No. 23-146

In the Supreme Court of the United States

THOMAS A. CONNELLY, PETITIONER

v.

INTERNAL REVENUE SERVICE

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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The government does not dispute that the two most important criteria for further review are satisfied here. *First*, there is a clear and expressly recognized circuit conflict on the question of federal tax law presented by the petition. *Second*, this case is an excellent vehicle for resolving that question. That should be more than sufficient for a grant of certiorari.

The government's arguments against review are few and feeble. The government concedes that the decision below conflicts with *Estate of Blount* v. *Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The government quibbles only with the depth of the conflict, attempting to distinguish *Estate of Cartwright* v. *Commissioner*, 183 F.3d

1034 (9th Cir. 1999). But those attempts are unpersuasive: none of the distinctions drawn by the government has any bearing on the legal question that has divided the circuits. While the government strains to reconcile its position in *Cartwright* with its position here, the only consistency between the two positions is the all-too-predictable one that the government was seeking to maximize its tax revenue in both cases.

In light of its recognition of the conflict, the government unsurprisingly devotes most of its attention to the merits. Of course, that is a matter for another day. But the government never comes to grips with the foundational problem with its position (and the court of appeals'): in conducting a valuation for estate-tax purposes, it makes no sense to take into account insurance proceeds designated to cover a stock-redemption obligation, but to ignore the offsetting obligation. Simply put, the insurance proceeds are a funding vehicle, not a genuine asset. Because those proceeds exit the company almost as soon as they enter, no rational buyer would consider them as effectuating a net increase in corporate assets for purposes of valuing the company's stock. The government advances several elaborate and formalistic theories to support its counterintuitive position, but they wither under scrutiny.

This case presents the Court with the opportunity to resolve an acknowledged circuit conflict on a discrete question of federal tax law. Contrary to the government's contention, the question presented is critical to the small businesses that form the backbone of the American economy. And because the parties have stipulated to all of the relevant facts, the question is cleanly presented and would be outcome-determinative. This case plainly warrants the Court's review.

A. The Decision Below Creates A Conflict Among The Courts Of Appeals

1. The government wisely concedes that the decision below creates a conflict among the courts of appeals. See Br. in Opp. 16-19. Specifically, the government recognizes that, in the decision below, the Eighth Circuit squarely rejected the Eleventh Circuit's reasoning in *Blount*. See *id.* at 19. And the government does not attempt to argue that *Blount* is in any way distinguishable.

2. In arguing that the circuit conflict does not "warrant[] this Court's review," Br. in Opp. 16, the government instead trains its focus on the Ninth Circuit's decision in *Cartwright*, whose reasoning the Eighth Circuit also rejected, see Pet. App. 13a n.5. Of course, even if *Cartwright* were distinguishable, the conflict with *Blount* would remain. Cf., *e.g.*, *Bittner* v. *United States*, 143 S. Ct. 713 (2023) (granting review on 1-1 conflict on a question of federal tax law). But the government's efforts to distinguish *Cartwright* fail in any event.

The government first cites the fact that "most of the insurance proceeds in *Cartwright* were to pay for the decedent's work in progress, not for the withdrawal of equity." Br. in Opp. 17. But the government never explains why that distinction matters. In *Cartwright* itself, the Ninth Circuit drew no distinction, in assessing the value of the company at issue, between the insurance proceeds used to fulfill the redemption obligation and those used to pay for the decedent's work in progress. To the contrary, the Ninth Circuit held that the entirety of the proceeds—including the portion used to fulfill the redemption obligation—should be excluded because they were "offset dollar for dollar." 183 F.3d at 1038.

The government also attempts to distinguish *Cartwright* on the ground that the Ninth Circuit did "not disregard[]" the agreement at issue there. Br. in Opp. 18.

But even if the court did not expressly disregard the agreement, it did not treat it as conclusive of the stock price. See 183 F.3d at 1038. Instead, the court held that the insurance proceeds did not qualify as an asset of the company for valuation purposes, and it remanded for the Tax Court to conduct a proper valuation that considered factors independent of any agreed-upon price. See *ibid.* The key point is that, in contrast to the decision below, the Ninth Circuit concluded that the insurance proceeds designated for the fulfilment of the stock redemption would not affect "what a willing buyer would pay for the firm's stock." *Ibid.* *Cartwright* thus directly conflicts with the decision below.

In a footnote, the government denies that it has reversed positions from *Cartwright*. See Br. in Opp. 18 n.3. That does not pass the straight-face test. To be sure, the government's "primary argument" in *Cartwright* was unrelated to the question presented here. *Ibid.* But as the government concedes, its "alternative" argument urged the court to discount the insurance proceeds on the ground that they were used to fulfill a redemption obligation. *Ibid.* While the government maintains that its "alternative" argument relied on the notion that the relevant tax regulation sets forth a "discretionary standard to be applied according to the circumstances of each case," *ibid.*, it offers no explanation for why that discretionary standard should apply any differently here. In any event, regardless of whether the government's position was right then and wrong now, or merely wrong now, the conceded circuit conflict warrants the Court's review.[*]

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[*] The government suggests in passing that the issues presented here are "highly factbound." Br. in Opp. 14. But the government does not dispute that the question presented—concerning how to calculate the value of a shareholder's shares for purposes of the federal estate

B. The Decision Below Is Incorrect

The government devotes most of its attention to defending the decision below on the merits, contending that a willing buyer and willing seller of a majority stake would ignore Crown's imminent redemption obligation when valuing the company. See Br. in Opp. 9-16. Although the merits are ultimately a matter for another day, the government's arguments are wholly unpersuasive.

1. The government first invokes the court of appeals' distorted version of the willing-buyer/willing-seller test (Br. in Opp. 10), in which a hypothetical buyer purchases all of Crown's stock and then either cancels the redemption obligation or redeems the shares from himself. As we have explained, however, that cannot be the correct test. Pet. 17-18. The property to be acquired is a 77.18% stake in Crown, not a 100% stake. And the holder of a 77.18% stake in Crown would lack the power unilaterally to cancel the redemption obligation. See Pet. C.A. App. 88, 91. Under a proper application of the willing-buyer/willing-seller test, therefore, Crown would still be required to redeem the shares that Michael once held. The government offers no explanation for why that legal obligation should be disregarded.

The government's test fails for another reason as well. The government assesses the value of the company only under the condition of unified, single-party ownership.

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tax—is a legal question that turns on the interpretation of the applicable provisions of the Internal Revenue Code and Treasury regulations. See, *e.g.*, *id.* at 9 (arguing that petitioner's position is "contrary to the text of the relevant regulations"); *id.* at 19 (arguing that the Eleventh Circuit's decision in *Blount* was "inconsistent with the regulatory text"). The courts of appeals have certainly treated it as such. And it is the resulting circuit conflict on that question that warrants the Court's review.

But such a valuation may substantially overstate a company's value where, as here, the company's stock is owned by multiple parties. See Pet. 17.

In response, government protests that "petitioner never objected in the lower courts to the propriety of valuing Crown as a whole as a means of determining the value of Michael's stock." Br. in Opp. 13. That is both true and irrelevant. Petitioner has never objected to *valuing Crown as a whole* in order to determine the value of the estate's stock. But petitioner has never agreed that *the appropriate way to value Crown* is to determine how much a hypothetical party would pay for 100% control of the company, as opposed to determining the difference between Crown's assets and liabilities. That is precisely where petitioner and the government part ways.

2. The government next argues that petitioner's proffered valuation cannot be correct because it values each of Michael's shares at "only 23%" of "one owned by Thomas at the exact same time." Br. in Opp. 11. Wrong. At the time of Michael's death, each of Crown's 500 outstanding shares—whether owned by Michael or Thomas—was worth approximately $7,727 (for a total of approximately $3.86 million). *See* Pet. C.A. App. 129. That figure takes into account both the proceeds from the life-insurance policy ($3.5 million) and Crown's offsetting redemption obligation ($3 million). The government can reach the contrary conclusion only by excluding the redemption obligation from the company's balance sheet and then valuing the company at the fleeting point in time after it has received the insurance proceeds but before it has redeemed Michael's shares. The government is famous for its expedient positions in tax cases; this one may take the biscuit.

The government claims that such treatment is appropriate because "an obligation to redeem stock is not a corporate 'liability' under traditional valuation principles."

Br. in Opp. 11. That is puzzling. It is well established that "[a] demand of any sort against a corporation, even though contingent, unliquidated, or disputed, * * * is still characterized as a liability." 3 James D. Cox & Thomas Lee Hazen, *Treatise on the Law of Corporations* § 19:5, at 463 (3d ed. 2011). Accounting standards confirm that "an obligation to repurchase the issuer's equity shares"—including "shares of stock that are required to be redeemed upon the death of the holder"—should be treated as liabilities. Financial Accounting Standards Board, *Accounting Standards Codification* ¶¶ 480-10-25-8, 480-10-55-64. Again, that just accords with common sense: the company is not only likely but certain to expend corporate assets to redeem the shares, because death is (sadly) guaranteed. Tellingly, the only contrary authority the government can muster is a conclusory statement in an expert report. See Br. in Opp. 11-12.

The government briefly asserts that, "even if an asset might be used to pay a corporate liability, that fact does not automatically justify excluding the asset from a valuation." Br. in Opp. 11-12. The government posits that a proper valuation "would account for both the asset and the liability by including the former in the company's assets and the latter in the company's liabilities." *Id.* at 12. Exactly right—and exactly petitioner's position. Petitioner has urged a valuation that accounts for both assets *and* liabilities, counting the insurance proceeds as an asset while treating the redemption obligation as an offsetting liability. And that explains why petitioner's approach treats the $500,000 difference between the insurance proceeds and the redemption obligation as a corporate asset. See Pet. 7-8. It is the government that seeks artificially to exclude a liability—namely, the redemption obligation—from the corporate books, so as to inflate Crown's valuation and thus the government's tax revenue.

The government makes much of the fact that, under petitioner's approach, "Crown's value remained the same before and after the redemption: $3.86 million." Br. in Opp. 12. True, but unremarkable. The *actual performance* of a contractual obligation to redeem outstanding stock upon the shareholder's death should have no material effect on a company's value, because the hypothetical willing buyer would already have factored the *certainty of future performance* into the price. After all, "[t]he hypothetical willing buyer is a rational, economic actor," so he would account for a guaranteed future outlay even if the money had not yet changed hands. *Estate of Jelke* v. *Commissioner,* 507 F.3d 1317, 1333 (11th Cir. 2007), cert. denied, 555 U.S. 826 (2008).

3. The government argues that the increase in the value of Thomas's stock as a result of the redemption is "evidence that the insurance proceeds were not offset dollar-by-dollar by a liability." Br. in Opp. 15 (internal quotation marks and citation omitted). But that confuses a benefit to Thomas with a benefit to Crown. Although the *value of Thomas's ownership stake* naturally increased as a result of the redemption (which left him as the sole shareholder), *Crown's value* remained unchanged as the insurance proceeds flowed into and then out of the company.

Channeling the court of appeals, the government expresses concerns about a "windfall" for Thomas, arguing that, "[i]f an estate disposes of property in a transaction that unduly benefits a recipient, the recipient's windfall indicates that the estate undervalued the property." Br. in Opp. 16. But Thomas was not the recipient of Michael's shares; any benefit to Thomas was simply the product of Crown's subsequent redemption of the stock held by Michael's estate. Taxing *Michael's estate* based on a benefit

that *Thomas* derived from another source effectively penalizes one taxpayer for the gains of another, and it has no basis in any "basic principle of estate tax law." *Ibid.*

C. The Question Presented Is Important And Recurring And Warrants The Court's Review In This Case

The government does not dispute that estate arrangements similar to those at issue here are commonplace among owners of closely held corporations. See Pet. 21-22; see also 1 F. Hodge O'Neal & Robert B. Thompson, *Close Corporations and LLCs: Law and Practice* § 7:45, at 7-220 (rev. 3d ed. 2020). Nor does the government dispute that the parties' factual stipulations make this case an ideal vehicle for resolution of the question presented. See Pet. 24. The government maintains, however, that the circuit conflict is "not likely to prove significant." Br. in Opp. 19-20. The government's arguments to that effect lack merit.

1. The government first contends that the question presented is "not one that often recurs," noting that only three circuits have addressed the question presented. Br. in Opp. 19. But leaving aside that the Court often grants certiorari on questions of federal tax law even when the conflict is shallow, see p. 3, *supra*, the Internal Revenue Service only rarely examines estate-tax returns and requires additional tax payments. See IRS, *Data Book* 36-44 (2022) <tinyurl.com/irsdatabook> (noting a range of examination of 4.7% to 8.5% for estate-tax returns for fiscal years 2012-2019). And until the decision below, the law was seemingly settled that petitioner's position on the estate tax was the correct one.

The government further argues that the question presented affects only a "small number of estates," because the "statutory minimum for the estate tax" makes the tax inapplicable to most Americans. Br. in Opp. 19. But that

proves far too much: it would defeat review by this Court of *any* question concerning the federal estate tax. It simultaneously proves too little: when measured in value, the amount of closely held stock reported by estates each year is significant. In 2021 alone, taxpayers filed estate-tax returns reporting over $15.8 billion in closely held stock. IRS, *SOI Estate Tax Data Tables*, tbl.1 <tinyurl.com/estatetaxtables> (last visited Nov. 14, 2023). In addition, although the current threshold for federal estate tax is nearly $13 million, that threshold has varied over time and is set to fall again in the near future. See 26 U.S.C. 2010 (c)(3)(C).

2. The government next contends that the question presented is of limited practical importance because companies can "plan around the issues raised in this case." Br. in Opp. 20. But the government fails to identify an alternative that would achieve the same objective (which may explain why this arrangement is in common use).

For example, the government recommends that the owners of a closely held corporation draft an agreement that "sets a value for the stock that is to be redeemed." Br. in Opp. 20. But the owners may not wish to lock in a specific price (or even method of valuation) in advance, because an owner's death may be many years away and a company's value may fluctuate in the meantime. And the government glosses over the stringent statutory requirements for ensuring that the IRS accepts an agreed-upon value. See 26 U.S.C. 2703(b). Companies that do reach an agreed-upon value may well find the IRS challenging it, as the government tacitly concedes. See Br. in Opp. 20.

The government further suggests that the owner of a closely held company might "bequeath[] his shares to an heir, rather than requiring the company to redeem the shares." Br. in Opp. 20. But that would fail to accomplish the fundamental purpose of the arrangement at issue: to

ensure that ownership remains in the hands of the current surviving shareholders.

Finally, the government floats the idea that the Connelly brothers "could have explored the option of using a trust to hold insurance policies for redemption purposes." Br. in Opp. 20. But the government does not explain how such an arrangement would work, and it opaquely acknowledges that there "may be reasons" why such an arrangement would not amount to an adequate alternative. *Ibid.*

The government has thus failed to show there is any alternative that would achieve the same objective. And even if there were, it would have no bearing on whether the Court should resolve the clear circuit conflict with respect to the commonly used arrangement at issue here.

* * * * *

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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