Value of Stock Included Life Insurance Proceeds Intended for Redemption of Stock

Jennifer Pierce
jpierce@mwlaw.com
(501) 688.8859

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The Eighth Circuit Court of Appeals recently affirmed the decision in *Connelly vs. United States*,[1] holding that the fair market value of stock in a closely-held corporation, for purposes of valuing that stock held by a deceased shareholder's estate, included life insurance proceeds intended for the redemption of the deceased shareholder's shares in the company.

Background

Brothers Michael and Thomas Connelly were the sole shareholders of a corporation. Michael owned 77.18% of the stock and Thomas owned the remaining 22.82% of the stock. To provide for a smooth transition of ownership upon either's death, the brothers and the corporation entered into a stock purchase agreement which provided that if one brother died, the surviving brother had the right to buy his shares. Under the agreement, if the survivor declined to make this purchase, the corporation was obligated to purchase the decedent's shares. The brothers always intended that that the corporation would complete this redemption (not the surviving brother).

The stock purchase agreement had two mechanisms for determining the redemption price. The principal mechanism required the brothers to execute a certificate of agreed value every year to set the price by mutual agreement. If a certificate was not executed, the brothers were supposed to obtain two or more appraisals to establish fair market value. The brothers never executed a certificate of agreed value nor did they obtain appraisals as required by the stock purchase agreement. However, the corporation purchased $3.5 million of life insurance on each brother to fund the redemption.

Michael died in 2013, and the corporation received life insurance proceeds of $3.5 million. The brothers had not executed the required certificate of agreed value as required by the stock purchase agreement and no appraisals were obtained pursuant to the stock purchase agreement. Instead, the corporation redeemed Michael's shares for $3 million as part of post-death agreement between Thomas and Michael's son. The remainder of the life insurance proceeds (about $500,000) were used by the corporation to fund operations.

Thomas (as executor) filed the estate tax return for Michael's Estate and reported that Michael's shares in the corporation were valued at $3 million. The valuation was based solely on the redemption payment and Thomas did not include the insurance proceeds as an asset that would have increased the corporation's value.

The IRS audited the estate tax return and concluded that Michael's Estate had undervalued Michael's shares by relying on the $3 million redemption payment instead of determining the fair market value of corporation, which should have included the life insurance proceeds. The IRS sent a notice of deficiency to Michael's estate for additional tax liability; Michael's Estate paid the deficiency and sued for a refund in district court.

Michael's Estate claimed that the redemption payment pursuant to the stock purchase agreement conclusively determined the value of the corporation for estate tax purposes so there was no need to conduct a fair market value analysis. Alternatively, Michael's Estate argued that the corporation's fair market value should not include the life insurance proceeds used to redeem Michael's shares because, although the proceeds were an asset, they were immediately offset by a liability (the redemption obligation) and added nothing to the corporation's value. The IRS argued that the stock purchase agreement should be disregarded and that any calculation of the corporation's fair market value must account for the proceeds used for redemption.

The district court granted summary judgment to the IRS, concluding that the stock purchase agreement did not affect valuation. The district court determined that a proper valuation of the corporation must include the life insurance proceeds. The district court declined to follow *Estate of Blount*,[2] which did not include life insurance proceeds in a valuation under similar facts. Michael's Estate then appealed to the Eighth Circuit Court.

Eighth Circuit Court Decision

The Court first addressed whether the stock purchase agreement controls how a corporation should be valued. Under § 2703(a) of the Code,[3] the value of any property is determined without regard to any option, agreement, or other right to acquire the property at less than fair market value or to other restrictions on sale or use of the property, unless such agreement meets the requirements of § 2703(b) of the Code. Under § 2703(b) of the Code, to affect valuation, an agreement must (1) be a bona fide business arrangement; (2) not be a device to transfer property to members of the decedent's family for less than full and adequate consideration; and (3) have terms comparable to similar arm's-length transactions. Michael's Estate argued that the Court should look solely to the stock purchase agreement to value Michael's shares because the requirements of § 2703(b) of the Code were met.

The Court, however, found that the stock purchase agreement missed an important component – some fixed or determinable price for determining the redemption price. Instead, the stock purchase agreement had two possible mechanisms by which the brothers might agree on a price: (i) a certificate of agreed value, which the court rejected since it would merely be a mutual agreement (an agreement to agree), and (ii) an appraisal process to establish fair market value. The appraisal provision did not fix or prescribe a formula for determining the price of the shares, and instead just required that the appraisers determine the fair market value of the corporation. In any event, the appraisal process was not completed in this case. As a result, the Court determined that nothing could be gleaned from the stock purchase agreement.

The Court then addressed the issue of determining fair market value for Michael's shares. The key question was whether the life insurance proceeds received by the corporation which were intended for the redemption of Michael's shares must be included in valuing the corporation at the time of Michael's death. The Court noted that the value of property in an estate generally is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. For establishing fair market value of closely-held corporations, Treasury Regulations under § 2031 identify factors which should be considered, including net worth, prospective earning power, dividend-paying capacity, goodwill of the business, economic outlook in the particular industry, the company's position in the industry and its management, and the degree of control represented by the shares being valued. The Regulations specifically provide that the valuation of a closely-held company must also consider nonoperating assets, including life insurance policies payable to the company.

The Court noted that the Eleventh Circuit Court, in *Estate of Blount*, had determined that although life insurance proceeds should be considered in a similar situation, the value of the insurance proceeds was offset by a stock purchase agreement redemption obligation. The Eleventh Circuit Court concluded that this offset resulted in zero effect on the company's value. The Eighth Circuit Court disagreed with the reasoning in *Estate of Blount* and noted that a willing buyer of the corporation would be purchasing the life insurance and could either extinguish the redemption agreement or ultimately receive the benefit of the proceeds. Similarly, the court reasoned that a willing seller of the corporation would want to be compensated for the value of the life insurance proceeds. The Eighth Circuit Court concluded that a willing buyer and seller would include the life insurance in valuing the corporation.

Based on this analysis, the Court disregarded the stock purchase agreement, found that a fair market value analysis of the corporation had to include the life insurance proceeds used for redemption of Michael's shares, and affirmed the district court's summary judgment in favor of the IRS.

Takeaways

While Connelly is something of a "bad facts" case, the Court's broad rulings do not turn on the existence of those facts. Going forward, stock purchase agreements should be reviewed while considering the following:

1. Follow the valuation mechanism in the agreement. If an appraisal is required to determine the value, obtain the appraisal and use that value for the redemption price.
2. Prepare for the possibility that a stock purchase agreement is both effective for property law purposes to set the actual amount payable to the decedent's estate for redemption of ownership interests, and also ineffective to set value for federal estate tax purposes. The result could be a cash-poor estate and an unfunded federal estate tax liability.
3. Avoid using certificates of value and certainly do not make them mandatory.
4. Respect the entity agreement in its entirety – courts in general abhor structures that are simultaneously ignored and hidden behind.
5. Rethink insurance funded redemption agreements.

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[1] *Connelly v. United States Department of Treasury, Internal Revenue Service*, 70 F.4th 412 (8th Cir. 2023).

[2] *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005)

[3] All references to the "Code" refer to the Internal Revenue Code of 1986, as amended.