SUMMER 2024

Life Insurance Proceeds Included in Estate Tax Value of Corporation

CCA 202352018: A Cautionary Tale

Magee Recognized for Excellence

planning matters

PRACTICAL INSIGHTS INTO ESTATE PLANNING & WEALTH PRESERVATION

Compliments of Lindabury's Wills, Trusts & Estates Group

You're thinking about succession planning, **and so are we.**

Lindabury, McCormick, Estabrook & Cooper has you and your family covered. The attorneys in our Wills, Trusts & Estates group have experience levels ranging from 10 to 40+ years in the field of estate planning and estate administration.

MEET THE PLANNERS

John R. Blasi, Esq.
Westfield
jblasi@lindabury.com

Chris Cardone, Esq.
Westfield
ccardone@lindabury.com

James K. Estabrook, Esq.
Westfield
jestabrook@lindabury.com

David G. Hardin, Esq.
Summit
dhardin@lindabury.com

Mary Patricia Magee, Esq.
Red Bank
mmagee@lindabury.com

Elizabeth Engert Manzo, Esq.
Westfield
emanzo@lindabury.com

Elizabeth Candido Petite, Esq.
Westfield
epetite@lindabury.com

Anne Marie Robbins, Esq.
Westfield
arobbins@lindabury.com

life insurance proceeds included in estate tax value of corporation

by Anne Marie Robbins, Esq.

In a unanimous decision issued on June 6, 2024, the Supreme Court held that life insurance proceeds payable to a corporation are includible in the corporation's value for Federal Estate Tax purposes, with no offset allowed for the obligation to purchase a deceased shareholder's interest. *Estate of Connelly v. United States*, 602 U.S. __ (2024) (No. 23-146, June 6, 2024).

Michael and Thomas Connelly were the owners of Crown C Supply, a building supply corporation (the "Company"). Michael was the CEO and owned almost 80% of the stock, with Thomas owning the rest. The brothers had entered into a buy-sell agreement that was to be effective in the event of their deaths. Under the agreement, the surviving brother was given the option to purchase the deceased brother's shares. If he did not do so, the Company itself would be required to redeem the shares. The Company obtained life insurance policies of $3.5 million on each brother.

When Michael died in 2012, Thomas elected not to purchase Michael's shares and therefore the Company was obliged to redeem them. The Company received the insurance proceeds and redeemed Michael's shares for $3 million, a value agreed to by Thomas and Michael's son.

The Federal Estate Tax return filed for Michael's estate reported the fair market value of the Company at Michael's death to be $3.86 million, which did not include the $3 million in life insurance proceeds used to redeem Michael's shares. The appraisal supporting the fair market value of the Company offset the insurance proceeds by the redemption obligation. On audit, the IRS disagreed with the estate's appraisal and included a portion of the insurance proceeds in the value of the Company, thereby increasing the Federal Estate Tax bill by $1 million.

Two lower federal courts, a Missouri District Court and the U.S. Court of Appeals for the Eighth Circuit, held for the IRS, and the Supreme Court affirmed.

In the Supreme Court's ruling, the Court agreed with the IRS. The Court held that contractual agreements to purchase shares of deceased shareholders do not serve to diminish the value of those shares, which must reflect the corporation's fair market value when calculating the Federal Estate Tax. Therefore, a company may not deduct a contractual obligation to purchase a deceased shareholder's shares with life insurance proceeds. The Court stated that "[a]n 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." *Connelly* Slip Op. at pp. 5-6.

A more favorable result could have been obtained if the brothers had established a cross-purchase buy-sell agreement or a life insurance LLC, thus avoiding payment of the insurance proceeds to the Company. It appears clear that in view of the result in *Connelly*, now is the time for business owners to review their buy-sell agreements and consider what changes may be advisable.

CCA 202352018 a cautionary tale

by Mary Patricia Magee, Esq.

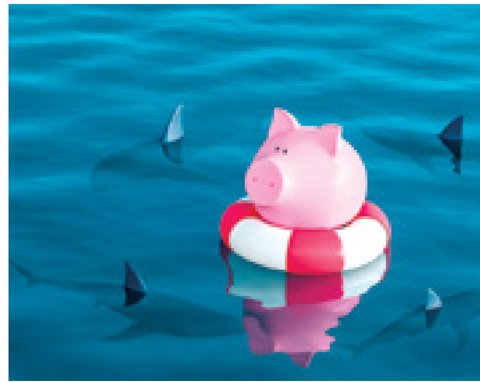
Since passage of the Uniform Trust Code in New Jersey in 2016, planners now have an established procedure to modify or terminate an irrevocable trust, and it is undoubtedly a valuable tool. Clients frequently have trusts that could be made better if one or two changes were made. However, while attractive, the modification or termination of an irrevocable trust so that the trust will accommodate circumstances unforeseen when the trust was created, can have unintended gift tax consequences.

It was just such a situation that a recent Memorandum issued by the Chief Counsel for the IRS, CCA 202352018 (hereafter the CCA or Memorandum), addresses. In that Memorandum the grantor of the trust established an irrevocable trust for her child for the child's life. The trustee had the power to distribute income and principal to the child, in the trustee's discretion, and on the child's death the trustee was directed to distribute the proceeds to the child's descendants. The grantor had no right to income or principal from the trust and essentially had relinquished all control over the assets in the trust. As such, the grantor appeared to have successfully removed the assets in the trust from her taxable estate.

The trust included a provision that made the trust income taxable to the grantor under section 671 of the Internal Revenue Code. Using such a provision in a trust is actually very popular. Because the trust will not pay any income taxes, the trust can grow more quickly. In effect, it is as if the grantor is making a tax-free gift to the trust each year in the amount of the tax the trust would otherwise have paid. Sometime after the trust in the CCA was operational, however, the grantor no longer wished to pay those income taxes and instead sought to have the trust reimburse her for those tax payments.

Pursuant to the law in her state the grantor brought an action to modify this otherwise irrevocable trust to permit the trustee to reimburse the grantor for the income taxes. The beneficiary consented to the request and an Order was entered by the court allowing the modification. Unfortunately, while the parties had legal authority to take the steps they did, the CCA held that there were gift tax consequences to this modification. Specifically, the CCA found that the beneficiary, the grantor's child (there were as yet no grandchildren), had made a gift back to the grantor of that portion of the trust which could be now used to reimburse the grantor for those income taxes!

As a result, the parties not only had to recognize a gift from the child to the grantor, which was never intended, but they also had to determine how to value that gift. While the Memorandum recognizes that such a gift is very hard to value, it gives no standard of measurement and worse, posits that where "a donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles the tax is applicable to the entire value of the property subject to the gift" (emphasis added). This language holds that the beneficiaries have in effect made a gift to the grantor in an amount equal to the total value of all the assets in the trust!



One way to solve this immediate problem is to create flexibility in the initial trust agreement. There should be a power in the trust that allows the trustee, in the trustee's discretion, to reimburse the grantor for income taxes. Alternatively, a broader provision could be included in the trust which allows a grantor to turn off or revoke the "Grantor Trust" status by releasing the power in the trust that "triggered" section 671 in the first place.

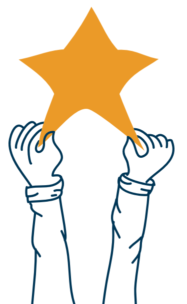
The more far-reaching impact of this Memorandum, however, is to call into question any trust modification that indirectly shifts an interest from one beneficiary to another beneficiary, or that shifts a trust benefit from a beneficiary back to the grantor. For example, what are the gift tax consequences when a family decides that a credit shelter trust created by the first parent to die for the benefit of the surviving parent is no longer needed? Frequently we see that with the current high federal estate tax exemption, even if the surviving spouse owned the trust assets herself her estate would not have to pay any federal estate taxes. Further, those assets if owned by the surviving spouse would receive a step-up in basis, which is unavailable if the assets are owned by a credit shelter trust. In such a case it seems that a termination of the trust whereby all of the assets are given to the surviving parent would be a win-win situation. However, the parties must recognize that the children, the remainder beneficiaries, are actually making a gift back to Mom of their remainder interests. Conversely, Mom might feel she no longer needs the income and would like to relinquish her remaining life estate so that the trust assets pass to the remainder beneficiaries now. These kinds of gifts can be valued using IRS tables which calculate the value of life estate and remainder interests, but not all modifications are so clear-cut.

CCA 202352018 is a powerful reminder that any attempt to modify or terminate an irrevocable trust must be analyzed for potential gift tax consequences.

MAGEE RECOGNIZED FOR EXCELLENCE BY MONMOUTH BAR ASSOCIATION

Congratulations to Mary Patricia Magee who recently received the Attorney Excellence Award in Probate, Estate Administration and Elder Law Practice from the Monmouth County Bar Association.

The Attorney Excellence Awards, determined by peers in the legal community, are given annually to celebrate an attorney's success and leadership within their practice area. Award recipients have earned the respect of their colleagues, adhered to the highest standards of professionalism and ethics, and supported the Monmouth Bar Association. We are incredibly proud of Mary Pat on this well-deserved honor.



For more detailed assistance with estate planning needs, **please visit lindabury.com**

LINDABURY

McCormick, Estabrook & Cooper, P.C.

Attorneys at Law

New Jersey | New York | Pennsylvania

lindabury.com

If you or your clients have questions about the issues discussed in this newsletter please contact a member of Lindabury's Wills, Trusts & Estates group. This newsletter is distributed to clients and professional contacts of Lindabury, McCormick, Estabrook & Cooper as a professional courtesy. The information contained in this newsletter is necessarily general and not intended as legal advice or as a substitute for legal advice. Any estate planning program should be undertaken only after consultation with a professional and an assessment of the relevant considerations.