TAX AND TRUSTS & ESTATES ALERT

LIFE INSURANCE FUNDED BUY-SELL AGREEMENTS SHOULD BE REVIEWED IN LIGHT OF UNITED STATES SUPREME COURT DECISION IN *CONNELLY V. UNITED STATES*

On June 6, 2024, in *Connelly v. United States*, the U.S. Supreme Court unanimously held that life insurance payable to a corporation to fund a contractual obligation to redeem the shares of a deceased shareholder must be accounted for in determining the value of decedent's shares for estate tax purposes, even if the redemption agreement specifically provides for the exclusion of such insurance in determining the redemption purchase price.

Brothers Michael and Thomas Connelly were the sole shareholders of Crown C Supply. They entered into a buy-sell agreement that allowed the surviving brother to purchase the deceased brother's shares upon his death, and if the surviving brother declined, the corporation itself was obligated to redeem the shares. Crown C Supply obtained life insurance policies for each brother so that if one brother died, the corporation could apply the proceeds to redeem his shares. When Michael Connolly died, Thomas Connolly opted not to purchase his shares, and thus, Crown C Supply was obligated to purchase the shares. Although the buy-sell agreement provided that the redemption price would be based on an outside appraisal of the company's fair market value, Thomas and Michael's son agreed that Michael's shares were worth $3,000,000.00, and Thomas, as Michael's executor, reported the same on Michael's estate tax return. The IRS assessed taxes on Michael's estate and asserted that his shares should be valued at $5,300,000.00 because the life insurance proceeds should have been included in the corporation's value. Consequently, it determined that the estate owed an additional $889,914 in estate taxes. Thomas Connolly sued for a refund after the estate paid the additional taxes, arguing that the insurance proceeds should not factor into the valuation for purposes of estate taxes because the proceeds gained were offset by the company's obligation to redeem the shares and were not a genuine asset.

The District Court granted summary judgment to the IRS, and the U.S. Court of Appeals for the Eighth Circuit affirmed. The Supreme Court upheld the lower court opinions, ruling that the value of the death benefit increased the value of the corporation and that the company's redemption obligation was not a liability that reduced the value of the shares for estate tax purposes. Thus, Michael Connolly's original estate tax return had been understated.

Justice Thomas, who delivered the opinion for a unanimous Court, wrote: "Although [a share redemption agreement] may delineate how to set a price for the shares, it is ordinarily not dispositive for valuing the decedent's shares for the estate tax. See 26 U. S. C. §2703. As a general rule, the fair market value of the corporation determines the value of the shares, and one must therefore consider 'the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors,' 'including proceeds of life insurance policies payable to . . . the company.' 26 CFR §20.2031–2(f) (2)." The Court also noted, "[f]or calculating the estate tax, however, the whole point is to assess how much Michael's shares were worth at the time that he died— before Crown spent $3 million on the redemption payment. . . . A hypothetical buyer would treat the life-insurance proceeds that would be used to redeem Michael's shares as a net asset." The opinion further stated: "Because a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares."

The Court noted that it did not hold that a redemption obligation can never decrease a corporation's value (for example, if it had to liquidate operating assets to fund the redemption), but that it was merely rejecting Connelly's argument that all redemption obligations reduce a corporation's value.

In response to Connelly's argument that affirming the lower court decisions would make succession planning more difficult for closely held corporations, the Court offered a cross-purchase agreement as an alternative structure but acknowledged that "every arrangement has its own drawbacks" and "its own tax consequences."

The decision will have a significant impact on many closely held companies. Business Owners should consult their legal and tax advisors to review current buy-sell agreements as well as other instances where insurance is payable to the company on an owner's death, and consider whether alternative structures would be appropriate in light of this decision. Please contact an attorney in Sherman Atlas Sylvester & Stamelman's Tax and Trusts & Estates Department for guidance.

CORPORATE TRANSPARENCY ACT FILING DEADLINE IS APPROACHING

On January 1, 2024, a new Federal law called the Corporate Transparency Act ("CTA") went into effect, with the purpose of creating a national database of entities operating in the United States and identifying their owners and control persons as part of an increasing effort to combat money-laundering, terrorism, tax evasion, and other financial crimes.

The CTA requires almost all LLCs, corporations, limited partnerships, and other closely held entities formed and/or operating in the United States (referred to as "reporting companies") to register with the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN"). Notable exemptions include public corporations, certain larger private operating companies (ie., $5 million in gross revenue <u>and</u> 20 or more employees), tax-exempt entities, and other categories of entities that are already required to disclose significant identifying information under current law.

The information that must be provided to FinCEN under the CTA is in addition to, and is significantly more burdensome than, the information you may be accustomed to filing in annual reports in the jurisdiction of organization of your reporting companies. In addition to requiring information about the reporting company, the CTA also requires identifying information regarding each "beneficial owner" of the reporting company.

The definition of a beneficial owner under the CTA is broad and generally includes anyone who either exercises "substantial control" over a reporting company or owns or controls at least 25% of a reporting company's ownership interests. The determination of what constitutes "substantial control" of an entity is fact-based but, at a minimum, includes anyone who directs or has substantial influence over important decisions of the reporting company, such as directors and senior officers and those with the power to appoint or remove officers and directors.

For all entities existing on January 1, 2024, the deadline to register with FinCEN and provide all required information is January 1, 2025. However, all entities newly formed on or after January 1, 2024 and before January 1, 2025 will have 90 days from the date of formation to register with FinCEN. After January 1, 2025, FinCen registration i s required within 30 days from the date of formation of the entity.

Additionally, once a reporting company has registered with FinCEN, it will be required to report any change to the information set forth in its FinCEN filing within 30 days of the date of such change. There are stiff civil and criminal penalties for failing to timely register and make all required filings – these include $500 per day of civil penalties, and criminal fines of up to $10,000, two years in prison, or both.

If you own any interest in an LLC, private corporation, or limited partnership, or if you are a director, manager, or senior officer of such an entity (even if you do not have any ownership interests in such entity), then you may be subject to these new filing requirements. If you have questions about the foregoing or would like our assistance in complying with CTA requirements, please reach out to one of your Sherman Atlas contacts and we can discuss what's involved and how we can assist. Please address promptly as the filing deadline is approaching.

DO YOU NEED TO MAKE A SUBSTANTIAL GIFT BETWEEN NOW AND THE END OF 2025 TO TAKE ADVANTAGE OF THE CURRENT FEDFEREL GIFT AND ESTATE TAX EXEMPTION BEFORE IT'S REDUCED IN HALF AT THE END OF 2025?

The short answer to this question is that current gifts to consume some of the federal gift and estate tax exemption will only have an overall tax benefit if the total taxable gifts made prior to the end of 2025 are greater than the approximately $7 million exemption amount that is expected to be available after 2025.

So, that tax savings strategy requires a big gift today – i.e., something in excess of $7 million.

By way of example, let's assume that Jean, who has never previously made any taxable gifts, makes a $10 million gift in 2024. Assume that Jean dies in 2026, after the gift and estate tax exemption has been halved, from approximately $14 million in 2025 to $7 million in 2026. Assume also that Jean dies with a $2 million estate (after making the $10 million gift). The estate tax on her estate would be $800,000 (i.e., 40% of $2 million). Since Jean's $10 million gift exceeds the 2026 available exemption amount of $7 million, she would be treated as having used up 100% of her exemption prior to death, and the entire $2 million in her estate at death would be subject to estate tax. Her estate will not be penalized for the fact that she made an earlier gift well in excess of the exemption available in 2026. The net effect is that Jean will have transferred $11.2 million net of federal gift and estate tax ($10 million + $2 million less $800,000 of estate tax), but only paid estate tax on $2 million, even though the exemption amount at the time of her death was $7 million.

Contrast this with the situation where Jean keeps her entire $12 million estate, makes no gifts, and then dies in 2026. Her estate would be subject to the (then) $7 million exemption, leaving a $5 million net estate, and her estate would pay $2 million in tax (40% of $5 million), rather than the $800,000 her estate pays in the scenario above. The net effect is that Jean will have only transferred $10 million net of federal gift and estate tax ($12 million less $2 million of tax), rather than $11.2 million.

For those that find tables easier to follow:

Scenario	Estate Tax Paid	Amount Passed to Heirs After Tax
Jean makes a $10m gift in 2024 and dies with $2m estate in 2026	$800,000 (40% tax rate x $2 million, which is the amount in excess of the $7 million exemption in place on the date of Jean's death)	$11,200,000
Jean makes no gifts prior to her death and dies with $12m estate in 2026	$2,000,000 (40% tax rate x $5 million, which is the amount in excess of the $7 million exemption in place on the date of Jean's death)	$10,000,000

Jean could have saved $1.2 million for her heirs by taking at least <u>some</u> advantage of the larger gift and estate tax exemption before the end of 2025.

But suppose Jean was not comfortable with making such a large gift in 2024. She was concerned about keeping enough for herself, and she also considered that tax laws might easily change before the end of her life such that the gift might not have been recommended in retrospect. Given these concerns, Jean is nevertheless prepared to make a $7 million gift in 2024. Since her $7 million gift is equal to the 2026 available exemption amount of $7 million, Jean would be treated as having used up 100% of her exemption prior to death, and her $5 million estate would bear a tax of $2 million. That's exactly the same after-tax consequence as would be the case if Jean made no gifts whatsoever and died with a $12 million estate.

Once again, the examples show that in order to take advantage of the higher exemption rates before 2026, a "big gift" of at least $7 million (or the remainder of your exemption amount, if you've already done some gifting in excess of $7 million) is needed.

Even if you are not in a position to gift more than $7 million to take advantage of the high exemptions before the scheduled reductions, it may still make sense to make gifts to irrevocable trusts or otherwise so that the income and the appreciation from the gifted assets escapes estate taxation. Additionally, if tax laws change, foreclosing certain opportunities to make future irrevocable trusts may be grandfathered and not subject to such future law changes.

FOR FURTHER INQUIRIES

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