Entity-redemption buy-sell planning after *Connelly v. United States*

Succession planning is a critically important part of business planning that helps to safeguard the value of a client's business interests. With proper planning today, a client can be better assured that if they die, become disabled, decide to retire, etc., there will be a ready buyer and funding in place to turn the client's business interest into cash. This planning protects not only the client and their family, but also the business, its employees, customers, and the other business owners. But to be most helpful, business owners must be able to expect that such planning will be accepted by federal and state laws governing taxes, property, contracts, and treated the way they intended. A case decision handed down on June 2, 2023, by the Court of Appeals in the Eighth Circuit, *Thomas A. Connelly, in his Capacity as Executor of the Estate of Michael P. Connelly, Sr., v. United States of America, Department of Treasury, Internal Revenue Service*, 131 AFTR 2d 2023-1902 (8th Cir. 2023), raised awareness that not all succession planning will be accepted and respected for estate tax purposes. On December 13, 2023, the Supreme Court agreed to hear the case; arguments are scheduled for March 27, 2024. Depending on their ruling, entity redemption buy-sell plans may become a less attractive option for some business owners.

Buy-sell agreements

First, it is important to note that the *Connelly* decision considered an "entity-redemption" type of buy-sell agreement. Buy-sell agreements generally provide if a triggering event (e.g., the death of an owner) occurs, a specified buyer will be obligated to buy an owner's interest and the owner (or their estate) will be obligated to sell the interest. If the buyer specified is one or more of the other owners, then this type of agreement is considered a "cross-purchase" arrangement. If the specified buyer is instead designated as the business itself, the arrangement is termed "entity-redemption." This latter type is what the Court examined in *Connelly*. All types of arrangements typically also include provisions for the funding of purchase obligations, such as life insurance on the life of the "selling" business owner, to ensure that the buyer will have the ability to buy the business interest when the agreement obligation is triggered. Also, most buy-sell agreements will contain provisions for determining the prices that the buyer(s) must pay for the business interest purchase. This is tricky, of course, because the purchase is to happen at some point the future, so it is not possible to know with any certainty what the actual value of the business interest will be.

The *Connelly* case

The *Connelly* case facts are fairly straightforward. Two brothers, Michael and Thomas, owned a roofing and siding company. Michael was president and CEO and owned 77%, and Thomas owned 23%. The brothers executed an entity-redemption agreement in 2001 that required the company itself to purchase the shares of either owner

INSURANCE PRODUCTS	MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED	
NOT INSURED BY ANY GOVERNMENT AGENCY		

if that owner died, which would leave the surviving brother as the sole owner. To fund the company's potential purchase obligation, the company purchased life insurance in the amount of $3.5 million death benefit on each of the owners (despite the disparity in their ownership interests). The agreement required that at the end of each year the owners must issue a "certificate of agreed value" fixing the value of the company for buy-sell purposes for the following year, but they never did. If an owner died in a year without a certificate setting the value (which happened, as we will see), then the value was to be determined by the average of two qualified appraisals.

When Michael died in 2013, there was no certificate of agreed value. What's more, Thomas, as executor of Michael's estate and the sole surviving owner of the company, did not commission appraisals. Furthermore, both Michael's estate and the company (both controlled by Thomas) ignored the obligations of the agreement, Michael's estate received $3 million from the company, and Thomas negotiated a sale of the entire company to Michael's son. Thomas filed an estate tax return for Michael's estate, using $3 million as the value of his 77% business interest (valuing the company at $3.89 million). Upon audit, the IRS included the full death benefit when determining the value of the company. As a result, the IRS valued the company at about $6.86 million and disregarded the company's existing contractual commitment to spend those life insurance funds for the buyout. On appeal the Court agreed, stating in essence that IRC §2703 required that the value of the company be determined without regard to any agreement to acquire property at a price less than the fair market value. The Court noted that the certificates of agreed value, even if they had been done as required, were based on no standard at all, much less fair market value.

What now

What must we take from the *Connelly* case with respect to entity-redemption plans going forward? First, the question presented to the Court is "[w]hether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax." If estate taxes are not a concern, then an entity-redemption plan can still be a viable option. If business owners have a taxable estate, they may prefer an alternative buy-sell arrangement, such as a cross-purchase buy-sell or an Insurance LLC. Second, the Court in *Connelly* was dealing with very bad facts: business owners who completely ignored the contractual requirement to determine the value of the business each year and to comply with a requirement to sell the shares upon death of an owner for a price determined by two qualified appraisals. In addition, the full value of the policy was not used to redeem the deceased owner's shares. The IRS and the courts disregarded the contract under IRC §2703 because the parties had disregarded it; however, the Eighth Circuit suggested in dictum that the procedures laid out in the agreement did not set a "fixed and determinable price" as required by §2703. Third, even if a buy-sell agreement does not effectively determine the value of the corporation for estate tax purposes, considering the life insurance proceeds when valuing the corporation does not necessarily mean the full value of the death benefit will be included. Finally, it would be well to note what this Court found lacking and to do what these taxpayers did not: pay attention to the formula or method by which the offering price required under the agreement is fixed or determined. And, though this should go without saying, help yourself by respecting the terms of your own agreement. If you don't, no one else will either.

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