

Understanding the Business Continuation General Partnership

One of the most essential forms of planning for business owners is a contingency plan, meaning a buy-sell agreement that describes what would happen in the event of the death, disability or departure of an owner. Unless the owner(s) anticipate that the business would simply cease to exist, buy-sell planning is necessary for the protection and continuity of any business.

Background

A key element of any effective buy-sell plan is that any life insurance purchased to provide funding for a buyout of an owner at death be owned by and payable to the party making the purchase. For most small to medium-sized businesses, buy-sell planning can usually be accomplished with one of the following three traditional approaches:

- **Cross purchase:** often used when there are only two owners. Each business owner owns life insurance on other. At the death of an owner, a surviving owner purchases the ownership interest of a deceased owner. An advantage of this approach is that the surviving owner receives an increased cost basis in his or her share of the business, whether that purchase is funded with life insurance or outside funds. However, this method can be impractical with three or more owners, because each owner needs a life insurance policy on all the other owners.
- **Entity purchase:** often used when there are three or more owners. The business owns one life insurance policy on each owner. At the death of an owner, the business redeems the decedent's ownership interest. In some cases, the surviving owners can receive an increased cost basis to the full extent of the life insurance flowing into the business, but in others (explained below) they may receive no increase, or only a partial increase. This method can allow a business with multiple owners to meet both the buyout need and the key person need with only one policy per owner.
- **Wait and see:** used when the owners want to delay making a decision about who will purchase shares of a deceased owner until the event actually occurs, or they want to employ a combination of cross purchase and entity purchase.¹ This method can require multiple policies on each owner.

In some situations, none of these traditional approaches achieve all the objectives of the owners. When this happens, business owners might consider using a [Business Continuation General Partnership](#) (BCGP) to own and manage the policies. Advantages of this strategy include:

- Only policy per owner is needed, regardless of the number of business owners;
- Each owner receives a proportionate increase in cost basis following a buyout at the death of another owner, to the extent life insurance is used for that purpose;
- It is subject to an exception to the transfer for value rule;
- Partnership agreements may be amended over time as business owners are added or removed; and
- It allows sufficient flexibility to cover multiple entities, even when the owners have varying percentages of ownership across the various businesses.

Concurrent goals

Once the business owners understand the need for buy-sell planning, they often have two concurrent goals:

1. They want to obtain an increased cost basis similar to that offered by a cross-purchase arrangement. An increased cost basis means that when a surviving owner eventually sells, that owner has a higher tax-free recovery of basis, therefore a lower capital gain tax;² *and*
2. They like to meet the business planning needs with just one policy per owner. This is also possible in a cross purchase agreement with only two owners, but with more than two owners, an entity purchase is needed in order to require only one policy per owner.

When can traditional buy-sell agreements satisfy both of these goals?

1. In a cross purchase arrangement where there are only two owners;
2. In an entity purchase arrangement where:
 - a. The business is taxed as an S corporation, and it qualifies for and uses the cash basis method of accounting. The surviving owners make a short tax year election after the death of an owner, which allows the basis increase from the life insurance to be allocated only among the surviving owners; or
 - b. The business is taxed as a partnership and contains special allocation language in its buy-sell agreement or operating agreement. The special allocation language calls for the basis increase from the life insurance to be allocated only among the surviving owners.

Put another way, this means that the full increase in cost basis would ordinarily be unavailable if the business is (a) taxed as an S corporation but does not qualify to use cash basis of accounting, (b) taxed as a partnership but does not have special allocation language in its documents, or (c) consists of multiple business entities with varying degrees of ownership. In all of these scenarios, a business continuation general partnership can usually meet both goals, as well as streamline and simplify the insurance funding.

What is a BCGP?

A BCGP is a partnership (or an LLC taxed as a partnership) formed by the business owners, for the purpose of holding and managing the policies funding a cross-purchase buy-sell agreement between the owners of the operating business. The partnership owns one life insurance policy on each owner. The premiums are paid with contributions to the BCGP by either the owners of it or by the operating business (generally taxable as bonuses to the owners³). Often, the BCGP can meet the concurrent goals described above.

The BCGP has a mandatory entity purchase provision and special allocation language allocating the increased cost basis from the death benefit proceeds only to the surviving owners. At the death of an owner, the BCGP receives the death benefit and redeems the deceased owner's interest in the BCGP, then distributes the remaining death benefit to the surviving partners. They use this income tax-free death benefit to complete the separate cross purchase agreement of their business (or combination of businesses).

A BCGP operates in the same manner as a "trusteed" or escrow buy-sell agreement. However, the BCGP avoids the transfer for value problem that can occur after the first death when a trust or escrow arrangement is used. After the first death, the ownership percentages of the policies on the other business owners shifts among the survivors. If the policy owner is an escrow agent or a trust, this shift of ownership

could trigger a transfer for value, making a portion of the death benefit potentially taxable. Two of the exceptions to the transfer for value rule are a transfer to a partner of the insured, or to a partnership in which the insured is a partner.⁴ Therefore, the use of a BCGP takes advantage of these exceptions, avoiding the tax impact of a transfer for value rule following the death of a second owner.

What are the alternatives?

Since a BCGP can solve even the most complex buy-sell planning challenges, why isn't it used all the time? The simple answer is that the legal fees to set up the partnership and file a tax return for it each year might not be justified. The owners may first consider other alternatives. For example, if the owners have an entity purchase agreement in a cash basis S corporation or in a partnership with special allocation language in its documents, they can potentially obtain an increased cost basis to the extent that the buyout is accomplished with life insurance on the deceased owner. Even in an accrual-based S corporation, the surviving owners receive a partial basis increase when the buyout is accomplished with life insurance.

Example: Al, Betty, Carol and Don are equal owners of Ace, Inc., a manufacturing business that is taxed as an S corporation. Assume the business is valued at \$4 million and uses the accrual method of accounting.⁵ The business owns four \$1 million life insurance policies on the owners. At the death of Don, the business receives the \$1 million death benefit income tax free. This increases the basis of all the owners by \$250,000 each. Don's increased basis is "wasted," because the widow will have a stepped-up basis, meaning she pays no capital gain on the buyout at Don's death. Each of the other surviving owners will have a \$250K increase in their cost basis.

If Ace, Inc. were a cash basis taxpayer – or if the owners decided to utilize a BCGP -- the basis increase would be higher: each of the three survivors would receive an increase in cost basis of \$333K. The owners may wish to consider the collective costs of the capital gain tax on the difference of \$83K to each owner to the costs of establishing and maintaining a BCGP.

Furthermore, even in some businesses that have multiple owners, if only two owners control the majority of the shares, it might be possible to plan a buyout of the minority owners with business cash flow and use a cross purchase agreement funded with life insurance for the two majority owners to buy one another out.

Summary

A Business Continuation General Partnership can solve a number of complex buy-sell objectives, even in a business with multiple entities and tax structures, and varying degrees of ownership among a variety of owners. It can also allow surviving owners to obtain an increased cost basis upon the buyout of an owner when it might otherwise be unavailable. Principal® offers a [sample BCGP agreement](#) for clients to share with their attorney as an example of what they may want.

¹ In a database of over 2,000 buy-sell agreements reviewed by the Business and Advanced Solutions team at Principal®, 94% of agreements utilized one of these three designs.

² Note that if the owner does not expect to sell (for example, if the business will be passed on to family), an increased cost basis might not be important.

³ The premiums paid into the BCGP could be taxable as distributions instead of compensation, but if the operating business is an S corporation, distributions generally must be made in the same proportion as the owners' relative interests in the business. Other methods of getting funds to the BCGP could include loans, or a contribution of income-producing property to the partnership.

⁴ See IRC Sec. 101(a)(2)(B).

⁵ Because it uses the accrual method of accounting, the S corporation is not eligible for a short tax year election.



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