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Connelly vs. United States: High Court's Decision Complicates Succession Planning for Closely Held Businesses

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On June 6, the US Supreme Court unanimously found in favor of the Internal Revenue Service (IRS) in a valuation case that will make succession planning for family and closely held businesses more challenging.

The court ruled in *Connelly v. United States* (U.S., No. 23-146) that the corporation's contractual obligation to redeem shares is not a liability that reduces a corporation's value for purposes of the federal estate tax.

When calculating the federal estate tax, the value of a decedent's shares in a closely held business reflects the fair market value of the shares. If life insurance proceeds are payable to a corporation as a result of the decedent's death, the corporation's fair market value increases.

This case raised the question whether the corporation's obligation to redeem the decedent's shares at fair market value offsets the value of the life insurance proceeds and reduces the corporation's fair market value.

Background: Connelly vs. U.S.

The Connelly brothers, Michael and Thomas, owned a closely held roofing and siding business, Crown C Supply, Inc., in St. Louis. Michael held a 77.18% interest, and Thomas held a 22.82% interest. To maintain family ownership and control over the company and to satisfy their estate-planning objectives, the brothers structured their buy-sell agreement as an entity redemption agreement. The business was the owner and beneficiary of a life insurance policy on the business owners.

When the insured died, the death benefit proceeds would be used to purchase the deceased owner's shares. The corporation then would retire those shares. The subsequent decrease in the number of outstanding shares would increase the value of the shares for the surviving owners.

Buy-sell agreements also can be structured as cross-purchase agreements — an arrangement in which shareholders agree to purchase each other's shares at death and purchase life insurance policies on each other to fund the agreement. However, the differences between redemption agreements and cross-purchase agreements and why you would choose one or the other are not covered in this article.

The Connellys' buy-sell agreement provided that the surviving brother had the right to buy the deceased brother's shares. If the surviving brother chose not to exercise that right, Crown C was required to redeem the deceased brother's shares.

In either event, the agreement provided that the value of the deceased brother's shares would be determined by reference to a certificate of agreed value or, failing that, through an appraisal process. Crown C also owned a $3.5 million life insurance policy on each brother, which would provide Crown C the liquidity to redeem the shares from the estate of the first brother to die.

Michael Connelly died October 1, 2013. Crown C collected the life insurance proceeds. Thomas opted not to exercise his right to purchase Michael's shares. Rather than secure an outside appraisal of the company's fair market value (as the agreement contemplated), Michael's son and Thomas decided that Crown C would redeem Michael's shares for $3 million.

Michael's estate return included the value of the Crown C shares at $3 million, the redemption amount. The IRS audited the return. During the audit, Thomas obtained a valuation from an outside accounting firm. That firm determined that Crown's fair market value at Michael's death was $3.86 million. That amount excluded the $3 million in insurance proceeds used to redeem Michael's share on the theory that the value was offset by the redemption obligation. The firm valued Michael's shares at $3 million ($3.86 million x 77.18%).

The IRS disagreed, arguing that the shares should be valued at $5.3 million ($3.86 million + $3 million = $6.86 million x 77.18%). That valuation included the life insurance proceeds with no offsetting reduction in value for the redemption obligation. The IRS calculation resulted in an additional estate tax liability of $889,914.

The estate paid the tax and sued for a refund. The federal district court granted summary judgment to the government, finding that the redemption obligation did not reduce the value of the shares for estate tax purposes. Furthermore, the court ruled that a proper valuation of the corporation must include the life insurance proceeds used for redemption, because they were a significant asset of the company. The U.S. Court of Appeals for the Eighth Circuit affirmed. The case was granted "certiorari" (the process of requesting a court case to be reviewed by the Supreme Court).

The Supreme Court's decision

The Supreme Court affirmed the decision of the lower courts. The deceased shareholder's shares must be valued just before death. At that point, the life insurance proceeds are a company asset and increase the company's fair market value. The company's contractual obligation to redeem the shares using life insurance proceeds is not a liability that reduces the taxable value of the deceased shareholder's stock at the time of death for federal estate tax purposes.

This is a change from prior case law that held that a redemption agreement created an obligation that offsets the life insurance proceeds received by a business using it to redeem a deceased's interest in the business (see *Blount Est. v. Comr., 428 F. 3d 1338,11th Cir. 2005,* and *Estate of Cartwright v. Comr,* 183 F. 3d 1034, 9th Cir. 1999).

The Supreme Court acknowledged that the decision could make succession planning more challenging. In this case, however, the shareholders could have used an alternate arrangement, such as a cross-purchase agreement, to avoid the particular tax outcome, the court said.

Implications of the decision

Here are some considerations as a result of the recent Connelly decision:

- Some business owners may not have an estate that currently is federally taxable if it is just based upon the value of the business. However, if the insurance proceeds are added to the business value, this may make the estate federally taxable.
- A buy-sell agreement may not necessarily set the fair market value of a business for estate tax purposes, even though it sets the purchase price for a buyout.
- The fair market value of the decedent's shares becomes the basis of the shares to the estate. Potentially, when the stock is redeemed, there could be a capital loss on the redemption. The estate should be able to use a capital loss to offset any capital gains the estate may recognize. In the estate's final tax year, any unused capital losses may be passed to the estate beneficiaries.
- Redemption agreements should be reviewed. Some of them may include a price adjustment clause, so that if the estate tax value of the business is higher than the purchase price, the business agrees to pay an additional amount to cover the shortfall. Some agreements may not have such a clause. Therefore, agreements should be reviewed.
- Going forward, business valuations may now include the death benefit in the valuation. This can result in underfunded arrangements.
- Going forward, there may be a substantial reduction in the use of entity purchase shareholder agreements funded with life insurance. Will closely held business owners with current entity purchase shareholder agreements restructure to a cross-purchase agreement? Cross-purchase agreements could be cumbersome if there are a large number of shareholders.
- A company may keep an entity redemption agreement but keep the insurance outside of the business. The owners could use the death benefits outside of the business to make capital contributions or loans to the business, so they can redeem the deceased owner's interest.
- If a business wants to transfer insurance policies from corporate owned to shareholder owned, there may be transfer-for-value issues to deal with.

For more information, please contact your advisor.

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About the Author

As the Director of Planning & Advice for Key Private Bank, Tina is responsible for managing the Central Planning Team, as well as overseeing the National Advisory Committee, Monthly National Advisory Call, the Key Wealth Institute, and any financial planning literature developed internally and externally. She works with our Regional Directors of Planning to help facilitate our best thinking and advice delivery to clients.

Tina earned a BS in Business Administration from the University of Richmond and an MTax from Virginia Commonwealth University. She is a CFP® certificant, CPA/PFS, and is an AEP®. She is Treasurer of the Put-in-Bay Community Swim & Sail Program. Tina received the 2016 Exceptional Service Award from the Cleveland Estate Planning Council and the Circle of Excellence Award by Key Private Bank in 2016 and 2018. Tina was also selected to attend the 2023 Wealth Education Symposium that recognizes select Key Wealth teammates for extraordinary commitment to serving our clients.

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