

How To Structure a Buy-Sell Agreement for Your Business

Are you a shareholder in a closely held business? Do you have a buy-sell agreement? The implementation and updating of the buy-sell agreement is integral to estate planning for shareholders in a closely held business. Let's take a closer look at some important issues surrounding the creation of a buy-sell agreement.

Agreement Benefits

A properly prepared buy-sell agreement can resolve a number of tax and business problems:

- **Liquidity.** A buy-sell agreement provides each shareholder with an available market for his or her interest in the business in the event of death, disability or other triggering event.
- **Control.** A buy-sell agreement ensures that shareholders retain or obtain control in the event of the death of a shareholder, the intended disposition of

shares by a shareholder, or another triggering event.

- **Selecting bedfellows.** A buy-sell agreement guards against the transfer of shares to an unwanted third party and can be used with your succession plan to ensure that shares will transfer to certain family members.
- **Valuation.** In nonfamily member situations, a buy-sell agreement can determine the value of shares for estate tax purposes.

How Do You Fund a Buyout?

Usually insurance policies on the lives of one or more shareholders can provide all or part of the cash resources needed to implement the buy-sell plan triggered by a shareholder's death. There is a real cost to using life insurance. The alternatives, however, may be more costly. The business may become cash strapped or heavily indebted. Or, the selling shareholder may have to take notes as part of

the selling price and feel somewhat insecure or too dependent on the successful operation of the business.

When a buyout is triggered by an event other than a death, installment payments with interest over a period of time may be advisable. This allows the buyer to secure financing or to fund the buyout through company earnings.

Typical triggering events besides death are disability and employment termination, but others also may be included in the agreement. For example, an act that discredits the company and may result in conviction of a felony, such as embezzlement or fraud, may be a triggering event. In fact, some buy-sell agreements have “bad boy” clauses which, when triggered, establish a very low buyout price.

Which Type of Agreement Suits Your Needs?

For buyouts triggered by death, there are two basic types of buy-sell agreements: the stock redemption agreement and the cross purchase agreement. Variations and mixes of these arrangements may be necessary to accomplish shareholder objectives.

Determining whether to use a stock redemption or a cross purchase agreement will depend on many factors, including overall premium expense, sources of funds to pay premiums, enforcement of agreement concerns, importance of step-up in basis, perceived simplicity and primary objectives.

Another consideration, at least in connection with a redemption arrangement, is whether the life insurance should be reflected in the purchase price of the stock. As a general rule, the cash value of the policies are considered part of the business’s assets, not the death proceeds. But, every general rule will have exceptions.

Let’s take a closer look at these two types of agreements.

Redemption Agreements

Under a typical stock redemption arrangement, the business owns insurance policies on the lives of each shareholder, and the shareholders enter into an agreement with the business. For example, Mary, Mike and Ralph are three equal shareholders in Company Q and enter into an agreement with Company Q. Upon Ralph’s death, Company Q collects life insurance proceeds and uses

them to buy Ralph's stock from his estate. Ralph's estate now has liquidity, and Mary and Mike each own 50% of Company Q.

Other characteristics:

- One policy is generally needed for each shareholder. (First-to-die policies are available that insure two or more lives.)
- The business owns, pays for and controls the policies.
- There is no transfer-for-value issue. When one shareholder dies, the business continues to own policies on the other shareholders, so there is no need to transfer policies.
- The policies are subject to the claims of the business's creditors.
- Since the business is the purchaser of the decedent's shares, the remaining shareholders do not get step-up in their basis as a result of the purchase.
- Dividend treatment can result from stock redemption in a family business due to family attribution rules unless specific, prescribed conditions are met.

- Alternative minimum tax may apply for other than a "small business" corporation.

Cross Purchase Agreements

Under a typical cross purchase arrangement, the business is not directly involved. Instead, each shareholder buys a policy on the life of each other shareholder, and all shareholders enter into a purchase agreement. Accordingly, in the same example discussed above, Mary would own one policy on Mike and one on Ralph, Mike would own one policy on Mary and one on Ralph, and Ralph would own one policy on Mary and one on Mike. Upon Ralph's death, Mary and Mike would use the proceeds from their policies on Ralph to each buy 50% of his stock from his estate. Again, Ralph's estate now has liquidity, and Mary and Mike each own 50% of Company Q.

Other characteristics:

- Multiple policies are needed. The total number of policies required is equal to $n(n-1)$ where n equals the number of shareholders (e.g., six separate policies are needed for Mary, Mike and Ralph).

- The shareholders own, pay for and control the policies.

- There may be a transfer-for-value issue because the policies owned by the deceased shareholder on the others may have to be transferred to the surviving shareholders.
- The policies are subject to the claims of the owning shareholders' creditors.
- Each purchasing shareholder receives a step-up in basis for the acquired shares.
- There is no dividend issue on the sale because family attribution rules do not apply.

- There is no alternative minimum tax issue because life insurance proceeds are not paid to the corporation.

Structuring an Agreement Is a Complex Task

How your buy-sell agreement should be structured depends on many factors. If we can be of assistance in connection with planning or updating your buy-sell agreement, please contact us. We would be glad to help.