ADVANCED PLANNING

# Supreme Court Upends Redemption Buy-Sell Agreements: Connelly v. U.S.

On June 6, 2024, the U.S. Supreme Court issued its opinion in *Connelly v. United States*, holding that a life insurance death benefit payable to a business for purposes of purchasing and redeeming the decedent's stock increases the value of the business and, consequently, the decedent's estate. The opinion settles the circuit split between the Eighth Circuit's opinion in the case and the 2005 Eleventh Circuit decision in *Estate of Blount v. Commissioner*. A unanimous Court held that life insurance death benefits paid or payable to a business to fund a share redemption buyout of a deceased shareholder increase the value of the shares in the decedent's estate and are not offset by any corresponding obligation to purchase such shares.

## BACKGROUND

Life insurance is often used to fund entity purchase buy-sell arrangements where a business purchases coverage on the lives of its owners to buy out and retire a deceased owner's share. An obvious question raised in such arrangements is whether the value of a death benefit is offset by the business's obligation to purchase that owner's share. The 2005 case *Estate of Blount v. Commissioner*, and, before it, *Estate of Cartwright vs. Commissioner* (1999), answered this question in the affirmative: a life insurance death benefit, considered as an asset, is offset dollar-for-dollar inasmuch as it fulfills the business's obligation to purchase the decedent's portion of the business. As an appellate court decision, *Estate of Blount* held sway in American jurisprudence and, consequently, in the practice of business succession planning.

Then along came *Connelly*. The case concerned brothers Michael and Thomas Connelly, co-owners of Crown C Supply. The company held life insurance on both brothers, with the funds set aside to redeem their shares upon their deaths. After Michael's death, Crown used $3 million in insurance proceeds to redeem his 77.18% interest in the company. Owing to various failures, Crown's agreement was found deficient with respect to S. 2703, and the Court was therefore required to determine value for estate tax purposes.

Connelly's executor argued that the company's worth was $3.86 million at the time of Michael Connelly's death and that the $3 million in proceeds used for the redemption did not increase that value. The IRS disagreed, included those proceeds in its estate tax valuation of Crown, and claimed the company was instead worth $6.86 million. The federal estate tax exemption in 2013 was $5.25 million. The IRS determined that based on this higher valuation, the estate owed an additional $889,914 in taxes.

The Supreme Court sided with the IRS, affirming a decision by the Eighth Circuit, which in 2023 created a "circuit split" against Blount by siding with the original district court ruling from 2021.

## ANALYSIS

The Court's reasoning centered on the idea that a share purchase obligation by itself does not depress share value. It reasoned, a redemption agreement between a company and its shareholders, whether funded or unfunded, would not effectively count as debt owed by the company to an outside party as this does not meet the basic mechanics of a stock redemption. In the words of the Court, "Because a fair-market-value redemption has no effect on any shareholder's economic interest, no hypothetical buyer purchasing [Connelly's] shares would have treated [company's] obligation to redeem [the] shares at fair market value as a factor that reduced the value of those shares." The Court relied on the IRS's representation that a willing buyer would disregard the obligation to purchase the decedent's share because a share redemption at fair market value does not affect any shareholder's economic interest. Therefore, a buyer would purchase the shares and their equivalent value in cash (the life insurance death benefit).

## IMPACT

While it is not yet clear how most entity purchase taxpayers and their advisors have reacted to this ruling, the sobering fact remains that the opinion singles out the purchase of life insurance as the factor driving the holding. And because Supreme Court rulings are not legislative or administrative in nature, they rarely prescribe guidelines or timeframes as to their implementation – in other words, there are no “grandfathering” terms to be found here; all existing entity purchase buy-sell agreements are subject, and taxpayers should consult with their attorneys and tax advisors on the implications to their specific arrangements.

Reactions may generally be divided into three categories:

- ***Rejecters*** – Eliminate all ambiguity and switch to cross purchase arrangements (including trusteed/escrowed arrangements, and possibly wait-and-see agreement types). Where life insurance is already owned by the company, questions of policy valuation and S. 101 transfer-for-value will have to be resolved. This group will likely include those, like Connelly, whose companies are majority-owned by one individual who risks undervaluing their shares for estate tax purposes in a life insurance-funded redemption arrangement. But where there are more than two insured owners, setup and administration of cross purchase plans can be much more complicated than a redemption plan.
- ***Accommodators*** – Accept the risk that life insurance may inflate share value in favor of its many practical benefits. This seems most likely among taxpayers who are roughly co-equal owners in their businesses, the value of whose stakes is less likely to cause significant adverse estate taxation. Example: where there are ten equal owners, the death of one can only increase their share value by 10%, since a death benefit insuring 10% of 100% only increases the company’s value to 110%/10.
- ***Careful drafters*** – Some planners will take note of the reason Connelly, and Blount before it, landed in court in the first place: in each case, the buy-sell agreements failed the safe harbor tests found in IRC S. 2703. Amendments to existing agreements with careful adherence to the terms of 2703 might effectively “audit-proof” the entity purchase buy-sell agreement by reducing or eliminating the IRS’s ability to dispute a valuation clause.

## CONCLUSION

Entity-purchase buy-sell planning agreements funded with life insurance are not dead; however, they should be reviewed in light of the Supreme Court’s decision. And though this may be a huge collective undertaking, the process also presents a tremendous opportunity for policy review. Financial professionals should encourage clients to consult with the clients’ own attorneys and tax advisors to review their buy-sell agreements and related funding, and keep tabs on the outcomes.

What they may find is that the Connelly case effectively puts entity-purchase agreements funded with life insurance on a risk spectrum: at one end are Connelly-type scenarios involving a supermajority shareholder and an improperly drafted/disregarded agreement; on the other end are business owners facing low-stakes tax consequences and following well-written agreements. The decision to use entity purchase is therefore no longer just about weighing the pros and cons of ease of administration vs. lack of basis step-up – the final, “true” cost of using life insurance to fund the agreements must be considered. In many cases, no doubt, life insurance will still be worth it.

If you have a buy-sell planning opportunity, Prudential’s Individual Life Advanced Planning team wants to help. We look forward to being of assistance, and can be reached at 800-800-2738, Option 4.



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