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ESTATE TAXATION OF REDEMPTION AGREEMENTS: THE TREASURY LOSES "CONTROL"

JAMES M. DELANEY†

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INTRODUCTION

For many years equity interest owners in closely held entities have engaged in buy-sell agreements. Buy-sell agreements provide for, among other things, restrictions on the transfer of equity interests upon the occurrence of certain triggering events such as the death, disability, or retirement of an equity holder. Parties to buy-sell agreements experience varying income and estate tax consequences depending on the type of agreement, form of business entity associated with the agreement, the manner in which an equity holder's interest is transferred, and the source of the funds that are used to purchase the interest. In many cases, an insurance policy on the life of an equity holder serves as a source for the funds that will be used to acquire a decedent equity holder's interest upon his or her death. Though complex, the federal tax consequences to business entities and equity holders that engage in such buy-sell arrangements have largely been settled.

However, with the advent of the limited liability company (the "LLC") and with two federal circuit courts of appeal issuing opinions that impact how estates of deceased corporate shareholders are taxed, the manner in which estate tax is imposed on transfers subject to certain common buy-sell arrangements has been called into question.[1] Further, an analysis of the policy underlying the applicable sections of the Internal Revenue Code[2] (the "Code") governing such transactions reveals very little consistency between the relevant Code sections and applicable Treasury Regulations.[3] Not surprisingly, there is also little consistency in the manner in which such sections are applied by the courts and ad-

1. *See* Estate of Blount v. Comm'r, 428 F.3d 1338, 1339-40 (11th Cir. 2005); Estate of Cartwright, 183 F.3d 1034, 1035 (9th Cir. 1999).
2. All section references to the Code are references to Internal Revenue Code of 1986 as amended from time to time.
3. *See infra* Part II.B.1.a.

ministered by the Internal Revenue Service (the "IRS" or the "Service").[4]

Current provisions of the Code and regulations have historically been interpreted to require the value of insurance proceeds received on a life insurance policy owned by a corporation to be ratably included in the estate of the insured decedent shareholder via an increase in value stock of the entity.[5] Under this interpretation, a deceased shareholder's gross estate would reflect a proportionate increase in the value of the stock due to the company's receipt of the insurance proceeds.

However, the Ninth and recently the Eleventh Circuit Courts of Appeal have issued opinions which impact the manner in which stock of a closely held corporation subject to a buy-sell agreement is valued for estate tax purposes.[6] The Ninth and Eleventh Circuit Courts of Appeal have held, among other things, that in determining the value of a corporation for purposes of determining the value of a deceased shareholder's interest, the value of insurance proceeds received by the corporation must be offset against the corporation's obligation to redeem the shareholder's stock under the buy-sell arrangement.[7] The holdings remove the value of insurance proceeds from the value of the corporation which, in turn, reduces the value of each shareholder's equity interest. While this interpretation may be logical, it is misplaced in calculating the value of a shareholder's stock in a redemption transaction for estate tax purposes.

In contravention to the apparent intent of the Code and historical application of current regulations, the two opinions appear under certain circumstances to allow the value of insurance proceeds received by a closely held corporation to completely escape estate taxation.[8] This outcome thwarts the Code's overall goal of including either all or a portion of the value of such insurance proceeds in the insured decedent's estate.[9] The opinions are also inconsistent with the IRS's interpretation of its own regulations that govern the manner in which insurance proceeds received by a corporation are included in the value of a deceased shareholder's stock.[10]

Directly related to the above problem and due to the increased popularity of limited partnerships and limited liability companies, taxpayers have increasingly sought to implement buy-sell agreements within partnership or LLC structures. Although the regulations provide guid-

4. *See infra* Part II.B.1.a.iii.

5. *See* I.R.C. §§ 2031, 2042; Treas. Reg. §§ 20.2031-2(f) (as amended in 2006), 20.2042-1(c)(6) (as amended in 1979); *see also infra* Part II.B.1.a; Part II.B.1.b.

6. *Estate of Blount*, 428 F.3d at 1339-40; *Estate of Cartwright*, 183 F.3d at 1035.

7. 428 F.3d at 1346; 183 F.3d at 1038.

8. *See infra* Part II.B.1.a.iii.(b).

9. *See* I.R.C. § 2042(a)(2).

10. *See infra* Part II.B.1.a.iii.(c).

ance on the tax consequences of insurance proceeds received by a corporation, no regulatory guidance is available in relation to receipt of insurance proceeds in a partnership structure.[11] Taxpayers and commentators are now inquiring as to the tax consequences of the receipt of insurance proceeds by a limited partnership or limited liability company. Without guidance from the Treasury on the use of an insurance funded buy-sell arrangement in an LLC or limited partnership structure, taxpayers and their advisors are left to interpret a small number of old cases and rulings to determine the tax consequences of various proposed structures. Further, existing rulings by the IRS in the partnership area are inconsistent with the manner in which the regulations treat corporations and shareholders under similar circumstances.[12] Given the increasing number of closely held companies that are being formed in the United States and the important business and estate planning goals that are served by such buy-sell agreements, the tax consequences of such arrangements should be clarified.[13]

In an effort to address these problems, this article first provides an overview of the manner in which buy-sell arrangements are structured with a specific focus on using insurance proceeds to fund the arrangement.[14] The article reviews the historical manner in which corporations and shareholders who are parties to buy-sell agreements are taxed where the agreement is funded by life insurance proceeds.[15] An argument is made that the recent holdings of the Ninth and Eleventh Circuit Courts of Appeal inappropriately allow taxpayers to exclude all of the value of insurance proceeds payable to a closely held corporation from the gross estate of a deceased shareholder.[16]

The article then analyzes the application of the Code, regulations, and rulings applicable to the receipt by partnerships and LLCs of insurance proceeds of a policy on the life of a member of partner where a buy-

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11. *See, e.g.*, Treas. Reg. § 20.2042-1(c)(6).

12. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39034 (Sept. 21, 1983), *available at* 1983 GCM LEXIS 83,*1-2; Rev. Rul. 83-147, 1983-2 C.B. 158.

13. For data and statistics on the increasing number of LLC formations over the last several years see TaxProf Blog, http://taxprof.typepad.com/taxprof_blog/govt_reports/index.html which shows the following statistical graphic that compares the cumulative increase in LLC formations to formations of corporations in several large states:

	Cumulative +/-		2005		2004		2003		2002	
State	LLC	Corp	LLC	Corp	LLC	Corp	LLC	Corp	LLC	Corp
CA	87.1%	20.1%	70,024	107,923	58,097	103,325	45,274	93,696	37,429	89,880
FL	237.9%	23.7%	130,558	175,698	100,070	177,490	62,406	168,080	38,639	142,036
NY	72.1%	(11.4%)	58,847	82,300	47,967	84,434	40,768	83,273	34,193	92,929
OH	60.3%	(18.5%)	42,594	14,921	38,765	16,386	31,147	16,601	26,575	18,299
PA	109.6%	4.6%	27,885	23,107	23,752	23,156	16,472	20,943	13,302	22,096
TX	81.3%	(27.3%)	59,076	40,945	49,677	42,302	35,285	55,107	32,593	56,319

The above graphic was synthesized by Larry Ribstein from data obtained from the International Association of Commercial Administrators, Ideoblog, http://busmovie.typepad.com/ideoblog/2006/05/the_data_is_out.html.

14. *See infra* Part I.

15. *See infra* Part II.

16. *See infra* Part II.B.1.

sell agreement is in place.[17] The article focuses on areas in which the cases, rulings, statutes, and regulations either inaccurately or inadequately provide guidance to taxpayers. A conclusion is reached that the guidance in relation to corporations is inconsistent with treatment accorded to partners of partnerships and members of LLCs. In this regard, the article proposes that the regulations applicable to corporations, with suggested amendments, should apply to limited liability companies and limited partnerships in the same manner as they apply to corporations.[18]

Finally, the article questions whether the case precedents and regulations now in force protect the overall goals of the Code as originally enacted by Congress.[19] The author concludes that the Eleventh Circuit Court of Appeal's recent decision is arguably inaccurate. At the same time, the author acknowledges the ambiguities in the current regulations as interpreted by the Courts of Appeal and proposes amendments that will assist courts and taxpayers in interpreting them. The amendments, if adopted, seek to clarify the regulations to make them consistent with the intent of the Code and apply equally to corporations and entities that are treated as partnerships for tax purposes.

I. OVERVIEW OF BUY-SELL ARRANGEMENTS

A buy-sell agreement is a contract pursuant to which a corporate shareholder, partner, or member of an LLC may (or must) offer his or her equity interest for sale to the company or the other equity holders upon the occurrence of certain triggering events.[20] Triggering events may include, among others, the equity holder's death, disability, retirement, or termination.

A buy-sell arrangement generally restricts the sale or transfer of an ownership interest in the entity to certain related parties or unrelated parties in general. For example, the equity holders of a closely held entity may wish to limit future ownership to individual family members who are perceived as capable of participating in management and operations of the entity. The terms of a buy-sell agreement also may include a method for determining a price for a unit of interest in an entity. By limiting ownership and setting a method of valuation, a buy-sell agreement can provide a method that is acceptable to all the equity holders of transferring control and continuing the existence of an entity upon the death, disability, or termination of employment of a single equity holder.

A buy-sell arrangement can create a market for a closely held equity interest. Without such an arrangement, little, if any, market may exist for

17. *See infra* Part II.B.1.b.
18. *See infra* Part III.
19. *See infra* Part III.
20. *See* Jonathan E. Strouse, *Redemption and Cross-Purchase Agreements: A Comparison*, THE PRACTICAL ACCOUNTANT, Oct. 1991, at 44.

an interest in a closely held entity. With a buy-sell arrangement in place, a minority interest in a closely held company may be transferred to other equity holders, family members or redeemed by the company. A buy-sell agreement will often set the price for the purchase.

A buy-sell agreement can also provide a source of funds upon a purchase or redemption of a deceased shareholder's ownership interest. For example, where a corporation, partnership, or LLC becomes a party to a buy-sell agreement and is required under certain circumstances to purchase the interest of an equity holder, the company may be authorized under the arrangement to purchase life insurance on each of the equity holders in order to fund the purchase of a deceased equity holder's interest. In the event the equity holder passes away, the entity will receive the insurance proceeds and use such proceeds to purchase the decedent's equity interest from his or her estate.

Of course, buy-sell arrangements differ in structure and form. The two most common forms of buy-sell agreements are cross-purchase agreements and redemption agreements.[21] The two structures result in different federal income and estate tax consequences to the entity and its equity holders. Depending on the facts and circumstances, the equity holders of an entity will select the structure that is most efficient from an economic, management, income, and estate tax perspective. This section initially focuses on the form of typical structures that use insurance proceeds to fund buy-sell agreements and then analyzes federal tax consequences of each of the basic structures.

A. Cross-Purchase Agreements

A cross-purchase agreement is a contract among the equity holders of a company. Under the terms of a cross-purchase agreement, each equity holder agrees or has an option to purchase some or all of the stock offered by the other equity holders.[22] The corporation, partnership, or LLC is typically not a party to a cross-purchase agreement. In a cross-purchase arrangement, the remaining equity holders must purchase, for example, another equity holder's interest upon a triggering event (e.g., death).

In a cross-purchase arrangement, each equity holder is authorized to acquire an insurance policy on the lives of each of the other equity holders.[23] Each shareholder pays the premiums on the policies that he or she has acquired on the lives of the other equity holders. Upon the death of

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21. There are also variants on these two basic forms of the agreements that may include, among others, agreements between companies and their equity holders under which the equity holder may offer his or her interest initially to the company and thereafter to the other equity holders. Alternatively, the equity holder may first offer his or her interest to the other equity holders and thereafter to the company.

22. Strouse, *supra* note 20, at 44.

23. *See, e.g.*, *id.* at 44-45.

an insured equity holder, the surviving equity holder will receive the life insurance proceeds as beneficiary on the policy ensuring the life of the decedent equity holder.[24] The surviving equity holders will then use the insurance proceeds to satisfy their obligation under the cross-purchase agreement to acquire the deceased equity holder's interest.

1. Tax Consequences to the Selling Equity Holder

There are a number of income and estate tax consequences to the equity holders in a cross-purchase agreement which differ depending upon whether the company is a C corporation, S corporation, or an entity treated as a partnership for tax purposes (e.g., a general partnership, limited partnership or LLC). Generally, there are no material tax consequences to the company when a cross-purchase agreement is executed and equity interests are exchanged among the equity holders under the terms of the agreement.

Upon the death of a shareholder, the estate will receive a basis step up to fair market value in relation to the deceased shareholder's stock.[25] Where insurance proceeds are used to fund a cross purchase obligation, the remaining shareholders use the policy proceeds to purchase a deceased shareholder's equity interest from the decedent's estate. Corporate stock generally fits into the definition of a capital asset.[26] Thus, any gain recognized on the sale of the corporate stock is generally subject to the lower tax rates applicable to capital gains.[27] Under these circumstances, when the remaining shareholders purchase the decedent's equity interest at fair market value from decedent's estate, the estate receives the stock with a basis equal to its fair market value and the estate will not realize any gain upon the death of the decedent.[28]

The receipt of the insurance proceeds by the remaining shareholders will not be included in deceased shareholder's estate unless the estate held incidents of ownership in the policy.[29] Where the remaining shareholders own the policies, the remaining shareholders should have all incidents of ownership in the policy insuring decedent's life. Neither the decedent nor the decedent's estate should hold incidents of ownership as contemplated under Code section 2042.

24. *Id.* at 45.

25. I.R.C. § 1014(a)(1). There is an exception to the above in relation to a shareholder of an S corporation. The estate of a deceased S corporation shareholder will not receive a step up in the basis to fair market value upon the shareholder's death to the extent of the shareholder's interest in unrealized receivables of the corporation.

26. I.R.C. § 1221. An exception exists where the shareholder is a "dealer" in stock.

27. *Id.*; *see also* I.R.C. §§ 1222, 1223.

28. This conclusion assumes that there was not a meaningful change in the value of the stock between the time that the decedent shareholder died and the time that the estate sells the stock to the remaining shareholders. In the event that the value of the stock changes in the interim period, gain or loss may be realized and recognized by the estate.

29. *See* I.R.C. § 2042.

The tax consequences to a selling partner or member of an LLC upon the sale of units subject to a cross-purchase agreement are similar to the tax consequences to a corporate shareholder. Similar to a corporate shareholder, any gain or loss realized by a partner upon a sale or exchange of an interest in a partnership or LLC is generally characterized as gain or loss from the sale of a capital asset.[30] Under these circumstances, the selling deceased partner or member's estate should experience a step up in the basis of the ownership interest and realize capital gain, if any, on the exchange.[31]

2. Tax Impact on the Cross-Purchase Buyer

A purchasing shareholder or purchasing partner's initial basis in an interest acquired from another shareholder or partner is equal to its cost.[32] Generally, the cost is equal to fair market value of the equity interest purchased from decedent's estate. A transfer of a partnership interest ordinarily will not terminate the partnership unless fifty percent or more of the total interest in capital and profits is sold or exchanged in a twelve-month period.[33]

3. Drawbacks of the Cross-Purchase Agreement

One drawback of the cross-purchase agreement exists when there are a large number of equity holders that are parties to the buy-sell arrangement. If, for instance, there are just two equity holders, two life insurance policies are sufficient; one policy is beneficially owned by A insuring the life of B and one policy is beneficially owned by B insuring the life of A. However, when there are a large number of equity holders, the number of policies required may become impractical. The number of policies required is equal to i (the number of equity holders) multiplied by $(i - 1)$.[34] For example, if a company has 6 equity holders, the number of required insurance policies would be 30 [calculated as follows: 6 x (6-1)]. Under these circumstances, the cost and administrative burden of managing the policies may become problematic. For this and various other reasons, equity holders may instead structure their buy-sell arrangement as a redemption agreement.

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30. I.R.C. § 741.

31. *See* Treas. Reg. § 1.742-1 (1960). Exceptions exist in relation to the above general rules where the partnership holds specific types of assets. Similar to the rule applicable to the estate of an S corporation shareholder, the estate of a deceased partner will not receive a step up in the basis to fair market value upon the partner's death to the extent the value of the interest is decreased by items of income in respect of a decedent (items of "IRD"). *See* I.R.C. § 691; *see also* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 23.04[1] (2006). Items of IRD include, among other things, certain partnership receivables and the deceased partner's distributive share of partnership income for the period ending with his death. *Id.* (citing I.R.S. Priv. Ltr. Rul. 91-02-018 (Oct. 12, 1990)).

32. I.R.C. § 1012.

33. I.R.C. §708(b); *see also* MCKEE ET AL., *supra* note 31, ¶ 15.02[2](d).

34. Strouse, *supra* note 20, at 45.

Another practical problem with cross-purchase agreements can arise when a new shareholder or partner enters into the agreement. The new shareholder or partner must obtain an insurance policy on the life of each of the other equity holders.[35] Obtaining an insurance policy on an older shareholder or partner who is in poor health or of advanced age can be expensive or hard.[36]

Finally, where insurance proceeds are received under a policy by remaining shareholders or partners, there is no guaranty that such proceeds will be used to purchase the decedent shareholder or partner's equity interest.[37] The proceeds may instead be expended in an unrelated fashion by the remaining shareholders or the proceeds may be subject to creditors' claims.[38]

B. Redemption Agreements

A redemption agreement is a contract between the equity holders of the company and the company itself. Under a typical redemption agreement, a corporation, partnership, or LLC agrees to purchase or redeem stock or units offered by the shareholders, partners, or members.[39] If, pursuant to the agreement, the company funds the purchase of the equity interests with proceeds from life insurance, the company generally purchases only one policy on the life of each equity holder.[40] Thus, for example, if six equity holders exist, the company need only purchase six policies.[41]

One benefit of a redemption agreement is that the premiums will be paid by the company which may oversee and confirm that the policy is maintained.[42] Since the company pays the premiums on the life insurance policies, the cost of insurance is borne by the shareholders in proportion to their equity interests.

Redemption agreements have specific federal income and estate tax consequences to the entities and equity holders that engage in such agreements. The federal income tax consequences to the parties involved in a corporate redemption agreement depend on whether the entity that is a party to the agreement is a C corporation, partnership, or LLC treated

35. MCKEE ET AL., *supra* note 31, ¶ 23.07[1].
36. *Id.*
37. *Id.*
38. *Id.*
39. Strouse, *supra* note 20, at 45.
40. *Id.*
41. *Id.* at 46. If, in the alternative, a cross-purchase structure had been implemented here, the company would have been required to purchase 30 policies under the formula. *See supra* note 34 and accompanying text.
42. *Id.* at 45.

as a partnership for tax purposes. The analysis below is intended to cover the basic federal tax consequences of a redemption agreement.[43]

1. Tax Impact on Corporation & Shareholders

Implementation of a redemption agreement between a C corporation and its shareholders requires analysis of whether the distribution of the insurance proceeds will be treated as a dividend distribution under Code section 301 or a taxable exchange between the corporation and the shareholder under section 302.[44] The complexity of sections 301 and 302 generally causes redemption agreements to be viewed as more complex than a cross-purchase buy-sell arrangement which is among only the shareholders. It can be time consuming and costly to determine the tax consequences of a corporate distribution.

Upon the death of a shareholder who is a party to a corporate redemption agreement, the remaining shareholders may be faced with the difficult task of determining whether the distribution in redemption is a dividend or consideration received in sale or exchange. In the event that the distribution is characterized as a dividend, the remaining equity holders will receive no step up in the basis of their equity interests upon the redemption.[45]

a. Tax Considerations: Sale or Exchange Treatment

A redemption qualifies as a sale or exchange of a shareholder's stock under four different circumstances: (1) if it is not essentially equivalent to a dividend,[46] (2) if the distribution is substantially disproportionate with respect to the shareholder,[47] (3) if redemption completely terminates the shareholder's interest in the corporation,[48] or (4) the redemption is from an unincorporated shareholder and is in partial liquida-

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43. For a more exhaustive analysis, see also HOWARD M. ZARITSKY, STRUCTURING BUY-SELL AGREEMENTS: ANALYSIS WITH FORMS ch. 8 (2005).

44. I.R.C. §§ 301, 302.

45. I.R.C. § 301.

46. I.R.C. § 302(b)(1). In general, in order to qualify under § 302(b)(1) as a redemption that is essentially equivalent to a dividend, the redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. United States v. Davis, 397 U.S. 301, 313 (1970); *see also* Rev. Rul. 85-106, 1985-2 C.B. 116. For this purpose, the attribution rules of § 318 of the Code apply. *Davis*, 397 U.S. at 307. In determining whether a reduction in interest is "meaningful," the most significant rights are: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets upon liquidation. *See* Rev. Rul. 85-106, 1985-2 C.B. 116 (citing Rev. Rul. 81-289, 1981-2 C.B. 82).

47. I.R.C. § 302(b)(2). In general, a redemption is substantially disproportionate within the meaning of § 302(b)(2) if the shareholder's interest in outstanding common voting and nonvoting common stock after the redemption is less than 80% of the shareholder's interest before the redemption, and if, after the redemption, the shareholder owns less than 50% of the combined voting power of all shares. I.R.C. § 302(b)(2)(C).

48. I.R.C. § 302(b)(3). In general, a redemption qualifies as a complete termination under § 302(b)(3) if a shareholder's interest terminates all interests in the corporation as a result of the redemption. For this purpose, the attribution rules of § 318 of the Code apply. *See* I.R.C. § 302(c)(2).

tion of the distributing corporation.[49] To the extent that the distribution in redemption meets any one of these specific circumstances, the distribution will qualify for capital gains rather than ordinary income treatment.[50] Again, the determination of whether a redemption is a sale or exchange under Code section 302(b) is complex. A complete discussion of each of the four circumstances is beyond the scope of this article.[51] Nevertheless, classification of a distribution in redemption as a sale or exchange, as opposed to a dividend, is important primarily because of the ability of the shareholder to benefit from his or her basis in the shares.

For example, assume A and B are shareholders of C Corp. (which has substantial earnings and profits). A, B and C Corp engage in a redemption agreement pursuant to which A's stock is to be redeemed for $100,000 ($1.00 per share as of the date of death; 100,000 shares) upon A's death. If the redemption is taxed as a sale or exchange of the stock, the shareholder decedent's estate should recognize no gain due to the step up in basis to fair market value on the date of the decedent's death.[52]

Thus, the main reason for avoiding dividend treatment is to take advantage of the tax-free return of basis. Prior to the imposition of a lower tax rate upon dividends, historically, the disparity between the ordinary tax rate imposed on dividend income and capital gains provided an even greater benefit to sale or exchange treatment upon redemption.[53]

b. Tax Considerations: Dividend Treatment

If a distribution in redemption of stock by a corporation does not meet the requirements of section 302(b), the distribution generally will be classified as a distribution of a dividend to the extent of the corporation's earnings and profits.[54] If a distribution exceeds earnings and profits, it will represent a return of capital to the extent of the shareholder's basis in its stock.[55] Finally, to the extent the distribution exceeds the shareholder's basis in its stock, the distribution will be treated as gain from the sale or exchange of property.[56] Due to the fact that an estate will generally receive a step up in the basis of the decedent's assets to fair market value on the date of the decedent's death, characterization of the distribution as a dividend can be very costly from a tax perspective as compared to sale or exchange treatment which results in little or no tax-

49. I.R.C. § 302(b)(4).

50. *See Davis*, 397 U.S. at 305.

51. For a thorough analysis of the application of these rules, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 9 (2005) (covering redemptions of corporate stock).

52. *See* I.R.C. § 302(a).

53. If the redemption is taxed as a "dividend" pursuant to § 301(a) and § 302(d), the estate will be taxed at net capital gain rates pursuant to §1(h)(11). *See* I.R.C. § 1(h)(11) (generally providing that qualified dividend income is subject to tax at the net capital gain rates).

54. I.R.C. §§ 301, 302(c)(1).

55. I.R.C. § 301(c)(2).

56. I.R.C. § 301(c)(3)(A).

able gain. This is because, where there are substantial earnings and profits, the full amount of the distribution in redemption will be treated as a dividend subject to tax. Whereas, in a redemption treated as a sale or exchange, gain subject to tax on the distribution will be reduced by the amount of basis that is recovered.[57]

2. Tax Impact on Partnerships, LLCs, Partners, and Members

Generally, the payment by a partnership to a partner in complete liquidation of a partner's interest does not result in a tax consequence to the partnership.[58] Further, assets may generally be distributed in kind tax-free.[59] However, liquidation payments to partners are governed by section 736.

Like the rules that apply to corporate shareholder distributions, the tax consequences to a partner (or member of an LLC which is treated as a partnership for tax purposes) can be quite complex from a tax perspective. Initially, section 736 divides liquidation payments into two categories meeting the definitions of section 736(a) and section 736(b). Payments classified as section 736(a) payments are further subdivided into two categories which include payments of a distributive share of partnership income and payments more in the nature of guaranteed payments.[60] The section 736(b) category generally includes payments to the partner for his or her share of the partnership property.[61] Payments to a partner in relation to partnership property are further subject to either ordinary or capital characterization depending upon the nature of the property.

For example, payments for substantially appreciated property and unrealized receivables generally will attract ordinary income treatment.[62] Cash payments for other types of property such as goodwill, for example, will attract capital gain treatment.[63] Further, tax treatment may differ depending upon whether the partner was a partner in a partnership in which capital was an income-producing factor versus a partnership in which capital was not an income-producing factor.[64]

II. FEDERAL TAX CONSIDERATIONS OF USING INSURANCE TO FUND BUY-SELL ARRANGEMENTS

In addition to general business and tax considerations, there are specific income and estate tax rules that may affect the decision to use insurance proceeds to fund either a cross-purchase agreement or redemp-

57. *See* I.R.C. § 1001(a).
58. I.R.C. § 736.
59. 33A AM. JUR. 2d *Federal Taxation* ¶ 10376 (2006).
60. *See* I.R.C. § 736(a).
61. *See* I.R.C. § 736(b).
62. *See* I.R.C. § 751.
63. *See* I.R.C. §§ 731, 741.
64. *See, e.g.*, MCKEE ET AL., *supra* note 31, ch. 22.

tion agreement. The Code accords special income tax treatment to insurance proceeds that are payable upon the death of the insured.[65] Additionally, the estate tax sections of the Code also provide specific rules that define when a decedent's gross estate must include insurance proceeds.

A. Income Taxation of Life Insurance Proceeds

Code section 101(a) generally provides that gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of death of the insured.[66] Under this rule, a beneficiary of a life insurance policy that receives insurance proceeds upon the death of the insured may exclude the insurance proceeds from gross income.

For example, assume A and B are the only shareholders of C Corp. Inc. They have engaged in a cross-purchase agreement (the "Agreement") under which, upon the death of either A or B, the other will buy the decedent's share for $100,000. Pursuant to the Agreement, A and B each purchase a life insurance policy on the life of the other and each of them intends to use the proceeds to purchase the other's interest upon the death of the other party. When A dies, B will receive the $100,000 from the insurer and may exclude the full amount of the proceeds from income.[67]

Exceptions to the section 101(a) general exclusionary rule apply under certain circumstances. If a life insurance contract or any interest therein is transferred for valuable consideration, the exclusion from gross income is limited to an amount equal to the sum of the actual value of the consideration plus any premiums paid by the transferee.[68] The phrase "transfer for valuable consideration" is defined as any absolute transfer-for-value of a right to receive all or part of the proceeds of a life insurance policy.[69] Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for valuable consideration of the policy or an interest therein.[70]

65. *See* I.R.C. § 101(a)(1).

66. *Id.* The tax-free receipt of proceeds can be likened to a free step up in basis. In effect, I.R.C. §101(a)(1) operates the same as a step up in basis. *See* I.R.C. § 101(a)(1). I.R.C. § 1022, which would replace I.R.C. § 1014 at the time of estate tax repeal under current law, provides for carryover basis. *See* I.R.C. § 1022(b)(2)(C). As such, life insurance could be viewed as even more tax beneficial than other properties.

67. *See* I.R.C. § 101(a)(1); *see also* ZARITSKY, *supra* note 43, ¶ 8.02[1][a].

68. I.R.C. § 101(a)(2). Also included with the amount paid and any future premiums are "other amounts" which phrase includes interest paid or accrued by the transferee on indebtedness with respect to such contract or any interest therein if such interest is not allowable as a deduction under § 264(a)(4). *Id.*

69. Treas. Reg. § 1.101-1(b)(4) (as amended in 1982).

70. *See id.*

For example, A pays a premium of $500 for an insurance policy in the face amount of $1,000 upon the life of B, and A subsequently transfers the policy to C for $600. Thereafter, C does not make any additional payments in relation to the policy and receives the proceeds upon the death of B. The amount which C can exclude from his income is limited to $600. The $400 of the proceeds which exceed the $600 purchase price must be included by C as income.

B. Estate and Transfer Taxation of Life Insurance

In addition to income tax consequences, the impact of using life insurance proceeds to fund a buy-sell agreement requires analysis of the estate tax consequences. Section 2031 operates in conjunction with section 2033 and generally defines "gross estate" as including the value of all of a decedent's property (tangible or intangible and wherever situated) at the time of death.[71] Broadly, section 2033 requires the value of all of a decedent's property be included in his or her gross estate at the time of death.[72] Although sections 2031 and 2033 each relate to value and inclusion, section 2033 identifies includible interests whereas section 2031 generally addresses valuation.[73]

Identification of specific interests includible in a decedent's gross estate is addressed in sections 2033 through 2046.[74] Included within that range of sections is section 2042 which provides rules in regard to inclusion of the value of insurance proceeds in a decedent's gross estate.[75]

1. Section 2042: Incidents of Ownership

Section 2042 operates under certain circumstances to require inclusion in a gross estate of the value of insurance proceeds payable upon a decedent's death.[76] Taxpayers generally attempt to structure their estates in a fashion that escapes application of section 2042 thereby excluding life insurance proceeds from their gross estates. Fundamentally, section 2042 is a specific inclusion section that requires insurance proceeds receivable by an executor on the life of a decedent to be included in his or her gross estate.[77] There is no question that insurance proceeds from a policy on the life of the decedent that are actually received by an executor must be included in a decedent's estate.

Less intuitive is section 2042's requirement under certain circumstances that amounts payable to beneficiaries other than the decedent's

71. I.R.C. § 2031(a); *see also* I.R.C. § 2033 ("The value of gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.").

72. *See* I.R.C. § 2033.

73. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE & GIFT TAXATION ¶ 4.01 (2006), *available at* 1999 WL 1031606.

74. *Id.*; *see also* I.R.C. §§ 2033-2046.

75. *See* I.R.C. § 2042.

76. *See id.*

77. I.R.C. § 2042(1).

estate under policies on the life of the decedent must also be included in the decedent's gross estate. Where the decedent possesses "incidents of ownership" in relation to the insurance policy, proceeds payable to a third party must be included in the decedent's gross estate.[78] The term "incidents of ownership" is not limited in its meaning to ownership of the policy in a technical legal sense.[79] Incidents of ownership include *any* economic interest or benefit from an insurance policy.[80]

The regulations specifically provide that "incidents of ownership" include the power to change the beneficiary, to surrender or cancel the policy, to assign the policy or revoke an assignment, to pledge the policy for a loan, or to borrow against the cash surrender value of the policy.[81] This list, though illustrative, is not exhaustive.[82] Incidents of ownership broadly encompass most every right that is retained in a policy.[83] In the obvious example, if an insured transfers a policy to another but retains the right to change the beneficiary on the policy, retention of such right will result in the proceeds being included in the insured's estate.[84]

A number of cases and rulings address less obvious examples and add to the definition of the phrase "incidents of ownership" for purposes of applying the Code and regulations. In Revenue Ruling 61-123,[85] the IRS ruled on a fact pattern in which an airline passenger purchased an accident insurance policy on his life prior to his death in an airplane crash.[86] After filling in the beneficiary designation, he mailed the policy insuring his life to the beneficiary and boarded the plane.[87] The proceeds were not payable to the decedent's estate. However, under these circumstances, the IRS ruled that the proceeds of the policy were includible in the decedent's gross estate even though as a practical matter it was impossible for him to exercise any incidents of ownership while the plane was in flight.[88]

Similarly, in *Commissioner v. Estate of Noel*,[89] the decedent's spouse purchased an accidental death insurance policy on his life several hours prior to a plane crash, which killed the insured husband.[90] Not-

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78. I.R.C. § 2042(2).

79. Treas. Reg. § 20.2042-1(c)(2) (as amended in 1979).

80. *See* Treas. Reg. § 20.2042-1(c); Chase Nat'l Bank v. United States, 278 U.S. 327, 335 (1929); *see also* ZARITSKY, *supra* note 43, ¶ 8.02[4].

81. Treas. Reg. § 20.2042-1(c); *see also* ZARITSKY, *supra* note 43, ¶ 8.02[4].

82. H.R. REP. NO. 2333-77, § 404 (1942), *reprinted in* 1942-2 C.B. 372, 491; *see also* STEPHENS ET AL., *supra* note 73, ¶ 4.14[4][a].

83. *See* STEPHENS ET AL., *supra* note 73, ¶ 4.14[4][a], *available at* 1999 WL 1031619.

84. *See* I.R.C. § 2042(2). This analysis is similar to the analysis applied in sections 2036 through 2038 relating to transfers of property where an interest is retained by the grantor of the property. *See* I.R.C. §§ 2036-2038.

85. Rev. Rul. 61-123, 1961-2 C.B. 151.

86. *Id.*

87. *Id.*

88. *Id.*

89. 380 U.S. 678 (1965).

90. *Estate of Noel*, 380 U.S. at 679-80.

withstanding that the decedent was in transit and could not actually have exercised any incidents of ownership, the Supreme Court held that the proceeds must be included in the decedent's estate.[91] The holding in *Noel* and the outcome in Rev. Rul. 61-123 indicate a tendency on the part of the Court and the IRS to find and apply incidents of ownership in an insurance policy where an individual has the right to change the beneficiary even though the individual had no real control over the beneficiary designation.

The right to change a beneficiary designation is not the only attribute that may result in incidents of ownership. Use of an insurance policy as collateral will also constitute "incidents of ownership." In *Estate of Krischer v. Commissioner*,[92] the decedent obtained loans, renewals of loans, or additions to existing loans from a financial institution.[93] At inception, each loan was secured by either one or both of two life insurance policies.[94] Renewals or additions to such loans were expressly made subject to an assignment of those policies as collateral.[95] The Commissioner determined that the decedent possessed incidents of ownership in the policies by virtue of his power to pledge them as collateral for past and future loans.[96] Attribution of incidents of ownership to the decedent caused the proceeds to be includible in decedent's gross estate pursuant to section 2042(2).[97] The Court in *Estate of Krischer* agreed.[98] Thus, notwithstanding that the policy owner irrevocably transfers a policy, if the owner retains the right to use the policy as collateral, the owner will continue to have incidents of ownership under section 2042(2).

In each of the above cases or rulings, the proceeds of the life insurance policy were payable to a third party and not the decedent insured's estate. Under these circumstances, section 2042 nevertheless operated to include the proceeds in the decedent's gross estate. The courts and the IRS have been very liberal in attributing incidents of ownership to a decedent where the decedent has retained even the slightest rights to exercise control over the policy.

However, the power to substitute one life insurance policy for another of equal value appears not to be an incident of ownership. In *Estate of Jordahl v. Commissioner*,[99] the decedent created a trust and named himself as one of three trustees.[100] The corpus of the trust included insurance policies on the decedent's life and other income-

91. *Id.* at 683-84.
92. 32 T.C.M. (CCH) 821, 1973 Tax Ct. Memo LEXIS 117 (1973).
93. *Id.* at *3.
94. *Krischer*, 1973 Tax Ct. Memo Lexis 117, at *3.
95. *Id.*
96. *Id.* at *9.
97. *Id.*
98. *Id.* at *13.
99. 65 T.C. 92 (1975).
100. *Jordahl*, 65 T.C. at 92.

producing assets.[101] The trustees were instructed to pay the premiums out of the assets of the trust and to pay over any remaining income to the decedent.[102] At no time was income insufficient to pay the premiums.[103] On his death, his daughter was to receive the income until she reached age 50 at which time she was to receive the principal.[104] The decedent retained the power to substitute securities, property, and policies "of equal value" for those transferred to the trust.[105] The court held that the insurance proceeds were not includible because the right to substitute other policies "of equal value" did not give him a right to the "economic benefits" of the policies and because his powers as trustee were strictly limited.[106]

a. Incidents of Ownership Held by Corporations

i. Current Treasury Regulations

Incidents of ownership on a policy held by a corporation can also be attributed to an individual shareholder of the corporation. Insurance proceeds payable to a third party other than the corporation must be included in an insured shareholder's estate if the insured shareholder can actually exercise any incident of ownership in the policy.[107] Thus, an insured shareholder will be attributed incidents of ownership held by the corporation where the insured owns a controlling interest in the corporation and the proceeds are payable to a beneficiary other than the corporation.[108] However, a shareholder may avoid being attributed incidents of ownership in an insurance policy possessed by the corporation under certain circumstances. Regulations under section 2042 provide an exception to this general rule of inclusion where a corporation's incidents of ownership will *not* be attributed to a decedent *through stock ownership* to the extent that the proceeds are payable directly to the corporation.[109]

The above analysis under the regulations first hinges on whether the corporation or a third party receives the insurance proceeds. More specifically, where a corporation is the beneficiary and recipient of proceeds of a life insurance policy on the life of a decedent shareholder, the corpo-

101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at 101 (citing I.R.C. § 2042(2)).
107. Treas. Reg. § 20.2042-1(c)(6) (as amended in 1979). An example is given in the regulations providing that if the decedent is the controlling stockholder in a corporation and the corporation owns a life insurance policy on his or her life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his or her stock ownership and the proceeds will be included in his or her estate under section 2042. *Id.*
108. *Id.*; *see also* KATHRYN G. HENKEL, ESTATE PLANNING & WEALTH PRESERVATION: STRATEGIES & SOLUTIONS ¶ 12.02[1][b][i] (2005).
109. Treas. Reg. § 20.2042-1(c)(6).

ration's incidents of ownership will *never* be attributed to the decedent shareholder through his or her stock.[110] This rule operates notwithstanding the fact that a majority shareholder would have actual control over any insurance policy held by the corporation. Applying this rule in isolation appears to allow the insurance proceeds to escape inclusion in a majority shareholder's estate and escape the direct requirements of section 2042 of the Code. However, as discussed extensively below, estates of majority shareholders have historically reported the value of the proceeds indirectly via an increase in the value of the decedent shareholder's stock under the general inclusion rule of section 2031.

On the other hand, where the insurance proceeds are not payable to or for the benefit of the corporation, the question arises as to whether incidents of ownership held by the corporation will be attributed to an insured shareholder. Where a decedent shareholder owns a controlling interest and the proceeds are payable to a third party (e.g., not the corporation), incidents of ownership held by the corporation are attributed to the decedent shareholder's estate under section 2042.[111] The attribution of incidents under these circumstances is based upon the fact that a majority shareholder has authority to actually exercise control over the policy. This, in turn, causes the insurance proceeds to be included in the majority shareholder's estate notwithstanding that the proceeds are payable to a third party. However, if a decedent shareholder owns only a *minority* interest, no incidents are attributable and no proceeds are directly included in the decedent shareholder's estate.[112]

Operation of these rules is demonstrated in the following example provided in the regulations under section 2042. Assume the decedent was the controlling stockholder in a corporation. Further, assume that the corporation owned a life insurance policy on the decedent shareholder's life and the proceeds were payable to the decedent's spouse, a third party. The incidents of ownership held by the corporation are attributed to the decedent through his stock ownership and all of the proceeds are includible in the decedent's gross estate under section 2042.[113] However, if in this example the policy proceeds had been payable forty percent (40%) to the decedent's spouse and sixty percent (60%) to the corporation, only forty percent of the proceeds would be included in decedent's estate under section 2042.[114] While the example in the Regulation does not specifically address the remaining sixty percent of the insurance proceeds that went to the corporation, it can be inferred that the value of the corporate stock in the decedent's estate will increase due to the corporation's receipt of the additional sixty percent. Further, it can

110. *Id.*
111. *See id.*
112. *Id.*
113. *Id.*
114. *Id.*

also be inferred that the increased value of the decedent's stock must be included in the decedent's gross estate under section 2031.[115]

In sum, the regulations appear to require inclusion of at least a ratable portion of the value of the insurance proceeds in a shareholder's estate where the proceeds are payable to the corporation under section 2031. Where the corporation receives the insurance proceeds, the Regulations operate on the presumption that the value of the corporate stock included in a decedent's estate under section 2031 will increase proportionately upon the corporation's receipt of the insurance proceeds. Conversely, where policy proceeds are payable to a party other than the corporation (or the insured shareholder's estate) and corporate incidents are attributable to the decedent shareholder, the decedent shareholder's estate is required to include all of the proceeds in his or her gross estate under section 2042. These rules reflect the close relationship that exists between section 2042 and section 2031.

ii. Current Case Law

The above analysis under the regulations is not, however, consistent with recent holdings of the Ninth Circuit Court of Appeals in *Estate of Cartwright v. Commissioner*[116] and the Eleventh Circuit Court of Appeals in *Estate of Blount v. Commissioner.*[117] In *Cartwright*, the decedent, Mr. Cartwright, was a majority shareholder in the CSB law firm ("CSB"), a California professional corporation.[118] Mr. Cartwright died in 1988 owning a majority 71.43% of the shares of CSB.[119] CSB held two insurance policies on the life of Mr. Cartwright which, upon his death, paid a total of $5,062,029 in proceeds.[120] Pursuant to a redemption agreement in place at the time of Mr. Cartwright's death between CSB and its shareholders, CSB paid the insurance proceeds that it received to Mr. Cartwright's estate in redemption of Mr. Cartwright's shares.[121] CSB treated $4,080,256 of the total payment as non-employee compensation and the remaining approximately one million dollars as a payment in redemption of Mr. Cartwright's stock.[122] However, the estate treated the full amount received as paid in redemption of Mr. Cart-

115. *See* T.D. 7312, 1974-1 C.B. 277, 1974 IRB LEXIS 835, at *3 (1974) (providing that where a corporation is the beneficiary of any portion of the proceeds of a life insurance policy, there is no need for that portion to be included in the gross estate under section 2042 because it directly affects the value of the stock that is included in the decedent's gross estate). *See infra* Part II.B.1.a.iii.

116. 183 F.3d 1034 (9th Cir. 1998).

117. 428 F.3d 1338 (11th Cir. 2005).

118. *Cartwright*, 183 F.3d at 1035; *see also* Estate of Cartwright v. Comm'r, 71 T.C.M. (CCH) 3200, 1996 Tax Ct. Memo LEXIS 299, at *3 (1996) (indicating that they incorporated the firm of Cartwright, Saroyan, Martin & Sucherman, Inc. (CSB), as a professional corporation under California law).

119. *Cartwright*, 183 F.3d at 1036.

120. *Id.*

121. *Id.*

122. *Id.*

wright's stock and none of the payment as non-employee compensation.[123] The IRS disagreed with the estate and determined that the $4,080,256 was compensation and that the estate owed $1,142,472 for its tax deficiency.[124] Consistent with CSB's treatment, the IRS treated the additional approximately one million dollars as the redemption amount.

The first issue the court addressed was whether the payment to Mr. Cartwright's estate was made solely for redemption of the stock or whether it was in part for Mr. Cartwright's stock and in part for his claim for compensation due.[125] Mr. Cartwright's estate contended that the full $5 million should be treated as paid in exchange for the redemption of the decedent's stock.[126] In affirming the Tax Court, the Ninth Circuit concluded that approximately one million dollars of the insurance proceeds constituted payment for Cartwright's stock and approximately four million dollars constituted compensation for services.[127] Under the Ninth Circuit's holding, approximately four-fifths of the payment constituted a liability of the company that related to compensation for services rendered before the decedent shareholder's death.

The court next addressed whether the five million dollars of insurance proceeds should have been included as an asset of CSB for purposes of valuing CSB stock held by Mr. Cartwright's estate under section 2031.[128] Affirming the Tax Court again and quoting the regulations under section 2031, the Ninth Circuit agreed that the Tax Court appropriately excluded *all* of the life insurance proceeds in valuing stock.[129] The court indicated that consideration must be given to non-operating assets including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such non-operating assets have not been

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123. *Id.*
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.* at 1036-38.
128. *Id.* at 1037-38.
129. *Id.* at 1038. Treas. Reg. § 20.2031-2(f)(2) provides that the fair market value of shares of stock should be determined by considering the company's net worth, prospective earning power and dividend-paying capacity, and other relative factors. The regulation states that:

> Some of the "other relevant factors" . . . are: The goodwill 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 of each case. *In addition to the relevant factors described above, consideration shall also be given to non-operating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such non-operating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.* Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

Treas. Reg. § 20.2031-2(f)(2) (emphasis added).

taken into account in determining net worth.[130] The court reasoned that the proceeds received by CSB from the insurance policy would not necessarily affect what a willing buyer would pay for CSB's stock because the insurance proceeds were offset dollar-for-dollar by CSB's obligation to pay out the entirety of policy benefits to Cartwright's estate.[131] Thus, the Court classified the insurance proceeds as being the kind of ordinary non-operating asset that should not be included in the value of CSB under the Treasury Regulations. Neither the Tax Court nor the Ninth Circuit Court of Appeals made any distinction between the approximately four million dollar payment related to compensation and the approximately one million dollars remitted to the estate in redemption of the decedent's shares. By excluding all of the insurance proceeds from the value of CSB, no distinction was made between the four million dollar obligation for services provided by the decedent prior to death and the one million dollar obligation to redeem the decedent's shares. Further, by failing to make any distinction between the two obligations, the holding in *Cartwright* allowed the estate to value its shares of CSB without proportionately increasing the value of the decedent's shares by a ratable portion of the one million dollars of insurance proceeds paid to the estate in the redemption.

On October 31, 2005, the Eleventh Circuit addressed a similar issue in *Estate of Blount v. Commissioner*.[132] In *Estate of Blount*, the decedent, Mr. Blount, was one of two shareholders of Blount Construction Company ("BCC"), a corporation formed in the state of Georgia.[133] The two shareholders, Mr. Blount and Mr. Jennings entered into a stock redemption agreement that required BCC to purchase the stock on the death of the holder at a price agreed upon by the parties.[134] In the early 1990s, BCC purchased insurance policies providing roughly three million dollars in order to fulfill its commitments to purchase the shareholders' stock under the redemption agreement.[135]

In 1996, Mr. Blount was diagnosed with cancer, and his doctor predicted that he had only a few months to live.[136] When Blount died in 1997, he owned roughly 83% of BCC, a clear majority interest.[137] In accordance with the redemption agreement, BCC paid Mr. Blount's estate four million dollars.[138] Mr. Blount's estate reported the value of the shares at four million dollars.[139] However, the IRS determined that the

130. *Cartwright*, 183 F.3d at 1038 (citing Treas. Reg. § 20.2031-2(f)(2)).
131. *Id.* at 1038.
132. 428 F.3d at 1339.
133. *Id.* at 1340.
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.* at 1341.
138. *Id.*
139. *Id.*

value of the stock was $7,921,975 and that the taxpayer had undervalued the stock by approximately four million dollars.[140]

Based upon expert testimony, the Tax Court concluded that the value of the company was approximately $6.75 million.[141] The Tax Court then added the insurance proceeds of $3.1 million to the value of the company to arrive at $9.85 million as the fair market value of the stock.[142] On review, the Eleventh Circuit concluded that the $6.75 million valuation for BCC was not erroneous.[143] However, the court of Appeals found that the inclusion by the Tax Court of the additional $3.1 million in insurance proceeds was in error.[144]

In declining to include the insurance proceeds in the value of BCC, the Eleventh Circuit agreed with the reasoning in *Cartwright* finding it to be "persuasive and consistent with common business sense."[145] Like the *Cartwright* court, the *Blount* court quoted regulations under section 2031 stating that in valuing the corporate stock, "consideration shall also be given to non-operating assets, including insurance proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such non-operating assets have not been taken into account in the determination of net worth."[146] Focusing on the last clause of the quoted section of the regulation, the court concluded that the language limiting inclusion to the extent that such assets have not been taken into account in determining net worth precludes inclusion of the value of the insurance proceeds received by BCC.[147] The court reasoned that insurance proceeds are not the kind of ordinary non-operating asset that should be included in the value of the corporation.[148] Further, to the extent the insurance proceeds are required to be used to redeem the decedent shareholder's interest in the corporation, the proceeds are offset dollar-for-dollar by the corporation's obligation to purchase decedent's stock under the redemption agreement.[149]

In a footnote, the court indicated that the Commissioner argued that this interpretation frustrates the clear intent of Congress to include corporate owned life insurance in the estate of its sole shareholder.[150] However, in the same footnote, the court stated that "the legislative history relied upon by the Commissioner indicate[s] only that Congress believed

140. *Id.*
141. *Id.* at 1342.
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.* at 1345.
146. *Id.*
147. *Id.* (citing *Estate of Cartwright*, 183 F.3d at 1038; Huntsman v. Comm'r, 66 T.C. 861, 875 (1976)).
148. *Id.* at 1346.
149. *Id.*
150. *Id.* at 1345 n.6.

that a sole shareholder was deemed to have the incidents of ownership possessed by his corporation on insurance policies on his life."[151] The footnote goes on to briefly interpret Congressional intent:

> [T]he [R]egulations now provide that the incidents of ownership held by a corporation are not to be attributed to its shareholder, and no indication is included in the committee reports that Congress intended property owned by a decedent to be includable in his gross estate at other than its fair market value.[152]

The court further supported this questionable conclusion by indicating that "[t]o suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value."[153]

iii. Applying the Case Doctrine Produces a Different Outcome than Application of the Code and Regulations

(a) Under the Cases

The opinions of the Ninth and Eleventh Circuits in *Cartwright* and *Blount* each addressed valuation of corporate stock within a decedent shareholder's estate in connection with a corporate redemption agreement. In both cases, the corporation in question owned a life insurance policy insuring the life of the majority shareholder, and the corporation received the insurance proceeds upon the majority shareholder's death. Both opinions focused upon determining stock value for purposes of including such value in the decedent shareholder's gross estate for purposes of section 2031. Each opinion concluded that the insurance proceeds received by the company should not affect the value of the stock in the decedent's estate. Each court reasoned that the insurance proceeds were to be offset dollar-for-dollar against an existing obligation of each corporation.

However, there is at least one factual distinction between the two cases. In *Blount*, all of the amounts received by the decedent shareholder's estate were in return for the stock redeemed by the corporation.[154] In *Cartwright*, however, only approximately one-fifth of the amounts received by the decedent shareholder's estate were received in return for the decedent shareholder's stock.[155] The remaining four-fifths of the amounts received were for services provided by the decedent shareholder prior to his death. The large majority of the amounts re-

151. *Id.*
152. *Id.*
153. *Id.* at 1346.
154. *See id.* at 1339-41.
155. *Estate of Cartwright*, 183 F.3d at 1036, 1038.

ceived by the decedent shareholder's estate represented an accrued compensation liability of the corporation not associated in any way with the obligation of the corporation to redeem the decedent shareholder's stock.

Due to the perceived dollar-for-dollar offset of these liabilities, each of the opinions results in the exclusion of insurance proceeds in valuing the corporate stock. Without an increase in the value of the stock related to the corporation's receipt of insurance proceeds, the estates of the two decedent majority shareholders effectively were allowed to exclude the value of any portion of the insurance proceeds in their respective estates. This outcome stands regardless of the fact that in each case, the majority shareholder actually had control over his respective corporation and, therefore, control over all of the incidents of ownership of the policies held by the corporations.

(b) Under the Regulations

Application of current regulations under sections 2042 and 2031 to the facts in each of these cases results in a different outcome than arrived at by the *Blount* and *Cartwright* courts. Because CSB and BCC received the proceeds of the life insurance policies on Cartwright and Blount respectively, the regulations specifically indicate that neither shareholder is attributed corporate incidents of ownership.[156] Therefore, neither of the decedent shareholders' estates would be attributed incidents of ownership, nor would either estate be required to include the insurance proceeds in gross estate under section 2042.

However, in determining the value of the stock under section 2031, Regulations section 20.2031-2(f) requires that consideration be given to non-operating assets, including proceeds of life insurance policies payable to or for the benefit of the company.[157] Contrary to the interpretations of the Circuit Courts of Appeal in *Cartwright* and *Blount,* the intent of this rule is to reflect the insurance proceeds received by the corporation as an asset that proportionately increases the value of the deceased shareholder's stock. The decedent shareholder's stock value for purposes of calculating gross estate must increase proportionate to the value of the insurance proceeds received by the company.

This conclusion is supported by the language in section 2042 and Regulations section 20.2042-1(c)(6). As previously discussed, section 2042 requires a decedent's estate to include all "amount[s] receivable by all other beneficiaries," under a policy on the life an insured shareholder with respect to which the shareholder possessed incidents of ownership.[158] Given that the definition of incidents of ownership is broad and includes "any" incidents of ownership, Congress must have intended that

156. Treas. Reg. § 20.2042-1(c)(6).
157. Treas. Reg. § 20.2031-2(f)
158. I.R.C. § 2042(2).

incidents of ownership be attributed to a majority shareholder of a corporation that owns a life insurance policy in the shareholder's life.[159] It is unlikely that Congress intended that a decedent majority shareholder be allowed to escape inclusion in his or her estate of life insurance proceeds received by his or her controlled corporation.

While the regulations under section 2042 clearly provide an exception to the inclusion of the proceeds *where the corporation receives the proceeds*, the regulations nevertheless attempt to further Congress' clear intent by requiring inclusion of a ratable portion of the proceeds in a decedent shareholder's gross estate as follows:

> In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation . . . . ***See § 20.2031-2(f) for a rule providing that the insurance proceeds of certain life insurance policies shall be considered in determining the value of decedent's stock.***[160]

The first sentence is the exception to the general rule of inclusion that prevents corporate incidents from being attributed to a sole or majority shareholder where the policy proceeds are payable to the corporation. If the goal of section 2042 is to include the proceeds in a decedent's estate where a decedent has incidents of ownership, why are the incidents of ownership in the case of a majority shareholder specifically not attributed under the above regulation? The answer lies in the third sentence in the above quoted portion of the regulation. The third sentence, highlighted in italics and bold, refers to regulations under subsection 20.2031-2(f), which is specifically discussed by both the *Cartwright* and *Blount* courts. This regulation provides factors and guidelines for valuing stock that is not publicly traded, like the stock of CSB and BCC.[161] Under this regulation, consideration must be given to non-operating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such non-operating assets have not been taken into account in the determination of net worth.[162] Read in conjunction with the first sentence of the above quoted language, section 20.2042-1(c)(6) is attempting to require inclusion of a ratable portion of the proceeds in the decedent majority shareholder's estate via a perceived increase in the value of the stock upon the corporation's receipt of the proceeds.

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159. *See* Treas. Reg. § 20.2042-1(c)(2).
160. Treas. Reg. § 20.2042-1(c)(6) (emphasis added).
161. Treas. Reg. § 20.2031-2(f).
162. *Id.*

The Treasury's statements in 1974 in the preamble to the amendments to regulations under sections 2031 and 2042 support this reading of the regulation.[163] In 1974, Treasury Decision 7312 was published amending the regulations under section 2042 to add, among other things, the current version of Regulation section 20.2042-1(c)(6) and to specifically amend paragraph (f) of Regulation section 20.2031-2.[164] The preamble to the 1974 amendments provides the following explanation:

> Under section 2042 of the Code, if a decedent died possessed of any incidents of ownership in a life insurance policy on his life, the entire proceeds of the policy will be included in his gross estate for estate tax purposes. The term "incidents of ownership" is described in § 20.2042-1(c)(2) as including "a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder."[165]
>
> A problem was presented in Revenue Ruling 71-463, 1971-2 C.B. 333, which ruling was later withdrawn by Revenue Ruling 72-167, 1972-1 C.B. 307, as to whether a controlling stockholder should be treated as a "sole stockholder" for purposes of section 2042. The position taken in the proposed rules is that a controlling stockholder should be so treated. ***However, where a corporation is the beneficiary of any portion of the proceeds of a life insurance policy, there is no need for that portion to be included in the gross estate under 2042 because it directly affects the value of the stock that is included in the decedent's gross estate.***
>
> Accordingly, §20.2042-1(c) is amended by this document to provide that, with respect to proceeds of corporate-owned life insurance which are payable to either the corporation or a third party for a valid business purpose, incidents of ownership held by the corporation will not be attributed to the decedent through his stock ownership.[166]

Thus, where the corporation is the beneficiary of any portion of the policy proceeds, there is no need for that portion to be included in the gross estate under section 2042 or the regulations thereunder because it directly affects the value of the stock that is included in the decedent's gross estate under the section 2031 Regulations.[167] The intent of the 1974 change in the regulations was to remove the insurance proceeds from section 2042's inclusion requirement because the proceeds directly increase the value of the stock that is included in the decedent's gross estate under section 2031.[168] Without the exclusionary provision in the section 2042 regulations, the insurance proceeds would conceivably be included in a decedent shareholder's estate twice. The insurance pro-

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163. *See* T.D. 7312, 1974-1 C.B. 277, 1974 IRB LEXIS 835, *1-4 (1974).
164. *Id.* at *5-10.
165. *Id.* at *2.
166. *Id.* (emphasis added).
167. *Id.* at *1-2.
168. *Id.*

ceeds would be included once via section 2042 due to the fact that the shareholder actually has incidents of ownership in the policies held by the corporation. The insurance proceeds would be included a second time under section 2031 due to the increase in the value of the shares held by the decedent shareholder's estate when the insurance proceeds are paid to the corporation. In an effort to prevent double inclusion in the decedent shareholder's estate of the value of the proceeds received by the corporation, the insurance proceeds included under section 2042 are removed by an amendment to the regulations leaving a single proportionate inclusion under section 2031 when valuing the stock held by the decedent shareholder at the time of his or her death.[169]

Without discussing the intent of section 2042 and the regulations thereunder, the opinions of the Ninth and Eleventh Circuits seem incomplete. A more complete analysis may have first acknowledged that each court, in effect, included the insurance proceeds in valuing the stock of each corporation but then removed the value of the insurance proceeds by offsetting the proceeds dollar-for-dollar against the perceived obligations to the decedent shareholder's estates. In short, by removing the value of the insurance proceeds from the value of the stock, the insurance proceeds have been completely excluded from the decedent majority shareholder's estate, notwithstanding that the decedent had incidents of ownership over the policy. Without a discussion of the regulatory exclusion of insurance proceeds and the history behind the exception, the explanation as to why the value of the insurance proceeds was offset dollar-for-dollar by each corporation's obligation to the decedent's shareholder's estate is at best incomplete and in both instances possibly inaccurate.

(c) The Analysis of the *Blount* and *Cartwright* Courts is Incorrect from an Accounting and Financial Perspective

In addition to incorrectly applying the Code and regulations to the circumstances in *Blount* and *Cartwright*, the conclusion reached by each of the courts that the obligation of BCC and CSB to redeem the shareholder should be offset dollar-for-dollar against the insurance proceeds is incorrect from an accounting and financial perspective. While a third party might value a target corporation by treating a redemption obligation as a liability, it is not at all appropriate for a shareholder to reduce the value of the company by the value of his or her shares.

The *Blount* court summarized its position when it stated that "[t]o suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity

169. Treas. Reg. §§ 20.2042-1(c)(6), 20.2031-2(f); *see also* T.D. 7312, 1974-1 C.B. 277, 1974 IRB LEXIS 835, *2-3 (1974).

and defies any sensible construct of fair market value."[170] While it may be logical from an unrelated third-party purchaser's perspective to include the liability associated with a redemption agreement in its purchase price analysis, neither the *Cartwright* court nor the *Blount* court compared a redeemed shareholder's perspective to a third-party purchaser's perspective. However, the Tax Court's opinion in *Blount* (later reversed by the Eleventh Circuit) did contain specific and persuasive analysis regarding the effect of a redemption obligation on insurance proceeds received by a corporation.[171] In the Tax Court, Mr. Blount's estate argued that the court should treat BCC's enforceable $4 million dollar redemption obligation as a corporate liability in determining the value of the decedent shareholder's shares.[172] In making this argument, the estate recognized the liability would operate to offset the value of the insurance proceeds received by the corporation. By lowering the value of the company, the proportionate value of the decedent's stock would also be reduced. In declining to allow the offset, the Tax Court reasoned that the redemption obligation should not be treated as a value depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued.[173] The Tax Court's holding would have resulted in a proportionate increase in the value of Mr. Blount's stock that would have increased Mr. Blount's gross estate for estate tax purposes.

In addressing the estate's argument, the Tax Court noted the distinction between a third-party purchase of the shares and the corporation's redemption of its shares from a shareholder and provided the following:

> A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $ 1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $ 500,000. If, at B's death, X's $ 500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $ 500,000 ($ 1 million cash less a $ 500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $ 250,000 (i.e., one half of the corporation's $ 500,000 value) upon B's death. Yet if B's shares are then redeemed for $ 500,000, A's shares are then worth $

170. *Estate of Blount*, 428 F.3d at 1346.

171. Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, 2004 Tax. Ct. Memo LEXIS 117, *78–86 (2004), *aff'd in part and rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).

172. *Id.* at *78.

173. *Id.* at *80.

> 500,000—that is, A's 50 shares constitute 100-percent ownership of a corporation with $ 500,000 in cash.[174]

The Tax Court then pointed out that it could not be correct that B's one half interest in one million dollars in cash was only worth $250,000, nor could it be correct that A's one half interest in the remainder shifted from a value of $250,000 pre-redemption to a value of $500,000 post-redemption.[175] Further, the error in relation to the valuation of B's shares in the example was the recognition of the corporation's redemption obligation as a claim on the corporate assets when valuing the same shares that would be redeemed with those assets.[176] By contrast, a hypothetical third-party buyer of A's shares would pay $500,000 for A's shares whether the redemption obligation existed or not.[177] This is because a third-party purchaser would take account of both the liability arising from the redemption obligation and the shift in the proportionate interest of A's shares as a result of the redemption.[178]

Treating the corporation's obligation to redeem a shareholder (or a shareholder's estate) as a liability in valuing the company for purpose of redemption would result in valuing the corporation in its post redemption configuration.[179] There is an important distinction between valuing stock to be redeemed from a shareholder and valuing stock prior to a purchase by a third party. With respect to valuing stock to be redeemed, the shareholder (or shareholder's estate) will always seek to receive his or her ratable share of the value of the company *previous* to the redemption.[180] Whereas, a third unrelated party would analyze the purchase of the stock held by the remaining shareholders based upon the value of the shares that remain *after* the redemption takes place.

So, why is it that the Tax Court decided in *Cartwright* that CSB's obligation to the decedent shareholder should offset the insurance proceeds received by the corporation while the Tax Court's decision in *Blount* denied a similar offset? That too was logically explained by the

174. *Id.* at *81-82 (footnotes omitted).
175. *Id.* at *82.
176. *Id.* at *82-83.
177. *Id.* at *83 n.36.
178. *Id.* at *83.
179. *Id.* at *79-80.
180. *See id.* at *80-83. In a more extreme example, it would make no sense that a 99% shareholder would base the value of his or her redemption on post-redemption value of 1%. On the other hand, a hypothetical third party willing buyer looking to purchase all of the stock of BCC prior to redeeming the decedent shareholder's estate would correctly consider the corporation's liability in determining the value of the shares. This is so because the obligation to redeem the decedent shareholder's estate would continue after the third party purchaser's acquisition of the stock. Such a hypothetical purchaser's stock value in BCC would decrease proportionately when the redemption occurred. Using the same example, where a third party seeks to purchase a company that is obliged to redeem a 99% shareholder. It would make no sense for the third-party acquirer to pay more than 1% of the pre-redemption value of the company. A third-party buyer will seek to value what he or she will have at the moment *after* purchase. Whereas, a shareholder that is to be redeemed will seek to value what he or she has a moment *before* the purchase.

Tax Court in its decision in *Blount*. As previously indicated, four-fifths of the liability in *Cartwright* was related to personal services provided by Mr. Cartwright to CSB before his death. This four-fifths portion of the liability was not a corporate obligation to redeem its stock.[181] Rather, it was a liability for services performed—not meaningfully different from any other liability of the corporation that would be netted against assets to ascertain the net value of the company.[182] Upon finding that approximately four-fifths of the obligation in *Cartwright* was not a redemption, the Tax Court concluded that the whole liability in Cartwright should be offset dollar-for-dollar against the insurance proceeds. Whereas, the Tax Court properly found that the obligation in *Blount* was a redemption, as opposed to an ordinary liability, which should not be an offsetting liability against the insurance proceeds.[183]

While this analysis explains why four-fifths of the liability in *Cartwright* should be a liability that is offset against the assets of the company (including any insurance proceeds received), the Tax Court failed to completely clear the air in relation to the remaining one-fifth of the liability related solely to redemption of Mr. Cartwright's shares held by his estate. The remaining one-fifth of the liability in *Cartwright* is indistinguishable from the whole liability in *Blount*. Recognizing this, the Tax Court conceded in its decision in *Blount* that the remaining one-fifth portion of the liability in *Cartwright* constituted an obligation to redeem stock.[184] Thus, it might have been appropriate for the Tax Court to have also conceded that the remaining one-fifth of the liability in *Cartwright* should not have been an obligation that was recognized in valuing the corporation.

iv. Summary: Incidents of Ownership Held by Corporations

Based upon the above analysis, it is clear that the manner in which the Treasury and the Tax Court value a decedent's ownership equity interest in a corporation are at odds with the manner in which the *Cartwright* and *Blount* courts have interpreted the Code and relevant Regulations. The Code generally requires a decedent to include in his or her gross estate the value of policy proceeds payable upon the decedent's death to the extent that the decedent held incidents of ownership in the insurance policy. However, the regulations allow a decedent majority shareholder's estate to exclude the value of insurance proceeds received by the decedent's wholly or majority owned corporation notwithstanding

181. *Id.* at *84.
182. *Id.*
183. *See id.* at *85-86; *see also* Huntsman v. Comm'r, 66 T.C. 861, 874 (1976) (indicating that insurance proceeds are treated like any other nonoperating asset when determining a closely held corporation's value); *Estate of Blount*, 2004 Tax Ct. Memo LEXIS 117, at *77.
184. *Estate of Blount*, 2004 Tax Ct. Memo LEXIS 117, at *84-85.

that the decedent could have exercised actual control over the insurance policy. The exclusionary exception provided by the regulations was designed to prevent double inclusion of the value of the insurance policies in the decedent's estate. By allowing an exclusion *where the corporation receives the policy proceeds*, the regulations contemplate inclusion of a single ratable share of the insurance proceeds via an increase in the decedent's stock interest. Thus, in order to include the value of the decedent's interest in the corporation, the value of the insurance proceeds must at least be included in the value of the company one time.

However, the Ninth Circuit's and the Eleventh Circuit's decisions in *Cartwright* and *Blount* thwart the above analysis. The *Cartwright* and *Blount* decisions require a dollar-for-dollar offset of the insurance proceeds received by a corporation against the corporation's obligation to redeem the decedent shareholder. This dollar-for-dollar offset reduces the overall value of the corporation when valuing the deceased shareholders shares. The effect of these holdings is to allow decedent sole or majority shareholders to avoid including a ratable share of the value of the insurance proceeds received by the corporation notwithstanding that such a shareholder may exercise actual control over the insurance policy held by the corporation. This outcome is contrary to the Code's overall requirement that such proceeds must be included in gross estate where the decedent has incidents of ownership in the policy. The outcome is also contrary to the goal of the regulations to include at least a ratable share of the proceeds in a deceased shareholder's estate.

b. Incidents of Ownership Held by Partnerships and LLCs

The above described inconsistency between the *Blount* and *Cartwright* opinions and the regulations under sections 2031 and 2042 also affects the valuation of a deceased partner or member's equity interest in a partnership or LLC where a redemption agreement is in place. In general, partnerships may be treated both as an "entity" for federal income tax purposes and, under other circumstances, partnerships may be considered as an "aggregate" of individuals each treated as directly owning an interest in the partnership assets and operations.[185]

If a partnership or LLC is considered as an entity separate from its partners or members under the entity theory of partnership taxation, the partnership itself, instead of the partners individually, would have all the incidents of ownership.[186] For purposes of the following discussion, it will be assumed that an LLC is treated as a "partnership" for federal income tax purposes and that the members of an LLC are "partners" for purposes of analysis. In relation to valuation for purposes of estate taxation of a deceased partner's interest in a partnership, the entity theory of

185. *See* MCKEE ET AL., *supra* note 31, ¶ 1.02[1].

186. *Id.*; *see also* I.R.C. § 701; MCKEE ET AL., *supra* note 31, ¶ 1.02[2].

partnership taxation would appear to be analogous to the manner in which the shareholders of a corporation would be taxed, as previously discussed. Except in certain rare circumstances, subchapter K of the Code generally imposes tax on the individual partners rather than the partnership.[187]

A different outcome might be obtained under the aggregate theory of ownership. If a general partnership owns an insurance policy, incidents of ownership appear to be attributed to an aggregate of the general partners and, therefore, to each one individually.[188] This rule would attribute to each general partner without regard to the percentage of ownership in the partnership, incidents of ownership in policies of insurance held by the partnership on a partner's life. Under the aggregate theory, several minority general partners might each be treated as having incidents of ownership in an insurance policy. Thus, where a minority corporate shareholder is clearly not attributed incidents of ownership in an insurance policy held by the corporation, it is unclear whether a minority general partner should be attributed incidents of ownership. Further questions arise in relation to treatment of limited partners and members of an LLC.

i. Where Proceeds are Payable to Partnership or LLC

Under the aggregate and entity theories of partnership taxation, the question arises as to whether partners of a partnership or members of an LLC should be attributed incidents of ownership in a policy owned by the entity. Cases and administrative rulings have addressed this issue without complete agreement on the treatment of incidents of ownership in the partnership setting. Arguably, at least one similarity exists in the treatment of incidents of ownership in the corporate and partnership settings. If the proceeds of an insurance policy on the life of a deceased partner are payable to or for the benefit of the partnership, then such proceeds should not be included in the gross estate under section 2042.[189] Of course, this similarity immediately calls into question whether the *Blount* and *Cartwright* opinions impact valuation of a decedent partner's equity interest where a redemption agreement is in place between the decedent and the partnership. Beyond this similarity, several inconsistencies arise in the treatment of corporate shareholders as compared to partners.

In 1955, the Tax Court analyzed and discussed incidents of ownership in an insurance policy held by a general partnership in *Estate of*

187. *See* I.R.C. §§ 701-777.

188. Rev. Rul. 83-147, 1983-2 C.B. 158.

189. *See id.*; *see also* I.R.S. Gen. Couns. Mem. 39,034 (Sept. 21, 1983); *see also* ZARITSKY, *supra* note 43, ¶ 8.02[4][b] (indicating that the IRS has not indicated formally whether it will apply this rule when the insured is only a limited partner).

Knipp v. Commissioner.[190] In *Knipp*, the taxpayer was the estate of a deceased partner, Mr. Knipp.[191] At the time of his death on November 21, 1947, Mr. Knipp had eleven insurance policies outstanding on his life, ten of which were assigned to the partnership prior to his death.[192] The partnership owned the policies and Mr. Knipp had no right to change the beneficiary designation on the policies.[193] The value of each of the policies was entered on the books of the partnership as an asset and, thereafter, the partnership pledged the policies as collateral for loans.[194] "The partnership paid the premiums on the policies . . . [and] [t]he increase of cash surrender value of the policies each year was considered income of the partnership."[195]

The Commissioner argued that all of the proceeds of the insurance policy paid to the partnership should be directly included in Mr. Knipp's gross estate under section 2042 because, as general partner, Mr. Knipp possessed incidents of ownership in the policies at the time of his death.[196] The court disagreed, finding that because Mr. Knipp's interest in the partnership never exceeded fifty percent (50%), the premium payments were made by the partnership, the insurance proceeds were payable to the partnership, and the policies were assets of the partnership.[197] In support of its conclusion, the court found that the partnership had complete control over the policies and the decedent had no rights in the policies other than those flowing from his partnership interest.[198] The Commissioner conceded that the insurance policy was an asset of the partnership and that Mr. Knipp had no rights in the policies other than those flowing from his partnership interest.[199] Based upon its finding that the partnership controlled the policies, the court also found that the partnership held all incidents of ownership in the policies.[200] The court held that the partnership's incidents of ownership in the policies insuring the life of the decedent were not attributed to the decedent, and the insurance proceeds were not includible in the decedent's gross estate.[201] The aggregate and entity theories of partnership taxation were not explicitly applied for purposes of attributing incidents of ownership in an insurance policy owned by the partnership to either the entity or the partners as a group. However, the outcome of *Knipp* would appear to be more consis-

190. 25 T.C. 153, 154 (1955), *acq.*, 1956-2 C.B. 6, *nonacq.*, 156-2 C.B. 10, *aff'd on other grounds*, 244 F.2d 436 (4th Cir. 1957).
191. *See Knipp*, 25 T.C. at 154.
192. *Id.* at 157.
193. *See id.* at 168-69.
194. *Id.* at 157.
195. *Id.*
196. *Id.* at 166.
197. *See id.* at 167-68.
198. *See id.* at 167-69.
199. *Id.* at 168.
200. *Id.* at 167.
201. *Id.* at 169.

tent with the application of an entity theory of partnership taxation where incidents of ownership are concerned. Further, this outcome comports with the manner in which corporations and their shareholders are taxed in relation to the proceeds of an insurance policy on the life of a shareholder.

Like a majority shareholder in a corporation, the court's holding that Mr. Knipp was not attributed incidents of ownership for purposes of section 2042 allowed Mr. Knipp's estate to exclude the proceeds in calculating his gross estate. But the holding in *Knipp* does not allow the taxpayer's estate to completely escape estate taxation of the insurance proceeds. Under the circumstances in *Knipp*, the value of the decedent's partnership units would appear to increase proportionately due to the partnership's receipt of the insurance proceeds.[202] Thus, the holding in *Knipp* accords the same treatment to a 50% general partner as the regulations accord to a majority shareholder in a corporation.

Unfortunately, however, the holding in *Knipp* did not fully resolve the question of attribution of partnership incidents of ownership in an insurance policy owned by a partnership. In General Counsel Memorandum 39034 (the "Memorandum"), the IRS analyzed the facts of proposed Revenue Ruling 83-147 and provided a detailed comparison of the treatment of incidents of ownership between partnerships and corporations.[203] The Memorandum addressed the facts of the proposed rules whereby C, D, and E are equal minority general partners of the XYZ partnership. The XYZ partnership obtained a life insurance policy on the life of D and designated D's child A as the beneficiary.[204] Thereafter, the premium payments were made by the XYZ partnership.[205] The issue for consideration in the proposed ruling was whether a partner possesses incidents of ownership as an insured in a life insurance policy held by the partnership, where the proceeds are payable *not to the partnership but, rather, to a third unrelated party.*[206]

The IRS first reasoned in the Memorandum that although the facts involve partnership-owned life insurance, the treatment of corporate-owned life insurance is relevant.[207] Further, the IRS noted that "[p]artnership-owned life insurance 'could' be given treatment analogous

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202. *See* I.R.C. § 2031(a).

203. *See* I.R.S. Gen. Couns. Mem. 39,034 (Sept. 21, 1983). By way of a memorandum, dated December 22, 1981, the Director of the Individual Tax Division of the requested that Chief Counsel consider two proposed revenue rulings, 83-147 and 83-148, referred to in the G.C.M. as Proposed Ruling A and Proposed Ruling B, respectively. *Id.* Ultimately, Proposed Ruling A was published as Revenue Ruling 83-147. *Compare* I.R.S. Gen. Couns. Mem. 39, 034 (Sept. 21, 1983), *with* Rev. Rul. 83-147, 1983-2 C.B. 158.

204. I.R.S. Gen. Couns. Mem. 39,034, at *2.

205. *Id.*

206. *Id.* at *1.

207. *Id.* at *4.

to corporate-owned life insurance."[208] The Memorandum again points out that a corporation's incidents of ownership are not attributed to a "controlling" shareholder where the proceeds are payable to the corporation.[209] The Service reasoned that this prevents the proceeds from being considered both as a factor in valuation of the decedent's stock and as a separate asset in the decedent's gross estate.[210] The IRS noted that this outcome was specifically intended by the drafters of Regulation section 20.2042-1(c)(6).[211] Citing *Knipp,* the IRS indicated that it acquiesced in and agreed with the holding in *Knipp* only where the insurance proceeds were payable to the partnership and where inclusion of the insurance proceeds would result in double inclusion of a substantial portion of the proceeds.

Based upon this reasoning, the Service indicated that it agreed with the conclusion in the proposed ruling that where:

> a partnership owns a life insurance policy on a partner's life and the proceeds are payable *other than to or for the benefit of the partnership,* [an] insured partner possesses incidents of ownership in the policy in conjunction with the other partners, that require direct inclusion of [all] the proceeds in the insured partner's gross estate under section 2042(2).[212]

In this regard, the Service noted that the proposed ruling treats "a partnership as an aggregate of the individual partners . . . where the insurance proceeds" are not payable to the partnership.[213] As such, the insurance proceeds are all directly includible in the decedent shareholder's gross estate under section 2042(2).

For purposes of section 2042(2), the Memorandum indicates that a partnership is treated "as an aggregate of individual partners."[214] Further, the Memorandum notes that "incidents of ownership will not be attributed to partners where the insurance proceeds are payable to or for the benefit of the partnership."[215] Under these circumstances, attribution of the partnership's incidents of ownership to the insured partner "would result in double taxation of the . . . proceeds."[216] The Service then stated that its position was to avoid such double inclusion by not including proceeds payable to the partnership directly in the decedent's estate under

208. *Id.* at *6 (citing Treas. Reg. § 20.2042-1(c)(6) (as amended in 1974)).
209. *See id.* at *5-6.
210. *Id.* at *7-8.
211. *Id.* at *5 (citing Memorandum from Commissioner on Amendment of Estate Tax Regulations (Feb. 28, 1974), 1974 TM LEXIS 84, *1-3).
212. *Id.* at *1-2 (emphasis added).
213. *See id.* at *7.
214. *Id.*
215. *Id.*
216. *Id.* at *7-8.

section 2042(2).[217] Although not specifically stated in the Service's reasoning, this conclusion would appear to indicate that where the proceeds are payable to the partnership, the partnership will be treated as an entity for federal tax purposes.

Post *Cartwright* and *Blount*, based upon *Knipp* and the Service's acquiescence to *Knipp* in the Memorandum, the same concern arises in the area of partnerships that exists in the corporate arena only to a much greater degree. The rulings in *Cartwright* and *Blount* allow insurance proceeds received by a corporation to be offset against a perceived obligation on the part of the corporation to redeem an equity interest from the decedent corporate equity holder. There would appear to be no logical reason why the Ninth and Eleventh Circuits, or any court following the decisions in *Cartwright* and *Blount*, would not apply the same reasoning to a redemption by a partnership or LLC of a decedent partner's or member's interest.

It is true that the *Cartwright* and *Blount* courts each based their holdings on regulations under sections 20.2031-2 which specifically relate to valuation of stocks of a corporation.[218] However, regulations under section 20.2031-3 address the valuation of interests in businesses and require taxpayers to determine the fair market value of a partnership in a manner consistent with the valuation of a corporation. Indeed, the net value of a partnership is determined on the basis of all relevant factors including, among other things, the factors set forth in paragraph (f) of Regulation section 20.2031-2 relating to the valuation of corporate stock.[219]

Thus, it would appear that the holding in *Blount* would equally apply to a partnership redemption causing a dollar-for-dollar offset of insurance proceeds received by a partnership or LLC on a policy insuring the life of a partner or member against the liability of the partnership or LLC to redeem a partner or member under a redemption agreement.

ii. Inconsistent Treatment of Minority Partners and Members of LLCs Where Insurance Proceeds Payable Outside the Partnership or LLC

Importantly, however, the Service went on in the Memorandum to make a distinction between a controlling shareholder and a partner under the circumstances of the proposed ruling. The Memorandum indicates that the proposed ruling takes a different approach than the regulations as they apply to corporations where the proceeds are payable outside the

217. *Id.* at *8.
218. *See* Treas. Reg. § 20.2031-2 (as amended in 1976).
219. *See* Treas. Reg. § 20.2031-3(c) (as amended in 1992); *see also id.* § 20.2031-2(f) (as amended in 1976).

partnership.[220] As previously discussed, the regulations under section 2042 provide that if a decedent corporate shareholder owns only a *minority* interest in a corporation, no incidents of ownership held by the corporation are attributable to the decedent shareholder and no proceeds are directly included in the decedent shareholder's estate.[221] However, unlike the case of a minority corporate shareholder, the Memorandum does not apply the same rule allowing the insurance proceeds to escape estate taxation where decedent is a minority general or limited partner or a minority member of an LLC.[222]

In addressing whether incidents of ownership in the policies would be attributed to the minority general partner, the Service conceded that partnership-owned life insurance could be given treatment analogous to corporate-owned life insurance in accordance with the regulations.[223] However, if treated the same as a shareholder-corporation arrangement, a partnership's incidents of ownership would only be attributed to a *majority* partner where the policy proceeds were payable to a third party. Whereas a *minority* partner, in theory, would not be attributed incidents of ownership.

However, the Memorandum indicates that a general partner insured under a policy held by a general partnership possesses incidents of ownership that are exercisable in conjunction with other general partners.[224] This broad statement attributes incidents of ownership in an insurance policy held by the partnership to any general partner regardless of the fact that such general partner is a majority or minority interest holder in the partnership. Such a conclusion would appear to be at odds with the Tax Court's holding in *Knipp*. Thus, the IRS appears to have taken a different approach in the Memorandum based upon the premise that "a partnership is generally regarded as an aggregate of its individual partners."[225] The Memorandum states that "[a]ny incidents of ownership in a life insurance policy held by the partnership are [in reality] held by the partners as individuals."[226] Based upon this reasoning, any policy proceeds payable to a third party are includible in the insured partner's gross estate under section 20.2042(2) regardless of whether the partner is a minority or majority owner of the partnership.[227] This conclusion appears to ignore the notion that "the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in a technical legal

220. *See* I.R.S. Gen. Couns. Mem. 39,034, at *6-7.
221. *Id.*
222. *See id.* at *4-8.
223. *Id.* at *6.
224. *See id.* at *7 (citing STEPHENS ET AL., *supra* note 73, ¶ 4.14[5][b], *available at* 1999 WL 1031619).
225. *Id.* at *7.
226. *Id.* at *23.
227. *Id.* at *22-23.

sense."[228] "Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy."[229] Further, as previously discussed, the conclusion also ignores the provisions under the regulations that attribute incidents of ownership in a corporate setting only to a controlling shareholder.[230] A minority shareholder of a corporation is not attributed incidents of ownership under any circumstances whereas a minority partner is attributed incidents of ownership where the policy proceeds are payable other than to the partnership.

In light of the above distinction, a question remains in relation to whether a limited partner or a member of an LLC would be attributed incidents of ownership in a policy held by the entity. In 2001, the IRS addressed a fact pattern which included a contribution of an insurance policy to a limited partnership. In Private Letter Ruling 200111038, two grantors (A and B) of two separate trusts (Trust A and Trust B) formed a new limited partnership (LP).[231] Trust A was to contribute insurance policies to LP in exchange for a limited partnership interest.[232] Trust B was to contribute cash in exchange for a general partnership interest in LP.[233] Grantors A and B also contributed cash in exchange for a limited partnership interest in LP.[234] Under the LP agreement, all taxable income and losses were to be allocated in accordance with the partners' interests in the partnership.[235] Further, the agreement provided that general partners had sole management authority over the partnership and limited partners had no right to participate in management or investment decisions including any decisions in relation to the LP's ownership of the insurance policies.[236] Importantly, however, the proceeds of the acquired insurance policies were to be paid to the LP.[237]

The ruling addressed the issue of whether, for purposes of section 2042, a limited partnership interest would be treated as being sufficient control such that the *limited partners* would be treated as possessing incidents of ownership by virtue of their interest in such an entity.[238] The IRS ruled that where the terms of a partnership agreement preclude the limited partners from exercising any control over the management and day-to-day affairs of the limited partnership or take part in the vote in respect to the limited partnership's management and operations, the limited partners will not possess incidents of ownership under section 2042

228. Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974).
229. *Id.*
230. Treas. Reg. § 20.2042-1(c)(6).
231. I.R.S. Priv. Ltr. Rul. 200111038, at *8 (Dec. 15, 2000).
232. *Id.* at *9.
233. *Id.*
234. *Id.*
235. *Id.*
236. *See id.* at *9-11.
237. *Id.* at *10.
238. *See id.* at *1.

with respect to insurance policies held by the limited partnership.[239] Thus, in an initial analysis, it would appear that the question turned upon whether the limited partners (or presumably a non-managing member of an LLC) had "control" over the policy for purposes of incidents of ownership.

However, this line of reasoning loses much of its force due to the fact that the IRS then fell back on its analysis in Revenue Ruling 83-147. The IRS indicated that its conclusions were due to the fact that the policy proceeds were payable directly to the limited partnership and not to a third party.[240] Thus, because the proceeds are payable to the partnership, the proceeds will increase the value of the decedent limited partner's interest in the limited partnership and, therefore, no incidents of ownership held by the partnership should be attributed to the decedent limited partner.[241] Even though the reasons given in the ruling address the lack of the limited partners' control over the policies in relation to section 2042, the fact that the limited partnership received the proceeds makes the ruling less intriguing and less valuable. Again, the question of how insurance proceeds on a policy held by a limited partnership or LLC payable to a third party will be treated for purposes of section 2042 specifically remains unaddressed. Further, the question of whether a partner's status as a limited partner alone will result in a sufficient lack of control such that the limited partner will not be attributed incidents of ownership remains unanswered. If the analysis turned solely on "control," a limited partner (majority or minority) would not appear to have any incidents of ownership regardless of whether the proceeds were payable to a third party.

III. RECOMMENDATIONS FOR A SOLUTION TO THE PROBLEM

There are two basic problems in relation to application of the rules under section 2042 of the Code. First, the *Cartwright* and *Blount* decisions allow taxpayers to completely avoid inclusion of insurance proceeds payable to a corporation where there is a redemption agreement in place that requires the corporation to redeem a deceased shareholder's equity interest in the company. Second, the IRS has created an inconsistency in applying the regulations under section 2042 attributing incidents of ownership in an entity-owned life insurance policy where the policy proceeds are payable to a third party. The inconsistency results where a minority limited partner is attributed incidents of ownership while a minority corporate shareholder is not. Both of these inconsistencies should be addressed by Congress, the courts, and the Treasury Department.

239. *See id.* at *19-20.
240. *See id.* at *18-19.
241. *See* I.R.S. Gen. Couns. Mem. 39,034, at *7-8.

Of primary importance is the anomaly created by the *Cartwright* and *Blount* opinions which have created precedent that can be relied upon by estates of deceased shareholders to support a complete exclusion of the value of insurance proceeds received by the corporation. This loophole should be closed. The policy behind the exception to inclusion provided for in the regulations under section 2042 is premised upon ratable inclusion of the proceeds under section 2031. This policy is thwarted by the Eleventh Circuit's decision in *Blount* and by the Ninth Circuit's decision in *Cartwright*.

A. Amend Section 2031 Regulations to Require Inclusion of Life Insurance Proceeds in Valuation

One possible solution would be for the IRS to amend the regulations under section 2031 to clarify that life insurance proceeds payable to or for the benefit of a company shall, to the extent the proceeds are excluded by the regulations under section 2042, be included for purposes of determining the value of the company. Specifically, the fourth full sentence of Regulation section 20.2031-2(f) could be amended to include following additional language:

> In addition to the relevant factors described above, consideration shall also be given to non-operating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such non-operating assets have not been taken into account in determining the net worth, prospective earning power and dividend earning capacity. *Such non-operating assets shall include, among other things, proceeds of a life insurance policy payable to or for the benefit of the company which proceeds have not otherwise been included in the insured shareholder's estate under section 2042 or the applicable regulations thereunder.*

The above amended section of the regulations would clarify that insurance proceeds received on the life of an insured shareholder would be included for purposes of valuing the decedent's stock in the company. This amendment would require inclusion of the insurance proceeds in an attempt to prevent an interpretation such as, for example, the interpretations in *Cartwright* and *Blount*, that the insurance proceeds are not the kind of non-operating asset that should be included in the value of the company under the regulations.[242] However, the holding in *Blount* could continue to create ambiguity because the court's holding also requires that where a redemption agreement is in effect between the company and the shareholders, the company's obligation under the agreement should offset the insurance proceeds "dollar-for-dollar."[243] This second requirement, in effect, would undermine the effect of the proposed

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242. *See* Estate of Blount v. Comm'r., 428 F.3d 1338, 1345-46 (11th Cir. 2005).
243. *See id.* at 1346.

amendment by leaving open the question of whether an estate must take the company's redemption obligation into consideration when valuing a decedent shareholder's stock.

The requirement that the company's redemption obligation be taken into consideration by the redeemed shareholder's estate in valuing the stock for purposes of determining gross estate is inappropriate for several reasons. First, such a requirement would result in undervaluing the redeemed shareholder's stock in virtually every instance due to the fact that a redeemed shareholder would never concede to selling his or her shares back for less than an arm's length consideration. Further, valuation based upon post-redemption assets is not arm's length for reasons explained by the Tax Court in its decision in *Blount*.[244] This portion of the holding by the Eleventh Circuit would not likely be addressed by the IRS in regulations but, rather, left to the courts to correct in a later case.

B. Amend Regulations Under Section 2042 to Require Attribution of Incidents of Ownership to Majority Shareholders, Partners, and Members of LLCs

Because of the inherent ambiguity in interpreting the court's holding in *Blount*, a larger, more expansive change in the Code and Regulations may be appropriate. Accepting the *Blount* court's holding that the insurance proceeds should not be included in the valuation calculation, it may be appropriate for the Treasury to reconsider the requirements of section 2042 and promulgate regulations that pertain to shareholders, partners, and members of LLCs that attribute incidents of ownership to a "controlling" equity holder.

Under current regulations, it appears that the Treasury envisioned that estates of deceased shareholders of corporations should be required to include only a ratable portion of the insurance proceeds received by the corporation. This policy is implemented via the regulations which prevent attribution of incidents of ownership to a sole or controlling shareholder where the economic benefits of a life insurance policy on the life of the shareholder are reserved to the corporation.[245] In turn, this allows the shareholder to exclude from the gross estate a portion of the value of the life insurance proceeds notwithstanding that such shareholder actually had control over the policy.

Historically, inclusion of the insurance proceeds via attribution of incidents of ownership to a controlling decedent shareholder resulted in a double inclusion of the proceeds. This outcome resulted because the value of the corporate shares in the decedent's estate was thought to increase proportionately due to the corporation's receipt of the insurance

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244. *See id.* at 1343-45.
245. *See* Treas. Reg. § 20.2042-1(c)(6) (as amended in 1974).

proceeds. However, under the *Cartwright* and *Blount* decisions, the proceeds are no longer subject to double inclusion due to the fact that the proceeds are offset dollar-for-dollar by the company's obligation to redeem the deceased shareholder's stock.[246] Thus, it may be appropriate for the Treasury to consider whether to amend the current regulations under section 2042 to provide that a sole or controlling shareholder, partner or member of an LLC will be attributed incidents of ownership where the equity holder has sufficient ownership interest. This outcome would appear to be consistent with Congress' intent to impose estate tax on decedents who have the ability to, for example, change the beneficiary designation on the policy held by the entity.

C. Amend Regulations to Treat Shareholders, Partners and Members Consistently with Respect to Attribution Rules

The above problems stem from a set of circumstances wherein the company receives the proceeds from an insurance policy which insures the life of an equity holder. A separate and different inequity arises where the proceeds of a company-owned insurance policy are payable to a third party. It makes little sense that a minority corporate shareholder should be treated differently than a minority partner or minority member of an LLC where the proceeds of an insurance policy are held by the entity but payable to a third party.

The advent, evolution, and increased popularity of limited liability companies require that the regulations under section 2042 that apply to corporations be reassessed in an effort to provide similar treatment to partners of partnerships and members of LLCs. The general policy behind the section 2042 regulations, directing the proceeds of a corporate-owned insurance policy payable to a third unrelated party be excluded from a minority shareholder's gross estate should apply to minority partners, limited partners, and non-managing members of LLCs.

However, the Treasury rulings and agency memorandums indicate unwillingness on the part of the IRS to treat minority partners and minority members of LLCs in a similar fashion. Instead, the Treasury views the partners or LLC members that are treated as partners for tax purposes as being an aggregate of partners each of whom individually has control over incidents of ownership of a policy held by the partnership or LLC. While the general theory of aggregate versus an entity approach to partnerships may be relevant to the analysis, there is a very large unaddressed grey area between the rights of shareholders and the rights of limited partners and non-managing members of an LLC. More specifically, where a limited partnership or LLC agreement authorizes certain partners or members to manage the assets, including insurance policies, held by the company, attribution of incidents of ownership to such part-

246. *See Estate of Blount*, 428 F.3d at 1346.

ners or members would be appropriate in that they have actual control. However, there appear to be many instances in which a limited partner or non-managing member of an LLC would have little if any control over a policy owned by the entity. A minority limited partner and a minority member of an LLC who has no management authority over a company-held insurance policy would, like a minority shareholder of a corporation, have no control over such a policy and there would be little reason to attribute incidents of ownership to such partners or members of an LLC.

As a result, the Treasury's rulings and memorandums that require a deceased minority limited partner or deceased minority member of an LLC to include the whole value of an insurance policy in gross estate notwithstanding that the proceeds are paid to an unrelated third party are likely unsupportable and outdated. The Treasury should embark on a regulation project to analyze and propose amendments to or new regulations which focus on the core control requirement of section 2042. Attribution of incidents of ownership should be limited only to those equity holders of a company that have actual control over the policy or have the independent ability to control the ownership rights of an insurance policy held by the company.

IV. SUMMARY & CONCLUSION

Generally, section 2042 requires a decedent who possesses incidents of ownership in an insurance policy on his or her life to include in the decedent's gross estate all insurance proceeds receivable under such policy.[247] A decedent possesses incidents of ownership in a policy to the extent that the decedent can, for example, change the beneficiary designation or otherwise has rights to the economic benefits of the policy.[248] A sole or majority shareholder has the power to control the beneficiary designation of a policy owned by the corporation. Thus, a sole or majority shareholder generally would be attributed incidents of ownership in a corporate-owned insurance policy. However, current regulations under 2042 provide an exception whereby a decedent sole or majority shareholder will not be attributed incidents of ownership in such a policy where the proceeds are payable upon death directly to the corporation.[249] The purpose of this exception is to prevent the double inclusion of the value of the insurance proceeds once through section 2042 by attribution to the majority shareholder via incidents of ownership and again through an increase in the value of the shares of stock that are required to be included in gross estate under section 2031.

247. *See* I.R.C. § 2042.
248. *See* Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974).
249. *See* Treas. Reg. § 20.2042-1(c)(6).

In relation to partnerships and limited liability companies, the cases and rulings have resulted in a similar exception with no attribution of incidents of ownership to partners or members where proceeds of a policy insuring the life of a decedent partner or member are payable to the entity. The Tax Court and the Treasury's rulings are supported by the same view that to require inclusion under section 2042 would result in unnecessary double inclusion of the value of the insurance proceeds in the decedent partner or member's estate.

Until recently, attribution of incidents of ownership and estate taxation of the receipt of policy proceeds by either an entity or the equity holder of such entity under the above described circumstances was largely undisputed under the cases, rulings and regulations. However, in 1999, the Ninth Circuit Court of Appeals in *Cartwright* found that proceeds received by a corporation from a policy insuring the life of the corporation's majority shareholder should not increase the value of the decedent's shares for purposes of determining the decedent's gross estate.[250] The court came to this conclusion based largely upon the fact that the value of the insurance proceeds was offset by an existing liability to the decedent shareholder's estate for services performed for the corporation prior to the decedent's death.[251] A small portion of the insurance proceeds received by the corporation were used to redeem the majority shareholder's stock pursuant to the terms of a stock redemption agreement that existed between the majority shareholder and the corporation.[252] The effect of the court's holding was to allow the shareholder's estate to completely avoid inclusion of the value of the insurance proceeds received by the corporation. Ignoring the small portion of the payment related to the redemption agreement, the outcome of the *Cartwright* case was consistent with the policy behind the estate tax provisions of the Code.

However, in October of 2005, the Eleventh Circuit Court of Appeals in *Blount* followed the decision of the Ninth Circuit in *Cartwright*. While the court's decision in *Blount* purports to follow the reasoning of the Ninth Circuit Court of Appeals in *Cartwright*, it appears to misapprehend the reasoning of the Tax Court which was affirmed by the Ninth Circuit in *Cartwright*. By holding that the liability to redeem the shares of the decedent shareholder operates to offset dollar-for-dollar the insurance proceeds received by the corporation for purposes arriving at the redemption value of a deceased shareholder's stock, the *Blount* court ignores the requirements of section 2042 and the regulations thereunder. In doing so, the holding of the Eleventh Circuit Court of Appeals in *Blount* completely removes the insurance proceeds in determining the

250. *See* Estate of Cartwright v. Comm'r., 183 F.3d 1034, 1038 (9th Cir. 1999).
251. *See Estate of Cartwright*, 183 F.3d at 1038.
252. *Id.* at 1035-37.

value of the shares of the corporation in the decedent shareholder's estate under section 2031. By removing the insurance proceeds from the calculation of the value of the decedent shareholder's stock under section 2031, no portion of the insurance proceeds are included in the decedent's estate.

The exception to inclusion of the proceeds in the regulations under section 2042 is based upon the premise that the increase in value of the stock due to the corporation's receipt of the insurance proceeds will result in a proportionate increase in the value of the corporate stock to be included in the shareholder decedent's gross estate under section 2031.[253] Consequently, the *Blount* opinion and the *Cartwright* opinion to a certain degree, appear to allow exclusion of the value of the proceeds from the section 2031 calculation. This, in turn, appears to create an apparent loophole that allows taxpayers to avoid estate tax payable on proceeds received from policies where such taxpayers clearly are attributed incidents of ownership. Further, there is no reason why the same anomalous result would not apply in the redemption of a partner or a member of an LLC where the entity received the policy proceeds.

In addition to the apparent loophole created by the *Cartwright* and *Blount* opinions, the IRS has created a distinction in the manner in which minority corporate shareholders and minority partners are treated when a third party, as opposed to the entity, receives insurance proceeds on the life of one of the equity holders. In a corporate setting under these circumstances, a decedent minority shareholder is not attributed incidents of ownership in the policy held by the corporation. By not attributing the corporate incidents of ownership to the decedent minority shareholder, no amount of the insurance proceeds received by the third party is required to be included in his or her estate. This same rule is not applied to minority partners or LLC members. Under these same circumstances, the minority member or partner is attributed incidents of ownership. As such, the draconian opposite outcome occurs requiring the estate of the decedent minority partner or member to include **all** of the value of the insurance proceeds in gross estate.

Given the widespread implementation of redemption agreements by shareholders and their closely held entities, there is a need to address the problems created by the holding of the Eleventh Circuit Court of Appeals in *Blount* and the Treasury's disparate treatment of minority corporate shareholders, minority limited partners and minority members of LLCs. Several possible solutions exist. First, the Treasury should amend the regulations to clarify that insurance proceeds received by a company on the life of a majority equity holder should be included in the equity holder's estate when valuing the equity interest. Although this outcome

253. *See* Treas. Reg. § 20.2042-1(c)(6) (as amended in 1974).

was intended by the Treasury and is explained in various Treasury pronouncements, the regulations are sufficiently ambiguous that two federal courts of appeal did not interpret the regulation as it was originally intended to operate.

In the alternative, the Treasury may wish to accept the treatment espoused by the courts of appeal and amend the regulations under section 2042 to require attribution of incidents of ownership to majority shareholders, partners, and members of LLCs. This alternative is in many ways more consistent with Congress' original intent when it enacted section 2042. Whereas, under current regulations, it was the intent of the Treasury to include only a ratable portion of the proceeds, this alternative would require majority equity holders in closely held entities to include in gross estate the whole amount of the insurance. Majority owners of entities that own insurance policies in fact have control of insurance policies held by their companies. It is for this reason that this alternative may be a viable solution.

Finally, the Treasury should equalize the treatment of minority shareholders with the treatment under the regulations of limited partners and non-managing members of LLCs. Under current regulations, where policy proceeds are payable to unrelated third parties outside of the company, minority shareholders are not attributed incidents of ownership under the rules. The Treasury's theory behind this treatment is premised upon the fact that a minority shareholder does not have actual control over the policy benefits. On the other hand, limited partners and non-managing members of LLCs are attributed incidents of ownership under the current rulings. This effectively requires such equity holders to include all of the policy proceeds in their estates upon their deaths. Such treatment is unwarranted and must be addressed by the Treasury in a manner that is consistent with the treatment accorded to corporate minority shareholders.