Reviewing Buy-Sell Agreements After *Connelly*

Connelly considerations

Connelly v. United States, No. 23-146 (U.S. June 6, 2024)

- The Supreme Court ruled that the proceeds from the life insurance policy used to buy out the deceased owner's share of the business were not offset by the company’s redemption obligation.
- Case has significant implications for business succession plans and estate tax calculations
- Business valuations for estate tax purposes could drasticly differ from purchase price established in buy-sell agreements

This ruling is especially important for closely held business and their owners.

- While this case focuses on estate tax valuation issues, the impact extends beyond just estate taxes.
- There are also potential concerns regarding step-up in basis, capital loss implications, and redemption price issues.
- Underscores the importance of ensuring that buy-sell agreements are structured to meet the stringent requirements of Section 2703 to be respected for estate tax valuation.

What was the *Connelly* case about?

Facts:	Issue:	Conclusion:
• Business redeemed a deceased shareholder at a negotiated value • Buy/sell allowed for brother to purchase the shares and in absence of that option required the company to redeem • Valuation performed after the fact reduced value for a redemption obligation to that shareholder • For estate tax purposes the value with a reduction for the redemption obligation was utilized	• Should the value of the company be reduced by the redemption obligation?	• The effect of the reduction to value related to the redemption obligation was to enrich the remaining shareholders • In a traditional redemption the remaining shareholders should not be enriched by the redemption • Therefore, the estate tax value should not be reduced by the redemption obligation

Connelly illustration

- What is the issue?
  - Many buy/sell agreements utilize a formula to calculate the strike price
  - Estate tax value may be determined in a different way that yields a larger number and reduces the after-tax proceeds
- Assume your buy/sell is a redemption agreement that sets the price based upon a formula and is funded with life insurance. Consider that this formula sets the value of a 50% interest at $5.0M and this is funded with $5.0M in life insurance. The value included in the estate may be $7.5M under *Connelly (50% share of the $15M company including life insurance).* The family in this example will take home only $2.0M of the redemption proceeds after estate tax vs. their expected $3.0M under prior case law assuming a taxable estate.

Description	Illustration pre-Connelly:	Illustration after Connelly:
50% value of company assets	$5.0M	$5.0M
50% value of life insurance proceeds	$2.5M	$2.5M
Offsetting redemption obligation	($2.5M)	--
Fair market value included in estate:	**$5.0M**	**$7.5M**
Redemption price received by family:	**$5.0M**	**$5.0M**
Less 40% estate tax on fair market value:	($2.0M)	($3.0M)
Actual cash to family:	**$3.0M**	**$2.0M**

When should an agreement be revisited in light of *Connelly*?

Answering yes to any of these questions indicates the need for a review

- Does your redemption agreement use company-owned life insurance?
- Does the agreement utilize something other than a fair market value valuation to set redemption value?
- Are the parties involved in your buy/sell family members?
- Are you uncertain of the tax treatment of your existing redemption agreement?
- Have there been significant changes in ownership structure or overall value of your business since the agreement was drafted?

Section 2703 considerations

General rule under section 2703

- For estate tax purposes, the value of any property is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than its fair market value, or
- Any restriction on the right to sell or use such property

Section 2703(b) provides exceptions where the general rule does not apply if:

- (1) The agreement must be a bona fide business arrangement, meaning it serves a legitimate business purpose beyond merely reducing estate taxes
- (2) The agreement must not be a device to transfer property to family members for less than full and adequate consideration in money or money's worth
  - Example: Any arrangement or agreement designed to shift ownership to family members at less than fair market value
- (3) The terms of the agreement must be comparable to similar arrangements entered into by persons in arm's length transactions

Note: if the buy-sell agreement does not meet all 3 requirements, the IRS will disregard the redemption price and instead use the fair market value of the property for estate tax purposes. There is an exception if more than 50% owned directly or indirectly by persons who are not members of the transferor's family.

Section 2703 considerations

Additional requirements of Treasury Regulation section 20.2031-2(h)

- The offering price must be fixed and determinable under the agreement
- The agreement must be legally binding on the parties both during life and after death
- The restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration

Benefits of a buy-sell agreement

- Provides a clear path for transfers of ownership interests.
- Helps avoid conflict between the surviving owner(s) and the deceased owner's family as well as provide a path to a solution for in life disagreements that cannot be solved without the "expulsion" of a member.
- Guarantees a buyer upon an owner's death, retirement or disability at an established price.
- Possibly establishes the value of the stock for estate tax purposes.
- Creates liquidity for the deceased owner's family through proper planning and funding of the buy-sell agreement.
- Provide liquidity for shareholders on a recurring basis.

Redemption agreements

A redemption agreement is a specific type of buy-sell agreement.

The business entity itself purchases the shares of a departing shareholder.

Requires the company to have sufficient funds or plan to obtain funds to purchase the shares.

Cross-purchase agreements

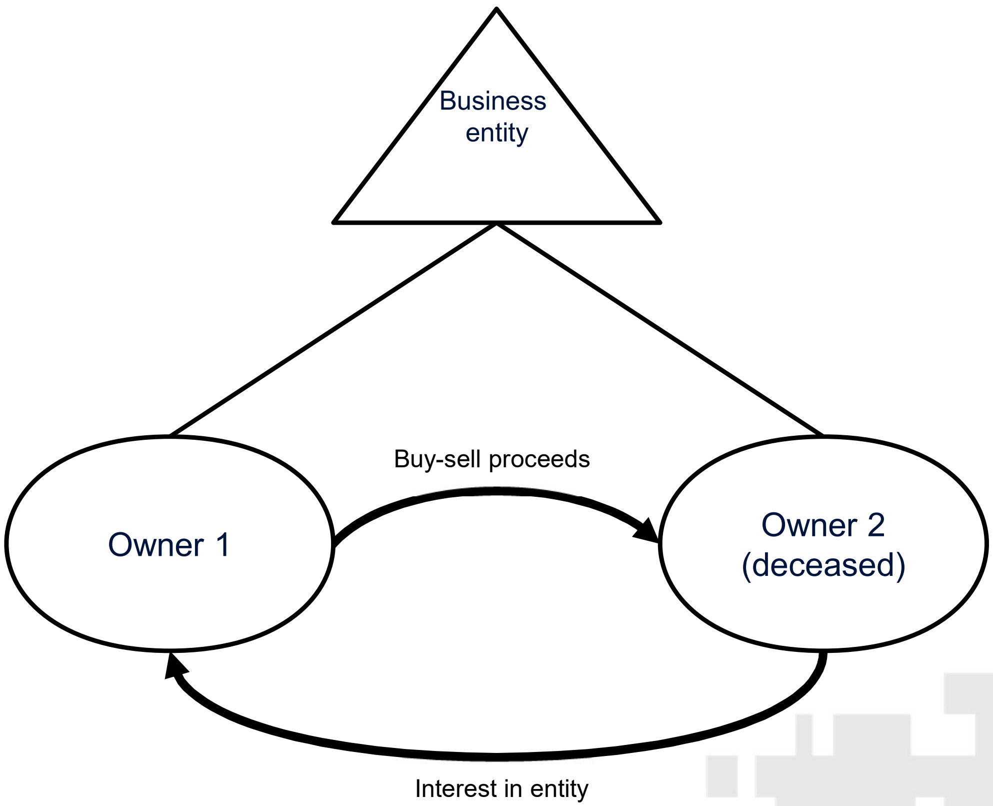
Each shareholder is the owner and beneficiary of an insurance policy on the life of the other shareholder(s) (i.e., policies are *cross-owned)*

At the death of a shareholder, the remaining shareholders receive the insurance proceeds and apply them to purchase the deceased's stock

Premiums paid by the shareholders are not deductible (*See* §264)

The corporation can bonus the premiums to the shareholders or premiums can be funded through a split-dollar arrangement. Premiums could also be funded through a distribution.

Death proceeds are received income tax-free, absent a transfer for value



Example: Agreement falls under section 2703 exceptions

Dad and son own a company with others. They own less than 50% together.

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Dad passes away

↓

Company purchases dad’s shares at redemption value. Same ‘deal’ as other unrelated shareholders.

↓

Value included in estate equals redemption price

- If the redemption agreement didn't qualify for special tax treatment under Section 2703, the estate would likely owe more in taxes because the shares would be valued at their full market price, but the estate would only receive the price stated in the redemption agreement (the outcome in *Connelly)*

What is involved in a buy/sell agreement review and design

Overall review of *Connelly's* effect upon a buy/sell agreement

- Understanding the outcome of the buy/sell agreement in certain circumstances in light of *Connelly*
- Recommending overall changes to the buy/sell agreement based upon our understanding of the goals of the owners

Review of life insurance

- Optimizing life insurance structures by evaluating the most effective arrangements to support buy-sell agreements, including cross-purchase, redemption, and other relevant options.
- Helping to calculate whether an increase in life insurance may be necessary if a redemption agreement is required

Key checkpoints in a review

Is it the right type of agreement for the type of entity and the number of owners?

- Is it right for the tax and personal objectives/circumstances of the owners?
- Is it consistent with their overall business succession plan?
- How important is it to get basis for the purchase price when shares are acquired?

Does it cover the critical points and triggering events clearly and thoroughly?

- When you cut through the verbiage, does it make sense?
- Common triggering events include death/disability/retirement of a shareholder, termination of a shareholder's employment, bankruptcy or insolvency of a shareholder; specified corporate events such as a merger, acquisition, or sale of assets

Is it appropriately and adequately funded?

- If not, why not? What's the problem?
- If not, are they aware of the issues (and stresses) awaiting both seller and buyer?
- Has the agreement been reviewed to assess the impact of *Connelly* on the parties involved?
- Consider engaging a life insurance professional to review type and amount of life insurance used.

When was it last reviewed vis-a-vis the above? Is it up-to-date?

Valuation considerations

Book value

- But maybe not in a family business setting

Agreed upon value

- With scheduled updates and a Plan B if the owners can't agree when the time comes

Appraised value / fair market value (IRS may scrutinize)

- With a Plan B if the parties or appraisers can't agree
- Generally, not a single appraisal. Example:
  - First get an appraisal and determine if parties agree. Then, get a second appraisal. If those two are within a certain threshold (for example, 10%), then you average the two, if not you get a third appraisal and average the two that are closest.
- Post *Connelly* valuation determination

Formula value

- Applies a specific formula to determine business value

Capitalization of earnings

- And the cap rate is…?
- The rate can change over time, how will the owners agree?

Thank you

for your time and attention