

Supreme Court Decision Negatively Impacts Company-Owned Life Insurance for Estate Tax Purposes

Following the recent United States Supreme Court decision in *Connelly v. United States*, owners of private companies could face unexpected and negative estate tax consequences if the companies have life insurance on the business owner's life to fund a company purchase of their ownership interest at death.

SUMMARY OF RELEVANT TAX LAW

Federal law imposes an estate tax on the *fair market value* of a decedent's property that they own or excessively control at death. Every person has an exemption from estate taxes (the "Applicable Exclusion Amount"), which increases annually with inflation. As of January 1, 2024, the maximum Applicable Exclusion Amount is \$13,610,000. People may use it during life to make gifts free of gift tax, but these gifts reduce the amount available at death. Unless the law changes, the inflation-adjusted Applicable Exclusion Amount will be cut in half starting January 1, 2026.



Estate tax is due nine months from death, at a 40% tax rate, to the extent that the fair market value of the decedent's estate not otherwise going to charity or a U.S. citizen spouse, less certain allowable deductions, exceeds the decedent's available Applicable Exclusion Amount at that time.

CONNELLY DECISION

In *Connelly*, the two shareholders of a closely held company signed a buy-sell agreement granting the surviving shareholder

the right to buy the stock of the first shareholder to die. If the surviving shareholder chose not to buy the stock, the company



was required to buy it. The company owned and was the beneficiary of life insurance on each shareholder's life to provide it with liquidity to buy stock at death.

When the first shareholder died, the survivor declined to buy the stock, so the company bought it using the life insurance proceeds to pay the purchase price.

In valuing the deceased shareholder's stock for estate tax purposes, the estate started with valuing the company as a whole (including the insurance proceeds received) but then offset that value by the price the company was contractually obligated to pay for the stock. Under this approach, the practical result was that the insurance proceeds didn't increase the estate tax value of the stock, because they were used to buy the stock. The IRS audited the estate tax return and disagreed with the estate's valuation.

Ultimately, the case reached the Supreme Court. The Court agreed with the IRS and held that, for estate tax purposes, the decedent's stock should be valued based on a valuation of the company that includes the insurance proceeds received by the company but without reducing that value by the amount that the company was contractually obligated to pay the deceased shareholder's estate to buy back his stock at death.

PLANNING CONSIDERATIONS

The *Connelly* decision should encourage closely held business owners to revisit any corporate-owned life insurance intended to fund a company purchase of a deceased shareholder's stock. Similar considerations apply if the business is structured in a different corporate entity (such as a partnership or LLC).

As a common alternative, each shareholder could own life insurance on the other shareholder and enter into an agreement obligating the surviving shareholder to buy the stock of the first shareholder to die. In this approach (called a "cross-purchase"), the value of the deceased shareholder's stock would not be impacted by the life insurance (because the company wouldn't own the policy). Yet, the life insurance proceeds could still be used to fund the stock purchase.

The cross-purchase structure might become more elaborate when a company has more than two shareholders. Still, the result should be the same – using life insurance to provide liquidity to buy the deceased shareholder's stock without increasing the stock's value for estate tax purposes.

NEXT STEPS

Turtle Creek Wealth Advisors works with successful business owners to develop tax-efficient business succession plans and funding strategies to facilitate business ownership transitions, whether during life or at death, in a manner consistent with each client's business and estate planning goals. Please feel free to contact us if we can answer any questions you may have about your situation.

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