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Legal Sidebar

A Corporation's Obligation to Redeem Shares Is Not Necessarily a Liability That Reduces the Corporation's Value for Estate Tax Purposes

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On June 6, 2024, the Supreme Court unanimously held in *Connelly v. United States* that a family-owned corporation's contractual obligation to purchase, or "redeem," a deceased owner's shares (redemption obligation) is not necessarily a liability of the corporation that reduces its value for estate tax purposes.

Brothers Michael and Thomas Connelly—the sole shareholders of Crown C Supply, a building supply corporation—contractually agreed with Crown that, in the event of one brother's death, Crown would redeem the deceased brother's shares if the surviving brother declined to do so. Crown then purchased an insurance policy on the life of each brother to ensure it would have the funds necessary to satisfy its redemption obligation.

Michael died in 2013 and Thomas declined to purchase Michael's shares. Crown then redeemed Michael's shares using $3 million in proceeds it received from the insurance policy on Michael's life. When the Internal Revenue Service (IRS) audited the tax return that Thomas filed on behalf of Michael's estate, Thomas argued that the life insurance proceeds that Crown used to purchase Michael's shares ought not to be treated as an asset of Crown that increased the corporation's value (and thus the value of Michael's shares) because Crown's redemption obligation was an equal offsetting liability of Crown. The IRS disagreed and required payment of additional estate taxes. Thomas commenced a refund suit in federal court that resulted in judgments for the Government at both the trial and appellate levels. On certiorari, the Supreme Court agreed with the Government and held that, under customary valuation principles, "'no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability'" that reduced Crown's value at the time of Michael's death.

While the decision in *Connelly* affects only the small group of taxpayers who are subject to the estate tax, the dispute in *Connelly* helps explain some of the valuation, measurement, and enforcement issues that arise when taxing assets that have not been sold recently or for which there is no robust or ascertainable market.

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The Federal Estate Tax

The federal estate tax is a tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." The "taxable estate" is typically the value of all property owned by a person at the time of their death, including shares in a closely held corporation (i.e., a corporation having only a few shareholders), less applicable deductions. In general, the value of an item of property is its fair market value at the time of the owner's death. Treasury Regulation Section 20.2031-1(b) defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Under Treasury Regulation Section 20.2031-2(f)(2), when selling prices or "bid and asked prices" are unavailable, the fair market value of shares in a closely held corporation is determined by considering a "company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." The Treasury Regulation states that "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity."

Crown's Redemption Obligation

In 2001, Michael and Thomas entered an agreement to ensure that Crown's ownership would remain within their family. Under the agreement, if either brother died, the surviving brother could purchase the deceased brother's shares. If the surviving brother declined, Crown then became contractually obliged to redeem the deceased brother's shares. Crown obtained a $3.5 million life insurance policy on the life of each brother to ensure it would have enough money to do so.

At the time of Michael's death in 2013, he held a 77.18% ownership interest (385.9 out of 500 shares) in Crown. Thomas opted not to buy Michael's shares, triggering Crown's redemption obligation. Rather than obtain an outside appraisal of Michael's shares, as contemplated by the brothers' agreement, Thomas and Michael's son agreed between themselves that Michael's shares were worth $3 million. Crown then paid Michael's estate $3 million from the life insurance proceeds Crown received from its policy on Michael's life to redeem the shares. Thomas thus became Crown's sole shareholder.

The Valuation of Crown and of Michael's Shares

Thomas, as executor of Michael's estate, filed an estate tax return reporting the value of Michael's shares as $3 million. The IRS audited the return, prompting Thomas to obtain a business valuation of Michael's shares from an accounting firm. The firm determined Crown's fair market value to be $3.86 million at the time of Michael's death. Given Michael's 77.18% ownership interest in Crown, the accounting firm valued Michael's shares at approximately $3 million ($3.86 million x 0.7718). In making this valuation, the firm excluded from Crown's value the $3 million in life insurance proceeds that Crown used to purchase Michael's shares. The firm based that exclusion on the holding in *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005), "that insurance proceeds should be 'deduct[ed] … from the value' of a corporation when they are 'offset by an obligation to pay those proceeds to the estate in a stock buyout.'"

The IRS disagreed that Crown's obligation to redeem Michael's shares reduced Crown's value by the amount it expended to execute the redemption obligation. The IRS thus included in Crown's value the $3 million in life insurance proceeds used by Crown to purchase Michael's shares. As a result, the IRS determined that (1) Crown's value at the time of Michael's death was $6.86 million (the accounting firm's business valuation of $3.86 million plus the $3 million in life insurance proceeds used to satisfy Crown's redemption obligation) and (2) Michael's shares were worth around $5.3 million at the time he died ($6.86 million x. 0.7718). Based on this increased valuation, the IRS determined that Michael's estate owed an additional $889,914 in taxes.

The Refund Lawsuit and the Supreme Court's Decision

Michael's estate paid the tax deficiency and then sued the United States in federal court for a refund. The United States District Court for the Eastern District of Missouri granted summary judgment to the Government, and the United States Court of Appeals for the Eighth Circuit affirmed that judgment. Thomas successfully petitioned the Supreme Court for review, and the Supreme Court affirmed the judgment of the Eighth Circuit.

The Supreme Court noted that the Government and Thomas agreed that, "when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value" and that "life insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value." Using that calculus alone, Crown's fair market value at the time of Michael's death would have been $6.86 million, as calculated by the IRS. Thomas contended, however, that "Crown's contractual obligation to redeem Michael's shares at fair market value" was a liability of Crown that offset, or canceled out, "the value of life-insurance proceeds committed to funding that redemption." The "narrow" question the Supreme Court had to decide, therefore, was whether Thomas's argument was correct. The Court held it was not, agreeing with the Government that "'no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability.'"

The Court grounded its holding on the principle that "a share redemption at fair market value does not affect any shareholder's economic interest." The Court used the following example to illustrate how the value of two shareholders' economic interests in a corporation worth $10 million would be the same before and after a redemption. Before a share redemption, A owns 80 shares worth $8 million and B owns 20 shares worth $2 million. When the corporation redeems B's shares at fair market value, the corporation must pay B $2 million. After the share redemption, the values of A and B's respective economic interests are the same as before: A is now the sole shareholder of a corporation worth $8 million and B has $2 million in cash. The Court concluded that, "[b]ecause a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares."

Thomas argued that a hypothetical buyer of Michael's shares would not consider insurance proceeds that would be used for redemption as net assets of Crown because the corporation would be less valuable once it used the proceeds for the redemption. The Court rejected that contention, however, because "the whole point" when calculating the estate tax is to determine how much the corporation and the shares were worth at the time the shareholder died, which is before the corporation spent the proceeds on the redemption payment. The Court noted that there might be situations when a redemption obligation could reduce a corporation's value, such as when a corporation is required "to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity." The Court rejected, however, Thomas's contention "that all redemption obligations reduce a corporation's net value."

The Court also concluded that Thomas's approach "cannot be reconciled with the basic mechanics of a stock redemption." The Court explained that a redemption transaction "necessarily reduces a corporation's total value" because the corporation must expend assets to purchase the shares, leaving the remaining shareholders "with a larger proportional ownership interest in the less-valuable corporation." Thomas's methodology, the Court emphasized, would turn the process "upside down" because it would leave the remaining shareholders "with a larger ownership stake in a company with the *same* value as before the redemption."

Finally, the Court rejected Thomas's complaint that treating the life insurance proceeds earmarked for the redemption obligation as a net asset would make succession planning harder for closely held businesses. Thomas asserted that Crown would have had to take out a life insurance policy worth significantly more than $3 million to redeem Michael's shares at fair market value. The Court observed that this circumstance was "simply a consequence of how the Connelly brothers chose to structure their agreement." The Court noted that there were other options, each having its own drawbacks, that the brothers could have chosen to ensure that Crown stayed in the Connelly family without causing an increase in Crown's fair market value. For example, the Court explained that the brothers might have entered a cross-purchase agreement in which they individually agreed to purchase the other's shares and then each took out a life insurance policy on the other to fund their purchase obligation.

Considerations for Congress

Share redemptions funded by life insurance are one approach for facilitating redemptions by closely held businesses with limited liquidity. In the wake of the Supreme Court's decision in *Connelly*, tax commentators have suggested that, to avoid the share redemption price increase that will come with including life insurance proceeds in the value of a corporation, closely held businesses might have to fund share redemptions with accumulated earnings or promissory notes coupled with smaller life insurance policies to cover cash down payments. By the same token, as the Supreme Court explained in *Connelly*, shareholders in closely held businesses have alternative ways to structure their transactions to meet their succession planning goals, all of which may have drawbacks.

Connelly also reflects both the flexibility that taxpayers have when valuing taxable assets that are not publicly traded or in readily valued forms and the difficulties the Government faces when it challenges those valuations. Taxpayers have a financial incentive to obtain and use valuations that minimize their tax liability. Third parties valuing assets might also have an interest in helping these taxpayers when the third party will receive a portion of any resulting tax savings or has a preexisting relationship with the taxpayer. The federal estate tax regime has several measures to prevent valuation abuse, such as the willing buyer-willing seller test for fair market value in Treasury Regulation Section 20.2031-1(b) and the valuation rules in Internal Revenue Code § 2703, which provide for certain rights and restrictions in agreements to be disregarded when determining the value of property. Still, these measures are limited because the IRS challenges taxpayer valuations through audits, which are relatively infrequent due to resource constraints. Tax commentators have offered several proposals to address valuation-related tax evasion, including increased reliance on third-party valuations done for nontax reasons (e.g., insurance appraisals and local government assessments); a stiffer penalty regime; and a new valuation compliance system that requires taxpayers to submit a valuation notice to the IRS describing the property and the basis for the valuation, and subjects taxpayers to arbitration procedures.

Future inquiries on this issue can be submitted to Craig Canetti, Section Research Manager, who supervised the composite writing of this Legal Sidebar and is listed as the coordinator.

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