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SUPREME COURT RULING IN CONNELLY V. UNITED STATES

On the death of a shareholder, the increase in the value of a corporation due to life insurance proceeds payable to the corporation to fund a stock redemption buy-sell agreement is undiminished by the obligation to redeem the decedent's shares.

In *Connelly v. United States,*[1] the Supreme Court of the United States ruled unanimously that the life insurance proceeds payable to a corporation to fund a stock redemption increases the value of the business for federal estate tax purposes, and this increase is not offset by a corresponding reduction in business value due to the stock redemption obligation. This case resolved a conflict between the *Connelly* holding in the 8th Circuit Court of Appeals and the *Blount v. Commissioner* holding in the 11th Circuit Court of Appeals.[2, 3] To put this decision in context, it is a narrow holding in that it will not apply if the requirements of Code Sec. 2703(b) exceptions and the case law to fix the value of the business for estate tax purposes are all met. However, with heightened IRS scrutiny of any buy-sell agreement, caution and a more conservative approach are advised.

BACKGROUND AND HOLDING

Two brothers were sole owners of Crown C Supply, a small building supply corporation.

Michael (decedent)	77.18%
Thomas	22.82%
Total	100.00%

The brothers executed a "wait-and-see" buy-sell agreement providing that the surviving brother would have the option to purchase the decedent's shares followed by the corporate obligation to redeem any remaining shares. Life insurance on each brother was purchased by the corporation to fund the agreement. During their lifetime, the brothers ignored the valuation clause that required them to update the value each year. Upon Michael's death, again ignoring the valuation clause in the agreement, Thomas and

1 Connelly v. United States, Supreme Court of the United States, No. 23-146 (June 6, 2024)
2 Estate of Blount v. Commissioner, No. 04-15013 (11th Cir., October 31, 2005)
3 Connelly v. United States, No. 21-3683 (8th Cir., December 14, 2022)

the decedent's son agreed in an "amicable and expeditious manner" that the value of Michael's 77.18% interest was $3 million. They subsequently had an accounting firm value the business at $3.86 million excluding the life insurance proceeds.

The IRS determined on audit that the value of the business should include the life insurance proceeds and valued Michael's interest at $5.3 million (77.18% x [$3.86 million + $3 million]). The district court ruled in favor of the IRS and, on appeal, the 8th Circuit Court of Appeals affirmed the district court ruling.

The 8th Circuit Court of Appeals focused on the fact that, having ignored the valuation provisions during their lifetime and after Michael's death, the agreement failed to establish a fixed or determinable price as required by Code Sec. 2703(a) and existing case law.

This holding created a conflict with the 11th Circuit Court of Appeals *Blount* decision. In *Blount*, the Court ruled that the redemption obligation did in fact offset the increase in value due to life insurance proceeds payable to the business to fund a stock redemption obligation.

Affirming the 8th Circuit Court of Appeals ruling in favor of the IRS, the Supreme Court of the United States held unanimously that the life insurance proceeds payable to a corporation increases the value of the business for federal estate tax purposes with no corresponding offset for the stock purchase liability.

While having sold the business interest for $3 million, Michael's estate was responsible for an additional $920,000 of federal estate taxes (40% x [$5.3 million – $3 million]).

CODE SEC. 2703 AND EXISTING CASE LAW

The *Connelly* Supreme Court decision is, in fact, a narrow holding. If the Code Sec. 2703 and existing case law requirements are all met, the agreement will fix the value of the business for estate tax purposes. In other words, in that case, the *Connelly* Supreme Court decision is rendered inoperative.

CODE SEC. 2703

Code Sec. 2703(a) provides that any right to acquire property at a price less than the fair market value will be disregarded unless:

1. It is a bona fide business arrangement.
2. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
3. Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

EXISTING CASE LAW

The existing case law requirements to fix the value of the business for estate tax purposes:

1. An estate must be obligated to sell at death.
2. The price must be fixed by the agreement or contain a method or a formula for valuing the business.
3. If selling during an owner's lifetime, the interest must first be offered to other owners at the agreement price.
4. The price must be fair and adequate when made.

PLANNING POINTERS

Whether the business is operated as a 'C' or an 'S' corporation, an LLC or as a partnership, all buy-sell agreements (redemption as well as cross-purchase) and business-owned life insurance coverage should be reviewed in light of the Code Sec. 2703(b) exceptions, existing case law requirements, and, with respect to redemption agreements, the *Connelly* Supreme Court decision:

1. In the family setting, it is extremely difficult to meet the requirements of Code Sec. 2703(b)(2) that the agreement is "not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth". In that case, a redemption agreement should typically be recast as a cross-purchase arrangement and business

owned life insurance policies should be purchased by, or distributed to, the noninsured shareholders.[4] (A discussion of transfer for value follows.)

2. In the unrelated shareholder/owner setting, although it is possible to meet the requirements of the Code Sec. 2703(b) exception, caution is advised. The heightened IRS scrutiny and audit risk as well as the negative repercussions if one of the three 2703(b) exception requirements is not met represent risks that may not be worth taking. If the business owner's counsel feels that the 2703(b) exemptions and the case law are all met and that the redemption agreement should be left in place, as a precautionary measure (i.e., as "insurance" against *Connelly*), the life insurance could be sold or distributed to the noninsured owners. On death, the surviving owners could loan the death proceeds to the business or contribute it to capital, providing the business with funds to redeem the decedent's interests.
3. As an alternative form of cross purchase buy-sell agreement, a life insurance only LLC, may be appropriate. Relying on special partnership allocations, each policy is owned for the benefit of the noninsured business owners.[5]
4. **Although the current emphasis is on redemption buy-sell agreements, and while not subject to the Connelly Supreme Court holding, even cross-purchase agreements should be reviewed to determine whether they meet the requirements of Code sec. 2703(b) and the existing case law and whether they should be revised.**
5. For all buy-sell agreements, the *Connelly* cases emphasize the importance of (1) adhering to a valuation clause that accurately reflects the fair market value of the business, (2) the importance of strictly observing all of the formalities of the agreement, and (3) the ownership and beneficiary of each buy-sell policy aligning with the party obligated to purchase a decedent's interest.
6. A review should include all corporate-owned policies, for example, key person policies and those funding nonqualified executive benefit plans for owners.

'C' AND 'S' CORPORATIONS

7. Transfer for Value
   a. The sale or distribution of corporate-owned policies to the noninsured shareholders will violate the transfer for value rule unless within an exception to the rule. The most likely exception is a transfer to a partner of the insured — that is, where each business owner also owns an interest in a common LLC or partnership (taxed as a partnership for federal tax purposes). For example, the business owners may each own an interest in an LLC that owns the business real estate.
   b. If the transfer of the policy is not within an exception to the transfer for value rule (1) new coverage may be called for (owned by, paid for, and payable to, the noninsured shareholders) or (2) the policies could be sold or distributed to the insured.
   c. With a life insurance-only LLC, since the business owners are now all partners, a purchase of the corporate-owned policies will be within the partnership exception to the transfer for value rule.
8. A sale or distribution of a permanent policy by a 'C' or an 'S' corporation where the value of the policy exceeds the corporation's cost basis will trigger taxation of the gain. Whether the policy is distributed or sold, in effect, the corporation is treated as if it sold the policy.

LLC OR PARTNERSHIP OPERATING BUSINESSES

9. An operating business organized as an LLC or a partnership (taxed as a partnership for federal tax purposes) has more favorable treatment than a corporation in two important respects. First, the distribution or sale of an LLC or partnership-owned

4 A distribution from a 'C' corporation will be treated as compensation or as a nondeductible dividend. A distribution from an 'S' corporation will be treated as compensation or as an 'S' distribution (nontaxable to the extent of the 'S' shareholder's basis in the corporation).

5 The special allocation provisions allocating the death benefit to the noninsured LLC members should place the coverage beyond the reach of the Connelly decision.

policy to a partner of the insured is an exception to the transfer for value rule. Second, a distribution of the policies from the LLC or partnership will not trigger gain, and the partner will take the cost basis of the LLC or partnership.

10. Even if a business owner's legal and tax advisors take the position that the Code Sec. 2703(b) exceptions and the case law are met, as a precaution for businesses operating as an LLC or a partnership, it may be possible to "cure" redemptions using special allocations.

KEY PERSON COVERAGE

11. It may be advisable to move key person life insurance to the noninsured owners because it could inflate the value of the business for federal estate tax purposes.
12. If retained by the business, on the death of the key person, a qualified valuation would be required to establish the diminution in the business value due to the death of the key person.

IN CLOSING

The *Connelly* decision has dramatically altered the longstanding understanding and usage of life insurance-funded stock redemption agreements. Buy-sell planning remains a critical component of any business owner's overall plan. Successful business owners should work closely with qualified advisors to address the *Connelly* holding and to ensure that their plan is compliant with Code Sec. 2703 and existing case law.

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