Business Transitions: Key Updates on *Buy/Sell Agreements*

Buy/sell agreements can be an essential planning tool for privately held businesses with more than one owner. But shifting case law has cast a new light on taxability of funds generated as an outcome of a buy/sell agreement. As a tax professional serving business owners, here's what you need to know.

What is a buy/sell agreement?

A buy/sell agreement is essentially a contract governing ownership and compensation in the event of an owner's death. Without a formal Buy/Sell Agreement in place, several challenges may arise:

- **Economic uncertainty** for the family of the deceased owner.
- **Infighting among remaining owners and "new owners"** (in other words, the family/heirs of the deceased owner, who suddenly and often unexpectedly have an inherited ownership claim to the business).
- **Operational issues** in the face of potential capital, leadership, and rainmaking constraints.

Buy/Sell Agreements can be a remedy to this problem by creating an efficient and transparent sale process for a deceased owner's equity. The deceased shareholder's estate is legally bound to follow the requirements of the Buy/Sell Agreement, ensuring continuity for the remaining shareholders and the business, as well as a transparent source of liquidity for the deceased owner's heirs.

In some cases, the Buy/Sell Agreement is backed by life insurance as a funding source. The repurchase transaction required by the Buy/Sell may come in two forms:

- **Cross Purchase**: Other owners are individually obligated to purchase the deceased owner's shares.
- **Redemption**: Company itself is obligated to purchase the shares of the deceased owner.

Buy/Sell Agreements sometimes feature both in order, giving shareholders the option to engage in a cross-purchase while ultimately requiring a redemption as to any unpurchased shares. The tax ramifications of these structures may differ. The chosen structure should be the product of an intentional planning process involving the business owners and their financial, tax, and legal counsel.

What's *changed?*

In June, 2024, the US Supreme Court ruled on Connelly v. United States, with a specific tax interpretation that may affect the overall value of the business. In this case, two brothers owned a business. When one of the brothers passed away, the Buy/Sell Agreement caused the Company (rather than the surviving brother) to redeem the shares held by the deceased brother at a price agreed to by the surviving owner and the deceased brother's estate. The redemption was funded by a life insurance policy owned by the Company.

The value of the life insurance death benefit, which was received by the Company, was excluded from the value of the Company. The IRS examined the deceased brother's estate tax return and argued that the life insurance death benefit should **increase** the value of the company, and thus the value of the deceased brother's shares, for Federal Estate Tax purposes. The IRS argued this was the case even though the buy-out price agreed between the estate and the surviving brother did not increase based on the insurance proceeds.

The US Supreme Court ultimately agreed with the IRS that the life insurance death benefit increased the value of the company for Federal Estate Tax purposes. As a result, the value of the deceased brother's shares went up on a pro rata basis, thus increasing the amount due in Federal Estate Taxes.

Planning Considerations **for Business Owners under Connelly.**

The decision in *Connelly* represents just one more reason for middle market business owners and their planning teams to review their Buy/Sell Agreements. Consider these elements:

- **The Buy/Sell Arrangement:** Is there a Buy/Sell Agreement in place? If not, consider implementing one to avoid the uncertainties that might arise if an owner passes away.
- **Cross Purchase or Redemption:** Identify whether the existing buy/sell arrangement contains a cross-purchase or redemption arrangement (or both). The nature of the buy/sell structure will ultimately weigh on other related provisions and planning.
- **Valuation and Other Terms:** Consider how reasonable the terms of the Buy/Sell Agreement are — like valuation, payment arrangements, and timing — given the current state of the business and its owners. These terms can sometimes fall out of date and no longer match the needs of the owners. In that case, consider updating.
- **Formalities:** Review the Buy/Sell Agreement for annual or other formalities that the owners are supposed to perform. One formality found in some Buy/Sell Agreements is an annual requirement to agree on the value of the company. If this or other required formalities are not being performed, consider how to come into compliance.
- **Funding Mechanism:** Identify how equity purchases are funded in the event of a shareholder's death: including company owned life insurance, shareholder owned insurance, or some other funding mechanism (i.e., the shareholders or the company directly). In any case, are the funding sources adequate? Is insurance up to date? Can the company or shareholders otherwise afford the repurchase "out of pocket" if need be?
    - If the chosen funding mechanism is **life insurance,** additional considerations may apply.
    - A **valuation exercise** might be undertaken in advance to calculate company value under the guidance of *Connelly* (including company-owned life insurance held for redemption purposes). Based on the results, each owner may need to engage in additional estate planning.
    - The shareholders might consider avoiding a redemption arrangement altogether – instead **opting for a cross-purchase** which would appear to avoid the effect of the *Connelly* ruling. Doing so may require updates to the Buy/Sell Agreement as well as any underlying insurance funding arrangements.
    - **Corrective provisions** might also be added to the Buy/Sell Agreement to ensure that a deceased shareholder's estate receives the greater of the value set forth under the Agreement or the value of the shares as finally determined for Federal Estate Tax purposes in the event the value is redetermined by the IRS or courts.
    - The *Connelly* case was heard first in the US 8th Circuit Court of Appeals. In the earlier 8th Circuit decision (which also upheld the IRS position), that Court noted a failure of the shareholders to abide by the formalities of the Buy/Sell Agreement at issue. This may support the conclusion that **business owners are well served by finding ways to precisely follow the requirements of their own Buy/Sell Agreements.**

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