Is your client's buy-sell causing their estate to be taxable?

A review of Connelly v. United States of America, Department of the Treasury, Internal Revenue Service, 2021

Will the IRS value your client's business the same way your client thinks they will? A recent tax case illustrates how the IRS may have a different interpretation of that value. For many closely owned businesses, a common strategy is to implement buy-sell agreements which set forth procedures for various triggering events the owners may find themselves in. Buy-sell agreements also provide the related value and terms assessed given the event the owners are presented with. In this piece, we will discuss how the outcome of the Connelly case is driving the need for proper buy-sell planning along with proper life insurance planning.

Overview

Connelly v. Dep't of Treasury, 2021 (filed June 2, 2023)

Crown C Supply, Inc., was owned by two brothers, Michael P. Connelly, Sr. and Thomas A. Connelly. Michael was the majority owner of the business (77.18%) at the time of his death, with the remainder of the business owned by his brother Thomas (22.82%). The brothers, like many closely owned businesses, entered into a buy-sell agreement with the intent to keep the business in their family. The agreement required the business to redeem the shares of a deceased owner at the time of their death if no current shareholder wished to purchase those shares first. Michael passed away and triggered the buy-sell agreement to be enacted.

At Michael's passing, the business received a $3.5 million death benefit. Thomas, acting as executor of the estate, agreed to a redemption price of $3 million for Michael's interest in the business. The $3 million value was stated to be based on their buy-sell and agreed upon between the estate and corporation. The assessed value of the business at the time of Michael's death did not incorporate the death benefit proceeds. The IRS however saw things differently with respect to the death benefit proceeds paid to the business and added those proceeds to the overall value of the business.

The buy-sell agreement required the brothers to attach a "Certificate of Agreed Value" annually to set the valuation of the business. Many buy-sell agreements have this requirement in place as a common business practice to assist with determination of value at a triggering event. The agreement stated that failure to attach the certificate would result in the value of the business to be determined based on an appraisal.

Thomas, acting on behalf of Michael's estate, argued that the Court should have looked to the stock-purchase agreement to value the shares of the business as the agreement stipulated valuation in the event of a triggering event. The court reviewed their agreement and found that the brothers failed to state in their agreement some metric that allowed for a fixed or determinable price to which value could be determined.[1] Failure to follow this key provision allowed the court to establish their own interpretation of the value of the shares of the business. This value included the life insurance death benefit proceeds. The court also relied on 26 C.F.R. Section 20.2031-2(h), which states how shares are to be valued and that the price of stock subject to a buy-sell agreement will be determined under this section for estate tax purposes to justify the inclusion of the death benefit proceeds.

The Court found the exclusion of the death benefit proceeds paid to the business was not appropriate and the funds should be included as a business asset to determine the overall value of the business.[2] This increased the value of the business from $3.86 million to $6.86 million.

The U.S. District Court for the Eastern District of Missouri granted summary judgement to the IRS, which resulted in Michael's estate receiving $3 million in redemption of his interest as well as being taxed on a higher valuation of the business interest. This led to a $1 million additional tax liability owed by the estate. On June 2, 2023, the U.S. Court of Appeals for the Eighth Circuit affirmed the District Court's decision.[3]

Where do we pivot?

The outcome noted above should be concerning for owners of closely held businesses that have stock purchase agreements that are entity or redemption style in nature. While the Eighth Circuit Court does not control law outside of its jurisdiction, it does serve as a warning for business owners across the U.S. of how important drafting and following business agreements should be. To help mitigate the risk of similar outcomes, business owners may pivot away from traditional entity or redemption agreements for business owners and adopt the below alternatives.

Some attractive solutions business owners could consider are:

- Cross-purchase agreements
- Life insurance LLC
- Trusteed buy-sell agreements

These alternatives use funds that are either outside of the business' main entity that requires buy-sell planning or use a professional to administrate the agreed upon terms of the buy-sell. Using one of these alternatives may be a way to minimize the risk associated with the Connelly case. However, if the client follows their agreement and that agreement meets the statutory requirements to be a valid buy-sell then the risk of a similar outcome should be significantly reduced.

Conclusion

Given the outcome of this case, individuals may be wondering, "What should I do?" For many closely held businesses, a default to stock redemption at the death of a business owner is common. Careful consideration should be given to alternative buy-sell designs. Prior to any decision related to the transfer of shares via a buy-sell agreement, skilled tax and legal professionals should be engaged.

Lastly, while the court seemed to focus on the adherence of terms the Connelly's failed to follow or omitted from their agreement, a larger issue is still at the forefront of this case opinion. Should life insurance be included in the value of the business? As other courts debate the outcome of the case, financial professionals and practitioners now must have an elevated level of due diligence and attentiveness with regard to buy-sell planning.

[1] 26 U.S.C. § 2703(a), 26 U.S.C. § 2703(b).

[2] 26 U.S.C. §§ 2001, 2051, §§ 2031(a), 2033, 26 C.F.R. §§ 20.2031-1, 20.2031-2, 26 C.F.R. § 20.2042-1(c)(6).

[3] *Thomas Connelly v. United States*, No. 21-3683 (8th Cir. 2023).

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