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Supreme Court Clarifies Estate Tax Consequences for Closely Held Company



The Supreme Court of the United States issued an important ruling on June 6, 2024, clarifying the federal tax consequences of certain succession plans for closely held businesses.

The Court held in *Connelly v. United States*, No. 23-146, 602 U.S. (2024), that a closely held company's obligation to purchase a decedent's shares at fair market value did not offset the value of the life insurance proceeds committed to fund that purchase. This Update provides the key takeaways for tax and estate planning practitioners from the unanimous opinion.

The Estate Tax

Generally, the Internal Revenue Service (IRS) collects taxes on the "transfer of the taxable estate of every decedent who is a citizen or resident of the United States." 26 U.S.C. §2001(a). A taxpayer's "taxable estate" is the fair market value of "all property," including shares in a closely held corporation, owned by the decedent "at the time of his death," minus applicable deductions. 26 U.S.C. §§2031(a)-(b), 2051.

The Case

Brothers Michael and Thomas Connelly were the sole shareholders in a Missouri company, Crown C Supply (the Company). Michael held 77.18% of the company's shares and Thomas held the remaining 22.82%. The brothers agreed that the Company would stay in the family when one of them died. Under the agreement, the surviving brother had the option to purchase the deceased brother's shares. If the surviving brother declined to do so, the Company had to buy the shares after an independent appraisal of their value. The Company had a \$3.5 million life insurance policy on each brother to ensure adequate cash to make such a purchase.

Michael died in 2013, and Thomas opted not to purchase his shares. Pursuant to their agreement, the Company was obligated to purchase Michael's shares. Michael's son and Thomas did not obtain an independent appraisal as required by the agreement and instead agreed that the shares were worth \$3 million. The Company used the life insurance proceeds to purchase the shares, making Thomas the sole shareholder.

Thomas—as executor of his brother's estate—then filed a tax return for the estate. Working with an accountant, Thomas reported the value of the shares as approximately \$3 million, reasoning that the Company's fair market value upon Thomas's death was \$3.86 million and Thomas's estate owned 77.18% of the business (\$3.86 million \times 0.7718). The accountant excluded from the Company's value both \$3 million of the insurance proceeds and the offsetting obligation to redeem Thomas's shares.

The IRS selected Michael's estate tax return for examination, disagreeing with the executor and his accountant. The IRS included the \$3.5 million in insurance proceeds but excluded the offsetting redemption obligation of \$3 million, resulting in a fair market value of \$6.86 million for the Company. Because Thomas's estate owned 77.18% of the shares, the IRS concluded that the value of the estate's shares was \$5.3 million $((\$3.86 \text{ million} + \$3 \text{ million}) \times 0.7718)$.

The estate paid the deficiency and sued the government for a refund, arguing that for valuation purposes, the redemption cost of \$3 million properly offset \$3 million of the \$3.5 million in life insurance proceeds. Thomas's argument lost in the district court, the U.S. Court of Appeals for the Eighth Circuit, and the Supreme Court of the United States.

The Court's Holding

The Court held that, for federal estate tax purposes, the Company's obligation to purchase shares at fair market value did not offset the life insurance proceeds committed to fund that purchase. The parties agreed that the federal estate tax properly applied to the fair market value of a decedent's interest in a closely held business and that life insurance proceeds are ordinarily an asset that increases the fair market value of that business. But they disagreed about whether the Company's obligation to buy the shares offset that increase.

The Court held that the IRS properly calculated the Company's fair market value at \$6.86 million. It reasoned that "[a]nyone purchasing Michael's shares would acquire a 77.18% stake in a company worth \$6.86 million," along with the Company's obligation to purchase those shares. The Court said that "the whole point" in calculating the estate tax was to assess "how much Michael's shares were worth at the time that he died—before [the Company] spent \$3 million on the redemption payment."

The Court acknowledged that *Connelly* does *not* stand for the proposition that a redemption obligation can never decrease a corporation's value. "We simply reject Thomas's position that all redemption obligations reduce a corporation's net value." 602 U.S.

Takeaways

There are three key takeaways from *Connelly* for tax and estate planning practitioners:

- **Life insurance proceeds and closely held businesses.** Practitioners should carefully consider the potential tax consequences of existing buy-sell arrangements, particularly those involving the contractually obligated payout of life insurance proceeds.
- **Alternative arrangements.** The Court noted that the brothers could have explored alternative arrangements, such as a cross-purchase agreement, in which shareholders agree to purchase each other's

shares and purchase life insurance policies on each other to fund the agreement. When evaluating any arrangement, closely held businesses should consider the valuation to be used in any buy-out situation.

- **Importance of advance planning.** The *Connelly* case reinforces that tax planning for closely held companies (and their shareholders) is not always straightforward. Most estate plans will not end up in the Supreme Court, but companies and shareholders should plan ahead with competent professionals to avoid surprises.

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