Buy-Sell Planning after *Connelly*

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I. Overview

Buy-sell planning is the intersection of two disciplines: business planning and estate planning. Estate planning is always about getting assets to whom you wish, when you wish, at minimal tax cost. But when a closely held business is one of those assets, or the majority of the estate, buy-sell planning plays a critical role.

A. For all business owners, regardless of the federal estate tax (FET), planning must include:
   1. Choice of an appropriate, effective buy-sell agreement structure for owner objectives, number of owners, business structure.
   2. Assuring that insurance ownership aligns with terms of buy-sell agreement
   3. Consistency between documents – buy-sell agreement and estate documents
   4. Estate equalization if transferring business to family

B. For those facing the Federal estate tax (FET): (threshold $13,610,000 in 2024; scheduled to drop by half on January 1, 2026)[1]
   1. Addressing the impact of *Connelly* (see part III): avoiding unintentional inclusion of business-owned life insurance in estate
   2. Following procedures that may allow the buy-sell agreement to set the price for estate tax purposes
   3. Looking ahead to 2026

II. Choosing and funding an effective buy-sell structure

A. Four basic designs: cross purchase, entity purchase, wait and see, third party structures . It is important that the insurance ownership align with the buy-sell design, as follows:
   1. Cross purchase: other owner(s) purchaser following a triggering event
      a. Funding typically with cross owned life and disability buyout insurance
      b. Advantages:
         i. Assurance that life insurance ownership can be kept outside the business, so it doesn't inflate the business value.
         ii. The surviving owner's cost basis is increased by the price paid for the shares[2] (regardless of whether life insurance is used for the purchase).
      c. Disadvantages
         i. If multiple owners, managing policies can become unwieldy: the number of policies needed is [number of owners minus one] times [number of owners]. (Example: four owners would need 12 policies.)
         ii. Business owners (or their spouses) not always comfortable with their co-owner owning life insurance on them.
            a. Premium costs may be disparate, particularly if one or more owners are younger/healthier than others. Business can smooth this

[1] Rev. Proc. 2023-34, 2023-48 IRB 1287.
[2] IRC Sec. 1012(a).

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difference by bonusing each owner the premium costs and grossing up the bonus to cover the tax on it.

d. One or more owners may be uninsurable, making other funding methods necessary.

e. The IRS determined in two longstanding private letter rulings that the need for coverage in a cross purchase agreement could be funded with life insurance in a qualified plan.[3]

2. Entity purchase: entity as the buyer
   a. Funding typically with business-owned life and disability buyout insurance
   b. Advantages
      i. Simplicity: one policy per owner can satisfy buy-sell need
      ii. Dual purpose: the same policy that covers the buy-sell need can provide key person protection as well.
      iii. The additional coverage available for key person needs can also help build in room for growth of the business.
      iv. However, if buy-sell agreement requires that "all" life insurance received by the company be applied to the buyout, key person coverage would have to be allocated to the purchase if needed.
      v. Business is in control of policies; can assure that premiums being paid in timely manner and that disposition of the policies upon unwinding of the agreement is as the owners intend.
   a. Disadvantages:
      a. Under *Connelly v. U.S.,* 602 U.S. ___ (June 5, 2024), if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company, with no offset for the redemption obligation.
      b. Common objection is that surviving owners do not receive an increased cost basis. This is true for C corporations, but not always entirely so for S corporations or partnerships.[4]
      c. Potential unintended shift of control:
         i. *Example*: Ace Corporation is owned by Dad (60%), daughter (15%) and lazy uncle (25%). Perhaps Dad and daughter think of lazy uncle as a harmless minority owner, but If Dad's shares are redeemed in an entity purchase arrangement, the control shifts to 62.5% lazy uncle and 37.5% daughter.

3. Wait and see: buyer to be determined when the triggering event occurs. Optional at first, often with a final mandatory buyout specified.
   a. Life and disability buyout insurance can be cross-owned or entity owned.

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[3] See Let. Ruls. 8108110, 8426090,

[4] See explanation at Section VI-C of this outline.

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b. Advantage: maximum flexibility -- allows future circumstances to be taken into account in determining the buyer. Will an owner's child be capable of taking over the business by then? Will the surviving spouse want to be (or stay) involved, or not? Will there be key people ready to take over?

c. Disadvantages:

   a. If funded with company-owned life insurance, raises same *Connelly* risks as entity purchase (meaning if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company, with no offset for the redemption obligation; see Section III).

   b. Wait and see structure provides no clear indicator of how life insurance should be owned. If all buyout rights are optional, no certainty that any buyout will take place.

   c. Possible solutions:

      i. Depending on number of owners, there could be some life insurance on each owner at the company level and some cross owned, with installment sale provisions as a backup.

      ii. An optional buyout could be established for the other owner(s), followed by a mandatory entity purchase by the company if the other owners choose to not buy. Life insurance could be cross owned by the top business owners for their buyout.

4. Third party ownership: based on the concept of a life insurance LLC, trusteed buy-sell or escrow buy-sell (carrying out a cross purchase agreement):

   a. Partnership structure for insurance ownership is suggested as a best practice, due to the transfer for value implications of a policy transfer after the first death.

   b. Advantages

      a. allows an underlying cross purchase arrangement to cover multiple owners (particularly in a C corp or accrual S corp, which would not be eligible for the simpler strategies for getting the surviving owners an increased cost basis);

      b. Underlying cross purchase structure should provide surviving owners an increased cost basis following the buyout of a deceased owner;

      c. Can also cover the needs of owners who have multiple business entities with varying percentages of ownership.

   c. Disadvantages

      a. Complexity of a separate LLC structure may be unnecessary for certain businesses or situations;

      b. Added costs to set up entity and file returns annually.

5. One-way buy-sell
   a. Buyer could be any planned successor – family, employee or the business entity.
      a. If buyer will be family member(s), identify how much will be gift versus sale; address estate equalization issues if applicable.
      b. Key person as buyer: usually doesn't have the money; hence, a need for accumulating funds to assist. A deferred bonus can serve the dual purpose of key employee retention and providing funds for a buyout (or down payment). A 5-10 year time frame is ideal.
   b. Oher issues around ownership of life insurance on business owner/seller for a one-way buyout:
      a. Key person could own (but business owner might not be comfortable with key person owning the policy)
      b. Company as owner (but this means the business covers the costs; key person has no "skin in the game"). However, it puts the business owner in control of the funding, timing, and price.
      c. Business owner could own policy on self and endorse part of death benefit to the key person (but this also means business owner is covering costs; also, must consider transfer for value issue with endorsement).
      d. Third party (such as a partnership) as owner raises same issues as other third party strategies, including costs of creating a partnership and filing annual returns.
   c. Advantages and disadvantages:
      a. Advantages: if successor known, can assure that a buyout is planned and funded. Gives business owner control over succession plan.
      b. Disadvantages: not available if no known successor. And, it raises the potential (under *Connelly*) for the life insurance to inflate the business value if life insurance is business-owned.
6. No buy-sell agreement, or "no-sell buy-sell": simply protect family with life insurance, or establish a trust with life insurance that is empowered to buy the business from the estate and oversee it until the timing is right for a sale.
   a. Owner makes sure family completely provided for with life insurance (either personally owned or trust-owned) and/or other assets;
   b. If no trust as purchaser, family does what they want with the business when death occurs – step into the business or sell it to a third party.
   c. Advantages and disadvantages:
      a. Advantages: flexibility for family; if trust buys business, trustee empowered to oversee business; can wait until the right buyer is found; for families subject to Federal estate tax, trust purchase allows payment of estate tax without a "fire sale" to pay estate tax.

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b. Disadvantages: decisions made following a death might not be as well-considered; also, other owners, family members and/or key employees might prefer more certainty. Further, if no buy-sell agreement exists, business might not have provisions for buyout for lifetime events or needs, such as transfer restriction, right of first refusal, or buyout structure for triggering events such as disability, divorce, bankruptcy, loss of license, etc.

B. Importance of mandatory versus optional buyout provisions

1. When buyout is optional, the surviving owner could simply walk away with the life insurance death benefit. If a buyout is intended, consider making it mandatory (or having a mandatory buyout follow an optional purchase right).
2. Consider also requiring the application of life insurance proceeds to the purchase; however, don't require that ALL proceeds received by the company be applied to the buyout, rather just those (or the amount) designated for the buyout. Why:
    a. The amount of death benefit might exceed the value of the business interest being purchased.
    b. Buyout need: allows the company to pay the family of the deceased owner for the value of his/her shares
    c. Key person need: provides the business with cash flow to pay any debts that come due as the result of an owner's death, meet ongoing expenses, and recruit/hire qualified replacement talent as needed for the business. Key person life insurance can be used to supplement funds for buyout, but agreement should not require that all life insurance payable to the company be applied to the purchase.

III. *Connelly v. U.S.*

A. *Connelly v. U.S.,* No. 21-3683, 602 U.S. ___ (June 5, 2024): held that if the buy-sell agreement does not successfully lock-in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation.

B. In the *Connelly* case, two brothers owned a small building supply company. Michael Connelly owned 77.18% and Thomas Connelly owned 22.82%. The brothers entered into a wait-and-see buy-sell agreement, which provided that at the first death, the surviving owner had a right to buy the deceased owner's shares, followed by a mandatory entity purchase if the survivor declined to purchase them. To set the purchase price, the agreement required that the owners annually complete a "Certificate of Agreed Value" (setting the price by "mutual agreement"), or if that was not done, they were required to get two or more appraisals to set the fair market value.

1. The company purchased $3.5 million of life insurance on each brother to fund the entity purchase agreement. Michael died in October 2013 and the company received the death benefit.

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2. Thomas and Michael's heirs simply agreed that Michael's business interest for the purpose of the buy-out would be $3 million (77.18% of the $3.86 agreed upon business value). The company used $3 million of the policy's death benefit to purchase Michael's interest from his estate. For estate tax purposes, the estate (with Thomas as executor) reported Michael's business interest as having a value of $3 million.
3. The Courts (Eastern District of Missouri[5], Circuit Court of Appeals for the 8th Circuit[6], and U.S. Supreme Court[7]) all ruled that the life insurance proceeds increased the value of the business (from $3.86 million to $6.86 million).
4. Michael's estate eventually agreed, but argued that the purchase obligation was a liability that offset the value of the proceeds, thereby reducing the value of the business. The Supreme Court disagreed, stating that "*a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.*" The Court also stated that, for calculating the estate tax, the purpose is to assess how much the decedent's shares were worth at the time that he died – after the life insurance death benefit is taken into account, but before the company spent money on the redemption payment ($3 million to Michael's estate).
5. Ultimately, the Court agreed with the IRS that, when taking into account the life insurance proceeds, the company owned by the Connelly's was worth $6.86 million at the time of Michael's death, so that his 77.18% interest was worth nearly $5.3 million, not the mere $3 million claimed by the estate. The additional estate tax ($889,914) imposed by the IRS was thus justified.

C. Problems with Connelly:

1. The buy-sell agreement called for an annual agreement of value between the owners, to be updated annually. The annual updates had not been completed.
2. The buy-sell agreement also called for an appraisal as a backup method for pricing, but Thomas did not obtain an appraisal. Instead, he and Michael's family agreed on a purchase price of $3 million for decedent's ownership.
3. The life insurance death benefit received by the business was $3.5 million, of which the parties treated $500,000 as key person coverage, and applied $3 million to the purchase. Aside from the life insurance proceeds, the business value was approximately $3.3 million at the time of death, meaning 77% would equal roughly $2.5 million. Counting the $500,000 of key person coverage increased the 77% share to just under $3 million, which is what Thomas paid to Michael's estate.
4. The buy-sell agreement was silent as to whether life insurance should or should not be counted in the value of the business.

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[5] 128 AFTR 2d 2021-5231 (E.D. MO, 9/21/21)
[6] 2023 WL 3769233 (8th Cir. June 2, 2023)
[7] No. 21-3683, 602 U.S. ____(June 5, 2024)

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   5. The sole surviving owner (Thomas) was the brother of the decedent (Michael) and executor of his estate. The courts viewed this as resulting in a conflict of interest.

D. The IRS successfully argued that the business value was increased to $6.8 million ($3.3 million before Michael's death, plus the $3.5M death benefit). The courts were persuaded by the parties' failure to follow the buy-sell appraisal requirement, and concluded that the agreement could not satisfy the requirements of Section 2703(b) for "locking in" the value of the business for this and other reasons.

E. *Connelly* opinion was unanimous, authored by Justice Clarence Thomas. It left many questions unanswered.
   1. It seems clear that failure to follow the agreement's protocol for determining value was a critical issue, without which the case might never have been litigated. At the District Court, this was fundamentally the rationale for the agreement being disregarded. Could the agreement have "locked in" the value if its procedures had been followed?
   2. If the survivor had not been the decedent's brother and executor, would the case have been decided differently?
   3. Are the findings limited to family-owned businesses, or to what extent do they dictate future valuations of all businesses?
   4. What are the implications, if any, for companies not affected by an estate tax?

F. Suggested alternatives:
   1. U.S. Supreme Court pointed out that owners can avoid the *Connelly* outcome by using a cross purchase agreement.
   2. Consider alternative means of carrying out a cross purchase agreement, such as a Business Continuation LLC, escrow agreement, trusteed agreement, or cross endorsements.
   3. Third option, particularly for businesses switching from an entity purchase to a cross purchase agreement:
      a. Transfer of policy to the insured is an exception to the transfer for value rule[8]
      b. Each owner could endorse out death benefit from a policy owned on self to other owners
      c. Note that both the business interest and the life insurance would be in business owner's estate, but owner should receive an estate tax deduction for the portion owed/endorsed to the other owners.
   4. If using entity purchase agreement funded with company-owned life insurance (in spite of *Connelly)*:
      a. Be specific in pricing provisions as to how life insurance values and death benefit are to be valued, and whether death benefit is to be included or excluded from the price of the business;

[8] IRC Sec. 101(a)(2)(B).

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b. Use valuation method likely to result in a current, accurate fair market value of the business, such as an appraisal or formula value.
c. If exposure to the Federal estate tax is anticipated, closely follow guidelines for "locking in" the value of the business with the buy-sell agreement, and emphasize to business owners the importance of following the valuation protocol set forth in the agreement.

IV. Business value: pricing provisions and estate tax value

A. Pricing is one of most-litigated areas of buy-sell planning, and proper planning is critical to try to prevent the IRS from setting its own value for the business for estate and gift purposes. The buy-sell agreement may be able to assist in establishing a value for estate tax purposes, in family owned businesses and non-family situations alike; however, the U.S. Supreme Court decision in *Connelly* raises questions as to the ability to do so.

B. Generally, the value of any interest is determined without regard to any option, agreement or other right to acquire or use the property at less than the fair market value (such as a buy-sell agreement).[9] However, if certain requirements are met, it may be possible to "lock in" the estate tax of a business interest at the price or by the formula contained in the buy-sell agreement.[10]

C. The requirements for "locking in" the buy-sell agreement price include the following:[11]
   1. The price must be fixed by the agreement, or the agreement must contain a formula or method for determining the price;
   2. The estate must be obligated to sell at death at the agreement price (either under a mandatory provision or an option held by a designated purchaser);
   3. The agreement must prohibit the owner from disposing of his or her interest during life without first offering it to the other party or parties at a price higher than the agreement price; and
   4. The agreement must be a bona fide, arm's length business arrangement and not a gift, or device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth.

D. Treas. Reg. §20.2031-2(f)(2) also states that "In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of **life insurance policies** payable to or for the benefit of the company, **to the extent such nonoperating assets have not been taken into account** in the determination of net worth, prospective earning power and dividend-earning capacity" (emphasis added).
   1. The U.S. Supreme Court in *Connelly v. US* (2024) held that where a buy-sell agreement does not successfully lock-in a value for estate tax purposes, life

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[9] IRC Sec. 2703(a).
[10] IRC Sec. 2703(b).
[11] These are facts and circumstances determinations, based on regulations and IRS guidance. See IRC Sec. 2703(b); Treas. Regs. §§20.2031-2(h), 20.2031-3; Rev. Rul. 59-60, 1959-1 CB 237.

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insurance paid to a company generally increases the value of the company for estate tax purposes. Furthermore, the Court did not view the redemption obligation as "accounting for" or offsetting the value of the life insurance proceeds as an asset of the company.

E. Earlier IRS guidance on valuing closely held corporations for gift and estate tax purposes is also relevant in setting pricing provisions:[12]
   1. For companies lacking market quotations, all available financial data and relevant factors concerning fair market value should be considered.
   2. Factors include, but are not limited to:
      a. Goodwill/other intangible value
      b. Earning capacity of the company
      c. Market prices of companies in similar line of business

F. What kind of valuation should the agreement call for? Owners can agree on what they want, but as best practices, consideration should be given to the following:
   1. A fixed price can quickly become outdated.
   2. Book value, or a pricing method that otherwise ignores goodwill or the earning capacity of the company may be inconsistent with the IRS guidance described above.
   3. Expecting co-owners, members and/or a spouse or family member to come to a mutual agreement shortly after a death, disability, divorce, bankruptcy or separation from employment may be unrealistic. When emotions are running high, people might not consider issues on either side as reasonably as one would hope.
   4. A formula or appraisal can assist with determining a fair price that is up to date at the time the triggering event occurs. In the case of an appraisal, the agreement may include instructions as to whether life insurance death proceeds are to be included in the value of the company.
   5. Having a spousal consent provision in the agreement, and signatures, may help prevent later litigation.
   6. If exposure to an estate tax is anticipated in a family owned business, careful adherence to requirements of IRC Sec. 2703(b) (for "locking in" the value of the business as set by the buy-sell agreement, for estate tax purposes) and guidelines under IRC Sec. 2031, and regulations thereunder, are of utmost importance.

G. Background: three general approaches to valuing a business: asset based, income based, market based.
   1. Each produces a number that measures something: assets net of liabilities, earning potential or value of similar businesses.

[12] Rev. Rul. 59-60, *supra.*

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2. Note that book value is often quite a bit lower than other values, and may be inconsistent with IRS guidance,[13] as it does not measure earning potential, goodwill, or prices of similar companies.
3. Income-based methods look at several years of operating income and analyze them different ways, using specific assumptions for each method.
4. Market value looks at real-world figures; prices for similar businesses. A formal appraisal may be necessary for the value to be respected for tax purposes.[14]

H. Regulatory guidance on determining fair market value of unlisted stock for estate tax purposes:
1. Value of stock of corporations engaged in the same or a similar line of business that are exchange-traded.[15]
2. Company's net worth, prospective earning power and dividend-paying capacity;[16]
3. Other relevant factors include goodwill, economic outlook of industry, the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, weight of these factors is based on facts and circumstances.[17]
4. Regulations state that "consideration shall also be given to nonoperating assets, *including proceeds of life insurance policies* payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity."[18] See discussion of this and *Connelly* at part III, above.

I. Examples of pricing provisions we see in buy-sell agreements, and considerations:
1. Initial agreed value (sometimes not filled in) and yearly updates on an attached exhibit (business owners rarely fill in updates)
2. Agreement of the parties at time of event (circumstances following a triggering event may make it difficult for parties to come to a fair agreement)
3. Book value (or variation thereof): not compliant with IRS guidance[19] stating that goodwill should be considered.
4. Life insurance amount – or greater of agreement value or life insurance proceeds: as time passes, the business value could change to a higher or lower

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[13] See IRC Sec. 2031(b); Rev. Rul. 59-60, *supra*.
[14] See IRC Sec. 2031(b).
[15] *Ibid.*
[16] See Treas. Reg. §20.2031(f).
[17] *Ibid.*
[18] Treas. Reg. §20.2031(f) (emphasis added).
[19] Rev. Rul. 59-60, *supra.*

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value than the death benefit. Death benefit is not a measure of company value and does not take into account the IRS guidance described above.

5. "ALL" life insurance owned by the company to be paid in the event of a buyout at death: this would require applying key person coverage, which is underwritten as business protection, to be applied to a buyout need. Key person coverage *can* be used to supplement coverage purchased for a buyout, but the agreement should not require that it be so used.

V. Funding and life insurance issues

A. Funding methods

1. Cash: requires liquidity and positive cash flow
2. Loan: requires cash flow to manage payments; future costs of borrowing are unknown
3. Savings/Sinking fund: can eventually cover need, but timing of an unexpected death or disability could mean insufficient funds available.
4. Installment sale: requires cash flow to manage payments, and payout is contingent on future success of the business.
5. Insurance (life and/or disability buyout): provides liquidity from inception of the contract; cost to insure need is much lower than amount needed to accumulate sufficient cash for buyout.
6. Relative funding costs: generally use of insurance (transferring risk) puts less pressure on company assets and cash flow.

B. What information should the buy-sell agreement include with respect to life insurance and potential estate inclusion?

1. Ownership of life insurance and disability buyout insurance should be aligned with buy-sell design, making sure insurance benefit is owned by and payable to the person obligated to do the buying.
2. Clause permitting owners who are parting ways to buy back life insurance owned by the other owner or the business:
   a. Should require payment of fair market value:
      i. For a cash value product: IRS guidance[20] establishes a safe harbor of the greater of (a) interpolated terminal reserve (ITR) plus unearned premiums and estimated dividends, or (b) premiums paid, plus earnings, less reasonable charges (known as the "PERC" value).
      ii. For a term product: companies vary; IRS is silent. At Principal we use unearned premiums.
   b. Life insurance can be retained to insure payoff, should an unexpected death occur, then allow purchase when payoff completed.

[20] See Rev. Proc. 2005-25, 2005-17 IRB 962, modifying and superseding Rev. Proc. 2004-16, 2004-10 IRB 559.

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c. Does this clause create an incident of ownership for the owner who is entitled to purchase the policy? A 1979 Revenue Ruling said yes;[21] however, the Tax Court (and a private ruling) said otherwise soon after.[22] In any event, the clause should not result in inclusion of both the insurance proceeds and the decedent's interest in the business in the gross estate.[23]

3. Importance of requiring that proceeds be applied to purchase following a death.
4. Clauses addressing situation of too much or too little life insurance:
   a. If death benefit exceeds purchase price: who gets (or keeps) the excess amount? Payment of excess amount to decedent's family results in a payment that may exceed the value of the business interest; might not be compliant with Revenue Ruling 59-60.
   b. If death benefit less than purchase price: installment payments over specified time period at a market rate of interest should be included in the agreement. Portion of death benefit allocated to buyout should be limited to the value of the business interest.
5. Clause instructing appraiser as to treatment of life insurance as an asset of the company:
   a. The agreement in *Connelly* did not include language excluding the death benefit from the value of the company. It is unclear whether such language would have changed the outcome.
   b. Some agreements call for the company value to be determined as of the day before the triggering event occurred. This would appear to result in excluding the life insurance death proceeds (but not cash values); however, the effectiveness of this language also remains unclear following *Connelly*.
   c. Practitioners may want to consider language stating that the death proceeds are to be included only to the extent that they exceed the redemption price.

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[21] Rev. Rul. 79-46, 1979 -1 CB 303, held that an employee's contractual right to buy a life insurance policy on the employee's life, owned by the business, is an incident of ownership under IRC Section 2042. This ruling did not involve a policy pertaining to a buy-sell agreement. However, in *Estate of John Smith v. Commissioner*, 73 T.C. 307 (1979), *acq. in result*, 1981-1 CB 2, the Tax Court held that the insured's contingent purchase option was not an incident of ownership. Also, in Letter Ruling 8049002 the IRS stated that where a shareholder had the right to purchase the policies on his life if he ceased being a shareholder, such contingent purchase option was not an incident of ownership. Accordingly, Revenue Ruling 79-46 may be of doubtful validity.

[22] See *Estate of John Smith v. Commissioner*, *supra;* see also *Estate of Jordahl*, 65 TC 92 (1975); and Rev. Rul. 2011-28 (right to "buy" policy out of an irrevocable trust).

[23] Even assuming the validity of Rev. Rul. 79-46, it should not result in inclusion of both the insurance proceeds and the decedent's interest in the business in the gross estate. *Estate of John T. Mitchell*, 37 BTA 1 (1938), acq. 1938-1C.B.20; *Estate of Ray E. Tompkins*, 13 TC 1954 (1949), acq. 1950-1 CB 5. However, see discussion of *Connelly v. U.S, infra,* at Section III of this outline.

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d. Will death benefit flowing into a company following a death be counted as a company asset following *Connelly*? Buy-sell agreement can say no, but cash surrender value (or similar proxy for value of the policy) just prior to date of death should be counted.

C. How does life insurance become income taxable?

1. Transfer for value:[24] general rule is that any transfer for valuable consideration results in taxable death benefit (to the extent the death benefit exceeds the basis of the transferee) unless an exception applies.

a. What are the exceptions?

i. Transfer to the insured, a partner of insured, a partnership in which insured is a partner, or a corporation in which insured is a shareholder or officer.[25]

ii. Transfer to someone for whom the policy has carryover basis in hands of transferee[26] (e.g., merger or acquisition; transfer incident to divorce), or to a trust that's a grantor trust with respect to the insured, or from such a trust to another grantor trust of the same insured.[27]

b. What are the most common transfer for value traps? Transfers between co-shareholders. Note that the exact same thing you can do in a partnership, between partners, can trigger a taxable death benefit if done in a C or S corporation, between co-shareholders. (This is why we suggest an LLC taxed as a partnership for third party ownership arrangements.)

c. Reportable policy sale rules add another layer to the transfer for value analysis. Transfers that are subject to a transfer for value exception (including certain gratuitous transfers) can, nonetheless, result in a taxable death benefit under the reportable policy sale regulations.

d. "How is the business taxed?" Common answer: LLC. But how is the LLC taxed? Often financial professional does not know. Usually partnership or S corp, but it makes a big difference when looking at transfer for value.

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[24] "Transfer for value" means a transfer for a valuable consideration of a right to receive all or part of the proceeds of a life insurance policy. See IRC Sec. 101(a)(2). In a business context, transfers are nearly always considered "for value"; they are rarely viewed as a "gift" (a possible exception may exist for transfers between family members).

[25] IRC Sec. 101(a)(2)(B). Note that the IRS has treated an LLC taxed as a partnership as subject to the same transfer for value exception as a partnership. See, e.g., Let. Rul. 9625013.

[26] See IRC Sec. 101(a)(2)(A).

[27] Rev. Rul. 2007-13, 2007-11 IRB 684.

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2. Reportable policy sale:[28] provision was designed to capture life settlements/commercial transfers, but rules are much broader and can make some legitimate transfers of policies result in a partially taxable death benefit.[29]
    a. General rules:
        i. Generally, transferee must have one of several specified "substantial business, family or financial relationships"[30] with the insured; otherwise, death benefit can become taxable to extent it exceeds basis of transferee.[31]
        ii. Most important takeaway: a reportable policy sale can result in a partially taxable death benefit even if a transfer for value exception applies.
    b. Potential trap with reportable policy sale regulations:
        i. Business A buys key person coverage on one of its most valuable employees. Later, the employee leaves, and the company retains the policy. Still later, the original owners sell Business A to Business B. The old key person contract is still in force, but Business B has no business, family or financial relationship to the insured. The death benefit on the policy will be taxable to the extent it exceeds Business B's basis in the contract.[32]
3. Failure to meet notice and consent requirements for employer owned life insurance results in taxable death benefit (to the extent exceeding basis).[33]
    a. Insured must sign a written notice and consent form prior to policy issue,[34] AND
    b. Assuming notice and consent satisfied, death benefit paid to employer remains tax-free if at least one of the following conditions are satisfied:
        i. Insured was an employee within the 12-month period preceding death; OR
        ii. Status of insured was one of the following at the time policy was issued:
            I. A highly compensated employee (HCE) under IRC Sec. 414(q);

[28] IRC Sec. 101(a)(3), as added by TCJA 2017 (P.L. 115-97, Sec. 13522(a)), effective for transfers occurring after December 31, 2017.
[29] See TD 9879, 84 Fed. Reg. 58460 (October 31, 2019); Treas. Regs. §§1.101-1, 1-101-6, 1.6050Y-1 to 1.6050Y-3.
[30] See Treas. Reg. §1.101-1(c)(1).
[31] See Treas. Reg. §1.101-1(b)(1)(i).
[32] Business B's basis will include the portion of the purchase price allocable to the policy, plus any premiums paid subsequent to acquisition. See IRC Sec. 101(j)(1).
[33] See IRC Sec. 101(j); Notice 2009-48, 2009-24 IRB 1085.
[34] See IRC Sec. 101(j)(4). The IRS determined in a private ruling that the signatures required for a buy-sell agreement and the life insurance applications to fund it provided the necessary notice and consent, even though no separate notice and consent forms were used. See Let. Rul. 201217017.

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II. A highly compensated individual (HCI) as defined at IRC Sec. 101(h)(5) and modified by Sec. 101(j); or

III. A director of the employer.

4. Unintentional split dollar

a. Scenario: business acquires life insurance for key person and/or buy-sell need. Someone – business owner or financial professional – suggests that maybe some of it should go to the employee's family. This creates a split dollar arrangement[35] to the extent the death benefit goes to someone outside the business.[36] The consequence is a taxable death benefit if it is not accounted for as a split dollar arrangement.[37]

b. Solutions and best practices if the goals include getting proceeds to family or someone else:

i. Acquire a separate policy (e.g., personally owned if the desired beneficiary is family) for that purpose, or

ii. Enter into an endorsement split dollar agreement and account for the value of the economic benefit each year.[38]

D. Recap: Provisions needed in the buy-sell agreement concerning life insurance

1. Disposition of cross-owned policies following the death of an owner;
2. Disposition of policy following a termination of the agreement or of employment;
3. Determination of price in both instances (e.g., interpolated terminal reserve less any loans, plus unearned premiums);
4. What happens if there's too much life insurance;
5. Following *Connelly*, it's unclear whether the agreement can dictate how an appraiser should treat business-owned life insurance.

VI. Estate planning issues specific to business owners

A. Does insured have incidents of ownership under IRC Sec. 2042 in business-owned life insurance? It depends on the party to whom the death benefit is payable. Examples:

1. Corporation A owns life insurance on Gordon, the majority owner. Entire death benefit is payable to, or for the benefit of, the corporation.[39] Gordon

[35] See Treas. Reg. §1.61-22(b)(2).
[36] If any part of a death benefit is designated for a co-owner, transfer for value implications should also be considered. See Section IV-C(1) of this outline.
[37] See Treas. Reg. §1.61-22(f)(3)(iii).
[38] See Treas. Reg. §1.61-22(f)(3)(i).
[39] This could include payment in satisfaction of a business debt, or for another valid business purpose. See Treas. Reg. §20.2042(c)(6).

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has no incidents of ownership.[40] However, based on *Connelly*, death benefit may inflate the value of the business under Section 2031.

2. Corporation A owns life insurance on Gordon, the majority owner. Some of death benefit payable to, the corporation, some is payable to Gordon's spouse. Gordon has an incident of ownership to the extent that the death benefit is payable to the spouse;[41]
3. Partnership B owns life insurance on Gordon, an owner. Death benefit is entirely payable to the partnership. Gordon has no incidents of ownership.[42]
4. Gordon is a general partner (percentage interest of any amount) in Partnership D, which owns a policy on him that is payable to someone else. Gordon has incidents of ownership in the policy to the extent that the death benefit is payable to the outside party.[43]

B. *Connelly* holding: life insurance death proceeds payable to the business DO inflate the value of the business in a deceased owner's estate, and Court ignored the impact of the business's obligation to redeem the deceased owner's shares.

1. Prior to *Connelly*, this issue represented a split between the circuits. Court of Appeals for the 11th Circuit in *Estate of Blount v. U.S.*[44] had held that the obligation of business to redeem shares of a deceased owner should be viewed as offsetting the portion of the life insurance death benefit used to purchase the shares pursuant to a buy-sell agreement.
2. Buy-sell agreement should address in detail the treatment of life insurance values and death proceeds in the appraisal instructions for the business. A fair means of determining a current fair market value of the business should be utilized, along with instructions as to how life insurance will be valued (both cash values and death benefit).
3. In family-owned businesses of sufficient value to potentially trigger the estate tax, close scrutiny should be given to following the procedures necessary to "lock in" the value of the business under the exception set forth in IRC Sec. 2703(b).

C. Need for estate equalization: the problem – one child is involved in the business and will eventually take over. The other child is an artist in Paris who wants nothing to do with the business. Parents want everyone treated equally. The business owner has no other assets close to the size/value of the business. What's an owner to do?

1. Leaving business equally to all kids: unfair to child in the business. Assume child in Paris has equal vote but without expertise, and is entitled to distributions (e.g., in S corp). Kids in business could buy out the others, but

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[40] Treas. Reg. §20.2042(c)(6); *Huntsman v. Comm.*, 66 TC 861 (1976).
[41] See Treas. Reg. §20.2042-1(c)(6).
[42] *Estate of Knipp v. Comm.*, 25 TC 153 (1955).
[43] Rev. Rul. 83-147, 1983-2 CB 158.
[44] *Est. of Blount v. Comm.,* TC Memo 2004-116*; aff'd in part, rev'd in part* 428 F.3d 1338 (11th Cir. 2005*). Blount* was effectively (though not explicitly) overruled by *Connelly v. US, supra.*

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need source of cash. And, if parents' involvement was critical to the business, loss of them plus need for cash could cripple the business.

2. Create voting and nonvoting stock for the kids? Problem – child in the business does all the work, yet the one in Paris is reaping a portion of the rewards. Also, conflict of owners' interests – nonvoting owners want dividends, voting owners may want to retain profits and grow the business.
3. Better idea: plan to create/establish another asset or combination of assets that can benefit the child in Paris, while the child in the business has full control and reaps the benefits from the family business.
   Examples:
   - if business owns real estate or equipment, child in Paris could inherit those assets (perhaps in a separate LLC) and receive rental income. However, this could reduce the borrowing power of the business.
   - Life insurance could help equalize. Note that amount does not have to be equal to be equitable.

D. Coordination of the buy-sell agreement with the business owner's estate documents and needs.

1. Are the terms of the buy-sell agreement and the owner's estate documents consistent? (E.g., if the buy-sell agreement calls for a buyout of the business by a key person, the will should not contradict it by leaving the business to a family member.)
2. Do the pricing provisions of the buy-sell agreement result in an accurate, up-to-date price when the need may arise? An agreed price that sounded good 15 years ago could be grossly out of date today. Business owners rarely do an annual update (as many agreements proscribe) for the value of their business.
3. Does the Agreement use the life insurance death benefit as the purchase price? This is inconsistent with IRS guidance[45] and could become unfair to either the buyer or seller.
4. Is the life insurance that's earmarked for the buyout sufficiently up to date to cover most of the purchase price, or if not, does the agreement establish terms for the rest of the purchase price to be paid? Is the installment term realistic, given the cash flow of the business, and does it set a reasonable interest rate that will be up to date in the future at such time as the buyout may occur? Best practice is to use a benchmark such as prime. We frequently see the applicable federal rate (AFR) used, but few commercial lenders would lend at a rate that low.

VII. Tax implications of business buyout

A. At death: taxation of deceased owner's family upon buyout

[45] For details, see Section III of this outline, *supra*.

1. The surviving spouse or children receive a stepped-up basis if value of business included in the owner's estate.[46]
2. Any growth in the value of the business after the valuation date but prior to sale will be taxed as capital gain.
3. If the business is acquired outside the estate, such as from an irrevocable trust, there is no stepped-up basis and capital gain tax may be due.[47]

B. Lifetime sale (or after-death acquisition from irrevocable trust): approaches to dealing with capital gain: strategies, advantages and disadvantages:

1. Lump sum: once and done, but could trigger highest capital gain rate of 20%.[48]
2. Installment sale: spreads out the gain,[49] but seller takes on additional risk, in that payments are dependent on how well the company is managed. Selling owner essentially replaces risks of ownership with risks of being a creditor to the successor owners. If successors are kids, and parent intends to stay involved during transition, this might be less of a concern. The higher the amount of gain, the more of it is pushed into the 20% capital gains bracket
3. Transfer of business to a charitable remainder trust – e.g., if charitable intent, and business is appreciating. Statutory requirements govern how much of the value must go to charity. Fees for implementation make this viable primarily at higher values.
4. Deferred sale trust:

   The concept is that the trust allows the owner to spread out gain by selling the business through an irrevocable trust, which sells it to the outside buyer. The trust manages the assets and pays the owners over time, using installment sale treatment to spread out the gain (ostensibly without the risk of being a creditor to the new owner). Pre-tax assets inside the trust can generate additional return that reportedly would not be possible if the tax were paid up front.

   a. Consider what the potential savings is, versus the cost/risks of the solution. For very high value company, savings might justify the risk. Attorney needs to have deep expertise in this topic. Trustee needs to be one that is truly independent, such as an institution.
   b. If income tax rates go up, the value of the deferral could be lost.
   c. Capital gain rate is only 5% higher regardless of the amount of gain. In a company with gain upon sale of $1M, $50K additional gain if simply sold/taxed in year 1. If trust and related costs = $30K, wouldn't gain much benefit.

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[46] IRC Sec. 1014(b).
[47] See IRC Sec. 1015.
[48] See IRC Sec. 1(h). In 2024, the 20% capital gain bracket begins with capital gain exceeding $583,750 (married filing jointly), or $518,900 (unmarried). Rev. Proc. 2023-34, 2023-48 IRB 1287.
[49] See IRC Sec. 453.

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d. Risks: IRS could challenge trust on grounds such as lacking economic substance, step transaction, sham or constructive receipt. Note that "monetized installment sales" have been included on the IRS's "Dirty Dozen" list for the past 3 years (2022 – 2024).

C. Impact of buyout on basis of remaining owners

1. Cross purchase: impact of owner A buying out owner B (regardless of whether life insurance used) is increased cost basis to full extent of buyout amount.
2. Entity purchase: impact of life insurance flowing into the business
    a. In a passthrough business with life insurance as the funding tool, some degree of increase in cost basis will take place, regardless of whether the company uses a cash or accrual method of accounting..
    b. This is because life insurance flowing into a passthrough entity raises the basis of all the owners proportionately.
    c. The deceased owner's basis increase is "wasted" because their spouse/family will have a stepped up basis.
    d. In some cases it is possible for all the basis increase to be allocated only to the surviving owners, to the extent that the purchase is funded with life insurance.
        i. For a partnership: the buy-sell agreement can provide for a special allocation of basis resulting from the life insurance death benefit flowing into the business, so that the increased basis is allocated only to the surviving owners.[50]
        ii. For an S corporation using cash basis accounting: use of a 1377 (short tax year) election can result in an effect similar to a cross purchase. Following a death, business issues a note to the widow/family of the deceased owner and then elects a short tax year, before filing the claim for the death benefit. When the death benefit flows into the S corporation, only the surviving owners remain. Therefore, the basis increase from life insurance flows only to the surviving owners.[51]
3. For an S corporation using accrual basis accounting: death benefit owned under the life insurance accrues when it becomes payable, so no 1377 election is available. *However,* the life insurance flowing into the S corporation still raises the basis of all the owners proportionately. The portion of it raising the decedent's basis may be "wasted" but the other owners still get their proportionate share of the basis increase resulting from the life insurance death benefit.

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[50] See IRC Sec. 704(b). The special allocation must have substantial economic effect, as defined in Treas. Reg. §1.704-1(b)(2).
[51] See IRC Sec. 1377(a)(2).

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4. C corporation
    a. For any increase in cost basis, owners would need to use a cross purchase approach; either a traditional cross purchase arrangement or a with a third party ownership structure (Business Continuation LLC or similar partnership structure).

VIII. Gifting in 2024-2025

A. In 2024, the Federal estate tax lifetime exemption amount is $13,610,000 per person.[52] In 2025 it is expected to increase to approximately $14 million per person ($28 million per couple) before it expires (sunsets) at the end of 2025. Beginning January 1, 2026, the exemption is scheduled to be cut in half, likely to about $7 million per person.

B. Clawback regs:[53] Final regulations issued in 2019[54] provided some assurance that if the Federal estate tax exemption amount were lower at the time of a decedent's death, gifts making use of it when it was higher generally would not be "clawed back" into the estate.
    1. The 2019 regulations did not distinguish between completed gifts that are not included in the gross estate and completed gifts that are treated as testamentary transfers and are included in the donor's gross estate.
    2. Proposed regulations issued in April 27, 2022[55] would create an exception to the "no-clawback" rule for transfers that are includable in the gross estate or are treated as such.[56] Examples include gifts subject to a retained life estate, or other powers or interests, such as transfers within 3 years of the decedent's death, transfers with a retained life estate and life insurance incidents of ownership.[57]

VII. Real world observations

A. Observations from our database of over 2,700 reviewed buy-sell agreements from 2014 to 2024:[58]
    1. Buyout at death is mandatory in 68% of agreements, optional in 26%.
    2. Entity purchase agreements made up 41% of the total, followed by wait and see (32%), cross purchase (21%) and other designs (6%).
    3. Buyout upon disability is mandatory in 33% of agreements, optional in 32%.

[52] Rev. Proc. 2023-34, 2023-48 IRB 1287.
[53] Prop. Treas. Reg. §20.2010-1(c)(3); Reg. 118913-21, 87 Fed. Reg. 24918 (April 27,2022).
[54] See Treas. Reg. §20.2010-1(c).
[55] See Prop. Treas. Reg. §20.2010-1(c)(3); Reg. 118913-21, 87 Fed. Reg. 24918 (April 27,2022).
[56] For purposes of IRC Sec. 2001(b).
[57] See Preamble, Reg. 118913-21, *supra,* referring to IRC Secs. 2035, 2036-2038 and 2042.
[58] The total number of agreements reviewed was 2,706 as of August 20, 2024.

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4. Buyout at retirement is provided for in only 31% of agreements; 15% make it mandatory, and 16% make it optional.
5. Agreement was created more than 10 years ago in 20% of cases.
6. Purchase price relies on owners to update each year in 20% of agreements.
7. In 76% of agreements, no spousal consent language was included.

B. Observations from 12,898 (as of August 20, 2024) informal business valuations:[59]

1. Many business owners overestimate the value of their business or have no idea what it is worth.
2. Book value is usually much lower than any of the earnings-based values.

C. Examples of agreement terms we flag for discussion with local counsel when we see them:

1. Pricing terms that have no relationship to the value of the business;
2. Life insurance ownership structure that is inconsistent with terms of agreement (e.g., entity purchase with cross ownership of life insurance, or vice versa);
3. Requirement that "all" life insurance proceeds received by the business be applied to the purchase of an owner's shares.
4. Life insurance provisions that may result in a taxable death benefit;
5. Insufficient insurance funding for the value of the business (when buy-sell review is combined with an informal business valuation)
6. Lack of transfer restriction or right of first refusal;
7. Use of a specified interest rate that might not reflect a market rate of interest when the triggering event occurs;
8. Lack of spousal consent and signature. (Not just for community property states.)

Appendix:

U.S. Supreme Court decision hinders entity buy-sell agreements

Insurance products issued by Principal National Life Insurance Co. (except in NY), Principal Life Insurance Company®, and the companies available through the Preferred Product Network, Inc., Plan

[59] Principal offers complimentary informal business valuations prepared by the Advanced Solutions team. In the past decade (2014-2024), the team had produced 12,898 informal business valuations as of August 20, 2024. These reports serve as financial underwriting for life and disability buyout insurance.

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