

The Shifting Buy-sell Landscape

If you own a business with a partner(s) beware: the buy-sell landscape has shifted significantly.

On June 6, 2024, the US Supreme Court ruled in *Connelly v. the United States* that the proceeds of a life insurance death benefit owned by the company under a buy-sell agreement were includable in the business value for estate tax purposes. This scenario is commonly called a redemption buy-sell agreement. And *Connelly* overruled a prior circuit court case by holding that the company's obligation to pay the insurance proceeds to redeem the stock of the deceased shareholder was not an offsetting deduction when valuing the business for estate tax purposes. The ruling in *Connelly* is important for business owners to be aware of because it could lead to some nasty surprises: It could increase the value of the business, the business owner's estate, and potentially what is owed to the IRS in estate tax payments. How can this unexpected result be avoided?

#1 Now is the time to review your buy-sell agreement

Given the *Connelly* decision, every business owner should review their buy sell agreement now - changes may be needed. Owners should review their buy sell agreement regularly (e.g., every two years), and any time there is a major change to ownership or value of the business. Items to review include the triggering events (death, disability, divorce, etc.), valuation formulas and funding mechanisms to make sure each still makes sense and fits with where the business is today. If your business is in an LLC, the buy-sell language typically is in the operating agreement and if you own a corporation, the language typically is in a separate buy-sell or shareholders agreement.

#2. Pay special attention to the buy-out mechanism

The *Connelly* decision of life insurance death benefit inclusion in value came down to the funding mechanism used in the buy-sell document. If you have a redemption provision funded by insurance, this is a potential red flag. Review by your attorney is a great place to start. Ask if your arrangement relies on redemption of shares by the company. The two other methods that are used in buy-sell agreements are cross-purchase and a hybrid. You, your other co-owners and your attorney should discuss which mechanism is best for your scenario.

Key points:

- You should review your buy-sell every two years and any time when there are changes to ownership, or changes in governing or tax laws.
- *Connelly vs. United States* is an estate tax decision about the inclusion of life insurance in business value as part of a buy-sell redemption mechanism.
- Become familiar with what mechanism your buy-sell utilizes. If a redemption, discuss if a change maybe appropriate; cross purchase and hybrid mechanisms may be acceptable alternatives.
- Review your valuation methodology and appropriateness of the formulas used.
- This review should also include a review of your estate plan.

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#3 Review how your buy-sell is funded

Many buy-sells are funded with insurance policies (just as in the Connelly case). Ask a professional to consider the suitability of your insurance in your current situation and discuss what insurance products may meet your needs. Consider including both death benefits and disability.

#4 Valuation is a critical factor

To determine share purchase values, buy-sell agreements typically rely on valuation formulas. Again, a timely review is important to ensure valuation metrics are current and appropriate. In the *Connelly* case, the valuation was outdated which further exacerbated the estate liability issue.

#5 Estate documents are companion elements of your buy-sell agreement

You should also review your estate planning documents when you review your buy-sell agreement – your business is likely the largest asset in your estate. The value of your estate will determine your estate tax liability, and the provisions of your buy-sell agreement will impact that value. An attorney can recommend adjustments to help minimize tax liability and ensure a smooth transition of ownership.

Bottomline: Now is the time to dust off your buy sell agreement and make sure it is structured appropriately, especially in light of the *Connelly* decision. Many owners may choose to switch from a redemption arrangement to a cross purchase or other structure.

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