



MetLife®

# SalesSolutions

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## The Tipping Point Solution: The Business Continuation Retirement Partnership

The business owner market can be both a rewarding and vexing undertaking. Most seasoned producers recognize that the principal share of an owner's individual net worth can be tied up in the business. For this reason, these assets represent the primary way to help an owner meet his or her business, retirement and estate planning goals. While it is relatively easy to identify these objectives, it is less obvious how to help the business owner bring these goals to fruition.

This opportunity soon proves elusive and becomes much like the proverbial double edged sword. The sheer number of lucrative sales possibilities tempts the producer to offer a plethora of seemingly viable solutions. The inevitable result – too many solutions – leads to the resistance and inaction on the part of business owner clients.

While the desire for effective planning solutions undoubtedly exists, business owners have little patience for multiple shortsighted solutions that serve to complicate, rather than simplify their busy lives. The lack of a straightforward, targeted approach will keep them perpetually stuck on the tipping point between inaction and action. The key is to assist the business owner in attaining their unique planning needs with a solution that can be leveraged to reach their personal goals. Unfortunately, conventional approaches offer something less than a complete solution.

### Hazards of Traditional Techniques

Traditional buy-sell planning typically involves some form of a stock redemption, cross purchase or trustee arrangement. While each can be effective in transferring a business interest,

these techniques are also encumbered with drawbacks that may lead to unfavorable tax treatment or prove unwieldy in application.

**Stock Redemption** plans have the benefit of one policy per owner, all controlled and owned by the business. Yet these arrangements often fail to allocate a full increase to the survivors' basis. Even flow through entities, such as S Corporations, may fall short of providing a full increase in basis to the extent that insurance proceeds are allocated to the deceased owner's interest. Another possible drawback is the Alternative Minimum Tax (AMT) since this tax may have an adverse impact on the treatment of death proceeds in a C Corporation. Moreover, a transfer of policies to corporate shareholders at retirement may have adverse tax consequences while the "attribution" rules can generate unforeseen estate planning issues.

**Cross purchase** plans contain their own shortcomings. This technique allocates a full step-up in basis to the survivors, although younger and healthier owners pay more than their proportionate share of premiums, since they own life insurance on the older and less healthy partners. Also, since each owner must own a policy on the others, multiple policies can prove unwieldy if the business has more than two owners. Finally, since the company will have no direct control over the life insurance, they are not a balance sheet asset of the company. Trustee buy-sell strategies, often offered as an alternative to the other techniques, contain latent transfer for value issues upon the transfer of the deceased's ownership interest to survivors.

The inconvenient truth is that none of these solutions may fully address the needs of the modern business owner. What's needed is a strategy that preserves the best traits of these solutions, while meeting the owner's retirement and estate goals. The challenge is to transform inaction into action by moving business owners beyond their tipping point with a focused and elegant strategy. The Business Continuation Retirement Partnership (BCRP) may represent just such a solution.

## The BCRP: The Tipping Point Solution

### *The Structure*

The owners initially enter into a typical wait-and-see agreement with the primary business entity. This is accomplished by giving the first option to purchase the deceased's shares to the business. The surviving owners then have the option to purchase the remaining interest. The company retains the ultimate obligation to redeem any un-purchased shares.

Note: It is vital the surviving shareholders have an *option*, but not the *obligation*, to purchase the ownership interest. If these owners had a legal obligation to purchase the deceased's interest and failed to do so, then the corporation's purchase would be treated as a dividend to the survivors because the corporation would be deemed to have discharged their obligation.

A general partnership or LLC taxed as a partnership will act as owner, premium payer, and beneficiary of one policy on each business owner. Note: A partnership formed solely to hold the policies may not pass IRS scrutiny as it relates to a valid business purpose. Consequently, only an otherwise valid partnership should be utilized for this technique. Fortunately, many business owners already utilize partnership entities for real estate ventures, lease back arrangements and other investment purposes.

The partnership agreement provides that upon the death of a partner, the deceased owner's interest in the partnership is transferred to the BCRP. The partnership will then pay the deceased partner's estate an amount equal to the deceased's partnership value, including his or her share of the value of life insurance policies on the survivors. This avoids a potential taxable transfer for value, as a transfer to a partnership in which the insured is a partner is a specified exception under

this rule. The remaining allocated proceeds are then available for the survivors to draw from to effectuate the original wait-and-see agreement with the primary business.

Let's take a closer look at three facets of the BCRP technique.

### **Allocation of Premium Burden:**

The life insurance premiums are paid by the primary business as a tax deductible IRC 162 bonus to each of the partners. These premiums will then be treated as capital contributions by the individual partners as the policies are owned by the BCRP. The amount of total premium bonus allocated to each individual partner is determined by the partnership agreement. It is usually tied to the premium a particular partner would have to pay if he or she owned the policies under a cross purchase arrangement.

Alternatively, the owners may choose to allocate the premiums equally. For example, assume the three owners: A, B and C, each possess a one-third interest in the primary business and the BCRP. Also assume the premiums necessary to insure A, B and C are \$20,000, \$17,000 and \$23,000 respectively. The partnership agreement can direct the allocation of the total \$60,000 premium equally (\$20,000 to each partner) as a capital contribution. Every owner/partner would then have \$20,000 of taxable income and \$20,000 of capital contributed to the partnership with the primary business taking a \$60,000 income tax deduction. This is just one of many ways the BCRP can resolve the disparity of premium burden.

### **Death of an Owner:**

A significant benefit of this technique is the ability to fully allocate to the surviving partners the tax-exempt death proceeds that are paid to the entity. This enables them to obtain a full basis increase without "wasting" any basis on a deceased owner who already obtains a basis step-up to fair market value under existing tax provisions.

For instance, assume an accrual basis S corporation has five shareholders/partners and each owner's interest is worth \$1 million. In a stock redemption funded with life insurance, upon the death of an owner, the cost basis of each owner would increase by \$200,000. However, the BCRP can specify the cost basis increase will be allocated **entirely** to the survivors. As a result, the four surviving partners will

each obtain a \$250,000 increase in basis. Furthermore, this allocation can exclude any portion of the death benefit from being included in the deceased's estate provided the agreement prevents a partner from exercising any control of the policy insuring his or her life.

## Retirement of an Owner:

Another important aspect of the BCRP, is the manner in which a policy can be used at an owner's retirement. When a partner retires or withdraws from the partnership, the policy insuring that owner may be distributed in exchange for the partner's interest in the partnership. Unlike a transfer from a C corporation to a shareholder, under IRC 731<sup>1</sup> there will be no gain or loss recognized on this transaction. If the value of the life insurance is not equal to the share of that owner's interest in the partnership, withdrawals from other policies can be also be made prior to distribution.

This method of distribution may be more in line with the owner's retirement and estate planning objectives. Once transferred to the retiring owner, the policy can be used meet

the owner's personal planning needs through tax favored distributions and loans.<sup>2</sup> The policy may also be leveraged to help the client attain their estate planning goals. The transfer of the policy to the departing owner will not adversely impact the subsequent taxation of the death proceeds as transfers to an insured are exempt from the transfer for value rule.

## Conclusion

The *Business Continuation Retirement Partnership* technique is a strategy that may capture the business owner's undivided attention. This strategy also avoids the seemingly unavoidable trade-offs between cross purchase and stock redemption plans, while accentuating many of their best attributes. The flexible design of this strategy provides the initial assurance of business continuation, while simultaneously building potential accumulation of tax advantaged future retirement dollars. Most importantly, it may offer the necessary prod to move business owners beyond their tipping point. Business owners considering this technique should be sure to consult with their independent tax and legal advisors.

<sup>1</sup>I.R.C. 731(a). Under 731(a), a distribution of property rather than money generally results in no gain or loss recognition to the partnership or the distributee partners.

<sup>2</sup>Loans and withdrawals will decrease the cash value and death benefit. Tax-free distributions assume that the life insurance policy is properly structured, is not a modified endowment contract (MEC), and distributions are made up to the cost basis and policy loans thereafter. If the policy has not performed as expected and to avoid a policy lapse, distributions may need to be reduced, stopped and/or premium payments may need to be resumed. Should the policy lapse or be surrendered prior to the death of the insured, there may be tax consequences.

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