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Article 10

Federal Income Taxation: Bais Adjustments Upon Payment of Life Insurance Proceeds to Deceased Partner's Designated Beneficiary: Victor G. Mushro

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RECENT DECISION

Federal Income Taxation: Basis Adjustments Upon Payment of Life Insurance Proceeds to Deceased Partner's Designated Beneficiary: Victor G. Mushro—Many of the problems which arise with dissolution of partnerships due to the death of a partner can be avoided or minimized by an adequate buy-sell provision in the partnership agreement. Partners can provide for the purchase of each other's interests, upon agreeable terms, and arrange for the provision to take effect upon the death of each partner. A popular method of funding such an agreement is through the use of life insurance. The insurance policy provides the cash needed by the surviving partner(s) to purchase the deceased partner's interest immediately and avoid the necessity of complete liquidation of the firm. Much has been written about the advantages and disadvantages of various details of these agreements, such as ownership of the policies and designation of beneficiaries.[1] Since the *Legallet*[2] case in 1940, however, these commentaries have consistently warned of the danger of having the policies payable directly to the insured's own designated beneficiary. In that case, the court refused to permit the remaining partners to adjust the bases of their interests by the amount of the insurance proceeds paid to the deceased partner's wife. The court reasoned that the payment of insurance proceeds and additional cash settled the deceased partner's interest in accordance with the agreement, but, since the insurance proceeds were paid directly to the deceased partner's wife, they could not be considered payments by the remaining partners or partnership. Therefore, the proceeds were not allowable as adjustments to the basis of the remaining partners' interests. The recent *Mushro*[3] case appears to have modified this position.

In *Mushro,* three brothers formed a commercial partnership for purposes of operating a motel. As the partnership agreement evolved through several modifications, it provided that the buy-sell provision would be funded by life insurance policies owned by the partnership, but payable to each partner's wife. It further provided that in the event of a partner's death, his personal representative should convey his interest to the surviving partners upon payment of the insurance proceeds to the deceased partner's beneficiary.[4] One brother died and the insurance proceeds were paid directly to his widow. The remaining two brothers signed a dissolution of partnership agreement with the deceased

[1] *See, e.g.,* Liles, *Income and Estate Tax Effects of Payments on Death of a Member of a Service Partnership,* N.Y.U. 20TH INST. ON FED. TAX. 769 (1962); Comment, 30 MO. L. REV. 117 (1965).

[2] Paul Legallet, 41 B.T.A. 294 (1940).

[3] Victor G. Mushro, 50 T.C. 43 (1968).

[4] This is an essential provision for any agreement wherein purchase of a deceased partner's interest is anticipated. It binds each partner's estate to convey his interest upon payments of the designated amount.

partner's widow and executor. On the same day the two brothers formed a new partnership. Six months later they sold the partnership assets and eventually dissolved the new partnership.

On their individual income tax returns, the partners reported gain from sale of the partnership assets calculated on an increased basis subsequent to their brother's death. Neither partner reported income from the dissolution of the new partnership, partly because they each increased the basis of their interests in the new partnership by one-half the value of the deceased partner's interest in the old partnership. The district director challenged both the basis of the new partnership's assets and the basis of the partners' interests. The court held that, in substance, the surviving partners received the insurance proceeds and then paid them to the deceased partner's wife in exchange for his interest. The surviving partners were therefore entitled to increase the bases of their interests under the Internal Revenue Code of 1954,[5] section 1012,[6] and the partnership was entitled to a basis adjustment under section 743(b)(1)[7] (the section 754 election[8] was in effect).

The key to the decision is in the court's finding that the insurance proceeds, in reality, were paid to the deceased partner's wife by the surviving partners or the partnership. This reasoning avoided the problem presented in the *Legallet* case and allowed an increase in basis of each partner's interest.

Although the court upheld the amount of the increases, it did not agree with the surviving partners' theory of adjustment. The partners argued that the insurance proceeds were non-taxable income to the partnership and therefore were allowable as adjustments to the bases of their interests under section 705(a)(1)(B).[9] The court, however, held

[5] Unless otherwise indicated, all references to certain sections are to the Internal Revenue Code of 1954.

[6] INT. REV. CODE of 1954, §1012: BASIS OF PROPERTY - COST—The basis of property shall be the cost of property. . . .

[7] INT. REV. CODE of 1954, §743: OPTIONAL ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY

(b) Adjustment to Basis of Partnership Property.—In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall—(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property. . . .

[8] INT. REV. CODE of 1954, §754: MANNER OF ELECTING OPTIONAL ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY.

If a partnership files an election . . . the basis of partnership property shall be adjusted . . . in the case of a transfer of partnership interest, in the manner provided in section 743.

[9] INT. REV. CODE of 1954, §705: DETERMINATION OF BASIS OF PARTNER'S INTEREST

(a) General Rule.—The adjusted basis of a partner's interest in a partnership shall . . . be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—(1) increased by the sum of his distributive share for the taxable year and prior taxable years of—. . .

(B) income of the partnership exempt from tax under this title. . . .

that the proceeds were paid to the surviving partners individually, rather than to the partnership, and therefore the payment to the deceased partner's wife was allowable as an adjustment to their interests under section 1012: cost basis. The court then allowed the adjustment to the partnership basis under section 743(b)(1), the adjustment allowed for partnership assets with respect to persons who purchase an interest in a partnership. The surviving partners were therefore considered transferee partners as to the interest of their deceased brother.

There are two basic types of funding agreements that are used in these situations: the "entity" plan and the "cross-purchase" plan.[10] Under the entity plan, the insurance policy on each partner's life is owned by the partnership and payable to the partnership entity. Under the cross-purchase plan, however, the partners take out policies on each others' lives, in such combinations that all surviving partners will receive the proceeds as individuals when another partner dies. In the *Mushro* case, the surviving partners argued that their agreement was of the entity type. The court, however, held that the intent expressed in the partnership agreement was that the insurance proceeds were to be treated as going to the surviving partners individually. Thus, although the partnership owned the policies, the effect of one partner's death was to cause the agreement to operate as a cross-purchase plan.

Had the court determined that, in substance, the proceeds were received by the partnership unit, an entity plan would be present. The effects of a partner's death would normally be different under an entity plan. The first difference would be that the assets of the entity would be increased by the excess of the insurance proceeds over the carrying value of the insurance policy's cash surrender value. This, in turn, would cause all partners' interests to increase in proportion to their profit-sharing ratio under section 705(a)(1)(B).[11] The deceased partner's interest would therefore be greater and would be more expensive to purchase, if the agreement providd for a purchase price related to the partner's interest at time of death. This problem could be avoided, however, by a provision in the agreement that insurance proceeds shall not increase the insured's interest proportionately with the surviving partners' interests.[12] The difference between the cash surrender value and the face amount of the policy, therefore, would inure to the benefit of the surviving partners only. An alternative provision would be that the deceased partner's interest is to be based on the partnership basis at the time of his death, without regard to insurance proceeds and cash surrender values.[13] Thus, the surviving partners' interests would be

[10] "Trust" plans are sometimes referred to as a third general type of funding agreement, but such plans are basically either an entity plan or a cross-purchase plan administered by a trustee.
[11] Treas. Reg. §1.705-1(a)(2)(ii) 1956).
[12] Comment, *supra* note 1, at 129.
[13] WILLIS, HANDBOOK OF PARTNERSHIP TAXATION §28.03, at 416-417 (1957).

increased when the proceeds were considered received by the partnership. If the proceeds were equal to the amount paid to the deceased partner's beneficiaries, the increase in basis to each of the surviving partners would be the same as under the cross-purchase plan.

The *payment* by the partnership to the deceased's beneficiaries might also involve a change in results under the entity plan. Payments made by the partnership (rather than the partners) generally constitute a "liquidation of the partner's interest" under section 736. A liquidation requires segregation of payments considered capital distributions and payments considered ordinary income distributions.[14] Payments considered ordinary income would reduce the taxable income left to the surviving partners.[15] Such payments would also reduce the capital assets that would be included in the decedent's estate, in that payments of ordinary income are considered "income in respect of a decedent".[16]

The increase in partnership basis would be the same, however, because section 743(b) applies, when the section 754 election is in effect, regardless of whether the surviving partners individually or the partnership unit purchase the deceased partner's interest.

The *Mushro* case does not change the basic effects of either the cross-purchase or the entity plans. Proper planning still requires consideration of the advantages and disadvantages of each method, and an analysis of the nature and purposes of each contemplated partnership. The *Mushro* case does allow providing for payment of insurance proceeds directly to the insured's designated beneficiary without jeopardizing the benefits under either plan, if certain conditions are met. How strictly these conditions are to be applied is open for future determination, but guidelines are established by this case. A clear intent that insurance proceeds are to be considered as paid to the partners or partnership, and then to the deceased partner's beneficiary to settle his interest, is required. Such intent must be evident from the partnership agreement.[17] It appears that the court will also require petitioners to prove to its satisfaction that the insured designated his own beneficiary solely for security reasons. In the *Mushro* case, the deceased brother named his wife beneficiary only because he feared the animosity existing

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[14] To the extent that payments are considered under Treasury Regulations as given in exchange for the partner's interest in partnership property, they are considered as a capital asset distribution. Treas. Reg. §1.736-1(b)(1) (1956). Any excess is treated as ordinary income to the deceased partner's estate, either as a distributive share of partnership income, or as a guaranteed payment. Treas. Reg. §1.736(a)(3)(i) and (ii) (1956). However, payments for partnership property that are applicable to unrealized receivables, substantially appreciated inventories, and goodwill amounts not provided for in the partnership agreement are treated as ordinary income distributions. Treas. Reg. §§1.751-1(a)(1), 1.736(b)(4), 1.736-1(2)(3) (1956).

[15] Treas. Reg. §1.736-1(a)(4) (1956).

[16] INT. REV. CODE of 1954, §691(a); Treas. Reg. §1.753-1(a) (1956).

[17] 50 T.C. at 49.

between his wife and his brothers might delay or prevent fair payment to his wife for his interest if he died. The court stated:

> Petitioners further proved that Lawrence, after seeing the original agreement, insisted that its terms be changed to circumvent any reluctance in his brothers to pay policy proceeds to his wife if he were the first to die. Thus, *for security reasons only,* the terms of the buy-sell agreement were changed and Pauline was named the beneficiary of the insurance policy on Lawrence's life. Under the circumstances here presented, we feel constrained to heed the realities of the situation as reflected by the proved intent of the partners, not the labels which they were forced by the exigencies of life to apply to the realities of their transaction.[18] (emphasis added)

The court supported this decision by referring to established policies of assuming partners' agreements to be the results of arms-length bargaining,[19] and of recognizing the priority of substance over form.[20] The most important factor in influencing the court's opinion was the clear intent of the parties to treat the insurance proceeds as being paid by the surviving partners or the partnership to the deceased's beneficiary. It seems likely, then, that future liberalizations of this ruling will mainly concern the requirement of naming one's own beneficiaries for security purposes only. Simple convenience is a justifiable reason for naming beneficiaries other than the surviving partners or the partnership, and may come to be recognized as sufficient. The future might also see *presumption* of intent that insurance proceeds be considered payment from the surviving partners or the partnership, although paid directly to the deceased's beneficiaries. This appears to be a valid presumption, since the partners pay the premiums, without the benefit of tax deductibility, and usually are in an advantageous position with such a provision.

In general, the *Mushro* decision is a logical one. Many writers, including the judge who rendered the concurring opinion, probably feel it effectively overrules the *Legallet* case. The majority of the court, however, distinguished the two cases. They felt that the partners in *Legallet* did not intend that the insurance proceeds were to be considered payments from the surviving partners or the partnership. As Judge Fay, speaking for the majority, pointed out:

> When the partners in Legallet named their wives beneficiaries of the life insurance policies, they were carrying out their basic intent—to provide an annuity to the wife of the first partner to die. It follows that in Legallet the partners did not intend, in their buy-sell agreement, for anyone other than their wives to receive the proceeds of the insurance policies.[21]

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[18] *Id.* at 49-50.
[19] Treas. Reg. §1.736-1(b)(1) (1956).
[20] Orr Mills, 30 T.C. 150 (1958).
[21] 50 T.C. at 50.

This appears to be a valid distinction, although a fine one, because the *Legallet* case suggested that the clear intent of the parties would be followed, even if it was found to be as in the *Mushro* case.[22] Thus, the broad warnings against allowing the insured to designate his own beneficiary, which followed the *Legallet* case, may have been due to a general misunderstanding of what that case actually held. The *Mushro* case somewhat clears the confusion and is commendable as a simple, realistic, and relatively straightforward interpretation of parts of the complex and much criticized[23] area of the 1954 Internal Revenue Code known as Subchapter K.

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[22] 41 B.T.A. at 299-300.

[23] *See, e.g.*, McKay and Moorefield, *Business Insurance Agreements*, 46 MASS. L. Q. 79, 105-106 (1961).