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Connelly – US Supreme Court decision hinders entity buy-sell arrangements

When it comes to succession planning, entity purchase agreements are a popular solution with business owners. Under an entity purchase plan, upon the death of an owner, the *business* buys the deceased owner's shares. To fund this obligation, the business frequently owns a life insurance policy on each business owner.

In the recent case of *Connelly v. US*,[1] the United States Supreme Court ruled that life insurance proceeds paid to a business inflate the fair market value of the business, but that the business entity's obligation to redeem a shareholder does not correspondingly reduce the value. As such, for estate tax purposes, the deceased business owner's interest is increased by the life insurance proceeds received by the business in proportion to the owner's percentage of ownership.

Overview of Connelly case

In the Connelly case, two brothers owned a small building supply company. Michael Connelly owned 77.18% and Thomas Connelly owned 22.82%. The brothers entered into a wait-and-see buy-sell agreement, which provided that at the first death, the surviving owner had a right to buy the deceased owner's shares, followed by a mandatory entity purchase if the survivor declined to purchase them. To set the purchase price, the agreement required that the owners annually complete a "Certificate of Agreed Value" (setting the price by "mutual agreement"), or if that was not done, they were required to get two or more appraisals to set the fair market value.

The company purchased $3.5 million of life insurance on each brother to fund the entity purchase agreement. Michael died in October 2013 and the company received the death benefit. Although required by the agreement, no Certificate of Agreed Value existed, and no appraisal was done. Instead, Thomas and Michael's estate simply agreed that Michael's business interest for the purpose of the buy-out would be $3 million (77.18% of the $3.86 agreed upon business value). The company used $3 million of the policy's death benefit to purchase Michael's interest from his estate.[2] For estate tax purposes, the estate reported Michael's business interest as having a value of just $3 million, as that is what it received in the redemption. Effectively, Michael's estate viewed the $3 million in proceeds received by the company as offset by the $3 million purchase obligation, thereby not increasing the value of the company or of Michael's interest in the company.[3]

The IRS – and ultimately the US Supreme Court – disagreed with the view of Michael's estate. The Court ruled that the life insurance proceeds increase the value of the business (from $3.86 million to $6.86 million). The estate agreed, but argued that the purchase obligation was a liability that offset the value of the proceeds, thereby reducing the value of the business.

The Court disagreed, stating that "a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself."[4] The Court also stated that, for calculating the estate tax, the whole point is to assess how much the decedent's shares were worth

at the time that he died – after the life insurance death benefit is taken into account, but *before* the company spent money on the redemption payment ($3 million to Michael's estate).[5]

Ultimately, the Court agreed with the IRS that, when taking into account the life insurance proceeds, the company owned by the Connelly's was worth $6.86 million at the time of Michael's death, so that his 77.18% interest was worth nearly $5.3 million, not the mere $3 million claimed by the estate. The additional estate tax ($889,914) imposed by the IRS was thus justified.[6]

Can't a buy-sell agreement "lock in" the value for estate tax purposes?

Federal tax law is somewhat muddled on this point, but generally it *is* supposed to be possible for a buy-sell agreement to set a value not only for a purchase obligation, but also set the value for gift and estate tax (transfer tax) purposes as well.

Long-standing guidance – principally Revenue Ruling 59-60 and Treasury Regulation § 20.2031-2(h) – instructs that, for a buy-sell agreement to set a value for estate tax purposes, the following criteria must be met:

1) The price must be fixed or determinable pursuant to a formula under the agreement.
2) The estate must be obligated to sell at death at the agreement price.
3) The agreement must prohibit the owner from disposing of his or her interest during life without first offering it to the other party or parties, at no more than the agreement price.
4) The agreement must be a bona fide business arrangement, and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth.

Internal Revenue Code (IRC) § 2703 has added (somewhat redundant) guidance when a *family* business is involved. It states that a buy-sell agreement to acquire property at less than fair market value will be disregarded for federal transfer tax purposes, unless certain requirements are satisfied.[7] The agreement must:

5) Be a bona fide business arrangement.
6) Not be 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.
7) Have terms that are comparable to similar arrangements entered into by persons in an arms' length transaction.

These final three criteria are deemed to be met in a non-family owned business (if over 50 percent of the business is not owned by the family of the transferor (decedent)).[8] Generally, "family" includes any lineal descendants of the parents of the transferor or the transferor's spouse (so, includes parents, children, siblings, nephews and nieces, and in-laws).[9] A family owned business might invite greater scrutiny.

Why didn't the Connelly's agreement lock-in the estate tax value?

In *Connelly*, both the IRS and Connelly's estate agreed that the buy-sell agreement did not meet the above criteria, so it did not lock-in the estate tax value. Specifically, the buy-sell agreement did not

meet the first criteria, i.e., it did not fix a value nor did it contain a formula for determining a value. Additionally, although the agreement called for a yearly valuation, or an appraisal at death, the Connelly family did neither (though they got an appraisal after litigation commenced).

Interestingly, the US Supreme Court's opinion gave virtually no recognition to the possibility that a buy-sell agreement could lock-in an estate tax value and stated, somewhat dismissively – and perhaps in contradiction with previously established law – that, "[a]lthough such an agreement may delineate how to set a price for the shares, it is ordinarily not dispositive for valuing the decedent's shares for the estate tax. See [IRC] § 2703."

What to do now

Time will tell what techniques will be acceptable in the eyes of the IRS and the estate planning bar. In the meantime, here are some ideas for executing buy-sell arrangements in reaction to *Connelly*.

A. If not wealthy enough to attract an estate tax, don't worry

The *Connelly* opinion inflates the value of a decedent's business interest for estate tax purposes. Those below the estate tax exemption amount (scheduled to be about $7 million per person starting in 2026), even if counting the life insurance proceeds, generally don't have to worry about the effect of the *Connelly* decision. Entity buy-sell plans funded with business-owned life insurance should be no problem.

Then again, the exemption has changed several times in the past few decades and it's hard to predict whether the amount will be sufficient to potentially avoid estate tax at the time of death. Simply counting on not being wealthy enough to get hit with the estate tax might not seem safe to some business owners.

B. Draft the agreement to have a fixed or determinable value – and follow the agreement

As stated above, the buy-sell agreement in *Connelly* did not meet the first criteria of having a value that was fixed or determinable by a formula. In theory, an entity purchase buy-sell agreement should still be able to do this, and have that value carry the day for estate tax purposes too. What's more, it seems that any such fixed or formula value could be written to exclude life insurance death proceeds. For example, it could call for a formula based on a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA), determined as of the last day of a fiscal year before the triggering death occurs. Or maybe (or additionally), it could simply expressly exclude life insurance proceeds.

Of course, *family* business situations give more pause. Even if the buy-sell agreement sets a fixed or determinable value, it has to also not be a device to family for less than full and adequate consideration. That's pretty close to saying it can't set a value that is lower than fair market value, so it might open the door to an IRS argument that it can, as it did in *Connelly*, ignore the buy-sell agreement and make a fresh inquiry into fair market value.

Even outside of a family situation, the *Connelly* decision causes some concern due to how dismissive it was of the notion that a buy-sell agreement often can set the value of estate tax

purposes. Given the short shrift the Supreme Court gave to this possibility, one can imagine that some estate planners might now be reluctant to rely on Revenue Ruling 59-60 and similar legal guidance.

C. Use a *cross-purchase* instead of an entity purchase

This approach was suggested by the US Supreme Court itself in *Connelly*. Namely, if you don't like the effect of life insurance being paid to the entity, then consider entering into a cross purchase agreement funded with policies that are owned outside the business or are payable to individuals. Below are several ways to arrange policies to carry out a cross purchase, along with comments about their various benefits and considerations.

1. Cross-own policies

This is the traditional set-up. This means that, if there are three owners – A, B, and C – then A would own and be the beneficiary of one policy on B's life and one on C's life. Likewise, B would own and be the beneficiary of one policy on A and one on C. And C would in turn own and be the beneficiary of one policy on A and one on B.

This works fine estate tax-wise, but the downside is that the number of policies needed can quickly become unwieldly. With two owners, only two policies are needed. But with three owners, six policies are needed. With four owners, twelve policies are needed. The formula for the number of policies needed is "Number of Owners x [Number of Owners – 1]."

2. Have policies owned in Business Continuation General Partnership (BCGP)

This potential solution calls for the creation of a new entity – a partnership, or an LLC taxed as a partnership. This Business Continuation General Partnership (BCGP) is designed to hold one policy on each business owner in the operating company. Each business owner is an insured on a policy on his life owned by the BCGP, and each insured is a partner in the BCGP.

The key, however, is that each policy is "specially allocated" to the non-insured partners.[10] As such, the policy insuring A is specially allocated to B and to C. The policy on B is specially allocated to A and to C. And the policy on C is specially allocated to A and to B.

When A dies, the death benefit is paid to the BCGP that owns the policies. Importantly, the special allocation means that the death benefit will be allocated only to still-alive partners B and C. This means that the death benefit coming into the BCGP raises the basis of only B and C in their BCGP interest. It does not raise A's basis in the BCGP. Given that B and C now have their bases raised, the death proceeds can be distributed from the BCGP to only B and C, lowering their respective basis in BCGP – tax-free – to where it was before the death benefit came into BCGP.

Next, B and C can use the newly obtained cash to carry out the cross purchase from A's estate of the operating business.

Here, there is the question of whether the death benefit coming into the BCGP raises the value of A's partnership interest in the BCGP, akin to how the *Connelly* court raised the value of

deceased Michael's interest in the company. Presumably, this shouldn't be a problem. The death benefit coming into the BCGP is specially allocated to B and to C, and it hopefully would be honored due to it having substantial economic effect – the proceeds are in fact distributed only to B and to C – so it seems that for A, neither the value nor the basis in the BCGP should increase.

3. **Trusteed (or escrow) cross-purchase**

Under a trusteed (or escrowed) cross purchase buy-sell design, the trustee/escrow agent is the owner and holder of life insurance policies funding the agreement (one policy per business owner).

The trustee/escrow agent is effectively a conduit or nominal owner and beneficiary – acting as owner and beneficiary of the policy insuring owner A on behalf of owners B and C, and so on down the line. Upon death of a business owner, the trustee/escrow agent collects life insurance death proceeds and oversees completion of the cross-purchase sale transaction.

However, a trusteed or escrow cross purchase arrangement could cause the life insurance death proceeds to be treated as taxable income to the beneficiaries if there's a violation of the transfer for value rule. To remedy this, the business owners may also want to enter into a partnership elsewhere, so that any transfer meets the exception for being transferred to a "partner of the insured."[11] In addition, if the arrangement is not carefully drafted and administered – e.g., the agreement must be clear that the policy on A is held for B and C – a trusteed or escrow cross purchase buy-sell arrangement could also cause inclusion of death proceeds in a deceased business owner's taxable estate if the insured has too much control over their own policies.

4. **Cross-endorse policies**

Though this is an uncommon set-up, it may achieve more traction in light of the *Connelly* decision. Consider again the three business owners: A, B, and C. With a cross-endorsement, A would own one policy on his own life. He would then endorse death benefit to B and to C pursuant to a split dollar arrangement. Similarly, B would own a policy on her own life, and would endorse death benefit to A and to C. In turn, C would do the same, owing a policy on himself and endorsing to A and to B.

If A dies, the death benefit goes to B and C, and it would not inflate the value of the business. Owners B and C would use the death proceeds they receive to buy business interests from deceased A's estate, pursuant to their cross-purchase obligation.

The two main downsides to this technique are (i) estate inclusion for A, since he owns a policy on himself, and (ii) income taxable death benefit to B and C, due to receiving proceeds in violation of the transfer-for-value rule.[12] Both downsides may be fixable. As for estate inclusion, A's estate can argue for an estate tax deduction for endorsed death benefit per IRC § 2053(a)(4) (mortgaged property), as was permitted in Private Letter Ruling 90-26-041. As for the transfer-for-value, the parties can first join a partnership, so that the endorsed death benefit meets the "transfer to a partner of the insured" exception.

5. **Cross-own policies, but have multiple owners on one policy**

   This is similar to the traditional set-up, except that regardless of how many owners there are, there would be only one policy on each insured business owner. For example, if there are three owners – again A, B, and C – there would be only one policy insuring A, but B and C would be co-owners and co-beneficiaries of this one policy. Likewise, the one policy insuring B would have A and C as its co-owners and co-beneficiaries. And, similarly, the one policy insuring C would have A and B as co-owners and co-beneficiaries.

   If A dies while the plan is in place, B and C receive death benefit from the one policy they co-own, and use those funds to buy from deceased A's estate.

   This reduces the number of policies needed, but there is a somewhat hidden transfer-for-value, which may result in an income taxable death benefit. When A dies, his interest in the policy insuring B will generally transfer to co-owner C, and A's interest in the policy insuring C will generally transfer to co-owner B. To remedy this, the parties may first want to enter into a partnership elsewhere, so that any transfer meets the exception for being transferred to a "partner of the insured."

   Another downside is that, even with one policy per insured, some clients may find having multiple owners on one policy to be problematic. If one policy has two owners, you will need two signatures to do anything with the policy (e.g., change the dividend option). If there are three owners, you will need three signatures. This may prove to be too cumbersome for some people to want to endure.

6. **Have the business own policies, but endorse to non-insured owners**

   This technique is similar to the cross-endorsement, but here, the *business* owns the policies – one on each insured business owner – and then endorses death benefit per a split dollar agreement to the other, non-insured, business owners.

   The two main downsides to this technique are the same as they are for cross-endorsement. First, insured owner A could have estate inclusion if the business' "incidents of ownership" in the policy are attributed to him. This happens with a corporation if he is a majority owner, and happens in a partnership if he is a general partner or otherwise can control the policy.[13] Nonetheless, the potential solution is the same as with a cross-endorsement, i.e., argue for an estate tax deduction for endorsed death benefit per IRC § 2053(a)(4) (mortgaged property), as was permitted in Private Letter Ruling 90-26-041.

   Second, there again is a transfer-for-value problem. But again, a solution could be to have the parties first join a partnership, so that the endorsed death benefit meets the "transfer to a partner of the insured" exception.

Conclusion

Business owners who face an estate tax may want to be more thoughtful before entering into entity purchase buy-sell agreements. The agreement should either fix a buy-out value or provide a value that

is determinable pursuant to a formula, and that excludes life insurance proceeds. And it's vital that the parties closely obey the terms of their agreement.

Others may want to avoid entity purchase agreements and turn to cross-purchase agreements instead. There are multiple ways to arrange the plan and its policies, each with its own benefits and considerations.

Finally, the *Connelly* decision demonstrates just how important it is to review buy-sell agreements to avoid unexpected results. Principal® offers complimentary buy-sell reviews, as well as a variety of sample documents that can be provided to clients' attorneys as a template. These agreements include language for provisions we suggest in our *Insurance-Related Best Practices*.[14]

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[1] *Connelly v. US*, No. 23-146, 602 U.S. ______ (June 6, 2024).

[2] The remaining $500,000 of death benefit was kept by the company to maintain operations.

[3] In a similar case about 20 years ago, the Court of Appeals for the Eleventh Circuit determined that the death benefit flowing into the company was in fact offset by the company's liability (buyout obligation). *Estate of Blount v. Comm'r,* 428 F.3d 1338 (11th Cir. 2005). The *Blount* decision is now effectively overruled by the new *Connelly* decision.

[4] The Court gave an example of a corporation holding $10 million in cash (the only asset in this example) and with 100 outstanding shares, so that each share is worth $100,000 ($10 million ÷ 100 shares). This hypothetical corporation also has 2 shareholders: one shareholder holds 80 shares worth $8 million (80 x $100,000); and the other holds 20 shares worth $2 million (20 x $100,000). If the shareholder with 20 shares is redeemed at fair market value, the corporation would pay $2 million cash. The other shareholder's 80 shares would thereafter still be worth $100,000 each, and would overall still be worth $8 million, it is just that 80 shares would now represent 100% ownership of the remaining (smaller) business. The salient point is that the value of each shareholder's interests after the redemption – one shareholder's 80 shares, and the other shareholder's $2 million in cash – would be equal to their respective interests in the corporation before the redemption. Again, the entity's purchase obligation does not, itself, reduce the value of any shares.

[5] The Court talks out of both sides of its mouth a bit here. In a footnote near the end of its opinion, it states 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' position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more." (emphasis in original).

[6] In 2013, the estate tax exemption was just $5,250,000. The rate was 40%.

[7] IRC Secs. 2703(a) and 2703(b).

[8] Treas. Reg. § 25.2703-1(b)(3).

[9] *Id.* and Treas. Reg. § 25.2701-2(b)(5).

[10] See Treas. Reg. § 1.704-1(b)(2) for a description of special allocations and the requirement that they have substantial economic effect.

[11] See IRC § 101(a)(2).

[12] A third downside is that the parties have to account for the one-year term rate of the endorsed death benefit, and this dollar figure gets higher as the insureds get older.

[13] See Treas. Reg. § 20.2042-1(c)(6); and Rev. Rul. 83-147.

[14] See *Insurance Related Best Practices Guide for Buy-Sell Agreements*, BB11258.

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