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 6, 2024, by the United States Supreme Court, *Thomas A. Connelly, in his Capacity as Executor of the Estate of Michael P. Connelly, Sr., v. United States*, 602 U.S. **** (2024), may change the succession planning landscape. More specifically, based on the Court's decision, entity redemption buy-sell plans may become a less attractive option for business owners due to guidance on how life insurance is treated when calculating fair market value for estate tax purposes.

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 that 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 price that the buyer(s) must pay for the business interest. This is tricky, of course, because the purchase is to happen at some point in 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 of the company 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

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

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).

When Michael died in 2013, Thomas, as executor of Michael's estate and the sole surviving owner of the company, and Michael's son, as surviving heir of the estate, negotiated the value of Michael's shares to be $3 million for redemption purposes. 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 Eighth Circuit Court of Appeals 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 Supreme Court agreed to hear the case and unanimously agreed with the lower courts. The Supreme Court held that a contractual obligation to redeem shares does not diminish the value of those same shares for purposes of the federal estate tax.

In its decision, the Court reasoned that in calculating the estate tax, the value to be included is based on the fair market value at the time the person died, before any redemption obligation. Additionally, the Supreme Court unequivocally dismissed Thomas's argument that including life insurance proceeds earmarked for redemptions as an asset for estate tax purposes would frustrate succession planning for closely held businesses. The Court stated that even though that may be true, it is simply a consequence of how they chose to structure their arrangement (i.e., as an entity redemption plan).

What now

What must we take from the *Connelly* case with respect to entity-redemption plans going forward? The facts and circumstances of each business entity and its shareholders must be considered when determining the appropriate type of buy-sell arrangement to use. If estate taxes are not a concern, then an entity-redemption plan can still be a viable option. The Court noted (in a footnote) that there could be circumstances where a redemption agreement would reduce the value of a business, although the example given suggests a narrow exception. 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.

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