Steve Leimberg's Estate Planning Email Newsletter - Archive Message #3127

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From: **Steve Leimberg's Estate Planning Newsletter**

Subject: **Martin M. Shenkman, Jonathan Blattmachr & Robert S. Keebler: Some Lessons of the SCOTUS Decision in Connelly**

Earlier this month, the Supreme Court of the United States entered a unanimous decision in *Connelly v. Commissioner* holding that the estate tax value of shares belonging to the principal shareholder of a C corporation, which received insurance proceeds upon the death of that shareholder and was obligated to redeem the shares of the shareholder, would not be reduced or otherwise affected by an obligation of the corporation to buy out the estate of that shareholder. This decision resolved a dispute on the issue among the lower courts and the views of many advisors. In their commentary, **Martin M. Shenkman, Jonathan G. Blattmachr** and **Robert S. Keebler** explain some of the consequences of the decision and how advisors and their clients need to rethink the use of redemption agreements and of cross-purchase agreements. As they point one, it is not a one size fits all situation now.

Martin M. Shenkman is an attorney in private practice in New Jersey and New York who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of dozens of books and hundreds of articles and has won many professional awards.

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Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished) is a partner with Keebler & Associates, LLP and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He has been

named by Forbes as one of the 2024 America's Top 200 CPAs, by CPA Magazine as one of the *Top 100 Most Influential Practitioners in the United States* and one of the *Top 40 Tax Advisors to Know During a Recession*. Mr. Keebler has been a speaker at national estate planning and tax seminars for over 30 years including the AICPA's: Estate Planning, High Income, Advanced Financial Planning Conferences, ABA Conferences, NAPEC Conferences, The Notre Dame Estate Planning Conference and the Heckerling Estate Planning Institute.

Now, here is Marty, Jonathan and Bob's commentary:

EXECUTIVE SUMMARY:

On June 6, 2024, the U.S. Supreme Court issued a unanimous opinion on a closely held business valuation case that may have significant impact on many families and closely held businesses. *Connelly v. United States*, U.S., No. 23-146, Opinion 6/6/24. The case can be found at https://www.supremecourt.gov/opinions/23pdf/23-146_i42j.pdf. The case addressed the valuation of stock in a closely held business and held that the obligation of an entity to buy a deceased equity owner's shares does not reduce the value of the entity or the value of the insurance proceeds received by the entity that were used, in part, to fund the buyout. The Supreme Court's ruling resolves the conflict between the *Connelly* case) and *Estate of Blount v. Commissioner,* 428 F.3d 1338 (11th Cir. 2005), which had reached the opposite conclusion.

FACTS:

Two brothers, Thomas and Michael Connelly, owned all of the stock in Crown C Supply, a C corporation that operated a building supply business. They had planned for the risk of either of them dying by putting in place a buyout agreement that set the value of the stock and the requirement for the corporation to buy or redeem a deceased shareholder's shares. They were even prudent enough to address the economic issue of how that requirement to buy out a deceased shareholder's shares would be funded and had the corporation buy life insurance on each shareholder's life. The goal was to keep the business in the family if either of them died. They were not particularly careful or prudent in adhering to the formalities of the arrangement, but that was not the critical issue in the Supreme Court's holdings.

COMMENT:

The key issue, which undermines many closely held and family business redemption buyout arrangements (that is when the entity owns the life insurance and buys the shares from the deceased owner's estate) is that the life insurance the corporation owned to fund the buyout had to be included in the value of the entity's interests being bought out. In other words, the life insurance proceeds were deemed a corporate asset that increased the value of the entity interests held in the decedent's estate, and thereby may increase the estate tax due. This result seemed called for under Treasury Regulation 20.2031-2(f)(2), which requires that non-operating assets, like life insurance, that are not included in the fair market value of the business, to be added to value.

The obligation the entity had to consummate the buyout is not to be treated as a liability which can be applied to reduce the value of the business interests being bought out Many advisers had thought that the entity's obligation to pay the deceased equity owner's estate should be an offset to the value of the life insurance policy, as occurred in *Estate of Blount.* No such luck for taxpayers after the Supreme Court's holding. So, the obligation to buy out a deceased equity owner's interests are not treated as a reduction in value as say a bank loan would be. An obligation to buy out equity is not a traditional liability and the Supreme Court held that it should not be treated as one. The Court reasoned that: "a fair-market-value redemption has no effect on any shareholder's economic interest, no hypothetical buyer purchasing [deceased shareholder'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 reasoned further: "For calculating the estate tax, however, 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. See 26 U. S. C. §2033 (defining the gross estate to 'include the value of all property to the extent of the interest therein of the decedent at the time of his death'). A hypothetical buyer would treat the life-insurance proceeds that would be used to redeem the deceased shareholder's shares as a net asset."

More specifically, here's how the above issues played out. The buyout agreement gave the surviving brother the first right to purchase the deceased brother's shares. Thomas elected not to purchase Michael's shares, so that the entity's obligation to purchase the shares was triggered. The deceased equity owner's son and Thomas, the surviving brother/equity owner and executor, agreed that the value of the decedent's shares was $3 million. The entity paid that amount to the deceased brother's estate. A federal estate tax return was filed for the estate reporting the value of the decedent's ownership interest as $3 million. The IRS audited the return. During the audit, the executor obtained an independent appraisal which set the value of the entity at $3.86 million. That calculation excluded the $3 million in insurance proceeds used to redeem the shares. The rationale for that was that the life insurance value was offset by the contractual obligation to redeem the deceased brother's share. The IRS disagreed. It insisted that the entity's obligation to redeem the deceased brother's ownership did not offset the life insurance proceeds. The IRS valued the company at $6.86 million ($3.86 million enterprise value + $3 million life insurance value). That is a big valuation difference.

It seems appropriate to note that the Supreme Court did not rely at all on Section 2703 of the Internal Revenue Code which provides, in general, that a buy-out agreement will not affect the value of a deceased owner's interest in the company. It seems the reason for not considering the section was because there was no dispute on value only whether the obligation to buy back the stock affected the value of the corporation.

What this Means to Families and Closely Held Businesses

Many business owners should take action immediately in light of *Connelly*. Review of the structure and terms of any buyout arrangement should be undertaken. If the buyout is structured as a redemption (as opposed to a cross purchase where surviving business owners buy out the deceased one), where the entity buys the deceased equity owner's interests, the decision by the new Supreme Court holding may well apply. Even for cross purchase arrangements evaluation of the impact of Connelly may be important. If the arrangement is structured with a trusteed cross purchase or an insurance LLC, might Connelly suggest that the interests in the contractual trusteed arrangement or an

insurance LLC have to include the value of the insurance in the proportionate part of the interests included in the decedent's estate?

If the value of each equity owner's estate is safely under the estate tax exemption (remembering that the exemption is to be halved beginning in 2026 and the exemption in many states is lower than the federal exemption), consideration may be given to choose to leave the insurance funded redemption agreement in place. Even though life insurance may add to the entity value, no federal estate tax would be due. However, as indicated, if any owner lives in a state with a lower estate tax threshold, or an inheritance tax, there may in fact be a tax incurred. There may be an income tax implication as discussed elsewhere.

Further, owners and their advisors should evaluate how the Supreme Court's ruling might affect any formula and terminology used in the buyout documentation. If the buyout agreement requires the entity to pay the estate the fair market value of the interest, or if it mandates a calculated payment but provides that if a greater value is determined on a tax audit, then the excess of that greater value over what the redemption agreement provided would have to be paid. In these cases, it may be especially important for the business owners to review the arrangement. Do they really want the results in Connelly to potentially cause a greater payment to be made under the buyout?

Also, business owners should continue to monitor the redemption agreement in the event of tax law changes, valuation changes, etc. should be undertaken. Presumably, the owners of the business hope it will increase in value and that too should be considered. Also, consideration, perhaps, should be given to purchasing additional insurance to cover the estate tax cost if one might be incurred post-*Connelly*.

If including the value of the entity owned insurance will trigger or increase estate tax it might be preferable to restructure the buyout arrangement as a cross-purchase arrangement (rather than a redemption or entity purchase one). With a cross-purchase, the equity holders own life insurance on each other to be used to fund the buyout. In that type of structure, the value of the insurance should not affect the entity value, as it did in *Connelly.* Also, with a cross-purchase, the surviving equity holders will obtain increased tax basis in the equity they purchase while there will be no effect on basis with a redemption (where

the entity purchases the deceased former owner's interest). Before undertaking such change, business owners need to consider the costs of all new documentation for the new cross-purchase arrangement, the costs of unwinding the existing redemption agreement (obviously, one would not want to leave a duplicative repurchase obligation on the entity) and the costs and availability of new life insurance. Also, as noted above, there may be an estate inclusion of a trusteed cross-purchase or insurance LLC arrangement to consider.

Also, consideration should be given to the different economic implications. In a cross-purchase arrangement, each equity owner must pay for insurance premiums on the lives of other equity owners. Will they do so? How will that be monitored? Some business owners feel more secure that the life insurance will in fact be in force when knowing that the entity is paying for these premiums. It may not be simply a change in the policies owned by a company to a cross-purchase structure. Additional or even different coverage may be required. (Some owners use an LLC insurance arrangement under which the LLC owns insurance on the lives of all owners and will use the insurance proceeds to fund the buy-out on behalf of the surviving owners. Some have each owner assign a portion of the earnings otherwise distributable to the owner to the LLC which will use the earnings to pay the premiums.)

Also, if the redemption agreement has been in effect for some time, it may be appropriate to review the valuation of the business and the economics of the buyout to see if changes in coverage amounts are warranted. And it is appropriate to insure that the proceeds in a cross-purchase agreement are not included in the gross estate of the deceased former owner. Cf. Rev. Rul. 83-147, 1983-2 CB 157 with Rev. Rul. 83-148, 1983-2 CB 158.

If the amount involved is quite large, it is appropriate to review the potential estate tax implications of the cross-purchase agreement and, as suggested above, the potential advantages of using a special LLC to own the life insurance policies earmarked for the cross-purchase buyout.

Finally, taxpayers need to examine the income aspects of the fair market value of the interest exceeding its actual redemption value. In *Connelly* the Court valued the asset at $6.86 million and Michael's shares were purchased for only $3 million. IRC §1014(a)(1) provides that basis is equal to "the fair market value of the property at the date of

the decedent's death." This dichotomy will result in a loss of $3.86 million. At some point the loss may be available to Michael's estate, or the beneficiaries of the estate.

Footnote 2

Footnote 2 in the Supreme Court's holding in Connelly provided: "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's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more."

This seems to say that insurance (or other non-business/non-operating assets) must be generally be included in the valuation. But if the business sells a business operating asset, like a warehouse, to pay for the redemption, that type of obligation may then be appropriate to apply to reduce the value. The real point might be hinge on what was included in the valuation of the business or not. If the asset, say the warehouse, is included in the value of the business then selling it to make the distribution to the deceased shareholder's estate may then reduce the value of the business. But if it were an investment warehouse not part of the valuation of the business then would the same conclusion apply? Is the difference that the warehouse may be part of the earning capacity of the business and the insurance is not? Or is it the impact on earning capacity? And does it matter how tangential or minimal the impact on earning capacity is? Footnote 2 may leave open the door for further discussion of the impact on value of some redemption arrangements.

Conclusion

Insurance proceeds payable to a company upon the death of an owner will be included in the value of the business and that value will not be affected by the obligation to redeem the interest in the company held by the deceased owner. The key for owners and their advisors is to determine whether a redemption or cross purchase agreement is the more appropriate one, taking into account the tax consequences of the arrangements.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITES:

Connelly v. United States, U.S., No. 23-146, Opinion 6/6/24; Section 2703 of the Internal Revenue Code of 1986 as amended; *Estate of Blount v. Commissioner,* 428 F.3d 1338 (11th Cir. 2005); Rev. Rul. 83-147, 1983-2 CB 157; Rev. Rul. 83-148, 1983-2 CB 158