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## U.S. Supreme Court to settle split between Circuit Courts of Appeals on this issue

*Should company-owned life insurance used to redeem stock be included in valuing a decedent's ownership interest?*

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On Dec. 13, 2023, the U.S. Supreme Court granted certiorari in the case of *Connelly v. Internal Revenue Service* (although, per the United States' brief, the correct party in this case shouldn't be the IRS, but rather the United States), with the aim of settling a split between: (1) the U.S. Court of Appeals for the 8<sup>th</sup> Circuit; and (2) the U.S. Courts of Appeals for the 11<sup>th</sup> and 9<sup>th</sup> Circuits, relating to the impact for estate tax purposes of company owned life insurance used to redeem a decedent's interest in the company. Pursuant to the petition for certiorari, the issue to be resolved is: "whether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax." The IRS frames the issue a little more narrowly, focusing on whether the lower courts simply erred by including the proceeds of the life insurance used to redeem the decedent's interest in valuing the company.

The facts and summary of the 8<sup>th</sup> Circuit holding in *Connelly* can be found [here](#). The reasoning (and outcome) in *Connelly* is at odds with *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11<sup>th</sup> Cir. 2005) and *Estate of Cartwright v. Comm'r*, 183 F.3d 1034 (9<sup>th</sup> Cir. 1999) and, specifically, whether company owned life insurance used to redeem a decedent's stock should be included when valuing the decedent's ownership interest.

### A Difference of Opinion

In *Connelly*, the 8<sup>th</sup> Circuit held that the proceeds from the life insurance should be included in determining the value of the decedent's interest in the company, with no offsetting deduction for the company's use of the proceeds (or a substantial portion thereof) to redeem the decedent's ownership, whereas in *Blount* and *Cartwright*, the 11<sup>th</sup> and 9<sup>th</sup> Circuits held that the proceeds from the life insurance should essentially be disregarded to the extent used to redeem the decedent's ownership interest, reasoning that the redemption obligation created an offsetting liability, effectively resulting in a net-zero valuation impact to the company.

### Two Inquiries

The arguments surrounding company-owned life insurance used to redeem owners' interest are broadly encompassed in two inquiries: (1) Is Internal Revenue Code Section 2703(b) applicable (and determinative) in valuing a decedent's interest in the company; and (2) What's the impact of the language in Treasury Regulations Section 20.2031-2(f) (2) (providing guidance for determining the fair market value of assets for estate tax purposes), which states "...

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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, prospective earning power and dividend-earning capacity.” *Connelly* and *Blount* are at odds with respect to the interpretation of the above-quoted language in Treas. Regs. Section 20.2031-2(f)(2).

In lower court proceedings, the taxpayer in *Connelly* argued that the valuation of the redeemed interest was governed by the provisions of IRC Section 2703(b), as the parties in *Connelly* had a basic stock-purchase agreement in place, although it’s questionable whether any of the formalities of the agreement were satisfied, and it’s arguable whether the stock-purchase agreement required the company to use the life insurance proceeds to redeem out the deceased owner. The taxpayer in *Connelly* doesn’t seek review of the 8<sup>th</sup> Circuit holding that found that the stock-purchase agreement in *Connelly* didn’t meet the requirements of Section 2703(b), essentially accepting that the stock-purchase agreement doesn’t govern the valuation of the redeemed interest. The stock-purchase agreement in *Blount* suffered from the same issue—that the court in that case didn’t find that the agreement met the requirements of Section 2703(b).

## Clarity Needed

It will be interesting to see where the U.S. Supreme Court lands on this issue. Although the IRS attempts to downplay the importance of the issue, stating that “in practice, however the difference between the [*Blount*] approach and the [*Connelly*] approach is not likely to prove significant,” the taxpayer frames the issue as much more pervasive, stating that “the question presented is critical to the small businesses that form the backbone of the American economy.” Clearly, there are conflicting cases with respect to the treatment of company owned life insurance used for the purpose of redeeming an owner’s interest in the company—some clarity in this area post-*Connelly* will be useful for practitioners.

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