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NKP - Colin Devlin.wpp 1.m4a

Transcript

But we know the drop. we Oh. Don't know the ocean.

Hello and welcome to the Newton Knowledge podcast. My name is Mark Singer, partner of Newton One advisors. I'm joined by our managing partner. As always, Steve target the New Knowledge Podcast is intended for our valued advisor, community, estate planners, tax planning attorneys, CPA's, Financial advisors, and wealth managers. Our discussions will deliver unique insights into the people, processes and products that make our industry so cry. Michael Newton, one is a national life insurance planning firm delivering. Insurance solutions structured to help clients and their advisors engaged in solving estate planning, wealth transfer, business succession and executive benefits challenges. We are a member of the Financial Group which grants our clients access to the nation's elite carriers and exclusive products available only through our network. Today, we have on the show a good friend of mine. Alan Devlin, who is a an estate and tax planning. Attorney with Lex Nova. He's a partner at Lex Nova. Predominantly a business and wealth management firm. Colin, it's great to have you on the show. We really appreciate you. Coming out here and sharing some time with us today.

Thanks, mark. Thanks, Steve. It's a pleasure to be here and appreciate the invitation to the.

Lake. So before we jump in to our topic, just give us background on yourself. Your your particular focus within your practice and and what you guys are.

Doing at Lex Nova? Sure. So as you mentioned, I'm a partner at Lex Nova Law. We're a relatively new firm. We launched Lex Nova about 3 1/2 years ago. Right before the pandemic, we hold ourselves out as a one stop shop for high net worth families closely held businesses and entrepreneurs. I practice primarily in the fields of estate planning, asset protection, and corporate law. We take pride in connecting the dots for our clients, who may own a closely held business and, you know, taking a holistic approach with respect to their estate and business planning.

Great. So the topic today is buy sell arrangements. Understanding that their structures as well as on the planning side pitfalls to to be aware of or avoid. But before we jump into to those details, just can you explain to our audience what what a buy sell is and the importance of it? On having one.

Sure. So essentially a buy sell agreement is a contractual arrangement between business owners that establishes the rules and procedures regarding the transfer of interest of an owner shares in a company, buy sell agreements can restrict the transfer of ownership interest or sometimes even force the transfer or buy out of an owner. Theirs upon some triggering. Whether that be. Death, disability, Divorce, retirement, bankruptcy and the list could go.

On and on. Why is it so important to have one? I mean, I know you went over some reasons, but what essentially happens if there's not a buy sell in place. Can you take us through that?

Sure. That's so that's that's a good question. The short answer is, you know it depends, but I can walk you through a few different scenarios. I think the most common scenario that we see or that I've encounters when you know, two partners who fail to enter into. A buy sell agreement before some irreconcilable dispute arises. You know I have a partner who calls me and says, hey, I can't work with this guy anymore. What are my options? The first thing we'll ask is, do you have an operating agreement or a shareholders agreement with certain buy sell provisions? If the answer is no, now we're potentially looking at a stalemate. And that's when we know that. You may be in trouble once the lawyers get involved and you know partners are are wasting time. You know, fighting. They generally spend substantially more in in legal fees trying to settle a matter than they would have if they had just paid a lawyer in the beginning to draft, you know, a proper document. You also need to take into account the stress and anxiety that comes in a long drawn out. Local battle and ultimately it's the business itself that suffers. Another example would be an owner who you know decides that he wants to sell his shares to a third party, and now you're potentially in business with a partner that you didn't choose where a properly drafted buy sell agreement could have a provision that you know prevents transfer of shares without the consent of the other shareholders. Or given the shareholder wants to remain in the business, the right of first or.

Choose.

Or let's take a scenario where a partner unexpectedly passes away. Now all of a sudden you may be in business with the partner, surviving spouse or even their children who have no involvement or active participation in the business. Maybe they're being unreasonable with respect to a a purchase price to buy them out. And had you had a a buy sell agreement, it could have triggered a buyout of the decedents interest that could have been funded with life insurance. Same thing if a a shareholder unexpectedly becomes disabled. Now the healthy partner is doing all of the work and running the business, yet the disabled partner or their agent under a power of attorney is reaping the benefits of ownership. A buy sell agreement could have triggered A buyout upon the partner's disability and again, the purchase price could been funded with disability insurance. We always say to begin with the end in mind. While one everybody's alive, but two more importantly, while everyone's getting along. As we all know, life happens. Everyone's aligned at the start, but differences can arise and then you also have to take into account the different factors between between shareholders or members in a company. For example, let's say the two of you were in business together, which you are. You guys have different lifestyles. There's an age gap there. One may be closer to. Retirement one they have a child who may potentially come into the business. You have different economic viability. One may be the bank and has the resources to buy the other person out, whereas if you have a properly drafted agreement then it helps even the playing field and it can. Help alleviate or mitigate anything that might happen unexpectedly.

Thanks, Cam. So why don't we keep diving in a little bit to buy sell agreements and arrangements and let's review, I guess probably the three most common arrangements, an entity purchase, a cross purchase. And then because we're in the insurance business. Let's review what an insurance LLC as part of the buy sell agreement can look.

Like, sure. So as you mentioned, there's different types of buy sell arrangements. The first thing you mentioned is what's called a cross purchase when the owners enter into an agreement amongst themselves and not necessarily with the business, the owners buy each other out upon some of the triggering events that we just talked about. And there can be life and disability policies that are cross owned. The pros of cross purchase agreement would be that upon the purchase, there's an increase in basis equal to the purchase price, which could reduce the capital gain on a future liquidity event. As we'll talk about later in the Connolly case, setting up a cross purchase agreement can also help avoid. The value of the business being included for state tax purposes, this is generally we would recommend a cross purchase agreement if there's two or three owners in the. Business because one of the negatives of setting up the agreement as a cross purchase is that it can be onerous or cumbersome if there's more Members because you have to own a policy on on each Member. One of the other options is an entity purchase or redemption agreement where the owners aren't actually entering the agreement among themselves, but rather with the business business. That triggering event, death or disability, it's actually the business that's redeeming the owner's interest upon one of those set event. So the life or a disability policy is actually owned by the business itself instead of the individual owners. The pros of this type of setup is only one policy is needed on each owner, unlike a cross purchase agreement where you need multiple policies on the various shareholders. One of the negatives of this is generally depending on the entity type, there isn't that step up and. Basis that we just discussed on the cross purchase arrangement a lot of times what we also see is actually a hybrid of the two where you can take a wait and see approach where you might give the company the option to purchase a departing shareholder or members and. And if the company chooses not to for whatever reason, then the other shareholders then would have the option to to to cross purchase.

Do you want to address anything with the insurance LLC? Is that is that something that you see in the marketplace, is there, are there some opportunities there for companies to to consider that?

Consider that, sure. So an insurance LLC is essentially where the owners of a company established the completely separate entity, usually in LLC tax as a partnership. And the beauty of the Insurance LLC is that can provide the advantages of both the cross purchase agreement as well as the the entity redemption. So you would still be able to get the increase in basis while also limiting the number of policies because again you have an insurance, you have a separate entity that's owning the policies instead of the individual owners taking out policies on each other. You guys can probably speak to it better than me, but you know there's also premium flexibility that would allow you to allocate premiums among the owners and also another benefit would be to potentially avoid. You know transfer for value issues as well.

So being in the insurance business, obviously our participation here. Providing insurance contracts, life and disability policies to help fund that purchase should a life for disability event be triggered and you know, one of the things that we run into is the the financial underwriting is actually quite different, issuing a life insurance policy and a disability specifically for buyout. And the reason is if there is a triggering. F. Where there's a life insurance policy in place, typically that life insurance in the agreement is used to fund either the the first portion of the buyout or maybe even the full buyout. We're going to talk about some of the legalities with that, but it's pretty clearly defined that if somebody is dead and there's a triggering event that there is a buy out there on the disability side, what makes it a little bit more. Difficult for us is there's there's a lot more financial qualification that needs to take place in order to issue the disability insurance policy upfront. And then there's there, there's that backside of that. Of what's the risk and and premiums. So not going into details or or a a deep explanation that's not the purpose of today's podcast about different types of life insurance policies. But there's all sorts of different contracts that can be issued. Some are short term oriented and some are long term oriented, others can offer. Ancillary, non qualified benefits, golden handcuffs sort of structures potentially. And then on the disability side, because of the likelihood of a claim on a disability policy being higher generally higher than on a life, some of those policies can become fairly cost prohibitive, sure, but it's something that we always want to talk to our business owner clients about so that they address that issue and many haven't realized that. In that that operating agreement. There is specifically noted if disability occurs then the other question that comes maybe for another podcast. Yeah, the question becomes who determines what the disability is? Is it a short term disability? Is it a full disability? Is it a total disability? Is there a possibility that the shareholder or the owner can come back at some point in? Future. So it becomes a little bit more complicated, but you know it kind of falls right in the of the zone of where we had Newton one spend a lot. Of our time. Alright, so let's pivot now to one of the things that are or really what we thought was going to be an interesting discussion from your standpoint. Let's talk about the Thomas Connolly versus United States case. Some of the lessons that were learned and some of the things that that maybe we all potentially will do differently or advise our clients differently on moving forward.

Sure. So that Connolly case is a somewhat recent case where there were two brothers who owned a family business, one brother owned approximately 80% of the business and the other brother owned 20% majority shareholder passes away. There was a buy sell agreement that required the company to redeem or buy back the shares of upon. My brother's death believe the company had $3.5 million of life insurance to fund a buyout in the event of one of the brothers death and within the Buy sell agreement, it provided 2 mechanisms. To determine the purchase price. The buyout, the first mechanism that the agreement provided for when determining the valuation of of a member shares, was that the the owners could essentially certify each year or come up with an agreed upon value, and then you would attach that agreed upon value as an exhibit to the to the agreement. See that in a lot of agreements that was, you know, much more common many years ago. But in the event that the shareholders either neglected or failed to agree on a an annual valuation. Then they were required to obtain 2 appraisals to determine the purchase price. So for 12 or 13 years the the brothers never did either, and the estate of the brother passed away. The executor of the estate agreed to accept $3,000,000 of life insurance as the buyout for. The decedent shares and he reported that $3,000,000 on the estate tax return. And the IRS audited the return and assessed an additional $1 million of state tax, where the rationale was sent was that the value of the business was worth much more than the $3,000,000 that was reported on the return, and the value of the life insurance should have actually been included in the valuation. So there's really, but there were two issues in the Connolly case, the. This is whether the buy sell agreement controls the value for estate tax purposes. Generally, the fair market value is the price of which property would change hands between a willing buyer and a willing seller. However, section 2703 of the code with respect to buy sell agreements, it actually permits. Buy sell agreement to to control if it meets certain standards, the first of which is, is there a bona fide business arrangement between the parties? This is a a relatively easy element to satisfy. You're running a family business, you have an agreement in place. The purpose of the agreement is to, you know, control and preserve the family business. So it's pretty easy to check that box. However, the 2nd element is that the arrangement can't be a device to transfer assets or wealth to a family member for less than full and adequate. Consideration. And this is where the IRS jumped in and said, hey, this was essentially A testamentary device to transfer assets. The parties completely ignored the terms of the agreement. They came up with a valuation on their own. As I mentioned earlier, for 12 or 13 years, they never agreed to an annual. Evaluation. They didn't follow the rules of the agreement and obtained 2 appraisals prior to reporting the value on the estate tax return. Essentially, there was an arbitrary number that that the decedents estate and the company came up with by reporting that $3,000,000 on the estate tax return. And the failure to follow the agreement in the courts eyes demonstrated that the agreement was really a testamentary device to transfer wealth. It wasn't binding at the decedents death. And then the third element is whether the agreement terms are comparable to a third party arms length transaction. So had they taken the company or did the student? Theirs to market would have $3,000,000 been a reasonable value that an unrelated third party would have would have. But really, the courts focus here was on that second element that we discussed, which is whether you know, it was really a a testamentary device to transfer wealth for less than full and adequate consideration. So in the courts eyes, as I mentioned, the failure to follow the agreement, they completely ignored it. Their own conduct demonstrated. That hey, yeah, we have this by cell agreements in place, but it's mere existence isn't enough to get you over the hump. You actually have to follow the terms of the agreement. That's the reason the agreements in place. The second issue was whether the life insurance proceeds should have been considered when determining the value for estate tax purposes. The estate argued that the proceeds should have been ignored because they were essentially offset dollar for dollar. By corporate obligation or corporate liability to pay the departing shareholder, per the terms of the agreement, now the court actually held that the life insurance proceeds should have been included in the fair market value and that there was a transfer to a beneficiary for less than full and adequate consideration. Now there's conflicting case law on this. There's another jurisdiction that ruled that the life insurance proceeds shouldn't have been included, but essentially the reason that we even got to this issue was because they failed to follow the agreement in the first place.

I look at this as what can we learn from this case study and how? How can Lex Nova law or whatever firm?

What are?

Hypothetically that a client like this is working with, how do we? How do you deter from that happening? Is it? From the insurance side and obviously I'm biased and this is going to be my example, but we set up annual reviews with our clients to engage with them first and foremost, but also to make sure that what we illustrate from the start is is close to how it's performing over its years and if adjustments need to be made that they can be made is that. Something where an estate planning attorney or their team of advisors should have been present to say, look, we need to do this so they're not sitting in the situation they.

Are in right now. Yeah, I think that's a a very fair point. You know, Mark, I think we're all guilty as. Attorneys, as the insurance planner. You know whether it's preparing the agreement as the attorney or or, you know, handling the the initial insurance policy. Once we get the plan in place, not doing a better job of of following up and make sure that you know the plan is actually being effectuated and that the agreement is.

Being followed A follow-up question there, Colin is if we are conducting annual reviews and there are annual valuations of the company and the agreement stipulates that there's an insurance, there can be an insurance policy in place and if the value of the company is greater than the insurance. Policy and the difference is paid out over a defined period of time. It might be 60 months, it might be 120 months, but as companies grow again from the insurance perspective, in many cases we need to true up that benefit absolutely. If the company was valued at 5:00 and we wrote a $5,000,000 life insurance. Policy to fund the death and then three years later, the companies valued at 15 and we still only have a $5,000,000 policy, you know, shame on all of us for not having that conversation, but I think you know, as Mark mentioned earlier, that's one of the things that's really table stakes for us is annual reviews, discussions about valuations of companies. And then at a a conversation about whether it it does make sense to to again true up the the benefit amount so that the remaining shareholders aren't at financial risk if there's been a tremendous growth in the company. And then for that matter for the estate, if you know they're relying on the company to be in business and to pay out that difference. And if that creates a financial hardship for the company, then the company might be in trouble. And that may mean that the family or the estate might not receive the proceeds if the company goes out of business.

Sure. So you you hit the nail on the head and I think equity is the is the key point here. You know what may have been perfectly fine. 5/10/15 years ago when you know the agreement or the plan was initially drafted, it might not produce an equitable result today. So our job, certainly as an attorney, is when we meet with a client who's in this situation where they're forming an entity is you've got to look at it both from a buyer and a seller's perspective, right? Where one shareholder may benefit from that bargain purchase price but to touch on what you just said, then whether it's the business or someones family, they could suffer a true economic loss. If we haven't effectively trued up the valuation. You know I just had a meeting with a client a few weeks ago. And we, you know, we're we're conflicted out, but there's a disagreement between between two brothers and the family business and historically our our firm has served as counsel to the family business. But similar to the Connolly case, there is a evaluation procedure in that agreement. That gives the shareholders, the two brothers the ability to come up with a value annually. Of course, over the past 25 plus years, they haven't done that and the default there isn't even to go to an appraisal, but rather it looks at the consumer price index. Which you know is is significantly outdated. It it uses a formula and there's there's a a gap between the true valuation today and what the consumer price index formula shows of like $2,000,000. So now we have a client who's looking to exit the business, but he's still a couple of years shy of retirement. Business has gotten so bad with his brother that you know he's considering just forgoing it altogether and accepting a significant discount on what he might have gotten had he just been able to hang on for another two years.

I'm sure we could go on and on about the cases you have and and the help you and your firm provide for such business owners. But we're we're coming up on time. So is there anything else you want to add that we didn't touch on before we close this this?

Recording out, I don't think so, Mark. Just again, I I appreciate the invitation and it's always a pleasure to to spend time with you. I I look forward to helping business owners avoid some of the potential issues that that we discussed today.

Thanks Colin.

Thank you.

Bye bye.

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