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WILLS, TRUSTS & ESTATES

Connelly v. United States

Corporate redemption agreements funded with life insurance are significantly impacted by the recent United States Supreme Court decision Connelly v. United States.[1]

In the Connelly case, the Court unanimously held that the estate tax value of shares of stock in a closely-held corporation owned by the estate of a decedent shareholder includes the value of life insurance payable to the corporation to fund the redemption of the shares, and that the obligation to redeem the shares cannot be treated as a liability of the corporation to offset the value of the life insurance proceeds.

Fact Summary

Michael P. Connelly and his brother Thomas A. Connelly were the sole shareholders of Crown C. Supply. To ensure that the shares of the corporation would stay within the family if either of them died, they entered into an agreement which provided that, upon the death of a shareholder, the survivor would have the option to purchase the decedent shareholder's shares. If the option was not exercised, the corporation had the obligation to redeem the shares. To fund the redemption, the corporation purchased a $3.5 million life insurance policy on the life of each shareholder.

Michael died and Thomas, as the surviving shareholder, elected not to purchase the shares, thus obligating the corporation to redeem the shares from Michael's estate. Leaving aside various procedural and factual details, for estate tax purposes, Michael's estate ultimately sought to value the shares owned by Michael on a fair market value basis, including the value of the life insurance payable to the corporation, and offsetting that figure with the liability owed by the corporation to Michael's estate for the redemption obligation. That approach has been commonly utilized following the principles articulated in Estate of Blount v. Commissioner.[2]

Ruling

The Supreme Court in Connelly rejected the Blount methodology, stating that "[a]n obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest." The opinion provides a mathematical example to support its logic:

> "A simple example proves point. Consider a corporation with one asset—$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 shares x $100,000) and B's shares are worth $2 million (20 shares x $100,000). To redeem B's shares at fair market value, the corporation would thus have to pay B

[1] Connelly v. United States, 144 S.Ct. 1406 (June 6, 2024).

[2] Estate of Blount v. Commissioner, 428 F.3d 1338 (CA11 October 31, 2005).

> $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷ 80 shares. Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interests after the redemption—A's 80 shares and B's $2 million in cash—would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself."

The hypothetical example uses cash as the sole corporate asset, but swapping cash with life insurance does not change the result. Accordingly, "[b]ecause 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."

To further its position, the Court noted that estate assets are to be valued at fair market value as of the time of death, but that taking a redemption obligation into account effectively values the corporation at a later date — that is, following the redemption.

The Court did however recognize that certain corporate liabilities may affect fair market value, noting by footnote: "We do not hold that a redemption obligation can *never* decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas' position that all redemption obligations reduce a corporation's net value. Because that is all the case requires, we decide no more."

Consequences

Business owners, particularly those that may be subject to federal and/or state estate taxes, who are parties to a corporate redemption agreement funded with life insurance must be aware of the impact of the Connelly decision. Estate tax liability may be assessed on the decedent's fair market value interest in the entity, which includes the life insurance funding the redemption, without any offset for the redemption liability. Depending on the terms of the redemption agreement, there are significant risks of unintended results with potentially consequential economic detriment to the decedent's estate or to the redeeming entity.

Alternatives

The Connelly ruling does not affect buyout agreements funded by life insurance which are structured as cross-purchase agreements. Under a cross-purchase agreement, the surviving business owners (shareholders of a corporation, members of a limited liability company, partners of a partnership), rather than the entity, have the right or obligation to purchase the interest of a deceased owner. This arrangement avoids the Connelly redemption result and provides income tax basis step up benefits that are absent with redemption agreements. However, cross-purchase agreements with more than two or three owners begin to become exceedingly burdensome if the purchase obligation is funded by life insurance, as each owner must own a life insurance policy on each other owner. With two owners, a cross-purchase agreement requires two policies. Increase the number to three, however, and the number of required policies increases to six, and so on.

An alternative which avoids the complications associated with cross-purchase planning funded by life insurance with multiple owners, may be the use of an insurance limited liability company. The business owners form a separate limited liability company to own the life insurance to implement the cross-purchase agreement, necessitating only one life insurance policy for each business owner. This arrangement offers income tax step up advantages that exist with simple cross purchase agreements, without the expense and complication with business entities with multiple owners. Unfortunately, it is not clear if the reasoning of Connelly case will cause a portion of the limited liability company owning the life insurance to be included in the deceased owner's estate.

Conclusion

To avert the potential pitfalls arising out of the Connelly ruling and its attendant tax consequences, a prompt and thorough review of business agreements by and among shareholders, partners and limited liability company members is warranted.

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