FEATURE:
INSURANCE

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Life Insurance Planning With Closely Held Companies in a Post-*Connelly* World

Five alternative strategies for businesses to consider on a shareholder's death

On June 6, 2024, closely held business owners learned that the highest court in the land may have significantly increased the valuations of their business interests; however, this wasn't a moment for business owners to rejoice. The U.S. Supreme Court's unanimous ruling in *Connelly v. United States*[1] potentially increases business interest valuations for estate tax purposes, obstructing the efficiency of a longstanding, popular method of providing liquidity to the estates of deceased business owners without increasing their estate taxes.[2]

Many estate planners and life insurance agents have historically advocated for companies to obtain life insurance on their shareholders' lives to satisfy the companies' redemption obligations on their shareholders' deaths. In *Connelly*, the Court ruled that the subject company's value for estate tax purposes in the deceased shareholder's estate included life insurance proceeds payable on the death of such shareholder without applying a corresponding offset for the company's obligation to redeem such shareholder's interests. In so ruling, the Court raised significant doubt over a ubiquitous succession planning strategy for consolidating control of closely held companies using the immediate liquidity of life insurance proceeds on a shareholder's death. While *Connelly*'s reach remains unknown, it has upset the footing of succession planning strategies implemented by countless closely held companies and their shareholders.

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In practice, *Connelly*'s impact merits careful consideration by the shareholders and advisors of any closely held company when: (1) the company owns life insurance policies[3] on its shareholders, earmarked to redeem such shareholders' company interests; and (2) the fair market value (FMV) of any shareholder's estate may exceed its applicable state or federal estate tax exemption. Although the 2025 federal estate tax exemption is $13.99 million per individual (or $27.98 million for a married couple), absent further action from Congress, this exemption sunsets on Dec. 31, 2025 and will essentially be halved. The impending sunset only broadens *Connelly*'s potential reach, and, as a result, shareholders and advisors of closely held companies should revisit their life insurance-based business succession planning and the available alternative strategies to sidestep its impact.

Post-*Connelly* Strategies

Closely held companies purchase life insurance on their shareholders' lives to achieve a variety of results, such as:

- Providing their shareholders with liquidity to pay estate taxes on the value of their company interests (and, potentially, for the beneficiaries of such shareholders' estates).
- Ensuring the company stays in the hands of its surviving shareholders rather than the heirs of a deceased shareholder or outside parties.
- Creating additional liquidity for the company to offset a key person loss.

In light of *Connelly*, it's imperative that any life insurance earmarked to achieve the results described above is optimally structured and owned, including a comprehensive buy-sell agreement.[4] The

Court reflected that the *Connelly* estate faced the consequences of the specific strategy employed by the decedent's company and advisors and that alternative strategies exist, each with its own advantages and disadvantages.[5] Five alternative strategies described below aim to avoid a *Connelly* outcome for other closely held companies.

> When a company wishes to retain existing life insurance policies, the shareholders could form a single insurance LLC owned by them in proportion to their company interests.

Modify Buy-Sell Agreement

Even if a company doesn't structure its life insurance policies and ownership thereof in accordance with any of the four strategies described below, one strategy is to review the company's existing buy-sell agreement and, if necessary, modify it in an attempt to defend against a *Connelly* challenge.[6] Although it's unclear why *Connelly* prompted a deviation from the long-accepted approach to valuing companies owning life insurance, one possibility is the old adage "bad facts make bad law."[7]

First, the buy-sell agreement could provide the company with the first obligation to buy out each shareholder—without granting the other shareholders a purchase option. This provision may be distinguishable from *Connelly* in that the company's redemption obligation is a true obligation at a shareholder's death, netting out such value against the insurance. Second, the buy-sell agreement could set the purchase price by a formula tying the price of a deceased shareholder's interest into market factors (such as earnings before interest, taxes, depreciation and amortization) rather than superficially tying the price into either life insurance proceeds or estate tax value. This provision may also be distinguishable from *Connelly* in that the buy-sell agreement meets the requirements to affect or control estate tax value,[8] although, if the buy-sell agreement categorically excludes life insurance proceeds from fixing the purchase price, *Connelly* may still prevail. Finally, the buy-sell agreement could explicitly provide that it's binding and enforceable during the lives of, and at the deaths of, the shareholders and require that the company (or its shareholders) has a first right of refusal at the fixed purchase price before any other lifetime disposition may be effectuated. This provision and compliance therewith may be distinguishable from *Connelly* on the basis that the buy-sell agreement is truly legally binding.

Single Insurance LLC

When a company wishes to retain existing life insurance policies, the shareholders could form a single insurance limited liability company (LLC) owned by them in proportion to their company interests. The company would distribute any existing policies to the single insurance LLC, which would be treated as a proportional distribution of the policies' FMVs to the single insurance LLC's members. This distribution would fall under an exception to the transfer-for-value rule as a distribution to a partnership of which the insured is a partner.[9]

The tax implications of the company's distribution may discourage enacting this strategy effectively, as long-standing permanent policies may have accumulated significant value. Any future company distributions to the single insurance LLC to pay premiums may also create additional taxable distributions to the shareholders.

On the death of the first shareholder to die, the single insurance LLC would collect the life insurance proceeds, purchase the insured's company interest and distribute it to the LLC's surviving members. Notably, in this and the other strategies described in this article, the insured's estate would receive a step-up in basis, which would significantly reduce (or potentially eliminate) any gain, depending on the valuation for estate tax purposes compared to the purchase price in accordance with the buy-sell provisions. This strategy may trigger the application of the *Connelly* ruling as to the single insurance LLC, depending on the LLC agreement's provisions, the

appraisal, its reporting for estate tax purposes and how the Internal Revenue Service and the courts apply *Connelly* going forward.

Pros. This strategy is administratively easy and doesn't raise concerns about violating the transfer-for-value rule because the transfer of existing insurance into the single insurance LLC and the shift in LLC ownership resulting from an LLC member's death would be transfers to partners of the insured.

Cons. This strategy likely triggers the *Connelly* ruling in a different entity owned by the deceased shareholder. It could also result in costly distributions for income tax purposes for permanent policies with accumulated cash value. Permanent policies are also problematic because the deceased shareholder would die owning an interest in an LLC owning policies on the other shareholders' lives with accumulated cash value.

Cross-Purchase Strategy

Consider the *Connelly*-endorsed cross-purchase strategy.[10] It involves one or more shareholders agreeing to purchase the company interest of a deceased shareholder. Each shareholder would own and pay premiums on new life insurance policies on the other shareholders' lives to fund the purchase of a deceased shareholder's interest later. There are several options for paying these premiums, including the company making distributions to the shareholders to cover the premiums (and resulting income taxes) and corporate split-dollar arrangements for permanent life insurance policies.

Pros. A cross-purchase strategy is administratively simple with two or three shareholders. For full coverage, two shareholders require two policies, three shareholders require six policies and so on. There are also premium payment options.

Cons. A cross-purchase strategy is administratively complicated with each additional shareholder.

Multiple Insurance LLCs

The company's shareholders can create an insurance LLC with respect to each shareholder. Each LLC would own insurance on one shareholder's life. The insured shareholder would have a 1% interest in the LLC (for transfer-for-value rule purposes[11]), while the other shareholders would own a percentage interest in the LLC proportionate to their ownership of the company. The company would distribute each existing policy to the corresponding insurance LLC (which would be treated as income to the LLC's members, so advance confirmation of each policy's FMV is essential).

The company, or the LLC's members on a pro rata basis, would either make an initial large contribution or annual contributions to the LLC to pay the policy's premiums. If the LLC's members make such contributions, the company may make taxable distributions to them to cover the premiums and resulting income taxes.

> At a minimum, shareholders and their advisors should factor into their analysis the company's structure, any existing buy-sell agreement, the structure of any existing life insurance policies and the ability (or desire) to obtain new policies.

On a shareholder's death, the life insurance proceeds would be paid to the LLC holding the policies on the deceased shareholder's life. The LLC agreement should provide that, on the deceased LLC member's death, their estate has the right to withdraw (and so terminate) its 1% interest. Such withdrawal right gives the estate 1% of the life insurance proceeds and captures in the insured shareholder's estate the appropriate estate tax value of the estate's ownership interest in the insurance LLC.

The insurance LLC would use some or all of the remaining life insurance proceeds to purchase the deceased shareholder's interest in the company from their estate and then distribute such interest to the LLC's surviving members in proportion to their

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ownership. Alternatively, if due to the company's structure, the LLC couldn't directly purchase the company interest, the life insurance proceeds could instead be distributed to the LLC's surviving members, and they could directly purchase the deceased shareholder's interest. If desired, the buy-sell agreement should contemplate this alternative. If the life insurance proceeds exceed the amount owed to the deceased shareholder's estate for the company interest, the balance of such proceeds would be paid to the LLC's surviving members or transferred to other insurance LLCs to fund other shareholders' policies. The buy-sell and LLC agreements should address the shareholders' desired application of any excess proceeds.

Pros. Administration of each LLC is fairly simple on a shareholder's death, and the insured shareholder doesn't risk realizing estate taxes on phantom assets from insurance on such shareholder's life.

Cons. Multiple LLCs (and additional tax filings) are required. This strategy only works with term policies, as permanent policies would result in the deceased shareholder's estate reporting the values of the surviving shareholders' insurance LLCs without a corresponding benefit.

Many *Connelly* inquiries have revealed significantly underfunded life insurance policies in light of companies' financial growth.

Multiple Insurance Trusts

Each shareholder can create one insurance trust, which would own either existing life insurance policies transferred to the trust or new policies purchased initially by the trust. Again, advance confirmation of any existing policy's FMV is essential in light of possible gift tax implications of transferring existing policies.[12] Advisors should also confirm whether the trusts can directly obtain new policies.

Each trust would include a defined class of current shareholders of the company and the insured shareholder's family as beneficiaries. On the insured's death, the trust agreement would require that the trustees purchase the insured's interests in accordance with the buy-sell agreement and then distribute such interests to the surviving shareholders based on their proportionate ownership (or as otherwise agreed in the buy-sell agreement). To the extent there are excess life insurance proceeds, the balance could be distributed to (or in trust for) the deceased shareholder's heirs.

This strategy also offers multiple methods of paying annual life insurance premiums. If premiums are sufficiently low, trusts could include *Crummey* powers and receive sufficient annual funds from the grantor-shareholder to cover the premiums. The trustees would then notify the beneficiaries of their right to withdraw such amount and the time period for the right's lapse, thus avoiding using the grantor-shareholder's lifetime gift tax exemption. Alternatively, akin to the multiple LLC strategy, the company could make distributions to the shareholder to cover such premiums and resulting income taxes. Finally, depending on the current insurability of the shareholders, the company could purchase policies eligible for corporate split dollar, allowing the company to fund the premium costs and the death benefit to be paid to the insurance trust. If corporate split dollar is an option, advisors should determine whether the economic benefit regime or loan regime is appropriate. See "Insurance Trusts as a Proposed Solution to *Connelly*," p. 41.

Pros. The FMV of all policies remains out of the estates of each shareholder, regardless of policy type (term or permanent) and cash value in the permanent policies. This strategy provides more company-funded premium options without forcing the shareholders to recognize more significant taxable distributions or the company to distribute significant liquidity to cover resulting income taxes.

Cons. Multiple trusts (and additional tax filings) are required, and trusts increase complexity. This strategy also requires careful analysis of the trust's provisions and the identities of the trustees and other control people to ensure appropriate individuals control the trust without causing negative income or

estate tax consequences.[13] Finally, there are potential gift tax issues depending on the value of existing policies transferred to the trust and the risk that any policies gifted to the trust would be includible in the insured's estate unless the insured survives three years from the date of the gift.

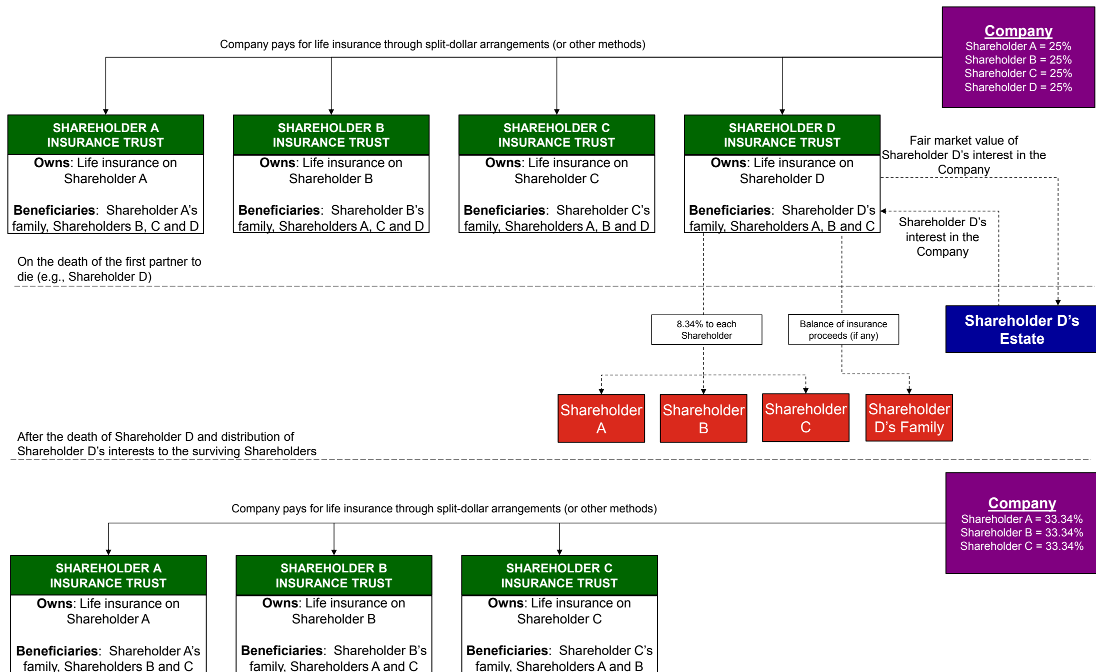
Additional complexity for significant future benefit. To preemptively remove newly purchased company interests from the surviving shareholders' estates, the trust agreements' dispositive provisions could distribute a deceased shareholder's interest in the company to trusts created by, and potentially for, the surviving shareholders. This continuing trust structure would also solve the problem of growing insurance needs on the surviving shareholders' lives each time another shareholder dies.[14] Note that such trusts would have to enter into the buy-sell agreement and that this structure may raise further legal, tax, accounting and business considerations. This structure may be most suitable when shareholders are family members who are comfortable coordinating their estate plans and potentially keeping the family company even after the current shareholders die.

Analyzing the Strategies

These strategies are complex, and it's essential to analyze them with a team of sophisticated advisors to achieve the desired results and avoid the specter of *Connelly*. At a minimum, shareholders and their advisors should factor into their analysis the company's structure, any existing buy-sell agreement, the structure of any existing life insurance policies

Insurance Trusts as a Proposed Solution to *Connelly*

Estate-planning vehicles can serve as a useful structure for succession planning for closely held businesses



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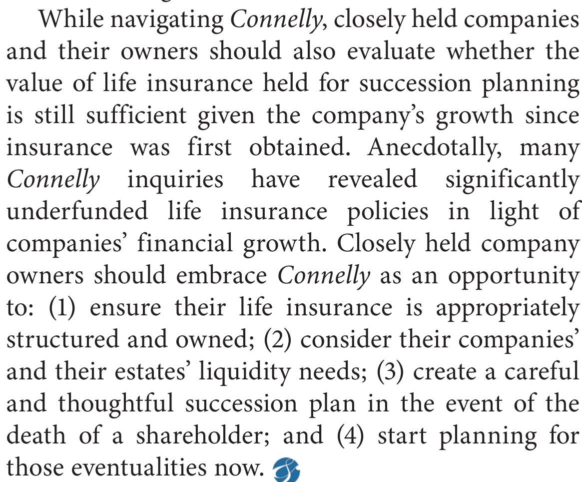
and the ability (or desire) to obtain new policies. But these factors should each be viewed through legal, tax, accounting and business lenses.



While navigating *Connelly*, closely held companies and their owners should also evaluate whether the value of life insurance held for succession planning is still sufficient given the company's growth since insurance was first obtained. Anecdotally, many *Connelly* inquiries have revealed significantly underfunded life insurance policies in light of companies' financial growth. Closely held company owners should embrace *Connelly* as an opportunity to: (1) ensure their life insurance is appropriately structured and owned; (2) consider their companies' and their estates' liquidity needs; (3) create a careful and thoughtful succession plan in the event of the death of a shareholder; and (4) start planning for those eventualities now.

Endnotes

1. *Connelly v. United States*, 144 S.Ct. 1406 (2024).
2. Federal appeals courts had previously sanctioned this method of liquidity planning. *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005) and *Estate of Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir. 1999).
3. Note that *Connelly*'s ruling would also apply if a company owned disability insurance in the event a shareholder became disabled.
4. A buy-sell agreement may be incorporated into the provisions of a company's existing operating agreement or may be a freestanding agreement.
5. *Connelly*, *supra* note 1, at p. 1413.
6. Because the lower courts' rulings extensively discussed the redemption agreement's provisions and the Court's final ruling didn't, it's unclear what provisions would weather a *Connelly* challenge, and the requirements described in endnote 8, *infra*, must be observed. *Connelly v. U.S.*, 70 F.4th. 412 (8th Cir. 2023) and *Connelly v. U.S.*, No. 4:19-cv-01410-SRC (E.D. Mo. 2021).
7. In *Connelly*, the company's redemption agreement provided that the purchase price would be determined by annual Certificates of Agreed Value (not executed) or, in default, two fair market value appraisals (not obtained until audit). *Connelly*, *ibid.*, 70 F.4th., at p. 414.
8. These requirements include Internal Revenue Code Section 2703(b), Treasury Regulations Section 25.2703-1(b), Treas. Regs. Section 20.2031-2(h) and related case law.
9. A detailed discussion of the transfer-for-value rule and exceptions are beyond the scope of this article, although they should be considered carefully by those contemplating any changes to an existing strategy involving life insurance (or any new strategy involving life insurance).
10. *Connelly*, *supra* note 5.
11. It may be necessary for the insured shareholder to have a 1% interest in the limited liability company (LLC) to transfer any existing life insurance policies owned by the company to the LLC without causing a transfer-for-value issue. Specifically, if a policy is transferred to the LLC for valuable consideration, the transferee exception to the transfer-for-value rule is met if the transfer of the policy is to the insured, to a partner of the insured, to a partnership that the insured is a partner or to a corporation that the insured is a shareholder or officer. IRC Section 101(a)(2)(B).
12. If a policy is transferred via gift to the insurance trust, the insured would need to survive three years for the proceeds to be outside their estate. Thus, ideally the trust would directly purchase policies from the shareholder, or it would directly obtain new policies.
13. Whenever structuring trusts, practitioners should consider a variety of potential IRC provisions and doctrines stemming from case law, which could result in unintended estate tax consequences, including the reciprocal trust doctrine, IRC Section 2036 and IRC Section 2042. Take care to avoid any adverse tax consequences.
14. Advisors would need to analyze the generation-skipping transfer tax inclusion ratios and perpetuities periods of any existing trusts to determine if they're appropriate to use as part of this structure.

SPOTLIGHT

A Bird's Eye View
The Complexity of Being Bestest Friends by Tania Marmolejo sold for HK$165,100 at Phillips New Now: Modern & Contemporary Art in Hong Kong on Oct. 4, 2024. A contemporary artist, Marmolejo started her career as a fashion and lifestyle illustrator for *Obsidiana* magazine. She's known for her large-scale female portraits.