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Is it Time to Revisit Buy/Sell Provisions for Your Business?

If your closely-held business utilizes life insurance policies to provide funding for buy/sell transactions, a recent decision by the Supreme Court may cause you to reconsider your options. In *Connelly v. United States*, 602 U. S. ____ (2024), the Supreme Court unanimously ruled that the life insurance proceeds received by the company following the death of one of the owners increased the fair market value of the company for federal estate tax purposes, and therefore the value of the decedent's ownership interest in the company. In light of this ruling, it may be prudent to revisit your governing documents and determine whether a change in strategy for ownership redemption might be advantageous.

The Facts

Two brothers were sole shareholders in Crown C Supply, ("Crown") a building supply corporation located in St. Louis, Missouri. The brothers executed an agreement that gave each of the brothers the option to purchase the shares of the other in the event one of them died. If the surviving brother declined the purchase option, the corporation would be required to repurchase the share of the deceased owner. The redemption price would be based upon the fair market value of the shares, as determined by an outside appraiser. The corporation purchased $3.5 million in life insurance for each of the two owners to ensure adequate cash in the event a redemption were triggered.

One of the brothers died in 2013 and the surviving owner declined the option to purchase the shares of the decedent, thus triggering the company's repurchase of the shares. Crown used $3 million of the life insurance proceeds to fund the redemption, and the value of the shares was reported as $3 million on the estate tax return filed on behalf of the decedent. An accounting firm engaged to value the business relied on *Estate of Blount v. Commissioner,* which held that insurance proceeds should be deducted from the value of a corporation when they are offset by an obligation to pay those proceeds to the estate in a stock buyout. This resulted in a company value of $3.86 million, which was multiplied by the decedent's ownership percentage (77.18%) to arrive at the value of the decedent's shares of approximately $3 million.

The IRS Position

In its audit of the estate return, the IRS took the position that the company's redemption obligation did not offset the life insurance proceeds. Therefore, the agency concluded that the value of the company was $3 million higher than the value determined by Crown's valuation firm – $6.86 million. The IRS then used the higher value to calculate the value of the decedent's shares – $5.3 million. Based on this value, the IRS concluded the estate owed around $890,000 in additional taxes.

Supreme Court Ruling

The only question at issue for the Supreme Court was whether the company's contractual obligation to redeem the decedent's shares at fair market value offsets the value of the insurance proceeds devoted to funding the redemption. The Supreme Court ruled that "redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax." It further explained that "an obligation to redeem shares at fair market value does not offset the value of life insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest." The ruling noted that a redemption transaction "necessarily reduces a corporation's total value. And, because there are fewer outstanding shares after the redemption, the remaining shareholders are left with a larger proportional ownership interest in the less-valuable corporation."

Implications of the Ruling

In it's ruling, the Supreme Court offered other options for how the buy/sell agreement could have been structured. One option is a cross-purchase agreement, whereby the shareholders agree to purchase each other's shares upon death. Each of the shareholders could then purchase life insurance policies on the other individuals to fund the purchase transactions. In such an arrangement, the life insurance does not flow through the company but rather directly to the surviving shareholders, and therefore would not impact the fair market value of the company. However, this requires the individual shareholders to pay the life insurance premiums, and if one of them failed to keep the policies in force there may not be adequate cash available to buy out a deceased shareholder as intended.

Some estate tax attorneys have expressed concern that this ruling makes it much more difficult for closely-held businesses to implement strategies that utilize life insurance to fully fund the repurchase of ownership interests. One option may be to use life insurance to fund a portion of the purchase price, with the remainder paid out over time using a promissory note.

Given the current estate tax exemption of $13.61 million, many small business owners may not be impacted by the ruling simply because the value of the business, even including life insurance policies owned by the company for ownership redemption purposes, still may not be large enough to put the deceased taxpayer over the threshold. However, this could become a much bigger issue if the exemption decreases when the provision in the Tax Cuts and Jobs Act expires at the end of 2025, which will happen unless Congress intervenes.

Should you have questions or would like assistance, JTaylor's experienced advisors are available to guide you in establishing buy/sell provisions to achieve your goals relating to transition of ownership in your business. Visit www.jtaylor.com for more information or to contact one of our tax professionals.