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The \$889,914 Question



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A recent Supreme Court case, *Connelly v. United States*, made an important ruling related to succession planning for closely held businesses. Today, we'll look at what the ruling says, how it could affect you, and steps you could take to avoid paying more in taxes than is necessary.

What Happened?

Connelly v. United States settled a question about whether life insurance proceeds owned by a corporation would increase the value of the corporation.

In this case, brothers Michael and Thomas Connelly wanted to keep their business in the family upon the death of either brother. To do so, they created an agreement wherein the surviving brother would have the option to purchase the deceased brother's shares. If the survivor refused to buy, then the corporation itself would be required to redeem the shares of the decedent.

To fund this strategy, the Connelly's had their corporation purchase life insurance policies on each brother.

When Michael, the majority shareholder, died, Thomas declined to buy Michael's shares. So, the corporation was required to buy the shares, which it did with the life insurance policy taken out on Michael, making Thomas the sole shareholder of the company.

When it came time to pay estate taxes on Michael's estate, Thomas—the executor of Michael's estate—tried to claim that the money received from the life insurance policy was offset by the liability of the share repurchase agreement, effectively resulting in zero change in value from the day before Michael passed away.

The IRS disagreed, saying that the \$3 million in insurance death benefit that the corporation received upon Michael's death increased the company's value—and thus, the value of Michael's shares—by the same amount. The IRS held that this change occurred on the date of death, not on the date the check was received from the insurance company.

Before this unexpected increase in value, the Connelly family – and their advisors – expected zero estate taxes. The corrected appraisal triggered estate tax exposure at a 40% rate and the final tax bill came out to \$889,914. Michael's estate paid the bill, then Thomas sued the United States for a refund. At every legal level, the family lost and they appealed all the way to the Supreme Court. The Supreme Court then unanimously ruled against Thomas Connelly, stating that simply because the corporation was obligated to buy Michael's shares did not mean that the corporation was less valuable because of the obligation.

What Does This Mean for You?

The Supreme Court's decision might be boiled down to, as Justice Clarence Thomas wrote in the Court's Opinion, ". . . a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself."

In other words, just because the Connelly's intended to use the life insurance proceeds so the corporation could buy Michael's shares doesn't mean that Michael's shares were worth any less. The intention or obligation to redeem corporate stock does not affect company value.

Because the corporation was the recipient of the insurance funds, the Supreme Court ruled that those funds must be counted as an asset for the company, which thus increased its value by \$3 million. In this case, the increased value of the corporation led to a higher tax bill for Michael's estate.

For owners of closely held businesses like you, this decision highlights the importance of working with professional tax attorneys, insurance agents, and succession-planning experts when creating plans to transfer ownership of your business.

As the Court's Opinion explicitly states, there were other ways for the Connelly brothers to implement their succession plan.

For example, the Court offered that they could have implemented a cross-purchase agreement, in which each brother agreed to buy the other brother's shares upon death, took an insurance policy out on the life of the other brother to pay for the

shares, and paid the premiums of the policy themselves. In this case, when one of the brothers died, the other brother would get the money to purchase the deceased brother's shares directly, rather than the corporation getting the money.

This likely would not have affected the company's value and may have created a different outcome in terms of the tax bill.

Steps You Can Take

Regardless of how much your business is worth, what your succession plan is, and what your overall goals are, an important part of business planning is reducing your tax burdens as much as possible.

Reducing your tax burdens could help you access more money to invest back into your business. As such, reducing your tax burdens could be an important growth strategy. Working with a qualified tax attorney could help you and your business avoid higher-than-expected tax bills by reviewing the consequences of any business decisions you make in terms of your tax burdens.

Additionally, you may consider working with an insurance professional who can help you create plans to help you achieve your goals as you see them. While all insurance plans have their pros and cons, an insurance professional can walk you through those pros and cons in the context of your business and goals, and ideally, help you avoid the type of pitfall that the Connelly brothers experienced.

Finally, it's important to consider how each of your strategies for a successful future may affect one another. For the Connelly's, they clearly wanted to keep the business in the family while reducing their tax burdens. And though their intentions were good, the execution of their plan did not align with current tax laws. It created an unexpected tax assessed at a 40% rate!

Working with a professional Advisor Team, which may include an advisor who can coordinate your plans among different advisors, could help you minimize the likelihood of unforeseen challenges having negative effects on your planning.

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