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Insights

Supreme Court Opinion in Favor of IRS Requires Review of Shareholder Buy-Sell Agreements

June 25, 2024

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On June 6, 2024, the U.S. Supreme Court unanimously affirmed the Eighth Circuit's ruling that a closely held corporation's contractual obligation to redeem shares is not a liability that reduces a corporation's value for purposes of the federal estate tax. With the Court's recent decision in *Connelly v. United States*[1], if a company earmarks life-insurance proceeds to redeem a decedent's stock in the company, the valuation of the company must include those proceeds for federal estate tax purposes. Given the significant implications of this opinion, all companies should revisit their succession plans.

A. The Connelly Brothers' Shareholder's Agreement

In *Connelly*, two brothers, Michael and Thomas Connelly, were the sole shareholders in Crown C Supply ("Crown"), with Michael holding a 77.18% ownership interest and Thomas owning the remaining 22.82%. To ensure Crown would stay in the family if one of the brothers died, the two entered into a shareholder's agreement (commonly referred to as a "buy-sell agreement") which provided the surviving brother with the option to purchase the departed brother's outstanding shares. If the surviving brother declined to purchase the shares, Crown was contractually obligated to purchase said shares. After entering into the agreement, Crown retained a $3.5 million life insurance policy on each brother to fund the potential share redemption.

Upon Michael's death in 2013, Thomas chose not to purchase Michael's outstanding stock, triggering Crown's obligation to redeem the shares. No appraisal was obtained at this time. Instead, Thomas and Michael's surviving son agreed to a value of $3 million for Michael's shares, which was funded with $3 million of the life insurance proceeds. A federal tax return was then filed for Michael's estate which reported the value of Michael's shares at $3 million. The Internal Revenue Service ("IRS") audited the return, so Thomas, acting as executor of the estate, obtained an appraisal from an accounting firm. The analyst concluded that the shares were worth $3.86 million, based on a holding in *Estate of Blount v. Commissioner*[2], which concluded that "insurance proceeds should be 'deducted from the value' of a corporation when they are 'offset by an obligation to pay those proceeds to the estate in a stock buyout.'" The IRS determined Crown's total value to be $6.86 million ($3.86 million + $3 million in life-insurance) resulting in Michael's shares to be valued at $5.3 million ($6.86 million x 0.7718). Thus, the IRS's position was that Michael's estate owed an additional $889,914 in taxes. The deficiency was paid, and Thomas sued the United States for a refund on behalf of the estate. Thomas argued that the proceeds that Crown used to purchase Michael's outstanding shares should not be counted when determining the value of the shares because the proceeds are offset by the redemption obligation to pay the estate for the shares.

B. A Win for the IRS

The Supreme Court sided with the IRS and held that Crown's redemption obligation is not necessarily a liability that reduces Crown's fair market value for estate tax purposes. Instead, in this case, the estate had to use the value of Crown at the time Michael died, before the life insurance proceeds were used for the stock redemption. In the opinion, Justice Clarence Thomas wrote, "Because a fair-market-value redemption has no effect on any shareholder's economic interest, no 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." Thus, the life insurance proceeds used to redeem Michael's shares are a net asset that increases Crown's fair market value.

The Supreme Court suggested that the brothers could have instead entered into a cross-purchase agreement, whereby the surviving shareholder agrees to purchase a decedent's shares, with each shareholder individually purchasing life-insurance policies on one another to facilitate the exchange of value. This method would keep the shares close while also maintaining the value of the decedent's shares.

C. Estate and Succession Planning after Connelly

In sum, the Supreme Court in *Connelly* has provided ammunition to the IRS to argue that life insurance proceeds are assets of a company, even if the intention of those proceeds is to fund a buy-out. As many corporations have purchased life insurance policies with intentions of using the proceeds to purchase a deceased shareholder's shares, many buy-sell, stock redemption, shareholder, and operating agreements, as well as the life insurance policies themselves, will need to be reviewed and potentially adjusted based on the ruling in *Connelly*. This can be complicated, but Krieg DeVault's estate planning professionals can help you and your business navigate the process.

If you have questions regarding the information in this alert or would like to review, update, or strategize about your succession plans, please contact Micah J. Nichols, Kendall A. Schnurpel, or your regular Krieg DeVault attorney.

If you would like to learn more about our Estate Planning and Personal Services Professionals, please click here.

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[1]Connelly v. United States, U.S., No. 23-146, 6/6/24.

[2]Estate of Blount v. Commissioner 428 F. 3d 1338 (CA 11 2005).