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VALUING CORPORATIONS FOR ESTATE TAX PURPOSES: A *BLOUNT* REAPPRAISAL

Adam S. Chodorow*

I. INTRODUCTION

Asset valuation issues have long been the bane of the estate tax. In addition to the basic problem of valuing property, taxpayers routinely enter into arrangements specifically designed to suppress the value of their property for estate tax purposes, without actually diminishing the value of the property itself.¹ Initially, the Internal Revenue Service and the courts developed a series of rules to determine when such arrangements would be respected.² Eventually, Congress enacted § 2703 of the Internal Revenue Code, which partially codified the preexisting rules and added additional requirements.³ Section 2703⁴ provides that arrangements that fail to meet its requirements should be disregarded and the underlying property valued “without regard to” the arrangement.

This article explores a “recurring issue of asset valuation for estate tax purposes,” which the Eleventh Circuit purported to resolve in *Estate of Blount v. Commissioner*.⁵ The broad question is how one should value a decedent’s shares in a corporation where those shares are subject to a buy-sell agreement that is either: (1) disregarded for estate tax purposes, or (2)

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1. Common techniques include the use of buy-sell agreements and family limited partnerships.

2. See, e.g., Treas. Reg. § 20.2031-2(h) (as amended in 2006); *Estate of Lauder v. Comm’r*, 64 T.C.M. (CCH) 1643 (1992).

3. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388 (1990) (codified as amended at I.R.C. § 2703 (2000)).

4. Unless otherwise specified, all section references are to the Internal Revenue Code.

5. *Estate of Blount v. Comm’r*, 428 F.3d 1338, 1339 (11th Cir. 2005).

omits the price of the shares it covers. The specific issue is how one should account for insurance proceeds a corporation receives on account of a decedent's death when those proceeds are offset by a corresponding obligation to redeem the decedent's shares.

In *Estate of Blount*, the Eleventh Circuit held that insurance proceeds are to be ignored when offset by a corresponding redemption obligation. In so doing, it joined the Ninth Circuit, the only other appellate court to consider this issue, which reached a similar conclusion in *Estate of Cartwright v. Commissioner*.⁶ The reasoning articulated by both the Ninth and Eleventh Circuits has a certain superficial appeal: a third party seeking to purchase a corporation would certainly take into account both the fact that the corporation was set to receive insurance proceeds and that it was obligated to redeem the decedent's shares. Insofar as such funds would not be available to one buying the corporation, they should be excluded when determining the corporation's value. In this article, I argue that the reasoning and result of both the Ninth and Eleventh Circuits are, in no uncertain terms, wrong.

The argument is divided into three parts. First, I review the legislative history of Treasury Regulation § 20.2031-2(f), on which both courts relied, and valuation theory to show how the courts have misread the relevant regulation. Second, using simple hypotheticals, I demonstrate why it is inappropriate (a) to take redemption obligations associated with the shares to be valued into account when valuing a corporation for estate tax purposes, and (b) to treat life insurance policies differently from other types of corporate assets. Finally, I examine the case law on which the Ninth and Eleventh Circuits relied to show that those cases do not support the conclusion that one must ignore insurance proceeds when offset by a redemption obligation.

This analysis makes clear that the relevant regulation requires that insurance proceeds be treated like any other non-operating assets and that they may not be ignored if offset by a redemption obligation. It further reveals that taking redemption obligations into account and ignoring life insurance proceeds leads to corporate values that defy logic and common sense. Finally, and perhaps most important, this analysis reveals that the Ninth and Eleventh Circuits's reasoning is based on a misapprehension of what property is to be valued.

The reason one values the corporation is to determine the value of the decedent's shares, which represent an ownership interest in the corporation. By taking the corporation's redemption obligation into account when valuing the corporation, one values the corporation on a post-redemption

6. *Estate of Cartwright v. Comm'r*, 183 F.3d 1034, 1043 (9th Cir. 1999), *aff'g* 71 T.C.M. (CCH) 3200 (1996).

basis, i.e., after the decedent's shares have been redeemed. The value obtained is what a hypothetical third party would pay if buying all the outstanding shares *other than the decedent's*. The property to be valued for estate tax purposes *is* the decedent's shares, which represent an ownership interest in the corporation. It makes little sense to value those shares by assigning to them a portion of the corporation's value after the decedent's shares have been redeemed and the shares no longer represent an ownership interest in the corporation.⁷

At first blush, this technical tax question seems of little significance. Why should we care if courts are improperly valuing corporations? Three reasons present themselves. The first is that Congress explicitly stated in § 2703(a) that one should determine value without regard to the disregarded arrangement. Offsetting insurance proceeds with redemption obligations allows taxpayers to accomplish precisely what Congress sought to prohibit. The second has to do with the tax code's internal logic. A rule that deviates from such logic is not only unseemly, but it also may lead to additional deviations and errors that cause the tax laws to appear (and be) unnecessarily arbitrary and complex. Finally, if left undisturbed, these decisions could seriously reduce estate tax revenues and skew the way in which stock redemption obligations are funded by creating an unintended and unwarranted tax preference for using insurance proceeds to fund stock redemptions.

Thus, despite their superficial appeal, both *Estate of Cartwright* and *Estate of Blount* should be overturned. When valuing a corporation for estate tax purposes, one should not be allowed to offset life insurance proceeds (or any other assets, for that matter) with a redemption obligation associated with the shares being valued.

II. BACKGROUND

This Part sets forth the basic rules for valuing estates and the facts and holdings of *Estate of Blount* and *Estate of Cartwright*.

7. This point may best be made through a simple hypothetical. Imagine a corporation whose only asset is \$100, with 4 shareholders (A, B, C and D) each owning $\frac{1}{4}$ of the corporation. Assume that the corporation is legally obligated to redeem A's shares for \$15 should he die. Finally, assume that A dies, and his shares must be valued without regard to the \$15 price set forth in the buy-sell agreement. If one takes the redemption obligation into account when valuing the corporation, the corporation is worth \$85 (\$100 - \$15), precisely the amount of cash left in the company after A's shares are redeemed. Insofar as B, C and D's shares will be the only outstanding shares post-redemption, \$85 represents the value of their shares. It makes little sense to conclude that A's shares are worth $\frac{1}{4}$ of the remaining \$85 because A's shares used to represent a $\frac{1}{4}$ interest in the corporation. See Part III.3.B *infra* for a more thorough discussion of this point.

A. VALUING PROPERTY FOR ESTATE TAX PURPOSES

The estate tax is imposed on the transfer of any “taxable estate” of a U.S. citizen or resident.⁸ The amount of tax is determined as a percentage of the taxable estate’s value.⁹ This value, in turn, is determined by valuing the “gross estate” and then subtracting allowable deductions.¹⁰ As set forth in § 2031, the value of the gross estate “shall be determined by including to the extent provided for in this part, the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.”¹¹ The general rule is that property is valued at its “fair market value.”¹² As the Tax Court explained in *Estate of Blount*, “Fair market value is defined for federal estate tax purposes as the price at which 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 all the relevant facts.”¹³

At times, taxpayers enter into agreements that restrict the transferability of their property or otherwise diminish its value. While taxpayers often enter into such arrangements for legitimate business reasons (e.g., to retain family control over a business), they sometimes do so specifically to reduce the value of such property for estate tax purposes. Over the years, the IRS and courts developed rules to determine when such restrictions would be respected when valuing property for estate tax purposes.¹⁴ In 1990, Congress enacted § 2703, which codifies the preexisting requirements and adds additional ones.¹⁵ Section 2703(a) provides that, where arrangements do not meet the statutory requirements set forth in § 2703(b), the property in question must be valued “without regard to”:

- (1) any option, agreement, or other right to acquire or use the property

8. I.R.C. § 2001(a) (2000).

9. I.R.C. § 2001(b)-(c) (2000).

10. I.R.C. § 2051 (2000).

11. I.R.C. § 2301(a). Under certain circumstances, the executor of an estate may choose an alternate valuation date. I.R.S. § 2032 (2000).

12. Treas. Reg. § 20.2031-1(b) (as amended in 2006).

13. *Estate of Blount v. Comm’r*, 87 T.C.M. (CCH) 1303, 1316 (2004) (citing among other things *U.S. v. Cartwright*, 411 U.S. 546, 551 (1973) and § 20.2031-1(b)). For an in-depth discussion of the concept of “fair market value,” see generally JOHN A. BOGDANSKI, *FEDERAL TAX VALUATION* ch. 2 (1996).

14. Under these rules, (1) the price in such an agreement must be fixed and determinable, (2) the agreement must be binding both during life and after death, and (3) it must have been entered into for bona fide business reasons and must not be a substitute for a testamentary disposition. See Treas. Reg. § 20.2031-2(h) (as amended in 2006); *Estate of Lauder v. Comm’r*, 64 T.C.M. (CCH) 1643 (1992).

15. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388 (1990) (codified as amended at I.R.C. § 2703 (2000)). Under § 2703(b), an arrangement 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, and (3) have terms comparable to similar arrangements entered into by people in an arms’ length transaction.

at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Despite the apparent clarity of this provision,¹⁶ disputes arise regarding just how property subject to a disregarded arrangement is to be valued. In particular, the question arises as to whether one must disregard only the restriction on the stock itself, e.g., the price set forth in the agreement, or whether one must also disregard the corporate obligation, which remains legally binding, even if the restriction on the stock is disregarded for estate tax purposes. The facts and holding of both *Estate of Blount* and *Estate of Cartwright* reflect just such a dispute, and are described briefly below.

B. ESTATE OF BLOUNT

Blount Construction Company was a closely held corporation.¹⁷ At the time of his death, George Blount was the majority owner, owning stock representing an eighty-three percent interest in the corporation.¹⁸ The other shareholders were employees who received their shares as participants in an Employee Stock Option Plan (ESOP). In prior years, the corporation and its then extant shareholders had entered into a buy-sell agreement, by which the corporation obligated itself to buy Mr. Blount's shares upon his death.¹⁹ The agreement established a formula for valuing the shares. At some point after entering into this agreement, the corporation obtained a \$3.1 million insurance policy covering Mr. Blount, with the idea that the corporation would use the proceeds of that policy to redeem Mr. Blount's shares,²⁰ though the corporation was not obligated to do so.²¹ Shortly before his death, acting on behalf of himself and the corporation, Mr. Blount amended the buy-sell agreement, setting a price of \$4 million for his eighty-three percent stake in the corporation.²²

16. See John A. Bogdanski, *Stock Buyouts Funded by Life Insurance: The Blount Conundrum*, 33 EST. PLAN. 40, 41-42 (2006) (asserting that the plain meaning of § 2703 is that one must disregard the entire agreement).

17. *Estate of Blount v. Comm'r*, 428 F.3d 1338, 1340 (11th Cir. 2005).

18. *Id.* at 1341.

19. To avoid unnecessary complexity, I discuss only Mr. Blount and the buy-sell agreement's effect on his shares. The other shareholder at the time the agreement was signed was Mr. Blount's brother-in-law. The agreement covered the shares owned by the brother-in-law as well. Thus, when the brother-in-law died, the corporation redeemed his shares as required in the agreement. This left Mr. Blount and the corporation as the sole surviving parties to the agreement. The ESOP participants obtained their shares long after the agreement was signed, but before the brother-in-law died. *Id.* at 1340.

20. The corporation had also obtained an insurance policy on the brother-in-law and used those funds to redeem his shares. *Id.*

21. *Estate of Blount v. Comm'r*, 87 T.C.M. (CCH) 1303, 1306 (2004).

22. *Estate of Blount*, 428 F.3d at 1340-1341. At the time he amended the agreement, Mr. Blount was seriously ill. Thus, this change was done in anticipation of his imminent death. The price he set

On Mr. Blount's death, the corporation collected the \$3.1 million in insurance proceeds and used those proceeds, along with cash on hand, to redeem Mr. Blount's shares for \$4 million. Mr. Blount's estate then reported the value of those shares at \$4 million on its estate tax return. The IRS contended that the buy-sell agreement could not set the value of Mr. Blount's shares and asserted instead that they should be valued at approximately \$7.9 million.²³ The estate argued that the buy-sell agreement did set the shares' value for estate tax purposes, and, in the alternative, that the shares should be valued at approximately \$5 million.²⁴

The Tax Court held that the buy-sell agreement failed both the common law and statutory requirements necessary for it to set the value of Mr. Blount's shares. As a result, the shares had to be valued without regard to the agreement and reported on the estate tax return at their "fair market value" as of the day Mr. Blount died. Because the shares were not traded on an exchange, the Tax Court concluded that their value should be determined by reference to the "fair market value" of the underlying corporation. After reviewing the expert testimony, the Tax Court determined that the value of the corporation was \$6.75 million, exclusive of the insurance proceeds. It then added to this amount the insurance proceeds to arrive at a final corporate value of \$9.85 million.²⁵ The court then valued Mr. Blount's eighty-three percent interest in the corporation at \$8.2 million.²⁶ Because the government did not amend its answer to assert higher value than that stated in the notice of deficiency, the Tax Court sustained the IRS's original determination that Mr. Blount's stock was worth \$7.9 million.²⁷

The Eleventh Circuit affirmed the Tax Court's ruling that the buy-sell agreement should be disregarded for estate tax purposes. It further accepted as not clearly erroneous the Tax Court's \$6.75 million valuation of the corporation, excluding insurance proceeds. However, the court reversed the Tax Court's determination that the insurance proceeds must be included in the corporation's value. The Eleventh Circuit's analysis of this

was approximately \$3.6 million below what the unamended agreement would have required and \$2.7 million below the value of his shares determined using the annual valuation prepared for purposes of distributing shares to ESOP participants. Mr. Blount's decision on the redemption price was motivated by a concern that the corporation be left with sufficient cash to operate after redeeming his shares and was not based on an analysis of the share's fair market value. *See also, Estate of Blount*, 87 T.C.M. (CCH) 1303.

23. *Estate of Blount*, 87 T.C.M. (CCH) 1303, 1308-09.

24. *Id.*

25. *Estate of Blount*, 428 F.3d at 1342.

26. Insofar as the parties did not argue either for a lack-of-marketability discount or majority premium, the Tax Court allocated the corporation's value proportionally. *Estate of Blount*, 87 T.C.M. (CCH) 1303, 1318. Thus, Mr. Blount's 83% stake was deemed to be worth 83% of the corporation's value.

27. *Id.*

issue comprises approximately one page and can be summarized as follows: Where a company uses insurance proceeds to redeem shares, the value of those proceeds may be offset by the corresponding redemption obligation. Accordingly, those proceeds should be ignored when valuing the corporation for estate tax purposes.²⁸

To support its holding, the court cited *Estate of Cartwright*²⁹, which observed that the existence of life-insurance proceeds would not necessarily affect what a third party would pay for a corporation's stock, especially when offset dollar-for-dollar by an obligation to pay such amounts to the decedent's estate. The court rejected the government's argument that, when a buy-sell agreement was disregarded for estate tax purposes, it should play no role determining the fair market value of the underlying corporation, describing the position as "overinclusive and represent[ing] a manifest departure from common business (i.e., market) sense."³⁰

Finally, the court examined Treasury Regulation § 20.2031-2(f), which requires that one give "consideration" to non-operating assets, including insurance proceeds, when valuing a corporation for estate tax purposes, to the extent such assets are not otherwise "taken into account." The court concluded that "insurance proceeds are not the kind of ordinary nonoperating assets that should be included in [a corporation's] value under [Treasury Regulation § 20.2031-2(f)]," finding instead that insurance proceeds "should not be included in the fair market valuation of a company where . . . there is an enforceable contractual obligation that offsets such assets."³¹

The court concluded by noting that it "strains credulity and defies any sensible construct of fair market value" to assume that a willing buyer would ignore the existence of a redemption obligation when valuing a corporation.³²

C. ESTATE OF CARTWRIGHT

Estate of Cartwright predates § 2703, but it raises the same basic issue of how to account for a redemption obligation when valuing a corporation for estate tax purposes. The valuation issue arose in an income tax, as opposed to an estate tax, dispute and did not involve a disregarded buy-sell agreement. However, the agreement did not set a price for the stock itself. Unlike *Estate of Blount*, here both the Tax Court and the appellate court

28. *Estate of Blount*, 428 F.3d at 1345.

29. *Estate of Cartwright*, 183 F.3d 1034, 1038 (9th Cir. 1999), *aff'g* 71 T.C.M. (CCH) 3200 (1996).

30. *Estate of Blount*, 428 F.3d at 1345 n.7.

31. *Id.* at 1346.

32. *Id.*

held that one could offset insurance proceeds with a redemption obligation.

Mr. Cartwright was a shareholder of the law firm he created. The firm obtained a \$5 million insurance policy on his life and contractually obligated itself to use such proceeds both to compensate Mr. Cartwright's estate for any claim he had in the firm's ongoing work and to redeem his shares in the corporation. The agreement purported to establish the value of the stock and claims together at \$5 million, but it did not separately value either.³³ On Mr. Cartwright's death, the firm paid the proceeds of the life insurance policy to his estate.³⁴

Shortly thereafter, the firm issued the estate a Form 1099-MISC,³⁵ indicating that it had paid the estate approximately \$4 million in non-employee compensation, i.e., for Mr. Cartwright's claims in ongoing work. It apparently arrived at this figure by first determining the value of the stock at approximately \$1 million and then subtracting that amount from the \$5 million it paid to the estate. It characterized the remaining amount as compensation for work in progress. As such, the estate was to report \$4 million on its income tax return as income in respect of a decedent.³⁶ It could exclude the \$1 million from income because it represented the amount realized from the sale of the stock, whose basis reset to \$1 million on Mr. Cartwright's death, thus yielding no gain or loss on the sale.³⁷

The estate argued that the buy-sell agreement established a \$5 million value for the stock alone, with nothing being paid for the claims.³⁸ In the alternative, it asserted that the stock's value was \$5 million, and that therefore, even if the agreement did state that the payment was to cover both the stock and the claims, no payment was actually made for the

33. *Estate of Cartwright*, 183 F.3d at 1035. Thus, the buy-sell agreement purportedly created a price range for the stock between \$0 and \$5 million, without setting a precise price.

34. In fact, there were two insurance policies for \$2.5 million each. The estate received \$5.62 million, which reflected premium adjustments associated with the life insurance policy. *Estate of Cartwright v. Comm'r*, 71 T.C.M. (CCH) 3200 (1996).

35. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, FORM 1099-MISC (1988).

36. See I.R.C. § 691 (2000).

37. The order in which the value of stock price and work claim is made has some significance. If the stock's value is determined first, one can legitimately argue that the price reflects fair market value, so long as the value is approximately \$5 million or less. However, if one were to value the work claim first, the stock price would be determined residually and would not necessarily bear any resemblance to the stock's true value. Even before § 2703, it was important that the price set in an agreement bear some relationship to the underlying value of the property covered by the agreement, lest the agreement look like a testamentary substitute, causing the agreement to be disregarded for estate tax purposes. The allocation of the payment between the stock and claims is also significant to the extent it may determine whether there is a gain or loss on the sale of the stock or whether the estate will collect more or less than what is owed for the claims.

38. The estate argued that the claims were actually owned by the firm, and not by any individual stockholder. Therefore, even though the agreement stated that the payments were for both the stock and the claims, in fact, none of the payment could be allocated to the claims because Mr. Cartwright did not have any.

claims.³⁹ It arrived at its \$5 million value for the shares by including in the corporate value the full \$5 million of insurance proceeds the firm received on Mr. Cartwright's death.⁴⁰ Thus, the estate sought to exclude the entire \$5 million payment from income.⁴¹

The Tax Court rejected the estate's argument regarding the agreement's meaning and then proceeded to value the stock at approximately \$1 million. The court found that the remaining \$4 million paid to the estate represented payment for the claims for ongoing work. Accordingly, it deemed the \$4 million income in respect of a decedent and sustained the deficiency. With regard to the insurance proceeds, the Tax Court concluded that "the insurance proceeds do not affect the value of decedent's stock because the entire proceeds were paid to the decedent's estate."⁴² Citing *Estate of Huntsman*,⁴³ the court concluded that "a buyer would not pay more for stock based on the corporation's ownership of life insurance if the proceeds would be largely offset by the corporation's liabilities."⁴⁴ Finally, the court noted that the insurance proceeds would not be available to the corporation as working capital because the corporation was required to pay them to the decedent's estate.⁴⁵

The Ninth Circuit affirmed the portion of the opinion addressing the treatment of life insurance proceeds.⁴⁶ Quoting Treasury regulation § 20.2031-2(f), the court noted that "consideration" should be given to life insurance proceeds. However, the court concluded that the existence of life insurance proceeds "would not necessarily affect what a willing buyer would pay for the firm's stock because it was offset dollar-for-dollar by [the firm's] obligation to pay out the entirety of the policy benefits to Cartwright's estate."⁴⁷

39. Implicit in this claim is the notion that the payments are allocated first to the stock redemption and then to the claims. Thus, the claims should be valued at \$0, since the estate received no payment for them.

40. As reflected in the Tax Court's opinion, the estate argued that the life insurance proceeds increased the value of the corporation on a dollar-for-dollar basis. *Estate of Cartwright*, 71 T.C.M. (CCH) 3200, n.8.

41. In arguing for an increase in the value of the corporation, the estate was trying to increase the value of one asset, the stock, and to reduce the value of another, the claim for work in progress. In this instance, where the estate was to receive \$5 million for both, and the combined value was actually less than \$5 million, there is a zero-sum gain from an estate tax perspective. Those assets would be included in the estate at a combined \$5 million value, regardless of how the value was allocated. As reflected above, the allocation has significant consequences from an income tax perspective.

42. *Estate of Cartwright*, 71 T.C.M. (CCH) 3200.

43. *Estate of Huntsman v. Comm'r.*, 66 T.C. 861, 875 (1976).

44. *Estate of Cartwright*, 71 T.C.M. (CCH) 3200.

45. *Id.*

46. The court reversed on an issue not relevant here. One judge dissented, accepting the estate's argument that Mr. Cartwright did not own any right to works in progress and concluding that the entire \$5 million was payment for the stock.

47. *Estate of Cartwright*, 183 F.3d 1034, 1038 (9th Cir. 1999), *aff'g* 71 T.C.M. (CCH) 3200 (1996).

III. ANALYSIS

Despite the Eleventh Circuit's strong language in *Estate of Blount* and the support it finds in the Ninth Circuit's *Estate of Cartwright*, the reasoning these cases use to reach their conclusion is flawed. The proof of this assertion is divided into three parts. Part A reviews the legislative history of the relevant regulations and valuation theory to demonstrate how the courts have misread the regulations. Part B employs a series of hypothetical examples to reveal how the courts' analysis fails as a matter of logic and tax policy. Part C examines the relevant cases to reveal how the courts have misinterpreted the case law.

A. REGULATIONS

Both the Ninth and Eleventh Circuits relied on Treasury regulation § 20.2031-2(f) to reach their respective conclusions regarding the proper treatment of redemption obligations and life insurance proceeds. That § provides in pertinent part: "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." In *Estate of Blount*, the Eleventh Circuit concluded that "insurance proceeds are not the kind of ordinary nonoperating asset that should be included" in a corporation's value under the regulation.⁴⁸ In particular, it found that such assets "should not be included in the fair market valuation of a company where . . . there is an enforceable contractual obligation that offsets such assets."⁴⁹ Citing this same regulation, the Ninth Circuit in *Estate of Cartwright* noted that the existence of life insurance proceeds would not necessarily affect what a third party would pay for the corporation because the corporation was required to pay out the entirety of the proceeds.⁵⁰

Neither the Ninth nor Eleventh Circuit engaged in any meaningful analysis of Treasury regulation § 20.2031-2(f). Rather, they both concluded that the insurance proceeds were "taken into account" because they were offset by the redemption obligation. As discussed below, the courts have misread the meaning of this regulation and improperly excluded the value of the insurance proceeds.

1. Legislative History

As described in *Estate of Huntsman*⁵¹ and acknowledged by the

48. *Estate of Blount v. Comm'r*, 428 F.3d 1338, 1346 (11th Cir. 2005).

49. *Id.*

50. *Estate of Cartwright*, 183 F.3d at 1038.

51. *Estate of Huntsman v. Comm'r*, 66 T.C. 861, 872-76 (1976).

Eleventh Circuit in *Estate of Blount*,⁵² the reference to life insurance proceeds in Treasury Regulation § 20.2031-2(f) reflects a change in the rules regarding the ownership of such proceeds and how they were to be treated for estate tax purposes. Thus, to understand why insurance proceeds are specifically addressed in § 20.2031-2(f) and what function this language serves, it is necessary to explore how the estate tax treatment of life insurance proceeds changed.

Between 1943 and 1974, the regulation relating to the estate tax treatment of life insurance proceeds (§ 20.2042-1) provided that, where a corporation owned life insurance on its sole shareholder, the proceeds were to be included directly in the shareholder's estate and excluded from the corporation's value.⁵³ The mechanism by which this was done was to attribute the "incidents of ownership" to the shareholder, thus causing the proceeds to be included in the shareholder's estate and excluded from the corporation's value. In 1971, the IRS sought to expand this rule to include shareholders who had voting control over corporations.⁵⁴ It quickly abandoned this attempt.⁵⁵

In 1974, the Treasury Department changed direction and amended § 20.2042-1⁵⁶ to provide that a corporation's incidents of ownership of a life insurance policy would *not* be attributed to a sole or controlling shareholder so long as the proceeds were paid to the corporation.⁵⁷ Thus, such proceeds would no longer be directly included in a shareholder's estate. However, the regulation further referred the reader to Treasury regulation § 20.2031-2(f) "for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock."⁵⁸ The logic underlying this cross-reference was that, if the proceeds were to be excluded from the shareholder's estate, they must be considered as part of the corporate value when valuing the shareholder's interest in the corporation for estate tax purposes. Otherwise, the proceeds would escape taxation completely.

When the Treasury Department amended regulation § 20.2042-1, it also amended § 20.2031-2(f) to add the following language:

In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, *including proceeds of life insurance policies payable to or for the benefit of the company*, to the extent such nonoperating assets have not been taken into account in the

52. *Estate of Blount*, 428 F.3d at 1345 n.6.

53. Treas. Reg. § 20.2042-1(2) (prior to 1974 amendment).

54. Rev. Rul. 71-463, 1971-2 C.B. 333.

55. Rev. Rul. 72-167, 1972-1 C.B. 307; see *Estate of Huntsman*, 66 T.C. at 873.

56. T.D. 7312, 1974-1 C.B. 277.

57. Treas. Reg. § 20.2042-1(c)(6) (as amended in 1979).

58. *Id.*

determination of net worth, prospective earning power and dividend-earning capacity.⁵⁹

The legislative history of Treasury Regulations §§ 20.2042-1 and 20.2031-2(f) makes clear that insurance proceeds are to be treated no differently from other types of non-operating assets when valuing a corporation. Indeed, as the court in *Estate of Huntsman* explained, the amended regulation “merely provides that in addition to the normal factors considered in determining the value of stock in a closely held corporation, life insurance policies payable to or for the benefit of the corporation shall be considered in the same manner as other nonoperating assets.”⁶⁰ Nothing in the regulation suggests that redemption obligations may be considered when valuing a corporation for estate tax purposes. Nor does anything in the regulation suggest that the combination of a redemption obligation with insurance proceeds allows one to offset insurance proceeds (but not other types of assets) when valuing a corporation.⁶¹ Thus, the Eleventh Circuit’s statement in *Estate of Blount* that life insurance proceeds “are not the kind of ordinary nonoperating asset that should be included in the value of [the corporation] under the treasury regulations”⁶² cannot be supported by reference to the regulation. Moreover, the assertion that life insurance proceeds are “taken into account” when offset by a redemption obligation, such that they need not be considered when valuing a corporation, cannot be supported.

The new language found in § 20.2031-2(f) simply serves as a reminder that one should take life insurance proceeds into account when valuing a corporation for estate tax purposes, where previously they were ignored because they were directly included in a taxpayer’s estate. To drive the point home, § 20.2031-2(f) provides that such proceeds must be separately considered if they have not been otherwise taken into account as part of a valuation technique. As a result, the impact of life insurance proceeds on corporate value depends on the valuation technique chosen.

59. T.D. 7327, 1974-2 C.B. 294; Treas. Reg. § 20.2031-2(f) (as amended in 2006) (emphasis added).

60. *Estate of Huntsman*, 66 T.C. at 874.

61. Recall that the corporation in *Estate of Cartwright* was legally obligated to use the insurance proceeds to redeem the decedent’s shares. 183 F.3d 1034, 1038 (9th Cir. 1999), *aff’d* 71 T.C.M. (CCH) 3200 (1996). In *Estate of Blount*, the corporation did not have such an obligation, though it obtained the insurance policy for that purpose and ultimately did so. 428 F.3d 1338, 1346 (11th Cir. 2005), *aff’d* 87 T.C.M. 1303 (2004). While the Eleventh Circuit in *Estate of Blount* emphasized both the intent in obtaining the insurance policy and the use of the proceeds, it did not limit its holding to such situations. *Id.* Thus, the court effectively held that the mere existence of a corporate redemption obligation in an amount equal to or greater than the insurance proceeds means that insurance proceeds have been “taken into account” under Treasury regulation 20.2031-2(f) and therefore did not need to be “considered” when determining corporate value. *Id.*

62. *Estate of Blount*, 428 F.3d at 1246.

2. Valuing Closely Held Corporations

The foregoing begs the question of just how life insurance and other non-operating assets should be taken into account when valuing a corporation for the purpose of determining a decedent's interest in it. As set forth in the Internal Revenue Code and regulations, stock in a corporation may be valued in a number of different ways. If there have been recent transactions in the stock, either on an exchange or over-the-counter, or through private agreement, one looks to those transactions to determine the value of the decedent's shares.⁶³ However, in many cases, stocks are not listed on an exchange or traded over-the-counter, and no transactional information is available. In such cases, § 2031(b) instructs that one is to value stock and securities "by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." Thus, the value of the shares is to be determined by comparison to the stock of similar companies.⁶⁴ Unfortunately, when dealing with closely held companies it is often difficult to identify similar companies and to obtain the relevant financial data to make these kinds of comparisons.

In the absence of market transactions in the stock, bid-asked prices, or information regarding the sales of similar companies, or the stock thereof, one must resort to other valuation techniques. Treasury regulation § 20.2031-2(f) indicates that one should consider "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors."⁶⁵ In other words, the value of the stock is determined by

63. Thus, the fair market value of a stock can be determined by averaging the high and low selling price on the valuation date. Treas. Reg. § 20.2031-2(b)(1) (as amended in 2006). If no sales occurred on the valuation date, the fair market value is determined by using a weighted average of the average sales price on the nearest day before and after the valuation date, so long as those dates fall within a reasonable period of the valuation date. *Id.* In addition, one can use bid and asked prices to determine fair market value in the absence of sales close to the valuation date. Treas. Reg. § 20.2031-2(c) to (e) (as amended in 2006).

64. An example of such a technique might be the use of multiples. For instance, if Corporation A and B were approximately the same size and the same business, it might be possible to determine the stock value of B's shares by determining the price/earnings multiple at which A's stock traded and then apply the same multiple to B's stock.

65. The regulation continues:

Some of the "other relevant factors" . . . are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts and circumstances of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth,

first determining the value of the underlying corporation and the allocating a portion of that value to the decedent's shares, based on the decedent's ownership interest in the corporation.

The regulation identifies many different ways to value the underlying corporation. The first valuation technique is based on the corporation's net worth. This technique, also referred to as the "asset-based" approach, derives corporate value based on the net value of the corporation's assets. The theory underlying this approach is that the corporation could be liquidated, with the owner or owners receiving the proceeds.⁶⁶ In this regard, no distinction is made between operating and non-operating assets. Rather all assets and liabilities are valued together.⁶⁷ This approach is widely acknowledged in the leading treatises⁶⁸ and has been widely used by courts.⁶⁹ When determining a corporation's value using this technique, insurance proceeds must be included as a corporate asset.⁷⁰

The second valuation technique identified in the regulation is based on the corporation's earning potential. This technique, most commonly called the "income-based" approach, is to value a corporation by projecting the corporation's income stream over a period of years and then determining a net present value for that income stream, using a specified discount rate.⁷¹ The theory underlying this method is that all assets are worth only as much as the net present value of the income they are projected to generate. As

prospective earning power and dividend-earning capacity.
Treas. Reg. §20.2031-2(f) (as amended in 2006).

66. Under such analysis, complications arise regarding the costs of liquidation, the obligation to pay taxes on appreciated assets, and whether fair market value for the assets could be obtained as part of a liquidation, *etc.* None of these issues is relevant to the question of how life insurance proceeds should be treated, and therefore I ignore them for simplicity's sake.

67. A simple example may help illustrate. Assume a corporation with two assets, a machine worth \$1 million that generates income, and a vintage car worth \$50,000. The machine is an operating asset, while the car is a non-operating asset because it is not used to produce income. Under the asset method, the corporation is worth \$1.05 million, the value of the assets. If the corporation had a \$100,000 liability, e.g., debt on the machine, its value would be \$950,000.

68. *See, e.g.,* SHANNON P. PRATT, THE LAWYER'S BUSINESS VALUATION HANDBOOK 168-173 (2000).

69. *See, e.g.,* Estate of Huntsman v. Comm'r, 66 T.C. 861, 875-76 (1976) (citing cases that value assets and liabilities together); Hamm v. Comm'r, 325 F.2d 934, 941 (8th Cir. 1963).

70. Estate of Huntsman, 66 T.C. 861 at 878. In the expert testimony in *Estate of Blount* and the briefs filed by the taxpayer in that case, it was suggested that non-operating assets are not normally included in a sale and therefore should be excluded from a corporation's value. 87 T.C.M. (CCH) 1303 (2004); Brief of Appellant at 23, Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303 (2004) (No. 540-2). While this may be true as a matter of commercial practice, for estate tax purposes, a shareholder owns a portion of a corporation's non-operating assets equal to his share of operating assets and the value of those assets cannot simply be ignored because such assets shareholders would not normally be included in the sale of the corporation.

71. Several different variants of the income-based approach exist, including the capitalized cashflow model and discounted cashflow model. *See, e.g.,* SHANNON P. PRATT, THE LAWYER'S BUSINESS VALUATION HANDBOOK 109-118 (2000).

with the asset-based valuation method, the income-based method is widely acknowledged in the leading treatises⁷² and has widely been used by courts.⁷³

Unlike the asset-based approach, the distinction between operating and non-operating assets is critical when using an income-based approach. The value determined using such an approach represents the value of the operating assets, *i.e.*, those assets used to produce income. Non-operating assets are not included in the value determined under this method. Thus, they must be separately added to a corporation's value determined using an income-based approach.⁷⁴

Quite often, experts and the courts derive an ultimate value for a given corporation by blending the results of different valuation techniques. The exact weight to be given to each approach depends on the facts and circumstances. For instance, it may be appropriate to rely more on an asset-based approach when valuing a capital-intensive business,⁷⁵ and an income-based approach when valuing a service-based business. As noted in the regulations, the exact weight to be given to each different technique depends on the facts and circumstances.⁷⁶

The experts in *Estate of Blount* used three of these techniques to value the corporation in question. I describe their efforts in some detail here because it helps to have a concrete example in mind when determining how regulation § 20.2031-2(f) should be construed.

The taxpayer's first expert offered testimony to support the claim that the buy-sell agreement at issue should be respected for estate tax purposes.⁷⁷ Section 2703(b)(3) requires that the terms of a buy-sell

72. See, e.g., PRATT, *supra* note 71, at 105-138; John A. Bogdanski, FEDERAL TAX VALUATION ¶ 3.05 (2003).

73. See, e.g., *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181 (2002); *Estate of Renier v. Comm'r*, 80 T.C.M. (CCH) 401 (2000); *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507 (1993), *aff'd* 53 F.3d 924 (8th Cir. 1995); *Estate of Gillet v. Comm'r*, 50 T.C.M. (CCH) 636 (1985); *Estate of Clarke v. Comm'r*, 35 T.C.M. (CCH) 1482 (1976).

74. See, e.g., *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181 (2002); *Estate of Renier v. Comm'r*, 80 T.C.M. (CCH) 401 (2000); *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507 (1993), *aff'd* 53 F.3d 924 (8th Cir. 1995); *Estate of Gillet v. Comm'r*, 50 T.C.M. (CCH) 636 (1985); *Estate of Clarke v. Comm'r*, 35 T.C.M. (CCH) 1482 (1976). Again, a simple example may help illustrate this point. Assume a company with two assets, a machine that generates an income stream and a vintage car worth \$50,000. The machine is an operating asset, while the car is a non-operating asset. Because the company could sell the car without affecting the income stream, the value of the car must be added separately to the capitalized income. Thus, if the capitalized income stream were determined to be \$1 million, the total value of the company would be \$1.05 million. The value of the operating asset or any liabilities associated with the company's operation would not separately be accounted for, insofar as they would be included in the capitalized earnings value.

75. See, e.g., *Estate of Huntsman*, 66 T.C. at 878 (affording great weight to the net asset method because of the company's strong cash position).

76. Treas. Reg. § 20.2031-2(f) (as amended in 2006).

77. *Estate of Blount v. Comm'r*, 87 T.C.M. (CCH) 1303, 1307-08 (2004).

agreement be “comparable to similar arrangements entered into by persons in an arm’s length transaction.” This includes the price term, and this expert attempted to demonstrate that the price set forth in the agreement at issue was comparable to what one might see in an arm’s length agreement. To do so, he looked at the sales prices of allegedly similar companies and determined that those companies sold for prices that equated to four times their cashflow, i.e., a multiple of four. He then concluded that the \$4 million price for Mr. Blount’s stock set forth in the buy-sell agreement was comparable to what people would have negotiated at arm’s length because it reflected a multiple of approximately four times the corporation’s cashflow. Although not framed as a “fair market value” analysis, this expert effectively argued that \$4 million was the fair market value of Mr. Blount’s shares based on a comparison with purportedly similar corporations.⁷⁸

In determining the value of the corporation, the expert ignored all non-operating assets, including the insurance proceeds, because of his belief that non-operating assets are seldom part of a sales transaction, as the seller usually retains them.⁷⁹ By implication, if such assets were to be sold along with the corporation, they would have to be added to the value determined using multiples of cashflow. If not sold, Mr. Blount would have been entitled to eighty-three percent of them, and their value would have to be included in Mr. Blount’s estate.

The taxpayer’s second expert used both asset- and income-based techniques to value the corporation.⁸⁰ For his income-based approach, he determined the corporation’s net free cashflow and then capitalized that amount to arrive at a preliminary figure. To this figure, he added the value of the corporation’s net working capital (defined as current assets less liabilities) and the difference between the book value and fair market value of the corporation’s assets. For his asset-based approach, he first capitalized the corporation’s excess earnings and then added to this amount the fair market value of the corporation’s assets. The expert then weighted the income-based approach at 75% and the asset-based approach at 25% to arrive at a final, blended value of approximately \$6 million for the corporation and \$4.9 million for Mr. Blount’s 83% interest in it. The expert excluded the life insurance proceeds from both his asset- and income-based analyses on the theory that those proceeds were “taken into account” because they were offset by the redemption obligation.⁸¹

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* Notably, the insurance proceeds of \$3.1 million were less than the \$4 million redemption obligation. The expert did not offset the amount of the obligation in excess of insurance proceeds against other corporate assets, suggesting that he believed that only insurance proceeds (and not other

The government's expert also used asset- and income-based techniques to value the corporation. Compared to the previous expert, he gave greater weight to the asset-based approach and derived a blended value of \$7 million for the corporation, exclusive of the insurance proceeds.⁸² The expert determined that the life insurance proceeds should have been added to both the asset-based value and income-based value and that they would have increased each on a dollar-for-dollar basis. He then added the \$3.1 million of insurance proceeds to the \$7 million value to derive a total value for the company of approximately \$10 million and a value of approximately \$8.3 million for Mr. Blount's 83% interest. In adding the insurance proceeds to the blended value he determined for the corporation, the expert determined that such proceeds should have been added to both the asset-based value and income-based value.⁸³

3. Applying the Regulations

With this background information regarding the meaning of the regulations and the actual valuation techniques used in *Estate of Blount*, it is now possible to apply the regulation to the facts to see what the terms "consideration" and "taken into account" mean and how the regulation should operate in practice.

The taxpayer's first expert sought to use a comparative technique to value the corporation at issue. He compared the multiple of cashflow implicit in the sale of allegedly similar corporations with that implicit in the price established for Mr. Blount's shares. He admittedly ignored non-operating assets, including the insurance proceeds. Thus, such proceeds were not "taken into account" as part of his valuation technique.⁸⁴ Accordingly, under the regulation, he should have given separate "consideration" to the existence of the proceeds in valuing the corporation.

This does not mean that the corporation's value would necessarily increase on a dollar-for-dollar basis. Indeed the value might not increase at all. For instance, if the corporations he used for comparative purposes were truly similar, including the level of non-operating assets, no further adjustment would be required. However, if one were to determine that Mr. Blount's corporation had significantly more in the way of non-operating assets than the other companies, some adjustment might need to be made to account for the existence of those assets.

non-operating assets) were subject to offset. The record does not reflect any attempt on his part (or on the part of counsel) to explain why insurance proceeds were different from other types of assets.

82. *Id.* Oddly, the government's expert did not set forth the precise weights used, but rather presented a total blended number.

83. *Id.* Adding the insurance after blending the two different values is mathematically equivalent to including the proceeds in each of the separate valuations and then blending them.

84. *Estate of Blount*, 87 T.C.M. (CCH) 1303, 1307.

In any event, the Tax Court rejected this expert's testimony as unreliable because, among other things, he relied solely on an income-based approach, he did not include non-operating assets, which must be considered for estate tax purposes even if irrelevant in many real-world transactions,⁸⁵ and his allegedly comparable corporations bore little resemblance to the corporation he sought to value. The Eleventh Circuit affirmed this decision.

In contrast, the government's witness used both income- and asset-based approaches that required the explicit consideration of non-operating assets, including the insurance proceeds. In both the techniques he used, the inclusion of insurance proceeds would have increased the corporation's value dollar-for-dollar. However, rather than consider those proceeds in each individual valuation method and then blend them, he took the somewhat confusing but expedient step of simply adding the proceeds to the value he determined after blending the value determined using the two techniques. Either way, because of the valuation techniques he chose, the existence of life insurance proceeds increased the corporation's value on a dollar-for-dollar basis. Insofar as the proceeds were "taken into account" as contemplated by the regulation, they did not need to be further "considered."

The taxpayer's second expert also used both asset- and income-based approaches that would have increased the value of the corporation dollar-for-dollar on account of the insurance. However, he intentionally excluded the insurance proceeds when deriving corporate values using such techniques. Nor did he consider the proceeds at any other point in his efforts to value the corporation. Rather, he argued that the insurance proceeds were "taken into account" by the offsetting redemption obligation and that no further "consideration" was necessary. Insofar as he did not offset any assets other than life insurance proceeds with the redemption obligation,⁸⁶ he effectively argued that life insurance proceeds are a special type of corporate asset that may be "taken into account" by virtue of an offsetting redemption obligation and that may therefore escape inclusion in corporate value whenever a redemption obligation exists.⁸⁷

As discussed above in connection with the legislative history of Treasury Regulation § 20.2031-2(f), nothing in the language or history of

85. As discussed above, this expert excluded all non-operating assets on the theory that such assets were not normally sold with the operating assets. Thus, he assumed that each corporation he looked at had no non-operating assets, making a straight comparison possible. For estate tax purposes, it is not acceptable simply to ignore non-operating assets because the decedent owns some portion of those assets. The value of those assets must be accounted for somehow, either as subsumed in the corporate value, or stated separately.

86. The redemption obligation was \$4 million and the insurance proceeds \$3.1 million, leaving \$0.9 million of obligation in excess of proceeds.

87. *Estate of Blount v. Commissioner*, 87 T.C.M. (CCH) 1303, 1308 (2004).

the regulation supports such a reading.⁸⁸ Rather, as illustrated above in connection with the government expert's efforts to value the corporation, insurance proceeds are "taken into account" when treated like all other non-operating assets for valuation purposes and included in asset- and income-based valuation efforts, as appropriate. Only then may one avoid separately considering such assets.

B. LOGIC

In addition to misreading the relevant regulation, the courts in *Estate of Cartwright* and *Estate of Blount* have posited a rule that defies logic, leads to bizarre and unacceptable valuations, and in fact values the wrong property by valuing the corporation after the decedent's shares have been redeemed and no longer represent an outstanding ownership interest in the corporation. Only by ignoring redemption obligations and treating insurance proceeds as one treats other non-operating assets can one derive values for the decedent's shares that make sense.

Both the Ninth and Eleventh Circuit justified their exclusion of insurance proceeds with the argument that such proceeds were offset by the corporation's obligation to redeem the decedent's shares and were therefore unavailable to the corporation or a hypothetical purchaser thereof. In *Estate of Cartwright*, the corporation was contractually required to use the proceeds in this manner.⁸⁹ In *Estate of Blount*, the corporation obtained a life insurance policy to fund its redemptions and chose (but was not obligated) to use the funds for this purpose.⁹⁰ The holding in *Estate of Blount* is not expressly limited to situations where the corporation has obtained the life insurance for redemption purposes or where the corporation actually uses the proceeds for such purposes.⁹¹ Thus, when these cases are taken together, the weakest version of the claim made is that, where a corporation obtains life insurance proceeds to fund a redemption and actually uses the proceeds to redeem a decedent's shares, it is appropriate to take a corporation's obligation to redeem the decedent's shares into account when valuing a corporation for estate tax purposes. The strongest version is that it is appropriate to offset life insurance proceeds (but not other corporate assets) with a redemption obligation, regardless of intent or how the proceeds are actually used.⁹²

The problems with either version are most easily demonstrated using a

88. See discussion *supra* Part III.A.1.

89. 183 F.3d 1034, 1036 (9th Cir. 1999).

90. 428 F.3d 1338, 1340-41 (11th Cir. 2005).

91. *Id.* at 1345.

92. This is precisely what the estate's second expert in *Estate of Blount* did. Although the redemption obligation was \$4 million and the insurance proceeds were \$3.1 million, the expert offset only the insurance proceeds. 87 T.C.M. (CCH) 1303, 1308 (2004).

hypothetical corporation, some basic simplifying assumptions, and a number of different scenarios. Thus, for purposes of this analysis, assume a corporation with 100 outstanding shares and two shareholders, A and B. Each owns 50 shares, representing a 50% interest in the corporation. The corporation's only asset is a bank account worth \$10 million. Assume that the corporation is unique and its shares cannot be valued by reference to transactions in the corporation's stock or by reference to other corporations. Finally, assume that the corporation's value is determined solely by reference to its assets and that no discounts or premia apply.⁹³

As described above in Part III.B.2, corporations may be valued in a variety of ways, including income stream capitalization or discounting, comparisons with similar corporations, or market transactions in the corporation's stock. I focus here solely on an asset-based approach to avoid some of the complexities of income-based approaches and to present the issue of redemption obligations and insurance proceeds as clearly as possible.

The following five scenarios reveal the following: (1) offsetting corporate assets with a redemption obligation leads to bizarre and unacceptable valuations; (2) nothing about life insurance proceeds warrants a deviation from the rule that precludes such offsetting; and (3) by taking a redemption obligation into account when valuing a company, one actually values the shares that have not been redeemed, as opposed to the shares of the decedent.

1. Scenario 1 – Effective Buy-Sell Agreement

In Scenario 1, A dies, and one must value the assets in his estate, including his fifty shares. A buy-sell agreement requires the corporation to buy A's shares for \$4 million even though the corporation is worth \$10 million, and absent the agreement A's shares would sell on the open market for \$5 million. Assuming the buy-sell agreement meets the requirements set forth in the case law and regulations and in § 2703, the price set forth in the agreement is the value to be used for estate tax purposes, and A's estate would report the shares on the estate tax return as having a value of \$4 million. Thus, it is not necessary to value the underlying corporation, and the question of how to treat a redemption obligation or the manner of funding it does not arise.⁹⁴

93. The existence of discounts and premia complicates matters without shedding light on the effect of redemption obligations and life insurance proceeds on corporate value. Accordingly, I assume them away for the sake of clarity.

94. The same would be true for a corporation with a \$6 million bank account and a \$4 million life insurance policy on A's life. Insofar as the effective buy-sell agreement establishes the value of A's stock for estate tax purposes, it is not necessary to value the underlying corporation to derive the value of A's shares. Accordingly, neither the existence of a redemption obligation nor the manner in which the redemption will be funded is relevant.

2. Scenario 2 – No Buy-Sell Agreement and no Insurance

In Scenario 2, A dies without a buy-sell agreement in place. To determine A's estate tax, one must value the property in his estate, including his fifty shares. Because the corporation is closely held and no market for A's shares exists, and because no comparable companies can be found, A's shares must be valued indirectly by valuing the corporation and then apportioning part of that value to A based on his ownership interest in the corporation.⁹⁵ Here, the value of the corporation on the date of death was \$10 million, and A's shares, representing a fifty percent ownership of the corporation, would be valued at \$5 million, or half the corporation's value. This is consistent with what A would have negotiated for had he attempted during his life to split the corporation's value fairly with B. As with Scenario 1, the question of how to treat a redemption obligation or the manner of funding it does not arise.⁹⁶

3. Scenario 3 – Ineffective Buy-Sell Agreement and no Insurance

In Scenario 3, A dies. However, before he dies, in an effort to reduce his estate tax and pass property to his heir (B) at a below market rate, A and the corporation enter into a buy-sell agreement requiring the corporation to purchase A's 50 shares for \$4 million. A and the corporation enter into the agreement despite the fact that the company has \$10 million in assets and A's 50 shares represent a 50% interest in the corporation. Unlike Scenario 1, the buy-sell agreement is disregarded for estate tax purposes under § 2703(a).⁹⁷ Thus, even though A's estate is only entitled to receive \$4 million for the shares, and indeed does receive \$4 million, the agreement cannot set the value of the shares for estate tax purposes. Thus, the taxpayer (or the court, if there is a dispute) must determine the fair market value of the shares "without regard to" the buy-sell agreement. As in Scenario 2, because no market for the shares exists and no comparable companies can be found, one must determine the value of A's shares by first valuing the underlying corporation and then deriving the shares' fair market value from that amount.

When A dies, the corporation has assets of \$10 million. However, it also has a legally binding obligation to redeem A's shares for \$4 million. On the one hand, the buy-sell agreement cannot directly set the value of the

95. See Part III.A.2, *supra*, for a discussion of the rules for how to value securities.

96. This holds true even if the corporation were later to agree with A's estate to redeem A's shares for \$4 million. The fact of a voluntary redemption after the date of death does not change the underlying value of the shares as of the date of death. While the redemption price might serve as evidence of what a third party would willingly have paid for the shares, it is not binding on the IRS or a court. Indeed, where A and B are related, raising the possibility that the redemption price might not have been set at arm's length, such evidence loses whatever persuasive power it might have had.

97. As will be seen, it makes no difference whether the buy-sell agreement is disregarded under § 2703(a) or under the preexisting rules governing buy-sell agreements.

shares for estate tax purposes and must be disregarded when valuing the stock. On the other hand, it represents a legally binding obligation on the corporation. To the extent that one recognizes this obligation when valuing the corporation for estate tax purposes, it will indirectly affect the value of A's shares. Thus, one must decide whether (1) to take the \$4 million redemption obligation into account when valuing the corporation, or (2) to disregard the buy-sell agreement entirely, meaning that the obligation must be ignored when valuing the corporation.

Taking the redemption obligation into account when valuing the corporation for estate tax purposes leads to a number of illogical and unacceptable results. First, if the redemption obligation is taken into account, A will be better off from an estate tax perspective with a disregarded buy-sell agreement than he would have been had the agreement been respected. Recall that the agreement's purpose was to depress the value of A's shares for estate tax purposes. It makes little sense that the taxpayer should be even better off if his scheme fails. Second, taking the redemption obligation into account leads to bizarre result that the fair market value of A's fifty shares will differ significantly from the fair market value of B's fifty shares, and the total value of the corporation derived by adding the value of A's and B's shares together will differ from the value obtained by valuing the corporation as a whole. Only by ignoring the redemption obligation when valuing the corporation for estate tax purposes does one obtain results that comport with common sense and logic.

The first point can best be illustrated with a simple numerical example. With an effective buy-sell agreement, A's shares would be valued at \$4 million for estate tax purposes even though they would have been worth \$5 million on the open market (see Scenario 1). If one disregards the price set forth in the agreement yet takes the redemption obligation into account when valuing the corporation, the corporation's value drops from \$10 million to \$6 million (\$10 million in assets minus the \$4 million obligation), and A's 50% interest is worth only \$3 million. Thus, A would be better off with a disregarded buy-sell agreement (\$3 million) than with an effective one (\$4 million), even though the very purpose of the buy-sell agreement was to reduce the value of his stock for estate tax purposes.⁹⁸ This result certainly runs contrary to the notion that

98. Indeed, he receives a double benefit because he receives \$4 million, but the shares are only valued at \$3 million for estate tax purposes. If the fair market value for estate tax purposes is equal to the fair market value for purposes of I.R.C. § 1014, which resets the basis on a decedent's death, this plan will trigger \$1 million in income tax because the estate must report a \$1 million gain on the redemption. However, that gain will be taxed at low capital gains rates, and not at the high estate tax rates. It is theoretically possible that the fair market value for estate tax purposes may be different from the fair market value for establishing the property's basis for income tax purposes under § 1014. If the shares were valued at \$5 million for purposes of § 1014, their fair market value ignoring the redemption

the law ought not permit taxpayers to artificially reduce the fair market value of their property to reap lower estate taxes.

This bizarre result is not limited to situations where the buy-sell agreement intentionally establishes a price below what would otherwise be the stock's fair market value. For instance, if A and B were relatives who simply wanted to ensure that the business remained in family hands, they could enter into a buy-sell agreement that sets the stock's value at \$5 million, its fair market value. If A dies and the agreement were disregarded for estate tax purposes (as might occur if the decedent were able to amend the agreement unilaterally), we would have to disregard the price set forth in the agreement and value the corporation to determine the value of A's shares. If we were to take the redemption obligation into account, the corporation would be worth \$5 million (\$10 million in assets minus the \$5 million obligation), and A's 50% interest would be worth only \$2.5 million.⁹⁹

Nor is the bizarre result limited to situations where the buy-sell agreement is disregarded. Where a buy-sell agreement simply imposes an obligation to redeem without setting the price, as was the case in *Estate of Cartwright*, it remains necessary to determine the stock's fair market value. However, if the value of the corporation is determined with reference to the obligation to redeem A's shares, it would be impossible to figure out the value of the corporation without first determining the value of A's shares, which depends on first determining the value of the corporation. Using the figures above, if one were to determine that the corporation had \$10 million in assets and A's 50% interest was worth \$5 million, then one would presumably have to subtract this amount from corporate value, leaving a value of \$2.5 million for A's shares, a value inconsistent with the value determined initially. In fact, it is possible to solve the problem and derive a value of A's shares. Under the facts above, A's 50 shares would be worth \$3.3 million, i.e., one third the value of the corporation's assets (despite the fact that it represents one half of the ownership interest), and \$1.7 million less than their value absent the agreement.¹⁰⁰

Thus, regardless of whether one creates an intentionally defective buy-sell agreement or simply omits the purchase price in an effective agreement, allowing taxpayers to subtract the redemption obligation from corporate value when valuing stock for estate tax purposes would provide a

obligation, the taxpayer could actually report a \$1 million capital loss on the redemption.

99. Were this to happen, A's estate would report the value of the shares at \$2.5 million for estate tax purposes and then report a gain of \$2.5 million on the sale of the shares. Given the high estate tax rates and the low capital gains rates, A's estate would be significantly ahead from a tax perspective.

100. If A's shares represent a fifty percent interest in the corporation, then the formula for determining the value of A's shares is: Value of A's shares = (Value of Corp. Assets - Value of A's shares) ÷ 2. This reduces to: Value of A's shares = Value of Corp. Assets ÷ 3.

wonderful planning technique for those who wished to sell their shares at death. By doing so, they could artificially lower the value of the corporation, and therefore the value of their stock, even if they ran afoul of the rules specifically designed to prevent such results. The only way to allocate fifty percent of the corporation's value to A and prevent such game-playing is to ignore the redemption obligation when valuing the corporation for estate tax purposes.¹⁰¹

The second problem that arises when one takes a redemption obligation into account when valuing a corporation for estate tax purposes is that it leads to bizarre results when the purported value of A's shares are compared to the value of B's shares and to the value of the corporation as a whole. It seems axiomatic that the two halves of the company ought to have the same fair market value. Moreover, under the simplifying assumptions described above, it is axiomatic that the combined value of the corporation's separate ownership interests should equal the value of the corporation's assets. Only by ignoring the redemption obligation are these two axioms satisfied.

Again, a numerical example may help illustrate this point. However, instead of starting by valuing A's shares, it helps to begin by valuing B's 50% interest in the company. If, as stated above, the corporation has \$10 million in assets and an obligation to redeem A's shares for \$4 million, a rational buyer would be willing to pay \$6 million for B's 50 shares. After the redemption, the company will have \$6 million in assets, and B's shares will represent a 100% of the corporation's outstanding shares.¹⁰²

Having determined the fair market value of B's shares, we turn next to the value of A's shares and the value of the corporation as a whole. If A's shares must be equal in value to B's, then A's shares must be worth \$6 million, and the corporation with \$10 million in assets is worth \$12 million (A's shares worth \$6 million plus B's shares worth \$6 million), a clearly unacceptable result. If the value of A's shares is determined by taking half the value of the corporation determined when taking the redemption

101. Another way to approach the question is to consider what A controls as of the time of his death. Originally, he had shares worth \$5 million. In agreeing to sell them for \$4 million to the corporation, B's shares jump in value from \$5 million to \$6 million. Thus, A takes \$4 million for himself and transfers \$1 million to B by entering into the agreement. The \$1 million is not taxed as a gift at the time A enters into the agreement and therefore should be included in his estate when he dies because it represents wealth he controlled.

102. As both the Ninth and Eleventh Circuits noted, a rational person would take the redemption obligation into account when determining the corporation's value and, derivatively, the value of B's shares, i.e., the shares not subject to the redemption obligation. This is true regardless of whether the buy-sell agreement is disregarded for estate tax purposes. My purpose here is to demonstrate that there is a difference between "valuing the corporation" and "valuing the corporation for estate tax purposes," where the value of the corporation is used to derive the value of the decedent's shares.

obligation into account, A's shares are worth \$3 million,¹⁰³ and the total value of the corporation is \$9 million (A's shares worth \$3 million plus B's shares worth \$6 million), despite the fact that it has \$10 million in assets. If, instead, the value of A's shares is determined residually by reference to the value of B's shares (\$6 million) and the total corporate value determined by ignoring the redemption obligation (i.e., \$10 million), the shares are worth \$4 million. This is the value established in the disregarded buy-sell agreement. Such a value is both more than half the corporation's value, taking the redemption obligation into account, and less than half the value when it is ignored. It is also the result that the common law and § 2703 were specifically designed to preclude.

As none of the preceding values for A's shares or the company as a whole are acceptable, the proper result must be that, for purposes of determining the value of a corporation for estate tax purposes, the value cannot be determined by taking the redemption obligation associated with A's shares into account. If the agreement is completely ignored, both A's and B's shares are valued at \$5 million (half of \$10 million), and the total value of their shares together equals the corporation's value. The problems identified above disappear.

This analysis reveals why the superficial appeal of the Ninth and Eleventh Circuit's logic is wrong: *Taking redemption obligations into account leads the court to value the wrong property.* As noted by the Tax Court in *Estate of Blount*¹⁰⁴ and ignored by the Eleventh Circuit on appeal, redemption obligations are different from other types of corporate obligations in that a redemption obligation both shrinks the corporate assets and changes its ownership structure. Any valuation that takes the redemption obligation into account effectively values the corporation on a "post-redemption" basis, i.e., after the decedent's shares have been redeemed. It makes little sense to assume the corporation redeems A's shares while at the same time ignoring the effect the redemption has on the ownership structure. The value derived by taking the redemption obligation into account actually reflects the value of all the outstanding shares *other* than the decedent's—in these examples, B's shares. It does not reflect the value of A's shares or a corporation in which A's shares make up a percentage of the outstanding shares. Thus, it makes no sense to value A's shares by assigning to them a portion of the value of the corporation determined by taking the redemption obligation into account.

Again, the foregoing can best be explained with a simple example. Assume a corporation has \$10 million in assets and a \$4 million obligation

103. The corporation is worth \$6 million (\$10 million - \$4 million redemption obligation) and A's 50% interest in that \$6 million is \$3 million.

104. 87 T.C.M. (CCH) 1303 (2004).

to redeem A's shares. After the redemption the corporation will have \$6 million in assets. However, A will own no interest in the remaining corporation. The corporation will own A's 50 shares, and B's 50 shares will represent 100% of the outstanding stock of a corporation worth \$6 million. Thus, the post-redemption corporate value of \$6 million reflects the value of B's shares, i.e., all the shares outstanding after the decedent's stock has been redeemed.

It makes no sense to assume that the corporation will pay \$4 million to redeem A's shares and that A's shares will also continue to constitute half of the outstanding shares. The expenditure and change in ownership structure are necessarily linked. Nor does it make any sense to assign to A's shares half of the value of the resulting \$6 million corporation. That figure represents the value of B's shares alone. B might be willing to sell 50% of *his* interest in the corporation (i.e., 25 of his 50 shares) to another for \$3 million. However, if he were to authorize the corporation to sell A's 50 shares to a third party, he would require that person to pay the corporation \$6 million, in which case, both B and the third party would own 50% of a company worth \$12 million.¹⁰⁵ Thus, if one takes the redemption obligation into account when valuing the corporation, the value of A's shares would be \$6 million.

I do not mean to suggest that A's shares should be valued at \$6 million for estate tax purposes. Rather, I mean to show that it is inappropriate to value the underlying corporation by taking the redemption obligation into account. Further, it is inappropriate to value a decedent's shares by assigning to them a portion of the post-redemption corporate value based on the percentage ownership that those shares represented before the redemption occurred.¹⁰⁶

In disregarding the buy-sell agreement, one must engage in a counterfactual inquiry. Even when the agreement is disregarded for estate tax valuation purposes, no willing buyer would pay more for property than the amount set forth in the buy-sell agreement because the corporation will purchase the shares for that price. Thus, to arrive at the shares' fair market value, one must ignore the fact that the shares will be redeemed at a price set in the buy-sell agreement. It makes little sense to ignore this fact, yet assume at the same time that the corporation will indeed incur the expense

105. Were the corporation to sell A's shares for less, say \$3 million, B would go from owning 100% of \$6 million to owning 50% of \$9 million. The value of his investment would drop from \$6 million to \$4.5 million.

106. Put another way, the corporation has a \$4 million obligation to purchase the shares that are to be valued. In taking the obligation into account and then allocating half of the remaining value to this person, such a person would receive a total of \$7 million (\$4 million for the shares + \$3 of the remaining \$6 million). That makes little sense. He has sold his shares for \$4 million and has no claim on the remaining value in the corporation.

of redeeming the shares. Rather, to give meaningful effect to the statutory admonition to disregard the agreement under § 2703, and to the statutory goal of preventing taxpayers from artificially lowering the value of their property for estate tax purposes, it is necessary to disregard the redemption obligation when valuing the corporation. Anything less undermines the statute.

4. Scenario 4 – No Buy-Sell Agreement and Insurance

Having demonstrated that redemption obligations cannot be taken into account when valuing a corporation, we turn next to the question of how to treat insurance proceeds where a corporation holds a policy on the decedent's life. In this scenario, the corporation has \$6 million in cash and owns a life insurance policy that will pay it \$4 million when A dies.¹⁰⁷ The corporation has no obligation to redeem A's shares should he die. When A dies, we must determine the fair market value of A's shares for estate tax purposes. Thus, we must decide whether there is something special about life insurance proceeds that might exclude them from the corporation's value, or whether the proceeds must be included in the corporation's value like any other asset. Neither the Ninth nor Eleventh Circuits made any attempt to distinguish life insurance proceeds from other types of corporate assets. Nor does any meaningful difference present itself.

While it is true that life insurance proceeds are different from other assets in that they are not available until the insured dies, at a slightly higher level of abstraction, a life insurance policy is simply an asset that matures on the occurrence of a specific event. In this regard, it is no different from a bond or certificate of deposit (CD) that matures on a date certain. That the exact date of maturity cannot be known in advance is certainly a difference, but not one that matters for this purpose. Moreover, as of the moment the insured dies, the corporation's right to the proceeds has fully matured. Thus, it makes no difference whether the corporation has \$10 million in cash, \$6 million in cash and a mature CD worth \$4 million, or \$6 million in cash and the right to \$4 million in insurance proceeds. A third party seeking to buy A's shares would be willing to pay \$5 million, representing half of the company's \$10 million value. This, then, is the shares' fair market value, which A's estate must report for estate tax purposes.¹⁰⁸

107. Insofar as a corporation purchases insurance with its assets, it effectively converts cash on hand into a different kind of asset. Normally, it will pay less in premiums than it expects to receive in proceeds. Nonetheless, it is possible, depending on the circumstances, that the hypothetical corporation we are discussing would have had \$10 million in cash had it decided not to purchase \$4 million of insurance. Assuming this is true is not important to the question of how life insurance proceeds should be treated, but it makes clear that the purchase of life insurance can be viewed as a change in the form of an investment or asset.

108. See discussion *infra* Part III.C.2, where this result is shown to be consistent with Estate of

Another way to approach the question of whether to include life insurance proceeds in corporate value is to imagine the negotiations between A and B on entering into a buy-sell agreement that splits the value of a corporation fairly on A's death. The corporation will have \$10 million in cash on A's death, and A would insist on his heir receiving \$5 million for A's interest in the company. It seems highly unlikely that A would ignore the life insurance proceeds and agree to take \$3 million (half the \$6 million in assets), leaving B with \$7 million.¹⁰⁹

5. Scenario 5 – Ineffective Buy-Sell Agreement and Insurance

The final scenario to be considered is where the corporation is legally obligated to redeem a decedent's shares and also owns an insurance policy on the life of the deceased. Both the Ninth and Eleventh Circuits found that where the insurance proceeds were offset dollar-for-dollar by a contractual obligation, such proceeds should not be included in the corporation's fair market value. However, the offsetting effect of the redemption obligation was limited to insurance proceeds.¹¹⁰ In *Estate of Cartwright*, the corporation was legally obligated to use the insurance proceeds to fund the redemption. In *Estate of Blount*, it was not. The courts' holdings, when read together, can be summarized as follows: one can offset life insurance proceeds (but apparently not other assets) with redemption obligations regardless of whether the corporation is legally obligated to (or does) use those proceeds to redeem the shares in question.

Having previously determined in the analysis of Scenario 3 that redemption obligations should not normally be considered when valuing a corporation for estate tax purposes, and in Scenario 4 that life insurance proceeds should normally be taken into account when valuing a corporation, we are left to decide whether the combination of a redemption obligation with insurance proceeds modifies the logic in any way. Neither the Ninth nor the Eleventh Circuit suggested any reason for such a modification, but one can imagine a number of possible justifications. These include an argument based on (1) the purportedly distinct nature of insurance proceeds and (2) the corporation's obligation, intent, or actual use of such proceeds to fund the redemption obligation. The following analysis will demonstrate that neither argument warrants deviating from the basic rules stated above. Indeed, allowing one to offset life insurance proceeds (but not other assets) with redemption obligations would create an

Huntsman v. Comm'r, 66 T.C. 861, 875 (1976).

109. Nor should it matter whether the corporation later decides to use the proceeds to redeem a decedent's shares, as occurred in *Estate of Huntsman*. Such an event, occurring after the decedent's death, should not have any effect on the corporation's value as of the date of death.

110. For instance, in *Estate of Blount*, only \$3.1 million of insurance proceeds were offset, even though the corporation had a \$4 million redemption obligation and significant other non-operating assets.

unwarranted preference for funding redemption obligations with life insurance. The analysis concludes with a simple example, demonstrating how a rule that allows taxpayers to offset insurance proceeds with redemption obligations would permit them to accomplish precisely what § 2703 was designed to prevent.

a) Life Insurance Proceeds

As noted above in the analysis of Scenario 4, neither the Ninth nor the Eleventh Circuit made any effort to distinguish life insurance proceeds from other types of corporate assets or to explain why they should be treated differently from other types of assets when valuing a corporation for estate tax purposes. Nonetheless, two possible justifications for offsetting life insurance proceeds with redemption obligations present themselves. The first is that life insurance proceeds only become available to the corporation when the insured dies. The second is that life insurance is a form of non-operating asset, i.e., it is an asset that is not used in the production of income.

As described above in Part III.B.4, the fact that life insurance proceeds have an indeterminate maturity date should not affect whether they should be included in corporate value. As of the moment the insured dies, when the corporation is to be valued, the corporation's right to the proceeds has fully matured. Nothing about life insurance proceeds suggests that they should be offset by redemption obligations while other assets should not be.

Nor does the fact that life insurance proceeds are a non-operating asset justify offsetting insurance proceeds with redemption obligations. Among other things, such a justification would apply to all non-operating assets, and neither the Ninth nor the Eleventh Circuit has sought to broaden the offset rule to include assets other than insurance proceeds. Notably, as discussed above in Part III.A, nothing in the relevant regulation suggests that insurance proceeds are to be treated differently from other non-operating assets.

b) Interlinked Obligations

The second possible justification for offsetting life insurance with a redemption obligation stems not from the nature of life insurance, but rather from the connection between the insurance and the redemption obligation. To the extent that this justification is based on the relationship between the redemption obligation and the asset, the nature of the asset to be used for the redemption may not matter. Nonetheless, because both *Estate of Cartwright* and *Estate of Blount* involved life insurance, I will analyze this possible justification assuming that the asset to be used for the redemption is life insurance proceeds.

The combination of a redemption obligation and life insurance proceeds can take three forms. The first is where the corporation obtains the insurance with no intention of using the proceeds to fund the redemption.¹¹¹ The second is where the insurance was obtained with such an intent, but the corporation does not obligate itself to use them in this way.¹¹² The third is where the corporation obligates itself to use the insurance proceeds to fund the redemption.¹¹³ As will be shown below, none of these circumstances warrant deviating from the default rules that insurance proceeds must be included and redemption obligations ignored when valuing a corporation for estate tax purposes.

With regard to the first combination, insurance proceeds are no different from any other corporate asset. The corporation may satisfy its redemption obligation with any corporate asset or even borrow money to do so. The simple fact that the corporation is set to receive insurance proceeds on the death of a decedent and also has a redemption obligation does not support a conclusion that one should offset the insurance proceeds, or any other asset for that matter, with the redemption obligation. Rather, as described above in Part III.B.4, the existence of life insurance proceeds can be viewed as simply a form in which the corporation holds some of its assets.

With regard to the second combination, the question is whether a corporation's intent should have an impact in determining corporate value. The Eleventh Circuit in *Estate of Blount* specifically highlighted the fact that the corporation "acquired the insurance policy for the sole purpose of funding its obligation to purchase Mr. Blount's shares in accordance with the stock-purchase agreement,"¹¹⁴ suggesting that intent had some special significance. However, neither the Eleventh nor Ninth Circuits articulated any reason why intent should matter. Nor does any policy present itself.

To the contrary, from an economic perspective, it is irrelevant why the corporation acquired a life insurance policy or that the corporation intended to fund its redemption obligation with the proceeds. Indeed, it would be illogical to allow a company with \$10 million in assets and a \$4 million redemption obligation to reduce its value for estate tax purposes to \$6 million simply by indicating which \$4 million of its assets it intended, but was not obligated, to use to fund its redemption.

The third combination is more troubling in that it seems reasonable to argue that, where life insurance proceeds are spoken for, i.e., contractually

111. Such might be the case with a key man policy designed to replace lost revenues associated with the demise of a major employee or shareholder.

112. This was the case in *Estate of Blount v. Comm'r*, 428 F.3d 1338, 1339 (11th Cir. 2005).

113. This was the case in *Estate of Cartwright v. Comm'r*, 183 F.3d 1034, 1038 (9th Cir. 1999).

114. 428 F.3d at 1345.

obligated to be used to fund the redemption, those assets are not available to the corporation and should not be included in corporate value. The simple answer is that the use of these funds to redeem shares simply frees up other assets that would otherwise have been used in the redemption. If the corporation has an obligation to redeem, then a corresponding amount of corporate assets must be used to purchase the shares. Such assets are not available to the corporation, irrespective of any legal obligation attaching to a specific subset of the corporation's assets. In valuing a corporation for estate tax purposes, it should not matter whether the company is legally obligated to use funds from a specific source.¹¹⁵

The more involved answer is that the focus on assets available to a third party purchaser misidentifies the asset to be valued.¹¹⁶ The corporate value derived by taking the redemption obligation into account reflects the value of the shares outstanding after the redemption, i.e., the shares other than the decedent's. Thus, determining what a third party would pay for the corporation does not reflect what a decedent's shares are worth.¹¹⁷

c) Unintended Consequences

A rule that allowed one to offset insurance proceeds (but not other assets) with redemption obligations when valuing corporations for estate tax purposes would create a preference for funding redemption obligations with life insurance. For example, a corporation with \$10 million in assets and a \$4 million redemption obligation would be valued at \$10 million, because, as described above in Part III.B.3, it is generally inappropriate to take redemption obligations into account. At the same time, a similar corporation that had \$6 million in assets and a \$4 million insurance policy would be valued at only \$6 million because the life insurance policy could be offset by the \$4 million redemption obligation. Thus, any rational person interested in reducing the value of his corporation for estate tax purposes would fund redemption obligations with insurance and avoid other funding mechanisms.

Such incentives have not gone unnoticed. As one treatise notes, "The Eleventh Circuit's recent decision in *Estate of Blount v. Commissioner*,

115. For example, it makes little sense to value a corporation with \$6 million in regular assets, \$4 million in life insurance proceeds, and a \$4 million redemption obligation at \$10 million because the company is not obligated to use the insurance proceeds to redeem shares, while valuing a company with the same assets and obligations at \$6 million because the life insurance proceeds must be used to fund a redemption. In both cases, the corporation will have \$6 million in assets after the redemption.

116. See *supra* Part III.B.3.

117. Indeed, a real-world investor would take the existence of a redemption obligation into account regardless of whether the corporation was contractually obligated to use life insurance proceeds or any other asset to fund the redemption. See, e.g., *Estate of Blount*, 428 F.3d at 1345. Thus, the existence of a binding obligation to use insurance proceeds to redeem shares is not relevant to the question of corporate value.

makes life insurance a more appealing funding vehicle.”¹¹⁸ Indeed, the treatise goes on to note that other funding vehicles may already suffer from tax disincentives. For instance, the use of retained earnings to fund a redemption could lead to the corporation being subject to the accumulated earnings surtax, as earnings set aside for redemption purposes are often treated as not necessary for business purposes.¹¹⁹

Neither the Ninth nor Eleventh Circuit presented any justification for creating a preference for life insurance-funded redemptions, nor does any tax or other policy present itself. The anomalous treatment of life insurance proceeds, in the absence of any justification, strongly supports the conclusion that one should not be allowed to offset life insurance proceeds with redemption obligations.

d) Hypothetical

In addition to the foregoing arguments, the following hypothetical illustrates why a rule permitting one to offset insurance proceeds with redemption obligations makes little sense. This example builds on that described above in the analysis of Scenario 4, which assumed a hypothetical negotiation between shareholders.¹²⁰ Assume that A and B each own 50% of a corporation with \$12 million in assets. Further assume that they take \$2 million and purchase a life insurance policy that will pay \$5 million on A's death. If A and B were negotiating in good faith to split the value of the corporation on A's death, A would insist on his heirs receiving \$7.5 million, half the assets of the company (\$10 million in cash plus \$5 million in insurance proceeds).

Now assume that A and B were related and entered into an agreement wherein A agreed to sell his shares for only \$5 million, leaving the corporation (and B by extension) with \$10 million.¹²¹ Further assume that the IRS challenged the agreement as an improper attempt by A to suppress the fair market value of his shares and prevailed, such that the agreement was disregarded under § 2703. If one takes the \$5 million redemption obligation into account when valuing the corporation and uses it to offset the \$5 million in insurance proceeds, the corporation is worth \$10 million, and A's shares would be valued at \$5 million, precisely the below-market value the IRS was challenging. In contrast, if the redemption obligation is ignored, the corporation's value is \$15 million, and A's shares are worth

118. HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS ¶ 9:10 (3rd ed. 1997) (footnote omitted).

119. *Id.*

120. See *supra* Part III.B.4.

121. In essence, A would be making a part sale/part bequest, similar to a part gift/part sale. He would be selling an asset worth \$7.5 million for \$5 million, effectively making a \$2.5 million bequest to B.

\$7.5 million, precisely what A and B would have agreed to if they were trying to split the corporate value evenly.

C. CASE LAW

Finally, we turn to the case law to determine whether it provides any support for offsetting life insurance proceeds with redemption obligations. The Eleventh Circuit cited three cases, including *Estate of Cartwright*,¹²² *Estate of Huntsman*,¹²³ and *Estate of True*.¹²⁴ Each is discussed in turn.

1. *Estate of Cartwright*

The Tax Court in *Estate of Blount* sought to distinguish *Estate of Cartwright* on several grounds, arguing that the rule in the latter case should not be extended to the facts of the former. In citing *Estate of Cartwright* with approval, the Eleventh Circuit implicitly rejected those efforts. However, it does not necessarily follow that, if the two cases cannot be distinguished, the outcome in *Estate of Blount* is dictated by the reasoning set forth in *Estate of Cartwright*. Equally plausible—and, I would argue, correct—is the conclusion that *Estate of Cartwright* should be overturned. By reviewing the points of difference between *Estate of Blount* and *Estate of Cartwright* that the Tax Court urged as a basis for distinguishing the two cases, I will demonstrate that those differences cannot justify different results in the two cases. Rather, under the facts of both cases, it is inappropriate to offset life insurance proceeds with a redemption obligation.

The Tax Court's first argument was that the obligation to pay out the \$5 million in *Estate of Cartwright* was to satisfy both the redemption obligation and the claims for work in progress. Indeed, both the Tax Court and the Ninth Circuit in *Estate of Cartwright* determined that the lion's share of the \$5 million was for work in progress. As such, that portion of the obligation represented a normal corporate obligation (as opposed to a redemption obligation), which can be used to offset corporate assets, including life insurance. Indeed, since the \$5 million would be paid out even if the stock were valued at \$0, an argument could be made that the entire obligation should be offset against corporate assets.

As noted above,¹²⁵ it does not matter for estate tax purposes how the amounts are allocated. The estate will report \$5 million in assets regardless. Nonetheless, as was true in *Estate of Cartwright*, the allocation may matter significantly for income tax purposes. The greater the value of

122. 183 F.3d 1034 (9th Cir. 1999).

123. 66 T.C. 861 (1976).

124. 390 F.3d 1210 (10th Cir. 2004).

125. See *supra* note 41 and accompanying text.

the stock, the smaller the value of the claims, which must be included in income. Moreover, the allocation may also affect the income tax deduction allowed with regard to income in respect of a decedent.¹²⁶ If the agreement is to be respected, the stock must be valued first, with any residual amount allocated to the claims or other obligations. Otherwise, the price called for in the agreement will bear no resemblance to the value of the stock. As reflected above in Part 0[AC1], offsetting corporate assets with redemption obligations leads to bizarre valuations.¹²⁷ Accordingly, even if the corporation is obligated to pay out the entire amount, it does not follow that the entire amount should offset the receipt of life insurance proceeds when valuing the corporation for estate tax purposes.

Moreover, where the value of the stock and claims is not limited to the amounts received for each, i.e., the agreement is disregarded for estate tax purposes, the ability to deduct the full amount owed against corporate assets may have a significant effect on the estate's value.¹²⁸ Thus, combining a redemption obligation with an ordinary obligation may not justify the deduction of the entire amount of the obligation.

Second, the Tax Court noted that the buy-sell agreement in *Estate of Cartwright* was not disregarded for tax purposes, implying that it might be appropriate to take the offsetting redemption obligation into account in such cases. However, as described above in Part 0[AC2], if one were permitted to offset corporate assets with redemption obligations in buy-sell agreements that were not disregarded, the potential for abuse and illogical results would be significant.¹²⁹ Thus, where the buy-sell agreement fails to establish a price for the decedent's stock, it does not matter for estate tax valuation purposes whether the agreement is respected or disregarded.

2. *Estate of Huntsman*

Neither the Ninth nor Eleventh Circuit discussed *Estate of Huntsman* in any detail. The key point for which they cited the case appears to be the statement that the existence of life insurance proceeds would not necessarily affect what a willing buyer would pay for a corporation. More to the point, the Tax Court in that case rejected the government's effort to determine the value of a corporation by first valuing the corporation without regard to the insurance proceeds and then simply add the value of

126. I.R.C. § 691(c) (2000).

127. Allocation may also matter to the corporation, as the payment of claims may be treated differently for tax purposes from the redemption of stock.

128. For instance, if the agreement were disregarded for estate tax purposes, such that the stock could be valued at more than \$5 million even though the estate were to receive only that amount, the ability to deduct amounts paid for the stock in determining the value of the stock could reduce the estate's value.

129. See *supra* note 101 and accompanying text (showing how a one-half interest in a company could be valued at one third the corporate value).

those proceeds to that value. Because the Tax Court in *Estate of Blount* apparently did just this, the Eleventh Circuit reversed.

As demonstrated below, the treatment of life insurance proceeds in *Estate of Huntsman* was a function of the valuation techniques used. *Estate of Huntsman* establishes clearly that life insurance proceeds are to be treated like all other non-operating assets when valuing a corporation.¹³⁰ In this regard, it is consistent with Treasury regulation § 20.2031-2(f).

In *Estate of Huntsman*, the decedent owned shares in a corporation that owned a life insurance policy on the decedent.¹³¹ There was no redemption obligation,¹³² though the corporation voluntarily redeemed a sufficient number of decedent's shares to allow the estate to pay estate taxes. The IRS sought to add the value of the life insurance proceeds to the value of the shares determined without regard to the proceeds. Such an approach would have increased the value of the corporation on a dollar-for-dollar basis. The Tax Court rejected this approach, stating that to do so would be to treat the proceeds differently from other non-operating assets. In particular, the court compared the life insurance proceeds to \$300,000 of cash that the corporation had on hand. The IRS did not add the cash separately to the share price it otherwise determined. Rather, its expert included that asset in the valuation techniques he used, as appropriate. The court held that the insurance proceeds were to be treated no differently.

In *Estate of Huntsman*, the taxpayer's expert blended two different valuation techniques, one that increased corporate value on account of non-operating assets on a dollar-for-dollar basis and another that did not. As a result, the blended value did not reflect a dollar-for-dollar increase in the corporation's value on account of the insurance proceeds. In contrast, in *Estate of Blount*, each of the two expert opinions the Tax Court considered used valuation techniques that *did* increase corporate value by the value of the corporation's non-operating assets on a dollar-for-dollar basis. This necessarily means that the total blended value would reflect a dollar-for-dollar increase in value by virtue of the insurance proceeds.

Thus, while it appears at first blush that the Tax Court in *Estate of Blount* did precisely what the Tax Court in *Estate of Huntsman* prohibited, i.e., determining the corporation's value exclusive of insurance and then simply adding such value to the total, in fact its treatment of the insurance proceeds and valuation of the corporation was completely consistent with the holding of *Estate of Huntsman*.

130. 66 T.C. 861, 875 (1976).

131. *Id.* In fact, there were two corporations and only one owned life insurance. I have simplified the facts somewhat to make the case easier to follow.

132. As a result, nothing in *Estate of Huntsman* suggests that life insurance proceeds (unlike other assets) may be offset by redemption obligations.

3. *Estate of True*

Treasury regulation 20.2031-2(h) provides that, when valuing property for estate tax purposes, “little weight” will be accorded a price set forth in a restrictive agreement that fails to satisfy the pre-§ 2703 administrative and common law. Section 2703 makes clear that one must disregard any agreement that fails to meet the requirements set forth in § 2703(b). Thus, the plain language of § 2703 clearly indicates that one must ignore the entire agreement, and not just the price term. Nonetheless, citing *Estate of True*,¹³³ the Eleventh Circuit noted in *Estate of Blount* that numerous courts have respected aspects of disregarded agreements. Thus, it declined to adopt what it described as the “broadest rule,” that “when an agreement is ignored for valuation purposes, the agreement plays no role in determining the fair market value,”¹³⁴ stating that such a rule was “overinclusive and represent[ative of] a manifest departure from common business (i.e., market) sense.”¹³⁵

Insofar as *Estate of True* and all of the cases cited therein pre-date § 2703, they can be distinguished on that ground alone. Section 2703 is more stringent than the preexisting law and explicitly states that one must disregard the arrangement, as opposed to just the price term contained in the arrangement. Nonetheless, the court raised an important question that bears further consideration.

Arrangements that suppress property value can be quite varied. In some cases, they are created to be independent of the property they cover, as was the buy-sell agreement at issue in *Estate of Blount*. In others, they are included in the very document that creates the property right at issue, such as a partnership agreement. The type of restriction also can vary significantly, ranging from a corporate obligation to redeem shares to restrictions on other shareholders in what they can do with their stock. As a result, there may well be cases where it is appropriate to disregard just the term that purports to establish the price of the property but take into account other restrictions, such as limitations on transferability, when determining the property’s fair market value.¹³⁶

However, drawing those lines is beyond the scope of this article and not necessary to resolve *Estate of Blount*. *Estate of Blount* involves simply the question of whether a corporation’s redemption obligation should be considered when assuming that the shares subject to the agreement will not in fact be redeemed by the corporation for the price stated in the agreement. Thus, the court need not adopt the “broadest rule” possible regarding

133. 390 F.3d 1210, 1239-41 (10th Cir. 2004).

134. 428 F.3d 1338, 1345 n.7 (11th Cir. 1005).

135. *Id.*

136. *See, e.g., Estate of Godley*, 80 T.C.M. (CCH) 158 (2004).

disregarded agreements to reach the right result. As demonstrated above, ignoring redemption obligations is both consistent with the plain language of § 2703 and necessary to derive an appropriate value for the decedent's stock for estate tax purposes. It certainly does not represent a manifest departure from common business sense, as the Eleventh Circuit suggested.

IV. CONCLUSION

When valuing a corporation for estate tax purposes, a rule allowing taxpayers to offset insurance proceeds with a corresponding redemption obligation has some superficial appeal. Nonetheless, as a matter of regulatory interpretation, valuation theory and tax policy, this is the wrong result. First, the relevant regulations make clear that insurance proceeds must be treated just as any other non-operating assets when valuing a corporation for estate tax purposes. Second, offsetting corporate assets with a redemption obligation leads to bizarre and unacceptable valuations. Third, taking redemption obligations into account values the wrong property, i.e., the shares that will remain outstanding after the redemption, as opposed to the decedent's shares. Fourth, insurance proceeds are no different from other types of corporate assets, such that it would be acceptable to offset insurance proceeds, but not other types of assets. And finally, creating a special rule for insurance proceeds would create an unwarranted preference for funding redemptions with insurance, as opposed to other means. Despite this, both circuits that have explored this question have come to the wrong conclusion.

When intuition and tax logic conflict, it may well be appropriate to re-examine one's tax logic. This has happened in a number of controversial cases. For instance, in *Zarin v. Commissioner*¹³⁷ (involving gambling losses and cancellation of debt income), the Court of Appeal (and a number of academics¹³⁸) sought valiantly to articulate a reason for not taxing the petitioner, despite the fact that he had been given millions of dollars with which to gamble and then not been required to pay that amount back. Similarly, with the contingent attorneys fees issue raised in the cases of *Commissioner v. Banks* and *Commissioner v. Banaitis*,¹³⁹ numerous courts and commentators struggled to articulate a theory under which damages recovered by a plaintiff but paid directly to the plaintiff's lawyer as attorneys fees could be excluded from the plaintiff's income (as opposed to

137. 916 F.2d 110 (3rd Cir. 1990), rev'g 92 T.C. 1084 (1989).

138. See, e.g., Daniel Shavero, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 236 (1990) (arguing that Mr. Zarin's gambling cannot properly be considered "consumption," thereby warranting exclusion of the debt cancellation from his income).

139. 543 U.S. 426, 430 (2005). The Alternative Minimum Tax and § 67 imposed limitations on the ability of taxpayers to deduct such fees. Thus, taxpayers ended up paying taxes on money they never received.

included and deducted).¹⁴⁰

Decisions that contravene general expectations and common notions of fairness risk bringing disdain upon the courts and engendering disrespect for their decisions. However, allowing courts to warp tax logic or borrow ill-fitting theories from other areas of law simply to achieve a desired result has its own problems. Such actions create unnecessary complexity and equally call into question the integrity of the system.

In light of the problems identified above, subsequent courts considering the question of how to treat life insurance proceeds should eschew following *Estate of Cartwright* and *Estate of Blount*. Indeed, assuming that the Ninth and Eleventh Circuits do not overturn these cases, Congress should enact legislation to do so. If, instead, Congress were concerned about the perceived (but misguided) injustice of including life insurance proceeds in corporate value, it could choose to make a specific exception for life insurance proceeds and redemption obligations. However, such a choice should be made explicitly and by the body properly charged with making such decisions, so as not to damage the basic fabric of the tax code and the logic underpinning it.

140. Theories included the claim that (1) the attorney had a property interest in the payment, (2) attorneys fees are "transaction costs" and should therefore be deducted from the amount realized, (3) the inclusion of attorneys fees in the plaintiff's income without a corresponding deduction is unfair, leads to double taxation, and frustrates the purpose of other laws that encourage private rights of action, and (4) the damage awards in an employment context qualify as reimbursed employee expenses and are therefore excluded under § 62(a)(2)(A) and Treas. Reg. 1.62-2(c)(4) (as amended in 2003). Respectively, see *Banaitis v. Comm'r*, 340 F.3d 1074, 1081 (9th Cir. 2003); Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 3-12, *Banaitas*, 340 F.3d 1074 (No. 02-70421); Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 5-15, *Banaitas*, 340 F.3d 1074 (No. 02-70421); and Brief for Amicus Curiae Stephen B. Cohen, Pro Se, in Support of Respondents at 6, *Banaitas*, 340 F.3d 1074 (No. 02-70421). Ultimately, the Supreme Court held that transfers from a plaintiff to his attorney were anticipatory assignments of income and could not be excluded from income. However, even before the case was decided, Congress amended § 62(a) to allow taxpayers to deduct attorneys fees from income under certain limited circumstances not present in the *Banks* or *Banaitis* cases. See The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418 (2004).