

Connelly and Blount Cases: What's the Life Insurance Consultant's View

By: Bill Boersma, OC Consulting
Group and Martin M. Shenkman,



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Some thoughts

- A recent court case, Connelly, held that the value of life insurance an entity receives in a redemption buy out arrangement must be included in the value of the business. For some that can create an estate tax cost and alternative planning may be better. But what does this mean to many business owners?
- A vast majority of buy sell policies are term so for many perhaps most policies there is likely little investment in the policy. That could be important as to how the parties view the insurance and the plan.
- Issue of having any life insurance inside an entity is that value and proceeds will be exposed to risks of the business. Why do that unless there is a specific and valid reason to do so?
- If you have key person insurance owned by the company, you'll have to pay taxes on it. So, instead if you can have key person insurance held personally but other owners.

Some more thoughts?

- The value of term policies in most cases is negligible in most cases.
- Some Stats for perspective: 1) The average buy out policy face value was indicated to be about \$1.8M. 2) Less than 2% of term policies pay off. 3) only the portion of the insurance payment equal to the co-owners' pro-rata ownership of the business could be included in his or her estate. 4) If the insurance pays off, the estate of the deceased owner must be taxable for this to be an issue. What percentage of business owners using insurance funded redemption buy sell arrangements will have a tax issue?
- A practical question is how much legal fees will young entrepreneurs be willing to incur if the cost of term insurance for perhaps a few million of coverage is so modest? The average coverage on a buy sell was indicated to be \$1.8M. If a 30-year-old purchased 10-year term for \$500,000 of coverage as a buy sell stopgap the cost is \$155/year. The cost of a \$2.5M on a 40-year-old preferred non-smoker (that is the 2nd best class not the best) 20-year term is \$1,750/year.
- For some young entrepreneurs it may be easier to just buy a personal insurance policy and if their assets are nominal not to even bother with an ILIT and just protect the family in that manner.

Some more thoughts?

- A practical issue is whether business owners will be willing to deal with the cost and complexity of an alternative plan. For example, if the cost of the insurance coverage is a few thousand dollars per partner, and there are three partners, what are the options? The business could create a simple redemption buy sell using a form from the insurance agent, or perhaps avoid the estate inclusion issue by having a cross purchase with six policies (or 3 if you have an LLC structure). So, while the Connelly case has created an estate tax concern, that may only be addressed by wealthier more substantial business owners.

Additional information

- Bill Boersma bill@oc-lic.com
- Martin M. Shenkman
shenkman@shenkmanlaw.com