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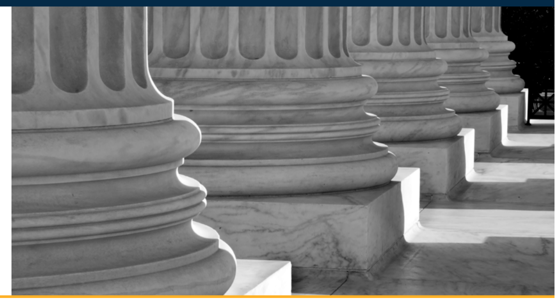
Supreme Court Sides with IRS in Stock Redemption Agreement Case



The U.S. Supreme Court issued a decision on June 6 with significant repercussions for business owners who use life insurance as part of their business succession planning. In an uncommon 9-0 ruling, the justices in *Connelly v. United States* held that for federal estate tax purposes, the value of life insurance proceeds payable to a company upon a shareholder's death was included in the corporation's federal estate tax value, and this value was not offset by the company's obligation to redeem the deceased shareholder's stock under a buy-sell agreement.

The Stock Redemption Agreement at Issue

Brothers Michael and Thomas Connelly were the sole shareholders of a building supply business. The brothers and the company entered into a stock redemption agreement that allowed the surviving brother to purchase the shares of the first brother to pass away. If the surviving brother declined to purchase the shares, the company would be obligated to purchase them. The company obtained $3.5 million of life insurance on each brother to finance the redemption.

After Michael Connelly died, Thomas Connelly declined to purchase his shares, and pursuant to the stock redemption agreement, the company became obligated to redeem them. The agreement laid out a number of methods for setting the redemption value of the shares (e.g., periodically executing a certificate of agreed value or having multiple independent appraisers provide valuation reports). However, the brothers never performed any of the valuation mechanisms. Instead, Thomas Connelly (as executor of his brother's estate) and Michael Connelly's son (an estate beneficiary) privately agreed to value Michael Connelly's shares at $3 million.

The company paid $3 million to the estate, and the estate valued Michael Connelly's shares at $3 million on the estate tax return. The Internal Revenue Service (IRS) audited the return and assessed additional federal estate tax on the basis that the value of Michael Connelly's shares included a proportional share of the life insurance proceeds.

Michael Connelly's estate paid the tax and sued the IRS for a refund. The estate claimed that the company's obligation to redeem Michael Connelly's shares was a liability on the company's balance sheet, which offset the life insurance proceeds dollar for dollar. In contrast, the government argued that a redemption obligation is not a liability in the traditional sense and that a hypothetical buyer of Connelly's shares would not have treated this obligation as a factor in reducing the purchase price.

Supreme Court Affirms Lower Court Decisions

The U.S. District Court for the Eastern District of Missouri and the U.S. Court of Appeals for the Eighth Circuit both ruled in favor of the government and the Supreme Court agreed, affirming the lower court decisions. The Supreme Court considered what a willing arm's-length buyer would reasonably pay for Michael Connelly's shares as of the date of his death. In the court's view, the stock redemption at fair market value had no economic impact on either shareholder. Therefore, a willing buyer would not consider the redemption obligation as a liability.

The court was careful to limit its holding to the specific facts of the case. In a footnote, the court mentioned that it does "not hold that a redemption obligation can *never* decrease a corporation's value" if the underlying facts differ. For instance, a redemption obligation could "require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity." However, the company's obligation to purchase the shares from the deceased shareholder's estate did not, on its own, offset the life insurance proceeds used to finance the purchase.

The Supreme Court did not address Internal Revenue Code Section 2703(b) and its regulations, which allow shareholders to set the value of company shares for federal estate tax purposes by agreement if certain criteria are met. However, the lower court opinions made it clear that the Connelly brothers' failure to follow the terms of their agreement caused Section 2703(b) to not apply and instead allowed the IRS to determine the fair market value of the shares without reference to the agreement. The value of a decedent's property at death should reflect its fair market value, which is the price at which the property could change hands between a willing buyer and a willing seller. In *Connelly*, the court determined that the fair market value of the corporation was increased by the life insurance proceeds payable to the corporation.

Going Forward

While *Connelly* held that a stock redemption obligation is not a liability that offsets life insurance proceeds in an estate tax analysis, careful planning and the use of alternative buy-sell arrangements (e.g., cross-purchase agreements or life insurance LLCs) may significantly reduce estate tax exposure. Business owners with buy-sell agreements in place should consider meeting with their advisers to review current valuation and funding provisions to ensure that their business documents will meet their intended planning objectives.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