by Terri Getman, JD, CLU, ChFC, RICP, AEP(Distinguished)

Is It Time to Reconsider Business Owned Life Insurance for Funding of Buy-Sell Agreements?

One of the major problems with all buy-sell agreements is finding the funds to enable the buyer to purchase the interest of a deceased owner. Life insurance is a tidy solution when it is available and affordable because:

- The insurance death proceeds are paid at the time when the obligation to purchase the business interest is triggered.
- Properly structured, the proceeds may be received income tax-free under IRC § 101(a).[1]
- The cost of the life insurance is generally less than the death benefit received.

However, funding a buy-sell arrangement with life insurance has its own issues. One issue is the treatment of the proceeds on the estate valuation of the business when life insurance is used to fund an entity purchase/ stock redemption buy-sell arrangement.

Prior to the June 6, 2024, Supreme Court decision in *Connelly v. US*[2], the main case regarding the impact of business owned life insurance on the value of a business for estate tax purposes was *Estate of Blount v. Commissioner*[3]. The Blount case held that the estate value of a company would <u>not</u> be increased by the value of the death benefit of life insurance when its purpose is to provide liquidity to a company to redeem a decedent's ownership interest. In other words, the value of the life insurance proceeds was offset by the entity's redemption obligation. However, in *Connelly* a unanimous Supreme Court rejected this approach; finding that for estate tax purposes life insurance proceeds are an asset that must be included in the calculation of the business value and that an entity purchase/stock redemption buy-sell agreement did not reduce the value.

Because of the Connelly decision it is important to think through the implications of business owned life insurance. Following are some pointers you might consider now:

Should business owners who have buy sell arrangements funded with business owned life insurance review their structure with their advisors - even if their net worth is not large enough to trigger estate taxes? Yes.

If a business owner's net worth does not raise to the level to trigger an estate tax (federal or state) s/he may not need to worry about the results of the *Connelly* decision. However, a business owner may still want their document reviewed to make sure the agreement reflects their intentions concerning whether the purchase price should or should not include the value of the life insurance proceeds. This is especially true if the method for determining the purchase price is based on an outside appraisal. Surprisingly, many buy-sell agreements are silent or ambiguous on whether the purchase price should take the insurance funding into consideration as an asset. Absent specific instructions in the buy-sell agreement, the business appraiser may have to make the determination. What the appraiser decide will almost certainly disappoint at least one side and may surprise both.

If a business owner desires to "fix the value of their business for estate tax purposes" and has a buy-sell agreement funded with business owned life insurance should s/he consider changing the buy-sell agreement and life insurance structure? Maybe.

Any business owner, especially a family closely held business owner, who has a buy-sell agreement, provisions in an operating or shareholders agreement, or a similar document which restrict transfers of business interest in hopes of using the value established by the agreement for estate purposes should check in with their succession planning advisors about what they should do as a result of the recent Supreme Court decision in *Connelly*.

One of the advantages of a properly structured buy-sell agreement is that it can eliminate estate tax valuation problems. The theory is that if the decedent is contractually bound to sell the business interest at a certain price, then that price should constitute the estate tax value of the business interest. However, to accomplish this objective the agreement must meet the requirements established in IRC § 2703 and Treasury Regulation § 20.2031-2(h) and the business owners must follow the terms of the agreement. There are more requirements for family business owners than there are in situations where owners are not related.

It should be noted that the Supreme Court did not hold that an entity purchase/stock redemption arrangement funded with business owned life insurance could never fix the value for estate tax purposes. An entity purchase/stock redemption agreement can stand-up in court when it contains clear, fixed valuation formulas or methods to determine the price and the owners comply with the terms of the agreement. So, one strategy is to maintain an entity purchase buy-sell arrangement, but make sure that that it is structured properly.

However, some legal advisors might be reluctant to use the entity purchase/stock redemption form of buy-sell agreement – especially in family business situations. Where this is the case legal counsel might suggest that the buy-sell agreement be changed to one of the many forms of cross-purchase buy-sell agreements. The question then becomes can existing business owned life insurance be used to fund the new buy-sell arrangement or must new coverage be acquired?

What are a couple of the most common cross-purchase buy-sell arrangement structures and can the existing life insurance be used?

There are many ways to structure a cross-purchase buy-sell arrangement with the following two being the most common:

Traditional cross-purchase structure.

In a traditional cross-purchase agreement the policies are owned outside the business with each business owner being the owner/beneficiary on all the other business owners. Specifically, where there are two business owners, owner "A" would be the owner and beneficiary insuring business owner "B" and vice versa. Since life insurance proceeds in this form of cross-purchase buy-sell agreement are not owned by or payable to the business the insurance proceeds should not increase the value of the business.

This structure works fine where the business has two or three owners but may not be practical with four or more business owners because of the large number of insurance policies required. The formula for the number of policies needed is "number of business owners x [number of owners – 1]. Also, if the business entity is taxed as a corporation and there is a need to transfer existing policies due to adverse health of a business owner it may not be possible to transfer existing insurance coverage to co-shareholders without causing the death proceeds to be subject to income tax.

Business continuation partnership/LLC structure.

Where large number of policies are a concern or where the business is incorporated it might be worthwhile to consider establishing a business continuation partnership or LLC to own the buy-sell life insurance. With this form of cross-purchase arrangement, the LLC is the owner and beneficiary of one policy on each business owner. The key is that each policy is specifically allocated to the non-insured partners so the death benefit should not increase the value of the deceased partner interest in the business continuation partnership.

For example, assume A, B, and C are shareholders in an corporation and they desire to enter into a buy-sell, but do not want to purchase 6 policies required in a traditional cross-purchase arrangement. With a business continuation partnership/LLC structure the LLC will be the owner and beneficiary of one policy on each A, B and C. Within the LLC agreement the policy insuring A will be allocated to B and C, the policy on B allocated to A and C, and the policy on C allocated to A and B. When A dies, the proceeds are paid to the LLC and allocated to partners B and C increasing their basis in the LLC. The proceeds can then be distributed to B and C giving them the proceeds to carry out a cross-purchase of A's interest in the corporation.

Unlike the traditional cross-purchase arrangement in this situation even if the owners are shareholders in a corporation, they are also partners in a newly established LLC thereby providing a tax exemption to transfer existing insurance coverage to the business continuation partnership without causing the death proceeds to be subject to income tax.

Does the Connelly decision have implication for other situations where a business owns life insurance such as key person coverage? Possibly.

Throughout the Court's opinion it stated that when calculating estate tax, "life insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value" citing Treasury Regulation 20.2031-2(f)(2). Consequently, key person coverage on a business owner could impact the value of a business. However, that same Regulation states that the fair market value of a business should take into account its "prospective earning power." The death of a key person is expected to negatively impact the earning power of a business. Consequently, one would expect the receipt of key person death benefit to be offset by the reduced earning power of the business.

---

[1] For employer-owned contracts issued after August 17, 2006, IRC 101(j) provides that death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally received income tax-free under IRC § 101(a).

[2] Connelly v. US, No. 23-146, 602 U.S. ______(June 6, 2024).

[3] Estate of Blount v. Commissioner, T.C. Memo. 2004-116, aff'd in part and rev'd in part, 428 F. 3d 1338 (11th Cir. 2005)

For the Education of Financial Advisors & Financial Professionals. Not for use with the General Public.

This material has been prepared to assist our licensed financial professionals and clients' advisors. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that we are not rendering legal, accounting or tax advice. Such services must be provided by the client's own advisors. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code.