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Steve Leimberg's Business Entities Email Newsletter - Archive Message #246

Date:	**18-Jan-22**
From:	**Steve Leimberg's Business Entities Newsletter**
Subject:	**Steve Seel & Dan Griffith on Connelly v. IRS: Casting Shadows on Buy-Sell Agreements**

"The ultimate issue for determination by the Connelly court was the fair market value of the decedent's interest in a business entity. The Connelly court, arguably in a break from prior caselaw, disregarded the entity agreement in question. It instead determined that the value of the entity in question for estate tax purposes included the life insurance proceeds that were paid to the company upon the owner's death. Although some may argue that this is a classic case of bad facts creating bad law, practitioners should be wary of drafting entity agreements that may accidentally trigger similar unwelcome circumstances."

Steve Seel and **Dan Griffith** provide members with their analysis of *Connelly v. IRS*.

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Daniel R. Griffith is a Senior Vice President and Director of Wealth Strategy at **Huntington Private Bank**. In this role, he leads a team of advisors dedicated to advising ultra-high net worth clients, develops intellectual capital of the Private Bank and educates clients and colleagues on planning techniques. Dan began his legal career in private practice where his client work focused on estate and tax planning, complex trust administration, business succession planning and charitable giving. Dan received his bachelor's degree from the University of Mount Union and law degree from The Ohio State University. As an attorney licensed in both Ohio and Florida, Dan has worked to develop legal innovations in the area of asset protection. He was instrumental in creating Ohio's Domestic Asset Protection Trust statute and continues to update the law as a member of the Estate Planning, Trust, and Probate Law Section Council of the Ohio State Bar Association. Dan frequently speaks and writes on planning topics for a variety of audiences. Dan also has a passion for community service, as reflected by his time on various charitable boards, as a former elected official and as a university adjunct faculty member.

Here is their commentary:

EXECUTIVE SUMMARY:

In the recent U.S. District Court decision, *Connelly v. Dept. of Treasury, Internal Revenue Service*, Judge Clark of the Eastern District of Missouri considered two issues: (1) when an entity agreement (presumably any form of entity) will effectively fix value for federal estate tax purposes, and (2) how an entity is valued when it owns life insurance on a deceased owner. This decision calls for business lawyers to carefully review any agreement that obligates an entity to purchase the interests of an owner at death (an "entity agreement"), especially if that obligation is funded by life insurance owned by the entity.

The ultimate issue for determination by the *Connelly* court was the fair market value of the decedent's interest in a business entity. The *Connelly* court, arguably in a break from prior caselaw, disregarded the entity agreement in question. It instead determined that the value of the entity in question for estate tax purposes *included* the life insurance proceeds that were paid to the company upon the owner's death. Although some may argue that this is a classic case of bad facts creating bad law, practitioners should be wary of drafting entity agreements that may accidentally trigger similar unwelcome circumstances.

FACTS:

Crown C Supply, Inc. was owned by two brothers, Michael and Thomas Connelly. Michael died in October 2013. Under a shareholder agreement (the "Agreement"), Crown C Supply was obliged to buy Michael's shares in Crown C Supply if the surviving brother did not, and it owned life insurance on Michael's life with a death benefit of $3,500,000. Without the life insurance, the parties stipulated that Michael's Crown shares were worth $3,100,000.

The Agreement provided for two mechanisms to fix the value for Crown C Supply: (1) execution of a certificate of value or (2) by securing two or more appraisals. The brothers never signed certificates of value and the estate did not appraise Michael's shares after his death. Instead, Michael's shares were redeemed for $3,000,000. As part of the transaction, Michael's son also received an option to purchase all of Thomas' shares for $4,166,666 (presumably a 100% interest) and Thomas agreed to split with Michael's son any gains from any sale that occurred within 10 years.

The estate argued that the Agreement should control the valuation of Crown C Supply. The IRS argued the Agreement failed to meet the requirements of the IRC, the Regulations, and caselaw to effectively fix the value of Crown C Supply.

The estate's expert at trial relied on *Estate of Blount v. Comm'r,* 2004 WL 1059517 (T.C. 2004), *aff'd in part, rev'd in part on other grounds*, 428 F.3d 1338 (11th Cir. 2005) and opined that the value of Crown C Supply should not include the insurance proceeds. The IRS' expert predictably argued that it should.

COMMENT:

Fixing Value -- Passing the Tests of 26 U.S.C. §§2703 and 2031

The *Connelly* court considered the three statutory legs of 26 U.S.C. §2703(b), each of which must be satisfied before an agreement will effectively fix value for federal estate tax purposes. The §2703(b) legs are as follows (and the ways in which the taxpayer in *Connelly* failed them are described after each):

1. <u>The Agreement must be a bona fide business arrangement</u>. The *Connelly* court did not pass on this point because the Agreement failed the other tests.

2. The Agreement must not be a device to transfer interests to members of the decedent's family for less than full consideration. The *Connelly* court concluded the Agreement was essentially testamentary, based on the following:

    a. The Agreement created a bargain price and resulted in a windfall to the surviving owner (the decedent's brother).

    b. The executors and the company failed to follow the pricing requirements under the Agreement.

    c. The Agreement prohibited the use of discounts and premiums in the valuation (a particularly troubling point, given how common it is for entity agreements to contain similar prohibitions).

3. The Agreement terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. The *Connelly* court concluded that no "real" buyer of a majority interest would accept the "windfall" effected by the Agreement's redemption terms.

The *Connelly* court then considered three other requirements based on 26 C.F.R. §20.2031-2(h), *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982), and *Estate of True v. Comm'r*, 390 F.3d 1210 (10th Cir. 2004) that must also be met before it would accept the Agreement's pricing terms:

1. The offering price must be fixed and determinable. The *Connelly* court noted that the parties failed to follow the Agreement's requirements on setting the redemption price. By coming to an independent agreement on price, the court concluded that the formula in the entity agreement was anything but fixed.

2. The Agreement must be legally binding during life and at death.

    a. During Life – The *Connelly* court found that the parties failed to execute certificates of value as required under the Agreement.

    b. At Death – The *Connelly* court found that the parties failed to follow the Agreement's death-time pricing requirements and that their post-death behavior implied that they did not consider the Agreement to be binding on them.

3. The Agreement must be bona fide and not entered into as a testamentary substitute. The *Connelly* court went "straight-to-fail" on this point, based on its findings under §2703.

The *Connelly* court's finding that the Agreement bestowed a valuation windfall on Thomas, making the Agreement inherently non-arm's length, is questionable. However, the facts of *Connelly* make the court's determination that the Agreement to be ineffective to fix value slightly less surprising. But far more problematic is the court's analysis of the value of Crown C Supply.

Fair Market Value Includes Insurance Proceeds – Ignoring *Blount*

The *Connelly* court concluded that the value of Crown C Supply must be increased by the death benefit of life insurance it held on the decedent's life, even though the entity paid the proceeds out to redeem the deceased owner's interests. In doing so it concluded that the "real" value of entity-owned life insurance is the death benefit, even though the policy is a non-operating asset that would typically be carried by the entity at its cash surrender value, at most. This finding appears to be in conflict with the Eleventh Circuit's prior decision in *Blount*.

In *Blount*, the panel established that the value of an entity would *not* be increased by the value of the death benefit of life insurance owned by the entity and used to fund a redemption. The *Blount* court reasoned that the value of the life insurance proceeds was offset by the company's redemption obligation. *Blount* was not, of course, binding on the *Connelly* court since the *Connelly* court's decision would be appealable to the Eighth Circuit. As such, the *Connelly* court was free to ignore *Blount* because it believed *Blount* to be "demonstrably erroneous." This signals that in cases litigated outside of the Eleventh Circuit, the courts may be unlikely to follow *Blount*. This in turn makes *Connelly* either a reality or a serious cause for pause for planners in most of the country outside the Eleventh Circuit.

Does the *Connelly* Value Analysis Make Sense?

The court's decision in *Connelly* appears to ignore some of the practical, common-sense realities of the valuation process.

First, the *Connelly* court presupposes that the true value of Crown C Supply is the entire death benefit of the insurance on Michael's life as a current asset on its books. However, under GAAP standards, at most the cash surrender value of life insurance would be carried as a current

asset. Arguably, *Connelly* requires valuation professionals to normalize the balance sheet of entities to reflect the difference between the cash value shown as a current asset and the death benefit.

Second, the real analytical focus should be on the value of Michael's shares to a buyer of *those shares*, not to a buyer of the total enterprise. Michael's estate was not enriched in the transaction – he traded roughly $3,000,000 worth of shares for an equivalent in cash, and his estate paid tax on that amount.

Third, the *Connelly* court's analysis does not make practical, economic sense on two points. For one, an arm's length buyer of a 100% interest in Crown C Supply would not pay the owners for the death benefit of the company's insurance policy. At best, they might buy the policy at its cash surrender value. For another, whatever value Crown C Supply had at the instant before Michael's death, it also had after the redemption. In fact, the enterprise value of the company is not increased by this or any other redemption. The *Connelly* court uses the inescapable fact that a redemption increases the ownership stake of the remaining owners to conclude that the redemption was a testamentary device.

Fourth, the Shareholder Agreement cannot be fairly characterized as a testamentary device. The court penalized Michael's estate because it perceived the redemption agreement to be a device to transfer untaxed value to his brother Thomas. However, it seems unlikely that Michael meant to benefit his brother at the expense of his family. Just because the entity agreement creates arrangements in anticipation of a shareholder's death does not mean that it was designed to be a testamentary substitute.

Finally, the option that Michael's son obtained reflected an agreed-upon value of $4,166,666 for the entire enterprise, further cutting against the court's belief that the enterprise value was $6,800,000.

Takeaways

While *Connelly* is something of a "bad facts" case, the court's broad pronouncements unfortunately do not turn on the existence of those facts. Going forward, as practitioners draft or review existing redemption agreements, they should consider the following:

1. Rethink insurance funded redemption agreements (while rare, they are out there). *Connelly* will make planning for more than two owners

challenging, given the complexities involved in a cross-purchase involving multiple owners.

2. Get an appraisal at death and follow it.
3. To avoid the *Connelly* court's concern over creating a "windfall" in value, consider defining the term *value* in entity agreements as the value determined by a third-party appraiser, without requiring or prohibiting discounts. However, note that if discounts are considered, a decedent's interest will likely be undervalued; if ignored, an interest may be overvalued.
4. Prepare for the possibility that a shareholder agreement is both effective for state law purposes to set the actual amount payable to the decedent's estate for entity interests, and also ineffective to set value for federal estate tax purposes. The result could be a cash-poor estate and an unfunded federal estate tax liability.
5. Avoid using certificates of value, and certainly do not to make them "mandatory."
6. Respect the entity agreement in its entirety – courts in general abhor structures that are simultaneously ignored and hidden behind.

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

Steve Seel

Dan Griffith

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