Connelly v. United States

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Law Easy

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Connelly v. United States

Valuation of Closely Held Businesses Impacted

Comments by Prof. Gans

- Some valuable unscripted insights.

Connelly v. United States - Facts

- Michael and Thomas Connelly were brothers. Together, they owned Crown, a 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 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 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.

Connelly v. United States – Facts (cont.)

- The brothers always intended that the Company would redeem the interest of a deceased owner rather than the surviving brother.
- 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.
- The company purchased $3.5 million of life insurance on each brother's life.

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

- Michael died in 2013. The company received life insurance proceeds on his and redeemed Michael's shares for $3 million. The redemption was the result of an agreement between Thomas and Michael's son.
- No appraisals were obtained at the death of Michael. Rather, any agreement regarding the redemption, the Connelly's identified a value of $3.89 million for the company as a whole and, Michael's 77% interest was worth $3 million.
- The additional proceeds of the insurance policy ($500,000) were used to pay operating expenses.
- How relevant was the fact that the brothers/shareholders ignored the formalities of the agreement they created?

Connelly Estate Tax Return

- Thomas was the executor of Michael's will.
- Thomas filed an estate tax return with respect to the estate and valued Michael shares at $3 million. Thomas relied solely on the redemption amount.
- The IRS audited the estate tax return of Michael.
- The IRS concluded that Michael shares had been undervalued. The IRS concluded that the life insurance proceeds we're required to be taken into account when valuing the company.
- The IRS said 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 (that is to buy Michael's shares)/

- The IRS took the position that the stock purchase agreement should be disregarded and that the life insurance proceeds must be included or added to the value of the business.

- 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)

Section 2703

Sec. 2703(a)

- **§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.” (Emphasis added.)

§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.

Eighth Circuit Decision

Life Insurance
Included in Value

The Stock Purchase Agreement

- The Court of Appeals noted that stock purchase agreements are used by closely held companies to limit the ownership of a company to a small group of people.

Fixed or Determinable Price

- The Court took the position based on 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 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.” (**Emphasis added**.)
- 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.
- 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.

Life Insurance Proceeds Augment by 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.
- 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.

Value of Shares

- The Court evaluated the value of the shares and noted that, exclusive of the life insurance proceeds, 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.
- **This increase in value contradicts the position of the estate that the life insurance proceeds we're offset by a liability.**

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 these 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 Jenning’s 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. There were no future investments based on the value.
- Blount died in September 1977.

Estate Tax Value and IRS challenge

- An estate tax return was filed for Blount’s estate valuing 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.)

- Section 2703, generally effective October 9, 1990 essentially requires that to be considered for estate tax valuation purposes, the 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 8th Circuit concluded that the life insurance proceeds should not be included because they had otherwise been taken into account.
- 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 business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value."

Connelly v. Commissioner

SCOTUS Rules No Offset in Value for Redemption Obligation

But Now SCOTUS Rules

According to SCOTUS, the taxpayer claimed that the relevant inquiry is what a buyer would pay for shares that make up the same percentage of the less-valuable corporation that exists after the redemption. The Court said that, for calculating the estate tax, the whole point is to assess how much the decedent's shares were worth at the time that he died—before the corporation spent $3 million on the redemption payment. See 26 U. S. C. §2033 (defining the gross estate to "include the value of all property to the extent of the interest therein of the decedent at the time of his death"). So, according to SCOTUS, a hypothetical buyer would treat the life-insurance proceeds that would be used to redeem the decedent's shares as a net asset of the corporation, thereby increasing its value.

Reasoning of Connelly

The Supreme Court was Right

Why *Connelly* Is Right

- First, SCOTUS is correct because the court is the final word on the law. The Congress could overrule the result but it won't because Connelly is correct.

Why *Connelly* Is Right Economically

- Second, Connelly is economically correct. The following examples show this.
- Example 1. Consider a company worth $1 million owned 50/50 by two brothers without any insurance payable to the company and they agree the estate of the first to die should be paid half the value of the company (without any discounts in valuation) or $500,000. But if the company is to receive $1 million of insurance the when the first brother dies, the company would then be worth $2 million. Hence, the deceased brother's estate should then get $1million, not $500,000.

Why *Connelly* Is Right Economically (continued)

- Example 2. Suppose there is no insurance but the company is obliged to buy out for company for half of its worth. The company is worth $1 million, so half (without discounts) is worth $500,000. So if we treat the obligation to buy out the deceased brother as reducing the company's value, then the company is worth only $500,000 and the deceased brother's estate would receive only $250,000. So the company's value drops to $750,000 (that is, $1,000,000 - $250,000 so half is worth $375,000...and so on. In turn, this produce a so-called "interrelated" calculation and the ultimate answer is that the deceased brother's estate would get only $333,333. But we know by premise that half is worth $500,000

Why Did the Court Ignore Section 2703?

- We may never know. But it seems that reference to it was unnecessary because the obligation didn't affect value as the foregoing examples demonstrate.

Connelly Footnote 2

Footnote 2

- Footnote 2 in the Supreme Court's holding in Connelly provided: "We do not hold that a redemption obligation can never decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more."

What Might Footnote 2 mean?

- This seems to say that insurance (or other non-business/non-operating assets) must be generally be included in the valuation. But if the business sells a business operating asset, like a warehouse, to pay for the redemption, that type of obligation may then be appropriate to apply to reduce the value. The real point might be hinge on what was included in the valuation of the business or not. If the asset, say the warehouse, is included in the value of the business then selling it to make the distribution to the deceased shareholder's estate may then reduce the value of the business. But if it were an investment warehouse not part of the valuation of the business then would the same conclusion apply? Is the difference that the warehouse may be part of the earning capacity of the business and the insurance is not? Or is it the impact on earning capacity? And does it matter how tangential or minimal the impact on earning capacity is? Footnote 2 may leave open the door for further discussion of the impact on value of some redemption arrangements.

What Might Be Done After Connelly

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 if insurance proceeds in the shareholder's gross estate.
  - By the same token, in both situations, the surviving shareholder would receive the benefit have life insurance proceeds.

Connelly Results in Different Results for Cross Purchase vs. Redemption

- After *Connelly,* 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 even though such value may result in an increase in estate tax.
  - In the case of a cross purchase agreement, the entire benefit the life insurance goes to the surviving shareholder.
  - Also, consider the wording of the agreement. If the agreement fixes a value that may be economically what is paid but the estate tax value may be greater. If the language in the agreement sets a value at fair market value, or provides for adjust to a higher value determined on audit the Connelly holding may result in a greater payment to the deceased shareholder's estate.
- Which is better?
  - That depends upon your perspective.

Example

- Assume a business worth $7 million. The business has two 50% shareholders. The shareholders enter into an agreement to buy each other out and fund the agreement with life insurance.
  - In a redemption applying Connelly analysis, the following results:
    - Business is valued at $10.5 million.
    - Deceased shareholder is bought out via redemption for $5.25 million (50% interest).
    - $5.25 million is included in deceased shareholder's estate.
    - Surviving shareholder owns a business worth $5.25 million.
    - The estate of the deceased shareholder receives a gross increase in value from the life insurance totaling $1.75 million. 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.
    - Note that the per value share of the surviving shareholder is also improved; however, the surviving shareholder does not get an increase in the outside basis of such shareholder's shares.

Example (cont.)

- Assume the same facts as the previous slide except that this structure is now a cross-purchase agreement.
  - In a cross-purchase agreement, 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 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 shares purchased from deceased shareholder equal to amount paid.
    - Under the cross-purchase structure, the surviving shareholder receives the entire benefit of the life insurance and gets a step up in basis.

Example (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 there will be a deferral of that tax until the death of the surviving shareholder.

The Life Insurance LLC

- An alternate is 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 under IRC 101(a).
- 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.
- Consider the impact of Connelly on the value of the insurance LLC that may be included in the deceased equity owner's estate.

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 shareholder, the purchasing shareholder obtains 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.

Considerations for the Practitioner After Connelly

Stock Purchase Agreements and Life Insurance

Redemption or Cross Purchase?

- Some commentators are suggesting that the *Connelly* case results in the cross-purchase agreement achieving the best result.
- 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 could be used. Both the deceased shareholder and the surviving shareholder could receive some of the benefits of the life insurance in a *Connelly* jurisdiction.
- In the cross-purchase arrangement, the surviving shareholder receives the entire benefit of the life insurance and the value will ultimately be included in his or her gross estate albeit deferred.
- The 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 you 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.

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.

Conclusion and Additional Information

Plan Carefully

Conclusion

- Using a redemption buy-out (that is, the company buys out) funded with insurance proceeds payable to the company will cause the proceeds to be considered in valuing the company without any offset in value for the redemption obligation.
- A cross-purchase may produce a better estate tax result by at least postponing the estate taxation of the insurance proceeds and, perhaps, providing an increase in basis for the purchased shares.
- Consideration should be given to an insurance LLC so there would be only one policy per shareholder
- However, how can one be sure of the payment of premiums and is a portion of the LLC included in the gross estate of the deceased owner?

Additional information

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