

BULLETIN: JUNE 30, 2023



## CONNELLY CASE: LIFE INSURANCE PROCEEDS INCREASE VALUE OF DECEDENT'S BUSINESS INTEREST

**Creating a conflict with the 11th U.S. Circuit Court of Appeals holding in *Blount*, the 8th U.S. Circuit Court of Appeals ruled in *Connelly* that life insurance can inflate the value of a decedent's business interest.**

In *Connelly v. United States*, the 8th U.S. Circuit Court of Appeals held that, when a stock redemption agreement fails to meet the requirements to fix the value of the decedent's business interest for estate tax purposes, (1) the life insurance proceeds should be included in the value of the decedent's shares and (2) the payment to the decedent's estate does not offset that value.<sup>1</sup>

As discussed below, this is a great time to review existing buy-sell agreements to ensure they meet current planning objectives, are adequately funded, and are compliant with Code Sec. 2703 and prior case law.

Pursuant to a redemption agreement, the Connelly brothers, as sole shareholders, entered into a stock redemption agreement. Each year the brothers were to agree upon the value of the shares and, failing that, each was to obtain an appraisal and then average the results. Corporate-owned life insurance was purchased to fund the agreement. During their lifetime, the brothers ignored both valuation provisions. Following the death of one brother, the surviving brother and

the decedent's son agreed to a \$3 million price for the decedent's interest in the business.

On appeal, the 8th Circuit affirmed the lower district court's grant of summary judgment holding that the agreement failed to establish a fixed or determinable price as required by Code Sec. 2703 and prior case law.<sup>2</sup> The court then established the fair market value of the decedent's stock applying a willing buyer/willing seller standard.<sup>3</sup> The court ruled that the value of the decedent's shares included the life insurance proceeds and that the redemption agreement was ineffective in creating an offsetting liability. The court opined that a hypothetical third-party buyer would pay up to \$6.86 million for the decedent's shares, not the \$3 million price agreed to by the surviving brother and the decedent's son.<sup>4</sup>

The 8th Circuit *Connelly* decision creates a conflict with the 11th U.S. Circuit Court of Appeals *Estate of Blount* decision.<sup>5</sup> *Blount* is a similar case in that the lower court (the U.S. Tax Court) ruled that the agreement did not fix the value for estate tax purposes, and the value of the decedent's shares included the life insurance proceeds with no offset. In overruling the Tax Court, the 11th Circuit stated that, where the redemption agreement is an enforceable liability under state law, even when a redemption agreement does not establish the value for estate tax purposes, the value of the decedent's interest does not include the life insurance proceeds because

the insurance proceeds are offset dollar-for-dollar by the corporation's redemption obligation.

## ADDRESSING CONNELLY

The 8th Circuit's (**Connelly**) opposite conclusion from the 11th Circuit (**Blount**) creates uncertainty in the remaining circuits. The **Connelly** decision can be criticized on a number of fronts. For example, a recent LSI article opines that the court likely erred in holding that the obligation to redeem the decedent's shares is not a liability that would offset the life insurance proceeds.<sup>6</sup> Although we agree, the **Connelly** decision is now the law in the 8th Circuit. Ultimately, the U.S. Supreme Court may resolve the conflict, but that could take years. In the meantime, there are two primary approaches to address **Connelly** directly, with the second being the recommended approach.

**Option 1:** *Keep the redemption agreement and business ownership of the policies in place and ensure that the redemption agreement meets the requirements of 2703 and prior case law.* In light of **Connelly**, extra care is needed to ensure the agreement establishes a fixed or determinable value that, in accordance with 2703(b)(3), is comparable to similar arrangements. In most cases, this means using a formula or appraisal process that accurately determines the value. This approach presents a real risk that the IRS will try to extend **Connelly** to all redemption agreements outside the 11th Circuit by presuming that the life insurance increases the value of the business. This is especially so since the burden is on the taxpayer to prove that "the terms are comparable to similar arrangements entered into by persons in an arm's length transaction."<sup>7</sup>

**Option 2:** *Switch the stock redemption agreement to a cross purchase agreement or to a life insurance only LLC.*<sup>8</sup> This is the recommended approach because, with a properly structured cross purchase buy-sell agreement, the insurance cannot increase the value of the decedent's interest (unless the insurance proceeds create a floor for the value of the decedent's interest). In fact, if **Connelly** had been a cross purchase buy-sell agreement (or a hybrid wait-and-see agreement<sup>9</sup>), the value would not have been disputed because the IRS and the estate agreed that the value of the decedent's interest excluding the insurance was approximately \$3.3 million.

If the redemption agreement had been a properly funded cross purchase agreement, we would not be reading about the Connelly brothers.

When moving a business owned policy to a non-insured business owner or owners to facilitate a cross purchase buy-sell agreement:

- Care must be taken to avoid violating the transfer-for-value rule.
- It is important that the owners recognize that, in the case of a corporate owned permanent policy with built-in gain, that gain will be taxable to the corporation.<sup>10</sup>
- If the business owners are insurable, it may be advisable to purchase new personally owned life insurance.

Finally, closing observations are in order for all forms of buy-sell agreements.

- It is recommended that all buy-sell agreements be reviewed (including redemption agreements in the 11th Circuit) as the **Connelly** decision may embolden the IRS, and there are a number of ways that a buy-sell agreement could fail to meet the requirements of 2703 and prior case law.<sup>11</sup>
- As **Connelly** demonstrated, it is essential, over time and in all situations, that the parties strictly adhere to all of the terms of the buy-sell agreement (including the valuation provisions).
- The IRS scrutinizes agreements among family members more closely (e.g., a parent transferring business interests to children or grandchildren.<sup>12</sup>) Therefore, when family members are involved, regardless of the form of the buy-sell agreement, even greater care must be taken to ensure that the agreement meets 2703 requirements and prior case law to fix the value of the decedent's business interest for estate tax purposes.<sup>13</sup>

## AN OPPORTUNITY TO REVIEW

Whether a redemption, cross purchase or other form of buy-sell agreement, this is a good time to review all existing buy-sell agreements to ensure that they are (1) properly structured to meet the owners' current planning objectives, (2) adequately funded, and (3) compliant with 2703 and prior case law. The review can start with a few initial questions (see sidebar) but should ultimately assess the agreement's valuation provisions and adherence to the terms of the agreement, and include a policy performance review.<sup>14</sup>

A team approach that includes working with a client's legal and tax advisors can help your client chart and follow a clear and secure path forward that complies with existing IRS codes and prior case law.

### REQUIREMENTS TO FIX VALUE OF A DECEDENT'S BUSINESS INTEREST

For a buy-sell agreement to fix the value of a decedent's business interest for estate tax purposes:

#### CODE SEC. 2703 REQUIREMENTS:

- It is a bona fide business arrangement.
- 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.
- Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

#### CASE LAW REQUIREMENTS:

- An estate must be obligated to sell at death.
- The price must be established by the agreement or contain a method or a formula for valuing the business.
- If selling during an owner's lifetime, the interest must first be offered to other owners at the agreement price.
- The price must be fair and adequate when made.

## INITIAL REVIEW QUESTIONS

- Does the valuation clause comply with Code Sec. 2703(b) and case law to establish a fixed or determinable price that is comparable to similar arrangements?
- Is the current buy-sell form (e.g., cross purchase and redemption) appropriate to meet the clients' objectives, and is that form tax efficient?
- Is the insurance ownership properly aligned with the purchase obligation?
- Is there adequate insurance to fund the obligation?
- Has the value of the business decreased since last reviewed?
- Have children or other individuals entered the business, changing the parties to the buy-sell agreement?

<sup>1</sup> *Connelly v. United States*, No. 21-3683 (CCA 8th Circuit, December 14, 2022)

<sup>2</sup> In affirming the district court's granting of summary judgment, the 8th Circuit ruled in *Connelly* that the facts were undisputed and the law was so clear that the IRS was entitled to prevail as a matter of law. In other words, the court felt that the outcome was so clear that the matter need not go to a full trial.

<sup>3</sup> A typical definition of fair market value is: The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.

<sup>4</sup> The IRS and the decedent's estate had agreed that the value of the business interest excluding the insurance was approximately \$3.3 million, so the case was focused solely on whether to include the insurance proceeds in the value.

<sup>5</sup> In *Estate of Blount v. Commissioner*, No. 04-15013 (CCA 11th, October 31, 2005), the decedent could unilaterally change the agreement. Pursuant to Reg. Sec. 20.2031-2(h), "Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime."

<sup>6</sup> LISI Business Entities Newsletter #275 (June 20, 2023) at <http://www.leimbergservices.com>. Copyright © L. Paul Hood, Jr. 2023. The author makes the important distinction between the "act of redemption" and the "obligation to redeem." As a binding legally enforceable obligation, the "obligation to redeem" is a corporate liability that should offset the insurance proceeds.

<sup>7</sup> The Legislative History and the Tax Court opinion in *Estate of Blount*, 87 TCM 1303 (2004) indicate that the burden is on the taxpayer to demonstrate that the agreement meets the Code Sec. 2703(b)(3) requirement that "the terms are comparable to similar arrangements entered into by persons in an arm's length transaction." This may be difficult for taxpayers to prove and may open a line of attack for the IRS.

<sup>8</sup> With the life insurance only LLC, the LLC is the owner and beneficiary of the insurance policies, the members contribute the premiums, and the proceeds are allocated to the non-insured members. The arrangement ensures completion of the agreement and offers the same benefits as a cross purchase agreement, for example, a full purchase price increase in basis. In addition, it limits number of policies and, as a partnership, meets the “transfer to a partner of the insured” exception to the transfer-for-value rule.

<sup>9</sup> A hybrid wait-and-see agreement is an alternative, where (1) the surviving owner has an option to purchase the decedent’s shares followed by an obligation of the business to redeem any remaining interests and (2) the insurance is owned by the non-insured owners.

<sup>10</sup> If operating as an ‘S’ corporation, that taxation will flow through to the shareholders.

<sup>11</sup> Especially if IRS staffing increases.

<sup>12</sup> Code Sec. 2703(b)(2) requires that an agreement “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.”

<sup>13</sup> In many family situations where it is desirable to keep the business in the family, a reasonable alternative is to manage the transfer of business interests through the client’s estate plan, valuing the business interest through appraisals whether a transfer is during the client’s lifetime or at death.

<sup>14</sup> See “Why Your Life Insurance Needs Periodic Review,” M Financial Group.

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