

## Advanced Planning Sushi: Supreme Court creates buy-sell hurdle (and opportunities) for business owners

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**Announcer:** Advanced Planning Sushi fresh and flavorful sales bites. Breaking news in Supreme Court creates buy-sell hurdle and opportunities for business owners.

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**Speaker 1:** Thank you for joining us today. My name is Jim Barbee and I'm joined by David Szeremet. And today we're going to be talking about recently issued United States Supreme Court opinion. Which is relevant to, of all things, advanced planning concepts and it impacts buy-sell designs and our life insurance agents. And so, David, can you set the stage for us? Please tell us a little bit about the underlying facts and what this case is really about.

**Speaker 2:** Sure, Jim, yah. This is the Connelly vs. United States case. This was a really, the case surrounded the Federal Estate Tax. So, we have a classic family business scenario. Michael and Thomas co-owned a building supply corporation. So, it was organized as a corporation. Michael owned seventy-seven percent and his brother, Thomas, owned twenty-three percent. So, Michael and Thomas entered into a written buy-sell agreement and the buy-sell provided that if either brother died the surviving brother would have the first option to buy-out the decedent, what you might call a cross-purchase option. And if the surviving brother refused the cross-purchase then it would trigger a mandatory stock redemption plan. So, this is a classic what we would call wait and see buy-sell, where you have the cross-purchase option, followed by a stop redemption obligation. And the redemption price was to be determined by an outside, you know, professional appraisal. So, the brothers purchased three and a half million dollars of life insurance to be owned by the business. The business would be the owner of each policy to fund the stock redemption and again, it was a three and a half million-dollar policies each, business as owner and premium payor. And of course, this case was in the Supreme court so, you know, somebody had to die to get there, and Michael passed away in 2013. His brother, Thomas, did not exercise the optional cross-purchase, thus triggering the mandatory stock redemption of Michael's seventy seven percent. Now, instead of obtaining an outside appraisal as required under the agreement, the family members informally agreed to three million dollars as the value for Michael's seventy seven percent, to this is the classic situation where the family got together and they kind of went of the record and they went with a three million dollar buy-out price. And they filed a Federal Estate Tax return to that extent indicating that Michael's portion was worth three million dollars. Well, enter the IRS after the Federal Estate Tax was filed, an audit was performed. And at that point that's the first time an appraisal was performed, so that's interesting that the family did not perform an appraisal as required under the agreement. They didn't have an appraisal performed until they were audited, which is usually not a good sign. So, the professional appraisal came back with a value of three million dollars for Michael's shares, which interestingly

excluded the life insurance proceeds that were payable to the business. So, the appraiser and the family argued that the stock redemption obligation created a liability that would offset the value of the life insurance. Not surprisingly, the IRS totally disagreed with the family and said that the life insurance should be included in the value of the business because it was a business owned policy and that there should not be an offsetting liability for the stock redemption obligation. So, when you look at the dispute, the family was at a value of about three million dollars for Michael's shares. The IRS was closer to a six-million-dollar value because of the inclusion of the life insurance in Michael's share of the business. Now, when you take the difference applying the Federal Estate Tax, that's close to nine hundred thousand dollars in additional taxes for Michael's estate. So, we have something that is close to a million-dollar problem there. Now, what the family did was, the family paid the additional nine-hundred thousand dollars in Federal Estate Taxes and then sued in Federal district court to recover what they felt was, you know, an unfair amount there. They sued to recover the nine-hundred thousand dollars. Well, the Federal district court agreed with the IRS and so did the eighth circuit court of appeals. So, we have the IRS winning at the district court level and at the court of appeals level. So, Jim, this case worked its way up to the U.S. Supreme Court, which is the highest court in the land and what happened there?

**Speaker 1:** It is, David. You know, it was a nine zero decision. Which, for all of us lawyers, tells us it's probably going to be the law of the land for a while. It was agreed to by all of the judges. What they really said was is that the life insurance proceeds are to be included when calculating the value of the business. That really wasn't in dispute. The court went on to hold though that the buy-sell redemption obligation does not offset any of the life insurance proceeds or otherwise reduce the fair market value of the business. Then the court stated the fair market value is usually determined when neither party is under a compulsion to buy or sell. Each has reasonable knowledge of the relevant facts. But in this case, when we received the life insurance death benefit, there is no reduction then because we have to buy out the interest from the decedent's estate. This is really a big decision for life insurance agents and everyone working in the buy-sell market. Now remember though, David, this is important to those individuals having an estate tax liability problem. So, if we don't have potential Estate taxes, this has less concern. Now, but, David, reading this decision I think our first question to talk to our agents about is was this necessarily the results or were there other things these business owners could have done to avoid this nearly, as you mentioned, nine-hundred thousand dollars in Estate taxes?

**Speaker 2:** Yah, the first point I would make is that they didn't even follow their own document. So, this could have been an example of, you know, bad facts make for bad law. By way of example, the first time that they performed an appraisal, which was required under their document, the first time they performed an appraisal was after they got audited. So, they really, they didn't follow their own document. So, that is the first point I would make is if you're going to take the time and trouble to have a buy-sell business succession plan in place, you should follow what it says. So, that's the first point. The second option, I would say is they could potentially have avoided this entire problem if they had used a different type of buy-sell specifically a cross-purchase

agreement. A cross-purchase agreement is where each owner buys insurance on the other owner. So, Michael would buy a policy on Thomas and Thomas would buy a policy on Michael. And they would be cross-owned so the fact that they are not business owned means they would have avoided this whole, you know, inclusion problem to begin with as far as increasing the value of the business because with a cross-purchase the policies are individually owned and in fact Justice Thomas on fact eight of the opinion says that they could have avoided this problem by using a cross-purchase. So, this is a rare case where we have a Supreme Court justice giving us Advanced Planning support. So, I think we should, if it is appropriate, we should take that advice and pass it along to our agents out there. But, Jim, other than the cross-purchase are there other options available?

**Speaker 1:** There are, and I agree with you were saying, David, about the cross-purchase. But, you know, if we have five business owners a cross-purchase design would require twenty different life insurance policies to properly fund it, which might be overly cumbersome and burdensome for both the owners and the agents. So, one solution we might talk about is what we refer to is the LLC buy-sell design. And we have a nice whitepaper on this. So, please contact us and we'll send you that whitepaper. But the basic design is that the business owners will set up a stand-alone LLC. The LLC will purchase life insurance on each business owner in an amount sufficient to redeem that owner's interest in the business. And then all of the owners will enter into cross-purchase buy-sell contracts. This is a nice handy solution. But, David, what about the business owners who don't want to create another entity? Can they also solve the problem without creating a new entity?

**Speaker 2:** Sure, you know, if they don't like the idea of the LLC buy-sell, which is really the modern trend, but if they don't prefer, you know, the requirement of putting together another entity. They could go the route of a trustee buy-sell. So, a trustee buy-sell is where they would have a trust drafted and the trustee would essentially administer a cross-purchase and the trust would hold the life insurance. So, again it would keep that life insurance out of the business and away from the Federal Estate Tax problem that they faced in Connelly. So, you know, Jim, if you are thinking about are there different planning options? Yes. There are a bunch, you know, cross-purchase, LLC buy-sell, trustee buy-sell, we just talked about three different options available. So, there are lots of alternatives out there where clients can pretty easily avoid this problem in Connelly. So, I just want it to be stressed that this case is important, but the sky is not falling.

**Speaker 1:** This sky isn't falling. But now, David, let's say the business owners really are wanting to stay with the entity redemption design. You know what this case is telling me is if we don't have an estate tax problem, yah our agents should keep in mind that they might need to be selling and the clients might need to be purchasing additional life insurance because that redemption obligation is not going to decrease the value of the business. Now, if you're clients have an estate tax problem, I think what this squarely telling us is you probably need to buy additional life insurance to fund the obligation because the life insurance benefit, the entire benefit, is going to be included in the

decedents interest and that benefit will be included and taxable. So, you may need to be selling more life insurance than you initially thought. That's what this is telling me. Now, what if the client doesn't know what their buy-sell says? How can we help them with those types of issues?

**Speaker 2:** Yah, Jim, I mean this Connelly case squarely reminds everybody out there that we have a very powerful service available. We call it the document review service. So, anyone out there, if you are working with business owner clients and you can get ahold of their buy-sell agreement or their LLC operating agreement or whatever business documents they might have, you can send those into our department. We can review those because, you know, this case clearly is creating a new potential tax trap. And in order to best help your clients out there, you know, we need to know what the documents say. So, just a reminder that the document review service is there. For everyone out there we encourage you to work with us on that. We can help untangle that and see if potentially the clients have a Connelly tax trap or if they don't. Maybe they're good to go, but without looking at those documents it's hard to really give them sound advice. But, you know, Jim, other than document reviews, are there other ways we can assist people out there with these concepts?

**Speaker 1:** There sure are. So, David, I mentioned that buy-sell whitepaper, that is form 2296. You can call, agents can call the department and we'll send it to you. You can get it on the website. We also have some buy-sell client guides and one pagers. Those are forms 2301, 2532. We have a really neat advisor guide, David, that is form 2412. You know, last year when we saw this issue was going to be coming up in the Supreme Court, we actually did a podcast on what I call Connelly one, the district court opinion. I would encourage our agent to go and listen to that podcast for some more background. We have a great PowerPoint on buy-sell concepts, David. We drafted speaker notes so agents can present buy-sell planning concepts to their clients. They can even modify the cover page of that PowerPoint. And of course, our case consultation for all of you agents listening, we hope that you are seeing if there's an entity redemption. There might be some issues about the fair market value of the company. Please call us and let our department help you with all of the buy-sell planning concepts and designs.

**Speaker 2:** That's great, Jim, and I know we have a lot of materials, a lot of support out there, we really want to help the field. And again, the Connelly case is important, it's a U.S. Supreme Court case, you know, it's the Supreme law of the land. But, you know, the sky is not falling on buy-sell planning. If nothing else, it's really shining a light on the importance of proper planning, proper funding, and you know careful planning.

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**Speaker 2:** So, work with us in Advanced Planning we'd love to help you navigate those waters.

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