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FROM "WHAT NOW?" TO HERE'S HOW — SOLUTIONS FOR BUSINESS OWNERS

With one of the most consequential U.S. Supreme Court business continuation decisions now law, it's imperative for business owners to review their succession funding agreements to ensure they have the right plan in place.

The recent unanimous U.S. Supreme Court decision in Connelly v. U.S. has significant consequences on succession and estate planning for closely held business owners. Business owners need to understand the narrow court decision and the alternative funding options available to them that could help avoid an IRS dispute.

THE FACTS

Connelly, as Executor of the Estate of Connelly v. United States (No. 23–146) was argued before the Court on March 27, 2024 and decided on June 6, 2024. It followed an 8th Circuit Court of Appeals affirmation of a district court ruling favoring the IRS over a deceased brother's estate regarding the value of the decedent's interest in a closely held building supply corporation.

The corporation, Crown C Supply, was owned by Michael (77.18%) and Thomas Connelly (22.82%). The brothers entered into a wait-and-see buy-sell agreement to keep the business in the family should one die. The agreement gave the surviving brother the option to purchase the deceased brother's shares. If declined, Crown would be required to purchase those shares. Life insurance totaling $3.5 million on each brother was purchased to ensure Crown would have the funds to redeem those shares if required.

When Michael died, Thomas elected not to purchase his shares. Thomas and Michael's son amicably agreed to value Michael's shares at $3 million which Crown paid to Michael's estate. Thomas, Michael's executor, filed the estate's federal tax return reporting the $3 million value. The IRS disagreed. It audited the return.

As part of the audit, Thomas hired an accounting firm that placed a $3.86 million valuation on Crown. The firm's valuation was based on an 11th Circuit Court of Appeals decision, Estate of Blount v. Commissioner, 428 F. 3d 1338 (CA11 2005)[1]. Blount concluded that insurance proceeds did not result in a net increase in the corporation's fair market value (FMV) because they were offset by a liability: the stock redemption obligation on the part of the corporation.

1 https://caselaw.findlaw.com/court/us-11th-circuit/1372756.html The 11th Circuit's decision in Blount was counter to the 8th Circuit's decision. It rejected a tax court's inclusion of insurance proceeds in the corporation's fair market valuation.

The firm valued Michael's 77.18% business interest in the company at approximately $3 million ($3.86 million x .7718). The IRS differed, valuing Michael's shares at $5.3 million (($3.86 million + $3 million of the insurance proceeds) x .7718). The higher valuation resulted in an additional $889,914 in taxes which the estate paid before initiating a lawsuit to obtain a refund. The district court held for the IRS and the 8th Circuit Court of Appeals affirmed that decision on appeal. The Supreme Court took up the appeal, presumably, to reconcile the conflict between the 8th and 11th Circuits.

What the Court Said

Justice Thomas delivered the Court's unanimous opinion. He noted:

- **The dispute is narrow with the crux being whether the stock redemption obligation always creates a liability that offsets the proceeds from the life insurance policy.**
- **For estate tax purposes, timing is everything. At the time of Michael's death, his shares included the value of the insurance proceeds prior to the redemption.**
- **Other funding options were available including a cross-purchase agreement which would have allowed the insurance proceeds to go directly to the surviving brother and not to Crown.**
- **It is possible for a redemption obligation to decrease a corporation's value. For instance, if a corporation is required to liquidate operating assets to pay for shares, its earning capacity could decline. The Court's decision is specific to Thomas Connelly's argument that all redemption agreement obligations reduce a corporation's net value.**

WHAT THIS MEANS

Valuation was a central component of the case. The brothers executed a "wait-and-see" buy-sell agreement, but during their lifetime ignored the valuation clause that required them to annually update the value of the business. This continued upon Michael's death in 2013 when Thomas and his nephew agreed that the value of Michael's 77.18% interest was $3 million. It may have contributed to the IRS audit.

By ignoring the valuation provisions, the agreement failed to establish a fixed or determinable price as required by Code Sec. 2703(a)[2] and existing case law. Interestingly, and perhaps because of its narrow scope, the Court did not speak to Code Sec. 2703, but by not doing so was not invalidating it.

NEXT STEPS & POTENTIAL SOLUTIONS

1. **All Buy-Sell Agreements *(see sidebar)* Should be Reviewed:** Although the priority should be to review entity redemption agreements, recent IRS scrutiny speaks to the need to also review cross purchase, wait-and-see, trusteed cross-purchase, and one-way buy-sell agreements for all types of business forms — C corporations, S corporations, partnerships, and limited liability companies. Business owners should review and adhere to the terms of the agreement or have them redrafted to reflect their current circumstances.
2. **Life Insurance Funding Should be Reviewed:** A policy review should examine details including the proper amount of insurance, and alignment of the policy owner, insured, and beneficiary with the buy-sell purchase obligations. It should also look at whether permanent or term should be used, and if permanent, how the policy is performing. If term is used, is the duration running out, and is it convertible without evidence of insurability? Other considerations include whether the insured's health has changed for the better or worse, and whether the carrier is financially stable.

2 Code Sec. 2703 provides a statutory three-part test that must be met in order for buy-sell agreements to establish FMV for federal estate tax valuation purposes.

3. **Code Sec. 2703 and Existing Case Law Review:** Family businesses should ensure that the asset prompting a succession agreement is valued at FMV. For non-family businesses, care should be taken to ensure a client's attorney is comfortable that terms of the agreement are comparable to similar arm's length transactions. FMV can be determined with a qualified appraisal. When possible, an industry-specific formula should be applied (e.g., car dealerships, or even more specifically, Ford dealerships).
4. **Migrate to Cross-Purchase Agreement:** A cross-purchase agreement with life insurance moved out of the business and to its owners can eliminate the dilemma created in the Connelly case. Alternate forms of cross-purchase agreements include trusteed cross purchase with only two owners (escrow arrangement); wait-and-see buy-sell; and a life-insurance only LLC.
5. **Leave Agreement As Is:** If legal counsel feels that the redemption agreement meets requirements of 2703(a) and existing case law, then it can be left unchanged. In this case, it may be advisable to move the life insurance out of the business to non-insured owners as a protective measure.
6. **Moving Policies — Beware Transfer-for-Value:** The transfer of an employer-owned life insurance policy to a non-insured owner may violate the transfer-for-value rule[3]. The transfer of a policy to the insured's business partner is the most commonly used exception to the transfer-for-value rule.
7. **Life Insurance-Only LLC:** Life insurance is owned by the LLC on behalf of noninsured members, and not by the operating business. Members contribute funds to pay premiums on their portion of the proceeds insuring other members. Upon the death of an owner, the death benefit is allocated to the surviving members who then purchase the deceased member's interest from their estate. Surviving members receive a stepped-up basis in the purchased interest equal to the price paid for it.

3 The transfer-for-value-rule, defined in IRC Section 101(a)(2), establishes that if a policy is transferred for consideration, proceeds can become taxable.

THE BASICS OF BUY-SELLS

A buy-sell agreement is a legal contract that predetermines how a departing partner's shares in a company are distributed and at what price if they leave the corporation. In the case of Michael Connelly, that exit was the result of death, although other departure reasons are also possible. Life insurance is commonly used as a funding vehicle. The goal is to create a market for a closely held business interest, establish a fair price (whether an owner is a buyer or a seller), and control who the owners are in a business.

There are different types of buy-sell arrangements delivering different results as the application of the specifics of Connelly illustrate.

- **Stock or entity redemption agreement:** The company purchases the stock of the departing partner. It usually funds the purchase with life insurance it purchases and pays premiums on.

  As it Applies to Connelly: $3.86 million valuation + $3 million in life insurance = FMV of $6.86 million.

- **Cross-purchase agreement:** The purchase of an exiting partner's shares is made by some or all of the remaining partners, and not the company. This is usually accomplished by having each partner purchase a life insurance policy on each of the other partners. If a partner dies, the death benefit provides the proceeds to fund the share purchase. Cross-purchase agreements have advantages: policy proceeds are not subject to income tax; the value of the company is not inflated as it was in the Connelly case; company creditors can't access the policies' value, and surviving owners get a step-up in basis. However, purchasing individual life insurance policies, particularly if there are a large number of partners, is cumbersome. Also, the age and health of a partner will determine whether life insurance is available, and at what cost, potentially disadvantaging younger and/or healthier partners.

As it Applies to Connelly: $3.86 million valuation for Crown. Michael and Thomas each purchase $3.5 million policies which are not included in Crown's valuation.

- **Wait-and-see agreement:** This hybrid between an entity-purchase agreement and a cross-purchase agreement delays the decision on who will purchase a partner's shares until a triggering event. In the case of Connelly, the trigger was Michael's death. Thomas had the option to purchase Michael's shares. When he declined, Crown was obligated to purchase them. Typically, the entity has the first right of purchase followed by the partner(s). Both entity and partner(s) can also be joint purchasers.

  As it Applies to Connelly: Crown had a valuation of $6.86 million, but with a different funding structure could have been valued at $3.86 million.

- **Trusteed cross-purchase agreement:** This buy-sell arrangement uses a trust to hold partners' shares. The trust purchases a life insurance policy on each shareholder, acting as owner and beneficiary. When a partner dies, the trust manages the payment to the decedent's estate and the transfer of the decedent's shares to the other partners. There is a potential transfer-for-value issue for policies remaining in the trust after the first death of a partner and distribution of policy proceeds.

  As it Applies to Connelly: A trust holds the shares for both Michael and Thomas and purchases a $3.5 million policy on each partner. Crown's valuation is $3.86 million.

- **Life Insurance-Only LLC:** Provides all of the benefits of a cross-purchase buy-sell agreement but with only one policy per owner. It is analogous to a trusteed cross-purchase without potential transfer-for-value issues (provided the LLC is taxed as a partnership for federal tax purposes) when there are multiple owners. The LLC owns a life insurance policy insuring each owner on behalf of the non-insured owners rather than the company. Each partner contributes to the LLC their pro rata share of premiums on the policies of the other owners. When a death occurs, the death benefit is paid to surviving partners who then purchase the deceased member's interest from that member's estate. A stepped-up basis is received by surviving partners.

  As it Applies to Connelly: The LLC holds a $3.5 million policy on both Michael and Thomas who pay premiums on those policies. Upon Michael's death, the death benefit is paid to Thomas who uses the proceeds to purchase Michael's shares from his estate.

- **One-way buy-sell agreements:** Sole owners who want to ensure their business continues may use a buy-sell agreement to sell to a favored family member or key employee. The agreement establishes a value for the business, and the future owner purchases a life insurance policy for that amount acting as owner and beneficiary. A bonus can be paid annually to cover the cost of the premiums. It would be deductible to the business and taxable to the future owner.

  As it Applies to Connelly: If Michael was the sole owner of Crown and wanted his son to continue in the business, a buy-sell would be executed with a valuation of $3.86 million. Michael's son purchases a $3.5 million life insurance policy and maintains it. Crown could provide a bonus to the son to cover premiums which would be deductible to Crown and taxable to Michael's son. Upon Michael's death, his son would use the proceeds to purchase Crown.

THE RIGHT OUTCOME

Connelly's narrow focus on valuation is not cause to rest easy. The potential exists for greater IRS scrutiny of succession funding agreements that could directly impact business continuation strategies and estate planning. Although the priority is to review entity redemption agreements, it's worth revisiting all existing buy-sell agreements to ensure that they are in order, reflect an accurate value of the business, and that they still meet the needs of their business owners. The complexity of succession funding agreements and the high stakes involved — the ongoing viability of the company and potential additional estate taxes — make it imperative for business owners to work with experts in business continuation planning to ensure the right outcome.

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