Bye Bye Buy-Sell? Not Quite, But Court Decision Changes the Planning Calculus

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First the Facts

On June 6, 2024, the U.S. Supreme Court (SCOTUS) rendered a unanimous decision in Connelly v. the U.S. (Connelly) that was not only unfavorable to the estate—to the tune of $889K in additional federal estate taxes—but carried far-reaching implications beyond the facts of the case.

Essentially, two brothers executed a buy-sell agreement that gave each the *option* to buy out the other upon his death, but *required* the corporation to buy the shares if the surviving brother declined. The corporation purchased life insurance to help fund its eventual obligation—as is typical with such agreements. Unfortunately, the face amount purchased—$3.5 million—wasn't tied to any valuation established in the agreement. The value of the deceased brother's shares was determined after the fact, in rather dubious circumstances. Bottom line: the brothers didn't follow their own agreement.

An Unexpected Decision

However, what SCOTUS decided far exceeded what many expected. Instead of "zeroing out" the life insurance amount that was used to buy the deceased brother's shares (as did the executor in valuing them), SCOTUS *added* the life insurance proceeds received by the corporation to value the deceased brother's shares in proportion to his ownership (even though that amount wouldn't have existed but for the brother's death!).

This resulted in the deceased brother's shares being valued at $5.25M … $4M value (determined after death) *plus* $3M in life insurance *multiplied* by 75% ownership interest. SCOTUS reasoned that the corporation's obligation to purchase a deceased owner's shares didn't offset receipt of life insurance proceeds to satisfy that obligation and that it instead could have used operating assets to do so (life insurance being a "non-operating" asset).

Putting the Decision in Perspective

While the facts of Connelly may have made the decision somewhat easier for SCOTUS to reach, a broader perspective requires a hard look at existing entity buy-sell agreements and additional considerations in purchasing life insurance to fund such agreements going forward.

For example, the corporation may need to buy additional life insurance to cover the additional estate tax liability, even though that would seem to exacerbate the issue (talk about a catch-22!). Alternatively, closely held businesses may need to consider cross-purchase agreements, despite the possible headache of having to purchase additional policies, or consider forming an Insurance LLC to own the policies, which itself adds costs and complexity. If a business proceeds with an entity-buy sell agreement in which the primary funding vehicle is a non-operating asset such as life insurance, the agreement must be deftly drafted and dutifully administered in light of Connelly.

The calendar presents an added consideration. Namely, the fact that historically high lifetime estate and gift tax exemption amounts are set to expire at the end of 2025 unless extended by Congress. That means that even more businesses could be ensnared by the nuances of Connelly.

Partner with Experience and Expertise

At the end of the day, the response from the financial professional to consult both legal and tax advisers regarding the appropriate form of buy-sell agreement to adopt has never been truer. The importance of drawing on these resources is all the more so with a potential increased estate tax liability looming for more businesses after 2025.

Fortunately, Advanced Markets has the skills and tools to prepare an estate tax analysis that can help guide the financial professional, the client's CPA and lawyer in determining whether the client is likely to have an estate tax liability and, if so, then designing and funding a buy-sell agreement in a way that makes sense and avoids the ramifications of Connelly.

For more information, contact the Lafayette Life Advanced Markets team today!
Call 877.238.6587, Option 3, or email advancedmarkets@lafayettelife.com.

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