



Insights: Publications

Estate Planning Considerations Post *Connelly v. United States*

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Written by

On June 6, 2024, the Supreme Court of the United States issued a unanimous decision in *Connelly v. United States* and found that life-insurance proceeds payable to a closely held business for the purpose of funding a share redemption were included in the fair market value of a deceased shareholder's interest in the business for federal estate tax purposes.¹

Summary of Facts

As brothers and business partners, Michael and Thomas Connelly owned a small but successful building supply corporation, Crown C Supply (the "Corporation"). To ensure a smooth transition of ownership, the brothers entered into an agreement so that upon the first of them to die, the surviving brother had the option to purchase the deceased brother's shares in the Corporation. The agreement also provided that if the surviving brother declined to exercise the option to purchase, then the Corporation would be obligated to redeem the deceased brother's shares at fair market value. To ensure they would have enough liquidity, the Corporation purchased \$3.5 million in life insurance for each of the brothers.

When Michael died in 2013, Thomas declined to exercise the option and the Corporation was obligated to redeem Michael's shares at a mutually agreed price of \$3 million. Based on this agreed price, when Thomas filed Michael's federal estate tax return, the reported fair market value of Michael's shares in the Corporation was listed as \$3 million. The Internal Revenue Service ("IRS") audited the return, at which point Thomas obtained a valuation of Michael's 77.18% ownership interest in the Corporation. The valuation report concluded that the total fair market value of the Corporation at the time of Michael's death was \$3.86 million, which excludes the \$3 million in life insurance as it was offset by the obligation to redeem Michael's shares. The IRS disagreed, taking the position that the obligation to redeem Michael's shares did not affect the overall value of the Corporation, which includes the \$3 million in life insurance. The IRS determined the total fair market value of the Corporation was \$6.86 million, which resulted in an additional \$889,914 in federal estate tax owed by Michael's estate. The estate paid the deficiency and promptly filed suit against the United States seeking a refund.

The Supreme Court's Ruling

Many years and appellate briefs later, Michael's estate reached the Supreme Court of the United States to answer the following question: does a closely held business's obligation to redeem a deceased shareholder's interest at fair market value offset the value of life insurance proceeds committed to fulfill that same obligation? Spoiler alert – the answer is no.² The Court held that life insurance proceeds earmarked for a share redemption are a net asset of the Corporation for estate tax purposes. The Court explained that the value of property includible in Michael's gross estate is the fair market value at the time of his death (*i.e.*, before the Corporation paid the \$3 million redemption price). The Court also reasoned that fair market value is the price at which the property would change hands between a willing buyer and a willing seller,³ and in this case, a hypothetical buyer would include the life insurance proceeds as a net asset of the Corporation.

Now What? Planning Solutions to Consider

As the Court noted in its opinion, the Connelly brothers could have avoided this issue altogether by using a properly structured cross-purchase agreement rather than a redemption agreement. In a cross-purchase agreement, Thomas and Michael would have each obtained a life insurance policy on the other so that upon Michael's death, the proceeds would be paid directly to Thomas to purchase Michael's shares from his estate rather than increase the value of the Corporation. As they say, hindsight is 20/20.

This solution is relatively straightforward where there are two shareholders, and it also provides the surviving shareholder with a step-up in basis on the purchase of the deceased shareholder's interest. In addition, shareholders should consider the benefits associated with using Irrevocable Life Insurance Trusts ("ILITs") to own the insurance policies. By owning the policies through ILITs, the purchased shares will be protected from creditors and will also be excluded from the purchasing shareholder's taxable estate. When structuring cross-purchase agreements with three or more shareholders, the shareholders should also consider using a limited liability company, preferably owned by irrevocable trusts, to own the life insurance policies instead.

Overall, using irrevocable trusts to properly structure a cross-purchase agreement allows shareholders to mitigate estate tax liability, provide liquidity for a smooth transition of ownership, and utilize his or her remaining lifetime estate and gift tax exemption. The latter is particularly timely, as the current exemption of \$13.61 million in 2024 is set to sunset to approximately \$7 million after 2025.

If you have any questions or would like to discuss further, please reach out to a member of [Kilpatrick's Private Client Group](#) – whether it be related to business succession planning post *Connelly*, utilizing lifetime exemption, or simply how to pass wealth from one generation to the next in the most tax efficient manner, we would be happy to help.

¹ See *Connelly v. United States*, 144 S. Ct. 1406, 1414, 219 L. Ed. 2d 31 (2024).

² In a footnote, the Court stated that this is not to mean that a redemption obligation can *never* decrease a corporation's value – for example, a redemption obligation could require a corporation to liquidate operating

assets to pay for the shares, thereby decreasing its future earning capacity.

³ See 26 CFR § 20.2031-1(b).