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Untaxingly Yours

The Bell Tolls for Entity Insured Redemption Agreements

By Brian T. Whitlock

A unanimous decision issued by the U.S. Supreme Court on June 6, 2024[1] may have sounded the death knell for entity redemption agreements that are funded with life insurance policies owned by the redeeming entity. In an opinion written by Justice Clarence Thomas, the Supreme Court affirmed the decision of the 8th Circuit Court of Appeals[2] and ruled that the contractual obligation to redeem the stock of a closely held corporation did not create a liability that would offset the value of the life insurance policies that were owned by the corporation.

In February of 2023,[3] this column consisted of a primer on the structuring and funding of closely held entity buy–sell agreements. In that column, we discussed the fact that buy–sell agreements are frequently funded with life insurance on the lives of the equity owners. In this column, we will revisit that discussion, focusing solely on Entity Redemption Agreements and specifically the facts and reasoning of the U.S. Supreme Court decision in *Connelly*.[4]

Entity Redemption Agreements

An Equity Redemption Agreement is a contract between the owners of the business entity and the entity to have the business entity directly purchase the equity interest of an owner. The timing of the purchase will likely be upon the occurrence of some type of terminating event (*e.g.*, the retirement, disability, or death of one of the equity owners). In a typical redemption, the equity interest of the departing owner is purchased directly by the entity. In a traditional corporate setting, the purchased stock may have become treasury stock. The concept of treasury stock has been eliminated for all practically purposes in many jurisdictions; today, we describe the redeemed equity interest as merely being canceled or unissued. As a result of the cancellation of the redeemed equity, the outstanding interests held by the other equity owners increase proportionately.

Connelly

The facts of *Connelly* are fairly straightforward. Two brothers owned all of the stock of a building supply company in Missouri. The brothers entered into an agreement to restrict the transferability of the company's equity. At the death of the first brother to die, the survivor had an option to directly purchase the equity owned by the deceased brother from the brother's estate. If the survivor did not exercise his direct purchase option, then the agreement required the entity to redeem (*i.e.*, purchase) the equity interest. The entity owned $3.5 million of life insurance on the lives of each of the brothers. The company paid all the premiums on the insurance while the brothers were alive. The primary purpose of the life insurance was to facilitate the entity's redemption of the stock of the first brother to die.

The brother owning 77.18% of the outstanding equity died in 2013[5] and the surviving brother and the executor (his nephew) agreed on a price of $3 million for the 77.18% interest. In reaching this value, the parties excluded the $3 million of life insurance proceeds that were received by the company after the decedent's death. The Internal Revenue Service (IRS) audited the estate tax return and disagreed with the valuation of the business. The IRS increased the value of 100% of the business from $3.86 million to $6.86 million. The IRS did not assert the presence of any valuation premium for the fact that the equity interest was clearly a majority interest. Rather, the IRS merely multiplied the $6,86 million by the decedent's 77.18% equity interest and rounded the result to $5.3 million. Federal estate taxes were assessed on the increased value. The additional tax was paid, and the estate sued in Federal District Court for a refund.

The estate and the IRS both stipulated that pursuant to Reg. §20.2031-2(f)(2), the fair market value of the entity must include the life insurance proceeds, as a non-operating asset, since it was payable to the entity. The sole issue as outlined by Justice Thomas was whether the corporation's obligation to redeem created a liability on the part of the entity, which offset a portion of the insurance proceeds that were required to be used to purchase the equity.

The Eleventh Circuit Court of Appeals had addressed this issue as early as 2005 in *Estate of Blount*.[6] Despite holding that the Buy–Sell Agreement did not validly fix the value of the equity interest,[7] the Court in *Blount* nonetheless held that the life insurance proceeds received by the entity were not the type of a non-operating asset that the Treasury Regulation had contemplated would add to the fair market value of the business. Instead, the Court held that the insurance proceeds were offset dollar for dollar by the entity's enforceable contractual obligation to redeem the equity interest, and thus the net fair market value of the entity was not increased by the life insurance proceeds.

The U.S. Supreme Court in *Connelly* rejected the Eleventh Circuit's reasoning in *Blount*. In doing so, the Supreme Court affirmed the decisions of both the U.S. District Court and the 8th Circuit Court of Appeal in *Connelly*. Both lower courts had concluded that the Redemption Agreement did not create an obligation on the part of the entity that would offset the increase in value related to the ownership of the insurance proceeds.

Justice Thomas went on to remark that the Connelly brothers could have avoided this result by structuring the agreement as a cross-purchase obligation. At the risk of offending, the Court is partially correct in its analysis. A Cross Purchase Arrangement that would have required the remaining equity holder to purchase the equity of the deceased equity holder would have clearly sidestepped this valuation issue of whether the agreement created a liability that would reduce the fair market value of the entity. The obligation to purchase would clearly be independent of both the entity and the valuation of the entity.

Walk, Do Not Run

Hopefully, business advisors will not panic as a result of the *Connelly* decision and advise clients to convert all their Redemption Agreements to Cross Purchase Agreements. The inference that a Cross Purchase Agreement will be better than a Redemption Agreement is incorrect. Redemption Agreements are not inherently wrong.

The timing of the purchase will likely be upon the occurrence of some type of terminating event (e.g., the retirement, disability, or death of one of the equity owners). In a typical redemption, the equity interest of the departing owner is purchased directly by the entity.

The key factor that increased the fair market value of the entity in the first place was not whether the agreement was a Cross Purchase Agreement or a Redemption Agreement; the key factor that increased the value was the ownership and the beneficiary of the life insurance policies on the lives of the brothers. If the life insurance policies had been owned outside of the entity and if the death benefit had not been paid to the entity, then the proceeds would not have increased the value of the entity.

Furthermore, the Court indirectly acknowledged that parties had a Redemption Agreement and held the life insurance outside of the entity, the obligation of the entity to redeem may in fact have created not only a liability, but it may have led to a valuation discount. In his Dicta[8] (which is contained in footnote 2 to the *Connelly* opinion), Justice Thomas remarks that the lack of non-operating assets in the entity at the time of redemption could require the entity to liquidate some of its operating assets in order to repurchase the equity of the deceased equity owner, thereby reducing the business' future earning capacity. In short, the lack of self-funding mechanism when coupled with a Redemption Agreement could lead to a valuation discount.

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Business advisors should focus not on the type of buy–sell agreement but rather on the funding mechanisms. If life insurance is being considered to facilitate the funding, then clearly the owners and beneficiaries of the insurance should be reviewed.

The Future Role of Redemption Agreements

Redemption Agreements may continue to have a role in future business succession planning and may provide a level of flexibility that is not available in Cross Purchase Agreements. Redemption Agreements that are similar in form to that used by the Connelly brothers can be beneficial. Their agreement was a Hybrid Type of an agreement. First, it granted the surviving shareholder an option to purchase the equity interest of the deceased equity owner. This option is in essence a Cross Purchase Option. Second, if the survivor elected not to directly purchase the equity of the deceased, then the agreement mandated the redemption of the equity by the entity. Frequently, this mandate is accompanied by a requirement that if the entity does not redeem the equity of the deceased owner, then the entity must liquidate. Where the underlying business is a service business and one of the key equity owners dies, this requirement that the entity should liquidate may in fact be the best business choice. A service business without its best asset in the form of a key service provider, sales person, or leader may be best served to liquidate rather than pay good money into a losing proposition.

Preserving Redemption Agreements with Indirect Funding

If the equity owners and their advisors ultimately conclude that the best form of Buy–Sell Arrangement is in fact a Redemption Agreement, and if they want to provide for life insurance in order to facilitate its funding, then the insurance should be held outside of the entity. The owners may wish to hold the insurance in a partnership, a limited liability company, or subject to an escrow arrangement in order to make sure that policies are properly maintained and premiums are timely *paid.*[9] If the proceeds are ultimately paid to the surviving owners, then the surviving owners would have had the ability to lend the required funds to the entity in order to complete the redemption. This additional flexibility can create several related income tax benefits for the surviving equity owners.

First, if the entity operates as a C Corporation, then the loan of the insurance proceeds to the C Corporation for the completion of the redemption will give the lender income tax basis equal to the principal portion of the loan. Contrast this with the receipt of the proceeds by the entity. If the insurance proceeds had been received directly by the C Corporation and used to redeem the stock of the deceased shareholder, then the redemption would not have resulted in any increase in income tax basis for the surviving shareholder.

Second, if the entity operates as an S Corporation the receipt of the insurance proceeds by the corporation would be an income tax-free receipt of income,[10] and the proceeds would increase the corporation's Other Adjustments Account, but the increase in income tax basis would be shared *pro rata* by all the shareholders. The redemption by the corporation would reduce all of the S Corporation's related equity accounts (*i.e.*, Accumulated Adjustments Account, the Other Adjustments Account, Accumulated Earnings and Profits (AEP), as well as Capital Accounts). Contrast this with the receipt of the insurance proceeds by the surviving equity owner. The surviving shareholder would receive the proceeds income tax free and have income tax basis equal to the full amount. If the proceeds were used by the survivor to directly purchase the stock under the purchase option, present in a Hybrid Type of an agreement, then they would have income tax basis in the full amount, and the Accumulated Adjustments Account would remain intact.[11]

Third, if the insurance proceeds are loaned from the surviving shareholder to the entity for the purposes of fulfilling the redemption obligation, then the loan will give the survivor a means of removing not only the principal amount of the loan but also receiving interest on the loan, without the need to pay taxable dividends from the C Corporation, or risk the creation of a second class of stock with an S Corporation.

Fourth, the loan could, if properly structured, could give the lender a preference over other creditors as part of its repayment plan. As a secured lender, the remaining shareholder would be in a stronger position if the business failed to perform at the same level, which is always possible in a closely held that has suffered the loss of a key employee.

"The report of my death was an exaggeration."

Perhaps like the great American literary giant and humorist, Mark Twain, the suggestion that the Supreme Court's decision in *Connelly* will be the death knell for all Redemption Agreements is merely an exaggeration. Nevertheless, it should be a wake-up call to all family business advisors that holding life insurance policies on the lives of the equity owners inside of the entity itself can be dangerous and may in fact result in unnecessary estate taxes. Now is the time to review Buy–Sell Agreements for all businesses with two or more equity owners and most importantly check how those agreements are being potentially funded.

ENDNOTES

1. *T.A. Connelly Est.*, SCt, 2024-1 USTC ¶60,140, 602 US __ (2024).
2. *T.A. Connelly Est.*, CA-8, 2023-1 USTC ¶60,737, 70 F4th 412 (2023); *affirming* DC-MI, 2021-2 USTC ¶60,729 (2021).
3. Whitlock, *UNTAXINGLY YOURS—Buy-Sell Agreements and Life Insurance—a Primer*, TAXES, February 2023, p 7.
4. *T.A. Connelly Est.*, SCt, 2024-1 USTC ¶60,140, 602 US __ (2024). Code Sec. 246(a)(1).
5. The Federal Estate Tax Exemption in 2013 was equivalent to $5,250,000.
6. *G.C. Blount Est.*, CA-11, 2005-2 USTC ¶60,509, 428 F3d 1338 (2005).
7. In order for a Buy–Sell Agreement to validly fix the value of an equity interest among family members, it must be a *bona fide* business arrangement and satisfy Code Sec. 2703 and case law. The agreement must: (i) not be a device to transfer property family members for less than full and adequate consideration; (ii) contain terms that are comparable to similar arrangements enter into by persons in arm's-length transactions; (iii) contain a purchase price that is fixed and determinable; (iv) be legally binding both during life and after death; and (v) not be a substitute for a testamentary disposition.
8. "Dicta" is any portion of the opinion that is essentially a side comment. It is not the issue being decided by the Court in the issue at hand, but rather part of the Justice's stream of thought on a related issue.
9. Code Sec. 101.
10. For a more detailed discussion of ways to hold life insurance as part of a Buy–Sell Arrangement see, Whitlock, *UNTAXINGLY YOURS—Buy-Sell Agreements and Life Insurance—a Primer*, TAXES, February 2023, p 7.
11. Code Secs. 1367(b) and 1368(b) and (c).