Perspectives
April 2025


Jacob Wackerhausen

ESTATE PLANNING AND BUY-SELL AGREEMENTS AFTER THE *CONNELLY* DECISION

By **Brent A. McDade** | Director, Atlanta

In *Connelly v. United States*, the Supreme Court was asked to decide a case that revolved around the obligation to redeem shares of a company. The court ruled that proceeds from company-owned life insurance related to a buy-sell agreement should be included when estimating the fair market value of the company for estate tax purposes. The result will, at a minimum, present drafting challenges to succession planners and emphasizes the importance of structuring a buy-sell agreement so its price terms dictate the value of the interest in an estate tax context.

Introduction

On June 6, 2024, the U.S. Supreme Court delivered its opinion in *Connelly v. United States*,[1] a case that was watched closely by those involved in estate planning since the result, unfavorable to the taxpayer, in the U.S. Court of Appeals of the Eighth Circuit (the "Eighth Circuit"). The Supreme Court ruled that life insurance proceeds earmarked to fund a redemption obligation under a buy-sell agreement should be included in the fair market value of the underlying business for federal estate tax purposes.

Some who read *Connelly* will say it is a landmark case that turns prevailing ideas about estate planning, corporate succession, and funded buy-sell agreements—prevailing ideas that survived the test of *Estate of Blount v. Commissioner* in the U.S. Court of Appeals of the Eleventh Circuit (the "Eleventh Circuit")—on their heads. Others will say *Connelly* is, at best, a footnote that will require more careful drafting on the part of corporate attorneys and more careful adherence to the procedures in buy-sell agreements on the part of business owners. Regardless, it demonstrates how terribly things can go wrong for the shareholders left behind after the death of a key fellow shareholder.

Life Insurance Proceeds and Blount

To talk about *Connelly*, we first must talk briefly about *Blount*. That case involved the estate of William C. Blount, the 83 percent owner of Blount Construction Company ("BCC"). The other shareholder of BCC was an employee stock ownership plan. Blount was party to a buy-sell agreement with BCC that was partially funded by life insurance proceeds and fixed the value of Blount's shares at $4.0 million, an amount set by Blount after discussion with his advisors concerning the amount BCC could pay for the shares without compromising the health of the business.

The $4.0 million purchase price was paid to Blount's estate in exchange for his shares after his death in 1997. The Internal Revenue Service ("IRS") disputed this valuation, claiming that the buy-sell agreement was to be disregarded for the purpose of determining the value of Blount's shares and that the value of BCC should be determined by adding the insurance proceeds as a dollar-for-dollar increase to the fair market value.

The Eleventh Circuit was presented with a two-pronged dispute. First, Blount's estate and the IRS disagreed regarding whether the buy-sell agreement was an exception to the general rule that property in a decedent's estate should be valued at its fair market value. Second, assuming the shares should be valued at their fair market value, Blount's estate and the IRS disagreed regarding whether the proceeds from the life insurance policy purchased to fund the agreement should be added to the value of BCC for estate tax purposes.

Property generally is included in an estate at its fair market value, but the Treasury regulations recognize an exception that generally has three requirements. First, the purchase price "must be fixed and determinable under the agreement."[2] Second, "the agreement must be binding on the parties both during life and after death."[3] Third, there must be a "bona fide business reason" for the agreement that does not effectively reduce it to a device to transfer property for less than fair market value.[4]

The U.S. Tax Court and the Eleventh Circuit agreed with the IRS that this buy-sell agreement did not qualify for an exception. The only parties to the buy-sell agreement in question were the decedent and the business he controlled, effectively giving him the unilateral ability to modify the agreement during his life. The courts agreed with the IRS that this resulted in an agreement that was not binding on Blount during his life because as controlling owner of BCC, he could cause the only party to the agreement other than himself, BCC, to agree to any modifications whenever he wished to do so.

The second prong of the Blount dispute addressed the

life insurance funding the buy-sell agreement. The IRS and Blount's estate eventually (after much disagreement but prior to the estate's appeal to the Eleventh Circuit) agreed that the value of the business before consideration of the life insurance proceeds was $6.8 million as of the date of Blount's death. Commenting on this value, the Eleventh Circuit noted that the $6.8 million "completely ignored the significant value Blount represented to the corporation. There is no discussion of the effect on BCC of losing Blount's leadership, connections, and general know-how."[5] In its calculation of fair market value, the IRS added the $3.1 million of life insurance proceeds. The U.S. Tax Court sided with the IRS, setting the value of BCC at $9.9 million. On this prong of the dispute, the Eleventh Circuit disagreed.

PROPERTY GENERALLY IS INCLUDED IN AN ESTATE AT ITS FAIR MARKET VALUE.

In its decision, the Eleventh Circuit pointed out that the insurance policy was purchased "for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the stock-purchase agreement. 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. … Thus, we conclude that the insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of BCC under the treasury regulations … the insurance proceeds are offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating 'assets' should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. ... We reject the Tax Court's inclusion of the insurance proceeds paid upon the death of the insured shareholder as properly included in the computation of the company's fair market value."[6]

The Connelly Case

Michael Connelly and Thomas Connelly owned 77 percent and 23 percent, respectively, of the shares of building materials supplier Crown C Corporation ("Crown"). They had a buy-sell agreement that gave the surviving brother the right, but not the obligation, to purchase the shares of the deceased shareholder. If the brother did not exercise that right, then Crown had the obligation to redeem the shares.

NOT PERSUADED BY THE LOGIC OF THE DECISION IN *BLOUNT* TO TREAT THE INSURANCE PROCEEDS AS SOMETHING OTHER THAN AN ORDINARY NONOPERATING ASSET, THE DISTRICT COURT GRANTED SUMMARY JUDGMENT TO THE IRS.

The buy-sell agreement contained a mechanism for the determination of the value for the purpose of the agreement that contemplated a regular revaluation of the business either by agreement between the brothers or, in the absence of agreement, by an appraisal process. The brothers neither documented a periodic agreement of value nor had the business appraised. To fund the buy-sell agreement, Crown purchased life insurance in the amount of $3.5 million on each of the brothers.

When Michael Connelly passed in 2013, Crown received the life insurance proceeds and agreed to purchase all his shares for $3.0 million, which represented the remainder of the $3.5 million of life insurance proceeds after using $500,000 to fund operations. The $3.0 million purchase price of the shares was memorialized in a broad post-death agreement between Thomas Connelly, the executor of Michael Connelly's estate, and Michael Connelly's son. The agreement was described as "amicable and expeditious"[7] and resolved several matters regarding the estate.

The estate filed an estate tax return that based the value of the 77 percent interest in Crown on the sale price of $3.0 million, implying a value of 100 percent of Crown of $3.9 million. The IRS took the position that the value of the shares for estate tax purposes was not the $3.0 million sale price but the pro rata fair market value of Crown, which should include the value of the life insurance proceeds. The IRS calculated the fair market value of 100 percent of Crown at $6.9 million inclusive of the insurance proceeds, implying a value of Michael Connelly's shares of $5.3 million and resulting in about $890,000 of additional tax liability. The estate paid the additional tax and sued for a refund.

Like the taxpayer in *Blount*, Thomas Connelly argued the redemption made pursuant to a buy-sell agreement established the value of Michael's interest, obviating the need for an analysis of fair market value. Also, like the taxpayer in *Blount*, Connelly argued that if the fair market value were to be determined, it should be determined without regard to the insurance proceeds.

Not persuaded by the logic of the decision in *Blount* to treat the insurance proceeds as something other than an ordinary nonoperating asset, the district court granted summary judgment to the IRS. The Connelly estate appealed, and the Eighth Circuit was direct in its summary of its own decision. "We first consider whether the stock-purchase agreement controls how the company should be valued. Finding that it does not, we then consider whether a fair-market-value analysis of Crown must include the life insurance proceeds used for redemption. It must."[8]

Having used the figurative bat of *Blount* to take two swings at this fact pattern, the Connelly estate again appealed, and the Supreme Court agreed to hear the case. The result was a third strike, with the Supreme Court deciding, "A corporation's contractual obligation to redeem shares is not necessarily a liability that reduces a corporation's value for purposes of the federal estate tax."[9]

The Connelly Decision

The Supreme Court decision outlines a thought experiment related to the impact of a share redemption at fair market value on value per share. Let us say a company has three shareholders, A, B, and C. Each of the shareholders puts in $1,000, so the only asset of the business is $3,000 in cash, and each shareholder owns one-third of the shares. Each one-third interest is therefore worth $1,000.

If shareholder B no longer wishes to participate in the company, the company might agree to purchase his shares for $1,000 because each shareholder owns one-third of the $3,000 company. The company pays B $1,000, and one-third of the share certificates are retired.

IT IS THIS CHANGE IN THE POST-REDEMPTION VALUE OF THE INTERESTS OF THE OTHER SHAREHOLDERS THAT MOTIVATED THE EIGHTH CIRCUIT AND THE SUPREME COURT TO LOOK AT THIS ANOTHER WAY.

After this transaction, the company only has $2,000 in cash. So its total value is reduced by $1,000, but each of the remaining shareholders, A and C, continues to have an interest worth $1,000. From the point of view of value per share, the transaction with B was neither accretive nor dilutive. Each of the three shareholders continues to have an asset with the same value as before the redemption.

That is a convenient thought experiment, one that is useful in some situations. But it ignores the challenge faced by an operating business when attempting to pay a sizable portion of the value of its net assets to redeem a shareholder.

Let us change the scenario a bit. Now, instead of a corporation that owns $3,000 in cash, let us say A, B, and C decide their business will invest that $3,000 in a machine. Shareholder A is the salesperson, and his relationships with customers allow the business to sell the output of the machine. Shareholder B has unique skill in operating the machine, and he uses the machine to convert raw materials to the finished product. Shareholder C performs maintenance on the machine, and he has relationships with suppliers all over the world that allow the company to procure the raw materials that make its product possible. Our shareholders, aware of their own mortality, understand that the loss of any of the three shareholders will create a significant operating and financial burden on the business.

They also understand the death of any shareholder will result in a need to redeem that shareholder's shares, a need the company cannot meet. The company no longer has any cash because its $3,000 is now in the form of the machine. The business cannot distribute one-third of a machine, and even if it could, it would not be able to operate with two-thirds of a machine.

A, B, and C therefore agree that the company should acquire life insurance in the amount of $1,000 on each of their lives. The idea here is that if one shareholder dies, that shareholder's estate will receive $1,000 (the value of one-third of the machine), and the remaining shareholders will do what they can to continue to operate without one of the three key employees.

That seems a reasonable goal, and the Eleventh Circuit in *Blount* got it. Under the logic of *Blount*, the $1,000 in life insurance proceeds would pass through the company, so the deceased shareholder, whose interest in the machine was worth $1,000 immediately before his death, received his $1,000, and the company was where it was before anything happened but with one less shareholder.

The interesting thing that changes is the value of the other two shareholders' interests. B's estate received a payment in the amount of $1,000, the value of B's shares immediately before the receipt of the life insurance proceeds. The business once again has no cash, and it continues to have a $3,000 machine. That means A and C, who are now the fifty-fifty owners of ABC, own shares worth $1,500 each.

It is this change in the post-redemption value of the interests of the other shareholders that motivated the Eighth Circuit and the Supreme Court to look at this another way. If B dies, the company, which only owned a $3,000 machine the moment before, receives

$1,000 in life insurance proceeds. Now the Company is worth $4,000, and B's interest is worth one-third of $4,000, or $1,333. After the redemption, each of the remaining shareholders also owns a pro rata share of the remaining $2,666, or $1,333 each. So, the fair market value of one-third of what is now, with the insurance proceeds, a $4,000 business is $1,333.

That logic works, as far as it goes, and such a transaction is neither accretive nor dilutive to the remaining shareholders. There is no dispute that $4,000 divided by three is $1,333.

However, let us look at the situation we have created for the remaining shareholders. The company needs to produce $1,333 to buy B's shares. The first $1,000 is easy—use the insurance proceeds—but that next $333 involves either selling the machine, which would effectively destroy the business, or borrow against the machine at a time when A and C have no one to operate the machine, that having been B's unique contribution to the enterprise. That is likely the very situation A, B, and C were contemplating when they entered into the buy-sell agreement and funded it with life insurance.

Conclusion

The good news about *Connelly* is that it does not appear that the Supreme Court was unaware of the benefit of having small businesses survive the death of a shareholder. In response to the argument that the logic of the Eighth Circuit decision would make succession planning more difficult, the Supreme Court says, "True enough, but that is simply a consequence of how the Connelly brothers chose to structure their agreement. There were other options."[10]

The discussion goes on to discuss cross-purchase arrangements as a workaround, even though some of the obvious drawbacks of cross-purchase arrangements are acknowledged in the following sentence. The existence of these options provides drafting challenges for succession planners and procedural challenges for small-business owners.

While the drafting challenges for attorneys involved in creating these documents are beyond the skills of the author, the simple path forward for business owners is to have key succession documents reviewed to see whether the procedures in a buy-sell agreement result in a purchase price that is determinative for estate tax purposes. If they are, follow them.

Much of the debate in *Connelly* arose not because of a failure of the procedures in the buy-sell agreement but because of the failure to follow those procedures. There is no way to know whether the Connelly brothers would have wound up in U.S. Tax Court had they annually established a purchase price consistent with the procedures in their buy-sell agreement. However, we know they did not follow those procedures, and we know the result of the ensuing litigation was unfavorable.

About the Author

Brent A. McDade is a director of our firm. He can be reached at (404) 475-2301 or at brent.mcdade@willamette.com.

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