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Connelly v. U.S. Its Affect on Buy-Sell Agreements

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Background

The value of an asset for federal estate tax purposes is its fair market value at the time of death. Fair market value is defined as the price a willing buyer would pay a willing seller for the property or interest in property, both with reasonable knowledge of the relevant facts and neither under a compulsion to sell or to buy. Under the regulations and the case law developed before the adoption of the special valuation rules contained in Chapter 14 (§2701–§2704), the purchase price determined under a buy-sell agreement could fix the value of an interest in a closely held business if the following four requirements were satisfied:

The price must either be fixed or determinable pursuant to a formula contained in the agreement.

The decedent's estate must be obligated to sell at death at the fixed price. This can be accomplished either by giving the entity or the other owners an option to buy the deceased owner's interest or by using a mandatory buy-sell arrangement.

The transfer restriction must apply during the deceased owner's lifetime. At a minimum, the other owners must have a right of first refusal to buy the interest at the fixed or determinable price before the owner can sell the interest to a third party. This requirement may not be satisfied if the owners may transfer their interests to relatives or other owners by gift during life unless the donees become subject to the same restrictions.

The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth. Historically, this requirement was satisfied if the price under the agreement was equal to the fair market value of the interest at the time the agreement was originally executed.

In *Rudolph v. United States*, which dealt with a buy-sell agreement pre-dating the effective date of §2703, the court reviewed the fourth requirement in some detail. In holding that the purchase price under the agreement controlled the estate tax value of the shares in a family-owned business, the court rejected the government's position that, because the price under the agreement was below fair market value, the agreement was a device to transfer the shares to the objects of the decedent's bounty without full and adequate consideration. The court held that "the reasonableness of the price set forth in a restrictive agreement should be evaluated based on the facts in existence at the date the agreement is reached unless intervening circumstances occur." In addition, intent to use the agreement as a testamentary disposition must be present before the agreement is held invalid.

Section 2703 in General

The general rule under §2703 is that, for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. A right or restriction means any option, agreement, or other right to acquire or use the property at a price less than the fair market value (determined without regard to the option, agreement, or right) or any restriction on the right to sell or use such property. A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement or may be implicit in the capital structure of the entity.

A lease also will be disregarded in valuing property for federal gift, estate, and generation-skipping transfer tax purposes if the terms are not comparable to leases of similar property entered into among unrelated parties. A perpetual restriction on the use of real property that qualified for a charitable deduction under either §2522(d) or §2055(f) is not treated as a right or restriction.

Exceptions

As detailed below, there are two exceptions to the general rule that rights or restrictions are to be disregarded. One exception, contained in the statute, is actually an enhancement of the case and regulatory law that existed before the enactment of Chapter 14. The second exception, contained in the regulations, can be viewed as a liberalization of the case and regulatory law when applied to entities that are not controlled by a single family.

Statutory Exception

Under §2703(b), a right or restriction will not be disregarded if it satisfies the following three requirements:

the right or restriction is a bona fide business arrangement;

the right or restriction is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's-length transaction.

It is contended that, as a result of the statutory exception, §2703 merely codified existing law. Under existing case and regulatory law, a price under a buy-sell agreement could establish the value of stock or a partnership interest for estate tax (but not gift tax) purposes if: (1) the price was fixed or determinable under the agreement; (2) the agreement bound the estate to sell the stock or partnership interest at that price; (3) the decedent was subject to the agreement during his or her life; and (4) the agreement was a bona fide business arrangement and not a device to pass the stock or partnership interest to the natural objects of the decedent's bounty for less than full and adequate consideration in money or money's worth.

As detailed below, the first two requirements of §2703 simply bifurcate the fourth requirement under existing case law, which courts had already effectively divided into two independent requirements. The third requirement of the statutory exception can be viewed as simply the means by which the estate may prove that the first two requirements of the statutory exception have been satisfied.

The regulations modify the statutory language in two ways. First, the regulations use the term "natural objects of the transferor's bounty" rather than "members of the decedent's family." Thus the regulation clarifies that §2703 applies for gift tax purposes as well as estate tax purposes and includes transfers to certain nonfamily members by expanding the class of recipients from members of the transferor's family to the natural objects of the transferor's bounty. Second, the regulations add "at the time the right or restriction is created" to the third statutory requirement, clarifying that the time frame for comparing the terms of the agreement with similar agreements is when the agreement is entered into, not later when any rights conferred thereby are exercised, such as at the death of the transferor.

A substantial modification of a right or restriction is treated as creating a new right or restriction. Therefore, the three requirements must be satisfied each time there is a substantial modification.

For a right or restriction to satisfy the exception, each of the three statutory requirements must be independently satisfied. Consequently, e.g., merely showing that a right or restriction is a bona fide business arrangement is not sufficient to establish the absence of a device to transfer property for less than full and adequate consideration.

A right or restriction is treated as "comparable to similar arrangements entered into by persons in an arm's length transaction" if the right or restriction would have been obtained in a fair bargain among unrelated parties in the same business dealing at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if the right or restriction conforms to the general practice of unrelated parties under negotiated agreements in the same business. Generally, this determination will entail considering such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the agreement, and the adequacy of any consideration given in exchange for the rights granted.

The use of comparables is more an art than a science. For example, evidence of general business practice is not satisfied by showing isolated comparables but, if more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because the right or restriction uses only one of the recognized methods. The terms of a right or restriction do not have to parallel the terms of any particular agreement. The regulations state that, if comparables are difficult to find because the business is unique, comparables from similar businesses may be used. However, as a practical matter, if the business is unique, it will be difficult to find similar businesses.

Regulatory Exception

Under the regulations, a right or restriction satisfies each of the three requirements of the statutory exception if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. Consequently, in such a case, the agreement would have to satisfy only the first three requirements developed under the case and regulatory law before the adoption of §2703. In other words, if more than 50% of the value of the property subject to the right or restriction is owned by nonfamily members, there need only be a fixed or formula price; a restriction applicable during life; and an obligation for the estate to sell at death. Presumably, the estate would not have to show that the agreement was a bona fide business arrangement and not a testamentary device, because these two requirements are deemed satisfied under the regulatory exception. To satisfy this exception, the property owned by the unrelated parties must be subject to the right or restriction to the same extent as property owned by the transferor.

The Connelly case

The Connelly case involved two issues: (1) whether the buy-sell agreement established the value of the decedent's interest for estate tax purposes, (2) and, if not, what was the fair market value of the decedent's interest for estate tax purposes. Because the fair market value of the company was stipulated if the value did not include life insurance proceeds payable to the company at the decedent's death to the extent they were used to purchase the deceased shareholder's shares, the only valuation issue was whether the proceeds were included in the value of the company.

Facts in the Case

Brothers Michael and Thomas Connelly were the only shareholders in Crown C Supply, Inc., a closely-held family business that sold roofing and siding materials. Michael owned 77.18% of the shares and Thomas owned 22.82% of the shares. They entered into a stock purchase agreement that gave the surviving brother the option to buy the shares of the first brother to die, and if the surviving brother did not exercise the option, the company was obligated to buy the deceased brother's shares. The company bought $3,500,000 of life insurance on each of the brothers to ensure it had enough cash to fund the purchase. When Michael died in October 2013, the company purchased his shares for $3 million, the amount reported as the value on Michael's estate tax return.

The IRS assessed additional estate taxes of over $1 million, based on the value of Michael's shares at $5.3 million. The company was worth roughly $3.86 million, not including the $3 million of life insurance proceeds received by the company that were used to purchase Michael's shares. Although the agreement specified that the brothers were to determine the agreed value of the company by executing a new Certificate of Agreed Value at the end of every year, they never signed a single Certificate of Agreed Value. The agreement also provided that if the Certificate of Agreed Value was more than 18 months old, the parties would each appoint appraisers to determine the value of the company. In addition, the agreement provided that discounts and premiums were to be ignored in determining the fair market value of the company.

Because Thomas chose not to buy Michael's shares, the company had to buy Michael's shares. The company did not obtain appraisals as required under the agreement, but instead entered into an agreement to buy Michael's shares for $3 million, and to give Michael's son a three-year option to buy the company from Thomas for $4,166,666 and the right to split with Thomas any gains from the sale of the company in the next ten years.

The IRS determined the value of the company should have included the $3 million of life insurance proceeds used to purchase Michael's shares. The parties stipulated that the fair market value of Michael's shares was $3.1 million, without taking into account the life insurance proceeds. The estate's expert, relying on the 11th Circuit holding in Estate of Blount, opined that the $3 million of life insurance proceeds used to buy Michael's shares should be excluded from the fair market value of the company because of the company's obligation to purchase Michael's shares. In that case the Court of Appeals reversed the District Court's opinion that held that insurance proceeds used to redeem the stock of a deceased shareholder should have been included in the value of the corporation. The Court of Appeals held that the proceeds should not have been included in the value of the corporation because they were offset by the corporation's obligation to purchase the stock under the corporation's buy-sell agreement. The IRS's expert opined that the insurance proceeds used to purchase Michael's should have been included in the value of the company as a non-operating asset because the resultant share price created a windfall for a potential buyer that a willing seller would not accept.

The estate argued that the stock agreement determined the value of the company for estate tax purposes, so that the Court did not need to determine the fair market value of the company and alternatively that the company's fair market value should not include the insurance proceeds used to purchase Michael's shares because of the offsetting obligation to redeem Michael's shares, relying on the 11th Circuit's opinion in Blount. The IRS argued that the agreement failed to meet the requirements under the Internal Revenue Code ("the Code"), Treasury regulations and applicable case law to control the valuation of the company and that under applicable law and customary valuation principles, the life insurance proceeds used to redeem Michael's shares increased the company's fair market value by $3 million.

District Court Opinion

The Court first determined whether the agreement satisfied the Code, Treasury regulations, and applicable case law to control the valuation of the company. It first determined whether the agreement satisfied the statutory exception to I.R.C. § 2703, provided for in I.R.C. § 2703(b). The Court deemed that the agreement was a bona-fide business arrangement. However, it went on to determine that the agreement did not meet the other requirements of I.R.C. § 2703(b). The Court determined that the agreement was a device to transfer property to a family member for less than full and adequate consideration because the parties ignored the life insurance proceeds in determining the purchase price, did not obtain the appraisals as required by the agreement, and the agreement excluded any control premium. The Court determined that the agreement was not comparable to similar arrangements because of its prohibition of a control premium and the exclusion of the life insurance proceeds in determining the purchase price.

The Court then determined whether the agreement satisfied the additional requirements under regulations and case law. Because the parties did not adhere to the provisions in the agreement requiring either a Certificate of Agreed Value or appraisals to determine the $3 million purchase price, the price was not fixed or determinable. The Court did not consider the parties' failure to agree to the agreed value every year was entirely dispositive of whether the agreement was binding during life. Because the parties did not consider the agreement to be binding or enforceable on them, they ignored the price mechanism in the agreement and redeemed Michael's share for $3 million without first obtaining any appraisals for the company. Therefore, the Court determined that the agreement was not binding after Michael's death. The Court had already addressed this issue and determined that the agreement was a substitute for a testamentary disposition for less than full and adequate consideration.

Because the parties agreed that the fair market value of the company, excluding the life insurance proceeds, was $3.86 million, the only remaining issue was whether the insurance proceeds should have been included in determining the fair market value of the company. Because the appeal would be to the 8th Circuit, the Court was not required to follow the 11th Circuit opinion in the Blount case. The Court determined that the life insurance proceeds used to purchase Michael's shares should be included in the fair market value of the company. Its decision is based on the following analysis:

Consider what a hypothetical 'willing buyer' would pay for a company subject to a redemption obligation. [citing Treas. Reg. § 20.2031-1(b)] The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all the shares that would be redeemed under the redemption obligation; in other words, the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem the shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him." Citing the Tax

Court decision in Blount as follows: “To treat the corporation’s obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the ownership interest represented by those shares.

Analysis of the Opinion

The Court correctly, in my opinion based on the facts in the case, found that the agreement was a testamentary devise and was not comparable to agreements that would have been entered into by unrelated parties. The Court also correctly, in my opinion based on the facts in the case, found that the agreement did not establish a fixed and determinable price and was not binding at death. In my opinion, the District Court in Blount and the District Court in the Connelly, have the better reasoning that the insurance proceeds should be included in valuing the company, notwithstanding that the company had an obligation under a buy-sell agreement to purchase the deceased insured owner’s interest at his or her death.

Court of Appeals Decision

The Court of Appeals for the Eight Circuit affirmed the District Court’s grant of summary judgment to the IRS. The Court of Appeals first agreed with the District Court that because the buy-sell agreement did not satisfy either I.R.C. §2703 or the case law and regulations before the enactment of Chapter 14, the price paid to the estate did not establish the value for estate tax purposes, based on the fact that the price was not determinable under the agreement. The Court of Appeals then held that the $3,000,000 of life insurance proceeds used to purchase the decedent’s stock was included in the value of the company for purposes of determining the value of the decedent’s stock. The Court of Appeals agreed that the redemption of stock is a reduction of surplus, not the satisfaction of a liability. Treating it so “distorts the nature of the ownership interest represented by the share.” It also agreed with the district court that a buyer of the company would pay up to $6.86 million for the company, taking into account the life insurance proceeds used to purchase Michael’s shares, because the buyer would not treat the liability as a reduction in the value of the company, since as the owner of all the shares, the buyer would then either extinguish the liability or redeem the shares and thus have the $3,000,000. The Court of Appeals also agreed with the district court’s conclusion that the exclusion of the proceeds resulted in a windfall for Thomas because of the increase in the value of each share from $7,720 before the redemption to $33,800 after the redemption. The Appeals Court ended by quoting Cox & Hazen, Treatise on the Law of Corporations, § 21:2: “(When a corporation purchases its own stock, it has depleted its assets by whatever amount of money or property it gave in exchange for the stock. There is, however, an increase in the proportional interest of the non-selling shareholders in the remaining assets of the corporation.).” In sum, the brothers’ arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders’ equity. A fair market value of Michaels’s shares must account for that reality.”

Petition for Writ of Certiorari

The executor, Thomas A. Connelly, filed a petition for a writ of certiorari on August 16. 2023. What the petition ignores is the following hypothetical scenario:

> When Michael died, the life insurance proceeds were paid to the company. If the company did not have an obligation to buy the shares from Michael’s estate, the estate was free to sell its stock to a willing buyer, who would have known that the insurance proceeds were paid to the company and would have taken into account the full $3,500,000 that the company received.

In addition, the cert petition, as does the Court of Appeals in the Blount case, treats an obligation to redeem a shareholder’s shares as any other liability of the company. However, other liabilities of the company reduce the value of the company, but when paid, they do not reduce the ownership of the company. In contrast, when the company redeems its shares, while the value of the company is reduced, the ownership of the company is also reduced. The petition argues that it is Thomas who benefits from the exclusion of the life insurance proceeds in the value of the company for purposes of determining the value of Michael’s stock. However, the fact that it is Thomas who benefits from the exclusion of the insurance proceeds is no reason for the IRS not to challenge the value of the assets Michael owned at his death. The petition also claims that the analysis of the Court of Appeals badly distorts the willing-buy/willing-seller test because it is predicated on the hypothetical purchase of the entire company, rather than the shares at issue.

Supreme Court Decision

On June 6, 2024, in a unanimous decision, the Supreme Court upheld the Eight Circuit's decision that the $3 million insurance proceeds used to redeem Michael Connelly's stock at his death should have been included in the value of the company in determining the value of his stock, rejecting the taxpayer's position that the proceeds should have been offset by the company's obligation to redeem his stock. Justice Thomas delivered the opinion of the Court. He stated at the outset that the only question was whether the company's obligation to redeem Michael's share at fair market value offsets the value of the life insurance proceeds committed to funding that redemption. He held that "[An] obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest." He uses the following example to prove his point:

Consider a corporation with one asset—$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,0000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 x $100,000) and B's shares are worth $2 million (20 shares x $100,000). To redeem B's' shares at fair market value, the corporation would thus have to pay B $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷80 shares). Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interest after the redemption—A's 80 shares and B's $2 million in cash—would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those share in and of itself.

Justice Thomas went on to state that "[B]ecause a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's share at fair market value as a factor that reduced the value of those shares." In addition, he believed that the proper way to calculate the estate tax was to assess how much Michael's share were worth at the time he died, before the company paid $3 million to Michael's estate, citing Internal Revenue Code § 2033, defining the gross estate to "include the value of property to the extent of the interest therein of the decedent at the time of his death." He also pointed out that as a result of a redemption, the remaining shareholders are left with larger proportional ownership interests in the less-valuable corporation.

He dismissed the claim that the decision below will make succession planning more difficult for closely held corporations, because there were other ways to avoid the inclusion of insurance proceeds in the value of the company, including using a cross purchase agreement. He did note that such an arrangement had its own risk that one of the shareholders would not be able to pay the premiums. As stated below, an LLC or trust could also be used to own the insurance policy in order to avoid having the insurance proceeds paid to the corporation.

In a footnote, Justice Thomas did admit that there could be cases where a redemption agreement could result in a decrease in the value of the corporation, such as when the corporation had to liquidate assets to pay for the shares being redeemed, thereby reducing its future earnings capacity.

In conclusion, I believe that most estate planners, including myself, would agree with Justice Thomas' opinion.

Planning Implications.

If life insurance is not going to fund the purchases of the equity interests under the buy-sell agreement, Connelly will not be an issue. If a cross purchase buy-sell agreement is being used, then Connelly will not be an issue. If an LLC or a trust is being used to hold the life insurance policies, again Connelly will not be an issue. If it is determined to use the buy-sell agreement to establish the value for estate tax purposes, make sure that the parties adhere to the terms of the agreement. For example, if the agreement requires that the parties agree to a valuation each year (a provision I would not recommend), then make sure that it is done yearly. Make sure that the agreement has terms that would be included in an agreement among unrelated parties and does not have terms that would not be included in agreements among unrelated parties, such as ignoring discounts and premiums when valuing the shares to be redeemed.

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ENDNOTES

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2 Reg. §20.2031-2(h).

3 *Estate of Weil v. Commissioner,* 22 T.C. 1267 (1954), acq., 1955 C.B. 10.

4 Reg. §20.2031-2(h); Rev. Rul. 59-60, §8.

5 93-1 USTC ¶60,130 (S.D. Ind. 1993).

6 §2703(a); Reg. §25.2703-1(a). See, e.g., *Estate of Elkins v. Commissioner,* 140 T.C. 86 (2013) (restriction on right to partition disregarded under §2703(a)(2) to value fractional interests in works of art), aff'd in part, rev'd in part on other grounds, 767 F.3d 443 (5th Cir. 2014).

7 Reg. §25.2703-1(a)(2).

8 Reg. §25.2703-1(a)(3).

9 Reg. §25.2703-1(d), Ex. 1.

10 Reg. §25.2703-1(a)(4).

11 Although the statute refers to an "arms' length transaction," the regulations use the term "arm's-length transaction." The latter term is used in this Study.

12 Reg. §25.2703-1(b)(1)(ii).

13 Reg. §25.2703-1(b)(1)(iii).

14 Reg. §25.2703-1(c)(1).

15 Reg. §25.2703-1(b)(2).

16 Reg. §25.2703-1(b)(4)(i). See also *Estate of Morrissette v. Commissioner*, T.C. Memo 2021-60 (comparison factors included vesting for years of service with long-term senior executives in similar situation).

17 Reg. §25.2703-1(b)(4)(ii).

18 Reg. §25.2703-1(b)(3).

19 Reg. §25.2703-1(b)(3).

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21 Estate of Blount v. Commissioner, 428 F.3d 1338 (11th Cir. 2005), aff'g, T.C. Memo. 2004-116.

22 Connelly v. U.S., 128 AFTR 2d 2021-5955, (E. D. Mo, t2021),

23 Connelly v. U. S., No. 21-3683, 131 AFTR2d 2033-192 (8th Cir. 2023) [70 F.4th 412 (8th Cir. 2023)], aff'g. 128 AFTR 2d 2021-5955, (E. D. Mo, 2021).

24 Connelly v. U.S., No.23-146, 133 AFTR 2d 2024-1680 (S Ct), 06/06/2024.