

Buy-sells may now cause estates to be taxable

A review of *Connelly v. Department of Treasury* Supreme Court ruling

On June 6, 2024, the Supreme Court affirmed the lower court's decision that the IRS may include life insurance proceeds used for redemption obligations in the calculation of an individual's estate tax. The rationale many practitioners relied on prior to this ruling was that redemption obligations were viewed as a liability and that life insurance proceeds were an asset that offset this liability. This rationale is now not necessarily true, and as a result, this ruling will greatly impact the way closely owned businesses choose to structure their buy-sell agreements. In this piece, we will discuss how this ruling will drive the need for proper buy-sell planning along with proper life insurance planning.

Overview

***Connelly v. Department of Treasury*, 2021 affirmed June 6, 2024**

Crown C Supply, Inc. was owned by two brothers, Michael P. Connelly, Sr. and Thomas A. Connelly. Michael was the majority owner of the business (77.18%) at the time of his death, with the remainder of the business owned by his brother Thomas (22.82%). The brothers, like many closely owned businesses, entered into a buy-sell agreement with the intent to keep the business in their family. The agreement required the business to redeem the shares of a deceased owner at the time of their death if no current shareholder wished to purchase those shares first. Michael passed away and triggered the buy-sell agreement to be enacted.

At Michael's passing, the business received a \$3.5 million death benefit. Thomas, acting as executor of the estate, agreed to a redemption price of \$3 million for Michael's interest in the business. The \$3 million value was stated to be based on their buy-sell and agreed upon between the estate and corporation. The assessed value of the business at the time of Michael's death did not incorporate the death benefit proceeds. The IRS, however, saw things differently with respect to the death benefit proceeds paid to the business and added those proceeds to the overall value of the business.

The buy-sell agreement required the brothers to attach a Certificate of Agreed Value annually to set the valuation of the business. Many buy-sell agreements have this requirement in place as a common business practice to assist with determination of value at a triggering event. The agreement stated that failure to attach the certificate would result in the value of the business being determined based on an appraisal.

Thomas, acting on behalf of Michael's estate, argued that the court should have looked to the stock-purchase agreement to value the shares of the business as the agreement stipulated valuation in the event of a triggering event. The court reviewed their agreement and found that the brothers failed to state a metric that allowed for a fixed or determinable price for which value could be determined.¹ Failure to follow this key provision allowed the court to establish their own interpretation of the value of the shares of the business. This value included the life insurance death benefit proceeds. The court also relied on 26 C.F.R. Section 20.2031-2(h), which states how shares are to be valued and that the price of stock subject to a buy-sell agreement will be determined under this section for estate tax purposes.

The IRS found the exclusion of the death benefit proceeds payable to the business was not appropriate and the funds should be included as a business asset to determine the overall value of the business.² This increased the value of the business from \$3.86 million to \$6.86 million.

The U.S. District Court for the Eastern District of Missouri granted summary judgement to the IRS, which resulted in Michael's estate receiving \$3 million in redemption of his interest as well as being taxed on a higher valuation of the business interest. This led to a \$889,914 additional tax liability owed by the estate. On June 6, 2024, the U.S. Supreme Court affirmed the lower court's decision.³

Arguments and key takeaways from Justice Thomas's opinion of the court

Corporate liability

"A corporation's contractual obligation to redeem shares is **'not necessarily'** a liability that reduces a corporation's value for purposes of the federal estate tax."³ As with many landmark Supreme Court rulings, this simple phrase turns the case against the taxpayer.⁴ Prior to Connelly, many practitioners relied on *Blount v. Commissioner*, 428 F. 3d 1338 (CA11 2005), which concluded that "insurance proceeds should be "deduct[ed]...from the value" of a corporation when they are "offset by an obligation to pay those proceeds to the estate in a stock buyout." *Id.*, at 1345. The IRS viewed this differently, concluding that Crown's redemption obligation did not create a liability that offset the life insurance death proceeds. The Connelly decision, while still leaving the opportunity that a liability could be created, leaves the risk for business owners that life insurance proceeds may be includable in the value of the business for most situations.

Valuation: What is fair market value?

The court focused on what the company's fair market value would have been for a reasonable buyer as a defining rationale for the inclusion of the life insurance death benefit. With respect to the repayment obligation, the question is: Does the fair market value change an owner's economic position post redemption? The court concluded that a reasonable buyer would be in the same economic position post redemption after purchasing Michael's shares. Therefore, the buyer would be willing to pay \$5.3 million (\$6.86 million x 0.7718). A purchaser at \$5.3 million would not see their economic position changed post redemption. Justice Thomas notes that, "Crown cannot be worth \$3.8 million before and after Michael's shares were redeemed. A corporation that pays out \$3 million to redeem shares should be worth less than before the redemption."³ Clients should consider if the repayment obligations decrease the corporation's value. If the corporation is required to liquidate assets, and

thereby decrease their future earning capabilities, one may argue that the corporation's value has truly decreased. With this ruling, it is unclear if traditional valuation guidance found in Revenue Ruling 59-60 will be followed or relied on as closely.

When it comes to business valuation, many business owners rely on a few points of guidance: Revenue Ruling 59-60, IRC § 2703, and Treasury Regulation §20.2031-2(h). These points of guidance set forth criteria to allow a buy-sell agreement to set a value for estate tax purposes. The item of focus from the court appeared to point to the establishment, or lack thereof, of a price that must be fixed or determinable pursuant to a formula under the agreement. In addition to this key factor, the buy-sell must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration. The court did not give an opinion as to if the valuation methodology was proper for the Connelly's case. This leaves the door open to what a reasonable fair market value is and how one should argue this value appropriately given the guidance noted above. The court specifically addressed this gray area stating that, "although such an agreement may delineate how to set a price for the shares, it is ordinarily not dispositive for valuing the decedent's shares for the estate tax."³

Succession planning

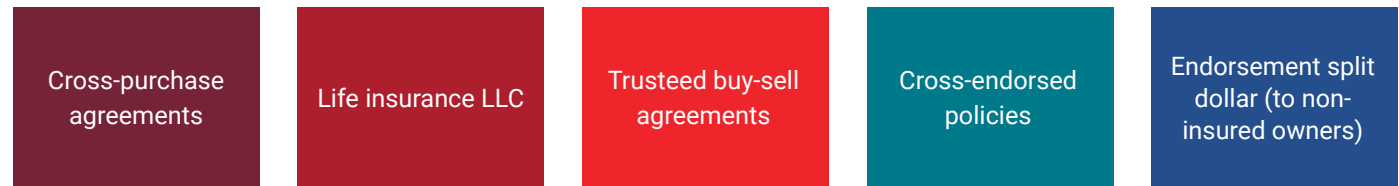
Succession planning was noted in the opinion as well, stating that, this decision "...will make succession planning more difficult for closely held corporations."³ However, the court noted that options like cross-purchase could have been used as an alternative to accomplish their buy-sell goal.

Where do we pivot?

The outcome noted above should be concerning for owners of closely held businesses that have stock purchase agreements that are entity or redemption style in nature. This ruling serves as a warning for business owners across the U.S. of how important drafting and following your business agreements truly should be.

For some business owners, the inclusion of life insurance in the value of the business for estate tax calculations may not be a large concern. Today, individuals are given a unified credit to deal with federal estate taxation. This credit currently allows each individual to avoid federal estate taxation on \$13.61 million in 2024. This elevated federal estate tax exemption is set to drop to pre-TCJA levels (indexed for inflation), which most assume will be roughly \$7 million. Business owners desiring to use a stock redemption strategy may not be impacted by the ruling in the Connelly case as the death benefit paid to the business may not push the total value of the business over the estate tax limits. As the estate tax limits shift over time, business owners should continue to monitor their exposure if using a redemption style buy-sell.

To help mitigate the risk of similar outcomes, business owners may pivot away from traditional entity or redemption agreements for business owners and adopt the below alternatives:



These alternatives use funds that are outside of the business's main entity that requires buy-sell planning. Using one of these alternatives may be a way to minimize the risk associated with the Connelly case. Even with the individual following their agreement — and that agreement meeting the statutory requirements to be a valid buy-sell — the risk of a similar outcome appears to still be present with respect to life insurance death proceeds paid to the business.

Another item business owners should consider is a detailed review of their current buy-sell. As the Connelly case illustrated, business owners need their buy-sell agreement to have a fixed or determinable value and need to follow the agreement. Practitioners and business owners should consider, if not currently noted, establishing a fixed and determinable price such as a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA).

Some additional questions to ask while drafting the agreement:

- Can the agreement be drafted in a manner that will exclude the life insurance death benefit?
- Will a value hold if based on the last day of the fiscal year prior to death?
- Should flexibility be included as to methodology of valuation?
- Does the agreement lower the fair market value, exposing the business owner to audit risk?

Conclusion

Given the outcome of this case, individuals may be wondering, what to do. For many closely held businesses, a default to stock redemption at the death of a business owner is common. Careful consideration should be given to alternative buy-sell designs. Prior to any decision related to the transfer of shares via a buy-sell agreement, skilled tax and legal professionals should be engaged. Legal and tax professionals and practitioners now must have an elevated level of due diligence and attentiveness when buy-sell planning.

¹ 26 U.S.C. § 2703(a), 26 U.S.C. § 2703(b).

² 26 U.S.C. §§ 2001, 2051, §§ 2031(a), 2033, 26 C.F.R. §§ 20.2031-1, 20.2031-2, 26 C.F.R. § 20.2042-1(c)(6).

³ *Connelly v. United States, U.S., No. 23-146, 6/6/24.*

⁴ *Heller, 554 U.S. 570 (2008), Obergefell v. Hodges, 576 U.S.*

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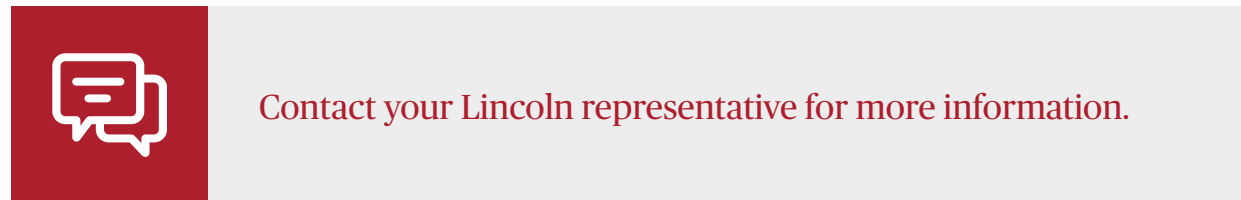
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LCN-6704334-061424

PDF ADA 6/24 **Z02**

Order code: ADV-CASE-FLI001



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