Estate Tax Considerations for Business Succession Planning After Connelly

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On June 6, 2024, the U.S. Supreme Court issued a unanimous decision in *Connelly v. United States* regarding a closely held business valuation for federal estate tax purposes. The court determined that life insurance owned by a closely held corporation to fund a redemption buyout arrangement was a corporate asset. Consequently, this determination increased the value of the entity interest held by the decedent's estate and resulted in additional estate tax. Such ruling by the Supreme Court has caused individuals with closely held business interests to consider alternative arrangements for succession planning, such as the use of cross-purchase agreements.

Review of Facts

Two brothers were the joint shareholders of a corporation. As part of their succession planning, they entered into a buy-sell agreement that gave the surviving brother the option to purchase the deceased brother's shares; however, if the surviving brother declined to do so, the corporation itself was obligated to redeem the shares. Thus, to ensure it would have enough liquidity for the potential redemption, the corporation purchased $3.5 million life insurance policies on each brother.

Upon the first brother's death, the surviving brother elected not to purchase the deceased brother's shares, so the corporation was obligated to do so. The surviving brother, as the executor of the deceased brother's estate, then filed an estate tax return listing the value of the deceased brother's interest in the corporation as $3 million at his date of death. Interestingly, this value was determined by an agreement between family members rather than by an independent appraiser. This value also excluded the life insurance proceeds received by the corporation on the deceased brother's life.

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Upon audit by the Internal Revenue Service (IRS), the surviving brother had an independent appraiser value the corporation. Such appraisal came back as $3.86 million for the entire corporation, of which approximately $3 million was attributable to the deceased brother's interest (77%). This appraisal also excluded the life insurance proceeds on the theory that their value was offset by the redemption obligation.

The IRS disagreed with this valuation and insisted that the corporation's redemption did not offset the life insurance proceeds. Accordingly, the value of the decedent's share of the corporation increased, and the IRS determined the estate owed additional estate taxes. After paying the additional amount, the surviving brother sued the United States in his capacity as executor of the estate.

Supreme Court Ruling

The key issue determined by the Supreme Court is whether the corporation's contractual obligation to redeem the deceased brother's shares at fair market value offsets the value of the life insurance proceeds committed to funding the redemption.

Ultimately, the Supreme Court sided with the IRS and answered "no" to this question. The court held that a corporation's contractual obligations to redeem shares is not necessarily a liability that reduces the corporation's value for federal estate tax purposes.

The Supreme Court reasoned that, when calculating the federal estate tax, the value of the decedent's shares in a closely held corporation must reflect the corporation's fair market value at the decedent's date of death—in other words, its pre-redemption value. Further, life insurance proceeds payable to the corporation are an asset that increases the corporation's fair market value. Thus, at the time of the deceased brother's death, the corporation was worth $6.86 million, including the $3 million in life insurance earmarked for the redemption plus the $3.86 million in other assets.

Notably, in Footnote 2 at the end of the opinion, the Supreme Court explained that it *did not* hold that redemption obligations can *never* decrease a corporation's value. For example, if a redemption

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obligation required a corporation to liquidate operating assets to pay for the shares, it would decrease the corporation's future earning capacity and could likely be discounted on an estate tax return.

Action Items

Entities should review the buy-sell provisions in existing organizational documents. If redemption provisions are included, and if there are planning purposes necessitating the use of a redemption structure, entities should consider whether revised language should be incorporated to reduce the likelihood of a similar result. Alternatively, entities may choose to restructure their buy-sell arrangements to include a cross-purchase agreement.

The estate tax implications resulting from the redemption agreement provisions at issue in *Connelly v. United States* may be avoided by structuring the transaction as a cross-purchase agreement. However, this structure will require the business owners to purchase life insurance policies on each other and individually pay the premiums. Moreover, the owners need to confirm the proceeds of the life insurance policies are not includible in the estate of the first owner to pass away. In general, if you hold a life insurance policy on the life of another and that person passes away, the life insurance proceeds are *not* includible in the decedent's estate for federal estate tax purposes unless the decedent had one of the following incidents of ownership over the policy:

- The right of the decedent or the decedent's estate to its economic benefits.
- The power to change the beneficiary.
- The power to surrender or cancel the policy.
- The power to assign the policy or to revoke an assignment.
- The power to pledge the policy for a loan.
- The power to obtain from the policyholder a loan against the surrender value of the policy.
- A reversionary interest if the value of the reversionary interest as more than five percent (5%) of the value of the policy

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immediately before the decedent died.

Thus, as long as there are no incidents of ownership present, the life insurance proceeds will not be included in the estate of the first owner to die.

If you are interested in learning more about business succession planning, please contact the author of this article or any attorney with Frost Brown Todd's Private Client and Wealth Planning Group. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state and local tax planning and tax administration.

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