Entity Purchase Arrangement For Owners of Partnerships & Limited Liability Companies

MAF COMPANIES

Business Continuation

Do you identify with the following?
You are a Business Owner …

♦ Who has spent many long hours working in and creating value in your business and it is one of the major or *the major asset* in your estate;

♦ You want to fix an estate tax value for your business interest, to reduce potential IRS disputes.

♦ You want to ensure a ready market for you shares at your death, turning your shares into cash; and

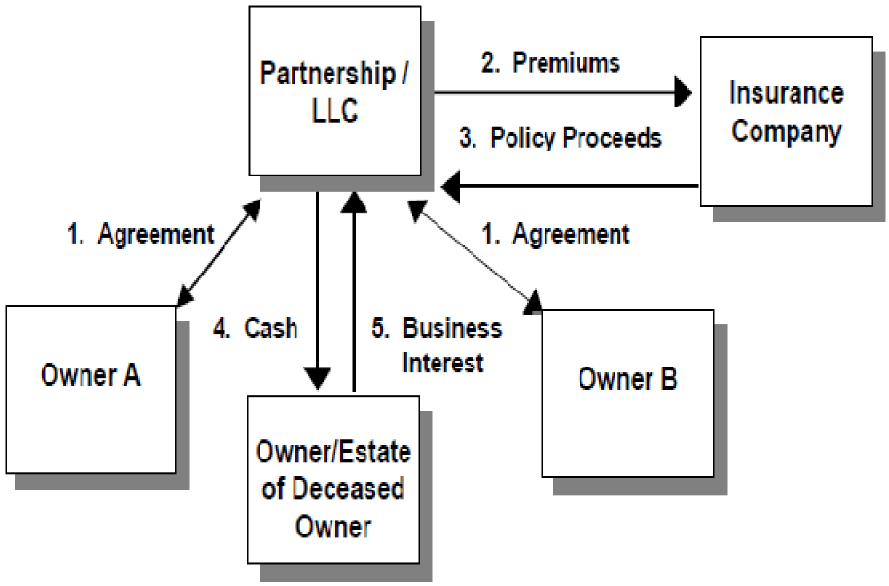
♦ You want to see that the business remains in the hands of just the surviving partners/members.

If so you may want to consider establishing an entity purchase buy-sell agreement. An entity purchase buy-sell agreement is:

♦ A contract among the owners and the business requiring the business to purchase the interest of an owner under specified terms and conditions.

♦ An arrangement that funded with life insurance helps ensure that cash will be available to help with the buy-out no matter when death occurs.

Entity Purchase Arrangement Funded with Life Insurance



1. The Partnership or LLC enters into an entity purchase agreement with each owner obligating the business to purchase the deceased owner's interest in the business and obligating the decedent's estate to sell.

2. The Partnership or LLC purchases life insurance protection on the life of each owner equal to at least the value of the owner's interest. The business is the policy owner, the premium payer and beneficiary of each policy.

3. At death of an owner, the business collects the proceeds from the insurance policy.

4. The business pays the agreed upon amount, determined according to the terms of the agreement, to the owner's estate.

5. The owner or the owner's estate releases the Partnership or LLC interest to the business.

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Advantages to the Departing Owner or Heirs:

♦ Properly drafted, implemented and maintained, the arrangement helps to establish the business value for estate tax purposes.

♦ Provides a ready market for the sale of the business interest.

♦ Ensures liquidity to pay estate taxes and/or to meet family needs.

♦ The heirs are relieved of further business responsibilities.

♦ Where life insurance is used to fund the buy-out, the heirs of the deceased owner immediately receive cash avoiding delays and potential liquidation losses.

Advantages to the Business and Remaining Owners:

♦ The business receives life insurance proceeds when needed to finance the buy-out of the deceased owner.

♦ The business continues uninterrupted with the surviving partners/members as owners.

♦ An entity purchase agreement funded with permanent life insurance can provide needed cash to help meet the contractual obligations established by the agreement, potentially minimizing the impact on working capital and cash flow.

♦ In contrast to a cross purchase agreement, an entity repurchase funded with life insurance requires that the business purchase just one policy on each owner.

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- ♦ Employees, creditors, and suppliers feel more secure knowing the business has a succession arrangement in place.
- ♦ Where permanent policies are purchased, the cash value of the policy is an asset of the business reflected on the balance sheet and available for business needs.[1]

Tax Considerations:

Note: Where the entity is a limited liability company (LLC), the assumption is made that for federal tax purposes the entity will be taxed under partnership rules.

- ♦ Life insurance premiums are not deductible and lower the basis of the owners to whom the expense is allocated (as determined by the partnership). However, life insurance death proceeds are generally received income tax-free under IRC § 101(a) and where life insurance is used as a funding vehicle in a partnership, death benefit proceeds received by the business entity do increase the owner's basis in the business interest. Since high basis in a partnership shelters future distributions from income taxation, the use of life insurance can be an important planning technique. The amount of basis increase the surviving owners receive depends on a number of factors.

Consult your legal and tax advisors for a complete discussion.

[1] Life insurance policy cash values are accessed through withdrawals and policy loans. Loans are at interest. Loans and withdrawals cause a reduction in cash value and death benefit, and may have tax consequences.

♦ Where the partnership/LLC owns a life insurance policy on a partner/member it is important that the insured has no “incidents of ownership” under IRC § 2042 such that the policy proceeds will be included in his/her estate.

Although regulations exist dealing with “incidents of ownership” in the shareholder context, no such regulations are found in the partnership taxation area. Based on revenue rulings, private letter rulings and case law, the general belief is that where the partnership is both the owner and beneficiary of a policy on a partner’s life, the partner’s gross estate includes just his/her share of the partnership interest (the value that reflects his/her proportionate share of the death proceeds). Furthermore, where the partner is a majority owner, the conservative planning position is to include provisions in the partnership agreement that prevent the insured from exercising any power over the policy. *For a more detailed discussion of this issue please refer to Prudential Financials’ marketing piece: IFS-A077810: An Alternative to an ILIT – Life Insurance in Partnership.*

♦ Unlike IRC § 302 stock redemptions, not all liquidations done in a partnership context will result exclusively in capital gains treatment to the withdrawing partner. IRC § 736 liquidation rules determine the tax effect when a retiring or deceased partner receives a distribution or distributions from the business in complete liquidation of the partner’s/member’s interest. The tax implications of IRC § 736 depend on whether “hot assets” are present in the partnership (IRC § 751 assets: unrealized receivables, substantially appreciated inventory); whether the payments are made in cash or non-cash property; whether an IRC § 754 “step up” election is present; and whether the partnership is primarily a service provider where capital is not a material income-producing factor.

The possibility of ordinary income treatment on a redemption/liquidation exists primarily for service-oriented partnerships such as general partnerships involving the practice of medicine, dentistry, law, accounting etc.

Partnership distribution rules are complex and clients should consult their tax and legal advisors before implementing any type of an entity purchase arrangement.