Buy-Sell Agreements

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"You can marry more money in five minutes than you can earn in a lifetime."

A buy-sell agreement is frequently the key document in a company's business continuation plan and the owners' estate plans. These agreements establish a fair price for an ownership interest in a closely-held business and ensure an orderly business transition. They usually provide that the business (or a portion thereof in the case of multiple owners) will be sold (or offered for sale) at a specified price and under certain circumstances, which are detailed in the agreement. The primary circumstances ("triggering events") are: death, disability or retirement (or a sudden uncontrollable desire to prepare tax returns for a living).

As most readers know, these agreements are designed to protect business owners and investors by providing agreed-upon arrangements not only in the event of death, disability or retirement, but also disagreement, firing, resignation, bankruptcy, dishonesty, divorce, insolvency — or simply the desire to terminate one's interest in the business for any reason. Perhaps the biggest mistake you can make is to not have such an agreement the moment there is more than one owner! The second biggest mistake is to not cover all of the just-mentioned contingencies.

We have encountered such unrealistic excuses as: (1) the owners will never disagree, (2) the legal fees to draw such an agreement are too high, (3) nobody wants to face such a disagreeable task at this time, (4) they are too busy operating the business, (5) they are too busy getting new customers — and similar cop-outs. Remember this (and where you heard it first): The cost of litigation will be 10-1,000 times the cost of such an agreement! Further, the fact that you have a comprehensive agreement will stop any potential litigation over the value of the ownership interest, the terms of payment and all the related issues. It will also prevent the possibility that the stock ends up in the hands of strangers — or competitors!

It is simply inarguable that the agreement should be executed on or before the time when a second owner is admitted to the company. This includes both minority interest employees and major partners as well. Finally, the agreement must be updated regularly to account for changing values of the shares (or other ownership interests), business conditions, profitability, etc. A formula to determine price and alternate valuation methods if the agreement was not updated can be very helpful. A covenant not to compete and a non solicitation agreement should always be included. If you don't have such an agreement and there is more than one owner — have one drawn up immediately. The following slogan is intended to haunt you, motivate you and scare you. Remember the famous lawsuit: "If the glove don't fit — you must acquit"? Well here is our version, about buy-sell agreements:

"If you procrastinate — you will surely litigate!"

Life Insurance

To fund the sale of a business interest under a buy-sell agreement, life insurance is a highly recommended solution in most cases. (It may be cost-prohibitive in the case of an elderly owner and/or one in poor health.) If the business can afford it, the purchase of whole life (or universal or variable) insurance builds cash surrender values that may also help fund the owner's retirement, or an outright sale of the business. Otherwise, level term insurance is the usual solution.

Redemption Agreements

This is the more typical plan — but not necessarily the better option. This arrangement allows the business entity to repurchase its own shares (or other ownership interest), usually using life insurance. (However, none of the four advantages listed in the following section apply to this type of plan, so think it over and get expert advice before you decide.) In this case, the insurance policy is owned by the business, the proceeds payable to the company, and the premiums paid by the company. The insurance premiums are not tax deductible, but the insurance proceeds are received by the company tax-free (usually).

While there is no regular income tax levied on the life insurance proceeds, there may be an Alternative Minimum Tax (AMT) of 20% applicable to the insurance proceeds. A "small corporation" is not subject to the AMT. A corporation that has had average annual gross receipts of $5 million or less over its 1994, 1995, and 1996 tax years — and $7.5 million or less over its 1995, 1996, and 1997 tax years — is considered to be a "small corporation."

Once a corporation is recognized as a small corporation, it will continue to be exempt from the AMT as long as its average annual gross receipts for the prior three-year period do not exceed $7.5 million. Also, any new corporation is not subject to the AMT for the first tax year of its existence (regardless of its gross receipts for the year).

TAXTIP: If your corporation will be liable for the AMT on the insurance proceeds, consider increasing the total life insurance coverage, so that the after-tax proceeds equal the sum you decided upon.

Cross-Purchase Agreements

These agreements provide that the remaining shareholders/partners/members buy the ownership interest of the departing or departed individual — again, typically using life insurance. The primary disadvantage of these types of agreements is when there are a considerable number of owners, because each one must own life insurance on every one of the other owners. However, there are a number of advantages:

- Those purchasing the ownership interest get a "step up" in the tax basis of their investment (e.g., you collect $200,000 in life insurance, tax-free, and then pay $200,000 for the ownership interest, which is your tax basis in the event of a future sale by you).
- The life insurance cash values and eventual proceeds are not available to the creditors of the business, since this is a private transaction between individuals and does not involve the business entity.
- The possibility of paying a corporate Alternative Minimum Tax is avoided (see earlier).
- The possibility that redemption of shares by a corporation might be treated as a dividend is avoided.

TAXTIP: In a number of cases we have seen, the actual insurance premiums are paid by the business; however, those payments are charged to the individual owners of the insurance policies as "additional compensation." This seems to make the arrangement more painless than if each individual has to "come up with the money."

Using A Trust To Hold All Ownership Interests

Assume you have a perfect and legal agreement that provides in the event of death, termination of employment, bankruptcy or whatever — the stock owned by that individual must be sold back to the business (or other owners) at a stated price and conditions. Absolutely airtight and inarguable! But the widow, widower or ex employee simply refuses to do so and says (in effect) "sue me!" Then what do you do? Spend $5,000 (or maybe $50,000-$100,000) litigating the matter? Plus time aggravation and who knows what else!

If you think this postulate is absurd or impossible, listen to an actual case. The 50% owner of a company died and there was a perfect, legal and binding buy-sell agreement. It provided that the company must buy back the stock of the decedent for $200,000 and that the widow of the decedent must sell the stock for $200,000 (and the corporation had $200,000 in life insurance on each owner, so the money was on hand to acquire the widow's stock). The widow then advised the remaining owner, "The stock is worth way more than $200,000, you took advantage of my poor John and misled him about the value of the business, he was probably already sick when you lied to him — and I'm not selling you the stock for $200,000. I want $500,000 or you can sue me!"

Gulp! How do you like that? Again, we have seen some clever attorneys solve that problem in advance. All the stock (or other entity ownership interest) of everyone subject to a buy-sell agreement (be they partner, member or minority-owner employee or even outside investor shareholder) is held in trust. The trust agreement states the exact terms of the buy-sell agreement covering all these individuals. In the event of death, termination of employment or other "triggering event," the trustee then surrenders the stock under the terms of the buy-sell agreement and pays the named beneficiary the designated amount. There is no widow, or widower, or ex-employee who can refuse to sell back the stock — nor can any owner! Because they do not own the stock, it's owned by a trust and the trustee will follow the terms of the trust instrument — exactly!

The IRS and "Fair Market Value"

Everyone involved in buying or selling a business is interested in doing so for the fair market value of the company involved. The IRS definition of fair market value is simply this:

"The price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell, and both having knowledge of the relevant facts."

There is usually no problem in meeting this IRS definition during any of our discussions, except if:

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- A completely unrealistic value is used, coupled with some other slick arrangement such as consulting fees, asset sales, inordinate rentals — or similar "side deals."
- The buyer and seller are related to each other. In such cases the IRS can challenge your valuations and agreements as not being at arm's length.

  TAXTIP: The IRS definition of "related" includes all blood relatives, both up and down the family tree. However, it does not consider a son-in-law or a daughter-in-law as being "related."

The Danger When the Corporation Buys Back the Stock

When the corporation buys back stock, it is usually cancelled or retired — in any event it no longer "counts," or votes. This can cause real trouble, as the percentage of remaining outstanding stock then changes.

EXAMPLE: There are 1,000 shares of stock outstanding. The two founding owners each own 300 shares, which gives them comfortable control of the corporation (600 shares = 60%). They have sold or bonused the other 400 shares (40%) to their top executive. They feel they are perfectly safe because they have a carefully drawn buy-sell agreement. It provides that any individual leaving the company must sell his stock and the corporation must buy the stock (and the price is fixed and all contingencies are covered — they think).

Some time later, the older of the two partners announces that he wants to retire and the buy-sell agreement kicks in. The corporation then repurchases his stock and the two partners amicably part company. Try the math now and you will instantly see what happened. The remaining partner still owns his 300 shares. The top executive still owns his 400 shares. There are only 700 shares outstanding, since the ex partner's 300 hundred shares are now canceled or held by the corporation as "treasury stock." Guess who then controls the corporation? Gee — you guessed it! And maybe the top executive (400 shares) now fires the remaining founding owner (300 shares) — and who is to stop him?

This all could have been prevented with various options that were not considered in our example:

- Allow the remaining stockholders the option of personally buying the stock of the retiring partner.
- Issue the executive a different class of "non-voting" stock originally.
- Have a "voting trust" for all the stock, controlled by both or either remaining founding owner(s).
- Give the executive "phantom stock," instead of the real thing. (This kind of "stock" shares in profits, but has no vote.)
- Or have your lawyer cover this contingency in some other legal manner.

But don't just ignore this potential problem. Keep in mind that not only retirement, but also death or disability of one original owner could also create this same trap for the remaining original owner.

Watch for Mel's column next month on **Tax Strategies At Year-End 2007.**

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