

Revisit Your Buy-sell Agreement in Light of the U.S. Supreme Court's *Connelly* Decision

Buy-sell agreements are essential estate and succession planning tools for many family businesses and other closely held companies. These agreements, among other things, ensure that the business stays within the family or other ownership group.

Typically, this is accomplished by providing that if an owner dies or leaves the business, the company or the remaining owners are permitted or required to purchase his or her interest. Often, life insurance is used to fund the buyout.

Most buy-sell agreements include a mechanism for setting the buyout price, and if certain conditions are met, that price can establish the value of a departing owner's interest for estate tax purposes.

Last summer, in *Connelly v. United States*, the U.S. Supreme Court held that corporate-owned life insurance proceeds used to fund a buyout under a buy-sell agreement had to be included in the corporation's value for estate tax purposes and weren't offset by the corporation's obligation to redeem a deceased shareholder's stock.

What happened in *Connelly*?

In the *Connelly* decision, two brothers owned a building supply corporation. They signed a buy-sell agreement providing that, if one brother died, the survivor had the option to purchase his shares; otherwise, the corporation would be required to redeem the shares. The corporation obtained \$3.5 million life insurance policies on each brother to fund such a redemption.

One of the brothers died in 2013. At the time, he owned 77.18% of the corporation's outstanding shares and the surviving brother owned the remaining 22.82%. The survivor declined to purchase the shares, triggering the corporation's obligation to redeem them.

Although the buy-sell agreement set forth procedures for establishing the price for the corporation's shares, the brothers had never followed them. Instead, in this case, the surviving brother and the deceased brother's son agreed on a purchase price of \$3 million. This was the value reported on the deceased brother's estate tax return. The IRS claimed that the shares should have been valued at \$5.3 million and assessed almost \$900,000 in additional estate taxes.

In connection with this dispute, the estate's valuation expert valued the company at \$3.86 million, meaning the deceased brother's 77.18% interest was worth about \$3 million. In valuing the company, the expert excluded the \$3 million in insurance proceeds used to fund the buyout, reasoning that they were offset by the obligation to redeem the stock. The IRS disagreed and asserted that the \$3 million in insurance proceeds should be added to the corporation's value, for a total value of \$6.86 million. Under the IRS's argument, the deceased brother's shares were worth 77.18% of \$6.86 million, or approximately \$5.3 million.

The U.S. Supreme Court sided with the IRS, holding that the life insurance proceeds were a corporate asset that increased the company's value and weren't offset by the company's obligation to redeem the shares.

What's next?

The *Connelly* decision leaves many questions unanswered. For instance, would the result have been different if the brothers had followed the valuation procedures outlined in their buy-sell agreement? The court also limited its ruling to the specific facts of the case, suggesting that there could be situations in which a corporation's obligation to redeem shares under a buy-sell agreement would reduce its value.

Nevertheless, in light of this decision and its potential tax implications, family and closely held business owners should review their buy-sell agreements with their tax and estate planning advisors and consider alternative structures if appropriate. For example, some companies may want to consider cross-purchase arrangements, under which the surviving shareholders, rather than the corporation, purchase a departing shareholder's stock and the shareholders use life insurance policies on each other's lives to fund such a buyout.