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Supreme Shift: Connelly v. United States and its Impact on Business Life Insurance

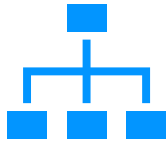
Goals for Today

- Explore the implications of *Connelly v. United States* regarding redemption agreements and other business life insurance agreements.

Agenda

- Overview of Facts of Connelly Case
- Overview of Court's Decision
- Applicable Regulations
- Where the Connelly brothers went wrong
- Where do we go from here?

Connelly: The Preliminary Facts



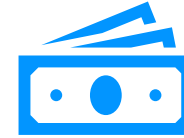
Two brothers, Thomas and Michael Connelly, were the sole shareholders of a closely held corporation (Crown C). Michael owned 75% of the shares and Thomas owned the remaining 25% of shares.



Thomas and Michael entered into a buy-sell agreement giving each brother the ability to purchase a deceased brother's shares. The agreement specified that the price would be based upon an appraisal at fair market value.



The corporation also had a contractual obligation to purchase a deceased brother's shares at fair market value if the remaining brother did not purchase shares.



The corporation held life insurance policies on both brothers to cover the potential cost of redeeming shares

What happened?


Michael died in 2013. At Michael's death, Thomas did not purchase Michael's shares. This triggered the corporation's obligation to redeem Michael's shares.



The corporation used the life insurance proceeds that it owned (\$3.5 million dollars) to redeem Michael's shares.



For purposes of federal estate tax, the estate valued the company around \$4 million dollars and Michael's shares around \$3 million dollars. The company did not conduct an independent appraisal of the corporation's fair market value as required by the agreement. In valuing the company, the estate did not include the value of the company's life insurance policy.



The IRS conducted an audit and adjusted the estate tax return to include the value of life insurance proceeds, increasing the company's value to just under \$ 7 million and also increasing Michael's shares to approximately \$5.3 million

Why is the IRS concerned?

- This transaction creates a windfall for the parties:
 - Before the redemption, Thomas' interest in the company was approximately \$1 million (25% of \$4 million) and after the redemption Thomas' interest in the company increases to approximately \$1.75 million and Michael's interest increases to \$5.25 million (the company now has \$7 million in assets, \$4 million of the original value + \$3 million life insurance)

What did the IRS do?

- IRS audited Michael's estate tax return and imposed an additional estate tax of over \$1,000,000 based on including the value of the life insurance policy.

What did the estate do?

- Estate challenged the IRS decision to impose an additional tax
- Filed suit in Eastern District of Missouri

District Court Opinion (Connelly v. Dept. of Treasury, Internal Revenue Service)

- Two Issues District Court Considers:
 - When does an entity agreement fix the value of the entity for federal estate tax purposes?
 - What is the value of an entity when it owns life insurance on a deceased owner?

District Court: Parties Arguments

Michael's Estate Argued:

- *The agreement should control the value of the company*
- Estate relied on Estate of Blount v. Comm'r and argued that it was not appropriate to include insurance proceeds paid upon the death of the insured shareholder in the company's fair value market share

IRS Argued:

- *The agreement failed to meet the requirements of the Internal Revenue Code (IRC), Regulations, and case law to effectively fix the value of the company*

Issue 1: Fixing the value of the estate

District Court considered three elements of 26 U.S.C. 2703(b) must be satisfied in order the fix value for federal estate tax purposes:

1. Agreement must be a bona fide business arrangement
2. Agreement must not be a device to transfer interests to members of the decedent's family for less than full consideration
3. Agreement terms must be comparable to similar arrangements entered into by persons in an arms' length transaction

The District Court Held that 2703(b) was not satisfied because...

- Court found that Agreement failed the 2703(b) test because:
 - The agreement created a bargain price resulting in a windfall to the surviving owner
 - The parties failed to follow the pricing requirements
 - The court reasoned that no “real” buyer would accept the windfall effect by the Agreement’s redemption

Issue 1 Continued: District court considered additional requirements of fixing the valuation

- Before accepting the agreement, the district court considered the following criteria must be met before a court would accept the pricing terms of the Agreement:
 - Offering price must be fixed and determinable
 - Agreement must be legally binding during life and death
 - Agreement must be bona fide and not entered into as a testamentary substitute to transfer interests

What does the District Court say about Blount?

- The District Court found that the value of the company must be increased by the death benefit of life insurance it held on the decedent's life (directly contradicting Blount)
- District Court believed Blount was “**demonstrably erroneous**”

Court of Appeals

- Eighth Circuit affirmed District Court's grant of summary judgment to IRS.
 - Appellate Court found that the buy-sell Agreement did not satisfy (1) 2703(b) or (2) regulations before the enactment of Chapter 14
- Executor of Michael's estate (Thomas Connelly) filed a petition for writ of certiorari on August 16, 2023

Connelly v. United States

Supreme Court adopted the Estate's version of the question presented:

- ***“Whether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in***

order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax”

Supreme Court: Parties Arguments

- Michael's Estate argued: A contractual obligation to redeem shares at fair market value is actually a liability ***offsetting*** the value of the life insurance policy to fulfill the redemption obligation
 - Its important to note that the parties agree that the life insurance policy increases the value of the estate.

Supreme Court Reasoned

“An obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder’s economic interest”

Justice Thomas' Example Regarding Redeemed Shares

- 10 million cash in assets, 2 shareholders A and B
 - A owns 80 and B owns 20 shares respectively
 - Each share is worth 100,000 (10 million/100 shares)
 - A's shares = 8 million, B's shares = 2 million
- Consider redeeming B's shares:
 - Redeeming B's shares at FMV, the corporation would have to pay B \$2 million dollars.
 - After the redemption, A would be the sole shareholder in a corporation worth \$8 million with 80 outstanding shares (8 million/80 = 100,000)
 - This redemption agreement would have no economic impact on either shareholder.
- Justice Thomas used this example to reason that a contractual obligation to redeem shares at fair market value does not necessarily reduce the value of the shares. This shows that a redemption is not always a liability...

Supreme Court Reasoning Continued

- What about the willing buyer example?
 - What if a willing buyer wanted to purchase Michael's shares? How would you value the company? Including the value of life insurance or disregarding the value of life insurance?
 - Thomas reasoned that because a fair-market-value redemption has no effect on economic interest, no buyer purchasing shares would have treated Crown's obligation to redeem shares as a reduction in value. A buyer would have valued the estate at the time of Michael's death (based on IRC 2033) including the value of the Company's life insurance

What does the Supreme Court say about this decision and its impact on succession planning?

- Supreme Court dismisses the idea that Connelly could make succession planning more difficult because there are other options:
 - “True enough, but that is simply a consequence of how the Connelly brothers chose to structure their agreement. There were other options. For example, the brothers could have used a cross-purchase agreement...”

The Supreme Court Footnote

There could be cases where a redemption could decrease the value of the corporation (i.e. when a corporation needs to liquidate assets to pay for the shares being redeemed)

“We do not hold that a redemption obligation can never decrease a corporation’s value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas’ position that all redemption obligations reduce a corporation’s net value. Because that is all this case requires, we decide no more.”

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Common Questions After Connelly

Common Questions after Connelly

Does this apply to all businesses or just family businesses?

Is this a bad facts case?

Can we use redemption agreements?

If we can't use redemption agreements, what else is out there to achieve the same goal of liquidity?

Does Connelly apply to all businesses?

- Connelly applies to all different business entities with company-owned life insurance including corporations, limited liability companies, and partnership (we discuss in terms of corporation and shareholders for simplicity)
- If the business is family controlled, or one person controls business, the regulations are stricter. (see 2703(b))
 - Purposes of 2703(b) is to prevent manipulation of asset valuations between family members.

What is different because this is a family owned entity?

- A right or restrictions satisfied the 2703(b) requirements if more than 50% of the value of the property subject to the right or restriction is owned directly or indirectly by individuals who are NOT family members
- Because of this, the agreement would only need to satisfy the first three requirements before 2703(b): fixed formula price, a restriction applicable during life, and an obligation for the estate to sell at death
- So.... Yes. Connelly does impact non-family owned entities, but the standards for assessing the agreement are less strict

Applicable Regulations

- IRC §20.2031-2(h) – imposes requirements in using buy-sell agreements to establish estate tax values
- IRC §2703 – imposes requirements unless 50% of the business is owned by non-family members

Is this a bad facts case?

- If so, what are the “bad” facts?
 - Agreement provided for 2 ways to fix the value of Crown C Supply (1) execution of certificate of value; or if not completed (2) securing two or more appraisals. (**agreement did not definitively fix the price**)
 - When considering this, the 8th circuit noted that this isn’t actually a formula, it is just an agreement to agree, not a determination of value
 - Also, none of this was ever done!!
 - Example: didn’t do certificate of value during life or after death

Bad Facts Continued

- Thomas was the only surviving shareholder and the executor of Michael's estate
 - Potentially may have been a dispute between Thomas and Michael's son. This casts a shadow onto the reason why Thomas and Michael's son agreed on the 3-million-dollar valuation for the company... they also did not use an appraisal, so how did they come up with the valuation?
 - Not an arms length transaction because Thomas was on both sides of the transaction
- Did not follow the terms of their agreement. This rubs courts the wrong way

Do the bad facts affect the ruling?

- Bad facts mostly apply to fixing the value of the company...
- *That is not the main issue here. The main issue here is whether the redemption obligation is offset by the life insurance proceeds.*



Where do we
go from here?

Alternatives



Can we still use redemption agreements?



Alternative vehicles:

Cross-Purchase

Use an LLC to fund insurance policies

How to structure insurance ownership after Connelly?

- Do not fund redemption agreements with company-owned life insurance
 - Company can self-fund or borrow money to pay the purchase price to avoid the impact of Connelly (i.e. if a shareholder owns life insurance on a deceased shareholder, the death benefit could be the source of funds for a loan)

But...redemption agreements are popular and I would like to use one... can you fund agreements with company-owned life insurance?

- Redemption agreements are popular because they are convenient!
- Theoretically, you could structure a redemption agreement that does economically impact the estate (for example, Supreme Court Footnote: *We do not hold that a redemption obligation can never decrease a corporation's value*)
- However, this is risky given the connotations of Connelly

Cross Purchase Agreement

- Each shareholder (or an ILIT or other irrevocable trust) owns, and is the beneficiary of, life insurance policies on the other shareholders. The surviving shareholder would then receive the death benefit and directly purchase the deceased shareholder's shares

Using an LLC to Own Life Insurance Proceeds

- A separate LLC owned by the shareholders is set up for the sole purpose of owning life insurance policies and funding the purchases by the surviving shareholders
- Advantages:
 - Classified as a partnership for federal tax purposes and subject to different rules than corporations
 - death benefit should stay out of the insured's estate this way

What if your company already owns life insurance?

- If you decide to change the ownership of life insurance there are hazards to be avoided when changing the ownership of life insurance:
 - Policies transferred from an S corporations will be treated as a taxable sale and may trigger a “transfer for value” rule causing a death benefit to be subject to income tax
 - Ownership in an LLC owning life insurance may cause the death benefit to be included in your estate for estate tax purposes if the operating agreement is not correctly structured
- Any changes should be made in consultation with both an attorney and financial professional

If using a redemption agreement to fund company owned life insurance... do you need to change it?

- ***It depends***
- Will any shareholders of the company be subject to estate taxes? If the answer to this is no, then changing your buy-sell agreement may not be necessary
- If your company owns life insurance and the shareholders will be subject to estate tax, you should review the buy-sell agreement and consider restructuring insurance ownership



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Questions?