COUNSELOR'S CORNER

BEST PRACTICES

STRUCTURING BUY-SELL AGREEMENTS FOR FARMERS, RANCHERS & OTHER BUSINESS OWNERS POST *CONNELLY V. UNITED STATES*

BY CRAIG W. BENSON & REBEKAH C. BIRCH, KOLEY JESSEN

IN *CONNELLY V. UNITED STATES*,[1] THE Eighth Circuit Court of Appeals (which includes Nebraska) ruled that life insurance proceeds received from company-owned life insurance (COLI) following the death of a shareholder must be considered a corporate asset in valuing the shares of the corporation's stock held by the estate of the deceased shareholder. The ruling resulted in a circuit split with the Ninth and Eleventh Circuits, which previously ruled that the value of COLI proceeds are offset by the corporation's contractual redemption obligation. The court also ruled that the company's buy-sell agreement was not binding to fix the value of the shares for estate tax purposes, finding that the agreement was not fixed and determinable in determining value since the owners merely determined value by mutual agreement, rather than the mechanisms provided for in the buy-sell agreement. The case impacts closely held business owners and illustrates the importance of thoughtful succession planning and key considerations when using COLI to help finance buyouts. The Supreme Court of the United States (SCOTUS) agreed to hear oral arguments on the dispute on March 27, 2024.

Background

In *Connelly*, two brothers jointly owned a corporation. To ensure business continuity in the event of one's death, the corporation secured life insurance policies on each brother, formalizing this arrangement with a buy-sell agreement. The agreement provided for two valuation mechanisms: executing certificates of agreed value at the end of each tax year, or, in the alternative, obtaining two or more appraisals of fair market value.

When Michael Connelly passed away, the corporation received a $3.5 million life insurance payout. The corporation redeemed Michael's shares for $3 million, valuing his interest in the business at the same amount on the federal estate tax return. Notably, the parties failed to use the valuation methods provided in the agreement in valuing the business interest. The IRS argued that the $3.5 million in insurance proceeds should be considered a corporate asset, inflating the total value of the corporation and increasing the estate tax owed.

The district court granted the IRS summary judgment, concluding that the buy-sell agreement did not affect the valuation since the parties did not adhere to the terms of the agreement and that a proper valuation must include the life insurance proceeds used for redemption. The Eighth Circuit affirmed. Notably, this result by the Eighth Circuit took the opposite approach for the inclusion of life insurance proceeds than two previous decisions by the Eleventh and Ninth Circuits in *Estate of Blount v. Commissioner*

and *Cartwright v. Commissioner.*[2] In those cases, each circuit court determined that any life insurance proceeds received were offset by the corporation's contractual redemption obligation and did not need to be included in the valuation; conversely, the Eighth Circuit determined that insurance proceeds were *not* offset by the corporation's redemption obligation and must be included.

Planning Considerations: Buy-Sell Agreements

For the valuation mechanism in a buy-sell agreement to be respected, the following must be true:

- The sale price must be fixed or determinable pursuant to a formula contained in the agreement;
- the decedent owner's estate must be obligated to sell at the fixed price;
- transfer restrictions must apply during the deceased owner's lifetime; and
- the agreement must be an arm's length bona fide business arrangement and not a tool used to pass assets to another for less than fair market value.[3]

The *Connelly* decision presents a variety of warning signs and planning considerations for practitioners involved in succession planning for closely held businesses. *Connelly* emphasizes the importance of adhering to the buy-sell agreement's provisions for valuing closely held business interests. While it is unclear from the Eighth Circuit's opinion whether strict adherence to a clear valuation mechanism in the buy-sell agreement would have led to a different outcome—the court emphasized that the agreement did not establish a "fixed or determinable price" to value the shares. Instead, the shareholders determined value by mutual agreement, ignoring the valuation mechanisms provided for in the agreement. Thus, a key planning consideration emerging from the court's emphasis on a fixed or determinable price is to consider whether a purchase price determined by mutual agreement that does not reflect fair market value causes estate tax valuation issues. Practitioners would be wise to clearly define valuation mechanisms within the buy-sell agreement and to ensure that clients follow the mechanism as defined. Given the *Connelly* ruling, practitioners should be leery of buy-sell agreements that allow valuation by mutual agreement following the death of an owner based solely on mutual agreement by the owners. The IRS could argue that valuation by mutual agreement alone is not an arm's length bona fide business arrangement, but rather a mere tool to pass assets to another for less than fair market value—particularly in transactions between related parties, which often garner increased scrutiny.

Planning Considerations: Company Owned Life Insurance

Another issue raised by the *Connelly* case is that of company-owned life insurance and the potential impact on entity valuations. In *Connelly*, the Eighth Circuit cited Treasury Regulation § 20.2031-2(f) in determining that the life insurance proceeds at issue must be considered a nonoperating asset that factors into the willing buyer-willing seller test for determining fair market value. Specifically, the court found that the willing buyer at the time of Michael's death would control the life insurance proceeds at issue and thus would be willing to pay more for the entity. The court concluded that "the proceeds were simply an asset that increased shareholders' equity," and that "[a] fair market value of Michael's shares must account for that reality." On the other hand, in both *Blount* and *Cartwright*, the Eleventh and Ninth Circuits determined that the life insurance proceeds would not affect what a willing buyer would pay for the companies, as the proceeds were offset dollar-for-dollar by the obligation to pay out policy benefits to a deceased shareholder's estate. Given the Eighth Circuit's stark departure from previous decisions, a key emerging planning consideration is to consider using cross purchase agreements with the use of life insurance policies, or, alternatively, to ensure that any valuation mechanism in a company owned life insurance funded redemption arrangement expressly excludes any life insurance proceeds.

Illustration. For an illustration of the impact of these decisions, consider the example of Company XYZ, a closely held entity owned in equal shares by Owners A and B. Company XYZ is currently valued at $10 million and owns a life insurance policy with a $5 million death benefit on each A and B for redemption purposes. Under *Connelly*'s reasoning, if B died tomorrow and the life insurance was included in the value of the company, the estate of B would have to report the value of B's interest as $7.5 million (i.e., $15 million multiplied by 50%). Conversely, under the reasoning of the *Blount* and *Cartwright* decisions, the value of B's interest would be reported as $5 million (i.e., $10 million multiplied by 50%). For business owners with taxable estates, this $2.5 million increase in value would result in an additional estate tax of $1 million.

The planning landscape surrounding buy-sell agreements and company owned life insurance should soon be clarified by SCOTUS. Until then, practitioners are wise to proceed with caution in advising clients in structuring buy-sell agreements, especially those with company owned life insurance policies involved. ◀

Craig Benson and Rebekah Birch are attorneys at Koley Jessen, focusing their practices on business succession planning, estate planning and administration, and implementing advanced tax planning techniques for farmers, ranchers, and other business owners. Benson and Birch work closely with CPAs in the structuring and implementation of succession plans to help ensure family harmony and minimization of tax, and to allow the farm, ranch, or other business operations to continue to grow and flourish as an economic engine into the future. If you would like to discuss a client matter with Craig and Rebekah, reach them by email at craig.benson@koleyjessen.com and rebekah.birch@koleyjessen.com, or by phone at (402) 390-9500.

ENDNOTES

1 *Connelly v. United States*, 70 F.4th 412 (8th Cir. 2023).

2 *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005); *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999).

3 Treas. Reg. § 20.2031-2(h); IRC § 2703.