Recent Supreme Court Decision Upends Business Succession Planning Strategies

Description

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In *Connelly vs. United States* (602 U.S. 257, June 6, 2024), the Supreme Court unanimously ruled that in a redemption of a deceased shareholder's shares of stock, the corporation's fair market value should include the proceeds received by the corporation from the life insurance policy insuring such deceased shareholder. Including life insurance proceeds in the corporation's fair market value vastly increased the value of the deceased shareholder's shares, resulting in significant additional Federal estate taxes – in this particular case, by almost $900,000.

Brothers Michael and Thomas Connelly were the sole shareholders of a closely held corporation. Michael and Thomas entered into a buy-sell agreement stipulating that upon the death of one of the brothers, the surviving brother could purchase the decedent's shares. Under the agreement, if the surviving brother declined to purchase the shares, the corporation would be obligated to redeem the shares using the proceeds of the decedent's life insurance policy, a provision found in many buy-sell agreements.

Following Michael's death, Thomas declined to purchase Michael's shares, triggering the corporation's contractual obligation to redeem the shares. The parties agreed that Michael's shares representing 77.18% of the corporation were worth approximately $3 million, and the corporation paid this amount to Michael's estate from the insurance proceeds it received. When the estate filed its estate tax return, the IRS objected on the basis that the corporation's fair market value should have been increased by the $3 million in life insurance proceeds that the corporation received to redeem the shares, thereby increasing the value of Michael's shares from $3 million to $5.3 million.

The question for the Court was whether the life insurance proceeds, which flowed to the corporation immediately after the death of a shareholder, should increase the fair market value of the corporation despite the corporation's contractual obligation to use the proceeds to redeem the deceased shareholder's shares. There was no dispute that the insurance proceeds were an asset of the corporation that increased its fair market value; however, the estate argued that the corporation's redemption obligation offset such increase in value. The Court affirmed the IRS's position and held that the corporation's obligation to redeem the shares using those proceeds was not necessarily a liability reducing the corporation's fair market value for estate tax purposes.[1]

The Court reasoned that no hypothetical buyer purchasing Michael's shares would have treated the redemption obligation as a factor that reduced the value of those shares.[2] A buyer would pay an amount equal to the value that the buyer could expect to receive in exchange for the shares upon redemption, which would include the amount of insurance proceeds received by the corporation for the purpose of effectuating the redemption. The Court therefore concluded that "[the corporation's] promise to redeem Michael's shares at fair market value did not reduce the value of those shares."[3]

Connelly raises important considerations for shareholders of closely held corporations when negotiating and implementing buy-sell agreements for succession planning purposes. Although the Court acknowledged that this decision may make succession planning more difficult for owners of closely held corporations, it pointed to alternative arrangements, such as the use of a cross-purchase arrangement for the brothers to individually purchase (rather than have the corporation purchase) life insurance policies on each other, that could have been used to reduce estate tax. However, every arrangement has its own drawbacks, and *Connelly* highlights

that taxpayers should analyze their buy-sell agreements and life insurance structures with succession planning goals in mind, so as to minimize unforeseen consequences.

[1] The Court reasoned that "Thomas' argument that the redemption obligation was a liability cannot be reconciled with the basic mechanics of a stock redemption […] because there are fewer outstanding shares after the redemption, the remaining shareholders are left with a larger proportional ownership interest in the less-valuable corporation."

[2] For purposes of calculating the estate tax, "the whole point is to assess how much Michael's shares were worth at the time he died—before Crown spent $3 million on the redemption payment."

[3] In a footnote, the Court clarified that it does not hold that a redemption obligation can *never* decrease a corporation's value, but rather rejects the position that *all* redemption obligations decrease a corporation's value.

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