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Advising Clients in Light of Connelly v. US

By Rachel Wassel on July 29, 2024

Issue: Whether life insurance proceeds received by a corporation to fund redemption obligation should be considered in valuing a company.

Held: Company's contractual redemption obligation does not necessarily reduce the value of the company for federal estate tax purposes.

Background:

Brothers Michael and Thomas were the sole shareholders in Crown C Supply (the "Company"), a building supply company. Michael owned a 77.18% interest in the Company and Thomas owned the remaining 22.82%. The brothers entered into a stock purchase agreement designed to keep Crown in the family upon the death of either brother. Pursuant to the agreement, upon the death of either brother, the survivor was permitted to purchase the deceased brother's shares. If the survivor declined to purchase the shares, the Company was required to redeem the shares at fair market value. [1] The Company obtained $3.5 million in life insurance on each brother to fund the agreement.

Upon Michael's death, Thomas declined to purchase his brother's shares, triggering the Company's redemption obligation. As executor of Michael's estate, Thomas filed a federal estate tax return and reported the value of Michael's shares (a 77.18% interest in the Company) as $3 million.[2] Rather than obtain appraisals to determine fair market value as required by the agreement, Thomas and Michael's son amicably agreed upon the redemption price. [3] The Company used $3 million of the insurance proceeds to redeem the shares from Michael's estate.

The Internal Revenue Service ("IRS") audited the estate tax return. During the audit, an outside accounting firm determined the Company's total fair market value at Michael's death was $3.86 million. The valuation excluded the $3 million in insurance proceeds used to redeem Michael's shares on the theory that its value was offset by the Company's redemption obligation. [4] The IRS disagreed. Taking the position that the redemption obligation did not offset the insurance proceeds, the IRS valued the Company at $6.86 million, resulting in an estate tax deficiency of $886,914. The estate paid the deficiency and sued for a refund. Declining to follow *Blount,* the *District* Court granted summary judgment in favor of the IRS, and the Eighth Circuit affirmed.

The Supreme Court granted certiorari and affirmed. The Court explained that a fair market value redemption obligation does not offset the value of life insurance proceeds earmarked for the redemption because the redemption does not affect any shareholder's economic interest. The Court rejected Thomas's position that *all* redemption obligations reduce a

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corporation's net value, acknowledging in a footnote that there are situations where a redemption obligation could decrease a corporation's value.

The Court emphasized that, for estate tax purposes, Michael's shares must be valued as of the time of his death, prior to the redemption under I.R.C. § 2033 and Treas. Regs. §20.2031(b). Furthermore, the Court distinguished a liability from a redemption obligation, analogizing that a willing buyer purchasing an entire company could extinguish the redemption obligation. In that situation, the Court stated that a willing seller would not accept only $3.86 million when the Company was about to receive $3 million of insurance proceeds.

POST-CONNELLY PRACTICE TIPS

- Although the *Connelly* holding is limited to redemption agreements funded with company-owned life insurance (i.e., entity purchase agreements), the decision serves as a reminder to periodically review buy-sell agreements and funding and monitoring compliance with contractual formalities.
- When drafting buy-sell agreements, consider using a cross-purchase structure (or blended structure) rather than a redemption agreement. Had the brothers in *Connelly* owned life insurance policies on each other to fund a cross-purchase obligation, the insurance proceeds would not have been deemed an asset of the company (The brothers' failure to comply with the valuation requirements contained in the agreements may have nevertheless given rise to an estate tax deficiency.)
- A blended structure may require the surviving shareholder(s) to purchase the deceased shareholder's share *up to* the amount of available life insurance. To the extent the life insurance proceeds are insufficient to purchase all of the shares, under a blended structure, the company is obligated to redeem the balance of the shares.
- When there are more than two owners of a closely held business, consider trusted cross-purchase agreements or life insurance LLCs. In these cases, the trustees of the trust or the separate LLC owns the life insurance policies. LLC classified as partnerships offer flexibility to transfer policies without running afoul of the transfer for value rules.[5] Before transferring existing policies, advisors must be mindful of the transfer for value rules and exceptions, as well as the potential income tax implications of transferring insurance policies. While clients and advisors may prefer the mechanical simplicity of redemption agreements, advisors should communicate the risks of this approach after *Connelly*.
- Ensure buy-sell agreements include appropriate and objective valuation mechanisms, such as requiring appraisals or following a formula to set certificates of value and insist upon strict compliance with the agreement. For a buy-sell agreement to govern value for estate tax purposes, the agreement must provide for a fixed or determinable price meeting all of the requirements of I.R.C. § 2703. [6] When using a certificate of stated value approach, advise clients to use an appraiser to establish a formula (this is good practice irrespective of the Connelly decision).
- The *Connelly* decision also serves as a reminder to advise clients on the economics and estate tax implications of various approaches to structuring and funding buy-sell agreements as well as risks associated with each approach.

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[1] Despite the cross-purchase option in the agreement, the Court noted that the brothers

always intended the Company would redeem the deceased brother's shares.

[2] The accounting firm determined the full fair market value of the Company to be $3.86 million and calculated the value of Michael's shares as follows: $3.86 million x 77.18%.

[3] The agreement provided two mechanisms for determining the redemption price: (1) the brothers were to agree upon a set price at the end of each year and document the price by a certificate of agreed value or (2) if the brother's failed to set the price, they would obtain two or more fair market value of appraisal.

[4] The accounting firm relied on *Blount v. Commissioner*, 428 F. 3d 1338 (CA11 2005) (concluding insurance proceeds should be deducted from valuation when the company is contractually obligated to use the proceeds to redeem shares of deceased shareholder).

[5] Life insurance proceeds, payable as a result of the death of the insured, are generally received income tax-free; however, if a life insurance policy is transferred for consideration, the death proceeds are taxed as ordinary income to the beneficiary. Important exceptions to the transfer for value rules include transfers to (1) the insured; (2) a partner of the insured; (3) partnership in which the insured is a partner; and (4) corporation in which the insured is a shareholder or officer. See I.R.C. § 101(a)(1)-(3).

[6] 26 U.S. Code § 2703 – Certain rights and restrictions disregarded

> (a) General rule, for purposes of this subtitle, the value of any property shall be determined without regard to—
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> > (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 (without regard to such option, agreement, or right), or
> >
> > (2) any restriction on the right to sell or use such property.
>
> (b) Exceptions Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following 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 arms' length transaction.

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