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Connelly v. United States (U.S. Supreme Court June 6, 2024)

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Buy-Sell Agreement Planning; Insurance Proceeds Paid to Corporation to Fund Redemption Obligation to Purchase Decedent's Stock Is Considered in Valuing Stock for Estate Tax Purposes

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1. Synopsis

A buy-sell agreement for a corporation owned by two brothers gave the surviving brother the option to purchase the decedent's shares, or if not exercised, required the corporation to buy the decedent's shares. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (which would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value, and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement but agreed the company would pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about $3 million, taking the position that the $3 million used to purchase the shares should not be included in determining the value of the corporation; under that approach, the corporation 's value was $3.86 million, and the decedent's 77% interest was worth $3 million. The IRS assessed an additional $890,000 of estate tax, maintaining the $3 million of life insurance proceeds should have been taken into consideration in determining the value. The estate paid the additional estate tax and sued for a refund.

The court considered whether the buy-sell agreement set a $3 million price that controlled for estate tax purposes, and if not, the only issue after stipulations was whether the $3 million of life insurance proceeds used to purchase the estate's shares should be considered in determining the value of the shares for estate tax purposes.

The district court and Eighth Circuit determined that the agreement did not set a price that was binding for estate tax purposes. In valuing the stock without regard to the agreement, both the district court and Eighth Circuit determined that the $3 million should be included in determining the value of the decedent's shares. Both courts disagreed with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* (2005) that the contractual obligation of a company to purchase a decedent's shares offsets the life insurance proceeds on the decedent's life paid to the company.

The U.S. Supreme Court affirmed in a unanimous opinion written by Justice Thomas, reasoning (1) a redemption of shares at fair market value does not affect any shareholder's economic interest, (2) no willing buyer purchasing the decedent's shares would have treated the corporation's obligation to redeem the shares at fair market value as a factor that reduced the value of those shares, (3) treating the redemption obligation as a liability cannot be reconciled with the basic mechanics of a stock redemption, and (4) that this result makes succession planning more difficult is simply a consequence of how the parties structured the purchase obligation, and other options existed that could have avoided increasing the value of the decedent's shares as a result of considering the insurance proceeds as a corporate asset.

Connelly v. United States., 602 U.S. ___ (June 6, 2024) (Justice Thomas, unanimous), *aff'g* 70 F.4th 412, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. September 21, 2021).

2. Basic Facts

The basic facts were concisely summarized in the unofficial syllabus of the Supreme Court opinion:

> Michael and Thomas Connelly were the sole shareholders in Crown C Supply, a small building supply corporation. The brothers entered into an agreement to ensure that Crown would stay in the family if either brother died. Under that agreement, the surviving brother would have the option to purchase the deceased brother's shares. If he declined, Crown itself would be required to redeem (*i.e.*, purchase) the shares. To ensure that Crown would have enough money to redeem the shares if required, it obtained $3.5 million in life insurance on each brother. After Michael died, Thomas elected not to purchase Michael's shares, thus triggering Crown's obligation to do so. Michael's son and Thomas agreed that the value of Michael's shares was $3 million, and Crown paid the same amount to Michael's estate. As the executor of Michael's estate, Thomas then filed a federal tax return for the estate, which reported the value of Michael's shares as $3 million. The Internal Revenue Service (IRS) audited the return. During the audit,

Thomas obtained a valuation from an outside accounting firm. That firm determined that Crown's fair market value at Michael's death was $3.86 million, an amount that excluded the $3 million in insurance proceeds used to redeem Michael's shares on the theory that their value was offset by the redemption obligation. Because Michael had held a 77.18% ownership interest in Crown, the analyst calculated the value of Michael's shares as approximately $3 million ($3.86 million x 0.7718). The IRS disagreed. It insisted that Crown's redemption obligation did not offset the life-insurance proceeds, and accordingly, assessed Crown's total value as $6.86 million ($3.86 million + $3 million).The IRS then calculated the value of Michael's shares as $5.3 million ($6.86 million x 0.7718). Based on this higher valuation, the IRS determined that the estate owed an additional $889,914 in taxes. The estate paid the deficiency and Thomas, acting as executor, sued the United States for a refund. The District Court granted summary judgment to the Government. The court held that, to accurately value Michael's shares, the $3 million in life-insurance proceeds must be counted in Crown's valuation. The Eighth Circuit affirmed.

3. Lower Court Analysis

a. **District Court and Eighth Circuit Analysis of Whether Buy-Sell Agreement Set $3 Million Value Binding For Estate Tax Purposes.** The district court determined that the buy-sell agreement did not fix the value of the shares for federal estate tax purposes. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test, it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

The Eighth Circuit agreed, reasoning more succinctly that the agreement did not set the estate tax value of the decedent's stock because the agreement did not establish a "fixed and determinable price." (Even if the pricing mechanisms in the agreement had been followed, the court expressed reservations about whether those pricing mechanisms would have been sufficient to establish a fixed and determinable price.)

For a more detailed discussion of the district court and Eight Circuit analysis of this issue, see Item 28.c-d of LOOKING AHEAD – Estate Planning in 2024 & Current Developments (Including Observations from Heckerling 2024) found **here** and Item 39.c of Estate Planning Current Developments (December 2021) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **District Court and Eighth Circuit Analysis of Whether $3 Million of Insurance Proceeds Used to Redeem Decedent's Stock Should be Included in Determining Value of Decedent's Shares.** Under stipulated facts, the only valuation issue was whether the $3 million of life insurance proceeds paid to the company that were used to redeem the decedent's stock should be considered in valuing the decedent's shares for estate tax purposes.

The estate's primary argument relied on the Eleventh Circuit's opinion in *Estate of Blount v. Commissioner,* 428 F.3d 1338 (11th Cir. 2005). The district court summarized the *Blount* holding and rationale:

> The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The district court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Estate of Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." A hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation; the hypothetical buyer "would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The district court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]."

The Eighth Circuit agreed with and expanded upon the district court's rejection of the rationale of *Estate of Blount* that the insurance proceeds were offset by the company's obligation to use the proceeds to redeem the shares.

> The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense…. Consider the willing buyer at the time of [the decedent]'s death. To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares *from himself*. This is just like moving money from one pocket to another. There is no liability to be considered—the buyer controls the life insurance proceeds**.**

The Eighth Circuit added a simple example and concluded: "In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased the shareholders' equity. A fair market value of Michael's shares must account for that reality."

4. Supreme Court Review and Opinion

a. **Briefs; Oral Arguments.** The U.S. Supreme Court granted the estate's petition for a writ of certiorari (surprisingly, to most planners) on December 13, 2023. For a summary of arguments in the parties' briefs and in various amicus briefs and of observations from the oral arguments before the Court, see Item 28.e of LOOKING AHEAD – Estate Planning in 2024 & Current Developments (Including Observations from Heckerling 2024) (June 5, 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Opinion.** The Court affirmed, holding that "redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax." The Court offered several reasons supporting this holding.

(1) **Fair Market Value Redemption Does Not Affect Any Shareholder's Economic Interest.** A fair market value redemption reduces the value of the corporation, but with each remaining shareholder holding a proportionately greater percentage of that lower value. For example, if a $10 million corporation with 100 shares (worth $100,000 per share) has an 80% and 20% shareholder, assume the 20% shareholder is redeemed for $2 million. The corporation's value is reduced to $8 million, but the remaining shareholder's 80 shares are still worth $100,000 per share. "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."

(2) **Hypothetical Buyer of Estate's Shares Would Not View Redemption Obligation as Reducing Value of the Shares.** "[N]o 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." At Michael's death, the company was worth $6.86 million – $3 million of insurance proceeds earmarked for the redemption and $3.86 million of other assets.

> Anyone purchasing Michael's shares would acquire a 77.18% stake in a company worth $6.86 million, along with Crown's obligation to redeem those shares at fair market value. A buyer would therefore pay up to $5.3 million for Michael's shares ($6.86 million x 0.7718)—*i.e.*, the value the buyer could expect to receive in exchange for Michael's shares when Crown redeemed them at fair market value. We thus conclude that Crown's promise to redeem Michael's shares at fair market value did not reduce the value of those shares.

(3) **Offsetting Value by Amount of Redemption Obligation Effectively Values Corporation on a Post-Redemption Basis.** A valuation that reduces the value by the redemption obligation effectively values the corporation on a "post-redemption" basis, but "for calculating the estate tax, the whole point is to assess how much Michael's shares were worth at the time that he died—before Crown spent $3 million on the redemption payment."

(4) **Cannot Reconcile Reducing Value by Amount of Redemption Obligation With Basic Mechanics of a Stock Redemption.** A redemption transaction **"**necessarily reduces a corporation's total value. And, because there are fewer outstanding shares after the redemption, the remaining shareholders are left with a larger proportional ownership interest in the less-valuable corporation." The estate argued that the corporation was worth only $3.86 million before the redemption and was worth $3.86 million after the redemption. That "cannot be reconciled with an elementary understanding of a stock redemption."

(5) **Making Succession Planning More Difficult.** The estate argued "that affirming the decision below will make succession planning more difficult" because a corporation would need policies with far more death benefits to have sufficient insurance proceeds to redeem a decedent's shares at fair market value. (Several of the amicus briefs made this same point.)

"True enough, but that is simply a consequence of [using a redemption agreement]." Other planning options are available; there are advantages and disadvantages of each of the options, but one result of the redemption arrangement is that insurance proceeds paid to the corporation that are used to fund the purchase will increase the value of the shares.

5. Observations

a. **Result Not Surprising; Makes Economic Sense Though Disagreeing With Prior Circuit Level Case.** Given the many lapses in the implementation of the Connelly redemption transaction, the taxpayer's loss is not unexpected. Including the life insurance proceeds received by a company at the decedent's death in valuing the decedent's interest in the corporation for estate tax purposes makes economic sense, as aptly summarized by the Supreme Court. Prior cases had been inconsistent; an amicus brief filed by the Chamber of Commerce of the United States of America and National Federation of Independent Business Small Business Legal Center, Inc. discussed the IRS's shifting positions in the history of relevant cases, cited in chronological order *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933); *Estate of Huntsman v. Commissioner*, 66 T.C. 861, 872 (1976); *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999); and *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The Court's opinion is very significant as a repudiation of the contrary holding by the Eleventh Circuit Court of Appeals in *Estate of Blount*.

The Eighth Circuit explained the "illogic" of excluding the life insurance proceeds by observing that the surviving shareholder's value would have increased from $7,720 per share (without including the life insurance proceeds to determine the value) to $33,800 per share. The survivor's shares would have quadrupled in value "without any material change to the company." "This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a 'liability.' A true offset would leave the value of Thomas's share undisturbed."

Carlyn McCaffrey (New York, New York) explains using a different example. Assume a company having an operational value of $10 million is owned equally by mom and daughter, and the company is obligated to purchase the shares from the estate of a deceased shareholder at 50% of the company's value. Assume the company owns a $5 million life insurance policy on mom's life to fund the purchase of her shares at her death. At mom's death, the company receives the $5 million of life insurance proceeds. If the life insurance proceeds are not taken into account in determining the value, mom's estate will be paid 50% of $10 million, or $5 million. On the other hand, if the company had accumulated $5 million of liquid assets to fund the buyout of mom's shares at her death, the company would be worth $15 million, and the purchase price would be $7.5 million. Under the estate's position, the company can fund the buy-sell agreement purchase by paying for a life insurance policy rather than by accumulating funds, and thereby decrease the purchase price from $7.5 million to $5 million. Carlyn's reaction: "That sounds like nonsense, doesn't it?"

b. **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of a decedent's shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds payable to the company is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* district court opinion).

The economic impact of not including insurance proceeds in valuing a decedent's shares is to produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent's shares without having to pay anything following the decedent's death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time. The Supreme Court's conclusion that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality is not surprising.

c. **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange vs. dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life. *See* Private Letter Ruling 200747002 (LLC owned life insurance for funding of cross-purchase buy-sell agreement of S corporation, with all shareholders of the S corporation as members of the LLC).

d. **"Fixed and Determinable Price in the Agreement" Dictum by Eighth Circuit Suggests That Many Buy-Sell Agreements Would Not Set the Estate Tax Value.** The Eighth Circuit held that a "fixed and determinable price" was not established under the stock purchase agreement, partly because the parties did not follow the pricing mechanisms set out in the agreement. Even if those procedures had been followed, however, the Eighth Circuit suggested (presumably in dictum) that would not have been sufficient to determine the estate tax value of the stock. That observation by the court is quite significant because the pricing procedures in the buy-sell agreement in *Connelly* ((1) annual valuation agreements and (2) appraisal procedures) are often found in buy-sell agreements. A purchase under a binding agreement pursuant to those procedures might not be recognized as the value for estate tax purposes of the purchased interest under the reasoning of this dictum in *Connelly*.

The Supreme Court did not address this aspect of the Eighth Circuit opinion.

e. **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should not merely be added to the value of the corporation determined without regard to the proceeds. *See Estate of Huntsman*, 66 T.C. 861, 872-76 (1976), *acq*. 77-1 C.B. 1 ("determine fair market value … by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner,* 66 F.2d 102, 103-04 (7th Cir. 1933) (key shareholder's estate established that stock increase was offset by decrease in corporation's value caused by loss of key shareholder).

f. **Alternative Argument.** Professor Mitchell Gans suggests an interesting alternative (and much simpler) analysis. If the §2703(b) safe harbor does not apply, §2703(a) says to value the stock for transfer tax purposes "without regard to … any … agreement to acquire … the property at a price less than the fair market value of the property ….". If the stock is valued "as if the agreement did not exist …, [t]his means not only that the price set in the agreement must be ignored, but also that the corporation's obligation to redeem does not reduce the value of the decedent's stock." Gans, *Reflections on the Oral Argument in* Connelly, 183 TAX NOTES FEDERAL 1585, 1587 (May 27, 2024).