Closely Held Business Buy-out Arrangements Should be Reviewed Immediately in Light of the Recent Connelly Case

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Connelly v. United States

Action Points To Consider

Connelly – What To Do Now

- Communicate to clients the greater risk post-Connelly, whether you agree with the holding or not, of the IRS and courts taking the position that redemption insurance is included in the value of the business for estate tax purposes.
- Revise the language in insurance funded redemption buyout agreements to clarify how life insurance used to pay for a buyout is intended to be included in the valuation of a business.
- Use Connelly as an opportunity to again communicate to clients the importance of monitoring buyout arrangements in a global sense, reviewing entity minutes/consents, funding, valuation, buyout agreement language, etc.
- Recommend that a formula be used to set a certificate of stated value, not merely an agreement between the parties.
- Emphasize the message of the vital importance of adhering to entity and contractual formalities considering Smaldino, Levine, Sorensen and now Connelly.

Connelly v. United States

Valuation of Closely Held Businesses Impacted

Connelly v. United States - 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 two brothers entered into a stock purchase agreement that permitted either brother to buy out the other upon the death of the other shareholder/brother. If the surviving brother chose not to purchase the shares of the deceased brother, then the company had an obligation to redeem the shares.
- Given the ability of the survivor to decide, could the survivor and the company be deemed one?
- The corporation obtained life insurance on each of the brothers to fund the purchase agreement.
- The life insurance purchase provided a resource to **fund the redemption** but ultimately the proceeds could be more or less than the redemption obligation. Additionally, the insured might separate from the company for reason other than death.

Connelly v. United States – Facts (cont.)

- The facts stated in the opinion noted that the brothers always intended that the Company would redeem the interest of a deceased owner rather than the surviving brother, so it is not clear why the cross-purchase option existed (perhaps for a non-death separation).
- The stock purchase agreement provided two mechanisms for determining the redemption price of the shares.
- The primary mechanism was the use of a certificate of agreed value. At the end of each tax year, the brothers would agree to a set price and document the same in a certificate of agreed value.
- If the brothers failed to agree to a set price, then they would obtain two or more appraisals of fair market value.
- The brothers never executed a certificate of agreed value or obtained appraisals. [as discussed below the parties ignored the provisions of their own agreement].
- The company did purchase $3.5 million of life insurance on each brother.

Connelly v. United States – Facts (cont. 2)

- Michael died in 2013. The company received $3.5 million of life insurance proceeds and redeemed Michael’s shares for $3 million. The redemption was the result of an agreement between Thomas, as executor, and Michael's son.
- No appraisals were obtained at the death of Michael. Rather, the Connelly’s agreed on a value of $3.89 million for the company (enterprise value). As a result, Michael's interest in the company was worth $3 million. [77.18% x $3.89M]
- The additional proceeds of the insurance policy ($500,000) were used to pay operating expenses. The proceeds that were not required to be used toward the redemption increased the value of the company.
- **The key issue is whether the life insurance proceeds applied to effectuate the redemption should be considered in valuing the company**.

Connelly Estate Tax Return

- Thomas was the executor for Michael's estate.
- Thomas filed an estate tax return with respect to Michael's estate and valued Michael's shares at $3 million. Thomas relied solely on the redemption amount as the estate tax value of Michael's shares.
- The IRS audited the estate tax return of Michael.
- The IRS concluded that Michael's shares had been undervalued. The IRS concluded that the life insurance proceeds were required to be taken into account when valuing the company.
- The IRS issued a notice of deficiency to the estate. The estate paid the deficiency and filed a suit for a refund.

Connelly Position in Tax Court

- The estate argued that the company's fair market value should not include the life insurance proceeds that were used to redeem shares because they were offset by a liability.

- The IRS took the position that the stock purchase agreement should be disregarded and that the life insurance proceeds must be included.

- The District Court granted summary judgment to the IRS.

- The District Court declined to follow the 2005 case *Estate of Blount v Commissioner,* 428 F 3rd 1338 (11th Cir. 2005).

Eighth Circuit Decision

The Stock Purchase Agreement

- The court In *Connelly* noted that stock purchase agreements are used by closely held companies to limit the ownership of a company to a small group of people.
- For a buy sell agreement to govern the value for estate tax purposes it must meet several requirements provided for in Sec. 2703 discussed below.

- **§2703(a)** – "For purposes of this subtitle, the value of any property shall be determined without regard to—
- (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."

§2703(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.
- Each of the three tests must be established independently. *Estate of Lauder v. Commissioner* (1990). The fact that an agreement is a bona fide business arrangement does not mean it is not a substitute for testamentary device.

Fixed or Determinable Price

- The Court took the position that the agreement did not provide a fixed or determinable price to be used in valuing Michael's shares.
- The Court referred to 26 C.F.R. § 20.2031-2(h) in taking the position that an agreement must contain a fixed and determinable price for the agreement to be considered for valuation purposes. The Court noted that § 20.2031-2(h) was to be interpreted "in tandem with §2703."
- The Court did not specify what would be considered a fixed and determinable price concluding that no such determination was required because the brothers and the company ignored the agreement's pricing mechanisms.
- The Court stated that the two approaches in the agreement were simply mechanisms to agree on a price and that while the appraisal method might be objective, the agreement did not prescribe any formula or measure for determining the price the appraisers will reach.

Fair Market Value of Shares

The Eighth Circuit View in *Connelly*

Willing Seller Willing Buyer

- The value of property in the 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.” 26 C.F.R. § 20.2031-1(b).
- For closely held corporations, the share value “shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.” 26 U.S.C. § 2031(b).

Non-operating Assets are to be Considered

- 26 C.F.R. §20.2031-2(f)(2) – "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."
- IRC §2042 – The value of a decedent's gross estate includes life insurance paid to the estate as well as proceeds received by beneficiaries under insurance policies to the extent that decedent had any incidents of ownership.
- Sec. 20.2042-1(c)(6) clarifies that a decedent does not possess the "incidents of ownership" described in § 2042 merely by virtue of being a controlling shareholder in a corporation that owns and benefits from the policy. As a result, the proceeds paid it to the company were not included in Michael's estate.
- Consider whether the argument should have been that the life insurance alleviated the obligation of the survivor. Recall that the survivor had the option to purchase the shares and the redemption only occurred in the event that the survivor chose not to cross purchase.

Life Insurance Proceeds augment Michael's Estate

- The Court stated that the life insurance proceeds indirectly augmented Michael's gross estate by virtue of a proper valuation of the company.
- The court rejected the argument that the life insurance proceeds are directly offset by a redemption liability. A distinction was made between a liability and an agreement to redeem shares.
- The court concluded that a willing buyer would pay up to $6.86 million for the company having considered the life insurance proceeds and the ability to extinguish or redeem this shares pursuant to the redemption agreement.

Willing Buyer

- Court used the analogy of a willing buyer purchasing the entirety of the company. A willing buyer would pay the entire $6.86 million.
- The willing buyer could then simply extinguish the redemption obligation and own a company worth $6.86 million.
- Alternately, the willing buyer could redeem the shares (from the willing buyer). The buyer would still have a total of $6.86 million.
- The court also stated that a willing seller would not accept only $3.86 million for the company when the company was about to receive $3 million in life insurance proceeds.
  - Is the above correct? If two unrelated parties, 50/50 owners of a closely held business, determined objectively by appraisal the value of their business, at $4M they would likely view that as the which their heirs should receive ½ of. If the entity purchased $2M of life insurance on each for a insurance funded redemption buyout they would not view the value of the business at $6M instead of $4M. They would view the life insurance as a funding device. And if one died a third party would not pay $6M for the business as the entity would be subject to a binding agreement to pay out $2M for half the shares. Is the court's logic really correct?

Value of Shares

- The Court evaluated the value of the shares and noted that, exclusive of the life insurance proceeds, upon Michael's death, each share was worth $7,720 before redemption.
- After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each.
- This increase in value contradicts the position of the estate that the life insurance proceeds we're offset by a liability.
  - The Court is looking at what the surviving shareholder had economically not what the deceased shareholder's estate was entitled to. That is not only the deal the parties in Connelly made but that is the same type of deal (leaving aside the parties ignoring the formalities of the valuation mechanism and setting an arbitrary price) that unrelated parties would make as well.

Blount v. Commissioner

Eleventh Circuit Concluded Differently

Facts of *Blount*

- In 1981, the owners of Blount Construction Company entered into a stock purchase agreement that provided that the company would purchase the stock on the death of the holder at a price agreed on by the parties, or in the event there was no agreement, for a purchase price based on the book value of the corporation.
- The company purchased life insurance policies for the purpose of being able to continue operations while fulfilling commitments under the stock purchase agreement.
- In January 1996, Jennings died while owning 46% of the company's shares.
- The company received $3 million from life insurance proceeds.
- The company paid a little less than $3 million to Jennings' estate to redeem his shares.

Blount (continued)

- In October 1996, Blount what is diagnosed with cancer. Blount was concerned about whether the company would be able to continue to operate after buying out his shares.
- In November 1996, Blount executed an amendment to the stock purchase agreement that required the company to buy him out at $4 million for the shares he owned at his death.
- The amendment to the stock purchase agreement was structured to lock in the amount of the buyout.
- Blount died in September 1977.

Estate Tax Value and IRS challenge

- An estate tax return was filed for Blount's estate valuing the shares redeemed at $4 million.
- The Internal Revenue Service filed a notice of deficiency claiming that the stock was worth nearly $8 million.
- The Tax Court added the value of the life insurance to the base value of the company and concluded that the stock was worth $8.2 million for estate tax purposes.
- The estate appealed the Tax Court ruling to the 11th Circuit.

Eleventh Circuit Analysis

- IRC §2001(a) - A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.
- IRC §2031(a) - The value of the taxable estate generally is the fair market value of the decedent's property at the date of death.
- There is an exception to various regulations on fair market value for property that is subject to a valid buy sell agreement. *See generally Estate of True v. Comm'r*, 390 F.3d 1210,1218 (10th Cir. 2004).
- Requirements of exception:
  - (1) the offering price must be fixed and determinable under the agreement;
  - (2) the agreement must be binding on the parties both during life and after death; and
  - (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition.

Eleventh Circuit Analysis (cont.)

- Omnibus Budget Reconciliation Act of 1990, Pub.L. 101-508, 104 Stat. 1388 ("OBRA"). Agreement must:
  - (1) have a bona fide business purpose,
  - (2) not permit a wealth transfer to the natural objects of the decedent's bounty, and
  - (3) be comparable to similar arrangements negotiated at arm's length.
- The 11th Circuit concluded that the life insurance proceeds should not be included because they had otherwise been considered.
- The 11th Circuit noted the same regulation, Treas. Reg. § 20.2031-2(f)(2), noted by the 8th circuit in the *Connelly* case but concluded that the life insurance proceeds were offset by an obligation to pay those proceeds in a stock buyout.
- The 11th Circuit noted that deducting the proceeds would not necessarily impact what a willing buyer would pay for the firm's stock because it was offset by a dollar-for-dollar obligation to pay out the policy’s benefit (referring to 9th circuit case, *Estate of Cartwright v. Commissioner*).

Blount – Insurance is Not Included

- The court noted that even when stock purchase agreement is not controlling for value, the agreement remains an enforceable liability against the valued company.
- The court concluded that the insurance proceeds are not the type of ordinary non-operating asset that should be included in the value of the company. “We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent businessperson, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.”

How Does This Work After *Connelly*

What Do You Do With Life Insurance Going Forward

Why *Connelly* Might Be Right

- If we accept the estate’s view and look to Crown’s value exclusive of the life insurance proceeds intended for redemption, then upon Michael’s death, each share was worth $7,720 before redemption. After redemption, Michael’s interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown’s $3.86 million value. Those shares are now worth about $33,800 each. Overnight and without any material change to the company, Thomas’s shares would have quadrupled in value. This view of the world contradicts the estate’s position that the proceeds were offset dollar-by-dollar by a “liability.” A true offset would leave the value of Thomas’s shares undisturbed.
- The result in Connelly shifts some of the benefit of the life insurance to the deceased shareholders estate despite the fact there could be an increase in estate taxes. Note that this statement assumes that the estate will receive half of the final valuation versus the $3 million agreed upon.

What Happens in A Cross Purchase?

- Compare *Connelly* case to what would happen in a cross-purchase agreement.
  - Surviving shareholder would receive life insurance proceeds. The life insurance proceeds would be used to purchase the deceased shareholder's shares.
  - Company would be valued without including the life insurance proceeds.
  - Estate at the deceased shareholder would receive payment based on a value that does not include the life insurance proceeds. As a result, the deceased shareholder would be in the same position under a cross purchase agreement as such shareholder would be in if such shareholder had received the payment from the company without including the life insurance proceeds in the value of the business as the Connelly Court did.
  - By the same token, in both situations, (cross purchase or entity redemption) the surviving shareholder would receive the benefit of the life insurance proceeds.

Connelly Results in Different Results for Cross Purchase vs. Redemption

- After *Connelly,* if the Connelly results cannot be mitigated by language in the buy out agreement, the ultimate results of a cross purchase and a redemption vary.
  - Based on the *Connelly* case, the value to the deceased shareholder will be greater and may result in an increase in estate tax due, despite not changing the economics of what the deceased shareholder's estate receives.
  - In the case of a cross purchase agreement, the entire benefit the life insurance goes to the surviving shareholder but, assuming the requirements of 2703 are met, that would be the entire value included in the deceased shareholder's estate.
- Which is better?
  - That may depend upon your perspective.
  - To the extent life insurance was purchased, what was the purpose? Was it just to fund the buy-out?

Example of Redemption 1 of 2

- Assume a business worth $7 million. The business has two 50% shareholders. The shareholders and company enter into an agreement to redeem the interest of a deceased shareholder. Life insurance with face value of $3.5 million is purchased on each shareholder.
  - In a redemption applying *Connelly* analysis, the following results:
    - Business is valued at $10.5 million ($7m plus $3.5m).
    - Deceased shareholder is bought out via redemption for $5.25 million (50% interest). This assumes that the buyout follows a *Connelly* analysis and includes the insurance proceeds of the entity in the value for buy out purposes. Many agreements will not do that.
    - $5.25 million is included in deceased shareholder's estate.
    - Surviving shareholder owns a business worth $5.25 million.
      - But is this really the case? If the business was worth $7 million and $3.5 million of insurance was received and $5.25 million was paid to the deceased shareholders estate then perhaps the business in the hands of the surviving shareholder s actually worth $7 million enterprise value less $5.3 Million [$7 million value + $3.5 million insurance - $5.25 million paid]

Example of Redemption 2 of 2

- The estate of the deceased shareholder receives a gross increase in value from the life insurance totaling 1.75 million (if that is what the buyout agreement provides). Assuming the deceased shareholder's estate is subject to estate tax, the estate tax cost will be $700,000.
- The estate of the deceased shareholder is improved by $1.05 million from the life insurance being added to the value of the company if subject to estate tax and if that is what the agreement provides.
- Note that the per value share of the surviving shareholder may also improved in the view of the *Connelly* court (but will it?); however, the surviving shareholder does not get an increase in the outside basis of such shareholder's shares.
- Also note that payment of the redemption is not deductible to the entity so the value paid in excess of life insurance will have a tax cost. Life insurance proceeds totaled $3.5 million and payment totaled $5.25 million. $1.75 million will have to be funded out of income or other assets of Company.

Example of Cross Purchase

- Assume the same facts as the previous slide except that this structure is now a cross purchase agreement. Shareholders enter into an agreement to buy the other out upon death. Each shareholder purchases life insurance on the other in the face amount of $3.5 million.
  - In a cross-purchase agreement, the following results:
    - Business is valued at $7 million (assuming that the 2703 requirements are met).
    - Deceased shareholder is bought out for $3.5 million (50% interest).
    - $3.5 million is included in deceased shareholder's estate.
    - Surviving shareholder receives $3.5 million of life insurance and uses the life insurance to purchase the deceased shareholder's interest for $3.5 million.
    - Surviving shareholder owns a business valued at $7 million.
    - Surviving shareholder has basis in purchased shares equal to the amount paid to deceased shareholder's beneficiary for that ½ of the shares and whatever the shareholder's basis was in the other ½ of the shares.
    - Under the cross-purchase structure, the surviving shareholder receives the entire benefit of the life insurance and gets a step up in basis. Either way, there are still $10.5 million of assets at play.

Example of *Blount* redemption (cont.)

- Assume the same facts.
  - In a redemption applying Blount analysis, the following results:
    - Business is valued at $7 million.
    - Deceased shareholder is bought out for $3.5 million (50% interest).
    - $3.5 million is included in deceased shareholder's estate.
    - Surviving shareholder owns a business worth $7 million.
    - Surviving shareholder does not receive a step up in basis of any shares.
    - The surviving shareholder receives the entire benefit of the life insurance proceeds. This results in an increase in the surviving shareholder's estate that will ultimately be included for estate tax purposes although there will be a deferral of that tax until the death of the surviving shareholder.
    - In a *Blount* jurisdiction, the difference in a redemption and a cross purchase agreement to the surviving shareholder will be that in the latter case, the surviving shareholder receives a step up in basis of some of the shares owned.
    - In a *Connelly* jurisdiction, some of the benefit of a life insurance in a redemption of a deceased shareholder may be shifted to the deceased shareholder's estate.

The Life Insurance LLC

- As an alternate to a cross purchase agreement where individuals' own policies on other owners, an insurance LLC can be used to own the life insurance policies.
- In the life insurance LLC, the business owners create an LLC to hold the life insurance on the various owners and facilitate a cross purchase agreement.
- The life insurance LLC should be formed as a partnership to avoid any transfer for value issues.
- In the event that the death of a business owner, the life insurance proceeds are paid to the insurance LLC and then distributed to the remaining owners to purchase the interest of the deceased owner.

Advantages of Life Insurance LLC

- Cross purchase agreement is facilitated.
- Only one life insurance policy per business owner is required.
- This structure may provide asset protection from personal and company creditors.
- When a purchase occurs from a deceased shareholders, the purchasing shareholders obtain a tax basis equal to the purchase price.
- Recognition of gain is avoided for those owners who leave the related business and want to take the policies that ensure them.
- When a life insurance LLC is utilized, the results are the same as the example previously demonstrated concerning cross purchase.
- But who owns the LLC? Under a Connelly rationale a pro-rata part of the insurance LLC may have to be included in the deceased shareholder's estate and could thereby increase the estate tax cost faced by that deceased shareholder.

Considerations for the Practitioner After *Connelly*

Stock Purchase Agreements and Life Insurance

Redemption or Cross Purchase? 1 of 2

- Some commentators are suggesting that the *Connelly* case results in the cross-purchase agreement achieving the best result by not having insurance proceeds included in the gross estate of deceased but rather as offset by the buyout obligation.
- According to some based on the Connelly reasoning the shareholder who dies first may prefer that his estate receive some of the benefits of the life insurance proceeds. If that is the case, then the redemption approach should be used in a *Connelly* jurisdiction. Both the deceased shareholder and the surviving shareholder received some of the benefits of the life insurance in a *Connelly* jurisdiction. But this also means that the parties would have to negotiate a payment that comports with the Connelly theory.
- In the cross-purchase arrangement, the surviving shareholder receives the benefit of the life insurance, and the value will ultimately be included in his or her estate albeit deferred. The deceased shareholder's estate receives the payment based on the life insurance amount but not the "phantom value" that the Connelly Court suggests.

Redemption or Cross Purchase? 2 of 2

- The possible consequences of redemption versus cross purchase agreement after the *Connelly* case should definitely be disclosed to the shareholders of a business considering a cross purchase agreement. The correct approach will really be based on the intentions of the business owners in entering into a stock purchase agreement and funding it with life insurance.

Valuation Formulas

- Regardless of jurisdiction, practitioners should consider the *Connelly* case when drafting stock purchase agreements for closely held businesses.
- If the certification of value approach is used, consider advising clients to determine the value according to a formula established by an appraiser. By way of example, the client can hire an appraiser when the agreement is originally created and have the appraiser create the methodology to value the business. That formula can then be used for future valuations pursuant to these certificate of agreed value. Variations or changes should be considered and documented.
- The same approach may benefit business owners when using an actual formula in an agreement. Closely held businesses often use a concept referred to as adjusted book value. Such approach uses book value and makes adjustments to such things as real estate and securities based on fair market value. To the extent such a formula is used, the formula could be best supported by having an appraiser or evaluation expert provide the methodology for the formula and confirm that the formula in fact reflects FMV.

Valuation Formulas

- The *Connelly* case seems to suggest that a formula should be provided to guide an appraiser; however, valuing a business is really the domain of an appraiser rather than the drafting attorney. Consulting with an appraiser in the drafting process would it likely be a best practice in the closely held business context.
- Non operating assets should be defined in any closely held business agreement. Doing so and excluding life insurance proceeds upon the death of a business owner may not change the result of the *Connelly* case but could establish more certainty for the business owners. This could be particularly important in regard to determining the amount of life insurance that should be purchased.
- **But perhaps the better approach is to acknowledge the inclusion of the life insurance but corroborate that it is offset, in part or whole, by a buyout obligation that complies with 2703. Further, the parties must and should respect the terms of their agreements so that the court may be more likely to respect it as well.**

Take-aways After *Connelly*

Client Discussion

- Ownership purchase agreements address various events that may trigger the provisions of the purchase agreement (“triggering event”).
  - Death
  - Disability
  - Retirement
  - Bankruptcy
  - Marital Dissolution
  - Active Owner Leaves the Company to Start a Competitor
- Decide on the best agreement structure based on the overall objectives of the business owners.
  - Control ownership.
  - Ensure business can continue to operate AND buy out owner.
- Life insurance typically comes into play only upon death, although in some instances disability buyout coverage might also be used.

Purchase Price Can Vary

- The purchase price does not have to be the same for each triggering event, but in a family context the value must pass muster under 2703.
- For example, it may be desirable to limit the amount that will be paid to an owner who is leaving he company to start a competitor.
- In the case of a disabled owner, a favorable price may be desirable but unless funded by insurance (which can be very expensive for disability), a buy-out can impact the operations of the company so terms may be structured to provide for a buy-out in a way that allows the business to continue to operate.
- In designing a valuation formula, consider whether the valuation will vary based on triggering event. Formula should be designed using a consistent approach but providing for discounts, adjustments, or premiums based on the objectives for each triggering event.

Blended Cross Purchase Redemption Agreement

- One approach that can be adopted is a blended cross purchase/redemption agreement.
- In such a structure, the shareholders and company enter into an agreement. For simplicity, assume two shareholders.
  - Agreement provides that a cross purchase shall occur up to the amount of life insurance owned by each shareholder on the other. The company shall redeem any shares that are not purchased by the surviving shareholder.
  - Each shareholder purchases life insurance on the other shareholder.
  - Agreement establishes a valuation approach for the company. Typical approaches include a Certificate of Agreed Value; an Appraisal; and a Formula.

Sample Language - Blended Agreement

1. Death of an Owner. Upon the death of an Owner (such Owner referred to herein as the “Deceased Owner”):

   (a) The surviving Owner(s) (each individually a “Surviving Owner” and collectively “Surviving Owners”) shall purchase and the legal representative of the Deceased Owner’s estate or other successor in interest to the Deceased Owner, as applicable (“Deceased Owner’s Representative”) shall sell the Owner Percentage Interest owned by or for the benefit of the Deceased Owner to the extent of the amount of death benefit proceeds of any life insurance owned or by a Surviving Owner on the life of the Deceased (“Death Benefit Proceeds”). To the extent that there is more than one Surviving Owner and any of such Surviving Owners receives no Death Benefit Proceeds or less Death Benefit Proceeds than any other Surviving Owner, then any such Surviving Owner shall have the option within sixty (60) days after the date of death of the Deceased Owner to purchase such portion of the Deceased Owner’s Owner Percentage Interest that would result in the same proportion of ownership among Surviving Owners as existed among Surviving Owners prior to Deceased Owners Death. The Purchase Price and Terms for any purchase pursuant to this paragraph shall be as specified in Paragraph 10 below. The Effective Date of Purchase shall be the date of death of the Deceased Owner.

Blended Cross Purchase Redemption Agreement

(a) If the provisions of subparagraph (a) of this section do not result in all of Deceased Owner's Owner Percentage Interest being purchased within one hundred twenty (120) days of Deceased Owners death, then the Surviving Owners, exclusive of the Deceased Owner's Representative, shall have the option to purchase all remaining Owner Percentage Interest of Deceased Owner upon the Purchase Price and Terms provided in paragraph 10 hereof. The option of each Surviving Owner shall be with respect to such amount of Deceased Owner's Ownership Percentage Interest as would result in the same proportion of ownership among Surviving Owners as existed among Surviving Owners prior to Deceased Owners Death In the event that some but not all Surviving Owners exercise the option provided hereunder, any remaining Owner Percentage Interest of Deceased Owner shall be purchased from Deceased Owner pursuant to subparagraph (b) of this section.

Blended Cross Purchase Redemption Agreement

(a) If the Surviving Owners do not purchase all of the Deceased Owner's Owner Percentage Interest pursuant to the previous subparagraphs, then the Company shall purchase, and the Deceased Owner's legal representative shall sell any and all of the Deceased Owner's remaining Owner Percentage Interest. The Purchase Price and Terms shall be those specified in Paragraph 10 hereof.

Certificate of Agreed Value

- A certificate of agreed value is a common strategy for determining value.
- When this approach is used, the shareholders and company agree on the value of the business at specified intervals, typically annually.
- The *Connelly* case does not necessarily completely eliminate the use of the certificate of agreed value but does require consideration of the structure as well as advising the clients to follow through the with the process established.
- When using a certificate of agreed value, specify the considerations that will be used in arriving at an agreed value.
- One approach is to obtain an initial appraisal of the business and as part of that appraisal, ask the appraiser to define the appropriate methodology to value the business going forward.
- Use the methodology established by the appraiser to support the agreed value. Note and document any reasons for variations.
- The agreement must comply with 2703 requirements and the parties must respect it, unlike the facts in Connelly.

More on Certificate of Agreed Value

- Use the methodology established by the appraiser to support the agreed value. Note and document any reasons for variations.
- Provide a method to be used in the event the certificate of agreed value is not up-to date. Note that the *Connelly* court did not reject the appraisal method in the entirety.
- As an alternate to specifying that an appraisal shall be used when a certificate of agreed value is not up to date, include a formula.

Focus on Objectives

- Focus on the objectives of the parties. Be clear about the economics of each approach and ensure that clients make a conscious decision about the impacts of the varying approaches.
  - Redemption with life insurance included as part of value results in surviving shareholders and estate benefitting from insurance. Keep in mind the tax cost to company of any redemption obligation that is not funded by insurance.
  - Cross Purchase results in survivor receiving full benefit of life insurance.
- Consider the reduction of the exemption by ½ in 2026 and the risk of other tax law changes in future years changing the tax implications.
- Keep in mind that if a business owner agrees to a specific dollar amount to be paid upon death, that amount could be less than the amount that the IRS determines should have been the value of the company. The estate may be contractually bound to the amount the estate will receive but subject to a higher level of estate tax.

Adjusted Book Value Formula

(a) Purchase Price. The purchase price for the Selling Owner's Owner Percentage Interest shall be the "Fair Market Value" as of the close of business on the Effective Date of Purchase. For purposes of this Section 3, "Fair Market Value" means the Adjusted Book Value with the following modifications. The term "Adjusted Book Value" shall mean the net book value of the Units of the Company as determined from Company's books and records using accounting methods and presentation consistent with those used in preparing Company's regular annual financial statements adjusted, to the extent necessary, as follows:

(i) Any life insurance proceeds received or receivable by Company, as beneficiary, as the result of an Owner's death shall be included but shall be included.

Pre-Connelly and maybe in Blount jurisdictions:

(i)Any life insurance proceeds received or receivable by Company, as beneficiary, as the result of an Owner's death shall be eliminated and shall not be considered a non-operating asset but the interpolated terminal reserve value or value as provided by the insurance company in accordance with applicable regulations, as of the date of the Owner's death, shall be included; however, life insurance proceeds shall be added back.

Adjusted Book Value Formula

(ii) Appropriate adjustment shall be made for any transactions affecting the net book value of Company which are outside the ordinary course of business and which occur in the period between an Owner’s actual date of termination of employment, death or disability, as applicable, and the Effective Date of Purchase;

(iii) In the event of the death of an Owner to whom a redemption obligation is due, an adjustment shall be made to reflect the tax cost of any portion of the redemption not funded by life insurance or another vehicle;

(iv) Digital assets shall be valued as agreed upon, otherwise by appraisal;

Adjusted Book Value Formula (cont.)

(v) Liabilities shall be recorded for all accounts payable, accrued wages and related employment taxes and accrued but unpaid contributions to any qualified retirement plans maintained by Company, if any. For purposes of the retirement plan accrual, and if the plan calls for discretionary contributions by Company, the amount thereof shall be determined on a basis consistent with the immediately prior year's contribution rate based on the assumption that the accrual occurs ratably throughout the year; (Should redemption obligations be specified?)

(vi) Assets shall be recorded for any prepaid assets;

Adjusted Book Value Formula (cont.)

(vii) Appropriate adjustment shall be made to substitute the fair market value of any investment assets owned by the Company for the book value of such investment assets as reflected on the Company's books and records. Assets that have been depreciated pursuant to an accelerated or bonus depreciation method shall be adjusted to a value based on a straight-line method of depreciation.

(viii) Appropriate adjustment shall be made to substitute the fair market value of any marketable securities for the book value of such assets as they appear on the balance sheet, with the fair market value being their closing price as of the day immediately preceding the Effective Date of Purchase.

Formula – Adjusted Book Value (cont.)

(ix) Appropriate adjustment shall be made to substitute the fair market value of any real estate held by the Company for the book value of such real property as reflected on the Company's books and records. The fair market value shall be such amount as agreed upon by the parties. In the event the parties cannot agree upon a value, then the parties shall rely upon and use the written appraisal of a licensed real estate or business appraiser, selected and agreed upon by the Company and Selling Owner. If the parties cannot agree on an appraiser or a value, the Selling Owner, or Selling Owner's representative, shall select an appraiser, and the Company shall select an appraiser, and the appraisals rendered shall be averaged to arrive at a value binding on all;

Certificate of Agreed Value – Language: 1 of 2

- The Purchase Price shall be the Fair Market Value of the units being purchased, calculated by dividing the Fair Market Value of the Entity as of the Effective Date of Purchase by the number of units of such Entity issued and outstanding as of such date and multiplying the quotient by the number of units of the Entity being purchased hereunder.
- Fair Market Value of the Entity shall mean as of 1/1/2023, $20,000,000.
- The Owners shall hold a meeting annually in January each year and establish by unanimous vote the Fair Market Value of the Entity as of the end of the prior year. Such value shall be the Fair Market Value of each such Entity for purposes of this Agreement until such time as the Owners agree on and establish a new value.
- In the event that no meeting is held or that agreement as provided hereunder as to Fair Market Value is not reached within sixty (60) days following any calendar year end (without regard to the fiscal year end of each Entity), then the last Fair Market Value established pursuant to this Agreement shall be determined by an appraiser. In establishing the initial Fair Market Value hereunder, Company engaged an appraiser who valued the Company and established a formula appropriate for valuing the Company.

Certificate of Agreed Value – Language: 2 of 2

- In establishing the Fair Market Value annually, the methodology established by the appraiser shall be utilized. Any variations therefrom shall be noted in the meetings of the minute establishing the value.
- Life Insurance Owned by Company. The parties hereto each own an interest in the Company. In the event a Purchase occurs as a result of the death of an Owner and there are life insurance proceeds from a policy insuring Deceased Owner (which was purchased to fund the purchase upon death) owned by Company, and such life insurance proceeds are in excess of any purchase requirements pursuant to any agreement among Owners and Company, the amount in excess of the purchase requirement may be considered in the value of the Company; however, any such proceeds up to the amount of the redemption obligation shall be considered a funding mechanism hereunder and shall not be considered in the valuation of the Company.

Consider 2703 When Drafting

- Agreement must be a bona fide business arrangement.
  - Maintaining control can be a bona business reason.
  - Hedge against minority ownership risk.
  - Investment strategy.
- Not a Device to Transfer for below Fair Market Value
  - Health of Decedent at time of Agreement.
  - Professional Advice in Determining Formula.
  - Periodic Review of Valuation.
  - Are the payment terms excessively generous?
  - Did negotiations occur?
  - Consistent Enforcement of Agreement.
  - Factors are considered at time the agreement is entered into.
- Arms Length Transaction

Conclusion and Additional Information

Conclusion

- Clients must respect agreements and mechanisms in place or the IRS, Courts, or credits will not respect them.
- Be certain that the requirements to set value under 2703 are met.
- If there is a redemption funded by out make express that the buyout obligation will, to the extent satisfied by insurance offset that insurance value. But warn clients other courts may take a Connelly view of that.
- There are always new developments, and it seems new tax legislation on the horizon with no certainty as to what may pass.
- Practitioners should rethink planning from a defensive and flexible lens.
- Caution clients about known risks and that there are always unknown risks.
- Don’t confine how you structure a plan to only existing case law. There are always lags in law and perhaps planning more proactively and more carefully might be prudent.

Additional information

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A KEY ESTATE PLANNING GUIDE

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