NORTHEAST BROKERAGE

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Northeast Brokerage: Supreme Court Rules Unanimously in Connelly Case Affecting Succession Planning

In a unanimous decision, the United States Supreme Court recently ruled on the landmark case Connelly v. United States, which addressed the inclusion of life insurance proceeds used to redeem a deceased shareholder's stock in the valuation of that stock for federal estate tax purposes. The case involved brothers Michael and Thomas Connelly, who were the sole shareholders of Crown C Supply, a closely held corporation. To ensure a smooth ownership transition, Crown C Supply held corporate-owned life insurance policies of $3.5 million on each brother, with a stock redemption agreement in place.

When Michael Connelly passed away in 2013, the company received $3.5 million in life insurance proceeds and used $3 million to redeem his shares. However, the IRS audited the estate tax return and determined that Michael's estate had undervalued the shares by not including the insurance proceeds in the company's fair market value. The Supreme Court sided with the IRS, ruling that the life insurance proceeds must be included in the company's valuation for estate tax purposes. This decision significantly increased the estate tax liability.

Implications for Buy-Sell Agreements

Businesses should closely reassess their buy-sell agreements, particularly those funded by corporate-owned life insurance policies. To mitigate potential tax liabilities, consider restructuring these agreements using cross-purchase agreements instead of corporate redemptions. In a cross-purchase agreement, surviving shareholders receive the insurance proceeds and directly buy the deceased shareholder's shares, removing the insurance proceeds from the corporation's valuation and potentially lowering estate tax liabilities. Additionally, ensure that buy-sell agreements contain clear, fixed valuation methods or formulas, such as binding appraisals, formula valuations, or regularly updated agreed values, to accurately reflect the fair market value of business interests. It is also crucial to review and ensure compliance with Section 2703 of the Internal Revenue Code, which requires that the valuation in the buy-sell agreement is bona fide and not a device to transfer property for less than full value.

Next Steps

We recommend evaluating current buy-sell agreements to ensure they align with the latest legal interpretations and effectively mitigate tax liabilities. Work with legal and financial professionals to explore restructuring options, such as cross-purchase agreements, and update valuation methods to comply with tax regulations. Additionally, educate clients about the implications of the Connelly decision and advise them on best practices for structuring their buy-sell agreements to minimize estate tax impacts.

The Connelly decision underscores the critical need for closely held businesses to reassess their buy-sell agreements to avoid potential estate tax liabilities. Our team at Northeast Brokerage is here to help you navigate these changes and ensure your agreements are both compliant and tax-efficient. We encourage you to give us a call to discuss possible solutions or to get more information. Let us assist you in safeguarding your clients' interests and planning for a secure financial future.