

From the MassMutual Strategic Distributors Advanced Sales Team

Supreme Court Upholds Connelly Decision: Implications for Entity Redemption Arrangements

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Summary:

On June 6, 2024, the U.S. Supreme Court unanimously affirmed the 8th Circuit Court of Appeal's decision supporting the Internal Revenue Service's (IRS's) stance on the treatment of life insurance proceeds and redemption obligations for federal estate tax purposes. The court ruled that a corporation's contractual obligation to redeem shares does not reduce the corporations' value for estate tax purposes.¹ Prior to *Connelly v. United States*, 602 U.S. __ (2024), most tax professionals assumed that if life insurance proceeds were included in the valuation of a business for estate tax purposes, the business's obligation to repurchase the deceased shareholder's interest would be an offset — essentially making the inclusion and the liability a wash. For taxpayers with a potentially taxable estate (for federal or state estate tax purposes) this case is game-changing. With the estate tax exemption scheduled to sunset after the end of 2025, the timing of this case creates some urgency for business owners to reexamine their buy-sell agreements.

¹ For more information, please see: https://www.supremecourt.gov/opinions/23pdf/23-146_i42j.pdf

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Action Plan:

Review Buy-Sell Agreements

Advisors should recommend that business owner clients review their buy-sell agreements. Most business owners are likely to know if the plan is an “entity” arrangement or some form of “cross purchase,” but a review of the plan is good advice for all business owners.

Review Buy-Sell Funding

It isn't uncommon for a buy-sell agreement to have documentation specifying one type of plan (such as a cross-purchase) but life insurance funding that doesn't necessarily match (such as entity-owned life insurance with a cross-purchase agreement). Maybe more importantly, does the amount of insurance match the business's current valuation? Does the client funding contemplate all exits covered by the agreement or is the funding merely term insurance? This may be a good time to discuss advantages of permanent life insurance to help fund lifetime buy-outs. Has the client considered disability insurance for disability buy-outs likely covered by the agreement?

Should ALL Entity Buy-Sell Plans Be Switched?

If the client's total estate (including value of the business and insurance proceeds) is less than the \$7 million projected estate tax exemption after sunset of the 2017 Tax Act, *Connolly* seemingly has no impact on a client's situation (although some state estate tax thresholds are lower than the \$7 million projected federal limit and should be considered). However, even before *Connolly*, an entity buy-sell agreement was often less tax-efficient than cross-purchase agreements for capital gains planning purposes. For a C corporation — an “entity” arrangement does NOT provide basis step-up to surviving (remaining) shareholders when an entity purchases shares of a deceased (or otherwise exiting) shareholder. Even with passthrough entities (such as partnerships, S corporations, and LLCs) — to attain a basis step-up for remaining shareholders, the business must file complicated and time-sensitive tax filings upon a shareholder's death. Capital gains taxes are a real concern for ALL clients — whereas estate taxes will only impact more affluent clients and larger business owners.

Revise Agreements if Necessary

If, upon review, it is determined that business owner clients may have a federal and/or state estate tax liability or want to maximize capital gains efficiency, they should revise their agreements. Several popular options are summarized below.

- **Switch to Cross-Purchase Agreements for Estate Tax Concerns:**

A potential strategy for those business owners with potential estate tax issues is to switch to a cross-purchase agreement. For business owners that are corporations, such as S corporation owners, the transfer of a policy to other business owners constitutes a transfer for value, so an exception to the transfer for value rule is needed. If the owners are partners in a valid partnership (or an LLC taxed as a partnership), even if the entity they are partners in isn't the same entity that is the subject of the buy-sell arrangement, they may qualify for an exception to the transfer for value rule. However, no transfer for value exception exists for mutual shareholders in a C corporation. Be cautious of this trap when converting from an entity buy-sell to a cross-purchase. A partnership will need to be created or consider using a Retirement Buy-Sell arrangement or an Insurance LLC.

- **Life Insurance Partnership/LLC**

One common buy-sell structure that has been suggested as a solution to *Connelly* is a Life Insurance Partnership or LLC. This structure is often used to facilitate a traditional cross-purchase arrangement to address a multiple policy problem

(e.g., five owners require 20 policies in a traditional cross-purchase). However, the court in *Connelly* does not differentiate between different types of entities, and because a Partnership LLC is still an entity, its value may potentially increase upon the death of an insured owner. This could result in an adverse estate tax consequence regarding the value of the pro rata share of the entity included in the deceased owner's estate. While many tax professionals are pointing to the Life Insurance Partnership or LLC as the preferred solution after *Connelly*, other professionals worry that the broad (and, arguably, overreaching) nature of the *Connelly* opinion could cause problems. Therefore, the safest options appear to be a traditional cross-purchase arrangement or the so-called "Retirement Buy-Sell" (also known as a Cross-Endorsement Buy-Sell).

- **Retirement Buy-Sell:**

An alternative to the traditional cross-purchase (where shareholders own policies on the lives of the other shareholders) is the "Retirement Buy-Sell" where business owners own policies on their own lives. These individually owned policies are then endorsed (essentially an annual rental — governed by the split dollar regulations) to other shareholders

to fund a cross-purchase agreement. In the simplest form, assume two owners (A and B). A will own a policy on A's life and B will own a policy on B's life. While the buy-sell is in effect, A will annually rent some or all of the death benefit (under an endorsement) to B. B will annually endorse the death benefit on B's policy to A. The cost of this endorsement/rental is governed by split dollar regulations.

- **Proactive Agreement Review:**

Now is an excellent opportunity to reach out to clients to review all existing buy-sell agreements, helping them meet current goals, verify that businesses are properly valued, and confirm that agreements are adequately funded. Most buy-sell agreements have some form of funding (often grossly inadequate) for a buy-out on death — but funding for buy-outs resulting from retirement or disability are rarely funded despite the reality that retirement or disability are the more likely events.



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