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Estate Planning Update Summer 2024 - Beware of the Corporate Buy-Sell: U.S. Supreme Court Issues Decision Impacting Life Insurance Funded Arrangements

On June 6, 2024, the U.S. Supreme Court released its much-anticipated decision in *Connelly v. United States*, causing an uproar in the world of insurance-funded buy-sell agreements. As a result of the Connelly decision, the value of life insurance proceeds received by a company upon the death of a shareholder will be included in the date-of-death value of the company, but the company's obligation to redeem the deceased shareholder's stock in exchange for those proceeds cannot be deducted for federal estate tax purposes.

Facts and Decision

Connelly involved two brothers who were the only shareholders of a closely held corporation. The brothers established a buy-sell agreement, and the company purchased life insurance on each of their lives to provide a fund to purchase the stock when one of the brothers died. When the first brother died, the surviving brother had the option to purchase the deceased brother's shares, which he did not exercise. Under the buy-sell agreement, the corporation was then obligated to redeem the deceased brother's shares, which the corporation did using the life insurance proceeds it received as the designated beneficiary of the policy when the first brother died. Upon audit of the deceased brother's estate tax return, all parties agreed that the corporation's valuation for federal estate tax purposes included the life insurance proceeds the corporation had received; however, the IRS disallowed a corresponding deduction representing the corporation's obligation to redeem the stock. The U.S. Supreme Court sided with the IRS and unanimously held that a corporation's contractual obligation to redeem stock pursuant to a buy-sell agreement is not necessarily a deductible liability that reduces a corporation's value for purposes of the federal estate tax. As a result, the deceased brother's estate paid more federal estate tax than anticipated.

Impact

The use of a buy-sell agreement and company-owned life insurance to fund obligatory purchases has been a staple of business succession planning for decades. As a result of the Connelly decision, clients having corporate-owned life insurance to redeem a deceased shareholder's stock must reevaluate and revamp their business succession plans. But while the Connelly decision negates effective planning with company-owned life insurance, it gives credence to another commonly used strategy.

In writing the opinion for the Court, Justice Clarence Thomas addressed (and in doing so, supported) the use of cross-purchase agreements between shareholders as a viable strategy. In a cross-purchase structure, each business owner purchases a life insurance policy insuring the life of the other owner, personally pays the premiums, and is the beneficiary of the policy. The face amount of the policy is based on the value of the other owner's interest in the company. While the strategy sounds simplistic, the pros and cons must be evaluated in each case. For instance, an age discrepancy between the shareholders can cause one shareholder's premiums to be much higher than another's. In addition, if shareholders are paying premiums individually, there is more opportunity for late or missing premium payments, which can cause policies to lapse.

Furthermore, the more shareholders there are, the more complex (and expensive) the cross-purchase agreement can get. Finally, shareholder-owned life insurance strategies require the shareholders to properly establish and regularly update their personal estate plans.

If you own a closely held business with at least one other partner, please contact your Day Pitney estate planning attorney to review your business succession plan and discuss its viability in light of the Connelly decision.