The Connelly Decision:
Why Closely Held Business Owners Should Review Their Buy-Sell Policies

Key Takeaways

- The *Connelly v. United States* decision changes how company-owned life insurance affects the estate tax valuation of a deceased owner's shares (or other interests) in that entity.
- Until Connelly, most believed company-owned life insurance did not increase the estate tax value of the shares (or other interests) in the company, so long as the company was subject to a buy-sell agreement requiring it to use the insurance proceeds to redeem (buy back) the deceased owner's shares.
- Business owners should review their buy-sell agreements with their professional advisors, both to avoid unexpected estate tax surprises due to Connelly, as well as potential issues regarding step-up in income tax basis, which might result in capital losses for the estate.

Business Owners - with Estate Tax Issues

The Connelly decision has given the planning profession a lot to unpack, and while there is still no "silver bullet" solution (too early for that), the biggest takeaway is this: If your business has a buy-sell agreement that is funded by life insurance, you should review your agreement with your professional advisors. Additionally, if you are a business owner with two or more owners and you *don't* have a buy-sell agreement in place, you should consult your advisor.

Michael Connelly died owning shares of a closely held corporation. The corporation owned insurance that paid $3,500,000 on his death. Pursuant to a buy-sell agreement between the corporation and the shareholders, the corporation was obligated to use the insurance proceeds to redeem the shares from Michael's estate. The full fact pattern of the Connelly case can be found **here**. The key issue before the Supreme Court was *how to value those shares for estate tax purposes*. There was a lot at stake – including the insurance proceeds in valuing Michael's shares (which the Court ultimately did) increased his estate taxes by $889,914!

Before we dive into the ramifications of the Connelly decision, let's review what a buy-sell agreement is, why they are a helpful tool for businesses and business owners, the various types, and what we can learn from and utilize going forward in successful business planning. We'll begin with an illustration.

A sole proprietor starts a business. They grow the business to a value of $10,000,000 and then they pass away. *What is the value of that business for purposes of estate tax considerations*? If you guessed $10,000,000 – you are correct. What happens to the business afterwards? Who knows, but let's say it is inherited by the deceased owner's children. They now have an asset whose tax basis is $10,000,000 – the value used for the deceased owner's estate calculation. If they simultaneously inherited and also sold the business for $10,000,000, they would have no realized or recognized gain on sale for income tax purposes.

Now let's take that same business valued at $10,000,000, but instead of a sole proprietorship there are two equal business owners (50% each) – we'll call them O and P. Both owners want to be in business with one another, but only with one another. If for whatever reason one of them no longer wants to work with the other, or if one passes away, they both want to protect the business as well as themselves – so they explore a buy-sell agreement (BSA). The type of document used depends on the type of entity. For a partnership, a BSA is normally part of the Partnership Agreement; for a limited liability company (LLC), it is normally part of the Operating Agreement; and for a corporation it is normally part of a separate Buy-Sell Agreement or Close Corporation Agreement. Regardless, key elements of a buy-sell agreement include[1]:

- Any stakeholders, including partners or owners, and their current stake in the business' equity
- Events that would trigger a buyout, such as death, disability, divorce, retirement, or bankruptcy
- A recent business valuation
- The structure by which partners would buy or sell their interest in the business
- Buyout funding sources (e.g., insurance policies)
- The tax implications of the purchase or sale of any partner's interest in the business

In conjunction with adequate funding as mentioned above, buy-sell agreements can[2]:

- Create a market for an illiquid asset, converting it into cash
- Avoid the forced sale of an asset to raise cash for final expenses and estate taxes
- Ensure both a fair sale and purchase price of an asset
- Control ownership (e.g., preventing surviving shareholders being in business with a deceased shareholder's surviving spouse or other family members)
- Fix the value of the business for estate tax purposes

There are a multitude of options for structuring a buy-sell agreement, each having their pros and cons, and the optimal set-up depends on the particular business and its owners. Regardless, whatever rules they agree on should be followed. Now back to O and P.

Because neither of them has an extra $5,000,000 lying around in case one of them needs to buy the other's share, each purchases a life insurance policy on the other with a $5MM death benefit. This arrangement is called a **cross-purchase agreement**. If O dies, P receives $5,000,000 which is income-tax free. P is then obligated to use that money to buy the shares from O's estate. O's beneficiaries get cash (also generally tax free), and with a new cost. P gets O's share (also generally tax free) with a new income tax cost basis of $5,000,000.

Taking our illustration one step further, let's now consider this same company but instead of two owners there are five equal owners (20% each). For a cross-purchase agreement to work, each of the five owners would have to purchase life insurance and pay for the premiums of policies on each of the other four owners. That results in twenty total policies in this example, and a lot of premiums. Instead of each person owning a policy on everyone else, what if the entity owned the policies, and the entity paid the premiums, and if an owner died the entity would receive the death benefit and had an obligation to buy out the deceased owner? This type of buy-sell agreement is known as an **entity redemption agreement.**

Revisiting our question from earlier, *how much would the deceased owner's share of the business be worth for estate purposes*?

Until <u>Connelly</u>, valuation experts relied on the interpretation of *Blount v. Commissioner*, which appeared to hold that because the entity's obligation to redeem the deceased owner's shares was a liability for that business, the enterprise value at time of death ought to be lower. The rationale looked like this using our five-owner example:

- There are five equal owners (20% each) of a business whose enterprise value is $10,000,000.
- The business therefore purchases life insurance of $2,000,000 on each owner.
- One of the owners dies, and $2,000,000 comes into the business; this increases the value of the business to $12,000,000.
- But because the entity has an obligation to redeem the deceased owners share of the business, for valuation purposes this should effectively act as a liability and reduce the value of the business by $2,000,000, thus arriving back at the original $10,000,000 valuation.
    - <u>For estate tax purposes of the deceased owner's estate, the value for their 20% interest therefore would be $2,000,000 ($10,000,000 x 20%).</u>

The Connelly estate made this argument, which was unanimously rejected by the United States Supreme Court.

The Court held the entity's obligation to redeem the shares did not cause a liability, or dollar-for-dollar reduction of enterprise value. Instead, it held that a willing and able buyer looking to acquire the 20% share in question would pay more than $2,000,000 since the total value of the enterprise would be $12,000,000 and not $10,000,000. <u>Therefore, for estate tax purposes of the deceased owner's estate, the value would be $2,400,000 ($12,000,000 x 20%)</u>, despite the estate only receiving $2,000,000 of life insurance proceeds in exchange for its shares.

Alternative Buy-Sell Structures - Each Present Their Own Complications

Additional alternative structures of BSAs already explored in this piece include the **trusteed buy-sell agreements**, which is somewhat of a "hybrid" between the cross-purchase and entity redemption agreements whereby a Trust is set up to own and also be the beneficiary of life insurance policies for all owners of a business entity. Upon the passing of one, the Trust would receive the death benefit and use those monies to purchase the shares of the deceased owner. However, this could potentially result in a transfer for value issue to the remaining shareholders, so again you should consult with you attorney.

Another option includes establishing a **special purpose limited liability company (SPLLC)** for the specific purpose of owning, managing, and funding life insurance contracts on the various owners of an operating entity, per the terms of its buy-sell agreement. This too presents complications, one of which being the BOI (beneficial ownership reporting) requirements of all new entities under the Corporate Transparency Act, as well as the cost of creating, setting up and maintaining a separate entity.

Estate exemptions are currently at historical highs ($13.61MM per individual) but are scheduled to be cut in half starting January 1, 2026, when (if) the 2017 Tax Cut and Jobs Act sunsets at the end of 2025. A lower estate tax exemption would make the issues raised by <u>Connelly</u> even more important.

Business Owners - No Estate Tax Issues, Still Complications (Income Tax)

Even if you do not have a current taxable estate, you should still review your entity's buy-sell agreement for any potentially unwanted or unintended income tax-based consequences, which could result from a specific business' entity type, accounting method (cash vs accrual), transfer for value limitations defined in IRC Section 101(a)(2). and also for the owners' current goals.

The Connelly decision is still very new, because of that it is not yet abundantly clear that there is a "right way" to proceed, furthering the point that now is a good time to review your current buy-sell agreements, regardless of your expected estate tax exposure, and if one does not exist but one is needed, to consult your advisors on how to implement one that fits best for you and your business.

We appreciate the confidence you have placed in Wellspring to be your trusted advisor. Please feel free to contact us at any time to discuss changes to your financial situation.

Sources:

1. Wolters Kluwer, Dave Griswold: https://www.wolterskluwer.com/en/expert-insights/drafting-an-effective-buy-sell-agreement
2. BLBB Advisors, Robert Flood: https://blbb.com/articles/trusteed-cross-purchase-buy-sell-agreements

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