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The Washington Report

Wealth Transfer Edition

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Connelly v. United States

MARKET TREND: Valuation appears to be trending within the Internal Revenue Service ("IRS") these days: insurance policy valuations, CCAs regarding GRATs, charitable planning targeted, and now the *Connelly* case.

SYNOPSIS: The U.S. Court of Appeals for the Eight Circuit (referred to herein sometimes as the "Eighth Circuit" or the "Court") found that the value of life insurance proceeds funding a redemption buy-sell agreement should be included in the value of a closely-held business for estate tax purposes, changing conventional thinking.

TAKE AWAYS: Business owners should consider a cadence of regularly reviewing their buy-sell agreements. These are living, breathing documents. If their buy-sell agreement happens to be a redemption agreement, the economics should be reviewed assuming the same treatment as the Connelly case. It may be that these buy-sell agreements are woefully underfunded, triggering an audit of their life insurance plans. And if the owner has an agreement in place, they should follow it to the letter, not set-it-and-forget-it.

MAJOR REFERENCE: *Connelly v. United States*, No. 21-3683 (8th Cir. Jun. 2, 2023); Internal Revenue Code ("IRC") § 2703(b).

The *Connelly* case demonstrates the value proposition behind proper buy-sell planning, which largely gets ignored.

All in the Family – A Tale of Two Brothers

The *Connelly* case centers on two brothers who owned Crown corporation ("**Crown**"), a roofing and siding business in the St. Louis area. Michael Connelly ("**Michael**") owned 77.18% of the outstanding shares, and Thomas Connelly ("**Thomas**") owned the remainder.

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To provide for a smooth ownership transition upon either brother's passing, the brothers and Crown entered into a stock purchase agreement ("**Stock-Purchase Agreement**"), which provided that if one brother passed, the other could buy his shares, and if not, Crown must redeem the shares. The brothers always intended that Crown, and not the surviving brother, would redeem the other's shares. Accordingly, to fund the redemption, Crown purchased $3.5 million of life insurance on each brother's life.

The Stock-Purchase Agreement provided two mechanisms for determining the value of Crown: (1) the brothers were required to execute a new "Certificate of Agreed Value" at the end of every tax year, which set the price by mutual agreement, and if no Certificate of Agreed Value was executed; then (2) the brothers were to obtain two or more fair market value appraisals. The brothers never did either.

Michael died in 2013 and Crown received the $3.5 million of life insurance proceeds. Crown redeemed Michael's shares for $3 million as part of a larger, post-death agreement between Thomas and Michael's son, resolving several estate administration matters. No appraisals were obtained pursuant to the Stock-Purchase Agreement, instead; Thomas and Michael's son declared they had "resolved the issue of the sale price of stock in as amicable and expeditious [a] manner as is possible" and they agreed the stock was worth $3 million.

Michael's estate ("**Estate**") filed an estate tax return reporting that Michael's shares of Crown were worth $3 million. To value the shares, the executor relied solely upon the redemption payment. The IRS audited the Estate's return and concluded that Michael's shares were undervalued because the valuation did not include the value of the life insurance proceeds.

Journey to the Eighth Circuit

The IRS sent a notice of deficiency to the Estate, which the Estate paid and then sued for a refund. The Estate claimed that: (1) the redemption transaction, made pursuant to the Stock-Purchase Agreement, determined the value of the Crown shares for estate-tax purposes, so there was no need to conduct a fair market value analysis; or, alternatively (2) the fair market value of the Crown shares should not include the life insurance proceeds used to redeem Michael's shares because, although the proceeds were an asset, they were immediately offset by a corresponding liability – the redemption obligation (and thus added nothing to Crown's value); relying on the so-called *Blount* case.

The district court granted summary judgment to the IRS, concluding that the Stock-Purchase Agreement did not determine the value and that the proper valuation of the Crown shares must include the life insurance proceeds. The Estate appealed to the Eight Circuit.

Does the Stock-Purchase Agreement Control?

On appeal, the Estate argued that the Stock-Purchase Agreement should control the valuation of the shares of Crown for estate-tax purposes, obviating the need to decide whether the life insurance is properly included in the valuation of the shares.

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The Law – IRC Section 2703, Case Law, and Regulations

The general rule under IRC § 2703(a) is that the value of assets, for transfer tax purposes, is determined without taking into account: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property; or (2) any restriction on the right to sell or use such property.

The exception (which the Estate would arguably rely on), IRC § 2703(b), provides that the general rule does not apply to any option, agreement, right, or restriction which satisfies all three requirements:

1. It is a bona fide business arrangement.
2. It is 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.
3. Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

There are additional requirements developed in caselaw and contained in Treasury Regulation § 20.2031-2(f) that a buy-sell agreement must satisfy to receive the exception treatment of IRC § 2703(b): (1) the offering price must be fixed and determinable under the agreement; and (2) the agreement must be legally binding on the parties both during life and after death.

Court's Analysis

The Eighth Circuit honed in on the fact that the Stock-Purchase Agreement was missing some fixed or determinable price when valuing Michael's shares. The Court noted that the brothers and Crown ignored the Stock-Purchase Agreement's pricing mechanism.

The Stock-Purchase Agreement contained no fixed price nor prescribed a formula for arriving at one. The Certificate of Agreed Value was nothing more than an agreement to agree. The second mechanism, while more objective, contained no meaningful calculation guidelines in the Stock-Purchase Agreement; it directs that independent appraisals are conducted on Crown.

The Court concluded that nothing can be gleaned from the Stock-Purchase Agreement and the value of the Crown shares must be determined without regard to the Agreement.

How much is $3 Million of Crown Stock Really Worth? – Inclusion of Life Insurance Proceeds

Generally, the value of property in a decedent's gross estate is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[1] The Estate and IRS stipulated that the enterprise value of Crown without regard to the life insurance proceeds, was $3.86 million.

[1] Treas. Reg. § 20.2031-1(b)

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Treasury Regulation § 20.2031-2(f)(2) and Estate of Blount

Treas. Reg. § 20.20231-2(f)(2) provides, that in valuing closely held corporations, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity."

Both the IRS and the Estate agree that this is the same issue found in *Estate of Blount v. Commissioner* from the Eleventh Circuit.[2] *Blount*, similarly, dealt with a stockholder agreement requiring the redemption of shares funded with life insurance. In *Blount*, the Eleventh Circuit declared that "nonoperating assets should <u>not</u> be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets." This, in effect, precluded the inclusion of life insurance proceeds in the determination of fair market value.

In *Blount*, the Eleventh Circuit viewed the life insurance proceeds as an "asset" directly offset by a "liability" to redeem the shares, yielding a zero effect on the company's value.

The Eighth Circuit And *Blount*

The Eight Circuit did not distinguish the *Blount* opinion, but rather directly disagreed with its holding. The Court points out that an obligation to redeem its shares is not a liability in the ordinary business sense. Quoting the Fletcher Cyclopedia of the Law of Corporations, the Court provides that "the redemption of stock is a reduction of surplus, not the satisfaction of a liability."

The Court made several attempts to display the illogical reasoning of *Blount*, and then summarized nicely, "the proceeds were simply an asset that increased shareholders' equity. The fair market value of Michael's shares must account for that reality."

Lessons on the Structuring of Buy-Sell Agreements

The *Connelly* opinion creates a split between the Eighth and Eleventh Circuits. The case teaches lessons on the structuring of buy-sell agreements, and the importance of understanding the estate-tax impact of a buy-sell agreement funded with life insurance.

The Circuit Split

Tax related decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them. The Eight Circuit found *Blount* to be "demonstrably erroneous." This does not mean that *Blount* was overturned, but rather in the Eighth Circuit the precedent will be *Connelly*, while the Eleventh Circuit will continue to follow the *Blount* reasoning.

[2] *Estate of Blount v. Commissioner.,* 428 F.3d 1338 (11th Cir. 2005)

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The Eleventh Circuit, by the way, is Alabama, Florida, and Georgia. The Eighth Circuit is North Dakota, South Dakota, Minnesota, Nebraska, Iowa, Missouri, and Arkansas. Probably worth noting.

Possible Problems – Satisfaction of IRC § 2703(b)

The opinion in *Connelly* does not provide an earth-shattering explanation of what a buy-sell agreement must contain to satisfy IRC § 2703(b) and control valuation for estate-tax purposes. However, it does point out the obvious – to have a chance for the buy-sell agreement to control the valuation for estate-tax purposes, there must be some fixed or determinable way to identify value under the four-corners of the Stock-Purchase Agreement. The Court did not have to go much deeper, because in this case, the Stock-Purchase Agreement did not have a fixed or determinable way to calculate value.

Even if the Stock-Purchase Agreement called for the fixed and determinable calculation of Michael's shares to equal the $3 million redemption price, the Court may have ultimately reached the same result. The final two prongs of IRC Section 2703(b) require the agreement to (1) not be 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; and (2) have terms comparable to similar arrangements entered into by persons in an arm's length transaction.

The Court's rationale regarding the valuation of the life insurance could be extended to those prongs of IRC §2703(b). Because the Stock-Purchase Agreement did not take into consideration the life insurance proceeds, it could be a device to transfer such property to members of the decedent's family for less than full and adequate consideration, and similarly, these terms would not likely be terms similar to arrangements entered into by persons in an arm's length transaction (because presumably, a third-party would take the life insurance proceeds into consideration). It could be argued that the determination of fair market value of a closely held business cannot simply be side-stepped by drafting a buy-sell agreement with a fixed and determinable pricing formula.

In valuing a closely-held business subject to a buy-sell agreement for estate tax purposes, the safest thing to do is use the fair market value standard. The way the exception in IRC § 2703(b) is written, it very nearly requires the traditional fair market value standard (and thus is no real exception).

The other concern here is: if you have a buy-sell agreement, follow it! The stockholders in *Connelly* made it easy for the Court to reject the Estate's use of the Stock-Purchase Agreement . . . simply put – if you can ignore it, so can we, and we will. If a business owner is going to commit to a process in writing, then he/she had better follow it.

Possible Solutions – A Few Ideas . . .

1. Redemption vs. Cross-Purchase

The specific facts of this case would have yielded a better result if a cross-purchase agreement was used instead of a redemption structure. Technically, the Stock-Purchase Agreement was a hybrid cross-purchase and redemption agreement because there was an initial option for the surviving brother to purchase the other's shares. Only if the surviving brother did not exercise

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this right did Crown have an obligation to redeem the shares. However, the opinion specifically states that the brothers always intended Crown, not the surviving brother, would redeem the other's shares, which is supported by the fact that the life insurance was owned by Crown, and not the brothers themselves.

If the brothers purchased insurance on each other's lives to finance the cross-purchase agreement, then the fair market value of the Crown shares for estate tax purposes would not have included the insurance proceeds on Michael's death. Thomas would have received the life insurance proceeds income tax free. The resulting increase in value to Thomas would not be subject to the estate tax until his death.

Under these facts, hindsight suggests a cross-purchase agreement might have yielded a better result. However, in many situations, for non-tax reasons, the cross-purchase agreement is not ideal. The number of life insurance policies needed in a cross-purchase buy-sell agreement jumps exponentially with the number of owners. At some point, this is unmanageable. There is also administrative peace-of-mind and efficiencies by having the company own and maintain the life insurance policies.

2. Acquire Additional Life Insurance

As a prophylactic measure, each owner of a closely-held business may consider acquiring additional life insurance in a traditional irrevocable life insurance trust. This will offer a safety net to offset any mismatch between a redemption agreement and the estate tax liability.

3. Conduct Annual Appraisal; Add a Formula Clause

Owners of a closely-help business should consider having the business appraised annually. And if the appraisal is not completed, then provide a fixed and determinable valuation of the business using a readily calculable formula clause in the agreement.

4. Follow the Agreement

This is simple: if you want the Court to follow your agreement, you must also follow your agreement.

Take Aways

Business owners should consider a cadence of regularly reviewing their buy-sell agreements. These are living, breathing documents. If their buy-sell agreement happens to be a redemption agreement, the economics should be reviewed assuming the same treatment as the Connelly case. It may be that these buy-sell agreements are woefully underfunded, triggering an audit of their life insurance plans. And if the owner has an agreement in place, they should follow it to the letter, not set-it-and-forget-it.

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