

IT WAS UNANIMOUS: THE SUPREME COURT AFFIRMS *CONNELLY*

IMMEDIATE NEED TO REVIEW REDEMPTION BUY-SELL AGREEMENTS FUNDED BY BUSINESS-OWNED LIFE INSURANCE



Question: For estate tax purposes, what is the value of a business if it receives life insurance proceeds on the death of an owner?

Answer: The value of the business is increased by the value of the life insurance proceeds with NO corresponding reduction for the redemption liabilities under the buy-sell.

"[A]n obligation to redeem shares at fair market value does not offset the value of life insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest." ¹

In the recent Supreme Court case of *Connelly v. US*, buy-sell planning with life insurance was turned upside-down.¹ In that case, two brothers, Michael and Thomas, were the sole shareholders of a closely held building-materials company, Crown Corporation. To keep the business in the family in the event of death, the brothers entered into a stock-purchase agreement providing that the surviving brother had the right to buy the shares of the deceased or, if the surviving brother did not purchase such shares, the company would redeem such shares. To fund the redemption, like many businesses, Crown purchased \$3.5mm of life insurance on each brother with the understanding that the company must redeem the shares with the life insurance proceeds.

Upon Michael's death in 2013, Crown received the \$3.5mm in insurance proceeds and used \$3 million to redeem Michael's 77.18% share in the company. In filing its tax returns, Michael's estate relied on the \$3mm redemption payment to value Michael's shares at the time of his death and failed to consider the insurance proceeds as an asset that increased the value of the firm and of these shares.² The IRS subsequently audited the estate for undervaluing Michael's shares and recalculated the value to be \$5.3 million when accounting for the insurance proceeds payable to the business.³ The estate paid the additional estate tax and sued the IRS for a refund in District Court. All parties agreed the value of the life insurance should be included in the value of the business; however, the estate argued that the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares and therefore offset the amount of the life insurance.

The Supreme Court, in its unanimous decision, found that "Crown's contractual obligation to redeem Michael's shares did not diminish the value of those shares" and affirmed the Court of Appeals judgement. The result is a clear message that business-owned life insurance should be considered when calculating the FMV of a business **for estate tax purposes.**

So, is this outcome a surprise? Not if one really digs into the economics. Even so, it is a shock to many who have established redemption buy-sell agreements funded with life insurance.

The key here is that *Connelly* serves as notice for clients and advisers who have entered into similar buy-sell agreements that there must be some level of consideration for the life insurance proceeds payable to the business when valuing their interest in the business for estate tax purposes. As noted in the opinion, perhaps this might not have been a problem if they had used a cross-purchase agreement.

Things to Consider:

- *What is the cost to the estate when the death benefit increases the value of the business for estate tax purposes?*
- *Will the tax status of the business (i.e. – partnership, S-Corp, C-Corp) further complicate the planning of when life insurance is payable to the business?*
- *Understanding that a policy in the entity is subject to estate taxes, moving an in-force policy out of an entity will have tax implications that should be understood prior to changing ownership.*
- *The idea of a Special Purpose Insurance LLC may be a solution going forward for many businesses.*

¹-*Connelly v. United States*, U.S., No. 23-146(2024), affirming 70 F.4th 412 (8th Cir. 2023).

²-Because of shareholders' relationship as brothers, the 8th Cir. Court of Appeals reviewed 2703(b) (ignore valuation agreements unless they (1) are a bona fide business arrangement to transfer property to members of decedent's family for less than full/adequate consideration, and (3) have terms comparable to other similar arrangements).

³-The IRS determined the gross value of the business was \$6.86m, which included \$3m from the life insurance and \$3.87m based on company operations and assets. Michael's 77.18% interest would be \$5.3m. 26 CFR § 20.2033-1 (Gross estate includes value of all property, real or personal, tangible or intangible owned by decedent at time of death) § 2031 (value of taxable estate generally FMV of decedent's property at date of death).

