



A buy-sell arrangement (or “business continuation arrangement”) is an arrangement for the disposition of a business interest upon a specific triggering event such as an owner’s death, disability, retirement, or other termination. Buy-sell arrangements should be considered in every closely held business. A well-drafted and properly funded buy-sell arrangement can protect the interests of the business owners and help facilitate the continuation of the business after the death, disability, or retirement of its current owners. Buy-sell arrangements take different forms including: (1) entity purchase or stock redemption, (2) cross-purchase, and (3) wait and see. The “best” type of arrangement depends upon several factors, including the type of business structure and the number of owners. This article will describe the primary types of arrangements, popular methods of funding arrangements, and other important considerations when contemplating a buy-sell arrangement.¹

BENEFITS OF BUY-SELL ARRANGEMENTS

Guarantee a Buyer. A buy-sell arrangement benefits the selling owner’s family by providing a guaranteed buyer(s). The remaining owners are protected against the sale of a significant (or, worse yet, majority) interest to an outside investor.

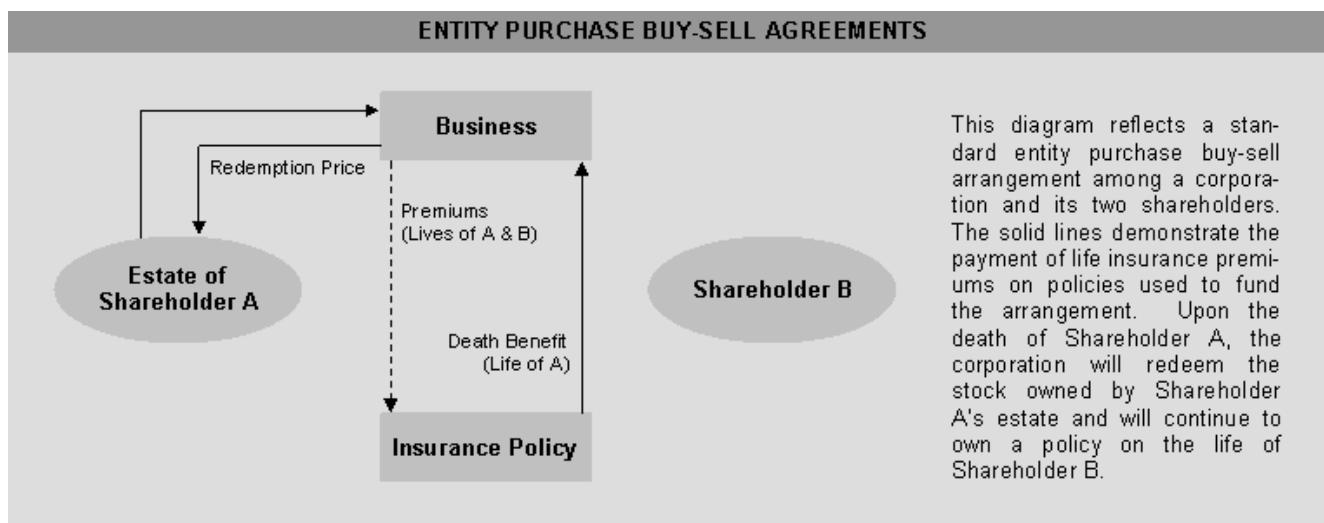
Create Liquidity. Upon a business owner’s death, retirement, or disability, his or her family has a continuing need for cash to pay ordinary living expenses as well as any estate tax liability. Estate taxes are typically due nine months after the date of death. Selling a business under these circumstances usually results in the family receiving less than the fair market value.

Set a Fair Selling Price. A business valuation strategy that is determined while all owners are active can usually be negotiated on an arm’s-length basis. Once a business owner has left the business, negotiating a fair sales price is much more difficult for the owner (or the owner’s estate) because the remaining owners hold most of the cards.

Fix Value. A buy-sell arrangement negotiated at arm’s length ordinarily determines the valuation for estate tax purposes. This allows the owners to plan their estates and can reduce the risk of costly valuation disputes among business owners or upon estate tax audit.

Maintain Harmony. Because of the pressures of business ownership and everyday life, it is often difficult for owners of a closely held business to maintain friendships and camaraderie. Maintaining harmony becomes more difficult after the family (spouse and/or children) of a deceased owner enters the business. A buy-sell arrangement can protect the owners and the business from problems that arise when a deceased owner’s family joins the business.

GENERAL TYPES OF BUY-SELL ARRANGEMENTS



An entity purchase buy-sell arrangement (or “stock redemption arrangement”) is an arrangement among the owners and the entity. The entity agrees to purchase (or redeem) all of the interest of a deceased owner and the owners agree to sell their interests to the entity.

SHAREHOLDER CONSEQUENCES

No Basis Increase. An entity purchase buy-sell arrangement with a C corporation does not increase the basis of the remaining shareholders’ stock. However, life insurance proceeds received by an S corporation will increase the basis of its shareholders’ stock.²

Possible Ordinary Income Treatment. Ordinarily, amounts received in a stock redemption are treated as a dividend to the shareholder that is having his or her stock redeemed. If treated as a dividend, the entire redemption amount (not just the gain) is taxed as ordinary income. However, if certain requirements are met, the redemption can be taxed as a sale. Taxation as a sale is usually beneficial because only the gain (i.e., the redemption price reduced by basis) is subject to tax at capital gain rates. When a redemption occurs at death, there is generally no gain to report because the deceased shareholder’s estate received a basis step-up.³

Risk of Corporate Creditors. Life insurance purchased by a corporation to fund a buy-sell arrangement will be subject to claims of the corporation’s creditors. Moreover, state law may prohibit a redemption if the corporation is insolvent or lacks adequate capital.⁴

CORPORATE CONSEQUENCES

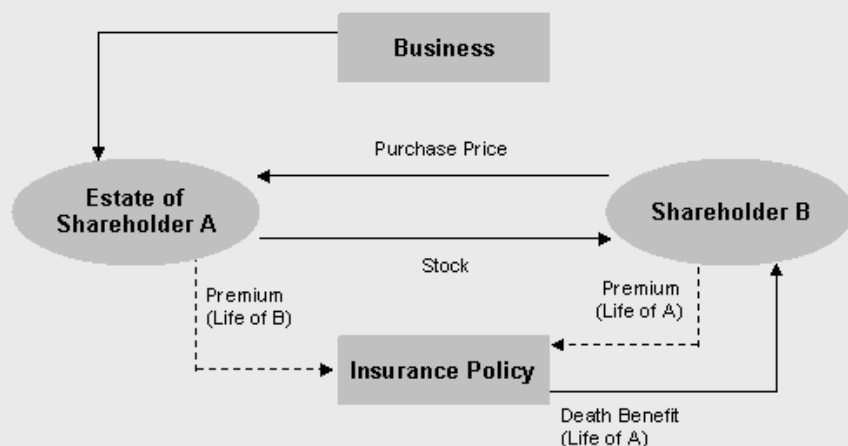
Premiums are Non-Deductible. Life insurance is a common means of funding a buy-sell arrangement. Life insurance premiums paid by a corporation are not deductible.

Alternative Minimum Tax (AMT). Life insurance proceeds are ordinarily received income tax free. However, in some instances, life insurance proceeds received by a C corporation can cause an alternative minimum tax liability. The possible application of the AMT is often cited as a primary reason not to use an entity purchase buy-sell arrangement. In reality, the AMT will not be applicable in many instances or may be nominal in amount. Therefore, the possible application of the AMT should be considered on a case-by-case basis.

Increased Value of Corporation. Any assets held by an entity to fund a buy-sell arrangement increase the value of the entity. This increase in the entity’s value (including the amount of life insurance proceeds received upon an owner’s death) should be considered when determining the selling price under an entity purchase buy-sell arrangement.

Accumulated Earnings Tax. When earnings are accumulated to fund an entity purchase buy-sell arrangement (including the cash value of a life insurance policy), the corporation can become subject to the accumulated earnings tax. However, a reasonable accumulation of cash to fund a buy-sell arrangement may be considered an exception to the prohibition on excess accumulations.⁵

CROSS PURCHASE BUY-SELL AGREEMENTS



This diagram reflects a standard cross-purchase buy-sell arrangement between two shareholders. The solid lines demonstrate the events upon the death of Shareholder A. The dotted lines demonstrate the payment of life insurance premiums on the policies used to fund the arrangement. Upon the death of Shareholder A, Shareholder B will buy out Shareholder A's stock. Shareholder A's estate will continue to own a policy on the life of Shareholder B. This policy can be sold to the corporation or to Shareholder B.

SHAREHOLDER CONSEQUENCES

In a cross-purchase buy-sell arrangement the owners (or their estates) are obligated to sell their interests to each other. The entity is not a party to the arrangement.

Basis Increase. The surviving owners receive basis in the purchased shares. This tax ramification is the primary advantage of a cross-purchase buy-sell arrangement.

Capital Gain Treatment. With a lifetime sale, the selling owner recognizes capital gain to the extent the purchase price exceeds his or her basis.⁶ Upon an owner's death, there is ordinarily no capital gain because the value of the shares receive a basis step-up to reflect fair market value — hopefully the same price received under the buy-sell arrangement.

Transfer for Value. Ordinarily, in a cross-purchase buy-sell arrangement, each shareholder owns a life insurance policy on the life of each of the other shareholders. Upon the death of the first shareholder, each of the remaining shareholders will use the proceeds of the policy they own on the life of the deceased shareholder to carry out their obligation to purchase a pro rata share of the deceased shareholder's stock. After this, the remaining shareholders will need to acquire additional insurance to fully fund their continuing obligations under the arrangement because each remaining shareholder will now own an increased portion of the business. If the remaining shareholders purchase the policies held by the estate of the deceased shareholder, the purchase will be a transfer for value.⁷ Sometimes the transfer for value rule can be avoided after the death of the first shareholder by allowing the deceased shareholder's estate to sell policies (on the other shareholders) to the corporation and then converting the arrangement to an entity purchase buy-sell arrangement.⁸

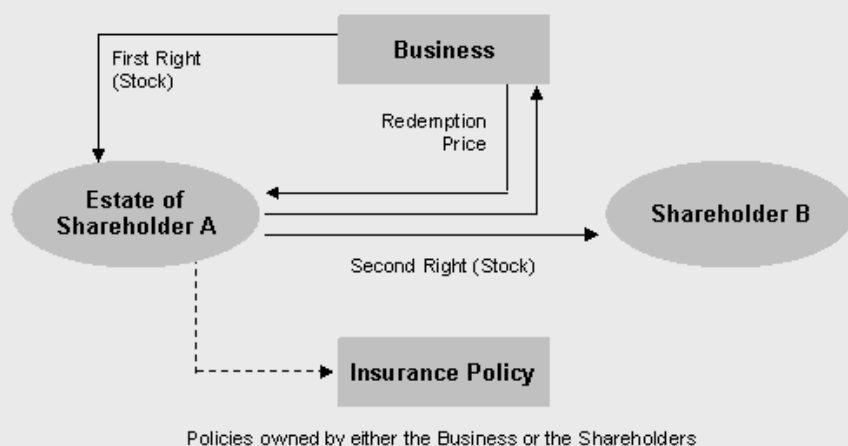
Complications. Where there are more than two or three owners, a cross-purchase buy-sell arrangement funded with life insurance can be complicated. The number of policies needed to fund the arrangement is typically equal to $[(n-1)*n]$ when "n" is the number of owners. Because of the necessity of purchasing multiple policies, the entity purchase buy-sell arrangement is commonly used in situations where there are more than two or three owners. However, because of (1) the tax disadvantages of entity purchase buy-sell arrangements (primarily the lack of basis increase to the remaining shareholders), (2) the desire to avoid the purchase of multiple life policies, and (3) concerns regarding the consequences of the transfer for value rule, attorneys have created alternatives to the standard cross-purchase buy-sell arrangement. Two such alternatives, the "trusteed arrangement" and the "partnership arrangement," are discussed at www.newportfg.com/buysell.com.

CORPORATE CONSEQUENCES

No Alternative Minimum Tax (AMT) or Accumulated Earnings Taxes. Because the corporation does not own the policy, there are no potential AMT and accumulated earnings tax problems.

No Increase in Corporate Value. Life insurance (or other assets) used to fund the arrangement will not increase the value of the corporation. The value of life insurance policies (or other assets) will not be reflected on the corporation's balance sheet. Although a cross-purchase buy-sell arrangement has no impact on the value of the corporation, the deceased shareholder's estate will be increased by "funding" assets (such as the cash value of life insurance on the other shareholders) owned by the deceased shareholder.

WAIT AND SEE BUY-SELL AGREEMENTS



This diagram reflects a standard cross-purchase buy-sell arrangement between two shareholders. The solid lines demonstrate the events upon the death of Shareholder A. The dotted lines demonstrate the payment of life insurance premiums on the policies used to fund the arrangement. Upon the death of Shareholder A, his or her estate will continue to own a policy on the life of Shareholder B. This policy can be sold to the corporation or to Shareholder B.

A wait and see buy-sell arrangement is a hybrid arrangement combining the features of both the entity purchase buy-sell arrangement and the cross-purchase buy-sell arrangement. A wait and see buy-sell arrangement generally gives the entity the option (or “right of refusal”) to buy any portion of the deceased owner’s interest within a certain time period after the owner’s death. If the entity does not fully exercise the option, the remaining owners have the second right of refusal. Finally, if the remaining owners do not exercise their right of refusal, then the entity must redeem the balance of the deceased owner’s interest. Depending upon how the arrangement is funded and whether the entity or the surviving owners acquire the deceased owner’s interest, the arrangement will function as either an entity redemption or a cross-purchase arrangement.

Maximum Flexibility. The primary advantage of the wait and see buy-sell arrangement is that it offers maximum flexibility. Rather than committing to an arrangement, the business owners can adopt the most advantageous strategy after the death of an owner.

Difficult to Fund. One disadvantage of a wait and see buy-sell arrangement is that it can be difficult to fund. If the buy-sell arrangement is to be funded with life insurance, should the insurance policies be owned by the entity (as with a traditional entity purchase arrangement) or by the individual business owners (as with a traditional cross-purchase arrangement)? Ordinarily, the arrangement is funded as if it were a traditional cross-purchase arrangement. If it later appears likely that the entity will exercise its option, the policies can usually be sold to the entity.

Possible Dividend Treatment. Care must be taken to avoid dividend treatment to the purchasing shareholders. If the corporation is given the right of first refusal and the

shareholders are required to purchase the stock if the corporation does not exercise its right, a corporate redemption will be treated as a dividend to the remaining shareholders. In addition, such arrangements must also be carefully structured to avoid possible dividend treatment to selling shareholders (as with an ordinary entity purchase arrangement).

FUNDING A BUY-SELL ARRANGEMENT

Life Insurance. Purchasing life insurance on the lives of the business owners is one of the most common methods of funding a buy-sell arrangement. In addition to being cost-effective, a primary advantage of life insurance is that it makes cash available upon the death of an owner. Moreover, if the arrangement is funded with permanent life insurance, the policy’s cash value may be sufficient to fund a buy-out at retirement. In a cross-purchase arrangement, life insurance is sometimes purchased on a split-dollar basis or with a bonus to mitigate the cost to the shareholder. It is also important to note that when a corporation purchases life insurance on the majority shareholder to fund an entity purchase buy-sell agreement, the proceeds of the life insurance can increase the value of the corporation for estate tax purposes.⁹

Borrow Funds. If the business or its owners plan to fund a buy-sell arrangement by borrowing funds after the death or retirement of an owner, several problems can occur. The business or the remaining owners may have difficulty obtaining a loan after the death or retirement of a key owner. Even if the business (or its remaining owner(s)) is able to get a loan to fund the buy-sell arrangement, the ability to get additional loans, for expansion or working capital, may be dramatically diminished.

Sinking Funds. A buy-sell arrangement can be funded with a sinking fund in which earnings of the business are retained to fund the arrangement. If an owner dies soon after the arrangement is executed, this strategy will not enable the business to accumulate the necessary funds to fulfill its redemption obligation. Retention of assets in a C corporation can trigger accumulated earnings tax.

Installment Purchase. A buy-sell arrangement can be funded by structuring the purchase as an installment purchase. However, this strategy puts a strain on cash flow that can be especially dramatic when the interest being purchased belonged to a majority or key owner. Although the business may be pushed into a transition period during which profitability may be reduced, increased cash flow is needed to fund the buy-sell arrangement. Such a cash flow strain can result in business failure.

VALUATION METHODOLOGY

An important consideration when structuring a buy-sell arrangement is the method by which the business will be valued (i.e., the “valuation methodology”). The following are several common methods of business valuation:

Specific Fixed Price. Shareholders fix the price periodically by arrangement. The primary disadvantage of this approach is that shareholders often fail to adjust the price for changes in value. If the price is not adjusted regularly, the purchase price may prove to be wholly unfair to the selling shareholder. Moreover, the IRS may disregard the actual selling price and attribute a higher value to the business interest. The primary advantage to this approach is that it is simple.

Book Value. Value is determined by book value on the date of death or on the close of the last fiscal year preceding the date of death. The primary disadvantage of this approach is that book value is seldom an accurate reflection of value because it (1) reflects depreciated historic (and not current) values and (2) ignores the entity’s earnings potential. The primary advantage to this approach is that it is simple.

Capitalization of Earnings. Value is determined by multiplying earnings by a capitalization factor. The capitalization factor is generally obtained by analyzing the price-earnings ratio of comparable businesses in the same industry. If this method is utilized, earnings over several years should be examined to alleviate the consequences of economic cycles. The primary disadvantage to this approach is that earnings of closely held businesses are often manipulated (through salaries) for personal tax planning purposes instead of the business needs of the entity.

Formula. Value can be determined by a combination of factors. It is not unusual for a sales price to be based upon both book value and capitalization of earnings. Sometimes, a combination of these approaches is incorporated into a formula to mitigate the disadvantages of each approach.

Appraisal. Value is determined by an independent appraisal at the time of sale. Sometimes an appraiser is agreed to in the arrangement. In other instances, both the selling shareholder and the remaining shareholders are allowed to pick an appraiser with the value being an average of the appraisals. This approach probably provides the value that most approximates fair market value. The primary disadvantages of obtaining an appraisal are that it can be expensive and that it can delay the settlement process.

Cut Throat. The purchase price is determined by the shareholders at the time of sale. A shareholder contemplating a sale will offer his or her shares to the other shareholders at a price determined by the offering shareholder. If the other shareholders do not purchase the shares at this price, the shareholder who made the offer must buy the shares of the other shareholders at this price. This approach sets a theoretically fair price. However, it favors the shareholder with the “deepest pockets.” It is primarily used for lifetime sales and usually in businesses owned equally (or nearly equally) by two individuals.

CONCLUSION

A well-drafted and adequately funded buy-sell arrangement is an important piece of a business owner’s succession and estate plan. Without a well-drafted buy-sell arrangement, a business owner (or his or her family) can lose much (or all) of the equity that the owner worked a lifetime to create. Not only is a buy-sell arrangement important to the family of a deceased shareholder, a buy-sell arrangement protects the interests of surviving shareholders by providing them with an opportunity to control ownership of the business after the death of an existing shareholder. An important aspect of buy-sell planning, which is sometimes overlooked, is funding. Without adequate funding, implementation of a buy-sell arrangement may not be possible. Because life insurance provides advantages not available with other methods of funding, it is a common method of funding a buy-sell arrangement.

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