Folks:

Take-Away: The Court held that a corporation's contractual obligation to redeem the stock of one of its shareholders was not a liability or debt.

Background: The U.S. Supreme Court, in *Estate of Connelly,* held yesterday that the life insurance proceeds that are received by a corporation on the death of one of its shareholders needs to be included in the value of the corporation for federal estate tax purposes, when it comes to valuing the interest of the deceased shareholder in that corporation. The life insurance death benefit was paid to the corporation to enable the corporation to fulfill its contractual obligation under a preexisting buy-sell agreement to redeem a deceased shareholder's stock in the corporation. The corporation was worth $3.0 million when its majority shareholder died. The majority shareholder owned about 77% of the stock. $3.5 million in death benefit was paid to the corporation on the majority shareholder's death. The corporation then used $3.0 million to full its redemption obligation. The decedent's shares were reported with a value of $3.0 for federal estate tax purposes. The IRS successfully claimed in the lower courts that the corporation was worth about $6.5 million on the majority shareholder's death, and that his interest in the corporations should have been valued at $5.3 million (not $3.0 million.) The lower court decisions were affirmed by the Supreme Court

Not a *Wash:* The decedent's estate had argued that while clearly the death proceeds were paid to the corporation, the corporation also had a corresponding binding legal obligation, a debt, under the existing shareholder buy-sell agreement for the corporation to use the same death benefit proceeds to fulfill its stock redemption obligation, thus leading to a 'wash', i.e., $3.0 million in, $3.0 million out, thus leaving the corporation's assets (and the corporation's intrinsic value) basically the same at the time of the deceased shareholder's death. The Supreme Court rejected this 'wash' argument, noting that the surviving shareholder, after the redemption, owned 100% of the corporation with that close-to-same value at the other shareholder's death. Accordingly, practically speaking, wealth was in some manner transferred to the surviving shareholder whose interest in the corporation swelled to the $3.0 million value. The Court seemed to be fixated on the fact that the surviving shareholder got some sort of benefit, when its analysis should have been focused solely on the value of the corporation, both its assets and its debts, at the time of the majority shareholder's death.

Consequences: As a result of the *Connelly* decision, many existing buy-sell agreements that require the redemption of an owner's interest in the entity, which obligation is funded by life insurance, should now be closely re-examined.

> **Cross-Purchase Agreement:** Whether to continue with a redemption agreement, as opposed to shifting to a stock-purchase agreement between the shareholders (and excluding their corporation), where the shareholder own the life insurance policy on the life of the other shareholder, needs to be re-evaluated.
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> **Life Insurance Owned by LLC:** Yet another option to consider is for the shareholders to form an LLC that is structured to purchase the life insurance policies on the lives of all shareholders, with the death benefit payable to the LLC used by the surviving LLC members to purchase the decedent's interest in the business entity, i.e., the corporation. The LLC, which would own a life insurance policy on the life of each shareholder, would avoid the major drawback of a cross-purchase agreement where a life insurance policy must be purchased by each shareholder on the lives of all other shareholders, leading to multiple policy purchases and premium obligations. Such an LLC-insurance owned arrangement used to fund the buy-sell agreement would keep the death benefit from being paid to the corporation and would thus avoid the problem

encountered in the *Connelly* case.

Conclusion: Perhaps the *Connelly* decision is something of a wake-up call for the estate planning community, which may have been lulled into a bit of complacency with high applicable exemption amounts and portability causing federal estate taxes to become something of an after-thought in planning. 2026 looms on the horizon. Here, with *Connelly,* we have a decision that arguably inflates the value of the decedent's interest in a closely held business. This decision can lead to mismatch between what is received, and the death tax associated with what is received. Mr. Connelly's estate was contractually obligated to take $3.0 million for the decedent's interest in the corporation, which it received. According to the IRS's analysis and $5.3 million *deemed* value, $2.12 million of that death benefit was 'paid back' in the form of federal estate taxes- the net effect was that Mr. Connelly's estate 'netted' roughly $900,000 on its sale of his shares, resulting in a mismatch.

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