



Buy-Sell Agreements



Buy-Sell Agreements

- Obligates one party to sell and another to buy a business interest

- Often triggered upon
 - Death of business owner
 - Disability of business owner

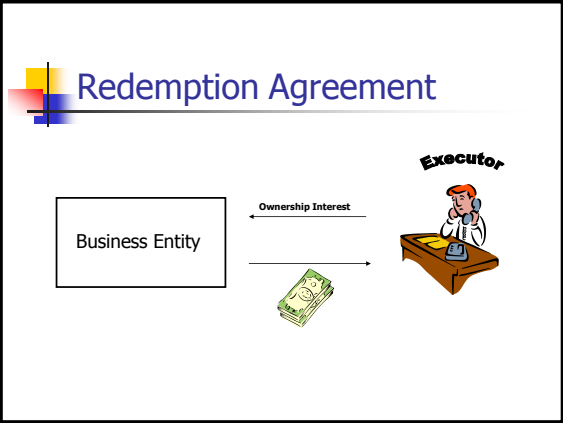


Advantages of Buy-Sell Agreements

- Provides liquidity for owner's estate
- Creates market for stock
- Avoids "fire-sale" of interest
- Fix value for tax purposes
- Maintain control of business

Types of Buy-Sell Agreements

- Redemption Agreements
 - a.k.a. Corporate Purchase, or Entity Agreements
- Cross-Purchase Agreements
- Hybrid Agreements

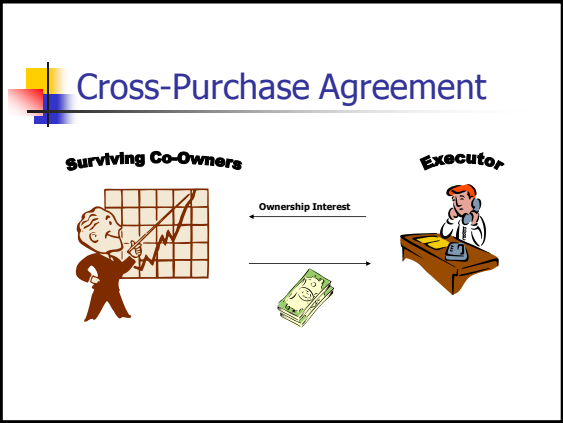


Redemption Agreement

- **Advantages**
 - entity controls funding/payment
 - Minimal owner involvement necessary
 - Life Insurance death benefits not taxable
 - Requires fewer life insurance policies for funding


Redemption Agreement

- **Disadvantages**
 - Life insurance premiums not deductible
 - Cash Value adds to accumulated earnings
 - Family attribution rules may apply to corporate agreements
 - Life Insurance death benefit may increase value of entity
 - State law may prohibit the buyout due to surplus requirements




Cross-Purchase Buy-Sell

- **Advantages**
 - Surviving owners receive life insurance death benefit tax free
 - Surviving owners receive increased basis in the entity
 - Life Insurance removed from claims of corporate creditors
 - Surplus/solvency statutes are not relevant



Cross-Purchase Buy-Sell

- Disadvantages
 - Greater number of life insurance policies required
 - Individual owners are responsible for funding
 - Life insurance policies are subject to claims of owners creditors




Hybrid Agreements

- Structure
 - First Option: Entity
 - Second Option: Surviving Owners
 - Remainder: Entity
- Purpose
 - Obtain tax benefits of both the redemption and cross-purchase agreements



Need for Spousal Consent

- Community Property States
 - Property acquired during marriage is community property
- Obtain consent to
 - Protect against possibility of non-owner leaving his/her interest to others
 - Bind the surviving spouse to the buy-sell agreement



Procedural Considerations

- Ensure governing documents of entity allow transfer restriction agreements
- Determine if creditors of the entity have restrictions on redemption rights
- Stamp restrictions on face of ownership certificates



Special Problems with Corporate Redemption Agreements




Application of Sec. 302

- A buy-sell agreement between a corporation and a shareholder may invoke the provisions of Sec. 302
- Sec. 302 mandates dividend treatment to the shareholder if a corporation purchases its own stock




Application of Sec. 302

- Dividend treatment results unless redemption is
 - Not essentially equivalent to a dividend
 - A complete redemption
 - A substantially disproportionate redemption
 - A Sec. 303 redemption



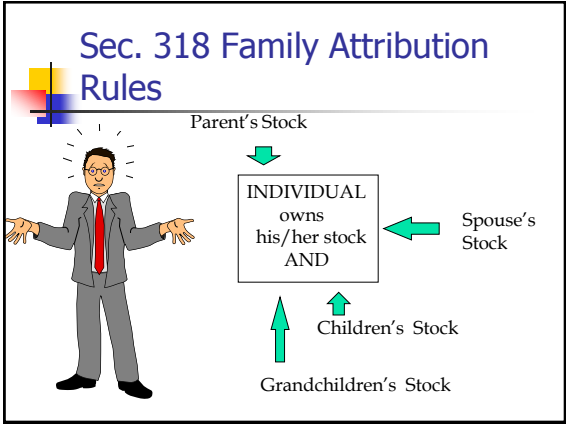
Not Essentially Equivalent to a Dividend

- "Meaningful Reduction" required
 - US v. Davis (1970)
- Metzger Trust 3-Step Test
 - Mechanically apply family attribution rules
 - Determine if SH's proportionate interest is reduced
 - Determine if it is meaningful



Complete Redemption

- Occurs when shareholder redeems all of his or her stock
- Special problems arise for family held businesses....




- ### Waiver of Family Attribution
- **No interest in corporation**
 - Except as creditor

 - **Does not acquire interest within 10 years**
 - Except by inheritance

- ### Waiver of Family Attribution
- **File agreement with IRS**


 - **10-Year Lookback**
 - Redeemed stock acquired within 10 years from person whose stock would be attributed
 - Family members owns stock acquired from redeemed shareholder



Other Attribution Rules


- Estate
- Trust
- Partnership
- Corporate

These Attribution Rules May NOT be waived!




Substantially Disproportionate

- Immediately after the redemption, the redeeming shareholder must own *less* than
 - 50% of combined voting power of all classes of stock
 - 80% of voting stock owned immediately prior to redemption
 - 80% of common stock owned immediately prior to redemption




Redemptions at Death

- Capital gains treatment can be obtained under Sec. 303
 - only applies to
 - Estate and death taxes,
 - administration expenses, and
 - funeral expenses
 - To qualify, 35% of the AGE must consist of a business interest



Sec. 303 Benefits

- Possibly avoids capital gains tax
 - Sec. 1014 "Step-up" at death
- Reduces Corporate E & P



Sec. 303 Caveats

- Remaining portion of redemption taxed as dividend if Sec. 302 requirements are not met.
- Family attribution rules do not apply
- Other attribution rules apply and cannot be waived



Issues with Cross Purchase Agreements


**Cross Purchase:
Tax Consequences to Seller**

- Recognize gain to extent of amount realized over adjusted basis
 - Sec. 1014 gives step-up at death

**Cross Purchase:
Tax Consequences to Buyer**

- Purchase business interest with basis equal to purchase price
- Receipt of death benefit on life insurance contract is tax-free
 - Provided that the policy was not transferred for valuable consideration

Miscellaneous Issues




Limits & Enforceability

- Transfer restrictions should be noted on
 - stock certificates
 - Articles of incorporation
 - Corporate bylaws
- Absolute restraints on alienation are unenforceable
 - Alternative: Right of first refusal



Triggering Events

- Death
- Retirement
- Withdrawal of employment
- Disability
- Competition with the entity
- Divorce
- Contemplated sale to 3rd party



Disability Trigger

- Define disability
 - To extent possible, make it consistent with any disability buy-sell insurance purchased
- Make the Period Reasonable
 - Too short a period deprives the owner of continued involvement
 - Too long a period drains the company

IRC Sec. 83 & Buy-Sell Agreements

- If employee required to resell shares to company at termination of employment, Sec. 83 may apply.
- If stock is not vested upon receipt, ordinary income on gain may result.
- Solution: Make an 83(b) election.
 - Includes value in gross income for year of receipt.
 - Subsequent gain is capital

Valuation Amount/Formula

- Determines amount seller receives
- Helps resolve disputes
- Can fix estate tax value
 - Requirements of I.R.C. Sec. 2703 must be met

Section 2703


Transfer restrictions in corporations and partnerships (Buy-Sell Agreements)

Prior to Section 2703.....

- It was possible to “peg” the value of a business by executing a buy-sell agreement. By entering into a mandatory buy-sell agreement, and fixing the price today, a senior generation (seller) could transfer future appreciation in the business to the junior generation (buyer), thereby achieving an Estate Freeze.


Restrictive Agreements Used to “Peg” Value of Stock

- Reciprocal options among stockholders
- Options to one stockholder
- Options to the Corporation
- Mandatory buy-sell agreements
 - Cross Purchase Agreements
 - Stock Redemption Agreements
 - Hybrid Agreements



Section 2703 - “Application”

- The value of any property 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, or
 - any restriction on the right to sell or use such property



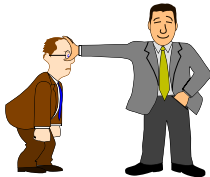
General Valuation Rule - Section 2703

- A buy-sell agreement or any other transfer restriction for a *family* business carries no weight in pegging the estate tax value

UNLESS.....

Section 2703 "Pegging" Requirements

- Bona Fide Business Purpose
- Not a Testamentary Substitute
- Comparable to similar Arms-length transactions



Bona Fide Business Purpose

- Factors to consider
 - Relationship of the parties
 - Relative number of shares held
 - Extent of shareholder's activity
 - Adequacy of price
 - Whether price formula bears reasonable relationship to unrestricted fair market value

Comparable to Similar Agreements

- Must conform with general business practice
 - Expected Term of the Agreement
 - The Current Value of the Property
 - Expected Value of the Property at the Time of exercise
 - Adequacy of consideration

Comparability must be established. Isolated evidence is not enough.

Section 2703 Liquidity Trap


- If the "Pegging Requirements" are not met, the estate is
 - bound to sell at the agreed price
 - forced to include (in the gross estate) the FMV of the business interest at the time of the decedent's death



Section 2703 - "Family"


- Spouse
- Lineal Descendants
- Ancestors
- Lineal Descendants of Parents of Transferor or Transferor's Spouse (siblings, nieces, nephews)
- "Natural Objects of the Decedent's Bounty"


Treas. Reg. Secs. 25.2703-1(b)(3), 25.2701-2(b)(5); Ltr. 9222043



Section 2703 Safe Harbors


- "Family Agreements" do not include:
 - agreements where more than 50% of the business subject to the agreement is owned directly or indirectly by individuals who are not members of the transferor's family
 - The interest of non-family members must be restricted similarly to the transferor's interest.






Section 2703 Grandfathered Agreements

- Agreements or options entered into prior to October 9, 1990 are grandfathered unless there is a substantial modification, defined as
 - any non-deminimis,
 - discretionary change.



Procedural Issues & Sec. 2703

- Document that all owners participated in negotiations
- Conduct formal appraisal
- Have appraiser consider
 - Term of the agreement
 - Current value of the business
 - Anticipated changes during term of agreement



Valuation Methodologies

- Fixed Price
- Book Value
- Capitalization of Earnings
- Formula (utilizing factors)
- Appraisal
- Formula based on future earnings
- Cut-throat method




Funding the Buy-Sell

- Sinking Funds

- Life Insurance

- ESOPs & Profit Sharing Plans



Sinking Fund Disadvantages

- Risk of premature death
- Potential for cash-flow problems
- Less security to selling shareholder
- Potential imposition of accumulated earnings tax

Tax Impact of Life Insurance Proceeds


- Death benefit generally excluded from income tax, unless
 - Transfer for value rule applies
 - Alternative minimum tax is imposed (corporations only)

Corporate AMT Exemption

- Small Business Corporation
 - Gross Receipts in Year 1 less than \$5 M
 - 3-Year Average Gross Receipts less than \$7.5 M
- Only transactions entered into after loss of exemption are subject to the AMT


Planning Alternatives if AMT Applies

- Increase coverage to pay AMT
- Use cross-purchase agreement
- Revise price to cause AMT liability to reduce corporations value
 - Selling shareholder's estate bears allocable share of AMT liability
- Elect S-Corp Status




Transfer for Value

- If life insurance has been transferred for valuable consideration, the death benefit over basis in the contract is taxable unless the policy was transferred to
 - The insured
 - A corporation in which insured is SH
 - Partnership in which insured is partner
 - Partner of insured
 - Transferee who takes transferor's basis




Transfer for Value Rule & Buy-Sell Agreements

- Problems arise
 - After first death in a corporate cross purchase agreement
 - Upon switch from entity to cross purchase buy-sell, followed by acquisition of policies from corporation
 - When trustee is used to hold the policies




Planning around the Transfer for Value Rule

- Convert corporate cross-purchase to entity agreement after death of first shareholder
- Use Partnerships in the planning process



Determining Payout Method

- Factors to Consider
 - Availability of funds
 - Needs of surviving family members
 - Liquidity need at death
 - Tax consequences to business & owners



Types of Payout Methods

- Lump Sum
 - Good with death trigger & life insurance
 - Can trigger taxable gain
- Installment Sale
 - If payout period long, there is risk
 - Of default
 - That IRS will re-characterize the debt as an equity instrument (fatal for S-Corps)
