Tax Alert: Agreement Fails to Set Value of Decedent's Interest in Business for Estate Tax Purposes

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A recent decision from the U.S. District Court for the Eastern District of Missouri (within the Eighth Circuit) (the "Court") provides a timely reminder for shareholders of closely held corporations about the requirement to determine the value of their shares at death when relying on life insurance funded shareholder buy-sell agreements (sometimes hereinafter **"shareholders' agreement"** or **"buy-sell agreement"**).

Facts of the Case

In *Connelly v. U.S.*, 128 AFTR 2d 2021-XXXX (DC MO), 09/21/2021, the two shareholders (who were brothers) of a closely held family company (the **"Company"**) entered into a stock purchase agreement (the **"Agreement"**) requiring the Company to buy back the shares of the first shareholder to die using a valuation based on a Certificate of Agreed Value and excluding a premium for control for a majority interest or a discount for a minority interest. The two shareholders held unequal interests in the Company, with one having a majority interest (77.18%) and the other a minority interest (22.82%), with the minority shareholder surviving the majority shareholder. Upon the majority shareholder's death, his estate (the **"Estate"**) thus held 77.18% of the Company while the surviving brother held 22.82% of the Company. At the death of the majority shareholder, the Company (exclusive of the life insurance proceeds which were payable to the Company) was worth approximately $3.3 million. The Company received a cash infusion of $3.5 million from the life insurance proceeds making the total value of the Company $6.8 million.

Upon the majority shareholder's death, the Company used a portion of the life insurance proceeds to purchase the Estate's shares. The Estate and the Company did not obtain an appraisal for the value of the shares. Instead, the Estate and the Company entered into a sale and purchase agreement for $3 million which resulted in the Estate's shares being valued at $7,774 per share, leaving the remaining shares being valued at $33,863 per share immediately after the redemption. The Estate filed an estate tax return using the $7,774 per share value. The IRS subsequently audited the Estate's return and determined the value of the Company should have included the insurance proceeds.

The dispute focused on the efficacy of the Agreement under IRC §2703(b) and the value of the Company's shares. The Estate argued that the Agreement determined the value of the Company under the IRC § 2703(b) exception to fair market value, or in the alternative, the Estate argued that the value of the life insurance proceeds should be eliminated due to the offsetting liability of the Company's obligation to buy back the shares if a fair market value standard was applied.

IRC § 2703(b) and Additional Requirements Under Regulations and Case Law Analysis

The Estate sought to use a value other than the fair market value. Under IRC 2703(b), *to qualify for this exception to the general valuation rule, a buy-sell agreement must:*

- Be a bona fide business arrangement (which is a question of fact);
- Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration; and
- Contain terms similar to an agreement that would have been negotiated between persons in an arm's length transaction.

In addition, the regulations require a buy-sell agreement to:

- Have a fixed and determinable offering price;
- Be legally binding on the parties during life and after death.

In holding that the Agreement did not qualify for the exception to the general rule, the Court held that the Estate failed to show that (i) the Agreement was not a device to transfer wealth to a family member for less than full and adequate consideration; (ii) the terms of the Agreement valuation formula were not similar to those which would be negotiated at arm's length; (iii) the parties did not rely on the Certificate of Agreed Value or follow the detailed appraisal mechanism in the Agreement; and finally, (iv) neither the Estate nor the Company treated the Agreement as binding after the majority shareholder's death because they did not use the Agreement to determine the redemption price.

Effect of Insurance and Redemption Obligation on Valuation and Rejection of Contrary Case Law from the Eleventh Circuit

Since the Estate did not satisfy the exception, the Estate argued either that the proceeds should be excluded or that the offsetting liability existed. The *Connelly* Court acknowledged that the Eleventh Circuit in Estate of *Blount v. Commissioner of Internal Revenue*, 428 *F.3d* 1338 (11th Cir. 2005)[1] had excluded the proceeds in the fair market valuation because of an offsetting obligation to redeem the shares. However, the Court relied on the portion of the regulations that provide that the focus is on fair market value and that the touchstone is fair market value using a willing buyer/seller standard. The Court, relying on the violation of general valuation principles that each share should be of equal value, concluded that it had demonstrated that the *Estate of Blount* decision was incorrect in that a hypothetical buyer would ignore or would not be impacted by the offsetting liability and ruled in the IRS's favor that the value of the Company included the life insurance proceeds and there was no offsetting corporate liability.

Summary

A buy-sell agreement can be a useful succession planning tool, but the burden of proof is on the taxpayer. *It is critical to understand the buy-sell agreement's relationship to fair market value. Fair market value is the norm.*

For more information or assistance, please contact:

David J. Ritter, Esq., Member and Chair, Tax Practice, at dritter@bracheichler.com or 973-403-3117

Stuart M. Gladstone, Esq., Member and Co-Chair, Trusts and Estates Practice, at sgladstone@bracheichler.com or 973-403-3109

Susan K. Dromsky-Reed, Esq., Member and Co-Chair, Trusts and Estates Practice, at sdromsky-reed@bracheichler.com or 973-403-3146

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[1] The Eleventh Circuit reversed a Tax Court decision in that case.