Connelly Decision Impacts Succession Planning

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Many auto dealership owners and co-owners have proactively engaged in succession planning for their dealerships. There are many techniques involved with implementing succession planning. One frequently used technique involves using life insurance to fund the purchase of a dying dealer's ownership interest by the remaining dealership co-owners, family members, employees, or a combination thereof.

There are two most-used methods of using life insurance for these kinds of "buy-sell" situations. The first is called a "cross-purchase" arrangement in which each owner buys insurance on the life of his or her shareholders. The second method, known as stockholder redemption, involves the business purchasing life insurance on the lives of its shareholders, so that when an owner dies, the business would receive the insurance proceeds and use those proceeds to buy back the shares or membership interest of the dying shareholder, leaving the remaining owners with the business.

The Supreme Court's June 6, 2024, holding in *Connelly v. United States (*144 S. Ct. 1406) requires revisiting dealers' succession plans based on business-owned life insurance. Before *Connelly*, many stockholder redemption agreements funded by corporate-owned life insurance were implemented on the assumption that the insurance proceeds received by a corporation upon a shareholder's death would have no effect on the value of the deceased shareholder's stock because the corporation's obligation to redeem the stock on the corporation's balance sheet would offset the value of the insurance proceeds. *Connelly* decimates that advantageous tax treatment, which may well result in higher estate taxes and reduced inheritances to the decedent's loved ones. Fortunately, there is a work-around through the use of cross purchase agreements rather than corporate redemptions.

Case Background

Brothers Michael and Thomas Connelly were the sole shareholders of a construction business, Crown C Supply ("Crown"). To ensure the business stayed in the family, Crown purchased insurance on each brother's life to provide cash to redeem the shares of the first to die. When Michael died, Crown used the life insurance proceeds to redeem his shares, representing 77.18% of Crown, for $3 million. Michael's estate paid estate tax valuing Michael's shares at the $3 million redemption price without increasing the value of his shares by a corresponding 77.18% of the insurance proceeds. An outside accounting firm later valued Crown at $3.86 million as of Michael's death. In doing so, the accounting firm offset the redemption obligation by the $3 million of insurance funding the redemption. The accounting firm relied on *Estate of Blount v. Commissioner,* 428 F. 3d 1338 (11th Cir. 2005), a case with similar facts to *Connelly. Blount* held that a corporate redemption obligation offsets the value of the insurance used to pay for the redemption in valuing shares for estate tax purposes.

The IRS disagreed with the estate's treatment, concluding that the $3 million in life insurance proceeds received by the corporation were not offset by the corporation's obligation to redeem Michael's shares, resulting in Crown being worth just under $7 million ($3.86 million plus $3 million in insurance proceeds). The IRS thus calculated Michael's shares as worth $5.3 million (77.18% of $6.86 million) instead of the $3 million value as filed on the estate tax return, resulting in an additional $889,914 of estate tax. The Executor paid the deficiency and then sued the United States for a refund. The United States District Court ruled in favor of the government, and, on appeal, the Eighth Circuit Court of Appeals affirmed the District Court. The Executor then appealed to the United States Supreme Court.

The Supreme Court sided with the IRS and rejected the estate's position that the redemption obligation reduced Crown's value. The Court held that a corporation's obligation to redeem shares is not necessarily a traditional balance sheet liability that reduces the value of a company's shares for federal estate tax purposes, because the redemption obligation does not impact a stockholder's economic interest in the corporation or how a buyer would view the value of the corporation in an arm's-length purchase.

Key Takeaways

The IRS effectively taxes the life insurance proceeds as a corporate asset through the deceased shareholder's estate, even if those proceeds will be used to redeem the decedent's outstanding shares, which results in no economic change for the estate.

The Court acknowledged its decision "will make succession planning more difficult for closely held corporations." Also, the Court identified "other options," such as cross-purchase agreements, that remain available to accomplish the same goals as the company-owned life insurance redemption in *Connelly*, recognizing those options pose drawbacks of their own.

Structuring a buy-sell agreement for any business has complexity. *Connelly* introduces additional complexity, and dealers are urged to consult with their advisors when adopting or amending buy-sell agreements. The *Connelly* decision highlights the importance of careful coordination with business owners' business succession and estate planning with the potential need to restructure the ownership and use of life insurance policies. Although there are many complicated tax issues in switching an insurance-funded redemption agreement to an insurance-funded cross-purchase agreement, this change should definitely be considered.

The risk to individuals caught on the wrong side of the *Connelly* decision will be even greater after 2025, when the federal estate tax exemption is projected to automatically decrease by approximately 50%. This will result in greater estate tax, since the amount passing free of estate tax will be half of today's $13.61 million, adjusted for inflation.

If you own a closely-held business with at least one other partner or shareholder, please contact your advisors to review your business succession plan and discuss its viability in light of the *Connelly* decision.