Takeaways from and Solutions for the Supreme Court Decision in *Connelly v. United States*

July 15, 2024

On June 6, 2024, the Supreme Court ("the Court") issued a unanimous decision in *Connelly v. United States*.[1] Below are key highlights along with observations, takeaways and solutions to consider for current and future buy/sell agreement planning. Much has already been written about the *Connelly* decision so if you'd like more detail regarding the facts or the Court's reasoning, we suggest to read the full opinion, or at least its brief syllabus, which can be downloaded here.

Highlights

- Michael and Thomas *Connelly* were brothers and the shareholders of Crown C Supply ("Crown"). They entered into an agreement where upon the first death the survivor had the option to purchase the deceased's shares and if the survivor declined then Crown was contractually obligated to redeem those shares at fair market value ("FMV") as determined by a "mutual agreement" or qualified appraisal. Crown purchased life insurance on each one to ensure it had adequate liquidity.
- Michael died in 2013 and Thomas declined the purchase option thus triggering Crown's obligation to redeem Michael's shares using the life insurance proceeds. The Internal Revenue Service (IRS) audited Michael's estate tax return and issued a deficiency on the basis that the redemption obligation did not offset the value of the life insurance proceeds included in the value of his shares as so reported by Thomas, Michael's executor. Thomas sued for a refund, but the district court sided with the IRS and the Court of Appeals for the Eighth Circuit later affirmed.
- The key question before the Court was whether proceeds of a life insurance policy owned by a closely held corporation on a shareholder 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 federal estate tax purposes.
- All parties agreed the value of shares in a closely held corporation must reflect its FMV for federal estate tax purposes and life insurance proceeds payable to the corporation are an asset that increases its FMV. The narrow question left to answer was whether the Crown's contractual obligation to redeem Michael's stock at FMV offsets the value of the life insurance proceeds earmarked to fund that redemption.
- The Court said no because such a redemption does not impact any shareholder's economic interest so no hypothetical buyer purchasing the shares would have treated the obligation to redeem them at FMV as an offsetting valuation factor.[2] It held that "redemption obligations are *not necessarily* liabilities that reduce a corporation's value for purposes of the federal estate tax" and affirmed the Eighth Circuit [emphasis added].
- Thomas's additional argument that a decision in favor of the Government would make succession planning more onerous for closely held corporations was acknowledged by the Court, but it reasoned the result was a consequence of how the *Connelly* brothers chose to structure their agreement and recognized that other options were available, such as a cross-purchase agreement, which would have had different risks and economic and tax consequences.

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Takeaways

The Decision is Rational and Makes Economic Sense

After Michael's death, Thomas and Michael's son agreed to a $3 million redemption price for Michael's shares, which was funded with life insurance proceeds and calculated by multiplying Michael's 77.18% stake by a $3.86 million FMV of Crown. This purported FMV was based on a $6.86 million total value reduced by the $3 million so-called redemption obligation liability.

The Court used a simple example and reasoning to explain how a redemption obligation at FMV does not offset the value of life insurance proceeds earmarked to fund the redemption because it does not impact the economic interests of any shareholder. Assume a corporation that solely holds cash in the amount of $10 million and has 100 shares of outstanding stock, 80 of which are owned by shareholder A and 20 of which by shareholder B. Each share of stock is worth $100,000 per share ($10 million ÷ 100). If the corporation buys B's shares for cash, the corporation is left with an $8 million net worth and 80 outstanding shares. A's stock is still worth $100,000 per share ($80 million ÷ 80), and B holds $2 million in cash, thus the same economic positions before and after the redemption.

Therefore, no "willing buyer" would recognize a redemption obligation at FMV as a factor that reduces the value of the shares. Crown was worth $6.86 million at Michael's death – $3 million in life insurance proceeds committed to the redemption plus $3.86 million in other assets and earnings capacity. A hypothetical buyer would count the life insurance proceeds to be used to fund the redemption as a net asset, pay $5.3 million for Michael's 77.18% stake in a $6.86 million corporation and receive that value after Crown redeems the shares. Thus, the redemption obligation does not reduce the corporation's value.

Thomas' argument that the redemption obligation was an offsetting liability would effectively value the shares post redemption and treat Crown as having a $3.86 million FMV both before and after, which the Court said cannot be possible and defies the basic mechanics of a redemption – Michael's shares must be valued at death pre-redemption and Crown must be worth less after it pays $3 million to redeem his shares. In other words, Thomas cannot end up with a larger stake in a company with the *same* value (and higher per-share price) but, instead, a larger stake in a *less valuable* company (same per-share price).

Consider Further the Problem of the Interrelated Logic of Thomas' Argument

To expand on why the decision makes sense, consider the following. Allowing a redemption obligation to be treated as a universal offsetting liability creates an interrelated liability-value calculation that could undervalue the shares and create a device allowing shareholders to shift wealth to family members with reduced estate tax. For example, assume the above $10 million cash corporation that is owned 80%/20%, but A and B are parent and child, A dies, and the redemption obligation is treated as a value-reducing liability in calculating the estate tax owed on the value of A's shares. A's economic interest during life is $8 million but at death it would only be $4,444,444 (80% ÷ (1+80%) x $10 million) for estate taxes, thus shifting $3,555,556 worth of economic value to B. Similarly to *Connelly*, if the $10 million corporation consisted of non-cash operating assets but held $8 million of life insurance payable upon A's death, A's economic interest would be $14.4 million ($10 million + $8 million x 80%), but the value of A's shares for estate taxes would only be $8 million (80% ÷ (1+80%) x $18 million), thus shifting $6.4 million to B. Not only could this logic be irrational as a matter of redemption economics, but it could also open an exploitative estate tax loophole.

The Outcome May Have Been the Same Regardless of "Bad Facts"

It may be tempting to chalk the outcome up to poor planning and follow-through by the *Connelly* brothers. The agreement called for an annual qualified appraisal to determine the FMV of Crown, which was never obtained until after Michael's death by Thomas in response to the audit of Michael's estate tax return. Hence, the focus was the FMV of Michael's shares at his death and the effect of the redemption obligation on this value, to which the Court applied general economic and estate tax principles. FMV is based on the "willing buyer/willing seller" definition under regulation § 20.2031-1(b) and proceeds of life insurance policies payable to the corporation must be *considered* in determining the FMV of its shares under § 20.2031-2(f)(2).[3] A redemption obligation at FMV does not impact

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a shareholder's economic interest, so a willing buyer under the FMV standard and definition would treat the life insurance proceeds as a net asset that increases FMV and not recognize the redemption obligation to reduce FMV.

Had the agreement been better administered, it still would've led to a $6.86 million FMV inclusive of the life insurance proceeds, as the parties agreed and was even confirmed by the post-death appraisal, because the redemption obligation had no economic impact. Because Michael was the majority shareholder and he and Thomas were siblings, had it been better structured with a fixed or determinable price, § 2703 could have been implicated to disregard the agreement if it delineated a price less than this FMV by not accounting for the life insurance proceeds (more on fixed or determinable price and § 2703 below).

The Decision Appears to Reject Conventional Wisdom

It had been a commonly held view to count the obligation of a corporation to redeem a deceased shareholder's stock at death as an offsetting liability to the value of life insurance proceeds used to fund the redemption, typically derived from the Eleventh Circuit's decision in *Blount v. Commissioner*.[4] Although it did not expressly overturn *Blount*, it seems the Court rejected its reasoning in *Connelly,* so relying on *Blount* may be a taxpayer peril going forward. For those who were taking the *Blount* approach, the value of their stock may be more and generate a larger estate tax than previously expected.

If the redemption value under an agreement is less than the estate tax value, the estate of a deceased shareholder may pay an estate tax on a larger amount than what it actually receives. This logic may also apply to entities taxed as a partnership to the extent there are no special allocations in the operating agreement directing a disproportionate economic share of the proceeds to surviving members for capital account maintenance and liquidation purposes because regulations mandate that an interest in a partnership is to be valued for estate tax purposes similarly as stock in a closely held corporation.[5]

"Not Necessarily" Means a Redemption Obligation Could Reduce FMV in Certain Situations

The Court acknowledged in footnote 2 that they "do not hold that a redemption obligation can never decrease a corporation's value," which may be why they added "not necessarily." The example provided was a redemption obligation requiring the liquidation of operating assets, thereby reducing the corporation's future earnings capacity. The Court noted they simply rejected Thomas's position that all redemption obligations reduce a corporation's value and limited the decision to that issue. This footnote may leave additional room for interpretation regarding the impact of certain redemption obligations on the FMV of a business. For example, consider a corporation without life insurance or adequate liquidity for redeeming stock under an installment obligation, the payments on which impairs its future earnings capacity. That said, it should be safe to assume life insurance-funded redemptions should face similar corresponding treatment as *Connelly* at least in regard to the treatment of life insurance.

FMV, Considering Life Insurance Proceeds, May Be the Ultimate Governor for Estate Taxes

One might ask aren't buy/sell agreements supposed to fix the value of a closely held business for estate tax purposes? The answer is that under historical and current law, it depends, and there are several requirements to consider but ultimately FMV may govern.

Regulation § 20.2031-2(h) and related case law that existed before the adoption of the special valuation rules of Chapter 14 (§§ 2701-2704) require the following criteria:

1. The price must be fixed or determinable based on a formula included in the agreement;
2. The deceased business owner's estate must be obligated to sell its interest at death at the fixed price;
3. The deceased business owner cannot be free to sell his or her interest during life at a higher price;[6] and
4. The agreement must be a bona fide business arrangement and not a device to transfer the interest to the natural objects of the deceased business owner's bounty for less than full and adequate consideration.[7]

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§ 2703, enacted against the backdrop of regulation § 20.2031-2(h), codified and expanded existing regulatory and case law with the general rule that the estate and gift tax value of any property will be determined without regard to any option, agreement or other right to acquire or use property at a price less than FMV, or any restriction on the right to sell or use such property. This rule does not apply to any option, agreement, right or restriction meeting the following conditions (numbering continues from above):[8]

5. It is a bona fide business arrangement;
6. It is not a device to transfer the property to family members for less than full and adequate consideration; and
7. Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

Note that "4" overlaps with "5" and "6" above and courts have interpreted regulation § 20.2031-2(h) and § 2703 in tandem. Additionally, an exception under regulation § 25.2703-1(b)(3) provides that all three requirements under § 2703, and therefore the fourth under § 20.2031-2(h), are deemed to be met if more than 50% of the value of the property is owned by individuals who are not members of the transferor's family and the interests owned by nonfamily individuals are subject to the same right or restriction as that of the transferor. Family members, in this context, include the transferor, transferor's spouse, applicable family members and any lineal descendants of the parents of the transferor or transferor's spouse.[9]

Therefore, with a business that is majority-owned by family members, an agreement must meet all seven requirements to fix the estate tax value of the family members' shares. Even if the agreement is bona fide and not a testamentary device, the arms' length comparability requirement ("7") under § 2703 may still require a price equal to FMV. As the Court said in *Connelly*, a willing buyer would treat life insurance proceeds as a net asset that increases the company's value so FMV should consider them accordingly under § 20.2031-2(f). If more than 50% of the business is owned by those that are not family members of the transferor and the agreement applies to all interests, the regulatory exception may apply for the transferor, but it must still meet the first three pre-§ 2703 requirements above under § 20.2031-2(h).[10]

FMV May Ultimately Govern for Agreements Among Nonfamily Individuals Too

Another question one might ask is can nonfamily shareholders agree to a fixed or determinable price that excludes life insurance proceeds from the company's FMV? Possibly. The § 25.2703-1(b)(3) exception focuses on the value owned by individuals other than the transferor, so if the transferor together with any family members own a majority then this exception may not apply because the nonfamily individuals own less than 50%, and it may be back to FMV considering life insurance proceeds payable. In situations where it does apply, a suppressed price in an agreement could still invite scrutiny if it deviates too far from a fair, objective calculation. Consider the example of A and B owning a $10 million cash-only corporation but assume A and B are unrelated. B dies and 80% (more than 50%) is owned by A. Would it be fair and objective to agree to a buyout of B for less than $2 million when cash is the only asset?

Regardless, where the exception does apply, the agreement must still meet the first three requirements under pre-§ 2703 law (fixed or determinable price, restriction applies during life, and estate is obligated to sell at death) and the shares owned by the other individuals must be subject to the same restrictions as those of the transferor. Therefore, a suppressed price may be unacceptable for those wanting to sell their shares during life or leave a legacy to their heirs at true FMV because they or their heirs may receive less, notwithstanding a lower estate tax. Additionally, it could limit a shareholder's estate from qualifying for § 2023A (special use valuation for real property used in a farm or closely held business), § 303 (sale or exchange income tax treatment on certain redemptions of stock to pay estate tax), or § 6166 (installment payment of estate tax on a closely held business interest). It may therefore be advisable, generally, to use FMV (considering any life insurance) in an agreement even with nonfamily shareholders.

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Reliance on § 2703 May Have Been Missing Because It Wasn't Needed

It's interesting to consider why the Court did not rely on § 2703. One reason could be that the redemption agreement was missing a fixed or determinable price which is generally required to be able to look to the agreement for valuation and determine applicability of § 2703 at death, as explained by the Eighth Circuit in its decision. Alternatively, or additionally, it could be that all parties agreed on the FMV of Crown and the narrow issue came down to whether the redemption obligation offset the value of the life insurance proceeds included in the FMV, which was addressed using general economic and § 2031 estate tax principles.

Allocating Life Insurance Proceeds Away from the Deceased's Shares Could Still Be Possible

To avoid life insurance proceeds from being included in the value of a deceased owner's shares for estate taxes, if needed, it may require a legally binding, economically substantive agreement to *actually* allocate the proceeds to the other owners. As the Court noted, a traditional cross-purchase agreement could have excluded the life insurance proceeds from the value of Michael's shares because the policies would have been legally owned by and payable to the other brother outside the corporation. For company-owned policies, special allocations may be most efficiently achieved in an entity taxed as a partnership. A specific amount of life insurance proceeds could be allocated to specific members based on the mutual economic deal they agree to in the operating agreement for capital account maintenance and liquidation purposes. The value of a deceased member's partnership interest for estate taxes should only reflect his or her economic share of the proceeds allocated to his or her capital account.[12, 13]

Query – Could special allocations be possible with a C corporation using separate classes of stock with a supporting shareholders agreement that *actually* affects liquidation rights and share price by class? It would obviously have to be respected for estate tax purposes to work. Crown didn't appear to have separate classes of stock, so the value of Michael's 77.18% stake unsurprisingly included 77.18% of the value of the life insurance proceeds. With S corporations, special allocations are not possible.[14]

Query – With an S corporation, could effectively ignoring life insurance proceeds payable in valuing a deceased shareholder's stock for redemption purposes, which results in an increase in share price and economic value for the surviving shareholder(s), create a deemed and disallowable second class of stock having different liquidation rights for the survivor(s)? The FMV of a life insurance policy at the insured's death is unequivocally the death benefit *payable* so even a short-year ("close the books") election may not be viable in this regard nor for avoiding pro rata inclusion of the proceeds in the value of the insured's stock for estate taxes.

Connelly May Not Pose a Problem Just for Those Subject to *Federal* Estate Tax

Some might conclude that the "*Connelly* problem" only exists if the business owner has a taxable estate large enough for federal estate tax liability and, given the large federal basic exclusion amount ($13.61 million for 2024), relatively few will be in this category, so a stock redemption buy/sell can be maintained or used without concern. It's true that the federal estate tax impacts a very small number of estates each year. However, considering these two points: 1) absent enactment of new legislation, the basic exclusion amount will get cut in half on 1/1/2026; and 2) several states impose a state estate tax with a lower exclusion amount than the federal exclusion. Therefore, the number of business owners who may be impacted by *Connelly* after 12/31/2025 may increase and, regardless, there could be many who may be impacted by state estate taxes. For those whose taxable estates are not subject to federal or state estate tax, the impact of *Connelly* may be moot from an estate tax perspective.

There Could Be Income Tax Consequences to Consider

The income tax consequences of situations in which the FMV of a deceased business owner's interest for estate tax purposes at death is deemed to be higher than that which the interest is redeemed for should be considered. § 1014 allows for a basis adjustment to FMV for any property includible in a deceased person taxable estate. If the FMV for calculating federal estate tax is higher than that which the estate receives upon redemption under any buy/sell agreement, then the basis for income tax purposes steps up to that value and the estate receives less than the adjusted basis in the redemption, so it or its beneficiaries could be eligible for a capital loss income tax deduction.

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Key Person Policy Proceeds Also Increase the Corporation's Value

A common question that may be asked is does the *Connelly* decision apply to key person policies purchased for reasons unrelated to buy/sell planning? The answer should clearly be "yes." Key person life insurance proceeds without any buy/sell agreement considerations or disputes clearly increase the net assets of the company as a general matter. *Connelly* simply rejected the erroneous claim that a redemption obligation offsets the value of insurance proceeds. It may not be of much estate tax concern if the key person has no ownership stake in the company, though.

Query – Could the loss of a key person shareholder adversely affect the future earnings capacity of the company and be a factor to consider valuing his or her share? It may not fully offset the value of life insurance proceeds payable to the company to insure against such loss, or may have no effect at all, but it could be one of many factors to consider in determining FMV of the company. The extent to which it may apply would be a question of fact.

Had the Shares Been Owned in Trust, the Issue May Have Been Mitigated

It's interesting to consider how *Connelly* may have played out had Michael been advised to transfer his shares to an irrevocable trust for the benefit of his family during life to remove them from his gross estate. With proper trust planning via gift or a sale, his shares may have been valued for gift tax purposes during life prior to the life insurance proceeds becoming payable (i.e., the FMV of the policy may have been far less than the death benefit) and the resulting estate tax consequence with respect thereto may have been lessened or avoided. Transfers of shares in trust could be an effective estate tax planning strategy but may require addressing any control and/or gift tax concerns of the transferor. It may also require living at least three years after a gift for any company-owned life insurance proceeds to be removed from the transferor's gross estate had they otherwise been includible under § 2042.[15]

Faithfully Following the Terms of Any Agreement and Reviewing It Periodically is Imperative

The terms of any buy/sell agreement, among family members or otherwise, must be faithfully complied with to achieve its intended outcome. The IRS and courts would likely not respect an agreement the shareholders themselves did not respect. Moreover, all agreements must be reviewed and updated periodically as needed, especially regarding valuation components which can become outdated as the business grows or otherwise changes over time. Corresponding life insurance policies should be reviewed for adequacy in terms of coverage and, if permanent, actual vs. illustrated performance.

Taxpayers Should Seek Qualified Financial, Tax and Legal Guidance

Those with existing entity redemption agreements should have them reviewed by independent financial, tax and legal advisors to determine the extent to which the *Connelly* decision may necessitate any revisions to their agreements and/or additional life insurance coverage. In some situations, especially majority-family-owned corporations and/or where estate taxes are a concern, it may be advisable to consider converting it to a cross-purchase agreement with individually-owned, LLC/partnership-owned, or trust-owned policies. There may be tax consequences to address with changing ownership of existing policies, though. In other situations, it may be advisable to stay the course but review and update the agreement to ensure the economics align with the shareholders' expectations, e.g., adding defined value-like valuation clauses that adjust to valuation challenges or disputes. For prospective agreements, the taxpayer and his or her advisors may want to carefully weigh whether to avoid a stock redemption and favor a cross-purchase arrangement to avoid the potential reach of *Connelly* altogether if life insurance is used as a funding vehicle and estate taxes are a current or future concern.

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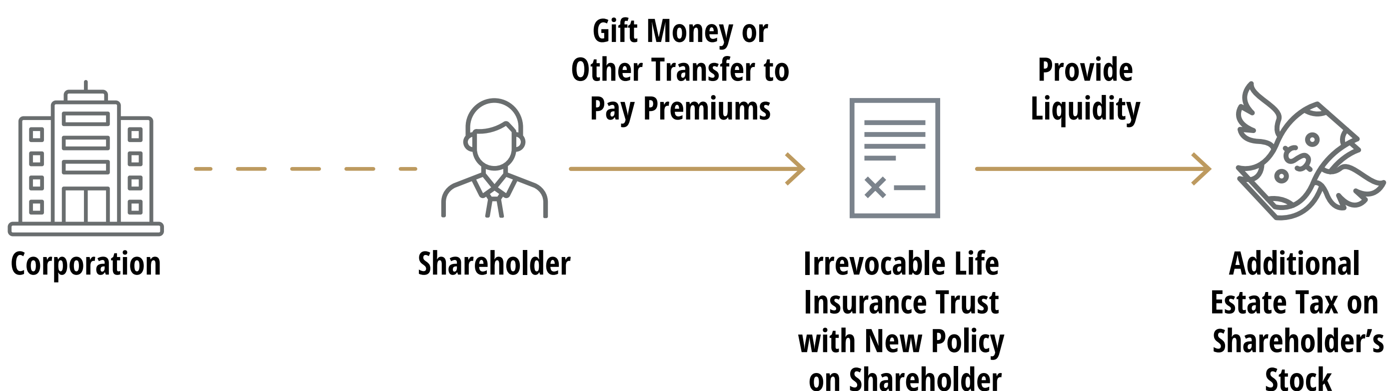
Potential Solutions

If the taxpayer does not have a federal or state estate tax problem, then *Connelly* may be of no concern and an entity redemption agreement funded with life insurance could be maintained or implemented. Conversely, if the taxpayer and his or her advisors want to structure, or restructure, a buy/sell agreement funded with life insurance to potentially avoid the reach of *Connelly*, and amending an operating agreement or recapitalizing a corporation won't be feasible, consider the following strategies.

The strategy summaries below are a general overview for discussion purposes only. If additional life insurance is acquired, the insureds must provide evidence of insurability to the carrier and meet the carrier's financial and medical underwriting requirements. Custom policy design may be needed for any permanent life insurance policies to be used with and optimized for each strategy. Additional formalities, considerations and tax consequences may apply that are beyond the scope of this discussion. Taxpayers should seek independent financial, tax and legal advice from a qualified financial, tax and legal professional and cannot rely on any comments herein for specific guidance regarding their individual situations.

Buy More Life Insurance in Trust



Overview: Each shareholder acquires additional life insurance insuring his or her life in an irrevocable trust to provide liquidity to pay any additional or unexpected estate tax on his or her stock at death. The trust can use the proceeds to buy assets, or lend money to, his or her estate to provide it with such liquidity.[16]

Benefits: This option is simple, possibly the simplest. It can allow a stock redemption to be maintained with policies held by the corporation and may require the least amount of effort and complexity compared to the other options.

Considerations: Each insured must set up an irrevocable trust, if one does not already exist, that can acquire a new policy, pay additional premium, and address any gift tax consequences of making transfers to the trust to pay such premium.

Existing Entity Redemption Plans: This option could be good to consider in situations requiring the maintenance of an entity redemption agreement and/or corporate-owned life insurance, where there is a concern over the estate tax impact or reach of *Connelly*. It could avoid certain challenges with switching to a cross-purchase, such as possible tax consequences to the corporation and/or shareholders with respect to transferring policies, administering a split dollar agreement, administering cross-policy ownership and beneficiary designations, the transfer for value rule, and/or forming, capitalizing and maintaining a limited liability company (LLC) taxed as a partnership.[17, 18]

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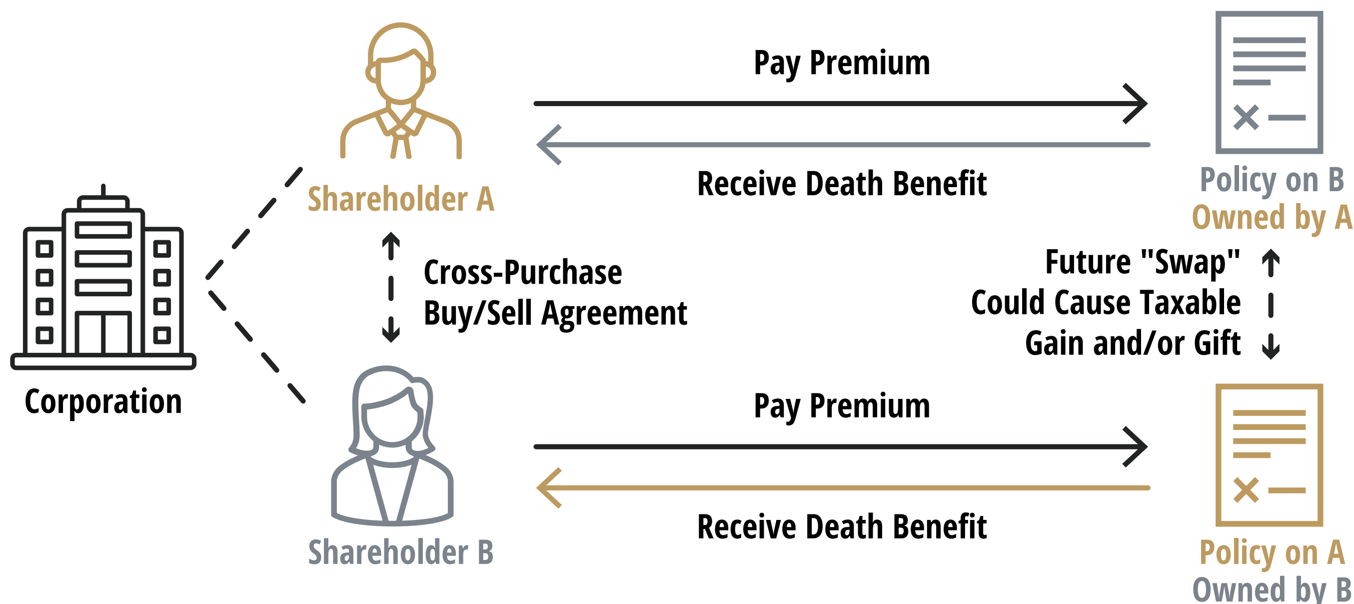
Traditional (Cross-Owned) Cross-Purchase



Overview: The buy/sell agreement is structured as a cross-purchase and each shareholder acquires a life insurance policy on the other(s). Each shareholder owns, pays the premiums on, and is the beneficiary of, a policy insuring the other. Upon death, the surviving shareholder would receive the proceeds of the policy insuring the deceased to help fund the purchase of the stock from the deceased's estate.

Benefits: This option may be relatively simple. The death benefit proceeds would not be included in the value of the deceased's stock for estate tax purposes. The surviving shareholder receives full basis credit in the stock purchased from the deceased's estate.

Considerations: If the policy owner does not pay the premiums needed to carry the policy insuring the other shareholder, the proceeds needed to buy the shares from the deceased shareholder's estate may not be available. Policy ownership and administration can be complicated because the total number of individual policies needed ("#P") increases exponentially with the number of shareholders ("#S"). For example, six policies would be needed for three shareholders, 20 total policies would be needed with five shareholders, 90 policies would be needed for 10 shareholders, etc., ((#S - 1) x #S = #P). If the shareholders exchange ("swap") policies with each other in the future so they can use the policies for which they are the insureds for personal planning, it could result in taxable income to the extent the value of the policy received exceeds the cost basis of the policy transferred in the exchange. Also, if between family members, it could result in a taxable gift to the extent the value of the policy transferred exceeds the value of the policy received. Lastly, it could be perceived as an unfair funding arrangement for the premiums if age and insurability of the insured is older and worse than that of the policy owner.

Conversion of Existing Entity Redemption Plans: If there is a desire to avoid the reach of *Connelly*, and there are only two shareholders, it may be possible to restructure the agreement to this approach. It can avoid the need to form trusts, administer a split dollar arrangement, and/or form, capitalize and maintain a limited liability company (LLC) taxed as a partnership. However, there may be income tax consequences to the corporation and/or shareholder related to transferring ownership of a policy, especially if the policy has inside gain.[19] Additionally, a transfer to a co-shareholder of the insured would not qualify as an exception to the transfer for value rule unless the shareholders formed, or already co-owned, an entity taxed as a partnership.[20]

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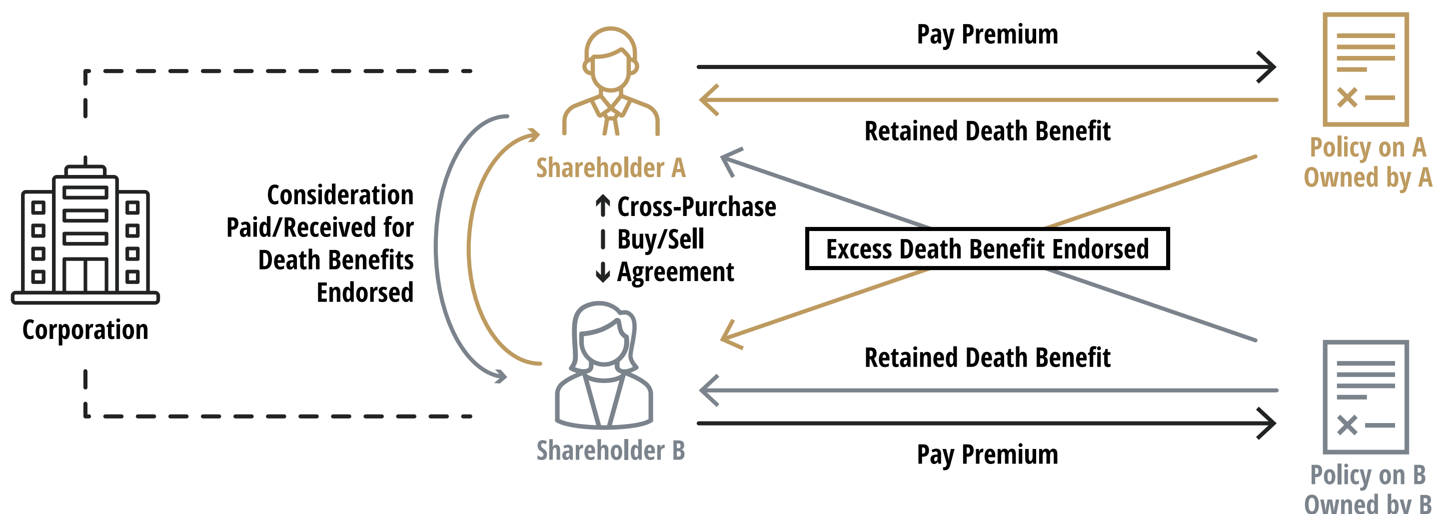
Insured-Controlled (Cross-Endorsement) Cross-Purchase



Overview: The buy/sell agreement is structured as a cross-purchase and each shareholder acquires a life insurance policy insuring his or her own life. Each shareholder owns and pays the premium on their own policy. Together they enter into an endorsement split dollar arrangement whereby the policy owner shareholder ("owner") endorses a portion of the death benefit, typically the excess over the greater of premiums paid and cash value, to the other shareholder ("non-owner") who designates himself or herself as the beneficiary of that portion. Each year the arrangement is in effect, the non-owner pays consideration to the owner in exchange for, and equal to, the cost of the life insurance protection received calculated using the Table 2001 rate or the carrier's one-year term rate, if less.[21] Upon death, the surviving shareholder receives the endorsed proceeds to help fund the purchase of the stock from the deceased's estate.

Benefits: It can allow for one policy per owner to simplify the ownership and administration requirements if there are more than two shareholders. The death benefit proceeds would not be included in the value of the deceased's stock for estate tax purposes. The surviving shareholder(s) receive full basis credit in the stock purchased from the deceased's estate. Upon termination of the agreement during life, each shareholder can be free to repurpose their own policy to meet personal planning needs without causing a taxable event because the ownership of the policy does not change. Lastly, each shareholder pays the premiums needed for their own policy based on their own age and insurability, which may be perceived as a fair funding arrangement.

Considerations: If the policy owner does not pay the premiums needed to carry the policy insuring his or her own life, the proceeds needed for the survivor to buy the shares from his or her estate may not be available. The consideration received by the owner for the death benefit endorsed to the non-owner is taxable income to the owner and not deductible by the non-owner.[22] The cash value must be accessible by the owner and owner's creditors to ensure it is not taxable as economic benefit to the non-owner, otherwise the non-owner's death benefit interest may have to be reduced by at least the inaccessible portion.[23] Endorsing the death benefit in this instance may be a transfer for valuable consideration and, to ensure the death benefit preserves it's tax exempt status, the owner and non-owner must be partners in a partnership or the non-owner must be a partnership in which the insured is a partner.[24] To be viable for estate tax planning purposes, the proceeds endorsed and payable to the non-owner must be eligible for a deduction from the owner's gross estate (as a claim thereagainst) to prevent the owner's estate from paying estate tax on this portion of the death benefit.[25]

Conversion of Existing Entity Redemption Plans: If there is a desire to avoid the reach of *Connelly*, and there are two or more shareholders, it may be possible to restructure the agreement to this approach. It can avoid the need to form trusts and complications related to administering cross-policy ownership and beneficiary designations. It may also provide attractive personal planning flexibility with respect to the policies. However, there may be income tax consequences to the corporation and/or shareholder related to transferring ownership of a policy, especially if the policy has inside gain.[26]

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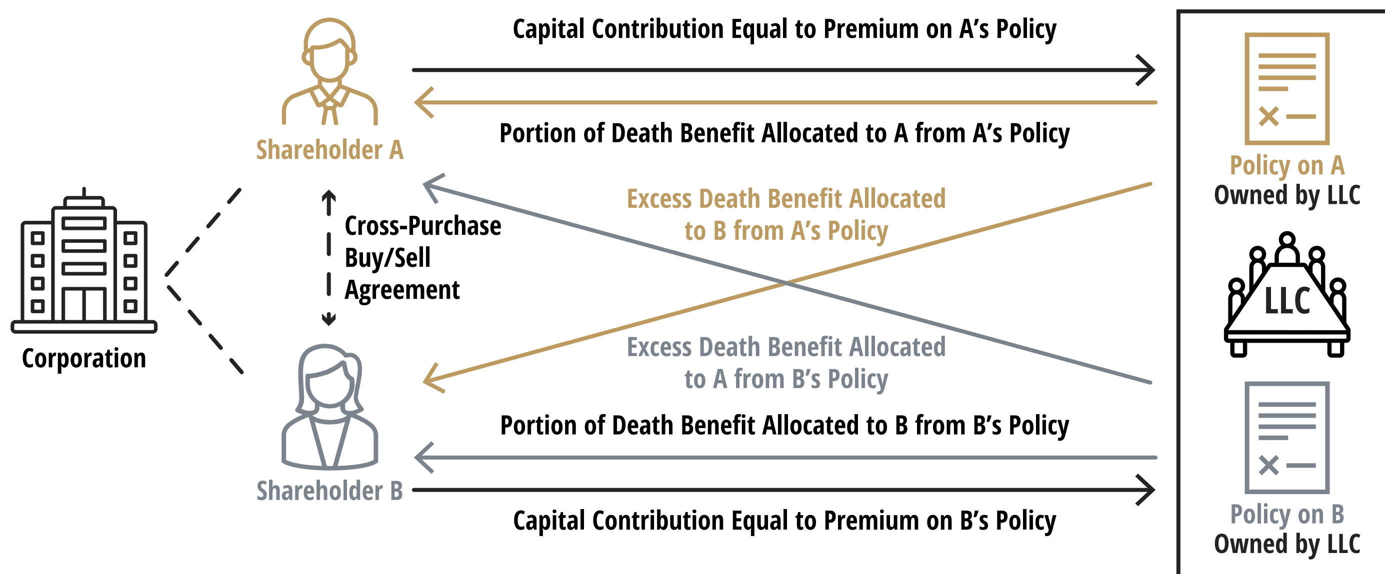
Special Purpose Insurance LLC Cross-Purchase



Overview: The buy/sell agreement is structured as a cross-purchase and the shareholders together form a special purpose LLC taxed as a partnership which acquires a life insurance policy on each member. Cash contributions are made by each member equal to the premium on the policy for which they are the insured, and the LLC pays the premiums. Special allocations in the operating agreement direct the death benefit equal to the greater of premiums paid and cash value to the deceased member's capital account, which is used to redeem his or her interest in the LLC at death.[27] The excess of the death benefit over this amount is directed to the capital account(s) of the surviving member(s), which is distributed to them to help fund the purchase of the deceased's shares in the operating entity.[28] During life, the allocations direct the book value of each member-insured's policy to his or her capital account, allowing the LLC to transfer the policies to each corresponding insured upon a liquidating distribution which can help simplify the capital account maintenance with respect to the policies if they are the only assets in the LLC.

Benefits: It can allow for one policy per owner to simplify the ownership and administration requirements if there are more than two shareholders. Death benefit proceeds allocated to the survivor(s) should not be included in the value of the deceased's shares in the separate operating entity nor in the deceased's gross estate for estate tax purposes. Current and liquidating distributions of the death benefit proceeds to the corresponding members should be income tax free.[29] The surviving member(s) receive(s) full basis credit in the shares purchased from the deceased's estate. Upon termination of the agreement during life, the LLC can transfer the policies to each respective insureds to be repurposed to meet personal planning needs without causing a taxable event because transfers of property from a partnership to a partner is generally not taxable.[30] There should be no split dollar economic benefits to account for.[31] Lastly, each member pays the premiums needed for their own policy based on their own age and insurability, which may be perceived as a fair funding arrangement.

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Considerations: The capital accounts and outside basis must be maintained in accordance with the partnership regulations, and any special allocations must have "substantial economic effect."[32] Because only the portion of the death benefit allocated to the deceased's capital account is included in the liquidation value of his or her LLC interest, this portion should be the value includible in his or her gross estate with respect to such interest if certain requirements are met. An independent manager should be appointed to possess all powers over the policies to prevent incidents of ownership being attributed to the members through their LLC interests.[33] It may be advisable for the operating agreement to document the business purpose of the LLC, e.g., to facilitate continuity of the operating entity. Notice to and consent from the insured for the LLC to buy the policy should be met prior to issue.[34]

Conversion of Existing Entity Redemption Plans: If there is a desire to avoid the reach of *Connelly*, and there are two or more shareholders, it may be possible to restructure the agreement to this approach. It can avoid the need to form trusts and complications related to administering cross-policy ownership and beneficiary designations. It may also provide attractive personal planning flexibility with respect to the policies. However, there may be income tax consequences to the corporation and/or shareholder related to transferring ownership of a policy, especially if the policy has inside gain.[35] Additionally, if the policy is transferred, or deemed transferred, first to the shareholder who then contributes it to the LLC which allocates a portion of the death benefit to other members, the shareholder must live at least three years from the contribution for the allocated portion to escape inclusion in his or her gross estate for estate tax purposes.[36]

Using Irrevocable Trusts to Help Mitigate Estate Tax

If properly structured, any of the cross-purchase arrangements above could be implement together with irrevocable trusts created by the shareholders for the benefit of their families. The policies, or LLC owning the policies, can be owned by the trusts, the surviving shareholder's trust can receive the policy proceeds, or portion thereof, and then buy the shares from the deceased's estate (or deceased's trust if the shares were gifted thereto during life). This approach can help ensure the value of life insurance proceeds remains outside the deceased shareholder's taxable estate and the accession of corporate share value for surviving shareholders can also occur outside their taxable estates. The shareholders would need to make gifts or other transfers to their trusts to fund premiums and/or split dollar economic benefits and address any related gift tax issues.

General Income Tax Consequences of Transferring Company-Owned Policies

Below is a general overview of income tax considerations when transferring a policy from a business entity to a shareholder or member. It only addresses the impact on taxable income to the entity and shareholder or member and does not cover the transfer for value rule under § 101(a), which impacts the income tax treatment of the death benefit and must be addressed separately. Additional income tax and accounting considerations may apply and any references to amounts taken into account assume the transfer consists of only one character (compensation, dividend, *or* distribution).

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Transferring Entity	Entity Recognizes Policy Gain Upon Transfer?	Taxable Income from Policy Gain Recognized by	Entity Gets a Deduction for the Transfer in Computing its Taxable Income?	Taxation to Transferee Shareholder or Member	Effect on Member Capital Account	Effect on Outside Basis in Shares of Shareholder or Member	Adjusted Basis in Policy Post Transfer
C corporation (separate taxpaying entity)	Yes[37]	Corporation[38]	• Yes, if reasonable *compensation*, equal to FMV of the policy.[39] • No, if *distribution* or *dividend*.[40]	• If *compensation* or *dividend* (E&P), taxable income equal to policy FMV • If *distribution* (no E&P), tax-free if policy FMV is less than stock basis. • If *distribution* (no E&P), capital gain for excess of policy FMV over stock basis.[41]	n/a	• None, if *compensation* or *dividend*. • Reduce by nontaxable portion of *distribution*.	FMV of policy
S corporation[42] (pass-through entity)	Yes[43]	Shareholders pro rata based on allocable share of taxable income[44]	• Yes, if reasonable *compensation*, equal to FMV of the policy.[45] • No, if *distribution*.	• If *compensation*, taxable income equal to policy FMV.[45] • If *distribution*, tax-free if policy FMV is less than stock basis. • If *distribution*, capital gain for excess of policy FMV over stock basis.[46]	n/a	• None, if *compensation*. • Reduce by nontaxable portion of *distribution*.[48]	FMV of policy
Partnership (pass-through entity)	No[49]	n/a	No	Nontaxable[50]	Reduce by book value of policy	If *non-liquidating*, reduce by inside basis of policy or outside basis in partnership if less.[51]	• If *non-liquidating*, inside basis of policy or outside partnership basis if less. • If *liquidating*, adjusted to equal outside basis in partnership.[52]

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1 *Connelly v. United States*, No. 23-146 (U.S. June 6, 2024).
2 The Court cited general estate tax principles, such as § 2031(a) defines the taxable estate to include the value of "all property, real or personal, tangible or intangible," owned by the decedent "at the time of his death," minus applicable deductions. The proper measurement for value is fair market value (FMV) and regulation § 20.2031-1(b) defines FMV as the price a willing buyer would pay a willing seller for the property, or interest therein, both with reasonable knowledge of the relevant facts and neither under a compulsion to buy or sell. § 2031(b) requires shares in a closely held corporation to be included in a deceased shareholder's estate, a corporation's FMV determines the share value, and regulation § 20.2031-2(f)(2) requires considering "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors," "including proceeds of life insurance policies payable to… the company."
3 See footnote 2 regarding the definition of FMV.
4 *Estate Blount v. Commissioner*, 428 F. 3d 1338 (11th Cir. 2005). The *Cartwright* case from the Ninth Circuit reached a similar conclusion as *Blount* and is often referenced in combination therewith. *Estate Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999).
5 Regulation § 20.2031-3.
6 See § 20.2031-2(h). Generally, providing to the other owners a first right of refusal to purchase the interest before the selling owner could be free to sell his interest to a third party was sufficient to satisfy the transfer restriction during life. See *Estate of Weil v. Commissioner*, 22 T.C. 1267 (1954), acq., 1955 C.B. 10.
7 See § 20.2031-2(h), Revenue Ruling 59-60.
8 § 2703(b).
9 § 25.2703-1(b)(3) cross-references § 2701 for defining family members, which includes the transferor, transferor's spouse, ancestors of the transferor and transferor's spouse, spouses of such ancestors, any lineal descendants of the parents of the transferor or transferor's spouse and natural objects of the transferor's bounty. Siblings, nieces and nephews of the transferor and transferor's spouse are included in this definition. See PLR 9222043. The indirect ownership rules of section 2701 also apply to treat certain property as held by a member of the transferor's family.
10 Regardless of the applicability of § 2703, a buy/sell agreement must still meet the requirements of pre-§-2703 law under § 20.2031-2(h) to be determinative for estate tax purposes. § 2703 does not change these other requirements for giving considering to a buy/sell agreement. See Staff of Senate Finance Committee, 101st Congress, Informal Report on S. 3209, Volume 136 Congressional Record S15679, S15681 (Oct. 18 1990).
11 See *Connelly v. United States*, No. 21-3683 (8th Cir. 2023).
12 "Substantial economic effect" is defined in § 704(b) and regulation § 1.704-1(b). Allocations must be managed properly in accordance with the regulations.
13 If incidents of ownership over a partnership-owned policy insuring a member are attributed to such member through his or her partnership interest then the proceeds could be includible in his or her gross estate under § 2042. § 20.2042-1(c)(6) does not require an insured to include in his or her gross estate the proceeds of a policy payable to or for the benefit of a corporation in which he or she was the sole or controlling shareholder, but cross-references § 20.2031-2(f) for the rule providing that life insurance proceeds shall be considered in determining the value of stock held by the insured at death. Similar general principles apply to partnerships. The partnership should be structured as manager-managed and it may be advisable to consider a corporate trustee company as manager. The manager should not be subordinate or related to any member. To help prevent the policy proceeds from being included in a deceased member's estate, the operating agreement should prohibit members from serving as managers and from being allowed to exercise any right or power over policies insuring their own lives, and it should allow a manager to be replaced only by a majority vote of all members. See § 20.2031-3, Revenue Ruling 83-147, PLR 200747002, and *Estate of Knipp*, 25 T.C. 153 (1955), acq. in result, 1959-1 C.B. 4, aff'd on another issue, 244 F. 2d 436 [51 AFTER 409] (4th Cir. 1957), cert. denied, 355 U.S. 827 (1957). Whether the IRS would attempt to disregard partnership special allocations, via § 2703 or otherwise, and argue the proceeds be allocated based on the interests in the partnership for estate taxes may be a question of fact that must be addressed by the member's tax and legal advisors. If structured and managed properly, an operating agreement with special allocations of the life insurance proceeds may be defensible for estate taxes because a properly maintained capital account should determine the liquidation value and what a willing buyer would therefore pay for the partnership interest (assuming no other relevant factors such as earnings capacity and goodwill). The proceeds would be considered in determining the FMV of the partnership and allocated among the members based on the economic deal to which they agreed. § 2703 may not apply because the agreement has no diminutive effect on the partnership's FMV. However, § 20.2031-2(h) requirements must still be met.
14 Special allocations are not possible with S corporations because there cannot be more than one class of stock with different distribution rights.
15 See §§ 2035, 2042 and § 20.2042-1.
16 Buying assets from the estate should generate minimal, if any, capital gain income to the estate as a result of the assets getting a basis adjustment to FMV at death under section 1014. Any loan interest payable by the estate to the trust would be recognized as taxable income by the trust.
17 A corporation must recognize any gain when transferring a policy to a shareholder which is taxable to the corporation if a C or shareholders pro rata based on their share of allocable taxable income if an S. A deduction may be available in computing the entity's taxable income if treated as compensation, otherwise a divided or distribution is non-deductible. Shareholders recognize taxable income on the value of the policy received if treated as compensation or dividend from a C corp. From an S corp., it is generally ideal to take it as a return of capital distribution, if possible, which reduces outside basis (capital gain to the extent of the excess over outside basis). Any loss on the policy is generally non-deductible and with an S corp. such loss will reduce the outside basis of the shareholders pro rata. Distributions from S corporations must be made pro rata to all shareholders. The FMV of a policy when transferred from an employer is generally the greater of the interpolated terminal reserve (ITR) or the sum of premiums and earnings less reasonable charges (PERC). See Revenue Procedure 2005-25.
18 The transfer for value rule under § 101(a)(2) provides that if an interest in a policy is transferred for valuable consideration, including a reportable policy sale, then the income tax exempt treatment of the death benefit proceeds attributable to the transferred interest is limited to the sum of the consideration and subsequent premiums paid, less any tax-free withdrawals, by the transferee. Exceptions to this general rule for transfers that are not reportable policy sales include transfers to "certain persons" (a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder) and "carryover basis" transfers (those where the transferee's basis is determined by reference to the transferor's basis.)
19 See footnote 17.
20 See footnote 18 regarding the transfer for value rule. If the transferee-shareholder is not one of the "certain person" exceptions to the transfer for value rule, then the income tax exempt treatment of the death benefit received by such transferee, or the estate or beneficiary thereof, may be limited to the sum of the consideration and any subsequent premiums paid by the transferee under § 101(a)(2). To establish a "certain person" exception, the shareholders could consider forming a separate partnership entity, e.g., with the business purpose of holding investments, real estate, etc.
21 Under § 1.61-22 (the "split dollar regulation"), the full economic benefit provided to the non-owner must be accounted for as taxable income or a gift depending on the relationship between the parties to the extent it exceeds the consideration paid therefor by the non-owner to the owner. Any such consideration paid by the non-owner is recognized as taxable income by the owner, which adds to the owner's cost basis in the policy under § 72(e)(6) to the extent not otherwise so added by reason of having been paid by the owner as a premium or other consideration for the policy, but does not create basis in the policy for the non-owner under § 72(e)(6). The economic benefit is generally the cost of the life insurance protection received by the non-owner plus any portion of the cash value to which the non-owner has, or is deemed to have, "current access." Cash value to which the non-owner has "current access" is defined by the split dollar regulation as that portion to which the non-owner has a current or future right, and that is currently accessible by the non-owner (directly or indirectly), in accessible by the owner or inaccessible by the owner's general creditors. Accessibility of the cash value by the owner's creditors is determined based on the terms and structure of the arrangement or by operation of law (e.g., applicable state law limiting the reach of the owner's general creditors to a portion or all the cash value could cause such portion to be treated as inaccessible for this purpose.) "Cash value" is defined by the split dollar regulation as the gross cash value disregarding surrender charges. Structured properly, the cash value should not be included in the economic benefit provided to the non-owner. According to IRS Notice 2002-8, to use the carrier's one year term rate as the applicable rate for calculating the cost of the life insurance protection, the carrier must "regularly sell" a corresponding one-year term product.

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22 See footnote 21 regarding effect on cost basis. Essentially, the owner is treated as "renting" the death benefit to the non-owner and the consideration received is "rent." Consideration paid by the non-owner for the economic benefits received is not deductible by the non-owner for income tax purposes – § 264(a) prohibits a deduction for premium paid by a taxpayer that is a direct or indirect beneficiary under the policy and § 265 prohibits a deduction for expenses or other amounts otherwise allowable as a deduction under any provision of the Code to the extent allocable to creating tax exempt income regardless of whether such exempt income is actually received or accrued.

23 See footnote 21 regarding the regulatory definition of "current access" and accessibility by creditors. An exclusive right to designate who receives the death benefits under the policy can cause the non-owner to be treated as having a future right to the cash value. See *De Los Santos v. Commissioner*, T.C. Memo 2018-155 (2018) and *Our Country Home Enters., Inc. v. Commissioner*, 145 T.C. No. 1 (2015).

24 See footnote 18 regarding the transfer for value rule. If the non-owner is not one of the "certain person" exceptions to the transfer for value rule, then the income tax exempt treatment of the endorsed portion of the death benefit received by the non-owner, or the estate or beneficiary thereof, may be limited to the sum of the consideration paid by the non-owner under § 101(a)(2). To establish a "certain person" exception, the owner and non-owner could consider forming a separate partnership entity, e.g., with the business purpose of holding investments, real estate, etc.

25 This consideration presumes the owner has a taxable estate large enough to result in an estate tax payable. §§ 2035 and 2042 require inclusion in the insured's gross estate the full death benefit proceeds payable from a policy in which the insured possessed any incidents of ownership within three years of death. § 2053 allows a claim against the estate to be deductible from the gross estate in determining the taxable estate. When a claim against the estate was originated on a promise or agreement, the deduction allowed by § 2053 is limited to the extent that it was contracted bona fide and for adequate and full consideration in money or money's worth.

26 See footnote 17.

27 The operating agreement addresses how the members agree to share in the economic benefits and burdens of the partnership. Essentially, it lays out the economic deal agreed to by the members. Upon death, allocating the greater of cash value and premiums paid to the deceased member from his or her policy helps avoid such person funding their own buyout with their own money, which may be attractive to many shareholders and members.

28 Special allocations must have substantial economic effect. See footnote 12. Otherwise, all items are allocated based on the interests in the partnership.

29 § 705 requires the member's basis in his or her interest in the partnership (outside basis) to be increased by tax exempt income received by the partnership. Death benefit proceeds paid by reason of the insured's death are exempt under § 101(a) and the portion that is allocated as tax exempt income for outside basis purposes is that which exceeds the policy's adjusted basis immediately before the insured's death. The surviving members, therefore, receive an increase in outside basis in the amount of proceeds allocated to them and can take a distribution of such amounts tax free which reduces outside basis accordingly. See §§ 731 and 733. A deceased member's outside basis should equal his or her capital account value as a result of it being adjusted to the fair market value under § 1014, or, in the case of an entity such as a trust as the member, being increased by any tax exempt death benefit proceeds in excess of the policy's cost basis allocated to its capital account, thus allowing a tax free liquidating distribution under § 731.

30 Generally, no gain or loss is recognized on distributions of property other than money from a partnership to a partner. In a current (non-liquidating) distribution, the partner takes a basis in the distributed property equal to the basis of the property to the partnership immediately before the distribution or the partner's basis in his or her partnership interest, if less. The partner's basis in his or her partnership interest is reduced by the basis of the distributed property to such partner. In a liquidating distribution, the partner takes a basis in the distributed property equal to the partner's basis in his or her partnership interest. See §§ 731- 733.

31 Regulation § 1.61-22(c)(1)(iv) is reserved for rules regarding the definition of an owner under the split dollar regulation. It has been over 20 years since the effective date of the final regulations and no guidance has been issued. However, the reserved clause in the regulation could mean that future guidance could be issued in regard to how the split dollar regulation could apply to partnership-owned policies.

32 See footnote 28.

33 See footnotes 13.

34 See § 101(j) and IRS Notice 2009-48 regarding the "Notice and Consent" requirements and to whom they apply. Form 8925 must be filed by the entity each year reporting the face amounts of employer-owned life insurance contracts and whether notice and consent was met for each. If there is doubt as to whether § 101(j) The cost of limiting the income tax exempt treatment of the death benefit to the premiums paid (general rule of § 101(j)(1)) may be far greater than the administrative effort needed to quality for an exception to this rule by satisfying the notice and consent requirements even when the insured is a member in a partnership and there is doubt as to whether § 101(j) applies to such insured. It may be advisable to err on the side of caution in this regard.

35 See footnote 17.

36 §§ 2035 and 2042 require inclusion in the insured's gross estate the full death benefit proceeds payable from a policy in which the insured possessed any incidents of ownership within three years of death.

37 See § 311(b).

38 See § 311(b).

39 See § 162.

40 Distributions and dividends are a return of a shareholder's investment, not ordinary and necessary business expenses that can be deducted.

41 Dividends are distributions out of a C corporation's earnings and profits (E&P) and are included in gross income of the shareholder and may be eligible for qualified dividend treatment at preferential tax rates under §1(h)(11). If there are no current or accumulated E&P, then the distribution is generally a tax-free return of capital and reduces the shareholder's stock basis, but taxable to the extent of the excess over such stock basis. See §§ 301 and 316.

42 The tax consequences mentioned for S corporations assume the corporation has no E&P from a prior conversion from C corporation status.

43 See § 311(b).

44 See § 1366.

45 Due to pass-through taxation, a deduction for compensation with an S corporation reduces its taxable income otherwise allocatable pro rata to individual shareholders, so amounts paid as compensation to a shareholder generally shift the entire tax burden on such amounts to the receiving shareholder.

46 Compensation paid to a shareholder of an S corporation is also subject to payroll taxes (Social Security, Medicare, unemployment, etc.)

47 See §§ 1367-1368. Distributions paid to a shareholder of an S corporation are not subject to payroll taxes as referenced in footnote 46.

48 See § 1367.

49 See § 731(b).

50 See § 731(a).

51 See §§ 732-733.

52 See § 732.

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