BUSINESS SUCCESSION | BUY-SELL DESIGN

Designing the Right Buy-Sell Agreement: Cross-Purchase, Stock Redemption, and the Lessons of Connelly

Buy-sell agreements are among the most important — and most frequently misdesigned — documents in closely held business planning. The Supreme Court's unanimous 2024 decision in Connelly v. United States has materially shifted the tax calculus for the stock redemption structure, reinvigorating the case for cross-purchase agreements as the preferred approach for most clients. This resource equips advisors with the analytical framework to evaluate both structures and make an evidence-based recommendation.

A buy-sell agreement is a legally binding contract among co-owners of a closely held business that governs how an ownership interest will be transferred when a triggering event occurs. Triggering events typically include death, permanent disability, retirement, voluntary departure, divorce, bankruptcy, or loss of a required professional license. Without a well-designed buy-sell agreement, the departure of any owner — especially at death — can force a sale of the business at distressed prices, introduce unwanted outside parties into the ownership structure, and expose the decedent's estate to severe liquidity problems.

The two foundational structures are the cross-purchase agreement, in which the individual co-owners agree to purchase the departing owner's interest, and the stock redemption agreement (also called an entity-purchase agreement), in which the business entity itself buys back the interest. A third approach, the hybrid or wait-and-see agreement, preserves optionality by granting the entity the right of first refusal, with the surviving owners purchasing any interest the entity declines. For funding purposes, life insurance is the most common and reliable mechanism in both primary structures, though installment payments, sinking funds, and lines of credit are alternatives in specific circumstances.

The choice between these structures has always carried significant tax implications. The Supreme Court's June 2024 ruling in Connelly v. United States fundamentally altered the estate tax calculus for redemption agreements funded by corporate-owned life insurance — a development that every advisor with closely held business clients must understand and act on.

The Connelly Decision: What It Holds and Why It Matters

Michael and Thomas Connelly were the sole shareholders of Crown C Supply, a closely held building supply company in Missouri. To ensure the business remained in the family, the brothers entered into a stock redemption agreement: if either brother died and the survivor declined to purchase his shares personally, the corporation was obligated to redeem the deceased's shares. Crown purchased $3.5 million in life insurance on each brother to fund the potential redemption obligation.

When Michael Connelly died, Thomas declined to purchase his brother's 77.18% interest. Crown used its life insurance proceeds to redeem Michael's shares for $3 million, a value agreed upon informally by Michael's estate and Thomas without a formal independent appraisal. Michael's estate reported the value of his shares as $3 million on the estate tax return — treating the corporation's redemption obligation as a liability that offset the insurance proceeds dollar for dollar.

The IRS disagreed. It valued Crown at approximately $6.86 million as of Michael's death, including the full $3 million in life insurance proceeds as a corporate asset without any offsetting reduction for the redemption obligation. At Michael's 77.18% interest, the IRS calculated his shares as worth $5.3 million rather than $3 million — producing an additional estate tax bill of approximately $890,000.

Connelly v. United States, 602 U.S. ___ (2024) — Decided June 6, 2024

In a unanimous 9-0 opinion authored by Justice Thomas, the Supreme Court affirmed the Eighth Circuit and held that: (1) life insurance proceeds received by a corporation upon a shareholder's death are a net corporate asset included in the corporation's fair market value for estate tax purposes; and (2) the corporation's obligation to redeem the deceased shareholder's stock does not offset or reduce that inclusion. The Court reasoned that a hypothetical arm's-length buyer would treat the insurance proceeds as a net asset, not a wash against the redemption obligation.

The Court's economic reasoning is straightforward: a redemption does not destroy corporate value — it merely redistributes it. Before the redemption, Crown held $3 million in insurance proceeds as an asset. After the redemption, Crown no longer held the proceeds, but Michael's shares no longer existed either. The surviving shareholders, and thus the surviving economic interests in Crown, were worth exactly what Crown was worth before the insurance proceeds arrived. As the Court noted, Thomas' argument that Crown was worth only $3.86 million after the redemption could not be reconciled with basic corporate accounting.[1]

Notably, the Court acknowledged that the Connelly brothers could have used a cross-purchase agreement instead, which would have allowed Thomas to personally purchase Michael's shares and avoid including the insurance proceeds in Crown's value. The Court did not call the redemption approach impermissible — it simply confirmed that it carries a distinct and avoidable estate tax cost. That observation is the strategic opening for advisors.[1]

The IRC §2703 problem: Why Connelly could not fix its agreement

A secondary lesson from Connelly is equally important: even a properly structured redemption agreement might have helped the estate if the brothers had strictly followed its terms and obtained a formal independent appraisal. The Connelly brothers did not. They informally agreed on a value of $3 million without an appraisal and without following the agreement's own valuation procedures. That failure prevented the estate from invoking the safe harbor of IRC §2703(b).

Under IRC §2703(a), buy-sell agreement prices are generally disregarded for estate tax valuation purposes. IRC §2703(b) provides a safe harbor: a buy-sell price will be respected if the agreement (1) is a bona fide business arrangement, (2) is not a device to transfer property to family members for less than full consideration, and (3) has terms comparable to those of arm's-length transactions among unrelated parties.[2] The nonfamily safe harbor of Reg. §25.2703-1(b)(3) provides that if more than 50% of the business is owned by non-family members, all three requirements are deemed satisfied.[3]

In Connelly, the estate conceded it could not satisfy the §2703(b) requirements because the agreement's own valuation mechanism was not followed. Advisors designing any buy-sell agreement — whether cross-purchase or redemption — must ensure the valuation methodology is objectively determinable, consistently applied, and defensible as arm's-length. A formula keyed to an independent appraisal, EBITDA multiple, or book value ratio reviewed annually is far stronger than a fixed price or an informal handshake agreement.´

The Two Primary Structures: Design, Mechanics, and Tax Consequences

Cross-purchase agreements

In a cross-purchase arrangement, each co-owner individually agrees to purchase the interest of any other owner whose departure triggers the agreement. Funding is typically accomplished by having each owner purchase and own a life insurance policy on each of the other owners, naming themselves as beneficiary. When one owner dies, the surviving owners collect the death benefit on the policies they hold on the deceased and use those proceeds to purchase the deceased's interest from the estate at the pre-agreed price or formula.

The cross-purchase structure has three distinct tax advantages that no other design can fully replicate.

First, the life insurance proceeds are received directly by the surviving individual owners — not by the corporation. They are therefore not a corporate asset and do not increase the value of the deceased's shares for estate tax purposes. Connelly does not apply. The proceeds are income tax-free under IRC §101(a)(1) and remain outside the corporate balance sheet entirely.µ

Second, the surviving owners receive a cost basis in the newly acquired shares equal to the purchase price paid — typically the current fair market value of the interest. This stepped-up basis is significant if the surviving owners later sell the business. Under IRC §1012, basis equals cost. A surviving 50% owner who purchases the deceased's 50% interest for $5 million now holds a $5 million basis in those shares. If the business later sells for $12 million, the capital gain on the purchased shares is measured against $5 million, not a near-zero historical cost.[6]

Third, the insurance policies are owned by individuals, not the corporation. The cash values and death proceeds are protected from the claims of corporate creditors — a meaningful protection in businesses carrying significant debt or operating in litigation-prone industries. Policy proceeds also avoid the corporate alternative minimum tax. For C corporations specifically, company-owned life insurance proceeds that accumulate as cash value can trigger additional complications under the earnings and profits rules that do not arise in cross-purchase structures.·

The Basis Step-Up: A Concrete Example

Three equal co-owners each hold a 33.3% interest in a business worth $9 million ($3 million each). One owner dies. In a cross-purchase structure, the two survivors each use life insurance proceeds to purchase half of the deceased's interest, paying $1.5 million each. Each survivor's total basis: their original $X basis plus $1.5 million in new basis from the purchased shares. In a redemption structure, the corporation buys back the deceased's interest. Each survivor's basis: unchanged at their original $X. If the business later sells for $15 million and each survivor receives $7.5 million, the cross-purchase survivors have $1.5 million more in tax basis to offset that gain — permanently.

Stock redemption (entity-purchase) agreements

In a stock redemption arrangement, the business entity itself — whether a corporation, LLC, or partnership — agrees to purchase the departing owner's interest. The entity purchases life insurance on each owner, pays the premiums, and collects the death benefit when an owner dies, using those proceeds to redeem the shares from the estate. From an administrative standpoint, the redemption structure is simpler: one policy per owner, premiums paid by the entity, and no concern about which owner is responsible for which premium.

The administrative simplicity of redemption has historically been its primary argument over cross-purchase when ownership groups are large. With seven co-owners, a cross-purchase structure requires 42 policies (7 × 6). The same seven-owner business under a redemption structure requires only seven policies.¸ That arithmetic has driven many advisors and business owners toward the redemption structure despite its tax disadvantages.

Post-Connelly, those disadvantages are now more precisely quantified and harder to defend. Beyond the estate tax valuation problem, the redemption structure's failure to provide a basis step-up to surviving owners is a compounding long-term cost. Surviving owners who eventually sell the business face capital gains measured against their original (often near-zero) historical cost basis. In a business that has appreciated significantly, this gap can represent hundreds of thousands — or millions — of dollars in additional capital gains tax at disposition.[6]

For C corporations specifically, the redemption approach carries additional risks. Under IRC §318, a redemption that does not fully terminate the deceased owner's interest — taking into account constructive ownership through family attribution rules — may be treated as a taxable dividend rather than a capital transaction. Advisors designing redemption agreements for family-owned C corporations must ensure the redemption qualifies as a complete termination under IRC §302(b)(3) or satisfies another recognized safe harbor.[1]

Comparative Analysis: When Each Structure Is Appropriate

Factor	Cross-Purchase	Stock Redemption
Post-Connelly estate tax impact	None — proceeds not a corporate asset	Life insurance proceeds inflate corporate value; redemption obligation does NOT offset
Basis step-up for survivors	Yes — IRC §1012 stepped-up cost basis equal to purchase price	No — surviving owners retain original historical basis
Number of policies required	N × (N−1) policies; 42 for 7 owners	N policies; 7 for 7 owners
Premium payer	Individual owners (after-tax personal dollars)	Business entity (non-deductible)
Creditor exposure	Policies/proceeds protected from corporate creditors	Cash value subject to corporate creditor claims
C corp AMT / E&P	Not applicable; proceeds paid to individuals	Proceeds may affect earnings and profits; AMT risk for larger C corps
Family-owned business	Strong; no IRC §318 attribution risk	Careful: IRC §318 attribution may cause redemption to be taxed as dividend
IRC §2703 valuation control	Fully applicable; formula pricing respected if arm's-length	Fully applicable; risk heightened post-Connelly if policy proceeds inflate value
Administrative complexity	High with multiple owners; manageable with 2–3	Simpler; one policy per owner regardless of owner count
Transfer-for-value risk	Avoided if partners insure each other (IRC §101(a)(2)(B) exception)	Avoided; proceeds paid to entity as policy owner and beneficiary

When cross-purchase is the right choice

Cross-purchase is the preferred structure in most situations today, particularly after Connelly. The following circumstances make the case compelling:

- Two to four co-owners. The policy count remains manageable. Two owners require two policies; four owners require twelve. This is the sweet spot where cross-purchase's tax advantages outweigh its administrative overhead.
- C corporation with owner ages and health that produce predictable premium costs. The premium disparity between older and younger owners is a real concern; it can be addressed through bonus or premium equalization arrangements funded at the entity level.
- Business with strong appreciation prospects. If the business is expected to grow significantly in value, the basis step-up available to surviving owners under cross-purchase becomes progressively more valuable over time.
- Estate tax-exposed decedent. Where the deceased owner's estate is at or near the federal estate tax threshold, keeping insurance proceeds off the corporate balance sheet (and out of the estate's share value) is directly material to the estate tax calculation.
- Family-owned business. Cross-purchase eliminates the IRC §318 attribution risk that can recharacterize a redemption as a dividend in family ownership situations.

- Owners with personal creditor exposure concerns. Individually owned policies are beyond the reach of corporate creditors and provide a layer of protection the redemption structure cannot match.

When redemption may still be considered

The redemption structure remains worth analyzing in specific circumstances — but it should never be the default choice post-Connelly. If the tax disadvantages are understood and accepted, the following conditions may support it:

- Five or more co-owners of roughly equal age and health, where the policy count under cross-purchase becomes genuinely unmanageable and administrative simplicity is a controlling priority.
- S corporations and pass-through entities (LLCs taxed as partnerships). In these entity types, the basis step-up problem is partially mitigated because owners already receive a basis adjustment through the pass-through of income and losses. The absence of C-corporation-level tax complications also reduces the estate tax impact of having insurance proceeds on the balance sheet.
- Where the entity has strong existing cash reserves and the practical concern is controlling premium cash flow at the entity level rather than distributing funds to individual owners.
- Note: even in these circumstances, advisors should fully disclose the post-Connelly estate tax exposure and document that the client made an informed decision after understanding that the redemption obligation will not offset the insurance proceeds for estate tax purposes.

The hybrid (wait-and-see) agreement

A hybrid buy-sell agreement grants the entity a right of first refusal to redeem the departing owner's interest, with the surviving owners holding a secondary right to purchase any interest the entity declines. This structure preserves flexibility but adds legal complexity. If the entity ultimately exercises the redemption right, the full Connelly analysis applies. If the individual owners exercise their purchase right, the cross-purchase tax treatment applies. For this reason, hybrid agreements funded by corporate-owned life insurance still carry the Connelly risk if the entity is likely to exercise its right. Advisors using hybrid structures should consider funding the insurance at the individual owner level or through a trust to preserve maximum flexibility on the tax outcome.

The LLC Trust Structure: A Post-Connelly Alternative for Larger Groups

For businesses with five or more co-owners where both structures present challenges, a Buy-Sell LLC (sometimes called a life insurance LLC or trust vehicle) has gained traction as a workable third path. Under this arrangement, a separate LLC is formed specifically to hold life insurance policies on each owner. Each co-owner holds a membership interest in the LLC proportional to their interest in the operating business. The LLC — managed by an independent third-party trustee or bank to avoid incidents of ownership — owns one policy on each operating-company owner and serves as the coordinating mechanism for policy administration.

When an owner dies, the LLC receives the death benefit on the relevant policy. Proceeds are allocated to the surviving members' separate capital accounts in the LLC (not to the deceased member's account), avoiding inclusion in the deceased's estate. The surviving members then use those funds to purchase the deceased's interest in the operating company directly, achieving the cross-purchase tax result — including the basis step-up — without requiring each owner to maintain separate individual policies on every other owner.[12]

Key design considerations for the LLC structure include: (1) the independent trustee requirement to avoid IRC §2042 incidents of ownership; (2) proper operating agreement provisions ensuring death benefits are allocated only to surviving members; and (3) notice and consent compliance under IRC §101(j) for employer-owned policies. This structure meaningfully addresses the administrative complexity objection to cross-purchase while preserving the tax advantages of the individual-ownership model. Advisors considering this approach should engage tax counsel experienced in business succession to ensure the LLC agreement is properly drafted.

Transfer-for-Value: A Cross-Purchase Caution Worth Noting

When a business restructures from a redemption to a cross-purchase arrangement, and existing policies on each owner are transferred from the corporation to the individual co-owners, the transfer-for-value rule under IRC §101(a)(2) may apply — converting what would have been income-tax-free death benefits into taxable income. A narrow exception applies: the rule does not apply to a transfer of a policy to the insured, to a partner of the insured, or to a partnership in which the insured is a partner (IRC §101(a)(2)(B)). In C corporations, no comparable exception typically applies. Advisors converting existing redemption agreements must analyze this risk carefully before any policy is transferred.

Valuation: Getting It Right Under IRC §2703

Regardless of structure, the valuation methodology in a buy-sell agreement is the foundation of its tax effectiveness. IRC §2703(a) establishes the general rule that buy-sell agreement prices are disregarded for estate and gift tax purposes. IRC §2703(b) provides the safe harbor: the price will be respected if the agreement is a bona fide business arrangement, is not a device to transfer property to family members for less than adequate consideration, and has terms comparable to arm's-length arrangements.[2]

For businesses where more than 50% is owned by non-family members, the Regulation §25.2703-1(b)(3) nonfamily safe harbor deems all three requirements automatically satisfied — making the valuation formula far more likely to control for estate tax purposes.[3] For family-owned businesses, each test must be independently satisfied, and the IRS applies heightened scrutiny. Fixed prices are dangerous; they become stale. Formula approaches tied to EBITDA multiples, adjusted book value, or capitalized earnings — updated at regular intervals by an independent appraiser — provide a much stronger foundation.

The Connelly brothers' failure was not only structural (the redemption design) but procedural: they informally agreed on a value without following their own agreement's appraisal requirement. Even the most tax-efficient buy-sell structure offers no protection if the parties fail to observe its terms. Advisors should build into every buy-sell agreement: (1) a clear, objective valuation formula or regular appraisal cycle, (2) an annual review obligation, and (3) documentation showing adherence to the agreed methodology at each triggering event.´

Funding Considerations: Life Insurance as the Primary Vehicle

Life insurance remains the most reliable funding mechanism for buy-sell agreements because it delivers a precise, income-tax-free death benefit at exactly the moment the obligation arises — without depending on business cash flow, accumulated reserves, or credit market access. The policy structure should match the agreement design: individual policies owned by individual owners in a cross-purchase arrangement; entity-owned policies in a redemption arrangement; and LLC-owned policies in a trust vehicle.

Permanent life insurance (universal life, whole life) is generally preferred for buy-sell funding over term insurance for two reasons. First, a buy-sell obligation typically has an indefinite duration — owners may not transfer their interests at a predictable age, and disability and retirement triggers may arise at any time. Term insurance provides no coverage beyond its term and may expire before the obligation arises. Second, permanent policies accumulate cash value that can be accessed or collateralized for disability buyout funding, which is a critical gap in many term-only buy-sell structures. Survivorship policies are not appropriate for buy-sell funding — the obligation arises at first death, not second.

When there is a significant age or health disparity among co-owners, the premium cost differential in a cross-purchase structure can be substantial. A 40-year-old owner insuring a 65-year-old partner will pay materially more than the inverse. This imbalance can be addressed through a premium equalization bonus paid by the entity to the younger owner, effectively leveling the net cost of ownership across the group — though this creates a taxable income event for the recipient that should be planned for.

AdvisorServe's Recommended Framework for Advisors

When approaching a buy-sell design engagement, we recommend the following sequential evaluation for every closely held business client:

- Identify the entity type. C corporations carry the greatest redemption risk (Connelly, §318 attribution, E&P complications). S corporations and pass-through entities present a more nuanced picture but cross-purchase still typically wins on basis. LLCs and partnerships have additional flexibility but the same core tax logic applies.
- Count the owners. For two to four owners, recommend cross-purchase unless a compelling reason exists for an alternative. For five or more, present the LLC trust structure as the primary solution that achieves cross-purchase tax results without the policy proliferation problem.
- Assess the estate tax exposure of each owner. If any owner's estate is at or near the federal threshold (currently $15 million under the One Big Beautiful Bill Act, effective 2026[13]), keeping insurance proceeds off the corporate balance sheet is critical. Connelly's math is unforgiving: at a 40% marginal estate tax rate, an unnecessary $3 million inclusion produces $1.2 million in avoidable tax.
- Evaluate the business's appreciation trajectory. A fast-growing business means a larger future disparity between historical basis and exit value for surviving owners. The step-up advantage of cross-purchase compounds with every dollar of appreciation.
- Determine the correct valuation methodology and build in compliance procedures. Get the valuation mechanism right, build in a review cycle, and document adherence.
- Engage qualified legal and tax counsel to draft the agreement. The structural recommendation can be made by the advisor, but the document must be prepared by an attorney with business succession experience and reviewed by the client's CPA.
- Review existing agreements immediately. Any client with an existing stock redemption agreement funded by corporate-owned life insurance should have that agreement reviewed in light of Connelly. The question is not only structural — it is whether the estate tax exposure is understood and whether restructuring is feasible.

References

[1] Connelly v. United States, 602 U.S. ___ (2024). No. 23-146. Decided June 6, 2024. Opinion by Justice Thomas. Available at https://www.supremecourt.gov/opinions/23pdf/23-146_i42j.pdf and https://www.law.cornell.edu/supremecourt/text/23-146.

[2] Internal Revenue Code §2703(b). See also Reg. §25.2703-1(b)(1)-(3). Requirements: (1) bona fide business arrangement; (2) not a device to transfer property to family members for less than adequate consideration; (3) terms comparable to arm's-length arrangements.

[3] Reg. §25.2703-1(b)(3). Nonfamily safe harbor: if more than 50% of the value of property subject to the restriction is owned by individuals who are not members of the transferor's family, all three §2703(b) requirements are deemed satisfied.

´ Feldhake, Eric A. "Key Takeaways from Connelly v. United States." Kulzer & DiPadova, P.A., 2024. The case underscores the importance of formula-based valuation provisions and strict procedural compliance. https://kulzerdipadova.com/news/u-s-supreme-court-agrees-to-decide-valuation-dispute-involving-buy-sell-agreements/

µ Internal Revenue Code §101(a)(1). Death benefits paid by reason of the death of the insured are excluded from gross income of the recipient.

[6] Internal Revenue Code §1012 (basis equal to cost); §1014 (stepped-up basis at death). In a cross-purchase, the purchasing owners' cost basis in newly acquired shares equals the purchase price. In a redemption, surviving owners' basis in their existing shares is unchanged. See also discussion in "Structuring Corporate Buy-Sell Agreements," https://www.keypersoninsurance.com/structuring-buy-sell-agreements/.

[7] "Buy-Sell Agreements: A Key Element of Business Succession and Preservation." Brown Brothers Harriman, 2017. https://www.bbh.com/us/en/insights/capital-partners-insights/buy-sell-agreements--a-key-element-of-business-succession-and-preservation.html.

¸ Policy count formula for cross-purchase: N × (N−1), where N = number of owners. For 7 owners: 7 × 6 = 42 policies. For redemption: N policies regardless of owner count.

[1] Internal Revenue Code §302(b)(3) (complete termination of shareholder's interest); §318 (constructive ownership / family attribution rules). Morgan & DiSalvo, P.C., News Alert, August 2024. https://morgandisalvo.com/news-alert-the-u-s-supreme-court-case-of-connelly-v-united-states/

[12] Michael Kitces. "Business Buy-Sell Agreements In The Wake of Connelly v. IRS." Kitces.com, December 2024. Discussion of the Buy-Sell LLC structure, independent trustee requirement, IRC §2042, and IRC §101(j) notice and consent requirements. https://www.kitces.com/blog/business-buy-sell-agreements-connelly-v-irs-internal-revenue-service-supreme-court-entity-purchase-agreements-life-insurance-llc/

[13] One Big Beautiful Bill Act (H.R. 1, signed July 4, 2025). Permanently raised the federal estate and gift tax exemption to $15 million per person effective January 1, 2026, with annual inflation adjustments.

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