A RECENT 8TH CIRCUIT DECISION REITERATES THE BENEFIT OF REVIEWING REDEMPTION BUY-SELL AGREEMENTS FUNDED BY BUSINESS OWNED LIFE INSURANCE

Question | For estate tax purposes, what is the value of a business if it receives life insurance proceeds on the death of an owner?

Answer | Generally, and a surprise to some, the value of the business is increased by the value of the life insurance proceeds.

Result | The 8th Circuit's recent decision in *Connelly* sounds the warning bell for clients with business owned life insurance.

In a recent case, two brothers, Michael and Thomas, were the sole shareholders of a closely held building-materials company, Crown Corporation.[1] To keep the business in the family in the event of death, the brothers entered into a stock-purchase agreement providing that the surviving brother had the right to buy the shares of the deceased. To fund the redemption, like many businesses, Crown purchased $3.5mm of life insurance on each brother with the understanding that the company, not the brothers, must redeem the shares.

Upon Michael's death in 2013, Crown received the $3.5mm in insurance proceeds and used $3 million to redeem Michael's 77.18% share in the company. In filing its tax returns, Michael's estate relied on the $3mm redemption payment to value Michael's shares at the time of his death and failed to consider the insurance proceeds as an asset that increased the value of the firm and of these shares.[2] The IRS subsequently audited the estate for undervaluing Michael's shares and for paying taxes on the $3MM valuation from the brothers' agreement rather than the $5.3 million the shares were worth when accounting for the insurance proceeds.[3] The 8th circuit agreed with the IRS, upheld an additional $1mm tax burden on the estate, and reaffirmed the traditional view that business-owned life insurance proceeds should be considered when calculating the FMV of a business for tax purposes to avoid a windfall.

So, is this outcome a surprise? Not really. Although it may contradict a few unique opinions, *Blount and Cartwright*, both in different Circuits than the 8th, *Connelly* does not create new law. In fact, due to the interplay of certain rules under well-established regulations and other cases such as *Knipp*,[5] *Connelly* reinforces precedent while painting *Blount and Cartwright* as exceptions to the traditional rule.[6]

Could a different court or circuit come up with a different result? Of course. Might this reach the Supreme Court since there is a difference between the Circuits—perhaps. The key here is that *Connelly* serves as a reminder for clients and advisers who have entered into similar buy-sell agreements that there must be some level of consideration for the life insurance proceeds payable to the business when valuing their interest in the business for estate tax purposes. While this treatment *may* differ among the circuits, ultimately the *Connelly* decision, especially in the 8th Circuit, should prompt advisers to consider alternative solutions, or at the very least, conduct an insurance review, where applicable.

Things to Consider:

1. *What is the impact if the death benefit does increase the value of the business for estate tax purposes?*
2. *Will the tax status of the business (i.e. – partnership, S-Corp, C-Corp) further complicate the planning when life insurance is payable to the business? For example, there are specific rules when accounting for life insurance proceeds in an S-Corporation that may be less desirable than an entity taxed as a partnership.*
3. *Is the business owned policy in compliance with the Notice and Consent rules under sec. 101(j)? Failure to do so would also cause the death benefit to be income taxable.*

[1]*Connelly v. United States,* Dep't. of Treasury, IRS, 70 F.4th 412 (8th Cir. 2023).

[2]Because of shareholders' relationship as brothers, the *Connelly* Ct. reviewed 2703(b) (ignore valuation agreements unless they (1) are a bona fide business arrangement, (2) not a device to transfer property to members of decedent's family for less than full/adequate consideration, and (3) have terms comparable to other similar arrangements.

[3]26 CFR § 20.2033-1 (Gross estate includes value of all property, real or personal, tangible or intangible owned by decedent at time of death) § 2031 (value of taxable estate generally FMV of decedent's property at date of death).

[4]*Estate of Blount v. Comm'r.,* 428 F.3d 1338 (11th Cir. 2005). (Value of ins. proceeds paid to co. at owner's death offsets company's liability to redeem shares resulting in zero net effect. *United States v. Cartwright,* 183 F.3d 1034 (9th Cir. 1999). (Ins. proceeds paid by firm to deceased owner's estate not an asset in valuing that owner's stock).

[5]*Estate of Knipp v. Commissioner,* 244 F.2d 436 (4th Cir. 1957). (When insurance proceeds are paid to a partnership, the valuation of the inclusion in the estate of the deceased partner is the pro rata portion for the year.)

[6]Treas. Reg. 20.2042-5, (The death benefit paid to a corp. where insured was a majority shareholder shall be included in firm's valuation but not directly included in the insured's estate. Cross-referenced under Treas Reg 20.2031-2(f)- (consideration shall also be given to nonoperating assets including life ins. proceeds payable to Co).