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Supreme Court decision impacts life insurance-funded buy-sell agreements

Business owners should review and amend agreements

On June 6, 2024, the U.S. Supreme Court decided a case that will affect all business owners who have life insurance-funded buy-sell agreements — specifically, agreements commonly referred to as "entity purchases" or "stock redemptions." The decision has muddied the waters around buy-sell strategies by reversing generally accepted principles long held by the estate and business planning community.[1]

In the Connelly decision, the Court addressed the narrow question of whether a corporation's fair market value — where the corporation has an obligation to redeem a decedent owner's shares — is impacted by life insurance proceeds received by the corporation and committed to funding the redemption for estate tax purposes. The Court unanimously held that the corporation's redemption obligation is not a liability that reduces the estate tax value of the decedent's shares and that the death benefits received by the corporation must be included as part of the estate tax valuation.

The message is clear: All buy-sell agreements, or provisions in corporate shareholders agreements, LLC operating agreements and partnership agreements, should be reviewed.

Agreements will need to be amended as valuation is impacted

The message is clear: All buy-sell agreements or provisions in corporate shareholders agreements, LLC operating agreements and partnership agreements, should be reviewed, **particularly if the agreements call for the business to buy back the ownership interest of a deceased owner and the business purchases life insurance on the owner to do that.**

Even if they do not specifically refer to a life insurance-funded buyout, the Connelly decision still affects the purchase price of the business. It is certain that life insurance-funded buy-sell agreements will produce HIGHER death-time business valuations versus unfunded arrangements, as the life insurance death proceeds payable to the business MUST be included in the valuation. Someday this point will be litigated as to why an agreement was not funded with life insurance as higher business valuations could be achieved.

Connelly case background

The Connelly case involves two brothers, Michael and Thomas Connelly, who were the sole owners of Crown C Corporation, a C Corporation ("Crown"). The brothers entered into a buy-sell agreement to, in part, determine what to do if one of the brothers died. Michael was the majority shareholder, having a little more than 77 percent of the company. Thomas was the minority shareholder with 22 percent. The agreement stated that the business would be valued via a Certificate of Agreed Upon Value, and Crown C purchased $3.5 million of life insurance on Michael's life and $3 million on Thomas' life. The buy-sell agreement stated that the brothers were to execute a Certificate of Agreed Upon Value annually. This requirement and several other provisions of the agreement were not followed. Michael died in 2013. Thomas was appointed executor of Michael's estate and the Connelly family agreed upon a valuation of Crown C at $3.89 million. As Michael owned 77.18 percent of the corporate shares, his ownership was valued at $3 million. Crown received the life insurance proceeds of $3.5 million, redeemed Michael's shares for $3 million and used the remaining $500,000 to fund company operations.

The IRS audited the estate tax return for Michael's estate. Michael's estate obtained a valuation that excluded the $3.5 million in life insurance proceeds used to redeem Michael's shares on the theory that the insurance was offset by the redemption obligation. This theory had previously been litigated in the Estate of Blount v. Commissioner, 428 F.3d 1338 (11th Cir. 2005). The court had stated that the redemption agreement created an offsetting liability to the receipt of the insurance proceeds and that the proceeds should be disregarded in the valuation. The IRS disagreed. The IRS valued the company at $6.86 million, bringing Michael's ownership stake up to $5.3 million. This resulted in an estate tax deficiency of nearly $900,000. Michael's estate paid the deficiency and then sued for a refund.

The U.S. District Court for the Eastern District of Missouri granted summary judgment to the IRS.[2] It rejected the estate's reliance upon a higher court decision from the U.S. Court of Appeals for the 11th Circuit, issued in 2005, known as the Blount case, which held that life insurance proceeds used for a stock redemption should be excluded from the determination of fair market value for the business.[3] Another appellate decision from the 9th Circuit, issued in 1999, known as the Cartwright case, was acknowledged but not found to be directly on point or persuasive.[4] It is these two Circuit Court opinions that the life insurance industry and attorneys practicing in business continuation have relied upon for many years.

The estate appealed the decision to the 8th Circuit Court which had jurisdiction over the region but lost.[5]

On December 13, 2023, the U.S. Supreme Court granted the estate's petition to hear the case since there were now competing Circuit Court opinions.[6] Oral arguments were held on March 27, 2024. During arguments, IRS Counsel stated: "It is correct that after the redemption, Crown becomes a smaller company. That's how redemptions work. But, if you're looking at the total value that the Connelly family walked away with, they are going to walk away with a total of $6.86 million. Some of it was used to buy out Crown — buy out Michael, and some of it was [not] used to [buy out] Crown."[7]

IRS Counsel further argued: "Tax advisors tend to be risk averse. I think they would be very well aware of the fact that **there are other ways to structure this, like the cross-insurance agreement or held by a trust or various ways in which the critical piece is that the life insurance proceeds do not go into the corporation,** because the premise of Blount and Cartwright, the court of appeals decisions, is that somehow you can have money come into a corporation and have it not count when you're valuing shares in the corporation. (emphasis added)"[8]

On June 6, 2024, the U.S. Supreme Court issued its decision affirming the lower court's decision. "We hold that Crown's contractual obligation to redeem Michael's shares did not diminish the value of those shares. Because **redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax,** we affirm the judgment of the Court of Appeals. (emphasis added)"[9]

Evaluate the impact on your business

Business owners who have entity purchase or stock redemption buy-sell agreements need to consult with their financial team to determine how their situation is impacted by this Supreme Court decision. It may be that buy-sell agreements or provisions need to be modified and amended to convert entity purchase and stock redemption arrangements into cross-purchase arrangements where co-owners buy each other out, leaving the business entity out of the transaction. More sophisticated techniques may need to be used, such as the creation and use of a Special Purpose or Insurance Only LLC like Life Cycle to own the life insurance policies to be used in a cross-purchase arrangement. There are numerous insurance, tax and legal consequences to these considerations and decisions.

What you and your financial professional can do in light of the decision

The Connelly decision must be addressed by all business owners. You and your financial professional team need to review your business goals and decide what is the most advantageous strategy from the following most common buy-sell techniques.

- Entity purchase/Stock redemption
- Cross purchase
- Wait-and-see
- Right of first refusal
- One-way buy-sell
- Trusteed buy-sell
- Cross endorsement buy-sell
- Special purpose LLC buy-sell
- Wealth transfer techniques
- Funded or unfunded

Of these techniques, the entity or stock redemption agreements are most directly affected. "Wait-and-see" buy-sells have also changed. The Connelly agreement was a "wait and see" with a right of first refusal to Thomas. When Thomas refused, the redemption agreement became mandatory. Regardless of the nature of the agreement, because the insurance was held by the company the value of the company was increased by the proportional amount of the death benefits paid. This means that the choice to fund with company-owned insurance may be a decision that directly affects the value of the business for many types of valuations.

Typically, wait-and-see arrangements were funded as redemptions. Now it might be advisable to set them as a cross-purchase or a Life Cycle buy-sell. However, the choice to fund the transaction at all is now an event which can be questioned by current and future owners. There may come a time in the not-so-distant future where insurance-funded redemption buy-sell agreements are a huge benefit for surviving shareholders. Imagine a company worth $1,000,000 with three owners each having a company-owned policy worth $333,333. When the first Owner A dies, the death benefit would be paid to the company and the company would be worth $1,333,333, of which the $333,333 is payable to A's estate on an installment note over 10 years of equal payments at 5 percent interest. B & C would own the company 50/50 and the note payable. In year one, the value of the company is $1,333,333 less the first payment of $33,333.30 so B&C now own 50 percent of a company worth $1.3 million or $667,000 each. Their company is more valuable than under a cross purchase as they would have bought out A at $333,333, the company would still be worth $1,000,000 and their shares $500,000 apiece. Such is the world of business continuation post-Connelly.

In light of this decision, you and your financial professional must consider options and decide on the best use of life insurance in a buy-sell arrangement.

1. Connelly v. US, 144 S Ct 1406. (2024)
2. Connelly v. United States, Case No. 4:19-cv-01410-SRC (E.D. Mo. Sep. 21, 2021)
3. Estate of Blount v. Commissioner, 428 F.3d 1338 (11th Cir. 2005)
4. Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999)
5. Connelly v. United States, 70 F4th 412 (8th Cir. 2023)
6. Connelly v. United States, 70 F4th 412, (8th Cir. 2023), cert. granted, 2023 WL 8605743, No. 23-146 (S.Ct. Dec. 13, 2023)
7. https://ballotpedia.org/Connelly_v._Internal_Revenue_Service (p. 46) Id.
8. (pp 50-51)
9. Connelly v. US, 144 S Ct 1406. (2024)

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