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The Supreme Court's *Connelly* Decision

A gamechanger for insurance-funded entity redemption buy-sell arrangements

On June 6, 2024, the Supreme Court unanimously held in *Connelly* that a corporation's obligation to redeem a deceased shareholder's shares is not a liability that reduces the corporation's value for estate tax purposes. Therefore, the corporation's receipt of life insurance proceeds that were used to redeem the decedent's shares were included in the value of those shares for estate tax purposes.[1]

Prior cases held a redemption agreement created an obligation that offsets the life insurance proceeds received by a business that is used to redeem a deceased's interest in the business.[2] Entity redemption agreements allowed a business to own life insurance to redeem an ownership interest while removing the death benefit from the company's valuation for estate tax purposes. However, given *Connelly*, businesses with existing entity redemption arrangements that are funded with company-owned life insurance should review their arrangements.

1 *Connelly v. U.S.*, 602 U.S. ___ (2024).

2 *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005); *Estate of Cartwright*, 183 F.3d 1034 (9th Cir. 1999).

Entity/stock redemption arrangements

With an entity/stock redemption agreement, the business purchases a deceased owner's interest in the business. Prior to *Connelly,* businesses may have preferred an entity/stock redemption agreement compared to a cross-purchase agreement when multiple life insurance policies were needed for a cross-purchase agreement (described below). Entity/stock redemption agreements only require the business to be the owner and beneficiary of one life insurance policy per owner. Also, there may be other reasons that business owners prefer the business to own the policies rather than their co-owners. For some entity/stock redemption arrangements, the survivors may not be able to increase their tax basis in their business ownership interests.[3]

Background on *Connelly*

The U.S. District Court for the Eastern District of Missouri held in *Connelly*[4] that the value of a corporation is increased by the proceeds of a life insurance policy that will be used to redeem the deceased's shares and the redemption obligation does not reduce the value of the shares for estate tax purposes. The Court of Appeals for the Eighth Circuit affirmed.[5] The Supreme Court has now affirmed.

3 It is possible for the surviving shareholders of S corporations to get a full pro rata increase in tax basis with a stock redemption plan funded with corporate-owned life insurance if the corporation is a cash basis taxpayer and the shareholders elect a short tax year when a shareholder dies. See IRC § 1377 and 1367(a). If an S corporation is an accrual basis taxpayer, there is a partial pro rata increase in tax basis equal to the death benefit. For C corporations, the surviving shareholders do not receive any increase to basis. An entity redemption plan for a partnership or LLC taxed as a partnership that is funded with company-owned life insurance provides the surviving owners with an increase to tax basis equal to the death benefit. See IRC § 705(a)(1)(B).

4 *Connelly,* 2021 WL 4281288 (E.D. Mo., September 21, 2021).

5 *Connelly,* 70 F. 4th 412 (8th Cir. 2023).

Here are some pertinent facts of the case:

- The Connelly brothers owned all the corporation's 500 outstanding shares, with Michael (the deceased) owning 385.90 shares (77.18%) and Thomas owning 114.10 shares (22.82%).
- The corporation's value was about $3.86m (not including the life insurance proceeds).
- The Connelly brothers and the corporation signed a stock purchase agreement giving the surviving brother the option to buy the deceased brother's shares. If the surviving brother did not buy the shares, the corporation was required to redeem the deceased brother's shares. When the agreement was signed, the brothers intended for the corporation and not the surviving brother to redeem the deceased brother's shares.

The agreement provided two mechanisms for determining the redemption price:

- (1) By annually agreeing to the value, or
- (2) If the brothers failed to execute a certificate of agreed value, they would obtain two or more business appraisals.
- The brothers never signed a single certificate of agreed value as required by the agreement.

The corporation bought $3.5m life insurance policies on both brothers to fund the redemption obligation.

Upon Michael's death, the corporation received $3.5m in life insurance proceeds.

Thomas chose not to buy Michael's shares, so the corporation used a portion of the death benefit to redeem Michael's shares from his estate.

Thomas was the executor of Michael's estate.

The corporation and the estate did not obtain appraisals for the value of Michael's shares (as required by the stock redemption agreement) and instead entered into a $3m sale agreement, which provided the estate would receive $3m in cash, Michael's son had a 3 year option to purchase the corporation from Thomas for $4,166,666, and in the event Thomas sold the corporation within 10 years, Michael's son and Thomas would evenly split any gains from the future sale. Thus, the terms of the stock redemption agreement were not followed.

Under *Connelly,* a corporation's stock redemption obligation does not offset the value of the insurance proceeds committed to funding that redemption. The Supreme Court stated a fair market value stock redemption has no effect on any shareholder's economic interest.[6] Additionally, the Supreme Court stated for estate tax purposes, the value of a deceased's shares is as of the time of death before the corporation spends the cash to redeem the shares.[7]

6 An interesting footnote at the end of the Supreme Court's *Connelly* decision stated "We do not hold that a redemption obligation can never decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more."

7 Fair market value for estate tax purposes is generally "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b). However, query if a willing buyer would pay $5m for shares that are required to be redeemed for $3m.

Buy-sell agreements setting the estate tax value

Buy-sell agreements have historically been able to set a company's value for estate tax purposes. Both the district court and Eight Circuit *Connelly* opinions analyzed the fact that a buy-sell agreement may set the purchase price for the shares, but may not necessarily set the fair market value of those shares for estate tax purposes based on IRC § 2703. The fact that neither the Connelly brothers nor the estate followed the terms of the buy-sell agreement is important under an IRC § 2703 analysis. However, the Supreme Court's opinion only made a passing mention of this by stating that "although such an agreement may delineate how to set a price for the shares, it is ordinarily not dispositive for valuing the decedent's shares for the estate tax. See 26 U.S.C. § 2703." Given the Supreme Court's *Connelly* decision, it is unclear if a buy-sell agreement may continue to set the estate tax value of a company.

If a decedent's business interest passes to a U.S. citizen surviving spouse, the estate can claim the unlimited marital estate tax deduction.[8] The value of the assets as of the time of the surviving spouse's death would be included in their taxable estate.

8 The estate tax marital deduction is not available when the surviving spouse is not a U.S. citizen, but there is an exception for property placed in a qualified domestic trust.

Is *Connelly* only an issue for taxable estates?

No. Even for business owners who do not have an estate tax concern, entity redemption arrangements funded with company-owned life insurance may present other issues. Based on Treasury Regulation § 20.2031-2(f) and *Connelly,* the estate tax value of the shares includes life insurance proceeds received by the corporation. The estate tax value of the decedent's shares in *Connelly* was $5.3m. As that is the final estate tax value, the decedent's estate obtains a step-up in basis equal to that value.[9] Note that for pass-through tax entities, the company's receipt of the death benefit may provide the estate with an additional increase to basis.[10] However, the estate only received $3m upon the stock redemption. Therefore, the estate realized a $2.3m capital loss on the redemption. The estate may be able to use that capital loss to offset capital gains.[11] In the estate's final tax year, unused capital losses may be passed through to the beneficiaries.[12]

Executors have a fiduciary duty to estates and may not willingly take a loss on the redemption. An executor may try to make the business give the estate a promissory note for the shortfall so the estate does not recognize a loss on the redemption. Further, buy-sell agreements may include a price adjustment clause so if the estate tax value of a business is higher than the purchase price, the business must pay an additional amount to the seller to cover the shortfall.

If the purchase price per an entity redemption agreement is fair market value, based on *Connelly,* that value would include any insurance proceeds received by the company. While business appraisals historically relied on *Estate of Blount* and *Cartwright* to exclude life insurance proceeds from a business valuation, appraisers may include the death benefit in the business valuation based on *Connelly.* This results in an underfunded arrangement. For example, in *Connelly,* if the $5.3m fair market value would have been the purchase price per the agreement (i.e., appraised value), the corporation only received $3m in insurance proceeds, leaving the corporation liable to pay $2.3m using other assets.

These issues were not addressed in *Connelly.* Given all the potential issues with entity redemption arrangements funded with company-owned life insurance, entity redemption arrangements may be a last resort, even for business owners who do not have a taxable estate. A company could still have an entity redemption plan and keep the ownership of the life insurance outside the business. For example, if a buyout is structured as an entity redemption upon death, life insurance proceeds received by the owners outside of the business could be used by the owners to make a capital contribution or loan to the business so it can redeem the deceased's ownership interest. It will be important for business owners to weigh the pros and cons of each buy-sell arrangement and the different ways to own life insurance funding the agreement.

9 IRC § 1014(a)(1).

10 IRC § 1367(a) and § 705(a)(1)(B).

11 In some situations, the related party loss rules under IRC § 267 may result in the loss being non-deductible.

12 Treas. Reg. § 1.642(h)-1.

Other buy-sell arrangements

Cross-purchase arrangements

With a cross-purchase agreement, the surviving owners purchase a deceased owner's interest in the business. Life insurance-funded cross-purchase arrangements involve each owner being the policyowner and beneficiary of a life insurance policy insuring the other owners. The survivors receive the income tax-free death benefit and increase their tax basis in their business ownership interests when they purchase a deceased's business interest. However, when there are more than two business owners, the number of life insurance policies needed to fund the arrangement multiplies.[13] For example, for a business with five owners, a total of 20 life insurance policies is needed because each of the five owners, would own four policies (one on each of the other owners' lives). Additionally, if the life insurance policies the deceased owned need to be transferred to the surviving owners (other than the insured) to keep the buy-sell agreement fully funded, that transfer may result in a transfer-for-value.[14] When there is a transfer for value, the death benefit exceeding the policy basis (i.e., cumulative premiums paid) is taxable ordinary income. Other issues may arise by having life insurance policies owned by co-owners instead of the business.

The *Connelly* decision should not impact cross-purchase arrangements as the life insurance policies are not owned by the business. The Supreme Court even referred to cross-purchase agreements in *Connelly* and said it avoids the risk the insurance proceeds would increase the value of the deceased's shares.

Shareholders of C and S corporations that currently have a stock redemption plan but want to switch to a cross-purchase arrangement by transferring corporate-owned life insurance policies to the shareholders will have a transfer-for-value issue to deal with. A transfer of a life insurance policy to a co-shareholder is not an exception to the transfer-for-value rule, so the shareholders may need to create a bona fide partnership (or LLC taxed as a partnership) where they are all partners so they can rely on the transfer to a partner exception to the transfer-for-value rule. Otherwise, the shareholders may need to purchase all new life insurance policies to fund the cross-purchase arrangement.

Trusteed cross-purchase arrangements

Trusteed cross-purchase agreements involve a trustee owning one life insurance policy per owner, which limits the number of life insurance policies needed to one per owner like in entity redemption arrangements and the survivors get an increase in tax basis upon a buyout. However, there may be several potential drawbacks to this arrangement, in particular a transfer for value concern. With corporations using a trusteed cross-purchase arrangement, upon the death of the first shareholder to die, the beneficial interest in the deceased's share of the trustee-owned policies shifts to the surviving shareholders, which is a transfer-for-value. There is also the additional cost in establishing and maintaining the trust.

Like regular cross-purchase arrangements, the *Connelly* decision should not impact trusteed cross-purchase arrangements. However, for trustee cross-purchase arrangements used by shareholders of C or S corporations, they may need to create a bona fide partnership (or LLC taxed as a partnership) where they are all partners so they can rely on the transfer to a partner exception to the transfer-for-value rule.

Further, who acts as trustee is important. If the insureds exercise control over the trustee that may be an incident of ownership over the life insurance resulting in the death benefit being included in the insured's estate under IRC § 2042. The business owners may want an independent trustee.[15]

13 Multiple life insurance policies are needed under traditional cross-purchase plans. The number of policies is calculated using the formula n × (n-1), where n equals the number of owners.

14 Under IRC § 101(a)(2)(B), a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer are exceptions to the transfer for value rule. A transfer to a co-shareholder is not an exception.

15 See IRS PLR 9349002.

Other buy-sell arrangements (Cont'd)

Retirement buy-sell arrangement

A retirement buy-sell arrangement is where business owners purchase cash value policies insuring their own lives and endorse the death benefit to their co-owners via a split-dollar agreement. Each business owner purchases and owns a life insurance policy on their own life. The policy's premium is paid by the insured, generally using a bonus or distribution from the business.

An endorsement split-dollar agreement is used to endorse the death benefit to the other business owners. The other owners would pay the economic benefit costs of the protection. The insured's receipt of the economic benefit payment would be taxable income to the insured. The economic benefit cost is measured annually using either the IRS Table 2001-10 rate or the insurance company's term life insurance rates.

If the insured dies, the other business owners receive the death benefit income tax-free, which they use to purchase the deceased's business interest per the buy-sell agreement. The split-dollar endorsement ends if the business is sold or the death benefit is no longer needed for the buy-sell agreement. The amount of the death benefit endorsed each year can be adjusted if the ownership percentages change or the value of the business changes.

There is a transfer-for-value issue with these arrangements in certain situations. The cross endorsement of the death benefits in consideration for the buyouts is a transfer-for-value. If this arrangement is used by shareholders of C or S corporations, they may need to create a bona fide partnership (or LLC taxed as a partnership) where they are all partners so they can rely on the transfer to a partner exception to the transfer-for-value rule.

There is also a potential estate tax issue because the insured owns the policy insuring their life, resulting in the death benefit being included in the insured's gross estate under IRC § 2042. However, the insured's estate can argue that the portion of the death benefit paid to the co-owners provides an estate tax deduction because of the contractual obligation under the split-dollar agreement for the proceeds to be paid to them.[16]

16 See IRS PLR 9026041.

Other buy-sell arrangements (Cont'd)

Special purpose insurance LLCs

The business owners create a cross-purchase agreement requiring each owner to purchase a deceased's business interest. Also, the owners establish the insurance LLC taxed as a partnership using cash basis accounting.[17] The insurance LLC applies for one life insurance policy per owner and the LLC is the policyowner and the beneficiary.[18] Upon an owner's death, the insurance LLC receives the death benefit income tax-free and distributes the proceeds to the survivors, who use the proceeds to purchase the ownership interest from the deceased's estate pursuant to the cross-purchase agreement, resulting in an increase in tax basis equal to the purchase price.[19] Alternatively, the insurance LLC can facilitate the buyout payment by directly transferring the funds to the deceased's estate instead of distributing the funds to the surviving owners (with the same tax treatment).

The death benefit received by the insurance LLC is income tax-free and is allocated to the LLC's surviving members, which provides them with an increase to tax basis in their LLC membership interests.[20] When the insurance LLC distributes the proceeds to the survivors, the distribution is income tax-free.[21] When the surviving business owners use the insurance proceeds to purchase the deceased's business interest in the operating company, the survivors get an increase in tax basis in the operating company equal to their purchase price.

The insurance LLC avoids a transfer-for-value concern because the policies are owned by the insurance LLC and should not be considered to have transferred upon an owner's death. If a transfer is considered to have occurred upon an owner's death, the owners are members of the insurance LLC which is taxed as a partnership, so the transfer to a partner exception to the transfer-for-value rule should apply.

The insurance LLC structure only requires one life insurance policy per owner, like an entity/stock redemption arrangement, but provides an increase to tax basis like a cross-purchase arrangement. Also, upon an owner's death, the insurance LLC maintains control over the life insurance policies insuring the survivors, unlike with a traditional cross-purchase arrangement where upon an owner's death the policies owned by the deceased may end up passing to their heirs as an asset of the estate and are included in the deceased's taxable estate. Further, upon an owner's lifetime exit from the business, the insurance LLC may distribute the policies income tax-free to each insured for use in their own estate plan.

17 IRS PLR 200747002 dealt with an insurance LLC.

18 Local legal counsel should be consulted when establishing a separate entity to own life insurance. While there is precedent for establishing partnerships or LLCs for the purpose of owning life insurance to fund a buy-sell agreement, there is limited guidance and the IRS will not issue a private letter ruling on whether the entity will be treated as a partnership or whether existing policies transferred to the new entity will be exempt from the transfer for value rules of IRC § 101 if substantially all of the entity's assets consist of life insurance policies on the lives of the owners.

19 Under IRC § 101(j) death benefits of life insurance owned by an employer on the life of an employee may be subject to income tax, unless certain notice, consent and reporting requirements are met.

20 Under partnership tax rules, a partnership's receipt of tax-exempt income increases the partners' adjusted basis in their partnership interests. IRC § 705(a)(1)(B). The death benefit received by the insurance LLC is allocated only to the surviving members' capital accounts.

21 Under partnership tax rules, a partnership's distribution of cash to a partner is income tax-free to the extent of the partner's adjusted basis in the partnership interest. IRC § 731(a)(1). The partner's adjusted basis in the partnership interest is reduced for tax-free distributions. IRC § 733 and § 705(a)(2).

Other buy-sell arrangements (Cont'd)

Special purpose insurance LLCs (Cont'd)

There are additional tax benefits upon an unwinding of the buy-sell agreement and the life insurance policies. With cross-owned life insurance policies, the swapping of the policies when the business is sold or liquidated is a taxable exchange.[22] In calculating the gain or loss on the exchange, an owner looks at the value of the policy received compared to the basis in the policy given up. If a corporation owns life insurance policies on the shareholders, the corporation's distribution of a policy to the insured may result in a taxable event.[23] However, under partnership tax rules, which apply to the insurance LLC, the LLC's distribution of a life insurance policy to the insured member should not trigger any gain recognition for the LLC or the member.[24]

The Supreme Court's decision in *Connelly* raises a potential issue with insurance LLCs. The Supreme Court stated life insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value. If this same reasoning is applied to the insurance LLC, the death benefit received by the insurance LLC would increase the LLC's value for estate tax purposes. As the decedent typically has ownership in the insurance LLC, a pro rata portion of the death benefit would be included based on the decedent's ownership percentage in the insurance LLC. *Connelly* dealt with shareholders in a corporation, but there was nothing in the Supreme Court's decision specifically limiting the decision to only corporations. Thus, LLCs and partnerships may also suffer from this same issue.

Special allocations under partnership tax rules are a way to address the death benefit increasing the value of the decedent's interest in the insurance LLC. Partnership tax rules allow for specifically allocating certain items to specific partners under certain circumstances. The insurance LLC operating agreement should specifically allocate the death benefits to only the surviving owners. For special allocations to be respected for tax purposes, they must have substantial economic effect. Thus, to support there being substantial economic effect, the insured should not make capital contributions to the insurance LLC to pay the premiums on the life insurance policy insuring their life; the other owners should make the capital contributions to pay the premiums on the insured's life insurance policy. The special allocation should allow for the buyout of the deceased's insurance LLC interest based on the value of the LLC before receipt of the death benefit. However, there is still the risk that *Connelly* could support the argument that the insurance LLC's value is increased for the death benefit and therefore the value of the decedent's interest in the LLC is also increased for estate tax purposes, especially if the special allocation of the death benefit is not deemed to have substantial economic effect.

Another option could be to create several insurance LLCs. The decedent would not have ownership in the insurance LLC that owns the life insurance policy insuring their life. For example, if Adam, Betty, Clay, and Dan owned a corporation where an insurance LLC buyout structure makes sense, the life insurance policy insuring Adam would be owned in an LLC that is owned by Betty, Clay, and Dan, and vice versa for the other life insurance policies.[25] Upon Adam's death, he would not own the insurance LLC that owns the life insurance policy insuring his life. Only the fair market value of the insurance LLCs that Adam owns at his death (in which no death benefit was paid upon his death) would be included in Adam's gross estate. This arrangement, however, would have the disadvantage of requiring several LLCs and since the insured is not a member of the insurance LLC that owns their policy, the ability for the LLC to make a tax-free distribution of the life insurance policy to the insured would not be an option.

22 IRC § 1001(a) states that "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis."
23 Under IRC § 311(b), a corporation that distributes a corporate-owned life insurance policy to the insured shareholder will recognize taxable income equal to the policy's gain. This applies to S corporations as well. IRC § 1371(a).
24 IRC § 731(a)-(b) and § 732(a)(1).
25 Another option could be to have multiple owners on one life insurance policy. For example, Betty, Clay, and Dan could co-own one life insurance policy insuring Adam.While this reduces the number of policies needed, there is a transfer-for-value issue because, similar to a trusteed cross-purchase arrangement, upon the death of the first shareholder to die their ownership share of the policy shifts to the surviving shareholders, which is a transfer-for-value. Additionally, having multiple owners on one policy can be problematic because all owners generally need to sign off on policy transactions and the policy ownership and policy beneficiary percentages should be aligned to avoid adverse tax consequences.

Key person life insurance

Business owners should consider how company owned key person life insurance policies may impact their business valuations. Under *Connelly* and Treasury Regulation § 20.2031-2(f), insurance proceeds received by the business would increase the business value for estate tax purposes. Where feasible, business owners may consider alternative ownership options for key person life insurance instead of having the policy owned by the business, especially for key person life insurance insuring the business owners. For company-owned life insurance insuring a non-owner key employee, if the insurance proceeds will be spent to hire a replacement and/or to pay expenses, there may be a relatively short period of time where the value of the business would include the insurance proceeds.

Nonqualified deferred compensation informally funded with company-owned life insurance

Nonqualified deferred compensation plans may be informally funded with company-owned life insurance. Insurance proceeds received by the company would increase the company's value for estate tax purposes. Where feasible, companies may consider alternative ownership options for life insurance that is informally funding a nonqualified deferred compensation plan instead of having the policy owned by the business. For company-owned life insurance insuring a non-owner key employee, if the insurance proceeds will be used to pay the employee's family the deferred compensation, there may be a relatively short period of time where the value of the business would include the insurance proceeds.

Conclusion

In the past, entity redemption agreements allowed a business to own a life insurance policy to redeem an ownership interest while removing the death proceeds from the business' valuation for estate tax purposes. However, the Supreme Court's decision in *Connelly* changes that. Now, entity redemption arrangements funded with company-owned life insurance may result in the value of the company plus the value of the insurance proceeds being included in the deceased's gross estate. Further, depending on the terms of the buy-sell agreement, a decedent's estate may realize a loss on a redemption or result in an underfunded agreement.

Business owners should consider other buy-sell arrangements before an entity redemption arrangement. Trusteed cross-purchase arrangements, insurance LLC arrangements, or retirement buy-sell arrangements may be preferable for many business owners. Entity redemption agreements are still valid, but instead of company-owned life insurance other ownership options of the insurance funding should likely be considered.

Business owners should periodically review their buy-sell agreements and life insurance funding. Given *Connelly,* now is a good time to review buy-sell agreements, business valuations, and life insurance funding.

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