BUSINESS BUY-SELL AGREEMENTS AFTER CONNELLY V. IRS

By: David B. Deutsch, Esq.

I. PRIMER ON BUSINESS BUY-SELL AGREEMENTS

For the owners of small, closely-held businesses, the idea of succession planning is partially about choosing someone to hand off the reins of the business to when an original owner retires, but also partially about ensuring that there is an orderly transition of ownership in the event of an owner's unexpected death, disability or retirement.

A. Mechanics of Buy-Sell Agreements

1. A buy-sell agreement is a contract that gives one owner the right or obligation to buy another owner’s share of ownership in a business when a triggering event occurs.

2. Typically triggering events are the death, incapacity/disability, or termination of employment (including retirement) of an owner.

3. Buy-sell agreements give business owners or the entity the right to purchase deceased, disabled or retired co-owner’s shares, ensuring that the owners won’t lose control over a portion of the business in the case of an unforeseen event.

4. The purchase and sale transaction can be structured as a cross-purchase agreement, an entity-purchase agreement (redemption), or combination of both – a “wait and see” transaction.

    a) In a cross-purchase agreement, the buy-sell transactions are between each individual owner.

    b) In a redemption agreement, the buy-sell transactions are between the entity and the owner.

5. In the case of a death trigger, businesses will frequently fund the obligation needed to buy out another owner's shares/membership interest. Each owner (or the entity) purchases life insurance on each of the other owner's life that will pay out on the death of an owner. Thus, each owner is assured to have liquid funds available to fulfill their end of the buy-sell agreement in the case of a death triggering event.

   a) For a business with only two owners, a cross-purchase agreement and an entity-purchase agreement require roughly the same amount of effort in setting up and maintaining the plan. However, as more owners get involved, the complexity of a cross-purchase agreement gets exponentially higher: Since each owner needs to buy life insurance on every other owner, a cross-purchase agreement for a company with "n" owners requires the purchase of $n \times (n - 1)$ separate life insurance policies.

   b) Thus, three owners require buying six life insurance policies and four owners requires buying 12 life insurance policies.

II. SUPREME COURT UNANIMOUSLY RULES IN FAVOR OF THE IRS

A. Summary

In a decision released on June 6, 2024, the Supreme Court held that a contractual obligation to redeem shares is not a liability that reduces the corporation's value for purposes of the federal estate tax.

B. Background of Connelly vs. United States

1. Thomas and Michael Connelly were the sole shareholders in a closely held corporation. Michael owned approximately 77.18% of the shares of the corporation and Thomas owning the remaining 22.82% of the shares.

MH Maddin Hauser
Attorneys and Counselors
One Towne Square, Fifth Floor, Southfield, MI 48076
p (248) 354-4030 | f (248) 354-1422 | maddinhauser.com

2. The brothers had a buy-sell agreement, which gave each brother the right to purchase the other brother's shares upon their death. The corporation had a contractual obligation to redeem either brother's shares at fair market value upon his death if the surviving brother did not buy the shares. The agreement specified that the redemption price would be based on an appraisal of the corporation's fair market value. In order to cover the cost of redeeming shares, the corporation held life insurance policies on the brothers to cover the potential costs of redeeming shares.

3. Michael died in 2013. Thomas opted not to purchase Michael's shares. As a result, the company was obligated to redeem those shares under the buy-sell agreement.

4. Although the buy-sell agreement had stipulated for the company to obtain an outside appraisal to determine how much it should pay for the shares, the estate and surviving owner decided on a less formal approach, agreeing on a value of $3 million for Michael's shares (representing 77.18% of the company's total valuation of $3.86 million) without taking the step of getting an outside valuation.

5. The company had owned a $3.5 million life insurance policy on Michael, so it used $3 million of the death benefit proceeds to purchase Michael's shares (leaving the remaining $0.5 million in the business).

6. Michael's estate subsequently reported the value of his shares at $3 million (i.e., the agreed-upon price that the company paid to redeem the shares) on his estate tax return. But upon auditing the return, the IRS disputed that number, saying that the business's value also needed to include the amount of the insurance proceeds used to buy Connelly's shares.

7. The estate did obtain an outside valuation for the business during the audit, which assessed the firm's value (without the life insurance proceeds) at $3.86 million, but the IRS maintained that, for estate tax purposes, the business's value was actually $6.86 million – that is, $3.86 million (the business's assessed value) + $3 million (the life insurance proceeds received by the business that were used to redeem Michael's shares from the estate).

8. The impact of including the life insurance proceeds in the valuation amounted to an additional $889,914 in estate tax owed by Michael's estate.

C. Issue of the Case

1. The issue before the Court was whether life-insurance proceeds earmarked to redeem a decedent’s shares of a closely held corporation must be included in the corporation’s valuation for purposes of the federal estate tax.

D. Connelly’s Argument

1. Connelly estate appealed the IRS on the basis of two arguments.

2. The entity-purchase agreement had 'fixed' the value of the shares for estate tax purposes at $3 million (the amount that was actually paid for the shares).

3. The obligation created by the entity-purchase agreement for the company to buy Connelly's shares effectively created an offsetting liability that canceled out the value of the life insurance proceeds.

E. Holding of the Case

1. The courts rejected both arguments.

2. On the first point, the lower courts ruled that the entity-purchase agreement itself couldn't be used to set the shares' value for estate tax purposes, because the agreement hadn't included a “fixed or determinable price” that could be used to set the business's value at a specific amount (and the owners hadn’t even followed the agreement’s own requirements to obtain an outside valuation but instead informally agreed on a $3 million price for the shares, diminishing the argument that the agreement itself should have any bearing on how the shares should be valued). The Connelly estate didn't even bother appealing this point to the Supreme Court.

3. The second argument that was central to the Supreme Court's ruling and that will have major implications for other business owners with similar entity-purchase agreements.

4. The Supreme Court upheld the lower courts' rulings that, for estate tax purposes, a business’s obligation to buy an owner's shares pursuant to a buy-sell agreement does not offset the value of the life insurance proceeds paid to the business.

5. In its reasoning, the Court focused on the fact that a redemption of shares at fair market value would not reduce the value of the shares or a shareholder’s economic interest. Additionally, the Court reasoned that if a hypothetical third-party buyer were buying the shares, they would be willing to pay for them based on the full value of the company including the life insurance proceeds.

6. In summary, the opinion states a contractual obligation to redeem shares is “not necessarily a liability that reduces a corporation's value” for federal estate tax purposes.

7. The Connelly case is significant since in 2005, the Eleventh Circuit Court of Appeals held in *Blount v. Commissioner* that the proceeds of life insurance policies owned by a corporation were offset by the corporation's obligation to redeem the decedent's shares. For nearly two decades, many taxpayers have relied on that ruling when structuring these types of agreements. In light of this decision, business owners may wish to revisit existing agreements to avoid falling into the same trap as Connelly.

F. Further Review of The Court's Decision

1. The big issue for the Court was the company's redemption of Michael's shares left Thomas with a larger ownership stake in a company with the same value as before the redemption. According to the Court, "That cannot be right: A corporation that pays out $3 million to redeem shares should be worth less than before the redemption."

2. The parties' positions are illustrated as follows:

ESTATE'S POSITION

		Michael	Thomas
Estate Tax:			
Shares	500	385.9	114.1
Ownership Percentage	100.00%	77.18%	22.82%
Estate Tax Value	**$3,860,000**	**$2,979,148**	**$880,852**
Per Share Value	**$7,720**	**$7,720**	**$7,720**
Redemption:			
Equity Value	$3,860,000		
Plus Life Insurance	3,000,000		
Less Redemption Liability	(3,000,000)		
Post-Redemption Value	**$3,860,000**		
Shares Redeemed	(385.9)	(385.9)	0.0
Shares Remaining Outstanding	114.1	0.0	114.1
New Stock Ownership	100.00%	0.0%	100.00%
Post-Redemption Value	**$3,860,000**	**n/a**	**$3,860,000**
Value Per Share	**$33,829.97**	**n/a**	**$33,829.97**

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Attorneys and Counselors
One Towne Square, Fifth Floor, Southfield, MI 48076
p (248) 354-4030 | f (248) 354-1422 | maddinhauser.com

1. The problem becomes clear. Prior to the redemption, Thomas' stock was worth $7,720 per share. After the redemption, it was worth $33,829.97 per share. The difference is difficult to justify.

2. The approach argued by the IRS eliminates this problem:

IRS POSITION		Michael	Thomas
Estate Tax:			
Shares	500	385.9	114.1
Ownership Percentage	100.00%	77.18%	22.82%
Pre-Life Insurance Value	$3,860,000		
Plus Life Insurance	3,000,000		
Estate Tax Value	**$6,860,000**	**$5,294,548**	**$1,565,452**
Per Share Value	**$13,720**	**$13,720**	**$13,720**
Redemption:			
Equity Value	$6,860,000		
Less Redemption Liability	(5,294,548)		
Post-Redemption Value	**$1,565,452**		
Shares Redeemed	(385.9)	(385.9)	0.0
Shares Remaining Outstanding	114.1	0.0	114.1
New Stock Ownership	100.00%	0.0%	100.00%
Post-Redemption Value	**$1,565,452**	**n/a**	**$1,565,452**
Value Per Share	**$13,720**	**n/a**	**$13,720**

3. Under this approach, Thomas' stock has a per share value both before and after the redemption of $13,720 per share

G. Implications of Connelly

1. As result of the Connelly decision, the way business owners commonly think of life insurance proceeds used to fund entity-purchase buy-sell agreements (i.e., that they're somehow separate from the rest of the business's assets and can be effectively canceled out for estate tax purposes because they're earmarked for the redemption of the deceased owner's shares) is fundamentally different from the way the IRS thinks of them.

2. In the IRS's view, insurance proceeds are simply a part of the business's total value and cannot be offset by any obligation to purchase shares.

H. Planning Strategies

1. Business owners working on drafting a new buy-sell agreement, the estate tax implications raised by the Connelly case might raise the question of whether it's best to avoid entity-purchase agreements entirely.

2. For example, a company could instead use a cross-purchase agreement where any life insurance proceeds go directly to the decedent's fellow owners and not to the business itself. Thus, the business's value would not be increased for estate tax purposes.

3. The Supreme Court's majority opinion explicitly noted that the business owners in question would have avoided having Connelly's life insurance proceeds included in the business's value if they had used a cross-purchase instead of an entity-purchase agreement.

4. If a business already has redemption agreement in place, then switching to a cross-purchase agreement can be challenging. It is not simply changing the owner and beneficiary of the life insurance policies for 2 reasons.

5. First, the number of life insurance policies required for a cross-purchase can be much higher than for an entity-purchase agreement, so there wouldn't be enough policies when changing from one agreement to another if the business owners owned the policies directly. For example, a business with three owners would require three insurance policies owned by the business under a redemption agreement, but it would need a total of 6 policies collectively owned by the owners for a cross-purchase agreement.

6. Second, transferring life insurance policies from the business to its owners would likely run up against the “transfer for value” rules governed by IRC Sec. 101(a)(2), which require the death benefits from a life insurance policy (which are typically income tax-free to the recipient) to become taxable if the policy is transferred or assigned to anyone who is not either 1) the person insured by the policy; 2) a partner of the insured; 3) a partnership in which the insured is a partner; or 4) a corporation in which the insured is a shareholder or officer.

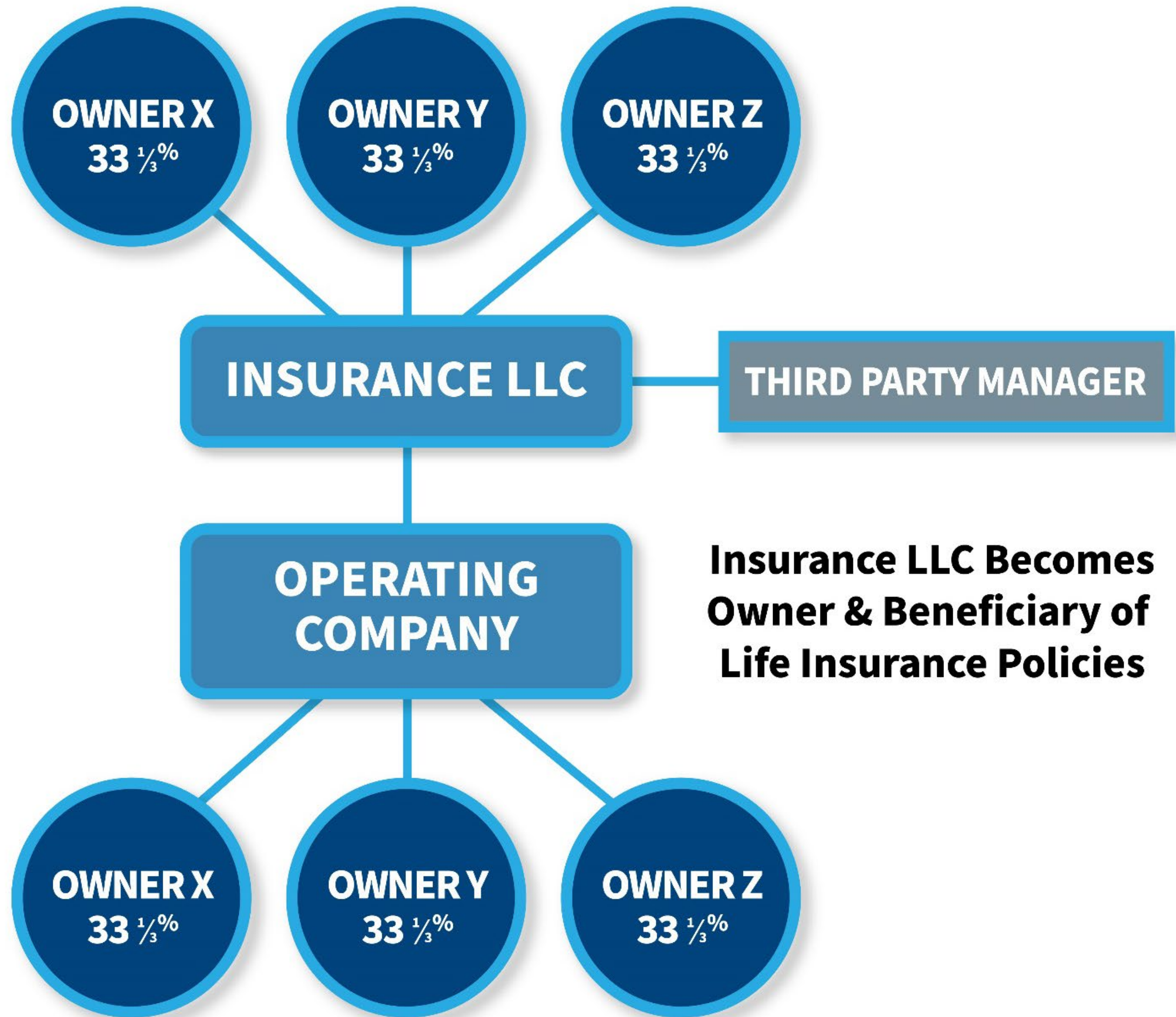
I. Buy-Sell Insurance LLCs

1. Business owners can move existing life insurance policies off the business's books without either triggering transfer-for-value issues by using a “Buy-Sell Insurance LLC.”

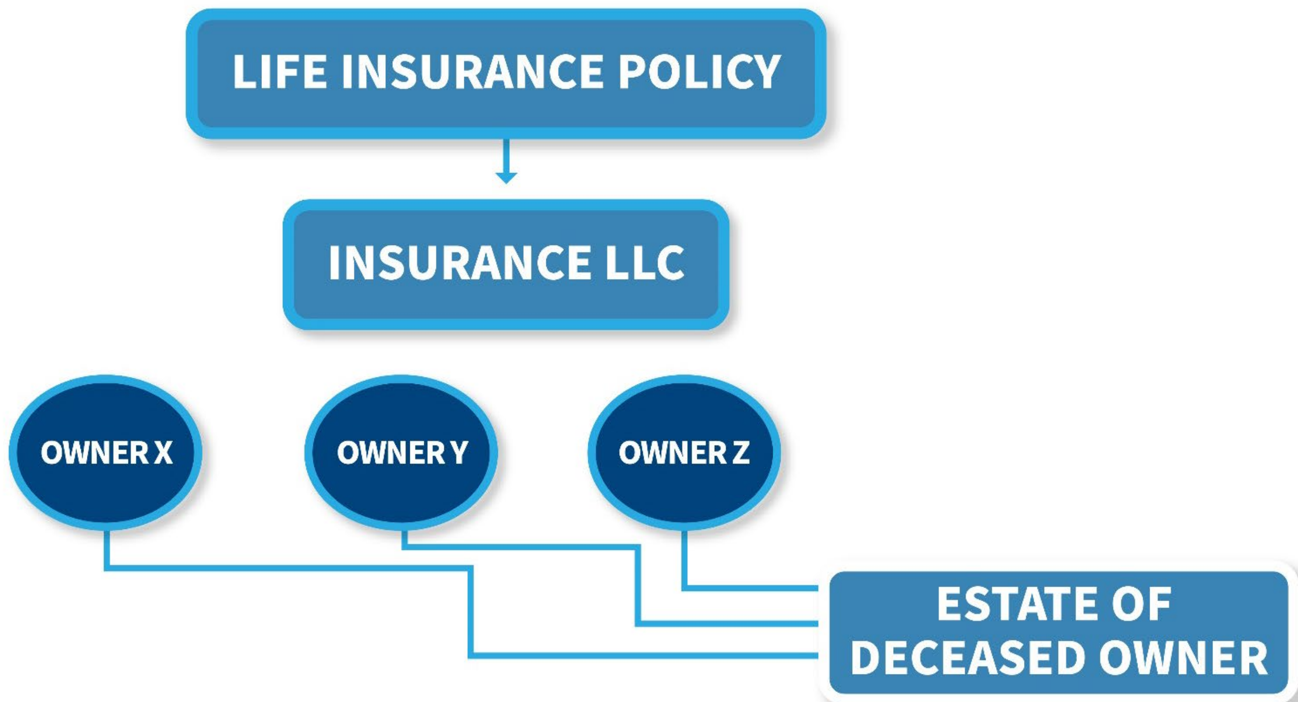
2. The owners create a new LLC (separate from the original 'operating' company) that will become the owner and beneficiary of the life insurance policies used to fund the buy-sell agreement.

3. The transfer-for-value rules specifically exclude any partnership in which the insured is a partner. Thus, as long as the LLC elects to be taxed as a partnership, it can receive the life insurance policies without their death benefits becoming taxable to the recipients.

Structure of a Buy-Sell Insurance LLC



Mechanics



Step 1: Death Benefit Paid to Insurance LLC

Step 2: Proceeds Distributed to Surviving Owners

Step 3: Surviving Owners Buy Deceased Owner's Interest in the Operating Company

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