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SCOTUS Decides Valuation of Corporate-Owned Life Insurance

By Roger Grabowski, FASA

In a unanimous decision, the United States Supreme Court[1] sided with the 8th Circuit[2] and ruled that the life insurance proceeds payable to a corporation that was to be used to redeem the deceased shareholder's stock should be included in the deceased's estate when calculating the value of the stock the deceased owned. The redemption liability did not offset the life insurance proceeds.

The Legal Dispute[3]

The 11th Circuit declared in *Estate of Blount* that 26 C.F.R. § 20.2031-2(f)(2) precluded the inclusion of life-insurance proceeds in the corporate value when the proceeds are used for a redemption obligation.[4] But 26 C.F.R. § 20.2031-2(f)(2) begins with a discussion of the factors considered in determining the fair market value of a closely held corporation, including "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." The regulation goes on to state that, "[i]n addition to the relevant factors described above, 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."

The district court in *Connelly*[5] found that the 11th Circuit's opinion in *Estate of Blount* was "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." Because the life-insurance proceeds are not offset by the corporation's obligation to redeem the decedent's shares, the fair market value of the corporation at the date of date of death and of the decedent's shares includes all of the life-insurance proceeds. Therefore, based on the undisputed facts in the record, the district court found that the estate failed to prove that the IRS' tax determination was incorrect.[6] The 8th Circuit concurred.[7]

Legal Reasoning for the Opinion

As the Supreme Court decision summarized:

1 *Thomas A. Connelly, as Executor of the Estate of Connelly v. United States,* No. 23–146. Argued March 27, 2024; Decided June 6, 2024.

2 *Connelly v. United States,* No.21-3638 (8th Cir. June 2, 2023).

3 The history of the dispute is summarized in Roger J. Grabowski, "Valuation Impact of Corporate-Owned Life Insurance on SCOTUS' Agenda," *Business Valuation Update,* Vol. 30, Iss. 1, January 2024, pp. 1-16.

4 Citing 428 F.3d at 1345 ("The limiting phrase, 'to the extent that such nonoperating assets have not been taken into account,' however, precludes the inclusion of the insurance proceeds in this case." (citing 26 C.F.R. § 20.2031-2(f)(2))).

5 *Connelly v. United States,* No. 4:19-cv-01410-SRC, 2021 U.S. Dist. LEXIS 179745 (E.D. Mo. Sept. 21, 2021).

6 The IRS had asserted that the fair market value of the decedent's corporate stock should have factored in the $3 million in life-insurance proceeds used to redeem the shares but the repurchase liability should not reduce the taxable estate.

7 *Connelly v. United States,* No.21-3638 (8th Cir. June 2, 2023).

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> The central question is whether the corporation's obligation to redeem Michael's shares (the decedent owned shares in closely held Crown)[8] was a liability that decreased the value of those shares. We conclude that it was not and therefore affirm….
>
> The dispute in this case is narrow. All agree that, when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value. And, all agree that life-insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value. The only question is whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption.

The court provided its legal reasoning as follows:

> But, for calculating the estate tax, the whole point is to assess how much Michael's shares were worth at the time that he died—before Crown spent $3 million on the redemption payment.[9] See 26 U. S. C. §2033 (defining the gross estate to "include the value of all property to the extent of the interest therein of the decedent at the time of his death"); 26 CFR §20.2031-1(b) (the "value of every item of property includible in a decedent's gross estate … is *its* fair market value at the time of the decedent's death" (emphasis added)). A hypothetical buyer would thus treat the life-insurance proceeds that would be used to redeem Michael's shares as a net asset.

The Court's Reasoning

The court provided an example to support its reasoning:

8 Parenthesis added.

9 Citing A. Chodorow, "Valuing Corporations for Estate Tax Purposes," 3 *Hastings Bus. L. J.* 1, 25 (2006) ("Any valuation that takes the redemption obligation into account effectively values the corporation on a 'post-redemption' basis, i.e., after the decedent's shares have been redeemed").

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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. A simple example proves the point. Consider a corporation with one asset—$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 shares × $100,000) and B's shares are worth $2 million (20 shares × $100,000). To redeem B's shares at fair market value, the corporation would thus have to pay B $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷ 80 shares).

Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interests after the redemption—A's 80 shares and B's $2 million in cash—would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.

Because a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares. At the time of Michael's death, Crown was worth $6.86 million—$3 million in life-insurance proceeds earmarked for the redemption plus $3.86 million in other assets and income-generating potential. Anyone purchasing Michael's shares would acquire a 77.18% stake in a company worth $6.86 million, along with Crown's obligation to redeem those shares at fair market value. A buyer would therefore pay up to $5.3 million for Michael's shares ($6.86 million × 0.7718)—*i.e.*, the value the buyer could expect to receive in exchange for Michael's shares when Crown redeemed them at fair market value. We thus conclude that Crown's promise to redeem Michael's shares at fair market value did not reduce the value of those shares.

Impact of Decision on Share Repurchase Agreements

Thomas, the petitioner, asserted that affirming the 8th Circuit would make succession planning more difficult for closely held corporations. He reasoned that, if life-insurance proceeds earmarked for a share redemption are a net asset for estate-tax purposes, then "Crown would have needed an insurance policy worth far more than $3 million in order to redeem Michael's shares at fair market value."

The court went on to discuss an alternative structure for a purchase agreement:

> There were other options. For example, the brothers could have used a cross-purchase agreement—an arrangement in which shareholders agree to purchase each other's shares at death and purchase life-insurance policies on each other to fund the agreement.[10] A cross-purchase agreement would have allowed Thomas to purchase Michael's shares and keep Crown in the family, while avoiding the risk that the insurance proceeds would increase the value of Michael's shares. The proceeds would have gone directly to Thomas—not to Crown. But, every arrangement has its own drawbacks. A cross-purchase agreement would have required each brother to pay the premiums for the insurance policy on the other brother, creating a risk that one of them would be unable to do so. And, it would have had its own tax consequences. By opting to have Crown purchase the life-insurance policies and pay the premiums, the Connelly brothers guaranteed that the policies would remain in force and that the insurance proceeds would be available to fund

10 Citing Shannon P. Pratt and the ASA Educational Foundation, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* 6th ed., New York, McGraw-Hill, 2022, at page 821.

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> the redemption. As we have explained, however, this arrangement also meant that Crown would receive the proceeds and thereby increase the value of Michael's shares. Thomas' concerns about the implications of how he and Michael structured their agreement are therefore misplaced.

Further, the court observed:

> We do not hold that a redemption obligation can *never* decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more.

The Opinion

We hold that Crown's contractual obligation to redeem Michael's shares did not diminish the value of those shares. Because redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax, we affirm the judgment of the Court of Appeals.

Implications of the SCOTUS' Decision

Attorneys advising shareholders of closely held businesses need to reassess the structure of an existing redemption agreement and its impact on potential estate tax liability were one of the shareholders to pass away.

Appraisers need to work with counsel to assess the mechanics of the specific redemption agreement to measure the impact on a potential estate tax liability. ◆

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