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Tax Alert

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Supreme Court decision shakes up valuation issues

By Patrick (Rick) M. Cox, Stephanie C. H. Ardino, and Joshua Caswell

Business owners may need to pivot succession planning strategies in light of how fair market value is interpreted for taxation purposes.

What's the impact?

- Business owners with insurance funded buy-back agreements should immediately consult their tax advisors to reevaluate such arrangements.
- The ruling changes the way that life insurance proceeds earmarked for the redemption of a deceased owner's stock are counted toward the company's valuation for federal estate tax purposes.

Last Thursday, the United States Supreme Court (the Court) unanimously ruled that a company's contractual obligation to redeem shares owned by a deceased shareholder at fair market value (FMV) does not offset life-insurance proceeds that have been earmarked to fund the redemption. The ruling has significant implications for business owners nationwide, as it casts doubt on the efficacy of a common succession planning strategy.

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Connelly v. United States impacts succession planning

The Connelly case involves two brothers and a building supply company. Together the brothers owned 100% of the company (the Company) and wanted to create a succession plan in the event that one of them died. To do so, they agreed that upon the death of one of the brothers, the surviving brother would have the option to buy all the shares owned by the deceased brother (the Decedent). If the surviving brother failed to exercise his option, the Company would have to redeem the Decedent's shares at FMV. In order to fund the redemption, the Company obtained life insurance policies with respect to each brother in the amount of $3.5 million. When the Decedent died, the surviving brother decided not to exercise the option to buy the Decedent's shares. As a result, the Company and the Decedent's estate mutually agreed that the Decedent's shares were worth $3 million and thus $3 million of the $3.5 million in insurance proceeds were used by the Company to purchase (redeem) the Decedent's shares.

The taxpayer's position for estate tax purposes was that Decedent's shares were worth $3 million. During the Internal Revenue Service (IRS) audit of the Decedent's estate tax return, an accounting firm calculated that the Company's FMV was $3.86 million, an amount that excluded the insurance proceeds. The IRS included the insurance proceeds in valuing the Company and thus arrived at a value of $6.86 million ($3 million + $3.86 million). The Decedent's estate filed a suit against the IRS seeking a refund.

Interpreting fair market value for tax purposes

In reaching its decision, the Court dismissed the taxpayer's argument that the redemption obligation was a liability, stating that such a position "cannot be reconciled with the basic mechanics of a stock redemption." The Court reasoned that "a fair-market value redemption has no effect on any shareholder's economic interest, no willing buyer would have treated [the] obligation to redeem ... as a factor that reduced the value of those shares."

The taxpayer also argued that the estate tax valuation of the Decedent's stock was equal to the FMV of such stock prior to receipt of the life insurance proceeds. The Court rejected this idea, finding that "for calculating the estate tax, the whole point is to assess how much [the Decedent's] shares were worth at the time that he died—before [the Company] spent $3 million on the redemption payment."

Succession planning for S corporations and closely held entities

The Court rejected the idea that its ruling would "make succession planning more difficult for closely held corporations," noting that a cross-purchase agreement would have achieved the taxpayer's goals. A cross-purchase agreement is a type of buy-sell agreement under which partners or shareholders purchase insurance on each other so that the partners or shareholders

can buy each other's shares in case of death, disability, or retirement. This type of agreement would have awarded the surviving brother with the insurance proceeds and at the same time burdened the surviving brother with the obligation to purchase the Decedent's shares, and would not have increased the value of the Company.

As a result of the decision in *Connelly*, business owners with insurance funded buy-back agreements should immediately consult their tax advisors to reevaluate such arrangements.

Additionally, the decision has implications beyond the estate planning and estate tax realm. Many S corporations or other closely held business entities use buy-sell agreements to avoid losing S corporation status or merely to ensure continuity of ownership. These businesses may not even be considering estate planning consequences when entering into these plans. The decision in *Connelly* is now another good reason to have a tax professional review these arrangements.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Patrick (Rick) M. Cox
212.940.3066
pcox@nixonpeabody.com

Stephanie C. H. Ardino
212.940.3163
sardino@nixonpeabody.com

Joshua Caswell
617.345.6062
jcaswell@nixonpeabody.com