Corporate-Owned Life Insurance – Impact on Corporate Value and Shareholder's Estate

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Overview

A corporate buy-sell agreement funded with life insurance is fairly common in farm and ranch settings where there is a desire to keep the business in the family for subsequent generations and there are both on-farm and off-farm heirs. When a controlling shareholder dies, it can be a good way to get the control of the business in the hands of the on-farm heirs and income into the hands of the off-farm heirs. But, how does corporate-owned life insurance impact the value of the company and the value of the decedent's gross estate?

The impact of corporate-owned life insurance on value – it's the topic of today's post.

Background

Valuation is where the "action" is when it come to federal estate tax. The rule for valuing property for federal estate (and gift) tax purposes is the "willing buyer-willing-seller" test. *Treas. Reg. §25.2512-1.* Whatever price the parties arrive at is deemed to be the property's fair market value. Id. But, how is a corporation to be valued when it will receive insurance proceeds upon the death of a shareholder and the proceeds will be offset by a corporate obligation to redeem the decedent's stock? Will the proceeds of an insurance policy owned by a corporation and payable to the corporation be taken into account in determining the corporation's net worth? Under the Treasury Regulations, the proceeds do *not* add to corporate net worth to the extent that they are otherwise reflected in a determination of net worth, prospective earning power, and dividend-paying capacity. *Treas. Reg. §20.2031-2(f).* This means that, for the stockholders that have various degrees of control, the insurance proceeds may be reflected in the pro-rata determination of stock value. The same is true for proceeds payable to a third party for a valid business purpose that results in a net increase in the corporate net worth. *See Treas. Reg. §20.2042-1(c)(6).*

A related question is what the impact is on the decedent's estate that has stock redeemed? Does state law matter?

The *Blount* Case

The issue of corporate valuation when life insurance proceeds are payable to the corporation upon a shareholder's death for the purpose of funding a stock redemption pursuant to a buy-sell agreement came up in *Estate of Blount v. Comr., T.C. Memo. 2004-116.* In *Blount*, the decedent owned 83.2 percent of a construction company. There was only one other shareholder, and the two shareholders entered into a buy-sell agreement in 1981 with the corporation. Under the agreement, the stock could only be sold with shareholder consent. Upon a shareholder's death, the agreement specified that the corporation would buy the stock at a price that the shareholders had agreed upon or, if there was no agreement, at a price based on the corporation's book value.

In the early 1990s, the corporation bought insurance policies for the sole purpose of ensuring that the business could redeem stock and continue in business. The policies provided about $3 million, respectively, for the stock redemption. The corporation was valued annually, and a January 1995 valuation pegged it at $7.9 million.

The first shareholder died in early 1996 at a time when he owned 46 percent of outstanding corporate shares. The corporation received about $3 million in insurance proceeds and paid slightly less than that to redeem the shareholder's stock based on the prior year's book value. The decedent was diagnosed with cancer in late 1996. The 1981 buy-sell agreement was amended about a month later locking the redemption price at the January 1996 value of the corporation. The decedent died in the fall of 1987. The corporation paid his estate about $4 million in accordance with the 1996 agreement. The decedent's estate tax return reported the $4 million as the value of the shares. Upon audit, the IRS asserted that the stock was worth about twice that amount based on the corporation being worth about $9.5 million (including the insurance proceeds to the other corporate assets).

Based on numerous expert valuations, the Tax Court started with a base corporate valuation of $6.75 million. After adding the $3.1 million of insurance paid to the corporation as a non-operating asset upon the decedent's death, the corporation was worth $9.85 million. Given the decedent's ownership percentage of 83.2 percent, the value of the decedent's stock for estate tax purposes was $8.2 million. But the Tax Court limited the stock value to slightly less than $8 million which was the amount that the IRS had determined in its original notice of deficiency. In making its valuation determination, the Tax Court disregarded the buy-sell agreement on the basis that it had been modified and, therefore, didn't meet the requirement to be binding during life. In addition, the Tax Court reasoned that the agreement could be disregarded under I.R.C. §2703 because it was entered into by related parties that didn't engage in arm's-length negotiation. Because the Tax Court disregarded the buy-sell agreement, the issue of whether the corporation's obligation to redeem the decedent's stock offset the proceeds was not in issue.

The appellate court affirmed the Tax Court's decision that the buy-sell agreement couldn't establish the value of the corporate stock for estate tax purposes primarily because the decedent owned 83.2 percent of the stock and could have changed the agreement at any time, but reversed on the issue of whether the insurance proceeds should be included in the corporation's value as non-operating assets. *Estate of Blount v. Comr., 428 F.3d 1338 (11th Cir. 2005).* The appellate court determined that the proceeds had already been taken into account in determining the corporation's net worth. The buy-sell agreement was still an enforceable liability against the company under state law even though it didn't set the value of the company for tax purposes. The appellate court noted that the insurance proceeds were offset dollar-for-dollar by the corporation's obligation to satisfy its contractual obligation with the decedent's estate. The appellate court grounded this last point in Treas. Reg. §20.2031-2(f)(2), which it held precluded the inclusion of life insurance proceeds in corporate value when the proceeds are used for a redemption obligation.

Note: The Ninth Circuit also reached the same conclusion in *Cartwright v. Comr., 183 F.3d 1034 (9th Cir. 1999).* In *Cartwright*, the court deducted the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds to the estate in a stock buyout.

Recent Case

Essential facts. In *Connelly v. United States, No. 4:19-cv-01410-SRC, 2021 U.S. Dist. LEXIS 179745 (E.D. Mo. Sept. 21, 2021),* two brothers were the only shareholders of a closely-held family roofing and siding materials business. They entered into a stock purchase agreement that required the company to buy back shares of the first brother to die. The company then purchased about $3.5 million in life insurance coverage to ensure it had enough cash to redeem the stock. The brother holding the majority of the company's shares (77.18 percent) died on October 1, 2013. The company received $3.5 million in insurance proceeds. The surviving brother chose not to buy his shares, so the company used a portion of the proceeds to buy the deceased brother's shares from his estate for $3 million pursuant to a Sale and Purchase Agreement. Under the agreement the estate received $3 million and the decedent's son received a three-year option to buy company stock from the surviving brother. In the event that the surviving brother sold the company within 10 years, the brother and decedent's son would split evenly any gains from the sale.

The estate valued the decedent's stock at $3 million and included that amount in the taxable estate. Upon audit the IRS asserted that the fair market value of the decedent's corporate stock should have factored-in the $3 million in life-insurance proceeds used to redeem the shares which, in turn, resulted in a higher value of the decedent's stock than was reported. The IRS assessed over $1 million in additional estate tax. The estate paid the deficiency and filed a refund claim in federal district court.

The buy-sell agreement. The court noted that a stock-purchase agreement is respected when determining the fair market value of stock for estate tax purposes upon satisfying the requirements of I.R.C. §2703(b). Those requirements are that the 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 in the money's worth; and 3) have terms that are comparable to similar arrangements entered in an arms' length transaction. The court also noted several judicially-created requirements – 1) the offering price must be fixed and determinable under the agreement; 2) the agreement must be legally binding on the parties both during life and after death; and 3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration.

The IRS expert claimed that the insurance proceeds should be included in the company's value as a non-operating asset, and that allowing the redemption obligation to offset the insurance proceeds undervalued the company's equity and the decedent's equity interest in the company, and would create a windfall for a potential buyer that a willing seller would not accept. The IRS expert concluded that the fair market value of the company was $6.86 million rather than $3.86 million. The IRS also took the position that the stock purchase agreement didn't meet the requirements in the Code and regulations to control the value of the company.

The estate claimed that the company sold the decedent's shares at fair market value and that the shares had been properly valued. Thus, the $3 million in life insurance proceeds were properly excluded from the decedent's estate based on the appellate opinion in *Blount*. The estate claimed that the stock purchase agreement provided a sufficient basis for the court to accept the estate's valuation as the proper estate-tax value of the decedent's shares. On that point, the IRS claimed that the stock purchase agreement was not a bona fide business arrangement and, as such, didn't control the value of the decedent's stock. The IRS position was that the stated estate planning objectives of the stock purchase of continued family ownership of the company were insufficient to make it a bona fide business arrangement, particularly because the brothers did not follow it by disregarding the pricing mechanisms contained in it.

The court passed on the bona fide business arrangement issue because it determined that the estate had failed to show that the stock purchase agreement was not a device to transfer wealth to the decedent's family members for less than full-and-adequate consideration. The process that the surviving brother and the estate used in selecting the redemption price bolstered the court's conclusion that the stock purchase agreement was a testamentary device. They also did not obtain an outside appraisal or professional advice on setting the redemption price, thereby disregarding the appraisal requirement set forth in the agreement. The court also noted that the agreement didn't provide for a minority interest discount for the surviving brother's shares or a lack of control premium for the decedent's shares with the result that the decedent's shares were undervalued. This also, according to the court, demonstrated that the stock purchase agreement was a testamentary device to transfer wealth to the decedent's family members for less than full-and-adequate consideration and was not comparable to similar agreements negotiated at arms' length.

Inclusion of life insurance proceeds in corporate value. On the issue of whether the life insurance proceeds should be included in corporate value, the court rejected the appellate court's approach in *Blount*, finding it to be analytically flawed. The court concluded that the appellate court in *Blount* had misread Treas. Reg. §20.2031-2(f)(2), and that the regulation specifically requires consideration to be given to non-operating assets including life insurance proceeds, "to the extent such nonoperating assets have not been taken into account in the determination of net worth." The court concluded that the text of the regulation does not indicate that the presence of an offsetting liability means that the life insurance proceeds have already been "taken into account in the determination of a company's net worth." The court concluded that, "by its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the fair market value of a company's stock…. And…a redemption obligation is not the same as an ordinary corporate liability." There is a difference, the court noted, between a redemption obligation that simply buys shares of stock, and one that also compensates for a shareholder's past work. One that only buys stock is not an ordinary corporate liability – it doesn't change the value of the corporation as a whole before the shares are redeemed. It involves a change in the ownership structure with a shareholder essentially "cashing out."

The court noted that the parties had stipulated that the decedent's shares were worth $3.1 million, aside from the life insurance proceeds. The insurance proceeds were not offset by the company's redemption obligation and, accordingly, the company's fair market value and the decedent's shares included all of the insurance proceeds, and the IRS position was upheld.

Conclusion

The *Connelly* opinion is appealable to the Eighth Circuit, which would not be bound to follow either the Ninth or Eleventh Circuits on the corporate valuation issue. The opinion does provide some "food for thought" when using life insurance to fund stock buyouts in closely-held business settings. That will be an even bigger concern if the federal estate tax exemption declines in the future.