

CONSIDER THE IMPORTANCE

The *Connelly* Decision's Impact on Business Owners

By Sean J. Link, J.D.

Sean Link is the Estate Planning Specialist at Underwriters Brokerage Service, an independent insurance brokerage firm established in 1970 and based in Pittsburgh, PA. Sean provides objective estate planning consulting to assist Financial Advisors and Independent Agents and can be reached at (412) 201-7950 or sean.link@ubsnet.com

In a landmark decision, the United States Supreme Court rendered its verdict in the case of *Connelly v. United States*, significantly impacting the landscape of buy/sell agreements for business owners nationwide. The case revolved around the tax implications of a buyout arrangement between business partners and the way in which the Internal Revenue Service interpreted such agreements. This ruling holds crucial ramifications for entrepreneurs and established closely-held businesses alike, so let's dive in and take a look!

THE BACKGROUND

At the heart of *Connelly* was a buy/sell agreement between two brothers, Thomas and Michael Connelly, and their C-corporation building supply business, Crown C Supply. The buy/sell was structured so as to give each brother the right of first refusal to purchase the deceased's shares, but in the event they did not, then the agreement would default to an "entity purchase," meaning that the company would be required to purchase the deceased owner's stock at a value (in this instance) determined by an outside appraisal of the company's fair market value. The brothers were forward-thinking and had the company purchase and own life insurance on each brother's life to fund a redemption. When Michael died, Thomas elected not to purchase his shares, triggering the entity redemption.

As Michael's estate was being settled, Thomas (as executor of Michael's estate) and Michael's son simply agreed that Michael's shares would be valued at \$3 million, and Crown C Supply used the death benefit payout from the insurance (also \$3 million) to purchase the shares per the buy/sell provisions. Michael's estate tax return was eventually audited, and during the audit the Connelys obtained an independent valuation. The IRS then took issue with the valuation of Michael's ownership interest in Crown C Supply when it did not include in the \$3 million life insurance proceeds.

CONSIDER THE IMPORTANCE

The Connelly Decision & Buy/Sell Agreements

THE CASE

When the IRS levied estate taxes consistent with the inclusion of the life insurance proceeds in Michael's ownership interest (to the tune of an additional \$889,914 in taxes), Thomas (as executor) sued for a refund. The estate's argument was essentially that even if the value of the insurance proceeds would be includable as an asset on the books of the company, it would be immediately offset by the company's obligation to redeem Michael's shares and therefore zero-out the calculation.

As the case wound its way through the court system, the federal District Court and the Eighth Circuit Court of Appeals sided with the IRS. Eventually, the Connellys would find themselves at the steps of the United States Supreme Court and, unfortunately for them, the Court affirmed the rulings below.

In line with the positions that the life insurance proceeds were a corporate asset, that those proceeds increased the fair market value of the corporation, and that estate calculations must be performed based on the "snapshot" assessment of the deceased's assets at the time of death, the Court wrote: "For calculating the estate tax, however, 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... A hypothetical buyer would treat the life-insurance proceeds that would be used to redeem the deceased shareholder's shares as a net asset." (*Connelly v United States*, U.S., No. 23-146). As such, the Court and the parties recognized that Crown C Supply was properly valued with the inclusion of the life insurance proceeds.

Regarding Connelly's argument that this value was then offset by the entity redemption obligation, the Court was unmoved, holding plainly: "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." (*Connelly*, emphasis added).

In sum, the Court unanimously agreed with the IRS's assessment of the situation and held that the Connelly estate had rightfully paid that extra \$889,914 in taxes with no refund warranted.

WHERE DO WE GO FROM HERE?

As is always the case, rulings such as *Connelly* require diligent review of a client's situation. Buy/Sell agreements can essentially be thought of as the "estate planning documents" of a business, and just as a client should review their estate documents in conjunction with any major life event (births, deaths, marriages, divorces, etc.), personal estate and business planning documents need to be reviewed any time there is a significant legislative or judicial intervention.

CONSIDER THE IMPORTANCE

The Connelly Decision & Buy/Sell Agreements

Advisors should bring *Connelly* to the attention of their closely-held business owner clients and engage insurance and business succession professionals to assess whether the *Connelly* holding could detrimentally affect the buy/sell arrangement and the estate treatment thereof. A short list of action items would be to:

- 1) Have buy/sell agreements reviewed¹
- 2) Have the insurance policies that fund a buy/sell reviewed
- 3) Perform regular business valuations
- 4) Schedule periodic reviews of all of the above
- 5) Ensure proper and thorough documentation of business transactions and agreements

While there is hardly ever a foolproof roadmap to planning in the wake of a significant judicial ruling or legislative event, having a structured plan to review and assess a client's situation will rarely, if ever, do them a disservice.

Sean J. Link, JD*

Estate Planning Specialist



www.ubsnet.com

ubs@ubsnet.com

*Not in the practice of law for Underwriters Brokerage Service

Underwriters Brokerage Service and its employees do not provide legal or tax advice. The information provided in this article is for informational purposes only, and should not be relied upon as legal or tax advice. You should consult with your own tax and legal professionals.

¹ The Court made specific mention of a possible alternative to entity redemption agreements, *i.e.* cross-purchase agreements