The Infinite Wisdom of the Supreme Court's *Connelly* Decision

Will Frazier and T.J. Liles-Tims

The Supreme Court's ("SCOTUS") affirmation of the Eighth Circuit Court of Appeals' decision in the case of *Connelly* has been widely discussed but little examination performed. In this article, we will focus on two issues that have - to our knowledge - escaped mentioning or analysis. First, the *Connelly* valuation solution, if strictly adhered to, sets in motion a perpetual mathematical loop resulting in a company's valuation equating to infinity. Second and, potentially, more important, footnote 2 of the SCOTUS Opinion may be an aid for this often used estate planning technique. It is not a "get out of jail free" card but, the punishment to the taxpayer is much less severe.

As a quick refresher, Crown C Supply, Inc. (the "Company") was owned by brothers Michael Connelly (77.18%) and Thomas Connelly (22.82%). In 2001, the brothers executed a redemption agreement outlining that upon the death of one brother, the other brother had the right of first refusal to purchase the deceased brother's shares of the Company. However, if the living brother elected not to purchase the shares, then under the redemption agreement the Company was to purchase the deceased brother's shares. Without commissioning a business valuation, the brothers agreed upon a value of $3.5 million for the Company and had the Company take out $3.5 million life insurance policies on both brothers, naming the Company as beneficiary.

In 2013, Michael passed away. His brother, Thomas, declined to exercise his right of first refusal which required the Company to purchase Michael's shares. Again, without obtaining a business valuation, Michael's estate (the "Estate") and the Company agreed on a value of $3.0 million for Michael's 77.18% interest. As such, the Company utilized $3.0 million of the $3.5 million death benefit to purchase Michael's shares back.

The Estate filed an estate tax return indicating Michael's 77.18% ownership interest carried a value of $3.0 million – the exact amount paid by the Company – which excluded the life insurance proceeds used for the redemption. The IRS audited the estate tax return and disagreed with the Estate's valuation of Michael's shares, claiming that the $3.0 million in insurance proceeds used for the redemption must be included in the Company's value. (The Estate had only added the $500,000 in insurance proceeds not used for the redemption to the Company's value.) During the IRS audit, the Estate obtained a business valuation from the same accounting firm that prepared the estate tax return. As a result, the taxpayer's valuation determined the value of the Company to be $3.86 million and, again, excluded the $3.0 million of life insurance proceeds used for redemption based on the findings in the *Estate of Blount* v. *Commissioner*, 428 F. 3d 1338 (CA 11 2005). In that case, the Eleventh Circuit recognized that an offsetting contingent liability is created when a redemption agreement is triggered by the death of an owner. Despite this precedent, the IRS held firm and issued a deficiency notice with a valuation of the Company at $6.86 million.

The Estate and IRS stipulated to a "base" value of the company at $3.86 million, however, the IRS maintained the position the $3.0 million of life insurance proceeds should be added to the "base" value. Therefore, the IRS argued, Michael's 77.18% interest was worth $5.3 million. Based on this higher valuation, the IRS determined the Estate owed an additional $889,914 in taxes. The Estate paid the specified deficiency amount and filed suit in the U.S. District Court for the Eastern District of Missouri for a refund. In the ensuing controversy, both the IRS and the Estate moved for summary judgment on the issue of whether the portion of the life insurance proceeds used to purchase Michael's shares must be included in the value of the company for estate tax purposes. The Court ruled in favor of the IRS. The Estate appealed to the Eighth Circuit which upheld the decision of the District Court even though their Opinion placed them directly opposite the Opinion of the Eleventh Circuit on the same issue. The Estate successfully petitioned the U.S. Supreme Court for *Writ of Certiorari*. Ultimately, SCOTUS upheld the decision of the Eighth Circuit.

The Company redeemed Michael's shares for $3.0 million. The Estate, however, paid nearly $900,000 in additional estate taxes since the SCOTUS mandated valuation method increased the Estate's value by $2.3

million. But, where, is the "infinite valuation loop" referred to earlier? Using the facts in the *Connelly* case and what we will call the "Connelly Method," we will provide the relatively simple explanation.

Suppose the Connellys and their advisers independently came to the same valuation solution as suggested by the IRS and endorsed by the three separate courts. The value of the buyout is set at "fair market value" of the redeemed shares. The initial value would be set by a qualified appraiser, and if not challenged by the IRS, that would be the final value. By presuming the correct usage of fair market value will incorporate the Connelly Method, it is understood that the insurance proceeds to be received by the Company for redemption purposes are to be included in the Company's value. It is this last step that opens the gate for the infinitely increasing value. See below.

Before Repurchase

** all figures have been rounded*

Fair Market Value of Michael's Interest

Total Equity Value	$3,860,000
Insurance Proceeds	-
Total Equity Value	$3,860,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$3,000,000
Thomas	22.82%	$ 860,000

LOOP 1

Fair Market Value of Michael's Interest

Operating Equity Value	$ 3,860,000
Insurance Proceeds	3,000,000
Total Equity Value	$ 6,860,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$5,290,000
Thomas	22.82%	$1,570,000

LOOP 2

Fair Market Value of Michael's Interest

Operating Equity Value	$3,860,000
Insurance Proceeds	5,290,000
Total Equity Value	$9,150,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$7,060,000
Thomas	22.82%	$2,090,000

LOOP 3

Fair Market Value of Michael's Interest

Operating Equity Value	$ 3,860,000
Insurance Proceeds	7,060,000
Total Equity Value	$10,920,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$8,430,000
Thomas	22.82%	$2,490,000

The illustration above paints the valuation picture of the Company and the to-be-redeemed 77.18% immediately prior to death. This valuation is followed by date of death values only for the first three loops in what would be an infinite chain of such loops.

The value of Michael's interest is approximately $3 million. However, since the interest is to be redeemed by company-owned life insurance and since the planners and appraisers are following the Connelly Method, the value of the Company shifts upwards by the amount of the insurance proceeds. This now causes the value of the Company to be $6,860,000. At this point, it can be seen that a simultaneously and infinitely increasing valuation loop has been triggered.

As the *Connelly* matter is described in the SCOTUS opinion, it seems all would have been well if the Connellys had simply purchased insurance not for a $3.0 million redemption amount but for the additional $3.0 million in value created by the inclusion of the insurance proceeds for the originally-planned redemption. The

adjusted valuation, at $6.86 million, increases Michael's value to approximately $5.3 million. But, wait a minute! Since Michael's redemption is being funded by insurance and if the required insurance proceeds were $5.3 million, the Company's value will immediately jump to about $9.2 million. So, it looks like even more insurance is required because in that step Michael's value just went to $7.1 million. But, if that amount is funded with insurance, the Company's value now increases to $10.9 million and Michael's shares rise in value to $8.4 million. Time for yet more insurance.

The above illustrates the point that, based on the Connelly Method, it is impossible to fund a redemption solely with company-owned insurance. The Connelly Method's mechanics set off an unstoppable valuation chain reaction. Post-Connelly, using insurance as a partial solution to fund a repurchase obligation with the Company-owned insurance is preferred. For example, insurance could be used to repurchase the stock value associated with the company's core business. The additional value created by the insurance proceeds might be redeemed with a note to the Company or the Company might sell assets to raise cash.

There is something amiss with the Connelly Method. Uncoupling the insurance proceeds from the repurchase liability has created a valuation monster. Is it wrong? Well, as Connelly is concerned, it cannot be appealed. Only an act of Congress could change it. That's not likely to happen. So, the best future estate planners can do is to avoid the *Connelly* error.

But, what is the error? Even SCOTUS, in its parting words of footnote 2 states: "We do not hold that a redemption obligation could never decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares thereby decreasing its future earning capacity." Where have we run into that before?

We have just shown you above that the ONLY way to prevent the Connelly infinite valuation loop from springing forth is to do exactly what SCOTUS' footnote 2 suggests. The portion of the redemption not funded by insurance will always be a direct reduction in company value.

If the IRS's Connelly Method was followed, SCOTUS' statement that the redeemed price for Michael's shares and the price a hypothetical, wiling buyer would pay are equivalent would not be a true statement. The portion of the redemption not funded by insurance must be satisfied either with additional borrowings or the sale, liquidation, or distribution of assets.

Accordingly, let us revise the valuation with this new information.

FOOTNOTE 2 - LOOP 1

** all figures have been rounded*

Fair Market Value of Michael's Interest	
Operating Equity Value	$3,860,000
Insurance Proceeds	3,000,000
Unfunded Redemption Obligation	-
Total Equity Value	$6,860,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$5,290,000
Thomas	22.82%	$1,570,000

FOOTNOTE 2 - LOOP 2

Fair Market Value of Michael's Interest	
Operating Equity Value	$3,860,000
Insurance Proceeds	3,000,000
Unfunded Redemption Obligation	(2,290,000)
Total Equity Value	$4,570,000

	Interest (%)	Pro-Rata Value
Michael	77.18%	$3,530,000
Thomas	22.82%	$1,040,000

Based on the above, it can be seen that the Connelly Method, when performed correctly in conformance with Connelly Footnote 2, does increase value over what the Connellys stated in Michael's Form 706. However, the correct value is only about $500 thousand higher, not the increased rate of nearly $2.3 million established by the *Connelly* courts.