THE BUSINESS OWNER AND SUCCESSION PLANNING—BUY-SELL AGREEMENTS

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INTRODUCTION TO BUY-SELL AGREEMENTS

Buy-sell agreements are perhaps the most frequently used device to transfer business interests. While it is sometimes difficult to get business owners to execute such agreements, they are very useful in the initial business succession planning stages. Of course, a better alternative to business succession planning, from an estate planning perspective, is to transfer all (or almost all) of the interests in a business prior to death, but buy-sell agreements are good initial planning tools to make sure that the business interest can be disposed of in a tax-efficient and economic manner at death.

A buy-sell agreement is simply an agreement that obligates one party to sell and another party to buy a business interest upon the happening of some event. Events typically triggering the buy-out provisions of a buy-sell agreement include death, disability, divorce, bankruptcy, and a shareholder's exit from the business.

PURPOSES OF BUY-SELL AGREEMENTS

Advantages to the Seller

There are several advantages of buy-sell agreements to the seller of the interest including:

- the provision of a purchaser of the business interest
- the ability to fix the value of the interest for estate tax purposes
- the ability to generate liquidity in the estate of a deceased owner
- the ability to achieve favorable income tax treatment

In many closely held and small business planning situations, finding a purchaser of the business interest is an important step in planning. Most small businesses are illiquid. If something happens to the business owner and the business owner needs to take cash out of the business by selling it, finding a buyer at that time is often a difficult thing to do. Having an interested party standing by to purchase the business upon the happening of some event can prevent a fire sale of the business. If there is a fire sale of the business, chances are that the business owner (or his estate or heirs) will receive only a fraction of the business' actual value. Buy-sell agreements between a business owner and his or her heirs, an employee of the business, or other interested party can be structured to help solve this problem.

Another problem commonly faced by closely held and family business owners is the valuation of the interest in the business. Due to the lack of an established market for trading interests in the business, and the fact that owners of less than a majority interest in the business are, in reality, at the mercy of the majority owners, the true value of the business interest held by the owner can become the subject of great debate. If the buy-sell agreement is properly executed, however, it may fix the value

of the business for estate tax purposes and offer a way for a deceased owner to withdraw money from a corporation at capital gains tax rates, as set forth in IRC Secs. 302 and 303, as opposed to the ordinary tax rate imposed on dividend payments.

Most buy-sell agreements are effective upon the death of a shareholder. When death is a triggering event, the fair market value of the deceased shareholder's interest in the business is included in his or her estate for federal estate tax purposes, thereby creating an estate tax liability. Owners of most closely held and family businesses are likely to have the business interest represent a substantial portion of their estate. Because the business interest is illiquid, generating the cash to pay estate taxes on the business interest may be difficult without an outside source of liquidity. Furthermore, a sale of the business by the executor may very well require the estate to accept a price far below the fair market value of the business, since purchasers know the executor must raise money to pay estate taxes within 9 months of the decedent's death. A properly funded buy-sell agreement will not only avoid a liquidity crunch in the estate, but will also ensure that the estate, and, therefore, the deceased business owner's heirs, will receive fair market value for the business interest.

Finally, in certain circumstances, it may be possible to structure the buy-sell agreement in a way to take advantage of special income tax rules. This is particularly true when the business is a C corporation and the provisions of IRC. Sec. 303 (concerning at-death redemptions of corporate stock) apply, or the business is a cash-basis S corporation. (These planning techniques will be discussed later.)

Advantages to the Buyer

The advantages to the buyer of a business interest pursuant to a buy-sell agreement include the

- transfer of business control with minimal interference from the deceased owner's family
- prevention of outsiders entering the business
- establishment of the value of the business to acquire the proper amount of funding
- maintenance of various business elections

In closely held and family owned businesses, the issue of control is an important one. When one owner dies, if other family members do not have the cash to purchase the interest and the interest must be sold to outsiders in order to raise cash for estate taxes, family control over the entity may become tenuous. If a properly drafted buy-sell agreement is in place, the surviving owners or family members can retain control of the business. By effectuating an orderly transfer of control of the business interest, the presence of a buy-sell agreement can also eliminate friction between the surviving shareholder and the deceased shareholder's heirs.

While fixing the value of the business interest is important for the selling owner (to minimize exposure to estate taxes), fixing the value is equally important to the purchasing owner. In order to have the funds necessary to effectuate the purchase at the first owner's death, the purchasing owner must know the price so that proper planning can be done. Funding the purchase price may involve the use of life

insurance, a sinking fund, borrowing from a creditor to purchase the shares, or an installment purchase from the estate.[1] In any circumstance, it will be important to know the price so the funding can be arranged.

If a business is run in the form of an S corporation, the S corporation must be careful not to violate any of the qualification rules, or it will loose it's Subchapter S status. A buy-sell agreement can be used to ensure that the S election will not be lost upon the death of a shareholder. For example, if any shareholder is married to a nonresident alien in a community property state, the death of the shareholder may terminate the S election. If, as a matter of state law, the nonresident alien obtains title to some of the S corporation shares, this will terminate the S election and the corporation will be treated as a C corporation from then on, which means it will be subject to the double level tax. The buy-sell agreement can also protect an S corporation by preventing stock from passing to testamentary trusts that are not Qualified Subchapter S trusts (QSSTs) or electing small business trusts (ESBTs).

TYPES OF BUY-SELL AGREEMENTS

Cross-Purchase Agreement

A cross-purchase buy-sell agreement is an agreement that obligates the surviving business owners to buy, and the estate of the deceased shareholder to sell the deceased shareholder's interest in the business. The business itself is not involved in the transaction, so this arrangement is not considered to be a corporate redemption (if the corporate form of business is used) for income tax purposes.

Cross-purchase agreements are convenient to use when there are only a few owners in the business. They can become increasingly complex as the number of owners increases if life insurance is used as a funding vehicle. To make the cross-purchase agreement work, each owner must purchase a life insurance policy on the life of each of the other owners. The greater the number of owners, the larger the number of insurance policies necessary to effectuate the buy-sell agreement. To determine the total number of life insurance policies needed to fund a cross-purchase buy-sell agreement, the following formula may be used: Total number of policies (N) x (N – 1), where N = number of owners in the business.

If the cross-purchase agreement is set up using a trust, partnership, or escrow arrangement, it may be possible to avoid purchasing multiple policies on the life of each owner. (Use of trusts, partnerships, and escrow arrangements will be discussed later in the reading.)

> *Example:* Windsor Industries is owned by Elizabeth and her four children. To set up a cross-purchase buy-sell agreement without a trust, partnership, or escrow arrangement, the total number of life insurance policies that must be purchased equals 20, Calculated as follows: 5 x (5 – 1) = 5 x 4 = 20. (If the buy-sell agreement were set up using a trust, partnership, or escrow arrangement, the total number of life insurance policies needed to fund the agreement would equal the total number of shareholders. In this example, five life insurance policies would be required.)

Life insurance is an ideal funding vehicle for a cross-purchase buy-sell agreement. The premiums paid on the life insurance policies are not tax deductible

by the business owners.[2] When the first business owner dies, however, the remaining owners receive the life insurance death benefit on the deceased owner's life income tax free.[3] The proceeds can then be used to purchase the deceased owner's business interest. When the survivor purchases the deceased owner's business interest, the survivor's basis in that interest equals the purchase price of the interest.[4] In essence, this means that the surviving owners of the business receive a stepped-up basis in their business interest at the death of the first owner. This increase in basis for the surviving owners will lower the taxable gain on the business interest when it is later disposed of by the survivor. An added benefit to using life insurance in a cross-purchase agreement is that the life insurance policies (and the cash value inside them) are not subject to the claims of the entity's creditors (unless the owners are individually liable for the entity's obligations), and can, therefore, be used to effectuate the required buy-out of a deceased shareholder regardless of state surplus requirements.

If the business is a corporation, it may be possible to pay for the life insurance premiums on the policies funding the cross-purchase agreement with corporate funds, and to avoid the double tax on corporate income. If the corporation makes additional distributions to its shareholder-employees to pay for the life insurance premiums, and the total compensation of the shareholder-employee, including the distribution for premium payment, is considered reasonable, the corporation can deduct the additional payment as compensation and the shareholder-employee will include the payment in his or her own income. In the event that the distributions to shareholder-employees to pay premiums exceed the reasonable compensation standards set forth by the IRS, the corporation will not be allowed a deduction for the payment of these amounts, and the shareholder-employee will report the payment on his or her own tax return as a dividend. Note that shareholders who are in a higher personal income tax bracket than the corporation will need more pre-tax dollars distributed in order to pay the premiums. This may still be an advantage, however, since the distribution will be taxed only once as long as it remains within the reasonable compensation limits.

While the life insurance used to fund a cross-purchase buy-sell agreement is not subject to the claims of the entity's creditors, it is subject to the claims of the individual owner's creditors. In many states, this will not pose a problem, since life insurance cash value and death benefits are exempted from creditor claims. In some states, however, this rule does not apply. In Pennsylvania, for example, life insurance is completely protected from the claims of creditors only when the beneficiary is the insured's spouse, children, or dependent family members. The Pennsylvania rule may protect the life insurance from the claims of creditors in a family business situation where a parent has entered into a buy-sell agreement with his or her child. However, if there is no family relationship, such as in a closely-held nonfamily business, a large portion of the cash value inside the life insurance policy may be accessible by a creditor, which can thwart the proper execution of the buy-sell agreement. For creditor protection purposes, in states like Pennsylvania, an alternative to outright ownership of life insurance policies to fund cross-purchase buy-sell agreements should be considered by business owners.

Entity Agreement

An entity type of buy-sell agreement obligates the business entity to purchase, and the estate of the deceased owner to sell, the deceased owner's interest in the

business. While the surviving owners are not required to purchase the decedent's business interest, all of the surviving owners benefit from the entity purchase. When the deceased owner's interest in the entity is purchased by the business, each of the surviving owners now holds a greater percentage ownership in the entity.

Entity type of buy-sell agreements are convenient when the business has many owners. If life insurance is used to fund the buy-sell agreement, only one policy will be necessary on the life of each owner, as opposed to multiple policies necessary to fund a cross-purchase agreement. The reduction in the number of life insurance policies needed to fund the agreement decreases the administrative burden associated with the buy-sell agreement.

An important issue arises in the use of entity type buy-sell agreements for corporations. If the agreement is entered into between a shareholder and a corporation, the ultimate purchase of shares pursuant to the terms of the buy-sell agreement is considered to be a corporate redemption, and is, therefore, subject to the redemption rules of IRC Secs. 302 and 303. (The impact of the corporate redemption rules is discussed at length elsewhere in this reading.)

One of the primary advantages of the entity type of buy-sell agreement is that the entity itself can maintain control over the funding of the arrangement and does not have to rely on the individual owners to fund their obligations. As the number of shareholders increases, there is an increased risk that the obligation set forth under the agreement will not be funded. This is particularly true if life insurance is used as a funding mechanism. If only one owner under a cross-purchase agreement does not make required premium payments when due, upon the death of the first owner, the funds may not be available to purchase the deceased owner's share.

In addition, if life insurance is used to fund the buy-sell agreement, the death benefit received by the entity upon the death of the first owner is not subject to federal income tax (although it may be subject to the alternative minimum tax), and the entire amount can generally be used to fund the purchase of the decedent's interest. The corporate alternative minimum tax (AMT) for nonexempt corporations may effectively impose a 15 percent tax on death proceeds if corporate-owned life insurance is used to fund a corporate purchase agreement. If life insurance is used as a funding mechanism, however, the premium payments made on the life insurance policy will not be deductible by the entity.[5]

A disadvantage of the use of a corporate entity type of buy-sell agreement funded with life insurance is that the cash value build-up inside the life insurance policy can trigger the imposition of the accumulated earnings tax. If the corporation purchases a life insurance policy on the life of a key person as key-person insurance, however, accumulations within the policy will be deemed to be for the reasonable needs of the business and will, therefore, not be subject to the accumulated earnings tax.

It should be noted that if life insurance is not used to fund the buy-out, and corporate earnings are the source of funds, an entity buy-sell agreement results in the corporation using the majority shareholder's profits to fund the purchase of his or her interest in the corporation. This can raise issues regarding the equitable allocation of entity buy-sell agreement funding.

A second disadvantage of the use of life insurance owned by the entity to fund an entity type of buy-sell agreement is the leveraging effect on the value of the decedent's interest. When a business owner dies, and the entity collects the life insurance proceeds, the value of the entity increases, as does the value of the deceased owner's interest in the entity.[6] The impact of this leveraging effect is different depending upon the type of entity, but must be taken into account in funding the buy-sell agreement. If the deceased owner was a key employee of the business, it may be possible to successfully argue, as one taxpayer did, that the increase in the value of the corporation due to the receipt of the life insurance proceeds was offset in full by the decrease in the value of the corporation due to the loss of the key employee.[7]

A third disadvantage of the entity of type buy-sell agreement is the impact of state law surplus requirements. Typically, surplus requirements apply only to banks and insurance companies, but may be extended under state law to other business entities as a way of protecting creditors. Many states have enacted statutes that disallow the purchase of an interest in an entity by the entity itself, if the entity does not have sufficient resources to meet creditor claims. This is really an anti-abuse provision. Without such a requirement, business owners could place the burden of business losses on creditors simply by having the business entity purchase their interest in the entity with remaining entity funds, thereby removing those funds from the grasp of entity creditors. In the event the entity is in such a position at the death of an owner, the entity may not be able to redeem the deceased owner's shares. If there is a possibility that the entity will face this problem in the future, an alternative to the entity type of buy-sell agreement should be sought.

Hybrid (Wait-and-See) Agreement

A hybrid, or wait-and-see, buy-sell agreement combines the features of both the entity and cross-purchase agreements. In this type of agreement, the entity is often required to redeem a certain amount of the deceased owner's business interest and has an option to redeem the remainder of the interest. If the entity does not exercise this option, the surviving owners are obligated to purchase the remaining interest of the deceased owner. This type of agreement builds flexibility into the buy-sell agreement by giving the parties to the agreement the ability to structure the purchase/sale to maximize the tax benefits of the transaction.

The hybrid buy-sell agreement is often used when it might be possible to redeem enough corporate shares from the estate of a deceased shareholder to pay for funeral and administration costs and death taxes. This favorable provision is found in IRC Sec. 303. A hybrid agreement may allow the corporation to redeem enough shares to meet the 303 limit, and then allow the remaining shareholders to purchase the additional shares to achieve a step-up in basis of their corporate investment.

In planning cross-purchase buy-sell agreements for clients, be very careful about using mandatory purchase provisions. If the purchasing shareholder would prefer at the time to use a corporate redemption, constructive dividend treatment may result. To avoid this potential problem, cross-purchase agreements can be drafted giving the shareholders a right of first refusal to purchase the shares, giving the corporation the second right to purchase the shares, and finally, if the corporation does not purchase the shares, requiring the surviving shareholders to purchase the shares.

LIMITATIONS ON TRANSFER RESTRICTIONS

Absolute restraints on alienation of property are generally enforceable. Consent restraints that are reasonable and that have been executed in good faith are generally enforceable. One example of a consent restraint is a first option or right of first refusal. "If a restriction takes any form other than a first refusal or option, it should be regarded as of doubtful validity in the absence of an express statutory provision or of case law in the state specifically validating the restraint."[8] The restrictions on the transfer of the stock or business interest must meet all of both the express and implied requirements of state law.

TRANSFER RESTRICTIONS AND TRIGGERING EVENTS

Death

The most common triggering event for buy-sell agreements is a buyout at death. Death is also the easiest triggering event to fund if life insurance is used as a funding device.

When death is the triggering event, a mandatory purchase is usually imposed. When death is a triggering event, it provides liquidity for the deceased shareholder's estate and relieves the business of any obligation (legal or otherwise) to pay salary or dividends to the family of the deceased shareholder. The funding for a buy-sell agreement with death as the triggering event usually involves the purchase of life insurance. The buy-sell agreement should obligate the parties to assist each other in obtaining appropriate life insurance coverage. While premium payments are nondeductible, death proceeds are income tax free. It is important to ensure that enough insurance is purchased to cover the fair market value of the business interest on the date of the decedent's death. If a family buy-sell agreement is contemplated, this is especially important in light of the requirements of IRC Sec. 2703.

Retirement

If retirement is a triggering event, provision must be made for adequate funding for the purchase of the business interest. If cash value life insurance policies are used to fund the buy-sell agreement, the cash value of the policy may be one available source of funds. A forced sale upon termination of employment does not constitute a forfeiture if the price was reasonable when set and the parties acted in good faith. If an employee must resell his or her stock upon termination and that restriction was in place from the time the stock was purchased, the stock will likely be treated as Sec. 83 property.

If a buy-sell agreement is to be effective upon retirement, consider requiring, as part of the buy-sell agreement, a separate consultation agreement with the retiring shareholder, or, in the alternative, a covenant not to compete. While payments under an entity type of buy-sell agreement will not be deductible by the company, payments under the consulting agreement or covenant not to compete will be deductible if they are reasonable. Note that this option requires a trade-off between potential capital gains treatment for the selling shareholder (and no deduction for the corporation), versus ordinary income tax rates for the selling shareholder if there is a consulting agreement or covenant not to compete (and a deduction for the corporation).

Withdrawal of Employment

A buy-sell agreement contingent upon withdrawal from employment raises similar issues to those that use retirement as a triggering event. If an entity type of buy-sell agreement is being used, the parties must consider how the buy-out will take place, and whether the business will have the funds necessary to effectuate the buy-out.

Disability

When one of the triggering events is disability, the important issue becomes the definition of disability. Determination of disability may include the following:

- examination by a group of physicians
- reliance upon a definition of disability in disability insurance policies
- the sole discretion of the board of directors
- mechanical objective standards

From the disabled shareholder's point of view, a required sale upon disability generates liquidity that will be required for support needs. The corporation, after the purchase of the stock, will be relieved of any future payments of salary or dividends to the disabled shareholder (which may otherwise create a strain on corporate cash flow when payments are being made to a noncontributing shareholder).

Competition

If the shareholder enters into competition with the corporation, the corporation will typically be given the option to purchase the shareholder's shares.

Divorce

A buy-sell agreement can be used as an alternative to a premarital agreement. In the event of divorce, the corporation or the shareholder-owner can be given the option to purchase any shares awarded to the spouse in a divorce settlement. This provision may be extremely valuable in community-property states, where each spouse is deemed to own half of the property acquired during marriage (which may include a closely held or family business interest). If possible, spouses of the shareholders should also be made party to the buy-sell agreement. It is unclear whether the provisions of Sec. 302(b) (corporate redemptions) or Sec. 1041 (transfers incident to divorce) apply to determine the tax treatment to the divorced spouse.

Contemplated Sale to Third Party

If a buy-sell agreement is to be triggered by a potential transfer of the stock to a third party, this provision must be specifically stated in the agreement. Both the agreement and the restriction on the stock certificates should state that the interest in stock cannot be pledged, assigned, or transferred. Unless the agreement so states, a creditor may contend that the transfer restrictions should not apply to involuntary transfers upon foreclosure (or bankruptcy), because the agreement did not prevent a pledge of stock.

BUY-SELL AGREEMENT PAYMENT METHODS

Introduction

The general factors that should be taken into account in determining an optimal payout method are (1) the availability of corporate or individual funds, (2) the needs of surviving family members, (3) the need for liquidity to pay death taxes, and (4) the tax consequences to the corporation and selling shareholder. The optimal funding solution may be different for different clients depending on their needs.

Lump-Sum Payments

Life Insurance Funding

The traditional funding vehicle for buy-sell agreements has been a life insurance policy on the life of the business owner. Many buy-sell agreements are triggered upon the death of an owner. Life insurance is ideal in this instance since the policy will pay off when the buy-out is triggered, providing sufficient cash for the corporation (in the event of an entity buy-sell agreement) or the surviving shareholder (in the event of a cross-purchase agreement) to purchase the deceased shareholder's interest. If the business interest is purchased for cash, the estate of the decedent will have sufficient liquidity to pay estate taxes and provide for the decedent's family, and the surviving shareholders can be assured that the continued operation of the business will not be impeded by the involvement of the deceased owner's family.

If all of the business owners are young, life insurance funding may not only be efficient, it may be very cost effective. If one or more of the business owners is older, however, the costs of the insurance can be prohibitive. When cross-purchase buy-sell agreements are structured between older and younger shareholders, it is often necessary to do some additional planning to ensure that the younger shareholders will have sufficient resources to pay for and maintain the insurance on the life of the older shareholder.

Sinking Funds

An alternative approach to using life insurance as a funding vehicle is to create a sinking fund. When a sinking fund is used, the company or the shareholders create an account into which they will deposit an amount of money that, combined with interest earnings on the deposits, will be sufficient to fund the purchase obligation under the buy-sell agreement when the agreement is triggered. Sinking funds have the advantage of avoiding the mortality charges associated with life insurance contracts. Sinking funds, however, do have several disadvantages. For example, if a shareholder dies at an unexpectedly young age, the accumulations inside of the sinking fund may not be sufficient to fund the purchase obligation. Furthermore, if the business subject to the buy-sell agreement is growing at a rapid rate, a sinking fund may actually dampen business success by draining cash that could be used to finance working capital away from the company to fund an eventual buy-out.

Sinking funds can be useful in situations where a definite time period to purchase can be established. Due to drains on working capital needs, however the sinking fund may be more appropriate for an established or mature business, as opposed to a growing company.

Tax Considerations

Since most buy-sell agreements are triggered at death, few individuals consider the tax ramifications of a sale during lifetime. Beware that the sale of stock by the shareholder at any time other than at death may generate substantial capital gain, which may be taxable in one year. This issue may be an appropriate consideration in specifying the triggering events in the buy-sell agreement.

Credit Purchase

Introduction

In some circumstances, a credit purchase of the business interest may be necessary. This situation may arise when one or more of the business owners is uninsurable, or in cases where the business owners have substantial resources outside of the business and do not wish to fund their buy-sell agreement with life insurance.

From the purchasing business owner's perspective, a credit purchase agreement is very favorable. Often, no immediate cash payment is necessary, and the interest can be paid over a series of years at a reasonable rate of interest. This allows the purchasing shareholder to finance the purchase through the earnings of the company that is purchased. While the purchasing shareholder will be pleased with this arrangement, the estate of the deceased holder (or the family of the selling shareholder) may not be so happy. From the seller's perspective, cash may not be available to pay estate taxes and family expenses shortly after death—it will only arrive in small installments over time. Furthermore, since the family is no longer involved in the business, the selling shareholder's family takes on additional default risk. If the business falters or fails, the family of the selling shareholder may not receive full value for their business interest.

There are several issues that should be considered when the purchase of the business would be made with credit.

Term of Notes

To help meet the liquidity concerns of the family or estate of the selling shareholder, the term of the note should be reasonable. Reasonable, from the perspective of the seller, is as short a time frame as possible. The shorter the term of the note, the less risk the seller's family takes on in the event of a default. Furthermore, needed cash will arrive for the use of the family.

If the payout period is too long, there are potential tax ramifications as well. A payout that is too long may unreasonably raise the risk of default and, consequently, the risk that the IRS will recharacterize the debt instrument as an equity instrument. This could be fatal if the company is an S corporation, since the S corporation election will be revoked. Furthermore, if the note is considered a form of equity, and an entity buy-sell agreement was used, the corporate redemption rules apply (if the business is a corporation), which may result in a recharacterization of the payments made under the note as dividends. From the purchaser's perspective, the interest paid to the seller will no longer be considered deductible interest payments on the note, and from the seller's perspective, the ability to treat part of the payment as a return of basis and part as a capital gain under the installment sale rules will be lost.

Avoiding Recharacterization of Note as Equity

To avoid recharacterization of the note as a form of equity, the note should be for a commercially reasonable period. It is in the interests of both parties to make the note as short as possible. Furthermore, if the business subject to the buy-sell agreement is an S corporation, the note should be structured in a form that meets the requirements of *straight debt*. In essence, this means that there must be an unconditional obligation to make the note payments regardless of the profitability of the company, that a fair market rate of interest is used, and that the holder of the note cannot, in any way, participate in the equity growth of the business. Failure to characterize the note as straight debt for an entity type of buy-sell agreement for an S corporation can result in a revocation of the S corporation election.

Security Arrangements

Due to the risk taken on by the seller in a credit purchase agreement, it may be appropriate to grant the seller a security interest in either the business interest or in property owned by the business in order to secure payment of the note. A security agreement prevents the remaining shareholders from benefiting from the continuing operations of the business and avoiding payment on the note if they run the business into the ground.

PARTIES TO THE AGREEMENT

Nontax Considerations in Entity Type of Agreements

Funding by the Corporation

An advantage of the entity type of agreement is that control over the funding of the agreement is maintained at the corporate or entity level. The business owners do not have to rely on each other to pay premiums on life insurance policies or to contribute to a sinking fund for the agreement funding.

Simplified Insurance Program versus Cross Purchase Arrangements

If an entity type of agreement is used, and the agreement will be funded with life insurance, administration of the entity type of agreement is much more efficient than the administration of a cross-purchase agreement. Under an entity type of agreement, the corporation must obtain a life insurance policy on the life of each shareholder, while in a cross-purchase agreement, each shareholder must obtain a life insurance policy on every other shareholder. As the number of shareholders grows, the number of life insurance policies necessary to fund the agreement also grows. Although there are additional tax issues that must be dealt with, it is possible for a trust or escrow agreement to be employed for funding a cross-purchase buy-sell agreement.

Leveraging Effect on Corporate Value

Life insurance purchased by the corporation to fund the buy-sell agreement is a corporate asset. While the death benefit is not subject to income taxation, payment of the death benefit may be deemed to increase the value of the corporation, and, therefore, the value of the interest that is being sold back to the corporation. In closely held businesses, this does not normally pose a problem, because the business can argue that the increase in business value due to the receipt of the life insurance

death benefit is offset by the loss of the shareholder who provided valuable services to the corporation. In essence, the life insurance is treated as key person insurance. (See *Estate of Newell v. Commissioner*, 66 F.2d 102, 10304 [7th Cir. 1933]).

Surplus and Solvency Concerns

Regardless of the existence of an entity buy-sell agreement obligating the business to purchase a shareholder's interest, state law may prohibit the purchase in certain circumstances. Most states have laws concerning the repurchase of corporate shares that state that a corporation is prohibited from repurchasing its own shares if it does not have sufficient surplus equity, or is insolvent. The purpose of these laws is to protect the creditors of the corporation. Absent these laws, the shareholders of a corporation that is nearing bankruptcy could have the corporation purchase all of their shares, draining the cash out of the corporation and into their own pockets. Such an action would leave the creditors of the corporation with several bad debts, because the creditors cannot seek to satisfy the debts owed to them by taking action against the shareholders of the corporation. Therefore, to protect creditors, most states have passed laws making it impermissible for a corporation with little or no surplus to repurchase its own shares.

In the event that a corporation is unable to purchase its shares due to the imposition of state law, the buy-sell agreement will not be honored. This result can be disastrous for the estate of a deceased shareholder that was counting on the proceeds from the buy-sell agreement to pay estate taxes or to provide cash for the use of surviving family members.

Nontax Considerations in Cross-Purchase Agreements

Removal of Funding from Attachment by Corporate Creditors

An advantage of the cross-purchase agreement over the entity type of agreement is that the source of funding is not available to the creditors of the entity. For example, the cash value of life insurance held by a corporation may, under the provisions of state law, be subject to the claims of the corporation's creditors in the event of bankruptcy. Life insurance policies owned by the shareholders are not generally subject to the claims of the corporation's creditors.

The flip side to this issue is that, in a cross-purchase agreement funded with life insurance, the life insurance policies held by the individual shareholders may be available to the creditors of the shareholder in the event that the shareholder files bankruptcy. Many states have legislatively protected cash value buildup in insurance policies by exempting the cash value buildup from the claims of creditors. Some states, however, provide more limited protection. For example, in Pennsylvania, the cash value of a life insurance policy is only protected if the policy is for the benefit of a spouse or dependent relative of the insured. To determine if the cash value of life insurance policies used to fund a cross-purchase buy-sell agreement in a particular state will be protected, it is necessary to review the applicable state law.

Use of After-tax Dollars to Pay Insurance Premiums

The premiums paid by shareholders to purchase life insurance policies to fund the cross-purchase buy-sell agreement are not tax deductible. This is similar to the situation with the entity type of buy-sell agreement funded by the corporation. While

the premium payments are not deductible, the death benefit received under the policy is not subject to income tax, which provides a significant benefit for the business owner. If the reverse situation prevailed, and the premiums were tax deductible, the death benefit would be subject to income tax, requiring the purchase of additional insurance to cover both the purchase price of the business interest as well as the taxes due on receipt of the death benefit.

MISCELLANEOUS PLANNING CONSIDERATIONS

Community-Property Issues

Nonworking Spouse's Consent

Under community property law, property acquired during marriage is considered to be owned equally by the spouses. While property owned prior to marriage or property acquired by gift or inheritance is generally considered to be the sole and separate property of the spouse that owns it, the income on such property is generally treated as community property.

If a business entity is formed while the owners are married, and the owners reside in a community-property state, the spouses of those owners will be deemed to own one half of the interest in the business. If the business was formed prior to the marriage of the owners, but income of the business has not been distributed and deposited into community-property accounts, a court may determine that the business interest owned prior to marriage was commingled with the community-property interest acquired after the marriage (the income of the business is community property), therefore, subjecting the business interest to the community-property rules. Furthermore, in some states, a widowed spouse's assertion of an interest in stock may alter the planned disposition of the stock under the terms of the decedent's will or under the terms of a buy-sell agreement with other shareholders or the corporation. A shareholder's execution of a binding buy-sell agreement may or may not be binding on his or her spouse, depending on state law management rights.

To avoid such problems, a nonworking spouse's consent should be obtained (1) to protect against the possibility that the nonshareholder spouse will predecease the shareholder and leave his or her community property interest in the stock to a third party and (2) to bind the surviving nonshareholder spouse to the buy-sell agreement. A buy-sell agreement can also protect against a division of the stock in the event of a divorce, and this, too, must be considered in drafting the agreement. A buy-sell agreement may obligate nonmarried business owners to enter into a valid premarital agreement whereby the future spouse waives all of his or her rights to the business interest in the event of a divorce or separation.

In executing the buy-sell agreement, it may be advisable to have the spouse sign the buy-sell agreement directly, thereby making the spouse a party to the agreement, as well as a separate confirmation for evidentiary purposes to establish that the spouse knew what he or she was signing. Spouses joining as parties to the agreement should be represented by separate and independent counsel.

Fixing Estate Tax Value With Respect to Spouse's Community-property Interest

Even if the buy-sell agreement effectively fixes the federal estate tax value of the working business owner's interest, the agreement will not fix the value of the

nonworking spouse's interest unless the agreement is operative upon his or her death.[9] If the decision is made to make the buy-sell agreement operative upon the spouse's death, beware that the surviving working spouse's interest may be converted from a 50 percent or majority interest to a minority interest.

Procedural Issues

Clarity and Workability

The buy-sell agreement should be clear and descriptive with regard to what will trigger the purchase and sale of business interests. The provisions should be drafted so that all parties are treated fairly.

Disposition of Unnecessary Life Insurance Policies

If a shareholder is bought out during life, the agreement should specify the way in which the life insurance policies on that shareholder would be disposed. Care should be taken in the disposition of these policies, however, because violation of the transfer-for-value rule will result in the death benefit being subject to income tax and a gratuitous transfer of the policy may invoke the 3-year rule of IRC Sec. 2035.

Treatment of Redeemed Shares

If shares are redeemed, the agreement should specify how those redeemed shares will be treated. If the shares are redeemed as treasury shares, it may be possible for majority shareholders to obtain a disproportionate amount of the value as compared with their percentage interest in the corporation, because some states deny the exercise of preemptive rights with respect to sales of treasury shares unless the articles of incorporation expressly so provide.

Procedural Corporate Law Considerations

Prohibitions in Corporate Charter

If the buy-sell agreement is to be set up for shareholders in a corporation, prior to executing a buy-sell agreement, the parties should ensure that the corporate charter and bylaws allow them to make such an agreement. The parties should also consider whether the corporation's creditors have restricted the corporation's right to redeem it's own shares as a condition for the extension of credit. If the corporate charter and bylaws will not allow such an agreement, or if creditors have restricted the corporation's right to repurchase it's own shares, the shareholders should consider the use of a cross-purchase buy-sell agreement as opposed to an entity or wait-and-see buy-sell agreement.

Noting Stock Transfer Restrictions Conspicuously on the Face of the Certificates

To prevent shareholders from selling corporate shares subject to a buy-sell agreement, the restriction should be clearly and conspicuously stamped on the face of the stock certificates. This places potential purchasers on notice that the sale of the stock is restricted to the terms of the agreement. Failure by the corporation to comply with this requirement may give way to a court determination that the buy-sell agreement was not properly executed, and the court will, therefore, not enforce the agreement.

Corporate Governing Documents

If an entity type of buy-sell agreement is used, it may also be necessary to place the transfer restrictions in the articles of incorporation, the corporate bylaws, or in a separate agreement. However, it is not generally necessary to include the transfer restrictions in the corporate bylaws or articles of incorporation. If the restrictions are placed in these instruments, regulatory approval may be necessary.

Personal Coordination

The will of the business owners should give authority to executors and testamentary trustees to implement the sale under the buy-sell agreement. Be careful in selecting fiduciaries, because statutory provisions that prohibit self-dealing by executors may prevent the implementation of an elaborately planned buy-out agreement.

Alternatives to Buy-Sell Agreements

Exchange of Stock/Recapitalization

In family companies, the shareholders may wish to retain an interest in the business at their death to provide for a surviving spouse or dependent children, but convert the common stock interest into a preferred stock interest. This can be accomplished by a preferred stock recapitalization. Recapitalizations are generally tax-free exchanges as long as they are structured in furtherance of a valid business purpose.[10.]

Nonvoting Stock

This procedure is similar to recapitalization discussed above, but involves the transformation of the voting common stock interest into nonvoting stock. This approach may be particularly valuable for owners of S corporations, because S corporations are not permitted to have more than one class of stock. Differences with respect to voting rights will not, however, create a second class of stock provided that distribution and liquidation rights are the same for both voting and nonvoting stock.

SCIN

In family-owned businesses, a self-canceling installment note (SCIN) can be useful. Instead of selling the business to his children at his death, the patriarch of the family business could sell the business interest to the children now in return for a SCIN. Under the terms of the SCIN, the children pay their father a specified amount every month, quarter, or year representing the purchase price of the business and a reasonable rate of interest. If the parent lives long enough, he will have received full value for the business, and the note will terminate by its terms. In the event the parent dies before receiving all of the payments, the note is canceled, and the children are not required to make further payments to the father's estate. Because the parent, in this instance, assumes the risk that he or she will die before receiving all payments under the note, the payments made by the children will be slightly higher than the payments under a straight installment note, reflecting the actuarial risk the parent is undertaking.

The primary benefit of the SCIN is that there is nothing included in the estate of the parent at death, since the note expires at death. Any unrecognized gain will, however, be recognized on the decedent parent's final income tax return, and the basis the children acquire in the business interest will be equal to the payments they made for the business.

Private Annuity

A private annuity, like a SCIN, is also very useful in family business planning. Under the terms of a private annuity, the parent sells the business interest to the children in return for the annuity payments. As long as the parent lives, the parent receives a payment. When a private annuity is used, it is the purchaser that assumes the actuarial risk—the risk that the seller will live beyond life expectancy (when full value for the business would have been paid). Payments must be made for the life of the seller, regardless of how long the seller lives. While at first, this may not seem attractive to the junior generation, it provides a way of allowing senior generation family members to retire from the business and receive the cash flow they need to fund their retirement. Often, the funding for the private annuity comes from the continued earnings of the business. In many family business planning situations, retirement funding is often ignored or delayed until shortly before the senior generation decides to retire. Without an assurance that required funding will be available for retirement, the senior generation may not turn over the reigns of the family business to the children until death, in which case they are funding their retirement from the earnings of the business anyway.

If a private annuity is employed, however, the seller may not take any security interest in the underlying property. It may be prudent for the seller to consider purchasing a life insurance policy on the life of the purchaser to ensure that cash will be available in the event the purchaser predeceases the seller and the business falters.

Installment Sales

An installment sale is simply a sale of the business in return for an installment note. Installment sales offer the seller the opportunity to spread the gain on the sale of the business over several tax years. Part of each payment received by the seller is deemed to be a return of capital, part is considered capital gain on the business interest, and part is deemed to be interest at a reasonable rate.

When a family business is being sold, the use of an installment note should be used with caution. Recent tax law changes require the gain on the sale of property subject to an installment note to be recognized in the year of sale, if the sale is between related parties. Competent counsel should be consulted when engaging in these types of transactions.

Coordination with Estate Planning

While a buy-sell agreement is primarily designed to ensure continuity of the business in the event of the death or exit of an owner, the business interest itself is often a major component of the owner's estate. As such, it is important for the business owner to consider the estate tax implications of the various transfer mechanisms when structuring the agreement.

When planning for a family business, it may be possible to coordinate the planning to achieve optimal results for both the business and the individual owners. In other situations, inherent conflicts can develop between the shareholders, since the situation facing one of the shareholders calls for one type of design that will produce suboptimal results for the other shareholders. The advisor should be careful in advising both the business as a whole and the individual shareholders in these situations. It is often best for each shareholder to retain separate counsel, and retain counsel for the business, to ensure that all parties' interests are properly represented.

Buy-out at Retirement or Cessation of Employment

A buy-sell agreement that is triggered on the retirement or exit of a business owner presents special problems. While an agreement triggered at death can be fully funded with life insurance on the life of the owner, retirement insurance is not available. When these triggering events are included in the agreement, it is important to consider how these events will be funded.

If the agreement provides for a buy-out at death or retirement, and life insurance is used to fund the at-death buyout, one source of funding for the payout could be the accumulated cash value inside the life insurance policy. In particular, if a variable universal life insurance policy is used, and the business owners anticipate a retirement buyout prior to death, the owners can plan for the buyout by contributing an appropriate amount of cash to the policy so that, at the anticipated retirement date, the company or remaining shareholders can take loans from the policy to fund the buyout (either as a lump sum or in installments). This will require annual funding at a greater level than would be required for an at-death buyout, but, in essence, combines the benefits of life insurance funding and the sinking fund. If the business owners are relatively young and there is a long accumulation period before the first retirement is anticipated, this may be a particularly appropriate planning technique. Care must be taken, however, to ensure that the contributions to the policy will not violate the modified endowment contract rules.

An alternative to using a cash value life insurance policy as a sinking fund for purchase of the business interest is to provide for a credit purchase at retirement or exit from the business. A reasonable term for the buyout can be chosen, which will stretch the purchase payments out over that time period. This approach has the advantage of giving the remaining owners the ability to use the business earnings to fund the buyout, and gives the exiting shareholder additional retirement income over the term of the installment note. A note that has a reasonable term and fair interest rate can be advantageous to both the seller and the buyer.

TAX CONSEQUENCES OF BUY-SELL AGREEMENTS

Entity (Corporate Purchase) Agreements

Avoiding Dividend Treatment Under Sec. 302

Generally, any distribution a corporation makes to its shareholders is treated for tax purposes as a dividend. Dividend treatment denies the corporation a deduction for the payment and requires the shareholder to include the payment in ordinary income.

Whenever a corporation purchases its own stock from a stockholder, a stock redemption occurs. Generally, a stock redemption will be treated as a dividend to the extent of corporate earnings and profits unless the tax code provides otherwise. Exceptions to the general rule requiring dividend treatment are found in IRC Sec. 302(b). The three primary exceptions to dividend treatment under Sec. 302(b) include:

1. redemptions that are not essentially equivalent to a dividend
2. redemptions that are substantially disproportionate
3. redemptions that result in a complete termination of the shareholders interest

If a corporate redemption meets the requirements of one of these exceptions, the transaction will achieve sale or exchange treatment, allowing the shareholder to achieve favorable capital gains treatment for income tax purposes.

For a stock redemption to qualify as a distribution that is "not essentially equivalent to a dividend" under IRC Sec. 302(b)(1), the shareholder's proportionate interest must undergo a "meaningful reduction." In *U.S. v. Davis*, 397 U.S. 301 (1970), the court found that when a 100 percent owner of a corporation's stock attempts to redeem all of the preferred stock of the corporation, a "meaningful reduction" is not achieved. The Davis case tells us that if the shareholder has the same interest in the corporation both before and after the redemption, the redemption is essentially equivalent to a dividend and does not meet the requirements of IRC Sec. 302(b)(1). In *David Metzger Trust v. Comm'r*, 76 T.C. 42, 61 (1981) aff'd, 693 F.2d 459 (5th Cir. 1982), the court applied a three-step test to determine whether a distribution is not essentially equivalent to a dividend. The three steps are:

1. Mechanically apply the family attribution rules.
2. Determine if there has been a reduction in the shareholder's proportionate interest in the corporation.
3. Determine if the reduction was meaningful.

The IRS has liberally construed the meaningful reduction test, but since there are no objective tests to determine if the requirements have been met, reliance on this exception is unwarranted for planning purposes.

IRC Sec. 302(b)(2) sets forth the requirements for a distribution to be considered "substantially disproportionate." For a distribution to be substantially disproportionate, immediately after the redemption, the redeeming shareholder

- must own less than 50 percent of the total combined voting power of all classes of stock entitled to vote;
- must own less than 80 percent of the voting stock he or she owned immediately prior to the redemption; and
- must own less than 80 percent of the common stock he or she previously owned.

To prevent abuses of multiple redemptions, the law requires this test to be applied at the end of a series of redemptions if the redemptions are all part of one plan. The substantially disproportionate redemption exception is usually not available for family-owned businesses, because the family attribution rules cannot be waived for substantially disproportionate redemptions.

If, however, a shareholder redeems all of his or her shares in the corporation and the family attribution rules do not apply, the transaction qualifies as a sale or exchange transaction, not as a dividend transaction.

IRC Sec. 302(c)(1) sets forth the general rule for constructive ownership of stock. According to Sec. 302(c)(1), "Except as provided [otherwise], Sec. 318 (a) shall apply in determining the ownership of stock for purposes of this section." Sec. 318 of the Code sets forth the requirements for family, entity, and option attribution of stock from one person to another.

For family business planning purposes, the most important consideration in planning corporate redemptions is the application of the family attribution rules. IRC Sec. 318(a)(1) deems all stock owned by the stockholder's spouse, children, grandchildren, and parents as stock "constructively owned" by the redeeming stockholder. Note that for purposes of Sec. 302, the stock owned by siblings is not attributed to the stockholder. (Different rules apply for valuation purposes under Sec. 2703.) If the shareholder owns, actually or constructively, 50 percent or more of a trust, partnership, or corporation, entity attribution rules may also apply.

It is possible under Sec. 302(c)(2)(A-C) to waive the family attribution rules when a shareholder completely redeems his or her shares under Sec. 302(b)(3). If the shareholder is completely redeeming his or her shares, the Sec. 318 attribution rules do not apply (are waived) if all of the following conditions are met:

- if immediately after the distribution, the distributee has no interest in the corporation (including an interest as an officer, director, or employee) other than an interest as a creditor,[11]
- if the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution;[12]
- if the distributee, at such time and in such manner as the secretary by regulation prescribes, files an agreement to notify the secretary of any acquisition described immediately above and to retain such records as may be necessary for the application of this paragraph;[13]
- if the 10-year look-back rule or principal-purpose test is met. A waiver of the family attribution rules is invalid with respect to the redemption of stock owned by a shareholder if either of the following apply unless the avoidance of federal income tax was not one of the principal purposes of the acquisition by the shareholder:
  - if any portion of the stock redeemed was acquired within the 10-year period ending on the date of the redemption from a person whose stock would be attributable to the redeemed shareholder under Sec. 318(a) or
  - if immediately after the distribution, any related person (determined under the family attribution rule) owns stock that he or she acquired from the redeemed shareholder within such 10-year period.[14]

Entities can waive the family attribution rules if

- the entity and each related person meets the general requirements to waive family attribution
- each related party agrees to be jointly and severally liable for any deficiency resulting from a reacquisition of the redeemed stock within 10 years

Note that if waiver of the family attribution rules is not necessary, and a redeeming shareholder continues to serve as an officer of the corporation, sale or exchange treatment of a complete redemption will not be defeated.[15] If the family attribution rules must be waived, a consulting contract will defeat the sale or exchange treatment.[16]

Avoiding Dividend Treatment under Sec. 303

IRC Sec. 303 provides a special rule for stock redemptions when stock represents a substantial portion of a decedent's estate. Sec. 303 applies only to entity interest, not debt instruments. If the value of the decedent's stock exceeds 35 percent of the gross estate, Sec. 303 allows redemption of the stock with sale or exchange treatment to the extent necessary to cover death taxes plus interest, funeral costs, and administrative expenses. The requirements of Sec. 302 do not have to be met, provided the redemption meets the requirements of Sec. 303. Because Sec. 1014 provides for a step-up in basis upon death, a redemption of the stock shortly after the death of the shareholder will frequently result in no recognized gain or loss for income tax purposes. To qualify for the treatment provided by this section, the redemption must take place within the period of limitations for assessment of estate taxes (3 years and 9 months after death). If a Sec. 6166 election has been made, however, the redemption period is extended to match the Sec. 6166 deferral period.

In the event that the estate of a deceased shareholder redeems stock valued at more than the allowable amount for purposes of IRC Sec. 303, the excess amounts must meet the requirements of IRC Sec. 302 (discussed above) in order to avoid dividend treatment. If an exception to the general rule of IRC Sec. 302 does not apply, any amounts redeemed in excess of the Sec. 303 limitation will be treated as a taxable dividend to the estate.

Accumulated Earnings Tax

Corporations are treated as persons for federal income tax purposes. As such, a corporation is taxed on its income. When the residual earnings of the corporation are distributed to its owners, those amounts are taxed again in the form of dividends. In an attempt to prevent owners of corporations from avoiding the second "dividend" tax on corporate earnings, Congress created the accumulated earnings tax. Under IRC Sec. 531, an additional tax is assessed on corporations to the extent that the accumulated earnings of the corporation are deemed to be unreasonable. Unreasonable accumulations are currently taxed at a rate equal to 15 percent of the unreasonable accumulated taxable income (pursuant to JAGTRRA 2003). IRC Sec. 535 provides a safe harbor amount that will not be subject to the accumulated earnings tax. The safe harbor amount for service corporations equals $150,000 and the safe harbor amount for all other corporations (nonservice corporations) is $250,000. Accumulations in excess of these amounts must be for reasonable business needs in order to avoid the imposition of the accumulated earnings tax.

When a corporation purchases a cash value life insurance policy to fund a buy-sell agreement, the cash value buildup inside of the policy is deemed to be part of the company's retained earnings. To the extent that the life insurance policy cash value, in addition to other retained earnings, exceeds the safe harbor amounts, the company is in danger of being assessed an accumulated earnings tax.

When planning for buy-sell agreements, it is important to properly characterize the life insurance used for funding the agreement in the corporate minutes. If the corporation purchases a life insurance policy for the purpose of funding a buy-sell agreement that was entered into for providing liquidity for the estate of a deceased shareholder, the IRS could take the position that the life insurance policy was purchased for a personal, not a corporate, purpose, and therefore the cash value in the policy may be considered in assessing the accumulated earnings tax. If, instead, the corporation passed a resolution stating that the purpose of the policy was to reimburse the corporation for the loss of a key employee, and this resolution is discussed and recorded in the minutes of the corporation, it will be difficult for the IRS to assert that the life insurance policy was purchased for a personal purpose. It has been long established that key person insurance used to reimburse the corporation for the loss of a key employee is an ordinary business expense, and, therefore, it would be deemed to serve a business, not a personal, purpose.

Basis of Remaining Shareholders

When an entity type of buy-sell agreement is used, the corporation purchases the shares from the deceased shareholder. Because the corporation purchases the shares, the basis of the remaining shareholders in their business interest remains the same even though their ownership percentage has increased. When the remaining shareholders later sell their shares, they will typically have a capital gain in excess of the capital gain they would realize had the buy-sell agreement been created on a cross-purchase basis.

> *Example:* Tom, Dick, and Harry each own one-third of the stock of Edsel, Inc. They created Edsel, Inc. 30 years ago, each contributing $1,000 to capitalize the company. The value of each shareholder's interest in Edsel, Inc. was recently valued by an appraiser at $1,000,000. Edsel, Inc. entered into a buy-sell agreement with Tom, Dick, and Harry, in which the corporation agreed to purchase the shares of a deceased shareholder, and funded the agreement with life insurance. One year after the agreement was entered into, Harry died unexpectedly, and the corporation purchased his one-third interest. Before Harry's death, each of the shareholders owned one-third of the company. After Harry's death, the remaining shareholders, Tom and Dick, each owned 50 percent of the outstanding stock of the company. Tom's and Dick's basis in their 50 percent interest, valued at approximately $1,500,000, is $1,000. If the shareholders entered into a cross-purchase buy-sell agreement, and purchased the life insurance outside of the corporation, upon Harry's death, both Tom and Dick would still own 50 percent of the outstanding stock of the company, but their basis in the 50 percent interest would be $501,000. If either Tom or Dick later sells his interest in Edsel, Inc., the cross-purchase agreement would have saved each of them approximately $100,000 in capital-gains taxes (20 percent of the $500,000 additional basis they would have acquired under the cross-purchase arrangement).

Effect on Corporate Earnings and Profits

Earnings and profits of a corporation represent the maximum amount of dividends that may be declared by the corporation. An entity type of buy-sell agreement will impact the corporation's earnings and profits. The impact is determined by the characterization of the redemption.

In the event that the redemption under the buy-sell agreement is treated as a dividend distribution under IRC Sec. 302, the corporation's earnings and profits will be reduced by the full amount of the redemption. In the event that the earnings and profits are reduced to zero, the corporation will no longer be able to declare dividends unless it has income from ongoing operations.

If the redemption triggered by the buy-sell agreement falls under an exception to the general rule of IRC Sec. 302 and is therefore treated as a capital transaction, the earnings and profits of the corporation will be reduced by a proportionate amount equal to the percentage of the outstanding stock that was purchased pursuant to the buy-sell agreement.

Recall that, under the laws of most states, the earnings and profits of a corporation cannot be reduced below zero. Therefore, if there are not sufficient earnings and profits to satisfy the buy-out amount, the entity buy-sell agreement may not be effective.

Redemption with Appreciated Property

If a corporation funds a corporate redemption with appreciated property as opposed to cash, additional tax problems arise. Whenever a corporation satisfies an obligation with appreciated property, gain or loss (including depreciation recapture, where applicable) is triggered at the corporate level. Therefore, purchasing corporate stock by distributing an asset to the selling shareholder will trigger an income tax liability for the corporation. (See IRC Secs. 311, 336, 338, and repealed Sec. 333.)

Cross-Purchase Agreements

Capital Gain to Selling Shareholder

A cross-purchase agreement obligates individual shareholders to purchase the shares of another shareholder upon the happening of some event, such as the death of a shareholder. The selling shareholder will recognize gain to the extent that the amount realized in the transaction exceeds the seller's adjusted basis in the stock. Recall that Sec. 1014 provides a step-up in basis of a deceased shareholder's stock; if the estate of the deceased shareholder sells the stock to the other shareholders shortly after the decedent's death, there may be no taxable gain because adjusted basis will approximate fair market value.

Constructive Dividend if the Corporation Discharges Individual Shareholder Obligations

In some circumstances, a cross-purchase buy-sell agreement will be treated like an entity type of agreement. For example, if a corporation immediately redeems stock from a buying shareholder and the court treats the buying shareholder as a mere agent or conduit for the corporation, the original seller may be treated as if his

or her stock had been redeemed directly from him or her.[17] Furthermore, if the corporation's funds are used to finance the buying shareholder's purchase, the amounts used to discharge the shareholder's purchase obligation may be deemed a taxable dividend to the purchasing shareholder. It should be noted, however, that a constructive dividend results only when the continuing shareholder had a "primary and unconditional obligation" to purchase the redeemed stock. A cross-purchase agreement is not a primary and unconditional obligation until the triggering event occurs.[18]

Basis of Remaining Shareholders

Unlike the case with the entity buy-sell agreement, the purchasing shareholders of a cross-purchase agreement receive the stock of the exiting shareholder with a basis equal to the amount paid in the exchange. If the remaining shareholder later sells the business interest, he or she will have to pay less capital-gains tax than would be due if the agreement were structured as an entity type of buy-sell agreement.

Deductibility of Life Insurance Premiums

If the buy-sell agreement is funded with a life insurance contract, the premium payments by the shareholders are nondeductible, but the policy proceeds upon the death of the decedent are received income tax free. This is assuming that the decedent held no incidents of ownership in the policy, and that the proceeds are also excluded from the decedent's estate and received estate tax free.

Buy-Sell Agreements and Sec. 83

IRC Sec. 83 holds that if property is transferred to any person in connection with the performance of services, the person who performed the services must include as compensation in gross income the difference between the property's fair market value and any consideration paid for it. This amount is includible in income when the interest becomes substantially vested. *Substantially vested* implies that the interest is freely transferable and not subject to any substantial risk of forfeiture. A substantial risk of forfeiture generally exists where rights in property are conditioned upon the future performance, or refraining from performance, of substantial services.

If an employee is required to resell his or her stock when employment terminates, and if that restriction was in effect from the time the shareholder purchased the stock, the stock will likely be treated as Sec. 83 property. If the stock is substantially nonvested at the time that it is received, the transferee will not recognize compensation income attributable to the stock until the stock becomes substantially vested. In the event that the stock does not become substantially vested until the triggering event in the buy-sell agreement occurs, when the stock is reacquired under the buy-sell agreement, the shareholder will realize compensation income equal to the difference between the amount received by the shareholder and the amount paid for the stock. Because the amount of the income to be recognized is determined by reference to the amount paid instead of by reference to the basis of the stock, there is no indication in the statute or regulations that there will be a step-up in the deemed amount paid at the shareholder's death.

One way to avoid this problem is to make a Sec. 83(b) election. Under this section, the employee may elect to include in gross income for the taxable year of the

transfer the difference between the fair market value of the property at the time of the transfer and the amount paid for the property. Subsequent appreciation in the value of the stock will not be taxable as compensation to the employee when the property becomes substantially vested. This election should ordinarily be made if there is any possibility that Sec. 83 will be applicable to the stock, even if the stock is purchased by the employee for its full fair market value at the time of its initial acquisition.

ENFORCEABILITY OF THE BUY-SELL AGREEMENT

Funding

Sinking Funds

Sinking funds allow the shareholders to use corporate assets to fund the buy-sell agreement. As a result, this funding mechanism is rarely used in cross-purchase agreements but is a good way to fund a buy-sell agreement when one or more of the shareholders is uninsurable.

The disadvantages of this type of funding arrangement include (1) the risk of premature death, (2) the potential for cash flow problems, especially if the shareholders are older and a large percentage of corporate profits must be set aside in the sinking fund, (3) less security to the selling shareholder, because the sinking fund assets are subject to the claims of corporate creditors and, in the event of premature death, there may not be sufficient funds to cover the purchase, and (4) the potential for the imposition of the accumulated earnings tax.

Most states' corporate laws restrict a corporation from purchasing shares except out of surplus. Generally, there must be sufficient surplus at the time the corporation makes each actual payment. The stock-purchase agreement, therefore, should have a provision requiring surviving shareholders to take actions that will cause the corporation to create a surplus. Because corporations cannot purchase their own shares if they are insolvent or will be rendered insolvent, this poses additional risk to the selling shareholder, and it must be considered in determining the type of funding mechanism to be used in the buy-sell agreement.

Life Insurance

Types of Insurance

Term insurance can be issued, but it provides no cash surrender value to assist in funding a predeath buyout and premiums become expensive after age 65. Cash value life insurance is typically chosen. Group term insurance is generally not used to fund buy-sell agreements and may violate state law.

Tax Considerations

The premiums paid for life insurance are nondeductible. If the corporation pays the premium, the shareholder-employee must pay income tax on the economic benefit received. In addition, when the cash value exceeds aggregate premiums paid by the employer, the excess cash value is taxable to the employee in the year that a split-dollar arrangement terminates.

If a life insurance policy has been transferred for valuable consideration, policy proceeds (less the amount paid for the policy plus premiums paid after purchase) will be treated as ordinary income. The transfer-for-value rule does not apply to (1) policies transferred to the insured or (2) policies transferred to the corporation. In the context of buy-sell agreements, transfer-for-value problems arise when

- under a cross-purchase agreement, remaining shareholders buy the policies owned by a deceased shareholder
- the parties switch from an entity buy-sell agreement to a cross-purchase buy-sell agreement and desire an individual shareholder to acquire corporate-owned policies insuring the lives of other shareholders
- a trustee is used to hold policies on the lives of shareholders under a cross-purchase agreement, because there is substantial danger that the automatic shift of a decedent's interest in the policies to the surviving shareholders constitutes a transfer for value even though there is no physical transfer or change in the legal title of the policies

Planning alternatives to avoid imposition of the transfer-for-value rule include (1) conversion of a cross-purchase agreement to an entity agreement following the death of the first shareholder, taking advantage of the corporate exception to the transfer-for-value rule or (2) usage of a partnership, because transfer of policies to a partner of the insured, or to a partnership in which the insured is a partner, does not trigger imposition of the transfer-for-value rule. If a partnership is used, however, it must actually operate as a viable partnership. No particular relationship between the partnership and the purpose for which the insurance policies are acquired is necessary. A newly formed partnership created to facilitate a cross-purchase agreement between shareholders of a corporation falls within the partnership exception of the transfer-for-value rule.[19] The use of a partnership can create adverse estate tax consequences. However, there is a risk that the deceased insured partner's estate will be subject to estate tax on his or her pro rata portion of the insurance proceeds, even though the proceeds are used to purchase the partner's stock under the corporate cross-purchase agreement. This would result in double inclusion of assets in the deceased shareholder/partner's estate.

The proceeds of corporate or individually owned insurance policies are generally excluded from the recipient's income. The exceptions to this rule involve the imposition of the transfer-for-value provisions under IRC Sec. 101(a)(2)(B) and the possible imposition of the corporate alternative minimum tax. Corporate alternative minimum taxable income (AMTI) is increased by 75 percent of the amount by which the adjusted current earnings exceed the AMTI calculated without this adjustment. *Adjusted current earnings* are defined to include the income on any life insurance contract, as determined by Sec. 7702(g), and a deduction is allowed for the portion of the premium attributable to the insurance coverage. For the alternative minimum tax to apply to cash value increases, generally, the corporation must already be in the alternative minimum tax situation. Because payment of the AMT generates a tax credit equal to the difference between the AMT and normal taxable income that is recovered in subsequent years, receipt of life insurance death proceeds results in a timing difference rather than a permanent tax difference, assuming the corporation will resume regular taxpayer status in future years. Planning alternatives, if a corporation is an AMT taxpayer, include the following:

- Increase the insurance coverage so the corporation can pay the AMT.

- Use a cross-purchase agreement instead of an entity buy-sell agreement.
- Revise the purchase price to cause AMT liability to reduce the corporation's value so the selling shareholder's estate bears its allocable share of AMT liability.
- Plan to use future corporate revenue to fund the buy-sell agreement (but be careful of possible recharacterization of the debt obligation as an equity interest).
- Elect S corporation status because S corporations are not subject to the AMT.

If an entity buy-sell agreement is used, the corporation's receipt of insurance proceeds does not result in income taxation to the selling shareholder, and the selling shareholder will generally be entitled to sale or exchange treatment only if the redemption qualifies under Sec. 302 or 303. Use of the life insurance proceeds is not treated as a dividend or as income to remaining shareholders, although the value of the remaining shareholders' respective interests in the corporation may increase. If the insured is a controlling shareholder of the corporation, entity attribution may apply, and the value of the proceeds of the life insurance policy will be included in the estate of the controlling shareholder. Where the insured is not a controlling shareholder, incidents of ownership may be found by other arrangements. For example, an insured is considered to hold incidents of ownership when the policy prohibits the corporation from changing the beneficiary without the insured's consent and when the employee has a right to repurchase the policy from the corporation.

If a cross-purchase agreement is used, sale or exchange treatment will be afforded to the selling shareholder. In the typical situation in which shareholders receive the insurance proceeds directly from a policy they owned, there will be no income tax effects to surviving shareholders. But if corporate insurance is used to fund a cross-purchase agreement, the surviving shareholders will be treated as having received a constructive dividend. Under a cross-purchase agreement, the amounts of insurance received will not be included in the insured's estate unless the insured had any incidents of ownership in the policy.[20]

ESOPs and Profit-Sharing Plans

Use of an ESOP or profit-sharing plan to fund a buy-sell agreement is also possible. If a loan is used to purchase stock, payments on the loan could be made from deductible contributions made from the corporation to the ESOP in subsequent years. A disadvantage of the ESOP is the high outside cost of creating the vehicle. In addition, family members may not participate in an ESOP.

VALUATION ISSUES IN BUY-SELL AGREEMENTS

Significance of Valuation

The valuation amount or formula in a buy-sell agreement is important for the following reasons:

- It determines the amount to be received by the selling shareholder.
- It helps resolve disputes because at the time of negotiation, the parties are attempting to set a fair value on neutral terms.
- It fixes the estate tax value of the business interest.

Requirements for Fixing Estate Tax Value Prior to Sec. 2703

In order to fix the estate tax value of the business interest, various conditions must be met. For family businesses, additional requirements, as set forth in IRC Sec. 2703, must be met. Failure to comply with Sec. 2703 when required results in a binding buy-sell agreement between the parties with a different value for the business included in the estate of the deceased shareholder.

The four general factors used to fix estate tax value prior to the enactment of Sec. 2703, which are still considered in the context of Sec. 2703, are

- price
- obligation to sell
- binding lifetime obligation to sell
- bona fide business arrangement

In order for the buy-sell agreement to fix the estate tax value of the business, the price found in the agreement must be a fixed price or must be determined by formula.

The estate of the deceased shareholder must be obligated to sell the business interest to the corporation or the surviving shareholders. If the corporation or surviving shareholders hold an option to purchase the shares, exercisable at will, the estate tax value is deemed to be fixed because upon exercise the estate will be obligated to sell its shares to the option holder. A right of first refusal will not fix estate tax value, but it could have a depressing effect on the value of the business interest.

The obligation to sell at the price found in the buy-sell agreement must be binding during the shareholders' lifetimes. If a shareholder subject to a buy-sell agreement is permitted to sell his or her business interest at a price higher than the price in the agreement during his or her lifetime, the agreement price will not fix estate tax value. A consent restriction, which allows transfers during life only with the consent of the other parties, satisfies the lifetime transfer requirement since presumably the parties will not permit a transfer at a price exceeding the agreement price. By waiting until one of the shareholders dies, the other parties can purchase the interest at a lower price, thereby gaining an economic benefit that would be lost if an inter vivos transfer at a higher price is permitted.

Finally, the agreement must be a bona fide business agreement. The intent of the buy-sell agreement cannot be to transfer value to the natural objects of the decedent's bounty at less than full and adequate consideration (that is, it cannot be used as a testamentary substitute). Factors to consider in determining whether the agreement is a bona fide business arrangement include the following:

- the relationship of the parties
- the relative number of shares held by the decedent
- the extent of the activity of the shareholders in the operation of the business
- the fairness of price at the time the buy-sell agreement is made (some courts, including the 8th Circuit, require the price to be reasonable at the date of death; this is the minority rule)
- the reasonable relationship the formula price bears to the unrestricted fair market value of the stock in question[21]

Continuity of management is considered a valid business purpose for a buy-sell agreement.[22] A gift to family members of an option to purchase shares without any purpose other than a desire to make a gift does not constitute a valid business purpose and does not fix the estate tax value of the shares in the grantor's estate.[23] (Note that the bona fide purchase test and the testamentary device test are applied independently, and both must be satisfied.[24] If the price found in the buy-sell agreement is not reasonable upon formation, the IRS may argue that a taxable gift has been made.)

Application of Sec. 2703 to Family Buy-Sell Agreements

Sec. 2703 provides that the value of any property (for estate, gift, and generation-skipping transfer tax purposes) shall be determined without regard to

- any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)
- any restriction on the right to sell or use such property

Sec. 2703(b) provides a statutory exception from this rule, however, if the following conditions are met:

- the agreement is a bona fide business arrangement
- it is not a testamentary substitute
- the agreement's terms are comparable to similar arrangements entered into by persons in an arm's-length transaction

Note that the first two requirements (the bona fide business test and the testamentary substitute test) were also requirements imposed by case law prior to the enactment of Sec. 2703. As previously noted with case law, the legislative history of Sec. 2703 indicates that the first two requirements are to be applied independently. Unlike prior law, the statute, in its legislative history, rejects the suggestion that the maintenance of family control, standing alone, assures the absence of a device to transfer wealth.

The third requirement of arm's-length dealing was implied by the fair price requirement of prior law. This requirement considers arrangements comparable if

- the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business.[25] This has generally been interpreted to mean that the agreement conforms to general business practice and will entail consideration of the following factors: term of the agreement; current fair market value of the property; anticipated changes in the value of the property during the term of the arrangement; and adequacy of consideration.
- the parties are dealing at arm's length

Sec. 2703 is designed to govern family buy-sell agreements. Therefore, the regulations provide an exception for unrelated parties. This exception is available if more than 50 percent of the value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. For purposes of Sec. 2703, "family" is broader than the definition of family

under the family attribution rules of IRC Sec. 318. *Family,* for Sec. 2703 purposes, includes children, grandchildren, parents, grandparents, siblings, nieces/nephews, and the lineal descendants of the parents of the transferor and the transferor's spouse. Also included in the definition of family for purposes of Sec. 2703 is any other individual who is the natural object of the decedent's bounty.[26] A person who has no family members, as defined by the statute, may find the provisions of Sec. 2703 applying if he or she enters into a buy-sell agreement with a close friend or business partner.

Sec. 2703 does not change the other requirements for fixing estate tax value found in case law. If property is subject to multiple rights or restrictions, Sec. 2703 applies to each separate right or restriction independently. Sec. 2703 is not limited to buy-sell agreements but is also applicable to easements, leases, rights of first refusal, and ownership of subsidiary entities subject to restrictions.

Due to the multiple restriction rule, it is not possible to avoid the application of Sec. 2703 through the use of holding companies. If Sec. 2703 applies, steps that assist in establishing a fixed estate tax value are as follows:

- Document that all shareholders participated in the negotiations leading to the buy-sell agreement.
- Conduct a formal appraisal, especially in the case of closely held businesses.
- Have the appraiser perform a detailed analysis of factors to determine an appropriate value for the stock in the future, considering such factors as the term of the agreement, the current value of the business, and anticipated changes during the term of the agreement.

Alternative Valuation Methods

Specified Fixed Price

This method of valuation is simple and easy to apply. It does not, however, reflect change in value after the agreement is executed. This disadvantage is sometimes addressed within the agreement by requiring the parties to reset the price of the business at frequent intervals. Such a requirement is merely an agreement to agree, and the price included in the agreement may not be binding on the IRS if the parties do not actually agree to a fair price at the required reset dates.

Book Value

The primary advantage of the book-value method is that it is simple. Depending upon the type of business being appraised, it may be a fair representation of value. Book value is, however, a historical measure, and does not take into account the earnings potential of the business. The IRS has consistently challenged valuations based on book value due to the fact that the future potential of the business is not considered—something that any prospective arm's-length purchaser of the business would consider in developing an offer price.

Capitalization of Earnings

Assuming earnings can be predicted with relative accuracy, the capitalization of earnings approach provides an easy estimate of the earnings potential of the business. Unlike the book-value approach, which only looks to the past for

determination of business value, the capitalization of earnings approach looks only to the future. Valuation of the business using this approach is determined by present valuing the projected earnings stream at some interest rate. The interest rate used is typically a prospective investor's required rate of return on the investment, which is a function of current interest rates and the risk inherent in the business operations.

Since capitalization of earnings relies on the use of a discount rate, the same business can be valued very differently depending on whether rates are high or low. Generally speaking, the higher the interest rate, the lower the value of the business; the lower the interest rate, the higher the value of the business, assuming that the same projected earnings stream can be achieved. This result is explained by the bond valuation theorem which states that value of a bond (a fixed cash flow stream) varies inversely with changes in rates. If the earnings stream is fixed, we know with certainty that when interest rates are high, the value of the business will be lower than when interest rates are low.

A potential problem with the capitalization of earnings approach is that it may yield unreasonable values for closely held corporations and new businesses that are growing at a fast rate. Other valuation methods may be appropriate to consider for these types of businesses.

Formula Using Different Factors

The advantage of formula valuation is that a simple calculation will determine the value of the business for purposes of the buy-sell agreement. Deriving the formula that has the ability to reflect true value can be difficult. Furthermore, the results of formula calculations can become distorted over time as changes in the business occur. When formula valuations are used in buy-sell agreements, the parties should consider revisiting the formula at defined intervals to avoid distortion of business value in the future.

Appraisal

Whenever a family business is involved, a formal appraisal should be the preferred method of determining value. With an appraisal, a trained professional is able to consider factors that cross many of the other valuation methods. Furthermore, an appraisal allows for consideration of minority and marketability discounts. The disadvantage of the appraisal is that it is expensive. Significant planning and transfers should be contemplated before this valuation approach is used.

Formula Based on Future Earnings

In some circumstances, it is difficult to arrange for the financing necessary to effect a buy-out at one moment in time. A formula approach to payments based on future earnings can be utilized with minimal, if any, advance funding. This approach will help alleviate the cash flow crunch for the purchasing shareholder, but can create a liquidity problem for the selling shareholder, particularly if the selling shareholder is the estate of a former shareholder.

A disadvantage of this approach is that it does not fix estate tax value. The value of the business will be determined at the death of the shareholder and will be included in the decedent's estate at its date-of-death value. Furthermore, it is not possible to waive the family attribution rules of Sec. 318 to achieve capital gains

treatment under Sec. 302. From the estate's perspective, the payout based on future earnings may be considered a type of equity interest in the business, recharacterizing interest payments as dividends and creating a second class of stock (which triggers a big problem for S corporations).

Cut-Throat Method

The cut-throat method involves a device whereby the exiting shareholder offers to sell his or her shares to the surviving shareholders. If the surviving shareholders do not purchase the offeror's shares, the offeror must purchase the surviving shareholders' shares. Theoretically, this method sets a fair price, because one shareholder will not offer his or her stock at a high price if he or she may be required to purchase others' stock at a high price. The disadvantage of this method is that it tends to favor wealthy shareholders and stockholders who have more knowledge of the business and the industry.

NOTES

1. IRC Sec. 264(a)(1).
2. IRC Sec. 264(a)(1).
3. IRC Sec. 101.
4. IRC Sec. 1012.
5. IRC Sec. 264(a)(1).
6. *See* Treas. Reg. Secs. 20.2031-2(f), 20.2042-1(c)(6). See also *Estate of John L. Huntsman*, 66 T.C. 861, 872-76 (1976), acq., 1977-2 C.B. 1.
7. *See Newell v. Commissioner*, 66 F.2d 102, 103-04 (7th Cir. 1933).
8. Akers, "Estate Planning for the Family Business," page 112.
9. Akers, "Estate Planning for the Family Business," IX(A)(2).
10. IRC Sec. 368(a)(1)(E); Rev. Rul. 74-269, 1974-1 C.B. 87.
11. IRC Sec. 302(c)(2)(A)(i).
12. IRC Sec. 302(c)(2)(A)(ii).
13. IRC Sec. 302(c)(2)(A)(iii).
14. IRC Sec. 302(c)(2)(B)(i)-(ii).
15. Rev. Rul. 76-524, 1976-2 C.B. 94.
16. *See Chertkof v. Commissioner*, 72 T.C. 1113 (1979); Rev. Rul. 70-104, 1970-1 C.B. 66.
17. *See Fox v. Harrison*, 145 F.2d 521 (7th Cir. 1944); Richard B. Bennett, 58 T.C. 381 (1972) acq. 1972-2 C.B. 1; W.P. Bunton, Sr., 27 T.C.M. 9 (1968).
18. Rev. Rul. 69-608, 1969-2 C.B. 43.
19. *See* PLR 9309021.
20. IRC Sec. 1042.
21. *See Estate of Joseph H. Lauder*, T.C. Memo 1992-736.
22. *See Estate of Bruno Bischoff*, 69 T.C. 32 (1977).
23. *See Dorn v. U.S.*, 828 F.2d 177, 181-182 (3rd Cir. 1987).
24. *See St. Louis County Bank v. US*, 674 F.2d 1207.
25. Treas. Reg. Sec. 25.2703-1(b)(4)(i).
26. Treas. Reg. Sec. 25.2703-1(b)(3).