Chapter 10

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AGREE NOT TO DISAGREE WITH BUY-SELL AGREEMENTS AFTER CONNELLY

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Agree Not To Disagree
With Buy-Sell Agreements After Connelly[1]

I. Introduction

A. Buy-Sell Agreements are a regular part of planning repertoire for owners of business and investment entities. They are familiar vehicles to both estate planning professionals and corporate lawyers. Scholarly articles and case law regularly address the contractual and tax aspects of the agreements.

B. Therefore, it was not a surprise when a tax case came out of the Eastern District of Missouri in 2021 concerning a buy-sell agreement between two brothers who owned 100% of a small building supply company, Crown C Supply. The case touched on topics familiar to estate planning attorneys – Section 2703 and valuation of the stock.

1. Nor was it unusual that the case was appealed to the Court of Appeals for the Eighth Circuit. The District Court's ruling did seem to disagree with an Eleventh Circuit Case. The Eighth Circuit affirmed the District Court and created a split in the circuits. The case, Connelly v. United States, No. 21-3683, 131 AFTR 2d 2023-1902 (8th Cir. 2023), then became a frequently discussed recent developments topic at conferences.

2. While the Eighth Circuit's opinion in Connelly was notable, the decision may have become nothing more than a notation that there was a disagreement among the Circuits on an estate tax valuation issue. It was very much a surprise, then, when the United States Supreme Court granted certiorari on this estate tax valuation case, concerning a company worth less than $10 million.

C. When the United States Supreme Court addresses a tax and estate planning issue, it deserves a closer look. And Connelly v. United States, 144 S. Ct. 1406, 602 U.S. _____ (2024), does raise several interesting questions, not the least of which is was it correctly decided? These materials will explore the decision in Connelly and its implications for business planning, the use of buy-sell agreements, and the funding of buy-sell obligations through life insurance.

II. Use of Buy-Sell Agreements in Planning with Business Interests

A. The buy-sell agreement is a contract among the owners of a business, or between the owners and the company, which sets out what will happen to their various ownership interests upon the occurrence of certain specified future events (such as death or withdrawal).

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1. Buy-sell agreements are used primarily to achieve non-tax goals. They can serve a number of useful purposes in a family business, before, during and after a period of succession.

2. Control. A typical agreement will give the entity, the owner, or both a right of first refusal on certain proposed transfers by a shareholder. This protects the existing owners from unwillingly becoming business partners with an undesirable owner. It may permit a senior family member who controls the business to become comfortable with making gifts of stock, since the agreement will give him or her some control over what his children do with the stock.

3. Liquidity. A buy-sell agreement can provide a withdrawing family member with a market for his or her interest by providing a put right in certain circumstances. The most common point in time to grant a put right is at the death of a shareholder. It allows a surviving spouse or children who are not interested in continuing in the business to liquidate their interest. Put rights also can be granted at retirement or when the shareholder ceases to be employed with the business for other reasons.

4. Planning. A buy-sell agreement helps push a family toward further succession planning by focusing them on what options should be given to the family of a deceased shareholder and how to fund the repurchase of stock under the agreement and the payment of estate taxes.

5. Preservation of Tax Benefits. It is also possible to include in a buy-sell agreement prohibitions against certain actions by the shareholder that would threaten tax elections. A buy-sell agreement for an S corporation typically prohibits a shareholder from transferring stock to an entity or person that is not a permissible shareholder of an S corporation, or from taking any other action that would adversely impact the S election.

B. A buy-sell or stock restriction agreement can have several implications in estates. The transfer restrictions or purchase options in an agreement can be in any one or more of several forms:

1. The owner's death or a subsequent transfer by an estate or post-death trust may trigger purchase options by the entity or other owners. In some cases, the options are triggered in all events; in some cases, the options are triggered only if the stock is transferred to someone who is not a permitted transferee, such as non-family members.

2. The estate or trust owning the interests may have put options, either in all events or to redeem stock pursuant to Section 303 of the Code.

3. There may be ongoing transfer restrictions that will apply to the interests and to the recipients of them.

4. In the case of a partnership or LLC interest, the estate or trust may have the status of an assignee as a result of the owner's death and must request being made (or the ultimate recipients being made) a substituted partner or member.

5. An agreement may facilitate liquidity in an estate or post-death trust, but it also could limit the executor's or trustee's ability to borrow against or sell the business interests. It also can create traps because of the difference between the agreement value for stock or

other business interests and the estate tax value of those interests. The fiduciary and the fiduciary's counsel should review the buy-sell agreement as soon as possible after the owner's death in order to determine how it applies and to answer, inter alia, the following questions.

6. What notices must the fiduciary provide to the entity or other owners?

7. What time periods apply for others to exercise purchase options or for the estate or trust to exercise put options?

8. How are the interests valued under the agreement, and does the agreement include a valuation appeals process that the fiduciary can elect to use?

9. Are there restrictions that may affect where the interests can be allocated under the estate plan?

10. Will the value for the interests determined under the agreement be binding for federal estate tax purposes?

C. This last question is critical. As discussed in more detail below, the price for closely held interests set in a buy-sell or option agreement among family members rarely will be binding for estate tax purposes. Yet, it usually is binding for contractual purposes with the other owners. As a result, a family of a deceased business owner can be hurt by a price in the agreement that is found to be substantially below fair market value.

D. It is important to note that several of the factors discussed above need to be taken into account at the estate planning stage for the owner of an interest in the business. The estate planner should focus in particular on what transfers are permitted under the agreement and on the valuation process dictated under the agreement - is it being followed and what could the impact be on the client and the client's estate.

E. Once it is determined that a buy-sell agreement is desirable, the next determination must be who the operative parties to the agreement will be.

1. Obviously, the withdrawing party will be the seller, but the purchaser may be the other owners (a cross purchase), the business itself (an entity purchase), or a combination of the two.

2. Except to the extent that tax consequences may vary, the seller is generally not concerned with the question of who acts as the purchaser (assuming that the purchase price terms are the same). The seller is primarily concerned with getting the appropriate amount of money for his interest. However, it is important that the purchaser be identified and that steps be taken to ensure that the purchaser has the funds necessary to make the required purchase.

F. Cross-Purchase Agreement.

1. From an income standpoint, an owner staying in the business may prefer a cross-purchase agreement since this will result in a stepped-up basis in the additional stock or other

ownership interests acquired. If the company buys the ownership interests, the remaining owners percentage interest in the company increases, but their basis does not.

a. The other owners of course need adequate capital to make the purchase. For purchase options expected to be exercised at death, this is often done by acquiring life insurance on one another's lives.

b. In any business with more than two or three owners, a cross-purchase arrangement with life insurance can be administratively cumbersome and expensive. If this is the arrangement used, at the death or withdrawal of one owner, the policies he or she holds on the lives of the other owners must be assigned to the remaining owners.

c. Younger owners may bear a disproportionate burden of the cost of such agreements because the policies on the lives of the older owners, which they must purchase, will have higher premiums than the policies on their lives, which the older owners must purchase.

2. Generally, the cross purchase of insurance by the owners is not associated with any adverse income tax consequences. When the surviving owners receive the insurance proceeds on the deceased owner's life at his death, those proceeds will not normally constitute taxable income to them. When they purchase the stock or other ownership interests from the decedent's estate, no significant taxable gains should occur because of the step-up in the income tax basis. Moreover, the full amount paid for the ownership interests so acquired is included in the surviving owners' income tax basis, so any subsequent sale of the business by them would result in their realizing less capital gain.

3. If corporate earnings are to be the principal source of premium payments, additional problems are created. When the owners own the policies, any premium payments by the corporation will be income to the owners. If the company owns the policies but distributes the proceeds to the surviving owners to allow them to make the purchase, the proceeds may be a taxable dividend. These taxable income concerns largely go away with a flow-through entity, but there still will be an impact on the tax basis of owners.

G. Entity Purchase Agreement.

1. Alternatively, the buy-sell agreement can be structured to have the business itself (rather than the other owners) be the ultimate purchaser at the time of the withdrawal or death of any of the owners.

2. For a C corporation, this alternative may seem attractive if the corporation has sufficient funds to effect the purchase; however, accumulating such funds could cause the corporation to run afoul of the unreasonable accumulation of earnings provisions in the income tax law. IRC §§ 531; 537.

3. If the business does not have sufficient funds to effect purchases at the death of an owner, it could acquire insurance for such purchases. Only one policy on the life of each owner would be necessary, and there would be no need for transfers of policies, eliminating concern over the transfer for value rules. Further, the cost differences of policies between owners of various ages are equalized (because the business pays for all policies).

4. The receipt of insurance proceeds by a C Corporation may have income tax consequences. Under Code Section 101(j), a corporate-owned policy issued after August 17, 2006, on an employee's life is non-taxable only to the extent of premiums and other amounts paid for the policy unless certain notice and consent requirements are met. While insurance proceeds received by the corporation are not subject to regular income tax liability, they were taken into account in determining the corporate alternative minimum tax under the tax as it existed before 2018. This could result in additional tax owed by the corporation, if the prior alternative minimum tax rules for corporations come back into the Code.

5. Although having the corporation serve as the purchaser in the buy-sell agreement may appear desirable, there are certain disadvantages.

   a. A corporate purchase will constitute a redemption for income tax purposes. Unless certain very specific requirements are met, the amounts distributed from the corporation for the stock interest constitute dividend income to the recipient.

   b. The tax consequences of this to the recipient would be undesirable in that the proceeds would be taxable as ordinary income. It's particularly problematic in a post-death redemption, where the proceeds otherwise would be nearly tax free because of the basis step-up. Accordingly, in structuring a corporate redemption, one must ensure that the redemption will qualify as (a) substantially disproportionate, (b) a complete termination of interest, or (c) a redemption to pay death taxes under Section 303.

III. <u>Section 2703, Valuation and Buy-Sell Agreements</u>

A. In the transfer tax setting, the buy-sell agreement can establish a value for a business interest that will be respected by the IRS when valuing that interest in a decedent's estate. It is difficult to achieve this result, however, especially since the enactment of Section 2703 as part of the Revenue Reconciliation Act of 1990.

B. Law Prior to Enactment of Section 2703

1. For many years, the IRS has maintained that the price for stock of a closely held corporation established by an agreement restricting the owner's right to sell or transfer those shares was one factor to consider in determining the fair market value of the shares. The effect the agreement price has on the fair market value of the shares will vary, depending on the circumstances of each case. <u>See</u> Treas. Reg. § 20.2031-2(h); Rev. Rule 59-60, 1959-1 C.B. 237, 243-44. The same rule would apply to an interest in businesses organized as an LP or LLP.

2. With respect to agreements that have an option or contract to purchase a security, Treas. Reg. § 20.2031-2(h) provides:

   "The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death.

Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not 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.”

3. When the agreement does not require a sale to an unrelated party, the courts have held that the agreement price will be controlling only if the agreement meets the requirements of the regulation:

   a. The agreement must have been entered into for bona fide business reasons.

   b. The agreement must not be a device to pass the decedent's business interest to the natural objects of his bounty for less than full and adequate consideration.

   c. The agreement must contain restrictions on the disposition of the business interest which are binding during the owner's life as well as at death.

   d. The agreement must obligate the decedent's estate or beneficiaries to sell the interest either without any choice, or at the option of the other parties to the agreement.

   e. The price set in the agreement either is fixed, or determinable according to a formula, and was reasonable at the time the agreement was entered into.

   See Estate of Seltzer v. Commissioner, 50 T.C.M. (CCH) 1250 (1985). See also Treas. Reg. § 20.2031-2(h). Cf. Estate of Godley v. Commissioner, 286 F.3d 210 (4th Cir. 2002) (affirming T.C. Memo 2000-242 (2000)) (agreement was testamentary device not negotiated at arm's length); Dorn v. U.S., 87-2 USTC (CCH) ¶ 13,732 (3d Cir. 1987) (options given to grandchildren to purchase decedent's stock had no valid business purpose and were not a bona fide business arrangement, and were therefore ignored for valuation purposes); Estate of Lauder v. Commissioner, 64 T.C.M. 1643 (1992) (agreement was testamentary device and therefore not binding for valuation purposes).

4. Under the law as it stood before Section 2703, if the above requirements were met, the value stated in the buy-sell agreement would be enforceable, even if the agreement value was than the fair market value of the stock at death. Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970).

5. The courts also recognized that, even if the price in the buy-sell agreement was not controlling, it could be a relevant factor in determining the fair market value of the stock or other interest. Estate Obering v. Commissioner, 48 T.C.M. (CCH) 733, 746-747 (1984); Estate of Jenner v. Commissioner, 36 T.C.M. (CCH) 241, 249 (1977), rev'd on other grounds, 577 F.2d 1100 (7th Cir. 1978).

C. Section 2703 of the Code provides that property will be valued without regard to restrictive agreements, options to buy, or rights of first refusal held by family members. Thus, for agreements entered into or substantially modified after the effective date of Section 2703 (October 8, 1993), private restrictions generally cannot be used to reduce the stock's value for transfer tax purposes. An exception applies to an option or restrictive agreement that meets each of the following requirements:

1. The transfer restrictions in the agreement are a bona fide business arrangement.

2. The transfer restrictions are not a device to transfer the business interest to members of the owner's family for less than full and adequate consideration.

3. The transfer restrictions are comparable to similar arrangements entered into by persons in an arm's-length transaction.

IRC §2703(b); Treas. Reg. §25.2703-1(b)(1).

D. If these three requirements are met, the agreement can be considered as a factor in determining value.[2] However, the legislative history indicates that Congress did not intend to eliminate the additional case law requirements that an agreement must meet if a formula price is to be conclusive of value for estate tax purposes. Thus, for more recent agreements, both Section 2703 and the case law requirements must be considered.

E. The first two requirements under Section 2703 also existed under the case law. Under Section 2703, these two requirements—the business purpose test and nondevice test—must be satisfied independently. See Treas. Reg. § 25.2703-1(b)(2). This was not always clear in the cases, although the trend has been to consider them as separate tests. See St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982); Bommer Revocable Trust v. Commissioner, 74 T.C.M. (CCH) 346 (1997); Estate of Lauder v. Commissioner, 64 T.C.M. (CCH) 1643 (1993).

F. The comparability test requirement does not derive directly from previous case decisions. It is intended to apply a more objective standard to a buy-sell agreement. The regulations state that a right or restriction will be considered to be comparable to similar, arm's length agreements if it is one that "could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length." A right or restriction is considered a fair bargain "if it conforms with the general practice of unrelated parties under negotiated agreements in the same business." Treas. Reg. § 25.2703-1(b)(4).

1. The regulations provide four factors to consider in determining whether the fair bargain standard has been satisfied:

- 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.

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[2] The regulations also provide an exception for a business where 50 percent or more of the value is owned directly or indirectly by individuals who are not members of the transferor's family. In that case, if the right of restriction applies equally to the non-family business, it is considered to meet the three requirements of Treas. Reg. §25.2703-1(b)(1). See Treas. Reg. §25.2703-1(b)(3).

2. The “fair bargain” seems to go well beyond the statutory requirement that the rights or restrictions in a buy-sell agreement merely be comparable to similar arrangements. This standard suggests that the IRS can ignore an agreement that it determines to be unfair, even if negotiated at arm's length and based entirely on business considerations. The regulations provide no significant examples of the application of the comparability test.

3. The Estate of Lauder case and the factors enunciated under the Section 2703 regulations that govern whether a right or restriction is a "fair bargain" suggest that an agreement in which the price set does not bear a reasonable relationship to fair market value, or an agreement in which there is no mechanism for modifying the price in future years, will have a difficult time satisfying the fair bargain and nondevice tests. In addition, the price in the agreement is more likely to be accepted if the agreement requires that it be updated on a regular basis. This does not necessarily mean that annual updates are necessary. It may be commercially reasonable to have modifications to the price every two or three years.

4. The most difficult aspect of the Section 2703 rules is the apparent high burden placed on the taxpayer to establish that the agreement and its transfer and price restrictions, are "comparable to similar arrangements entered into by persons in an arm's length transaction." Treas. Reg. § 25.2703-1(b)(4). The regulations state that the taxpayer does not establish this "by showing isolated comparables." The IRS has asserted that general testimony as to accepted business practices is insufficient proof under the regulations. Rather, it is necessary to provide evidence of actual use of similar approaches in specific fact situations. Since there are no published studies of buy-sell agreement restrictions, this seems virtually impossible to do.

5. Case law has reduced the burden of satisfying the comparability test to a degree.

   a. In Estate of Amlie v. Commissioner, T.C. Memo 2006-76, the court suggested that the burden is not as high as the IRS asserts. There, the court accepted as persuasive the testimony of the estate's expert, an attorney with extensive experience in the purchase and sale of non-marketable business interests. In response to IRS arguments that the attorney's testimony was insufficient, the court stated:

      > "While the regulations caution against using 'isolated comparables,' we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown."

   b. Estate of Amlie was cited favorably for the proposition in both Estate of Morrisette v. Commissioner, T.C. Memo 2021-60, and Huffman v. Commissioner, T.C. Memo 2024-12.

   c. In Huffman v. Commissioner, the court examined right to purchase agreements concerning shares of Dukes Research and Manufacturing, Inc. The agreement gave Chet Huffman an option to purchase shares of Duke from his parents or entities controlled by them, and fixed a maximum price. Chet exercised his purchase rights in 2007. The IRS asserted that the agreements were not binding for gift purposes under Section 2703 and that Chet's parents made gifts to Chet when he exercised his purchase rights.

(i) The court found that the agreements were not a testamentary device and that the purpose of retaining the Dukes shares in the Huffman family was a valid business purpose.

(ii) The court concluded that the taxpayers did not satisfy the comparability test. The taxpayers cited a similar (but not identical) agreement that was between Chet's father, Lloyd, and a non-family member. While the court acknowledged that an isolated comparable can be adequate, it noted that the other agreement itself was not introduced in evidence. In addition, based on the testimony about the other agreement, it was sufficiently different as not to satisfy the comparable test.

d. In Kress v. United States, 372 F.Supp.3d731, (E.D. Wis. 2019), one issue litigated in valuing the stock transfers made by the taxpayers was the reliance of the taxpayers' expert in part on restrictions on transfer of the stock contained in the by-laws. The court agreed with the taxpayers that the restrictions were a bona fide business arrangement but found that the Kresses had not submitted specific evidence showing that the restriction was comparable to similar arrangements entered into by persons in an arm's-length transaction. A contention that similar restrictions were common to the commercial world was not sufficient.

G. A buy-sell or option to purchase agreement may be able to fix the price of stock or partnership interests where the value is being determined by a professional appraisal and updated regularly. There are a number of potential advantages to this even if a significantly reduced value is not one of them.

1. If the agreement is found to fix price, then the IRS is not free to adjust values because of significant changes in the business that have occurred since the last appraisal. For example, if the price of a company's stock was last set on January 1, 1993 pursuant to the buy-sell agreement and will not be modified until January 1, 1995, the January 1, 1993 price may be binding even if the company has appreciated significantly at the time of a stockholder's death in 1994.

2. The agreement can build in discounts for lack of marketability. For example, based on statistical information on lack of marketability discounts, it could be considered reasonable and in conformance with general business practice to dictate a 25% or 30% discount in the agreement.

3. A buy-sell agreement negotiated at arm's length usually does not require consideration of a control premium in valuing the stock of a majority stockholder. Usually, the agreement sets one method for determining price that is applicable to all stock, regardless of the holder. This has been recognized in at least one case concerning buy-sell agreements. See Rudolph v. United States, 93-1 U.S.T.C. ¶ 60,130 (February 5, 1993). Thus, an agreement that is found to fix price can be very beneficial to a controlling stockholder by preventing the IRS from using a control premium in valuing his or her stock.

IV. Life Insurance

A. Life insurance frequently is used by taxpayers with illiquid assets, as a means of funding future estate tax or other obligations.

1. Life insurance has the dual advantages of providing cash exactly when it is needed, at the death of the insured, or in the case of a second-to-die policy, the death of the survivor of husband and wife; and providing the cash income tax free.

2. The use of an irrevocable insurance trust to own life insurance, and to keep it outside the estate for estate tax purposes, is well-known. The structure of the trust, and planning options for them is a full topic in its own right and is not covered here.

3. This section covers a couple of specialized arrangements with life insurance that are often relevant to business owners.

B. Funding Buy-Sell Agreements and Redemptions

1. Insurance frequently is used in the business context to provide a source of funds for owners to buy from a deceased owner or to enable the company to redeem the equity interests (in a Section 303 redemption or otherwise).

2. A cross-purchase agreement is more complicated to fund using life insurance. Each owner must own a policy on the life of each other owner. As a result, if there are 5 owners, 20 policies are needed [n*(n-1), where n = number of owners].

3. This problem is often addressed by using an escrow arrangement or a partnership or LLC among the owners with only 1 policy on the life of each owner.

a. Escrow agreements were more common historically before limited partnerships became as broadly used as they are now and before LLCs existed. See, e.g., Addis E. Hull, Stock Purchase Agreements in Estate Planning – With Forms (3d ed. 1986).

(i) The escrowee, usually a bank or other independent party, would act as agent for owners and accept deposit of the insurance policies, arrange for payment of the premiums (from cash deposited by the owners), pay out proceeds of a policy as directed in the buy-sell agreement.

(ii) Not a lot of financial institutions are as willing to undertake a longer-term escrow obligation as they once were, and of course there is a cost to these services.

b. A partnership or LLC can be used to accomplish the same purposes. Letter Ruling 200747002 illustrates the terms of such an LLC. The LLC held policies to fund a cross-purchase agreement. The manager was a corporate trustee. Each policy had capital accounts associated with it, which were allocated to the owners other than the insured. The capital accounts were credited with premium payments from the insureds, and the death benefit would be paid out proportionate to the relevant capital accounts.

4. The funding of the premium payments also is more complicated in a cross-purchase arrangement.

   a. Absent other arrangements, stockholders or other owners would have to pay premiums personally. Younger owners might be paying the premium on the policies of one or more older owners, and therefore be paying more.

   b. The business could make additional distributions, bonus out the premium amounts to the owners, or use a conventional loan. In a C corporation the distribution would be a taxable dividend, for any business a bonus is taxable income, and a loan has costs associated with it too.

   c. Previously, split-dollar arrangements often were used to enable the corporation to pay the bulk of the premiums. As discussed below, with the greater limitations on split-dollar financing, this option may have less appeal.

5. The presence of these complications suggests that an entity purchase buy-sell makes more sense in many cases. The <u>Connelly</u> decision, however, casts some doubt on that conclusion.

6. Although no income tax problems generally result from cross-purchase agreements, if the insurance policies are transferred among the remaining owners, problems can arise as a result of changes in stock ownership. In these cases, assignments of the policies may run afoul of the transfer for value rules (IRC § 101(a)(2)) and may cause the proceeds of the insurance to be fully income taxable when the transferee owner collects them.

C. Split-Dollar Insurance

1. Split dollar is of course not a type of insurance. It is a way of financing the purchase of insurance. It often takes the form of an arrangement between a closely held business and an owner-employee, in which the business and owner agree to split the payment of premiums on the policy. It can also be done with individuals and trusts, one of whom agrees to pay the bulk of the premium in exchange for an interest in the policy. Split-dollar arrangements may be applied to single-life policies as well as to second-to-die policies. The policies may be held outright or in an irrevocable trust.

2. Split-dollar arrangements were very popular in the 1980's and 1990's and the tax treatment at the time allowed the business or individual who paid most or all of the premium to take an interest in the policy limited to the amount of premiums it paid. It in effect was a tax-free loan. For large amounts of insurance coverage, the arrangement worked particularly well with irrevocable trusts because the premium payments otherwise required to fund the trust would be prohibitively expensive from a gift tax standpoint to maintain the policy through an irrevocable trust.

3. The popularity lessened with the IRS' issuance of new regulations in 2003 that significantly altered the way split-dollar arrangements were treated for tax purposes. Under the current regulatory scheme, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply in lieu of the prior tax treatment – the "*economic benefit regime*" and the "*loan regime*."

a. ***Economic Benefit Regime***. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as a compensation related agreement. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Code.

(i) With respect to these split-dollar insurance arrangements, the owner and non-owner must also account for any right in, or benefit of, the contract provided to the non-owner other than current life insurance protection. For example, if an employee non-owner has any interest in the cash surrender value of the policy under the arrangement (a so-called "*equity arrangement*"), the value of that interest must generally be included in the employee's gross income to the extent that the employee can access such equity. If the life insurance policy is transferred or deemed transferred to the employee, its cash value, in excess of what is paid or owed to the employer, will be taxable income to the employee at that time.

(ii) These rules will apply both to (1) arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to (2) so-called "*non-equity arrangements*" in which the employee owns the policy but the employee's only rights are to the insurance protection. (In the latter case, the employer will be deemed to own the policy.) Treas. Reg. § 1.61-22.

b. ***Loan Regime***. Any split-dollar arrangement not described above in which the employee owns the policy will be governed by the Section 7872 below market loan rules. Thus, transfers by the employer will be treated as loans, and there will be deemed interest to the extent the arrangement does not mandate adequate interest. The deemed interest will be treated as compensation paid by the employer to the employee and then repaid as interest by the employee. Treas. Reg. § 1.7872-15.

4. While split-dollar arrangements may be less attractive under current law, they are still a viable funding mechanism for insurance particularly if a non-equity arrangement is used. In the business context, the company can pay the premiums and keep all rights to cash value in the policy if greater than the amount of premiums paid. The policy can be owned by the insured equity owner or an irrevocable trust and rights can be collaterally assigned to the company.

a. The insurance industry also seems to have responded, by creating types of life insurance that rely much less on cash value build-up. This allows a larger share of the policy proceeds to be used by the equity owner who is purchasing the deceased owner's stock.

b. In any split-dollar arrangement being used in a business context, it is important at the planning stage to take into account the projected share of the proceeds the company will keep, and purchase a policy or policies that will leave the targeted amount for the owners even after the company is repaid. Of course, in a hybrid buy-sell arrangement, the purchasing owner could use her share of the proceeds to buy equity interests from the decedent, and the company could use its share to buy additional interests.

5. Alternatively, a portion of the death benefits under the policy can be endorsed over to the non-owner.

6. As Steve Gorin has explained, the transition from a redemption agreement to a cross-purchase agreement can present tax challenges depending upon the form of the operating business. A split-dollar life insurance arrangement in conjunction with establishing a separate life insurance LLC (to be discussed later in this outline) can potentially provide a solution. See Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," part II.Q.4.i.vii. Transitioning from Redemption to Cross-Purchase, which can be downloaded by clicking on the link in the yellow box in the middle of his most recent newsletter, available at https://www.actec.org/resource-center/gorins-business-succession-news/.

    a. If the operating business is an entity taxed as a partnership, the operating entity can distribute policies to a separate life insurance LLC. This would be deemed a tax-free distribution to the partners, followed by a deemed contribution by the partners to the life insurance LLC.

    b. If the operating business is instead taxed as either a C corporation or an S corporation, then a distribution of the life insurance policies would constitute a taxable sale causing income taxation on the distribution, and trigger the need for a special exception from the transfer-for-value rule of Section 101 of the Code to preserve the exclusion from income for life insurance death benefits. Exceptions include transfers to: (i) anyone whose basis is determined by reference to the original transferor's basis; (ii) the insured (or the insured's spouse or ex-spouse if incident to divorce under IRC § 1041); (iii) a partner of the insured; (iv) a partnership in which the insured is a partner; or (v) a corporation in which the insured is a shareholder or officer. See IRC § 101(a)(2). Often, having the shareholders of the C corporation or S corporation invest in a partnership together to satisfy the exception applicable to transfers to a partner of the insured is the simplest way of satisfying this exception.

    c. In that case, instead of distributing policies from the corporation, consider having the life insurance LLC "rent" the death benefits under a split-dollar endorsement arrangement that is subject to the economic benefit regime. Treas. Reg. § 1.61-22.

        (i) The corporation would retain the death benefit to the extent of the policy values on the date that the split dollar agreement is entered into and would also retain any subsequent additions to cash value.

        (ii) The corporation would pay the future premiums and be entitled under the split dollar agreement to the recovery of its premiums from the death benefits as well.

(iii) The life insurance LLC, in turn, would pay the corporation the annual one-year term value of the LLC's share of the death benefits being endorsed over to it.

D. Impact on Life Insurance on Valuation

1. In Rev. Rul. 82-85, 1982-1 C.B. 137, the IRS abandoned its earlier position that if a buy-sell agreement is funded with a life insurance policy and the proceeds of the policy are payable to the company and are used to redeem the shareholder/insured's stock upon the insured's death, the proceeds of the policy are includible in the insured's estate.

2. The IRS concluded that, instead, the proceeds would be reflected in the valuation of the decedent's stock. This is in agreement with the provision of Treas. Reg. § 20.2031-2(f); § 20.2042-1(c)(6) that insurance proceeds payable to or for the benefit of a corporation are among the factors to take into account in valuing a company:

"In addition to the relevant factors described above, 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. . . ." Treas. Reg. § 20.2031-2(f).

"In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholders, the corporations' incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence." Treas. Reg. § 20.2042-1(c)(6)

V. Connelly v. Commissioner and Prior Cases

A. It is helpful to consider the decision in Connelly v. Commissioner in light of several cases that preceded it and addressed valuation of a corporation when there was a redemption obligation.

B. Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999)

1. The Cartwright case arose prior to the enactment of Section 2703. However, the court addressed essentially the same issue of how to account for a redemption obligation when valuing a corporation for estate tax purposes. Unlike the other cases discussed in this section, the valuation issue here arose from an income tax dispute relating to the purchase of Cartwright's shares at his death.

2. Robert Cartwright was the majority shareholder of the law firm of Cartwright, Slobodin, Bokelman, Borowsky, Wartnick, Moore & Harris, Inc. ("CSB"). Cartwright and his colleagues incorporated CSB and only CSB attorneys were shareholders. The firm distributed no dividends. The associates and shareholders were paid a salary and the firm distributed its profits as bonuses.

3. In 1988, CSB amended its shareholders agreement only with regard to the purchase of Cartwright's interest at his death. No price was set for the shares to be purchased. The amendment specifically stated as follows:

"In the event of the death of Robert E. Cartwright, the proceeds of said policies payable to the Corporation will be exclusively used to purchase and acquire from the estate and heirs of Robert E. Cartwright all of Mr. Cartwright's stock in the Corporation together with any claim to any cases or work in process that may otherwise be made on behalf of Robert E. Cartwright. In this regard, the Corporation agrees to buy all of said stock and Robert E. Cartwright agrees to sell it. The value of said stock and claim in said cases and work in process is hereby fixed as the amount of proceeds of said life insurance policies."

4. Cartwright died on June 30, 1988. There were no facts indicating that he was ill at the time of the amendment.

5. CSB had purchased a $5 million life insurance policy on his life. In connection with the life insurance purchase, CSB and Cartwright entered into a contract in which the parties agreed that CSB would use the proceeds to compensate Cartwright for any claims he had in the firm's current cases at his death <u>and</u> to redeem his shares in CSB. The agreement didn't specify a separate price for the CSB shares. Instead, the contract appeared to value both items relying on a single figure.

6. When Cartwright died, the firm received life insurance proceeds of over $5,062,029, which it paid to Cartwright's estate under the terms of a shareholder's agreement. Cartwright's Estate took the position that the payment of the life insurance proceeds was paid to redeem Cartwright's stock and nothing was paid for Cartwright's claims in the firm's pending work. CSB had issued a 1099 showing that just over $4,000,00 was paid to the Estate as non-employee compensation. The IRS disagreed with the Estate's position, finding a $1,142,472 income tax deficiency.

7. The Tax Court had valued Cartwright's stock at approximately $1 million and found the remaining $4 million related to Cartwright's claims for ongoing work. Thus, the Court held that the fixed price equal to the insurance proceeds was paid partly for Cartwright's stock and partly for any claims he may have regarding the firm's cases or work in progress. Regarding the inclusion of the insurance in the value of the stock, the Tax Court concluded that "the insurance proceeds do not affect the value of decedent's stock because the entire proceeds were paid to the decedent's estate."

8. The U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's opinion on the treatment of the life insurance proceeds.

   a. Quoting Treasury regulation § 20.2031-2(f), the Ninth Circuit noted that "consideration" should be given to life insurance proceeds. However, the Ninth Circuit decided that the existence of life insurance proceeds "would not necessarily affect what a willing buyer would pay for the firm's stock because it was offset dollar-for-dollar by [the firm's] obligation to pay out the entirety of the policy benefits to Cartwright's estate."

   b. The Ninth Circuit held that the Tax Court did not err by not including the life insurance proceeds as an asset of the firm for stock valuation purposes. The

Court's view was that the insurance funds were not available to the corporation. Rather, these funds were "pledged" in that they had to be used for the potential buyout and could not be spent. The Ninth Circuit didn't address the allocation of the insurance proceeds between the claim for work in progress and the return of Cartwright's equity. The case was remanded to the Tax Court to determine a proper valuation of the stock.

c. The Ninth Circuit stated "It is true that in valuing stock, 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. 26 C.F.R. § 20.2031–2(f)(2)." Citing Estate of John L. Huntsman v. Commissioner, 66 T.C. 861, 875 (1976), the Court noted that the Tax Court's holding arose from its finding that the insurance was "offset dollar-for-dollar by CSB's obligation to pay out the entirety of the policy benefits to Cartwright's estate."

C. Estate of Blount v. Commissioner, 428 F.3d 1338 (11th Cir. 2005)

1. Blount is the case frequently referred to as contrary to Connelly, with the Connelly Eighth Circuit Court of Appeals decision creating a split in the circuits. It was a valuation case, with a focus on whether the stock purchase agreement entered into by the deceased stockholder would be binding for estate tax purposes. The Eleventh Circuit took the additional step of disagreeing with the Tax Court's inclusion of insurance proceeds in the non-operating assets of the company, without much analysis.

2. In 1981, shareholders William C. Blount and James Jennings and Blount Construction Company ("BCC") entered into a stock purchase agreement that required shareholder consent to transfer stock and established that BCC would purchase the stock on the death of the holder at price agreed upon by the parties, or if there is no agreement, for a price based on book value of BCC. Under the agreement, the stock could only be sold with shareholder consent and would be binding on subsequent shareholders. Upon a shareholder's death, the 1981 Agreement specified that the corporation would buy the stock at a price that the shareholders had agreed upon annually or, if there was no agreement, at a price based on the corporation's book value.

3. In the early 1990's, BCC purchased insurance policies to fund the buyout and ensure continuing operations. Insurance was roughly $3 million for each party. In 1992, BCC set up an employee stock ownership program ("ESOP"). Annual valuations were obtained by a third party to facilitate purchases by the ESOP.

4. Jennings died in January of 1996 and his shares were redeemed. In October 1996, Blount was diagnosed with cancer. He began exploring options for the buyout of his shares upon his death while preserving BCC's liquidity.

5. In November 1996, Blount and BCC executed an amendment to the 1981 stock-purchase agreement that bound Blount and BCC to exchange $4 million for the shares that Blount owned at his death. Unlike the 1981 agreement, the 1996 agreement did not provide for future price adjustments in accordance with book value. Thus, the later agreement locked

the price at the January 1996 value of BCC. The 1996 agreement also removed a provision allowing BCC to pay its obligation in installments.

6. Blount died in September 1997 owning 83% of BCC. BCC paid $4 million to his estate in November pursuant to the 1996 Shareholders Agreement. Blount's estate tax return valued his shares at $4 million and the IRS filed a notice of deficiency claiming that the stock was worth $7,921,975. The Tax Court held that the 1981 agreement, as modified by the 1996 amendment, should be disregarded in determining the value of the shares.

   a. The Tax Court concluded the differences between the two agreements were substantial. In light of the 1997 appraisal which determined BCC's book value to be $8.5 million, the Tax Court found that BCC's obligation under the agreement had changed significantly. BCC also lost the ability to pay in installments. Finally, the price adjustment clause was removed. Therefore, although the agreement was entered into before the effective date of section 2703, the agreement had been substantially modified and thus was required to satisfy the requirements of the Section.

   b. Blount could unilaterally change the agreement. The court determined that the terms were not comparable to similar transactions in the industry. Thus, the Tax Court must establish the value of BCC.

   c. Three experts testified as to the value of the stock. One expert only relied on a cash flow approach. The other two experts used an income-based value and an asset-based value and reached similar conclusions finding that the shares should be valued at $6.75 million. The Tax Court added the insurance to arrive at a value of $9.85 million for the company and a value of $8.2 million for Blount's stock. Ultimately, the Tax Court used the IRS's assessed value from their original notice of deficiency and found the shares were valued at just under $8 million.

7. The Eleventh Circuit concluded that the life-insurance proceeds were not the type of ordinary non-operating assets that should be included in the value of the corporation under the Regulations.

   a. The Court noted "in valuing the corporate stock, 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 that such nonoperating assets have not been taken into account in the determination of net worth. Treas. Reg. §20.2031-2(f)(2). The limiting phrase, 'to the extent that such nonoperating assets have not been taken into account,' however, precludes the inclusion of the insurance proceeds in this case."

   b. The Court also emphasized that BCC's sole purpose in purchasing the insurance policy was to fund its obligation to purchase Blount's shares. "Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation."

8. The Court concluded that, because the 1996 agreement remained an enforceable obligation against BCC, the extent that the $3 million life-insurance proceeds covered only

a portion of the decedent's 83% interest in the $6.75 million company, the insurance proceeds were offset dollar-for-dollar by the corporation's obligation to satisfy its contract with the decedent's estate.

9. The Blount case can also be categorized as a bad facts case. The Tax Court specifically noted that Blount realized that he was undervaluing his shares by a third. Estate of Blount, 87 T.C.M. at 1307. The court stated that Blount "was aware when he signed the 1996 agreement setting the price for his shares at $4 million ($92.85/share) that the most recent appraisal had valued BCC at approximately $8 million ($155.32/share).

10. Historical Treatment of Corporate Owned Life Insurance Under Treasury Regulation § 20.2042-1

a. An article examining the Blount case commented on what can be learned from the historical treatment of corporate owned life insurance. See Chodorow, "Valuing Corporations For Estate Tax Purposes: A Blount Reappraisal," 3 Hastings Bus. L.J. 1 (2006). The article noted that, between 1943 and 1974, the regulation addressing estate tax treatment of life insurance proceeds provided that "where a corporation owned life insurance on its sole shareholder, the proceeds were to be included directly in the shareholder's estate and excluded from the corporation's value." This rule required attributing incidents of ownership over the policy to the individual shareholder. Under the old version of the regulation, the corporation could exclude the insurance proceeds from its value since the proceeds were included in the individual shareholder's taxable estate.

b. In 1974, the regulations under Sections 2031 and 2042 were amended and the provisions quoted above in the paragraphs on life insurance at the end of Section IV were added.

c. The author points out that the Regulations do not include any references to consideration of a redemption obligation as a way to offset the insurance proceeds. Instead, the author argues that the new language of Section 20.2031-2(f) of the Regulations should serve as a reminder that insurance should be considered when valuing a corporation since it no longer is included in the shareholder's estate. Finally, the author notes that there is no provision in the Code or Regulations that permit life insurance to be excluded from a corporation's value just as there is no exclusion available for any other asset used to fund a redemption obligation.

D. Connelly v. United States

1. In Connelly v. United States, 144 S.Ct. 1406, 602 U.S. ____ (2024), the United States Supreme Court affirmed a decision of the Eighth Circuit Court of Appeals in favor of the government concerning the estate tax treatment of life insurance proceeds that are used to fund a corporate redemption obligation under a buy-sell agreement. The specific question presented was whether, in determining the fair market value of the corporate shares, there should be any offset to take into account the redemption obligation to the decedent's estate under a buy-sell agreement. The Supreme Court concluded that there should be no such offset. In doing so, the Supreme Court resolved an apparent conflict that had existed among the federal circuit courts of appeal on this offset issue.

2. Brothers Michael and Thomas Connelly were the only shareholders in Crown C Supply, Inc. ("Crown"), a closely held family business that sold roofing and siding materials. Michael owned approximately 77% of the company's shares, while Thomas owned approximately 23% of the company's shares.

3. The two brothers and Crown entered into a stock-purchase agreement. If Michael or Thomas died, the survivor of them had the right to buy his shares. If the surviving brother declined, Crown had to redeem the shares. By entering into this agreement, the brothers intended to ensure that control of the company would stay within the family. The brothers always intended that Crown, not the surviving brother, would redeem the other's shares. To fund its redemption obligation, Crown purchased $3.5 million of life insurance on Michael and Thomas.

4. The corporation obtained life insurance on each brother so that if one died, the corporation could use the proceeds to redeem his shares. When Michael died, the IRS assessed taxes on his estate, which included his stock interest in the corporation. According to the IRS, the corporation's fair market value includes the life insurance proceeds intended for the required stock redemption. Michael's estate argued otherwise and sued for a tax refund. The district court agreed with the IRS.

5. The stock-purchase agreement provided two mechanisms for determining the price at which Crown would redeem an owner's shares. The primary mechanism required the two brothers to execute a new Certificate of Agreed Value at the end of every tax year, which set the price per share by "mutual agreement." If the brothers failed to agree on a set value, then the brothers were supposed to obtain two or more appraisals of fair market value. The brothers never followed through, and neither mechanism was utilized.

6. Michael died in October 2013, and the company repurchased his shares which constituted an approximately 77% ownership interest in the company for $3 million. The rest of the life insurance proceeds ($500,000) went to fund company operations. Michael's estate paid estate taxes on his shares in the company, and the IRS audited and assessed additional estate taxes of nearly $900,000. Thomas, as executor of his brother's estate, paid the deficiency and filed a suit in federal district court for the Eastern District of Missouri seeking a refund.

7. The District Court granted summary judgment in favor of the government, holding (1) that Section 2703 of the Internal Revenue Code applied to disregard the buy-sell agreement to determine the value of the decedent's ownership interest in the company for estate

tax purposes, and (2) that in determining the fair market value of the corporate shares, there should **not** be any offset to take into account the redemption obligation to the decedent's estate under the buy-sell agreement.

a. The District Court distinguished Cartwright based on its interpretation of the corporation's redemption obligation. The court found that the corporate liability in that case was not just an obligation of the corporation to redeem its own stock. Instead, the corporation was obligated to compensate the deceased shareholder for his services prior to his death which similar to a third-party claim. Therefore, when valuing the corporation, it was appropriate to reduce the value by this obligation.

b. The United States Court of Appeals for the Eight Circuit affirmed. The insurance was treated as a corporate asset that increased the value of Crown and of Michael's shares in Crown.

8. As stated by the Supreme Court, the sole question before it was "whether Crown's contractual obligation to redeem [the decedent's] shares at fair market value offsets the value of life insurance proceeds committed to funding that redemption" obligation. The Supreme Court concluded that the redemption obligation does **not** provide any such offset.

9. The Supreme Court held that "redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax..." The Court's finding distinguishes an obligation to repurchase shares pursuant to a redemption agreement from a standard corporate liability, which would be taken into account for net asset value and offset the inclusion of insurance proceeds in the valuation of the decedent's interest in the entity.

a. The Supreme Court explained its reasoning by providing an example that focused on how the per share value of a closely held corporation is generally unaffected by the corporation's redemption obligation under a buy-sell agreement. According to the Supreme Court, no willing buyer purchasing the decedent's shares would have treated the redemption obligation as a factor that reduced the value of those shares.

b. It did not matter that the redemption obligation constituted an enforceable obligation under applicable state law – according to the Court, it was not the sort of liability to be given effect for valuation purposes in determining the fair market value of the corporate shares.

10. The Supreme Court added a footnote stating that "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."

E. Lessons from Redemption/Valuation Cases

1. The failure of the Connelly brothers to follow the formalities of the agreement they had entered into invariably worked against them.

   a. Although the Supreme Court did not focus on the formalities of the agreement that had been reached, both of the lower courts analyzed the parties' failure to follow the terms of the buy-sell agreement with regard to obtaining appraisals and executing a statement of value.

   b. After drafting a buy sell agreement, consider docketing any important dates contained in the agreement such as annual statements of value or appraisal requirements. After the death of a shareholder, consider docketing any deadlines relating to required notices.

2. This failure to follow formalities is a frequent theme in tax cases. For practitioners, and particularly clients, Connelly is a good reminder to follow through on the conditions set forth in business and estate planning arrangements. These contracts must be respected and administered properly by the parties if the taxpayers expect the IRS to respect the arrangements. See Smaldino v. Commissioner, T.C. Memo. 2021-127 (November 10, 2021) (court applied step transaction doctrine to collapse gifts from husband to wife and then to children to treat said gifts as having been made by husband resulting in additional gift tax); Sorensen v. Commissioner, Tax Ct. Dkt. Nos. 24797-18, 2479818, 20284-19, 20285-19 (decision entered Aug. 22, 2022) (case ultimately settled; the IRS sought to invalidate Wandry clause utilized to transfer shares to trusts for children in part due to taxpayers failure to properly document receipt of shares by trusts, subsequent distributions and stock powers).

3. It is difficult to satisfy the conditions of the Section 2703 exception that enables the taxpayers to rely on the value determined under the agreement for estate or gift tax purposes. An actual statement of a fixed value, in the agreement or simply agreed to by the parties, is almost always fatal. At a minimum, the buy-sell agreement needs to have a mechanism for updating value and should require reliance on neutral third party appraisers.

4. Does the decision in Cartwright provide an opening for offsetting the value of the insurance proceeds with the obligation related to the redemption? The agreements between Robert Cartwright and his law firm were very specific about the use of insurance proceeds in part to pay Cartwright for his shares, and to satisfy any right to compensation for work in progress.

VI. Applicable Valuation Principles for Closely Held Entities

A. The standard of value applied to all federal gift, estate and income tax matters is fair market value. See Treas. Reg. § 20.2031-1(b), § 25.2512-1 and § 1.170A-1(c)2. Fair market value 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. Revenue Ruling 59-60 provides guidance with respect to the concept of fair market value and the general approach, methods, and factors which must be considered for the purpose of valuing closely held businesses for gift and estate tax purposes.

B. For the valuation of closely held business interests, there are three general approaches that must be considered: the Income Approach, the Market Approach, and the Asset Approach. It is not a requirement that each of these three approaches be applied and relied upon. The only requirement is that the appraiser at least considers each approach in the analysis. The appraiser may use more than one valuation method and weight the value indications from the various valuation methods according to the applicability to the subject business, the quality of the underlying data, and using informed judgment about the reasonableness of the valuation indications.

1. Income Approach. The theory of the Income Approach is that the value of a business is equal to the present value of the cash flows expected to be generated in the future. The rate of return used to determine the present value of projected cash flows accounts for the investment characteristics of the business and risk of achieving the future income. Examples of the Income Approach include the Capitalized Cash Flow Method and Discounted Cash Flow Method.

2. Market Approach. The Market Approach is based on the concept that the value of a business can be derived by analyzing transaction prices in the marketplace involving similar companies. Valuation multiples are calculated by dividing a guideline company's enterprise value or stock price by a relevant financial metric. Applying these valuation multiples to the subject company's financial metrics provide a value indication of the business. Examples of valuation multiples include Equity Price/Net Income and Enterprise Value/EBITDA. Examples of the Market Approach include the Guideline Public Company Method and the Guideline Transactions Method.

3. Asset Approach. The Asset Approach provides an indication of value through the development of a market value balance sheet. All of a company's assets and liabilities are identified and listed, including any off-balance sheet assets and/or liabilities. This may entail appraising a company's machinery and equipment and real estate. The market value of assets less the market or economic value of liabilities results in the value of equity of the business. The Asset Approach is commonly referred to as the Adjusted Book Value Method or Net Asset Value Method.

C. Operating business. The Income Approach and Market Approach (i.e., "going concern" approaches") tend to be more applicable in valuing operating businesses that are profitable and have intangible value.

1. Normalizing adjustments. When applying the going-concern approaches, the analyst may consider various normalizing adjustments to the historical and projected financial statements. Normalizing adjustments include items such as adjustments for nonrecurring events, adjustments related to nonoperating assets, and adjustments to convert transactions to be on a market/arm's-length basis.

a. Nonoperating assets. Many closely held companies own assets that are not part of their operations. These assets may add value to the business above the value indicated by the going-concern valuation approaches applied. If nonoperating assets are given separate consideration, any income and expenses associated with nonoperating assets should be removed from the operating company financial data. The value of nonoperating assets would be accounted for as an adjustment to the enterprise value of the business. The premise is that the nonoperating assets could be liquidated without impairing business operations. Example of nonoperating assets may include excess cash, marketable securities, real estate held for investment, and life insurance.

D. Holding company or investment entity. The Asset Approach is often utilized for investment holding companies, unprofitable operating companies, or companies that are not generating an adequate return on assets.

E. Levels of Value. Valuation theory provides for various levels of value applicable to a business equity interest. A valuation analyst can employ assumptions or adjustments to the valuation method to derive results at the appropriate level of value. Depending on the valuation method employed, adjustments such as a discount for lack of control or discount for lack of marketability may be applied to determine the fair market value of the subject interest.

Valuation Method	Level of Value
Guideline Transactions Method - acquired companies	Strategic or Synergistic Value
Asset Approach Income Approach - controlling cash flows Guideline Public Company Method - controlling cash flows	Marketable, Controlling Interest
Income Approach - minority cash flows Guideline Public Company Method - minority cash flows	Marketable, Minority Interest (as if freely traded)
Guideline Transactions Method - past transactions of minority interests in subject company's stock	Nonmarketable, Minority Interest

F. Impact of buy-sell agreements. In the valuation of a closely held business interest, restrictive agreements should be considered by the appraiser in determinations of fair market value. The degree of consideration will relate to the facts and circumstances of each case. The appraiser must be aware of the special valuation rules of Section 2703, which do not always follow the typical fair market value convention for estate and gift tax purposes.

1. Rev. Rul. 59-60 (Section 8) provides valuation guidance with respect to consideration of restrictive agreements. Sometimes restrictive agreements can be determinative of value as with a binding buy-sell agreement that is adequately funded and determinative of the pricing of transfers among shareholders. At other times, the existence of restrictions on transfer can be detrimental to value. For example, if the restrictions are so onerous that they diminish the potential pool of likely qualified buyers, the marketability, and therefore the value of the subject shares may be diminished. Shareholder agreements that enhance liquidity, such as the mandatory put option, can impact value by reducing the marketability discount that otherwise might be applicable to the shares.

2. If applicable, Section 2703 will cause rights, restrictions or other provisions included in a buy-sell or similar agreement to be ignored for purposes of determining value for transfer tax purposes.

a. Although primarily intended to address perceived abuses in connection with buy-sell agreements, Section 2703 is applicable to other types of agreements such as partnership agreements, options, bylaws and articles of incorporation as well as restrictions contained within agreements that may otherwise impact valuation.

b. Section 2703 can have the effect of disregarding the value established in a buy-sell agreement or restrictions on the right to sell or use property. Section 2703(a) covers any property restriction or option. If any restriction or option fails to qualify for safe harbor provided in Section 2703(b), then the valuation of must be determined "without regard to" that restriction or option.

3. How do actual buyers and sellers account for buy-sell agreement restrictions?

a. In negotiating a transaction price, buyers and sellers consider contractual governance attributes that impact the investment characteristics of a business interest including the timing and process to achieve liquidity.

b. If the restrictions are so onerous such that the number of interested qualified buyers would be substantially reduced, and/or the cost and time associated with identifying a buyer would be substantially increased, the marketability, and therefore the value of the subject shares may be diminished. Perhaps in a real-world arm's-length situation, a buyer simply may not agree to become a party to the restrictive shareholder agreement and may pass on the deal.

4. How do actual buyers and sellers account for redemption obligations?

a. The key issue to address is whether arms-length parties would reasonably enter into an agreement such as the subject shareholder agreement. If so, the agreement may be determinative of fair market value. If not, then the agreement is not determinative of fair market value. Perhaps what is most typical in an arm's-length transaction is a change of control event that results in existing shareholder agreements being revised or terminated to accommodate the buyer.

b. Shareholder agreements that enhance liquidity, such as the mandatory put option, can impact value by reducing the marketability discount that otherwise might be applicable to the shares. A key issue to address is whether the company has the financial wherewithal (i.e., the "funding mechanism") to satisfy this redemption and the timing for the redeeming shareholder to be paid.

VII. <u>Planning Options After Connelly</u>

A. Apportionment Matters

1. After <u>Connelly</u>, there could be "phantom value" included in the taxable estate of a deceased shareholder for which the estate is not compensated in the buyout. Do clients want that their beneficiaries to bear the estate tax on the phantom buyout price? Should the estate plan address whether the recipient of the insurance payout must also pay apportioned estate tax? That may not work in all situations.

EXAMPLE: Sister owns 1,000 shares of stock in XYZ Co., a family corporation. The other shareholders are her three siblings and a trust created by her parents. The stock is subject to a buy-sell agreement that gives the company an option to buy the stock at a shareholder's death for $2,000 per share. The company exercises the right at sister's death and pays her estate $2,000,000. The IRS determines that the fair market value of the stock for estate tax purposes is $3,500 per share. If sister is in a 50% combined federal and state estate tax bracket, the estate pays estate tax on the stock of $1,750,000, but receives only $2,000,000 for it. Sister's family nets only $250,000 after estate tax.

2. Could the estate have a provision in its tax clause that applies state law tax reimbursement to any bequest stock in XYZ Co., defined to include a transfer of stock as a result of death to the extent the value of the stock, as finally determined for estate tax purposes, exceeds the consideration received for it? It would apply to the $1,500,000 of excess value received by XYZ, and the company would pay $750,000 of the estate tax.

3. Drafting attorneys should consider communicating with clients (or their business attorneys if separate) to advise them of tax apportionment issues that can arise from these situations. Clients must consider which beneficiaries/bequests they intend to bear the burden of any estate tax and address that in their will or revocable trust.

EXAMPLE: Same facts as above with Sister owning 1,000 shares of stock in XYZ Co., a family corporation, which are redeemed at her death for $2,000 per share, but subject to estate tax at a value of $3,500 per share. Sister's estate plan provides that her stock, or the proceeds from it, pass outright to her children. The remainder of her estate passes to a generation-skipping trust for her descendants. Should the children bear the estate tax on the shares, and therefore, net only $250,000 after estate tax? Conversely, if the tax clause in sister's estate plan provides for the residue to pay all taxes, her children receive the full $2,000,000.

B. Adhere to Buy-Sell Agreement Formalities

1. As noted earlier, the Connelly brothers, and the surviving brother Thomas and Michael's estate failed to adhere to most of the formalities of their agreement. Doing so might have made a difference. If Crown had obtained business appraisal on a periodic basis and updated the company value, there would have been an established record of the manner in which the company was valued, and better support for whatever value was reported on the estate tax return.

2. Even if the buy-sell agreement is not binding under Section 2703, a history of regular appraisals using a consistent, reasonable methodology can be persuasive in an estate tax audit. This is especially the case if other transactions involving the stock or other equity interests have occurred using the price determined under the agreement.

3. As stated early, an agreement that has a mechanism for updating value and requires reliance on neutral third-party appraisers is almost certainly a prerequisite for any agreement that could be binding for estate tax purposes.

a. It was suggested earlier that a binding agreement possibly could build in valuation discounts or other assumptions about the methodology for valuation of the business.

b. It certainly seems reasonable that an agreement that insurance proceeds that are committed to redeeming a deceased shareholder would not be included in the business value could be an acceptable provision.

4. There may be another factor related to the formalities of the agreement, and that is whether there is an important element of typical business agreements – independent contracting parties.

a. In Blount, the taxpayer and the corporation were the only parties to the buy-sell agreement. In Connelly, the surviving brother was the executor of the deceased brother's estate. The surviving brother was on both sides of the transaction in which the deceased brother's shares were acquired after his death. Could the lack of independence have been a factor in the Eleventh Circuit or the Supreme Court's decisions?

b. In Estate of Marion Levine v. Commissioner, 158 T.C. No. 2 (2022), the decedent entered into a highly complex insurance transaction in which her revocable trust paid premiums on life insurance policies taken out on her daughter and son-in-law that were held by an irrevocable trust. The decedent's revocable trust had the right to be repaid for those premiums. After Levine's death, the Tax Court examined what was includible in her taxable estate because of this transaction, specifically whether to include the cash surrender values of the insurance policies. The court found that only an independent trustee and an independent investment advisor had the right to cash in the insurance. Levine did not retain the right to cancel the policies. The Tax Court analyzed the fiduciary duties of the fiduciaries and concluded they were not illusory.

C. Redemption Agreements Going Forward

1. For family businesses that have entity purchase agreement, or hybrid agreements, the family owners should consider several options.

a. Can the business increase amount of life insurance to account for inclusion of proceeds in the company value, without an offset by the redemption obligation?

b. For many companies, the life insurance the company has on the shareholders is not adequate to fully redeem the shares of a deceased owner. This is particularly true where the purpose of the agreement is not to take the owner's family out of the business entirely. The redemption option in the agreement may be designed only to cover redemptions that qualify under Section 303, or to provide some assistance to each shareholder's family if the family needs liquidity to help with estate tax. These agreements usually are designed with a valuation for redemption purposes that is modified from time to time and reasonably reflects likely fair market value.

c. The life insurance may not cover what is needed because the value of the business may have grown beyond the expectation of value at the time it was purchased. This also might mean the inclusion of proceeds in the business value at the death of a shareholder has a nominal impact on valuation.

d. In all these situations, the business and its advisers should consider whether the ruling in <u>Connelly</u> has any material impact on the operation of the agreement.

e. If the shareholders wish to move to a cross-purchase arrangement, are there ways to distribute the life insurance policies to the shareholders? In a C corporation, this will invariably result in tax to the shareholders, assuming meaningful cash value has been built up in the policies. Could the corporation enter into split-dollar agreements with the insured shareholders? If the corporation transfers the right to receive the net proceeds after the corporation is reimbursed for the greater of premiums paid or cash value, what is the value of that distribution?

2. Cross-purchase agreements continue to be less attractive in most situations where there are multiple owners. Even with the use an escrow arrangement or an LLC, the life insurance will be reflected in some manner in the value of the deceased owner's estate. In an escrow the deceased owner still would have an interest in the other policies held in the escrow that has to be bought out (unless the parties all agree that the deceased owner forfeits their interests). In an LLC, there is the same issue of the insurance proceeds being part of the LLC value at the deceased owner's death and they would be counted in determining the value of the deceased owner's interest in the LLC.

   a. The owner could avoid this with advance planning, by holding the LLC interest (or even the policies on the other owners) in an irrevocable trust.

   b. This may work well for a shareholder who would like to have the additional shares acquired from a deceased owner excluded from their estate.

3. Buy-Sell Life Insurance LLC Planning. As described above and elsewhere in these materials, the use of an LLC to be the owner and beneficiary of buy-sell life insurance can be a valuable solution. In structuring an LLC to hold life insurance to fund a cross-purchase arrangement, there are a number of variables that become relevant. Some of those variables include:

   a. It is important that the LLC be taxed as a partnership to include some provisions of Subchapter K relevant to administration of the LLC. Also, holding life insurance in a partnership allows application of the transfer-for-value exception applicable for transfers to a partner of the insured. IRC § 101(a)(2)(B).

   b. Typically, ownership percentages in the LLC should mirror image ownership of the operating business entity. This allows life insurance death benefits to be allocated to the surviving members in proportion to their cross-purchase obligations.

   c. The LLC will be the owner and beneficiary of the life insurance policies funding the buy-sell plan. In order to maintain the death benefits as outside of the taxable estate of the deceased owner, it will be important to avoid the business owners holding incidents of ownership in those policies as determined under IRC § 2042 and the regulations thereunder. There are at least two primary ways of accomplishing this:

(i) In PLR 200214028, the IRS ruled, distinguishing the facts from Rev. Rul. 83-147, that the deceased owner would not hold incidents of ownership over a policy held in a partnership in which the owner was a 1/3 partner along with his brother and an unrelated individual when the death benefits were obligated under the partnership to be used to fund a purchase of the deceased owner's interests in the partnership. Following this logic, it should be possible to have life insurance held in the LLC/partnership under terms which negate each owner's ability to exercise incidents of ownership on the policy insuring his or her life.

(ii) In PLR 200747002, the relevant operating agreement vested all management in the hands of an independent bank as manager, with any successor manager also having to be a corporate manager. The operating agreement also limited any member's ability to vote on the partnership's incidents of ownership of the life insurance policy insuring the member. As such, the owners held no incidents of ownership under the policy insuring his or her life.

(iii) It clearly is necessary to include provisions in the LLC operating agreement limiting any owner's ability to exercise incidents of ownership with respect to the policy insuring his or her life. Likewise, any party exercising those powers should be limited to the same extent as the trustee under an ILIT would be limited, such as not allowing the insured owner to remove/replace a manager exercising incidents of ownership and replace that manager with a related or subordinate party. See Rev. Rul. 95-58 and TAM 8922003. Added comfort may be given by requiring that the manager always be an independent, corporate manager exercising all incidents of ownership.

(iv) An example provision may read as follows:

The Company is the sole owner of all incidents of ownership of all insurance policies owned by the Company. Notwithstanding anything in this Agreement to the contrary, no Member (individually or on behalf of any Person) shall vote or exercise any control over the administration of any insurance policy owned by the Company insuring such Member's life including, but not limited to, the right to policy dividends, make policy loans, surrender the policy, name the beneficiary, or any other power which would constitute incidents of ownership as that term is defined pursuant to Section 2042 of the Internal Revenue Code. Any vote or exercise of control over the administration of any insurance policy owned by the company insuring a Member's life which would constitute incidents of ownership pursuant to Section 2042 of the Internal Revenue Code shall be exercised by [the Manager (with appropriate limitations on appointment of manager)] or [an affirmative vote of the majority of Members whose lives are not insured under such policy]. Further, notwithstanding any right of the Members to amend or modify this Agreement, no Member on whose life the Company owns a life insurance policy, individually or on behalf of any Person, shall participate or vote regarding the amendment or modification of this paragraph.

d. The operating agreement should specially allocate death benefits received on the death of a partner to the other partners. See IRC § 704(a). Even though life insurance death benefits are excluded from income tax, this allows an increase in the outside basis of the non-deceased partners under IRC § 705(a)(1)(B). Therefore, the non-deceased partners should have sufficient outside basis against which to receive a distribution funding the buy-sell agreement. See IRC § 731(a)(1).

An example provision may read as follows:

> The Members acknowledge and agree that one of the purposes of the Company is to facilitate and fund the succession plan for certain entities owned by the Members. In furtherance of that purpose, the Members agree that any death or disability benefits received by the Company, less any loans secured by the policy or other liabilities associated with the policy, shall be specially allocated among the capital accounts of the Members in such a manner as to comply with the terms of the Buy-Sell Agreement. All insurance benefits received upon the death or disability of a Member, less any loans secured by the policy or other liabilities associated with the policy, shall be specially allocated to the nondisabled or non-deceased Members proportionately, the numerator being the Company Interests held by the nondisabled or non-deceased Member, and the denominator being the Company Interests held by all nondisabled or non-deceased Members.

e. The deceased owner's interests in the life-insurance LLC should be redeemed at death. Depending on the type of policies owned under the buy-sell plan and the intention of the owners, the value of such redemption vary. For example, the redemption price can merely be equal to the positive capital account balance of the deceased member. With all death benefits specially allocated to the non-deceased members, this generally should be equal to the premium payments and other administrative costs, if any, contributed by, or on behalf of, the deceased member. Alternatively, particularly if policies accumulating significant cash value will be owned by the LLC, the redemption value may equal the total partnership value, including cash surrender values, at the time of death (specifically excluding intangible assets).

An example provision may read as follows:

> Upon the death of a Member, the Company shall purchase, and the estate of the Member shall sell, the Company Interests of the deceased Member. The purchase price shall be equal to the [positive capital account balance of the Member] or [deceased Member's proportionate share of the total Company value immediately prior to the date of death, including the deceased Member's proportionate share of the total cash value of all life insurance policies owned by the Company immediately

before the Member's death but excluding the value of any intangible assets such as goodwill or trade name]. Payment to a deceased Member's shall be in cash and shall occur no later than X days after the date of the Member's death.

f. In a traditional cross-purchase structure, each owner is responsible for paying premiums on the policies held by that owner on the lives of the other owners. For younger, healthy owners, for example, this puts them paying a higher premium burden than the older, less healthy owners. Use of an LLC to hold life insurance opens up the ability to be more flexible in allocation of the overall premium burden. The primary options for allocating premiums, treated as capital contributions to the LLC, are:

(i) Allocation of premiums on a pro-rata basis equal to their proportionate ownership of the operating business and life-insurance LLC;

(ii) Allocation of premiums as a payment by the insured (i.e., each insured responsible for paying premiums on his or her own life); or

(iii) Allocation of premiums the same as premiums would have been allocated under the traditional cross-purchase plan (i.e., each owner is responsible for paying their share of premiums on the life of the other owners).

Note that some or all of the premiums may be paid under a split-dollar agreement with the operating business, premium financed, or other than purely through contributions by the business owners. For example, this LLC may also own other assets such as real property (for example, the business location being leased to the operating business) which produce cash flow used to fund premiums.

g. While the life insurance LLC buy-sell structure is predominately used to facilitate purchase of interests on the death of an owner, many buy-sell plans will be terminated, in whole or in part (i.e., with respect to a particular owner), prior to death. Commonly, this occurs on the retirement or other departure of an owner. When that occurs, the departing owner may desire to acquire the policy insuring his or her life. A partnership may distribute this policy to the departing owner without the potential for gain such as under IRC § 311(b) for an S or C corporation distributing a policy with cash value exceeding cost basis. Rather, there will be no gain or loss on distribution. IRC § 731. The distributee partner receiving the policy in liquidation of his or her LLC interests, will take as a cost basis in the policy equal his or her outside basis in the partnership. IRC § 732(b). As a distribution to the insured, there will be no transfer-for-value. IRC § 101(a)(2)(B). As noted above, allocation of premium payments among the owners will affect outside basis and capital accounts, thereby altering the results if the policy is later distributed.

h. Mechanically, with these items addressed, the LLC buy-sell structure at death should operate as follows:

(i) The LLC is the owner and beneficiary of life insurance policies on the lives of the members.

(ii) The members contribute funds to the LLC, directly or indirectly (by having the operating business make payments to the LLC directly), by compensation or distributions from the operating business, to pay premiums and other costs of administration such as the fees of any third-party LLC manager.

(iii) Upon the death of an owner, the LLC collects death benefits and allocates those death benefits to the non-deceased members.

(iv) The LLC redeems the interests of the deceased member and uses the remainder of the death benefits to either distribute to the non-deceased members to fund their cross-purchase obligations or acquires the interests of the deceased member in the operating business, then distributing those interests to the non-deceased members.

i. A similar but somewhat different alternative structure, which still allows only one policy per owner is to have separate LLC's to hold each policy. The insured owner would either have no ownership interests in that LLC. This minimizes concerns regarding incidents of ownership. The primary benefit of this structure is that, to the extent *Connelly*-like principles could include death benefits in the value of the deceased LLC member's value, notwithstanding the special allocation to the other members and the closing of the books that occurs at death under IRC § 706(c)(2)(A), the deceased member would not have any ownership in the LLC holding a policy on his or her life allowing for that value to be added to his or her interests in the LLC owning that policy.

4. Trusts in Buy-Sell Planning. Although a complete discussion of using trusts to facilitate buy-sell arrangements is beyond the scope of these materials, it is important to at least understand some of the structures that may be used to facilitate buy-sell planning through the use of trusts. Some of those structures are as follows:

a. There may be a single trust holding a single life insurance policy on the life of each business owner. In this way, the trust functions similarly to a life insurance LLC in that it minimizes the number of policies in multi-owner businesses, facilitates the buy-sell purchase, and can appoint a third party responsible for making sure the plan is completed who also holds incidents of ownership. A concern that arises here is that, upon the death of any owner, the other owners' proportionate interest in the other policies increases. Absent an exception that may apply, this may constitute a transfer-for-value.

b. Each owner may hold a policy insuring his or her life in a special purpose trust. That trust purchases the interests of the deceased owner, then distributes those purchased interests to the other owners. As with a life insurance LLC, this should allow one policy per owner. Also, properly structured, this should avoid inclusion of the death benefits of the deceased owner's taxable estate. However, this does not aggregate policies into a single entity controlled by all owners. As such, this plan may be most useful in the family business context.

c. Another use of trusts as owners of life insurance to fund buy-sell plans is to have each owner establish a trust that holds policies on the lives of other owners, or the LLC holding the policies. By using this structure, the non-deceased owners do not add to their taxable estates the value of interests of their deceased partners. Rather, the non-deceased owners establish trusts that serve as buyers under the buy-sell plan to keep the acquired interests out of their taxable estate. This structure can be seen in PLR 200747002 where beneficiary defective IRC § 678 trusts, holding interests in the life insurance LLC, were partial buyers under the buy-sell plan

d. With any of these alternatives, as with buy-sell life insurance funding generally, the source for payment of premiums is an important consideration. Depending on the structure, premiums may constitute taxable gifts to trust. As such, qualification for annual exclusion under *Crummey*¸ split-dollar funding, or other methods of minimizing gift and estate tax costs of trusts in buy-sell planning must be considered.

Considerations for Buy Sell Agreements After Connelly[1]

	A. Entity Purchase/ Redemption	B. Cross-Purchase	C. Insurance LLC
Brief Description[2]	Business redeems interest of deceased owner upon triggering event	Remaining owners agree to purchase the interest of an exiting owner upon triggering event	LLC owns insurance and business owners are members[3] Ownership percentages should match operating business ownership
Overall structure	Business and owners enter into redemption agreement which sets purchase price and terms of buyout	Business owners enter into cross-purchase agreement to buy each other's interests in the business upon specified triggering events, setting forth purchase price and terms of purchase owners use insurance proceeds received at death of exiting owner to purchase the exiting owner's interest pro-rata	LLC buys insurance policies and is owner and beneficiary of each policy on the lives of owners Utilize independent manager to avoid incidents of ownership by owners Death benefits specially allocated to surviving owners to fund buyout of exiting owner
Funding Mechanism	Business purchases insurance on the lives of owners, resulting in the need for only one policy per owner	Each owner buys life insurance on the other owners ("cross-purchase" arrangement), resulting in multiple policies per owner if more than 2 owners	LLC buys insurance, allowing cross-purchase structure without multiple policies per owner
Payment of premiums	Business pays the premiums	Individual policy owner pays the premium Disparate premium cost can result when owners ages and/or health status differ Consider split-dollar arrangement	Members contribute capital which are used to pay premiums; Rely on flexibility for allocation of premiums to avoid disparate impact of cost of life insurance (younger owners paying premiums on older owners) Consider split-dollar arrangement

[1] This chart is limited to situations where death is the triggering event.
[2] Any of these techniques could be structured as a hybrid agreement with other owners having first right to purchase.
[3] Trusts could be used as owners in lieu of individuals or in lieu of LLC.

Considerations for Buy Sell Agreements After Connelly[1]

	A. Entity Purchase/ Redemption	B. Cross-Purchase	C. Insurance LLC
Estate and Certain Income Tax implications to consider	Comply with IRC Section 2703 Transfer for value rule (IRC Section 101)	Comply with IRC Section 2703	Policies owned separately from operating business. Structure operating agreement to negate incidents of ownership (IRC Section 2042) held by insured members to avoid risk of application of Connelly. Transfer for value rule exception for partners in a partnership (IRC Section 101)
Applicable Case law	Connelly (redemption obligation did not offset insurance) If 2703 is satisfied, Connelly should not apply.	Avoids issue in Connelly because the insurance is not owned by the entity. Therefore, its value is not included in the entity's valuation.	Connelly PLR 200214028 and PLR 200747002 address this technique
Is insurance an asset of the business?	Yes under Connelly ruling[4] See Footnote 2 in Connelly (a redemption obligation may offset insurance value)	No	No, asset of separate entity
Alternative structure	Consider whether redemption obligation could be offset per Footnote 2 of Supreme Court opinion. Consider transition from redemption agreement to cross-purchase agreement and "rental" of death benefits under a split-dollar arrangement	If Connelly would not cause adverse estate tax result, redemption would be alternative structure	Consider whether to create separate LLCs for each owner's policy to mitigate 2042 concerns and application of Connelly (which may be addressed through special allocations)

[4] Under prior case law, insurance was not included in company's value.

Considerations for Buy Sell Agreements After Connelly[1]

	A. Entity Purchase/ Redemption	**B. Cross-Purchase**	**C. Insurance LLC**
Action Items After Connelly	Review agreement Advise clients to monitor compliance with formalities of agreement annually • Routinely obtain valuation; • Review structure of redemption obligation Can insurance be distributed without adverse income tax consequences?	Not impacted by Connelly	Consider impact of Connelly Consider separate LLCs Structure may be easier to exit or terminate after some owners die If terminated, distribution of policy should avoid transfer for value