No. 23-146

In The
Supreme Court of the United States

THOMAS A. CONNELLY, AS EXECUTOR OF
THE ESTATE OF MICHAEL P. CONNELLY, SR.,

PETITIONER,

v.

UNITED STATES OF AMERICA,

RESPONDENT.

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

AMICUS CURIAE BRIEF OF LAW PROFESSOR ADAM CHODOROW SUPPORTING RESPONDENT

ADAM CHODOROW
Counsel of Record
4620 E. Arcadia Lane
Phoenix, AZ 85018
(623) 986-7540
Adam.Chodorow@gmail.com

COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

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I. INTEREST OF *AMICUS CURIAE*

Professor Adam Chodorow is the Jack E. Brown Professor of Law at the Sandra Day O'Connor College of Law at Arizona State University.[1] He teaches and writes in a broad range of tax specialties, including estate tax, and has an interest in seeing that federal tax law is properly understood and applied.

II. SUMMARY OF THE ARGUMENT

With limited exceptions, not at issue in this appeal, Section 2703[2] instructs that property is to be valued for estate tax purposes "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)."

Petitioner concedes that a redemption agreement disregarded under Section 2703 cannot *directly* set the value of the shares at issue in this case. Nonetheless, relying on Rev. Rul. 59-60 and Treasury Regulation § 20.2031-2(f)(2), Petitioner argues that a disregarded agreement can *indirectly* affect the value of those shares because it is a corporate obligation that

[1] No counsel for any party authored any part of this brief, and no one other than *amicus* contributed money to fund the brief's preparation or submission. Professor Chodorow's title and affiliation are for identification purposes only. All views stated are his own.

[2] Unless otherwise indicated, all references to the Code, Tax Code, or Section refer to the Internal Revenue Code of 1986 (as amended).

purportedly reduces a corporation's fair market value for estate tax purposes and therefore the fair market value of a decedent's interest in that corporation. Pet. Br. 13-16.

Petitioner's claim fails for several reasons. First, Petitioner misconstrues the relevant authorities. Offsetting life insurance proceeds—or other corporate assets—with a disregarded redemption obligation ignores Section 2703's plain language. Moreover, neither Rev. Rul. 59-60 nor Treasury Regulation § 20.2031-2(f)(2) authorizes a taxpayer to use a disregarded obligation to offset life insurance proceeds—or any other assets—when valuing property for estate tax purposes.

Second, Petitioner misconstrues the nature and effect of redemption obligations. Regular corporate obligations reduce both corporate and shareholder value. In contrast, redemption obligations divide corporate value among existing shareholders *without changing the value of the shareholders' pre-redemption interests*. Offsetting life insurance proceeds—or other corporate assets—with a redemption obligation changes both corporate *and* shareholder value, resulting in discrepancies between the corporation's purported pre-redemption value and the value held post-redemption by the original shareholders.

Third, offsetting life insurance proceeds with a redemption obligation functionally assumes that the redemption has already happened. Thus, it values the wrong property, yielding the value of all the shares *other than those to be valued for estate tax purposes*.

It is inappropriate to attribute a portion of the post-redemption corporation's value to the redeemed shares.

Fourth, redemptions at fair market value have clear markers. Offsetting insurance proceeds—or other corporate assets—with a redemption agreement leads to absurd and illogical results that lack these markers. This is demonstrated first with a series of hypotheticals and then by considering the specific facts of this case.

Fifth, Petitioner's arguments regarding the tax consequences of differently structured transaction and double taxation are of no avail.

Finally, Petitioner's position is not limited to life insurance proceeds and, if adopted, would open the door to tax evasion on a large scale.

III. ARGUMENT

Many of the arguments in this brief are derived from Adam S. Chodorow, *Valuing Corporations for Estate Tax Purposes: A* Blount *Reappraisal*, 3 Hastings Bus. L. J. 1 (2006) (*Valuing Corporations*). This brief sets forth those arguments—and others—concisely for the Court's benefit.

A. Offsetting life insurance proceeds with a disregarded redemption obligation violates the plain language of Section 2703.

Section 2703 provides that property is to be valued for estate tax purposes "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)," except under limited circumstances not at issue in this case. Petitioner concedes that a disregarded agreement cannot directly set the price of a decedent's shares. However, Petitioner argues that disregarded agreements still constitute a binding corporate obligation that affect corporate value, thereby indirectly affecting the value of a decedent's shares. Pet. Br. 13-16.

Taking a redemption obligation into account when valuing the corporation—as opposed to the shares to be redeemed—is simply a backdoor way of taking the disregarded agreement into account, clearly violating the statute's plain meaning. Nothing in the statutory language suggests that a disregarded agreement can be used to offset corporate assets of any kind.

B. Petitioner misconstrues Rev. Rul. 59-60 and Treasury Regulation § 20.2031-2(f)(2).

Petitioner argues that Section 2703 did not displace pre-existing law and that Rev. Rul. 59-60 and

Treasury Regulation § 20.2031-2(f)(2) permit taxpayers to offset corporate assets with disregarded agreements. Pet Br. 28. Section 2703 certainly left in place judge-made requirements that agreements had to satisfy to be respected, J.A. 110, but nothing suggests that it permits disregarded agreements to be considered when valuing corporations for estate tax purposes. Nonetheless, assuming, *arguendo*, that Section 2703 leaves *all* pre-existing law unchanged, Petitioner's claim still fails because Petitioner misconstrues Rev. Rul. 59-60 and Treasury Regulation § 20.2031-2(f)(2).

Rev. Rul. 59-60 indicates that disregarded agreements are a "factor" to be considered when valuing a corporation for estate tax purposes; however, the ruling does not specify what that consideration entails. Nothing in the ruling—or any other administrative guidance for that matter—indicates that one may offset corporate assets with a disregarded redemption agreement.

Treasury Regulation § 20.2031-2(f)(2) instructs that, when valuing a non-publicly traded company for estate tax purposes, "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." Petitioner claims that insurance proceeds—and possibly other corporate assets—are "taken into account" when they are offset by a redemption obligation. Pet. Br. 14.

This argument has three fundamental flaws. First, the regulation provides general valuation guidance; it does not address how to handle a disregarded obligation. As explained in *Valuing Corporations*, *supra* at 10-12, Treasury Regulation § 20.2031-2(f)(2)'s language referring to insurance proceeds was designed to ensure that life insurance proceeds be *included* in corporate value, as appropriate for whatever valuation technique was chosen. Between 1943 and 1974, Treasury Regulation § 20.2042-1 provided that life insurance proceeds of a closely held corporation were attributed to the owner and directly included in a decedent's estate. In 1974, the Treasury Department amended that regulation to provide that such insurance proceeds were to be deemed to belong to the corporation.

To effect this change, the Treasury Department amended Treasury Regulation § 20.2031-2(f)(2) to make clear that life insurance proceeds should be considered along with the corporation's other non-operating assets. Given the various ways one might value a corporation—multiple of earnings, net worth, comparable sales—the regulations make clear that "consideration" should be given to such assets to the extent they have not otherwise been "taken into account."

Petitioner has framed the case about the proper treatment of life insurance proceeds. Treasury Regulation 20.2031-2(f)(2) is clear on this matter. The real question is the proper treatment of a disregarded redemption obligation. Treasury Regulation § 20.2031-2(f)(2) is silent on this question.

Second, Petitioner misconstrues what it means to be "taken into account" for purposes of Treasury Regulation § 20.2031-2(f)(2). That language was included in the regulation to ensure that insurance proceeds were not double counted. That is, if the proceeds are used in a given valuation technique, they cannot also be added separately to the corporation's value as a non-operating asset. For instance, if the company is valued using the comparable sales method, and the comparable company has a similar insurance policy, the life insurance proceeds need not be separately accounted for because they have already been "taken into account." In contrast, if the purportedly comparable company does not have a similar insurance policy, it would be appropriate to include the policy in the corporation's value.

Finally, as discussed below in Part C, *et seq*., Petitioner's position misapprehends the nature of redemption obligations; values the wrong property; and leads to absurd and illogical results inconsistent with fair market value redemptions.

C. Redemption obligations differ from other kinds of corporate obligations because they divide existing corporate assets among shareholders without reducing shareholder value.

Regular corporate obligations reduce both corporate and shareholder value without affecting the corporation's ownership structure. In contrast, redemption obligations divide corporate assets and alter the corporation's ownership structure, *without affecting the value of the shareholders' interests*. This difference is critical when deciding whether redemption obligations can offset insurance proceeds—or other corporate assets—when valuing a corporation for estate tax purposes. This point is best demonstrated with two simple examples.[3]

Imagine a corporation with \$10 million in assets and two shareholders, A and B, where A owns 60 shares and B owns 40 shares, representing 100% of the outstanding shares. Using the net worth approach to value the corporation yields a \$10 million fair market valuation, where A's 60% interest is worth \$6 million, while B's 40% interest is worth \$4 million.[4]

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[3] Similar examples can be found *Valuing Corporations*, *supra* at 19-33.

[4] Other valuation methods, such as comparable sales or multiple of earnings, exist. This discussion focuses solely on an asset-based approach to simplify the analysis and because the parties have stipulated to the corporation's value and dispute only whether the insurance proceeds should be added to that value.

Next assume that the corporation incurs a $6 million obligation to pay consultants. Taking this obligation into account, the corporation is now worth $4 million, and A's shares are worth $2.4 million, while B's are worth $1.6 million, reflecting their proportional interests in the corporation. This obligation shrank the corporation's assets; left A's and B's ownership interests unchanged; and proportionally reduced the value of their shares to reflect the new corporate value.

In contrast, assume that, instead of hiring consultants, the corporation redeems A's shares for $6 million, their fair market value. After the redemption, A has $6 million in cash and B owns 100% of the corporation, which is now worth $4 million. The redemption has divided the corporate assets, without changing the value held by the individual shareholders. Moreover, A's shares are no longer outstanding *and do not comprise any part of the post-redemption corporation's fair market value*. As a result, it would be inappropriate to allocate any of that value to A's shares.

As demonstrated below, offsetting corporate assets with a redemption obligation does not simply divide corporate assets. It alters both the corporate value *and* the value held by the shareholders post-redemption,

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Control premia and minority discounts can cause the shareholders' respective values to differ from their proportional interest in the corporation. This discussion ignores these to simplify the analysis and because the parties ignored control premia and minority discounts when valuing Petitioner's shares. J.A. 47.

relative to the corporation's pre-redemption value and their interests therein.

D. Offsetting life insurance proceeds (or other corporate assets) with a disregarded redemption obligation values the wrong property.

Under Section 2703, Rev. Rul. 59-60, and Treasury Regulation § 20-2031-2(f)(2), the task is to value A's shares at the moment of death, when they are still outstanding. This is done by valuing the corporation as a whole and then attributing some of that value to A's shares. As explained in *Valuing Corporations*, *supra* at 25-27, insurance proceeds are a corporate asset. Offsetting them with the redemption obligation functionally assumes that the redemption has taken place and therefore values the wrong property. The value derived by considering the redemption obligation is the post-redemption corporation's value, that is, the value of all shares *other than those that will be redeemed*.

In the example above, assume that the parties agreed in advance that A's shares were to be redeemed for $6 million. It is nonsensical to reduce corporate value to account for the pending redemption and then assign some of the corporation's remaining value to the redeemed shares. The $4 million left after the redemption reflects the value of B's shares alone. A will receive his $6 million when the redemption occurs, and it is inappropriate to allocate to him any part of the post-redemption corporation's value.[5]

E. Fair market value redemptions have clear markers that distinguish them from below-market redemptions.

1. Markers of a Fair Market Value Redemption

Comparing a fair market redemption with a below-market redemption allows one to identify the markers of a fair market redemption. In the hypothetical redemption above, where A receives $6 million, one can see several markers characteristic of fair market redemptions. The cash A receives ($6 million) matches the value of his interest in the corporation ($6 million) before the redemption was even contemplated. B's interest in the corporation increased as a result of the redemption (from 40% to 100%), but the *value* of his interest remains the same ($4 million). Adding A's cash ($6 million) to the value of B's post-redemption

[5] As described more fully below in Part E.2, the proper way to value shares that have already been redeemed is to ask what the corporation would charge to sell them to a third party, taking into account the percentage of the corporation they represent and protecting the existing shareholders' financial interests. In this hypothetical, the answer is $6 million. A third party paying $6 million for the redeemed shares would own 60% of a $10 million corporation, with his interest worth $6 million. B would own the other 40%, worth $4 million. Any other price would either allocate some of the third party's investment to B or *vice versa*.

interest ($4 million) yields the corporation's pre-redemption value of $10 million. Finally, the corporation shrinks.

If, instead, A's 60% interest were redeemed for $4 million, the resulting corporation would be worth $6 million, with B owning 100% of the outstanding shares. Note that A's cash ($4 million) differs from the value of his pre-redemption interest ($6 million), while the value of B's interest in the post-redemption corporation increased from $4 million to $6 million.

From this, we can deduce that, in a fair market value redemption, (1) the value of the shareholders' post-redemption interests (cash in A's case, and shares in B's) equals the value of their respective pre-redemption interests in the corporation; (2) adding the cash from the redemption to the corporation's post-redemption value yields the corporation's pre-redemption value; (3) the value of B's pre- and post-redemption interest does not change, despite the fact that his proportional interest in the corporation increases; and (4) the corporation shrinks.[6]

[6] A below-market redemption need not violate all these conditions. For instance, in the example above, A's $4 million in cash and B's $6 million in post-redemption corporate value equal the corporation's pre-redemption $10 million value. Moreover, the corporation shrank. However, as demonstrated below, if a redemption obligation offsets life insurance proceeds, these conditions will be violated as well.

2. The Redemption/Resale Price Test

Another simple test reveals whether a redemption was done for fair market value. If the redemption amount and the price at which the corporation would resell the redeemed shares to a third party while maintaining its original percentage interest in the corporation and protecting the value of that interest are the same, the redemption was at fair market value. If instead, the corporation would charge more for the redeemed shares than it paid to redeem them, the redemption was below fair market value. Again, this is best explained with a simple example.

Returning to our company worth $10 million with a 60/40 split, imagine that it redeemed A's shares representing 60% of a corporation for $4 million, leaving the post-redemption corporation worth $6 million. Knowing only the redemption price, the percent interest in the corporation the redeemed shares represent, and the value of the post-redemption corporation, we can determine the price at which the corporation would need to sell those redeemed shares, while protecting its $6 million investment in the corporation.

To do so, we divide the corporation's post-redemption value ($6 million) by the pre-redemption interest of the remaining shareholders (40%), yielding $15 million. We then multiply that amount by the interest represented by the redeemed shares (60%), which yields a sales price of $9 million. If the corporation sold A's former shares for $9 million, the corporation would be worth $15 million; the new shareholder would own 60% of the corporation, worth $9 million; and B's 40%

interest would be valued at $6 million.[7] That the redemption price ($4 million) differs from the computed sale price ($9 million), reveals that $4 million was not the shares' fair market value.[8]

F. Offsetting life insurance proceeds with a disregarded redemption obligation leads to absurd and illogical results.

Petitioner asserts that the government's position would yield irrational results that defy common sense.

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[7] Any price below $9 million would transfer some of B's $6 million value to the new shareholders. For instance, if the corporation sold the shares for their redemption price, $4 million, the corporation would be worth $10 million, and the new shareholder's 60% would be worth $6 million, effectively transferring $2 million from B to the new shareholder. B would never agree to such a deal.

[8] The proper way to value a decedent's shares is to value the pre-redemption corporation and then allocate to the decedent's shares their proportional value. However, we can also determine their fair market value *without knowing the corporation's pre-redemption value*—a useful technique when the corporation's pre-redemption value is at issue. For every dollar the redemption amount falls below the shares' fair market value, the corporation will have to charge proportionally more when selling the shares if it wishes to protect its investment. All that is needed is (1) the redemption price, (2) the percent interest in the corporation the redeemed shares represented, and (3) the corporation's post-redemption value. The formula is quite simple. The fair market value of the redeemed shares equals (the redemption price x the percent interest of the redeemed shares) + (the calculated resale price x the percent interest of the remaining shares). Substituting numbers for the terms using the example above yields the following: ($4 million x 60%) + ($9 million x 40%) = $2.4 million + $3.6 million = $6 million.

Pet. Br. 15. Petitioner has it exactly backwards. The difficulties Petitioner identifies arise because the parties (1) failed to comply with Section 2703's requirements, such that the Stock Purchase Agreement did not set the fair market value of the decedent's shares for estate tax purposes; (2) did not understand that an insurance policy is a corporate asset that affects corporate value from the moment it is acquired;[9] and (3) misapprehend the nature of redemption agreements. In fact, Petitioner's position yields absurd and illogical results. This Part F demonstrates the difficulties with Petitioner's position using a series of hypotheticals. Part G, below, applies the insights from this analysis to the specific facts of this case.

Recall from Part E.1, *supra*, that if a redemption at fair market value occurs, (1) the value of a shareholder's interest after a redemption (whether in cash or retained shares) reflects his proportional interest in the value of the pre-redemption corporation; (2) the aggregate post-redemption values held by the current and former shareholders equals the pre-redemption corporation's value; (3) the value of the remaining shareholders' interests remains unchanged, even as their percentage interest in the corporation increases; and (4) the corporation shrinks. Allowing taxpayers to offset insurance proceeds with a disregarded

[9] The receipt of insurance proceeds is excluded from the corporation's income under Section 102, but it is included for estate tax purposes.

redemption obligation leads to a valuation and redemption that lacks all these markers.

To begin, let's return to our hypothetical corporation and assume that the corporation had acquired a $6 million life insurance policy on A without entering into a redemption agreement.[10] When the corporation collects $6 million on A's death, it is worth $16 million.[11] If A's estate wanted to sell A's shares to a third party, those shares would be valued at $9.6 million. B shares would be worth $6.4 million. The same is true if A's estate decided to retain the shares and they were valued for estate tax purposes.

Finally, assume that instead the corporation decided to redeem A's shares for their fair market value. This decision—whether captured in a binding agreement or not—does not change the corporation's value or the value of A's shares. The corporation was worth $16 million both before the parties agreed to redeem A's shares and after. The redemption simply divides that value between the shareholders. In this case, A's estate would receive $9.6 million (60% of $16 million), leaving B owning a corporation worth $6.4 million

[10] For examples without life insurance, *see Valuing Corporations*, *supra* at 19-33.

[11] To simplify the analysis, it is assumed that the corporation's assets do not decrease when it acquires the insurance policy. In fact, the corporation would need to spend some of its assets to acquire the life insurance policy, essentially converting them from cash into a different form. This reinforces the notion that a life insurance policy is just another type of corporate asset. It also calls into question the claim that life insurance proceeds simply pass through the corporation.

(40% of $16 million). Otherwise, the shares' value would differ depending on whether they were being sold to a third party, retained by the decedent's heirs, or redeemed. That makes no sense.

* * *

The question before the court is whether entering into a redemption agreement *before* A dies should affect the corporation's value when valuing the corporation—and indirectly A's shares—for estate tax purposes. In particular, should such an obligation offset the value of life insurance obtained to fund the redemption. On its face, this claim seems suspect. Why should agreeing to redeem A's shares *before* A dies yield a result different from deciding to do so *after* A dies? And why should it matter what assets the corporation uses to fund the obligation?

As demonstrated below, this intuition is correct. The first hypothetical considers an agreement that specifies only fair market value, while the second sets a specific price for the shares to be redeemed. In both cases, offsetting life insurance with a redemption obligation leads to absurd and illogical results.

1. Redemption Agreements that Specify Only Fair Market Value

Let's return to the $10 million corporation with a 60/40 split and assume that the parties entered into a binding agreement to have the corporation redeem a decedent's shares for their fair market value. Next assume that the corporation acquired a $6 million insurance policy to fund the redemption.[12] When A dies, the corporation collects the $6 million and now has $16 million in assets. We must determine the corporation's fair market value so that we may allocate a portion of that value to A's shares to determine both the redemption amount and the shares' fair market value for estate tax purposes. The question is whether the redemption obligation offsets some of these assets when determining the corporation's value.

Redemption agreements that specify only fair market value create a logical loop if redemption obligations affect corporate value in this context. We cannot know the corporation's fair market value without knowing the amount of the redemption obligation. But we cannot determine the amount of the redemption obligation without knowing the corporation's fair market value. This alone suggests that Petitioner's position is flawed.

Efforts to solve this problem raise their own complications. For instance, we could value the corporation without regard to the redemption obligation, determine the redemption amount, and then revalue the

[12] Assuming the parties expected A to die first, the $6 million policy makes sense if one ignores the impact the insurance proceeds would have on the corporation's value. However, insurance *is* a corporate asset that increases corporate value. Petitioner argues that this fact makes it difficult to fund redemptions with insurance. Pet. Br. 33. However, as described below in Part G.4, Petitioner could avoid this result by structuring the transaction differently, *e.g.*, by having the shareholders—and not the corporation—acquire the insurance.

corporation and A's shares for estate tax purposes. If we start with a $16 million valuation for the corporation, A's 60% share is worth $9.6 million, which would be the redemption amount. If we offset corporate value by the redemption amount, the corporation is worth $6.4 million, and A's 60% interest has a $3.84 million value for estate tax purposes.

This makes little sense. How could A's shares be worth both $9.6 million and $3.84 million at the same time? And how could A's shares have a $3.84 million fair market value if A's estate receives $9.6 million to redeem those shares? Indeed, Petitioner would have a significant tax liability if he received $9.6 million for shares valued at $3.84 million because the basis of the shares would be set at their $3.84 million estate tax fair market value.[13] No one suggests this occurs.

We could avoid this problem by having the corporation redeem the shares for their purported fair market value of $3.84 million, but that would also be problematic because the $3.84 million valuation presumes a redemption at $9.6 million. If the corporation pays less than that amount, reducing the corporation's value by $9.6 million to value the shares is inappropriate.

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[13] *See* Section 1014 (basis resets to fair market value on the date of death). While it is theoretically possible that fair market value for estate tax purposes and for basis to differ, it is not clear what facts might support such a result. Certainly, nothing here suggests that the two should differ.

Alternately, we could assume this issue away and suppose that the redemption obligation is $6 million, consistent with the insurance proceeds, given that this is what the parties may have expected. Under Petitioner's approach, we would offset the insurance proceeds with the obligation, yielding a corporation valued at $10 million. A's 60% share would be worth $6 million, leaving B with a corporation worth $10 million company after the redemption.

The difficulty with this approach is that offsetting the life insurance proceeds with the presumed redemption obligation yields a redemption that lacks all four of the fair market redemption markers described above. First, A's estate would receive $6 million for A's 60% of the corporation, while B's 40% would be worth $10 million after the redemption (100% of a $10 million corporation). While A's payout would match his purported interest in the pre-redemption corporation, B's would not. Indeed, B's 40% would be worth more than A's 60%, an impossible result.

Second, when we add the cash A received to the corporation's post-redemption value, we should get the value of the pre-redemption corporation. Here, adding A's $6 million to B's $10 million yields $16 million, $6 million more than the pre-redemption corporation's purported $10 million value. Redemptions divide corporate value. This one improbably increased it.

Third, the value of B's interest in the corporation increases as a result of the redemption. Before the redemption, his 40% share in the purportedly $10 million corporation was worth $4 million. After the redemption, his interest is worth $10 million. If the redemption had been at fair market value, the value of his shares would not have changed.

Finally, the corporation did not shrink. Under Petitioner's approach, it was worth $10 million before the redemption and $10 million after 60% of its assets ($6 million) were used to redeem a shareholder. That simply cannot be correct.

In contrast, if we do not offset the insurance proceeds with the redemption obligation, all the fair market redemption markers are present. First, the pre-redemption corporation is worth $16 million, and A's 60% share is worth $9.6 million, while B's 40% share is worth $ 6.4 million. As part of the redemption, A's estate will receive $9.6 million, and B will own 100% of a corporation worth $6.4 million, consistent with their pre-redemption interests. Second, the aggregate value of A's and B's post-redemption interests is $16 million, the same value as the pre-redemption corporation. Third, B's shares will have the same pre- and post-redemption value ($6.4 million), despite the increase in B's percentage ownership of the corporation. Finally, the corporation will shrink.

* * *

Offsetting insurance proceeds with the redemption obligation for purposes of determining estate tax value also violates the Redemption/Resale Test described in Part E.2. A redemption is at fair market value if the price at which the shares were redeemed matches the price at which the corporation would sell those shares to a third party, while protecting its investment. Regardless of which approach above is taken, the purported fair market value would differ from the price at which the corporation would need to resell those shares, while protecting B's investment in the corporation.[14]

The conclusion one must draw is that redemption obligations cannot be used to offset life insurance proceeds—or other corporate assets—when valuing a corporation for estate tax purposes, regardless of whether they are disregarded.

2. Redemption Agreements that Specify a Set Price

But what happens if the redemption agreement specifies a $6 million price for A's shares instead of fair market value. If the parties satisfy Section 2703's requirements, the value of A's shares is $6 million for estate tax purposes, and the existence of insurance is irrelevant. However, if the parties fail to satisfy Section 2703's requirements, the agreement must be disregarded, and we must determine the corporation's fair

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[14] As noted above in n. 9, we can calculate the shares' actual fair market value without knowing the corporation's pre-redemption value. Regardless of the approach taken, the shares' actual fair market value is $9.6 million. If the redemption were for $3.84 million, the fair market value would be ($3.84 million x 60%) + ($18.24 million x 40%) = $9.6 million. If the redemption were for $6 million, the fair market value would be ($6 million x 60%) + ($15 million x 40%) = $9.6 million.

market value and then A's portion of that value. With a set price, we would avoid the logical loop described above in the context of agreements that specify only fair market value. However, offsetting insurance proceeds with a disregarded fixed-price redemption obligation yields similar absurd and illogical results.

Allowing the redemption obligation to offset the insurance, as Petitioner suggests, would lead to a fair market valuation of $10 million, such that before the redemption A's 60% interest would be valued at $6 million, the precise result of the disregarded agreement, while B's 40% interest would be worth $4 million. On its face, the idea that the result for A's estate is the same, regardless of whether the agreement is disregarded, should raise questions. However, we have clear evidence that the shares' actual fair market value differs from the price determined when offsetting corporate assets with the redemption agreement: a fair market valuation and redemption for $ 6 million lacks all the markers of a fair market value redemption.

First, while A gets a payout purportedly consistent with his pre-redemption interest in the corporation, B receives $10 million, far in excess of his purported $4 million interest. Moreover, B's 40% interest is worth more than A's 60% interest. That alone should give one pause. Second, adding A's $6 million to B's $10 million yields an amount greater than the corporation's purported $10 million pre-redemption value, which should not happen in a transaction that simply divides a corporation's value. Third, the value of B's interest increased from a purported $4 million to $10 million. Finally, the corporation does not shrink.

In essence, Petitioner's position allocates 100% of the insurance proceeds to B, even though those proceeds are a corporate asset and should be allocated 60%/40%. The proceeds are formally used to redeem A's shares, but the value of B's interest increases by the full amount of the proceeds, when compared to a redemption with no insurance to fund it.

In contrast, ignoring the disregarded redemption obligation and including the insurance proceeds as a corporate asset yields a fair market value and redemption that has all the markers of a fair market redemption and allocates the value of the insurance according to the shareholder's proportional interests. Including insurance proceeds yields a fair market value for the corporation of $16 million, with A's shares being worth $9.6 million and B's worth $6.4 million. A redemption at this amount would cause A's and B's post-redemption interests to equal their pre-redemption interests. Adding the two interests would yield the value of the pre-redemption company. The value of B's interest would remain unchanged as a result of the redemption, despite the fact that his interest in the corporation increased. Finally, the corporation would shrink.

Because of the agreement to redeem A's shares for only $6 million, B would be left with 100% of a corporation worth $10 million. At first blush, this appears to violate two of the markers for fair market redemptions. The value of A's 60% and B's 40% pre-redemption interests don't match the value of their post-redemption interests. In addition, B's interest is worth more after the redemption than before. However, this is a function of the below-market redemption that occurred.

When A receives $6 million, he is shorted $3.6 million (60% of the insurance proceeds). B receives $3.6 million extra, increasing his interest from $6.4 million to $10 million. When the shortfall is accounted for, the first two markers of a fair market redemption are present. The other markers are already present because A's and B's post-redemption interests equal the pre-redemption corporations $16 million value, and the corporation shrank (from $16 million to $10 million).

* * *

Offsetting insurance proceeds—or other corporate assets—with a disregarded redemption obligation also violates the Redemption/Resale Test described in Part E.2. Redemptions are at fair market value if the price at which the shares are redeemed matches the price at which the corporation would sell those shares to a third party, while protecting its investment. In this case, the shares were redeemed for $6 million, leaving a corporation worth $10 million. If the corporation were to sell a 60% stake while protecting its $10 million investment, it would charge $15 million ($10 million/40% x 60%), which would result in a corporation worth $25 million, with B's 40% interest worth $10 million. Because the $6 million redemption price differs from the calculated $15 million asking price to resell A's shares, we know that the $6 million price was not the shares' fair market value.[15]

G. Petitioner's proposed reading of Section 2703, Rev. Rul. 59-60, and Treasury Regulation § 20.2031-2(f) yields absurd results when applied to the facts in this case.

Having demonstrated through a series of hypotheticals why disregarded redemption obligations cannot be used to offset insurance proceeds or other corporate assets when valuing a corporation for estate tax purposes, it may help to apply the lessons learned to the specific facts in this case.

1. Offsetting $3 million in life insurance proceeds with the disregarded redemption obligation results in a redemption that lacks the markers found in a fair market value redemption.

At his death, Michael Connelly owned 77.18% of the company, while his brother Thomas owned 22.82%. J.A. 1. Thus, Michael's shares should have been worth about 77% of the corporation's total value, while

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[15] As noted above in n. 9, we can calculate the shares' actual fair market value without knowing the corporation's pre-redemption value using the formula described therein. Under these facts, the shares would be worth ($6 million x. 60%) + ($15 million x 40%) = $9.6 million, reflecting 60% of a $16 million corporation.

Thomas's shares should have been worth about 23%. Michael's estate received $3 million for Michael's shares, which Petitioner asserts reflects their fair market value. D. Ct. Dkt. 53-2, at 14.[16] The post-redemption corporation was worth $3.86 million. J.A. 102.

If Michael's shares were redeemed at their fair market value, (1) Michael's estate should receive 77% of the corporation's value, while Thomas retained 23% of that value within the corporation; (2) the aggregate of the cash Michael's estate received and the value of the post-redemption corporation should equal the corporation's pre-redemption value; (3) the value of Thomas's shares, pre- and post-redemption, should not change; and (4) the corporation should shrink.

Offsetting the insurance proceeds with the disregarded redemption obligation leads to a valuation and redemption that lacks all these markers. First, if Petitioner's position is correct and the fair market value of Michael's shares was $3 million,[17] Thomas's interest should be worth approximately $896,000. However, the post-redemption company was worth about $3.86 million. J.A. 102. This is 100% of the pre-redemption value

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[16] Over the course of the litigation, the parties have used three different valuations, ignoring the life insurance, including the original $3 million at which the shares were redeemed, J.A. 26, $2.98 million proposed by Petitioner's expert, J.A. 43, and a stipulation of $3.1 million. J.A. 37. For purposes of this brief, I use the $3 million figure because that was the actual amount of the redemption. Using the other amounts yields slightly different figures without affecting the overall analysis.

[17] The stock agreement explicitly instructs that there be no control premium or minority discount. J.A. 47.

Petitioner claims, strongly suggesting that Michael's shares were worth far more than the $3 million Michael's estate received.

Second, if one adds Michael's $3 million in cash to Thomas's $3.86 million interest in the post-redemption corporation, the total value of the corporation was $6.86 million, not the $3.86 million Petitioner claims. Moreover, Thomas's 23% interest in the pre-redemption corporation (now reflected in the post-redemption corporation's value) is worth more than Michael's 77% interest. That simply cannot be.

Third, Thomas's shares purportedly increased in value from about $896,000, pre-redemption, to $3.86 million, post-redemption. That cannot occur with a fair market redemption.

Finally, if one accepts Petitioner's $3.68 pre-redemption valuation, the corporation did not shrink after the redemption. Redemptions must shrink corporations because they allocate part of the pre-redemption value to the redeemed shareholder.

In contrast, if the disregarded redemption obligation does not offset the insurance proceeds, the corporation would have been valued at $6.86 million, meaning that Michael's 77% interest was really worth approximately $5.28 million, while Thomas's 23% interest was worth approximately $1.57 million. If Michael's shares had been redeemed for $5.28 million, Thomas would have owned a corporation worth $1.57 million; adding the amounts both parties held post-redemption would equal the corporation's pre-redemption value;

Thomas's value pre- and post-redemption value would remain unchanged at $1.57 million; and the corporation would shrink. All the markers of a fair market value redemption would be present.[18]

2. The $3 million redemption price fails the Redemption/Resale Test.

The redemption also fails the Redemption/Resale Test described above in Part E.2. Michael's shares—representing 77% of the pre-redemption corporation—were redeemed for $3 million. Post-redemption, the corporation was worth $3.86 million. Without knowing the pre-redemption corporate value, we can easily test whether the redemption was at fair market value.

If the corporation were to sell Michael's shares (representing a 77% interest in the company) while protecting its 23% stake in the company—worth $3.86 million—it would demand $12.92 million.[19] The corporation would then be worth $14.78 million, and Thomas's 23% interest would still be worth $3.86 million. That the $12.92 million resale price differs from

[18] Redeeming Michael's shares for $3 million dollars, i.e., about $2.28 million below their fair market value, would cause Thomas's interest in the corporation to rise from about $1.6 million to close to $4 million, the corporation's actual post-redemption value.

[19] ($3.86 million/23%) * 77%.

the redemption price of $3 million establishes that redemption was not at fair market value.[20]

3. The option agreement the parties negotiated indicates that the estate's shares were worth more than $3 million.

The difficulty with Petitioner's position can also be seen by looking at the Sale and Purchase Agreement the parties negotiated after Michael's death. J.A. 25. If Petitioner's $3 million valuation for Michael's shares represented 77% of the corporation's value, Thomas's 23% stake should be worth about $896,000. Tellingly, the agreement granted Michael's son an option to purchase the entire corporation from Thomas—for an 18-month period—for $4,166,666. J.A. 26. How could it possibly be that the value of corporation left *after* the redemption was worth roughly $4 million, while 77% of the pre-redemption corporation was worth only $3 million? Something simply does not add up, and that something is the fact that Petitioner improperly offsets the life insurance proceeds with the disregarded redemption obligation, leading to a below-market valuation for Michael's 77% interest in the corporation.

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[20] As noted above in n. 9, we can determine the shares' fair market value without knowing the corporation's pre-redemption value. Applying the formula to the facts in this case yields a fair market value of ($3 million x 77%) + ($12.92 x 23%) = $5.28 million for Michael's shares, consistent with the government's position.

4. Petitioner's arguments regarding differently structured transactions and double taxation are of no avail.

Petitioner argues that (1) the parties could have structured the deal differently—with the shareholders owning the life insurance policies—and obtained a different tax result; and (2) the government's position leads to double taxation. Pet. Br. 37-39. Neither argument is persuasive.

Treasury Regulation § 20.2031-2(f) makes clear that corporate-owned insurance is a corporate asset that can affect corporate value. Had the individual shareholders acquired the insurance, it would not have affected the corporation's value. However, the insurance would have been an asset in the shareholders' respective estates. The general rule in tax law is that taxpayers may not disavow the form of the transactions they choose. *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967). The fact that a different arrangement might have resulted in a different tax result does not mean that treating the different transactions the same is appropriate. Ownership of life insurance matters for tax law, and it is inappropriate to pretend it does not.

Petitioner's claim of double taxation is also flawed. Offsetting insurance proceeds with a redemption agreement artificially lowers the estate's value (which is taxed at a higher rate) and substitutes an increased latent income tax for the remaining shareholder (which would be taxed at lower capital gain rates).

While both the decedent's estate value and the surviving shareholder's value will increase under the government's view, the decedent's estate will incur an offsetting tax loss on the redemption because the redemption price is below the shares' basis, which is set at their fair market value. The low valuation and underpayment for Michael's shares creates the problem, not the government's position in this case.

H. Petitioner's reasoning is not limited to insurance proceeds, significantly broadening the impact of Petitioner's position and leading to additional irrational results.

Another problem with Petitioner's position is that the reasoning is not limited to insurance proceeds. If redemption obligations are binding obligations, they must offset any and all corporate assets, not just those that were acquired to fund the redemption or that purportedly pass through the corporation.[21] Treasury Regulation § 20.2031-2(f) makes clear insurance proceeds

[21] Petitioner's claim that insurance proceeds merely pass through the corporation is wrong. An insurance policy is a corporate asset that affects corporate value from the moment it is acquired. Thus, this asset did not just pass through the corporation. In addition, assets are fungible, and the use of insurance proceeds to fund a redemption merely preserves other corporate assets that would otherwise have been used. The post-redemption value of a corporation with insurance is greater than the post-redemption value of a corporation without insurance. It follows that the pre-redemption value of a corporation with insurance must be greater than the pre-redemption value of a corporation without insurance.

are not special and should be treated just like other non-operating assets.

Allowing redemption obligations to offset all corporate assets would significantly expand the impact of Petitioner's proposed rule. Moreover, it could result in a taxpayer being better off with a flawed effort to reduce the value of his shares for estate tax purposes than if he had succeeded. Returning to our corporation with \$10 million in assets and a 60/40 split, imagine that the corporation enters into a redemption obligation to acquire A's shares for \$4 million, despite the fact that they are worth \$6 million. Further assume that the parties fail to meet Section 2703's requirements, such that the agreement is disregarded and we must determine the shares' fair market value.

If the disregarded agreement nonetheless offsets corporate assets, then the corporation is worth only \$6 million, and A's 60% is worth \$3.6 million, *less than the \$4 million value that was disregarded*. Congress (or the IRS) cannot have intended that a failed effort to lower the value of A's shares yields a better tax result for A than had the agreement been respected. Were the court to bless Petitioner's position, creating *intentionally* defective redemption obligations would become the next tax planning tool for closely held corporations.

IV. CONCLUSION

Section 2703 requires taxpayers to disregard redemption agreements when valuing corporations for estate tax purposes. Petitioner's claim that Rev. Rul. 59-60 and Treasury Regulation § 20.2031-2(f)(2) nonetheless permit parties to offset insurance proceeds with a redemption obligation when valuing a corporation simply provides a backdoor way of taking a disregarded agreement into account.

More important, it misreads those authorities and misconstrues the nature of redemption agreements. Redemptions divide corporate assets *without affecting the value held by the existing shareholders*. Offsetting corporate assets of any kind with a redemption agreement yields the value of the post-redemption corporation, which is the value of all shares other than those that are to be valued for estate tax purposes. It is inappropriate to allocate any of that value to the redeemed shares. Rather, one should ask what the corporation would sell those shares for, while protecting the existing shareholders' economic interests.

Fair market redemptions have certain markers that distinguish them from below market redemptions. Offsetting corporate assets with a redemption obligation leads to absurd results that lack these markers. In contrast, ignoring such obligations and including the value of insurance obtained to fund redemptions in corporate value for estate tax valuation purposes lead to results that bear all the markers of a fair market value redemption.

Accordingly, the judgment below should be affirmed.

Respectfully submitted.

Dated this 27th day of February, 2024.

ADAM CHODOROW
Counsel of Record
4620 E. Arcadia Lane
Phoenix, AZ 85018
(623) 986-7540
Adam.Chodorow@gmail.com