Funding a Buy-Sell Agreement with Corporate Owned Life Insurance – Will Corporate Value Be Enhanced?

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
December 2023
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

Overview

In part one of this series (published back on July 3), I discussed buy-sell agreements in general and noted how beneficial they can be in the intergenerational transfer of a farm or ranch where keeping the business in the family is the key goal. There I covered buy-sell agreements in general, the various types of agreements and common triggering events.

With today's article I dive deeper into other issues associated with buy-sell agreements -valuation rules and funding approaches. A recent court opinion points out the importance of following the valuation procedures set forth in the buy-sell agreement.

Part two of a two-part series on buy-sell agreements – it's the topic of today's post.

Valuation

While very few farming and ranching operations (and small businesses in general) are subject to the federal estate tax because of the current level of the exemption, some are. For those that are, in addition to providing a market for closely held shares at a determinable price, the buy-sell agreement can serve as a mechanism for establishing the value of the interest for estate tax purposes – or otherwise establish value of the decedent's interest at death.

General rule. In general, the value of a closely held business (or other property) is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the FMV of the property, or any restriction on the right to sell or use the property. *I.R.C. §2703(a).*

Exception – statutory requirements. A buy-sell agreement can establish the value of a deceased owner's interest if six basic requirements are satisfied. Three of the requirements are statutory and three have been judicially created. The statutory requirements are found at I.R.C. §2703(b).

The statutory requirements specify that the buy-sell agreement must:

- Be a bona fide business arrangement; *I.R.C. §2703(b)(1)*
- Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth; *I.R.C. §2703(b)(2)* and

- Contain terms that are comparable to other arrangements entered into by persons in arms' length transactions. *I.R.C. §2703(b)(3)*

A buy-sell agreement must satisfy each of the three statutory requirements if family members own 50 percent or more of the property subject to the restriction. An agreement is deemed to satisfy all three of the statutory requirements if more than 50 percent of the value of the property subject to the restriction is owned directly or indirectly by individuals who are *not* members of the transferor's family. The interests owned by the nonfamily members must be subject to the same restrictions as the property owned by the transferor. *Treas. Reg. §25.2703-1(b)(3).*

Exception – caselaw requirements. Judicial opinions have created three additional requirements that a buy-sell agreement must satisfy to be effective to establish the value of a decedent's interest. *See, e.g., Estate of True v. Comr., 390 F.3d 1210 (10th Cir. 2004); St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982).* Based on these cases, the agreement must also: contain a purchase price that is fixed and determinable under the agreement; be legally binding during life and after death; and have been entered into for a bona fide business reason and not be a substitute for a testamentary disposition for full and adequate consideration. To establish the purchase price with certainty an appropriate valuation method must be established. An independent party valuation will not only satisfy the requirements of I.R.C. §2703 but also provide an estimate of the potential funding obligation and the liquidity expectations of the seller/estate. *See Rev Rul. 59-60 as amplified by Rev. Rul. 83-120,1983-2 CB 170.*

The courts have indicated that preserving a business with family control for purposes of continuity and management can serve as a bona fide business arrangement. *See St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982); Estate of Lauder v. Comr., T.C. Memo. 1992-736; Estate of Gloeckner v. Comr., 152 F.3d 208 (2nd Cir. 1998).* This includes planning for the future liquidity needs of the decedent's estate. *Estate of Amlie v. Comr., T.C. Memo. 2006-76.* But an entity that consists only of marketable securities is not a bona fide business arrangement. *Holman v. Comr., 601 F.3d 763 (8th Cir. 2010).* The long-established position of the IRS is that, "It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts to determine whether the agreement represents a bona fide business arrangement or a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." *Rev.Rul 59-60, 1959-1 CB 137. See also Estate of True v. Comr., T.C. Memo 2001-167, aff'd., 390 F.3d 1210 (2004); Estate of Blount v. Comr., T.C. Memo. 2004-116.*

Note: The business reasons for executing the buy-sell agreement should be documented.

The buy-sell agreement must not simply be a device to reduce estate tax value. This requires more than expressing a desire to maintain family control of the business. *See, e.g., Estate of True v. Comr., 390 F.3d 1210 (10th Cir. 2004); Estate of Lauder v. Comr., T.C. Memo. 1992-736.* In addition, a buy-sell agreement must have terms that are comparable to other buy-sell agreements that are entered into at arms-length. This requirement is satisfied if the agreement is one that unrelated parties in the same line of business could have reached in an arms' length transaction. *Treas. Reg. §25.2703-1(b)(4).* This fair bargain standard is typically based on expert opinion testimony.

Funding Approaches

To be operational, the parties to the agreement must have funds available to buy the stock at the time the agreement is triggered. It is possible to use accumulated earnings of the business to fund a redemption. But such a strategy may not be treated as a "reasonable need of the business" with the result that the business (if it is a C corporation) could be subject to the accumulated earnings tax. *I.R.C. §531.* However, corporate accumulations used to pay off a note given a stockholder for a redemption is a reasonable need of the business, as a debt retirement cost. *But see Smoot Sand & Gravel Corp. v. Comr., 274 F.2d 495 (4th Cir. 1960), cert. denied, 362 U.S. 976 (1960).*

The use of life insurance. Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment). However, the premiums on such policies are not deductible *(see I.R.C. §264)* and can create a substantial ongoing expense.

Corporate-owned. One approach is for the corporation to buy a life insurance policy on the life of each stockholder, with the corporation as the policy owner, premium payor, and beneficiary of these policies. The corporation would then use the life insurance to finance the purchase if, at the end of the first option period, the corporation buys the deceased stockholder's interest. Or the corporation could lend the insurance proceeds to the stockholders if, at the end of the corporate option period, it is decided that the surviving stockholders should be the buyers (or to the extent stock remained to be purchased after the corporation's option expires). Investment payments would be deductible to the stockholders and income to the corporation.

Shareholder-owned. An alternative approach is for each shareholder to buy, pay for, own, and be the beneficiary of a life insurance policy for each of the other shareholders. The surviving shareholders would then receive the proceeds when one shareholder dies, and, if a cross-purchase is indicated and appropriate, use the proceeds as the necessary funds to carry out the buy-sell agreement. The surviving shareholders could also lend the proceeds to the corporation if a redemption agreement is utilized, to enable the corporation to buy additional shares, or the surviving shareholders could make capital contributions which would have the effect of increasing each shareholder's stock basis.

Note: The cash value of a permanent life insurance policy may be withdrawn by loan or surrender of the policy, but the value may be a very small percentage of the death benefit, inadequate to finance the buy-out. Disability insurance may be used to finance a purchase occasioned by an owner's disability, but it can be quite expensive, and cannot be applied toward the purchase of an interest of an owner who is retiring or used to prevent the sale of an interest in the business to a buyer outside the family unit.

Other Approaches

A combination of the above approaches could also be used for funding the wait-and-see buy-sell agreement. For example, the corporation could own cash value life insurance and the owners could own term insurance. Also, the parties could have a split-dollar arrangement whereby the corporation pays for the cash value portion of the premiums and the shareholders own the policy and pay for the term portion of the premiums, with the proceeds split between them.

Potential Problem of Life-Insurance Funding

One potential problem of a corporation being the beneficiary of a life insurance policy designed to fund the buy-out of a deceased shareholder is that the IRS could argue that the policy proceeds are included in the corporate value. In *Estate of Blount v. Comr., T.C. Memo. 2004-116,* the issue was whether the insurance proceeds contractually deduction to the redemption of corporate shares being valued be treated as corporate property for valuation purposes. The decedent owned 83 percent of the stock in a corporation at death. There was a life insurance policy owned by the company that provided some $3.1 million to pay off the mandated buyout of the shares under a buy-sell agreement providing for a fixed value of the decedent shares. The buy-sell agreement value was held not to be controlling for estate tax purposes, mainly because the deceased owned 83 percent of the stock and could have changed the agreement at any time. Furthermore, the court determined that the buy-sell agreement was not similar to those involved in arm's length transactions.

The 11th circuit reversed on the basis that the redemption obligation of the buy-sell agreement was a liability that offset the value of the death benefits used to fund the redemption. *Estate of Blount v. Comr., 428 F.3d 1338 (11th Cir. 2005).* Thus, even if the death benefits were included in the corporate value, there was a corresponding offsetting liability that would be accounted for by a "reasonably competent business person interested in acquiring the company." *Id.*

Note: In a decision preceding the Tax Court's decision in *Blount*, the Ninth Circuit court deducted the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds to the estate in a stock buyout. *Cartwright v. Comr., 183 F.3d 1034 (9th Cir. 1999).*

The issue in *Blount* and *Cartwright* resurfaced in *Connelly v. United States, No. 4:19-cv-01410-SRC, 2021 U.S. Dist. LEXIS 179745 (E.D. Mo. Sept. 21, 2021).* In *Connelly*, two brothers were the only shareholders of a closely-held family roofing and siding materials business. They entered into a stock purchase agreement that required the company to buy back shares of the first brother to die. The company then purchased about $3.5 million in life insurance coverage to ensure it had enough cash to redeem the stock. The brother holding the majority of the company's shares (77.18 percent) died on October 1, 2013. The company received $3.5 million in insurance proceeds. The surviving brother chose not to buy his shares, so the company used a portion of the proceeds to buy the deceased brother's shares from his estate for $3 million pursuant to a Sale and Purchase Agreement. Under the agreement the estate received $3 million, and the decedent's son received a three-year option to buy company stock from the surviving brother. If the surviving brother sold the company within 10 years, the brother and decedent's son would split evenly any gains from the sale.

The estate valued the decedent's stock at $3 million and included that amount in the taxable estate. Upon audit the IRS asserted that the fair market value of the decedent's corporate stock should have factored-in the $3 million in life-insurance proceeds used to redeem the shares which, in turn, resulted in a higher value of the decedent's stock than was reported. The IRS assessed over $1 million in additional estate tax. The estate paid the deficiency and filed a refund claim in federal district court.

The district court noted that a stock-purchase agreement is respected when determining the fair market value of stock for estate tax purposes upon satisfying the requirements of I.R.C. §2703(b) (as noted above), and the additional judicially created requirements (also noted above). The IRS expert claimed that the insurance proceeds should be included in the company's value as a non-operating asset, and that allowing the redemption obligation to offset the insurance proceeds undervalued the company's equity and the decedent's equity interest in the company, and would create a windfall for a potential buyer that a willing seller would not accept. The IRS expert concluded that the fair market value of the company was $6.86 million rather than $3.86 million. The IRS also claimed that the stock purchase agreement failed to control the value of the company. The estate claimed that the company sold the decedent's shares at fair market value and that the shares had been properly valued. Thus, according to the estate, the $3 million in life insurance proceeds were properly excluded from the decedent's estate based on the appellate opinion in *Blount*. The estate claimed that the stock purchase agreement provided a sufficient basis for the court to accept the estate's valuation as the proper estate-tax value of the decedent's shares. On that point, the IRS claimed that the stock purchase agreement was not a bona fide business arrangement and, as such, didn't control the value of the decedent's stock. The IRS position was that the stated estate planning objectives of the stock purchase of continued family ownership of the company were insufficient to make it a bona fide business arrangement, particularly because the brothers did not follow it by disregarding the agreement's pricing mechanisms.

The district court did not rule on the bona fide business arrangement issue because it determined that the estate had failed to show that the stock purchase agreement was not a device to transfer wealth to the decedent's family members for less than full-and-adequate consideration. The process that the surviving brother and the estate used in selecting the redemption price bolstered the court's conclusion that the stock purchase agreement was a testamentary device. They also did not obtain an outside appraisal or professional advice on setting the redemption price, thereby disregarding the appraisal requirement set forth in the agreement. The district court also noted that the agreement didn't provide for a minority interest discount for the surviving brother's shares or a lack of control premium for the decedent's shares with the result that the decedent's shares were undervalued. This also, according to the district court, demonstrated that the stock purchase agreement was a testamentary device to transfer wealth to the decedent's family members for less than full-and-adequate consideration and was not comparable to similar agreements negotiated at arms' length.

On the issue of whether the life insurance proceeds should be included in corporate value, the court rejected the appellate court's approach in *Blount*, finding it to be analytically flawed. The court concluded that the appellate court in *Blount* had misread Treas. Reg. §20.2031-2(f)(2), and that the regulation specifically requires consideration to be given to non-operating assets including life insurance proceeds, "to the extent such nonoperating assets have not been taken into account in the determination of net worth." The district court concluded that the text of the regulation does not indicate that the presence of an offsetting liability means that the life insurance proceeds have already been "taken into account in the determination of a company's net worth." The district court concluded that, "by its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the fair market value of a company's stock.... And...a redemption obligation is not the same as an ordinary corporate liability." There is a difference, the court noted, between a redemption obligation that simply buys shares of stock, and one that also compensates for a shareholder's past work. One that only buys stock is not an ordinary corporate liability – it doesn't change the value of the corporation as a whole before the shares are redeemed. It involves a change in the ownership structure with a shareholder essentially "cashing out." The court noted that the parties had stipulated that the decedent's shares were worth $3.1 million, aside from the life insurance proceeds. The insurance proceeds were not offset by the company's redemption obligation and, accordingly, the company's fair market value and the decedent's shares included all of the insurance proceeds, and the IRS position was upheld.

On appeal the U.S Court of Appeals for the Eighth Circuit affirmed. *Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).* The appellate court held that the stock purchase agreement requiring the redemption of a deceased shareholder's shares did not affect the value of the shares for estate tax purposes under I.R.C. §2703 because it did not provide for a fixed price or a formula for arriving at one. Instead, the agreement merely laid out two mechanisms by which the brothers might agree on a price - mutual agreement or appraisal. As for the appraisal approach, there was nothing in the agreement that fixed or prescribed a formula or measure for determining the price that the appraisers would reach. Thus, neither mechanism constituted a fixed or determinable price for valuation purposes. The appellate court determined that the $3 million that the corporation actually paid for the deceased brothers shares constituted an amount determined after death that was derived by an agreement between the brothers and not by any formula in the buy-sell agreement.

As for the value of the corporation (and, hence, the deceased brother's interest in the corporation), the appellate court determined that the life insurance proceeds were an asset that increased the shareholders' equity and that an obligation to redeem shares is *not* a liability in the ordinary business sense. Thus, the proper valuation of the corporation in accordance with I.R.C. §§2042 and 2031 must include the life insurance proceeds without treating the obligation to redeem shares as an offsetting liability. The court reasoned that in order for a willing buyer at the time of the brother's death to own the stock outright, a willing buyer would account for control the life insurance proceeds and therefore would pay up to $6.86 million for the corporation, quote taking into account end quote the life insurance proceeds and then either extinguishing the agreement or redeeming the shares. Conversely, the appellate court determined that a hypothetical willing seller of the corporation would not find acceptable a price of $3.86 million with the knowledge that the company would be receiving $3 million in life insurance proceeds.

To illustrate its rationale, the appellate court explained explain that if it valued the corporation without accounting for the life insurance proceeds intended for redemption, then upon the brother's death each share was worth $7,720 before redemption. After redemption, the deceased brother's interest is extinguished, with the surviving brother having full control of the corporation's $3.86 million value. The appellate court noted that this would essentially quadruple the value of the surviving brother's shares, but that treating the life insurance as an offsetting liability would leave the stock value undisturbed (which was the estate's position). The economic reality of the situation, the appellate court concluded, was that the life insurance proceeds was an asset that increased shareholders' equity. The buy-sell agreement thus had nothing to do with being a corporate liability.

Note: A separate insurance LLC could be used to fund a buy-sell agreement in light of *Connelly.* The insurance LLC would collect the life insurance proceeds on the deceased owner. The LLC's value would not be increased by the death benefit because it is allocated to the other owners in accordance with the buy-sell agreement due to special allocations in a LLC taxed as a partnership. *See I.R.C. §704.* A formal appraisal would likely only be required if there is real estate or some other difficult to value asset that the LLC owns. This does add a layer of complexity, but if there are more than two owners the additional complexity may be worth it.

Arguably, there is now a split on this issue between the 8th Circuit on one hand, and the 9th and 11th Circuits on the other (keep in mind the brothers in *Connelly* didn't follow the buy-sell agreement). Indeed, a petition for certiorari was filed with the U.S. Supreme Court on August 15, 2023. Will the Supreme Court agree to hear *Connelly*? Not very likely at all.

Conclusion

A buy-sell agreement can be a very important part of a succession plan for a family farming/ranching business (or any small, family-owned business for that matter). However, it's critical that the agreement be drafted properly and followed by the business owners.