VOLUME 78 ◆ NUMBER 7

Employee Benefit Plan Review

# *Connelly v. United States*: U.S. Supreme Court Rules Redemption Buy-Sell Increased Estate Taxes

By Abigail R. McGowan

If you are an owner of a closely held business that has a redemption buy-sell agreement, the U.S. Supreme Court has ruled that this may impact the amount of taxes owed by your estate at death.

## Background

Closely held companies generally have buy-sell arrangements to control how a deceased owner's interest can pass at death. A common buy-sell arrangement is called a "redemption" agreement, which requires the company to purchase a deceased owner's interest in order to prevent outside investors from infiltrating the company. Typically, the company will purchase life insurance on the owners and use the proceeds to purchase the deceased owner's interest.

## The Court's Decision

In *Connelly v. United States*,[1] the Supreme Court held that the value of the life insurance proceeds received by a company upon the death of an owner increases the fair market value of the total company. This ruling diverges from the previous understanding that a company's obligation to redeem (purchase) the deceased owner's interests offsets the value of the life insurance proceeds. The Supreme Court explicitly stated that was not the case for the company in question.

## The Implications

If you are in a similar situation, the value of your business interest will increase, which means the value of your estate will increase, resulting in potential estate taxes.

The holding in *Connelly* likely extends to all closely held businesses, including corporations, partnerships and LLCs. This means that all closely held business owners can face increased estate tax liability where life insurance proceeds are payable to the company at the death of an owner.

Consider the following implications of the Supreme Court's decision when evaluating your current redemption plan:

- *Estate Taxes*. If you have a taxable estate upon your death (i.e., an estate valued at $13.61 million or more for 2024 and doubled for married couples), you may face higher estate taxes due to the increase in value of your company. Even if you do not currently have a taxable estate, the increase in value of the company may be enough to trigger an estate tax, especially given that beginning in 2026, estates valued at approximately $7 million or more (and doubled for married couples) will be subject to estate taxes.

- *Company Valuation.* It will be more important than ever for your executor to get an appraisal of your company upon your death for estate tax reporting. Given the Supreme Court's decision, there will almost assuredly be a spike in IRS audits of deceased business owners' estate tax returns. The litigation in *Connelly* could have been avoided had the executor obtained a proper appraisal of the underlying business interests.

## Alternative Options

There are several alternative options to redemption agreements that keep life insurance proceeds outside of the company's operating assets, preventing its increase in value upon the death of an owner, including:

- *Cross-Purchase Agreements.* In a cross-purchase agreement, business owners individually agree to purchase a deceased owner's interests. The business owners themselves will purchase life insurance on each other, and the surviving owner(s) will use the proceeds to purchase the decedent's interests. Because the individual owners receive the life insurance proceeds, the company avoids the increase in value. A downside of this strategy is that the individual owners will have to pay the premiums on the life insurance policies. Additionally, if a company-owned policy is already in place, transfers of company-owned policies to individual owners can have tax consequences if not properly structured.
- *Capital Contributions and Loans.* The surviving individual owners could provide capital contributions or loans to the company to fund the purchase of a deceased owner's interests. In turn, the owners could fund the contributions or loans with the proceeds of individually held life insurance policies.
- *Revised Redemption Agreements.* The Supreme Court noted that a redemption agreement that requires the company to liquidate operating assets, rather than using life insurance proceeds, to purchase a deceased owner's interest will not increase the company's value. Since liquidating operating assets would decrease the company's future earning capacity, the value of the company would not increase.

## Next Steps

The *Connelly* decision provides an excellent opportunity to review your company's redemption agreement with your advisors to avoid inadvertently increasing the value of your business interests and potential estate taxes. It additionally serves as a good reminder that your business succession plan should align with your overall estate and tax planning objectives.

## Note

1. Connelly v. United States, No. 23-146 (U.S. June 6, 2024).

**The author, an attorney with Reinhart Boerner Van Deuren s.c., may be contacted at amcgowan@reinhartlaw.com.**