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Business Owners: Reach Out to Your Attorney and Insurance Agent Immediately!

On June 6, 2024, the U.S. Supreme Court decided a case that will affect many business owners that have life insurance funded buy-sell agreements. The Court reversed generally accepted principles long held by the insurance and legal communities. 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.¹

As a result of this decision, business owners should immediately contact their attorney and insurance agent to determine the impact of this decision on their own business continuation plans. Buy-sell agreements, or provisions in corporate shareholders agreements, LLC operating agreements and partnership agreements, may need to be revised and amended, 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. These agreements or provisions are commonly referred to as entity purchase or stock redemption agreements.



Background

Two brothers, Michael and Thomas Connelly, were the sole owners of Crown C Corporation (“Crown”). The brothers entered into a buy-sell agreement to, in part, determine what to do if one of the brothers died. Crown purchased \$3.5 million of life insurance on Michael’s life. Several of the provisions of the agreement were not followed and the brothers did not have a formal or informal valuation of the company when Michael died in 2013. Thereafter, the Connelly family agreed upon a valuation of Crown at \$3.89 million. Michael owned 77.18% of the corporate shares so 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 million in life insurance proceeds used to redeem Michael’s shares on the theory that the insurance was offset by the redemption obligation. 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 planning 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 used to 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

Clearly, business owners who have entity purchase or stock redemption buy-sell agreements need to consult with their insurance agents and attorneys to determine whether 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, 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.

For More Information Contact:



Contact your local Security Mutual life insurance advisor immediately. Your Security Mutual life insurance advisor will assemble your team and coordinate with your attorney and tax professional to review your situation and to determine the business continuation and estate plan that will best suit your needs and objectives.

¹ *Connelly v. United States*, 602 U.S. ____ (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 Ballotpedia. "Connelly v. Internal Revenue Service." Ballotpedia.org. https://ballotpedia.org/Connelly_v._Internal_Revenue_Service (p. 46). (accessed 6/11/2024)

⁸ Ballotpedia. "Connelly v. Internal Revenue Service." Ballotpedia.org. https://ballotpedia.org/Connelly_v._Internal_Revenue_Service (pp. 50-51). (accessed 6/11/2024)

⁹ *Connelly v. United States*, 602 U.S. ____ (2024).

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