SUPREME COURT RULING

Could Mean Higher Taxes for Business Owners

BY **ABIGAIL MCGOWAN | ATTORNEY | REINHART BOERNER VAN DEUREN s.c.**

IF YOU OWN AN INTEREST IN A CLOSELY HELD COMPANY, the Supreme Court's recent ruling may increase your estate taxes.

A closely held company, which can be a corporation, LLC or partnership, is a business that is owned by a small group of individuals, usually family members, friends or close business partners. Many closely held companies have a buy-sell agreement, which is a succession tool that controls how an owner's interests in the company can pass at death. A "redemption agreement" is a common buy-sell arrangement that requires the company to purchase a deceased owner's interests in order to prevent outside investors from infiltrating the company. In order to fund that purchase, the company will typically purchase life insurance on the owners and use the proceeds to purchase the deceased owner's interests.

The value of life insurance proceeds distributed to a company upon the death of an owner increases the fair market value of the company. However, prior to the Supreme Court's decision, many argued that a company's obligation to purchase the deceased owner's interests offset that increase in value, causing an effective "wash" in the company's value. This was an important concept when determining the value of a deceased owner's business interests for purposes of calculating the owner's estate taxes.

However, in *Connelly v. United States*, the Supreme Court ruled that a company's obligation to purchase does not offset the increase in value caused by the life insurance proceeds. The ruling renders the previous argument for "washing" the value of the company invalid. This means that, in a situation where a company has a redemption agreement funded by life insurance, the value of an owner's interests increases upon their death.

The Implications

Owners of closely held businesses that are subject to redemption agreements funded by company-owned life insurance may face increased estate taxes. In general, the value of a person's estate is calculated by adding the fair market value of all of the person's property. If the person's total estate is valued at more than $13.61 million in 2024 (doubled for married couples), the estate is subject to estate taxes. Given the Court's ruling, the fair market value of a business owner's interests increases due to the company's receipt of life insurance proceeds. This means a larger estate and potentially higher estate taxes. Business owners will want to keep a close eye on this, as beginning in 2026, estates worth more than approximately $7 million (doubled for married couples) will be subject to estate taxes.

Additionally, it will be incredibly important to get an independent appraisal of the company upon the death of an owner for purposes of reporting the value of the deceased owner's interests on an estate tax return. There will likely be an increase in IRS audits of deceased business owners' estate tax returns in the aftermath of this ruling.

Alternative Options

There are several alternative options to redemption agreements that keep life insurance proceeds outside of the company, preventing its increase in value upon the death of an owner.

One alternative is a "cross-purchase" agreement. In a cross-purchase agreement, business owners individually agree to purchase a deceased owner's interests. The business owners themselves will purchase life insurance on each other, and the surviving owner(s) will use the proceeds to purchase the decedent's interests. Because the individual owners receive the life insurance proceeds, rather than the company, the company avoids the increase in value.

Another alternative to consider is a loan by the surviving owners to the company. The business owners could individually purchase life insurance on each other, and upon the death of an owner, the surviving owners could loan the insurance proceeds to the company to fund the purchase of the deceased owner's interests.

Finally, the Supreme Court explicitly gave the alternative of a redemption agreement that required the company to sell operating assets in order to purchase a deceased owner's shares. Because this would decrease the company's future earning capacity, the value of the company would not increase. However, decreasing future earning capacity is generally not an ideal option for most companies.

Next Steps

The Supreme Court's decision in *Connelly v. United States* emphasizes the significance of proactive planning and regular review of your buy-sell agreements. As such, closely held business owners should review their current succession plan with their advisors to avoid inadvertently increasing the value of the company and potential estate taxes. The decision additionally serves as an excellent reminder that a business succession plan should align with overall estate and tax planning objectives.

If you have questions or concerns regarding your buy-sell arrangement or have questions about your business succession plan, please contact attorney Abigail McGowan or another member of Reinhart's Trusts and Estates Team.