PUBLICATION

Supreme Court Upholds Life Insurance Valuation in Estate Tax Calculation

Authors: Peyton H. Lacoste, Laura Walker Plunkett
June 25, 2024

The United States Supreme Court (Supreme Court) released the *Connelly v. United States* opinion on June 6, 2024. The opinion affirmed the Eighth Circuit's holding in favor of the IRS that a company's contractual redemption obligation to a deceased shareholder's estate does not offset the company's increased value after life insurance policy proceeds are paid to the company. As a result, the taxpayer in *Connelly* owed federal estate tax reflecting the (post-death) increased value of his shares. Therefore, because redemption obligations will no longer reduce the value of life insurance proceeds, many entities will have to consider re-working key person life insurance policies and their corresponding redemption agreements in order to avoid adverse federal estate tax results for their shareholders.

At issue was the valuation of life insurance proceeds payable to the Connelly brothers' corporation, Crown C Supply (Crown). Brothers Michael and Thomas Connelly, the sole shareholders in Crown, each took out a life insurance policy with Crown as the beneficiary upon death; however, to protect each of their interests in the closely held company, each contractually agreed that the surviving brother would have the option to purchase the other's shares. If the surviving brother declined to do so, then Crown was obligated to redeem the deceased brother's shares.

Michael passed away and Crown received his $3 million life insurance payout, burdened by the contractual obligation to redeem Michael's shares in Crown.

Thomas, as the executor of Michael's estate, filed an estate tax return under the belief that the $3 million life insurance payout was accompanied by the offsetting redemption agreement and should not increase Crown's valuation (which would increase the value of Michael's shares in Crown and thus his estate tax liability). Historically, this offsetting obligation would have canceled out the policy proceeds and would not increase the value of Crown for estate tax purposes. The IRS disagreed – it reasoned that the $3 million payout should be included in Crown's valuation when calculating Michael's estate tax, even considering the obligation to redeem the shares.

The Supreme Court sided with the IRS, holding that a corporation's contractual obligation to redeem shares is not necessarily a liability that reduces a corporation's value for purposes of federal estate tax. Looking through the lens of a hypothetical buyer of Michael's shares, the Court reasoned that "no hypothetical 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." The Court emphasized that the appropriate valuation for estate tax purposes is at *the time of death* – and here, at the time of Michael's death, Crown, and thus Michael's shares, were worth $3 million more than before Michael's death because the life insurance payout was immediately payable at that time.

The Court reasoned that valuing Crown *after* the redemption conflicts with the general rule of estate tax calculation, which is to value the estate, and thus the shares, at the time of death.

Lastly, the Supreme Court was not sympathetic to the argument that this holding would make succession planning difficult for closely held corporations. The Court reasoned that this result was a consequence of their structuring, and presented alternative methods, such as a cross-purchase agreement that would lead to other more favorable results.

Closely held corporations should take note of this opinion when structuring their business succession plans to avoid a dispute such as this one; there may be other structuring methods that will lead to more tax-efficient results.

Should you have any questions about this opinion, please contact Peyton H. Lacoste, Laura Walker Plunkett, or any member of Baker Donelson's Tax Group.