No. 23-146

In the Supreme Court of the United States

THOMAS A. CONNELLY, PETITIONER

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a net corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax.

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OPINIONS BELOW

The opinion of the court of appeals (J.A. 104-118) is reported at 70 F.4th 412. The opinion of the district court (J.A. 119-158) is not reported but is available at 2021 WL 4281288.

JURISDICTION

The judgment of the court of appeals was entered on June 2, 2023. The petition for a writ of certiorari was filed on August 15, 2023, and granted on December 13, 2023. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Pertinent statutory and regulatory provisions are reproduced in an appendix to this brief. See App., *infra*, 1a-5a.

STATEMENT

Closely held corporations are the backbone of the American economy. Those corporations—mostly small businesses, many family-owned—depend on the close relationship between their shareholders. The death of a shareholder can have a profound effect on the operation of a closely held corporation. Accordingly, many closely held corporations agree to redeem the stock of a shareholder upon the shareholder's death and obtain a life-insurance policy on the shareholder in order to fund the redemption obligation. If a shareholder dies, the corporation will redeem the decedent's shares; using the life-insurance proceeds, the corporation will pay an agreed-upon amount of cash to the decedent's estate; the remaining shareholders will control the remaining shares; and the corporation will maintain its closely held nature.

This case is about the effect of that common arrangement on the estate tax owed by the decedent's estate. The estate-tax liability created by a decedent's stock holdings can be significant, with marginal rates reaching 40% for some estates. But that is not enough for the Internal Revenue Service (IRS). Instead, the IRS has sought to inflate the value of the stock by treating life-insurance proceeds used to fund the redemption obligation as an asset that increases the corporation's value, while ignoring the offsetting liability created by the corporation's obligation to pay those proceeds to the decedent's estate. The question presented is whether that is an appropriate way to value

shares in a closely held corporation for estate-tax purposes. The IRS says the answer is yes; common sense says the answer is no.

Petitioner Thomas Connelly is the executor of the estate of his brother, Michael Connelly. Thomas and Michael were the sole owners of Crown C Supply, a small but successful building-materials company in St. Louis, Missouri. In order to preserve the closely held nature of their company, the brothers and the company entered into an agreement providing that the company would redeem the shares of whichever brother died first. To ensure adequate liquidity for the eventual stock purchase, the brothers' company purchased $3.5 million in life insurance on each brother.

Michael died in 2013. After his death, Michael's son and Thomas negotiated a price of $3 million for Michael's stock. As contemplated by the brothers' agreement, the company used $3 million of the life-insurance proceeds to fund that redemption obligation.

When Michael's estate filed its tax return, it reported the value of Michael's stock at the time of his death as $3 million. But the IRS rejected that valuation, asserting that the valuation failed to account for the increase in the company's value resulting from the receipt of the approximately $3.5 million in life-insurance proceeds. Petitioner filed suit, taking the position that the bulk of the life-insurance proceeds did not create a net increase in the company's value because they were offset by a corresponding liability—namely, the redemption obligation.

The district court agreed with the IRS, and the court of appeals affirmed. It reasoned that the company's contractual obligation to repurchase Michael's outstanding stock did not constitute a true liability, even though the corporation was undisputedly required to spend $3 million from its coffers in order to satisfy the obligation. The

court further reasoned that a hypothetical buyer of the *entire* company could cancel the redemption obligation and capture $3 million of the insurance proceeds as additional value. Finally, the court concluded that additional tax was warranted on Michael's estate because of an asserted windfall the transaction gave to Thomas.

The court of appeals' reasoning was not only counter-intuitive, but counter to the law. The valuation of Michael's stock was governed by a test known as the "willing-buyer/willing-seller test." And from the perspective of a rational willing buyer of a company's stock, a contractual obligation requiring the company to spend cash to redeem outstanding shares is plainly a liability that reduces the company's net worth, because the company will be required to expend that cash upon the shareholder's death. Treating the property to be valued as the entire company, rather than the decedent's percentage ownership of the company, also distorts the analysis where, as here, the purchaser of the entire company would obtain control rights that the decedent lacked. And if any windfall is created, it is a windfall to the government from the IRS's position, because the increase in value of Thomas's shares would separately be subject to taxation in its own right. The court of appeals reached the wrong result based on the wrong reasoning. Its judgment should be reversed.

A. Background

1. The death of a shareholder in a closely held corporation can "create a serious problem" for surviving shareholders that wish to retain control of the company. George Gleeson Bogert et al., *Trusts and Trustees* § 253, at 387 (3d ed. 2012) (Bogert); see 3 James D. Cox & Thomas Lee Hazen, *Treatise on the Law of Corporations* § 14:9, at 32-33 (3d ed. 2011) (Cox & Hazen). If the surviving shareholders are unable to reach an agreement

with the decedent's heirs to buy the decedent's stock, the heirs may sell the stock to a third party with no existing relationship—or even an adverse relationship—with the surviving shareholders. See Cox & Hazen § 14:9, at 32-33; Bogert § 253, at 388. For a family business, that could result in the family's losing control of the corporation. And even when the existing owners lack family ties, the presence of a new owner may harm the "close working relationship that often exists among owners and managers" in a small business. Cox & Hazen § 14:9, at 32.

To avoid those complications, a closely held corporation will often enter into buy-sell agreements with its shareholders that require the corporation to redeem each shareholder's outstanding shares upon the shareholder's death, based on an agreed-upon price or method of valuation. Shannon Pratt, *Valuing A Business* 820 (6th ed. 2022); Samuel M. Fahr, *The Business Purchase Agreement and Life Insurance*, 15 Law & Contemp. Probs. 319, 320-322 (1950); see Cox & Hazen § 18:13, at 425. A corporation will often also purchase life-insurance policies on its shareholders, so as to ensure that it has sufficient liquidity for the redemption. See 1 F. Hodge O'Neal & Robert B. Thompson, *Close Corporations and LLCs: Law and Practice* § 7:45, at 7-220 (rev. 3d ed. 2020). When a shareholder dies, the corporation uses the insurance proceeds to redeem the stock for the agreed-upon price, thus maintaining continuity of ownership. *Id.* at 7-220 to 7-221.

2. While buy-sell agreements backed by life insurance can ensure continuity of corporate ownership, they have implications for the federal estate tax owed by the estate of a decedent shareholder.

When a citizen or resident of the United States dies, the federal government imposes an estate tax on the decedent's privilege of transferring property to others upon death. See 26 U.S.C. 2001(a); *United States Trust Co.* v.

Helvering, 307 U.S. 57, 60 (1939). The amount of tax liability depends on the size of the "taxable estate," see 26 U.S.C. 2001(b)-(c), which consists of the "gross estate"—all of the decedent's property—minus certain statutory deductions. See 26 U.S.C. 2031(a), 2051.

The "necessary first step in calculating the taxable estate" is to "determine the property included in the gross estate, and its value." *Commissioner* v. *Estate of Hubert*, 520 U.S. 93, 99-100 (1997). For estate-tax purposes, the value of property is ordinarily the property's fair market value on the date of the decedent's death. See 26 U.S.C. 2031(a); 26 C.F.R. 20.2031-2(a). Treasury regulations define 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." 26 C.F.R. 20.2031-1(b). The willing buyer and willing seller are "hypothetical, not actual persons," and each is presumed to be a "rational economic actor." *Estate of Jelke* v. *Commissioner*, 507 F.3d 1317, 1321 n.11 (11th Cir. 2007), cert. denied, 555 U.S. 826 (2008). As this Court has explained, the "willing buyer-willing seller test of fair market value is nearly as old" as the federal estate tax itself. *United States* v. *Cartwright*, 411 U.S. 546, 551 (1973).

With respect to securities owned by a decedent, there is a longstanding rule—first developed by the lower courts and later recognized by the IRS—that, where the decedent had entered into a buy-sell agreement to sell the securities at the time of his death, the price set by the agreement will conclusively establish the value of the securities, provided that the agreement satisfies certain requirements. See, *e.g.*, 26 C.F.R. 20.2031-2(h); Rev. Rul. 59-60, § 8, 1959-1 C.B. 237, 243-244; *Estate of True* v. *Commissioner*, 390 F.3d 1210, 1218 (10th Cir. 2004) (collecting cases); *St. Louis County Bank* v. *United States*, 674 F.2d

1207, 1210 (8th Cir. 1982) (collecting earlier cases). In 1990, Congress codified a version of that rule in 26 U.S.C. 2703, which provides that the value of property for estate-tax purposes "shall be determined without regard to * * * any option, agreement, or other right to acquire or use the property at a price" lower than "fair market value" unless certain requirements are satisfied. Lower courts have held that Section 2703 supplements, not supplants, the earlier case law and administrative practice. See, *e.g.*, J.A. 110.

If the price in a buy-sell agreement is disregarded for failure to satisfy the requirements of Section 2703 or other provisions, another measure must be used to determine the value of the securities. See 26 C.F.R. 20.2031-2(a), (h). For stock freely traded in a market, the fair market value is generally "the mean between the highest and lowest quoted selling prices on the valuation date." 26 C.F.R. 20.2031-2(b). But when an estate owns stock in a closely held corporation for which no public market exists, applying the test is more complex. In that circumstance, fair market value is determined by considering several factors enumerated by regulation. See 26 C.F.R. 20.2031-2(f)(2). Those factors include "the company's net worth, prospective earning power and dividend-paying capacity," as well as "[the company's] nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." 26 C.F.R. 20.2031-2(f).

B. Facts And Procedural History

1. Michael Connelly was the president, chief executive officer, and controlling shareholder of Crown C Supply Company, a closely held family business that sold building materials in St. Louis, Missouri. Pet. C.A. App.

264-265. Michael died on October 1, 2013. *Id.* at 264. At the time of his death, a trust controlled by Michael owned 385.9 of Crown's 500 shares, or 77.18% of the company; Michael's brother Thomas, the petitioner here, owned the remaining 114.1 shares, or 22.82% of the company. J.A. 1; Pet. C.A. App. 265.

Anticipating the effect of their deaths on the family business, the Connelly brothers had entered into a stock-repurchase agreement with the company that established procedures for the redemption of a decedent shareholder's stock. J.A. 1-24. As the recitals in the operative version of the stock-repurchase agreement explain, the brothers and the company "deem[ed] it to be in their respective best personal and business interests if the [s]hares remain closely held and not generally distributed on the open market." J.A. 2. Missouri law governed the agreement, which was to remain in force unless the company underwent bankruptcy or a similar event; all of the shareholders died simultaneously; or the holders of all of the outstanding shares agreed to terminate the agreement. J.A. 19, 21.

Under the agreement, Michael and Thomas were precluded from transferring their shares in Crown to another party except in certain limited circumstances not applicable here. J.A. 2-7. Of particular relevance here, the agreement also established rules governing the redemption of Crown shares upon a shareholder's death. Under those rules, the remaining shareholders had an initial option to purchase the decedent's shares according to a formula laid out in the agreement. J.A. 10-11; see J.A. 4-6. If the remaining shareholders did not purchase all of the decedent's shares, Crown was required to purchase any remaining shares at a purchase price to be determined either by a certificate of agreed value executed by all of the parties, as long as the certificate was no more than 18

months old, or by the appointment of appraisers. J.A. 11-14.

The agreement also authorized Crown to purchase life-insurance policies on its shareholders, the proceeds of which could be used to buy a decedent shareholder's outstanding shares. J.A. 17-18. Pursuant to that authority, Michael obtained $3.5 million in insurance policies on his own life and assigned the policies or benefits to Crown; Crown also acquired insurance policies of the same amount on Thomas's life. Pet. C.A. App. 266-267. It is undisputed that the brothers always "intended that, after the first of them died, [Crown] would buy the deceased brother's * * * stock from the deceased brother's estate with the life insurance policy proceeds the [c]ompany received after the brother's death." J.A. 34.

2. When Michael died, Thomas was appointed by a Missouri state court as the executor of Michael's estate. Pet. C.A. App. 1, 263. On November 13, 2013, the estate, Michael's son (Michael Connelly, Jr.), and Crown entered into a sale and purchase agreement for Michael's shares of Crown. J.A. 25-26. As is relevant here, the parties agreed that the value of the shares was $3 million and that Crown would purchase them when it received the proceeds from Michael's insurance policy. J.A. 26.

Crown later received approximately $3.5 million in insurance proceeds and used them to purchase Michael's shares. Pet. C.A. App. 270. As a result of the redemption, Thomas became Crown's sole shareholder. *Id.* at 279; Resp. C.A. App. 35.

In 2014, the estate filed its federal estate tax return. See D. Ct. Dkt. 53-2 (original return); D. Ct. Dkt. 53-3 (amended return). The estate's return listed the value of Michael's shares of Crown stock as $3 million, in accordance with the sale and purchase agreement. See D. Ct. Dkt. 53-2, at 14.

The IRS audited the return. During the audit process, the estate provided the IRS with an estimate from an accounting firm that valued Michael's stock at $2,982,000 (slightly below the $3 million valuation on the return). Pet. C.A. App. 103-107. The IRS expressed the view, however, that the revised figure failed to account for the $3 million that Crown received in insurance proceeds and subsequently used to redeem Michael's shares. *Id.* at 67-68.

In 2017, the IRS sent the estate a deficiency notice. Pet. C.A. App. 54. According to the notice, the IRS valued Michael's stock at $5,297,000, which is the sum of $2,982,000 (the estate's valuation of Michael's shares) and 77.18% of $3 million (representing Michael's proportional share of the insurance proceeds). *Id.* at 59. The IRS stated that, in valuing the stock, it was disregarding the stock-repurchase agreement, which the IRS determined to constitute an agreement to acquire the stock at less than fair market value under 26 U.S.C. 2703. *Ibid.*

Ultimately, the estate paid $1,027,041.77 in additional estate taxes. Pet. C.A. App. 52. Petitioner sought a refund for that payment, but the IRS did not respond to the request. *Ibid.*; Resp. C.A. Br. 12.

3. On May 23, 2019, petitioner, in his capacity as executor of the estate, filed a refund action under 28 U.S.C. 1346(a)(1) in the United States District Court for the Eastern District of Missouri. See Pet. C.A. App. 1-6. As is relevant here, petitioner argued that the $3 million of insurance proceeds used for the stock redemption should not be considered an additional asset of Crown for purposes of calculating estate-tax liability. Petitioner contended that those insurance proceeds were already effectively taken into account as part of the valuation of the company's net worth, because any additional benefit from

$3 million of the insurance proceeds was offset by the contractual obligation to repurchase Michael's stock. In support of that contention, petitioner cited the Eleventh Circuit's decision in *Estate of Blount* v. *Commissioner*, 428 F.3d 1338 (2005), and the Ninth Circuit's decision in *Estate of Cartwright* v. *Commissioner*, 183 F.3d 1034 (1999), which held that life-insurance proceeds should not be considered in materially identical circumstances. See Pet. C.A. App. 4-6.

In the course of the district-court proceedings, the parties stipulated to a number of facts. See J.A. 32-38. Of particular note here, the parties stipulated that, under the agreement, the brothers always intended for Crown (rather than the surviving brother) to purchase the deceased brother's shares. J.A. 34. The parties also stipulated that, if the life-insurance proceeds were not added to the total value of Crown, the fair market value of the estate's shares would be $3.1 million. J.A. 37.

4. The parties filed cross-motions for summary judgment, and the district court granted summary judgment to the government. J.A. 119-158.

The district court first concluded that the $3 million valuation in the buy-sell agreement between the estate, Michael's son, and Crown did not control the value of the stock. J.A. 146. The court accepted that the agreement was a bona fide business arrangement, as required by 26 U.S.C. 2703(b), but it ultimately concluded that the agreement did not satisfy the other requirements. J.A. 130-146.

The court then turned to assess the fair market value of Michael's stock. J.A. 146-158. The court explained that, because "[t]he parties agree[d] that the facts relating to [Crown's] fair market value are undisputed," "the only remaining issue [was] how to allocate the life-insurance proceeds." J.A. 147.

At the IRS's urging, the district court rejected the Eleventh Circuit's holding in *Estate of Blount*, concluding instead that "a redemption obligation is not a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." J.A. 151 (internal quotation marks and citation omitted). The court reasoned that, if a hypothetical buyer purchased 100% of Crown's shares, the buyer would have been able to cancel the redemption obligation and retain the insurance proceeds for itself. J.A. 151-152. The court further reasoned that treating the redemption obligation as a liability improperly valued the corporation in its post-redemption configuration rather than valuing it on the date of Michael's death. J.A. 152-153.

5. The court of appeals affirmed. J.A. 104-118. Like the district court, the court of appeals began with the question whether the buy-sell agreement controlled the value of Michael's shares. J.A. 109-112. It agreed with the district court that the $3 million valuation in the agreement was not controlling. *Ibid.*[1]

The court of appeals then addressed the effect of the life-insurance proceeds on the fair market value of Michael's stock. J.A. 112-118. It agreed with the district court that the proceeds effectuated a net increase in the corporation's value, relying on the same hypothetical the district court used involving the purchase of a 100% interest in Crown. J.A. 117. The court of appeals further reasoned that, because the value of Thomas's shares increased after the redemption, the insurance proceeds were not truly offset by the redemption obligation. J.A. 117-118. The court of appeals acknowledged that the

[1] The court of appeals treated the value of Michael's shares as $2,982,000, rather than $3.1 million (as the parties stipulated at summary judgment). J.A. 37, 106-107 n.2. That difference does not affect the Court's analysis of the question presented here.

Eleventh Circuit's decision in *Estate of Blount* "present[ed] the same fair-market value issue," but it rejected the Eleventh Circuit's holding. J.A. 115-116.

SUMMARY OF ARGUMENT

This case presents the question of the appropriate treatment of the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder, and used to fulfill an obligation to redeem the shareholder's shares upon his death, for purposes of the federal estate tax. The court of appeals erred by holding that the proceeds of the life-insurance policy, but not the offsetting obligation to redeem the decedent shareholder's stock, should be taken into account when valuing the stock for estate-tax purposes. The judgment of the court of appeals should therefore be reversed.

A. The fair market value of stock in a closely held corporation is assessed under the willing-buyer/willing-seller test, which seeks to determine the price at which property would change hands in a hypothetical exchange between a hypothetical willing buyer and a hypothetical willing seller. Those hypothetical parties are presumed to be acting rationally, without compulsion, and with complete information about all relevant facts.

Because the willing-buyer/willing-seller test posits parties with knowledge of all relevant facts, it necessarily accounts for legal and practical limitations affecting the value of the property in question. The Court applied the willing-buyer/willing-seller test in precisely that manner in *United States* v. *Cartwright*, 411 U.S. 546 (1973). That case concerned the estate-tax valuation of mutual-fund shares, which have a limited resale market in light of the Investment Company Act. The Court concluded that the willing-buyer/willing-seller test, and thus the fair market value of the shares, must take that limitation into account.

B. Under a proper application of the willing-buyer/willing-seller test, life-insurance proceeds used to fund an offsetting obligation to redeem a decedent shareholder's stock do not increase the value of the stock. Because stock constitutes a fractional interest in a company, a willing buyer and willing seller of stock in a company would reach an agreed-upon price that is based primarily on the value of the company as a whole. Because the willing buyer and willing seller are informed and economically rational, they would take account not only of a company's anticipated assets but also its anticipated liabilities. And because a company's redemption obligation constitutes a binding contractual obligation, a willing buyer and willing seller would consider a redemption obligation to constitute a corporate liability, and take that liability into account when bargaining over the value of the company's stock. To the extent insurance proceeds are designated for a stock redemption, the willing seller and willing buyer would therefore view them as offset by the redemption obligation.

That conclusion is supported by Treasury regulations, traditional accounting principles, and this Court's precedents. The applicable regulations confirm that the fair market value of closely held stock is determined by assessing the value of the company as a whole. Under general principles of corporate valuation, a mandatory obligation to redeem a shareholder's stock constitutes a liability against the corporation's assets. *Cartwright* confirms that a proper valuation must consider all relevant economic facts, such as restrictions or liabilities. And the text and history of 26 U.S.C. 2703 make clear that, while a court may not treat a buy-sell agreement as determinative of a stock's price in certain circumstances, the court need not disregard the existence of the agreement altogether (and its effect on the corporation's value).

C. In the decision below, the court of appeals misapplied the willing-buyer/willing-seller test by incorporating an improper control premium into the value of the estate's stock. When valuing a block of stock, the degree of control over the corporation the block provides the owner factors into the price of the stock. But an assessor must assume only the degree of control in fact available to the owner of the percentage being valued. The court of appeals, however, concluded that a prospective buyer of the estate's shares could capture the value of the life-insurance proceeds by purchasing not only the estate's shares, but all of Crown's shares, and then extinguishing the corporation's mandatory redemption obligation. That approach incorrectly imputes to a portion of Crown's stock a control premium that would be available only to an owner of the *entire* company. It is inconsistent with the willing-buyer/willing-seller test to assume that a willing buyer of some stock would ultimately purchase and control additional stock.

D. The valuation approach proposed by the IRS and adopted by the court of appeals would lead to economically harmful and irrational consequences. Insurance proceeds designated for a mandatory stock redemption are a critical tool for allowing small businesses to preserve the closely held character of their companies. Treating those proceeds as a net asset for estate-tax purposes would badly hamper those efforts. In particular, the IRS's approach would force companies to purchase life insurance policies many times larger than the value of the stock they seek to redeem, in order to cover the spiraling costs of a prospective redemption. The IRS's approach would also disrupt decades-old settled understandings of tax law. And it would permit the IRS to collect an improper windfall, subjecting the same value to both estate tax and capital-gains tax despite congressional policy

against such double taxation. The Court should thus conclude that insurance proceeds earmarked for a stock redemption are not a net corporate asset that increases the value of stock for estate-tax purposes, and it should reverse the court of appeals' judgment.

ARGUMENT

LIFE-INSURANCE PROCEEDS USED BY A CLOSELY HELD CORPORATION TO FULFILL AN OFFSETTING OBLIGATION TO REDEEM THE INSURED'S CORPORATE SHARES DO NOT INCREASE THE VALUE OF THE SHARES FOR ESTATE-TAX PURPOSES

Under the Internal Revenue Code, the amount of federal estate tax owed by an estate is determined by measuring the value of the decedent's "gross estate" and then applying certain deductions to arrive at the value of the "taxable estate." See 26 U.S.C. 2001, 2051. The "necessary first step in calculating the taxable estate for federal estate tax purposes" is thus to "determine the property included in the gross estate[] and its value." *Commissioner* v. *Estate of Hubert*, 520 U.S. 93, 99-100 (1997). The gross estate consists of "all property, real or personal, tangible or intangible, wherever situated," at the time of the decedent's death. 26 U.S.C. 2031(a). The gross estate thus includes any stock held by the decedent, including stock in a closely held corporation. See 26 C.F.R. 20.2031-2.

Where the decedent's stock in a closely held corporation is subject to a buy-sell agreement requiring the corporation to redeem the stock, the value of any life-insurance proceeds used by the corporation to complete the redemption does not increase the stock's value for estate-tax purposes. The value of the stock is determined by applying the willing-buyer/willing-seller test, which takes

account of all relevant facts, including the net value of the corporation as affected by both assets and liabilities.

Under a proper application of that test, a willing buyer of the corporation's stock would not consider the corporation's receipt of life-insurance proceeds as effectuating a net increase in the corporation's value to the extent those funds are offset by a corresponding obligation to redeem the decedent's shares. The redemption obligation constitutes a liability that offsets the value of the insurance proceeds, and a purchaser of a subset of the corporation's shares would treat the two as canceling each other out. The contrary conclusion urged by the IRS and adopted by the court of appeals rests on a misapplication of the willing-buyer/willing-seller test and a misunderstanding of principles of corporate valuation. The judgment below should be reversed.

A. The Willing-Buyer/Willing-Seller Test Accounts For All Relevant Facts Concerning The Relevant Property

The willing-buyer/willing-seller test used to determine the value of property for estate-tax purposes is objective in nature, and it requires analysis of a hypothetical exchange between two hypothetical rational actors with knowledge of all relevant circumstances. As demonstrated by this Court's decision in *United States* v. *Cartwright*, 411 U.S. 546 (1973), the willing-buyer/willing-seller test takes account of legal and practical limitations affecting the value of the property in question.

1. IRS regulations provide that the property within a decedent's gross estate is valued at the "fair market value at the time of the decedent's death." 26 C.F.R. 20.2031-1(b). In turn, fair market value is determined by applying the willing-buyer/willing-seller test. See, *e.g.*, *Cartwright*, 411 U.S. at 551. Under that test, the value of the property is 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." 26 C.F.R. 20.2031-1(b).

The willing-buyer/willing-seller test provides an "objective standard" to determine the fair market value of property. *Propstra* v. *United States*, 680 F.2d 1248, 1252 (9th Cir. 1982); see, *e.g.*, *Estate of Baird* v. *Commissioner*, 416 F.3d 442, 444 n.3 (5th Cir. 2005); *Ruehlmann* v. *Commissioner*, 418 F.2d 1302, 1304 (6th Cir. 1969), cert. denied, 398 U.S. 950 (1970). The willing buyer and willing seller are "hypothetical, not actual persons." *Estate of Jelke* v. *Commissioner*, 507 F.3d 1317, 1321 n.11 (11th Cir. 2007), cert. denied, 555 U.S 826 (2008); accord Br. in Opp. 2. They must thus be "postulated * * * objectively and impersonally"; the test cannot be "tailor[ed]" to treat the willing buyer and the willing seller as "the particular persons who would most likely undertake the transaction." *Morrissey* v. *Commissioner*, 243 F.3d 1145, 1148 (9th Cir. 2001) (citation omitted).

The willing buyer and willing seller are also "fully informed," *Cartwright*, 411 U.S. at 552, and "economically rational." *Holman* v. *Commissioner*, 601 F.3d 763, 775 (8th Cir. 2010); see *Estate of Jelke*, 507 F.3d at 1321 n.11. The test thus requires consideration of "[a]ll relevant facts and elements of value as of the applicable valuation date." 26 C.F.R. 20.2031-1(b). The test does not "permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer [or seller]." *Estate of Curry* v. *United States*, 706 F.2d 1424, 1429 (7th Cir. 1983).

Application of the willing-buyer/willing-seller test "depend[s] upon the circumstances in each case." Rev. Rul. 59-60, § 3.01, 1959-1 C.B. 237, 238. As the IRS has ex-

plained, "[n]o formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate * * * tax [cases]." *Ibid.* In applying the test, an assessor should rely on "the elements of common sense, informed judgment[,] and reasonableness" when "weighing th[e] facts and determining their aggregate significance." *Ibid.*

2. As this Court's decision in *Cartwright* demonstrates, the willing-buyer/willing-seller test accounts for legal and practical limitations affecting the value of the property in question.

In *Cartwright*, the Court considered the appropriate valuation of an estate's shares in a mutual fund. See 411 U.S. at 546-547. As the Court explained, mutual-fund shares are not freely traded on the open market. See *id.* at 549. Instead, under the Investment Company Act, a mutual fund is required to redeem shares at a particular price set by statute. See *id.* at 547. Trading in mutual funds thus occurs through a purchase from the fund at an initial asking price and a later sale to the fund at the statutorily defined redemption price. See *id.* at 547-549.

In light of those market dynamics, "the only price that [an] estate [can] hope to obtain" for mutual-fund shares is the redemption price. 411 U.S. at 551. The estate in *Cartwright* thus argued that the redemption price constituted the fair market value of the shares. See *ibid.* The government, however, took the position that the mutual fund's asking price on the date of death constituted the fair market value. See *id.* at 551-552.

Applying the willing-buyer/willing-seller test, the Court agreed with the estate. See 411 U.S. at 552-557. The Court explained that the proper way to view an exchange of mutual-fund shares, in light of the legal rules imposed by the Investment Company Act, is "as the final step in a voluntary transaction between a willing buyer

and willing seller." *Id.* at 552. The mutual fund is the willing seller of the shares, and the willing buyer is a person who purchases shares from the fund on the condition that he sell them back to the fund at the statutory redemption price. See *id.* at 552-553. The shares were worth only the redemption price under the willing-buyer/willing-seller test, the Court reasoned, because the buyer could only ever obtain the redemption price for the shares in a subsequent sale to the mutual fund. See *ibid.* The Court saw "no valid justification for disregarding th[at] reality connected with the ownership of mutual fund shares." *Id.* at 554.

The Court in *Cartwright* thus fashioned the hypothetical transaction under the willing-buyer/willing-seller test to account for the legal and practical restrictions on the transfer of mutual-fund shares. The Court declined to treat the willing buyer as a private actor purchasing mutual-fund shares from the private holder of the shares, because such a transaction would never occur in light of the absence of a private market for the shares. See 411 U.S. at 552-553. The Court also declined to treat the public asking price as the fair market value, because "the estate could not hope to obtain" that price, and "the fund could not offer" it, in light of the Investment Company Act. *Id.* at 553. The Court thus applied the willing-buyer/willing-seller test to account for the legal and practical limitations affecting the value of the property at issue.

B. The Willing Buyer And Willing Seller Valuing A Closely Held Corporation Would Disregard Life-Insurance Proceeds Used By The Corporation To Fulfill An Offsetting Obligation To Redeem The Insured's Stock

In the particular context of corporate stock, the price at which a willing buyer and willing seller would trade is ordinarily determined by looking at prices on the open

market or bona fide bid and asked prices. See 26 C.F.R. 20.2031-2(b)-(e). But when such prices are unavailable, the fair market value depends on "the company's net worth, prospective earning power and dividend paying capacity, and other relevant factors," including "good will of the business," "the economic outlook in the particular industry," and "the degree of control of the business represented by the block of stock to be valued." 26 C.F.R. 20.2031-2(f). The value also takes into account "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 connection with other factors. *Ibid.*

As the regulation indicates, one of the most important factors to consider when valuing closely held corporate stock is the corporation's net worth. The determination of net worth involves "a mathematical computation, into which of necessity enter all [the corporation's] assets subject to liabilities." *State of Missouri ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U.S. 313, 323 (1930) (Stone, J., dissenting); see 1 Joni Larson, *Valuation Handbook* § 2.03[2][c], at 2-56 to 2-57 (2023) (Larson); American Institute of Certified Public Accountants, *Statements on Standards for Valuation Services VS Section 100: Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* ¶ 34, at 12 (2007). Consideration of net worth as a metric for valuing stock makes sense where, as here, the life-insurance proceeds are a nonoperating asset, for the simple reason that stock represents "a fractional interest in the corporate enterprise that includes an indirect interest in its property and earnings, subject to its liabilities." 3 James D. Cox & Thomas Lee Hazen, *Treatise on the Law of Corporations* § 16:12, at 310 (3d ed. 2011) (Cox & Hazen).

Under traditional principles of valuation, a closely held corporation's obligation to redeem a shareholder's stock constitutes a corporate liability. And under a proper application of the willing-buyer/willing-seller test, the willing buyer would treat such a liability as reducing a corporation's value when assessing the value of the corporation's stock. That liability should thus be treated as offsetting the value of any life-insurance proceeds when valuing corporate stock for estate-tax purposes.

1. For purposes of valuation, a corporation's contractual obligation to purchase a shareholder's stock upon the shareholder's death constitutes a liability. Under traditional accounting principles, "[a] demand of any sort against a corporation, even though contingent, unliquidated, or disputed, such as a damage claim or a guaranty of another's obligation, is * * * characterized as a liability." Cox & Hazen § 19:5, at 463. A stock redemption agreement creates precisely such a demand. It embodies a corporate commitment to spend cash from the company's coffers and thereby reduce the company's assets.

An obligation to redeem shares also gives rise to a legal right that can be enforced against the company. Consider Missouri law, for example, which governs the buy-sell agreement and stock-repurchase agreement here. See J.A. 21. Under Missouri law, "the remedy of specific performance may be invoked to enforce contracts for the sale of corporate stock." *Stiff* v. *Stiff*, 989 S.W.2d 623, 628 (Mo. Ct. App. 1999); see *Kludt* v. *Connett*, 168 S.W.2d 1068, 1074 (Mo. 1943). If Crown had refused to honor the agreements and redeem Michael's shares, Michael's estate could thus have filed suit to compel Crown to buy the shares—and vice versa, if Michael's estate had refused to tender them. See *Rosemann* v. *Roto-Die, Inc.*, 276 F.3d 393, 398-401 (8th Cir. 2002); *Lake Cable, Inc.* v. *Trittler*,

914 S.W.2d 431, 434 (Mo. Ct. App. 1996); see also 12A William M. Fletcher, *Cyclopedia of the Law of Corporations* § 5634, at 501 (rev. ed. 2017) (Fletcher). And if the estate had sold Michael's shares to a third party with knowledge of the agreement, Crown could have moved to unwind the transaction under the doctrine of constructive trust. See, *e.g.*, *Schultz* v. *Schultz*, 637 S.W.2d 1, 4-5 (Mo. 1982); *Wier* v. *Kansas City*, 204 S.W.2d 268, 270 (Mo. 1947); see also Dan B. Dobbs & Caprice L. Roberts, *Law of Remedies* §§ 4.3(2), 4.3(8), at 406-407, 427 (2018) (Dobbs); 1 F. Hodge O'Neal & Robert B. Thompson, *Close Corporations and LLCs: Law and Practice* § 4:42, at 4-185 to 4-187 (rev. 3d ed. 2020).

It is thus unsurprising that, under generally accepted accounting standards, any financial instrument that embodies "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"—is treated as a liability. Financial Accounting Standards Board, *Accounting Standards Codification* ¶¶ 480-10-25-8, 480-10-55-64 (Feb. 2023 ed.).[2] Those standards specifically confirm that, "[i]f an equity instrument is required to be redeemed for cash * * * upon the death of the holder, the instrument is classified as a liability * * * even if an insurance policy would fund the redemption." *Id.* ¶ 480-10-S99-3A(3)(g) n.9. That principle not only enjoys the approval of the accounting community but accords with com-

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[2] This Court has recognized that the "generally accepted accounting principles" promulgated by the Financial Accounting Standards Board are the "conventions, rules, and procedures that define accepted accounting practices." *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 811 n.7 (1984); see *SEC* v. *Jensen*, 835 F.3d 1100, 1105 n.1 (9th Cir. 2016) (noting that the SEC treats the Board's standards as authoritative).

mon sense: because death is guaranteed, a company obligated to repurchase the insured's shares is certain to expend corporate assets to redeem them. At the moment of death, that liability simply converts from a guaranteed future one to a present one.

Because a company's commitment to redeem the shares of a deceased shareholder represents a liability affecting the company's net worth, a proper valuation of the company must account for that liability. See 26 C.F.R. 20.2031-2(f)(2); see also *Estate of Jelke*, 507 F.3d at 1331-1333; *Eisenberg* v. *Commissioner*, 155 F.3d 50, 57 (2d Cir. 1998). It does not matter whether the corporation has carried out the redemption at the precise moment of valuation (*i.e.,* the date of the decedent's death). After all, present value takes into account unpaid liabilities. See, *e.g.*, *Estate of Hubert*, 520 U.S. at 101-102. Accordingly, just as a valuation of a company as of the date of an insured's death would consider life-insurance proceeds expected to flow in, so too must the valuation consider the amount of those proceeds expected to flow out as fulfilment of an offsetting redemption obligation.

That is not to say that *every* stock redemption involves a liability. See J.A. 116-117. "[B]y issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets." *Accounting Standards Codification* ¶ 480-10-05-3. The mere possibility that a company may voluntarily choose to redeem shares in the future does not create a liability. And when a company does voluntarily redeem shares, it is merely choosing to expend resources for business purposes. By contrast, when a company is subject to a contractual obligation to redeem the shares, it incurs a liability, and the subsequent redemption constitutes the satisfaction of a liability.

2. Treating the redemption obligation as a corporate liability that depresses the value of the corporation's shares comports with how the willing buyer and willing seller would analyze a hypothetical transaction in those shares.

As *Cartwright* demonstrates, the willing-buyer/willing-seller test takes into account legal and practical limitations affecting the value of the property at issue. See pp. 19-20, *supra*. The willing buyer and willing seller would thus be aware that a portion of the company's shares are subject to an enforceable buy-sell agreement requiring the decedent's estate to tender, and the corporation to redeem, the decedent's shares. The willing buyer and willing seller would likewise recognize that the existence of that agreement would necessarily result in the company's spending the assets necessary to fulfill that agreement. As explained above in the context of Missouri law, if anyone other than the company were to attempt to transact in the decedent's shares, the corporation could block or even unwind the transaction. See, *e.g.*, Dobbs § 4.3(2), at 406-407; 12A Fletcher § 5634, at 501; see also *Moore* v. *Crawford*, 130 U.S. 122, 128 (1889). The hypothetical parties would therefore assume a diminution in net corporate assets equivalent to the redemption price when transacting in the company's shares.

To be sure, the estate's particular shares are not subject to exchange; under the purchase agreement, both the company's purchase and the estate's sale of those shares are mandatory. But the unavailability of the precise shares at issue does not matter. As the relevant regulations explain in the context of the valuation of an automobile, fair market value "is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which

the particular automobile of the decedent would be purchased by a dealer in used automobiles." 26 C.F.R. 20.2031-1(b). So too here. The hypothetical willing-buyer/willing-seller test posits hypothetical shares that make up the same percentage of the corporation as a whole, not the decedent's actual shares.

So considered, a hypothetical buyer seeking to purchase 77.18% of Crown would treat the liability created by a redemption obligation as effectively canceling out life-insurance proceeds used to fulfill that obligation. From the perspective of a willing buyer, the existence of the redemption obligation would make it impossible to capture the full value of the insurance proceeds, at least where, as here, a unanimous vote of all shareholders is required to terminate the redemption obligation. The willing buyer would thus not consider proceeds that would be used for redemption as net assets in which Crown stock would provide an interest.[3]

In sum, the proper way to value a decedent's shares subject to a buy-sell agreement accompanied by life insurance is to treat the life insurance used to fulfill the buy-sell agreement as adding no value to the shares. As 26 C.F.R. 20.2031-2(f) instructs, nonoperating assets should be considered in valuing a company only to the extent they "have not been taken into account in the determination of net worth." In valuing Crown, the determination of net worth takes into account both life-insurance proceeds payable to the benefit of Crown and the offsetting redemption obligation to purchase the estate's shares. For estate-tax purposes, therefore, the company should not be

[3] By contrast, approximately $500,000 of the life-insurance proceeds were excess proceeds not offset by Crown's mandatory redemption obligation. That amount would indisputably be considered a net asset that is incorporated into the value captured by hypothetical Crown shares.

treated as having the same value that it would in the absence of the redemption obligation.

3. In the audit process, the IRS determined that 26 U.S.C. 2703(a)(1) required it to value the estate's interest in Crown without regard to the provisions of the Connelly brothers' stock-repurchase agreement. See Pet. C.A. App. 59. That was incorrect. Section 2703(a)(1) states that "the value of any property shall be determined without regard to * * * any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)." That provision is a partial codification of, and supplement to, a preexisting rule that the price set by a buy-sell agreement can conclusively establish the value of securities in some circumstances, provided that the agreement satisfies certain requirements. See, *e.g.*, 26 C.F.R. 20.2031-2(h); Rev. Rul. 59-60, § 8, 1959-1 C.B. 243-244; *Estate of True* v. *Commissioner*, 390 F.3d 1210, 1218 (10th Cir. 2004) (collecting cases); *St. Louis County Bank* v. *United States*, 674 F.2d 1207, 1210 (8th Cir. 1982) (collecting earlier cases); Richard B. Stephens et al., *Federal Estate and Gift Taxation* ¶ 19.04[1][c], at 19-139 (9th ed. 2013).

As the text and history of Section 2703 demonstrate, that provision does not require an assessor to *ignore* the fact of a buy-sell agreement when determining the net worth of the corporation whose stock is at issue. Instead, the provision means only that the value agreed to in a buy-sell agreement is not *conclusive* of the fair market value of the property if the agreement does not satisfy the statutory and other legal requirements. The IRS has long recognized that, even when the value set by a buy-sell agreement is disregarded, "such agreement is a factor to be considered * * * in determining fair market value" of the corporation. Rev. Rul. 59-60, § 8, 1959-1 C.B. 244.

Case law postdating the enactment of Section 2703 is in accord. See, *e.g.*, *Estate of True*, 390 F.3d at 1238-1239. Nothing in Section 2703 suggests that Congress intended to displace that longstanding law. See, *e.g.*, J.A. 110.[4]

C. The Proper Valuation Of A Block Of Corporate Shares Does Not Include Value Available Only To A Purchaser Of The Entire Company

In the decision below, the court of appeals concluded that insurance proceeds designated for a stock redemption create a net increase in the value of a closely held corporation because a hypothetical purchaser of a 100% stake in the corporation could capture the full value of the life-insurance proceeds. J.A. 117. The court theorized that a prospective buyer could buy both the decedent's shares and all other outstanding shares and then "extinguish the stock-purchase agreement or redeem the shares from himself," thus ending up not only with full ownership of the corporation but also with the full amount of the insurance proceeds. *Ibid.* Because a buyer of 100% of the corporation would be willing to pay the previous value of the corporation plus the insurance proceeds, the court of appeals reasoned, the decedent's shares should be valued based on that larger figure. *Ibid.* That analysis is deeply flawed.

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[4] Unsurprisingly, the government did not argue in either of the lower courts that Section 2703 precluded consideration of the buy-sell agreement here when calculating the value of Crown. And if Section 2703 did preclude consideration of the agreement in that manner, the same text would necessarily preclude consideration of insurance purchased for the sole purpose of funding that agreement as well. After all, a hypothetical company that never entered into such an agreement would never have purchased insurance to fund that agreement either. Indeed, the authority for Crown to purchase the insurance came from the stock-repurchase agreement that would need to be ignored. See J.A. 17-18.

1. The court of appeals' approach impermissibly inflates the value of a block of shares by incorporating value available only to an owner of the entire company.

The fair market value of a portion of a company's stock can differ substantially from a simple proportion of the purchase price of the total company. That is because the degree of control represented by particular shares can be an important aspect of their value. Traditional accounting principles require assessors to consider "inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability," including "a control premium or noncontrolling interest discount." *Accounting Standards Codification* ¶ 820-10-35-36B. Bids that seek control of an entire company usually offer a substantial premium above the fair market value of individual stock. See, *e.g.*, *Katz* v. *Gerardi*, 655 F.3d 1212, 1215 (10th Cir. 2011); see generally Shannon Pratt, *Valuing A Business* 385-407 (6th ed. 2022).

Treasury regulations governing estate taxation reflect the fact that the potential purchase of an entire company often differs substantially from the purchase of a lesser share of its stock. Under those regulations, the estate-tax value of stock depends on an array of additional factors in addition to the underlying corporation's net worth. See 26 C.F.R. 20.2031-2(f)(2). Some of those factors relate to the characteristics and prospects of the whole company, such as the quality of a company's management and the economic outlook in the relevant industry. See 26 C.F.R. 20.2031-2(f). But crucially, others relate to the quantity and quality of the shares at issue. The regulations thus direct an assessor to consider "the degree of control of the business represented by the block of stock to be valued." *Ibid.* IRS guidance likewise provides that, if a corporation "has more than one class of stock outstanding, the charter

or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues." Rev. Rul. 59-60, § 4.02(c); 1959-1 C.B. 240.

Premiums or discounts to the value of stock are thus often warranted based on the marketability or degree of control associated with particular quantities or classes of stock. See, *e.g.*, *Estate of Stewart* v. *Commissioner*, 617 F.3d 148, 154 (2d Cir. 2010); *Estate of Hoover* v. *Commissioner*, 69 F.3d 1044, 1047 (10th Cir. 1995). For example, if a block of stock represents a controlling interest in a company, it "will be valued above what the stock is trading for," because the controlling interest "gives the shareholder the ability" to "control the corporation by dictating its policies, procedures, or operations"; to "make changes to the business"; or even to "force a liquidation." Larson § 2.03[4][a], at 2-84 to 2-84.1. On the other hand, a block of stock may be discounted because it represents only a minority interest that does "not convey control" or because the stock is not marketable. *Id.* § 2.03[4][c], at 2-93 to 2-97.

Those principles apply with particular force in the context of closely held stock subject to a buy-sell agreement terminable only by a unanimous vote of all shareholders. As the court of appeals recognized, the only way a hypothetical buyer could capture the value of corporate life-insurance proceeds in the face of such an agreement would be by purchasing "all" of a company's shares and then either "extinguish[ing] the stock-purchase agreement or redeem[ing] the shares from himself." J.A. 117 (emphasis omitted). Naturally, then, a purchaser of 100% of the corporation's shares would treat the life-insurance proceeds as a net corporate asset, because control of the entire company would allow the sole owner to pocket the insurance proceeds. The same is not true for a buyer of some subset (or even a majority) of corporate shares, because the

buyer could not capture the value of the life-insurance proceeds.

By treating the life-insurance proceeds as a net corporate asset, the court of appeals effectively incorporated a control premium for complete ownership into its valuation of an incomplete block of stocks. That was improper.

2. In other contexts, the IRS has occasionally sought to inflate the value of assets by treating a portion of an asset as part of a larger whole. Courts have consistently rejected that approach to valuation.

For example, in *Propstra*, *supra*, the IRS argued that a decedent's undivided one-half interest in several parcels of real estate should be valued as a "proportionate share of the market value of the whole." 680 F.2d at 1251. The IRS theorized that the partial interests would likely be sold along with the other undivided one-half interest. See *ibid.*

The Ninth Circuit rejected that contention, holding that the appropriate measure of value was the partial interests sold independently. See 680 F.2d at 1251. Among other reasons, the court explained that attempting to value the sale of the interests together would introduce uncertainty by creating a need to "account for the likelihood that estates, legatees, or heirs would sell their interests together with others who hold undivided interests in the property." *Id.* at 1252. By focusing instead on the one-half interests independently, an assessor "will not have to make delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question." *Ibid.*

The Fifth Circuit's en banc decision in *Estate of Bright* v. *United States*, 658 F.2d 999 (1981), is to the same effect. There, a husband and wife had jointly owned 55% of the stock in several corporations; when the wife died, she de-

vised her one-half interest in the block of stock to her husband as the trustee of a trust for the benefit of their children. See *id.* at 1000. The IRS argued that the wife's one-half interest should be valued by valuing the controlling 55% block of stock and then taking half of that figure. See *id.* at 1001.

The Fifth Circuit rejected that approach, concluding that the estate's interest represented only "the equivalent of a 27½% block of the stock." 658 F.2d at 1001. Of particular relevance here, the Court rejected the IRS's argument that a control premium was appropriate because the entire 55% stake would be held by a single family, such that the estate would be able to sell the stock as part of a single 55% unit. *Id.* at 1002. As the court explained, that approach contravened "long established precedent" and was "logically inconsistent with the willing buyer-seller rule," which requires consideration of a "hypothetical seller" rather than "the estate itself." *Id.* at 1005.

The court of appeals' assessment of the value of the estate's stock here, based on an imagined purchase of the entirety of Crown's stock, was similarly erroneous. The stock to be valued is a 77.18% interest in Crown, and the value of that interest cannot be calculated by positing a hypothetical in which the willing buyer purchases the entire company. Such a hypothetical improperly inflates the value of the stock in question, and it would require a court to assess "the feelings, attitudes, and anticipated behavior of those holding" the remaining corporate shares in order to determine whether the remaining shareholders "would sell their interests." *Propstra*, 680 F.2d at 1252. That approach cannot be reconciled with the objective nature of the willing-buyer/willing-seller test.

D. Increasing The Value Of An Estate's Stock Based On Corporate Insurance Proceeds Designated For A Stock Redemption Would Create Negative Practical Consequences

The IRS has long recognized that valuation is "not an exact science" but requires the exercise of "elements of common sense, informed judgment[,] and reasonableness." Rev. Rul. 59-60, § 3.01, 1959-1 C.B. 238. Treating insurance proceeds designated for a stock redemption as a net asset for estate-tax purposes flouts that principle. Doing so would force small businesses to expend disproportionate sums to preserve their character. It would disrupt a long-settled, common-sense approach to valuation on which small businesses have relied for decades. And it would allow the IRS to reap an illegitimate windfall, collecting both estate tax and capital-gains tax on essentially the same amount.

1. Adopting the IRS's approach to valuation in this case would be grossly inequitable and would substantially interfere with the ability of small businesses to preserve the closely held character of their companies. For starters, the IRS's approach would compel companies to engage in a staggering ratcheting-up of insurance purchases in order to fund a redemption obligation. Businesses seeking insurance to cover the cost of a modest stock redemption would have to purchase policies several times the expected value of that stock simply to cover the purported increase in value caused by the insurance proceeds themselves.

This case illustrates the absurdity. Under the IRS's valuation theory, Crown would have needed an insurance policy worth far more than $3 million in order to redeem Michael's shares at fair market value, even though the undisputed value of Michael's shares in the absence of the insurance proceeds was $3.1 million. J.A. 37. In fact, even

a policy of $5.3 million—the IRS's approximate valuation of Michael's shares—would not have sufficed to purchase Michael's shares at fair market value under the IRS's view. After all, if Crown had purchased a policy worth $5.3 million, the IRS would argue that the purchase increased the value of the company (and thus of the estate's stock) even further. When all the math is said and done, the IRS's approach would require Crown to purchase over $13.5 million in life insurance in order to fully cover the costs of redeeming Michael's $3.1 million stake at fair market value.[5]

To be sure, at the certiorari stage, the government proposed alternative arrangements that business owners could pursue in order to ensure continuity of ownership for Crown. See Br. in Opp. 20. In particular, the government suggested that a shareholder could "bequeath[] his shares to an heir" or that the shareholders could "us[e] a trust to hold insurance policies." *Ibid.* But the government did not explain how either of those arrangements would achieve shareholders' goal of ensuring continuity of a corporation's closely held nature, much less do so without incurring additional transaction costs or risks.

Requiring small businesses to purchase massively expensive insurance policies in order to achieve their continuity goals would create serious problems for a sector that forms the backbone of the American economy. Closely held corporations account for over 90% of all American companies, produce 51% of all private sector

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[5] The small print: in order for the insurance proceeds to fully fund the redemption under the IRS's approach to valuation, the value of the life insurance (x) would need to equal Michael's proportion (77.18%) of the life-insurance proceeds (x) plus the value of Michael's shares absent the insurance proceeds ($3.1 million). Solving the resulting equation yields a required insurance amount of over $13.5 million.

output, and employ 52% of the national labor force. See Venky Nagar et al., *Governance Problems in Closely Held Corporations*, 46 J. Fin. & Quant. Analysis 943, 944, 948 (2011).

The American economy derives enormous benefits from the closely held character of so many businesses. Closely held ownership eliminates costly overhead and facilitates innovation by allowing owners directly to manage a company's affairs without burdensome formalities and a board of directors. See William S. Hochstetler, *Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. Corp. L. 849, 852-853 (1985). And closely held ownership allows shareholders to shape the values of a company in ways not necessarily available to shareholders of a publicly traded company. See, *e.g.*, *Burwell* v. *Hobby Lobby Stores, Inc.*, 573 U.S. 682, 717 (2014).

Adopting the IRS's approach would hamstring companies seeking to maintain those benefits after a shareholder's death. For many closely held businesses, purchasing life-insurance policies several times the value of their entire company simply to ensure continuity would make little financial sense. In the face of prohibitive premium costs, some businesses may simply give up on maintaining their closely held character—to the detriment of the corporation and the national economy.

2. The IRS's approach also represents an unwarranted disruption of a settled understanding in corporate tax law. For decades, shareholders of closely held corporations have relied on a common-sense approach in seeking to ensure business continuity after they pass away: they have valued their stock and then purchased sufficient life insurance to cover that value. And for decades, particularly in light of the Ninth Circuit's decision in *Estate*

of Cartwright v. *Commissioner*, 183 F.3d 1034 (1999), and the Eleventh Circuit's decision in *Estate of Blount* v. *Commissioner*, 428 F.3d 1338 (2005), small business owners have had no reason to doubt the correctness of that approach. In fact, that consensus was the initial position of the IRS as well, which argued in *Estate of Cartwright* that liabilities such as a redemption obligation "would offset the value" of insurance proceeds. Br. at 40-41, *Estate of Cartwright*, *supra* (9th Cir. No. 97-70032). And when the Eleventh Circuit rejected the IRS's transparently expedient about-face in *Blount*, the IRS gave no indication that it would continue to challenge that judicial consensus. Cf. Internal Revenue Manuals 4.10.7.2.8.8.1(4)(c) (Jan. 1, 2006); Internal Revenue Manuals 4.10.7.2.9.8.1(4)(c) (May 14, 1999).

The IRS urges this Court to unsettle that settled understanding. But this Court has been "reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences." *United States* v. *Byrum*, 408 U.S. 125, 135 (1972). As the Court has explained, taxpayers must be able to "rely with assurance on what appear to be established rules," and, "[w]hen a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences." *Ibid.*

The Court should be particularly reluctant to unsettle longstanding expectations here. "If the words [of a tax statute] are doubtful, the doubt must be resolved against the government and in favor of the taxpayer." *United States* v. *Merriam*, 263 U.S. 179, 188 (1923); see *United Dominion Industries, Inc.* v. *United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring). Here, there is nothing in the tax statutes that supports the IRS's approach.

3. Finally, the Court should reject the IRS's approach as an improper attempt to collect an illegitimate windfall.

The true beneficiaries of the type of arrangements at issue in this case are the corporation and the surviving shareholders. Here, for example, the redemption of Michael's shares left Thomas with the same number of shares but with 100% control of the company. Crown, as a corporation, benefited from that shift in ownership, as it ensured continuity and avoided a potential battle for control with Michael's heirs. And Crown paid heavily to secure that benefit, in the form of hundreds of thousands of dollars in insurance premiums that it could have used for other purposes. J.A. 74. To be sure, Thomas's shares "skyrocketed in value" as a result of the redemption, because the life-insurance proceeds allowed Crown to redeem Michael's stock without expending preexisting resources. Br. in Opp. 15. But given that the arrangement at issue here benefits only the corporation and the surviving shareholders and that the corporation paid for those benefits, it makes little sense to tax *the decedent shareholder's estate* for them.

Levying additional tax on Michael's estate because of Thomas's benefit is particularly nonsensical given that Thomas's benefit is attributable to life-insurance proceeds. Proceeds of life-insurance policies owned by and payable to a third party are generally not subject to estate tax. 26 U.S.C. 2042; 26 C.F.R. 20.2042-1(c)(6). There is thus no reason to think the estate escaped taxation because of Thomas's benefit. To the contrary, if Thomas himself had taken out the life-insurance policy on Michael, with proceeds payable to Thomas, there would be no question that the insurance proceeds would have no effect on Michael's estate tax. In such a scenario, Thomas could have purchased the estate's shares from Michael's estate

himself, producing an economically equivalent result to the one that occurred here. In both scenarios, Thomas would have obtained complete ownership of Crown, and the estate would have been fully compensated for Michael's stake. Taxing the two scenarios differently makes no economic sense.

If anything, subjecting the estate to additional tax because of Thomas's benefit makes considerably less sense on the facts of this case. The federal estate tax is a tax "on the act of the testator not on the receipt of property by the legatees." *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, 155 (1929). Although several States impose taxes on the receipt of inherited property, "[t]here is currently no federal inheritance tax." Restatement (Third) of Property: Wills and Other Donative Transfers § 9.3, reporter's note comment c, at 230 (2003). When a recipient receives property already taxed as part of an estate, he thus receives it tax-free.

But *Thomas* did not receive the additional value he gained tax-free. Rather, because he received that value in the form of an increase in the value of his own shares, see Br. in Opp. 15, those gains are subject to capital-gains tax upon realization. See 26 U.S.C. 1(h), 1221, 1222; 26 C.F.R. 1.643(a)-3(b). The IRS's approach thus effectively seeks to tax the same value twice: first by taxing the transfer of the proceeds of the life-insurance policy in the form of estate tax, and then by taxing the increase in the value of Thomas's shares as a result of the redemption in the form of capital-gains tax.

The duplicative imposition of estate tax and capital-gains tax is particularly egregious in light of clear legislative policy that the two taxes be mutually exclusive. As courts have consistently explained, "Congress[] inten[ded] that unrealized gain taxed to the decedent's estate at his death shall not be subjected to another tax

when it is subsequently realized by the estate or a legatee." *Janis* v. *Commissioner*, 469 F.3d 256, 262 (2d Cir. 2006) (quoting *Levin* v. *United States*, 373 F.2d 434, 437-438 (1st Cir. 1967)).[6] Indeed, one common justification for the existence of an estate tax "has been as a backstop to the escape from the capital gains tax." Congressional Research Service, IF11812, *Tax Treatment of Capital Gains at Death* 1 (June 4, 2021). It would thus be inconsistent with the structure and intent of the tax code to tax an estate for gains that ultimately accrue—and that are taxed as accruing—to the surviving shareholders. The Court should not allow the IRS to adopt an approach that allows it to reap such an improper windfall and to eliminate a valuable tool for ensuring the continuity of small businesses.

[6] Cf. H.R. Rep. No. 1380, 94th Cong., 2nd Sess. 36 (1976) ("For the purposes of determining what property is given a stepped-up basis, the test is generally whether the property was included in the gross estate of the decedent.").

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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1. 26 U.S.C. 2001 provides in relevant part:

(a) Imposition

A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

(b) Computation of tax

The tax imposed by this section shall be the amount equal to the excess (if any) of—

(1) a tentative tax computed under subsection (c) on the sum of—

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the modifications described in subsection (g) had been applicable at the time of such gifts.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent. * * *

2. 26 U.S.C. 2031 provides in relevant part:

(a) General

The value of the gross estate of the decedent shall be determined by including to the extent provided for in

this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated. * * *

3. 26 U.S.C. 2042 provides in relevant part:

The value of the gross estate shall include the value of all property—

(1) Receivable by the executor

To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) Receivable by other beneficiaries

To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. * * *

4. 26 U.S.C. 2051 provides:

For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the deductions provided for in this part.

5. 26 U.S.C. 2703 provides:

(a) General rule

For purposes of this subtitle, the value of any property shall be determined without regard to—

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

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

(b) Exceptions

Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

6. 26 C.F.R. 20.2031-2 provides in relevant part:

(a) *In general.* The value of stocks and bonds is the fair market value per share or bond on the applicable valuation date.

* * *

(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, 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.

7. 26 C.F.R. 20.2042-1(c)(6) provides:

   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 stockholders, the corporations' 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. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. * * *