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Gift, Estate, & Income Tax Valuation Insights Newsletter

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Beyond Life Insurance: Broader Lessons from *Connelly*

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In the practice of professional services sometimes a single issue or event garners much attention. Such is the situation with the *Connelly* case and the valuation of an equity interest in a small building supply company, Crown C Supply (“CCS”).

The question to be resolved in the case was how $3 million in life insurance proceeds received by CCS and purposed for the redemption of an equity interest from the estate of one of the company’s two shareholders should be treated when valuing the equity interest.

The *Connelly* case attracted much attention when the United States Supreme Court agreed to hear it, and rightfully so, as few estate tax cases are heard by the highest court in the land.

Much has been written about the case since then and the implications of the Court’s decisions for life-insurance funded entity purchase buy-sell agreements and business valuation are important to understand. We have written about the case in our most recent book published by the ABA, ***Buy-Sell Agreements: Valuation Handbook for Attorneys.***

Alongside a detailed analysis of these issues, however, it is instructive to also consider the timeless lessons that can be drawn from the case.

These lessons become evident when one ponders the inevitable question: Why did the estate of a shareholder in a small, family-owned business with a value of less than $7.0 million have to appeal and argue its case in front of the United States Supreme Court?

Some of the answers to the question lie in the errors, often ones of omission, that can be made by taxpayers when planning for the eventual estate tax liability from their ownership of a family-owned business.

Four Lessons from Connelly

Below we review four lessons that lie in the puzzle of the Connelly case.

Estate Plans Accomplished Through a Family Business Will Inevitably Have Implications for All Stakeholders That Need to Be Considered and Balanced

When the primary source of wealth is an interest in a family-owned business, there may be an understandable inclination for family members to implement an estate plan that will be executed within the bounds of the business.

However, it is important to keep in mind that estate taxes are the responsibility of the individual shareholders rather than the family business.

In the *Connelly* case, after the redemption of the deceased brother's 77.2% controlling interest in CCS with $3.0 million in life insurance proceeds, the surviving brother's pre-redemption 22.8% minority interest in the business effectively converted to a 100% controlling ownership interest. Thus, the redemption of the estate's interest increased both the ownership share and basis of value of the surviving shareholder.

The increase in value to the surviving shareholder was not captured by the transfer system in the sequence of steps and reportable transactions and therefore likely attracted greater scrutiny by the IRS.[1]

To the Extent Shareholders Do Not Respect the Formalities of a Shareholders' Agreement, Don't Expect the IRS or a Court to Do So Either

When an estate plan is put in place, its provisions may require regular follow-up by the parties.

It is not surprising that the time demands of running a successful business often limit the attention business owners can devote to estate plan requirements. Thus, estate plans can sit on the proverbial back shelf for years. Such lack of attention can unravel even well laid out plans.

The Connelly brothers had entered into a stock-purchase agreement ("SPA") with buyout provisions for their respective ownership interests in the event of the death of either brother.

The SPA required the shareholders to annually determine the value of CCS shares and had provisions for an appraisal process to be used in determining the fair market value of CCS shares in redemption. None of these requirements were fulfilled by the Connelly brothers.

Buy-Sell or Other Restrictive Agreements Need To Be Properly Drafted in Order to Have the Desired Effects for Estate Planning Purposes

Buy-sell agreements ("BSAs") are used by private business owners for a variety of purposes, including ownership control, succession planning, and liquidity needs. BSAs and similar restrictive agreements are also important tools in estate planning and can establish the value of an equity interest for estate or gift tax purposes.

In order for an agreement transfer price to be considered as a factor in determining value for estate or gift tax reporting purposes, the agreement needs to meet three exception test requirements of Section 2703 of Chapter 14, namely, the agreement needs to be 1) a bona fide business arrangement, 2) not a device to transfer property for less than full and adequate consideration and 3) have terms comparable to similar arrangements entered into by unrelated parties in an arms' length transaction.

The IRS did not put forth an argument on whether the purchase price for Michael Connelly's interest in CCS should be disregarded for estate tax reporting purposes based on the provisions of Section 2703 of Chapter 14.

While such an argument was not part of the *Connelly* case, many legal commentators believe that the facts of the case should be examined with regard to both the provisions of Section 2703 and related case law.

Estate Plans Should Incorporate Appraisals by Qualified Professionals When Fair Market Value Cannot Be Readily Established by Other Means

Fair market value, defined as the price at which an asset would change hands between a willing buyer and a willing seller when neither is under any compulsion to buy or to sell and both have reasonable knowledge of relevant facts, is the standard of value for estate and gift tax reporting purposes.

When fair market value cannot be readily established by reference to market or transaction prices, the opinion of a management representative will not be a suitable substitute for the opinion of a qualified appraiser.

One of the missing puzzle pieces in the *Connelly* case is the appraisal of the subject interest by a qualified appraiser.

The SPA had specific provisions for an appraisal process for shares subject to redemption, but this process was not followed by the parties. Rather, the redemption price was agreed upon in an "amicable and expeditious manner" by the estate executor and a son of the decedent.

Counsel for the estate argued that the $3.0 million redemption price "resulted from extensive analysis of CCS'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."

These decisions made by the parties in the *Connelly* case ultimately failed to establish a supportable fair market value conclusion for the subject interest.

Defining Fair Market Value and Selecting Qualified Appraisers

Fair Market Value

Fair market value 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 CCS 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 opened the door for three interpretations of fair market value. And with multiple interpretations comes the increased likelihood of litigation.

Appraiser Qualifications

Additionally, 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.

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. In court, the petitioners argued that the investment banker was qualified to prepare the appraisal for charitable giving purposes 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 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.

Final Thoughts

This tale of a small building supply company making its way to the Supreme Court emphasizes how significant—and tricky—managing business and family interests can be.

Aside from the issues surrounding how to treat life insurance proceeds, *Connelly* is a vivid reminder of the simple errors of omission that can spiral into monumental issues, and it highlights some timeless lessons about the necessity of dotting i's and crossing t's in estate planning and business agreements. It also underscores the importance of clearly defining fair market value, ensuring appraisers are properly qualified, and strictly adhering to appraisal standards.

This whole saga reminds us of the importance of getting things right from the start to avoid a domino effect of complications down the road.

For more information or to discuss a valuation issue in confidence, please reach out.

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[1]This observation was made by Stephanie Loomis Price of Perkins Coie LLP and Amy K. Kanyuk of McDonald, Kanyuk, PLLC in their discussion of the case at the 59th Annual Heckerling Institute on Estate Planning.

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