

# Did Connelly v. United States impact your clients' buy-sell arrangements?

## Connect with your clients to determine impact and next steps

On June 6, 2024, the U.S. Supreme Court decided a case that will affect all business owners who have life insurance-funded buy-sell agreements – specifically agreements commonly referred to as “entity purchases” or “stock redemptions.” This decision has muddied the waters around buy-sell agreements by reversing generally accepted principles long held by the financial services community.

In Connelly v. United States, the Court addressed the narrow question of whether a corporation's fair market value, where the corporation has an obligation to redeem a decedent owner's shares, is impacted by life insurance proceeds received by the corporation and committed to funding the redemption for estate tax purposes. The Court unanimously held that the corporation's redemption obligation is not a liability that reduces the estate tax value of the decedent's shares and that the death benefits received by the corporation must be included as part of the estate tax valuation.<sup>1</sup>

## Connecting with business-owner clients is crucial

As a result, it's imperative that financial professionals reach out to business-owner clients to determine the impact of this decision. Don't make the client come to you. The message is simple: All buy-sell agreements or provisions in corporate shareholders agreements, LLC operating agreements, and partnership agreements should be revised and amended, **particularly if the agreements call for the business to buy back the ownership interest of a deceased owner and the business purchases life insurance on the owner to do that.**

Even if it does not specifically refer to a life insurance funded buy-out, the Connelly decision still affects the purchase price of the business. It is certain that life insurance-funded buy-sell agreements will produce HIGHER death-time business valuations versus unfunded arrangements, as the life insurance death proceeds payable to the business MUST be included in the valuation. Someday this point might possibly be litigated as to why an agreement was not funded with life insurance as higher business valuations could be achieved.

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## What you can do to help business owners:

The Connelly decision must be addressed by all business owners. Your clients should review business goals and decide what is the most helpful strategy:

- Entity purchase/Stock redemption
- Cross purchase
- Wait-and-see
- Right of first refusal
- One-way buy-sell
- Trusteed buy-sell
- Special purpose LLC buy-sell
- Wealth transfer techniques
- Funded or unfunded

Of these strategies, the entity or stock redemption agreements are most directly affected. The “wait and see” buy-sell strategy has also changed. The Connelly agreement was a “wait-and-see” with a right of first refusal to the surviving partner. When the surviving partner refused, the redemption agreement became mandatory.

## Decision directly affects all business value

Regardless of the nature of the agreement, because the insurance was held by the company, the value of the company was increased by the proportional amount of the death benefits paid. The choice to fund with company-owned insurance is now a decision that directly affects the value of the business for all types of valuations.

Typically, wait-and-see arrangements were funded as redemptions. Now it might be advisable to set them as a cross-purchase or a Life Cycle buy-sell. However, the choice to fund the transaction at all is now an event that can be questioned by current and future owners. There may come a time when insurance-funded redemption buy-sell agreements are a huge benefit for surviving shareholders. Imagine a company worth \$1,000,000 with three owners each having a company-owned policy worth \$333,333. When the first Owner A dies, the death benefit would be paid to the company and the company would be worth \$1,333,333, of which the \$333,333 is payable to A's estate on an installment note over 10 years of equal payments at 5 percent interest. Owners B & C would own the company 50/50 and the note payable. In year one, the value of the company is \$1,333,333, less the first payment of \$33,333.30. So, B&C now own 50 percent of a company worth \$1.3 million or \$667,000 each. Their company is more valuable than under a cross purchase as they would have bought out A at \$333,333. The company would still be worth \$1,000,000 and their shares \$500,000 apiece.

This is a hypothetical example for illustrative purposes only.

Financial professionals need to communicate these changes to clients because of the Connelly decision and further discuss the appropriate use of life insurance in a buy-sell arrangement.



## Learn more

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1. Connelly v. United States, 602 U.S. (2024).

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