

Recent Court Ruling Could Make Your Buy/Sell Agreement Generate a Tax Bill



A recent ruling in a US Court of Appeals has flipped the script on life insurance death benefits paid to a business under a buy/sell agreement resulting in an inflation of the value of the business and consequently, inflation of the value of the deceased's taxable estate.

The conundrum created by the new ruling

Buy/Sell agreements allow business owners to ensure a fair and orderly disposition of their business interest in certain circumstances including death or disability. Life insurance is often used to provide funding for share purchases at death. In many arrangements, the business owns a policy on each owner so that the business can purchase the ownership from the estate of a deceased owner. A pivotal question in such an arrangement is whether the life insurance proceeds will inflate the value of the business for tax purposes. A court case (Blount) in 2005 in the US Court of Appeals, 11th Circuit indicated life insurance proceeds did inflate the value but had an offsetting liability through the repurchase obligation. Now, the US Court of Appeals 8th Circuit rejected the Blount case and essentially ruled in Connelly v. United States that the life insurance proceeds must be considered part of the value of the business for tax purposes while an obligation for the business to repurchase the deceased owner's interest does not provide an offsetting liability.

Now we have what amounts to two different results for taxpayers in different circuits. Business owners in the 11th circuit (FL, AL, GA) may not have their net business value inflated by life insurance proceeds paid to the business for a buy/sell because they get recognition of an offsetting liability. Business owners in the 8th circuit (ND, SD, NE, MN, IA, MO, AR) may see the value of their business inflated by the life insurance paid to the business with no offsetting liability. The people in the rest of the circuits are caught in between these rulings. The tax decisions of other circuits generally should be followed. Which circuit's decision should be followed? If the 8th Circuit approach prevails, the family/heirs of business owners may find themselves owing more tax.

What should you do?

It has long been prudent to periodically review buy/sell agreements to ensure they accurately reflect current ownership and use a fair valuation methodology. The ruling in the 8th Circuit provides yet another reason to revisit the agreement. It also highlights a need to ensure some specificity exists in how the life insurance proceeds paid to the business are to be used. In addition, the ruling may be a reason to pivot away from arrangements where the business owns any life insurance policies for buy/sell purposes.

Is there a better approach?

Fortunately, there may be a better approach that uses a special purpose buy/sell insurance LLC. The LLC, which will be taxed as a partnership, will own the policies on the owners and be the beneficiary as well. The income tax free death benefits are allocated or distributed to surviving members to purchase a deceased owner's interest in the operating company. The LLC may be structured and operated in a way to:

- better integrate with estate plans of the business owners
- improve creditor protection
- allow a step up in basis for surviving owners
- equitably address large premium differentials across different insureds
- more easily facilitate policy changes due to ownership changes over time

An important aspect is that there are special considerations in the drafting and operation of the LLC to ensure the most advantageous outcomes.

Summary

While the 8th Circuit ruling is one reason to revisit your buy/sell agreement, the benefits of the special purpose buy/sell insurance LLC are enough to explore whether the change makes sense for your business. In addition, this planning may impact how some businesses want to handle key person insurance for closely held or family businesses where estate tax considerations might be applicable. We'd be happy to help you explore these options.

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