U.S. District Court Casts Shadow on Redemption Buy/Sell Agreements: Connelly v. U.S.

On September 21, 2021, the U.S. District Court for the Eastern District of Missouri issued its opinion in *Connelly v. United States*, holding that a life insurance death benefit payable to a business for purposes of purchasing and redeeming the decedent's stock increased the value of the business and, consequently, the decedent's estate. The opinion is in conflict with the 2005 Eleventh Circuit decision in *Estate of Blount v. Commissioner*.

Background

Life insurance is often used to fund so-called entity purchase buy/sell arrangements, where a business purchases coverage on the lives of its owners to purchase a deceased owner's share. A question raised in such arrangements is whether the right to receive a death benefit at the death of an owner increases the business's value by the same amount. The 2005 case *Estate of Blount v. Commissioner*, and, before it, *Estate of Cartwright vs. Commissioner* (1999), answered this question in the negative: a life insurance death benefit, considered as an asset, is offset dollar-for-dollar inasmuch as it fulfills the business's obligation to purchase the decedent's portion of the business. As an appellate court decision, *Estate of Blount* holds considerable sway in American jurisprudence and, consequently, in the practice of business succession planning.

Analysis

The task of determining the fair market value of their subject decedents' businesses fell, sixteen years apart, to the *Blount* and *Connelly* Courts. Ordinarily this is not the case: since 1990, Congress has provided business owners a valuation safe harbor via Internal Revenue Code Section 2703, which allows the decedent's buy/sell agreement to control valuation so long as the agreement conforms to conditions specified in the statute. Owing to various failures, both Blount's and Connelly's agreements were found deficient with respect to S. 2703, each Court was therefore required to determine value, and their divergent analyses bring us to the present moment.

In brief: fair market value is defined in the Code of Federal Regulations as "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." 26 C.F.R. § 20.2031-1. The *Blount* Court in 2005, reversing the lower U.S. Tax Court, found that a willing buyer would discount a business's purchase price by its obligation to purchase a decedent owner's share, effectively "washing" the life insurance death benefit. The *Connelly* Court, by contrast, relied on the IRS's representation that a willing buyer would disregard the obligation to purchase the decedent's share because the obligation would be effective *against the buyer*, who would therefore both hold the shares AND receive their purchase price, increasing the business's value by the amount of that price.

The Scene post-Connelly

The *Connelly* case creates a rift in the law governing so-called entity purchase buy/sell arrangements. For businesses and estates in the Eastern District of Missouri, *Connelly* now controls. For Eleventh Circuit jurisdictions, *Blount* continues to control. For the rest of the country, *Blount* remains persuasive over *Connelly*, but the possibility of future affirmation of *Connelly* in the Eighth Circuit should act as a caution. When different Appellate courts hold opposite positions, the only possible arbiter is the U.S. Supreme Court, who could alter the treatment of entity purchase arrangements forever.

Conclusion

There's a silver lining for planners, namely, the reason both Blount and Connelly landed in court in the first place: in each case, the buy/sell agreements failed S. 2703 safe harbor treatment. Planners who take care to draft agreements conforming in form and substance to 2703 can help their clients avoid audit and possible adverse outcomes.

If you have a buy/sell planning opportunity, Prudential Individual Life Advanced Planning team wants to help! We look forward to being of assistance, and can be reached at 800-800-2738, Option 4.