The Connelly Decision and the Impact on Planning for Business Owners

On June 6, 2024 the United States Supreme Court affirmed the lower Court's decision to uphold the Internal Revenue Service (IRS) position on the treatment of life insurance proceeds and entity redemption obligation for federal estate tax purposes by unanimous decision. The case in question was *Connelly, As Executor of the Estate of Connelly v. United States*[1]. The affirmation of this position highlights the importance of diligent estate planning, proper ownership of life insurance policies and an understanding of the tax implications of all agreements businesses have in place.

Case Background

Michael and Thomas Connelly were the sole shareholders of a closely held corporation, Crown C Supply (Crown). To ensure that the corporation would stay in the family if either passed, the brothers entered into a buy-sell agreement. Under the agreement, the surviving brother would have the option to purchase the shares of the deceased brother. If the surviving brother declined purchase, Crown would be obligated to redeem, or purchase, the shares of the deceased brother. Planning to fund this potential obligation, Crown purchased a $3.5 million life insurance policy on each brother.

When Michael died, Thomas decided not to purchase the shares. Crown was now obligated to redeem the shares and was prepared to do so via the proceeds of the life insurance policy. Michael's son and Thomas agreed that Michael's shares were valued at $3 million – Crown paid this amount to Michael's estate. A federal tax return was also filed, reporting the value of Michael's shares at $3 million. The IRS audited the return and disagreed with the valuation, valuing them at $5.3 million – a value including the $3 million in life insurance proceeds used to redeem Michael's shares. The result was an additional estate tax liability of $889,914 to Michael's estate. Michael's estate disputed the IRS decision and sued for a tax refund.

The District Court and the Eighth Circuit upheld the view of the IRS, with the Supreme Court affirming, that a corporation's contractual obligation to redeem shares does not reduce the corporation's fair market value for estate tax purposes.

Impact on Planning for Business Owners

The importance of working with trusted advisors to create strategic estate plans for business owners has never been clearer.

- Regularly obtain professional valuations and ensure compliance with current market values and tax obligations.
- Work with your estate planning attorneys, tax accountants and financial service professionals to ensure corporate agreements and structure align with current laws and court rulings.
- Ensure any buy-sell agreements are structured with consideration to tax implications.
    - A cross-purchase plan where individuals own the policies on the other shareholders could avoid complications of inflating business valuations and estate tax values.

[1] 23-146_142.pdf

- Plan for future tax liabilities.
- Work with an experienced professional to ensure proper ownership and valuation of life insurance policies.
- Keep detailed records of all agreements, valuations and transactions in the event of a dispute or audit with the IRS.

Conclusion

The decision of the Supreme Court highlights the importance of engaging with the proper estate planning attorneys, tax accountants and financial services professionals to properly design agreements, value assets and structure insurance plans. Doing so, business owners and families will be able to avoid costly and unforeseen consequences inside their estates and within the transition of their businesses.