COMMITTEE REPORT:
INSURANCE

By **Robert W. Finnegan**

Responding to *Connelly*

A guide to help advisors navigate the options

In the recent case of *Connelly v. United States*, the U.S. Supreme Court ruled unanimously that life insurance owned by and payable to a corporation to fund a stock redemption agreement was included in valuing a decedent's interest in the corporation with no offset for the obligation to redeem the decedent's stock.[1] Much has been written about *Connelly*, raising many questions. Was it merely a bad facts case? Bad law? How far-reaching is the holding? Why did the Court even take up the case?[2] Although important, in one sense, these questions are largely academic because the Supreme Court hasn't sufficiently explained its rationale, making it difficult to determine the ruling's scope. The fact remains that *Connelly* upended a well-established and useful planning strategy, and we're left to deal with the fallout in a way that protects our clients from potential negative consequences.

Many businesses own life insurance to help ensure that they can fund the redemption agreement. Let's take a practical look at the options for responding to *Connelly*. I'll focus on buy-sell agreements among unrelated business owners.[3]

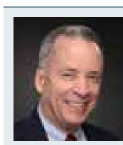
Here's an example of the effect of using life insurance to fund a redemption agreement, based on *Connelly*: Business X, valued at $9 million, is the owner, premium payor and beneficiary of $3 million of life insurance coverage on each of three equal owners: A, B and C. On A's death, Business X redeems A's interest with the $3 million of proceeds. B and C now own the $9 million business equally, or $4.5 million each. While the estate was obligated to sell A's interest for $3 million, based on *Connelly*, A's interest in the business is valued at $4 million: the $3 million agreement price plus one-third of the $3 million of life insurance proceeds paid to the business. At a 40% estate tax rate (and assuming that neither the unlimited marital deduction nor remaining estate tax exclusions are available), the estate would pay an additional $400,000 in taxes so that A's heirs would only net $2.6 million from the buyout. See "Using Life Insurance to Fund Redemption," p. 31.

Let's look at some alternative options.

Leave As Is

In some instances, it may make sense to leave the redemption agreement and the business-owned life insurance in place:

1. If the unrelated business owners have combined interests that are greater than 50% of the value of the business, then they can take advantage of the Internal Revenue Code Section 2703 regulations, which give free rein in setting the business' value (when the owners have met the case law requirements to fix the value of the business).[4]
2. In the family setting or when unrelated owners don't meet the greater-than-50%-of-value threshold, the business is valued based on a formula that's well-established for the industry in question and strictly adhered to. The insurance death benefit should be closely related to that value.
3. When the owner's estate, including the business, is less than the available lifetime gift/estate and generation-skipping transfer tax exclusions so that the potential *Connelly* increase in the estate tax value of a decedent's business value isn't a concern.



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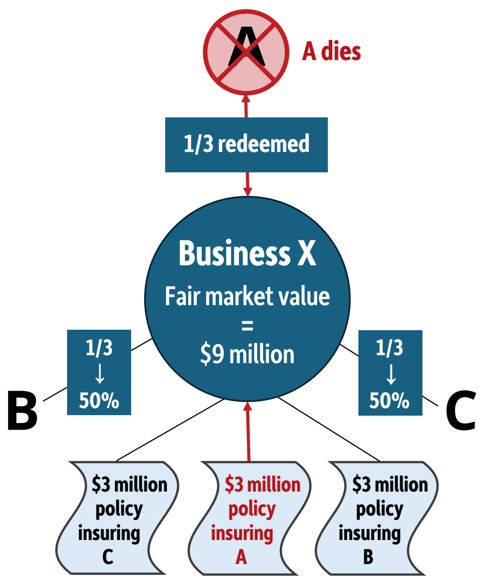
Using Life Insurance to Fund Redemption

Example of a typical arrangement



- **Individuals A, B and C each own one-third of the operating business valued at $9 million**
- **Business X is the owner, premium payor and beneficiary of all three $3 million policies**
- **On death, the $3 million death benefit is paid to the business and used to redeem the decedent's interest**

— Robert W. Finnegan

4. If the business has multiple owners so that each owner's share is relatively small, for example, 10%, then only that percentage of the death proceeds would be included in the decedent's estate, and the risk of *Connelly* inflating the value is small.[5] However, as the number of owners dwindles, the survivors' percentage ownership increases as does the percentage of the death proceeds that could be included based on *Connelly.*

In the latter two instances, the risk of an Internal Revenue Service audit and a *Connelly* assessment may be small. However, over time, gift and estate tax exclusions get reduced, businesses increase in value and ownership changes, so that leaving the redemption and life insurances as is may ultimately be a risky strategy.

Regarding the above, if the business didn't satisfy the IRC Section 101(j) notice and consent requirement, the taxable death benefit taint can't be removed as long as the policies are owned by the business. Therefore, those policies should be transferred out of the business to the non-insured business owners (non-insureds) and the redemption agreement replaced with a wait-and-see buy-sell agreement. If it's desirable to maintain business-owned life insurance to fund a redemption and new coverage is available, it may be advisable to replace the old coverage while satisfying the notice and consent requirement prior to issuance of the new coverage.

Transfer to Non-Insureds

In many cases, it may be advisable to transfer the business-owned policies (or an interest in the policies) to the non-insureds. Whenever policies are transferred from an entity to the non-insureds, it's important to be aware of and address these five factors:

1. The best way to transfer the policy (as a distribution, as compensation or as a sale)
2. Policy built-in gain taxable to the business on the transfer of the policies
3. Section 101 issues (transfer for value, reportable policy sale and notice and consent)
4. Policy valuation
5. Underfunding

Determine the best way to transfer the policy. When the owners are also employees, there are three options to transfer the policies: (1) distribution; (2) employee compensation; or (3) sale. For flow-through entities (limited liability companies (LLCs), partnerships and S corporations (S corps)) with sufficient basis, the distribution will be the most common method because the owners will only be taxed to the extent that the fair market value (FMV) of the policy exceeds their cost basis in the business. For a C corporation (C corp), a distribution will be taxed to the non-insureds as a dividend. As

compensation, the policy will be included in the employee/owner's gross income (at the policy FMV), and it may be deductible to the business provided that the employee's total compensation is considered "reasonable." In the case of the sale of the policy, each non-insured will purchase their interest with after-tax dollars or a promissory note.

Consider taxable gain to the business on the transfer of the policies. When the policy has built-in gain (that is, the policy's FMV exceeds the business' cost basis), whether the policy is transferred as a distribution, compensation or a sale, the business will recognize gain except in the case of a distribution from an LLC or partnership (taxed as a partnership for federal tax purposes).[6] An endorsement split-dollar plan offers the opportunity to avoid gain while mitigating the effects of *Connelly*. Although gain is more likely to come into play with permanent cash value policies, there may also be gain in a term insurance policy.

SPOTLIGHT

Overcrowded
The Beach At Cannes by LeRoy Neiman sold for $2,048 at Doyle Fine Art & Photographs auction on Dec. 5, 2024 in New York City. Neiman was known for his Playboy illustrations as well as paintings of sports stars. This commercially successful work overshadowed some of his other accomplishments, such as his images of the signing of the Egypt-Israel peace treaty at the White House in 1979.

Address the Section 101 issues. Failure to successfully navigate Section 101 (transfer for value, reportable policy sale, notice and consent) would be apocalyptic due to the loss of the policy death benefit's income-tax-free character:

Transfer for value. The transfer of a corporate-owned policy to a non-insured as a distribution, a payment of compensation or a sale will be a transfer for value, and the policy death benefit will be taxable unless the transfer is within an exception to the rule. A transfer to a partner of the insured or to a partnership in which the insured is a partner are the most likely exceptions applicable.[7] The exception is met if the operating business itself is a partnership or LLC[8] that's taxed as a partnership for federal tax purposes. For example, the exception will be met if the operating business is a C corp or S corp, and the shareholders are all partners in a separate partnership or LLC that holds business real estate. As a partnership for federal tax purposes, the special purpose LLC discussed below would satisfy the partnership exceptions. For our purposes, being within an exception to the transfer-for-value rule is essential when a policy is distributed from the business to a non-insured, when a surviving non-insured purchases a policy from the decedent's estate or the business endorses the death benefit to the non-insureds pursuant to a split-dollar agreement.

The reportable policy sale under Section 101(a)(3). The Tax Cuts and Jobs Acts of 2017 introduced the reportable policy sale.[9] If the transfer or acquisition of the policy is a reportable policy sale, the policy's death benefit loses its income-tax-free character. A reportable policy sale is the acquisition of an interest in a life insurance policy when the acquirer has no substantial family, business or financial relationship

to the insured apart from the acquirer's interest in the life insurance contract, for example, in a life settlement. In most cases, the transfer of a policy to a co-owner of the business will have a substantial financial relationship because "the acquirer and the insured have a common investment where the buy-out of the insured's interest by the acquirer is reasonably foreseeable."[10]

Notice and consent requirement. To maintain a policy's income-free tax-free death benefit on "employer owned life insurance contracts" issued after Aug. 17, 2006, businesses must provide notice to insured employees prior to the issuance of the policy.[11]

Determine policy valuation. Determining the value of a life insurance policy is a complex topic in and of itself. IRS guidance has been sporadic and inconsistent and doesn't cover every possible situation.[12] When requested, carriers report their estimation of the value of the insurance contract on Form 712. Fortunately, the IRS generally accepts that value, and consequently, most legal and tax advisors rely on this reported value.

Frequently however, the value listed on Form 712 isn't the FMV. The Form 712 value may be unreasonably high, for example, in the case of level term or guaranteed universal life policies. Likewise, the declining health of the insured may indicate a higher value than that reported on Form 712. Interpolated terminal reserve (ITR) is the basis of many carrier valuations[13] and, even in the case of term insurance policies, may result in an FMV in excess of basis. As a result, a transfer of the policy may trigger taxable gain. Of note, one prominent carrier reports unearned premiums as the value of level term policies.[14]

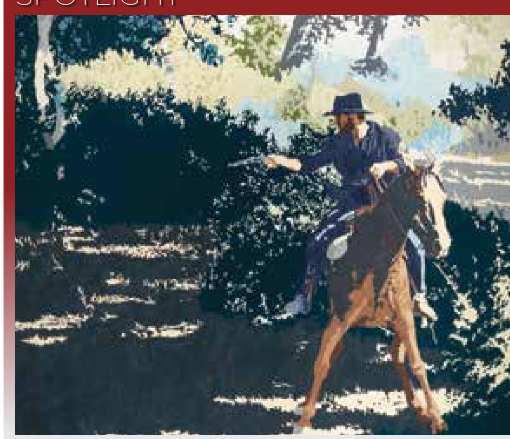
Because a client is obligated to report the Form 712 value once the form is issued, to avoid having to contest a reported value, it's advisable to

first have the carrier provide the value it will report should the form be requested. In many cases, based on the willing buyer/willing seller standard, a qualified appraisal from a valuation professional may be indicated.[15] Bottom line: It's critical to work with legal and tax advisors with expertise in this area.

Address underfunding. Many buy-sell agreements are underfunded because the business has appreciated since the insurance was purchased. Following the death of an owner, the underfunding is even greater.

> **Example:** Before A's death, A, B and C each own one-half of each policy on the other. Following A's death, B and C each own one-half of the $9 million business or $4.5 million each—but they only own one-half of the $3 million policy on each other ($1.5 million of death benefit). A's estate owns the other half of the two policies insuring the survivors.
>
> Therefore, B and C should have the right to purchase A's interest in the policies. That is, B should be able to purchase A's interest in the policy insuring C, and C should have the right to purchase A's interest in the policy insuring B. After they do, B and C will each own $3 million of coverage on the other (keeping in mind the need to address the transfer for value). The agreement is still underfunded because they each own a $4.5 million interest in the business.
>
> Suppose that the business has appreciated so that it's now worth $12 million. Each business owner's interest is worth $6 million with only $1.5 or $3 million each of insurance. Additional coverage is called for. Overfunding the insurance with inexpensive term insurance while the insureds are in good health may be attractive.

SPOTLIGHT



Wild Wild West
Incident Near Cedar Creek by Bill (William Clinton) Schenck sold for $12,800 at Doyle Fine Art & Photographs auction on Dec. 5, 2024 in New York City. Schenck is sometimes referred to as the "Warhol of the West" because of his blend of Western Americana with the style of Pop Art. Like Warhol, Schenck's works often mimic the comic book panel style.

Three Options

Three primary options for transferring an interest in a corporate-owned policy to the non-insureds are:

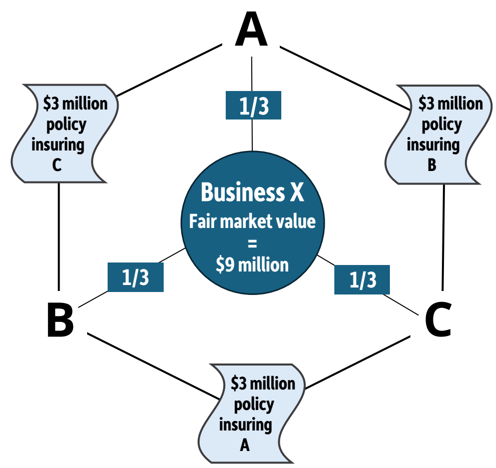
Leave the redemption in place, but move the life insurance out of the business to the non-insureds. Because the business no longer owns the life insurance policies, *Connelly* doesn't apply. With the redemption agreement, there's only one policy per owner. However, because most carriers won't split an in-force policy, when there are more than two business owners, the non-insureds will co-own the policy, typically as tenants in common. The non-insureds will pay their respective share of premiums and be entitled to their pro rata share of the death benefit.

> **Example:** A, B and C decide to leave the redemption agreement in place and transfer each of the $3 million policies to the non-insureds. As a result, B and C own the policy insuring A; A and C own the policy insuring B; and A and B own the policy insuring C. B pays one-half the premium on the policy insuring A and one-half the premium on the policy insuring C (and so on). See "Leaving Redemption Agreement in Place," p. 35.

On the insured's death, each non-insured receives their pro rata share of the policy proceeds.

Leaving Redemption Agreement in Place

Move life insurance outside of the business



B and C (policy insuring A) each:

- **Owns one-third of the business**
- **Is owner, premium payor and beneficiary of one-half the policy insuring A**
- **Is entitled to one-half the death proceeds**

- **On A's death, B and C each receive one-half the proceeds**
- **To fund the redemptions, they can each make a contribution to the capital of the business (increasing their cost basis) or make a loan to the business**

— Robert W. Finnegan

To provide the business with the cash needed to fund the redemption, the proceeds can be either: (1) loaned to the business to fund the redemption; or (2) contributed to the capital of the business. Provided that the distribution of the policy to the non-insureds was within an exception to the transfer-for-value rule (and otherwise complied with Section 101), the policy proceeds will be received income tax free. In the case of the contribution to capital, each non-insured's basis in the business will be increased.

> **Example:** B and C split the premiums on the policy insuring A and, on A's death, B and C each receive $1.5 million (one-half) of the proceeds. B and C each contribute the $1.5 million to Business X to fund the redemption of A's interest, valued at $3 million.

When a non-insured predeceases the insured, the surviving non-insureds should have the contractual right to purchase the decedent's interest in the policies insuring the survivors.

Transfer the policies to the noninsureds and implement a cross-purchase buy-sell agreement. *Connelly* doesn't apply to any of the cross-purchase options because the business doesn't own the life insurance policy.

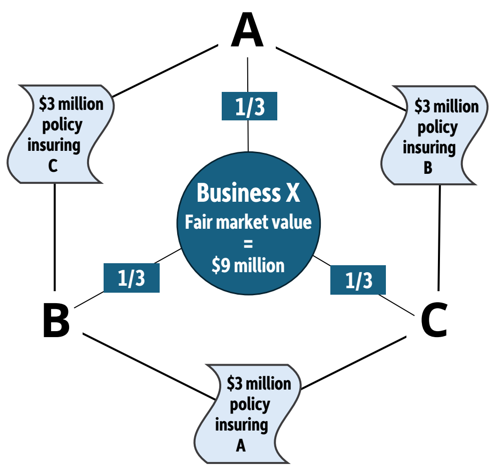
Traditional cross-purchase buy-sell agreement. The non-insureds are personally obligated to purchase the decedent's shares, and the non-insureds, therefore, own the insurance personally. The business-owned policies are transferred to the non-insureds who become the owners, premium payors (from personal after-tax funds) and beneficiaries of each policy.[16] On death, the policy proceeds are paid to the non-insureds, and they purchase decedent's interest in the business. Properly structured, the proceeds will be received income tax free.

> **Example:** Business X transfers each $3 million policy to the non-insured: the policy insuring A to B and C; the policy insuring B to A and C; and the policy insuring C to A and B. Going forward, the non-insureds will each pay one-half of the annual premium on the policies they co-own and, on an insured's death, each non-insured will receive one-half the death proceeds. If A dies, B and C each receive one-half the death benefit ($1.5 million each) and personally purchase A's interest in Business X from A's estate. See "Funding Cross-Purchase Agreement," p. 36.

Trusteed cross-purchase agreement. An escrow agent (the trustee) acts on behalf of each of the individual owners.[17] The benefit of this agreement is that it simplifies ownership of and administration of the policies and ensures that terms of the buy-sell

Funding Cross-Purchase Agreement

Policy proceeds are paid to non-insureds



B and C (policy insuring A) each:

- Owns one-third of the business
- Is the owner, premium payor and beneficiary of one-half the policy insuring A
- Is entitled to one-half the death proceeds

- B is owner and beneficiary of one-half the policy on C
- C is owner and beneficiary of one-half the policy on B

— Robert W. Finnegan

agreement will be honored by both the buyers and, when the trustee also holds the business interests, the seller. In effect, the trustee stands in the shoes of each owner and, as their agent, is empowered to act on their behalf. That is, legally and thus literally, the acts of the trustee are the acts of the individual owners. In "Funding Cross-Purchase Agreement," on behalf of the non-insureds, the trustee would be the owner, premium payor (with funds contributed by the non-insured) and beneficiary of each policy. Provided the transfers of the policies by the business to the non-insureds are within an exception to the transfer-for-value rule, the retitling of the policies in the trustee's name (as the agent of the non-owners) isn't a transfer for purposes of the rule. The trustee could be the parties' attorney or accountant, or they could hire a trust company to fill that role.

> **Example:** Business X transfers the policies to the non-insureds (the policy insuring A is transferred to B and C, and so on). The parties decide to implement a buy-sell and transfer their interests in the policies to the trustee.[18] The trustee now owns the policy insuring A on behalf of B and C. Going forward, B and C each contribute one-half of the annual premium on A's policy to the trustee. If A dies, the trustee receives the proceeds and purchases A's interest in Business X from A's estate on behalf of B and C. Additionally, the trustee purchases A's interest in the policy insuring B on behalf of C and the policy insuring C on behalf of B.

Because the trustee is an agent of each non-insured, there's no transfer when they transfer the policies to the trustee.

Special purpose LLC. The LLC's sole role is to own the insurance and complete the buy-sell, a valid non-tax or business purpose. Because all of the business owners are members of the LLC (taxed as a partnership for federal tax purposes), any transfers of the policies, from the business to the non-insureds or by the non-insureds to the special purpose LLC directly, are within the partnership exceptions to the transfer-for-value rule. In effect, it operates exactly like the cross-purchase agreement. Although there are a number of ways to allocate premiums, having each party responsible for the premiums exactly as they would be if they owned an interest in the policies personally to fund a cross-purchase seems to be fairest and most easily understood.

> **Example:** Following the transfer of the business policies to the non-insureds, the parties form a special purpose LLC and transfer their interests in the policies to the LLC. The trustee now owns the policy insuring A on behalf of B and C, and so on. Going forward, the non-insureds each contribute one-half of the annual premiums for the two policies held by the

LLC on their behalf. If A dies, the partnership receives the proceeds and may distribute the proceeds to B and C who can then purchase A's interest in the business (and in the policies insuring the surviving owners).

The LLC operating agreement uses special allocations to ensure that each insured doesn't have any interests in the policy insuring their own life (incidents of ownership).[19] Some commentators have cautioned that *Connelly* may apply to the special purpose LLC. If that's a concern, then a partnership could be created for each policy. For example, B and C would be partners in the partnership that owns the policy insuring A and so on. To avoid the reach of Section 101(j), the members of the LLC shouldn't be employees of the LLC (and, in fact, there's no reason for them to be employees).

Wait-and see buy-sell agreement. This is a hybrid between a cross-purchase and a redemption agreement in which: (1) the surviving owners have the option to purchase the decedent's business interest (the cross purchase); and (2) the business has the obligation to redeem the decedent's interest (the redemption). This provides a great deal of flexibility in allowing the parties to choose the best form of buy-sell to suit their goals at the time a buyout is triggered.

Example: The parties have entered into a wait-and-see buy-sell agreement in which B and C own the \$3 million policy on A, and so on. On A's death, A's interest in the business is valued at \$4 million based on the formula clause in the agreement. The non-insureds each purchase \$3 million of proceeds from A's estate, and Business X redeems the \$1 million balance with a 10-year promissory note. Alternatively, they could have each contributed the policy proceeds to the business and, along with the \$1 million note, fund a 100% redemption.

Leave the policies in the business with each policy subject to an endorsement split-dollar arrangement coupled with a wait-and-see buy-sell agreement. Under an economic benefit regime endorsement split-dollar plan, the business continues to own the policies and endorses the excess death benefit to the non-insureds. During the insured's lifetime, the business is entitled to the greater of: (1) the premiums advanced; or (2) the policy cash value (undiminished by surrender charges). On death, the business is entitled to an amount equal to the premiums advanced.

Each year, each non-insured must account for the reportable economic benefit (REB) by: (1) paying their REB to the business; or (2) reporting it as employment compensation or a distribution. The REB equals the 1-year term rate based on the insured's attained age multiplied by the non-insured's share of death benefit. The term rate equals the Table 2001 rate or the substantially lower carrier's alternate term rates.[20]

A split-dollar plan can provide a number of benefits to address *Connelly*. First, because only a portion of the death benefit equal to the premiums advanced will be paid to the business and only the decedent's share of that amount would be added to the value of the decedent's business interest, the risk of inflating the estate value due to *Connelly* is greatly reduced.

Second, many policies funding redemptions have built-in gain to the extent that the FMV of the policy exceeds the business' cost basis. Other than a distribution from a partnership or LLC, whether transferred as a distribution, as compensation or in a sale, the business will have to recognize that gain. An economic benefit regime endorsement split-dollar plan[21] will avoid triggering that gain because the business always owns the policy.

Third, coupling the split-dollar plan with the wait-and-see agreement allows the full policy proceeds to be used to fund a buyout. The excess death benefit will be paid to the non-insureds who will use their share of death benefit to purchase a portion of the decedent's business interest; the business redeems the balance of the decedent's interest with its share of death benefit (and a note if necessary).

Fourth, the policy proceeds should be income tax free to the employer and to the non-insureds provided that the endorsement of the death benefit to the non-insureds has addressed the Section 101 issues.[22]

Endnotes

1. *Connelly v. United States,* 602 U.S. ___(2024).
2. For an interesting discussion of *Connelly*, including what it means and what it doesn't, *see* Paul Hood and Edwin Morrow, "United States

Supreme Court Unanimously Affirms Eighth Circuit in *Connelly Est. v. Internal Revenue Service*: What the Decision Means, Doesn't Mean and the Ramifications on Future Planning," *LISI Business Entities* Newsletter #299 (June 17, 2024).

3. Generally, in the family setting, business continuation is an estate-planning matter. It requires less insurance to pay a 40% estate tax on the value of the business versus a buy-sell, in which 100% of the business value is needed.
4. Treasury Regulations Section 25.2703-1(b)(3).
5. In *Connelly*, the deceased brother owned 77.18% of the business, so the value of his interest was inflated by $2.3 million of the $3 million life insurance policy on his life.
6. Internal Revenue Code Section 731(b).
7. Other exceptions include the basis exception, a transfer to the insured or a transfer to a corporation in which the insured is a shareholder or an officer (however, a transfer to a co-shareholder or co-officer of the insured isn't an exception).
8. All references to a partnership or limited liability company assume that it's a partnership for federal tax purposes.
9. *See also* Treas. Regs. Section 1.101-1.
10. Treas. Regs. Section 1.101-1(d)(3).
11. To meet the notice and consent requirement of IRC Section 101(j)(4), before the issuance of the contract, the employee must be notified in writing that:
    (1) The employer intends to insure the employee and that the maximum face amount of such coverage is issued
    (2) Such coverage may continue after the insured terminates employment, and
    (3) The employer will be a beneficiary of any proceeds payable on the death of the employee.
12. For example, *see* Revenue Procedure 2005-25, Revenue Ruling 59-19 and Treas. Regs. Section 25.2512-6.
13. Interpolated terminal reserve (ITR) plays a prominent role in valuing a policy. With respect to universal life and level term policies (that have proliferated since the early 1970s), there's no definition of ITR in the Tax Code or related authority, nor is there an agreed-on actuarial definition. As a result, carriers use widely different methods when determining ITR for these policies. Some carriers have started

reporting multiple values on the Form 712, leaving it up to the advisors to choose the value to use.

14. Unearned premium represents the pro rata portion of the annual premium for a guaranteed premium level death benefit term policy (that is, 10-year level term) that hasn't yet been "earned" by the carrier. For example, with a $1,000 annual premium, if the policy is transferred on April 1, three-quarters of the premium hasn't been earned, so the transfer value would equal $750.
15. In a recent valuation dispute, the Internal Revenue Service refused to accept a qualified appraisal and insisted on the ITR value. Ultimately, the dispute was settled between the parties.
16. Funds may be bonused or double-bonused to the owners.
17. Rather than using the escrow agent approach, a trust valid under state law can accomplish the buy-sell.
18. As an alternative, the owners can give the funds to the trustee to purchase the policies from the business.
19. *See* Private Letter Ruling 200747002 (Nov. 23, 2007).
20. IRS Notices 2002-8 and 2002-1 provide that for the carrier's alternate term rates to qualify:

    > … (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.

    The Notices don't define the phrase "regularly sells." Currently, the IRS apparently isn't enforcing the "regularly sells" requirement and is accepting carrier rates that are published on the carrier's letterhead.
21. Treas. Regs. Section 1.61-22. Although economic benefit regime split dollar is typically used with permanent life insurance policies, there's nothing in the regulations to prevent it from being used to fund a term insurance policy. A term insurance may have a fair market value greater than the owner's cost basis.
22. If the Section 101(j) notice and consent requirement wasn't met, it may be possible to change ownership to the non-insureds and enter into a collateral assignment split-dollar plan relying on Notice 2009-48, A-1.

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