6/25/23 - Life Ins / Buy sell

Steve Leimberg's Business Entities Email Newsletter - Archive Message #274
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From: Steve Leimberg's Business Entities Newsletter

Subject: Mary E. Vandenack on Connelly v. United States

"In Connelly v. United States, a three-judge panel of the Eighth Circuit held that the value of a company is increased by the proceeds of a life insurance policy taken out against the life of a deceased shareholder and intended to be used to purchase the interest of the deceased shareholder."

Mary Vandenack provides members with timely and important commentary on the Eighth Circuit's opinion in *Connelly v. United States*.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, Accredited Estate Planner® (Distinguished) Nominee, is founding and managing member of **Vandenack Weaver Truhlsen** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, executive compensation, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, and tax-exempt organizations. Mary will be inducted into the NAEPC Hall of Fame in November 2023. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as on Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Chair Elect. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, legal ethics, technology in the practice of law and process automation. Mary hosts a podcast called Legal Visionaries. https://www.vwattys.com/resources-vw-podcasts/

Here is her commentary:

EXECUTIVE SUMMARY:

In *Connelly v. United States,*[1] a three-judge panel of the Eighth Circuit held that the value of a company is increased by the proceeds of a life insurance policy taken out against the life of a deceased shareholder and intended to be used to purchase the interest of the deceased shareholder.

FACTS:

Michael and Thomas Connelly were brothers. Together, they owned Crown C Corporation. Michael owned a 77.18% of the Company and Thomas owned the remaining 22.82%. The corporation obtained life insurance on each of the brothers to assure that there would be a smooth transition of ownership if either of the brothers passed away. The purpose of the life insurance was to provide a source to redeem the shares of either brother if one of them died. The two brothers entered into a stock purchase agreement that permitted either brother to buy out the other upon the death of one. If the surviving brother chose not to purchase the shares of the deceased brother, then the company had an obligation to redeem the shares.

The stock purchase agreement provided that the value of the company would be determined annually and documented in a certificate of agreed value. In the event that a certificate of agreed value was not created, then the value of the company upon a triggering event would be determined by two or more appraisals of fair market value. No certificate of agreed value was ever created. Additionally, no appraisals were obtained. Regardless, the company purchased life insurance on each of the brothers with face value of $3.5 million.

Michael died in 2003. The Company received the life insurance proceeds and purchased Michael's shares for $3 million. The purchase price was determined as part of an agreement between Thomas and Michael's son.

Thomas was the executor for Michael's estate. An estate tax return was filed reporting the value of Michael's shares at the redemption price of $3 million.

The IRS audited the estate return. The IRS concluded that Michael's shares had been undervalued by relying solely on the redemption payment. The IRS valued the Company by adding the value of the life insurance proceeds. The estate paid the tax liability pursuant to an IRS notice of deficiency and then filed for a refund.

The estate claimed that the redemption transaction determined the value of the Company for estate tax purposes. As a result, no fair market value analysis was required. The estate also argued that to the extent that the life insurance proceeds are included as a value item, the value of the proceeds was offset by a liability to redeem Michael's interest.

The district court granted summary judgment to the IRS concluding that the stock purchase agreement did not affect the valuation and that a proper valuation must include the life insurance proceeds. The district court declined to follow the 11th circuit case, *Blount v. Commissioner.*[iii] The estate appealed to the Eighth Circuit.

The Eighth Circuit determined that the stock purchase agreement in this case does not control how the Company should be valued. The court also concluded that the life insurance proceeds used for redemption must be considered in a fair market value of the Company.

The Eighth Circuit stated that the value for tax purposes is determined "without regard to any option, agreement, or other right to acquire . . . the property at a price less than the fair market value" or to "any other restriction on the right to sell or use such property." 26 U.S.C. § 2703(a).

The Eighth Circuit noted that valuation formulas in stock purchase agreements of closely held corporations are to be ignored unless they meet the criteria of § 2703(b). To meet the criteria of that section, an agreement must be a bona fide business arrangement, must not be a device to transfer property to the members of the decedent's family for less than full and adequate consideration, and have terms that are comparable to other similar arrangements entered into in an arm's length transaction.

The court stated that a valuation and a stock purchase agreement must establish a fixed or determinable price calculated in a definite way. The court did not provide an opinion on exactly what will constitute a fixed or determinable price. Rather, the court noted that a determinable price would be one arrived at by a formula and indicated that the stock purchase agreement in this instance failed to do so.

In determining whether the life insurance proceeds required to be included in the value of the Company, the court relied on the concept of the value of property being "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."[iii] the court also noted that in valuing a closely held corporation 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."[iv]

The Eighth Circuit considered whether the life insurance proceeds could be included in Michael's estate based on an incident of ownership argument. The court noted that the regulations under §2042 specify that the decedent does not possess incidents of ownership merely by being a controlling shareholder. The court then went on to conclude that § 20.2031-2(f) provides a rule that requires certain life insurance proceeds to be included in valuing the decedent's stock. The court stated that in this instance, a proper valuation of the Company required the inclusion of the life insurance proceeds as part of the value of the Company.

The Eighth Circuit explained its rejection of the *Blount* case by stating that the obligation to redeem the shares of a deceased shareholder is not a liability in the ordinary business sense. The court suggested that a willing buyer of the Company would pay the value of the Company including the life insurance proceeds.

COMMENT:

It is a common practice for closely held companies to use certificates of agreed value or require appraisals as a mechanism to determine company valuation for purposes of a stock purchase agreement. Based on the *Connelly* case, such a stock purchase agreement can be disregarded. This conclusion is questionable in the instance where a certificate of agreed value is well supported by a documented formula. Additionally, appraisals use formulas and the particular stock purchase agreement in this case required two appraisals. Advisors should be aware of this case and consider providing some language concerning the formula considerations for an appraisal. In doing so, advisors should be careful to avoid telling an appraiser how to do the appraiser's job. That would raise another issue. If the certificate of agreed value is relied on to establish company value, documentation as to the approach to valuation should it be part of the certificate of agreed value. By way of example, at some point, the company could hire an appraiser to appraise the company but also specify the formula that is appropriate to use for valuation of the company. That is, a

certificate of agreed value should be supported by some form of formula that was used to determine the value.

Using insurance to fund stock purchase agreements of closely held companies is a common practice. The conclusion of the Eighth Circuit that the value of the company should be increased by the entire value of the proceeds is not an unreasonable conclusion. By way of example, assume a company is worth $5 million prior to receipt of insurance proceeds related to the death of a shareholder. The life insurance proceeds are $3 million. The company has a redemption obligation to pay $3 million to the deceased shareholder. As distinguished from a different type of liability, when a redemption of shares is made, the remaining shares increase in value per share. If the insurance proceeds are worth $3 million and the redemption is $3 million, then the underlying value after the transaction is $5 million. It is worthy of note that the life insurance proceeds and the actual buy-out amount will often differ and the company may have a windfall or the redemption will not be fully funded.

Practitioners might view this case as a reason to consider more cross purchase agreements and insurance LLC's. Such a conclusion is reasonable. In doing so, note that alternative strategies to fund cross purchase agreements do not necessarily avoid estate inclusion but rather defer it. By way of example, if Shareholder 1 and Shareholder 2 have a cross purchase agreement funded with cross owned life insurance and Shareholder 1 dies, Shareholder 2 is the beneficiary of the life insurance proceeds on Shareholder 1. Those proceeds increase the value of Shareholder 2. Shareholder 2 uses those proceeds to purchase the shares of Shareholder 1. Essentially, this is the same result as the *Connelly* case but the estate inclusion is deferred until Shareholder 2 dies.

The main takeway in this case is that practitioners should reconsider the language used in agreements for closely held companies regarding valuation. Additionally, consideration should be given to whether redemption by the company is the best mechanism to repurchase shares when life insurance is involved.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

CITE AS: