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BUY-SELL AGREEMENTS

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There are several reasons for business owners to enter into buy-sell agreements with their partners or co-shareholders: (1) to create a market for the owner's business interest at certain triggering events such as death, disability or retirement; (2) to facilitate a smooth transition of management and control for the surviving or remaining owners; (3) to provide a mutually-agreeable price and terms (so as to avoid litigation and friction); (4) to establish the value of the business for estate tax purposes; and (5) to provide the family of a deceased owner with liquidity rather than a non-marketable business interest.

A buy-sell agreement can be broken down into three major components. First, there are the **triggering events** that require a business owner to sell (or offer for sale) his or her interest in the business. The most common triggering events are death, total and permanent disability, retirement or termination of employment, transfers to third parties, and deadlock. Second is the **purchase price** for the business interest. The purchase price may be based on a formula (e.g., book value, multiple of earnings, or fair market value) or may be a fixed amount that is subject to periodic revaluation. The final component of a buy-sell agreement are the **payment terms**. The agreement should set forth the down payment, the number and amount of any installments, and the interest rate to be used for an installment sale.

Corporations usually set forth buy-sell provisions in a separate agreement rather than in the articles of incorporation or bylaws. Partnerships and LLCs commonly include the provisions in the partnership or operating agreement.

A buy-sell agreement may be an entity plan, a cross-purchase plan, or a wait-and-see plan. In the entity plan, the corporation, partnership, or LLC buys the deceased or withdrawing owner's interest. In the cross-purchase plan, the surviving or remaining shareholders, partners, or members agree to buy the interest of a deceased or withdrawing owner. In the wait-and-see plan, at the time a triggering event occurs, the owners agree among themselves whether they, the entity, or a combination of both will purchase the interest of a deceased or withdrawing owner. Which type of buy-sell plan is preferable depends on both tax and nontax issues.

CHOOSING THE RIGHT PLAN FOR CORPORATIONS

Stock Redemption Plan. A corporate entity plan is usually referred to as a stock redemption agreement. Under it, the corporation agrees to purchase a shareholder's shares at an agreed price on the occurrence of a triggering event such as death, disability, or retirement. If the buy-sell agreement is funded with life insurance, the corporation should be the policy owner, beneficiary, and payer of premiums.

The primary advantage of a stock redemption plan is its simplicity. If the agreement is funded with life insurance, only one policy is required on the life of each shareholder. In contrast, in a cross-purchase agreement involving four shareholders, twelve policies would be required. The primary disadvantage of a stock redemption plan is that the surviving or remaining shareholder (or shareholders) do not receive a stepped-up basis in their shares when the corporation redeems the deceased or withdrawing shareholder's shares.

Because of the so-called "family attribution rules", stock redemption agreements are not recommended for family-owned corporations. The general rule is that the purchase by a corporation of its own shares is treated as a dividend taxable as ordinary income. However, one of the major exceptions to this general rule is that a redemption in complete termination of a shareholder's interest is treated as a sale or exchange of shares subject to capital gain treatment. Because the shares of a deceased shareholder receive a stepped-up basis, a subsequent sale of the shares at their estate tax value would result in no capital gains tax.

The attribution rules are best explained by example. Assume that a father and son own 80 percent and 20 percent, respectively, of the shares of ABC Company. Assume further that the son is a beneficiary of the father's estate and that father and son have entered into a stock redemption agreement with the company. If, upon the father's death, the company redeems all of the father's shares from his estate, it would appear that the father's estate has completely terminated its interest in the company. However, the son's shares are constructively attributed to the father's estate, thereby making a complete termination of the estate's interest impossible. As a result, the redemption of the father's shares is fully taxable to his estate as ordinary income. Note that while

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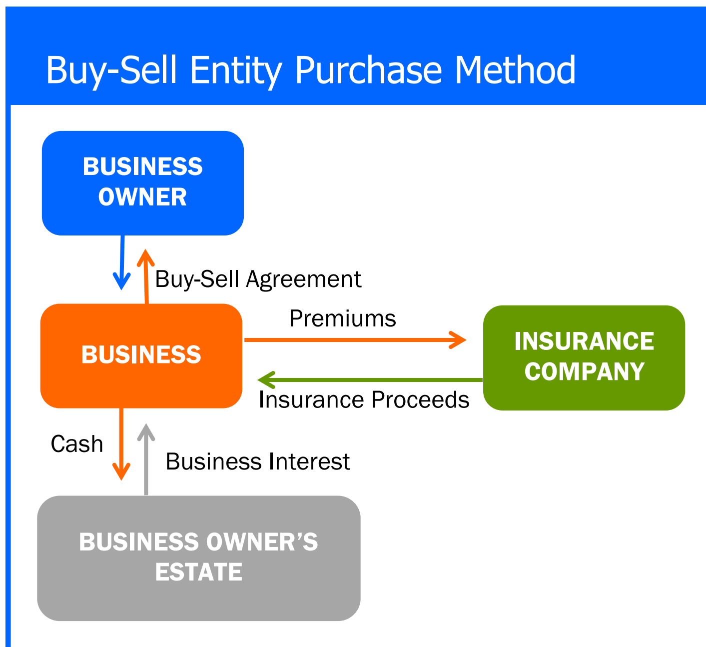
attribution between family members can be waived under certain circumstances, there can be no waiver of entity attribution.



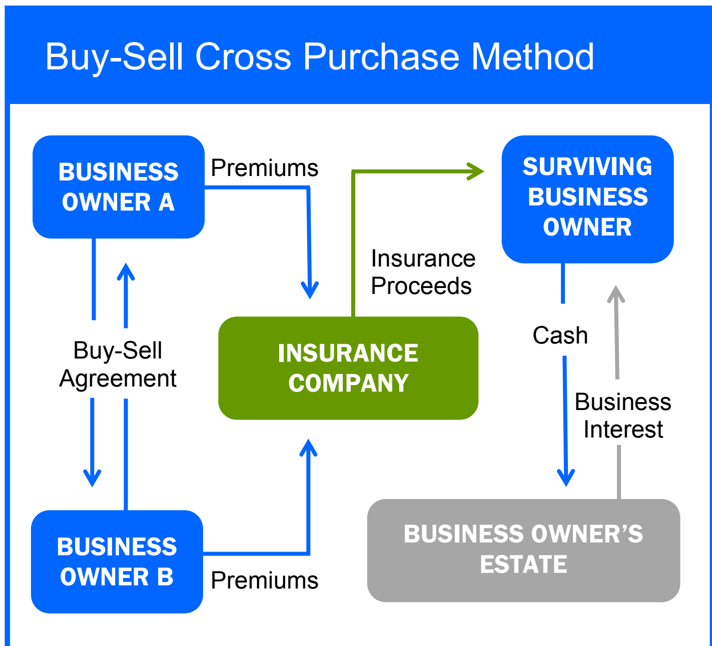
Cross-Purchase Plan. In a corporate cross-purchase buy-sell agreement, the shareholders agree to purchase the shares of a deceased, disabled, or withdrawing shareholder. If the agreement is funded with life insurance and there are three or more shareholders involved, the plan can be cumbersome because multiple policies will be required. Where *n* is the number of shareholders, the formula $n \times (n - 1)$ equals the number of policies needed.

It is possible to avoid purchasing multiple policies by using a trusteed buy-sell agreement. In such an arrangement, an independent trustee owns one policy on each shareholder's life for the benefit of the other shareholders. However, the death of one shareholder could create a "transfer-for-value" problem if the deceased shareholder's interests in the surviving shareholders' life insurance policies are reallocated among the surviving shareholders.

Life insurance proceeds are generally exempt from income taxation under the Internal Revenue Code. However, where a policy is transferred for value to a nonexempt transferee, the death proceeds are taxable as ordinary income. The taxable amount is the face value of the insurance policy less any consideration (purchase price and subsequent premiums) the transferee has paid. In a cross-purchase agreement involving three shareholders, a transfer for value will occur when Shareholder A dies and Shareholder B purchases (from A's estate) A's interest in C's policy, and vice versa.

An exemption from the transfer-for-value rule is available when the transferee is a "partner" (as contrasted to a co-shareholder) of the insured. IRC 101(a)(2). In the example above, if the three shareholders were also partners or members of an LLC, the transfer-for-value rule would not apply. If no partnership or LLC existed, one could be established solely for purposes of avoiding the transfer-for-value rule. For example, the shareholders could create an LLC to lease equipment to their corporation.

A cross-purchase plan offers several advantages over a stock redemption agreement. The primary advantage is that the surviving or remaining shareholders receive a stepped-up basis for the shares they purchase equal to the purchase price paid for the shares. Finally, with a cross-purchase plan, there is no concern of dividend treatment to the deceased shareholder's estate where the corporation is family owned.

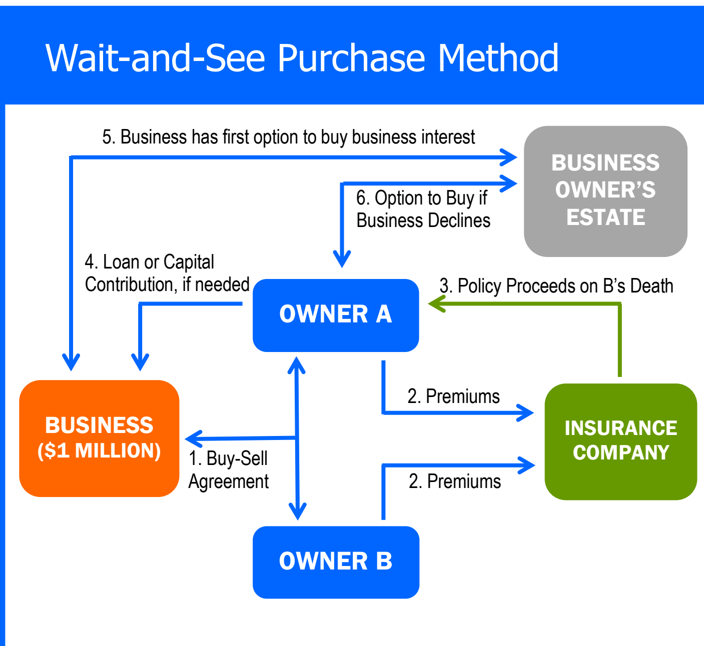


Wait-and-See Plan. Perhaps the optimal buy-sell agreement for a corporation is the so-called "wait-and-see" plan. Like a stock redemption or cross-purchase plan, a wait-and-see buy-sell agreement sets forth the triggering events, the purchase price, and the payment terms. However, unlike the other two plans, the wait-and-see agreement does not identify the purchasers until the triggering event occurs.

If the wait-and-see agreement is to be funded with life insurance, it is recommended that the policies be cross-owned (as with a cross-purchase agreement) because it is generally preferable from an income tax standpoint to have the surviving shareholders loan money to the corporation to redeem the deceased shareholder's shares (if a stock redemption is desirable) rather than have the shareholders borrow from the corporation (if a cross-purchase is desired).

In the typical wait-and-see buy-sell agreement, on the occurrence of a triggering event, the corporation has the first option to purchase the deceased or withdrawing shareholder's shares. If the corporation does not exercise

its option, or purchases less than all of the shares, the surviving or remaining shareholders have the option to purchase the shares pro rata. Finally, the corporation is required to purchase any shares not purchased under the first two options. The bottom line is that the wait-and-see buy-sell agreement affords the parties the greatest degree of flexibility.



SPECIAL CONSIDERATIONS FOR SUBCHAPTER S CORPORATIONS

"S" corporations are unique. The need for a buy-sell agreement in "S" corporations may be even more important than for "C" corporations to avoid any inadvertent termination of "S" status due to stock passing to an ineligible person or entity. "S" corporations, like "C" corporations, have a choice between cross purchase and stock redemption agreements.

However, the effect of a stock redemption agreement on "S" corporation shareholders is quite different than that on "C" corporation shareholders. In a stock redemption agreement, the "S" corporation purchases, owns and is the beneficiary of the insurance policies on the lives of the shareholders. At the death of a shareholder, the insurance proceeds received by the corporation are allocable to each shareholder according to their percentage ownership in the corporation. This allocation increases the basis of each shareholder. However, because the decedent's stock already receives a stepped-up basis at death, a portion of the surviving shareholders' increased basis is wasted.

If the "S" corporation is a cash basis taxpayer, the Internal Revenue Code allows for a short year election. By terminating the tax year at the death of a shareholder, surviving shareholders can get an increase in their basis similar to that of a cross-purchase agreement. The "S" corporation must provide the decedent's estate with a promissory note in exchange for the decedent's stock when the year is terminated. Thereafter, the "S" corporation, with only the surviving shareholders in ownership, then files the claim to the insurance company and receives a full step-up in basis by using the proceeds to pay off the promissory note.

CHOOSING THE RIGHT PLAN FOR PARTNERSHIPS AND LLCs

A partnership or an LLC buy-sell agreement may be either an entity plan or a cross-purchase plan. Like a stock redemption plan, an entity plan requires the partnership or the LLC to purchase each partner's or member's interest on death, disability, retirement, or withdrawal. If the buy-sell agreement is funded with life insurance, the entity is the owner, beneficiary, and premium payer of the policy. Like a stock redemption plan, an entity plan avoids the use of multiple life insurance policies where there are three or more partners or members.

In a partnership cross-purchase plan, the interest of a deceased or withdrawing partner or member is purchased by the other partners or members. As in the corporate setting, when there are three or more partners or members, multiple life insurance policies are required. However, it is possible to limit the policies to one per partner or member by using a trusteed buy-sell agreement. In this case, an independent trustee would own one policy on each partner or member for the benefit of the other partners or members.

The status of a partnership as a pass-through entity, rather than as a taxable entity, means that there are relatively few differences between the tax treatment of a partnership's redemption of a partner's interest and the cross-purchase of that interest by the other partners. The principal difference between an entity plan and a cross-purchase plan in the partnership context is that in an entity plan the partners or members have the flexibility of treating goodwill as either a capital asset or as an ordinary income item. If the entity buy-sell agreement makes no provision for goodwill, the entire goodwill amount will give rise to ordinary income. If treated as ordinary income, the amount paid for goodwill in an entity plan is taxable to the seller as ordinary income and is deductible by the partnership or LLC. This treatment may be elected only if capital is *not* a material income-producing factor in the partnership or LLC. Moreover, for the Internal Revenue Service to agree with this result, the allocation to goodwill must be reasonable.

Where capital is not a material income-producing factor in the partnership or LLC, why would the parties want to treat goodwill as an ordinary income item in an entity plan? The answer is apparent when the tax consequences to the remaining partners or members are examined. When the payments for goodwill are taxed as capital gains, the remaining partners' or members' basis in the partnership assets increase, but there is no immediate

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income tax benefit to them. On the other hand, if goodwill is treated as an ordinary income item, the remaining partners or members get an immediate income tax deduction for amounts paid by the partnership or LLC for goodwill. The recipient must report such payments as ordinary income (instead of as a capital gain). Nevertheless, in a family business, if the remaining partners or members expect to be in a substantially higher income tax bracket than the deceased partner's or member's beneficiaries during the buyout period, substantial taxes can be saved by providing the remaining partners or members with this current deduction.

METHODS OF FUNDING A BUY-SELL AGREEMENT

Guaranteeing sufficient funds with which to purchase the interest of a deceased, disabled or withdrawing business owner is an important part of buy-sell planning. A business has essentially five methods of funding a buy-sell agreement.

First, the funds can come from the business's assets or operating profits. However, most successful business owners do not keep large sums of liquid assets on hand. Instead, they put their money to work in their business.

Second, a sinking fund can be established. But such a fund may be inadequate if a business owner dies prematurely. In addition, for regular corporations, establishing such a fund may expose the corporation to an accumulated earnings tax problem.

Third, the business can borrow the funds from a bank. The problem with borrowing, however, is that the loss of a key person might impair the business's credit-worthiness. In addition, the interest costs may be excessive and the interest expense may not be deductible.

Fourth, the business can pay the purchase price on installments. This approach presents the same problems for the business as borrowing from a bank. Moreover, the seller runs the risk that the business may fail and the payments stop.

The fifth and final method of funding a buy-sell agreement is life insurance. This approach offers the following advantages: (1) complete financing is guaranteed from the beginning; (2) the death proceeds are generally free from federal income taxes; (3) the policy's cash value can be used for a buyout due to retirement or disability; (4) it may be the most economical method because the premiums paid are usually a fraction of the death benefit (i.e., discounted dollars); and (5) the business's credit position is strengthened.

TAXABILITY OF EOLI

IRC Section 101(j) introduces an exception to the general rule that life insurance death benefits are income tax free for certain Employer-Owned Life Insurance (EOLI) policies. IRC Section 101(j) will apply to nearly every buy-sell agreement where the entity is purchasing life insurance to fund the buy-sell agreement. Nevertheless, the insurance proceeds will remain income tax free if, *prior to policy issuance*, the employee: is notified in writing of the employer's intent to insure, and of the maximum possible amount of insurance; provides written consent to being insured and that such coverage may continue after employment termination; and is informed in writing that the employer will be a policy beneficiary upon death. In addition to closely following the pre-policy issue procedural steps, every policyholder owning EOLI issued after August 17, 2006 must file IRS Form 8925 annually.

The notice and consent provisions can be made part of the buy-sell agreement itself. However, the notice and consent provisions in a buy-sell agreement will be effective only if the agreement is executed before the issuance of the life insurance contracts.

SELECTING THE TRIGGERING EVENTS

Most business owners think of buy-sell agreements in the context of what happens to their business interest upon their death. However, a comprehensive buy-sell agreement will also include a number of other triggering events. For each such event, a market is created that might not otherwise exist in a closely-held business, and the remaining owners are guaranteed control of the business without outside interference.

Next to death, the most common triggering events are total and permanent disability (usually following a one- to two-year waiting period), retirement or termination of employment, transfers to third parties, and deadlock. With respect to disability, a provision defining what constitutes total and permanent disability must be included in the buy -sell agreement. The agreement should also specify the normal retirement age. Under termination of employment, the agreement should cover both voluntary and involuntary terminations. Transfers to third parties should include not only sales but also gifts and involuntary transfers that might occur if a business owner divorces, is sued, or becomes bankrupt. Finally, a buy-sell agreement may be used to structure a fairly priced buy-out when the shareholders are deadlocked.

Once the parties determine the triggering events to be included in the agreement, they must decide which triggering events result in a mandatory purchase and which events simply trigger a right of first refusal or an option to purchase. Most agreements treat death and disability as mandatory purchases because the deceased or disabled owner is no longer in a position to negotiate with his or her co-owners. In addition, attaining normal retirement age is often treated as a mandatory purchase. For the other triggering events, most agreements give the remaining owners a right of first refusal to match a third-party offer or an option to purchase under the price and terms set forth in the buy-sell agreement.

DETERMINING THE PURCHASE PRICE

There are a number of ways to value a closely-held business in a buy-sell agreement. Many agreements use a fixed price subject to periodic revaluations and provide for an appraisal if the parties cannot agree to revalue or if they simply neglect to do so. However, valuation formulas are the predominant measuring device. Among the many formulas used are (1) net book value, (2) adjusted book value, (3) multiple of earnings, and (4) fair market value as determined by an independent appraiser or the corporation's accounting firm.

The net book value of a business is its total assets less total liabilities as reflected on its balance sheet. The net book value formula may be appropriate for a business that is relatively new. It is important to note that book value does not take into consideration the value of the business's goodwill, if any. In determining net book value, assets are valued at cost less depreciation.

The adjusted book value method starts with net book value but then adjusts the business's value upward or downward to reflect the current fair market value of tangible assets such as equipment, real estate, and inventory. Usually, an independent appraisal of the tangible assets is required to make the adjustment. The adjusted book value formula works well for a business where goodwill is not present.

If a stock redemption or entity agreement is funded with life insurance and uses either a book value or an adjusted book value formula, the valuation date should be the last day of the month immediately preceding the triggering event. This will prevent the life insurance proceeds from inflating the purchase price (and estate tax value) of a deceased owner's interest.

The multiple of earnings method bases the valuation on the business's income statement instead of on its balance sheet. The business value is obtained by multiplying earnings by a multiplier. Earnings are usually based on an average of three to five years and are often weighted to emphasize the business's most recent earnings. To arrive at the business's true earnings, adjustments may be necessary for items such as nonrecurring expenses and excessive salaries because these can cause earnings to be understated. The exact multiplier to be used reflects the degree of risk inherent in the business and varies among industries. An independent appraiser or the business's accountants are typically in the best position to develop the multiple of earnings formula to be used in the buy-sell agreement.

Perhaps the best valuation formula is that based on fair market value as determined by an independent appraiser. Although the appraiser may use a variety of approaches, it is common to look at the business's book value, net book value, and the value determined under the multiple of earnings method. The values can be weighted to give one of the formulas greater emphasis (as may be dictated by the particular industry) and then averaged. In any event, regular review of the valuation formulas and payment terms must be coordinated and considered.

Estate Freezing with Unrelated Owners. A buy-sell agreement, when properly implemented, can fix the estate tax value of a deceased owner's business interest. Case law has established the following rules by which unrelated owners may fix the estate tax value of a business interest in a buy-sell agreement:

1. The estate must be obligated to sell at death (under either a mandatory purchase agreement or an option held by the business or surviving owners).
2. The purchase price must be fixed by the terms of the agreement, or the agreement must contain a formula or method for determining the price.
3. The agreement must prohibit the owner from disposing of his or her interest during his or her lifetime without first offering it to the business or to the other owners at no more than the contract price.
4. The price must be fair and adequate when the agreement is entered into.

In the absence of a binding agreement, a deceased owner's business interest must be valued at the fair market price. The estate tax regulations define this as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Factors that should be considered include the business's book value, earning capacity, goodwill, recent sales of other business interests, economic outlook, and nature and history. Moreover, where the decedent owns a noncontrolling interest in the business, the value of the business interest may be discounted for lack of control and lack of marketability.

Estate Freezing with Related Owners. For buy-sell agreements between family members entered into after October 8, 1990, or substantially modified after that date, to fix the estate tax value of the business interest, Internal Revenue Code Section 2703 requires the following tests be satisfied *in addition to* the rules set forth above relating to nonfamily businesses. First, the agreement must be a bona fide business arrangement. Second, it may not be a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth. Third, it must have terms comparable to those entered into by persons in an arm's-length transaction. The last requirement suggests, but does not clearly state, that agreements among unrelated parties would be treated solely under the rules discussed above. Moreover, the regulations expressly exempt an agreement if more than 50 percent of the business interests are held by unrelated owners.

If a family buy-sell agreement does not meet the requirements of IRC 2703, two disastrous results can occur. First, the selling estate may receive less for the business interest than the estate tax obligation for the

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interest. Second, if the business interest is left to a surviving spouse who is required to sell the interest for less than its estate tax value, the unlimited marital deduction could be significantly impaired, resulting in estate taxes on an estate that anticipated little or no tax.

The third test of IRC 2703 makes it essential that the buy-sell agreement result in the business being valued at its fair market value. A purchase price formula requiring a fair market value appraisal by an independent appraiser should guarantee that the value finally determined for the business interest will be accepted as its estate tax value. Alternatively, a formula established by a professional business appraiser that is appropriate for the business's size and industry should also satisfy the requirements of IRC 2703, provided the formula is reviewed and, if necessary, modified as the business grows or changes. The use of a fixed price would not likely satisfy IRC 2703 unless it were established by an independent appraiser and regularly reevaluated.

SETTING THE PAYMENT TERMS

A buy-sell agreement must set forth the terms upon which the purchase price will be paid. Although the buy-sell agreement may require the purchase price to be paid in full at closing, such a requirement is often impractical because of the cash-flow problems it can cause the business and the remaining owners. Instead, most agreements permit the purchase price to be paid in installments over a period ranging from three to ten years. Payments may be made monthly, quarterly, or annually, as the parties prefer. Installment-sale tax treatment is available to the selling business owner where he or she receives at least one payment after the close of the taxable year in which the sale occurs.

The down payment must also be specified. In most cases where the buy-sell agreement is funded with life insurance, 100 percent of the insurance proceeds will be required as the down payment for a deceased owner's business interest. For lifetime sales where insurance proceeds are not available, a down payment in the range of 15–30 percent is typical.

In installment sales, an interest rate must be specified. For buy-sell agreements involving nonfamily members, the interest rate is often a floating rate geared to the prime lending rate and can be adjusted annually or more frequently during the term of the installment note. For family businesses, it is not uncommon for the family members to want to use the lowest interest rate possible. In such a case, the interest rate should be set at the minimum rate required to avoid imputed interest or original issue discount problems (i.e., it should be set at the "applicable federal rate").

The unpaid purchase price should be evidenced by a promissory note setting forth the face amount of the loan, the interest rate, the payment amount, and the number of installments. Most buy-sell agreements allow for prepayment without penalty. Finally, it is advisable to attach the promissory note as an exhibit to the buy-sell agreement.

Most sellers will want the buy-sell agreement to provide some form of security for the deferred purchase price. The security may be in the form of a guarantee, a security interest in the shares being sold, or a security interest or mortgage in other assets of the buyer. In a stock redemption or an entity plan, a lien or mortgage on the corporation's or entity's assets can secure the note.

In many buy-sell agreements, the owners agree that any promissory note given by the entity pursuant to the agreement will be subordinate to any institutional financing afforded the corporation or entity. Such a provision will facilitate the corporation's or entity's ability to obtain financing while it is obligated to purchase an owner's interest under an installment sale.

Finally, in a stock redemption or an entity plan, most sellers find that it is advisable to include operating restrictions pending payment in full. Such restrictions prevent the corporation or entity and the remaining owners from siphoning the business's profits and thereby putting the business at risk of being unable to make all of the installment payments. Among the more common restrictions are the following: excessive increases in the compensation paid to the remaining owners and/or members of their family, a sale of all or substantially all of the business's assets, merging or consolidating the business with another company, incurring debt beyond certain limits or ratios, and changes in the business's voting control.

SUMMARY

As seen above, a properly designed and funded buy-sell agreement provides assurance to the surviving or remaining owners that the business will continue in a successful manner. At the same time, it provides deceased, disabled or retiring owners with funds that will enable them to meet their needs and pay their estate settlement costs. Overall, a buy-sell agreement gives the business owners, employees, suppliers, customers, lenders and bonding agents comfort and security that the business will successfully survive the death, disability or retirement of one or more of its owners.

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