Current Federal Tax Developments

Week of September 27, 2021

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CURRENT FEDERAL TAX DEVELOPMENTS
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Current Federal Tax Developments

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SECTION: 274
TAXPAYERS LOSE ON MULTIPLE ISSUES BEFORE THE TAX COURT

Citation: Parker v. Commissioner, TC Memo 2021-111, 9/23/21

In the case of *Parker v. Commissioner*, TC Memo 2021-111[1] the taxpayers faced a number of issues related to their tax return for 2015. We will look at a few of the issues, primarily to discuss where the taxpayers failed to obtain the benefits they claimed on their returns.

Car and Truck Expenses

IRC §274(d) was enacted to override the option for taxpayers to attempt to use the *Cohan* rule to claim a deduction for certain expenses for which they do not have documentation. The *Cohan* rule is described in the opinion as follows:

> Under *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), if a taxpayer claims a deduction but cannot fully substantiate the underlying expense, the Court in certain circumstances may approximate the allowable amount, "bearing heavily if it [so] chooses upon the taxpayer whose inexactitude is of his own making." The Court must have some factual basis for its estimate, however, else the allowance would amount to "unguided largesse." *Williams v. United States*, 245 F.2d 559, 560 (5th Cir. 1957).[2]

Congress later determined that some expenses must be documented and, if not documented, the expenses could not be deducted, regardless of whether the taxpayer otherwise met the *Cohan* rule. IRC §274(d) provides for these rules:

> (d) Substantiation required
>
> No deduction or credit shall be allowed --
>
> > (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
> >
> > (2) for any expense for gifts, or

[1] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/couple-denied-business%2c-retirement%2c-demolition-deductions/79g2y (retrieved September 24, 2021)

[2] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

> (3) with respect to any listed property (as defined in section 280F(d)(4)),
>
> unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of the person receiving the benefit. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).

In this case the issue arose with regard to listed property, specifically expenses related to the business use of an automobile. As the opinion notes:

> Section 274(d)(4) sets forth heightened substantiation requirements (and overrides the Cohan rule) with respect to "listed property." As in effect during 2015, "listed property" included "any passenger automobile." Sec. 280F(d)(4)(A)(i); sec. 1.280F-6(b)(1)(i), Income Tax Regs. No deduction is allowed for vehicle expenses unless the taxpayer substantiates, by adequate records or sufficient evidence corroborating her own statements, the amount, time and place, and business purpose for each expenditure. See sec. 1.274-5T(c), Temporary Income Tax Regs., 50 Fed. Reg. 46016 (Nov. 6, 1985). Substantiation by "adequate records" generally requires the taxpayer to "maintain an account book, diary, log, statement of expense, trip sheets, or similar record" prepared contemporaneously with the use of the vehicle, as well as evidence documenting the expenditures. Id. para. (c)(2), 50 Fed. Reg. 46017. An actual contemporaneous log is not strictly required, but records made at or near the time of the expenditure have greater probative value than records made later. Id. subpara. (1).[3]

The taxpayers had claimed the following deductions for auto expense:

> On that Schedule C they claimed a deduction of $25,870 for car and truck expenses. They calculated $32,313 of expenses for operating the Camaro in 2015 and multiplied that sum by a "business use" percentage of 80.06% (assuming 10,662 business-use miles and 2,656 miles devoted to commuting or personal use). They also claimed a deduction of $4,083 for depreciation on the Camaro.[4]

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[3] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[4] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

The Court goes on to describe their records, which the Revenue Agent found adequate only to allow $4,815 of the auto expenses, though the entire depreciation deduction was allowed by the agent:

> Petitioners did not keep a contemporaneous mileage log in 2015 and did not have access to reliable odometer readings from that period. During the IRS examination they tried to estimate Ms. Parker's business mileage using her calendar, her driving habits, and distances drawn from Google Maps. They eliminated commuting miles from their calculus and assumed no personal miles other than weekly trips to buy groceries, biweekly trips to buy household items, and monthly trips to Costco. Alleging $29,402 of expenses for operating the Camaro and a "business use" percentage of 97%, they claimed a deduction of $28,520.[5]

The Tax Court sided with the IRS on this issue, noting:

> In urging a larger deduction petitioners have changed their assumed facts and computational theory at least three times since filing their 2015 return. Their final position on post-trial brief is that they are entitled to a deduction of $23,358, reflecting $26,817 of expenses for the Camaro and a business use percentage of 87.1% (assuming 6,399 business miles and 951 personal miles).
>
> We find that petitioners have not proven their entitlement to a deduction larger than respondent has allowed. First, petitioners produced no contemporaneous (or otherwise reliable) records of the total mileage driven on the Camaro during 2015. Second, they have not satisfactorily accounted for both spouses' personal use of the car. We do not find plausible their assumptions that their personal use of the Camaro was limited to weekly, biweekly, and monthly trips to buy groceries and household supplies. Third, the evidence they provided at trial to substantiate Ms. Parker's business use of the Camaro was, at times, inconsistent with other evidence in the record and therefore not credible. We conclude that petitioners have fallen far short of satisfying the strict substantiation requirements of section 274(d).[6]

Retirement Plan Contributions

The taxpayers also claimed a deduction for $60,444 for funding a profit sharing/401(k) plan for the year (which the taxpayers referred to as a "Solo 401(k)" plan). The facts outlined in the opinion are as follows:

> In January 2015 petitioners created a "Solo 401(k)" plan for Ms. Parker's personal training business, intending it as a vehicle for consolidating their existing [*7] retirement accounts. On April 14, 2016, they deposited $140,000 into this account, intending that the deposit be attributed to the 2015 tax year. This sum was broken into

[5] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[6] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

> $100,267 (labeled "cashier's check"), $26,793 (labeled "funds received"), and $12,940 (labeled "funds received"). The $26,793 was a rollover from Mr. Parker's retirement account with British Telecom. The $12,940 was a rollover from Mr. Parker's retirement account with CTS. The remaining $100,267 consisted of $39,823 rolled over from an earlier "Solo 401(k)" account plus $60,444 of unexplained funds.
>
> On their 2015 return petitioners claimed a Self-Employed SEP, Simple, and Qualified Plans deduction of $60,444.[7]

The opinion outlines some of the rules surrounding the plan and deductions for funding it:

> The Code allows taxpayers to deduct certain qualified contributions to retirement plans. Secs. 62(a)(6) and (7), 219(a), 404(a). As with other deductions, the burden of showing the amount and deductibility of contributions to an eligible plan is on the taxpayers. See *Barie v. Commissioner*, T.C. Memo. 2016-160, 112 T.C.M. (CCH) 255, 257. "Rollovers" — that is, transfers from one retirement account to another — are not deductible. See sec. 1.219-1(b)(2)(iii), Income Tax Regs.[8]

In this case, the Revenue Agent's and Court's skepticism arose from the fact that the taxpayers made a large part of the contributions to the plan during the year with a single cashier's check, with at least a portion of the payment arising from a rollover, as well as depositing another rollover into the account. When asked to show where the $60,444 for which they were claiming a current deduction came from, the taxpayers weren't able to provide evidence of where the funds came from:

> On April 14, 2016, petitioners deposited $140,000 into their "Solo 401(k)" account, intending to designate it for tax year 2015. Of that sum, $39,733 was rolled over from Mr. Parker's retirement plans with British Telecom and CTS. The balance consisted of a $100,267 cashier's check.
>
> Petitioners contend that $39,823 of the latter sum was rolled over from an earlier "Solo 401(k)" plan and that the remaining $60,444 was a deductible retirement contribution. But they submitted no evidence showing where the $60,444 [*13] originated, i.e., whether it consisted of new cash or whether it was also a rollover from a preexisting retirement account. Admitting their failure to produce bank or brokerage records showing the source of these funds, they asserted in their post-trial brief that they prefer to keep their savings "at home where they are protected * * * and safe from unscrupulous individuals including IRS agents." This assertion does not satisfy their burden of proof.[9]

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[7] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[8] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[9] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

The Court noted that the taxpayers had other sources of retirement funds, so it wasn't clear this amount was not a rollover of funds from another plan or plans, rather than being pulled from their stash of funds in the mattress at home (or whatever their hiding spot for those funds from IRS agents and other "unscrupulous individuals" might be).

> Mr. Parker testified that he created the new "Solo 401(k)" to consolidate petitioners' retirement accounts. Evidence in the record (including petitioners' prior tax returns) indicates that they had other retirement plan assets that could have been the source for the $60,444 slice of the cashier's check. For 2013 and 2014 alone, petitioners claimed deductions totaling $82,363 for contributions to self-employed SEP, SIMPLE, and qualified plans. But they admit a rollover from their prior "Solo 401(k)" of only $39,823. Viewing the evidence as a whole, we find that petitioners have failed to carry their burden of proving that any portion of the $60,444 contribution consisted of new cash rather than nondeductible rollover.[10]

Demolition Expenses for a Rental Property

The final item we'll look at in this article is the taxpayer's claim of rental repair expenses on Schedule E related to demolition expenses for a home the taxpayer had unsuccessfully attempted to rent in prior years and which had been destroyed in a fire the prior year.

The facts of this situation were described as follows:

> In September 2008 Mr. Parker bought a house, sight unseen, on English Avenue in Atlanta (English Avenue property) for $17,000 and closing costs. He originally thought he might live in the house but decided against it after his first on-site visit. His initial efforts to rent the house were unsuccessful, and he never derived any income from it.
>
> In early 2010 Mr. Parker canceled the insurance policy on the house. In January 2014 vandals broke into the building and set a fire that destroyed it. In 2015 petitioners paid $10,000 to have the burned-out structure demolished and $175 for a related permit. Mr. Parker continued to own the property as of the trial date.
>
> On Schedule E, Supplemental Income and Loss, petitioners claimed a deduction of $10,000, denominated a "repairs" expense, for the cost incurred to have the structure demolished.[11]

Before the Tax Court the taxpayers agreed that it was not proper to deduct the amount on Schedule E (which the IRS disallowed), but argued instead they should have been able to claim a deduction on Schedule A for a larger amount that, in addition to the demolition expenses, included a permit for the demolition and their basis in the demolished building.

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[10] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[11] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

In 1984 Congress adopted IRC §280B to deal with expenses related to the demolition of structures. That provision reads:

> In the case of the demolition of any structure--
>
> > (1) no deduction otherwise allowable under this chapter shall be allowed to the owner or lessee of such structure for--
> >
> > > (A) any amount expended for such demolition, or
> > >
> > > (B) any loss sustained on account of such demolition; and
> >
> > (2) amounts described in paragraph (1) shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located.

The taxpayer first argued that, despite that provision in the IRC, they are allowed to claim the loss based on Reg. §1.165-3, but the Tax Court pointed out that enactment of §280B in 1984 overrode that 1960 regulation:

> In support of a contrary conclusion petitioners cite section 1.165-3, Income Tax Regs. That regulation, captioned "Demolition of Buildings," was promulgated in 1960 and amended in 1976. See T.D. 6445, 1960-1 C.B. 93, as amended by T.D. 7447, 1977-1 C.B. 51. This regulation has no effect for demolitions carried out after section 280B's effective date. See *Tonawanda Coke Corp. v. Commissioner*, 95 T.C. 124, 128 & n.2 (1990) (applying the regulation to a demolition expense deduction claimed for 1978 but noting that section 280B applies to all demolitions after July 18, 1984).[12]

But the taxpayers had another theory to advance to allow their deduction. They claimed the loss, including the demolition costs, would be allowed as a casualty loss. The taxpayers claimed their loss is supported by Notice 90-21. But the Tax Court found two distinct problems with this view.

First, the fire had taken place in 2014, not 2015 which was the year before the Court. So, to the extent amounts would be allowed as a casualty loss on the building, those losses had to be claimed on the 2014 return. A taxpayer does not, absent a specific provision in the IRC, get to select the year in which a deduction will be claimed—the taxpayer either claims it in the proper year or never obtains the benefit of the deduction.

[12] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

Second, the Court points out the Notice in question does *not* allow a deduction for demolition expenses.

> …Notice 90-21, supra, does not support their position. The relevant passage (much of which they omit from their brief) reads as follows:
>
> > Section 280B of the Code does not disallow casualty losses allowable under section 165, but it does apply to amounts expended for the demolition of a structure damaged or destroyed by casualty, and to any loss sustained on account of such a demolition. If a casualty damages or destroys a structure, and the structure is then demolished, the basis of the structure must be reduced by the casualty loss allowable under section 165 before the "loss sustained on account of" the demolition is determined. [Notice 91-21, 1990-1 C.B. at 333.]
>
> The notice includes several examples. In Example (2), the owner of a building damaged by an earthquake pays a contractor $200,000 to demolish the building and dispose of the rubble. The notice states that the owner "may not deduct the $200,000 expense. Under section 280B of the Code, * * * [the owner] must charge that expense to capital account with respect to the land." Id. at 334.[13]

No deduction will be allowed either on Schedule E or Schedule A, as the Court concludes:

> In sum, petitioners are not entitled to deduct for 2015 any amounts related to the demolition of the structure at the English Avenue property. Any costs associated with the demolition must be capitalized into the basis of the land and will be recovered if and when the land is sold. To the extent petitioners are seeking to deduct a casualty loss attributable to the fire itself, that loss deduction cannot be claimed on their 2015 return.[14]

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[13] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

[14] *Parker v. Commissioner*, TC Memo 2021-111, September 23, 2021

SECTION: 2703
BUY-SELL AGREEMENT FAILS TO SET VALUE OF DECEDENT'S INTEREST IN BUSINESS FOR ESTATE TAX PURPOSES

Citation: Estate of Connelly v. United States, USDC ED MO, Case No. 4:19-c-01410, 9/21/21

In the *Estate of Connelly v. United States*,[15] the US District Court for the Eastern District of Missouri determined that a buy-sell agreement did not set the value of the decedent's interest in a closely held corporation he owned a majority interest in and the proceeds of the life insurance policy held by the company that was used to redeem his shares from his estate had to be included in the calculation of the value of the company for estate tax purposes.

The opinion provides the following broad outline of the facts of this case:

> Brothers Michael and Thomas Connelly were the only shareholders in Crown C Supply, Inc., a closely-held family business that sold roofing and siding materials. As is typical in family businesses, the brothers entered into a stock purchase agreement that required the company to buy back the shares of the first brother to die, and the company bought life insurance to ensure it had enough cash to make good on the agreement. When Michael died in October 2013, Crown C repurchased his shares for $3 million, and Michael's Estate paid estate taxes on his shares in Crown C. But the IRS assessed additional estate taxes of over $1 million. Thomas, as executor of Michael's Estate, paid the deficiency and filed this suit seeking a refund. At the core of the dispute lies the question of the proper valuation of Crown C on the date of Michael's death.
>
> Aside from the life-insurance proceeds, Crown C was worth roughly $3.3 million on the date of Michael's death. On that date, Crown C had an obligation to repurchase Michael's shares from his Estate. Also on that date, Crown C received (or was about to receive) a cash infusion of $3.5 million from the life-insurance proceeds; without these proceeds, Crown C would have had to deplete its assets or borrow money (or both) to buy Michael's shares.[16]

The buy-sell arrangement entered into was described as follows:

> The Connelly brothers and Crown C signed a Stock Purchase Agreement (the "Stock Agreement") in 2001, to maintain family

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[15] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/life-insurance-proceeds-included-in-company%e2%80%99s-estate-tax-valuation/78c7k (retrieved September 23, 2021)

[16] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> ownership and control over the company and to satisfy their estate-planning objectives. Id. at ¶¶ 13-14. The Stock Agreement provided that upon one brother's death, the surviving brother had the right to buy the decedent's shares, but the Stock Agreement required Crown C itself to buy (i.e., redeem) the deceased brother's shares if the surviving brother chose not to buy them. Id. at ¶ 15. When the brothers signed the Stock Agreement, they always intended that Crown C, not the surviving brother, would redeem the deceased brother's shares. Id. at ¶ 16.
>
> To fund its redemption obligation, Crown C bought $3.5 million in life-insurance policies on both Connelly brothers. Id. at ¶¶ 17-22. Article VII of the Stock Agreement provided two mechanisms for determining the price at which Crown C would redeem the shares. Id. at ¶ 23. Article VII specified that the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed Value" at the end of every tax year. Id. at ¶ 24; Doc. 53-4, Art. VII., Sec. A-B. If the brothers failed to execute a "Certificate of Agreed Value[,]" the brothers would determine the "Appraised Value Per Share" by securing two or more appraisals.2 Doc. 53-4, Art. VII., Sec. A, C. The Connelly brothers never signed a single Certificate of Agreed Value under the Stock Agreement. Doc. 58 at ¶¶ 25-36.[17]

Thus, per the terms of the agreement, since no Certificate of Agreed Value had ever been signed, if Michael's brother (Thomas) did not exercise the option to buy the shares directly from Michael's estate (which he did not), there should have been formal appraisals that would have been used to determine the value of the stock for redemption purposes. But that did not happen—rather Thomas and Michael's estate came to a separate agreement that governed the sale:

> Upon Michael's death on October 1, 2013, Crown C received about $3.5 million in life-insurance proceeds. Id. at ¶ 39. Thomas chose not to buy Michael's shares, so Crown C used a portion of the life-insurance proceeds to buy Michael's shares from Michael's Estate. Id. at ¶ 16, 39-40. Crown C and the Estate did not obtain appraisals for the value of Michael's shares under the Stock Agreement, instead entering a Sale and Purchase Agreement (the "Sale Agreement") for the price of $3 million. Id. at ¶¶ 37-38, 64. Through the Sale Agreement, (1) the Estate received $3 million in cash; (2) Michael P. Connelly, Jr., Michael's son, secured a three-year option to purchase Crown C from Thomas for $4,166,666; and (3) in the event Thomas sold Crown C within 10 years, Thomas and Michael Jr. agreed to split evenly any gains from the future sale. Id. at ¶¶ 64-66.[18]

Thomas, as executor of his brother's estate, treated the value of the shares for estate tax purposes as $3 million (the amount paid from the life insurance proceeds to redeem the estate's interest). The IRS disagreed with that value, finding that the value of the

[17] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[18] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

company taken as a whole had to include the $3 million of life insurance proceeds the estate had the right to immediately upon Michael's death. The IRS adjustment in value resulted in an assessment of over $1 million in taxes on Michael's estate. The estate paid the tax in question and then filed suit to obtain a refund of the taxes in U.S. District Court. The parties stipulated that the value of the shares would be $3.1 million if the life insurance proceeds were found by the court to not be considered in determining the value of the company.

Stock Agreement

The first question before the Court was whether the buy-sell agreement controlled the value of the stock for estate tax purposes. Although under IRC §2703(a) the fair market value of the interest in the company is generally determined without regard to such agreements, IRC §2703(b) allows such an agreement to control the value if three standards are met:

- The arrangement is a bona fide business arrangement,
- The arrangement is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and
- The agreement's terms are comparable to similar arrangements entered into by persons in an arms' length transaction.[19]

The opinion notes that this issue may not actually be relevant in this case:

> The Court begins by observing that the Estate's arguments all turn on the same premise. The Estate argues that the company sold Michael's shares at fair market value, Doc. 65 at p. 7, which in turn relies on the assumption that the Estate's valuation expert correctly valued Michael's shares. The Estate's valuation expert, Kevin P. Summers, excluded $3 million in life-insurance proceeds from the valuation, presuming that the Eleventh Circuit's decision in Estate of Blount controls. Doc. 55-1 at pp. 11-12. And, even though the parties to the Sale Agreement did not value Michael's shares using the valuation mechanisms set forth in Article VII of the Stock Agreement, the Estate nonetheless argues that the very existence of the Stock Agreement — the parties' failure to adhere to it notwithstanding — provides sufficient basis for the Court to accept Thomas and the Estate's ad hoc valuation as the proper estate-tax value of Michael's shares. Doc. 46 at pp. 8-9.[20]

But the opinion does look at the agreement to see if it fits the statutory requirements in any event. It is important to remember that the agreement has to meet *all three* of the requirements to be controlling for the value, so a failure to meet just one of the three

[19] IRC §2703(b)

[20] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

requirements is enough to remove the agreement from controlling the value of the interest being redeemed.

Bona Fide Business Arrangement

The IRS first argues the agreement was not a bona fide business arrangement, arguing the brothers did not follow this agreement in good faith, raising both the disregard of the pricing provisions of the agreement and the retention by Michael's son of an interest in any future sale.

The Court did not find the IRS's argument on this point persuasive, noting:

> "The ultimate question of whether there was a bona fide business arrangement is a question of fact[.]" See *Holman v. Comm'r*, 601 F.3d 763, 769 (8th Cir. 2010) (citing *Estate of True*, 390 F.3d at 1218-19). Courts have recognized the validity of agreements to maintain family ownership and control over closely-held businesses. *St. Louis Cty. Bank*, 674 F.2d at 1210. To establish that the Stock Agreement was a bona fide business arrangement, the Estate needed only to show that the Connelly brothers entered the Stock Agreement for a bona fide business purpose. See id. ("We have no problem with the District Court's findings that the stock-purchase agreement . . . had a bona fide business purpose — the maintenance of family ownership and control of the business."); *Estate of Lauder v. Comm'r*, 1992 WL 386276, *21 (T.C. 1992) (buy-sell agreements had a bona fide business purpose because the "agreements, on their face, serve the legitimate business purpose of preserving family ownership and control of the various Lauder enterprises. We are persuaded that these concerns were a motivating factor in the Lauders' decision to enter into the agreements."); *Estate of Gloeckner v. Comm'r*, 152 F.3d 208, 214 (2d Cir. 1998) ("[W]e agree with the tax court that the Gloeckner agreement represents a bona fide business arrangement. This test is sufficiently satisfied when the purpose of a restrictive agreement is to maintain current managerial control — whether by family or outsiders.").[21]

In fact, the IRS had agreed to a stipulation that the brothers entered into the agreement to assure continued family control over the business, a reason that the cases cited found to be a valid business purpose for such an agreement. The opinion continues:

> The parties here have stipulated that the Connelly brothers entered the Stock Agreement for the purpose of ensuring continued family ownership over Crown C. Doc. 47 at ¶¶ 1-3. The IRS does not provide any support for its contention that the Estate's actions taken after Michael's death alter the purpose of the Stock Agreement, making it no longer a bona fide business arrangement. Doc. 61 at p. 12. Based on the parties' stipulation, the Court deems the Stock

[21] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> Agreement a bona fide business arrangement for purposes of summary judgment.[22]

While the Court did not conclude that the IRS would be unable to show that the brother's actions served to make the arrangement no longer meet the bona fide business arrangement test, that would require consideration of additional information by the court—thus, summary judgement could not be granted.

But whatever hope the estate might have had based on this finding was extinguished in the following sentence as the Court noted:

> Even so, resolution of this issue is ultimately unnecessary because the Stock Agreement fails to meet the other requirements under 26 U.S.C. § 2703(b).[23]

Device to Transfer Property to Family Members at Less Than Full and Adequate Consideration

The bottom line here is whether the buy-sell arrangement was a method to transfer wealth to the decedent's sibling for less than full and adequate consideration—and here the Court would agree with the IRS that this was the case.

As the reader should note, this provision makes it much tougher for a buy-sell to be respected when the shareholders are related, since the question here is whether it is a design to transfer property to a family member—so had Michael and Thomas been unrelated, this issue would not have arisen. The burden is on the estate to show that the agreement was not such a device—a burden the estate did not carry.

As we'll discuss later, the Court found that the life insurance proceeds had to be included as part of the value of the company, disagreeing with the holding of the Eleventh Circuit in the *Estate of Blount,*[24] instead agreeing with the original Tax Court analysis.[25] As Missouri is not in the Eleventh Circuit, but rather in the Eighth, the opinion of the Eleventh Circuit does not bind this Court if the opinion is not found to be persuasive on the issue—and the District Court did not find it so.

But even ignoring that issue, the Court found the actions of not following the agreement, but arguing it set the value, made it into solely a device to transfer assets to the decedent's brother at less than fair value. The opinion notes:

> …[E]ven though Crown C fulfilled the purpose of the agreement by redeeming Michael's shares, Thomas and the Estate's process in selecting the redemption price indicates that the Stock Agreement was a testamentary device. See *Estate of Gloeckner*, 152 F.3d at 216 ("[C]ourts scrutinize the processes employed in reaching the share price contained within the redemption agreement to shed light on the nature of the relationship between the decedent and the person to

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[22] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[23] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[24] *Estate of Blount v. Commissioner,* 428 F.3d 1388 (11th Circuit 2005)

[25] *Estate of Blount v. Commissioner*, TC Memo 2004-116, May 12, 2004

> whom the stock was conveyed.") (citing *Estate of Lauder*, 1992 WL 386276, *21-22 and *Cameron W. Bommer Revocable Trust* v. C.I.R., 1997 WL 473161, at *13 (T.C. 1997)). Thomas and the Estate excluded a significant asset (the life-insurance proceeds) from the valuation of Crown C, failed to obtain an outside appraisal or professional advice on setting the redemption price, Doc. 58 at ¶¶ 23-38; Doc. 51 at p. 4, and as discussed further below, disregarded the appraisal requirement in Article VII of the Stock Agreement, see Section III.A.2.a-b, infra. See also *Estate of Lauder*, 1992 WL 386276, *21-22 (exclusion of major intangible assets, absence of a formal appraisal, and failure to obtain professional advice may mean the agreement is a testamentary device); *St. Louis County Bank*, 674 F.2d at 1211 (lack of regular enforcement of the buy-sell agreement's terms may mean the agreement is a testamentary device); *Estate of True*, 390 F.3d at 1222 ("[W]here the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute.")[26]

The lack of a control premium for Michael's stock and a minority discount for the value of the stock held by Thomas was also found to indicate that this was a mere device to get the stock to Thomas while bypassing an estate tax on the value of that control premium:

> …[T]he Stock Agreement's lack of a minority discount for Thomas's shares and corresponding lack of a control premium for Michael's shares substantially overvalues Thomas's shares and undervalues Michael's shares. The Stock Agreement required that in determining the appraised value of the shareholders' shares in Crown C, "[t]he appraisers shall not take into consideration premiums or minority discounts[.]" Doc. 53-4, Art. VII., Sec. C. The Stock Agreement's lack of a control premium for Michael's majority interest indicates that the price was not full-and-adequate consideration. See 26 C.F.R. § 20.2031-2(f)(2) (fair market value for a corporation's stock is determined by "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors" including "the degree of control of the business represented by the block of stock to be valued . . ."); *Bright's Estate v. U.S.*, 658 F.2d 999, 1006-7 (5th Cir. 1981) (a willing buyer would account for a controlling interest or a minority interest in a closely-held corporation); *Estate of True v. Comm'r*, 2001 WL 761280, at *100 (T.C. 2001) ("[Plaintiff's] 58.16-percent interest represented a majority of the shares entitled to vote; therefore, [Plaintiff] owned a controlling interest in Black Hills Trucking at his death. Accordingly, [the expert] should have added a control premium to compute entity value . . ."); see also *Zaiger's Estate v. Comm'r*, 64 T.C. 927, 945-46 (T.C. 1975) ("Petitioner's experts applied discounts to their valuations to reflect the minority interest involved and to compensate for the fact that voting control would not

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[26] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> be in the hands of the purchaser. Such considerations were proper and discounts were appropriate.").[27]

Advisers are able to use minority discounts in many estate planning situations because that is found to reflect the economic reality—a buyer will pay a premium for a controlling interest in an enterprise and will demand a discount for a minority interest without such control. These are not concepts the estate or its advisers can simply ignore when not convenient—the IRS has just as much right to assert their actual economic relevance in the minds of a willing buyer.

Thus, the opinion concludes:

> While the Connelly brothers' good health when they executed the Stock Agreement weighs in favor of the Estate's argument, the parties' abject disregard of the Stock Agreement so as to undervalue the company and underpay estate taxes, as well as the Stock Agreement's lack of a control premium or minority discount, demonstrates that the Stock Agreement was a testamentary device to transfer wealth to Michael's family members for less than full-and-adequate consideration. See Section III.A.2.a-b, infra.[28]

Note that the last two issues do not depend on the Court's rejection of the Eleventh Circuit view of how the life insurance proceeds should be treated for valuing the company. Failing to follow the buy-sell agreement's terms to negotiate a separate deal and having an agreement that fails to take into account valuation concepts such as control premiums would put a buy-sell agreement at risk of being disregarded for estate tax valuation purposes even if the life insurance proceeds are excluded from the valuation as a matter of law.

Comparable to Similar Arms Length Agreements

The court also found that the estate failed to show this agreement was comparable to similar agreements negotiated at arms' length.

Much of the Court's conclusions rests on its view that the life insurance proceeds had to be included in the company's value, thus rendering the amount paid well below the true value. But the court also again found that the lack of payment of a control premium for Michael's majority interest also was a key factor in finding this agreement was not like one that would be negotiated between unrelated parties in arms' length negotiations.

Fixed and Determinable Offering Price

The opinion notes that, in addition to the statutory requirements just discussed, case law and the regulations require an agreement to provide a fixed and determinable price

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[27] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[28] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

in order to be respected. In practice, the IRS argued that this agreement simply didn't provide such a readily determinable price:

> The IRS contends that the price of Michael's Crown C shares was not fixed and determinable under the Stock Agreement because Thomas and the Estate ignored the agreement's pricing mechanisms and came up with a valuation of their own. Doc. 52 at p. 7; Doc. 61 at p. 5. The Stock Agreement required shareholders Michael and Thomas to agree on and sign "Certificates of Agreed Value" every year to establish the price-per-share; but in the 12 years the agreement was in place before Michael's death, they never agreed on the value, or created or signed such certificates. Doc. 61 at p. 5; Doc. 53-4, Art. VII., Sec. A-B. Under the Stock Agreement, the failure of the shareholders to do so triggered the obligation to obtain the Appraised Value Per Share through a very specific process involving multiple professional appraisers. Doc. 53-4, Art. VII., Sec. C. But Thomas and the Estate never followed that specific process and never determined the Appraised Value Per Share; instead, they chose to come up with their own ad hoc valuation of $3 million. Doc. 58 at ¶¶ 23-38; Doc. 51 at p. 4.[29]

The opinion agreed with the IRS that these issues meant that the agreement did not provide for a fixed and determinable share price arising from the buy-sell agreement.

The estate attempts to rescue this issue by arguing that the mere existence of such an agreement, even if ignored, satisfied this requirement. That is, had the brothers set a value each year or had appraisers been used to arrive at the value (rather than just an agreement between the estate and the minority shareholder/executor), the agreement would have met this requirement. But the Court noted that, regardless, the value the estate placed on the shares was *not* obtained from this agreement:

> But the Estate does not ask the Court to apply one of the price-setting mechanisms set out in the Stock Agreement; it wants the $3 million price to control estate-tax valuation, even though that price has no mooring in the Stock Agreement. Id. Further, the Estate's citation to *Estate of Gloeckner* is unpersuasive, as in *Estate of Gloeckner*, the Commissioner conceded that the buy-sell agreement at issue had a "fixed and determinable" offering price. 152 F.3d at 213 ("The Commissioner does not dispute that the restrictive agreement affecting Gloeckner's shares meets the first three requirements. That is, it concedes the stock price at issue was fixed within the redemption agreement . . .").[30]

The opinion concludes that the agreement's mechanism was ignored because the parties believed it would result in a far higher value than served the parties' interests:

> The Estate argues that the $3 million price "resulted from extensive analysis of Crown C's books and the proper valuation of assets and liabilities of the company. Thomas Connelly, as an experienced

[29] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[30] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> businessman extremely acquainted with Crown C's finances, was able to ensure an accurate appraisal of the shares." Doc. 51 at p. 4. Leaving aside Thomas's obvious self-interest in arriving at a below-market valuation, this argument reveals the frailty of the Estate's position: the Estate didn't believe that the very specific valuation mechanism in the Stock Agreement produced an accurate value that bound the Estate, but the Court should treat it as if it did. The Court finds this position as untenable as it is unpersuasive.[31]

Binding During Life and After Death

As well, the case law and regulations require that such an agreement, to set the value of the interest, must be binding both during life and after death.

The court did not agree with the IRS view that the agreement was not binding during life because the parties had failed to set a value annually:

> As discussed in section III.A.2.a, above, the Stock Agreement required shareholders Michael and Thomas to agree on and sign "Certificates of Agreed Value" every year to establish the price-per-share, but they never agreed on the value, or created or signed such certificates. Doc. 61 at p. 5; Doc. 53-4, Art. VII., Sec. A-B. During life, the parties did not treat that aspect of the Stock Agreement as binding, but the Stock Agreement (for reasons unknown) anticipated that they might not comply with Certificates-of-Agreed-Value provision; accordingly, and insofar as the binding-during-life-and-death analysis goes, the Court does not find the parties' failure in this regard entirely dispositive. See Doc. 53-4, Art. VII., Sec. C.[32]

The existence of a "fall back" provision should the parties fail to set a value did provide a mechanism for the agreement to continue to operate even in that condition. But what happened at Michael's death proved that the parties did not view the agreement as binding at death:

> The parties' own conduct demonstrates that the Stock Agreement was not binding after Michael's death. Thomas and the Estate failed to determine the price-per-share through the formula in the Stock Agreement. See St. Louis County Bank, 674 F.2d at 1210-11 (parties' post-execution conduct can determine whether the court applies the terms of a buy-sell agreement for estate-tax purposes); Estate of Lauder, 1992 WL 386276, *19 (allowing some minor deviations from the buy-sell agreement's terms, but finding that the family still considered the agreement's terms to be binding because the family executed formal waivers and modifications as the buy-sell agreement required). As already discussed in section III.A.2.a, Thomas and the Estate did not consider the Stock Agreement to be binding or enforceable on them; they ignored the price mechanism in Article VII

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[31] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[32] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> and sold Michael's shares for $3 million without first obtaining any appraisals for Crown C.[33]

Fair Market Value

Having now determined that the buy-sell agreement does not qualify to set the value of the decedent's interest, the court turns to whether the life insurance proceeds should be considered when determining the value of the company.

The estate argues that the $3 million in life insurance proceeds triggered by Michael's death should be ignored because it is offset dollar for dollar by an obligation that existed to redeem Michael's interest in the corporation. The Eleventh Circuit in *Blount* had arrived at exactly that view:

> The Tax Court in *Estate of Blount* included the life-insurance proceeds in the value of the company and the shareholders' shares, determining that the redemption obligation was not like an ordinary liability because the redemption involved the very same shares being valued. 2004 WL 1059517, at *26. The Eleventh Circuit reversed on this issue, holding that the fair market value of the closely-held corporation did not include life-insurance proceeds used to redeem the shares of the deceased shareholder under a stock purchase agreement. *Estate of Blount*, 428 F.3d at 1346. The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life-insurance proceeds. Id. at 1345-46. The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate." Id. at 1346 (citing 26 C.F.R. § 20.2031-2(f)(2)).[34]

However, this court does not accept the Eleventh Circuit's view—and, as was noted earlier, since this case would not have its appeal heard by the Eleventh Circuit the District Court was free to disagree with that view since the Eighth Circuit had not spoken to this issue.

The key issue is whether the redemption obligation was a corporate liability that would serve to reduce the value of the corporation. The opinion agrees with the Tax Court's view in this area that since the insurance proceeds would go directly to the holder of the shares being valued, it should not be excluded in valuing those shares prior to that asset being transferred to the holder of those shares:

> Under the willing-buyer-willing-seller principle, a redemption obligation does not reduce the value of a company as a whole or the value of the shares being redeemed. A redemption obligation requires a company to buy its own shares from a shareholder, and just like any other contractual obligation, a redemption obligation expends

[33] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[34] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

company resources. But as the Tax Court observed in *Estate of Blount*, a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." 2004 WL 1059517, at *25.

Consider what a hypothetical "willing buyer" would pay for a company subject to a redemption obligation. See 26 C.F.R. § 20.2031-1(b). The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation; in other words the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him. See *Estate of Blount*, 2004 WL 1059517, at *25 (T.C. 2004) ("To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.").

A willing buyer purchasing Crown C on the date of Michael's death would not demand a reduced purchase price because of the redemption obligation in the Stock Agreement, as Crown C's fair market value would remain the same regardless. The willing buyer would buy all 500 of Crown C's outstanding shares (from Michael's Estate and Thomas) for $6.86 million, acquiring Crown C's $3.86 million in estimated value plus the $3 million in life-insurance proceeds at issue. If Crown C had no redemption obligation, the willing buyer would then own 100% of a company worth $6.86 million.

But even with a redemption obligation, Crown C's fair market value remains the same. Once the buyer owned Crown C outright, the buyer could either: 1) cancel the redemption obligation to himself and own 100% of a company worth $6.86 million, or 2) let Crown C redeem Michael's former shares — the buyer (and not Michael's Estate) would receive roughly $5.3 million in cash and then own 100% of a company worth the remaining value of about $1.56 million, leaving the buyer with a total of $6.86 million in assets. Therefore, with or without the redemption obligation, the fair market value of Crown C on the date of Michael's death was $6.86 million.[35]

Or, to put it more simply, the buyer of all interests in the company ends up with either:

- A company worth $6.86 million (assuming the proceeds are retained by the company) *or*

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- $3 million in cash and a company now worth $3.86 million following the redemption of the portion of the shares acquired that represented the decedent's interest.

The opinion then argues that what is really happening is a transfer of the full value of the company prior to the insurance proceeds to Thomas at no cost to him—a transfer for less than full and adequate consideration:

> Demonstrating this point, exclusion of the insurance proceeds from the fair market value of Crown C and valuing Michael's shares at $3 million results in drastically different share prices for Michael's shares compared to Thomas's. If on the date of his death, Michael's 77.18% interest was worth only $3 million ($7,774/share), that would make Thomas's 22.82% interest worth $3.86 million ($33,863/share) because Thomas owned all other outstanding shares and the residual value of Crown C was $3.86 million. See Doc. 53-19 at ¶ 61. The residual value of Crown C is the value of the company apart from the $3 million of insurance proceeds at issue. The parties have agreed that this value was $3.8 million. Doc. 48 at ¶¶ 1-3; Doc. 58 at ¶¶ 43, 79-81. Because Thomas was the only other shareholder of Crown C, his ownership interest must therefore equal the residual value of Crown C: $3.8 million. This outcome violates customary valuation principles because Thomas's shares would be worth 336% more than Michael's at the exact same time. See Doc. 53-19 at ¶ 61. A willing seller of Michael's shares would not accept this bargain, as it creates a windfall for the buyer (Crown C of which Thomas would now have 100% control), while undervaluing Michael's shares in comparison.
>
> Only by including the insurance proceeds in the fair market value of Crown C do Michael's and Thomas's shares hold an equal value on the date of Michael's death. Michael's 77.18% interest in a $6.86 million company would be worth $5.3 million ($13,782/share) and Thomas's 22.82% interest would be worth $1.56 million ($13,782/share). This outcome tracks customary valuation principles, because the brothers' shares have the same value-per-share. A willing seller of Michael's shares would only accept this outcome, because it assigns the same value to Michael's shares as to Thomas's and neither party's economic position changes through the transaction.[36]

Ultimately the opinion concludes:

> For these reasons, the Court respectfully finds that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) ("[T]he tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them." (internal quotation marks and citation omitted)). Accordingly, the Court holds that the $3 million

[36] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

in life-insurance proceeds used to redeem Michael's shares must be included in the fair market value of Crown C and of Michael's shares.[37]

[37] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021