

Publications

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Supreme Court Holds Life Insurance Proceeds Paid to Closely-Held Corporation to Fund Buy-Sell Agreement Increases Estate Tax on Deceased Shareholder's Estate

In *Connelly v. U.S.*, 144 S.Ct. 1406 (June 6, 2024), the United States Supreme Court upheld an estate tax deficiency of \$889,914 in a decision that will impact many families and closely-held businesses. A Buy-Sell Agreement is often used to ensure that a closely-held company will remain within the family after the deaths of its owners or otherwise ensure the continuity of the business after an owner's death. Many Buy-Sell Agreements, such as the one in *Connelly*, provide that upon the death of an owner, the surviving owner has the option to purchase the deceased owner's interest in the company, and if the surviving owner declines, the company must redeem the deceased owner's interest. To ensure that the company will have funds for the redemption, the company will often obtain life insurance for its owners. For years, planners thought it possible to structure such an arrangement so that life insurance proceeds would not increase the value of the company for estate tax purposes. However, in *Connelly*, the Court held that the life insurance proceeds paid to a corporation upon the death of a shareholder do increase the value of the corporation's stock for estate tax purposes and that the corporation's obligation under a Buy-Sell Agreement to redeem the deceased shareholder's shares does not offset the life insurance proceeds. Under the Court's decision, the type of entity does not appear to be relevant, and the holding will equally apply to partnerships and limited liability companies. Thus, if any Buy-Sell Agreement is structured as a redemption funded with entity-owned life insurance, the insurance proceeds may increase the value of the deceased business owner's interest for estate tax purposes.

In *Connelly*, two brothers, Michael and Thomas Connelly, owned a business supply corporation. Michael owned 77.18% of the company, and Thomas owned 22.82% of the company. The brothers entered into a Buy-Sell Agreement as described above. The brothers ignored provisions under the agreement that required them to value the company annually and obtain an appraisal upon a shareholder's death. After Michael's death in 2013, Thomas and Michael's son simply agreed to a redemption price of \$3 million for Michael's shares. The company used \$3 million of life insurance proceeds to redeem Michael's shares, and Thomas, as Michael's executor, reported the value of Michael's shares as \$3 million on Michael's estate tax return without completing an appraisal. Upon audit of the estate tax return, Thomas belatedly obtained an appraisal that determined the

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fair market value of 100% of the company at Michael's death to be \$3.86 million, excluding the life insurance proceeds. Based on the valuation of the company at \$3.86 million, Thomas argued that the value of Michael's ownership interest was \$3 million ($\$3.86 \text{ million} \times 77.18\%$).

Connelly rejects the position of the 11th Circuit Court of Appeals in *Blount v. Comm'r.*, 428 F. 3d 1338 (CA11 2005), that the life insurance proceeds paid to a company are offset by the company's contractual obligation to redeem a deceased owner's interest. Rather than allowing an offset for the redemption obligation, the Court focused on the value of the company before and after the redemption. If the entire company was worth \$3.86 million, as claimed in *Connelly*, the value of Michael's 77.18% would be \$3 million and the value of Thomas' 22.82% would be \$860,000. The Court reasoned that upon redemption of Michael's shares, Michael's estate would receive \$3 million, leaving Thomas with 100% ownership of a company worth \$860,000. However, Thomas' argument meant that post-redemption, 100% of the company that Thomas owned was worth \$3.86 million. The Court refused to accept that a company which pays out \$3 million to redeem shares was worth the same overall amount before and after the redemption. The Court found that the company's value should be increased from \$3.86 to \$6.86 million, accounting for the insurance proceeds, increasing the value of Michael's ownership from \$3 to approximately \$5.3 million ($\$6.86 \text{ million} \times 77.18\%$). The net result was an additional estate tax of \$889,914.

Although the implications of *Connelly* are wide, there are limitations to the Court's decision. *Connelly* will have little impact on a business owner whose estate is well under the estate tax exemption, which is currently \$13.61 million for each individual and scheduled to be decreased by 50% in 2026. In addition, the Court did not address the application of Section 2703 of the Internal Revenue Code, which provides in relevant part that the value of a deceased owner's interest in a business may be established by a Buy-Sell Agreement if certain requirements are met. Perhaps the Court did not review Section 2703 because the shareholders did not follow the valuation terms of the Buy-Sell Agreement and arbitrarily determined the redemption price instead. But because Section 2703 was not addressed in *Connelly*, it may yet be possible to avoid its impact with a properly structured and adhered to, Buy-Sell Agreement.

The Court also explicitly stated in a footnote that the holding does not mean that a redemption obligation can never decrease a corporation's value. The Court implies that if a company is required to sell an operating asset to redeem shares, the redemption obligation might reduce the company's value.

The Court acknowledged that a differently structured Buy-Sell Agreement can avoid the risk that insurance proceeds would increase the value of a deceased shareholder's shares. Specifically, the Court referenced a "cross-purchase agreement" in which business owners, rather than the company, agree to purchase the others' ownership upon death using proceeds from non-company owned policies. In addition to avoiding the *Connelly* result, a cross-purchase agreement provides an increased tax basis for the surviving owners who purchase a deceased owner's interests. However, the more owners a business has, the more complicated a life insurance-funded cross-purchase will be. Other options to avoid the *Connelly* result may include a life insurance partnership or limited liability company or creatively structured split-dollar arrangements.

After *Connelly*, all business owners with Buy-Sell Agreements funded with entity-owned life insurance, or with other entity-owned insurance vehicles (split-dollar plans, key-person life insurance, etc.) should evaluate and consider restructuring their arrangements. In some cases, the restructuring of a Buy-Sell Agreement may require the transfer of life insurance policies which raises other tax issues, such as in-kind corporate distributions, S

corporation elections, transfer-for-value rules, and incidents of ownership.

Polsinelli's Trusts and Estates Group stands ready to assist clients in determining the best course of action for business owners in order to avoid the negative implications of *Connelly*.