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Entity-redemption buy-sell planning after *Connelly v. U.S.*

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-XXXX (8th Cir. 2023), is getting a lot of attention in succession planning circles about what planning will be accepted and respected.

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 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 $3.5M 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 $3M 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 $3M as the value of his 77% business interest (valuing the company at $3.89M). 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 $6.86M 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 of all, we recognize that this is a decision from the Court of Appeals in the Eighth Circuit and is therefore controlling in the federal courts of the Eighth Circuit. It takes issue with the interpretation of a 2004 case from the Eleventh Circuit, *Estate of Blount v. Commissioner*, 87 T.C.M. (CCH) 1303, 1319 (2004), without distinguishing it on the facts. Whatever we make of the *Connelly* decision, it is not controlling outside the Eighth Circuit, though it may be considered persuasive. Secondly, 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. The IRS and the courts had already disregarded the contract under IRC §2703, so it is impossible to know how the decision would have read if the business owners had substantially complied with all of the agreement provisions. 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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MLINY070723371-1