

Supreme Court Holds Value of Closely-Held Business Stock Includes Life Insurance Proceeds

Alert

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On June 6, 2024, the U.S. Supreme Court, in *Connelly v. United States*, unanimously agreed that life insurance proceeds owned by a closely-held company should be included in the valuation of the company in determining the value, for estate tax purposes, of a deceased owner's stock.

The salient facts weren't disputed. Two brothers, Michael and Thomas Connelly, owned a closely-held family roofing and siding business, Crown C Supply, Inc. Michael held a 77.18% interest; Thomas held a 22.82% interest. Michael and Thomas had an agreement that governed the disposition of a brother's Crown C stock at the first of their deaths. It provided that the surviving brother had the right to buy the deceased brother's shares. If the surviving brother chose not to exercise that right, Crown C was required to redeem the deceased brother's shares. In either event, the agreement provided that the value of the deceased brother's shares was to be determined by reference to a Certificate of Agreed Value or, failing that, through an appraisal process. Crown C owned \$3.5 million in life insurance which would provide Crown C with the liquidity to redeem Crown C equity from the estate of the first of the brothers to die.

At Michael's death in 2013, Crown C collected the life insurance proceeds, and Thomas opted not to exercise his right under the agreement to purchase Michael's shares. Thomas and Michael's executor (the Estate) ignored the valuation requirements of the agreement and just decided that Crown C would redeem Michael's shares for \$3 million. Michael's estate tax return showed the value of Michael's Crown C shares as \$3 million, the redemption price. When the estate tax return was audited, the Estate and the IRS stipulated that, if the life insurance proceeds were excluded from consideration, Crown C's value at the time of Michael's death was \$3.86 million, and the value of Michael's shares in Crown C was \$3 million (3.86 million x 77.18%). The only issue before the Supreme Court was whether the \$3 million paid to Michael's estate from the life insurance proceeds should be included in the valuation of Crown C.

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The Court held that the \$3 million in life insurance proceeds should have been included in the value of Crown C's shares. The reasoning is quite simple and straight-forward. Crown C's "redemption debt," unlike an "ordinary course of business debt," had no impact on the shareholders' equity interest. As an example, if the \$3 million in life insurance proceeds had been required to be used to pay a debt owed by Crown C to a third-party provider of services, that \$3 million would be gone from Crown C's balance sheet and appropriately would have reduced the value of Crown C. However, in the "redemption debt" scenario, Crown C's balance sheet remained unchanged. \$3 million in cash disappeared, but the redemption (a purchase and retirement as "treasury stock" of the redeemed shares) brought Michael's shares into Crown C – obviously, at the redemption price. Thus, the economic effect of the redemption was not to decrease the value of Crown C but, rather, to increase, dramatically, the value of Thomas' shares, which, post-redemption, represented 100% ownership of Crown C.

As a direct result of *Connelly*, existing life insurance-funded entity purchase shareholders' agreements should be reviewed and, as necessary, corrective action should be taken. Going forward, the real-world impact of *Connelly* will likely be a substantial reduction in the use of entity purchase shareholders' agreements funded with life insurance. Admittedly, cross-purchase buy-sell agreements have their own practical and income tax disadvantages. Closely-held business owners engaged in succession planning will need to weigh those disadvantages against the estate tax result mandated by *Connelly* when an entity purchase arrangement is used. To offset at least some of the practical difficulties arising when using a cross-purchase agreement, particularly if a large number of shareholders is involved, ownership of life insurance policies by an LLC may be worth considering.

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