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Tax Management Memorandum™

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Scrutinize Your Buy-Sell Agreements in the Wake of 'Connelly'

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Shareholder stock redemption obligations pursuant to a buy-sell agreement no longer can be ignored in a business entity's valuation for estate tax purposes, and may result in significant additional tax liability, as the taxpayer in a recent Supreme Court case found, financial planners Robert Barnett and Henry Montag explain.

The U.S. Supreme Court's June 6, 2024 determination in *Connelly v. United States*, that a corporation's life insurance policy held for redemption of a deceased shareholder's stock increases its fair market value, will significantly affect many buy-sell agreements, many of which utilize life and disability insurance as the ideal funding mechanism for payment of the purchase price upon death, disability, or retirement.

In *Connelly*, two brothers who owned a roofing and building supply corporation entered into a buy-sell agreement to ensure that the business would stay in the family if one of them died — and one of them died. After the survivor opted not to redeem his late sibling's shares and the company used $3 million in life insurance proceeds to do so, the IRS asserted that the $3 million must be added to the company's valuation for estate tax purposes. Under I.R.C. §2031, gross estate includes the fair market value of property owned at the time of death. The estate paid the tax deficiency and sued for refund. The suit failed all the way up to the nation's highest court.

Until *Connelly*, insurance used in redemption planning was presumed not to count toward the valuation of a business entity, based on decisions of the Eleventh Circuit in *Estate of Blount v. Commissioner* (2005) and the Ninth Circuit in *Estate of Cartwright v. Commissioner* (1999).

Buy-Sell Agreements: The Mechanisms and the Benefits

One of the prime benefits of an updated buy-sell agreement is, in the event of the death or disability of a partner, to allow the surviving members to maintain control of the business and avoid unwanted partners. (For purposes of this article, we use the terms "member," "partner," and "shareholder" to denote the owners of various business entities.) The agreement should also provide certainty to all interested parties and their families. A comprehensive agreement will address the appropriate funding, payment terms in the event of a premature death or disability, and the mechanics.

The three most common structures of buy-sell agreements are the cross-purchase, the stock-redemption, and a hybrid alternative sometimes described as a "wait-and-see" agreement. (The Connellys' agreement was the latter.)

Buy-Sell Agreement Structures

Cross-Purchase

In a cross-purchase agreement, each owner agrees to purchase their proportionate share of the interest of the retired or deceased partner. If insurance is the funding mechanism, each partner is the owner, beneficiary, and premium payor of policies insuring the life of other partners. As such, multiple policies are required. One of the tax benefits to the cross-purchase agreement is that the purchasing partners receive a cost basis in the interest that they are purchasing. In the event of a purchase at death, the surviving partner's estate generally receives a step-up in basis under §1014, and therefore no capital gain results to the selling estate. One of the detriments of a cross-purchase is that the ultimate payment obligation still rests with the remaining partners and may be subject to their financial instability or creditor risks, as the Court noted in *Connelly*. Another detriment exists if there is a difference in age or health of the respective partners, necessitating a differential in insurance cost. Such differentials can be addressed with a differing profit or bonus arrangement and can be cumber-

some to keep track of with three or four or more partners or shareholders.

Stock Redemption

In a stock redemption agreement, the entity purchases the interest of the retired or deceased partner. If insurance is a funding mechanism, only one policy is required on the life of each owner. This arrangement provides for more efficient administration and helps equalize the differential in insurance premiums. Although the partner's creditor risk is diminished, the financial wherewithal of the entity must be considered. The remaining business owners will not receive a step-up in basis in their underlying corporate or partnership interest; this is a dramatic difference to the benefit obtained under a cross-purchase.

Hybrid (a.k.a. 'Wait-and-See')

In a hybrid policy, such as the Connellys', the remaining shareholders are generally given the first option to purchase, and if they decide not to purchase, the business is then required to do so. There are many contractual provisions to be considered, including whether such corporate purchases are mandatory, whether the remaining shareholders must guarantee the obligation, and whether life insurance will be utilized as a funding mechanism, as well as other payment terms and obligations. It is important for the shareholder decision to be structured as an option in order to avoid adverse tax consequences.

Other Considerations

Buy-sell agreements must also consider the type of life insurance policy used to fund the purchase obligation. Consideration must be given to the general business plan, whether cash surrender value will be desired to fund a lifetime or disability buy-out, and whether the business is intended to remain in the member's ownership for an extended time or only a short period. If a duration of five to 40 years is all that is required, a term-life insurance policy is often chosen, as it is the least expensive, depending on the members' ages. Term insurance provides only a death benefit, and so other mechanics, such as a sinking fund, will be needed in the event of a lifetime or disability purchase. The longer one waits to obtain coverage, the higher the cost of all various life insurance policies. A guaranteed universal policy will have a higher premium, but will guarantee death benefits, costs, and coverage for the duration of the guaranteed period, which can be up to age 120. It is also possible to provide living benefits and utilize other investment type products, such as variable life policies, which can accumulate and grow their cash value for eventual supplementation of an owner's retirement income on a tax-free basis, if set up correctly.

Employee retention remains an important goal, and a deferred compensation plan is a great mechanism to retain key employees. Such a plan can provide living as well as death benefits utilizing cost-effective term insurance or whole life or variable life policies. Such arrangements can help ensure that key employees remain at the business by structuring a benefit only if various agreed-to conditions are met, otherwise known as Golden Handcuffs.

The 'Connelly' Decision

The *Connelly* case centered around the ownership of Crown C. Supply, Inc., a roofing and building supply corporation (the "Corporation"). Michael and Thomas Connelly were the sole shareholders of the Corporation; Michael owned 77.18% of the common shares, and his brother, Thomas, owned the remainder. In order to ensure that the Corporation would stay in the family if either brother died, they entered into a buy-sell agreement. The structure of this agreement is fairly common; the surviving brother had the option to purchase the deceased's shares, and if he declined, the Corporation would redeem the shares using a $3.5 million life insurance policy it had obtained. After Michael died, Thomas elected not to purchase Michael's shares, obligating the Corporation to do so.

The buy-sell agreement contained a certificate of value, which was intended to provide an agreed-upon purchase price for the Corporation. The brothers were required to annually determine and document the agreed-upon value. Despite being required to do so, the brothers never completed the certificate of valuation. In default of a timely and effective agreed-upon certificate of value, the buy-sell agreement contained an appraisal procedure; in order to determine fair market value, the Corporation and the estate were each required to hire experienced appraisers. The average value was to be used if the appraisers were close in value. The Connelly family similarly failed to follow the procedures in the buy-sell agreement requiring multiple appraisals.

Thomas was appointed executor of Michael's estate, and the appraisal mechanism was never implemented; instead, the parties agreed to a purchase price of $3 million paid by the life insurance proceeds. The final agreement also provided future benefits to Michael's son, granting him a favorable purchase option for three years, and also providing that if the Corporation were sold within 10 years, he would receive part of the profits upon sale. The district court found this to be evidence of a testamentary intent.

Tax Management Memorandum
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ISSN 0148-8295

Michael's estate filed an estate tax return, reporting the Corporation's fair market value to be the agreed-upon purchase price, $3 million, and not including any additional value for the life insurance policy. On audit, the IRS, challenging the valuation, determined that the valuation should be $3.86 million. The IRS asserted that the $3 million in life insurance proceeds used to fund the redemption must be added to this valuation. When applying Michael's ownership interest of 77.18%, the resulting value of the Corporation for estate tax purposes was $5.3 million. This increased value resulted in an additional $889,914 in estate taxes. The estate paid the tax deficiency and requested a refund. The district court granted summary judgment to the government. On appeal, the Eighth Circuit affirmed. The Supreme Court upheld the Eighth Circuit's decision.

The taxable estate includes the value of all property owned by the decedent at the time of death (§2031(a)) minus allowable deductions (§2051). The determination of valuation is the fair market value- as Reg. §20.2031-1(b) states: "the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." In *Connelly*, the ultimate issue was how the corporate-owned life insurance policy would enter into the calculation of fair market value.

Lower Courts: Taxpayer Missteps

Originally hearing the case, the Eastern District Court of Missouri devoted substantial attention to the many faults and missteps between the Corporation and the estate in failing to follow the agreed-upon procedures. The court determined that the shareholder agreement and the final agreed purchase price failed to properly meet the statutory requirements of §2703. Under §2703(a) and (b), fair market value is generally determined without regard to a family buy-sell agreement, but the agreement is respected if three requirements are met: (1) it is a bona-fide business arrangement; (2) it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) its terms are comparable to similar arrangements involving persons in an arm's-length transaction. The court held that although the shareholder agreement was a bona fide business arrangement, it was held to be a device to transfer the property to members of Michael's family for less than full and adequate consideration, and that its terms would not be comparable to a similar arrangement entered into in an arm's-length transaction. The court discussed that in an arm's-length transaction, unrelated parties would have considered the value of a life insurance policy. After a thorough analysis of statutory requirements, the court concluded — stating its disagreement with the Eleventh Circuit's decision in *Estate of Blount* — that the life insurance would be considered in valuation and increase the value of the Corporation. Reg. §20.2031-2(f)-2 states that: "…consideration shall also be given to non-operating assets, including proceeds of life insurance policies, payable to or for the benefit of the company, to the extent such non-operating assets have not been taken into account in the determination of net worth…."

Michael's estate took the position that the insurance proceeds should not increase the fair market value of the Corporation because they are offset by an obligation to pay the proceeds in the stock redemption, and therefore represent an offsetting liability. The IRS took a contrary view, and the district court and the Eighth Circuit agreed with the government; the Supreme Court agreed to hear the case due to the split decisions.

The Supreme Court's Focus

The Supreme Court wasted no time in getting to the heart of the matter and did not focus upon the many faults and other missteps analyzed and discussed in the lower courts. Justice Clarence Thomas wrote the Court's opinion, focusing on valuation of the Corporation and the effect of the corporate-owned life insurance policy. The Court discussed that valuation of a corporation includes an analysis of various factors, including proceeds of life insurance policies, which are payable to the company. The Supreme Court agreed with the district court that the $3 million in life insurance proceeds, must be counted to accurately value Michael's shares in the Corporation. The Court affirmed that the life insurance proceeds must be considered and that the Corporation's obligation to redeem Michael's shares, "was not a liability that reduced the Corporation's fair market value." In footnote 2, the Supreme Court stated that "[w]e do not hold that a redemption obligation can *never* decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas [Connelly]'s position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more."

The Supreme Court agreed with the IRS that "no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability." The Corporation's "contractual obligations to redeem the shares at fair market value, does not reduce the value of those shares." A purchaser, knowing that the insurance was readily available to purchase Michael's shares, would have paid

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ISSN 0148-8295

more for Michael's stock, and the Court determined that a hypothetical buyer would consider life insurance proceeds in determining valuation. The Court also supposed that Thomas Connelly would receive a substantial windfall, under the estate's analysis.

The Supreme Court opinion did mention that the Connelly brothers might have been well advised to utilize a cross-purchase agreement; each shareholder would own a life insurance policy on the life of the other shareholders and be required to use those proceeds to purchase the shares of the deceased shareholder — thereby avoiding the risk of increased valuation. This method obviously creates more complexity as multiple policies are necessary to cover whatever number of shareholders are involved. There is also an increased risk that a shareholder will refuse or be unable to purchase when the time comes. Alternatively, a transfer for value issue occurs when a shareholder dies, and policies are restructured. Section 101(a)(2) provides that where a life insurance policy is transferred for a valuable consideration, the general exclusion from gross income may not apply or shall be limited to basis. A detailed discussion of alternatives is beyond the scope of this article. However, it is common to utilize a trustee buy-sell structure in order to avoid some of the cross-purchase complexity and risk.

What to Consider in Reviewing a Buy-Sell Agreement

Post-*Connelly*, planners should meet with their clients to scrutinize any buy-sell agreements. In particular, determine the answers to the following:

1. Does the agreement meet the requirements of §2703(b)?
2. If a certificate of value is utilized, has it been properly and timely implemented?
3. Is there an appropriate appraisal procedure used to determine fair market value?
4. Is the agreement binding during life, death, or disability? Is it adequately funded?
5. Has consideration been given to transfer for value, and appropriate planning?
6. Is an insurance partnership possible? Can we utilize a split dollar arrangement?

Always consider the client's objectives, as well as the ownership, beneficiaries, and cost and duration of the life and disability insurance coverage in incorporating a buy-sell agreement into an estate plan — especially in light of the *Connelly* decision.

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ISSN 0148-8295