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Connelly Decision "Easter Egg" Upends Buy/Sell Agreements & Estate Planning

The unanticipated reversal of what was thought to be settled law seen in the Supreme Court's Connelly decision puts all stock redemption buy/sell agreements at risk of insurance proceed inclusion in business valuation.

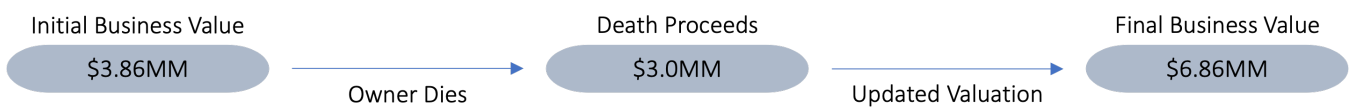
When the Supreme Court took up the Connelly case, virtually no one anticipated the decision would have a far-reaching impact on buy/sell agreements and estate planning. The facts of the case were believed to be unique enough that they would serve as nothing more than a cautionary tale. The lack of periodic review and ongoing management of the agreement and funding rendered the Connelly family vulnerable upon audit. The prudent client and advisor could avoid the issue all together by simply following best practices.

Ultimately, the decision did shine a light on the need to follow best practices, but it also included two additional outcomes, similar to an "Easter Egg" in a movie, that have created quite a stir:

- A buy/sell agreement may NOT be sufficient to set or fix the value of the business for estate planning purposes in all cases.
- If the business is the owner and beneficiary of life insurance under a stock redemption arrangement, the life insurance proceeds should be included when determining the value of the business upon the death of a shareholder. Further, the obligation to redeem the shares does NOT offset the value of the life insurance.

For the Connelly family, that played out as outlined below in Figure 1.

Figure 1: Business Valuation Pre and Post Audit



Based on the share of the business owned by the deceased (77.18%), the result was a significant increase in the taxable estate and estate taxes due for the Connelly family, as follows:

Value of Ownership Interest Reported on Estate Tax Return:	$3,000,000
Value of Ownership Interest Post-Audit:	$5,224,785
Net Increase:	$2,224,785
Estate Tax Rate:	40%
Additional Estate Tax Due:	$889,914

Keep in mind, this outcome is not the result of failing to follow best practices. This is an updated interpretation of the relevant law and could be applied to virtually any stock redemption buy/sell agreement.

Some of the impacts of this decision are rather straight forward:

- Stock redemption plans involving clients with a net worth that could expose them to an estate tax will almost certainly need to be rewritten using a new structure that does not involve the company as the owner or beneficiary of the insurance.
- Annual review of the agreement, to include any periodic updated valuations and the like, need to occur and be thoroughly documented.
- Funding of the agreement should likewise be updated as outlined in the agreement.

There are some additional considerations to keep in mind beyond the items listed above.

- The court's view on the inclusion of life insurance death benefits in the value of a business may have farther reaching impacts that are just now being considered by the planning community. These include but are not limited to:
  - The possible inclusion of other corporate owned policies in business valuation calculations
  - Impacts on business owner clients who are not subject to an estate tax
- The need for funding strategies to keep pace with the value of the business is critical. Both agreement structure as well as insurance product selection need to be considered as part of the strategy for best practices adherence. Simply using the lowest priced term insurance solution, as an example, may no longer be the most suitable way to fund an agreement.

In terms of solutions, there are any number of alternative buy/sell agreement structures that avoid the fundamental issue inherent in stock redemption agreements. Further, many of them also address one of the primary reasons stock redemption agreements are used so frequently: ease of administration. The days of needing to suffer through managing an unwieldy number of policies under a cross-purchase agreement, as an example, are over. In addition, the availability of purpose-built insurance solutions that take the pain out of updating funding strategies and increasing coverage amounts has simplified that part of the process as well. The most suitable approach will be case-specific rather than there being a singular strategy that stands out from the rest.

The bottom line, regardless of the net worth of the business owner, is that it is time to pull those old agreements and life insurance policies out of the drawer where they have been gathering dust, with an eye toward keeping the family from becoming the next Connelly.

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For more background on the Connelly case, please follow this link.