Reshaping buy-sell planning after *Connelly*

Legal and practical considerations

March 26, 2025

Red River Valley Estate Planning Council

APRIL CAUDILL, J.D.*, CLU®, ChFC®, AEP® (Distinguished)
Advanced Solutions Director
Principal Financial Group®

* J.D. is an educational degree, and the holder does not provide legal services on behalf of the companies of the Principal Financial Group.

Basics of buy-sell agreements

Business succession

What is a buy-sell agreement?

"Buy-sell agreements are agreements (contracts) by and among the shareholders (or equity partners of whatever legal entity) of a business and perhaps the business itself. They establish the mechanism for the purchase of equity interests following the death (or other adverse or significant change) of one of the owners."

-- Z. Christopher Mercer from his book, *Buy-Sell Agreements.*

Buy-sell agreement needs

- Effective choice of agreement
  - Cross purchase
  - Entity purchase
  - Wait and see
  - Third party structures
  - One way buy-sell

- Considerations
  - Tax structure and accounting method of company
  - Number of owners
  - Status of potential successor - known or unknown
  - Estate planning objectives

Primary focus of the buy-sell review

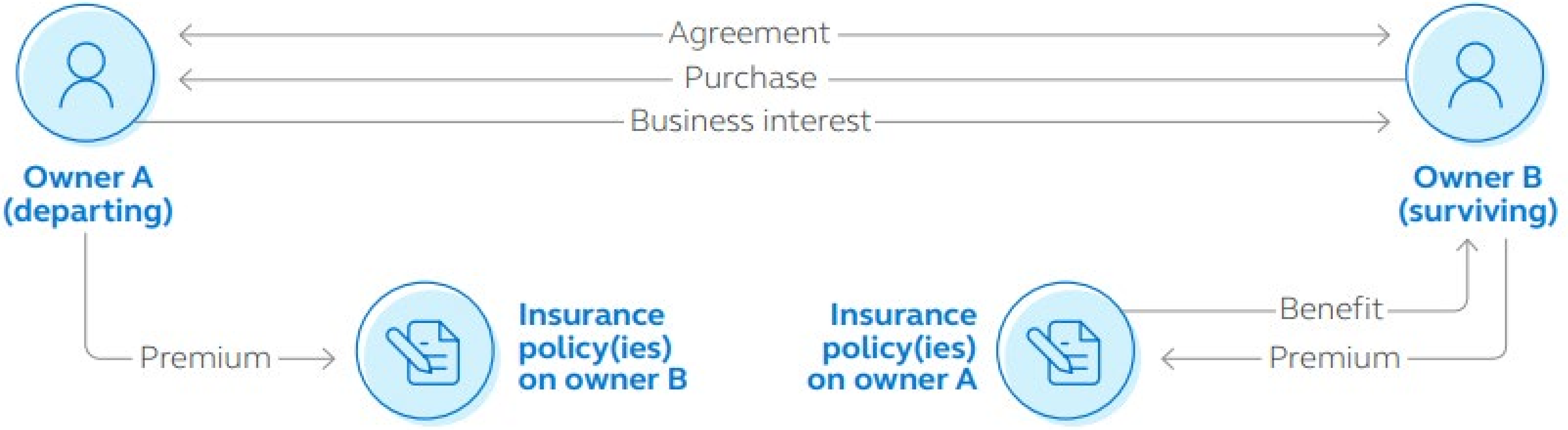
- STRUCTURE OF THE AGREEMENT
- BUY-SELL TRIGGERS (MANDATORY AND OPTIONAL)
- HOW THE PARTIES DETERMINE THE SALE PRICE
- THE TERMS OF THE PURCHASE TRANSACTION
- HOW THE FUNDING IS STRUCTURED

Real world observations*

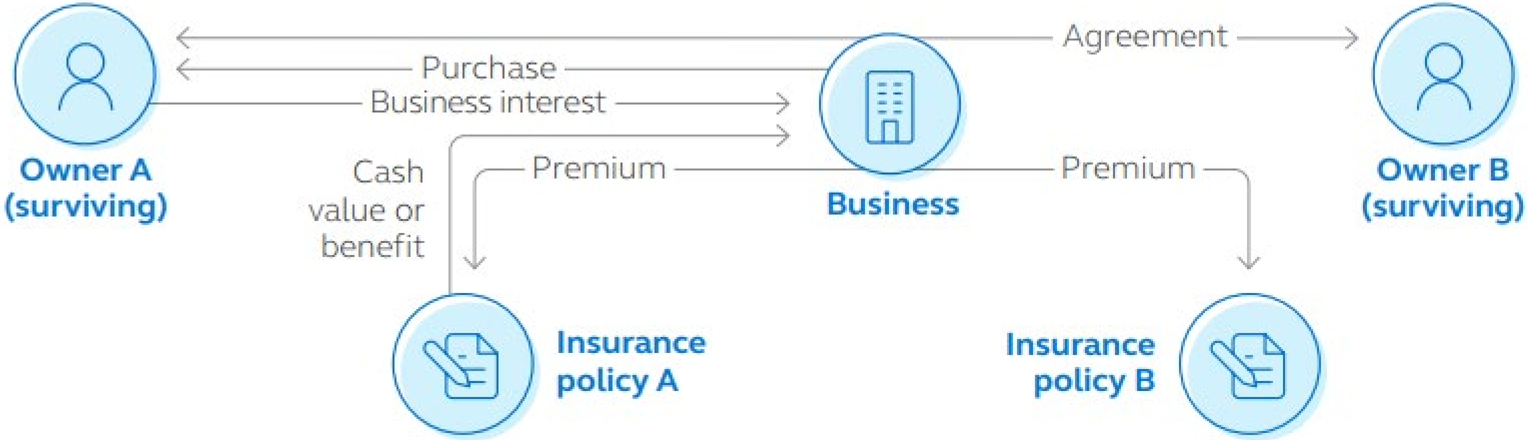
Buy-out			Other provisions	
Mandatory at death	69%		Agreement not reviewed in >10 years	21%
Optional at death	25%			
Mandatory at disability	33%		Pricing relies on certificate of value	20%
Optional at disability	31%			
Entity purchase	**41%**		No spousal consent language	76%
Wait and see	**31%**			
Cross purchase	**21%**		Buyout provided at retirement	30%
Other designs	**6%**			

* Based on over 2,500 buy-sell agreements reviewed since 2014.

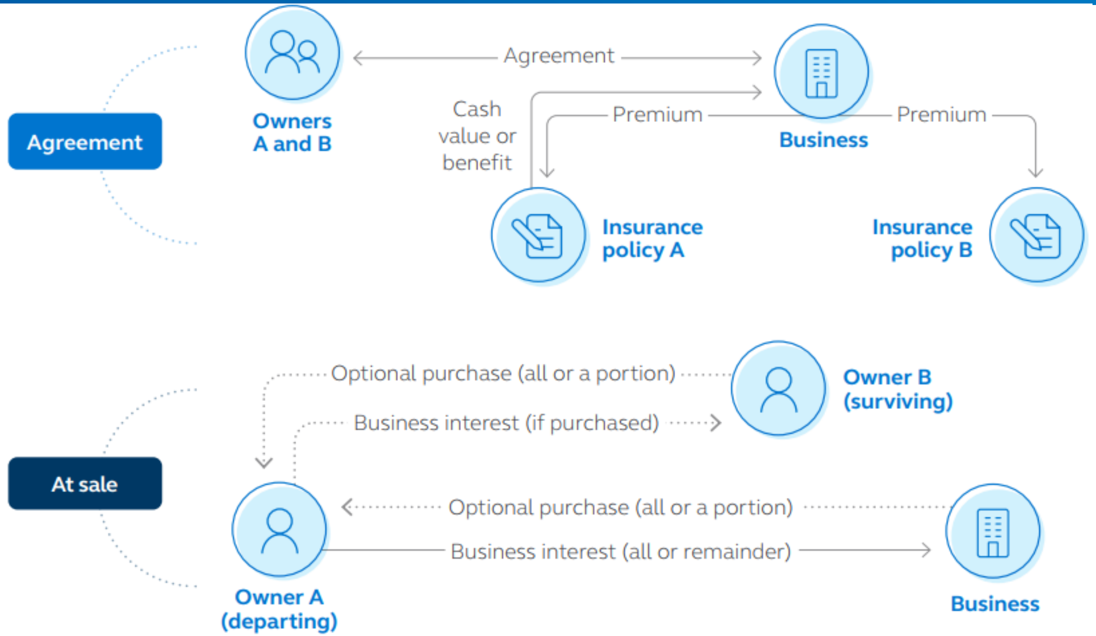
Cross purchase buy-sell



Entity purchase buy-sell

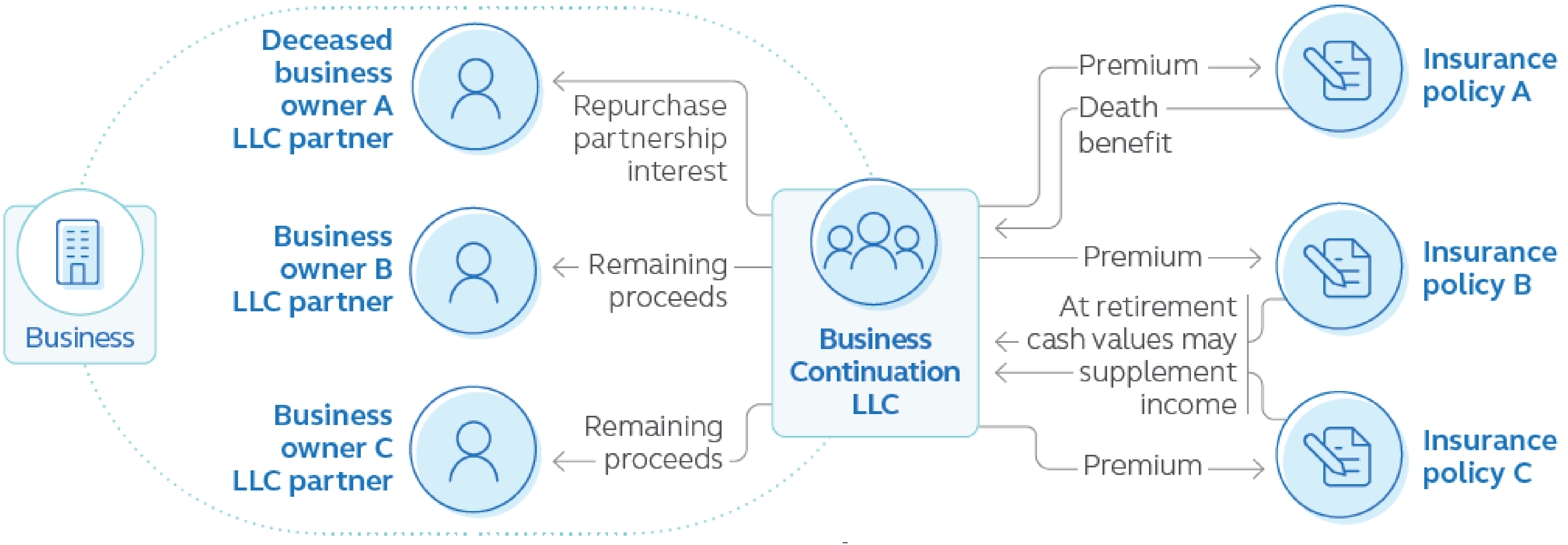


Wait and see buy-sell



Business succession

Business continuation LLC



Estate and gift tax system

- Transfer tax system is "unified"—it takes gifts made during the donor's lifetime and assets owned at death.
- The rate for estate and gifts taxes is 40%.
- Gift and estate tax exemption is $13.90 million per individual in 2025. Annual gift tax exclusion is $19,000
- Certain gifts aren't taxed:
  - Unlimited deductions for transfers to U.S. citizen spouse or charity
  - Exclusion for gifts for educational/medical expense made directly to provider
  - Annual (per done) and lifetime (per person) exemptions

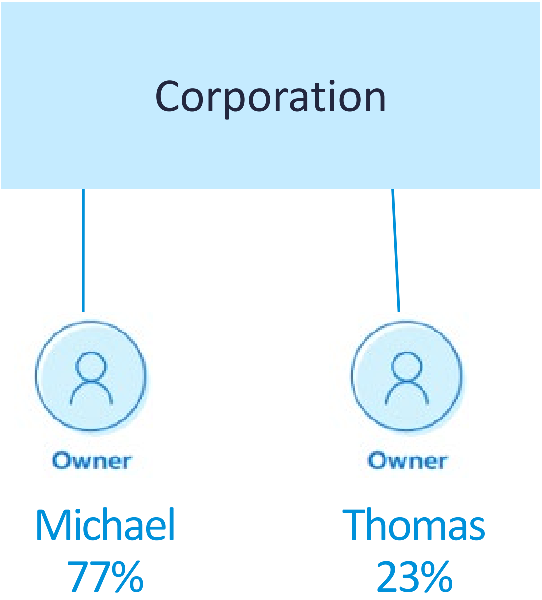
The lifetime gift and estate tax exemption is set to be cut in half by Jan. 1, 2026

Impact of *Connelly v. U.S.*

U.S. Supreme Court, June 6, 2024

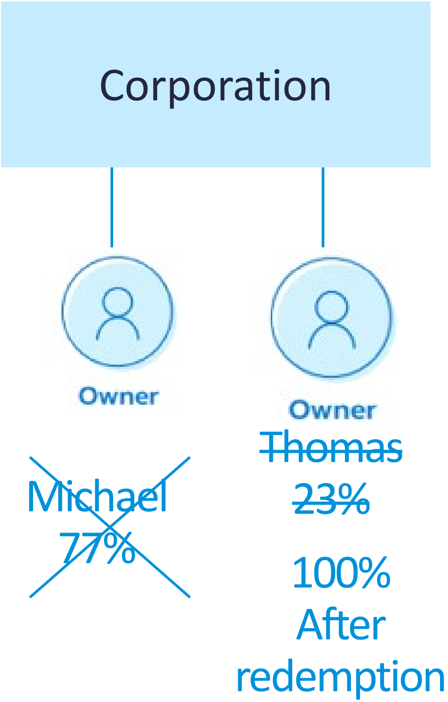
Connelly v. U.S.: U.S. Supreme Court

- Brothers Michael and Thomas owned building supply company (C corp) and had a wait and see buy-sell agreement.
- Agreement called for annual determination of value. Backup method was appraisal. Neither was done.
- Agreement was silent on whether life insurance was to be excluded from business value, and how life insurance proceeds were to be used.



Connelly v. U.S.: U.S. Supreme Court

- Michael died in 2013; his executor was his brother Thomas. Company received death benefit of $3.5M. $500K was key person; $3M was used for buyout.
- Thomas filed estate tax return claiming Michael's shares valued at $3M. IRS audited and issued notice of deficiency. Thomas paid the tax and appealed to District Court (E.D. Mo.)
- Formal valuation was obtained as part of audit litigation, (not at the outset as agreement required).
- All parties (IRS and Thomas) agreed that company value *before* Michael's death was $3.36M.



Connelly v. U.S.: U.S. Supreme Court

Connelly position:

- Value agreed on was a fair value based on the company value just prior to Michael's death
- $3,360,000 appraisal (during litigation)
- +$500,000 key person (Co. retained)
- $3,860,000

- $3,860,000 x 77% = $2,972,200 (Agreed on $3M)
- $3M death benefit offset by $3M buyout obligation (*Blount, 11th Cir.* 2005)

IRS position:

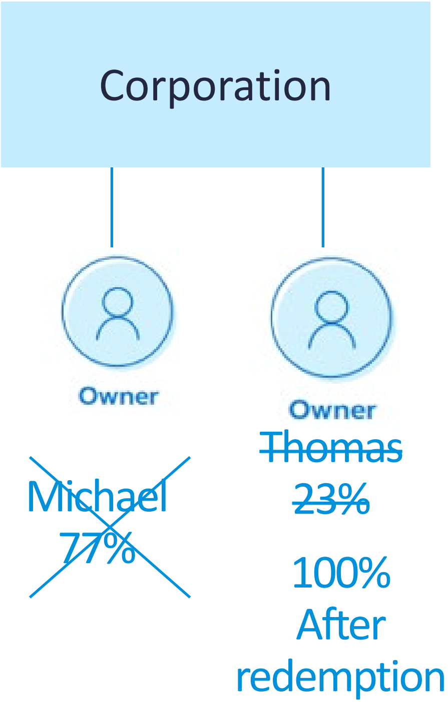
- Value should have included all death proceeds payable to the company upon Michael's death. Agreement could not lock in price.
- $3,360,000 appraisal
- + $3,500,000 all life proceeds
- $6,860,000

- $6.86M x 77% = $5,282,200
- Redemption obligation did not offset death proceeds in the value of the company.

Connelly v. U.S.: U.S. Supreme Court

Supreme Court held for the IRS:

- Owners didn’t follow procedures required by their buy-sell agreement for pricing.
- Therefore, IRS was free to determine FMV.
- Court agreed with IRS position and lower courts that the death benefit increased the FMV of the company.
- Redemption requirement was not a true liability to the company, but simply required cutting the company into two parts.
- Result: nearly $1M additional estate tax



Connelly vs. U.S. (U.S. Supr. Ct., June 2024)

- When a buy-sell agreement fails to “lock-in” an estate tax value, the life insurance death proceeds paid into the business increase the value of the business – without any reduction due to the business’ obligation to redeem the deceased insured’s interest – and thus increase the value of the deceased owner’s proportionate business interest.
- Most relevant in entity purchase buy-sell and wait-and-see buy-sell agreements (see a few slides ahead).
- It may still be possible to draft a buy-sell agreement that locks-in a value for estate tax purposes, in a way that also excludes the value of life insurance death proceeds paid into the business (but not all attorneys agree that this can be done).
- Clients must seek advice from their own counsel.

Implications: Who is most impacted by *Connelly* decision?

1. Business owners with:
   - Company-owned life insurance for buy-sell planning
   - Potential exposure to Federal or state estate or inheritance taxes
2. Other potential impacts:
   - Price of buying out a deceased owner
   - Ambiguity when price under agreement differs from fair market value price as determined under *Connelly*
3. *Blount* case (previous authority for death benefit being offset by purchase obligation) effectively overruled

Implications: What to do now?

1. If likely to face estate tax, consider having your client ask the attorney to design agreement to “lock-in” value of company for estate tax purposes *and* follow what the Agreement says to do.

2. Consider choosing one of several cross purchase designs.

3. Consider choosing a third-party approach (to carry out a cross purchase):

    - Escrowed buy-sell; or
    - Business Continuation LLC taxed as a partnership

4. Do nothing?

Questions – 1st hour

Business valuation practices and provisions

Business valuation approaches

Know the value of your business.

Determining the value of your business is the starting point and an integral part of the planning process. There are many different methods to value a business, but there's no one method that's always appropriate. At the end of the day, the "fair market value" of a business is the amount agreed upon by a willing buyer and a willing seller. Neither party is under any compulsion to buy or sell, and both must have reasonable knowledge of all the relevant facts. This is a common definition used for valuing a business, but we'll try to add a little more clarity to it below.

Valuation approaches and methods

Business valuation methods are generally categorized under three approaches: asset approach, income approach, and market approach. Since no single method is most appropriate for valuing every business, it's common to reference a business valuation method under any one or all three approaches.

Considerations for valuing a business per IRS Revenue Ruling 59-60

- Nature and history of business
- Outlook of the economy and the specific industry
- Financial condition of the business and its book value
- Earnings capacity of the company
- Nature and value of any intangible assets of the business, such as goodwill
- Relative size and block of the business interest to be valued and any prior sales
- Market price of actively traded stock of corporations in the same or similar business

Asset approach

This is typically used with businesses that have substantial tangible assets, usually in the form of inventory and equipment. It's most appropriate for businesses with a substantial amount of fixed assets.

Adjusted book value. This generally represents the "liquidation" value—assets, with adjustments, less liabilities.

Income approach

This type of approach uses prior earnings to estimate company value based on income potential. It's most appropriate for businesses with consistently favorable earnings. Specific methods include the following:

Capitalization of earnings method. Applicable for consulting-type businesses and/or those with few or no tangible assets.

Excess of earnings method. Generally for manufacturing-based firms with significant assets.

Discounted cash flow method. Uses projected values. Projected future earnings are forecast, then discounted using an appropriate rate representative of the "next best investment opportunity" with a comparable level of risk. Used mainly for mergers and acquisitions.

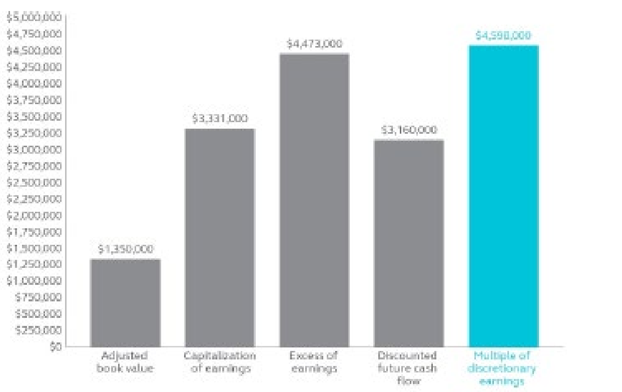
Multiple of discretionary earnings method. Applicable for more service-oriented firms, such as legal, accounting, healthcare systems, dental, engineering, etc. Goodwill of the owner(s) has a significant impact on value.

Market approach

This is based on the prices of similar or comparable businesses that have recently sold. This data is more challenging to find for the sale of small businesses and professional practices, rather than for large businesses. **A valuation using this method is not provided in this report.**

Business valuation proposal

5 common valuation methods



Adjusted book value method Assets, with adjustments, less liabilities - generally represents the "liquidation" value	$1,350,000
Capitalization of earnings method Amount of capital that would have to be invested at a specified rate to yield the current average net annual earnings of the business	$3,331,000
Excess of earnings method A combination of the adjusted book value and capitalization of earnings methods	$4,473,000
Discounted future cash flow method Projected future business earnings forecast, then discounted using an appropriate rate	$3,160,000
Multiple of discretionary earnings method Earnings provided by goodwill, times a multiplier; adjusted book value is added to this number	$4,598,000

Sample Informal Business Valuation Proposal (BB11286)

Principal®

Business valuation approaches

Calculations

Assumptions

Average operating income: $907,000
Excess owner compensation[1]: $50,000
Capitalization rate: 23.0%
Rate of return on assets: 6.0%
Earnings multiplier: 4
Number of years to forecast: 5
Discount rate: 15.0%
Growth rate: 10.0%

Excess of earnings method	
Average operating income	$907,000
Plus excess owner compensation	$50,000
Less adjusted book value multiplied by rate of return on assets	$72,000
Total	$885,000
Divided by capitalization rate	23.0%
Excess of earnings on assets	$3,847,826
Plus adjusted book value	$1,200,000
Excess of earnings	**$5,047,826**

Multiple of discretionary earnings method	
Average operating income	$907,000
Plus excess owner compensation	$50,000
Less adjusted book value multiplied by rate of return on assets	$72,000
Total	$885,000
Multiplied by earnings multiplier	4
Total goodwill	$3,540,000
Plus adjusted book value	$1,200,000
Multiple of discretionary earnings	**$4,740,000**

Capitalization of earnings method	
Average operating income	$907,000
Plus excess owner compensation	$50,000
Total	$957,000
Divided by capitalization rate	23.0%
Capitalization of earnings	**$4,160,869**

Discounted future cash-flow method	
Average operating income	$907,000
Plus excess owner compensation	$50,000
Total	$957,000
Growth rate	10.0%
Number of years to forecast	5
Discount rate	15.0%
Discounted future cash flow	**$4,300,613**

Adjusted book value method	
Book value	$1,200,000
Plus adjustments	$0
Adjusted book value	**$1,200,000**

[1] Excess owner compensation is defined as salary over and above what the owner would pay a key employee to perform similar services that the owner is now performing, without incurring the additional risk of business ownership.

“Locking in” value of business for estate tax purposes.

Use of buy-sell agreement to “lock in” the business value for estate tax purposes

Many business owners want to use a low value when transferring the business to family members or when facing a potential estate tax.

The IRS is aware of owners’ attempts to try to avoid the use of fair market value; therefore, scrutinize family business transfers for estate tax purposes.

Hypothetical example:

Business: Valued at $26M

Owner: “Let’s use $10M in buy-sell agreement.”

IRS at owner’s death: “No, I don’t think so.”

IRC Sec. 2703(b); Treas. Reg. §§ 20.2031-2(f)(2), 20.2031-2(h); Rev. Rul. 59-60, 1959-1 CB 237

Buy-sell agreements can establish estate tax value if certain criteria are met.

For any situation:

1. The price must be fixed or determinable pursuant to a formula under the agreement.

2. The estate must be obligated to sell at death at the agreement price.

3. The agreement must prohibit the owner from disposing of their interest during life without first offering it to the other party/parties at no more than the agreement price.

4. The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth.

See Rev. Rul. 59-60; Reg. § 20.2031-2(h)

Buy-sell agreements can establish estate tax value if certain criteria are met.

For family situations (additional criteria):

5. It's a bona fide business agreement.

6. It's not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

7. *Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.*

Yes, there's redundancy and overlap!

See IRC § 2703(b)

Optimal business valuation provisions

Optimal pricing (price that is up to date and accurate *at the time an event occurs)*:

- "Fixed" or determinable based on a formula
- Appraisal of the company's fair market value as of a date prior to death, with specific instructions excluding life insurance death proceeds
- Formula based value example:
  - 5 times Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)

Most important for estate tax purposes: Owners need to follow protocol established in the agreement.

Considerations with business valuation provisions

Common methods	Issues
Book value	Inconsistent with IRS guidance for estate tax purposes
Annual certificate of value	Few do this
Mutual agreement at time of event	Inconsistent with IRS guidance for estate tax purposes
Life insurance proceeds	Inconsistent with IRS guidance, could pay too much/little

Real world observations*

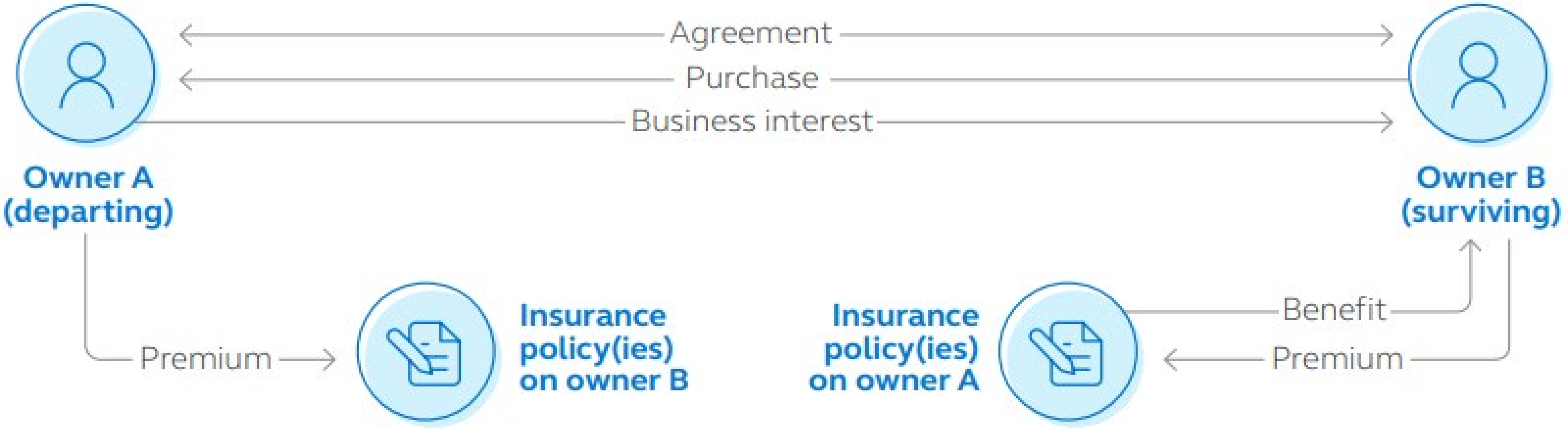
Buy-out			Other provisions	
Mandatory at death	69%		Agreement not reviewed in >10 years	21%
Optional at death	25%			
Mandatory at disability	33%		**Pricing relies on certificate of value**	**20%**
Optional at disability	31%			
Entity purchase	41%		No spousal consent language	76%
Wait and see	31%			
Cross purchase	21%		Buyout provided at retirement	30%
Other designs	6%			

* Based on over 2,700 buy-sell agreements reviewed since 2014.

Principal®

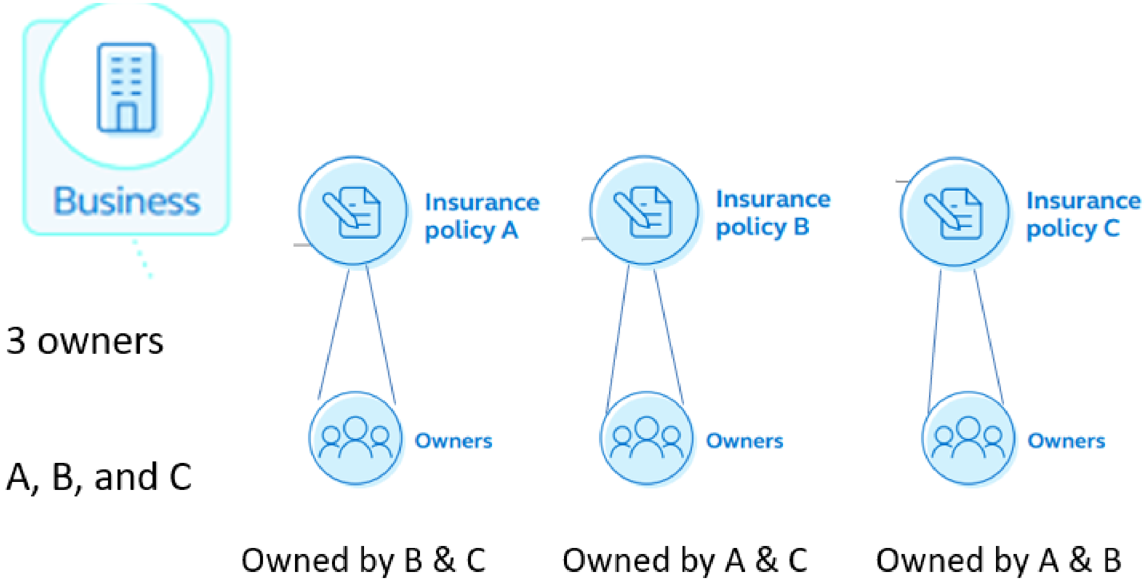
Cross purchase planning opportunities

Traditional cross purchase buy-sell

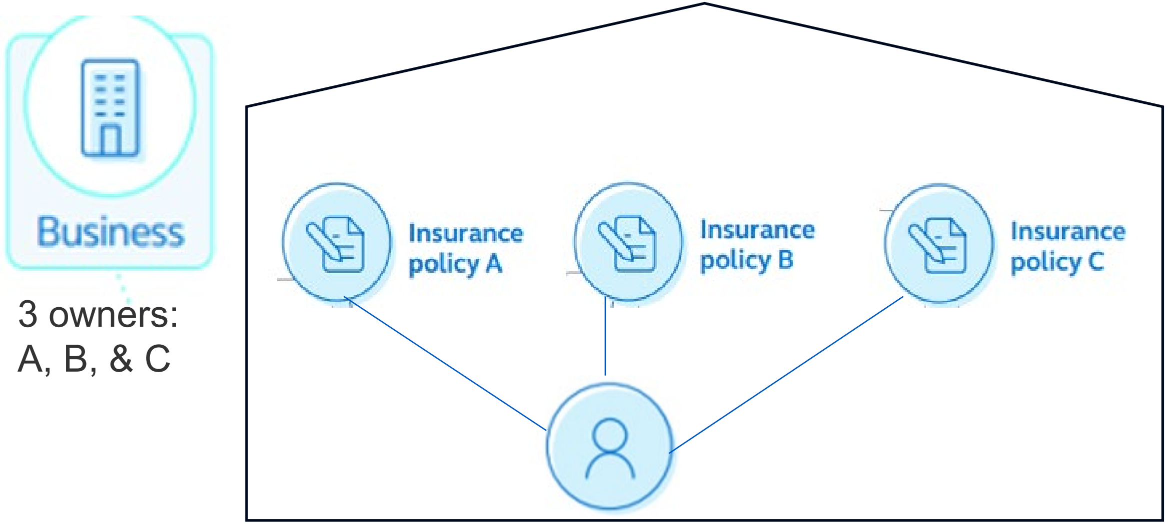


Business succession

Cross purchase with joint ownership



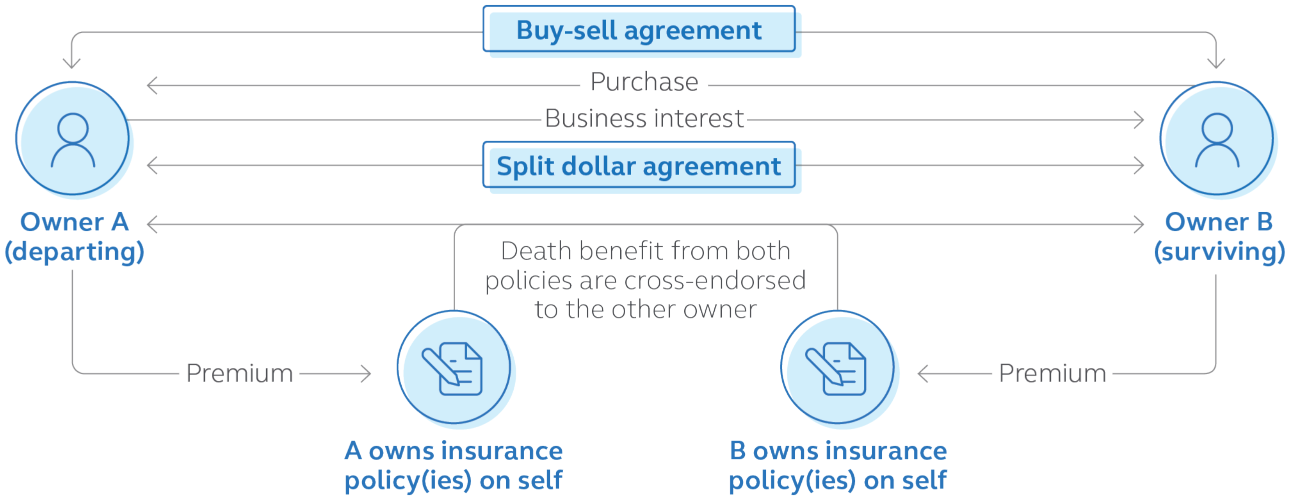
Cross purchase with trust or escrow arrangement



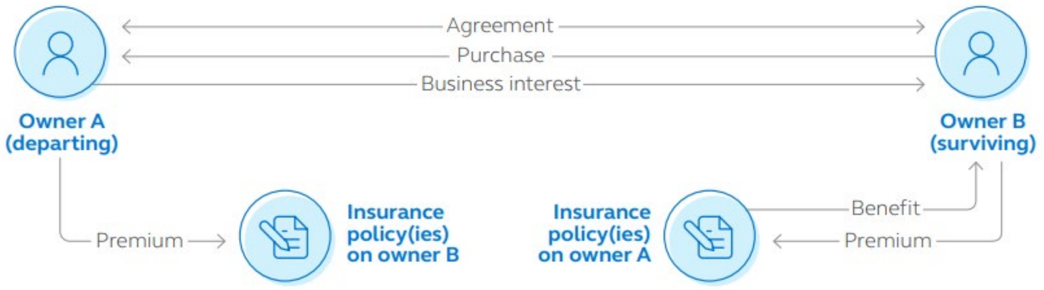
Trustee or escrow agent: Owns each policy on behalf of non-insureds

Business succession

Cross-endorsed cross purchase buy-sell

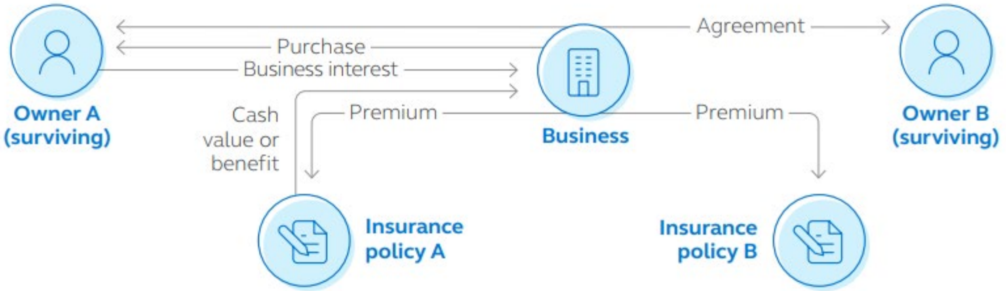


Hybrid buy-sell



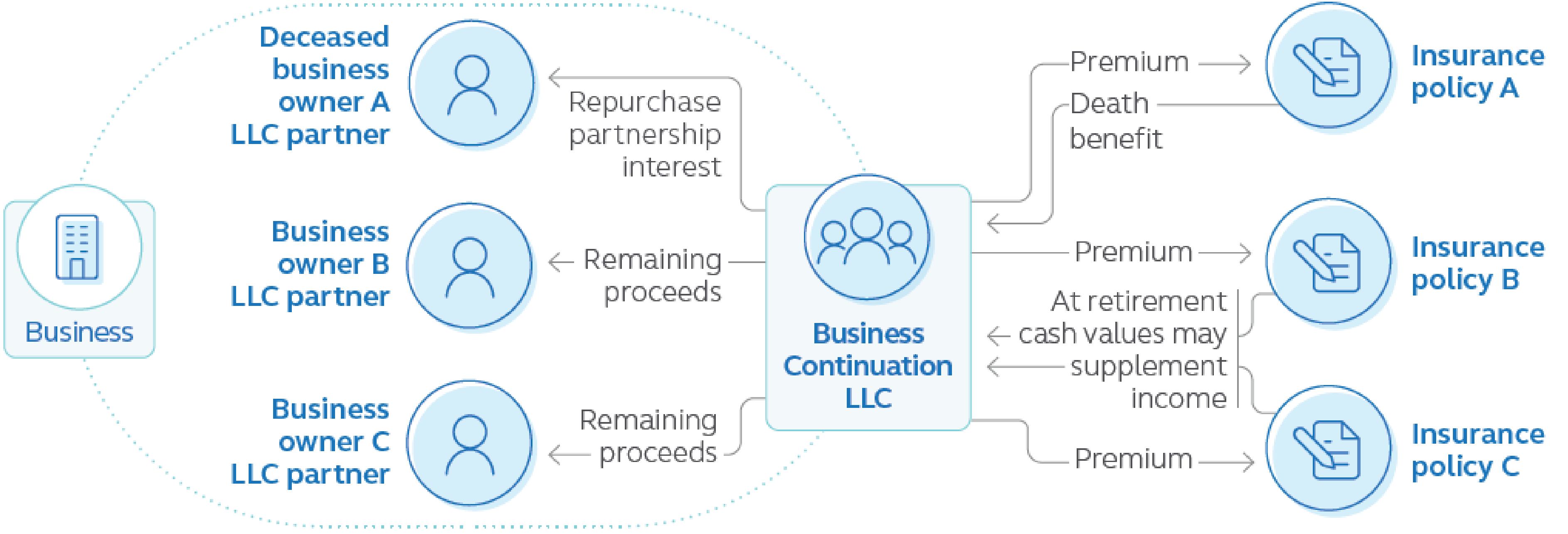
Majority shareholders buy out one another (cross purchase)

Business owns policies on minority owners and buys them out (entity purchase)



Business succession

Business continuation LLC



Questions – 2nd hour

Principal®

Transfer for value issues

Principal®

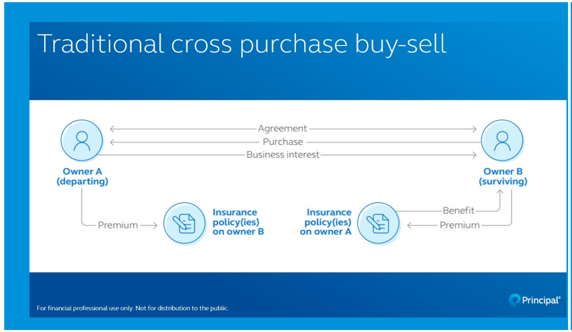
Transfer for value exceptions

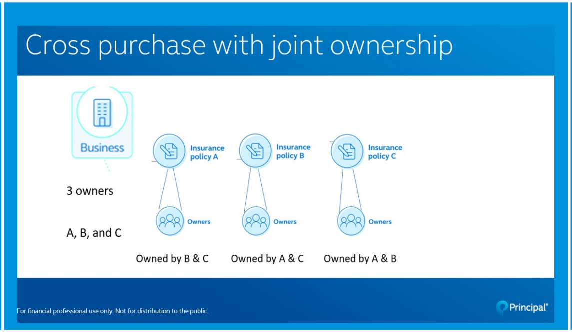
Exception	Buy-sell example
Transfer to the insured	Unwinding of a cross purchase by transferring the policy from a co-owner to the insured
Transfer to a partner of the insured	Transfer of existing policy to a partner of insured to fund a cross purchase
Transfer to a partnership in which the insured is a partner	Transfer of existing policy to a partnership in which insured is a partner to fund an entity purchase
Transfer to a corporation in which the insured is an officer or shareholder	Transfer of existing policy to a corporation in which insured is an owner or officer to fund an entity purchase
Transfer in which transferee has a carryover basis	Transfer of a business that has a policy in it as part of a tax-free reorganization or merger (also, transfer between spouses pursuant to divorce)

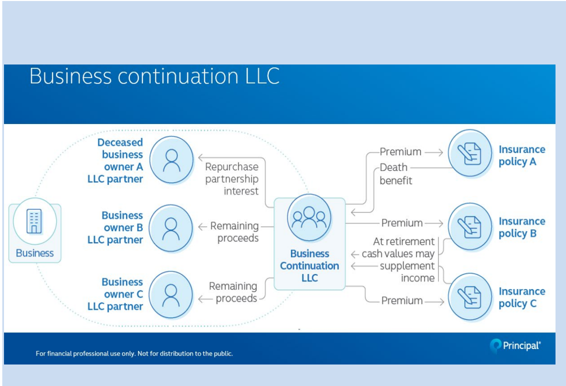
Note: any exception is available only if the acquirer has a substantial family, business, or financial relationship with insured.

Case Studies

Principal®







For financial professional use only. Not for use with the public.

Principal®

Do nothing? Assess costs and plan for additional ongoing costs.

Principal®

Why business owners might wish to leave existing business-owned coverage in place

Practical issues:

- Owners never expect to face estate or inheritance taxes (even if sunset* occurs).
- **Concern about a transfer for value**
- One or more insured owners no longer qualify for more insurance.

Considerations:

- Monitor legislative changes and be aware of growth in business value.
- Consider other potential solutions to transfer for value from business (e.g., transfer to the insured).
- Consider alternate funding options

* The Federal estate tax lifetime exemption ($13,990,000 in 2024) is scheduled to be cut by half on January 1, 2026.

Impact of *Connelly* on existing entity purchase arrangements left in place

Buy-out price for buying deceased owner's shares higher.

Personal estate planning needs include higher value of business in taxable estate.

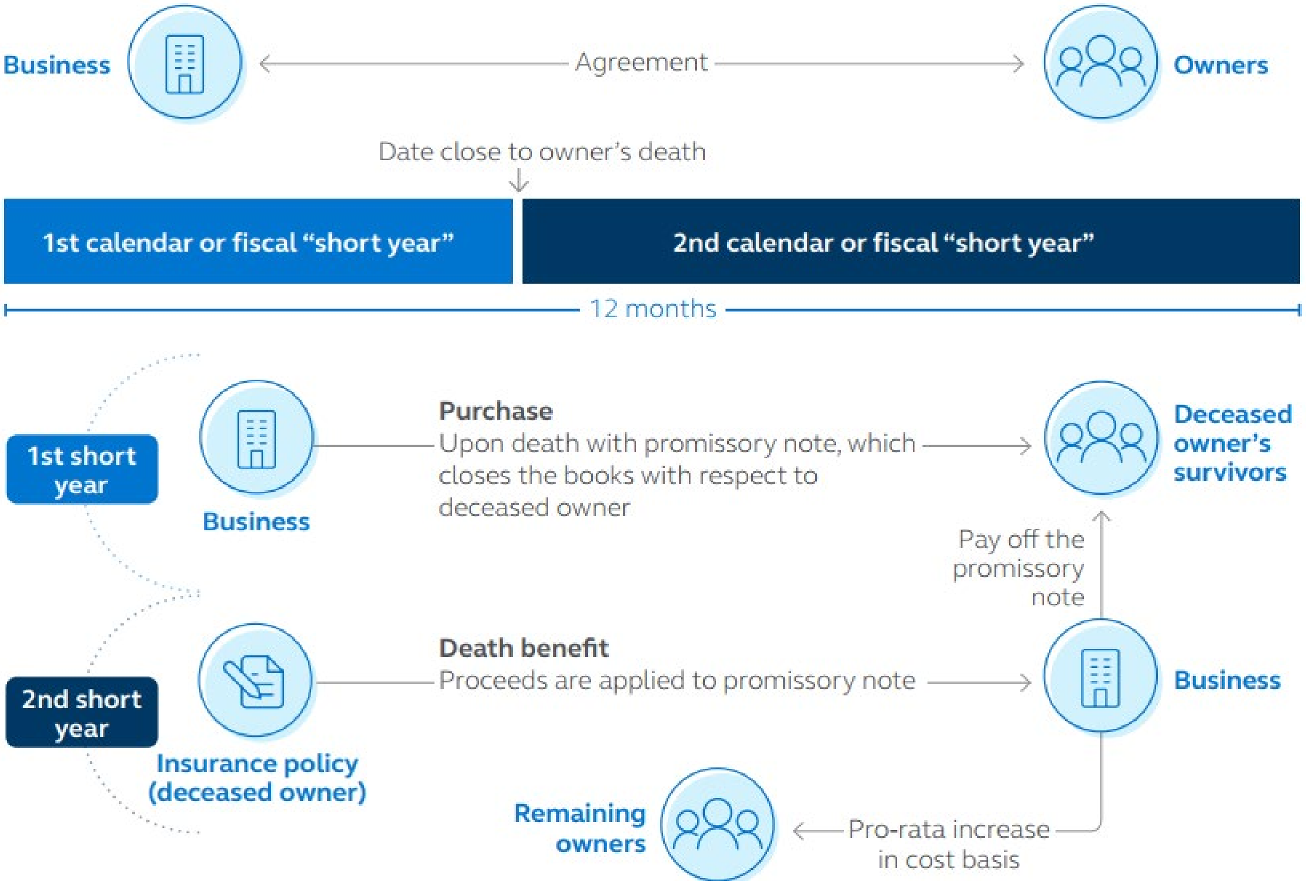
What about using alternate valuation date?

Alternate valuation date under IRC Sec. 2032:

- Available only if estate subject to federal estate tax (therefore, not available at death of first spouse if unlimited marital deduction used)
- Allows executor to elect to value assets 6 months after date of death if requirements met;
- Must have effect of reducing estate tax
- Must be applied to ALL assets in the estate (cannot pick and choose)

Can an S corporation avoid *Connelly* by making a Sec. 1377 election?

Operation of Sec. 1377 election



Buy-out impact on basis of surviving business owners

Entity type	Buy-sell type	Basis of surviving purchaser(s)
Any	Cross purchase	Increased by value paid, regardless of whether life insurance used
Partnership or cash basis S corp	Entity purchase	Increased cost basis available to extent purchased with life insurance flowing into the business, assuming special allocation (partnership) or 1377 election (S corp)
Accrual basis S corp	Entity purchase	Partial increase in cost basis available to extent purchased with life insurance flowing into the business
C corp	Entity purchase	No increase in cost basis

Connelly v. U.S.: U.S. Supreme Court

What if?

- The brothers had followed the exact terms of their buy-sell agreement?
- Life insurance had been cross-owned, and Thomas had exercised his option to do a cross purchase rather than having the company buy the shares?
- The agreement had included language requiring the value upon death to be determined just before the death of an owner?
- The agreement had met requirements to “lock in” the value, and explicitly excluded life insurance from the value of the company?
- Thomas had been an unrelated third party, not Michael’s brother?

Next steps

Request a complimentary buy-sell review and informal business valuation.

Implement or update your buy-sell agreement

What’s needed to get a proposal?

Informal Business Valuation

- Completed RFP
- Three most recent years’ business tax returns
- Expect 5 business days for turnaround

Buy-Sell Review

- Completed RFP
- Current buy-sell agreement and any amendments
- Information on any insurance in place to fund the agreement
- Expect 15 business days for turnaround

Business Continuation

- Completed RFP
- Information on any insurance in place to fund the agreement
- Expect 3 business days for turnaround

Let’s connect.

Contact the Business and Advanced Solutions hotline at 833-803-8345.

Visit us at advisors.principal.com.

Principal®

Principal®