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The Supreme Court Blows Up a Popular Small-Business Succession Plan

Life insurance can help pay for a transfer of ownership after a small-business owner dies. Now it may bring an unexpected tax bill.

By Laura Saunders Follow

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Small-business owners have lots of aggravations. The U.S. Supreme Court just added to their burden.

The Court's little-noticed decision in *Connelly v. United States,* issued in June, throws a wrench into a common succession strategy for many closely held firms with more than one owner. In this strategy, a company buys life insurance on its owners so that when one dies, there's cash to repurchase his or her stock.

The goal is for the insurance payment to be tax-free and for the company to avoid the burden of funding a share repurchase from operating profits. In *Connelly,* however, the court ruled that the strategy didn't provide the expected benefits.

As a result, the owner's estate owed nearly $900,000 more in estate tax.

"This case is a wake-up call to business owners using life insurance to fund stock redemptions. Traps for the unwary can wreak havoc on families when the owner dies," says John Resnick, a tax and insurance planner in Naples, Fla. who advises affluent business owners.

The decision spells trouble for many owners of closely held businesses with similar arrangements. Too often these entrepreneurs don't have the time, inclination or resources to pay attention to tax and legal issues. But ignoring them can cause financial pain.

Here are the facts in *Connelly,* and why they matter.

Michael and Thomas Connelly were brothers and the owners of Crown C Supply, a building-supply corporation in St. Louis. Michael, the majority owner, died in 2013 and Thomas was his executor.

Earlier, Crown C had bought $3.5 million of life insurance on each brother and agreed to repurchase the shares of either brother who died. After Michael's death, Thomas agreed with Michael's son that Crown C would buy Michael's 77% stake for $3 million, although they never had the business formally appraised. A valuation done later, during the Internal Revenue Service audit that led to the court case, pegged the firm's value at $3.86 million without the insurance payment.

The Connellys thought the life insurance payout would be estate-tax-free. In the 2005 case of *Estate of Blount v. Commissioner,* a federal appeals court held that such a payout was excluded from a corporation's value because it was offset by a liability—the obligation to repurchase the owner's shares.

The Supreme Court disagreed. In a unanimous opinion written by Justice Clarence Thomas, the Court overturned *Blount* and sided with the IRS. As a result, $3 million of insurance proceeds were added to Crown C's value, giving it a total value of $6.86 million at Michael's death. That raised his total stake to $5.3 million and increased his estate taxes by $889,914.

The Court reasoned that the requirement to repurchase Michael's shares wasn't an offset because it wasn't a liability like a debt. Instead, the exchange of shares for dollars provided something of value to the firm.

A number of tax specialists agree with the Court's conclusion. "If Apple adopts a buyback plan, the obligation to pay for the stock is not an ordinary liability like an amount owed to a creditor, because it's getting something of value in return," says Mitchell Gans, a professor at Hofstra Law School.

For owners who might be affected by *Connelly*, here are moves to consider.

Begin by checking the company's buy-sell agreement, especially if no one has reviewed it in years. Buy-sell agreements are crucial contracts explaining what happens if an owner dies, retires, or otherwise leaves the business.

In many cases, these agreements require an independent appraisal of the company with annual adjustments. Is there a valuation, and have the updates been done? The *Connelly* brothers didn't get the valuations they were supposed to.

"Taxpayers should never think they'll beat the IRS if they ignore the terms of their own agreements," says Martin Shenkman, an estate-planning attorney in New York. He expects further crackdowns in this area now that the agency has a clear win from the Supreme Court.

Next, are there insurance policies in place to fund a buyout at an owner's death, and are they owned by and payable to the company?

If so, beware: This structure is attractive because it ensures premiums are paid and can work well when there are multiple owners. But it was also what caused Michael Connelly's estate to owe higher taxes, so it's important to check the effect on the owners' estate taxes.

That could be tricky. The estate-tax exemption, which is currently $13.6 million per individual, is scheduled to snap back to about $7 million if the 2017 tax changes expire at the end of 2025. While many small businesses won't cross this threshold, others will—especially if insurance proceeds are added to the value of the company.

A better arrangement, as the *Connelly* opinion noted, may be to use "cross-purchase" agreements in which each owner buys life insurance on the others to acquire the shares if one dies. This can keep insurance proceeds from inflating the value of the company and the estate of the deceased owner. It also can provide the buyer with a higher cost basis in the stock, which could lower future capital-gains taxes if he or she sells.

But cross purchases have issues too: They can be impractical if a company has multiple owners, as each would have to buy policies on all the others. It can also be hard to track whether premiums are actually paid.

To avoid these problems, Resnick often advises setting up limited-liability companies to hold the life insurance on the owners. Doing so may keep the insurance from inflating the value of the company, provide a cost-basis step up to survivors and ensure that premiums are paid.

The bottom line: For many closely held business owners, dealing with the *Connelly* decision requires help from advisers aware of both income- and estate-tax consequences. This advice won't come cheap and could suck energy away from running the business.

That's an aggravation—but it's not as big a pain as a surprise estate-tax bill.

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