Niche Alert

Stock Redemption Plans are Problematic at any Net Worth

The recent discussion surrounding Stock Redemption Buy/Sell Agreements has been largely focused on clients who anticipate a future estate tax liability. While the driver of this conversation, the Connelly decision, makes this appropriate and understandable, it also created yet another reason using a stock redemption agreement may be a mistake for any business owner, regardless of net worth.

The potential inclusion of life insurance proceeds received by a business under a stock redemption Buy/Sell Agreement (BSA) ushered in by the Connelly decision is a significant change to what was thought to be settled law. Initial analysis has focused on the increased estate tax exposure created by a higher-than-expected business valuation. While this is a significant issue for these clients, the actual number of impacted clients is rather small, with fewer than 3,000 taxable estate tax returns filed most years.

But what about clients who don't have a potential estate tax exposure?

Turns out, the Connelly decision impacts them as well, just not as directly. Businesses owned by these clients will also be worth more than anticipated if life insurance proceeds are received by the business under a Stock Redemption BSA. A business worth $4MM with a stock redemption plan between two equal shareholders would suddenly be worth $6MM upon receipt of the $2MM life insurance proceeds.

If that new, higher value is then the basis for execution of the BSA, each owner's share of the business is now worth $3MM and there is a resulting $1MM liquidity shortfall that needs to be addressed. The theoretically straight forward solution of purchasing additional life insurance will only further complicate the matter as each additional $1 of insurance also increases the value of the company and may not be justified in the eyes of the insurance company under traditional financial underwriting protocols. The resulting lack of clarity around how to actually value the business and execute the BSA is likely to create chaos rather than the clarity all involved are seeking.

That alone could be enough to consider updating an existing Stock Redemption BSA to an alternative structure. However, some will argue that this can be addressed in other ways or might not even come to light based on the lack of an IRS audit or other "trigger" that brings it to the attention of surviving owners or beneficiaries. Rather than debate this issue, however, taking a broader perspective uncovers this is simply an additional problem inherent in these types of agreements that can be easily avoided.

The primary issue is one of taxation, and it impacts the surviving owners of the business at the point they ultimately sell the business.

In the example above, if the $4MM business was capitalized with a total of $500,000 split evenly between two owners, their individual cost basis in the business is $250,000. With each owner's share now worth $2MM, if the business was sold each owner would be taxed on the gain of $1.75MM. At today's long term capital gains rate, that likely translates to a tax bill of $262,500 for each owner, as seen in Table 1.

Of course, if one of the owners dies, the deceased owner no longer has a problem under current law, nor does their family, as the cost basis is stepped up at death. For the surviving owner, however, the potential tax is now much higher. They are the sole owner of a business worth $4MM, but their cost basis remains $250,000. Because the business redeemed the shares rather than the surviving owner purchasing them directly, the surviving owner's cost basis is unchanged. Should they elect to sell the business, they will now be taxed on $3.75MM! The surviving owner's tax bill should they sell the business at this point is likely to be $562,200, as seen in Table 2.

Table 1: Projected Tax – Both Owners Live

	Owner 1	Owner 2
Cost Basis	$ 250,000	$ 250,000
Current Valuation	$ 2,000,000	$ 2,000,000
Taxable Gain	$ 1,750,000	$ 1,750,000
Capital Gain Tax Rate	15%	15%
Taxes Due	**$ 262,500**	**$ 262,500**

Table 2: Projected Tax – Surviving Owner - Stock Redemption

	Surviving Owner
Cost Basis	$ 250,000
Current Valuation	$ 4,000,000
Taxable Gain	$ 3,750,000
Capital Gain Tax Rate	15%
Taxes Due	**$ 562,500**

Under a different BSA structure that is based on the surviving owner receiving the insurance proceeds and purchasing the shares directly, not only do they avoid the issues created by the Connelly decision, but they also increase their cost basis by an amount equal to the purchase price. Between this new purchase and their original capitalization of the business, their total cost basis is now $2.25MM, and the taxable gain should they sell is only $1.75MM. At today's long-term capital gains rates, that translates into a $400,000 tax savings. All they may need to do to unlock this tax savings is update a buy/sell agreement to a different structure that allows for the direct purchase of the deceased owner's share of the business.

Table 3: Projected Tax – Surviving Owner – Alternative BSA

		Surviving Owner
Cost Basis	$	2,250,000
Current Valuation	$	4,000,000
Taxable Gain	$	1,750,000
Capital Gain Tax Rate		15%
Taxes Due	**$**	**262,500**

Bottom line? While the Connelly decision may be the catalyst, stock redemption plans have been a sub-optimal strategy in most circumstances for quite some time. Business owners of any net worth, regardless of estate tax exposure, would be well-served by avoiding them. The remaining question at this point is which of the various structures that allow the surviving owner to realize the increased cost basis would be most appropriate? The answer to that question depends on the nature of the business in question and the broader planning landscape for the business.

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