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This Washington Report is prepared exclusively for Finseca Influencer members by Todd I. Steinberg (Partner) and Jennifer M. Smith (Senior Counsel) at Loeb & Loeb, LLP.

From the Desk of an Estate Planning Attorney: Buy-Sell Planning Since Connelly – What are we doing now?

KEY TAKE-AWAYS: *Post-Connelly*, closely held business owners must carefully consider the practical and various tax issues associated with life insurance funded buy-sell structures, and we are advising them as follows:

- Don't ignore the need for business succession planning, as a proactive approach to the topic, despite potential challenges and costs, will almost always be preferable to no planning. Effective business succession plans should (i) identify and address the effects on the business, its activities and key owners/employees from an owner's untimely death/disability and (ii) ensure that an owner's heirs can access the wealth that is concentrated in the business after an owner passes (or is disabled). Existing plans should be reviewed and revised to accomplish these goals.

- Continue to use life insurance products and solutions for business succession planning, as the availability of life insurance death benefits, even in a less than optimum tax structure, generally will outweigh the disadvantages of having an unfunded/underfunded arrangement that leaves a deceased owner's heirs without liquidity or tangible value for the business interests. At a minimum, business owners should pursue personal planning solutions to mitigate current and unaddressed risks.

- Business succession planning is a highly-customized, multi-step process with the goal of finding a structure that is the most optimal fit for the business owners' needs and risk tolerance. There is no single or perfect solution, however, as each structure comes with its own set of unsettled questions and possible areas of tax exposure (see attached summary of structuring options). Having a clear understanding of the business's governing documents and its (and the owners') current circumstances, however, can assist in implementing alternative solutions that may mitigate the "gaps" in both planning and available protection.

- *Connelly* still can affect business owners with non-taxable estates, including by impacting the potential step up in income tax basis for the interests acquired from a deceased owner. To avoid being whipsawed, owners also may want to consider incorporating tax adjustment clauses in their business succession agreements to ensure the price paid for a deceased owner's interest equals the finally determined estate tax value.

- Include tax and insurance advisors as early as possible in the planning process. Insurance-funded business succession arrangements involve several tax and technical nuances that may not be understood by general business counsel, and revising or unwinding existing life insurance arrangements can be more challenging and costly than starting with a clean slate. Also make sure to regularly review the existing plans, related agreements, business operations and valuation, and the underlying life insurance products and their performance with these allied advisors. Very few businesses remain static, and early detection or communication of changes may produce cost savings or avoid unexpected losses or taxes.

Last summer, in *Connelly v. U.S.*, the U.S. Supreme Court unanimously ruled that life insurance proceeds received by a closely held company and earmarked to redeem a deceased shareholder's ownership interests *increased* the estate tax value of the company and, consequently, the deceased shareholder's interests. This decision has made redemption arrangements funded by company-owned life insurance less appealing for estate tax purposes. Below are the issues we, as estate planning attorneys, are discussing with closely held business clients, post-*Connelly*, to address and/or update their existing business succession arrangements (**BSAs**).

Don't Ignore the Need for Business Succession Planning. As noted at the annual Heckerling Institute on Estate Planning earlier this year, there is an approaching "silver tsunami" of small business ownership transition, but most of these business owners have no succession arrangements in place or have plans that are improperly structured and/or underfunded, particularly post-*Connelly*. We are continually reaching out to closely held business clients to advise them of the importance of discussing and implementing BSAs or having their existing BSAs reviewed, given recent tax developments and their particular business operations, valuation, and overall objectives.

Don't Get Lost in the Weeds. Even with the *Connelly* decision, life insurance remains one of the best options for BSA funding and one of the first recommendations we make for closely held business clients. The availability of life insurance proceeds, even in a less than optimum tax structure, generally will outweigh the disadvantages of having an unfunded/underfunded BSA that leaves a deceased owner's heirs without desired or required liquidity, and/or tangible value for the business interests. Potential tax complexities should not put clients off from using life insurance to support their BSA planning, even if an owner simply opts instead to acquire initial or excess death benefit coverage in a personal irrevocable life insurance trust (**ILIT**) to help provide estate liquidity.

But Accept That There May Be No Simple (or Perfect) Solution. Numerous practical and tax considerations remain when selecting from the various life insurance-funded BSA alternatives. Each option comes with its own set of unsettled questions and possible areas of estate or income tax exposure -- see the attached chart summarizing these considerations for various BSA structures, including redemption arrangements, cross purchase arrangements (where each owner owns life insurance on each other owner to buy the deceased owner's interest), and trusteed arrangements or special purpose "Insurance LLCs," (where ILITs or LLCs hold the policies that fund the purchase of business interests). We counsel closely held business clients and their allied advisors that developing or revising a BSA is a *highly-customized, multi-step process* requiring a detailed understanding of each separate owner's (or primary owner's) objectives and planning goals, business operations, and personal/family circumstances, with the goal of finding a BSA structure that is the most optimal fit to the clients' unique needs, risk tolerance, and available cash flow to fund a life insurance solution. With full knowledge of the available opportunities and transparent communications, each owner also can explore alternative personal solutions to accomplish their respective goals and address any "gaps" or concerns leftover from any BSA structure implemented (or not).

Look At and Beyond Estate Tax Considerations. For business owners with taxable estates (or those who could have taxable estates if the business value is increased by life insurance proceeds), the *Connelly* decision certainly prioritizes estate tax concerns in BSA planning. While the unlimited marital estate tax deduction will help defer the taxes if the business interests pass to a U.S. citizen spouse (and the spouse will receive a step-up in income tax basis to the final estate tax value), whatever the surviving spouse continues to hold at death will then be included in his or her taxable estate. So business owners with taxable (or close to taxable) estates will certainly want to consider restructuring life insurance-funded redemption arrangements and/or using other suitable alternatives.

Yet, over 99% of estates are non-taxable, and most will remain so even if the business owns the life insurance funding the BSA. So how could *Connelly* affect clients with non-taxable estates who have or want to use an insurance-funded redemption BSA? The issues revolve around the step-up in income tax basis of the business interests and the desired fixing of the purchase price by the BSA to facilitate a smooth transition and less risk to the future business operations upon an owner's death. Generally, under IRC §1041(a)(1), the tax basis of property acquired from a decedent is the property's fair market value for estate tax purposes as the decedent's date of death. A higher estate tax value for assets will benefit estate heirs by providing a higher income tax basis in the inherited assets (particularly if the higher value does not trigger an offsetting estate tax liability).

As a simple example,[i] assume a AB Co. is equally owned by Alex and Bob and is worth $8 million. AB Co. acquired $4 million of insurance on each owner to fund its purchase of each owner's interest at death under a redemption BSA. Alex dies. Post-*Connelly*, the estate tax value of AB Co. is now $12 million, due to the inclusion of the $4 million of life insurance, making Alex's interest likely worth $6 million for estate tax purposes. Under IRC 1041(a), Alex's estate would be entitled to claim a step up in basis in Alex's interest to $6 million. *Connelly*, however, does not automatically adjust the purchase price set under a BSA, so this estate tax value/purchase price mismatch, if it occurs, may result in a $2 million capital loss for Alex's estate, unless the redemption agreement contains a price adjustment provisions (as discussed below).

Avoid Being Whipsawed – Take Care in Drafting the BSA. The *Connelly* decision only enhances the importance of ensuring that the BSA clearly articulates the valuation method or formula to use for valuing and determining the purchase price of an owner's business interests and *whether or how* life insurance death benefits are factored into that determination. As a "back-up" to those valuation provisions, the parties may consider including a tax adjustment clause in the BSA to address what happens if the final tax value determined for a deceased owner's business interests differs from the purchase price set by the valuation method used by the BSA. The difference should be paid, with interest at the applicable federal rate (or at such higher rate as agreed to by the parties) to the sellers of the deceased owner's interests if the final tax value is higher, and to the purchaser if the final tax value is lower.

For redemption arrangements, however, note the circular calculation required under *Connelly* due to the inclusion of life insurance in a company's valuation. In the example above, if AB Co.'s redemption arrangement included a tax adjustment clause, AB Co. could not fully satisfy the redemption of Alex's interest with the $4 million of life insurance proceeds received from Alex's death, because the Company's receipt of those insurance proceeds increased the purchase price for Alex's interest to $6 million, the final tax value. Accordingly, it may be impossible to fully fund redemption arrangements solely by life insurance, and additional payments of company cash/property or promissory notes would be needed to cover the difference.

Watch for Potential Traps. Acquisition of life insurance in any BSA structure should ensure a review, and if needed, compliance with any employer-owned life insurance (**EOLI**) tax provisions, including execution of notice and consent statement by insured owners, to avoid any potential income tax, pursuant to IRC §101(j), on the otherwise income tax-free payment of policy death benefits under IRC §101(a).

Also, if considering a restructure of an existing insurance-funded BSA, watch for the potential application of the transfer for value (**TFV**) and reportable policy sale (**RPS**) rules under either IRC §§101(a)(2) and/or (3) if there will be any transfers or deemed transfers of life insurance policies between or among the business, the business owners, and/or related trusts or entities, or any §1035 exchanges of existing policies. Triggering those rules also could inadvertently subject otherwise tax-free policy death benefits to income tax, unless the policy transfers fall under one or more specifically defined exceptions.[ii] Underwriting and/or EOLI compliance issues also may arise if new or additional life insurance is recommended to address an increase in the company's value or to offset estate tax risks. ***Working with qualified insurance advisors can help avoid these potential traps.***

Carefully Evaluate Premium Funding Options. Maintenance of an insurance-funded BSA requires a sustainable premium funding plan. Despite these renewed estate tax concerns of redemptions BSAs, especially post-*Connelly*, they offer simplicity in insurance acquisition and funding, since the business acquires, pays for, and manages the policies. If other persons own the policies, such as the owners individually or through Insurance LLCs or ILITs, additional planning for the funding of premiums and the associated tax consequences is needed. For instance:

- Distributions or deemed distribution from the business to the owners (or for their benefit) may be subject to income tax as compensation or as a distribution to owner, and additional considerations may apply for S corporations.

- Transfers to ILITs to pay insurance premiums will be gifts that could use available annual exclusions and/or may require the allocation of gift and possibly GST tax exemption (depending on the structure).

- Split dollar arrangements also will have tax consequences depending on the parties to the arrangement and who owns the policy:

    - For economic benefit (**EB**) split dollar arrangements, the annual EB amount may be taxable as compensation or a distribution to the insured and also treated as a deemed gift to any ILIT that holds the policy. The EB amount also must be monitored as it will increase annually with the insured's age.

    - Loan arrangements can avoid gift and GST tax issues (unless later forgiven), but if the loan is between the business and an owner, any forgone loan interest or loan forgiveness may be taxed as compensation or a distribution to the owner (and as a corresponding gift to any ILIT that holds the policy). The business also likely will be required to recognize any loan interest annually, whether or not it is paid or accrued. Loans also can be subject to interest rate "creep" (as we have seen these last few years) and the death benefit will need to be monitored to ensure sufficiency to repay the loans and buy the deceased owner's business interests at the anticipated value. Again, carrier and product selection and design are important considerations.

    - Carrier selection and product design are important planning considerations to ensure the appropriate life insurance product is acquired to support the BSA and is sustainable under the selected funding arrangement. Continued communication between the parties and the advisory team also is necessary to facilitate compliance with the split dollar administration and annual tax reporting obligations and to review the flexibility and optionality in the selected insurance products and design (e.g., lowering underwriting classification and saving costs or obtaining additional desired life insurance capacity before a future negative health change or age/risk classification).

Incorporate Insurance Specific Provisions. Regardless of the chosen structure, BSAs funded by life insurance should address insurance-specific issues, including:

- **Maintenance.** Assigning responsibility for keeping insurance policies in-force and monitoring the policy's status/performance and the timely payment of premiums, as well as the carrier's confirmation of any acquired (and desired) ongoing riders (i.e., return of premium, guaranteed coverage, etc.).

- **Coverage Sufficiency**. Ensuring the policies offer adequate death benefit coverage to support the agreed upon buy-out price, requiring regular reviews of coverage as needed to adjust to changes in that determined price, and addressing what happens if insurance is insufficient to buy out the deceased owner's interests based on a higher valuation (e.g. use other business assets or promissory notes to pay balance).

- **Excess Proceeds.** Identifying who receives any insurance proceeds that exceed the buy-out price (e.g., the business, the remaining owners, etc.).

Stay On Top of Post-Implementation Administration. *Connelly* emphasized the importance of compliance with all BSA terms, particularly valuation procedures, if the parties expect their BSA to be respected for tax purposes. Clients should implement and follow protocols to ensure compliance with their BSAs, including regular reviews with all interested parties (business owners, key executives, insureds, etc.) and their legal, tax, insurance and investment advisors.

Involve Insurance and Tax Advisors ASAP. As shown, structuring of BSAs, particularly if insurance funded, involves numerous technical tax and legal issues that should be addressed in coordination with experienced legal, business and tax advisors. Ideally, these advisors are included from the start and can work with a "clean slate" or at least a transparent dialogue of the risks to the current structure (or lack thereof). Frank and honest discussions about how a death or disability of a business owner will be handled, with or without the BSA, will lead to opportunities for all sides to address the inherent gaps in protection and coverage (to the business and the individuals/families). Too often, we find that existing BSAs are drafted by in-house or outside general or corporate counsel who are not as familiar with these technical nuances. These issues are more challenging to resolve when the clients come in with an existing plan, especially if the life insurance has already been acquired, as unwinding and/or restructuring is more difficult in light of the TFV/RPS rules noted above rules.

While potential disagreements or rifts can arise among the business and business owners when having these discussions, based on our experiences before and after *Connelly*, we believe that opening the dialogue, at a minimum, raises awareness and allows the individual owners to try and plan more effectively for their own families and estates.

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[i] See e.g., Michael Geeraerts and Jim Magner, "Connelly Hits Its One-Year Anniversary, What's Your Fix?" Steve Leimberg's Business Entities Newsletter #313.

[ii] Exceptions to the transfer for value rule apply for (a) a transfer of a policy or interest therein that is not a reportable policy sale, has a basis for determining gain or loss in the hands of a transferee as determined by reference to the basis in the hands of the transferor (a "carry-over" basis), and does not fall under another exception, or (b) a transfer of a policy or interest therein that is not a reportable policy sale, was not previously transferred in a reportable policy sale, and is a transfer to any of: (i) the insured (including a wholly-owned grantor trust as to the insured), (ii) a partner of the insured, (iii) a partnership in which the insured is a partner (LLCs taxed as partnerships fall under the partnership exceptions), or (iv) a corporation in which the insured is a shareholder or officer. Note that a transfer of a policy on an insured shareholder of a corporation to another shareholder of the corporation is ***not*** an exception to the transfer for value rule. *See* Treas. Reg. §1.101(b) and (c). A transfer of a policy is not a reportable policy sale if the acquirer of the interest in the policy has a substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance, as determined under the applicable regulations. *See* Treas. Reg. 1.101-1(c).

OUTLINE OF STRUCTURING OPTIONS FOR INSURANCE-FUNDED BUY-SELL ARRANGEMENTS (BSAs)

Funding BSAs with life insurance can provide closely-held businesses and their owners with needed resources to buy a deceased owner's interests. The below summarizes typical options for insurance funded BSAs and some of the potential benefits and considerations, which also will be affected by the entity type involved (partnership/LLC, S corporation, C corporation). For ease of reference, the term "**Company**" refers to a business, "**Interests**" refer to the business interests, "**DO**" refers to a deceased owner, "**SO**" refers to a surviving owner, and "**FMV**" refers to fair market value for estate tax purposes. Note that this outline does not specifically address planning for the departure of an owner due to disability or retirement, but those topics and potential solutions should be addressed during the death planning discussions.

BSA Option	Potential Benefits	Considerations/Issues
Self-Purchase Owner creates an ILIT to buy life insurance on owner. At owner's death, the ILIT can buy Interests from owner's estate for FMV and hold them per the ILIT terms for the benefit of the beneficiaries or make loans to the estate to help pay administrative costs and taxes.	***Estate Exclusion.*** Death benefits should <u>not</u> be included in estate tax value of Company or DO's Interests. ***Basis Step-Up***. DO's estate receives a basis step-up to FMV for DO's Interests. If the ILIT purchases the DO's Interests, generally no capital gain is recognized, and future capital gain is saved if (or when) the ILIT later sells DO's Interests. ***Estate Planning***. ILIT can offer estate and GST tax planning for DO's family. ***Creditor Protection***. Policy proceeds are not subject to claims of the Company creditors	***Post-Death Ownership***. Interests will remain in DO's ILIT and/or with DO's heirs, who may not want to be involved in the Company. SOs also may not want to share management/ownership (cash flow and appreciation) of the Company with DO's heirs. ***Valuation***. FMV of DO's Interests is set by estate tax value at DO's death.
Redemption Company buys and owns a policy on each owner and pays the premiums. At DO's death, the BSA directs the Company to use the policy death benefits to redeem the DO's Interests.	***Simplicity***. Structure is easy to implement. Company is policy owner and beneficiary and maintains and administer polices. No separate trusts are required. Company pays premiums (generally a non-deductible expense). No separate gifts/loan/distribution planning is needed and the impact of premium disparities for older/unhealthier	***Increased Business Value***. Per *Connelly*, death benefits likely increase the estate tax value of Company and DO's Interests and result in an interrelated calculation, whereby the inclusion of more life insurance to address the higher value will only increase the redemption price. ***No Basis Adjustment for SO***. SO may not receive a step-up in basis for redeemed Interests.

	owners is minimized. Company manages and monitors policies so they stay in force. ***DO Receives Basis "Step Up"***. DO's Interests receive an adjusted basis in DO's estate. ***Fewer Policies Needed***. Business only needs one policy per owner.	***Valuation.*** Business's governing agreement must specify valuation method for redeeming DO's Interests. Potential for DO's estate to have a capital loss and for SOs to receive a lower step up in basis if BSA purchase prices is less than estate tax value (absent an effective tax adjustment clause). ***Excess Proceeds***. Distribution of excess insurance proceeds from a C corporation to SOs may be a taxable dividend. And be careful with S corporation planning. ***Business Creditors***. Business creditors may attach insurance proceeds or prohibit distribution to redeem DO's Interests based on restrictions in existing lending arrangements. State law may prohibit distributions if it would make Company legally insolvent.
Cross-Purchase Each owner buys a separate policy on each other owner. All owners sign a BSA requiring a DO to sell, and SO(s) to buy DO's Interests at the value set by the BSA using any death benefits received from DO's death.	***Basis Step-Up***. DO's estate receives a basis step-up to FMV for DO's Interests. SOs take a new tax basis in DO's Interests equal to purchase price paid. ***Fixed Estate Tax Value***. BSA can fix the estate tax value of DO's Interest based on BSA's specified valuation method, if respected. ***Estate Exclusion***. Death benefits should not be included in estate tax value of Company or DO's Interests (although value of policies held by DO on any SOs will be includible in DO's estate, suggesting a potential reason or benefit of using term policies). ***SOs Solely Own Business***. DO's heirs do not receive any Interests, minimizing potential conflicts with SOs. ***Simple for 2 Owners***. Structure is simple to implement/administer if only two owners.	***Valuation***. BSA must specify valuation method (e.g., independent appraisal), and compliance with BSA terms is required for value to be respected for tax purposes. **FMV/Price Mismatch**. If BSA's purchase price is lower than final estate tax value, DO won't receive full FMV and SOs won't receive full step up to estate tax value, absent tax adjustment clause in the BSA. ***Multiple Policies.*** Policies needed increase exponentially with each added owner (e.g., 3 owners – 6 policies). ***Premium Disparities.*** Premiums will be higher for older/unhealthier owners. ***SO Creditors***. Insurance proceeds received by SOs may be subject to attachment by their personal creditors. ***Premium Funding.*** Parties must agree on premium funding and address tax consequences (e.g.,

		business distribution taxed as compensation? Will owners be grossed up for additional tax costs?)
Trusteed Arrangements One or more ILITs are created to buy policies insuring owners. The ILIT may be created by the business or the owners, with separate considerations for each. One or more current owners (and possibly insured owner's family) are ILIT beneficiaries. BSA and ILIT(s) require DO to sell, and ILIT to buy, DO's Interests at the value set by the BSA. The ILIT deals with purchased Interests as specified by trust (e.g., Interests are distributed out or remain in trust for SOs). Excess life insurance proceeds can pass to or be held in trust for DO's heirs (or as otherwise agreed in the BSA).	***Basis Step-Up***. DO's estate receives a basis step-up to FMV for DO's Interests. SOs take a new tax basis in DO's Interests equal to purchase price paid. ***Fixed Estate Tax Value***. BSA can fix the estate tax value of DO's Interest based on BSA's specified valuation method. ***Estate Exclusion***. Death benefits should not be included in estate tax value of Company or DO's Interests. DO's interests in policies on SOs also remain excluded from DO's estate. In addition, any of DO's Interests retained in an ILIT for SO's benefit after buy-out will remain outside of SO's taxable estate. ***SOs Solely Own Business***. DO's heirs do not receive any Interests, minimizing potential conflicts with SOs. ***Hybrid Option.*** Allows structuring flexibility, e.g., can structure to give SOs first option to buy DO's Interest directly, as a cross purchase.	***Valuation***. BSA must specify a method for valuing Interests at buy-out (e.g., independent appraisal). ***Added Complexity***. Multiple trusts agreements and related tax filings are required. Appropriate and independent trustees and other fiduciaries must be identified. Trust provisions must be carefully reviewed and coordinated with all owners and may require coordination with the owners' personal estate plans (which may be undesirable among unrelated owners). ***Control/Incidents of Ownership***. If the IRS considers the trusts/trustees as being too controlled or directed by the owners, they may argue for estate tax inclusion of the insurance proceeds. ***Transfer for Value.*** Even if retained in trust, a DO's beneficial interest in policies on the lives of SOs is effectively shifted to the surviving SOs, which potentially could be deemed a transfer for value with respect to any policy interest that is not transferred to an insured (or other qualified exception to the TFV rules).
Insurance LLCs One or more LLCs (taxed as partnership) are created and owned, outside the business, by the Company owners solely to holding life insurance to fund the BSA for the business.	***Similar to Trusteed Arrangement***. Insurance proceeds are likely excluded from the value *of the Company* and the DO's estate, DO's estate receives a basis step-up to FMV for DO's Interests and SOs take a new tax basis in DO's Interests equal to purchase price paid, the BSA can fix the estate tax value of DO's Interests, and the SO's solely own the Company after DO's death.	***Application of Connelly.*** After Connelly, the value of the DO's interest *in the LLC* may be increased by the death benefits the LLC receives (e.g., DO holds 50% of Insurance LLC which receives $5 million on DO's death, DO's LLC interest has an estate tax value of $2.5 million), unless the death benefits can be effectively "specially allocated" to SOs' capital accounts (which requires "substantial economic effect" and not just made for tax-driven purposes).

On DO's death, per a BSA, the LLC uses the life insurance proceeds to buy DO Interests and distribute it to the SOs, as the LLC's surviving members.	***Transfer for Value.*** Neither a transfer of a policy to the LLC nor a shift in policy interests resulting from a DO's death should trigger transfer for value issues, as they fall under the exception for transfers of policies to a partner/partnership of the insured. ***Limited Creditor Exposure.*** Policies and death benefits received in the LLC protected against the claims of owners' personal creditors, to the extent of applicable state law. ***Single LLC Mimic Redemption Benefits***. Using a single LLC can replicate redemption arrangement benefits including one policy needed per owner, management of disparities in premiums due for each owner,	Creating multiple Insurance LLCs, one to hold each policy on an owner, and giving an owner a minimal (1%) interest in the LLC holding the policy on his or her life also could address this issue, but would require additional administrative complexities and filings. ***Control/Incidences of Ownership.*** LLC should have an independent manager (*e.g.*, not related or subordinate to any member). None of the members should be able to exercise any incidents of ownership with respect to any policy owned by the Insurance LLC. ***Administration***. Continuing involvement and cooperation with the Company's and owners' accountants is critical to the proper tax treatment and functioning of the Insurance LLC structure to ensure it is respected for tax purposes without unintended consequences.