Connelly Decision Upheld

In a decision that surprised few, the Supreme Court resolved a split amongst the Circuit Court of Appeals on June 6, 2024. The case, Connelly v. United States, unanimously held that "a corporation's contractual obligation to redeem shares is not necessarily a liability that reduces a corporation's value for purposes of the federal estate tax."

Background

Michael and Thomas Connelly were the sole shareholders of Crown C Supply, a small building supply corporation. They had an agreement that if either brother died, the surviving brother would have the option to buy the deceased brother's shares, or the corporation would redeem them. To fund this, the corporation took out life insurance policies on both brothers.

After Michael's death, Thomas did not buy Michael's shares, so Crown had to redeem them. The estate and Thomas agreed the shares were worth $3 million, which Crown paid. However, the IRS audited the estate and valued the shares at $5.3 million, which included the $3 million life-insurance proceeds. As a result, an additional tax assessment of $889,914 was made. The estate paid the tax and sued for a refund. The District Court and the Eighth Circuit Court of Appeals sided with the IRS, and included the life insurance proceeds in the corporation's valuation.

What is the significance of the ruling and next steps to consider?

The central issue was the valuation of shares in a closely held corporation for federal estate tax purposes. The ruling clarifies how life insurance proceeds used to redeem shares should be treated in the context of estate taxes, potentially impacting how closely held corporations plan for succession and tax liabilities. Given that the Supreme Court's decision is the final authority on this issue, the following actions should be taken:

1. Existing buy-sell structures should be reviewed. Undoubtedly, there are many entity purchase life insurance structures in place that relied on the Eleventh Circuit's decision in the Estate of Blount case. The Supreme Court's decision effectively reversed Blount which excluded from valuation, life insurance proceeds used to redeem shares. Where possible, entity purchase arrangements should be avoided. Instead, consider cross-purchase agreements where insurance is purchased on each other. This would ensure that the insurance death benefit does not inflate estate tax values and go directly to purchasing deceased owner's shares.

2. Discuss with tax and legal advisor whether to modify existing entity purchase structures. The estate in the Connelly case argued that affirming the lower courts' decision would make succession planning more difficult for closely held corporations. Justice Thomas, who delivered the Court's unanimous opinion wrote succinctly, "the result here is simply a consequence of how the Connelly brothers chose to structure their agreement." In other words, a change in structure may lead to a different result.

NFM-24017AO (06/24)