Buy-Sell Agreement Planning Strategies

Are Redemptions Buy-Sell Agreements Using Life Insurance Still Effective?

Revisiting Separate Life Insurance LLCs for Entity Buy-Sell Agreements After *Connelly*

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Articles Related to Presentation

- *In addition to the material submitted for the institute, see Ed Morrow and Steve Seel on Revisiting Life Insurance LLCs for Entity Buy-Sell Agreements After Connelly*, LISI Business Entities Newsletter (November 9, 2022)
- *Steve Seel & Dan Griffith on Connelly v. IRS: Casting Shadows on Buy-Sell Agreements*, Steve Leimberg's Business Entities Newsletter #246 and *Paul Hood and Ed Morrow: Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States?* Leimberg's Business Entities Newsletter #247
- *The Special Purpose Buy-Sell Insurance LLC*, available from Leimberg Information Services.

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Agenda

I. Buy-Sell Basics, Including Important Transfer for Value and Employer Owned Life Insurance Rules to Keep in Mind
II. Drawbacks of Cross-Purchase v. Entity Buy-Sell Agreements
III. Impact of the *Connelly* decisions – in 8th Circuit and Beyond
IV. IRC §2703 Test: When is Value Set for Estate Tax Purposes?
V. Lemons into Lemonade? Impact on Non-Taxable Estates?
VI. How Separate LLCs to Hold Insurance and Fund Buy-Sell Avoid the *Connelly* Arguments – Best of Cross-Purchase & Entity?
VII. Important Partnership Allocation Issues
VIII. Takeaways from *Connelly,* Drafting Tips and Conclusions

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I. Buy-Sell Agreement Basics

- **Buy-sell agreement -** a contractual arrangement that restricts the transfer of shares in a closely held entity by either providing the option or requiring the entity or other owners (members, partners, or shareholders) to purchase the deceased or departing member's or partner's interest or shareholder's shares – on death, disability, retirement,
- Many buy-sell agreements are funded, in whole or in part, by life insurance on the lives of individual owners. Some with disability insurance as well.
- This session will focus on **buy-outs at death, at least partially funded with life insurance owned by the entity, potentially impacted by the *Connelly* 8th Circuit decision**.

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I. Traditional Buy-Sell Agreements

- ***Entity Purchase Agreement –***
  - A contract among owners (partners, members, or shareholders) of a business *and the entity* to purchase the ownership interest owned by a deceased partner/member or shareholder. Usually the remaining owners are given an *option* to purchase, then to the extent that they do not, the entity ***must*** purchase (a requirement for binding estate tax value, which will be discussed).
  - The ownership interest of the deceased/departing owner is conveyed back to the company typically through redemption.
- ***Cross Purchase Agreement –***
  - A contract among owners (partners, members, or shareholders) to purchase the ownership interest that a deceased partner/shareholder held in a business entity.
  - The ownership interest of the deceased/departing owner is conveyed directly to the other partners, members or shareholders by the deceased owner's estate, not to the company.

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I. Funding Mechanism: Life Insurance

- **Entity purchase agreement**:
  - The entity owns a life insurance policy on each owner.
  - If an owner dies, the entity receives the life insurance benefit, which it is then contractually obligated to use to purchase the deceased owner's interest (typically the death benefit is paid outright, with any remaining deficiency payable on an installment basis)
- **Cross purchase agreement:**
  - Each owner owns a life insurance policy on each other owner.
  - If an owner dies, each owner holding a life insurance policy on the deceased owner is contractually obligated to use the death benefits to purchase the deceased owner's interest.

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I. Understanding "Transfer for Value" Basics

- **Insurance death benefits are *generally* income tax free, but the Transfer for Value rule in IRC §101(a)(2) can make the proceeds taxable when there was previously a transfer for valuable consideration, unless either:**

  "**(A)** if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

  (B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."

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I. Basics: Employer Owned Life Insurance (EOLI)

- IRC §101(j) outlines some further exceptions to when life insurance benefits are tax-free (meant to combat so-called "janitor insurance").
- These can trip up any entity owned buy-sell or key man life insurance policies a company owns on employees if the appropriate Notice and Consent (IRS Form 8925) is not filed. Remember that S corporation owners are often also employees of their own corporation (or should be if they work there, otherwise there may be employment tax issues for paying insufficient salary disguised as distributions).
- Although an insurance and minor investments-only LLC should not rise to the level of a "trade or business", it may be prudent to file those just in case. This may be even true of family office LLCs owning life insurance as well – see *Michael Geeraerts and Jim Magner: Will the EOLI Tax Trap Capture Life Insurance Owned by a Family LLC,* Leimberg Information Services Business Entities Newsletter #254 (August 10, 2022).

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I. Basics: Incidents of Ownership Through Entity

- IRC § 2042 can bring insurance death benefits into one's estate if the decedent has "incidents of ownership"
- For corporate owned policies, however, Treas. Reg. § 20.2042-1(c)(6) usually will exempt policies owned through a company from indirect application, for the simple policy reason that the decedent's share of the company will be included in their estate. However, this rule requires that the death benefits are paid to the company for a valid business purpose (such as to effectuate a buy-sell agreement), so if you had an odd case where the beneficiary of a company-owned policy were a family member, this may not be the case. There is a similar rule for partnerships (incl. LLCs taxed as partnerships). Rev. Rul. 83-147, PLR 2002-14028.

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II. Issues with Cross-Purchase Agreements

- Cross-Purchase Agreement
  - Premiums are paid by the owners and not the entity (tracking!)
  - Perceived fairness problem due to cost differences (e.g., older or unhealthy owner v. healthier or younger owner – should the younger, healthier owner pay more?)
  - Premium payments made by the *company* would be regarded as taxable compensation or distribution and could lead to improperly withholding taxes if not reported properly
  - Life insurance premiums are non-deductible – IRC § 264
  - Death benefits are (generally) income tax free - IRC § 101
  - Purchase of ownership increases cost basis of surviving owners (either the purchased stock lot has a cost basis, or if the entity is a partnership and the partners already owned a portion, the purchasing partners have a "blended" basis increased by cost).

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II. Issues with Cross-Purchase Agreements

- Cross-Purchase Agreement Drawbacks
  - Technique becomes quite cumbersome with more than two owners:
    - 3 owners = 6 policies (each owner purchases two)
    - 4 owners = 12 policies (each owner purchases three)
    - 5 owners = 20 policies (each owner purchases four)
    - 6 owners = 30 policies (each owner purchases five)
    - 7 owners = 42 policies (each owner purchases six)
  - To a commissioned insurance agent, this may be a great advantage!
  - Heirs of a decedent might retain policies on other owners (which surviving owners may not want), but it is more difficult to unwind (e.g., if the business sells) so that each owner receives the policy on their life, because “swapping” policies could be a taxable event (although a transfer for value to an insured would be exception to transfer for value rules).

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II. Issues with Entity Buy-Sell Agreements

- **Entity Purchase:**
  - Premiums are non-deductible – IRC § 264(a)(1)
  - Death benefit is income tax free – § 101(a)(1) (unless previously mentioned exceptions apply)
  - Death benefits are not typically includable in the estate of the decedent as an “incident of ownership” imputed through ownership of company – Treas. Reg. § 20.2042-1(c)(6)
  - Death benefits ***may*** be taken into account in valuing the stock of the deceased owner--- See *Connelly v. U.S. discussion.*
  - *Unwinding – if an S or C corporation distributes a policy to a shareholder, it may trigger gain (if any).*

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II. Issues with Entity Buy-Sell Agreements

- Entity Purchase – *Basis Disadvantage!*
  - ***Example: A $2 million S corp is owned 50/50 by two owners. Their basis is $100,000 each.***
    - ***<u>Cross Purchase</u> -- With a cross-purchase, if one owner dies and the surviving owner uses $1 million of insurance proceeds she receives to purchase the deceased owner's interest, her new basis is $1.1 million ($100,000 carryover for 50% plus $1 million cost basis for 50%).***
    - <u>Entity Purchase</u> -- By contrast, with an entity buy-sell agreement, if the *S Corp* receives the $1 million of insurance and purchases the deceased owner's interest, the remaining owner's basis in their stock remains only $100,000! Note, however, that IRC 1366(a)(1)(A) and 1367(a)(1)(A) allow an increase in basis for a shareholder's share of tax-exempt income, but this may only be $500,000 for the surviving shareholder ($600,000 total) (depending on when received, whether "close the books" election made on sale, etc.)
  - ***The increased basis issue is extremely important even for non-taxable estates. That $500,000 of additional basis for the surviving owner could be used to reduce state and federal long-term capital gains taxation on later sale, saving $100,000-$200,000.***

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III. *Connelly v. United States*

Connelly v United States calls into question the impact of company-owned life insurance death benefit on the value of the company for estate tax purposes, especially after the 8th Circuit affirmed the underlying decision.

Facts:

- Two brothers, Michael and Thomas Connelly were the only shareholders of Crown C Supply, Inc. (77.18% and 22.82% respectively)
- The brothers and the company entered into a stock purchase agreement
- The agreement provided that upon one brother's death, the surviving brother had the right to buy the decedent's shares.
- The agreement also required the company itself to buy (i.e., redeem) the deceased brother's shares if the surviving brother chose not to buy the stock.
- Michael died and Thomas (who was also PR for deceased brother's estate!!!) failed to follow the provisions of the buy-sell agreement and did not have the stock appraised prior to the redemption.

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III. *Connelly v. United States*

- The issue was whether the company's buy-sell agreement set the value and whether the redemption obligation qualified as a liability offsetting the value of any death benefits that were used to fund the redemption.
- Held: the liability to purchase the decedent's stock was not an ordinary liability and thus should not reduce the value of the corporation. It did not meet the 6-part test discussed on next slides.
- The same issue had previously been addressed by the Tax Court and the 11th Circuit in *Estate of Blount*, which *Connelly* expressly declined to follow.
- In *Blount,* the Tax Court found that life insurance death benefits payable to the corporation on the death of a shareholder which were to be used to redeem his stock under a buy-sell agreement should be included in valuing the corporation without any offset for the liability. The 11th Circuit disagreed and overturned the Tax Court, holding that the **obligation was a liability that offset the value** for estate tax purposes. On appeal of *Connelly*, the Government argued *Blount* was wrongly decided. The 8th Circuit agreed with the district court – taxpayer appealed to U.S. S.C.

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III. *Connelly*: Differentiating Key Person Insurance

- In *Connelly*, the business entity owned $3.5 million of life insurance on the deceased brother, but only $3 million was used to buy out the deceased brother's interest.
- The Estate conceded that the $500,000 of the death benefit was more akin to "key man" insurance that was ***properly included*** in the valuation of the company, so only the $3 million redemption "obligation" was subject to the dispute (thus, the decedent's interest would have been valued 77.18% times $500,000 less than $3 million had there been that much less insurance).
- Keep this in mind for large entity-owned policies that are *not* tied to buy-sell obligations or overestimated – if the parties had scrupulously followed the agreement and obtained a binding appraisal, the excess insurance ($500,000) still would have added to the value of the business and therefore a portion (77.18%) added to the decedent's estate.

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IV. Controlling Valuation in Buy-Sell Agreement

For a buy-sell agreement to control value *for estate tax purposes*, the buy-sell agreement must meet the following requirements, which overlap a bit (IRC § 2703 and case law):

1. Be a bona fide business arrangement; [no problem in *Connelly*]
2. Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth;
3. Contain terms that are comparable to similar arrangements entered into by persons in arms- length transactions;
4. Contain a purchase price that is fixed and determinable under the agreement;
5. Be legally binding during life and after death; and
6. Have been entered into for a bona fide business reason and not be a substitute for testamentary disposition for full and adequate consideration.

IV. Controlling Valuation in Buy-Sell Agreement

Consider the sections of the six- part test that the Court found that Connelly *Failed (the first one the court conceded)*:

2. Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth - Failed;

"While the Connelly brothers' good health when they executed the Stock Agreement weighs in favor of the Estate's argument, the parties' abject disregard of the Stock Agreement so as to undervalue the company and underpay estate taxes, as well as the Stock Agreement's lack of a control premium or minority discount, demonstrates that the Stock Agreement was a testamentary device to transfer wealth to Michael's family members for less than full-and-adequate consideration,"

- Many excellent buy-sell agreements *IGNORE CONTROL PREMIUM AND MINORITY DISCOUNTS*! If the attorney for the Department of Justice and the district court judge owned a business together 50/50, would they want their widow/widower/family to get 50% of the value of the business at their death, or 50% minus a 20-40% valuation discount???

IV. Controlling Valuation in Buy-Sell Agreement

Consider the sections of the six-part test that the District Court deemed that *Connelly Failed*:

3. Comparability to similar arrangements - Failed.

> "Other than the Anders Minkler [CPA firm] report and Summer's testimony, the Estate failed to provide any evidence of similar arrangements negotiated at arms' length. That closely-held family corporations generally use life-insurance proceeds to fund redemption obligations does not establish that this particular Stock Agreement was comparable to an arm's-length bargain, particularly when the $3 million valuation was so far below fair market value."

- It is unclear from the district court opinion whether they would have found the *Connelly* buy-sell agreement "comparable to similar arrangements" had they followed through w/an independent appraisal, but it certainly does not sound like that from the opinion. The language of the buy-sell agreement was fairly typical and not defective on its face. It should bother practitioners that this prong should be so hard to prove, because it appears to indicate the estate would have lost even if they had an independent appraisal for $3 million. To the courts, $3 million is just not "fair and adequate" or "fair market value" if there is extra insurance there at death not counted in the value.

IV. Controlling Valuation in Buy-Sell Agreement

Consider the sections of the six- part test that the District Court deemed that Connelly *Failed*:

4. Fixed and determinable offering price - Failed. In finding that the buy-sell agreement didn't produce the fixed and determinable price required by this requirement, the district court observed:

"The parties did not rely on a Certificate of Agreed Value or follow the detailed appraisal mechanism of the Stock Agreement to determine the price-per-share; instead, they completely disregarded the Stock Agreement and negotiated their own value, which not surprisingly was less than the value of the life-insurance proceeds."

- Unlike the prior two prongs, at least this one we can chalk up to the specific bad facts of their Connelly brothers' failure to obtain an independent appraisal pursuant to the agreement. This one we can control/fix.

IV. Controlling Valuation in Buy-Sell Agreement

Consider the sections of the six- part test that the District Court deemed that Connelly *Failed*:

5. **Binding during life and after death-Failed.** In finding that the buy-sell agreement flunked this requirement, the district court observed: "[t]he parties' own conduct demonstrates that the Stock Agreement was not binding after Michael's death. Thomas and the Estate failed to determine the price-per-share through the formula in the Stock Agreement."

- Again, the "bad facts" kill this prong. Query: what if they had merely missed a timing deadline (e.g., the document required hiring or completing appraisal within 6 months, etc.)? Hired a different firm than originally contemplated? Used one not two appraisal firms? Contracts are binding, but parties can and often do deviate from the terms. What if the parties had obtained the appraisal, but then deviated from the payout terms to pay more on installment, for example? Minor deviations in a business setting should be expected! But we don't know where the line is!

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IV. Controlling Valuation in Buy-Sell Agreement

Nutshell – the district court (and 8th Circuit) did not *just* limit itself and decide on "bad facts", but concluded that *Blount* was demonstrably erroneous in its reasoning that the death benefit from life insurance should not be considered in valuation of the business. This is now binding in the 8th Circuit and persuasive elsewhere.

More importantly, how would this case have come out had the Connelly brothers held the $3.5 million policy *in a separate LLC*? Would the bad facts of failing to obtain an appraisal have led to the same disastrous result? Probably ***not***. Cross-purchases and separate insurance LLCs avoid the prospect of the death benefit being included in the valuation of the operating business.

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IV. 8th Circuit Decision: Quotes to Remember

"We first consider whether the stock-purchase agreement controls how the company should be valued. Finding that it does not, ***we then consider whether a fair-market-value analysis of Crown must include the life insurance proceeds used for redemption. It must."*** [emphasis added]

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IV. 8th Circuit Decision: Quotes to Remember

"To further see the illogic of the estate's position, consider the resulting ***windfall to Thomas****. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before redemption. After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each. Overnight and without any material change to the company, Thomas's shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed. See Cox & Hazen, supra, § 21:2 ("When a corporation purchases its own stock, it has depleted its assets by whatever amount of money or property it gave in exchange for the stock.* ***There is, however, an increase in the proportional interest of the nonselling-shareholders in the remaining assets of the corporation.").*** *In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that* ***increased*** *shareholders' equity."* [emphasis added and footnotes omitted]

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IV. 8th Circuit Decision: Quotes to Remember

- The Eighth Circuit unanimously agreed with the district court's rejection of the Eleventh Circuit's decision in *Blount Est.*, concluding:
  "Blount's flaw lies in its premise. ***An obligation to redeem shares is not a liability in the ordinary business sense.*** *See 6A Fletcher Cyclopedia of the Law of Corporations § 2859 (Sept. 2022 update) ("The redemption of stock is a reduction of surplus, not the satisfaction of a liability.").* [emphasis added]
- <u>The Bottom Line</u>: The ultimate decision is probably correct on the merits. I predicted it would be upheld. They attempted to hide behind a buy-sell agreement procedure that no one followed. The surviving brother was on both sides of the transaction (a bad idea for a number of reasons due to the clear conflict, but this was not cited by either court as influential).

Neither court left it at a mere "bad facts" decision only based on the failure to strictly follow the agreement. Reading both decisions, it is a fair to conclude the result would have been similar if the family had strictly followed the procedure in the buy-sell!

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V. *Lemons into Lemonade?* Impact on Non-Tax Estates

- What is the Connelly Estate's basis for *income tax* purposes when they sold the shares back to the company? Under IRC § 1014 and regulations thereunder, it is NOT the value that they received, but the value of the stock as finally determined for estate tax purposes (i.e., about $2.3 million more, the 77.18% ownership share times the $3 million of life insurance disputed – the estate tax value).
- Did the Connelly Estate declare (or file a protective refund claim) for the $2.3 million long term capital loss that it incurred (which, upon termination of the estate, can pass out to the estate's beneficiaries to later use under Treas. Reg. § 1.642(h)-1)? Basis increases lessen the sting of the estate tax.
- **99.99% of estates are non-taxable**. Have you had any widows, widowers or family (estates/trusts) who have inherited and sold a business interest pursuant to an entity buy-sell in recent years? What is the tax basis for that purchase under *8th Circuit law now*? The ***fair market value***. **Period**. *Not* "the fair market value but only if that causes estate *tax* and we collect revenue from it."

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VI. Separate LLC to Fund Buy-Sell Agreements

- Owners can form an LLC for the sole purpose of owning life insurance on the owners (and should be formed in state where "any lawful purpose" allowed). This would be a sister company with similar owners, not a parent-subsidiary.
- The "insurance-only" LLC is more akin to a cross purchase arrangement where an LLC owns the life insurance policies on the business owners. The LLC has a third-party manager so there is centralized management of the group of policies. The LLC is treated as a *partnership* for tax purposes. The operating business makes distributions to the owners, and they make capital contributions to the LLC so the LLC can pay the premiums (though it could make distributions to the LLC that are deemed distributions to the owners to be more direct).

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VI. If Changing to Cross-Purchase or Separate LLC, Remember TFV!

- Sometimes it makes sense if parties want to abandon an entity buy-sell to simply let the current life insurance lapse and start anew, but the parties' health may have declined or there may be significant cash value or other reasons why it's desirable to keep the current policies but just move them to a new ownership structure (e.g. sell them to owners or new LLC).
- Just remember the transfer for value rule (IRC §101) and its important exceptions, notably:

"(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) if such transfer is to the insured, **to a partner of the insured, to a partnership in which the insured is a partner**, or to a corporation in which the insured is a shareholder or officer."

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VI. Separate LLC to Fund Buy-Sell Agreements

- PLR 200747002 - In this ruling, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Established separate LLC to own insurance owned by same (but in BDITs/grantor trusts).
- Used outside manager-managed LLC and LLC agreement precluded member/insured from voting on decisions regarding insurance on the member/insured's life to prevent "incidents of ownership" (IRC 2042). Usually we have a Treas. Reg. to protect against insureds having incidents of ownership through a company, but this is an extra conservative step that apparently the IRS or taxpayer preferred.
- Members also participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.

VI. Separate LLC to Fund Buy-Sell Agreements

The Separate LLC is the:

- Applicant
- Owner
- Beneficiary

Of the life insurance policies on each of the owners.

VI. Separate LLC to Fund Buy-Sell Agreements

The mechanics of funding the Insurance LLC before an owner's death:

(1) Individuals can contribute directly to the LLC, or

(2) The Operating Entity can pay it to the LLC but treat it as bonus compensation to the employee/owners, and they would be deemed to have contributed their portion as capital to the partnership accordingly.

(3) Either way, the individual's contributions (directly or deemed) comprises their capital contribution and determines their basis.

(4) Contributions/ownership need not be equal. Just as cross-purchases rarely involve equal payments. Do owners want to compensate for the "unfairness" of life insurance being more expensive for older, unhealthier owners? Or not?

(5) Pre-death buyouts (e.g., if owner sells/retires) would be based on capital account/contributions.

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VI. Separate LLC to Fund Buy-Sell Agreements

The mechanics of the Insurance LLC, when one of the owners dies:

(1) The Insurance LLC collects the life insurance proceeds on deceased owner policy

(2) The Insurance LLC redeems the insurance LLC membership interest that was owned by the deceased member (i.e., from the deceased member's estate, revocable living trust or TOD beneficiary), which value is NOT increased by the death benefit, because that is allocated to the other owners per the agreement (IRC §704(a)). This value would often be quite small relative to the value of the operating company, and could be for an annually agreed upon value, or based on the deceased owner's capital account and the value of the assets before death (usually just cash values and a checking/investment account). A formal appraisal would probably only be required if there is real estate or some harder to value asset owned by the LLC.

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VI. Separate LLC to Fund Buy-Sell Agreements

The mechanics of the Insurance LLC, when one of the owners dies (continued):

(3) The Insurance LLC distributes the remaining insurance proceeds to the surviving members (or the LLC could then purchase the deceased owner's share, if it is not an S corporation, or purchase it for the owners, which would be a deemed distribution).

(4) The remaining LLC members (i.e., the other business owners) use the proceeds to purchase the deceased business owner's equity in the operating business.

(3&4) Variation: The LLC could also mandate distribution of proceeds directly to widow/estate/revocable trust of deceased owner and deem it to be a distribution to members and a credit towards their purchase price of the deceased owner's operating company interest mandated by the buy-sell.

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VII. Unique Partnership Tax Allocation Issues

- Any life insurance LLC should be taxed as a partnership, which is the default for multi-owner LLCs, filing a Form 1065 Partnership Tax Return.
- It can own other assets, such as an investment account or even real estate, which is commonly held in LLCs outside of operating company. Pooling investments is a common trigger for partnership status.
- Partnerships are more flexible than C/S corporations, and can specifically allocate certain income to specific partners.
- The death benefit from the policies would be *specifically allocated to the surviving owners*, increasing their basis under IRC §705(a)(1)(B) even though it is not taxable income. Distributions out to partners not in excess of basis are generally nontaxable. IRC §731(a)(1).
- Specifically allocating this income to the surviving owners permits the redemption of the deceased owner's LLC interest and the valuation of it to be based on the value of the LLC before receipt of the death benefit (i.e., the cash value of the policies and proportionate share of other assets which is likely minimal).

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VIII. Conclusions and Drawbacks to LLC Structure

- The drawbacks to the separate LLC structure are that it involves more than one agreement, and if there is taxable income or deductions (e.g. from money market or minor investments) to pass through for the Insurance LLC, then another Form 1065 partnership tax return. The agreements have to not only buy-out the deceased owner's share of the operating company, but the decedent's share of the insurance LLC.
- This additional complexity will probably convince many two-owner firms to keep their simpler cross-purchase buy-sell agreement.
- Once there are more than two owners, however, the additional complexity may be worth it.
- While a pure traditional entity buy-sell is simpler (arguably simpler than a cross-purchase), the lack of a cost basis step up for the survivors on the death of an owner is very meaningful and that benefit alone would likely more than exceed any additional costs of the structure, even if one did not fear the prospect of a *Connelly*-type attack by IRS.

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VIII. Conclusions re Connelly; Takeaways

- It's **uncertain** at best (I would assume the worst) whether strict post-mortem compliance with entity buy-sell agreement would avoid the *Connelly* result (including the life insurance death benefit in the entity's valuation), especially for related parties. This could be a disaster for taxable estates, but maybe not for non-taxable estates.
- Those with cross-purchase (or trusteed or insurance-LLC buy-sells) should *still remember* – strict compliance with agreement to fix value!
- For non-taxable estates – will the appraiser now (at least in the 8th Circuit) conclude that they have to include all the life insurance in the valuation? **Shouldn't it be spelled out to the appraiser in agreement**?
- If you don't switch to an insurance-LLC structure or cross purchase, you could simply buy more life insurance, but this can get expensive.
- If the IRS/courts do value the company higher than the appraisal/buy-sell (not just due to life insurance/Connelly), is there a clause to "correct" the value for the decedent's beneficiaries? Who wins/loses? In *Connelly*, the decedent brother Michael's family "lost" and his brother Thomas "won". Consider a clause such as the following:

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VIII. Conclusions re Connelly; Takeaways

- (*i) Price. If a Transfer of Interests is triggered by the exercise of the Death Option, then, except as provided in Section ____, the price of the Interests owned by or for the benefit of the Deceased Owner and/or the Deceased Owner's Spouse* ***shall be the value of the Deceased Owner's Interests and/or the Interests of the Deceased Owner's Spouse as finally determined for tax purposes; prepared initially by a business appraiser*** *as directed in Section _____.* [emphasis added; the deceased owner's spouse may have community property interest]
- *(b) Tax Adjustments. The parties recognize that the Internal Revenue Service, the applicable state taxing authorities, and/or the courts may, after any Transfer pursuant to this Agreement, rule that the value of the Interests of the Deceased Owner and/or Deceased Owner's Spouse for estate and/or inheritance tax purposes is higher or lower than the value of those Interests as listed on the estate and/or inheritance tax return, and all parties who purchase or Transfer such Interests agree to pay an additional amount to the seller equal to the increase in the value of the Interests as computed herein as finally determined for federal estate and/or income tax purposes, or to return the difference in value to the buyer(s) if the value as finally determined for tax purposes is less than that shown on the federal estate and/or state inheritance tax return, in both cases plus interest from the due date of the estate and/or inheritance return at the applicable federal rate for the month during which the return was due.*

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VIII. Conclusions re Connelly; Takeaways

- The problem noted previously could occur even if there were no life insurance involved at all. E.g., appraisal values company at $10 million and other owner/company buys out 50% owner/decedent for $5 million, and the IRS/Tax Court decides it's worth $12 million and the decedent's share therefore worth $6 million. Does the company owe the widow another $1 million?
- What are the terms for payment if the life insurance does not cover the buy-out? Over 5 years with interest at prime plus 2%??
- Is there a buy-out trigger for disability? Leaving the company? The terms do not have to be the same for each trigger.
- Does the agreement instruct the appraiser to consider or not to consider any life insurance payable to the entity for the buy-out?
- Does the agreement allow for transfer on death (TOD) designations? Transfers to revocable living trusts?

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The Monte Carlo simulation uses at most 1000 scenarios to determine the probability of outcomes resulting from the asset allocation choices and underlying assumptions regarding rates of return and volatility of certain asset classes. Some of these scenarios will assume very favorable financial market returns, consistent with some of the best periods in investing history for investors. Some scenarios will conform to the worst periods in investing history. Most scenarios will fall somewhere in between.

The outcomes presented using the Monte Carlo simulation represent only a few of the many possible outcomes. Because past performance and market conditions may not be repeated in the future, your investment goals may not be fulfilled by following advice that is based on the projections.

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