Connelly v. United States (2024)

How this game-changing decisions will adversely affect insurance funded buy-sell agreements.

Summary of Case.

Two brothers entered into a buy-sell agreement with a corporation owned by them that ultimately required the corporation to buy a deceased shareholder's shares.

The purchase price was to be set under a certificate of value approach, although the brothers never signed one.

The company's obligation was funded with life insurance policies on the two brothers' lives, each of which policies was owned by the corporation, and the corporation was designated as the beneficiary.

Following the death of one of the brothers (who owned about 77% of the company), the estate and the corporation agreed not to have an appraisal of the shares completed. Instead, they agreed upon a $3 million purchase price, to be paid using a portion of the $3.5 million of life insurance proceeds paid to the corporation.

The estate reported the value of the shares on its estate tax return at about $3 million.

The IRS assessed additional estate tax, based in part on its assertion that the proceeds paid to the corporation should have been taken into account in determining the value of the corporation and value of the decedent's shares. The estate paid the additional estate tax and filed a claim for refund. The court considered whether the buy-sell agreement should be valid to set the purchase price (not discussed here) *and whether the life insurance proceeds used to purchase the estate's shares should be considered in determining the value of the shares for estate tax purposes.*

Resolution.

The district court and the Eighth Circuit Court of Appeals both determined that the proceeds should be included in determining the value of the decedent's shares, and disagreed with the rule of *Estate of Blount v. Commissioner* (2005) that, although the amount of the proceeds received by the corporation increases its value, the contractual obligation of a company to purchase the decedent's shares offsets this amount on a dollar for dollar basis.

The U.S. Supreme Court affirmed, reasoning, among other things, that: (1) a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself; (2) a valuation that reduces the value by the redemption obligation effectively incorrectly values the corporation on a "post-redemption" basis; (3) no willing buyer purchasing the decedent's shares would have treated the corporation's obligation to redeem the shares at fair market value as a factor that reduced the value of those shares; and (4) treating the redemption obligation as a liability cannot be reconciled with the basic mechanics of a stock redemption.

Example: If A and B each owns 50% of COMPANY, COMPANY has a value of $10 million (determined under an appraisal), A and B enter into an insurance funded redemption agreement, and Company purchases a $5 million life insurance policy on the life of each of A and B, then upon A's death, under *Connelly*, COMPANY'S value will be immediately increased by $5 million (to $15 million) upon its receipt of the insurance proceeds under the policy insuring A. A must include $7.5 million (50% of $15 million) as the value of A's shares of COMPANY on A's estate tax return.

Implications and Strategies.

Redemption Agreements. In any case where the potential seller of an interest in an entity has or could have an estate tax liability exposure, avoid using insurance funded redemption arrangements.

Use Cross Purchase Structures. Under this approach, the remaining owners agree to directly purchase the shares of a deceased owner. Where insurance is involved, the owners will purchase and own policies insuring the lives of each other owner. The insurance funding will be "outside the entity", will not increase the entity's value at the death of an owner, and the purchasing owners will receive a step-up in the basis of the acquired shares. This is easy where there are two owners and more difficult where there are multiple owners.

Partnership Insurance Structure

If an entity has multiple owners, the recommended strategy is to have the owners form a separate partnership (or LLC) to own a single life insurance policy on each owner's life, rather than having each owner purchase a life insurance policy on each other owner's life. In this arrangement, the business owners form a separate partnership or LLC (entity) to acquire, own and manage life insurance policies purchased on the lives of each owner, pursuant to an insurance funded cross-purchase agreement.

- Key Features
  - Ownership: Each business owner becomes a partner or member of the entity. Each business owner's % interest in the entity is the same as the owner's % interest in the business.
  - Policy Management: The entity purchases and owns a single life insurance policy insuring the life of each business owner.
  - Funding: The partners/members contribute funds to the entity to pay the insurance premiums, pro-rata, based on their % interests or another arrangement.
  - Beneficiary: The entity is named as the beneficiary of all of the policies.
  - The written agreement governing the entity aligns with the existing cross-purchase agreement.
  - If a business owner dies, the entity collects the proceeds paid under the policy insuring the deceased owner, and distributes the funds to the other partners/members, to be used by them to purchase their proportionate share of the interest of the deceased owner.
- Advantages
  - This structure reduces the number of policies required.
  - Administrative Ease: With fewer policies to manage, the arrangement becomes much simpler to administer and maintain.

  - Cost Equalization: The entity can equalize the cost of premiums among partners/members, addressing situations where there are significant age or health differences between owners.
  - Flexibility: It is easier to add or remove partners/members as the business evolves and ownership interests change, without needing to restructure multiple individual policies.
  - Privacy: Individual owners don't need to directly own policies insuring other owners, which can enhance privacy and simplify personal financial planning.
- Implementation Process
  - Form the entity specifically for insurance ownership purposes.
  - Enter into an agreement that: outlines how the entity will function; sets forth the owners' respective ownership interests; sets forth the capital contributions required from each owner; and provides for what happens if an owner withdraws from the business (which should require the owner's withdrawal from the entity and a possible return of such owner's capital contribution to the entity).
- Compliance: Ensure that the structure complies with insurance regulations.
- Taxation
  - Ensure that the transfer of any existing polices doesn't violate the transfer-for-value rule. (Note - For partnerships specifically, the transfer-for-value rule is not applicable with respect to transfers to a partner of the insured or to a partnership in which the insured is a partner.
  - Life insurance proceeds received by a beneficiary (the entity) are generally income tax-free, both as to the entity and the partners/members.
  - The death benefit received by the entity is tax-exempt income that will be allocated to the non-insured members and will increase the tax basis of each partner/member in his or her interest in the entity. Because of this, the distribution of the proceeds received by the entity to the non-insured partners/ members is not taxable to the extent of his or her tax basis.
  - A partner/member is not required to reduce the basis of his or her interest in the entity on account of life insurance premium payments paid by the entity.
  - When the entity receives the proceeds upon the death of a partner, the proceeds are generally not included in the deceased partner's/member's gross estate for estate tax purposes.