Supreme Court v. Small Businesses

A Fight Between Business Valuation & Taxation

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August 1, 2024

Contents

The Takeaways

1. The Supreme Court ruling on the Connelly case is a legal milestone, impacting numerous small or closely held businesses profoundly.

2. There were over 32 million small businesses within the United States, with an estimated 61.2 million small business employees, making up 99.9% of all US businesses.

3. Most small businesses are "closely held," because on average, each small business has fewer than two employees.

4. A Key Person insurance (KPI) policy is a part of "life insurance through work," or a type of "employer provided life insurances." It is always owned by the business and always with the business as the beneficiaries, making it more restrictive than Employer Owned Life Insurance or EOLI (also known as COLI for "Corporate-Owned Life Insurance").

5. Its main purpose is to provide a fund, through lump sum death benefit payout, for the business to buy, or more accurately to redeem, the shares of a deceased owner to overcome the cash flow problem and liquidity challenge to ensure business continuity.

6. The Supreme Court did a good job to make the KPI death benefit a part of the estate FMV (free market value) of the late owner, clarified or corrected the previous case ruling on valuation by the lower courts.

7. The Connelly ruling, however, did not say a word to the IRS charging a tax to the estate of the departed Connelly brother, which means any businesses with a similar KPI arrangement will pay up to 40% estate tax to redeem shares. This is worse than a loan, which is unlikely to have 40% interest.

8. There are two issues on the table: **Valuation** and **Taxation** of the business and/or estate FMV. Valuation is best based on free market, while taxation is done by governments. The

Supreme Court has limited itself to the first issue, as was asked by the disputing parties, but has not paid due attention to the second.

9. Not all FMV is taxable, as there are many deductions and exemptions set by the tax laws. Adding death benefits to the FMV does not automatically give the IRS the right to charge an estate tax on the KPI proceeds paid by after-tax premium.
10. We hold a higher expectation for the Supreme Court, simply because it has the final say on all the cases it has chosen to rule.
11. The Connelly team's double taxation argument was weak, as double taxation typically concerns the same income (e.g., corporate income and individual dividends) or the same person (e.g., international double taxation).
12. Life insurance, including KPIs, has a built-in, legally sanctioned mechanism to avoid double taxation: The premium is paid with after-tax money, so the death benefits are typically tax-free for the beneficiaries.
13. The most important tax legislations are the Internal Revenue Code (IRC) Section 101(a) and 101(j), which set the general and specific rules on tax-free death benefits in business life insurance.
14. By suggesting a cross-purchase agreement, the Supreme Court effectively dismissed the value of KPI as a viable business continuity option, which would hurt all closely held companies as owners may not be able to pay premium to keep the policy alive.
15. Cross-purchase agreement has its own problem, especially with the number of policies required when there are many owners or partners.
16. Simpler alternatives include buy-sell trusts and special purpose LLCs.
17. Business life insurance, including KPI and EOLI, is a way for small or closely held businesses to invest in themselves, which should be encouraged, not penalized.

1 Introducing the Connelly Case & Ruling

The Supreme Court ruling in June 2024 on the "Connelly v. United States" case is a legal milestone that will impact numerous small or closely held business profoundly. It offers a different, but solid or well-found, interpretation of an entity's fair market value, especially in relation to the death benefit from a business life insurance policy, such as Key Person insurance or KPI or Employer Owned Life Insurance or EOLI.

Not everything is praiseworthy, however, as the ruling has raised reasonable confusions and concerns about the future viability and value of key person insurance (KPI), which is a financial/investment vehicle that has served American businesses well for decades or even more than a century. For example, Lincoln Financial, a prominent provider of key person insurance, has been in the insurance industry since 1905.

We must examine the Connelly case closely to fully comprehend all the uncertainties and potential conflicts created by the Supreme Court this time.

2 Introducing KPI

2.1 Defining KPI

According to this Wikipedia page, "There is no legal definition of 'key person insurance.' In general, it can be described as an insurance policy taken out by a business to compensate that business for financial losses that would arise from the death or extended incapacity of an important member of the business."

I would add one word to the above: "... In general, it can be described as a **life** insurance policy..." to emphasize its nature of covering life (or death) related losses, instead of just any business insurance, like the P&C coverage.

The term "key person insurance" is self-explanatory, indicating whom the policy is designed to protect. We only need to add two features that apply to all KPI policies: (1) its company ownership; and (2) its beneficiary being the business, to compensate its financial losses caused by the death, sometimes disability, of key employees. In a closely held company, where a relatively small number of people own the company's stock, including family-owned businesses, partnerships, and small corporations with a limited number of shareholders, the key person often denotes an owner or founder.

> "The term "key person insurance" is self-explanatory. The policy is always owned by the business, and always names the business as the beneficiary."

2.2 KPI vs. EOLI

Google Gemini tells us that KPI and EOLI (Employer Owned Life Insurance) are the same, while Perplexity separates the two by saying that not all EOLI policies are KPI. The latter is more specialized, protecting the most critical employees, whereas EOLI refers to any life insurance policy owned by an employer on the life of an employee and can serve various purposes beyond this specific risk mitigation strategy.

The "business as beneficiary" part is also stricter for a KPI than an EOLI. KPI always lists the business as beneficiary, while an EOLI can sometimes name a different beneficiary, like an employee's family members.

Perplexity is more to be trusted, although for our discussion of the Connelly case, the two are the same as the policy is apparently only for the Connelly brothers, Michael and Thomas. We don't know what exactly the policy is named, but in spirit, it is pretty clear that it is to protect owners like a KPI does.

2.3 The UK Statistics

This article from UK gives us some interesting background why the Key Person (or Key Man) Insurance matters. It begins by saying that "nearly half of the businesses here in the UK would fail if a key member of staff were to become seriously ill or die."

This says how important KPI is to the UK businesses, which can be true to the US businesses as well. A study by the US Small Business Administration found that only about 30% of family-owned businesses survive into the second generation, partly due to inadequate succession planning.

This article from Protectionguru in UK tells us that "94% of businesses had at least one key person and 52% of firms identified the death of an owner or key employee as the top risk to their business.

2.4 KPI, Cash Flow & Business Failures in the US

This blog site Luisa Zhou cites Small Business Administration that "At the end of 2021, there were over 32 million small businesses within the United States. The SBA considers these firms with fewer than 500 employees. Small businesses make up 99.9% of all U.S. businesses. With an estimated 61.2 million small business employees, these firms make up almost half (46.8%) of America's workforce."

But the SBA may be too lenient in defining small business. Let's look at the numbers again: There are 32 million small businesses in the US, but only about 61.2 million employees working for small businesses. That means, on average, there are fewer than two employees per business.

> "The vast majority of small businesses are "closely held," unlike publicly traded companies that have a large number of shareholders with shares traded on a stock exchange."

The threshold of 500 employees is way too high. But that also means that most small businesses are "closely held," just like the Crown C Supply, owned by the Connelly brothers, the late Michael and the surviving Thomas.

The same blog site cites the Washington Times for family owned businesses that "only one-third of businesses make it to the next generation. Even less, only 12%, make it to the third generation."

But here is a figure more relevant to our discussion: According to Business Insider, cited by the same blog Luisa Zhou, "the #1 reason that businesses fail? Money, or tangentially, cash flow problems. More than 8 in 10 businesses admit to experiencing cash flow problems at some point during their operations. To sum it all up, a study revealed that 82% of businesses fail because of cash flow mismanagement."

> More than 8 in 10 businesses fail because of cash flow problem.

2.5 How KPI May Help

Such a close link between cash flow and business failure is what makes KPI crucially important. Here are the ways it can help business survive in both short and long runs.

First, it can provide immediate liquidity upon the death of a key employee, after the insurance policy pays out a death benefit to the company, providing an immediate influx of cash, which helps smooth out cash flow irregularities and compensate for lost revenue during the transition period. This is true, especially considering that the insurance money comes typically in a lump sum.

The same insurance proceeds can be used to hire and train new personnel to replace the key person. This includes covering expenses like recruitment, relocation, and training costs. This is not what the Connelly case is about, but is certainly relevant in other cases.

The payout can also help the business meet debt obligations and other financial commitments during a potentially difficult period. Again, this is not in the center of the Connelly case, but still valuable elsewhere or at different times.

If the key person was responsible for a significant portion of the company's revenue, the insurance can help offset the financial impact of their loss. This is perhaps the most direct financial impact from the KPI.

Finally, having key person insurance in place can increase confidence among banks, creditors, and partners, potentially improving the company's ability to secure financing. At the end of the day, KPI is just any other insurance policies, they are all about peace of mind, for owners and lenders.

3 How to Best Learn the Connelly Case

The full name of the case is “Connelly vs. United States” to be found in all formal legal documents. “Connelly” refers to the two Connelly brothers, the deceased Michael and the surviving Thomas. In our discussion below, we simply call it the “Connelly case.”

The best place to learn it, including the background facts, the disputed points from both sides: the Michael Connelly estate and the United States, and court rulings on this and precedent cases, is nowhere else but the published Supreme Court opinion in its entirety, especially the “Opinion of the Court” starting from Page 4 to Page 12, delivered by Justice Thomas. The other three pages are “syllabus” or headnote, which, as the document states, is “prepared by Reporters of Decisions for the convenience of the reader.”

This is the first time I have ever read the Supreme Court opinion, and I must say I have been impressed by the format, structure and the choice of words.

The opinion was well written, well cited, thoughtful, and does a timely legal service to clarify the positions on several issues related to business/estate valuation and business continuity — at the same time a disservice by wrongly penalizes business life insurance without seemingly fully realizing it.

> “ The Supreme Court opinion was well written, well cited, thoughtful, but wrongly penalized business life insurance, perhaps without realizing it. ”

4 Life Insurance & Business Continuity

Some quick background knowledge helps here: It has been a fairly common practice for a business entity to buy a life insurance policy to prepare for the death of one or more owners, top executive, or another individual critical to the business. For this reason, it is often called "the key person (or "key man" in its "politically incorrect" version) insurance."

4.1 Redeeming vs. Purchasing Shares

Although sometimes used indifferently, redemption and purchase of shares from a departed owner are not the same. A redemption occurs when the company buys back shares from a shareholder, with terms and conditions predetermined or outlined. A purchase happens when a shareholder decides to sell their shares to another individual or entity. It is voluntary, with terms and conditions determined by market.

Also, redeemed shares are essentially retired. They are no longer part of the outstanding shares and cannot be reissued. When shares are purchased, however, they typically remain in circulation.

> "Redeemed shares are retired, no longer part of the outstanding shares and cannot be reissued."

In the Connelly case, the important difference that the redemption has made is that Thomas Connelly, the survived brother, became the sole owner of the Crown C Supply.

4.2 Buy-Sell Agreement & Life Insurance

To make sure this ownership transition will occur as planned, owners often enter a business "buy-sell" agreement to specify what happens to an owner's interest in the business if they die, become disabled, retire, or otherwise leave the business.

The only problem there is that in a small firm with a few owners, often referred to as "closely held" company, each owner may hold a large number of shares. This happened to the Connelly brothers, who jointly own the firm called the "Crown C Supply." Michael, who died in 2013, owns more than 77% of shares, while Thomas, who is still alive, only owns less than 23%. Now, since

Michael passed away, Thomas may not have so much money, at least not so much cash, to buy all his brother's shares.

The solution is to buy a life insurance policy before any owner died, such as KPI. The policy will pay a death benefit for the surviving owner (e.g., Thomas) to pay for the shares of the departed owner (e.g., Michael). This was exactly what the firm did.

The vast majority of life insurance policies, whether they are individual policies, group policies, or key person insurance, typically pay out a lump sum death benefit upon the insured's death. This is exactly what the policyholders want: the liquid fund to quickly redeem the shares left by the deceased owner.

> "The key function of Key Person Insurance is to provide fund, through the lump sum death benefit of the policy, for buying the shares of a deceased owner to ensure business continuity."

Of course, there could be exceptions, such as life income options, where the death benefit is paid out in installments over a specified period. However, these are less common.

Finally, A key person insurance death benefit is often, but not always, used to redeem the shares of a deceased owner. It can also be used for other business purposes, such as covering the costs associated with finding and developing a new employee to fill the key person's role; using the proceeds to pay off business debts and business expansion, investing the funds to offset the loss of the key person's contributions.

It is often the Buy-Sell agreement, rather than the KPI, that restricts the use of death benefit.

> "KPI death benefit is often, but not always, used to redeem the shares of a deceased owner. It can also be used for other business purposes."

5 The Supreme Court's Core Opinion

I won't restate other details of the case, but just cite the Supreme Court opinion that reads: "The central question is whether the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares. We conclude that it was not and therefore affirm."

5.1 The Two "Lodestars"

The opinion also specifies two "lodestars" behind the ruling. The first is the well-defined "taxable estate," for which "Congress has long imposed a tax 'on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."'

Taxable estate here is defined as "the value of 'all property, real or personal, tangible or intangible,' owned by the decedent 'at the time of his death,' minus applicable deductions."

The other lodestar is "fair market value" or FMV, which "is the price at which the property would change hands between a willing buyer and a willing seller," which "determines the value of the shares, ..., **'including proceeds of life insurance policies payable to ... the company."'** (Emphasis added).

Two quick notes here. The highlighted sentence above is quoting 26 CFR §20.2031-2(f)(2), a section of the Code of Federal Regulations (CFR) that deals with the valuation of bonds for purposes of the federal estate tax in the United States.

The second note: proceeds of life insurance are included in FMV, but not in taxable estate, at least not explicitly. This is for a good reason that we will discuss later.

> "The Supreme Court is well-founded to treat life insurance death benefit payout as a part of the fair market value of an entity."

5.2 The Advantages of FMV

Using FMV as a gauge of entity's value is useful and sensible. This article compares strategic value vs fair market value. It defines FMV as "the overall price a company would sell for with a willing buyer and willing seller... It's just a generalization of a company's worth as-is."

The Perplexity AI lists a few FMV advantages, which I will cite a few major ones here, with my comments following:

- FMV provides current and up-to-date information on the value of assets and liabilities.

  My comments: This is relevant because for business life insurance, the FMV must be assessed at the time of death for the deceased "key person," not before and not long after the death.

- FMV requires companies to disclose the methods and assumptions used in determining fair values, promoting transparency.

  My comments: This matters as there is little hiding info behind FMV, which assumes that the sale is an arm's length transaction, meaning the two parties doing business are not affiliated with one another and are acting in self-interest.

- FMV allows for better comparability between companies by providing a common standard for valuing assets and liabilities. This facilitates easier benchmarking and analysis.

  My Comments: FMV helps make seemingly incomparable values comparable.

- Using FMV helps in identifying and managing risks associated with market fluctuations. It provides a clearer picture of how market changes affect the financial position of a company.

  My Comment: This is because FMV assumes that both the buyer and seller are rational investors, who look at the economic and financial factors in the transaction.

> FMV provides time-sensitive, transparent and comparable information for entity valuation and risk management.

6 What Are the Debated Issues?

6.1 The Court's Summary

Section II of the court opinion starts by saying that "The dispute in this case is narrow." It then lists two agrees and one disagree. Below, I add some emphasis and comments.

1. All agree that, when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value.

   My Comments: This is indeed all agreed, with no disagreement between the parties.

2. All agree that life insurance proceeds payable to a corporation are an asset **that increases the corporation's fair market value.**

   My Comments: The two parties in the case had different opinion on the highlighted part, see more discussion later.

3. The only disagreement is whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption.

   My Comments: This disagreement holds.

> The Supreme Court sees two agreements: Both sides agree to use FMV to gauge a firm's or estate's value, and both agree life insurance proceeds are an asset boosting FMV. But the second agreement is only partly right.

6.2 The Disputes in My View

I believe there are only "1.5 agrees" plus "1.5 disagrees." The first agree and the last disagree both hold true: using the fair market value to gauge the business and estate valuation; and whether redeeming stocks helps shield life insurance proceeds from the FMV.

But we must split the second point into two parts: the agreed part and disagreed part. All parties agreed that life insurance proceeds are an asset for the business and estate. But they differ on whether that asset should be used to boost the Fair Market Value (FMV).

To prove this is true, we can cite differences (or disagreements) both between parties and between this and previous cases.

The court opinion itself mentions that the survived Connelly brother "Thomas obtained a valuation from an accounting firm. The firm's analyst took as given the holding in Estate of Blount v. Commissioner, 428 F. 3d 1338 (CA11 2005), which concluded that insurance proceeds should be 'deduct[ed] ... from the value' of a corporation when they are 'offset by an obligation to pay those proceeds to the estate in a stock buyout."

We have just seen the key citation here: Estate of Blount v. Commissioner, which explains similar moves in the Connelly case, as we will see later.

Apparently, the Connelly brother Thomas only agreed that the life insurance proceeds are an asset, just like the IRS does — but *not* the asset that would increase the corporation's fair market value, otherwise why would they report the value of the firm at $3.86M instead of $6.86M like the IRS did? They are arguing that life insurance proceeds should have been deducted from the firm's FMV, just like in the case of Estate of Blount v. Commissioner in 2005.

I believe a more accurate summary of the status quo of the disputes facing the Supreme Court therefore is:

1. All agree that, when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value.

2. All agree that life insurance proceeds payable to a corporation are an asset.

- But whether that asset increases the corporation's fair market value is debated.
- It all depends on whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption.

3. For Connelly, life insurance proceeds should not enter Crown's FMV and the value of Michael's estate. But for IRS, they should.

> Counting life insurance proceeds as asset is not the same as believing it should enter the FMV.

6.3 "Remedy" vs. "Disease"

I find this article by Buchanan Ingersoll & Rooney law firm interesting:

"The decision in Connelly creates uncertainty for closely held businesses that have entered into buy-sell agreements funded by life insurance owned by the company as part of their succession planning. In such instances, **the remedy may be worse than the disease** for companies hoping their careful planning would result in business continuity without risking cash flow." (Emphasis added)

What they were saying, I believe, is that businesses often buy life insurance policies as a "remedy" to solve the cash flow problem and ensure business continuity. Now, with the latest Supreme Court ruling, the IRS can and will legitimately charge 40% estate taxes on the KPI proceeds.

> Some lawyers raised the right question about the future value of KPI in the Post-Connelly era, when the IRS will charge up to 40% estate taxes on KPI proceeds.

6.4 How Much Extra Tax Michael Estate Paid

Why do I say almost 40% estate tax? Here is how I arrive at the conclusion, thanks to all the key pieces of information in the court opinion:

We know that Michael Connelly estate calculated its FMV at $2,979,148, from the audited FMV of $3.86M for the corporation, multiplied 77.81% of Michael's share — with the KPI death benefit excluded.

$$\$3.86M \times 77.81\% = \$2,979,148$$

But the IRS calculated the FMV of the corporation at $5,294,548, from a larger FMV of $6.86M, which comes from $3.86M + $3M, where $3M is the KPI death benefit. It then times $6.86M by the same 77.81% for Michael:

$$(\$3.86M + \$3M) \times 77.81\% = \$5,294,548$$

The two values differed by

$$\$5,294,548 - \$2,979,148 = \$2,315,400$$

Now, we learned from the Court Opinion that the IRS charged the estate an additional tax of $889,914, which is totally due to the extra FMV for Michael Estate.

Therefore,

$$\frac{\$889,914}{\$2,315,400} = 0.384.$$

In the above, the numerator is the extra tax of $889,914 that the IRS believed the estate of Michael owed, while the denominator is the extra estate FMV of $2,315,400 also according to IRS (see above calculation).

This is not quite the maximum estate tax rate of 40%, but very close.

Translating all these figures into plain English: Under the above scenario with such a heavy tax burden, having a KPI policy does not help relieve the cash flow headache. Instead, the KPI makes it worse: A business could have borrowed a bank loan to redeem shares of deceased shareholders without having to pay 40% interest.

The Supreme Court, by not saying a word to the extra tax of almost $900,000 charged by the IRS, has penalized business life insurance by effectively rendering it worthless.

> "The Connelly ruling means that using the death benefit payout from a KPI policy, the business may end up paying 40% estate tax. This is worse than a loan, which is unlikely to have a 40% interest."

7 Valuation v. Taxation

7.1 The Root Problem

The root problem in the Connelly case is that we failed to realize two issues on the table, one is the valuation of business and/or estate, another is the taxation of the same business/estate.

The Supreme Court has limited all its attention to valuation, without giving due diligence to taxation of life insurance proceeds. We end up with a thoughtful and correct opinion on the valuation, but (unintentionally) penalized business life insurance by charging high taxes.

> "There are two issues on the table, fair market valuation and taxability of the business and/or estate. The Supreme Court has limited itself to the first issue, completely ignored the second issue."

The takeaway lesson is that separating "valuation" from "taxation" (or "taxability") matters because not every dollar in the FMV is taxable. There are many deductions and exemptions set by the tax laws. Adding the life insurance fund to the FMV does not necessarily mean we treat every FMV dollar the same way in taxation, or tax all FMV money without exemption or deduction.

> Not all FMV is taxable. There are many deductions and exemptions set by the tax laws. Adding the death benefit to the FMV does not automatically give the IRS the right to charge a tax.

7.2 The Excuses of the Court

But the Supreme Court is not the only one to blame. It clearly stated from the very beginning, like a disclaimer, that, "The central question is whether the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares. We conclude that it was not and therefore affirm."

In plain English, the nine justices of the Supreme Court were essentially saying the following to the disputing parties and to the lower court:

"You guys asked us to review the case and to decide whether using the death benefit payout from a life insurance policy to buy a dead owner's shares would reduce the value of the corporation, and the nine of us all agree that it won't. That's all."

Honestly, if this were the ruling opinion of a lower court, we would be happy to accept it. But with the Supreme Court, our expectation is frankly higher. Part of the job is to get a comprehension of all the issues involved, even when the debated parties themselves have failed to notice or overlooked the key issue(s).

The Supreme Court did well on what it had been asked to do: determining the fair market value (FMV) of business and/or estate, counting in business life insurance proceeds. But as the highest court of the country, it should have a few words on the taxability of life insurance.

> We hold a higher expectation for the Supreme Court, simply because it has the final say on all the cases it has chosen to rule.

7.3 The Connelly Problem

If the Supreme Court is not the only one to blame, who else is responsible for where we are now?

The answer is the Connelly brother and his legal team. They had a wrong focus on the business/estate valuation, when they should have presented the case more as an issue of taxability.

Let me translate their two "value offsetting" arguments to plain English:

"We did have the money from a KPI policy, but that money is like the tokens to enter the Disneyland, not real money as we cannot use it for any other purpose, except to buy back Michael's company shares. Plus, the insurance money left the company as soon as it arrived, because we gave it to Michael's estate right away in exchange for his shares."

But the arguments are weak and easy to be defeated. First, tickets to Disneyland, before they are used, are a "prepaid expense," which is an asset of the corporation. When a buyer wants to buy the firm, the firm can count in the value of the unused tickets and the buyer would have to accept that. This is essentially what the IRS and the Court said.

The IRS, and the Court, is right on this. In accounting, an asset is a resource with future economic benefit, and therefore contribute to the overall value of the business. Disneyland tickets represent a future benefit that has been paid for in advance.

Recall that fair market value FMV is the price at which a willing buyer would pay a willing seller in an arm's length transaction, which is a business deal between two parties that act independently of one another, typically have no relationship with each other, act in their own self-interest without undue influence, and with equal bargaining power.

> "From the accounting perspective, prepaid expense is a type of asset, and should enter FMV."

But the KPI death benefit is even better than Disneyland tickets because not everyone likes to visit Disneyland, but everyone likes the future lump sum of cash when an owner died. The seller may have to discount the value of the Disneyland tickets for a less interested buyer, but not for the KPI death benefit.

The argument for a quick transaction of the KPI money for company shares is also ineffective — if we keep in mind that the valuation of the FMV has a definite time point: when an owner like Michael died. At that time, the KPI money was not yet received, somewhat like an item of "Account Receivable" for the company, although account receivable is counted as a "current asset" in the balance sheet. Practically speaking, death benefit typically takes 14 to 60 days for the insurer to process a death claim.

Simply put, it is virtually impossible to exclude insurance proceeds from the calculation of fair market value (FMV) of any entity. By common sense, by generally accepted accounting principles, or by legal terms, we can't deny the existence of a large sum of cash in valuation.

> "It is a dead end to travel on the "valuation" path to exclude death benefit from the FMV, as it is always vulnerable to be rejected by someone following the FMV "lodestar.""

7.4 The Blount v. Commissioner Case

But Thomas Connelly and his team also had their own excuse: the ruling in the previous case of Estate of Blount v. Commissioner, which used the same valuation argument that insurance proceeds could be properly deducted from the value of a corporation, as long as they were "offset by an obligation to pay those proceeds to the estate in a stock buyout."

The Blount v Commissioner ruling, together with its language, had a direct and profound impact on the Connelly, who made the same argument of "value offsetting" for value deduction all the way to the Supreme Court, which overruled this time.

> "The Blount v Commissioner ruling, together with its language, had a direct and profound impact on the Connelly case."

But looking back and thinking again, both Blount and Connelly cases followed the "valuation" path. Even though the Blount ruling has been followed by many taxpayers for nearly two decades, as pointed out by this article by Eisneramper.com, it is always vulnerable to be overruled by someone using the FMV "lodestar" sooner or later, like the Supreme Court did this time.

> Both the Blount and Connelly cases travelled on the "valuation" thinking path. Excluding death benefits from the FMV because of their special usage purpose, which is at the core of Blount and Connelly, is inherently susceptible to judicial reversal.

8 The Issue of Double Taxation

To be fair to Connelly, his team did raise the taxation issue, more specifically the "double taxation" issue to the bench.

As this report tells us, "At oral arguments March 27, the petitioners were represented by Kannon Shanmugam, who told the bench that the estate would be taxed on the increased value of the shares due to the life insurance proceeds, and that Thomas Connelly would eventually be subject to capital gains tax on the increased value of his shares.

"And that, in our view, ... is why this is effectively double taxation."

But the value increased for Michael's estate and capital gain for Thomas are not from the same source and applied to the same person or entity. Double taxation on the other hand often involves the same income (e.g., corporate income tax and personal dividends tax) or same person (e.g., international double taxation).

Consider the common example of corporate income tax and dividends taxation: Corporations pay taxes on their profits. When they distribute these profits as dividends to shareholders, those shareholders often pay personal income tax on the dividends, resulting in double taxation involving the same income.

> The double taxation argument by the Connelly team was weak, as double taxation typically concerns the same income or applied to the same person or entity.

9 Advantages with The Taxability Argument

We have so far been discussing the topic of valuation and why it is not a good approach for defending death benefits from KPI — because it is hard to exclude the benefit from the FMV for any reasonable minds. Now is the time to switch to the taxability approach, which, in my opinion, explains effectively why death benefits from business life insurance, including both EOLI and KPI, are usually tax-free, even with the recent legislation changes implemented in IRC Section 101(j).

9.1 Begin from the Fact

Death benefits from a life insurance policy are commonly received tax-free by named heirs or beneficiaries. We must take that as a basic fact and think of why. But regardless of what the drivers are, the simple fact remains that we do not have to pay tax for death benefit. This is a key advantage of life insurance as a financial or estate planning tool.

That said, we do have to understand why death benefits are generally not taxable. The issue of double taxation can easily come to our mind, given that the life insurance premiums are commonly paid with after-tax dollars, so taxing death benefits would mean the same money being taxed twice.

But there are actually multiple reasons behind. I have checked several AI chatbots with the same prompt to explain why we have tax-free benefit, and Claude.AI came out with the longest list of reasons, including double taxation:

> **Social policy**: Governments aim to provide financial support to bereaved families without adding tax burden during a difficult time.
>
> **Avoiding double taxation**: In many cases, life insurance premiums are paid with after-tax dollars, so taxing the benefit could be seen as double taxation.
>
> **Encouraging financial planning**: Tax-free status incentivizes

people to purchase life insurance, promoting financial responsibility.

Estate planning: It allows more of the deceased's assets to pass to beneficiaries rather than being reduced by taxes.

Economic stimulus: Tax-free benefits provide more money to beneficiaries, potentially stimulating economic activity.

Simplifying administration: Making these benefits tax-free reduces paperwork and administrative costs for both the government and recipients.

Preserving the intended benefit: Ensures the full amount reaches the beneficiary as intended by the policyholder.

> “There are multiple reasons why the death benefit is tax-free for beneficiaries, avoiding double taxation is just one of them.”

9.2 The Crucial Tax Legistration

Even such a long list from Claude still misses a highly relevant, arguably the most important, reason for our discussion, for which I will quote ChatGPT here: “**Tax Legislation**: US tax laws generally exclude life insurance death benefits from the beneficiary's gross income. This provision is established under Section 101(a) of the Internal Revenue Code, which states that life insurance proceeds paid by reason of the insured's death are generally not included in taxable income.”

Perplexity similarly points out that “The primary legal basis for the tax-free status comes from specific tax code provisions: Internal Revenue Code Section 101(a) explicitly excludes life insurance proceeds from gross income. This legal framework has been in place for many decades and reflects long-standing tax policy.”

It is IRC 101(a) that lays down the legal foundation for not counting life insurance death benefits in the gross income. This general principle applies to both individuals and businesses.

> IRC 101(a) has explicitly excluded life insurance proceeds from gross income for decades. It separates valuation and taxation, particularly concerning life insurance proceeds, for both individual and businesses.

But, there are complexities regarding taxable death benefits that we will get into later. For now, let's look at more details of the IRC 101(a).

9.3 The Spirit of IRC 101(a)

I like the Claude AI response to my prompt of separating valuation and taxation under IRC 101(a):

> "This provision effectively creates a situation where a portion of value (the death benefit) is **deliberately** excluded from taxation, **regardless of its economic value**... This exclusion is based on the public policy goal of encouraging financial protection for beneficiaries and recognizing the unique nature of **life insurance as a risk management tool rather than an investment vehicle**." (Emphasis added)

But instead of pitting risk management against investment, in a fashion of "not this, but that," like the Claude does, I would reconcile them, for the simple, and perhaps obvious at least to some people, reason that we can better manage risk through investment.

But it is good to know that IRC 101(a) is a deliberate public policy, not an oversight. I can't help notice that the US tax system is an unconscious realization of the idea of "storing wealth among the people" or in Chinese 藏富于民 by Guan Zhong 管仲, who lived approximately from 723 BC to 645 BC, and was perhaps the earliest scholar proposing the idea.

Of course, Deng Xiaoping also famously promoted that idea, encouraging private enterprise and individual wealth accumulation that was a dramatic departure from previous policies that emphasized collective ownership and state control of the economy.

> The idea of "storing wealth among the people" may have some implicit link with the US system of making death benefit tax-free.

9.4 Nuances with Employer Owned Life Insurance (EOLI)

Philosophic issues aside, let's consider the exceptions to IRC 101(a).

This article from the Legal Information Institute LII of the Cornell Law School tells us how generally IRC 101(a) can be applied:

> "In general. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient... The exclusion from gross income allowed by section 101(a) applies **whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust**." (Emphasis added).

But there are exceptions to general rules. Claude warns us that "there are some exceptions to this rule, such as cases involving transferred policies or certain employer-owned life insurance contracts."

So I prompted, "Tell me more about exceptions related to employer owned life insurance."

Here is how it has responded. Given its high relevance to the Connelly case, I will cite them completely, followed by my comments to bring critical thinking into the discussion:

> "The exceptions related to employer-owned life insurance (EOLI) are important nuances to the general rule established by IRC

> Section 101(a). These exceptions were introduced primarily through the Pension Protection Act of 2006, which added Section 101(j) to the Internal Revenue Code."

My Comments: The above talks about EOLI, would it cover Key Person Insurance or KPI? The answer is yes, as KPI is considered one type of EOLI, at least when IRC Section 101(j) is concerned. See this edition of Washington Report by the Association for Advanced Life Underwriting or AALU, which says,

> "It has come to our attention that some people do not realize that key man life insurance is subject to section 101(j). Because the policy is taken out by the employer on the life of an employee, key man life insurance fits squarely within the definition of employer-owned life insurance."

Back to the Claude response, listing the general rule to EOLI death benefits in IRC 101(j)(1):

> "General rule for EOLI: Under Section 101(j), death benefits from employer-owned life insurance contracts issued after August 17, 2006, are generally **included** in the employer's gross income." (Emphasis added).

My Comments: If you just read this, you would get the clear impression that IRC 101(a) basically does not apply to EOLI, as any EOLI contract would **not** allow death benefit to be excluded from the company's gross income.

But not so fast: We must note the activation date of August 17, 2006, for the IRC Section 101(j) to start working. This matters because later we will learn that EOLI contract activated *before* August 17, 2006, will be treated different from those activated *after* that date.

This makes a huge difference in the Connelly case. Although we do not know when exactly the EOLI policy was signed for the Connelly brothers, what we do know is that Michael Connely died on October 1, 2013, per this case text, seven years after the IRC 101(j) was activated. More on this later.

For now, it is crucial to know that there are many items under IRC 101(j) that will specify provisions to *allow* companies to exclude the entire death benefits from their gross income (i.e., to be completely exempted for tax purposes).

> "Exceptions to taxation: However, the death benefits can still be excluded from the employer's income if certain requirements are met:"

My Comments: Below is where the qualified exceptions are listed that allow firms to have their death benefits exempted from taxation.

> a. **Notice and Consent**: The employee must be notified in writing that the employer intends to insure the employee's life and the maximum face amount for which the employee could be insured. The employee must provide written consent to being insured and to the coverage continuing after the employee terminates employment."

My Comments: This "Notice and Consent" condition must be satisfied for every firm, while only one of the other conditions is required to meet.

This is not obvious from the chatbot response, but this Notice from IRS has explicitly stated that

> "Even if an exception described in § 101(j)(2)(A) or (B) is otherwise satisfied, § 101(j)(2) requires that the notice and consent requirements of § 101(j)(4) be met in order for the general rule of § 101(j)(1) not to apply."

The rule was poorly stated, as it was framed with a negative sentence for the general rule of IRC 101(j)(1) "not to apply." It really is saying that the notice and consent requirements must be met, otherwise IRC 101(j)(1) would apply. What does it mean to apply IRC 101(j)(1)? It means in general, EOLI death benefits must be counted toward business gross income, not to be exempted.

The same IRS Notice also offers a detail regarding the IRC 101(j)(1). It says in general,

> "in the case of an employer-owned life insurance contract, the amount excluded from gross income of an applicable policyholder under § 101(a)(1) shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract."

In other words, an EOLI policy should not exclude life insurance proceeds of any amount more than the employer has paid in premium.

For example, in the Connelly case, we know the death benefit for Michael was $3.5M. But let's say the company only paid $100,000 premium by the time Michael died in 2013. Then according to IRC 101(j)(1), the company's income tax can only deduct $100,000 from the gross income, it must count in the remaining $3.4M.

Of course, this is the worst scenario, but it explains why meeting the exemption conditions matters so much, because doing so allows a company like the Connelly to exclude the entire death benefit of $3.5M from their gross income.

Let's continue with the other exemption conditions listed below, bearing in mind that only one of these conditions has to be satisfied, unlike the "Notice and Consent" condition that must be satisfied for every entity.

> "b. Insured's Status: The insured must have been an employee within 12 months of death, or was a director or highly compensated employee at the time the contract was issued."

My Comments: Condition b is easy to satisfy, because EOLI and KPI cover key employees, and the IRS is saying that people need at least 12 months to prove their economic value to the firm. For most businesses, this condition is not very demanding.

> “c. Beneficiary Requirements: The benefits must be paid to the insured’s family members, the insured’s estate, or used to purchase an equity interest in the employer from a family member, estate, or trust.”

My Comments: In the Connelly case, Condition c has been undoubtedly satisfied, as the code clearly allows the benefits to be used to buy equity interest.

> “3. Reporting requirements: Employers must file annual returns reporting their EOLI contracts, including the number of employees insured, the total amount of insurance in force, and whether they have valid consent from the insured employees.”

My Comments: Most companies would happily obey this reporting requirement, as long as they can make the death benefits tax-free.

> “4. Purpose of these rules: These provisions were enacted to curb potential abuses of corporate-owned life insurance, particularly "dead peasant" or "janitor" insurance policies where companies insured rank-and-file employees without their knowledge.”

My Comments: This explains why Congress had introduced IRC 101(j) in the first place — to prevent businesses from abusing EOLI. That said, calling the abuse as “janitor” insurance is a bit insulting to the janitor, although it means KPI should not be used to rank-and-file employees, especially without their knowledge.

Item 5 is omitted as it is less important.

> "6. Grandfather provision: EOLI contracts issued before August 17, 2006, are generally grandfathered and still receive the full tax-free treatment under the original Section."

My Comments: This is a very important provision, which says for any EOLIs or KPIs signed *before* August 7, 2006, the IRS will allow them to function without meeting the same exemptions after August 17, 2006 — even not meeting the "Notice and Consent" rule. In other words, they will all be subjected or governed by IRC 101(a) to allow the full tax-free death benefit.

The million-dollar question here is when did the Connelly brothers enter the EOLI or KPI. I asked in Perplexity, which is the best when crucial citations are needed, but it did not find anything that mentioned when the life insurance policies in the Connelly case were signed or issued.

I then asked Perplexity another question, "How long has the Crown C Supply in existence in the Connelly case?" My thinking was that maybe we can get an "educated guess" in the hope that an earlier life insurance policy before 2006 is more likely if the Crown C Supply has existed for a long time.

This time, the chatbot still could not find when the firm was established. Fortunately, it cites one court document from Casetext.com, it says that "The Connelly brothers and Crown C signed a Stock Purchase Agreement (the 'Stock Agreement') in 2001, to maintain family ownership and control over the company and to satisfy their estate-planning objectives."

This is good, because there is a high chance that the brothers bought the KPI contract at the same time when they signed the Stock Purchase agreement in 2001. If that's the case, then we know the life insurance policy will be "grandfathered," meaning it is not governed by the IRC 101(j), but rather by IRC 101(a) for complete exclusion of death benefits from gross income.

> One crucial fact is that the Connelly brothers entered a Stock Purchase Agreement (the 'Stock Agreement') in 2001, long before 2006 when IRC 101(j) is activated. The entire death benefits of $3.5M should have been tax exempted.

9.5 The Hidden Hero

I would add another financial reason that has been missed by all chatbots, but highly relevant as it makes the tax-free death benefit feasible: life insurers generally invest the premium in interest-generating, dividends-bearing or equity creating assets. This includes a wide range of financial instruments such as Treasury bonds, corporate bonds, and other fixed-income securities.

In that sense, the ability of insurance companies to pay out substantial death benefits is directly linked to their ability to invest premium dollars wisely. By investing premiums in interest-bearing financial vehicles like bonds, stocks, and other assets, insurers generate investment returns that help offset the risk of paying out claims.

We should all thank the thriving and healthy US financial markets, without which the insurance industry's sustainability, or more specifically, the ability to pay death benefits, will be called into question.

9.6 A Quick Demo of the Financial Market Power

Here is an interesting exercise demonstrating the financial market power. I asked Perplexity the following question:

> "How does the average premium compare to the average death benefit?"

This prompt can be interpreted differently, but the chatbot is smart enough to responded with exactly the answer I want:

> "If we assume a term life policy with a $500,000 death benefit and a monthly premium of $25, the total premium paid over

> 20 years would be $6,000. That means the death benefit is more than 83 times of the total premium paid.
>
> For a whole life policy with a $500,000 death benefit and a monthly premium of $250 (remember whole life policies are much more expensive than term life), the total premium paid over 20 years would be $60,000. So the death benefit is still more than 8 times of the total premium paid."

We should not forget another (open) "secret" that renders the death benefit much larger than total premium paid and tax-free feasible is the large risk pool. In the above example, we assume death benefit is due in 20 years. In real life, different people die at different ages. Simply put, those who lived 100-year-old are effectively paying extra premiums to compensate those who died 10 years after signing the life insurance contracts.

> "Two secrets for making death benefits so much larger than total premium paid are the interest-bearing or equity-creating investment vehicles and insurance risk pool."

Instead of using the double taxation argument, the Connelly should have argued in the court for two things: (1) fighting against the "double taxation" levied to the death benefits of an KPI/E-OLI policy, plus (2) the even stronger argument of the long existing tax legislation code exempting death benefit from gross income. Each of these is more vigorous than the "value offsetting" point, because the former is simple, well recognized and well separated from the valuation issue.

I am a bit surprised to see that nobody has brought up Internal Revenue Code Section 101(a) in this case. That legislation sets a solid foundation for separating valuation and taxation, as it explicitly designates a portion of the value as off-limits for taxation.

> "Someone should have brought up IRC 101(a) to the Court, the only "weapon" that can "defeat" the FMV argument."

10 KPI v. Cross-Purchase Agreement

Let's end the discussions by considering the alternative to KPI, as suggested by the Supreme Court itself.

10.1 The Argument of Thomas Connelly

Toward the end of the Court Opinion, it cites a valid concern raised by Thomas Connelly:

> "Thomas asserts that affirming the decision below will make succession planning more difficult for closely held corporations. He reasons that if life-insurance proceeds earmarked for a share redemption are a net asset for estate-tax purposes, then 'Crown would have needed an insurance policy worth far more than $3 million in order to redeem Michael's shares at fair market value."'

Let me explain what Thomas Connelly was saying to the Court: If the IRS was right that the Connelly's firm should be valued at $6.86M instead of $3.86M, then the life insurance policy by Crown C Supply would have to buy a higher coverage in the KPI, otherwise the $3M coverage won't be enough to redeem Michael's share.

In insurance, this is called "under-coverage," a situation when the coverage provided by an insurance policy is insufficient to fully cover the potential loss or liability.

Thomas' concern was well-supported by the IRS figures. Recall that Michael's estate FMV was calculated by the IRS at $5,294,548, or roughly $5.3M. On the other hand, their life insurance policy only provided $3M death benefit, far short of what is needed to buy all Michael's shares.

> Thomas Connelly made a valid, albeit still valuation focused, argument that adding death benefits to the company FMV would imply an inflated KPI coverage to fully cover the losses — if tax applies to every dollar in the FMV.

It is in vain to argue against the valuation part, where the Supreme Court holds a valid position, from which it is unlikely to depart. The only meaningful argument is on the taxability part. Thomas should have brought up IRC 101(a), and even IRC 101(j), to defend himself and Michael's estate.

10.2 How The Court Responded

The response from the Supreme Court is very interesting. It admits the problem by saying, "true enough." But, instead of directing us to the real solution of excluding the KPI death benefits, following IRC 101(a) and even IRC 101(j), it blames the existing buy-sell agreement.

In its own words, the Court calls it

> "a consequence of how the Connelly brothers chose to structure their agreement. There were other options. For example, 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."

The court has offered explanations why the cross-purchase agreement would be better.

> It "would have allowed Thomas to purchase Michael's shares and keep Crown 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 Crown."

But while the interpretation of the cross-purchase arrangement is correct, it is wrong to make it the "recommended" solution for business continuity facing the cash flow challenge. It creates an impression that insurance proceeds going to the business are to be avoided. This is not the case, as KPI and EOLI have been functioning for decades, if not longer. See more details next.

> “The Supreme Court opinion has created an impression that insurance proceeds going to the business are to be avoided, despite that business owned life insurance has been functioning for decades.”

10.3 Comparing KPI & Cross-Purchase

By blaming the existed arrangement with KPI, the Supreme Court effectively dismissed the value of KPI and encouraged the cross-purchase agreement.

A cross-purchase agreement cannot replace KPI, and the Court is fully aware of the drawbacks by saying

> “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.”

This is right on the point. The issue is that cross-purchase demands more from each owner or partner than KPI. If it works, Thomas Connelly would have bought all the shares from his late brother, Michael, using his own money, or money from his personal insurance death benefits. The fact that he did not tell us that sometimes KPI is the only viable solution for smooth business transition, overcoming the cash flow challenge.

There are other non-trivial issues with cross-purchase. ChatGPT points out that “Key Person Insurance involves purchasing a single policy on a key individual, making it easier to administer compared to the multiple policies required in a Cross-Purchase Agreement, especially in businesses with multiple partners.”

The reason is that each partner or owner must hold a policy on every other partner/owner.

For example, say there are four partners/owners, then each must hold three contracts, one for each partner/owner.

There is a formula for determining the number of life insurance policies needed in a cross-purchase agreement: $N \times (N - 1)$, where N is the number of partners or owners. So if N=4, we need $4 \times (4 - 1) = 12$ cross-purchase agreements, a quite overwhelming number for most people to handle.

Notice that a cross-purchase is not an insurance policy, just a legal contract, although life insurance policies are often used to fund the cross-purchase agreement.

KPI is also more flexible in its usage. The business can use the death benefit anyway it sees fit, while the cross-purchase is to buy out the late owner's shares. For this reason, the face value of the life insurance policy should be equivalent to the value of each owner's share in the business.

In the Connelly case, Michael's share was determined at $2,979,148 (before the IRS pushed it up to $5,294,548). So the life insurance that funds the cross-purchase agreement must have a coverage roughly that amount. In the Connelly case, the policy had a death benefit of $3M, which was enough.

All the chatbots have mentioned that a KPI does not require frequent valuations of the business or the partners' shares, which can be complicated and contentious in Cross-Purchase Agreements. However, they all ignore that per IRC 101(j), businesses do need to file an annual report for EOLI. KPI and cross-purchase arrangement are therefore the same in this respect.

Finally, KPI can cover key employees who are not owners, whereas Cross-Purchase Agreements are generally limited to owners or partners.

Simply put, a cross-purchase arrangement would put us back to the cash flow problem that broke 82% of businesses and that the KPI was designed to solve.

> “A cross-purchase agreement is unlikely to replace KPI, which sometimes is the only viable solution for smooth business transition.”

10.4 Other Arrangements or Models

We can briefly mention other arrangements in addition to cross-purchase agreement recommended by the Supreme Court.

One option is a buy-sell with a trust or escrow agent, in which life insurance on each owner is held by a trust or paid to an escrow agent, rather than the owners themselves being required to maintain them.

Unlike the cross-purchase model, here we would have typically only one life insurance policy, owned by the trust or managed by the escrow agent, ensuring that the funds are properly allocated according to the terms of the agreement.

Upon the death of the owner, the trustee or escrow agent distributes the stock of the deceased owner to the remaining owners for the purchase of the deceased owner's interest. Alternatively, the trust could purchase the decedent's interest in the company and hold the interest for the benefit of the decedent's intended beneficiaries.

Special Purpose LLC (Limited Liability Corporation) is another model, where an LLC owned by the owners can be used to hold the life insurance policies. Upon the death of one of the owners, the LLC would receive the proceeds and distribute them to the remaining partners to purchase the decedent's shares.

This type of entity is similar to a buy-sell trust for the purpose of managing ownership interests and streamlining succession planning. The SP LLC holds the life insurance policy and ensures that the proceeds are used according to the terms of the agreement, thereby providing a smooth transition of ownership and protecting the business from disruptions.

Claude offers the following comparisons between a buy-sell trust and a special purpose LLC:

> "**Complexity**: Special purpose LLCs are generally more complex to set up and maintain than buy-sell trusts.
>
> **Scope**: LLCs can be used for broader purposes beyond just ownership transfer, while buy-sell trusts are more focused on

> the specific transfer event.
>
> **Ongoing management**: LLCs require more ongoing management and potentially annual filings, while buy-sell trusts are more passive once established.
>
> **Flexibility in transfer**: LLCs offer more flexibility in how the business transition occurs, while buy-sell trusts typically have predefined terms.
>
> **Cost**: Setting up and maintaining an LLC is usually more expensive than establishing a buy-sell trust.
>
> **Tax implications**: The tax treatment can differ significantly between the two options, depending on how they're structured."

One thing I noticed regarding "ongoing management," Claude says "LLCs require more ongoing management and potentially annual filings, while buy-sell trusts are more passive once established."

But this overlooks the demands from IRC 101(j) if the trust is funded with EOLI policies, there will be ongoing reporting requirements as well. After I pointed it out, Claude admits its oversight:

> "Under IRC 101(j), businesses must file annual reports (typically Form 8925) for each EOLI policy. This includes reporting on the number of employees covered, the total amount of insurance in force, and certifying that certain notice and consent requirements have been met."

It then tells me the following:

> "Buy-sell trusts may have more focused reporting requirements specifically related to the life insurance policies.
>
> LLCs typically have broader ongoing management and reporting requirements related to the entity's overall operations."

These differences are well-taken, if we remember that an SP (Special Purpose) LLC can be used for different purposes, not limited to business continuity or transitions.

> We do have alternative models that can reduce the number of policies and the paperwork hurdle: Buy-Sell trust and special purpose LLC, both require just one policy for all the transactions.

10.5 The Unique Advantages of KPI to Small Business

I won't feel doing my service well without highlighting the pros and cons of the three business continuity models: KPI, Buy-Sell Trusts and Special Purpose LLC.

None of the other alternatives is as convenient and easy as KPI for small businesses, which does not involve any additional entity like a trust or an SP LLC and the associated paperwork and legal work.

When I entered the following prompt

> "Compared with buy-sell trust or special LLC, key person insurance is the easiest way for business continuity."

I received confirmation from the Gen AI platform ChatGPT.

> "Yes, key person insurance is often considered one of the easiest and most straightforward ways to ensure business continuity compared to buy-sell agreements or special LLC structures."

But I like the response, to the same exact prompt, from Claude, which is more balanced, listing pros and cons of each of the three models.

For KPI, Claude has the following to say:

> "**Pros**:
>
> Relatively straightforward to set up.
>
> Provides immediate liquidity upon the death of a key person.
>
> Can be used to cover business losses or fund a buy-out.
>
> **Cons**:
>
> Only addresses death or sometimes disability.
>
> Doesn't provide a framework for ownership transfer.
>
> May not cover all scenarios of business transition."

My Comments: The three "cons" of KPI, as listed by Claude, actually point to the same problem: not having a broad or umbrella coverage for all kinds of ownership transfer.

If we look at it closely, there are three main scenarios: owner's death, owner's disability, and owner's retirement — all have direct impacts on ownership transition and business continuity.

Other complexities can arise from owner's divorce, owner's legal issues, and partners' disputes.

While it is true that a KPI does not cover retirement, divorce, legal troubles or partners' disputes, no insurance policy covers all losses. The same may be said to buy-sell trust or SP LLC. In general, no model can solve all legal challenges, especially if one party claims the agreement itself is unfair or invalid.

That said, many sources of loss, like divorces and legal disputes, can typically find well-established legal solutions in the courts.

Compared with other legal solutions, insurance has two features. It focuses on financial compensation for the losses, and it is cost-effective in the sense that the insurance proceeds are typically a multiple of premium paid.

Retirement can sometimes bring business losses, especially the retirement of a key person. But retirement is not death. A retired owner still has time to find and hire the replacement. Sometimes the retired owner can even return to work if no replacement has been identified.

Now, let's return to what Claude has to say about Buy-Sell Trust:

> "**Pros**:
>
> Provides a clear framework for ownership transfer.
>
> Can address multiple scenarios (death, disability, retirement).
>
> Often funded by life insurance, providing liquidity.
>
> **Cons**:
>
> More complex to set up than key person insurance.
>
> Requires regular review and updates.
>
> May have tax implications."

My Comments: While the buy-sell trust is legally more complicated than KPI, it can indeed work for different scenarios. For example, they can stipulate that business interests are not transferable to a spouse in divorce proceedings. Instead, they must sell their share back to the company or other owners. These provisions help preserve other owners' interest.

Of course, a spouse might challenge the agreement, especially if they feel it's unfair. The point is that no model is perfect or fits for all cases, and no legal agreement can foresee all future risks.

I will skip the SP LLC part, which share similar features as the trust, with an added advantage of operational flexibility. Remember, the "special purpose" could be anything that the business sees fit.

Claude ends with the following summary:

> "While key person insurance is perhaps the simplest to implement, it's not necessarily the most comprehensive solution

> for business continuity. The best approach often depends on the specific needs, size, and structure of the business."

My Comments: This is exactly right. It is always a trade-off: Being simplest and being comprehensive usually do not go together in a single model. That said, KPI insurance still works the best for a small business, while more complicated setups like trusts and LLCs work better for large corporations.

Regardless of the business sizes, one thing that a business owned life insurance can uniquely provide is to work with other more complicated legal models and provide a solid financial foundation for them. For example, whether a buy-sell trust or a special purpose LLC, they both can use an underlying life insurance policy or even policies to fund the ownership transition, provide liquidity for business continuity.

Bearing in mind that the death benefits are tax-free, and can be used for different purposes, even though the payout can only be triggered by deaths or disabilities.

It is important to keep these in mind when making model choice of business continuity, avoiding the cash flow trap.