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Considerations and best practices for estate planning in wake of *Connelly*

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The question of whether life insurance earmarked for a corporate redemption should count toward a corporation's valuation for federal estate tax purposes has landed on the docket of the U.S. Supreme Court. The justices' decision in *Connelly v. United States* may upend what has been, until recently, an uncontroversial estate planning tool. Depending on the outcome of the case, the tool could create significant tax impacts for estates, especially if the estate tax exemption is reduced as scheduled in 2026.

In this case, the assumption that life insurance proceeds would not be counted when valuing stock of a closely held corporation — combined with the buy-sell agreement's inability to control the price of the stock — left the taxpayer's estate exposed to tax liability.

What are the facts in *Connelly*?

The case involves a Missouri company, Crown C Supply Co. Inc.; the estate of deceased shareholder Michael Connelly; and Michael Connelly's brother, Thomas — the executor of the estate and the company's only remaining shareholder. After Michael Connelly's death, his share of stock in Crown was purchased by the company using the proceeds of life insurance that was acquired for the purpose of fulfilling a redemption agreement. Crown bought all of Connelly's stock for $3 million and his estate reported the stock at the same value on its federal estate tax return.

The Internal Revenue Service disagreed with the stock valuation, arguing that the stock redemption agreement failed to set the price, and therefore Connelly's stock was worth $6.86 million ($3.86 million valuation, which both sides agreed on, plus the $3 million proceeds) multiplied by 77.18 percent (Michael's ownership interest).

The question before the Supreme Court — whether life insurance proceeds earmarked for a stock redemption increases a company's valuation for the purposes of determining a stock's value in the hands of an estate for federal estate tax purposes — is a question that has been answered now by three circuit courts, with one saying it is and two saying it is not. The justices' decision to accept the *Connelly* case is expected to resolve the circuit split between the U.S. Court of Appeals for the 8th Circuit (*Connelly*) and the 11th and 9th circuits' decisions in *Estate of Blount v. Commissioner* (2005) and *Estate of Cartwright v. Commissioner* (1999), respectively.

All three cases hinged on the interpretation of the limiting phrase in Treasury Regulation Section 20.2031-2(f)(2) which says, in relevant part, that "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth."

Connelly's estate argued before the 8th Circuit that, using the willing-buyer/willing-seller test in Treasury Regulation Section 20.2031-1(b), a willing buyer of the shares would "take into account" that the $3 million in proceeds are an "asset" that is directly offset by the "liability" of the redemption agreement.

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The IRS argued the redemption is not a liability in the ordinary business sense and that a willing buyer at Connelly's death who endeavored to purchase all the shares would expect to pay $6.86 million, and then either extinguish the redemption agreement, or redeem the shares from himself.

How will the decision impact which assets are counted?

Any *Connelly* decision will only impact the valuation of privately held corporate stock where selling prices or bid and asked prices are unavailable, and which are being at least partially redeemed using life insurance proceeds. This best describes stock held in closely held corporations, especially those held by families where there is little, if any, stock being sold with any sort of frequency.

What could this mean for estate planning and corporate clients?

Should the court rule in favor of the IRS, clients will likely be advised to consider cross-purchase agreements rather than stock redemption agreements, especially in the case of an entity like the one in *Connelly*, which prior to Connelly's death had only the two brother-shareholders. A cross-purchase agreement would prevent the life insurance's value from being added to the corporation's

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valuation, and thus lower the chances that the estate will be required to pay taxes — an especially relevant factor as the estate tax exemption sundown date approaches.

In a cross-purchase agreement, each shareholder purchases a life insurance policy on every other shareholder. This avenue can become quite cumbersome as the number of shareholders increases. This option would also be less desirable for a company with shareholders who vary widely in age, as the younger shareholders would be paying higher premiums than the older shareholders.

How can these issues be avoided?

The safe-harbor provision of IRC Section 2703(b) and the accompanying Treasury Regulation Section 20.2031-2(h) allow a contract to set the price for estate tax purposes as long as:

- The contract is a bona fide business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than full and adequate consideration.
- The contract contains terms that are comparable to other similar arrangements entered into in arm's-length transactions.

There are also several court-created rules such as:

- The contract must contain a fixed or determinable price.
- The agreement must be legally binding on the decedent's life and the decedent's estate after death.
- The price set for selling the shares during the decedent's lifetime cannot be higher than the price that would be required by the estate on the decedent's death.
- The restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full and adequate consideration.

Distilling these requirements down, the safe harbor requires that the contract make a certain amount of business sense, is not a means to transfer an asset to a family member for less than its value and is similar to other contracts. The agreement must apply during the shareholder's lifetime and after the death of the shareholder, and the estate cannot be entitled to a lower price than the shareholder would have been entitled to during life. The contract must also contain a fixed or determinable price.

What can estate planning lawyers learn from *Connelly*?

Should judgment be for the estate, there is still a lesson to learn about drafting the terms of the redemption agreement. The buy-sell agreement in *Connelly* failed to satisfy multiple of the aforementioned IRC Section 2703(b), Treasury Regulation Section 20.2031-2(h) and court-created conditions, but the Eighth Circuit focused on the lack of a fixed and determinable price as particularly noteworthy.

The corporation in *Connelly* had a buy-sell agreement that contained a "certificate of agreed value" as a means of determining the value of the stock in question, which the 8th Circuit concluded was little more than an agreement to agree that the brothers never once exercised in 12 years. This, the 8th Circuit reasoned, did not create a fixed or determinable price.

The alternative, if the brothers could not agree, was to have two appraisals performed and average them, or a third appraisal if the previous two appraisals differed by more than 10 percent of the value of the lower appraisal amount. The 8th Circuit also found this unused approach to be lacking as a means of determining a fixed and determinable price.

The 8th Circuit pointed out that the appraisal in the contract was a rather ordinary fair-market analysis, with very little guidance or limitations. It seems implied that an appraisal subject to a specific formula would be acceptable.

When selecting one or more valuation methods in a redemption agreement, the drafting lawyers should explain the reasoning for the selection in the agreement. Contracts and agreements over time have become longer and more intricate with plenty of boilerplate language that too many lawyers gloss over and don't give the necessary attention.

Taking the time to read and understand the nature and meaning of each provision is paramount to determine whether they are truly sufficient for our — and our clients' — respective purposes.

About the authors

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