SUPREME COURT RULING ON CONNELLY CASE IMPACTS BUSINESS SUCCESSION PLANS

After the U.S. Supreme Court ruling in Connelly v. United States, owners of private, closely held businesses might need to update their plans and strategies for succession planning. The Supreme Court ruled that for estate purposes, the value of the company must include the life insurance proceeds received by the company to purchase the shares of the deceased shareholder, which was obtained through a buy-sell agreement.

Michael and Thomas Connelly were the sole owners of a closely held business worth nearly $4 million. They had an agreement that if one brother died, the company would buy his shares if the surviving brother did not. To pay for this, the company bought life insurance on both brothers.

When Michael died, the company used the $3.5 million received from the life insurance proceeds to buy his shares. Michael's estate did not count this $3.5 million as part of the company's value because it was considered an offset by a corresponding liability to purchase Michael's shares. Therefore, they valued the company at $4 million for estate purposes.

The IRS disagreed, saying the life insurance proceeds should count as part of the company's value, making it worth almost $7 million. The Supreme Court ultimately agreed with the IRS that a redemption obligation is not a liability that offsets the asset.

Buy-sell agreements are often used to make sure that shares in privately owned businesses do not end up being bought by outside investors if a shareholder dies or divorces. These agreements usually require the company to buy back the shares of a deceased shareholder at a set price or based on a specific method. Life insurance is often used to provide the cash needed for this.

However, buy-sell agreements usually are not enough by themselves to accomplish estate tax objectives. They only set the value of the shares if they meet certain conditions. In this case, the Supreme Court found that the Connelly brothers' agreement was a valid business arrangement but did not properly set the share value because no professional valuation was done and the agreement didn't specify a fixed price for the shares.

The Connelly decision brings uncertainty for private businesses with buy-sell agreements funded by company-owned life insurance. For these businesses, what was meant to ensure smooth succession might end up being more costly than expected. If shareholders' estates are worth more than the estate tax limit, currently at $13.61 million per person, using life insurance to buy back shares can become much more expensive.

Owners in closely held businesses should consider the following:

1. Shareholders of closely held businesses should check their current buy-sell agreements to make sure they meet the rules for setting share prices for estate tax purposes. This means the agreements should clearly state a set price for the shares or include a formula to calculate it.
2. Perform an appraisal of the business at the time of the execution of the buy-sell agreement. Periodic or annual valuations should also be completed.
3. Consider other strategies, such as creating an LLC to hold the life insurance policies, consider cross-purchase agreements where owners individually own the policy on the other owners, or even consider holding life insurance policies on each shareholder in a trust or paid to an escrow agent, rather

than the shareholders themselves being required to maintain them.

Contact our advisors today to discuss the best solution for your business.