

GIBSON DUNN



Appellate and Constitutional Law Update

June 6, 2024

Supreme Court Holds That A Corporation's Life Insurance Proceeds Used To Redeem A Decedent's Shares Must Be Included In Federal Estate Tax Calculation

Connelly v. United States, No. 23-146 – Decided June 6, 2024

Today, the Supreme Court unanimously held that the proceeds from a life insurance policy taken out by a corporation to redeem a decedent shareholder's stock are a corporate asset for federal estate tax purposes.

"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."

JUSTICE THOMAS, WRITING FOR THE COURT

Background:

Michael and Thomas Connelly were the sole shareholders of a closely held building supply business valued at just under \$4 million. The brothers entered an agreement obligating the corporation to redeem the shares of the first brother to die if the surviving brother declined to purchase them. The corporation then obtained a life-insurance policy on each brother to fund that stock redemption. This is a common practice in family businesses to prevent a decedent's heirs from selling shares to outsiders.

When Michael Connelly died, the corporation used the life insurance proceeds to redeem his shares for \$3 million. Michael's estate did not treat the life-insurance proceeds as a net corporate asset because those proceeds were purportedly offset by a corresponding liability to purchase Michael's shares, and it therefore paid estate taxes based on the corporation's previous valuation of just under \$4 million. The IRS concluded that the \$3 million in life insurance proceeds were not offset by the corporation's obligation to redeem Michael's shares, such that the corporation was worth just under \$7 million. The IRS sent a notice of deficiency to the estate, which paid the deficiency under protest.

The district court granted summary judgment for the IRS and the Eighth Circuit affirmed, holding that the life insurance proceeds were a net asset that increased the corporation's value.

Issue:

Are the proceeds of a life insurance policy taken out by a corporation on a shareholder to redeem the shareholder's stock a corporate asset when calculating the value of a deceased shareholder's shares for federal estate tax purposes?

Court's Holding:

Yes. Life insurance proceeds are an asset that increases a company's fair market value, and a redemption obligation is not necessarily a liability that offsets that asset.

What It Means:

- Today's decision focuses on the economic realities of the underlying transaction, explaining that "[b]ecause a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated [the corporation's] obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares."
- The decision confirms that the IRS may tax life insurance proceeds as a corporate asset, even if those proceeds will ultimately be used to redeem a decedent shareholder's outstanding shares. Companies and estate planners should carefully review succession plans, including shareholder life insurance provisions and buy-sell agreements, with today's decision in mind.

- Today’s decision imposes potentially substantial costs on a common practice among closely held companies to ensure ownership remains within a family upon a shareholder’s death. The Court acknowledged that its decision “will make succession planning more difficult for closely held corporations.” The Court also identified “other options,” such as cross-purchase agreements, that are still available to accomplish the same purposes as the device employed here, but recognized those options pose drawbacks of their own.
- The Court emphasized the narrowness of its decision, and specifically noted that it did “not hold that a redemption obligation can *never* decrease a corporation’s value,” and gave as an example a redemption obligation that “require[s] a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity.”

Gibson Dunn represented the Chamber of Commerce of the United States of America and National Federation of Independent Business Small Business Legal Center, Inc., **as Amici Supporting Petitioner.**

Gibson Dunn Appellate Honors



The Court's opinion is available [here](#).

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding developments at the U.S. Supreme Court. Please feel free to contact the following practice group leaders:

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