



November 28, 2005

Court Holds Buy-Sell Life Insurance Does Not Increase Business Value

U.S. Court of Appeals issues favorable ruling on stock redemption buy-sell plan

There was good news recently from the 11th Circuit Court of Appeals regarding a buy-sell arrangement funded with life insurance. The appeals court reviewed a stock redemption plan funded with corporate-owned life insurance. The insurance proceeds were required to be used to purchase the insured's shares of stock upon his death.

Rejecting the IRS and the Tax Court positions, the appeals court determined that the amount of life insurance proceeds should not be included in the computation of the corporation's fair market value. *Estate of Blount v. Commissioner*, No. 04-15013, F.3d (11th Cir. October 31, 2005)

Now, there is greater legal precedent for the traditional position that life insurance proceeds should not influence the value of the corporation, to the extent that the proceeds are obligated to purchase shares.

Court addresses business valuation, disregards life insurance

This ruling applies to stock redemption buy-sell agreement that was in place for a number of years. Even though the corporation received the death benefit proceeds, the court held that these proceeds were not included in the value of the business when determining the value of the business for federal estate tax purposes.

The court provided a "dollar for dollar" offset for life insurance proceeds that are required to be used to purchase shares of stock. This ruling also cited in a similar Ninth Circuit Court of Appeals ruling that also disregarded the value of life insurance for business valuation purposes.

This portion of the ruling affirmed the widely held position that life insurance proceeds are offset by the obligation to repurchase and/or the loss of the key person.

Buy-sell arrangements, generally

This ruling provides additional support for business continuation planning with stock redemption arrangements (also known as entity purchase arrangements.) The typical advantages of stock redemption arrangements include:

- the ease of using corporate dollars to pay for life insurance,
- using fewer number of policies than a cross purchase arrangement, and
- permits pooling of premiums, allowing more equitable treatment for insureds with different ages, ownership interests and health conditions.

Another way to structure buy sell agreements is the cross purchase arrangement. A cross purchase arrangement avoids the issue of insurance proceeds influencing the business valuation, because the policies are owned by individuals. However, cross purchase arrangements do not work as well with multiple shareholders or shareholders that have different ownership interests, ages and health issues.

Court addresses business value stated in buy-sell agreement

The court also held that the agreement did not "peg" the value of the business for federal estate tax purposes. In the facts of the Blount case, the value stated in the agreement was disregarded because it was unilaterally changeable by the decedent during his lifetime. He was the majority shareholder and changed the value just months before his death.

Business valuation based on buy-sell agreements, generally

In order for a buy-sell agreement to set the value of the business for tax purposes, Treasury regulations and the courts generally require that:

- the agreement price be fixed or determinable by formula;
- the estate be obligated to sell under a valid and enforceable agreement;
- the obligation to sell must be binding during lifetime; and

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- the agreement constitutes a bona fide business arrangement and not a device to pass shares to family or others for less than full and adequate consideration.

The court reiterated these requirements, along with newer statutory requirements of Internal Revenue Code Section 2703, that provides a three-point “safe-harbor” test for the agreement to set values for estate tax purposes. This section was added in 1990 and applies to any agreement put in place or materially modified after that time. The agreement must meet the following requirements:

- It is a bona fide business arrangement.
- It is not a device to transfer property to member’s of decedent’s family for less than full and adequate consideration. (It is not a testamentary wealth transfer.)
- Its terms are comparable to similar arrangements entered into by persons in an arms’ length transaction. (It is comparable to similar arrangements negotiated by independent, non-related parties.)

Because of these tests, most decisions on business valuation for estate tax purposes are very fact specific.

Resources from Jefferson Pilot Financial

More information is available on business continuation planning, stock redemption, cross purchase and wait-and-see buy-sell agreements and business valuation in the following:

- JPF Business Continuation kit (Form No. SP-04049 and on My JPF),
- JPF Virtual Sales Assistant, in the Tools and Techniques of Life Insurance planning,
- Impact Wealth Planning Suite,
- JPF Advanced Sales - Case Design attorneys and consultants are always available for assistance.

For more information, feel free to contact Jefferson Pilot Financial Advanced Sales – Case Design consultants at 866-457-3658, Option 2, or by email at advancedsales@jpf.com. Check for updates to this document at www.myjpf.com >> Marketing >> JP Life & Annuity >> Advanced Sales. Do not use this document after April 2006.

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