

Lessons from Failed Buy-Sell Agreements

2025 Southern Federal Tax Institute



Todd G. Povlich, CFA, ASA

Overview

- Buy-sell agreements are critical tools for business succession planning
- Recent court decisions highlight significant pitfalls when agreements deviate from fair market value (“FMV”)
- Two landmark cases: Connelly v. United States (2024) and Huffman v. Commissioner (2024)
- Financial consequences can be substantial: unexpected tax liabilities and penalties reaching millions
- These decisions provide clearer guidance on regulatory requirements and commercial reasonableness

Connelly v. United States

144 S. Ct. 1406 (2024)

THE ISSUE

Do life insurance proceeds owned by a corporation offset the redemption obligation in estate tax valuation?

The Facts

- Brothers Thomas and Michael owned Crown C Supply
- Buy-sell agreement: surviving brother had purchase option; if declined, corporation would redeem
- Corporation purchased life insurance on both brothers
- Michael died in 2013 owning 77%; Thomas declined to purchase
- Estate valued shares at \$3M, excluding and ignoring \$3M in life insurance proceeds from the value
- Company & Estate agreed to a \$3M buyout, excluding and ignoring \$3M in life insurance proceeds from the negotiation
- No independent appraisal obtained despite agreement terms

Connelly: The Regulatory Framework

Treasury Regulation §20.2031-2(f)(2)

"When determining fair market value of closely held stock, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company..."

Key Implications:

- Life insurance proceeds must be included as nonoperating assets.
- Estate's attempt to exclude proceeds conflicted with regulatory guidance.
- Estate's effort to recharacterize the redemption as a corporate liability failed.
- No evidence was provided of comparable agreements that excluded insurance proceeds.

Connelly: Supreme Court's Ruling

The Court's Reasoning

- Life insurance proceeds are corporate assets that increase enterprise value
- Redemption obligation at FMV does not offset insurance proceeds
- No hypothetical buyer would reduce value for an FMV redemption obligation
- Redemption at FMV divides equity value between redeeming and non-redeeming shareholders rather than reducing aggregate equity value
- Distinguished from traditional corporate debt (which reduces owners' equity)

THE SPIRALING EFFECT

Court's ruling implies businesses need substantially more insurance coverage than anticipated.

Example: If business worth \$1M needs insurance for 50% shareholder buyout, may need ~\$1M policy (not \$500K) because proceeds increase company value.

Alternatives: Cross-purchase agreements; Insurance LLCs.

Huffman v. Commissioner

THE CHALLENGE

Can a fixed-price buy-sell agreement satisfy Section §2703's comparability requirements when price significantly deviates from FMV?

THE FACTS

- Randall and Suzanne Huffman owned RoyO Martin Timber Partners (timber partnership)
- 2010 agreements to transfer interests to son Chet (longtime manager)
- Fixed price: \$5 million (unchanged for 14 years)
- Actual FMV determined by IRS: \$31.3 million
- Transfer occurred at ~16% of fair market value (16 cents on the dollar, or at an 84% discount)
- Agreements designed to reward Chet's 'sweat equity' and below-market compensation

Huffman: Section §2703 Three-Part Test



**BONA FIDE
BUSINESS
ARRANGEMENT**

Maintaining family
ownership and
rewarding Chet's service
= legitimate purposes

SATISFIED



**NOT A
TESTAMENTARY
DEVICE**

Chet's decades of below-
market compensation =
legitimate consideration

SATISFIED



**COMPARABLE
TO ARM'S-
LENGTH**

- Fixed price (14 years)
- Unrestricted exercise
- Family-only transfers
- Stated family purpose

NOT SATISFIED

Success Story: Amlie Estate

T.C. Memo. 2006-76

The Situation:

Pearl Amlie, elderly and under conservatorship, owned minority stock in First American Bank Group. A conservator managed the illiquid position and negotiated a fixed price to be paid upon Ms. Amlie's death.

The Result: All three Section §2703(b) requirements satisfied

Lesson: Agreements that follow established valuation principles and use current professional valuations can avoid challenges

KEY DIFFERENTIATORS

- Professional independent valuation (\$109/share)
- Arm's-length negotiation by fiduciary
- Court oversight and approval
- Valid business purpose was demonstrated
- Risk management and fiduciary's desire to protect downside

Success Story: Morrisette Estate

T.C. Memo. 2021-60

The Situation:

The Morrisette estate established intergenerational split-dollar life insurance arrangements with mutual termination restrictions. The IRS challenged these arrangements under Section §2703.

Result: Successfully satisfied Section §2703(b) comparability requirement with market data on yields

Lesson: Comparability can be established with widely accepted valuation methods and widely recognized market data even though the comparables were not split-dollar policies

KEY SUCCESS FACTORS

- Estate demonstrated mutual termination restrictions resembled standard executive compensation vesting requirements
- Approximately 30% of public company plans impose similar restrictions
- Satisfied comparability test through evidence of general business practice under Treasury Regulation §25.2703-1(b)(4)
- Industry evidence and market data were used to prove commercial reasonableness
- No need for specific comparable agreements when proper valuation methods and market analogs are used

Common Pitfalls in Buy-Sells

Valuation Mechanism Failures

- Fixed buyout price that is never updated
 - Static pricing inevitably becomes stale and fails IRC §2703 comparability requirements
- Buyout at book value
 - Doesn't work in the large majority of industries and situations; book value rarely reflects economic reality or FMV
- Fixed multiple approach
 - Feels better than book value but probably isn't; still creates IRC §2703 comparability problems when divorced from current market conditions
- Certificate of Agreed Value provisions
 - Owners inevitably forget to update them, leaving agreements with indefensible and stale prices

Common Pitfalls in Buy-Sells

Structural and Funding Traps

- The Connelly-like failure: Undervaluation + underestimating insurance needs
 - Using entity redemption with COLI creates "spiraling effect" where insurance proceeds inflate taxable estate value while redemption obligation doesn't offset
 - Insufficient insurance coverage – failing to account for how life insurance proceeds increase company value when calculating total coverage needed
- Wrong structure for the situation
 - Using entity redemption for taxable estates when cross-purchase or insurance LLC would have been more tax efficient
- Individual owners managing policies in cross-purchase – Risk of lapsed coverage when individuals fail to pay premiums
- Transfer-for-value problems – Improper policy transfers when ownership changes
 - Keep close eye on exceptions / safe harbors
 - There are numerous paths to navigate around these problems

Common Pitfalls in Buy-Sells

Compliance and Documentation Deficiencies

- Assuming the buy-sell automatically controls for estate tax purposes – Agreements must satisfy all three IRC §2703(b) requirements; don't assume binding = controlling
- Incomplete files – Can't demonstrate arm's-length intent and commercial dealing; burden is on taxpayer to prove comparability
- Missing appraisal protocol – No clear mechanism for determining fair market value at triggering event
- No clarity on level of value and discounts – Ambiguity about whether discounts for lack of control or marketability apply
- Unilateral amendment power sits with one shareholder – Non-commercial term that signals family device rather than arm's-length arrangement
- Below-market payment terms for non-cash consideration – Extended payment terms without market-rate interest or adequate security
- Unclear or missing buy-sell trigger events – Ambiguity about what events activate purchase obligations
- Unrestricted exercise rights without business justification – Ability to trigger purchase without notice or legitimate business reason
- Ignoring existing agreement provisions – History of non-compliance undermines argument that agreement is binding
- Family-only carve-outs in transfer restrictions – Broad exceptions for family transfers signal testamentary device

Best Practices in Buy-Sells

- Structure Selection
 - For 2-3 Owners:
 - Use cross-purchase agreement funded with individual policies
 - Insurance proceeds go directly to surviving owners (outside entity and estate)
 - Provides full basis step-up for survivors
 - Avoids Connelly valuation trap entirely
 - For 4 or More Owners or Complex Situations:
 - Use insurance LLC structure
 - Centralizes policy management while keeping proceeds outside operating entity
 - Avoids $N \times (N-1)$ policy complexity of cross-purchase
 - Requires meticulous drafting to avoid "incidents of ownership" pulling proceeds into estate
- Consider Corporate-Owned Life Insurance When:
 - Too many owners to administer other structures
 - All owners are well below estate tax exemption
 - Business structured as a C-Corporation and income tax advantages are present

Best Practices in Buy-Sells

Valuation Mechanism (Process Over Price)

- Design the Agreement as Procedural Roadmap:
 - Mandate qualified, independent appraiser with recognized credentials (e.g., ASA)
 - Clearly define standard of value – typically "fair market value" per Treasury Regulations and Revenue Ruling 59-60
 - Specify level of value – explicit statement on whether discounts for lack of control or marketability apply
 - Detail appraiser selection process:
 - Each party selects one appraiser
 - If valuations differ by > X% (typically 10%), the two appraisers select third appraiser
 - Establish timeline for completion
- Include dispute resolution mechanism for valuation disagreements

Action Items for Existing & New Agreements

EXISTING AGREEMENTS

- For COLI-funded buy-sells, review insurance coverage to test adequacy
- Assess whether life insurance proceeds are properly considered and understood by the parties in the equity valuation process
- Does the buy-sell pricing mechanism tie to current fair market value – is there Chapter 14 exposure?
- Evaluate all provisions in the context of understanding comparability with commercial norms
- Are existing Agreement provisions being followed?
- Establish periodic review schedule

NEW AGREEMENTS

- Must consider all funding structures - COLI, cross-purchase and separate LLC structure - to balance insurance and valuation and tax considerations
- Use independent professional appraisals – at the outset and ongoing
- Identify and implement objective valuation methodologies from inception
- Document business purposes clearly
- Ensure terms reflect commercial reasonableness
- Consider three-prong test under Section §2703
- Include dispute resolution procedures

Key Takeaways

- Life insurance proceeds held by a corporation MUST be included in valuation
- Redemption obligations at FMV do not offset insurance proceeds
- Fixed or stale pricing that deviates materially from FMV creates substantial risk
- Professional valuations and arm's-length terms are critical
- Section 2703 comparability requires alignment with commercial norms
- Early coordination of legal, financial, and valuation expertise is essential

Final Thoughts

The cost of getting a buy-sell agreement wrong has never been clearer. Recent decisions provide guidance on the standards buy-sell agreements must meet. Rather than obstacles, they offer a framework for effective succession planning that balances business objectives with regulatory requirements.

Buy-sell arrangements function best when legal, financial, and valuation perspectives are coordinated from the outset, producing structures that are both workable for all stakeholders and technically sound.

When properly designed, families and business partners can achieve reduced tax uncertainty, fewer disputes, and greater confidence their succession planning will operate as intended.

Disclaimer

- *The information provided herein has been prepared without taking into account any specific objectives, financial circumstances or needs. Accordingly, MPI disclaims any and all guarantees, undertakings and warranties, expressed or implied, and shall not be liable for any loss or damage whatsoever (including human or computer error, negligent or otherwise, or actual, incidental, consequential or any other loss or damage) arising out of or in connection with any use or reliance upon the information or advice contained within this publication. The viewer must accept sole responsibility associated with the use of the material in this publication, irrespective of the purpose for which such use or results are applied. This material should not be viewed as advice or recommendations. This information is not intended to, and should not, form a primary basis for any investment, valuation or other decisions. MPI is not acting as a fiduciary, an expert or advisor in any capacity whatsoever in providing the information set forth herein. The information set forth herein may not be relied upon and is not a substitute for competent legal and financial advice.*
- *The information provided in this publication is based in part on public information. MPI makes every effort to use reliable and comprehensive information, but makes no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the information provided herein and MPI shall not have liability for any damages of any kind relating to any reliance on such data. Further, the information set forth herein may be subject to change. MPI has no obligation to update the information set forth herein or to advise the viewer when opinions or information may change.*
- *This publication is not a solicitation or offer to buy or sell securities. The information contained in this publication was prepared for information purposes only and was not intended or written to be used as investment or tax advice or as a recommendation to buy or sell securities.*

Speaker Biography:

Todd G. Povlich, CFA, ASA

Partner and Practice Leader – Private Client Appraisal Group

Todd is a Partner at MPI and is based in the firm's New York City office. Since joining MPI, Todd has determined the value of closely held securities of companies and partnerships in many industries for a variety of purposes, including estate and gift tax, income tax, matrimonial proceedings, employee stock ownership plans, corporate planning and restructuring, financial reporting, sale, merger, stock purchase plans and buy-sell agreements. Todd has prepared valuations of closely held operating companies, asset holding entities, as well as other securities such as undivided interests in real estate, closely held promissory notes and preferred stock. While his experience is broad with respect to entity structure and industries, Todd specializes in the valuation of pass-through entities, alternative asset management firms and carried interest.

Education: Chartered Financial Analyst®, CFA Institute
M.B.A., Concentration in Finance: Rutgers University, 2009
B.S., Major in Finance: The College of New Jersey, 2003

Associations: Accredited Senior Appraiser ("ASA"), American Society of Appraisers (BV)
Member, Estate Planning Council of New York City, Inc.
Member, New York Society of Security Analysts
Affiliated Professional Member of the American Bar Association ("ABA")
Group Member of the ABA's Real Property, Trust and Estate Law Section ("RPTE")
Adjunct Professor – The College of New Jersey Business School (2016-2019)
Faculty – Southern Federal Tax Institute (2017-2019, 2022-Present)
Faculty – New Jersey Society of Certified Public Accountants (2018)
Faculty – Massachusetts Continuing Legal Education, Inc. (2017-Present)