

UNITED STATES SUPREME COURT HOLDS REDEMPTION INSURANCE PROCEEDS INCREASE VALUE OF CORPORATION DESPITE REDEMPTION OBLIGATION

In a unanimous decision issued on June 6, 2024, the United States Supreme Court upheld the 8th Circuit Court of Appeal's opinion in *Connelly v. United States*.

As a result of *Connelly*, a redemption agreement funded with life insurance owned by a closely held entity is no longer a viable planning option. However, with adversity comes opportunity.

BACKGROUND

The 8th Circuit had previously held that life insurance proceeds used to fund a redemption of a deceased shareholder's shares in their closely held company are includable in determining the fair market value of the corporation in the deceased shareholder's estate for estate tax purposes. However, the court also held that the shares are not offset by a contractual obligation of the company to redeem the shares under a written redemption agreement between the shareholders.

The 8th Circuit's decision is contrary to the 11th Circuit's decision in *Estate of Blount v. Comm'r (2005)*, which held that life insurance proceeds used for redemption purposes are offset dollar-for-dollar by a legally enforceable contractual redemption obligation. Although there was always some remaining doubt, for nearly twenty years many estate planning attorneys relied on the *Blount* case to advise clients to fund redemption agreements with life insurance. Moving forward, this is not an option.

NEXT STEPS FOR CLIENTS

Connelly provides an excellent opportunity to contact clients and COIs to inform them of the decision and provide them with options and action items.

The first and perhaps most important action item for clients is to review their buy/sell agreements and life insurance policies.

Once the review is complete, clients will have several options including:

1. Terminate the redemption agreement and replace it with a cross-purchase agreement.
2. Terminate the redemption agreement and replace it with a wait-and-see agreement.
3. Transfer any existing redemption life insurance to the shareholders or an insurance LLC owned by the shareholders.

The Supreme Court decision invalidates redemption agreements funded by corporate-owned life insurance, prompting the need to review buy/sell agreements and explore alternative planning options.



If the redemption insurance is term insurance or permanent insurance that is not in a gain position, it may be relatively easy to transfer the policies to the shareholders or an insurance LLC. Of course, one must consider any tax consequences to the shareholders (as the transfer of a policy will be treated as a compensation event or as a dividend/distribution).

However, if the redemption policies are permanent insurance and the policies are in a gain position, one must consider gain recognition on any transfer out of the corporate structure (C or S corporation).

Fortunately, there are options here as well:

1. The company can maintain the coverage and enter into an endorsement split dollar agreement with the shareholders. The company's retention of the greater of premiums paid or cash value can be used for key person purposes. If this option is contemplated, one must consider an exit strategy as economic benefit costs become prohibitively expensive in later years.
2. The company could consider a 1035 exchange of the policy and use endorsement split dollar for a few years. Once the policy has been in force for more than a year, it may be possible to transfer the policies to the shareholders when the FMV of the policy could be less than basis, negating any income tax on the prior policy gain.
3. The company and the shareholders can form an insurance LLC. The company can transfer the policy to the LLC as its initial capital contribution and the shareholders can contribute cash to pay the next scheduled premiums. The company can take a preferred interest for its initial contribution and the shareholders can take the "common" or "equity" interests. Each year going forward, the shareholders can make additional capital contributions to pay ongoing premiums.
4. The company and shareholders may decide to simply terminate the existing policies, pay any income tax on the policy gain and start over with new insurance to be owned outside the company.

Connelly does not just affect corporate structures. Many businesses are structured as partnerships or LLCs taxed as partnerships. Many such entities provide for the redemption of interests in the operating agreement and insurance is held in the entity for this purpose. The partnership tax rules may make it possible to move to a cross purchase structure without gain recognition at the partnership level. And a separate insurance LLC may be used as well.

For clients who do not have a buy/sell in place, planning will likely focus on cross purchases agreements. However, it is important to remember that *Connelly* essentially means that buy/sell life insurance can no longer be owned by the closely held entity. It does not mean that an entity cannot be used. If it makes sense to do a redemption, the shareholders can use an insurance LLC and a wait-and-see agreement. At the time of death, a decision can be made as to whether it makes more sense to have the surviving shareholders buy the decedent's interest outright or make an additional capital contributions to the entity and let the entity redeem the interest.

When considering options, one must remember to address transfer for value issues. As we all know, the transfer for value rules can be a trap for the unwary.

LOOKING TO THE FUTURE

Connelly may have struck the death knell for redemptions funded with entity-owned insurance. But the sky is not falling. When the dust settles, *Connelly* will have just closed one planning door. We have others to open, and we can help clients open those doors.

Your PartnersFinancial team is here to help. Please call us with any questions or comments you may have.

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06/24 | 24-IS-PF-SR-198843 | Copyright © 2024 NFP. All rights reserved.