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Will a Business Owned Buy-Sell Life Insurance Policy Increase the Value of a Descendant's Business Interest?

Situation: One of the chief concerns for owners of a closely held business is what will happen to the business if one of the owners can no longer continue. Surviving owners generally want to ensure a continuity of ownership and management without having the departing owner's successor thrust upon them. Disabled or deceased owners want their families compensated fairly for their business value and, where applicable, they want this value to be respected for estate tax purposes.

I suspect that, as experienced practitioners, we have all stated that a properly drafted buy-sell agreement will address all the above goals by:

- Providing that upon the occurrence of specific "trigger events," owners are assured that their interest in the business will be purchased;
- Providing that an owner's interest must be sold to the company, the remaining owners, or a combination of the two; and
- Establishing a valuation formula that will help ensure the family is compensated fairly and be respected for estate tax purposes.

Equally important to having a properly drafted buyout agreement is making sure the continuity of the business is not compromised by requiring buyout payments/terms that significantly burden the business. Neither the surviving owner(s) nor the departing owner wants to unduly compromise the continuity of the business by requiring payments that create a burden. Consequently, many buy-sell agreements are funded, in whole or in part, by life insurance on the lives of individual owners.

Solution: Life insurance is a tidy solution for funding a buy-sell agreement when it is available and affordable. However, it is important to think through the implications of life insurance from a valuation perspective when the business is the owner and beneficiary of the policy. In a prior publication of *Counselor's Corner* we discussed the importance of complying with the IRC § 101(j) notice and consent requirements under the employer owned life insurance rules. In this article we will discuss how life insurance proceeds received by the business may impact the valuation of a deceased owner's business interest. However, before we discuss the impact life insurance proceeds may have on the valuation of a business, it's helpful to review the rules regarding how a buy-sell agreement can "fix" the estate tax value of a business.

When Can a Buy-Sell Agreement “Fix” the Estate Tax Value of a Business Interest?
One of the advantages of a properly structured buy-sell agreement is that it can minimize, and in some cases, eliminate estate tax valuation problems. The theory is that if the decedent is contractually bound to sell the business interest at a certain price, then that price should constitute the estate tax value of the business interest. However, this logic does not necessarily pass muster with the IRS. There have been IRS challenges, court litigation and even legislation to resolve this issue. Due to tax legislation enacted in the 1990’s, scenarios involving buyout between family members have become more complex than non-family scenarios. Let’s start with the basics in the non-family scenario because these elements are carried over into any family member situations.

The starting point for a non-family business valuation situation is with Treasury Regulation § 20.2031-2(h). This regulation speaks in the negative, stating that the buy-sell agreement will be disregarded unless “the agreement represents a bona fide business arrangement and not a device to pass the decedent’s shares to the natural objects of his bounty for less than an adequate and full consideration in money or money’s worth.”

Revenue Ruling 59-60 restated positively the scant guidance set forth in Reg. § 20.2031-2(h), adding that a buy-sell agreement that is binding during life and upon death is only one of many factors to consider in valuing the business. Under case law that developed around Reg. § 20.2031-2(h), the purchase price determined under a buy-sell agreement was held to fix the value of an interest in a closely held business if the following four requirements were satisfied:

- The price must be fixed by, or determinable from, the agreement.
- The agreement must be binding on the parties during life and after death.
- The agreement must have been entered into for bona fide business reasons.
- The agreement must not be a substitute for a testamentary disposition to transfer the business interest for less than adequate consideration.

The first attempt to “codify” this judicial approach occurred in 1987 with the enactment of IRC § 2036(c), which was designed to eliminate abusive estate-freezing techniques. Buy-sell agreements were pulled into this controversial and disastrous code section. After numerous “fixes,” IRC § 2036(c) was retroactively repealed in 1990. The void was immediately filled by the addition of the Chapter 14 valuation rules. Within Chapter 14 lives IRC § 2703, which deals specifically with buy-sell agreements.

IRC § 2703 Valuation Rules. IRC § 2703 was enacted to curtail perceived abuses in connection with agreements among owners of closely held businesses and their families.[1] IRC § 2703(a) provides that property must be valued for transfer-tax purposes:

- Without consideration of any options, agreements, or other rights to acquire or use the property for less than its fair market value, and
- Without any restrictions on the sale and use of the property.

However, an exception to this general rule is found in IRC § 2703(b). Basically, the exception provides that, if the agreement meets the following three-part test, it will fix the estate tax value of the business:

- It is a **bona fide** business arrangement.
- It is **not a device** to transfer property to members of the decedent's family for less than full and adequate consideration.
- It has **terms comparable** to similar arrangements entered into by a person in arms-length transactions.

Each of the above requirements must be satisfied independently. It should be noted that IRC § 2703 supplements the prior four-part test. So, if IRC § 2703 applies to a buy-sell agreement, the agreement must meet both its test and the requirements of the four-part test required by the prior law. The statute places the burden of proof on the taxpayer.

Practically speaking, unrelated parties have little incentive to transfer assets for less than full and adequate consideration. Reg. § 25.2702-1(b)(3) recognizes this and provides a safe harbor. When individuals who are not "members of the transferor's family" own more than 50% of the value of the property, the buy-sell transaction will qualify for the IRC § 2703(b) exception.

The first two requirements of IRC § 2703(b) evolved over time in case law under Treasury Reg. § 20.2031-2(h) before they were codified by IRC § 2703(b). Even before IRC § 2703 was enacted, these were difficult tests to meet. With the addition of the comparability requirement, it has become more difficult for a buy-sell arrangement in a family business to be respected for estate tax valuation purposes.

Bona Fide Business Arrangement Test. Courts have held that the following reasons for entering into a buy-sell arrangement constituted a bona fide business arrangement: [2]

- The maintenance of family ownership and control of a business;
- The retention of a family member as a key employee of a company in which the family members were hostile to each other;
- To create an incentive for effective management when an owner wished to withdraw from management of a business;
- To ensure the continued employment of stockholders who were valued employees and to facilitate a transition of the ownership of the company to the shareholders, thereby ensuring the company's permanency;
- To avoid expensive appraisals in determining the price;
- To prevent the transfer to an unrelated party;
- To provide a market for the equity interest; and
- To allow owners to plan for future liquidity needs.

Testamentary Device Test. A buy-sell agreement cannot have a testamentary purpose. A determination of whether a buy-sell agreement has a testamentary purpose involves an inquiry into the intent of the parties at the inception of the agreement. In *Estate of True v. Commissioner*, the court listed eight factors that might indicate a buy-sell agreement would fail the testamentary purpose test:[3]

- The decedent's poor health when entering into the agreement;
- No negotiation of buy-sell agreement terms;
- Inconsistent enforcement of buy-sell agreement provisions;
- Failure to seek significant professional advice when selecting a price formula;
- Failure to obtain or rely on appraisals when selecting a price formula;
- The exclusion of significant assets from the price formula;
- No periodic review of the price formula; and
- The decedent's business arrangements fulfilled by this testamentary intent. (For example: The fact that the children of a deceased business owner received equal percentage interests in the business despite their different management responsibilities would indicate that the transfers were based on family relationships, not business relationships.)

Comparability Test. IRC § 2703 added the "comparability provision," to discourage excessive discounting situations involving family members. Treasury Regulation § 25.2703-1(b)(4)(i) attempts to clarify comparability by instituting a new three-part approach. These three new requirements are:

- The agreement must be similar to a fair bargain among unrelated parties.
- The agreement must follow the general business practice of unrelated parties.
- The agreement must be similar in result to negotiated agreements of unrelated parties.

Other than to imply that "comparability" is to be analyzed on an industry-by-industry basis, the regulations seem to merely paraphrase the code provisions and provide little guidance as to how "comparability" is proven. It is difficult to determine whether an intra-family buy-sell is comparable to an arms-length transaction, as most buy-sell agreements are typically private. An agreement that provides that the purchase price is to be determined by a qualified independent appraiser should comply. What is unclear is which other valuation approaches will be recognized. If an approach other than appraisal is used, care should be taken to document why that approach meets the "comparability" requirements.

The Meaning of "Family." Another ambiguity of IRC § 2703 is the meaning of the term "family." It may have wider application than its usual definition. The regulations under IRC § 2703 do not refer to "members of the decedent's family" but instead substitute the phrase "natural objects of the transferor's bounty." Nowhere in the regulations is this term defined. However, the preamble to the regulations specifically provides that the class of persons who may be objects of an individual's bounty is not necessarily related by blood or marriage.[4] To date, it does not appear that the IRS or the courts have pursued an expansive application of this definition. However, when drafting and designing a buy-sell agreement, care must be taken to consider this "wider" definition and its implications in the individual planning scenario.

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Grandfathering Rules. IRC § 2703 does not apply to buy-sell agreements entered into before October 8, 1990 unless such an agreement is "substantially modified." However, it is important to note that even if IRC § 2703 does not apply, the arrangement must still meet the prior four-part test to control value for estate tax purposes. There is little guidance on what the IRS considers to be a substantial modification. Treasury Regulation § 25.2703-1(c)(2) speaks in the negative, listing those modifications that are not considered substantial modifications:

- A modification required by the agreement;
- A discretionary modification of an agreement conferring a right or restriction that does not change the right or restriction;
- A modification of a capitalization rate, if the rate is changed in a manner that bears a fixed relationship to a specified market interest rate;
- A modification that results in the establishment of a price that more closely approximates fair market value.

It should be noted that "inaction" as well as "action" can be detrimental to grandfathered agreements. If the agreement includes a provision requiring periodic modification and none is made, Reg. § 25.2703-1(c)(2) provides that such a *failure to update* the agreement is presumed to be a "substantial modification." However, this presumption can be overcome if it can be shown that the updating would not have resulted in a substantial change. Taxpayers should consult legal counsel before altering the terms of, or the parties to, a pre-October 8, 1990, agreement.

Now that you have an understanding of when a buy-sell agreement can "fix" the estate tax value of a business interest, we can delve into how life insurance proceeds received by the business may impact the valuation of a deceased owner's business interest.

Impact of Business Owned Life Insurance in Determining Business Value. One of the major problems with all buy-sell agreements is finding the funds to enable the buyer to purchase the interest of a deceased owner. Life insurance is usually a preferred option for funding a buy-sell triggered by the death of an owner because:

- The insurance death proceeds are paid at the time when the obligation to purchase the business interest is triggered.
- Properly structured, the proceeds may be received income tax-free under IRC § 101(a).[5]
- The cost of the life insurance is generally less than the death benefit received.

Funding a buy-sell arrangement with life insurance, however, has its own issues. One issue is the treatment of the proceeds for valuation purposes. Specifically, should the life insurance proceeds be considered as an asset to be used solely for the purpose of funding the repurchase liability created by a buy-sell agreement, or alternatively, should the proceeds be considered as a separate asset (non-operating asset) to be included in the calculation of value for the deceased shareholder's business interest? Surprisingly, many buy-sell agreements are silent or ambiguous on this issue. Absent specific instructions in the buy-sell agreement, the business appraiser may have to make the determination. What the appraisers decide will almost certainly disappoint at least one side and may surprise both.

Let's consider an example of the two different treatments. Assume Bill and John each own 50% interest in a business. The company owns term life insurance on Bill and John in the amount of $6 million each. Assume Bill dies from an unexpected heart attack. Assume the business value prior to consideration of the insurance proceeds is $10 million.

Following is the result if the proceeds are used solely for the purpose of funding the repurchase liability:

	Company	**Bill's Estate**	**John**
Ownership %	100%	50%	50%
Business Value - Pre Insurance	$10 million	$5 million	$5 million
Insurance Proceeds	$6 million		
Repurchase Liability	($5 million)		
Business Value - Post Insurance	$11 million		
Repurchase Interest	($5 million)	($5 million)	
New Ownership %	100%	0%	100%
Business Value - Post Insurance	$11 million		**$11 million**
Proceeds Received by Heirs		**$5 million**	
Net Change in Value	$1 million		

Alternatively, following is the result if the proceeds are considered an asset of the business to be included in the calculation of the value:

	Company	**Bill's Estate**	**John**
Ownership %	100%	50%	50%
Business Value - Pre Insurance	$10 million	$5 million	$5 million
Insurance Proceeds	$6 million	$3 million	$3 million
Business Value - Post Insurance	$16 million	$8 million	$8 million
Repurchase liability	($8 million)		
Repurchase Interest	($8 million)	($8 million)	
New Ownership %	100%	0%	100%
Business Value - Post Insurance	$8 million		**$8 million**
Proceeds Received by Heirs		**$8 million**	
Next Change in Value	($2 million)		

In both situations the value of the business prior to the receipt of the insurance proceeds is $10 million. In the first situation the proceeds are not added to the value of the business so Bill's heirs receive $5 million and John ends up with a business worth $11million. In the second situation where the life insurance is included in the business value, Bill's heirs receive $8 million and John ends up with a business that is addled with additional debt of $2 million caused by the repurchase of the business interest.

What can be seen by this example is that the valuation treatment of life insurance proceeds is too important to not address in the provisions of the buy-sell agreement.

Impact of Business Owned Life Insurance in Determining Estate Value.
Another issue is whether business-owned life insurance must be included in determining the estate value of a decedent's stock. The Tax Court in *Estate of Blount v. Commissioner*[6] held that the life insurance owned by the corporation increased the value of the business entity for estate tax purposes. On appeal, the Eleventh Circuit court reversed the Tax Court on the life insurance valuation issue noting:

"The insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of Blount Construction Company under the Treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by the company's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent business person interested in acquiring a company would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value."

While the results of Blount should not be ignored, advisors need to recognize the realities that life insurance proceeds are valuable assets and that other courts may not follow the results of *Blount*. In fact, in a 2021 decision, *Connelly v. United States*, the District Court for the Eastern District of Missouri held that the business owned insurance used to redeem the decedent's shares must be included in the fair market value of the corporation and the decedent's estate.

In Summary.
When establishing a buy-sell agreement to be funded with business owned life insurance it's important to consider the impact life insurance can have on the value of the business. If you have clients with existing agreements that are silent on how to treat the life insurance, it's best to get all the parties together now to make an informed decision on how to treat the proceeds. At the same time, you might want to conduct a policy performance review to make sure the policies continue to meet expectations. In addition, where it's important that the buy-sell value "fix" the value for estate tax purposes the agreement should be reviewed by the client's legal advisor to make sure the arrangement meets the terms established under IRC § 2703.

[1] IRC § 2703 does not apply to buy-sell agreements entered into before October 8, 1990, unless such an agreement is "substantially modified." PLR 201313001 reminds us that pre-October 8, 1990, agreements exist. In such situations practitioners should exercise discretion in modifying or terminating the agreements.

[2] St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982); Estate of Lauder, 64 T.C.M. 1643 (U.S.T.C. 1992).

[3] T.C. Memo 2001-167 (2001).

[4] Preamble to final regulations: TD 8395, 1992-1 CB 316, 320.

[5] For employer-owned contracts issued after August 17, 2006, IRC 101(j) provides that death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally received income tax-free under IRC § 101(a).

[6] Estate of Blount v. Commissioner, T.C. Memo. 2004-116, aff'd in part and rev'd in part, 428 F. 3d 1338 (11th Cir. 2005)

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