

TRUST AND ESTATE INFORMATION MEMO

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New Challenges to Family Business Succession Planning: Life Insurance and Tax Implications

Amidst many recent sharply divided decisions, the United States Supreme Court (SCOTUS) on June 6, 2024 issued a rare unanimous ruling in *Connelly v. United States*, which addressed estate tax considerations relative to succession of closely held businesses. In particular, the Court changed how to value closely held businesses for estate tax purposes that use life-insurance proceeds to redeem the shares of a shareholder upon death.

In *Connelly*, two brothers owned a building supply company. They entered into a traditional buy/sell agreement to ensure that the company would stay within the family upon the death of either brother. Under the agreement, the surviving brother would have the option to purchase the shares of the deceased brother, but if the surviving brother declined to do so, the company would be contractually required to redeem the deceased brother's shares. To ensure the company had sufficient funds to redeem either brother's shares, the company purchased \$3.5 million of life insurance on each brother.

After the first brother's death, the surviving brother did not exercise his right to purchase, and therefore the company was required to redeem the shares at the contractually agreed upon price of \$3 million. The company used \$3 million of the life-insurance proceeds to pay the deceased brother's estate in redemption of his shares, which left the surviving brother as the sole shareholder. For estate tax reporting, the estate of the deceased shareholder engaged a firm which valued the company by excluding the \$3 million in life-insurance proceeds that were used to redeem the shares. The IRS did not agree with this valuation, instead arguing that the company's redemption obligation did not offset the \$3 million life-insurance proceeds. The IRS therefore determined the company's total value to be \$3 million higher which resulted in almost an additional \$900,000 in federal estate tax due relative to the deceased shareholder's shares.

The estate paid the tax and sued the United States in District Court for a refund. The District Court ruled in the IRS's favor, holding the \$3 million in life-insurance proceeds must be included in the company's valuation to accurately determine fair market value. The estate appealed to the Court of Appeals for the Eighth Circuit, which affirmed on the same basis.

The SCOTUS granted certiorari "to address whether life-insurance proceeds that will be used to redeem a decedent's shares must be included when calculating the value of those shares for purposes of the federal estate tax." All Justices of the SCOTUS unanimously agreed with the IRS and reasoned that an "obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest."

The Court also addressed the concern that its decision would make succession planning

more challenging for closely held companies. The Court noted that there were other ways the shareholders could have structured their agreement; for example, by using a cross-purchase agreement in which the shareholders could have agreed to purchase each other's shares at death and purchase life-insurance on each other to fund the agreement. According to the Court, this would have prevented the life-insurance proceeds from increasing the value of the company.

Given the *Connelly* decision, business owners and their advisors should reexamine their succession planning, especially if it involves a redemption agreement similar to the one in *Connelly*. Business succession planning can present significant additional (tax) considerations not addressed in this writing.

If you have any questions on business succession planning, please contact [Anthony A. Levitskiy](#), [Elizabeth Morgan](#), [William Rubenstein](#), or any other member of Bond's [trust and estate](#) or [business and transactions](#) practices who can review these matters in detail with you and assist you in making fully informed and effective decisions.

