

THOUGHT LEADERSHIP

ARTICLES

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Unanimous Supreme Court Determines Company-Owned Life Insurance Increases Fair Market Value

On June 6, 2024, the Supreme Court held 9-to-0 in *Connelly v. United States* that company-owned life insurance increases the company's fair market value for estate tax purposes, and the company's obligation to redeem a deceased shareholder's shares does not necessarily decrease the company's value. This decision may have significant impact on businesses with company-owned life insurance but does not impact businesses where only the shareholders own life insurance on each other's lives.

Please note that the holding in *Connelly* applies to all different business entities, such as corporations, limited liability companies, and partnerships. The principles will be discussed here in terms of a corporation and shareholders for simplicity.

Why is the *Connelly* decision important?

Because the life insurance death benefit paid to a company is considered an asset of the company for purposes of valuing the company, the value of the deceased shareholder's shares may now be higher for estate tax purposes.

Connelly does not invalidate buy-sell agreements. Shareholders and companies will still be contractually obligated by such agreements. Companies will pay—and the families of deceased shareholders will receive—the prices agreed to. But there could be a significant discrepancy between the amount received by the family of a deceased shareholder and the estate tax value of the purchased shares if the company owns life insurance on the deceased shareholder.

The Internal Revenue Code and the related regulations set strict rules for when a buy-sell agreement, whether it is a redemption agreement (where the company buys the deceased owner's shares) or cross-purchase agreement (where the surviving owners buy the deceased owner's shares), will set the value of a deceased shareholder's shares for estate tax purposes. The rules are even stricter when the shareholders are related.

The *Connelly* decision may negatively impact shareholders who may be subject to federal or state estate taxes. The current federal estate tax exemption is \$13.61 million per person, but under current law, this amount sunsets in 2026 to approximately \$7 million per person.

What should be done in response to *Connelly*?

Does your company own life insurance policies on the shareholders? If not, you do not need to take any action as a result of *Connelly*. Still, you should review your buy-sell agreement to determine if there are outdated provisions and to make sure the agreement meets your current intentions.

Will any shareholders be subject to estate taxes? If not, then changing your buy-sell agreement may not be necessary. The holding in *Connelly* may impact the income tax basis of the deceased shareholder's shares but likely without triggering immediate income tax.

If your company owns life insurance and the shareholders will be subject to estate tax, you should review your buy-sell agreement and consider restructuring the insurance ownership.

What are my options for structuring insurance ownership?:

Do not fund redemption agreements with company-owned life insurance

How it works: A company can still buy out a deceased shareholder if that is desired. However, the company should either self-fund or borrow money to pay the purchase price in order to avoid the impact of *Connelly*.

- If another shareholder owns life insurance on the deceased shareholder, this death benefit could be the source of such a loan.

Use a cross-purchase type agreement

How it works: Each shareholder (or sometimes an irrevocable trust) owns, and is the beneficiary of, life insurance policies on the other shareholders. The surviving shareholders receive the death benefit and directly purchase the deceased shareholder's shares.

Use an LLC to own the life insurance policies

How it works: A separate LLC owned by the shareholders is set up for the sole purpose of owning the life insurance policies and funding the purchases by the surviving shareholders.

If your company already owns life insurance, you should be aware that there are income tax and estate hazards to be avoided when making any changes to the current ownership of life insurance. For instance:

Life insurance policies transferred from an S corporation to shareholders will be treated as a taxable sale and may trigger what is known as the “transfer for value rule” causing the death benefit to be subject to income tax.

Ownership in an LLC owning life insurance on your life may cause the death benefit to be included in your estate for estate tax purposes if the operating agreement is not correctly structured.

There are a whole host of practical issues as well. Redemption agreements are popular because they provide a convenient way to fund the life insurance premiums and ensure that the life insurance policies stay in force. When switching to a different buy-sell structure, you must plan for:

How to fund the premiums that will be paid by the new owners of the life insurance policies.

How to keep the death benefit out of the new owners’ estates for estate tax purposes.

How to ensure that the life insurance policies stay in force.

All changes should be considered in consultation with an attorney well-versed in buy-sell agreements and the income tax and estate tax issues associated with them.

Contact us

If you have any questions about the *Connelly* decision’s impacts, please contact Jill Palmquist, Stefanie Ravenhill, Chloe Russell, or your Husch Blackwell attorney.