Corporate Insights: Life Insurance, Buy-Sell Agreements, and the Connelly Problem: What Closely Held Business Owners Need to Know

BY JULIE K. O'NEILL • DECEMBER 11, 2025

Closely held businesses routinely use life insurance to fund buy-sell obligations when an owner dies. The logic is simple: the company or surviving owners need liquidity to effect redemptions or repurchases, and life insurance provides it. But after the Supreme Court's 2024 *Connelly v. United States* decision, business owners must pay much closer attention to how the insurance is owned and who benefits from it.

This article explains the tax issues, highlights the impact on LLC and shareholder agreements, and offers practical recommendations — including how structures such as an Insurance LLC can help (and where they can fail).

THE CONNELLY PROBLEM: INSURANCE PROCEEDS INCREASE COMPANY VALUE

In *Connelly*, two brothers owned a corporation that held a life insurance policy used to fund a redemption upon the death of one of the owners. The Supreme Court held that:

1. The value of the company for estate tax purposes includes the life insurance proceeds, even if those proceeds are immediately used to redeem the deceased equityholder's stock.
2. A redemption does not reduce the company's value when performing the estate tax valuation.
3. As a result, the deceased equityholder's taxable estate was significantly larger.

This result creates a real risk for owners of closely held businesses: if the company owns a policy and uses it to redeem units, the IRS may increase the decedent's estate tax value by the amount of the insurance proceeds.

IMPACT ON BUY-SELL ARRANGEMENTS AND LLC/SHAREHOLDER AGREEMENTS

Many buy-sell arrangements — especially in LLC Agreements and Shareholder Agreements — give the company an *optional or mandatory redemption right* when a member dies. These provisions routinely assume that a) the company will be the policy owner, and b) the insurance will fund the redemption price.

But after *Connelly*, that structure can backfire.

Why?

Because the redemption itself does not eliminate the insurance proceeds from the company's value. The decedent's

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estate must include the fair market value of the decedent's share of the company before the redemption — which is inflated by the insurance proceeds.

Despite the fact that the company has used the insurance proceeds to buy the decedent's equity, the decedent's estate is taxed as if the business were suddenly much more valuable.

Business owners should anticipate possible IRS scrutiny whenever a) the company owns the policy, or b) the buy-sell is structured as a company redemption.

CROSS-PURCHASE AGREEMENTS AND WHY THEY OFTEN AVOID THE PROBLEM

In a cross-purchase structure, the surviving owners personally own the policies, receive the proceeds, and use those proceeds to buy the deceased owner's equity.

Because the company is not the beneficiary of the policy, the insurance proceeds never increase company value.

However, cross-purchase arrangements have a major drawback: if the company has more than two or three equityholders, the structure quickly becomes unmanageable.

For example:

- For 2 equityholders, 2 policies are needed
- For 3 equityholders, 6 policies are needed
- For 4 equityholders, 12 policies are needed (each equityholder needs a policy on each of the other 3 equityholders)

This administrative burden is one of the main reasons practitioners often explore another structure: the Insurance LLC.

THE INSURANCE LLC: HELPFUL BUT NOT A SILVER BULLET

An Insurance LLC (sometimes called a Policy LLC or SPV) is a separate LLC created solely to own life insurance policies for buy-sell funding.

How it works (briefly)

- The LLC owners are typically the same people, in the same percentages, as the operating company.
- The Insurance LLC owns one policy on each owner and is the beneficiary.
- On an owner's death, the Insurance LLC receives the proceeds and either:
  - distributes them to surviving owners (funding a cross-purchase), or
  - loans or distributes them to the operating company to support a redemption.

When the IRS respects it

The IRS is more likely to respect an Insurance LLC if:

- It funds a cross-purchase, not a redemption.
- It has a substantive business purpose, such as avoiding dozens of cross-owned policies and equalizing funding responsibilities.

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- It is operated as a real entity with its own accounts, records, and governance.

In this case, the Insurance LLC can allow owners to avoid the complexity of cross-owned policies while also preventing insurance proceeds from inflating the value of the operating company.

When the IRS does *not* respect it

If the Insurance LLC is merely a shell — holding policies solely for the operating company's benefit — the IRS may disregard it for estate tax valuation.

This is most likely when:

- the Insurance LLC funds a redemption rather than a cross-purchase, and
- the owners and percentages mirror the operating company exactly, and
- there is no meaningful business activity besides policy ownership.

In such cases, the IRS may treat the arrangement as if the *company* effectively owns the policy, recreating the *Connelly* problem.

DRAFTING RECOMMENDATIONS TO PROTECT BUSINESS OWNERS

Business owners should revisit governance documents, especially:

- LLC Agreements
- Shareholder Agreements
- Buy-Sell Agreements

We recommend incorporating:

1. **A clear cross-purchase structure, even if funded through an Insurance LLC.** This is the safest way to avoid *Connelly*-style estate tax valuation issues.
2. **Clauses that prohibit the operating company from being the policy beneficiary.** This keeps proceeds outside company value.
3. **Mandatory or optional purchase rights that require surviving owners to buy, not redeem, when insurance proceeds are used.**
4. **If using an Insurance LLC, include specific business purpose language, such as administrative efficiency, equalization of premium obligations, and reduction of cross-owned policy proliferation.**

CONCLUSION

Life insurance-funded buy-sell agreements remain a powerful tool for closely held businesses. But after *Connelly*, companies must take care to structure ownership and funding arrangements to avoid unintended estate tax consequences. Whether through a clean cross-purchase, a carefully drafted Insurance LLC, or a modified buy-sell agreement, proper planning and governance document drafting are critical to protecting equityholders and their heirs.

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