BUY-SELL AGREEMENTS

I. IN GENERAL

Where there is more than one owner of a business, Buy-Sell Agreements are essential in planning the estates and business relationships of the owners.

Two types of Buy-Sell Agreements:

A. Cross Purchase - Remaining owners buy seller's business interest.

B. Entity (Redemption) - Business purchases seller's business interest.

II. PURPOSE

A. Assures uninterrupted, conflict-free continuation of the business. Decedent's estate and heirs may need funds for taxes, administration expenses and income. Business may not be willing or able to distribute earnings to non-employee owners, such as the heirs. Purchasing their interest eliminates sources of conflict.

B. Provides decedent's estate with liquid assets, rather than an unmarketable interest in a closely-held business. Business may be worthless to family from a cash flow standpoint, yet have substantial value for estate tax purposes.

C. May fix the estate tax valuation of the business. CAVEAT: I.R.C. Sec. 2703 which partially replaced Sec. 2036(c), now makes it difficult to use buy-sell agreements to fix valuation in intra-family transfers. Sec. 2703 basically provides that property will be valued for estate tax purposes without regard to the buy-sell agreement unless it is:

1. A bona fide business arrangement;
2. Not a device to transfer assets to family members for less than adequate consideration; and
3. Its terms are similar to other arms-length agreements.

These new requirements only apply to agreements entered into after October 8, 1990. They are in addition to already existing requirements, such as the requirement that the agreement must have been binding on the parties during their lifetimes.

D. Provides a mechanism for the acquisition of a business owners interest in the event of an owners long-term disability, termination of employment (voluntary and involuntary), divorce, voluntary sale to a third-party or death as noted above.

III. DETERMINING PRICE

A. Predetermined Price subject to periodic review. This is usually the best method since the owners are best able to value the company. However, healthy owners could refuse to agree to update the purchase price if one owner becomes ill, or owners may merely neglect to update it, so a back-up clause is necessary.

B. Appraisal or Arbitration may be used as a back-up to the predetermined price.

C. Formulas may be used to determine the price. However, formulas can be very complex and may produce inequitable results.

IV. PAYING THE PURCHASE PRICE

A. Life Insurance (should always be considered)

1. Advantageous to Buyer because it provides funds to consummate the purchase without damaging the business' cash flow.

2. Advantageous to Seller because seller is not dependent upon the ability of the buyer to pay the full purchase price. Payment with a long-term note makes the seller take a business risk that the note will not be paid, while not sharing in the profits.

3. Insurance policies must be coordinated with the type of buy-sell agreement used (i.e. Cross Purchase vs. Redemption) and whether or not a trust will be used to own the policies.

4. Consider the "First to Die" insurance policy. Premium savings can be as much as 50% of the premiums on a standard single life insurance policy. Certain

life insurance companies <u>will</u> pay for up to two simultaneous deaths under a "First to Die" policy.

B. Sinking Fund: Establish a savings account and gradually fund it with sufficient assets to meet the proposed buy-out price.

C. Long-Term Payout: For example: 20% down, with the balance amortized over five years. A promissory note, secured by a pledge of the stock can be given for the unpaid balance.

D. Disability insurance may be used to fund a buy-out in the event of disability. Premiums will not be deductible. However, proceeds are not taxable to the business upon receipt. The disabled shareholder will have capital gain on the sale of their business interest.

V. FORM OF AGREEMENT

A. Corporations

1. Stock Redemption (Entity):

a. Fewer policies required where there are numerous owners, if life insurance will be used to fund the agreement.

b. Unreasonable compensation issues may prevent distribution of funds to the owners in order to pay premiums.

c. Corporation may be in a lower tax bracket (unless a professional corporation or an "S" corporation) so lowest corporate bracket may be used to pay non-deductible premiums.

d. Corporation may have surplus cash, which could be used to redeem a deceased shareholder's stock. This would allow the surplus cash to be removed from the corporation without being subject to ordinary income tax, as it would be if it were disbursed as dividends or compensation. The capital gains tax should be eliminated because the cost basis should be increased to equal the buy-out price due to the shareholder's death.

CAVEAT: Corporate Alternate Minimum Tax may be incurred on a C corporation's receipt of insurance proceeds (discussed further in VI, below).

2. Cross Purchase:

a. State Law Restrictions on Redemption. State law may not allow a corporation to redeem stock unless it has sufficient earnings. This is generally not a problem, if life insurance is used to provide the necessary surplus! If no life insurance exists, the agreement can require the remaining shareholders to purchase the shares, if the corporation has insufficient funds.

b. Unequal Ownership If a business is owned 80%/20% for example, then with a Redemption Buy-Sell agreement which is funded with life insurance, the majority owner will be using his own money to pay the premiums to buy himself out. Consequently, he will prefer a Cross Purchase arrangement.

c. Tax Consequences

i) Higher basis in stock after purchasing from decedent. This is lost with a Redemption Buy-Sell, unless the shareholders make capital contributions to the corporation to enable it to purchase the stock. This would not occur, however, if the life insurance to fund the purchase is owned by the corporation. The life insurance must be owned by the shareholders (or a trust on behalf of the shareholders) in order to obtain a higher basis.

ii) Cross purchase or Redemption doesn't usually affect the decedent's estate since the estate will have no capital gain either way, unless members of the family are surviving shareholders. Then there may be attribution of ownership in the corporation so that redemption of shares by the corporation isn't a complete termination of the shareholder's interest or substantially disproportionate. Therefore, proceeds from the corporation under a Redemption Buy-Sell might be considered taxable dividends to the decedent's estate (to the extent the corporation has earnings and profits). In some cases, this can be avoided

through proper structuring of the agreement and by making the proper elections. Otherwise, a Cross Purchase is preferable.

B. Partnership Buy-Sell Agreements (May be in the partner-ship agreement itself or in a separate document).

1. Major difference between Cross Purchase and Redemption has to do with goodwill, because life insurance proceeds are non-taxable to the partners whether received directly or indirectly through the partnership.

2. Purchase price attributable to goodwill in a Cross Purchase is a capital transaction, not part of partner's distributable income, and not deductible by surviving partners.

3. With Redemption Buy-Sell, Partners have a choice:

a. If the agreement mentions a specific price for goodwill, then it is a capital transaction.

b. If agreement is silent as to goodwill, then under I.R.C. Sec. 736, purchase price allocable to goodwill is an income item, taxable as ordinary income to decedent's estate. It is also deductible by the partnership (and, therefore, the surviving partners).

c. Note that the deceased partner's estate will prefer that the purchase of goodwill be treated as a capital transaction. The estate will have a basis in the partnership interest equal to its purchase price, so that there will be no gain on its sale. The surviving partners, however, will prefer goodwill to be treated as an income item, because that will give them an immediate deduction (equal to the taxable income allocated to the deceased partner's estate. If there is a substantial difference in the life expectancies of the partners when the buy-sell agreement is adopted, then this may be an important area for negotiation.

EXAMPLE: The founder of Business X is 55. Goodwill makes up a large part of its value. He wants to bring his 30 year old key employee on as a partner. Since the founder's life

expectancy is much less than the employee, he will want to ensure that the buy-sell agreement allocates a specific amount of the purchase price to goodwill. This will minimize the taxable income generated as a result of the sale of his interest upon his death.

d. Regardless of how goodwill is treated, some portion of the price paid for a deceased partner's interest will be treated as a capital transaction.

Is the Following True in a Redemption?

This will increase the surviving partners' basis in their partnership interests. In order for the partnership to step-up the basis in its assets (for depreciation, etc.) an election under IRC Sec. 754 must be made. Generally, such an election will increase the partnerships deductions, allowing it to shelter more of its income.

VI. USE OF TRUST TO AVOID ALTERNATIVE MINIMUM TAX, TO OBTAIN STEP UP IN BASIS AND TO MINIMIZE THE NUMBER OF POLICIES

A. **Avoid AMT**. Currently, the receipt of life insurance proceeds will cause a corporation to have Adjusted Current Earnings (ACE) in excess of its alternative minimum taxable income. 75% of this excess is subject to the corporate alternative minimum tax (AMT). **This does not apply to S Corporations.** Some experts think Congress may eventually exclude life insurance proceeds, but it hasn't happened yet. Because of AMT, where a Redemption Buy-Sell is appropriate, it is preferable to have a trust acquire the policies and receive the proceeds, rather than the corporation. Then the AMT problem is avoided.

B. **Step-Up in Basis**. If a Redemption Buy-Sell is appropriate, then the use of a trust to receive the insurance proceeds also provides the surviving shareholders with a step-up in the basis of their stock. This is done by having the trust receive the insurance proceeds on the surviving shareholders' behalves. The trustee then pays to the corporation as much of the proceeds as the corporation needs to fulfill its obligation (under the buy-sell agreement) to purchase the deceased shareholder's stock. This increases the shareholders' bases in their stock. The corporation then uses the funds and any corporate surplus to purchase the deceased

shareholder's stock. Any unused insurance proceeds are distributed directly to the shareholders (tax-free).

C. **Premiums Paid by Shareholders**. If this approach is used, however, the policy premiums cannot be paid out of the corporation's income. The premiums must be paid by the shareholders.

D. **Reduced Number of Policies**. If a Cross Purchase Buy-Sell is to be used, then the use of a trust to own the policies can reduce the total number of policies required. The trust only needs to acquire one insurance policy on each shareholder's life. As a result, if there are four shareholders, only four policies are required. Without the trust, twelve policies would be required, since every shareholder must hold a policy on the life of every other shareholder.

As with a Redemption Buy-Sell, the shareholders would contribute the premiums to the trust. The trust would be the owner and beneficiary of the policies. Upon a shareholder's death, the trustee would collect the proceeds of the insurance policy on that shareholder's life, and use them to acquire the deceased shareholder's stock on behalf of the surviving shareholders. As a result, the surviving shareholders would receive a higher basis in the stock, as discussed.

E. **Protection of Proceeds by Trustee**. Where the corporation or the surviving shareholders are the recipients of the insurance proceeds, there is always the possibility that they may breach the buy-sell agreement and keep the proceeds, or use them for other purposes, instead of using them to purchase the deceased shareholder's stock. Then the deceased shareholder's heirs would have to sue, in order to get the funds. Even after a successful lawsuit, the proceeds may have been dissipated and the defendant judgement proof, so that nothing can be collected. Using a trust to receive the insurance proceeds, should provide greater assurance that the proceeds will be properly used.

F. **Transfer for Value Issues**. In general, if a life insurance policy is transferred, and the transfer is not a gift, it causes the life insurance proceeds to become taxable to the beneficiary. This is known as a "transfer for value". Where the primary relationship between the transferor and the transferee is a business relationship, the IRS will presume a transfer for value, even though no consideration is apparent.

Under the trust arrangement, the deceased shareholder will own an interest in the life insurance policies on the surviving shareholders' lives. The surviving shareholders will want to buy these interests (in addition to such shareholder's stock) so that they may continue to be used to fund the buy-sell agreement. However, this would be a transfer for value, which would cause the insurance proceeds to become taxable to the recipients.

Alternatively, shareholders may already have a Redemption Buy-Sell Agreement which is funded with permanent insurance policies. They may wish to transfer such policies to a trust, to avoid AMT and to obtain the step-up in basis upon a shareholder's death. Such a transfer would be a transfer for value.

1. **Term Insurance**. If the insurance policies are term insurance policies, then one solution is to cancel the policies and then obtain new ones.

2. **Exception for Partners**. A transfer for value that occurs between partners does not cause the proceeds to become taxable due to an exception provided for transfers between partners. There is no such exception for transfers between shareholders, however. Therefore, if the buy-sell agreement is funded with permanent insurance, and if this exception is going to be relied upon, it will be necessary for the shareholders to also be partners.

Oftentimes, the shareholders in a closely-held corporation are already partners in other related ventures. Their relative ownership interests as partners do not have to be the same as their ownership interests in the corporation. They may have a partnership which owns real estate or equipment which their corporation is using. Such partnerships can often be used to convert what would have been unshelterable ordinary income from the corporation, into shelterable passive income from a rental activity.

If they already have such a partnership, then they satisfy the transfer for value exception. If they do not, then they should consider forming one as a valuable tax planning tool, in addition to solving the transfer for value problem.

G. **Tax Returns**. If the trust is revocable (a "Grantor" trust), or earns less than $100 of taxable income, then no tax returns are required.