The Five Biggest Mistakes that Sabotage Buy-Sell Agreements

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Agenda

- Succession Landscape and Review of Basic Designs
- Mistake #1: Incorrect Structure/Failure to Update
- Mistake #2: Inappropriate or Inefficient Valuation Method
- Mistake #3: Ignoring Non-Death Triggering Events
- Mistake #4: Failure to Coordinate Estate and Succession Planning
- Mistake #5: Inadequate Funding of the Buyout Obligation
- Questions and Answers

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The Great Business Succession Wave

According to the McKinsey Institute for Economic Mobility:

- More than **50% of small business owners are over age 55.**
- **6 million** U.S. small and midsized businesses expected to face ownership transition by **2035**.
- More than **1 million businesses** are viable sale candidates representing up to **$5 trillion** in enterprise value.
- Successful transitions could preserve **12 million jobs**.

1 The $10 Trillion Transfer: How Baby Boomer Business Exits Will Reshape the Economy, McKinsey Institute for Economic Mobility

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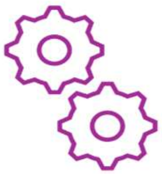
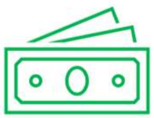
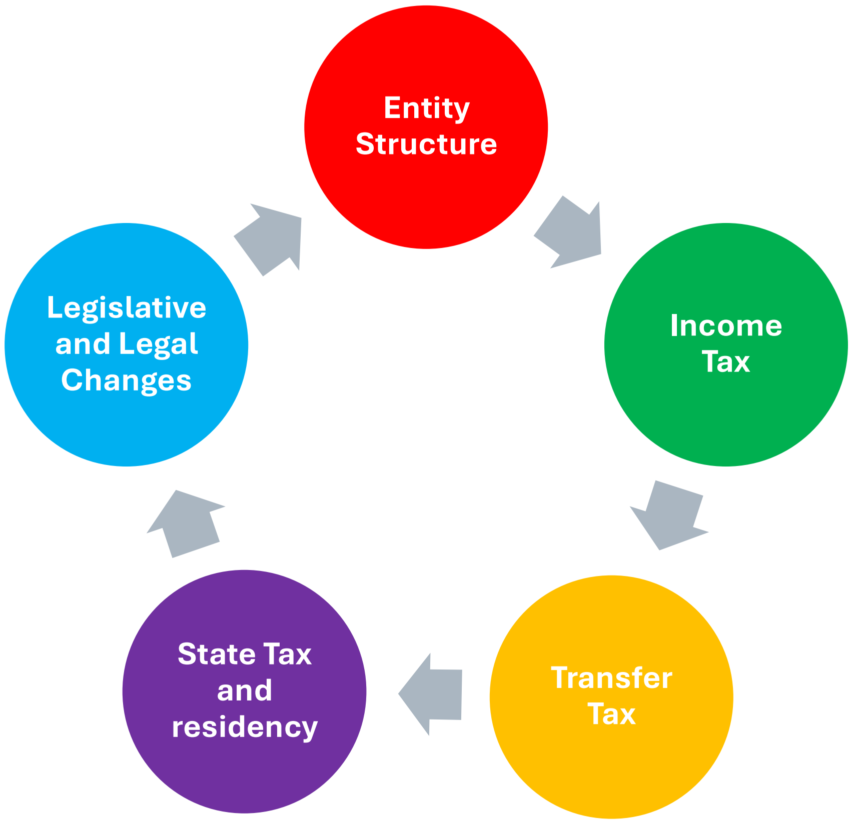
Why Owners Avoid Succession Planning

Emotional Barriers	Operational Barriers
• Confronting mortality • Loss of identity • Fear of losing control • Uncertainty about retirement	• Too busy running the business • Process seems overwhelming • Too many advisors involved • Belief there is plenty of time
Financial Barriers • Valuation uncertainty • Retirement funding concerns • Fear business is worth less than expected	**Family Barriers** • Choosing among children • Perceived favoritism • Family conflict concerns • No clear successor




Considerations



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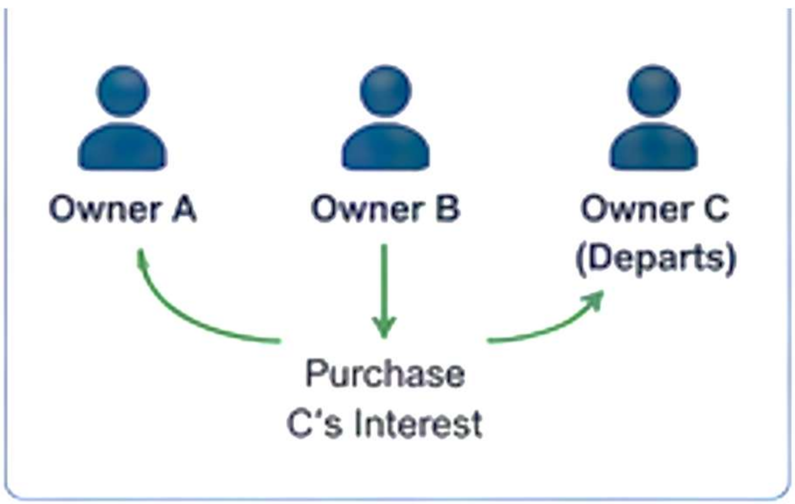
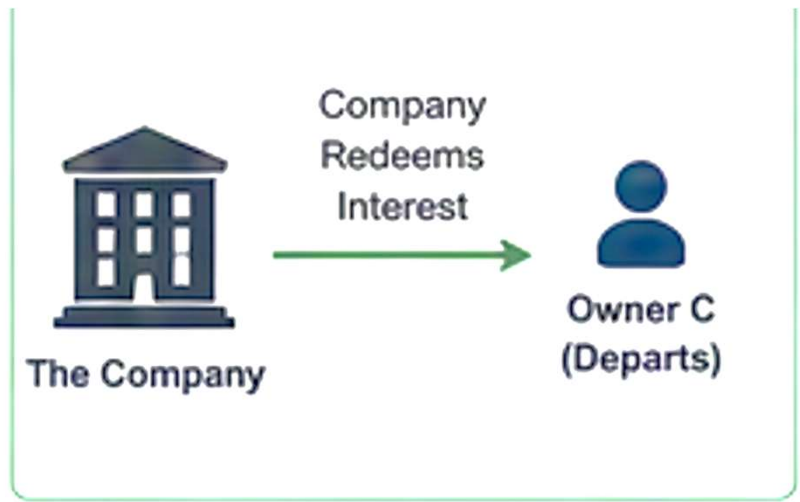
Buy-Sell Structures at a Glance

Cross Purchase Agreement:



Redemption Agreement:



Wait and see or Hybrid

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Comparison of Basic Designs

Factor	Cross-Purchase	Redemption	Wait-and-See
Basis Increase	✅ Yes	❌ No	✅ Possible
Administrative Ease	Moderate	High	Moderate
Insurance Complexity	High	Low	Moderate
Connelly Risk	Low	High	Low
Flexibility	Moderate	Low	High

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Mistake #1: Incorrect Structure/Failure to Update

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- Owners choose a cross-purchase or redemption structure at formation and never reconsider whether it remains appropriate.
    - Income Tax Basis Consequences
    - Life Insurance Funding
    - Effect on Business Liquidity and Creditors
    - Estate Planning Considerations
    - Ownership Control
    - Special considerations for S Corporations
- Business adds additional owners, sees significant increases in revenue, or changes tax status and original structure becomes undesirable, but owners fail to take action.

Mistake #1: Incorrect Structure/Failure to Update - Example

Cathy and Doug begin their business as a LLC with a cross-purchase buy-sell agreement funded with life insurance. As the business grows, they bring on additional members but fail to properly fund their buy-sell agreement.

One of the additional members dies and the surviving members have the personal obligation to purchase a pro rata share of the deceased member's interest, but do not have the funding in place to do so.

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Mistake #1: Incorrect Structure/Failure to Update - Example

Business began as a C corporation, and the buy-sell was drafted accordingly. Business elects to be taxed as an S corporation but fails to update their buy-sell agreement. When a shareholder dies, her interest passes to an entity that does not qualify as an S corporation shareholder, putting the company's S election at risk.

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Mistake #2: Inappropriate or Inefficient Valuation Method

Key valuation provisions

- Revenue Ruling 55-60
- Agreed upon value
- Formula Valuation
- Appraisals
  - What type (calculation of value vs. conclusion of value)?
  - How many?
  - On what basis (controlling interest vs. minority)?
- Impact of IRC §2703 in the family business context

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Connelly v. United States (2024)

- Michael and Thomas Connelly were brothers and the only shareholders of a closely held corporation.
- They entered a buy–sell agreement:
  - The surviving brother could buy the deceased brother’s shares.
  - If he declined, the corporation had to redeem (buy back) the shares.
- To fund this obligation, the corporation owned life insurance on each brother (~$3–3.5M).

Connelly v. United States (2024)

- Michael died, Thomas declined to purchase the shares → corporation redeemed them using ~$3M in insurance proceeds.
- The estate reported the value of Michael's shares as $3 million.
- IRS said the corporation's value should include the $3M insurance proceeds.
- Result: corporation valued at ~$6.86M → Michael's shares worth ~$5.3M, IRS assessed ~$890K additional estate tax.

Connelly v. United States **(2024)**

- ***Issue***: Whether, for federal estate tax purposes, a corporation's value must include life insurance proceeds used to redeem shares without offsetting them by the corporation's redemption obligation.

- The Supreme Court held that **corporate-owned life insurance proceeds used to redeem a decedent's shares must be included in valuing the corporation for estate tax purposes, without reduction for the redemption obligation**, because such an obligation does not reduce the corporation's economic value.

Planning to Mitigate *Connelly* Risk

- Purchase personal insurance in an ILIT to address additional estate tax.
- Enhanced Valuation Drafting - Clarify treatment of insurance proceeds in agreement and coordinate with appraiser methodology
- Irrevocable Life Insurance Trusts (ILITs)
- Use Cross-Purchase Arrangements

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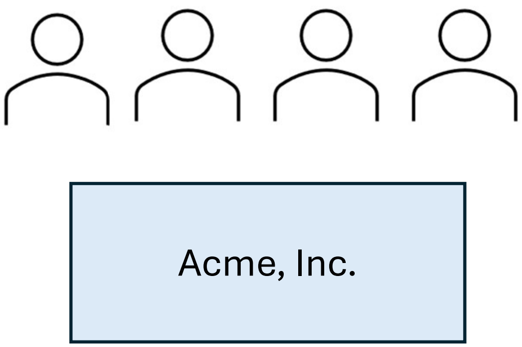
Using a Life Insurance LLC to Mitigate Connelly Risk

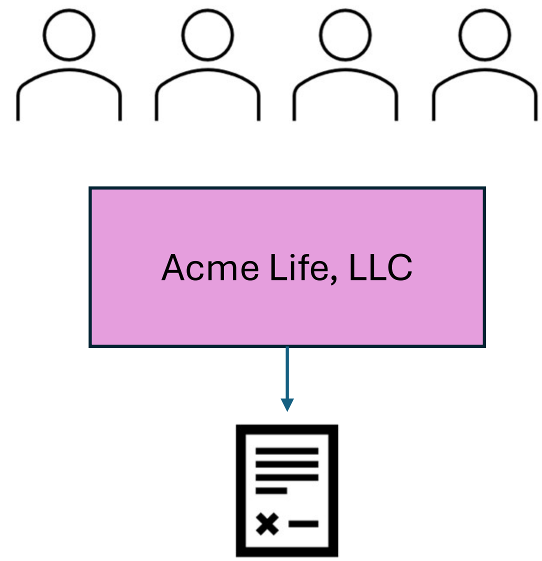
- Acme Corporation has four shareholders, each of whom hold 25% of the outstanding stock in the company.
- The fair market value of the Company, on a controlling interest basis is currently $20M, but is increasing rapidly.
- The shareholders are entering into a buy-sell agreement and plan to purchase permanent life insurance to fund it.
- The shareholders do not want to purchase a large number of policies and one of the shareholders has a potentially taxable estate.
- They decide to establish Acme Life, LLC to hold the life insurance policies to fund the buyout

Using a Life Insurance LLC to Mitigate Connelly Risk



LLC Taxed as a partnership with special provisions

- No member/manager may exercise incidents of ownership on policy insuring his/her life
- Upon a member's death, special allocation provisions allocate death benefit to survivors
- Survivors withdraw proceeds income tax free and use them to purchase Acme, Inc. shares



Mistake #3: Ignoring Disability and Other Non-Death Triggering Events

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Common Triggering Events

- Disability
- Divorce
- Bankruptcy / Assignment for Benefit of Creditors
- Voluntary Termination of Employment (Retirement)
- Involuntary Termination (for Cause / Not for Cause)
- Loss of Professional License
- Deadlock Among Owners

Best Practices

- ✓ Clear definitions of each triggering event.
- ✓ Establish mandatory vs. optional purchase rights.
- ✓ Coordinate with employment agreements and restricted stock/options/other grants.

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Mistake #4: Failure to Coordinate Estate, Tax, and Succession Planning

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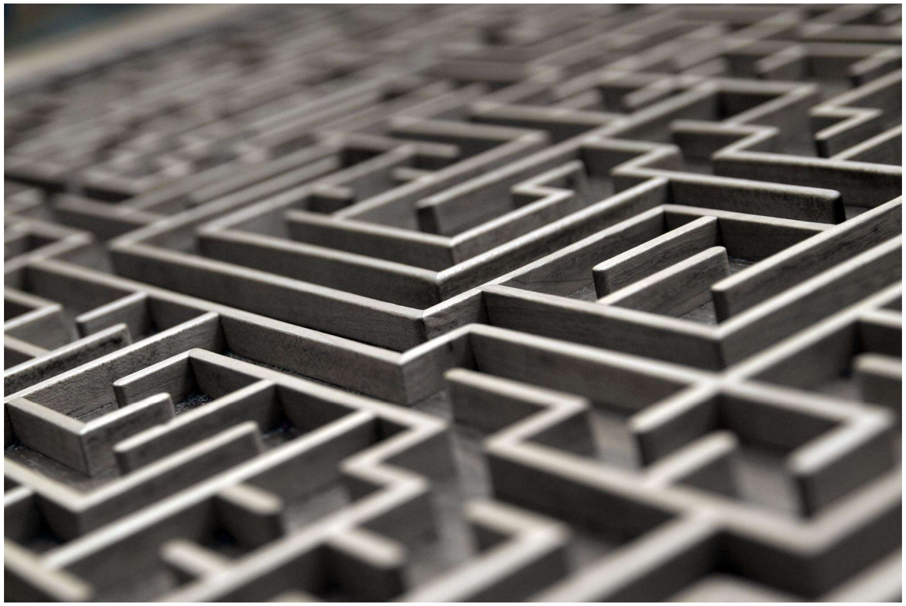
- Revocable trust ownership issues.
- Advanced planning (sales to IGITs or gifting trusts).
- Family limited partnership planning.
- S corporation eligibility concerns.
- Mismatched beneficiary designations.



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Best Practices to Avoid Mistake #4!

- Review buy-sell agreements whenever estate plans are updated.
- Coordinate among attorneys, CPAs, valuation experts, and wealth advisors.
- Evaluate income, estate, and gift tax consequences together.

Mistake #5: Inadequate Funding of the Buyout Obligation

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Mistake #5: Inadequate Funding of the Buyout Obligation

- Insufficient life insurance coverage.
- Failure to update policies after business growth.
- “Bought term need perm”.
- No disability buyout funding.
- Reliance on future cash flow that never materializes.

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Best Practices to Avoid Mistake #5!

- Conduct periodic funding audits.
- Coordinate business valuation with insurance coverage.
- Address death, disability, retirement, and voluntary transfers separately.
- Consider blended funding strategies.
- Always include a promissory note option that is reasonable for all parties.

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Questions and Answers

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