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Time to Take Another Look at Your Closely Held Company's Redemption Agreement

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The recently announced United States Supreme Court decision in the *Connelly*[1] case may have unexpected consequences for the estates of shareholders in closely held companies, and the amount remaining for their beneficiaries once the IRS claims its share. It is fairly common, in closely held companies, for the shareholders to execute agreements requiring, upon the death of one of the shareholders, that either the remaining shareholders or the company itself buy back the shares of the company that the deceased shareholder owned. To ensure that the remaining shareholders or the company have the necessary cash on hand to complete the required buyback, life insurance policies on the lives of the shareholders are purchased and maintained by the company. Upon the death of a shareholder, the shareholders' agreement requires the proceeds from the life insurance policy to be used to redeem the deceased shareholder's shares in the company.

While that might seem like a rather straightforward solution, the situation gets complicated when determining the company's fair market value in order to calculate the Federal estate tax owed by the deceased shareholder's estate on the decedent's shares in the company. Do the insurance proceeds payable to the company become an asset of the company, increasing its value, even when those proceeds must contractually be used to buy back the deceased shareholder's shares? In its recent decision in the *Connelly* case, the Supreme Court clarified that in most instances, yes, the insurance proceeds increase the value of the company for Federal estate tax purposes, despite the contractual obligation that the proceeds be used to fund the stock buyback.

Prior to *Connelly*, this type of transaction was generally considered not to have a consequential impact on the company's value, the value immediately before and immediately after the shareholder's death were essentially the same. Consequently, if two shareholders each held a 50% stake in a $1M company, and one shareholder died, the estate of the deceased shareholder would expect to be paid $500,000 for the deceased shareholder's shares, even if a $500,000 death benefit was received by the company to fund the purchase. But in the *Connelly* case, the Court said not so fast. If a $1M company, receives $500,000 in life insurance death benefit upon the death of a 50% shareholder, regardless of what the company is contractually obligated to do with that money, the company now has a fair market value of $1.5M. Therefore, the deceased shareholder's 50%

[1] *Connelly v. United States*, 144 S. Ct. 536, 217 L. Ed. 2d 285 (2023).

ownership interest in the company is now actually worth $750,000, and that is the value of the decedent's stock in the company for Federal estate tax purposes. As the Federal estate tax rate is currently 40%, in this scenario, the increased valuation of the deceased shareholder's stock is an additional $100,000 in Federal estate tax owed to Uncle Sam.

So, what do we do now? Definitely review your partnership, shareholders, operating, and buy-sell agreements. If the parties to the relevant agreement are primarily family members, your agreement includes life insurance policies owned by the company, a valuation of the business was not completed prior to the execution of the agreement, or specific redemption pricing terms are not included in the agreement, contact your legal and tax advisors to help you evaluate all available alternatives to ensure that your agreement provides you and your family with your desired results.

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About the author: Leigh Segal focuses her practice on implementing estate and tax planning strategies for individuals, families and businesses. If you have any questions about this Client Alert, or your estate and business planning in general, please email Leigh at lsegal@wispearl.com, or call her, or any of the attorneys in Wisler Pearlstine's Business, Corporate, and Tax practice group, at (610)-825-8400. We look forward to hearing from you.

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