Finseca

The Washington Report

Business Uses Edition

www.Finseca.org

This Washington Report is prepared exclusively for Finseca Influencer members by Jonathan M. Forster, Partner, and Matt P. Wochok, Partner at BakerHostetler.

THE SUPREME COURT'S DECISION IN CONNELLY AND WHY LIFE INSURANCE FUNDED REDEMPTION AGREEMENTS ARE NOT DEAD…

MARKET TREND: The IRS continues to question valuations used by taxpayers and challenge the theories used by taxpayers to support their positions.

SYNOPSIS: In Connelly, the Supreme Court considered the question of whether the proceeds from a life insurance policy, taken out by a closely held corporation on a shareholder to facilitate the redemption of the shareholder's stock upon death, should be included when calculating the value of the shareholder's shares for purposes of the federal estate tax. In a unanimous decision, the Supreme Court rejected the argument that a redemption obligation is a liability that necessarily reduces the net value of a corporation. Initial reactions in the market suggest taxpayers and their advisors are interpreting the decision as fatal to redemption agreements funded with life insurance proceeds. But on closer review, the Court's decision was extremely narrow—holding only that it rejected the taxpayer's position that all redemption obligations reduce a corporation's net value. Consequently, properly arranged redemption agreements funded with life insurance remain possible.

TAKE AWAYS: The Court removed from the taxpayer's arsenal of arguments the theory that a redemption obligation necessarily reduces the net value of a corporation. But even before the Court's decision, many advisors had been hesitant to rely on that theory because of its flawed logic. Taxpayers still have multiple avenues available for structuring redemption agreements funded with life insurance. Given the Connelly decision, it is highly recommended that taxpayers review their sale and redemption agreements to determine what changes, if any, should be made in light of the Court's decision.

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.

THE DECISION

In Connelly v. United States,[1] the Supreme Court considered the question of whether the proceeds from a life insurance policy, taken out by a closely held corporation on a shareholder to facilitate the redemption of the shareholder's stock upon death, should be included when calculating the value of the shareholder's shares for purposes of the federal estate tax. The taxpayer argued that the corporation's obligation to redeem its shares from the shareholder's estate represents a corporate liability offsetting the value of the life insurance proceeds while the Government argued life insurance proceeds represent a nonoperating asset of the corporation and should therefore, just like any other corporate asset, be considered in the value of the shareholder's shares.

On June 6, 2024, Justice Clarence Thomas, writing for a unanimous Supreme Court, issued a narrow decision in favor of the Government writing that an 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. In a footnote to the opinion, Justice Thomas stated that the Court was not holding that a redemption obligation can never decrease a corporation's value but that it was merely rejecting the assertion that all redemption obligations reduce a corporation's net value—because that was all that was required in deciding the case, the Court decided nothing more.[2]

RELEVANT FACTS

The Connelly brothers, Michael (owning 77.18 percent and Thomas (owning 22.82 percent, owned 100 percent of Crown C corporation, a small but successful building supply company in St. Louis, Missouri. To maintain continuity of Crown C, the brothers and Crown C entered into a stock purchase and redemption agreement. The agreement provided that upon the death of a brother, the surviving brother would have the right to purchase the decedent's shares from his estate. If the surviving brother did not execute such purchase, Crown C was obligated to redeem any shares held by the decedent's estate. The brothers always intended that Crown C would carry out the redemption and Crown C secured life insurance on each brother in the amount of $3.5 million to fund a potential redemption.

The Stock Purchase Agreement provided two mechanisms for valuing a deceased brother's shares. The primary mechanism required the brothers to execute a new Certificate of Agreed Value at the end of every tax year which set the price per share by mutual agreement. If a Certificate of Agreed Value was not executed, then the brothers were required to obtain two or more appraisals for determining fair market value of the shares held by the deceased brother.

[1]Connelly v. United States, No. 23-146 (U.S. 2024).
[2]Connelly, No. 23-146, at n.2.

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.

Michael died in 2013 and Crown C received $3.5 million in life insurance proceeds. Crown C redeemed Michael's shares for $3 million. Notwithstanding the fact that the stock purchase agreement provided two mechanisms for determining the redemption price for a decedent's shares, neither mechanism was used. The brothers never executed a Certificate of Agreed Value and did not obtain outside appraisals. Instead, the estate and Thomas agreed to their own valuation of $3 million saying that they had resolved the sale price in as amicable and expeditious a manner as possible. In their view, the pricing mechanisms set forth in the agreement were only relevant if they could not otherwise agree on a price.

The IRS audited the estate arguing that Michael's shares were worth significantly more than $3 million. The estate paid the additional tax and then sued the Government for a refund. The district court granted summary judgment in favor of the Government and the Eighth Circuit affirmed.

Aside from the $3 million used to redeem Michael's shares, the parties were in agreement that Crown C was worth roughly $3.36 million before considering the $3.5 million in life insurance proceeds. Using that valuation, Michael's shares were worth approximately $2.6 million (77.18 percent of $3.36 million). After adding in Michael's 77.18 percent of the proceeds not used in the redemption (which nobody argued that such proceeds should be excluded in the valuation), Michael's shares increased in value to about $2.98 million. Consequently, the only argument before the Supreme Court was whether the $3 million in life insurance proceeds used to fund the redemption should be included in the value of Michael's shares (i.e., whether Michael's shares were worth approximately $3 million or $5.3 million).

SECTION 2703 OF THE INTERNAL REVENUE CODE

A tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.[3] A decedent's estate includes the value of all property of the decedent with such property generally being valued at its fair market value at the time of death. Fair market value is generally determined based on a willing buyer, willing seller test where each party is not under compulsion to buy or sell with each having reasonable knowledge of the relevant facts.

While agreements to acquire property at less than fair market value are generally ignored for purposes of valuing such property, an important exception to this rule exists.[4] Specifically, section 2703(b) of the Internal Revenue Code provides that an agreement to acquire or use property at less than fair market value will be considered for valuing such property if the agreement meets certain criteria. In particular, the agreement must:

- be a bona fide business arrangement,
- not be a device to transfer property to members of the decedent's family for less than full and adequate consideration,

[3]Estates valued below a specific threshold are not subject to the tax.
[4]Section 2703 of the Internal Revenue Code of 1986, as amended.

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.

- include comparable terms to similar arrangements entered into by persons in an arm's-length transaction,

- include a fixed and determinable price (judicially imposed requirement), and

- be binding during life and after death (judicially imposed requirement).

In fact, the taxpayer in Connelly argued in the lower courts that the stock purchase and redemption agreement entered into by Crown C and the Connelly brothers met such requirements and that the $3 million redemption price should therefore be respected. But the lower courts rejected that argument because the parties did not follow the terms of the purchase agreement. Specifically, they ignored the pricing mechanisms set forth in the agreement.

After losing in the Eighth Circuit on this argument, the taxpayer conceded that it could not rely on the stock purchase agreement and did not ask for review by the Supreme Court on that issue. Instead, the taxpayer relied on its alternative theory that a redemption obligation is a liability of the company and therefore reduces the corporation's value—an argument supported by an Eleventh Circuit ruling.[5]

While the Supreme Court rejected the theory that a redemption obligation necessarily reduces a corporation's net value, it said nothing with respect to section 2703(b). Accordingly, nothing in the opinion of the Court prevents taxpayers from structuring arrangements to comply with section 2703(b) and having such arrangements use a redemption price that does not include the value of life insurance proceeds necessary to fund a redemption.

THE NUMBERS: A DEEPER DIVE AND ALTERNATIVE THEORY

While the Supreme Court's decision to reject the logic that a redemption obligation necessarily reduces a corporation's net value is correct, the outcome feels wrong. It seems obvious that the Connelly brothers expected the life insurance to provide liquidity for a redemption and not for a decedent's estate to otherwise share in its value. When analyzing the impact of having a decedent participate in the value of the life insurance proceeds, the results are compelling.

---

[5]Estate of Blount v. Commissioner, T.C. Memo. 2004-116, aff'd in part and rev'd in part, 428 F.3d 1338 (11th Cir. 2005).

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.

Specifically, if the parties intended for Michael to participate in the value of the insurance proceeds, based on a $3.36 million company valuation, Crown C would have needed to secure coverage of nearly $11.4 million on Michael. Such an extreme amount of coverage, over three times the value of Crown C, would be necessary because Michael would be entitled to 77.18 percent of every dollar of the proceeds. As a result, only 22.82 percent of each dollar would be available to carry out the original redemption amount of $2.6 million. Assuming for the sake of discussion that the parties intended for Michael to participate in the value of the proceeds, taking out only $3.5 million in coverage merely reduced the original $2.6 million liquidity problem (the amount needed to redeem Michael's shares) to a $1.8 million problem (Michael's shares would be worth $5.3 million if he participated in the value of the proceeds but the company would only have $3.5 million to use in the redemption). It seems unlikely that the parties would have been satisfied with that result given the clear desire to provide for continuity of Crown C and liquidity for a decedent shareholder.

What seems more plausible is that the parties did not expect either brother to participate in the value of the proceeds (to be clear, the restriction on participation is limited to the value of the decedent's shares before any life insurance proceeds are taken into account—any excess proceeds would be taken into account just like any other asset of the company) and that Thomas was insured for the same amount as Michael to provide each brother with a similar economic gain upon the death of the other brother. It turns out that if Thomas had died instead of Michael, Michael would have had a net economic gain of about $2.9 million which is close to the $2.8 million net economic gain that Thomas would have had on Michael's death under this theory.

But the taxpayer did not argue that the life insurance proceeds should be excluded from the valuation of the decedent's shares because of this implicit understanding in their arrangement (i.e., that a decedent's shares do not benefit from the life insurance proceeds beyond the liquidity such proceeds provide). It's unclear how the Court would have treated such an argument if the taxpayer had raised it. Regardless, the Court's decision did not shut down the possibility of structuring arrangements under this theory moving forward. Thus, parties should be able to create an explicit arrangement whereby a decedent's shares do not participate in the value of life insurance proceeds—under such an arrangement the fair market value of a decedent's shares would naturally not reflect the value of the proceeds.

DRAFTING AGREEMENTS AFTER CONNELLY

While the Court's decision effectively overruled the Eleventh Circuit's logic in Estate of Blount that a redemption obligation necessarily reduces a corporation's net value, the Connelly decision should not be read as preventing taxpayers from entering into a redemption agreement funded with life insurance. As discussed previously, parties should still be able to enter into agreements complying with section 2703(b) using a redemption price that excludes any life insurance proceeds. Alternatively, parties may simply enter arrangements that prevent a decedent from participating in the value of life insurance proceeds earmarked for a redemption—such an arrangement could be effectuated through issuing separate classes of stock or potentially by just including express language in the redemption agreement. In addition, and as noted in the Court's opinion, cross-purchase agreements with insurance secured at the shareholder level remain an option as well. Of course, such arrangements create a different economic, tax, and risk profile though.

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.

COLLATERAL CONSEQUENCES OF CONNELLY LITIGATION

Interestingly, the Court's decision in Connelly may have exposed a tax benefit for smaller estates. Upon death, the basis in a decedent's shares is generally increased to the value placed on such shares for estate tax purposes. Thus, taxpayers may view the Court's opinion as requiring the inclusion of value from the life insurance proceeds when determining the basis of a decedent's shares. Assuming a redemption price would not include the value of such proceeds (i.e, the proceeds are simply used to provide liquidity to execute the redemption), the estate would consequently have a capital loss on the redemption. While the additional estate tax resulting from the inclusion of the value of the proceeds would generally outweigh the benefit of the capital loss, estates below the estate tax threshold would only get the benefit of the capital loss. It is unlikely that many taxpayers would have thought such benefit proper prior to the Connelly decision. As a result, some taxpayers may intentionally structure redemption agreements to fail to comply with section 2703(b) to obtain a capital loss for their estate.

CONCLUDING THOUGHTS

While the Supreme Court's decision in Connelly rejected the conclusion that all redemption obligations necessarily reduce a corporation's net value, nothing in the decision prevents parties from continuing to engage in life insurance funded redemption agreements. Taxpayers previously relying on the logic from the holding in Estate of Blount, however, will be prevented from doing so moving forward. But agreements that comply with section 2703(b or that clearly restrict a decedent from participating in the value of proceeds earmarked for a redemption should still be respected. It would be prudent for taxpayers to review their existing agreements to determine what adjustments, if any, should be made.

Finseca has granted Albert Gibbons permission to share this article with select individuals through their Finseca Influencer membership. Parties receiving this content from the aforementioned Finseca Influencer member may not share it in any format. For additional access, please email learning@finseca.org.