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News and trends that could impact your business

The Connelly Decision and its potential impact on buy-sell agreements using life insurance

A recent Supreme Court decision reaffirms that shareholders of corporations that use life insurance to fund the purchase of a deceased shareholder's shares may be at risk of increased estate tax liability. **Here's what you need to know and may want to consider.**

SUMMARY AND EFFECT

On June 6, 2024, the United States Supreme Court issued a final decision in *Connelly v. United States*, a case which has been winding its way through the federal courts for the past few years. The case involved two brothers who were the sole shareholders of a closely held corporation. The company had purchased life insurance on each shareholder and was contractually obligated to use the death benefit to purchase (redeem) the shares of a deceased shareholder.

The case focused on the proper estate tax valuation of shares in a closely held corporation. But it has broad implications for businesses that rely on buy-sell agreements structured as redemption agreements (sometimes referred to as "entity-purchase," "wait-and-see," or "hybrid" agreements) which use life insurance to fund the redemption of a deceased shareholder's shares.

The central question in *Connelly* was whether life insurance proceeds used to redeem shares of a deceased shareholder must be included, as an asset of the corporation, when calculating the value of those shares for estate tax purposes.

The Court, ruling in favor of the IRS, concluded the life insurance must be included when valuing the shares. The Court rejected the taxpayer's argument that the redemption obligation effectively created an offsetting liability thereby allowing a shareholder to exclude or deduct the insurance proceeds from the value of the corporation.

As a result, the shareholders of corporations that have corporate-owned life insurance used to fund the purchase of a deceased shareholder's shares may be at risk of potentially increased estate tax liability.

DETAILS OF THE CASE

Michael Connelly owned 77.18% of Crown C Supply, a building supply corporation. His brother Thomas owned the remaining 22.82%. The brothers and Crown had a buy-sell agreement which gave each brother the option to purchase the shares of the other if they died. If the survivor elected not to purchase, then Crown was required to purchase the deceased shareholder's shares. The agreement further provided that the redemption price would be determined by an outside appraiser. To be sure Crown would have sufficient money to redeem the shares, it purchased a $3.5 million life insurance policy on each brother.

When Michael died in 2013, Thomas elected not to purchase Michael's shares. Consequently, Crown redeemed the shares. But instead of having an outside appraiser determine the value of the company, Crown and Michael's estate, for expediency, simply agreed that the value of the company was $3.89 million, and that Michael's shares were therefore valued at approximately $3 million ($3.89 million x Michael's 0.7718 ownership). Crown used $3 million of the life insurance proceeds it received to purchase the shares, leaving Thomas as the sole remaining shareholder.

Michael's estate filed an estate tax return, valuing Michael's shares at $3 million (not including the life insurance proceeds received by Crown) and paid federal estate tax accordingly. The IRS challenged the valuation, arguing that: (1) the life insurance proceeds received by Crown are an asset of the corporation and must therefore be included when valuing Michael's shares; and (2) Crown's redemption obligation did not offset the life insurance proceeds.

The IRS instead valued the company at $6.86 million ($3.86 million + $3 million of life insurance) and Michael's shares at roughly $5.3 million ($6.86 million x 0.7718). Based on the higher valuation, the estate owed an additional $889,914 in federal estate tax. Michael's estate paid the additional tax and then sued for a refund.

WHAT IT MAY MEAN

Ultimately, the Supreme Court upheld the rulings of the lower courts that the death benefit from the life insurance policy on a deceased shareholder's life used to redeem those shares is an asset of the corporation which increases its fair market value. The Court reasoned that if an unrelated third party were to purchase the shares, that purchaser should certainly be willing to pay a price based on the value of all assets of the company, including the life insurance death benefit received.

To put it another way, a hypothetical third-party purchaser would include the value of the life insurance in the price they would expect to pay for Michael's 77.18% ownership stake in the company. At the time of Michael's death, the company was appraised at $3.86 million but had also received an additional $3 million of life insurance otherwise earmarked for redemption. A hypothetical buyer would therefore treat the insurance proceeds as a corporate asset. So, the life insurance must be included in the total value of the corporation, thereby increasing the value of the shares for the purpose of calculating estate tax.

The Court further held that the company's contractual obligation to redeem a deceased shareholder's shares is not necessarily a liability that will reduce the value of a corporation or diminish the value of a deceased shareholder's stock for purposes of federal estate tax. The Court reasoned that the proper estate tax value should not affect the economic value for the remaining owners.

KEY TAKEAWAYS

- *Connelly* resolved the split in authority that had developed over time as the result of federal courts issuing differing opinions on the valuation issue.
- While some may argue with the economic logic the Court applied, the *Connelly* case was not a close call. Not one of the three federal courts that issued opinions in *Connelly* ruled in favor of the taxpayer. Moreover, the Supreme Court's decision in *Connelly* is a unanimous opinion, without dissent.
- The valuation method described in *Connelly* presumably applies whether the corporation qualifies under subchapter C or subchapter S if it owns life insurance that must be used to redeem the shares of a deceased shareholder.
- The IRS disregarded the valuation of Michael's shares even though agreed-upon between the company and Michael's estate. Generally, valuation methods in a buy-sell agreement will not be binding on the IRS for estate tax purposes.

STRATEGIES TO CONSIDER

In the wake of ***Connelly***, closely held corporations, with the help of their insurance financial professionals and attorneys, should review their existing buy-sell agreements to determine:

1. What, if any, estate tax may be owed by the estate of a deceased shareholder;
2. If the valuation method still makes sense or is likely to be disregarded by the IRS for estate tax purposes;
3. Whether additional life insurance may be necessary to create liquidity to pay any estate tax due;
4. Whether the life insurance amounts on each shareholder are adequate in light of the *Connelly* analysis;
5. Whether the buy-sell is under-funded. For example, additional life insurance may be necessary due to an increase in the value of the business, or if there have been changes in the ownership structure (e.g., additional shareholders);
6. Whether there are additional shareholders since the buy-sell was created who may be uninsured;
7. Whether a special-purpose insurance LLC should own and be the beneficiary of the life insurance used to fund the buy-sell.

→ Understand the potential estate tax implications for shareholders

In 2024, the federal estate tax exemption is $13.61 million per individual, and double that amount for a married couple. Most individuals currently have estates which are less than the exemption amount. But exemptions may be reduced by 50% or more as certain parts of the *Tax Cuts and Jobs Act* are set to expire after 2025. As a result, more individuals, including many closely held business owners, may have estate tax exposure and therefore be affected by the *Connelly* decision after 2025.

→ Avoid using a redemption buy-sell

If a corporation does not yet have a buy-sell in place, it may be worth considering whether a cross-purchase buy-sell agreement could work. Interestingly, the Supreme Court commented in *Connelly* that inclusion of the life insurance proceeds in the value of the shares could have been avoided had a cross-purchase agreement been used as instead of a redemption agreement. But for a company with more than a few shareholders, the number of life insurance policies required may be prohibitive. Cross-purchase agreements may also be less practical if there is substantial disparity in the ages or health of the shareholders, potentially resulting in higher premium costs for some shareholders.

→ Reforming an existing buy-sell agreement

For a business that already has a redemption buy-sell in place, funded with corporate-owned life insurance, it may be tempting to switch to a cross-purchase agreement in reaction to *Connelly*. Doing so would require not only reformation of the agreement, but also transferring life insurance from the company to individual shareholders. There are at least two potential problems with this strategy. First, if there are more than two shareholders, then additional policies will likely be needed. For example, a business with four shareholders would need only four policies to fund a redemption agreement; but 12 polices may be necessary if a cross-purchase agreement is used. Secondly, the transfer of policies may violate the transfer-for-value rule, resulting in the death benefit being taxable to the recipient unless an exception to the rule applies.

→ Use of a special-purpose LLC to own the life insurance

One way to avoid the potential transfer-for-value trap described above may be to use a special-purpose limited liability company (LLC). A transfer of an existing life insurance policy from a corporation to a partnership in which the insured is a partner is not considered a transfer-for-value, so long as the LLC elects to be taxed as a partnership. Because the corporation is no longer the owner or beneficiary of the life insurance on it shareholders, a deceased shareholder's estate may be able to avoid including the life insurance when valuing the shares for estate tax purposes. While the special-purpose LLC may seem like an attractive strategy, the use of LLC to own life insurance can be complex and, if not properly structured and documented, may be challenged by the IRS. For example, the IRS may determine that the LLC has no valid business purpose and should therefore be disregarded. In fact, it would not be surprising if the IRS elevates its scrutiny of special-purpose LLCs following its victory in *Connelly*.

Your **Allianz Life Advanced Markets** team can help assess the potential impact of the *Connelly* decision on your client's business and explore life insurance solutions that align with your client's goals.

TO GET THEIR HELP
contact the **Life Case Design Team** at
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