Handling the Buy-Sell Agreement

In addition to life insurance carried to finance the purchase of stock interests at the death of a stockholder, a properly written agreement setting out the rights and obligations of the various parties to the plan is essential.

# Types of Buy-Sell Agreements

After the close corporation shareholders are convinced there is a need for a stock purchase agreement, they must then decide upon the type of plan which will best suit their circumstances. There are many factors which should be considered in making such a decision. The types of agreement and the factors to be considered are discussed immediately following.

Individual Cross-Purchase Agreement

A cross-purchase buy-sell agreement is an arrangement in which the shareholders individually enter into the buy-sell agreement. Such an agreement is commonly known as a cross-purchase agreement. The corporation would in no way be a party to the agreement. The surviving stockholders, as individuals, agree to buy the interest of the deceased, and the insurance owned by them on the life of the deceased underwrites their obligation to make this purchase at death.

Stock Redemption Agreement

Where the corporation has the power to buy shares of its own stock, the agreement can be between the individual shareholders and the corporation. Such an agreement is commonly called a stock retirement or repurchase agreement. The individual stockholders agree to sell to the corporation, and the corporation agrees to buy, at the death of any such stockholder, the shares of such deceased stockholder at an agreed price. The corporation maintains insurance on the life of each stockholder to make certain that it will have funds available for making the purchase at death, without impairing the financial position of the corporation.

Factors Determining Choice of Plan

In choosing between an individual cross-purchase agreement and a stock redemption agreement, several factors must be considered.

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(1) Legal Validity

The ability of the corporation, under applicable state corporations law, to buy shares of its own stock must be determined. (See material immediately following.) If such purchase is not permissible, a cross-purchase agreement will have to be used.

(2) Income Tax Considerations

The relative income tax consequences should be determined. The cross-purchase method is generally more advantageous because the increased percentage ownership in the business acquired by the surviving shareholders will be accompanied by an increase in the tax basis of such position. Under a corporate redemption transaction the surviving stockholders will have the same increase in their percentage ownership interest (through shrinkage of the total outstanding shares), but without the increase in basis which would result if they had purchased the deceased party's shares.

The cross-purchase arrangement has additional advantages when the corporation's marginal tax rate is higher than that of the stockholders. The premiums are generally nondeductible to the corporation. On the other hand, if the corporation pays bonus compensation to the employee-stockholders, who would own the policies and pay the premiums, the payments would be deductible by the corporation and taxable income to the stockholders (so long as the bonus payments are not reclassified as dividends (because they are deemed unreasonable compensation).

An additional important distinction involves the operation of I.R.C. §101(j), which may require the insurance policy proceeds (in excess of the cumulative premium costs) to be treated as taxable income when the insured is an employee and the policy is owned by the employer. Since the rule of §101(j) applies to “employer-owned life insurance contracts,” it would appear to be applicable to a stock redemption arrangement, but not applicable in the context of a cross-purchase arrangement. However, there are circumstances in which §101(j) might be deemed to apply to a policy under a cross-purchase plan. While it is quite likely that one or more of the several exceptions to taxation under §101(j) will be applicable with respect to either form of buy-sell arrangement, notice and consent requirements must be met in order for an exception to apply.  And failure to satisfy the notice and consent requirements would result in income treatment for the death benefit under a stock redemption arrangement, whereas this adverse result would be unlikely under a cross-purchase arrangement.

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(3) Number Of Stockholders And Prospective Changes

Where there are more than two stockholders and it is desired that the agreement extend beyond the first death, there is no problem of the transfer of the remaining policies for a valuable consideration following the first death if a stock redemption agreement is used. In such event, there is no disturbance of the ownership of the policies by the corporation. A cross-transfer of the remaining policies under a cross-purchase agreement, however, would run afoul of the transfer-for-value rule.

Where changes in the stockholdings of the corporation are anticipated, either among the present stockholders or as a result of the addition of new stockholders, a stock redemption is indicated. Again, this is because a readjustment of the ownership of the policies under a cross-purchase plan would be impeded by the transfer for value rule.

(4) Convenience And Practicality

The matter of convenience will often prove a material factor in the decision. In many ways, a stock redemption agreement is more simple in construction and organization than an agreement between the individual stockholders. Only one policy will be required for each policyholder, and the corporation will carry the insurance and pay the premiums. On the other hand, a cross-purchase plan involving several stockholders calls for a multiplicity of policies and a network schedule of premium payments.

A stock redemption plan often is more practicable where there is a substantial difference in the ages of the stockholders and in their relative stockholdings. The younger stockholders with the smaller number of shares sometimes are unable or unwilling to pay the larger portion of the premiums required of them under a cross-purchase plan.

(5) Equity Of Results

Under a cross-purchase plan, each stockholder agrees that upon the death of a stockholder he or she will purchase a proportionate number of the deceased's shares at a price based upon their agreed value. Each purchases and maintains insurance on the lives of the others in the approximate amount of purchase price he or she will be called upon to pay in the event of a death among the others. Under such a plan of individual cross-ownership of the policies, the insurance does not enter into the purchase price. Assuming that the price represents true value, the plan functions with complete equity among the parties-regardless of the variations in the ages of the stockholders or in their respective stockholdings.

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Under a stock redemption plan, the payment of premiums by the corporation is mathematically the same as if each stockholder had contributed directly to the premiums in the same proportion as his or her stockholdings in the corporation. Under a cross-purchase arrangement, the estate of the deceased shareholder will end up owning the insurance policies on the lives of the other shareholders which had been maintained under the plan during his or her lifetime. These policies may have some value to the estate and the heirs. But, by contrast, under a corporate redemption plan, the decedent's estate does not end up with any such asset, event though the deceased shareholder indirectly shared the cost of the premiums that had been paid by the corporation. Therefore, it seems obvious that a stock redemption plan does not function equitably among the stockholders unless the purchase price paid to a deceased stockholder's estate takes into consideration the life insurance the corporation owned.

Partial equity is achieved by setting a purchase price that takes into consideration, in valuing the stock, the value of all the policies immediately prior to the death of a stockholder. Substantially complete equity is achieved by setting a purchase price that takes into consideration the proceeds payable on the death of a stockholder, as well as the then value of the policies on the lives of the surviving stockholders owned by the corporation. This latter method, however, will call for additional coverage if the purchase price is to be fully insured by the corporation.

(6) Availability of Policy Values

The desirability of having the cash values of the insurance available as an emergency cash reserve for the business and included in business assets may be important. Under the individual plan, it may be difficult to make the cash values indirectly available for business purposes. Under the corporation plan, the cash values are automatically business assets, and the corporation can use the policies for emergency loans if necessary.

(7) Corporate Creditors

The possible effects relating to corporate creditors of having the insurance proceeds paid to the corporation must be considered. If under a stock redemption plan the corporation is insolvent when a stockholder dies, the insurance proceeds would no doubt have to be used to pay corporate creditors. Under a cross-purchase agreement, the proceeds would nevertheless be available to purchase the deceased's stock, unless by its terms the agreement terminated on the insolvency of the corporation. In such event, however, the proceeds would not be subject to claims of the corporation's creditors.

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(8) Federal Estate Tax Considerations

As a deceased stockholder under a cross-purchase plan will not have possessed any of the incidents of ownership in the insurance on his or her life payable to the surviving stockholders, or to a trustee acting for them, the value of such insurance will not be includible in the decedent's gross estate [I.R.C.,§2042(2); Rev. Rul. 56-379, 1956-2 C.B. 599]. The value of the policies that the deceased stockholder owned on the lives of the surviving stockholders, however, will be includible in his or her gross estate [Est. of Richard C. duPont, 18 T.C. 1134, cert. denied 352 U.S. 8782].

The value of the deceased stockholder's shares also will be includible in the gross estate and that value will typically be measured by the purchase price paid for the stock under the agreement.

Under a stock redemption agreement, the value of the insurance on the life of the deceased stockholder will not be includible in the gross estate where the corporation is the owner and beneficiary of the policy and the insured held no incidents of ownership at the time of death [I.R.C.,§2042(2)]. The value of the deceased stockholder's shares (presumably affected by the corporation's entitlement to the insurance death benefit) will be includible in the gross estate.

See Subdivision I for a more comprehensive discussion of how cross- purchase and stock redemption agreements affect stock value for federal and state death tax purposes.

(9) Desires Regarding Any Excess of Insurance Proceeds

The wishes of the parties with respect to the excess of insurance over the value of the stock, if any, may be a factor. In some instances, the insurance is designed to serve a dual purpose: providing the funds for retiring a deceased's stock and providing additional funds to offset the intangible loss to the business operation from the discontinuance of the decedent's participation. In such case, any excess of insurance over the value of the stock would be used by the corporation for business purposes.

(10) Ratio of Stockholdings Desired Among Survivors

Use of the cross-purchase arrangement is indicated when there are more than two stockholders and there is a desire to reallocate the relative shares of equity ownership among the survivors following the death of a stockholder. This can be achieved by providing for the

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shares of the deceased stockholder to be acquired by the respective survivors in a ratio which differs from their existing pro-rata ownership. By contrast, in the case of a corporate redemption, each surviving stockholder's equity interest, while it will be increased as an absolute percentage, will remain in the same proportion to the interests of the other surviving stockholders as existed before death.

# Nature and Legality of Buy-Sell Agreements

Under a proper agreement for the purchase of shares of stock at the death of a stockholder, there is an immediate and binding contract supported by the mutual promises of the parties. This contract may run between the individual stockholders only and provide that on a shareholder's death the surviving stockholders will purchase decedent's stock at an agreed price. The contract may be between a stockholder and the corporation, obligating the corporation to purchase the shares at the stockholder's death.

Agreement between the Stockholders as Individuals

Agreement Valid

An agreement between stockholders to purchase the shares of a deceased stockholder, coupled with the right to purchase the shares in the event of a sale during life, is clearly an enforceable contract supported by adequate consideration.

Agreement Specifically Enforceable

Since the validity of a buy-sell agreement between stockholders is generally established, of more importance is the question of what can be done if one of the parties to the agreement refuses to carry through his or her part of the agreement. In these cases, the courts may grant specific performance of the contract and require the recalcitrant party to perform [Bohnsack v. Detroit Trust Co., 292 Mich. 167, 290 N.W. 367 (1940); Cardos v. Christadoro, 228 La. 975, 84 S.2d 606 (1955)].:

In the Bohnsack case, the court granted specific performance to the surviving stockholders even though, in violation of the agreement, the decedent's insurance was payable to personal beneficiaries. In the Cardos case, the heirs obtained specific performance of the surviving stockholder's agreement to buy.

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Agreement between the Corporation and Stockholders

The validity of an agreement between the corporation as an entity to buy, and its stockholders to sell their stock at death, depends mainly on state law.

Generally, state statutes, or in the absence of statutes, court decisions, favor the legal authority of a corporation to purchase its own stock and hold it as treasury stock. However, there are various restrictions upon such a purchase. For example, in most states the corporation can purchase if there is earned surplus, or can purchase from capital surplus with approval of the stockholders or if the articles of incorporation so provide.

Conservatively applied actual values, rather than book values, are determinative of the existence of surplus [Mountain State Steel Foundries, Inc. v. Comm'r, 284 F.2d 737 (CA-4, 1960); Goldberg v. Peltier, 75 R.I. 314, 66 A.2d 107 (1949); Baxter v. Lancer Indus., 213 F. Supp. 92 (E.D.N.Y., 1963)].

The corporation should consult with its attorney so he or she can apply the state law to the facts and circumstances and give an opinion as to the validity of a contemplated agreement. The attorney will, of course, draft the agreement.