



Buy-Sell Agreements After Connelly

James M. Rosa, CPA, PFS

Robert J. Zahner, CPA/ABV, ASA, CVA

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Buy-Sell Agreements

- Sometimes called:
 - Buy-sell agreements
 - Shareholder agreements
 - Close corporation agreements
- Applies to any entity owned by more than one person, whether a corporation, partnership, or LLC
- Provisions in a partnership or LLC are included in the partnership or operating agreement



Buy-Sell Agreements



Common types of buy-sell agreements

- Redemption agreements
- Cross-purchase agreements
- Hybrid agreements
- Special Purpose Buy-Sell Insurance LLC

Buy-Sell Agreements

REDEMPTION AGREEMENTS

- The owner of a business entity and the entity itself (whether it is a corporation or a partnership, including an LLC treated as a partnership for tax purposes) enter into a contract
- The owner agrees to sell his or her ownership interest to the entity according to the price, terms, and circumstances specified in the contract
- A redemption agreement may also require the estate of a deceased owner to offer the ownership interest to the entity at the price and terms specified in the agreement

Buy-Sell Agreements

CROSS-PURCHASE AGREEMENTS

- A contract between the owners of a corporation, partnership, or LLC
- Under this arrangement, the owners agree to offer their ownership interests for sale to the other owners at the price and terms designated in the contract
- In the event of an owner's death, the estate normally must offer the decedent's ownership interest for sale to the other owners at the specified price and terms
- If there is no third-party buyer, the other owners are generally obligated to buy the interest in the event of certain circumstances (e.g., death, disability, or retirement)
- Thus, a cross-purchase agreement is essentially a right of first refusal combined with a purchase obligation (or option)

Buy-Sell Agreements

HYBRID AGREEMENTS

- The owners of a business contract both with the entity and with the other owners
- Upon certain events, the owners agree to offer their ownership interests for sale to the entity and/or the other owners at a price and terms specified in the contract
- The same is true for the estate of a deceased owner
- Some hybrid agreements provide that the ownership interest will be offered first to the entity and then to the other owners if the entity does not buy the interest
- In other agreements, the owners may have the option to purchase the interest with the entity required to redeem it if the other owners decline to exercise their option

Buy-Sell Agreements

TYPICAL ISSUES FOR BUY-SELL AGREEMENTS

- Restricting ownership transfers and requirements to transfer ownership by sale, gift, owner bankruptcy, divorce or at death
- Consider whether to allow gifting and transfers to family members and transfers to other shareholders upon approval by a specified percentage of all shares
- The agreement should define who are permitted transferees
- Defining what happens at the death, disability or withdrawal, encumbrance of shares
- Determination of value
- Payment provisions
- Funding the buy-sell
- Management decisions
- Limitations on borrowing
- Admission of new owners
- Acquisition of businesses
- Approval of budgets
- S corporation provisions

Buy-Sell Agreements

S CORPORATION PROVISIONS

- Require maintaining eligible S corporation ownership
- Approval of trusts as shareholders
- Allocation of income or loss in year of a change of ownership
- Distribution for taxes
- Valuation and payout provisions
- Approval of termination of S election



Buy-Sell Agreements

SPECIAL PURPOSE BUY-SELL INSURANCE LLC

- LLC formed to own life insurance on all the owners
- Only one policy is needed per owner
- Insurance LLC is separate from the operating companies
- Members of the LLC are the owners of the businesses, but successor owners may be Members
- Each Member contributes to the LLC to fund premiums
- LLC Operating Agreement must address allocation of death benefit
- At the death of a Member, the death benefit may first distribute to the surviving Members to fund the buy-sell obligation
- If the death benefit exceeds the aggregate value of the purchase price, then the excess may to be distributed to the estate of the deceased Member or however else agreed

Buy-Sell Agreements

SPECIAL PURPOSE BUY-SELL INSURANCE LLC

- Operating business buy-sell agreements must be coordinated with Insurance LLC operating agreement
- If an owner exits from the business, the Insurance LLC may allow for the distribution of the policy to each of the insured business owner for use in the owner's estate plan
- Avoids transfer for value issues
- Allows increase to the surviving business owners' basis in the operating companies
- Provides creditor protection
- Insurance LLC must comply with Employer Owned Life Insurance Notice and Consent and file Form 8925 with the IRS each year

Buy-Sell Agreements

Will a buy-sell agreement define value for estate tax purposes?

- An agreement to set the value of a business among unrelated owners will generally be respected by the IRS
- Agreements among related parties are subject to more scrutiny
- Requirements:
 - It is a bona fide business arrangement
 - It is not a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth
 - At the time the agreement or restriction is created, its terms are comparable to similar arrangements entered into by persons in arm's-length transactions

Connelly v. United States Case Review and Business Valuation Impact



Presented by

Robert J. Zahner, CPA/ABV, ASA, CVA

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FACT PATTERN

- Michael and Thomas Connelly were brothers and the sole shareholders in Crown C Supply, a small building supply corporation (Michael 77.18%; Thomas 22.82%).
- The brothers entered into a Stock Purchase Agreement to ensure the company would remain in the family if either brother died — basically a buy-sell agreement with death as a triggering event.
- Pursuant to the agreement, the surviving brother would have the option to purchase the deceased brother's shares.
- If he declined, Crown itself would be required to redeem the shares.
- Company obtained \$3.5 million in life insurance on each brother (company-owned life insurance).
- At some point, was reduced to \$3 million.
- Michael died on October 1, 2013.
- Thomas elected not to purchase Michael's shares, triggering Crown's redemption obligation.

STOCK PURCHASE AGREEMENT SUMMARY

- August 29, 2001
- Agreed upon value (certificate of value): \$5 million
- Set a process to determine FMV: Crown and the estate of the deceased brother were to select separate appraisers. If the two appraisal conclusions were more than 10% apart, the appraisers were to select a third appraiser, who would provide an opinion of FMV
- At the time of Michael's death, no agreed upon certificate of value
- Instead of following the SPA, Michael's son and Thomas agreed in an "amicable and expeditious manner" that Michael's shares were worth \$3 million
 - Interestingly, less than the original \$5 million

FACT PATTERN *(continued)*

- Crown redeemed Michael's 77.18% interest for \$3 million
- Thomas filed a federal estate tax return which reported the value of Michael's shares as \$3 million
- IRS audited the return
- During the audit Thomas obtained a valuation from an outside accounting firm
 - \$3.86 million value
 - Excluded the \$3 million life insurance proceeds
- IRS disagreed, saying Crown's redemption obligation did not offset the life insurance proceeds
 - Assessed a total value of \$6.86 million (\$3.86 million operating equity plus \$3 million life insurance proceeds)
 - Michael's shares valued at \$5.3 million
 - Estate owed an additional \$889,914 in taxes

Connelly v. United States



DECISION

- District Court granted summary judgement to the government
- Eighth Circuit Court of Appeals affirmed
- Supreme Court granted writ of certiorari
 - Decision was rendered June 6, 2024

Connelly v. United States

BLOUNT v. COMMISSIONER

- US Court of Appeals, Eleventh Circuit
- October 2005
- Primary takeaway: Life insurance used as a funding vehicle to pay a company's repurchase liability upon the death of a shareholder does not add to the value of the company for federal gift and estate tax purposes



BLOUNT *(continued)*

- Tax Court decided that the life insurance proceeds should **not** be offset by a stock redemption payable because the buy-sell agreement in place had been disregarded as irrelevant for estate tax purposes
 - Tax Court had found that the buy-sell was not binding nor was it comparable to an arm's length transaction
- Eleventh Circuit reversed the decision
 - “Even when a stock purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company. To suggest that a reasonably competent business person interested in acquiring the company would ignore a \$3M liability strains credulity and defies any sensible construct of fair market value.”
- Focus here seems to be on the overall value of the company after the impending redemption

...BACK TO CONNELLY

- Decision: Supreme Court unanimously affirmed the Eighth Circuit's decision
 - Redemption obligation **did not** offset the life insurance proceeds
- Narrow focus:
 - Did not appear to reject the Eleventh Circuit's decision in Blount
 - Simply rejected Thomas Connelly's argument that the Blount case called for redemption obligations to offset life insurance proceeds
 - Even still, would not rely upon the Blount decision in light of Connelly
- No record of an appraisal conducted on behalf of the IRS

OPINION DISCUSSION

- Central Question: whether the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares
- All agree that:
 - The value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value
 - Life insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value
- Connelly argued that anyone purchasing a subset of the corporation's shares would treat the life insurance proceeds and related redemption obligation as canceling each other out
- Government argued that no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability

OPINION DISCUSSION

- Court agreed with the government
- “An obligation to redeem shares at fair market value does not offset the value of life insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder’s economic interest”
- “Thomas’s argument that the redemption obligation was a liability cannot be reconciled with the basic mechanics of a stock redemption”
- The Court said that Thomas views the relevant inquiry as what a buyer would pay for shares that make up the same percentage of the less-valuable corporation that exists after the redemption
 - But, for calculating the estate tax, the whole point is to assess how much Michael’s shares were worth at the time that he died – before Crown spent \$3M on the redemption payment

Connelly v. United States

COURT EXAMPLE

- Corporation with \$10 million in cash
- Shareholder A: 80 shares
- Shareholder B: 20 shares
- Each individual share is worth \$100,000
- A's shares worth \$8 million
- B's shares worth \$2 million



Connelly v. United States

COURT EXAMPLE

	Pre-Redemption		Post-Redemption	
Operating Equity Value		\$ 10,000,000		\$ 10,000,000
Non-Operating Assets		-		-
Redemption Payment		-		(2,000,000)
Total Equity Value		10,000,000		8,000,000
Outstanding Shares		100		80
Per Share Value		100,000		100,000
Shareholder A	80	8,000,000	80	8,000,000
Shareholder B	20	2,000,000	-	-
Total		10,000,000		8,000,000
Value to Shareholders				
Shareholder A Stock		\$ 8,000,000		\$ 8,000,000
Shareholder B Stock		2,000,000		-
Shareholder B Redemption		0		2,000,000
Grand Total		10,000,000		10,000,000

Equity value decreases, but per share value does not

No difference, so why dilute for impending redemption?

Connelly v. United States

BETTER EXAMPLE

	Pre-Redemption		Post-Redemption	
Operating Equity Value		\$ 10,000,000		\$ 10,000,000
Non-Operating Assets		2,000,000		2,000,000
Redemption Payment		-		(2,400,000)
Total Equity Value		12,000,000		9,600,000
Outstanding Shares		100		80
Per Share Value		120,000		120,000
Shareholder A	80	9,600,000	80	9,600,000
Shareholder B	20	2,400,000	-	-
Total		12,000,000		9,600,000
Value to Shareholders				
Shareholder A Stock		\$ 9,600,000		\$ 9,600,000
Shareholder B Stock		2,400,000		-
Shareholder B Redemption		0		2,400,000
Grand Total		12,000,000		12,000,000

Include because triggered at death

Notice that the redemption payment is greater than the insurance proceeds

Exiting shareholder receives their share of FMV, including the non-operating assets

OPINION DISCUSSION *(continued)*

- Court noted that Thomas was arguing that Crown had the same value before and after the redemption, but that Thomas now owned 100% of the company.
- I believe it to be a timing issue
 - Those that agree with Connelly see it as value prior to the triggering event (death) being equal to value after redemption
 - i.e., \$3.86M value before death, plus the \$3M life insurance after death, less \$3M after the redemption = the same \$3.86M
 - Those that agree with the IRS's logic see it as an increase in value at death due to the existence of the non-operating life insurance proceeds. Thereafter, a redemption at FMV does not reduce value per share, and the hypothetical buyer would be paid for his or her portion of the non-operating life insurance proceeds.

Connelly v. United States

OPINION DISCUSSION *(continued)*

- Think about how stock buybacks work with publicly traded companies — supports SCOTUS's decision
 - Equity value isn't reduced by expected cash outlay for the buybacks
 - In fact, the stock price typically increases

CONTRASTING THE CONNELLY AND BLOUNT DECISIONS

Blount:

- Tax Court's reasoning for disregarding the redemption payable was that the buy-sell agreement in place had been disregarded for estate tax purposes
 - This didn't resonate with the Court of Appeals
- Focus is on the overall value of the company after the impending redemption

Connelly:

- Reasoning for excluding the redemption payable has nothing to do with whether the agreement is disregarded, rather, the mechanics of a typical stock redemption
- Focus is on the overall value immediately after death
- True that the redemption reduces overall value, but per share value is unchanged
- Exiting shareholder receives fair share of value, including non-operating assets



Connelly v. United States

TAKEAWAYS

- Unwise for appraisers to offset company owned life insurance with a redemption payable
- Are the days of entity re-purchase agreements over?

TAKEAWAYS *(continued)*

- A lot of unknowns at this time, but every company with company-owned life insurance on the lives of its owners should evaluate the effectiveness of their buy-sell agreements and related life insurance
 - Circular problem — including the life insurance increases value, which increases the buyout
 - If you continue to increase life insurance, this keeps happening
 - Determine the economic and tax effects of life insurance being included as part of the valuation of the business
 - Adding a gross-up clause to the value, as finally determined by the IRS, should also be considered to ensure the FMV matches the payout to the decedent's estate. For business owners with a taxable estate, it may be prudent to change redemption agreements to a cross purchase agreement. The insurance policies could then be owned by the shareholders. It is important to avoid transfer for value when policies are transferred out of the corporation.
 - If no gross-up clause, could be dealing with a capital loss

POSITIVE TAKEAWAYS

- Footnote #2 to the Opinion: “We 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’s position that all redemption obligations reduce a corporation’s net value. Because that is all this case requires, we decide no more.”
 - Remember Example #2 previously — redemption was greater than life insurance proceeds
 - If long-term financing is required to fund the redemption, how does that impact the risk profile of the company?
 - What about its prospects for growth?
 - Key person risk associated with the deceased — if we are considering the death triggering the insurance receivable, we also have to consider the impact of the key person’s absence going forward



Connelly v. United States

POSITIVE TAKEAWAYS *(continued)*

- The Court also stated, “because redemption obligations are ***not necessarily*** liabilities that reduce a corporation’s value for purposes of the federal estate tax, we affirm the judgement of the Court of Appeals.”
 - Seems to leave the door open for instances where redemption obligations are liabilities that reduce FMV

The Presenters



James M. Rosa CPA, PFS

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Jim is a Principal in the Tax Advisory Group in the Youngstown, Ohio, office of HBK CPAs & Consultants and has been with the firm since 1986. Jim also leads the firm's Production Planning Committee which provides insurance solutions to meet business and personal objectives. He has extensive experience in personal and estate planning, charitable planning, tax-exempt organizations and individual tax and financial planning. Jim earned the Personal Financial Specialist (PFS) designation, which is awarded by the American Institute of Certified Public Accountants to recognize CPAs who provide financial planning service. Jim also has experience in tax policies, procedures and resources, which HBK uses in their tax practices. He provides counsel to high-net worth individuals throughout HBK and HBKS. He was HBK's tax practice chair for over 25 years and now focuses his efforts in working with business owners and high-net worth individuals. He is one of the firm's preeminent presenters and specializes in addressing business owners and individuals on topics such as personal tax planning, estate and gift planning, shareholder agreements, protection planning, charitable giving opportunities, exempt organization issues among many other tax and financial planning topics.

The Presenters



Robert J. Zahner CPA/ABV, ASA, CVA

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Robert Zahner is a Principal in the Downtown Pittsburgh, Pennsylvania, office of the HBK Valuation Group. He has been with the firm since 2009 and has exclusively practiced business valuation since 2014. His expertise includes appraisals for gift and estate tax planning, shareholder transactions, buy/sell and stockholder agreements, financial reporting, ESOPs, personal goodwill, intangible assets, S corporation conversions, and litigation support such as divorce and shareholder disputes.

He began his career at HBK in 2009, and his public accounting experience includes extensive involvement with businesses and individuals planning for and complying with federal, state, and local tax filing requirements, as well as financial statement analysis for attest. His years of experience as a Certified Public Accountant have given Robert valuable tax and accounting perspectives as a business appraiser.

In addition to being a CPA, Robert holds various business valuation credentials including Accredited Senior Appraiser (ASA), Certified Valuation Analyst (CVA), and Accredited in Business Valuation (ABV). He was part of NACVA's 2020 40 under 40 award class and has spoken at various seminars and continuing education events in Pittsburgh, PA and the surrounding communities. He has been admitted as an expert witness in Allegheny County, Pennsylvania, Westmoreland County, Pennsylvania, and Crawford County, Pennsylvania.

Thank you for attending



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