Estate Planning

Connelly v. U.S. decision allows proceeds of corporate-owned life insurance to be included in estate tax value of shares.

By Steve R. Akers, JD

Using life insurance is a popular way of funding an obligation to purchase a decedent's interest in a business entity under a buy-sell agreement. A recent federal district court case, *Connelly v. U.S.*,[1] addresses the valuation for federal estate tax purposes of stock of a closely held corporation. The stock was purchased at Michael Connelly's death pursuant to a requirement in a buy-sell agreement that the corporation purchase the stock, and the corporation had funded the purchase obligation by owning a life insurance policy on Michael Connelly's life.

Buy-Sell Agreement and Purchase of Decedent's Shares

The buy-sell agreement required the company, which was owned by Michael and his brother, Thomas Connelly, to purchase a decedent's shares following his death. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (that would not consider control premiums or minority discounts).

The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value. On the death of Michael Connelly, who owned about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement, but the company agreed to pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company).

1 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021).

The estate reported the value of the shares at $3 million, but the IRS assessed an additional $1 million of estate tax, maintaining the $3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The IRS and the estate stipulated that the value of the decedent's shares was $3.1 million if the life insurance proceeds were not considered, and the open issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

Buy-Sell Agreement Did Not Fix the Value for Estate Tax Purposes

The initial consideration was whether the purchase price was binding as the value for federal estate tax purposes because of the buy-sell agreement. Section 2703(a) of the Internal Revenue Code provides generally that the value of property for transfer tax purposes is determined without regard to an agreement to acquire the property at a price less than its fair market value. A "safe harbor" exception in §2703(b) applies if three requirements are satisfied, but the court held that exception did not apply for Mr. Connelly's stock. The buy-sell agreement met the first condition – that the agreement was a bona fide business arrangement – but it did not meet the other two requirements. It failed to meet the second requirement – that it was not a device to transfer property to the decedent's family for less than full consideration – because the purchase price did not include the life insurance proceeds in determining the company's value, the process of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts. The agreement also failed to meet the third requirement – that its terms were comparable to similar arrangements by persons in an arms' length transaction – because the estate "failed to provide any evidence of similar arrangements negotiated at arms' length."

In addition, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values:

- The agreement did not provide a fixed and determinable price;
- It was not binding at death (evidenced by the fact that its procedures were not followed); and
- It was a substitute for a testamentary disposition for less than full consideration.

Value Should Be Determined Taking into Consideration Life Insurance Owned by the Corporation for Funding the Buy-Sell Obligation

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the rationale of the Federal Court of Appeals for the Eleventh Circuit in *Estate of Blount v. Commissioner*[2] that the value of life insurance proceeds on the decedent's life paid to the company was offset by the contractual obligation of a company to purchase the decedent's shares. The court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e., including Michael's shares)."

The court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The life insurance proceeds used to redeem Mr. Connelly's shares must be taken into consideration in determining the fair value of the company and of the decedent's shares.

Buy-Sell Agreement Structuring

A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the Connelly agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

ENTITY PURCHASE. The parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase

2 428 F.3d 1338 (11th Cir. 2005).

life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*). For a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange versus dividend treatment.

CROSS PURCHASE. The parties must rely on the remaining owners to purchase their interests at death; funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted. These advantages are quite significant. Cross purchase arrangements are often used and if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life.

Buy-Sell Agreement with Life Insurance Funding

One of the factors in determining whether to use a corporate purchase or a cross-purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents' shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* opinion).

The economic impact of not including insurance proceeds in valuing a decedent's shares would produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent's shares without having to pay anything personally following the decedent's death. The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fully fund the buy sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time, so it is not surprising that the IRS maintains that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality.

Conclusion

This ruling is being appealed, so the final outcome of this case remains uncertain. For now, however, taxpayers and their financial advisors should keep the District Court's ruling in mind when creating buy-sell agreements that are funded with life insurance and carefully choose a structure for the agreement that can help avoid a similar valuation whipsaw.

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