**

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

**Short-Term…**

- ☐ Draft and execute a cross 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

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