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From: Jay Utterback <jutterback@thewatermarkgrp.com>
Sent: Thursday, June 6, 2024 10:36 AM
To: David@lighthouseadvisorsinc.com
Subject: FW: Breaking: Supreme Court Upholds Estate's Tax Bill for Undervaluing Stocks

Hey Dave,

I hope you are doing well.

I just saw this come across the wire and thought you might be interested.

From: Daily Tax Report - Bloomberg Tax <bloomberg@bna.com>
Sent: Thursday, June 6, 2024 10:24
To: Jay Utterback <jutterback@thewatermarkgrp.com>
Subject: Breaking: Supreme Court Upholds Estate's Tax Bill for Undervaluing Stocks

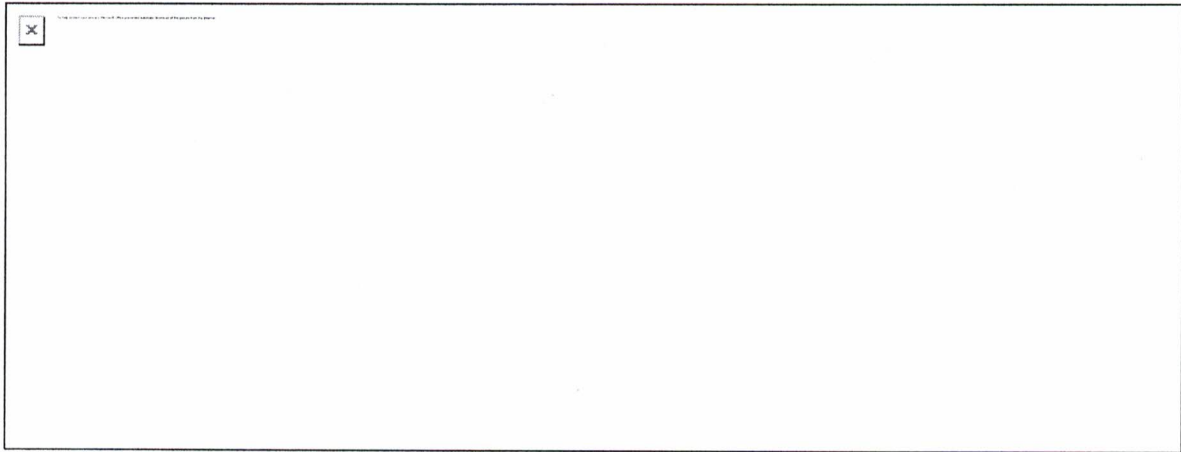


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Bloomberg Tax Daily Tax Report

Thursday, June 6, 2024



Supreme Court Upholds Estate's Tax Bill for Undervaluing Stocks

The US Supreme Court denied a major tax benefit to estates on Thursday, ruling that \$3 million in life-insurance proceeds earmarked by a company to redeem a decedent's stock must be included when valuing the company's stock for estate tax purposes.

The high court ruled against an estate whose deceased owner had his stock redeemed by his family business using proceeds from an insurance policy the business took on his life. The estate's executor had challenged an IRS determination that the estate owed about \$890,000 in additional tax after undervaluing the stock because the family business had become significantly more valuable after its insurance payout.

Michael and Thomas Connelly, co-owners of Crown C Supply Co., agreed in 2001 that, if either brother died, Crown would be obligated to redeem the decedent's shares using proceeds from life insurance policies. Crown received more than \$3 million from its policy when Michael died, then used the money to extinguish his 77% stake in the business, making Thomas its sole stockholder, the estate's brief [said](#).

Michael's estate reported the redeemed stock as having been worth \$3 million, equal to the amount Crown paid for it. But the IRS determined it was actually worth \$5.3 million because Crown's value as a company nearly doubled—from \$3.86 million to \$6.86 million—when it received its insurance payout, per the IRS's [brief](#).

Thomas, as executor of Michael's estate, challenged the IRS's determination on the grounds that Crown's insurance proceeds shouldn't factor into the company's valuation for the purposes of the estate's taxes because the money gained was offset by Crown's obligation to redeem Michael's shares. The challenge failed in the district court, after which the estate appealed.

However, the IRS [convinced](#) the US Court of Appeals for the Eighth Circuit that permitting such an offset would create a discrepancy in the value of Michael's shares compared to those owned by Thomas.

By excluding insurance proceeds, Michael's \$3 million, 77% equity interest would be worth significantly less per share than Thomas's 23% interest, worth the company's remaining \$3.86 million value, the government later told the justices in its brief.

The Supreme Court sided with the IRS, agreeing that corporation's contractual obligation to redeem shares isn't necessarily a liability that reduces a corporation's value for purposes of the federal estate tax.

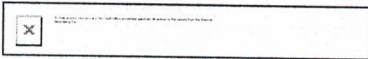
"Because a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares," Justice Clarence Thomas said for the court.

The court's decision was unanimous.

Paul, Weiss, Rifkind, Wharton & Garrison LLP and Aegis Law represented Thomas Connelly.

The case is Connelly v. United States, U.S., No. 23-146, 6/6/24.

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5th Circuit of Appeals Upholds Ruling in Nelson v. IRS

Appellate Court upholds that a farmer can't take back the cows.

Following the U.S. Tax Court's decision in the case of *James C. Nelson & Mary P. Nelson v. Commissioner of the Internal Revenue* (T.C. Memo 2020-81), we covered a plethora of valuation issues, including the appropriate valuation methodology for Warren Equipment as well as the appropriate consideration of dual level discounts for valuing a minority interest in Longspar Partners, Ltd., which held the interest in Warren Equipment. However, the brunt of the opinion tackled the hyper-relevant topic of how to properly structure and document a formula gift. Specifically, Judge Pugh found that the fixed-dollar amounts of certain gifts (\$2.1 million made by the petitioners in December 2008) and a sale of Longspar interests (\$20.0 million in January 2009), were in fact gifts and a sale of specific percentage interests. Accordingly, the size of the gifts/sale, in terms of percentage interests in the partnership could not be adjusted in audit to ensure the values of such transfers did not exceed \$2.1 million and \$20.0 million, respectively, as intended by petitioners. The 5th Circuit held that Judge Pugh got it right in the original Nelson case and here is why:

Breaking Down the Appellate Court's Decision

Most of the appeal court's analysis focused on the specific verbiage of the gift and sale document:

The Nelsons will be transferring right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND and NO/100THS DOLLARS as of December 31, 2008, **as determined by a qualified appraiser within 90 days of the effective date of this agreement.**

The appeals court found that the additional bolded language added expressly qualifies the definition of fair market value for the purpose of determining the interests transferred. This verbiage separates their agreement from the formula clauses considered in other cases that defined the interests transferred as the fair market value as determined for federal-gift or estate tax purposes (as in *Petter*¹, *Christiansen*², and *Wandry*³). Having the appraiser determine the fair

market value at a set dollar value, converted to a set percentage, locks in that percentage without the possibility of change, even if the value changed.

Further, the gift/sale document lacked crucial language that described what would happen to any additional shares that were transferred upon successful challenge of the valuation. Some documents contain language that excess shares will go to charity and *Wandry* provided that the number of gifted units shall be adjusted so that the value of the number of units gifted to each person equals the amount set forth. The Nelsons' agreements contain no such language. Nothing in the agreements compels the trust to return excess units, or do anything with the excess units, should the valuation change.

Relying upon the colorful example provided by the government, if a farmer agrees to sell a number of cows worth \$1,000 as determined by an appraiser, and the appraiser determines that five cows equal that stated value, then the sale is for five cows. If a later appraisal determines that each cow was worth more, and that too many cows were included in the deal, nothing in the agreement would allow the farmer to take any cows back.

As stated in our [previous write up of the original case](#), the devil is in the details when it comes to the proper drafting of the gift/sale document.

1. Estate of Petter v. Commissioner of Internal Revenue, T.C. Memo. 2009-280.
2. Estate of Christiansen v. Commissioner of Internal Revenue, T.C.
3. Dean Wandry v. Commissioner of Internal Revenue, T.C. Memo. 2012-88.

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Michael Jackson's Estate Moonwalks Past The IRS In Tax Court Battle



Written by Chris Walton, JD(<https://etonvs.com/author/cwalton/>)

Kress v. United States: A Turning Point in Business Valuation for Pass-Through Entities

The landmark case of *Kress v. United States* (<https://casetext.com/case/kress-v-united-states-3>), decided on March 26, 2019, has significantly impacted the field of business valuation, particularly in regard to valuing pass-through entities like S corporations. The U.S. District Court's ruling in this case has strengthened the case for tax affecting when valuing pass-through entities, a practice that has long been debated among valuation professionals.

Background of the Kress Case: Tax Implications for S Corporations

The Core Issue: Transferring Minority Shares and Valuation Challenges

Kress centered around the gift tax implications of transferring minority shares in an S corporation, a type of pass-through entity that avoids double taxation by passing its income, deductions, and credits through to shareholders. The case examined the appropriate valuation methodologies for determining the value of these minority shares.

Both the taxpayers' and the government's experts applied a C corporation tax rate to the company's earnings. While the court accepted this practice, it rejected the government expert's S corp. adjustment. Ultimately, the court's decision sided with the taxpayers and signaled a shift toward accepting tax affecting as a valid method for valuing pass-through entities.

The Ongoing Debate Over Tax Affecting in Business Valuation

Traditionally, there has been substantial debate among valuation professionals over the appropriate method for valuing pass-through entities like S corporations. One key issue is whether to tax affect earnings, a practice that involves applying a hypothetical corporate tax rate to the entity's earnings to account for potential taxes that would be paid if the entity were a C corporation.

Opponents of tax affecting argue that it is inappropriate to apply a hypothetical tax rate to a pass-through entity's earnings because such entities are not subject to corporate-level taxes. On the other hand, proponents of tax affecting assert that the practice leads to more accurate and consistent valuations, as it accounts for the economic reality that shareholders will eventually pay taxes on their income.

The Controversy: To Tax Affect or Not?

The ruling in *Kress* has significant implications for valuation professionals, particularly those who specialize in valuing pass-through entities. By accepting the tax-affecting method used by the taxpayers' expert, the court has lent credibility to this approach and provided a solid foundation for its continued use in future valuations.

Moreover, the *Kress* decision has highlighted the importance of employing well-supported valuation methodologies when valuing pass-through entities. The court's acceptance of the taxpayers' tax-affecting method suggests that clear explanations and strong justifications for the chosen approach are crucial in ensuring that valuations are accurate, reliable, and defensible in court.