Advanced Sales Comment

Buy-Sell Agreements:

The Common Cure for a Business Headache

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Three young business partners are sitting back in their chairs, each enjoying a well-deserved cup of coffee in the small, but comfortable, office in the back of the brick building that houses their Company. It seems like yesterday that each of them was contemplating whether or not to choose C corporation status; painstakingly searching for the right employees that now have become the foundation of their business; and sweating out each and every detail to make their dreams become reality. Their business is thriving in its market and their employees are happy. Oh what a beautiful life they lead!

The last thing on each partner's mind is the thought of business continuation planning. After all, each of them is young, healthy and ready to take on all obstacles. Time to sit back and enjoy the ride for a while. Right? Wrong! By taking a little time today to plan for the future, each partner can help avoid the numerous headaches and pitfalls that could jump up and bite them later.

Would the business be able to continue if a partner should pass away? Are there funds available in order to buy the stock back from the deceased partner? Can your family still be a part of the business that you helped create when you pass on? These are just a few of the plethora of questions that can be answered by giving some thought to a buy-sell (business continuation) agreement.

The purpose of such an agreement is to protect, preserve and pass on the control and value of a family or closely held business at the death of a stockholder. The control and management of the business will be continued uninterrupted by the stockholders, and a fair price will be paid to the estate/family of the decedent stockholder for the value of his/her interest. *(Buy-sell agreements may also be triggered by the disability, retirement, or other termination of service by a stockholder; or by a stockholder's attempted sale, gift, pledge (bankruptcy), or other transfer of stock. For simplicity, this article will focus on plans triggered by death.)*

There are two basic forms of agreements that must be funded: (Life insurance is most often chosen to fund the agreement.)

Stock Redemption (Entity) Plan: This is where the corporation owns life insurance on the stockholders and uses the proceeds to purchase (redeem) their stock at death. Stock redemption, in many ways, offers the virtues of simplicity and ease of administration. If the agreement is funded by life insurance, the corporation is the owner, premium payer and beneficiary of a policy on the life of each stockholder. The premiums are non-deductible by the corporation. Using the corporation as the premium payor may ease the cost burden for a stockholder who is younger and/or has minority interest.

The fact that the corporation can record the cash value of a policy as an asset on its balance sheet may be viewed as a plus by the insured's accountants, bankers and other financial advisers.

When a stockholder dies, the corporation receives the proceeds income tax-free* and pays the proceeds to the decedent's estate in exchange for the redemption of stock. Following the death of a stockholder, the surviving owners of the corporation own the decedent's shares in the same ratio as their ownership had been prior to the redemption.

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One definite drawback to the stock redemption plan is that the surviving stockholders are not able to increase the basis of their shares following redemption because the corporation has purchased the policy. This could affect the capital gain amount if the surviving shareholders ever were to gift or sell their respective shares.

If the stock redemption plan is selected for a family-owned corporation, the possible application of the attribution rules of *Internal Revenue Code Section 318* must be considered. For example, if the corporation redeems all of the shares owned directly by a decedent's estate, but the other shareholders are the decedent's children, the redemption may be treated as a taxable dividend, rather than as a tax-free sale or exchange. Certain planning techniques can circumvent these rules, and should be taken into account if a stock redemption plan is used for a family-owned business.

Cross-Purchase Plan: This is where the stockholders own insurance on each other and buy out the shares of the deceased partner. If more than two stockholders are involved, a cross-purchase plan may be cumbersome because of the number of policies required. The premiums paid for the life insurance used to fund a cross-purchase can be deducted as compensation paid to the stockholders who own the policies. The premiums may constitute taxable income to the stockholders, and while discrepancies in age and stock ownership may create problems, in many cases the payment of bonuses or other adjustments in compensation can reconcile an unbalanced allocation of cost.

A cross-purchase plan avoids potential problems related to the corporate AMT and the operation of the attribution rules. In addition, a purchasing stockholder can increase his or her basis in the stock acquires under a cross-purchase agreement because he or she pays for the shares personally. An increased basis is important to the stockholder who anticipates a possible sale or gift of the stock at some point in his or her lifetime.

Summary

The decision to establish a stock redemption or cross-purchase plan may require several factors to be weighed. The chart that accompanies this article can serve as a guide in the decision-making process. Please remember it's always recommended that the parties work with a life insurance specialist to help navigate the process. This article is not intended as tax or legal advice. Please consult a tax advisor on matters such as these.

* If the corporation has gross annual receipts in excess of $7,500,000 for the three previous years then the alternative minimum tax (AMT) could apply. The proceeds will not be tax free to the corporation.

FACTORS IN DETERMINING THE FORM OF CORPORATE BUY-SELL AGREEMENT

FACTOR	CONSIDERATION
Number of parties	The larger the number of parties, the more complex the establishment and administration of a cross-purchase plan will be. This would include a far greater number of insurance polices if that was the funding vehicle.
Age and ownership differential	The greater the age difference, the larger the financial obligation imposed upon the younger/minority stockholder or partners, under a cross-purchase plan. An entity plan may be preferable since it allows for a pooling of the premium obligations within the business (corporate dollars).
Life insurance funding	An entity purchase plan would not necessitate the business owners' personally paying premiums for funding life insurance. However, split dollar life insurance may assist in funding a cross-purchase.
Cost basis	Since a cross-purchase plan generally will result in the surviving owner receiving a higher cost basis for the business interest, the survivor would incur lower capital gain for any subsequent sale.
Attribution of ownership rules	Due to potential dividend taxation under *Internal Revenue Code Section 301,* redemption may be inadvisable for a family corporation. Therefore, a cross-purchase plan may be the only viable approach.
Possibility of plan change	If the parties anticipate that they may change from one type of plan to another, the effect of the transfer-for-value rule *{Internal Revenue Code Section 101 (a)(2)}* favors the initial establishment of a cross-purchase plan for a corporation, since the policies could later be transferred to the corporation to fund a redemption without creating a transfer-for-value. However, the parties normally would not be able to transfer the policies from the corporation to the non-insured stockholders to fund a cross-purchase plan, without creating a transfer-for-value and, therefore, subjecting the death proceeds to income taxation.
Tax considerations	Funding a stock redemption agreement requires attention to be paid to possible accumulated earning tax and the corporate alternative minimum tax. A cross-purchase plan can ignore these concerns.
Tax bracket	If the corporate tax bracket is higher than the policy-owner's individual tax bracket, a cross-purchase arrangement would be the logical choice and vice-versa.

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