
Planning with Life Insurance LLCs after *Connelly and Huffman*

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Connelly

- Setting up the issue
- Parameters of the law
- Cross purchase using life insurance LLC

Materials

- Slides
- [Article on Connelly](#) (2nd quarter 2024)
- Several thousand page PDF, which can be downloaded using link in yellow box in middle of [2nd quarter 2025 newsletter](#), which includes selected parts of budget reconciliation act of July 4, 2005

Navigate between Slides and Big PDF

- Open both documents
- Highlight cross-reference in slides
- Ctrl-c to copy
- Go to FULL TABLE OF CONTENTS in big PDF
- Ctrl-f to find
- Ctrl-v to paste
- Click ENTER to execute search (might need to specify “exact” or “whole word” search)
- Warning: search works only for to the fifth level of the heading, not the sixth, which ends in parentheses. For the latter, use the fifth level of the heading and scroll down just a little.

Example (II.Q.4.h)

- Company worth \$4M
- A owns 75%; B owns 25%
- Goal is to redeem A for \$3M (75% of \$4M) when A dies
- Company buys \$3M insurance on A's life to fund buyout, so it could buy A's interest when A dies (if able to keep policy until then)

Example (II.Q.4.h)

- A dies
- Company has \$7M assets (\$4M original value plus \$3M life insurance)
- Business deal was to buy out A for \$3M
- But 75% of \$7M equals \$5.25M

Example (II.Q.4.h)

- Should A be bought out for \$5.25M or \$3M?
- If B is not related to A and it's a pure business deal, \$3M is correct
- Note that B's interest in the company increased from \$1M (25% of \$4M) to \$4M (100% of \$4M after redemption)

Example (II.Q.4.d)

- What if B is A's adult child?
- A's estate is taxed on the \$3M sale proceeds and A gets to pass a \$3M (increased) business interest to B, free from estate tax
- A's estate (or B) should pay estate tax on this deemed bequest to B

Example (II.Q.4.h)

- Distinguishing between B as an unrelated business associate and B as a child receiving a bequest is what *Connelly* and other cases are all about
- What if B is A's child, but B grew the business and deserves more equity as compensation for B's efforts, rather than as a bequest?

Buy-Sell Agreements (II.Q.4.h)

- Reg. § 20.2031-2(h) prerequisites for respecting every buy-sell agreement to establish estate tax values
- IRC § 2703 adds a requirement to these prerequisites where at least 50% of business is, in the aggregate, owned by family members (III.B.7.e. and III.B.7.b.i.(b))

Buy-Sell Agreements (II.Q.4.h)

- Reg. § 20.2031-2(h) provides:

Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. **Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime.** Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death.....

Buy-Sell Agreements (II.Q.4.h)

- Reg. § 20.2031-2(h) further provides:

Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a **bona fide business arrangement** and **not a device to pass the decedent's shares to the natural objects of his bounty** for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Buy-Sell Agreements (II.Q.4.h)

IRC § 2703(a) values property without regard to:

- any option, agreement, or other right to acquire or use property at price less than fair market value of that property (without regard to such option, agreement, or right), or
- any restriction on right to sell or use that property

Buy-Sell Agreements (II.Q.4.h)

IRC § 2703(a) N/A if satisfy all of:

- Bona fide business arrangement
- Not device to transfer property to decedent's family for less than full and adequate consideration in money or money's worth
- Terms are comparable to similar arrangements entered into by persons in arms' length transaction

Buy-Sell Agreements (II.Q.4.h)

- *Huffman v. Commissioner*, T.C. Memo. 2024-12: buy-sell agreement did not satisfy comparability test of IRC § 2703, leading to a higher estate tax value
- First quarter 2024 [newsletter article](#) and [webinar](#)
- Possible ways to prepare for comparability attack

Buy-Sell Agreements (II.Q.4.h)

- *Huffman* held that first two requirements were satisfied, but comparability test was not
- Explore comparability test

Buy-Sell Agreements (II.Q.4.h)

Reg. § 25.2703-1(b)(4)(i), “In general”:

A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm’s length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm’s length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it **conforms with the general practice of unrelated parties under negotiated agreements in the same business.** This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

Buy-Sell Agreements (II.Q.4.h)

Reg. § 25.2703-1(b)(4)(ii), “Evidence of general business practice”:

Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

Buy-Sell Agreements (II.Q.4.h)

Estate of Amlie v. Commissioner, T.C. Memo. 2006-76, held:

For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables," we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Buy-Sell Agreements (II.Q.4.h)

After citing *Amlie*, *Huffman* noted that an isolated comparable may satisfy the comparability test, but not in this specific case:

Petitioners argue that the final section 2703(b) requirement is satisfied by the Lloyd-Barneson agreement, which they claim is comparable to the RTP agreements and was entered into in an arm's-length transaction. Petitioners note that the Lloyd-Barneson agreement contained the following provisions, which are also included in the RTP agreements: (1) a right to purchase on the death of the grantor and by a right of first refusal; (2) a maximum purchase price; and (3) no specific termination or exercise date. Petitioners also point out that the Lloyd-Barneson agreement was entered into by unrelated parties - Lloyd and Mr. Barneson - and executed at arm's length.

Buy-Sell Agreements (II.Q.4.h)

Huffman continued:

Respondent counters that the Lloyd-Barneson agreement cannot serve as a good comparable because it was not submitted into evidence. Respondent notes that there are only two pieces of evidence which describe the Lloyd-Barneson agreement: a one-paragraph reference in the Assignment agreement and another in the Chet-Barneson agreement. Otherwise, the only information provided about the Lloyd-Barneson agreement comes from witnesses' testimony, which made vague references to the agreement.

Buy-Sell Agreements (II.Q.4.h)

Huffman continued further:

Respondent contends that even if we are to find that the testimony regarding the Lloyd-Barneson agreement is credible, there are differences among it and the RTP agreements which render the Lloyd-Barneson agreement not a good comparable.

The noted differences are that (1) Lloyd Huffman was allowed to freely transfer his rights whereas Chet had to obtain consent from the owners; (2) the right of first refusal in the RTP agreements exempted offers from Chet's brothers; (3) the RTP agreements had an addendum that granted Chet the right to purchase the shares at any time at his discretion; and (4) the stated purpose of the RTP agreements was to retain ownership of Dukes within the Huffman family.

Buy-Sell Agreements (II.Q.4.h)

Huffman agreed with IRS that evidentiary proof was thin:

We agree with respondent. As we noted in *Estate of Amlie*, T.C. Memo. 2006-76, slip op. at 41, reliance on an isolated comparable is adequate given that the regulations “delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.” Use of the Lloyd-Barneson agreement then would be acceptable to show that the RTP agreements had terms similar to an agreement entered into at arm’s-length. But as respondent notes, we do not have the Lloyd-Barneson agreement in evidence. We have only vague and incomplete references to it and testimony based on those references. We do not have an isolated comparable to undergo the section 2703(b)(3) analysis.

Buy-Sell Agreements (II.Q.4.h)

Huffman agreed with the IRS that the purported comparable agreement was too different from the one before the court:

Even if we were to accept witnesses' testimony as sufficient evidence, we do not think that the Lloyd-Barneson agreement is sufficiently similar. Even though the three agreements purport to create rights to purchase Dukes shares for a maximum price, the differences among them are significant. For example, Chet had the unfettered right to purchase the Dukes shares at any time and at his sole discretion; Lloyd did not have this same right. Further, Lloyd was permitted to assign or otherwise transfer his purchase rights whereas Chet had to obtain consent to do the same. Chet then had rights superior to Lloyd's in purchasing the shares but inferior in transferring those rights. The terms of the agreements are therefore not comparable within the meaning of section 2703(b)(3).

Buy-Sell Agreements (II.Q.4.h)

Huffman concluded:

On the basis of the foregoing, we do not think that petitioners have satisfied the final requirement of section 2703(b). See *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, slip op. at 48 (finding that solely testimony without production of comparable agreements was insufficient to satisfy section 2703(b)(3)), *aff'd* in part, *rev'd* in part and remanded, 428 F.3d 1338 (11th Cir. 2005). Section 2703(b) is therefore not satisfied, and so the RTP agreements must be disregarded for purposes of valuing the Dukes shares that Chet purchased in 2007. See § 2703(a).

Buy-Sell Agreements (II.Q.4.h)

- The citation to *Blount* in the last paragraph above is a little misleading. *Blount* said that:
 - Congress contemplated that business “comparables” that established “the general practice of unrelated parties” would constitute the evidence satisfying section 2703(b)(3), and that “expert testimony” could be used for this purpose.
- However, *Blount* did not find how expert applied comparables to be credible
- Unfortunately, taxpayer in *Huffman* relied almost exclusively on one comparable and did not have appraiser present evidence about other comparables beyond mere brief testimony

Buy-Sell Agreements (II.Q.4.h)

Bona fide and comparability tests are somewhat intertwined:

- Tax Court seems to be saying that, not only does agreement itself need to be intended to yield fair market value sale, but also comparable clauses need to be designed to reach fair market value result
- In *Blount*, a multiple of cashflow was reasonable approach, but Tax Court rejected multiple used and also cited inconsistency regarding the impact of nonoperating assets
- As to latter, buy-sell formula was based on sale of only operating assets, but actual sale was for operating and nonoperating assets

Buy-Sell Agreements (II.Q.4.h)

- Contemporaneous evidence tends to be most probative
- When drafting, reviewing, or revising a buy-sell agreement where trying to set estate tax values is important, consider gathering proof that its terms are comparable to similar arrangements entered into by persons in an arms' length transaction
- Following slides are some opportunities to consider in light of *Huffman* and may or may not be practical, depending on materiality of issue

Buy-Sell Agreements (II.Q.4.h)

Drafting agreement, focusing more on buy-sell provisions:

- Preserve original form - copy form into new document and save all edits to new versions of that new document, to see how varied from form
- Document the business reasons for any variations from the form

Buy-Sell Agreements (II.Q.4.h)

Drafting agreement:

- If the agreement is based on forms service:
 - Document who authors are
 - Document what authors say about provisions being used in commercial (non-estate-planning) settings and any objective support for those statements
- If agreement is based on internal forms, document whether form is used in agreements with third parties

Buy-Sell Agreements (II.Q.4.h)

Obtaining appraisals

- Each time an appraiser values business interest, ask how buy-sell provisions compare to other buy-sell provisions appraiser has seen in agreements between unrelated third parties
- See whether appraiser is comfortable discussing in report how buy-sell provisions compare to other companies that size in same industry (which would be ideal but often is not practical), to other companies of that size with similar ownership structure among unrelated owners, or to anything else that may be reasonable and meaningful

Employer Owned Life Insurance Requirement To Avoid Income Taxation (II.Q.4.g.i.)

- Company owned policy issued or materially changed after August 17, 2006
- 5% or greater owner or a highly compensated employee

Employer Owned Life Insurance Requirements To Avoid Taxation (II.Q.4.g.i.)

- Notice and consent must be obtained on or before policy issuance
- Notice can be stand-alone or can be incorporated into buy-sell agreement, but need to make sure signed on or before policy issuance
- Notice can be drafted by attorneys or provided by agents – make sure a qualified tax advisor reviews whatever the agent provides
- Form 8925 – must be attached to corporate income tax return annually

Employer Owned Life Insurance Consent For Owner Who Is Not an Employee (II.Q.4.g.iii.)

Notice and Consent
For _____
Under I.R.C. Section 101(j)(4)

I acknowledge notification that _____ (the “Employer”) intends to obtain a policy insuring my life with a maximum face amount of \$_____. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an “employee” for purposes of I.R.C. Section 101(j). Therefore:

- (A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.
- (B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.
- (C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

Employer Owned Life Insurance Consent For An Employee (II.Q.4.g.iv.)

Notice and Consent

For _____

Under I.R.C. Section 101(j)(4)

I acknowledge notification that _____ (the “Employer”) intends to obtain a policy insuring my life with a maximum face amount of \$_____, and:

- (A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.
- (B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.
- (C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

Employer Owned Life Insurance

What To Do If You Don't Have Notice (II.Q.4.g.i.)

- Best option – get new policies, but this does not always work
- See if relief is available – do you have procedure in place and accidentally made a mistake, then you fix it in a short time?
- Buy-sell agreement can protect if the agreement includes notice and consent

Connelly (II.Q.4.h)

- Agreement violated Code § 2703
- Life insurance included in determining business value, according to E.D. Mo., 8th Cir., and unanimous Supreme Court
- Same result in *Blount* Tax Court, but 11th Cir. held life insurance excluded from business value, because it was a liability of the business

Connelly (II.Q.4.h)

Example from Supreme Court *Connelly* opinion:

- \$10M corp owned 80% by A (\$8M) and 20% by B (\$2M)
- Corp redeems B for \$2M
- \$8M corp (\$10M - \$2M) owned 100% by A (\$8M)
- Redemption did not reduce value of A's shares

Connelly (II.Q.4.h)

- “We hold that [the company’s] contractual obligation to redeem Michael’s shares did not diminish the value of those shares.²”
- “²We do not hold that a redemption obligation can never decrease a corporation’s value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas’s position that all redemption obligations reduce a corporation’s net value. Because that is all this case requires, we decide no more.”

Connelly (II.Q.4.h)

Significance of footnote 2:

- Using nonoperating asset, such as buy-sell life insurance, for redemption does not decrease value of business to remaining owners
- Using an operating asset would tend to decrease value of business to remaining owners
- When key person dies, business' value may decrease, and key-person life insurance (not used for redemption) might merely restore that lost value – need to see whether death benefit is more or less than this decrease

Connelly (II.Q.4.h)

- “...the brothers could have used a cross-purchase agreement - an arrangement in which shareholders agree to purchase each other’s shares at death and purchase life-insurance policies on each other to fund the agreement.”
- “A cross-purchase agreement would have allowed Thomas to purchase Michael’s shares and keep [the company] in the family, while avoiding the risk that the insurance proceeds would increase the value of Michael’s shares. The proceeds would have gone directly to Thomas - not to [the company].”

Connelly (II.Q.4.h)

- “But, every arrangement has its own drawbacks. A cross-purchase agreement would have required each brother to pay the premiums for the insurance policy on the other brother, creating a risk that one of them would be unable to do so.”
- “And, it would have had its own tax consequences.”

Connelly (II.Q.4.h)

- *Connelly* was a bad facts case
- If parties do everything correctly and have a buy-sell agreement that satisfies Code § 2703, would a life insurance-funded redemption agreement work?
- Note that *Connelly* increases risk of redemption if one violates Reg. § 20.2031-2(h)

Cross-Purchase Agreement (II.Q.4.h)

- Each owner holds one or more policies on lives of other owners
- Transfers of existing policies between old and new owners may generate income tax on sale (II.Q.4.c.) and may cause death benefit to lose its income tax exclusion (II.Q.4.b.)
- Contributing to (II.M.3) or receiving distribution from (II.Q.8.b.) partnership not taxable
- Distributing from C or S corporation is taxable event and may cause death benefit to lose its income tax exclusion
- Holding policies in life insurance LLC means that the policies are not transferred as owners come and go; LLC ownership is all that changes (II.Q.4.i.)

Life Insurance LLC – Letter Ruling 200747002 (II.Q.4.i)

- LLC held insurance policies to fund cross-purchase
- Corporate trustee was manager (nontax reasons for independent manager, too)
- Operating capital account for administrative expenses
- Each policy had capital accounts associated with it, which were allocated to owners other than insured

Life Insurance LLC – Letter Ruling 200747002 (II.Q.4.i)

- Premiums for term policies allocated to capital accounts of those who paid them
- Death benefit proportionate to relevant capital accounts
- Capital accounts amortized and, immediately before next premium is due, drop to zero
- Trusts who were permitted transferees of operating business can participate

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- Operating company pays premiums and treats them as distributions or compensation to relevant members of life insurance LLC
- Those premium payments should be administratively effectuated without any contractual mandated in operating company's governing documents - important for an S corporation operating business (II.A.2.i.iii, II.A.2.i.xii, and II.A.2.i.xiii)

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- A owns 75% and B owns 25% of Company.
Suppose Company is worth \$1M
- A needs to buy \$250K of insurance on B,
whereas B needs to buy \$750K of insurance on
A
- B needs to buy three times as much life
insurance death benefit as does A
- But B receives only one-third (25% divided by
75%) the distributions as A receives

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If A is older than B is, then cost of each \$1K of death benefit on A will be higher than cost of each \$1K of death benefit on B, further exacerbating disproportionality of premium payments
- If Company treats premiums as distributions, then deemed disproportionate distribution to B, so A needs additional cash distributions to make overall distributions proportionate

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If Company is making huge cash distributions, perhaps premium payments will be immaterial relative to cash flow, so make-up distributions to A (or cut-off of cash distributions to B) might not be big deal
- In many cases, B is much younger than A, and B will be frustrated at lack of distributions that B actually takes home

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- So that B does not get frustrated, Company treats as compensation some portion of premiums allocated to B regarding insurance on A's life
- Note that these payments need to be “grossed-up” –additional compensation to pay the income tax on premium compensation

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If \$10,000 of premium is treated as compensation to B and B is in 40% tax bracket, Company needs to pay \$16,667 bonus, of which \$10,000 is allocated to premium and \$6,667 (which is \$16,667 multiplied by 40%) is income tax withholding
- Company (or its owners, if pass-through) will get \$16,667 deduction, so save taxes more or less than \$6,667 income tax withholding

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If operating business is C corporation, it would account for premium payments as compensation (as officer or director), because dividends are nondeductible to company and taxable to shareholders
- When operating company taxed as partnership, it might consider setting up separate distribution account for premiums paid on behalf of each owner, to facilitate reconciliation with life insurance LLC is doing

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If Code § 2703 applies, consider whether policies for one insured should be held in separate LLC in which insured is not member to avoid *Huffman* settlement value
- Insured's family needs protection from death benefit being misused if members fire manager and put in someone who will do their bidding or change the use of the death benefit
- Consider protection against that as third-party beneficiaries to operating agreement (II.F.8.)

Life Insurance LLC – Practical Logistics

(II.Q.4.i)

- If hold policies for one insured in separate LLC in which insured is not member (to avoid *Huffman* settlement value), then unwinding life insurance LLC after sale of business will not let insured get policy from LLC income-tax-free
- Contrast that with one master life insurance LLC, which can be amended after sale of business and have policies distributed to insureds or to irrevocable life insurance trusts for their families income tax free

Transitioning from Redemption to Cross-Purchase (II.Q.4.i.vii)

- If the operating business is an entity taxed as a partnership, it can distribute policies to life insurance LLC
- Deemed tax-free distribution to its owners, followed by
- Deemed tax-free contribution to life insurance LLC

Transitioning from Redemption to Cross-Purchase (II.Q.4.i.vii)

If operating business is entity taxed as a corporation - C or S, then any distribution will constitute taxable sale:

- Causing income taxation, and
- Needing special exception from transfer-for-value rule to preserve exclusion from income tax

Transitioning from Redemption to Cross-Purchase (II.Q.4.i.vii)

Instead of distributing policies from corporation, consider having life insurance LLC rent death benefit under split-dollar economic benefit arrangement:

- Corporation retains death benefit to extent of policy value on date that life insurance LLC agrees
- Corporation pays future premiums
- Life insurance LLC pays corporation annual 1-year term value of LLC's share of death benefit

I Don't Want to Mess with a Cross-Purchase!

- Consequence of disregard of buy-sell agreement is artificially inflating insured's estate
- Instead of cross-purchase, consider irrevocable life insurance trust for insured's family owning additional insurance on insured's life to fund payment of additional estate tax

Conclusion

- Free quarterly newsletter includes most recent version of the PDF and comparison against prior quarter's PDF
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