

## LEGAL UPDATES

# Supreme Court Confirms Life Insurance Proceeds Received by Corporation Increase Estate Tax Value of Decedent's Shares

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The June 6 unanimous ruling by the United States Supreme Court in *Connelly v. United States* creates a significant change for closely held businesses planning to utilize life insurance proceeds to fund buy-sell agreements. The *Connelly* Court concluded that the valuation of a closely held company for federal estate tax purposes has to include life insurance proceeds received by the company even though the company also has a contractual obligation to use those proceeds to redeem stock from a deceased owner. Since 2005, many closely held businesses had relied on the Eleventh Circuit decision in *Estate of Blount*, that even when a stock-purchase agreement did not meet the requirements of the tax code exception to general valuation-at-fair-market-value rule, it was not appropriate to include insurance proceeds paid upon the death of the insured shareholder in the computation of the company's fair market value.

## Overview of the Connelly Case

In *Connelly v. United States*, the U.S. Supreme Court addressed a critical issue regarding whether life insurance proceeds used to redeem the shareholder's stock affect the valuation of the stock for purposes of the deceased shareholder's estate tax. The case involved brothers Michael and Thomas Connelly, who were the sole shareholders of Crown C Supply, a closely held corporation. Michael owned 77% of the stock, while Thomas owned the remaining 23%. To ensure a smooth transition of ownership upon either brother's death, the company had a stock redemption agreement funded by corporate-owned \$3.5 million life insurance policies on each brother.

When Michael passed away in 2013, Crown's value was roughly \$3.86 million and the corporation received \$3.5 million in life insurance proceeds, of which it used \$3 million to redeem Michael's shares and retained \$500,000 for operating purposes. Michael's estate reported the value of his shares based on the \$3 million redemption payment. The IRS audited the estate tax return and determined that Michael's estate had undervalued the shares by not reporting the fair market value of the shares. It asserted that the fair market value of the shares must reflect the fair market value of the corporation at the time of Michael's death, which, in turn, must factor into account the life insurance proceeds. The IRS determined that the life insurance proceeds increased Crown's value from \$3.86

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million to \$6.86 million. Michael's shares in Crown, based on the \$6.86 million valuation, were worth \$5.3 million, and Michael's estate owed \$890,000 in additional estate tax due to undervaluing Crown's stock by \$2.3 million.

The U.S. Supreme Court sided with the IRS, ruling that the life insurance proceeds should be included in the valuation of the estate. Specifically, the Court held that Crown's contractual obligation to redeem shares was not a liability that reduced Crown's value for purposes of the federal estate tax and that a fair-market-value redemption does not reduce the date-of-death valuation of the decedent's shares. In essence, there is a smaller company value after the redemption, but fewer shares, so the value per share would be the same before and after the redemption was completed.

## Why the Insurance Proceeds Must Be Reflected in the Value of the Shares

The Court's rejected the argument that Crown's contractual obligation to redeem Michael's shares was a liability that offset the value of life-insurance proceeds used to fulfill that obligation. The Court ruled that an obligation to redeem shares from the estate of a shareholder at **fair market value** does not offset the value of the life-insurance proceeds because redemption at fair market value does not affect the shareholder's economic interest as the redemption does not reduce the value of those shares in and of itself.

## Mitigating Tax Liabilities

To avoid similar tax liabilities, closely held businesses should consider restructuring their buy-sell agreements. One such strategy is to use a cross-purchase agreement funded by life insurance instead of a corporate redemption funded by corporate-owned life insurance. In a cross-purchase agreement, the surviving shareholders receive the insurance proceeds and directly buy the deceased shareholder's shares. This removes the insurance proceeds from the valuation equation, allows the buyers to acquire the shares with a basis equal to the date-of-death purchase price, and avoids the corporation's direct involvement. The payment of policy premiums and long-term company ownership structures impact the considerations of how any ownership group decides to structure a plan.

Additionally, it is crucial to ensure that buy-sell agreements contain clear, fixed valuation methods or formulas to determine the price of shares. These methods can include binding appraisals conducted by qualified professionals, formula valuations, or annual (or other periodic) agreed values, but in the case of agreed values it is important to actually agree on the values as contemplated and have a fall back if that does not occur (for example, defaulting to an appraisal process or formula if the value has not been agreed for more than 15 months). Regularly reviewing and updating buy-sell agreements can ensure they comply with current laws and accurately reflect the fair market value of the business interests.

Finally, a buy-sell agreement must pass muster under Section 2703 of the Internal Revenue Code, which will disregard the valuation in the buy-sell agreement unless it is a bona fide arrangement, is not a device to transfer property to members of the decedent's family for less than full and adequate consideration, and contains terms that are comparable to similar arrangements entered into by persons in arm's-length transaction. This should usually protect buy-sell arrangements involving shareholders that are not members of the same family, but it may be wise to review all such arrangements that are funded with life insurance.

## Next Steps

The U.S. Supreme Court decision on this matter underscores the urgency for closely held businesses to reassess their buy-sell agreements. Now is the critical time to engage with our firm to ensure your agreements are structured to minimize tax liabilities and comply with the latest legal standards. Contact us today to schedule a consultation. Our team of experienced attorneys is ready to assist you in navigating these complex legal waters and safeguarding your business's financial future.