The Optional Buy-Sell

# Background

Unquestionably, the most practical and flexible of the corporate buy-sell alternatives is the optional buy-sell. The optional resolves the inevitable quandary facing close corporation owners: Which method do we adopt, the stock redemption or the cross-purchase? Under the optional, the stockholders need not make any decision as to which method they will use, until the event triggering the buy-out occurs (e.g., death, disability, or retirement). The reason is that both methods are included in the optional as alternative elections. Because of this flexibility, the optional is frequently referred to as the “wait and see buy-sell.”

Perhaps there is an earlier origin, but as far as we are aware, the optional buy-sell became popular following the enactment of carryover basis under the Tax Reform Act of 1976. Capital assets no longer received a stepped-up basis at death, but rather passed to the estate carrying the deceased’s original cost basis. Therefore, a sale thereafter, either by the estate or by the beneficiaries, triggered a capital gains tax on the difference between the carryover basis inherited from the deceased and the sales price. This new tax had, of course, a horrendous impact upon buy-sell agreements, because the very mandatory sale under the agreement automatically generated a new capital gains tax and liquidity requirement for the estate! The results could be disastrous to the estate and heirs.

There was, however, a difference in basis generated by a stock redemption or cross-purchase agreement. For corporations formed in 1977 and after, the cross-purchase offered a higher cost basis, because of an adjustment referred to as the “fresh-start adjustment.” On the other hand, corporations formed before 1977, or those who experienced substantial post-’77 gain, frequently obtained a higher basis under stock redemption. Thus, carryover basis simply *compounded the existing quandary of which agreement close corporation owners should elect!*In response to this tax unpredictability, the optional buy-sell evolved. The original concept was the subject of an article in 1978, (Stevenson, “Creating Flexibility In Buy-Sell Planning After TRA ’76", *Trusts & Estates,*May 1978.) reviewed in subsequent works (Leimberg and Rosenbloom, *The Wait and See Buy-Sell*(Farnsworth Publishing Co., 1978). Lane, “Redemption Agreements Funded By Shareholders Provide Greater Opportunities For Tax Savings,” *Estate Planning,*September 1980.). Though carryover basis was subsequently repealed in 1980, the tremendous flexibility and versatility generated by the optional buy-sell is no less valuable today than under the carryover basis era.

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# How Does It Work?

In addition to standard buy-sell provisions dealing with valuation, restrictions on lifetime sales, and terms of payment, and so on, the optional agreement provides:

1. a first option to the corporation to redeem all or a part of deceased, disabled, or retiring stockholders’ shares;

2. a second option to the stockholders, individually, to cross-purchase such shares, as above;

3. a final, mandatory option that the corporation must redeem any such shares not previously redeemed, or not purchased by the stockholders.

Thus, the Agreement constitutes a *mandatory*buy-sell (despite the options offered), and establishes a guaranteed market for the stockholders’ shares. A proportionate equity purchase results, though the cross-purchase portion could be drafted to generate any percentage equity split the parties desired.

In this fashion, total flexibility is provided. If the redemption approach is more appropriate at the date of purchase, this method is elected, in whole or in part. To the extent the corporation does not exercise its option, the stockholders may exercise their cross-purchase option. (Of course, the stockholders really determine which options will be selected in the first instance.) Accordingly, the following varied options are possible:

1. corporation redeems all or part, using existing surplus;

2. corporations redeems all or part, using capital contributions from the stockholders;

3. stockholders exercise total or partial cross-purchase using the insurance proceeds or benefits received;

4. a combination redemption/cross-purchase from either existing surplus: capital contributions, or insurance proceeds and benefits.

In the specimen agreements provided in this service, it is presumed that life insurance and disability insurance are cross-purchased by each stockholder on each other stockholder. (A trusteed specimen is provided in the event there are more than two stockholders, to avoid multiple policies, fees, minimum premiums, etc.) As with the other specimen agreements, it is anticipated that cash values will be used to fund retirement installment sales. The face amount of life insurance equals the current established value in the agreement, and accrued cash values, together with future cash values triggered by waived premiums are available at disability, together with individual disability policy benefits.

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If a corporate redemption (in whole or in part) is elected and the use of corporate surplus is impractical, the stockholders will contribute the insurance benefits or proceeds as capital contributions to the corporation. This is the key to establishing a total step-up in basis to the remaining stockholders, even where redemption is elected. Conversely, if cross-purchase is elected, the stockholders simply apply the proceeds or benefits they receive to the cross-purchase option.

Premiums for the life insurance or disability insurance may come from:

1. the stockholders, personally;

2. corporate bonuses to the stockholders;

3. split dollar arrangements between the corporation and the stockholders.

The split dollar technique is made to order for the optional in those situations where the stockholders are in a higher income tax bracket than the corporation, because it *enables the stockholders to use the corporate premium dollar at nominal cost to them. In addition, the corporate reimbursements for its premium outlays can be used to exercise a partial redemption.*Accordingly, all benefits under split dollar are readily available for funding, and hence are more likely to keep pace with increasing future corporate values.

# Why Does It Appear to Be the Agreement of the Future?

Because the optional resolves the inherent weaknesses in both the stock redemption and cross-purchase, it may very well be the most utilized buy-sell approach of the future. The table below highlights and summarizes the shortcomings of each approach and shows how the optional provides a solution:

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| The Problem | Optional Buy-Sell Solution |
| Redemptions*:*Policy cash values are subject to claims of business creditors. | Policy cash values are owned by stockholders (or trustee) on behalf) and are not subject to corporate creditors. |
| Survivors equity is always proportionate. | The optional can be amended to generate equal ownership (or whatever percentages are desired). |
| Surviving stockholders receive no step-up in cost basis. | Surviving stockholders receive full step-up in basis, no matter which purchase method is elected. (Under redemptions, step-up occurs through stockholder contributions to capital.) |
| Possibility of IRS asserting unreasonable accumulation of earnings penalty. | Unreasonable accumulations are not an issue. |
| Danger of dividend tax treatment on redemptions in family corporations. | If dividend dangers arise, simply avoid the redemption option. |
| Death proceeds are subject to the corporate alternative minimum tax. | If this is true, the cross purchase method may be elected. |
| *Cross purchase:*Unavailability of corporate premium dollar (especially where corporation is lower-taxed source). | Resolved through use of split dollar insurance |
| Multiple policies involved where more than two stockholders exist. | Solved through use of trustee (i.e., one policy per stockholder). |
| Transfer for value problems may arise on survivor policies. | Deceased’s estate simply sells policies to corporation, which exercises its redemption option. (Such purchases are exception to the transfer for value rule. Further, there is no need for new agreement). |

# Tax Issues

The general tax rules with respect to stock redemption and cross-purchase (such as, non-deductibility of premiums, tax-free death proceeds, and exclusion of death proceeds from an insured stockholder’s estate) apply equally to the optional buy-sell.

There are two tax issues which frequently arise from tax counsel with respect to the optional:

1. “If a combination redemption/cross-purchase occurs, has there been a violation of the complete redemption rules of IRC Sec. 302, which would create dividend tax treatment to the estate (particularly where the partial redemption occurs first, followed by the cross-purchase)?”

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**Answer:**

Fortunately, a complete tax-free redemption has occurred, according to the IRS:

. . . the amount received by the shareholder from the corporation will be treated as received in payment for the stock surrendered under Section 302(a) of the Code, since the transaction when viewed as a whole results in the shareholder terminating his interest in the corporation within the meaning of Section 302(b)(3). Holding in Rev. Rul. 55-745, 1955-2 CB 223, as restated in Rev. Rul. 75-447, 1975-2 CB 113, both rulings following *Zenz v. Quinlivan,*213 F.2d 914 (6th Cir. 1954).

Thus, whether the redemption follows or precedes the cross-purchase, a complete redemption will be deemed to have occurred and no dividend problem will arise.

2. “If the corporation makes the final redemption, in lieu of the stockholders exercising their cross-purchase option, could there be possible dividend tax treatment to the stockholders in that the corporation satisfied a stockholder obligation?”

**Answer:**

No. The stockholders’ cross-purchase is simply an option to them, not a mandatory obligation. In fact, the way the optional agreement is drafted, the final mandatory purchase obligation falls to the corporation. Hence, there can be no corporate satisfaction of a stockholder obligation! Rev. Rul. 69-608, Sit. 5, 1969-2 CB 42, 44.

# Practical Applications of the Optional Buy-Sell

Because of its tremendous flexibility, there seems little reason not to use the optional buy-sell in corporate planning. The ability to obtain a step-up in basis, whichever method is elected, seems reason enough. However, there are particular situations which seem uniquely applicable:

* Where the corporation lacks adequate surplus for redemptions.
* Where state law on redemptions is muddied or lacking.
* Where stockholders are concerned that corporate creditors might seek to attach policy cash values or proceeds.

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* Where stockholders anticipate that one or more of their children may ultimately come into the business and be the recipient of their stock by gift. A later redemption could trigger family attribution, but optional agreement provides an out.
* Where a younger minority stockholder simply cannot pay full insurance premiums on the older majority stockholder, he could fund on cross-purchase to the extent practical and have corporation purchase redemption insurance for the balance. (Split Dollar is an alternative here, too.)
* Where stockholders have given (or anticipate giving) stock to family members as a form of estate freeze for estate planning purposes.
* Where two children, active in the corporation, desire to buy out Dad, they may exercise cross-purchase at Dad’s prior death yet retain the redemption option later, as between themselves. (There is no attribution between siblings.)
* Where an employee-purchaser cannot afford full premiums, a non-par policy, level benefit universal life, or dividend option-type policy can be purchased under the split dollar technique to resolve the premium problem; yet all death proceeds could be utilized by having the corporation use its split dollar share for redemption.