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CONNELLY V. UNITED STATES (NO. 23-146)

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In a recent opinion, the United States Supreme Court unanimously ruled that life-insurance proceeds from a policy owned by a closely held business on the life of one of its owners must be factored into the valuation of the business for estate tax purposes when the insured owner dies. This ruling has important implications for owners of closely held businesses, so we recommend that clients with an active buy-sell or shareholders' agreement review that agreement with an attorney to ensure that it will not give rise to any unintended tax consequences in light of this decision.

Below is the summary of the Supreme Court decision authored by our colleagues in the Appellate Group at Wiggin and Dana.

Connelly v. United States (No. 23-146) deals with the two inevitables: death and taxes. The question presented was whether a corporation that receives life insurance proceeds following the death of one of its (two) shareholders must count that benefit in valuing the business for estate-tax purposes even when the corporation has a contractual obligation to use the policy's proceeds to redeem the deceased shareholder's shares. Justice Thomas, writing for a unanimous Court, upheld the Eighth Circuit's conclusion that the life insurance proceeds must be counted in the corporation's (and hence the estate's) value, and the obligation to buy the shares should not be treated as an offsetting liability.

The background of the case is straightforward. Two brothers, Michael and

Thomas, were the sole shareholders in a building supply corporation called Crown C Supply. They wanted to make sure Crown stayed in the family if one brother died, so they entered into a two-phase contract with Crown: First, if either brother died, the surviving brother would have the option to buy the deceased brother's shares. Second, if the surviving brother declined that option, Crown would be contractually obligated to redeem the deceased brother's shares. The only problem was making sure that Crown would have enough cash available to redeem the shares in the event of one brother's death. To address that, Crown took out a \$3.5M life insurance policy on each brother, the proceeds of which would be enough (or so they thought) to purchase the dead brother's shares.

The plan worked as far as keeping the business in the family goes. When Michael died, Thomas declined to buy Michael's shares. Crown then used \$3M of the proceeds from Michael's life insurance policy to redeem his shares, a price that Thomas and Michael's estate agreed was the shares' fair market value. The only hiccup occurred when Michael's estate attempted to value the estate's shares in Crown for purposes of paying the estate tax: It first provided a fair-market valuation of Crown's normal assets and liabilities, including the \$3.5M in life insurance proceeds. But it then reduced that total amount by the \$3M used to redeem Michael's shares, relying on an Eleventh Circuit decision holding that in such circumstances, the policy proceeds are

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"offset" by the obligation to redeem the shares and so should be deducted from the value of the company. The estate thus came to a total value of Crown of \$3.86M, and because Michael owned about 77% of the company, his estate valued his shares at \$3M (77% of \$3.86M). But the IRS disagreed, reasoning that the full insurance proceeds (including the \$3M used to redeem the shares) should be included in the value of the company, leading to a total fair market value of \$6.86M for Crown and \$5.3M for Michael's part of it. That resulted in a tax deficiency of roughly \$900K. The estate paid the deficiency under protest and sued the Government for a refund. But the District Court and then the Eighth Circuit sided with the IRS. The Court granted cert to resolve this split between the Eighth Circuit and several other courts, like the Eleventh.

In a short opinion for a unanimous Court, Justice Thomas affirmed the Eighth Circuit. As he saw it, Crown's obligation to redeem Michael's shares did not decrease the value of shares in Crown, so it wouldn't have impacted the value of the company to someone interested in purchasing the shares. "Because a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares."

Justice Thomas quickly disposed of the estate's efforts to counter this straightforward analysis. In the estate's view, because the proceeds of the life-insurance policy would leave the company as soon as they arrived in order to complete the redemption, no buyer would consider those proceeds in valuing the company. But that approach, Thomas countered, looks to what a buyer would pay for the shares that make up the same percentage

of the (less-valuable) corporation that exists *after* the redemption. The "whole point" of the estate tax, by contrast, is to assess how much Michael's shares were worth *at the time he died*, a time before Crown had spent this \$3M. At that time, the \$3M would be treated as a net asset, so it has to be factored into the value of the shares. Thomas also observed that the estate's argument resulted in a logical problem: The transaction that "cashed out" the value of Michael's shares should have reduced Crown's total value, while at the same time reducing the number of outstanding shares (so the remaining shareholder, Thomas, would have a larger proportional interest, 100%, in a less-valuable corporation). But under the estate's calculation, Crown was worth \$3.86M *before* the redemption and it was worth \$3.86M *after* it. That makes no sense: If Crown was truly worth \$3.86M after the buyout, then it should have been worth \$3M more before that \$3M was taken out of the company.

Last, for all the trusts and estates lawyers out there, Justice Thomas addressed the estate's argument that the Eighth Circuit's (and IRS's) approach would make succession planning more difficult for closely held corporations, because it would require them to purchase even more in insurance to cover the cost of a redemption like this one. But Thomas disposed of that too: The Court's decision was simply the result of how these brothers chose to structure their agreement. Other approaches, like a cross-purchase agreement, could have avoided the risk that the insurance proceeds would increase the value of Michael's shares (though, to be sure, this approach too might have tax drawbacks). Finally, in a short footnote, Thomas noted that the Court was not holding that a redemption obligation can *never* decrease a corporation's fair market value. All the Court was saying that this particular redemption obligation did not do so for this particular corporation.