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Observations from a Buy-Sell Agreement Gone Bad
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A Matter of Life (Insurance) and Death

A buy-sell agreement among family shareholders should provide clear instructions for how the company's stock is to be valued upon the occurrence of a triggering event, such as the departure or death of a shareholder. The United States Court of Appeals for the Eighth Circuit recently heard ***Thomas A. Connelly, in his Capacity as Executor of the Estate of Michael P. Connelly, Sr., Plaintiff-Appellant v. United States of America, Department of Treasury, Internal Revenue Service, Defendant-Appellee, No.21-3683 (8th Cir. 2023)*** The Eighth Circuit court affirmed a district court decision that concluded that life insurance proceeds received by a company triggered by a shareholder's death should be included in the valuation of the company for estate tax purposes.[1]

Connelly is an estate tax deficiency case dominated by two themes: (i) the treatment of life insurance in the valuation of stock of a private company when a shareholder dies and (ii) the consequences of executing a buy-sell agreement that fails to meet the requirements under the Internal Revenue Code, Treasury regulations, and applicable case law, for purposes of controlling the valuation of a closely held company.[2] Using *Connelly* as a backdrop, we first demonstrate how opposing applications of life insurance proceeds received upon the death of a shareholder impact a company valuation. We then offer observations from a study of the *Connelly* buy-sell agreement from a valuation perspective that private business owners and their advisors should mind when drafting, reviewing, and amending buy-sell agreements.

The Stock Purchase Agreement

Crown C Supply Company, Inc. is a roofing and siding materials company founded in 1976 and headquartered in St. Louis, Missouri.[3] Crown C (an S corporation) and brothers Michael, Thomas, and Mark Connelly originally entered into a stock purchase agreement ("SPA") on January 1, 1983. Mark's interest in Crown C was terminated prior to the stock purchase agreement being amended and restated on August 29, 2001.[4] Crown C had 500 shares of common stock at the date of the SPA's execution. Michael, via a trust, owned 385.9 shares of Crown C stock representing a 77.18% ownership interest. Thomas, individually, owned the remaining 114.1 shares representing a 22.82% ownership interest.

Pursuant to the terms of the SPA, Michael and Thomas executed a certificate of agreed value that set the purchase price of Crown C's stock upon a triggering event at $10,000 per share (see graphic on the next page). Based on this pur-

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chase price per share, which disregarded accepted valuation principles and methodologies, the implied aggregate market value of the company's stock on August 29, 2001, was $5.0 million.

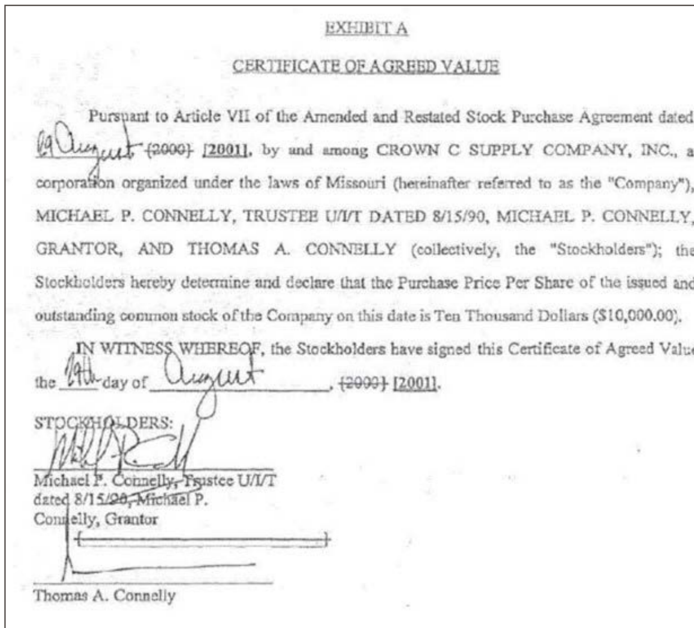


EXHIBIT A

CERTIFICATE OF AGREED VALUE

Pursuant to Article VII of the Amended and Restated Stock Purchase Agreement dated 29 August ~~[2000]~~ [2001], by and among CROWN C SUPPLY COMPANY, INC., a corporation organized under the laws of Missouri (hereinafter referred to as the "Company"), MICHAEL P. CONNELLY, TRUSTEE U/I/T DATED 8/15/90, MICHAEL P. CONNELLY, GRANTOR, AND THOMAS A. CONNELLY (collectively, the "Stockholders"); the Stockholders hereby determine and declare that the Purchase Price Per Share of the issued and outstanding common stock of the Company on this date is Ten Thousand Dollars ($10,000.00).

IN WITNESS WHEREOF, the Stockholders have signed this Certificate of Agreed Value the 29th day of August, ~~[2000]~~ [2001].

STOCKHOLDERS:

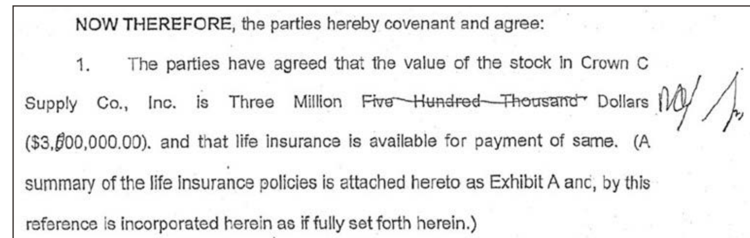
Michael P. Connelly, Trustee U/I/T dated 8/15/90, Michael P. Connelly, Grantor

Thomas A. Connelly

Therefore, at that date, Michael's shares would have had an agreed value of approximately $3.9 million, while Thomas's shares would have had an agreed value of approximately $1.1 million. In July 2009, with no update to the agreed value of the company's equity, Crown C purchased life insurance policies on both Michael's and Thomas's lives in the amount of $3.5 million each. The rationale for purchasing the same amount of life insurance on each brother's life when one brother's ownership interest was approximately 3.4x larger than the other brother's is unclear. **The SPA dictated that life insurance proceeds were to be used to redeem a deceased shareholder's interest.**

The Sale and Purchase Agreement

Michael, who served as Crown C's president and CEO, died on October 1, 2013. Thomas was the executor of Michael's estate. Effective November 13, 2013, Thomas, as trustee of Michael's trust and a second trust for Molly C. Connelly, Michael's daughter, recused himself from "all matters touching upon the sale, pricing, negotiation, and transaction of any sale of the stock of Michael P. Connelly, Sr.'s interest in Crown C Supply Company, Inc." [5] Had Thomas not recused himself he would have been in the conflicted position of negotiating on behalf of Michael's estate with the company, of which he was now the sole surviving shareholder. Effective the same date, Thomas and Michael's son, Michael P. Connelly, Jr., executed a sale and purchase agreement governing the redemption of the estate's shares in Crown C as well as in other entities.[6] Thomas (representing Crown C) and Michael Jr. (representing Michael Sr.'s estate) agreed, without relying upon a formal valuation, to a purchase price of $3.0 million for the estate's shares (see graphic below).


NOW THEREFORE, the parties hereby covenant and agree:

1. The parties have agreed that the value of the stock in Crown C Supply Co., Inc. is Three Million ~~Five Hundred Thousand~~ Dollars ($3,000,000.00). and that life insurance is available for payment of same. (A summary of the life insurance policies is attached hereto as Exhibit A and, by this reference is incorporated herein as if fully set forth herein.)

The estate noted, however, that the $3.0 million purchase price "resulted from extensive analysis of Crown C's books and the proper valuation of assets and liabilities of the company. Thomas Connelly, as an experienced businessman extremely acquainted with Crown C's finances, was able to ensure an accurate appraisal of the shares.[7] I'll discuss the importance of engaging a qualified appraiser in matters such as these below.

The Estate's Argument: Life Insurance Proceeds Are Not a Corporate Asset

Crown C received $3.5 million in life insurance proceeds upon Michael's death. Crown C immediately recognized a corporate redemption liability and used $3.0 million of the life insurance proceeds to redeem the estate's interest in Crown C. It is interesting to note from the graphic above that Michael's estate's interest originally was equal to the total cash value of the life insurance proceeds, but at some point was reduced by $500,000 because the company needed additional funding.[8] Figure 1, on the next page, demonstrates this narrative.

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Figure 1:: Proceeds Excluded When Calculating Estate Tax And Redemption Value

Description/Step	Company	Michael (Estate)	Thomas	Comments
Estate Tax Valuation Analysis				
Stock Ownership (Shares)	500	385.9	114.1	
Stock Ownership (%)	100.00%	77.18%	22.82%	
Estate Tax Value	**$3,887,017**	**$3,000,000**	**$887,017**	*Agreed value; life insurance excluded from analysis*
Value Per Share	**$7,774**	**$7,774**	**$7,774**	*Both shareholders have same value per share*
Redemption Analysis:				
Equity Value	$3,887,017			*Agreed value*
Add: Life Insurance Proceeds	3,000,000			*Life insurance proceeds allocable to redemption*
Less: Redemption Liability	(3,000,000)			*Michael redeemed at $7,774 per share*
Post-Redemption Value	**$3,887,017**			
Shares of Stock Redeemed	(385.9)	(385.9)	0.0	
Shares of Stock Remaining	114.1	0.0	114.1	
New Stock Ownership	100.0%	0.0%	100.0%	*Thomas now owns 100% of business*
Post-Redemption Value	**$3,887,017**	**n/a**	**$3,887,017**	
Value Per Share	**$34,067**	**n/a**	**$34,067**	*Thomas' value per share is now $34,067*

Key takeaways from this scenario:

- One would expect to see a "top-down" valuation methodology in which the value of 100% of Crown C's equity is established first, followed by the determination of value attributable to the estate's shares. However, the aggregate value of Crown C's equity of $3.9 million was implied based on the value of the estate's interest of $3.0 million.
- Crown C immediately recognizes a redemption liability equal to $3.0 million in life insurance proceeds and pays $3.0 million to Michael's estate in exchange for redeeming the estate's 385.9 shares; Michael's estate is redeemed at $7,774 per share.[9]
- Post-redemption, the total value of the company's equity does not change while the share count decreases from 500 shares to 114.1 shares, all owned by Thomas.
- Thomas now owns 100% of the company at a value of $34,067 per share,which is approximately 4.4x the value at which Michael's estate was redeemed.[10] The value of Thomas's ownership interest increased by 338% with no additional investment.

The IRS's Argument: Life Insurance Proceeds Are a Corporate Asset

The IRS saw things differently, arguing that the insurance proceeds should be included in Crown C's equity value. See Figure 2 on the next page.

Figure 2:: Redemption Obligation Not a Corporate Liability

Description/Step	Company	Michael (Estate)	Thomas	Comments
Estate Tax Valuation Analysis				
Stock Ownership (Shares)	500	385.9	114.1	
Stock Ownership (%)	100.00%	77.18%	22.82%	
Pre-Life Insurance Value	$3,863,819			*Represents value of company operations*
Add: Life Insurance Proceeds	3,000,000			*Life insurance proceeds considered a corporate asset*
Estate Tax Value	**$6,863,819**	**$5,297,496**	**$1,566,323**	*No redemption liability recognized*
Value Per Share	**$13,728**	**$13,728**	**$13,728**	*Both shareholders have same value per share*
Redemption Analysis:				
Equity Value	$6,863,819			*Same as estate tax value* *Michael redeemed at $13,728 per share*
Less: Redemption Liability	(5,297,496)			
Post-Redemption Value	**$1,566,323**			
Shares of Stock Redeemed	(385.9)	(385.9)	0	
Shares of Stock Remaining	114.1	0	114.1	
New Stock Ownership	100.00%	0.00%	100.00%	
Post-Redemption Value	**$1,566,323**	**n/a**	**$1,566,323**	
Value Per Share	**$13,728**	**n/a**	**$13,728**	*Thomas' value per share is still $13,728*

Key takeaways from this scenario:

- The equity value of the business for estate tax purposes was $6.9 million inclusive of the $3.0 million in life insurance proceeds. The IRS did not include the excess $500,000 of life insurance in its valuation.
- The resulting value per share is $13,728.[11]
- The estate's 385.9 shares have a total value of $5.3 million and Michael's estate is redeemed at $13,728 per share, reducing the company's equity value to $1,566,323.
- Post-redemption, the share count decreases from 500 shares to 114.1 shares, all owned by Thomas at a value of $13,728 per share, which is equal to the pre-redemption value per share.
- As the life insurance proceeds utilized only totaled $3.0 million, the redemption liability of $5.3 million would have been underfunded by approximately $2.3 million, leaving the company (in this case, solely Thomas) on the hook to finance the shortfall.

The Funding Mechanism Dilemma

It should be obvious that the manner in which life insurance proceeds are treated can have a dramatic impact on the selling shareholder, the remaining shareholders, and the company's ability to buyout the selling shareholder. In one scenario, the estate is redeemed relative to a windfall received by the surviving shareholder. In the second scenario, the estate is redeemed at a higher value, but to the detriment of the company most likely having to finance a portion of the buyout. So, what is the fair way to treat life insurance in this situation? Ultimately, the parties to the buy-sell agreement decide what is fair with the help of their legal and other professional advisors, but such a decision must be addressed directly and without vagueness in the buy-sell agreement.

The Defining Elements of a Valuation Process Agreement

We now turn to observations of the *Connelly* SPA itself from a valuation perspective. Valuation process agreements such as the *Connelly* SPA have six defining elements:[12] (1) standard of value; (2) level of value; (3) the "as of" date; (4) qualifications of the appraiser; (5) appraisal standards; and (6) funding mechanisms. The first five elements are required to specify an appraisal that is consistent with prevailing business appraisal standards. We've seen how the *Connelly* SPA addressed element #6, funding mechanisms. So, how, then, does the *Connelly* SPA stack up regarding defining elements #1 through #5?

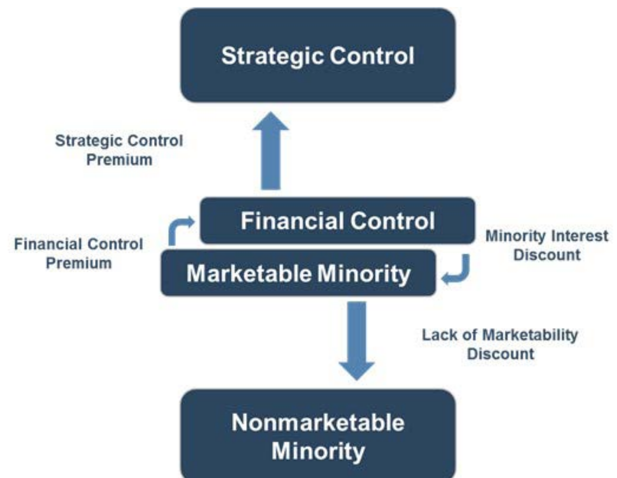
Standard of Value

Per the American Society of Appraisers *ASA Business Valuation Standards*, the standard of value is "the identification of the type of value being used in a specific engagement; e.g. fair market value, fair value, investment value." [13]

Fair market value, the standard that applies to nearly all federal and estate tax valuation matters and which is specified in most buy-sell agreements, is referenced in the *Connelly* SPA as part of the definition of appraised value per share. Fair market value itself, however, is not defined in the SPA. Without a specific, clear definition of fair market value, such as that from the *ASA Business Valuation Standards* or the Internal Revenue Code, the interpretation of fair market value is left to the appraiser(s). In the *Connelly* matter, upon a triggering event two appraisers were to be engaged (one by Crown C and one by the selling shareholder). Should the opinions of these two appraisers diverge by more than 10% of the lower appraised value, a third appraiser could have been engaged. The SPA as drafted opens the door for three interpretations of fair market value. And with multiple interpretations comes the increased likelihood of litigation.

Level of Value

Valuation theory suggests that there are various "levels" of value applicable to a business or business ownership interest. The graphic on the right depicts these levels. A formal business valuation for gift and estate tax purposes will clearly state the level of value, and therefore, no interpretation is needed as to the applicability of control premiums or discounts for lack of control and lack of marketability.



Per the *Connelly* SPA, in the scenario in which appraisers are utilized in lieu of issuing a certificate of agreed value, "the appraisers shall not take into consideration premiums or minority discounts in determining their respective appraisal values." In the absence of minority interest discounts, Thomas's minority interest (22.82%) would have been valued on a pro-rata basis relative to Crown C's total value.

The As-Of Date

Every appraisal has an "as-of" date, more commonly referred to as the valuation date. Why is the valuation date important? Business appraisers rely upon information that was "known or reasonably knowable" on the valuation date. For purposes of filing Form 706, the valuation date is the date of death (estates may elect the alternate date, six months from the date of death, as the valuation date). For redemption purposes, however, the *Connelly* SPA refers to "Appraisal Date," which is "the date an option is exercised or a mandatory purchase is required." As such, the Connelly SPA does allow for a redemption to occur on a specific date.

Qualifications of Appraisers

If the qualifications of an appraiser are not specified, just about anyone can do the appraisal. The *Connelly* SPA mentions that an appraiser "shall have at least five years of experience in appraising businesses similar to the Company."

That's it. The SPA makes no mention of formal education, valuation credentials such as ASA, ABV, or CVA, or continuing education and training requirements.

Ultimately, this was a moot point for *Connelly* because no appraiser was ever hired to do a valuation. But what could happen if an unqualified appraiser is hired to perform a valuation? A recent tax court case, ***Estate of Scott M. Hoensheid, deceased, Anne M. Hoensheid, Personal Representative, and Anne M. Hoensheid, Petitioners, v. Commissioner of Internal Revenue Service, Respondent*** (T.C. Memo 2023-34), addressed this situation head-on. While the case was related to the donation of closely held stock, not using a qualified appraiser had a damaging impact on the taxpayer. The company whose shares were subject to the charitable gift had been marketed for sale by an investment banker prior to the gift. The taxpayer's attorney suggested that the investment banker be considered to do the appraisal for the gifting because "since they have the numbers, it would seem to be the most efficient method." [14] In court, the petitioners argued that the investment banker was qualified because he had prepared "dozens of business valuations" over the course of his 20+ year career as an investment banker.

According to the court, an individual's "mere familiarity with the type of property being valued does not by itself make him qualified." The court further noted that the investment banker "does not have appraisal certifications and does not hold himself out as an appraiser." The court relied on testimony at trial about appraisal experience to be instructive, as the investment banker testified that he conducted valuations "briefly" and only "on a limited basis" before starting at the investment bank the year before the appraisal. The investment banker also testified that he performed (presumably at no charge) business valuations for prospective clients "once or twice a year" in order to solicit their business. The court found the investment banker's "uncontroverted testimony sufficient to establish that he does not regularly perform appraisals for which [he] receives compensation."

The end result for the taxpayer in *Hoensheid*: the Tax Court found that the taxpayer failed to comply with the qualified appraisal requirements and denied the charitable deduction.

Appraisal Standards

Occasionally, buy-sell agreements lay out the specific business appraisal standards to be followed by the appraiser. Standards most often cited in buy-sell agreements are the ***Uniform Standards of Professional Appraisal Practice*** (commonly referred to as "USPAP"), the ASA Business Valuation Standards, AICPA's *Statement on Standards for Valuation Services No. 1* (commonly referred to "SSVS") and NACVA's Professional Standards. The Connelly SPA did not reference any of these standards. Without any appraisal standards referenced, any appraiser elected to perform a valuation under the SPA who was not a member of one of the national appraisal organizations has no requirement to follow any set of standards or code of ethics.

Tax Court Conclusions

Connelly was first decided by the District Court in September 2021. Having been appealed by the estate, the Eighth Circuit affirmed the District Court's decision in June 2023.

The District Court Decision

The IRS had contended that the life insurance proceeds should be included in the valuation of Crown C's equity. The estate argued that the redemption obligation was a corporate liability that offset the life insurance proceeds dollar for dollar. The District Court sided with the IRS, noting that "Because the insurance proceeds are not offset by Crown C's obligation to redeem Michael's shares, the fair market value of Crown C at the date of date of death and of Michael's shares includes all of the insurance proceeds." [15]

The Circuit Court Decision

The Circuit Court affirmed the District Court's decision, noting "In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders' equity. A fair market value of Michael's shares must account for that reality." [16]

Current Status

Shareholder buyouts often occur at inconvenient times, and poor planning can have financially devastating con-

sequences. In *Connelly*, a poorly drafted buy-sell agreement resulted in a notice of deficiency from the IRS in the amount of $998,155 and undisclosed legal and professional fees incurred to litigate the matter. [17] The estate has sought a refund of $1,027,042 that it views was "erroneously, illegally, and excessively assessed against and/or collected from Plaintiff as federal estate tax…" [18] In August 2023, counsel for the estate filed with the Supreme Court of the United States a petition for a writ of certiorari to the United States Court of Appeals for the Eight Circuit. On December 13, 2023, the Supreme Court granted the petition for writ of certiorari, signifying its acceptance of the case for review. As of February 2024, the case had not yet been set for argument.

We will report back after the Supreme Court has issued its ruling. In the meantime, if you have any questions or would like to discuss a valuation issue in confidence, feel free to contact us.

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[1] Courts have had differing opinions on the life insurance/valuation matter. In ***Estate of George C. Blount, Deceased, Fred B. Aftergut, Executor, v. Commissioner***, the United States Court of Appeals, Eleventh Circuit ruled that life insurance proceeds used to redeem a stockholder's shares do not count towards the fair market value of the company when valuing those same shares.

[2] The buy-sell agreement that is the subject of Connelly was challenged by the IRS as invalid for controlling the valuation of the subject company's stock in an estate tax scenario. The district and circuit courts both agreed and deemed the buy-sell agreement invalid.

[3] Crown C was sold to SRS Distribution, Inc., a portfolio company of Leonard Green & Partners and Berkshire Partners, in 2018. Terms of the deal were not disclosed. Crown C continued to serve the St. Louis market as of the publication date of this article.

[4] Amended and restated stock purchase agreement by and among Michael P. Connelly, trustee U/I/T dated 8/15/90, Michael P. Connelly, grantor, and Thomas A. Connelly, executed effective August 29, 2001.

[5] Sale and purchase agreement by and among Thomas A. Connelly, trustee of The Michael Connelly Irrevocable Trust dated 15 August 1990, Crown C Supply Co., Inc., a Missouri Corporation, Thomas A. Connelly, individually, Connelly Partnership/Connelly, LLC, and 5200 Manchester, LLC, executed November 13, 2013.

[6] Ibid.

[7] *Connelly v. United States*, Memorandum and Order, page 21, September 2021.

[8] Appeal from the United States District Court for the Eastern District of Missouri – St. Louis, No. 21-3683, page 3, filed June 2, 2023.

[9] ($3.0 million / 385.9 shares) = $7,774 / share.

[10] ($3.9 million / 114.1 shares) = $34,067 per share.

[11] ($6.9 million / 500 shares)

[12] Mercer, Z. Christopher, ***Buy-Sell Agreements for Closely Held and Family Business Owners*** (Peabody Publishing LP, 2010).

[13] ***American Society of Appraisers Business Valuation Standards*** (Updated February 24, 2022).

[14] T.C. Memo. 2023-34; *Estate of Scott M. Hoensheid, deceased, Anne M. Hoensheid, Personal Representative, and Anne M. Hoensheid, Petitioners, v. Commissioner of Internal Revenue Service, Respondent.*

[15] *Connelly v. United States*, Memorandum and Order, page 35, September 2021.

[16] Appeal from the United States District Court for the Eastern District of Missouri – St. Louis, No. 21-3683, page 13, filed June 2, 2023

[17] Complaint of Thomas A. Connelly, Executor of the Estate of Michael P. Connelly, Sr. dated May 23, 2019.

[18] Ibid.

Munger Games: Charlie Munger's Legacy

And His Common Sense Approach to Business and Investing Legacy

In this article we step aside from our usual musings on valuation trends to honor the late Berkshire Hathaway Vice Chairman with our thoughts on some of his famous quotes (that might be relevant to you and your clients):

> *"I think the reason why we got into such idiocy in [personal] investment management is best illustrated by a story that I tell about the guy who sold fishing tackle. I asked him, 'My God, they're purple and green. Do fish really take these lures?' And he said, 'Mister, I don't sell to fish."*
>
> –1994 speech at the University of Southern California Business School

We've all taken the bait on a flashy investment opportunity that didn't pan out. We knew better but couldn't resist the prospect of doubling our money in a short amount of time. Rational investing leads to rational returns, and irrational investing leads to irrational returns (typically below 0%). Maximizing the ratio of rational investing to irrational investing for clients is easier said than done, but one of the primary responsibilities of a prudent financial advisor. Feel free to share Charlie Munger's thoughts on crypto the next time a client asks about Bitcoin:

> *"A cryptocurrency is not a currency, not a commodity, and not a security. Instead, it's a gambling contract with a nearly 100% edge for the house, entered into in a country where gambling contracts are traditionally regulated only by states that compete in laxity."*
>
> – 2023 ***Wall Street Journal* op-ed piece**

Charlie Munger often distinguished between investing and gambling, which, in his mind, was the same thing as "investing" in a cryptocurrency. That probably seems obvious to you (and your clients), but unfortunately, that's not the case for much of the investing public. Interestingly, he had a similar disdain for diversification, which probably isn't so practical for most individual investors:

> *"A lot of people think that if they have a hundred stocks they're investing more professionally than they are if they have four or five. I regard this as insanity."*
>
> – 2021 shareholder meeting for the Daily Journal Corporation

Mr. Munger called this 'diworsification,' and this philosophy allowed him to achieve above-market returns for several decades and become one of the most successful investors of all time. This mentality probably only applies to active managers (like he was himself) who devote much of their professional careers to investment research and analysis. His colleagues Warren Buffet and **Jack Bogle** would certainly not recommend this approach to most individual investors.

> *"Usually, I don't use formal projections. I don't let people do them for me because I don't like throwing up on the desk, but I see them made in a very foolish way all the time, and many people believe in them, no matter how foolish they are. It's an effective sales technique in America to put a foolish projection on a desk."*
>
> –2003 Herb Kay Undergraduate Lecture at the University of California, Santa Barbara Economics Department

Since we often rely heavily on projections in our DCF valuation models, it's probably best that Mr. Munger was never a client of ours (actually, I'm sure he would've been great to work with). We understand the **fallacies of projections** and contend that all models are wrong, but some are useful (to quote the British statistician George Box) when grounded in reason and reality.

> *"I think you would understand any presentation using the word EBITDA, if every time you saw that you just substituted the phrase, bull**** earnings."*
>
> –2003 Annual Berkshire Hathaway Shareholder Meeting

We often utilize **EBITDA metrics** in our valuation models, so Mr. Munger probably wouldn't have appreciated that aspect of our analysis either. Mr. Munger clarified this later in the meeting by stating, "There are two kinds of businesses: The first earns 12%, and you can take it out at the end of the year. The second earns 12%, but all the excess cash must be reinvested — there's never any cash. It reminds me of the guy who looks at all of his equipment and says, 'There's all of my profit.' We hate that kind of business." Fortunately, your business is the former, and you get to keep most of its EBITDA every year.

> *"I am personally skeptical of some of the hype that has gone into artificial intelligence. I think old-fashioned intelligence works pretty well."*
>
> – 2023 Berkshire Hathaway Annual Meeting

Mr. Buffet took this one step further – "I will confidently wager that no computer will ever replicate Charlie." Unfortunately, he was probably right.

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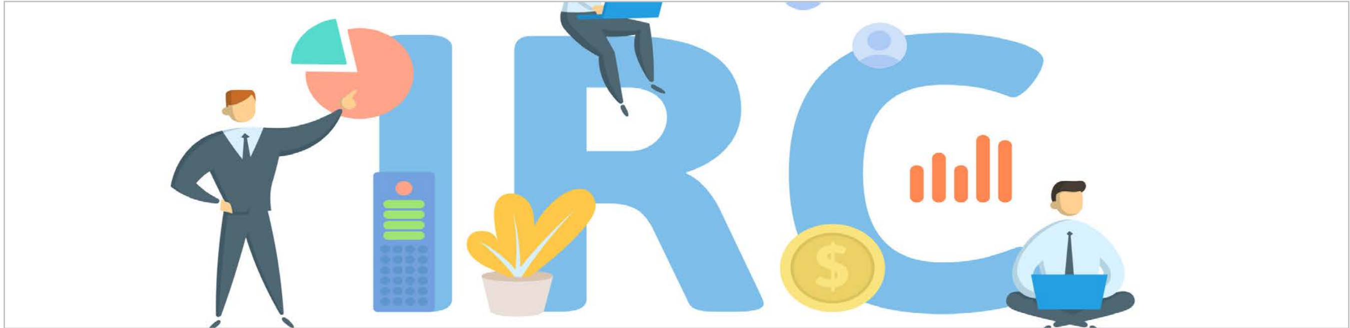

Capital Planning and IRS Section 6166

Successful enterprising families are careful and deliberate consumers of family capital. Thoughtful capital planning comprises two distinct but related decisions.

- Capital budgeting is a disciplined process for identifying and evaluating potential capital projects available to the family business. A well-designed capital budgeting process consists of a series of "gates" or strategic and financial criteria that help to cull worthwhile projects from the larger herd of the possible.
- Capital structure is the mix of debt and equity financing used to fund the projects that survive the capital budgeting process. Many family businesses identify a so-called "target" capital structure that represents an optimal blend of funding costs, availability, and risk for the business and the family shareholders.

For family businesses with significant ownership concentrations, the estate taxes eventually payable upon the death of a primary shareholder can represent a significant contingent "non-operating" liability. Unlike the uses of capital typically evaluated in capital budgeting, the obligation to pay estate taxes is not discretionary. But if the deceased shareholder's estate does not include sufficient liquidity, the economic burden of the tax effectively falls upon the family business, which must allocate capital toward either a redemption of the estate's shares or a pro rata distribution. From the perspective of the business, this obligation may "crowd out" other, more attractive uses of capital that would help build value for subsequent generations.

In specific circumstances, **Section 6166 of the Internal Revenue Code** provides a capital planning alternative for family businesses facing large contingent liabilities for shareholder estate tax obligations.

Key Provisions of Section 6166

Section 6166 provides qualifying estates with a five-year deferral period, followed by an installment period of up to ten years to pay estate taxes. Estates qualify for the Section 6166 election if:

- Ownership interests in active (not passive) closely held businesses comprise at least 35% of the adjusted gross estate;
- The ownership interests represent at least a 20% ownership position in the subject closely held business; and,
- The closely held business has no more than 45 shareholders.

An estate may elect to defer that portion of the aggregate estate tax liability attributable to qualifying closely held business interests under the terms of Section 6166, which include:

- A five-year deferral period, during which only interest is payable;

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- Following the deferral period, the tax may be paid in up to ten equal annual installments (along with corresponding interest);
- The interest rate on a portion of the estate tax obligation (**$740 thousand in 2024)** is fixed at 2%, and the balance of the estate tax obligation bears interest at a floating rate equal to **45% of the prevailing rate** on unpaid taxes (45% x 8.0% = 3.6% for the second quarter of 2024);
- The deferred estate tax becomes due and payable upon the occurrence of any of the following:
    - Cumulative distributions equal to 50% of the value of the ownership interest;
    - Sale of 50% or more of the underlying ownership interest;
    - Failure to make timely interest or principal payments.
- Under certain circumstances, the business may have to pledge assets as collateral for the deferral and be subject to certain reporting and monitoring obligations;
- Finally, any undistributed net income of the estate in years following the deferral election must be paid to reduce the outstanding principal of deferred tax.

Pros and Cons

Section 6166 can be an important element of responsible capital planning for qualifying family businesses and estates. Taking advantage of Section 6166 probably makes more sense for some family businesses than others.

- Family business directors need to know **what time it is**. If it is planting season for your family business, diverting capital from attractive investment opportunities to fund shareholder estate tax obligations could negatively affect shareholder returns for generations. In such cases, the Section 6166 election could provide a great opportunity to ensure the family business is not starved of needed capital.
- For family businesses in harvest mode, the distribution and sale limitations may foreclose liquidity options that would benefit the family shareholders as a group. From the perspective of these families, the ability to defer the tax payments at generally favorable rates may not offset the forfeited financial flexibility.
- For companies already operating at or near their target capital structures, Section 6166 can represent a financially attractive opportunity for off-balance sheet funding. The interest rate is attractive (as of the date of this writing, the Section 6166 rate of 3.6% compares quite favorably to the bank prime rate of 8.5%). Furthermore, there are no underwriting criteria for the loan.

Despite its attractive features, the Section 6166 election should not be treated as an alternative to responsible estate planning. While reducing estate taxes is certainly laudable, tax management is only one component of a broader ownership succession planning strategy. The availability of tax deferral under Section 6166 should not distract family shareholders from the more important work of planning for an orderly and strategic ownership succession that is both tax-efficient and promotes the sustainability of the family business.

Intentional capital planning is a key element of success for family businesses. Directors should give careful thought to the place of Section 6166 in the capital planning toolbox for their family business.

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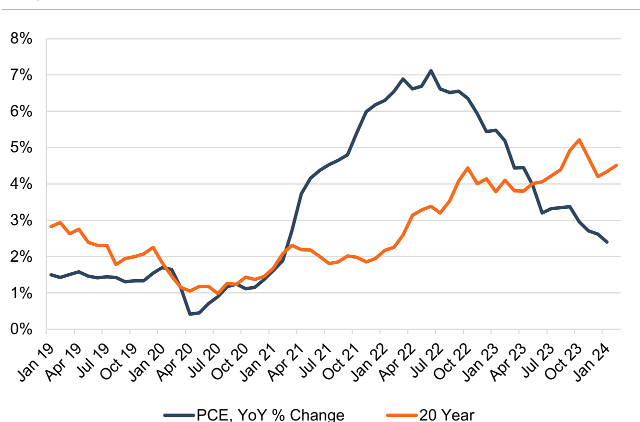
Now Could Be a Great Time to Transfer Stock to Heirs

Rising inflation has been top of mind for business owners (and everyone for that matter) over the last few years. As measured by the Federal Reserve's preferred gauge — the personal consumption expenditures price index — inflation increased from an average of 1.5% in 2019 and 2020 to 5.0% in 2022. Inflation has since decelerated from its peak in 2022 to 2.8% in January 2024 but still remains above the Federal Reserve's target of 2.0%. In an effort to curb inflation, the Federal Reserve hiked the fed funds target range, leading to a sharp increase in interest rates over 2022 and 2023. The yield on the 20-year US treasury increased from less than 2.0% in 2019 and 2020 to a peak of about 5.2% in October of 2023. Yields currently stand at approximately 4.5%.

Figure 1 :: Inflation and Interest Rates



Sources: BEA, FR

Higher inflation and interest rates have affected every business with few exceptions. All else equal, higher interest rates will negatively affect business value. This is due to higher discount rates used to bring future cash flows to the present. Figure 2 illustrates the impact of higher interest rates on business value, all else equal. In some industries, inflation-driven increases in earnings growth expectations have offset (or even outweighed) the negative impact of higher interest rates. However, not all industries have been immune to pressure from higher interest rates on the value of their shares.

Figure 2 :: Effect of Higher Interest Rates on Business Value

	Higher Interest Rates	Lower Interest Rates
Risk-Free Rate	4.5%	2.0%
Equity Risk Premium	5.5%	5.5%
Market Beta	1.00	1.00
Beta Adjusted Equity Risk Premium	5.5%	5.5%
Size Premium	4.0%	4.0%
Specific Company Risk Premium	2.0%	2.0%
Equity Discount Rate	16.0%	13.5%
less: Perpetual Growth Rate	-2.5%	-2.5%
Capitalization Rate	13.5%	11.0%
Capitalization Factor *(1 / cap rate)*	7.4x	9.1x
Ongoing Earning Power	$5,000,000	$5,000,000
times: Capitalization Factor	7.4x	9.1x
Indicated Value	**$37,000,000**	**$45,500,000**
Difference in Value ($)	*($8,500,000)*	
Difference in Value (%)	*-19%*	

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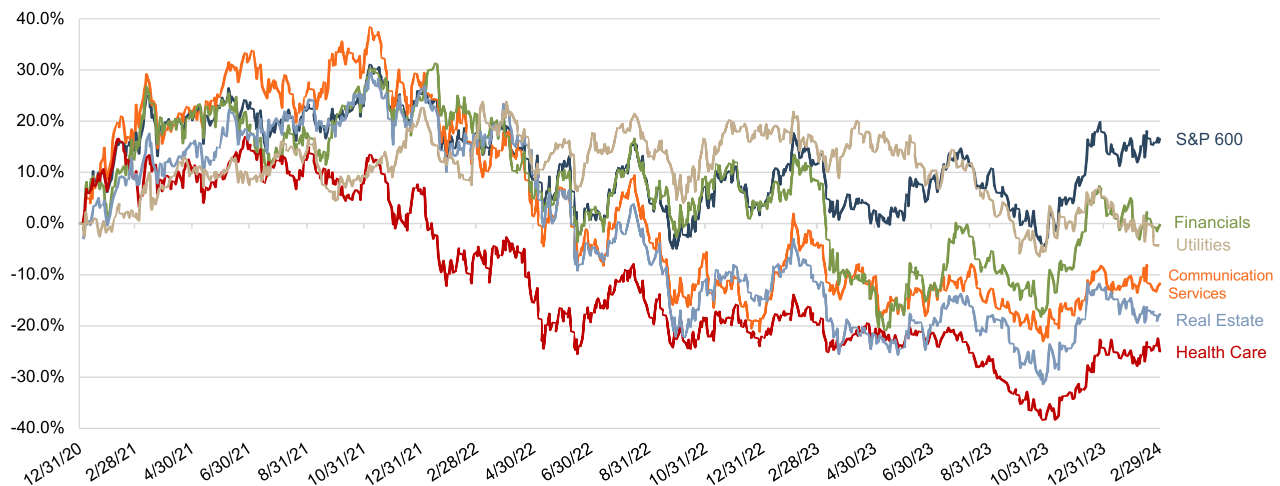
Figure 3 :: Select Small Cap Performance



Since the beginning of 2021, when inflation began turning higher, the *S&P 600 Small Cap Index* has increased about 17%. However, several *S&P 600* Sector Indices have underperformed the broader index over this period, including financials (0%), utilities (-4%), communication services (-12%), real estate (-18%), and healthcare (-25%), per Figure 3. It's clear that certain industries have been able to push through the higher-rate environment, while investors are skeptical of the "new normal" in others.

The period of rising or high interest rates **may be reversing soon.** In prepared remarks before the Committee on Financial Services, Federal Reserve Chair Jerome Powell said, "We believe that our policy rate is likely at its peak for this tightening cycle. If the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year." The Fed has signaled that rate cuts will likely happen later this year, and **markets have priced in** about a 64% chance that the first rate cut will occur in June. The easing cycle is imminent and will have broad implications for businesses and the overall economy. Like the tightening cycle, the easing cycle will likely have divergent outcomes for different industries. You and your advisors are likely the best to gauge where you stand amidst the sharp increase in interest rates. At this point between cycles, it is important to consider the potential opportunity to favorably transfer business value to future generations.

Issues on the tax and policy front also should be top of mind in current estate planning discussions. *The Tax Cuts and Jobs Act* enacted in December 2017 doubled the basic exclusion amounts individuals could give away without paying estate taxes. The **sunsetting** of this provision on December 31, 2025, makes considering transfers all the more important.

Inflation and higher interest rates may still present an opportunity for your family business to favorably transfer stock to heirs. Sunsetting favorable estate tax provisions should also be at the forefront of your mind when sitting down with your advisors. Schedule a quick call with your estate planning advisors to see if there are steps you can take to help reduce the burden of future estate taxes on your family and business. Many strategies will require a current valuation of your business, and our professionals are here to help.

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