CHAPTER 41

BUY-SELL (BUSINESS CONTINUATION) AGREEMENT

INTRODUCTION

A business continuation (buy-sell) agreement is a legal contract providing terms for the disposition of a business interest in the event of the owner’s death, disability, retirement, or upon withdrawal from the business at some earlier time. Business continuation agreements can take a number of forms:

(1) an agreement between the business itself and the individual owners (either a corporate stock redemption agreement or partnership liquidation agreement), frequently called an “entity” plan;

(2) an agreement between the individual owners (a cross-purchase or “criss-cross” agreement);

(3) an agreement between the individual owners and key person, family member, or outside individual (a “third-party” business buy-out agreement); or

(4) a hybrid combination of the foregoing, such as the “Wait and See” Buy-Sell[[1]](#endnote-1) discussed below.

In the case of corporations, the most common types of business continuation agreements are stock redemption plans (often called stock retirement plans), or shareholder cross-purchase plans. The distinguishing feature of the redemption agreement is that the corporation itself agrees to purchase (redeem) the stock of the withdrawing or deceased shareholder. In a cross-purchase plan the individuals agree between or among themselves to purchase the interest of a withdrawing or deceased shareholder.

In the case of a partnership, an agreement similar to the corporate stock redemption plan is the partnership liquidation agreement, where the partnership in effect purchases the interest of the deceased or withdrawing partner by distributing assets in liquidation of the partner’s interest, or the partners agree to a cross-purchase similar to the corporate cross-purchase plan.

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. When a guaranteed market must be created for the sale of a business interest in the event of death, disability, or retirement.

2. When it is necessary or desirable to help establish the value of the business for federal and state death tax purposes.

3. When a shareholder or partner would be unable or unwilling to continue running the business with the family of a deceased co-owner.

4. When the business involves a high amount of financial risk for the family of a deceased owner and it is desirable to convert the business interest into cash at the owner’s death.

5. When it is necessary or desirable to prevent all or part of the business from falling into the hands of “outsiders.”

This could include a buyout of an owner’s interest in the event of a divorce, disability, or insolvency, if there is a danger a business interest would be transferred to a former spouse or creditors.

6. Where it is desirable to lend certainty to the disposition of a family closely-held business. Rather than relying on will provisions of a parent to transfer the business interest, a binding buy-sell agreement between parent and child or other relative could be used. However, under IRC Section 2703, this has become exceedingly difficult.

7. When state law restricts the parties who can own an interest in the entity. An example is a professional corporation or association. State law might allow only licensed practitioners in that field, doctors for instance, to own the stock. In such a case, an heir or beneficiary of one of the doctors who is not a duly licensed professional in that field could not be an owner of an interest in the firm. A buy-sell agreement between the practitioners already in the firm or with a practitioner outside the firm (perhaps a friendly competitor) would be a legal and practical necessity.

WHAT ARE THE REQUIREMENTS?

A written agreement is drawn stating the parties to the agreement, purchase price (or a formula for determining that price), terms, and funding arrangements. The agreement typically obligates the retiring (or disabled) owner (or owner’s estate) to sell the business either (a) to the business itself, (b) to the surviving owner(s), (c) to a third party non-owner, or (d) to a combination of parties.

Occasionally the agreement combines the types of obligations. For example, the agreement may give the remaining owners the option to purchase the stock or partnership interest, but provide that if they fail to exercise that option, the interest must be redeemed or liquidated by the corporation (or partnership). Conversely, the agreement may provide that, if the entity cannot purchase the interest, the remaining owners have either an obligation or option to do so. Such agreements must be carefully drafted to avoid a situation in which the entity discharges an obligation of the other individual owners to purchase the interest, which could have adverse tax consequences to the other owners. For example, if the shareholders under the agreement are personally legally obligated to buy the stock of a deceased shareholder, and the corporation redeems (buys back) the stock, the entire amount of the obligation of which the remaining shareholders are relieved could be considered a taxable dividend to them. They would pay tax at ordinary income rather than capital gains rates.

The buy-sell agreement specifies the event triggering the respective obligations. Generally that event is death, disability, or retirement of the owner. However, as already indicated, it could (and usually should) include other potential events such as divorce, insolvency, or bankruptcy, and should also include such possible events as long term disability, loss of a professional license by an owner, or conviction of an owner of a state or federal crime. Valuation may be based on several factors, including book value, asset value, formula value, or some agreed amount.

“Funding” pertains to how the promises under the agreement will be financed. Generally - and preferably - in a redemption or liquidation agreement, the business will purchase, own, pay premiums, and be the beneficiary of adequate and continually reviewed amounts of life (and often disability income) insurance on each person who owns an interest in the business. In the case of a cross-purchase agreement, the prospective buyer (each business associate) purchases, owns, pays for, and is a beneficiary of a life and disability income insurance policy on the other owners.

HOW IT IS DONE – AN EXAMPLE

Stock Redemption Plan

Herb and Steve are equal stockholders in a business valued at $5,000,000. The business purchases $2,500,000 of life insurance on both men.

At Herb’s death, his stock passes to his estate. The life insurance proceeds on Herb’s life are paid to the business. Then the business pays the agreed upon amount or formula price to Herb’s estate according to the agreement. In return for the cash, Herb’s executor transfers the stock to the business. Steve, therefore, ends up with ownership of all the outstanding voting stock (the stock owned by the business itself is not entitled to vote).

Under the buy-sell agreement, should Herb become totally disabled prior to retirement, he would receive his full salary for one year. At the end of a year of total disability, Herb’s interest would be sold to the business. The business would pay at least $250,000 (10% x $2,500,000) as a down payment to Herb. The business would also issue Herb a 10-year note (secured by his stock which is placed in an escrow account) for the remaining value of the stock. The business would pay interest on the note. The rate would be the safe harbor rate needed to avoid the unstated interest rules. In order to help pay off the note, the business would apply for, pay for, and name itself beneficiary of a disability income insurance policy.

In the event Herb retired, he would sell his stock to the business. The business would pay Herb at least $250,000 (10% x $2,500,000) as a down payment, plus it would give Herb a 10-year note (secured by his stock) for the remaining amount. The business would pay interest on the note at the safe harbor rate needed to avoid the unstated interest rules. The cash value of the life insurance policy on Herb’s life could be used to help finance the down payment. One limiting factor, in general, is that in many states, the corporation can redeem its stock only to the extent it has earned surplus.

Cross-Purchase Agreement

Assume Herb and Steve are equal stockholders in a business valued at $5,000,000. Herb purchases a $2,500,000 life insurance policy and a disability income policy on Steve’s life. Steve purchases policies in equal amounts on Herb’s life.

Assuming Herb dies first; his stock passes to his estate. The insurance proceeds on Herb’s life are paid directly to Steve. Steve then pays cash to Herb’s estate according to the cross-purchase agreement. In return for the cash, Herb’s executor transfers stock to Steve. Therefore, Steve becomes the sole owner of the corporation.

In the event of Herb’s disability, he receives his full salary for one year assuming he is totally disabled. At that time, Herb must sell his business interest to Steve. Steve will pay at least $250,000 (10% x $2,500,000) as a down payment to Herb. Steve will also give Herb a 10-year note (secured by his stock) for the balance. Steve will pay interest on the note at the safe harbor rate needed to avoid the unstated interest rules. During this time, Steve will be receiving income from the disability income insurance policy purchased on Herb’s life that can be used to pay off the note.

At Herb’s retirement or departure from the firm prior to normal retirement Herb will sell his stock to Steve. Steve will pay at least $250,000 (10% x $2,500,000) as a down payment to Herb. Steve will also give Herb a 10-year note (secured by his stock) for the balance. Steve will pay interest on the note at the safe harbor rate needed to avoid the unstated interest rules. Steve can use the cash value of the policy he owns on Herb’s life to help provide the down payment.

These, of course, are merely examples. There are infinite variations on how the buy-sell can be arranged and what the terms will be. The professional's challenge is to match the forms with the facts and the objectives and circumstances of the parties.

TAX IMPLICATIONS

Stock Redemption Agreements

1. Assuming the corporation is sole owner and sole beneficiary of the policy(ies), the value of the insurance on the decedent’s life will not be includable (as insurance proceeds per se) in his gross estate for federal estate tax purposes. However, the receipt of the insurance proceeds will be considered in valuing the decedent’s interest in the business unless there is a valid arm’s length agreement fixing the price for federal estate tax purposes and the proceeds are excluded from the purchase price under the terms of the agreement.[[2]](#endnote-2)

The buy-sell agreement will generally establish the value of the business owned by unrelated parties for federal estate tax purposes if: (1) the estate is obligated to sell at the decedent-shareholder’s death, or the estate is obligated to offer the decedent’s shares at his death at the agreement price; (2) the agreement prohibits the shareholder from disposing of his interest during his lifetime without first offering it to the corporation at no more than the contract price; (3) the price was fair and adequate at the time the agreement was made and resulted from a bona fide arm’s length transaction between the parties; and (4) the price was fixed by the terms of the agreement, or, preferably, the agreement contained a formula for determining the price.[[3]](#endnote-3) Where the shareholders or partners are related, or the “natural objects of the bounty” of each other, there are additional requirements, discussed later under the heading “Family Business Enterprises.”

2. Life insurance or disability income premiums used to fund the agreement are not deductible by the corporation.[[4]](#endnote-4) On the other hand, death proceeds (or disability income proceeds) will be received by the corporation income tax free regardless of amount.[[5]](#endnote-5) (But see the discussion later on the corporate alternative minimum tax). Premiums paid by the corporation will not be taxable income to its shareholders.

3. The biggest potential problem in a corporate stock redemption agreement is the possibility that the redemption will be treated as a dividend distribution. The Internal Revenue Code states the general rule that, no matter how the parties label a transaction, a distribution of money or property in redemption of stock by a corporation will generally be treated as a dividend (resulting in subjecting the entire distribution to income taxation to the extent of the corporation’s earnings and profits). Fortunately, the seller can often avoid this treatment and can usually have the transaction treated as a capital gain if the distribution or redemption meets certain exceptions to the general rule. (The sting of dividend characterization is diminished by the currently low dividend rates. But of course, with federal deficits as large as they are and the need for revenue a continuing fiscal problem, dividend rates could be significantly increased in the future).

The clearest and most commonly used exception to the general rule that “any distribution from a corporation to its shareholder with respect to its stock is a dividend” is that a redemption of *all* of a shareholder’s stock (a complete termination of his interest) will not be treated as a dividend. For example, Herb and Steve, unrelated parties, own all of the stock in a closely held corporation. Herb dies and his stock passes to his estate. The corporation redeems (buys back) all of Herb’s stock from his estate. The result is a total redemption. The distribution will not be subjected to dividend treatment. This is because Herb’s estate has given up all control, share of future profits, and share of future assets in the event of a sale or liquidation of the corporation, i.e., Herb’s estate has *completely* terminated its interest. Therefore, the transaction will be treated as a sale rather than as a dividend. So only the gain, the difference between the amount realized by the seller and the seller's basis (generally stepped up to fair market value if the stock was obtained at a shareholder's death) is taxed. And that amount is taxed at capital gains rates.

Unfortunately, this favorable tax treatment can be complicated or even thwarted by what is known as “constructive ownership” (attribution) rules.[[6]](#endnote-6) Essentially, the basic constructive ownership rules work as follows:

a. The “estate/beneficiary” attribution rule. Under this rule, stock owned by a beneficiary of an estate is considered constructively (treated for tax purposes as if it were actually) owned by the estate.[[7]](#endnote-7) A redemption of all the stock actually owned by the estate (without a simultaneous redemption of stock owned by a beneficiary) may be considered a partial redemption and may be taxable to the estate as a dividend. The estate is still considered a stockholder because it is deemed to own stock actually owned by its beneficiary.

*Example.* Herb and Steve are father and son. Herb owns 75% of the stock while Steve owns the remaining 25%. Steve is a beneficiary under Herb’s will. If the corporation redeems only Herb’s stock from his executor, the entire amount paid by the corporation for the stock may be treated and taxed as a dividend (to the extent of corporate earnings and profits) because the redemption is *deemed* to be of less than all the stock owned directly or indirectly by the estate. After the redemption, the estate is considered to own *all* the outstanding shares of the corporation because Steve’s stock is attributed to (deemed to be owned by) Herb’s estate.

In other words, according to the fiction conjured up by IRC Section 318, Herb’s estate constructively owns the shares actually owned by Herb’s son. (It may be possible to avoid the estate/beneficiary attribution rule by “eliminating the beneficiary.” If, *before* the redemption takes place, the son has received all the property to which he is entitled from the estate, no longer has a claim against the estate, and no liabilities of the estate can be assessed against him as a beneficiary, his stock will not be attributed to the estate because he will no longer be considered a beneficiary.)

b. The “family/trust/corporation” attribution rule. Under this rule, an individual is considered to own the stock owned directly or indirectly by or for the individual’s spouse, children, grandchildren, and parents. Stock owned by certain other parties and entities is also attributed to and from each party or entity in determining whether all the stock has been redeemed.[[8]](#endnote-8) These other parties include:

(i) With certain exceptions, a trust and its beneficiaries.

(ii) A partnership and its partners.

(iii) A corporation and over-50% shareholders.

There is also the possibility of an incomplete termination as a result of stock being attributed through a *double* linking, first from a close family member to an estate beneficiary and then through the estate beneficiary to the estate.

*Example.* Herb owns 1,000 shares in a closely held corporation. His son, Steve, owns the remaining 500 shares. Herb’s widow is the sole beneficiary under Herb’s will. Even if the corporation immediately redeems Herb’s entire 1,000 shares at his death, the redemption will be treated as less than a complete redemption and therefore may become subject to dividend treatment because Steve’s 500 shares are attributed to (treated as if actually owned by) his mother under the family attribution rules. Then the shares she is deemed to own are in turn considered to be owned by Herb’s estate under the estate/beneficiary attribution rules. So even after all the shares Herb actually owned are purchased by the corporation from Herb’s estate, his estate is still constructive owner of all the outstanding stock of the corporation. Steve’s shares are traced to his mother and from her to Herb’s estate.

There is an important exception to the family attribution rule. Under certain circumstances, it may be possible to “waive” the family attribution rule (but not the estate or entity rules) and therefore break the fictional “chain link” between family members. This “10-year family attribution waiver rule” works as follows: In essence, the family attribution rules will not be applied if, immediately following the redemption, the stockholder whose stock is redeemed has no interest in the corporation (except as creditor) and agrees not to acquire an interest for 10 years following the redemption, other than by bequest or inheritance.[[9]](#endnote-9)

One of the difficulties of implementing a redemption of a family member coupled with a waiver of family attribution is the typical unwillingness of a key person, often a founder of the business, to completely disassociate from it. The cases are clear that the key person severing the link cannot safely function in the business in any capacity (other than creditor), even as a consultant.

In the example discussed above, Herb’s executor would sell Herb’s stock to the corporation. Herb’s widow would notify the IRS of her election to waive attribution between her son, Steve, and herself. Because she doesn’t own any stock personally and because she has “waived” her right to receive any stock except by bequest or inheritance, when the corporation redeems the stock held by the estate’s executor, there is no attribution from Steve to her and then from her to the estate. Therefore, the redemption results in a complete termination of the estate’s interest. The proceeds of the redemption, therefore, are not subject to dividend treatment.

Entities such as a corporation, trust, or estate may waive the constructive ownership and break the fictional ownership linkage from a family member who actually owns stock to a beneficiary who does not (but is deemed to own it). The individual who is deemed to own stock must join in the waiver. After the redemption, neither the entity nor the beneficiary may hold an interest in the corporation. They must agree not to acquire such an interest for at least 10 years. They must also agree to notify the IRS if they do acquire such an interest. There is joint and several liability in the event either the entity or the waiving family members acquires a prohibited interest within the 10-year period. The statute of limitations remains open during that time for the IRS to levy on any deficiency.

As noted above, it is important to be aware that an entity may break the fictional linkage only between family members; it may not waive “entity” attribution, the constructive ownership between a beneficiary and an entity. For example, assume 30% of the stock of a corporation is owned by a trust. Its beneficiaries, Michael, David, and Danny Green, own no stock personally. Debbie Green, the trust beneficiaries’ mother, owns 52% of the corporation’s stock. The remaining stock is held by unrelated employees of the corporation.

Assume the trust sells all of its stock back to the corporation. The redemption is still not complete because the trust’s beneficiaries, Michael, David, and Danny, are deemed to own stock owned by their mother through the “family” attribution rule. The stock they are deemed to own is then attributed from them to the trust through the entity attribution rule. So the redemption of stock from the trust would be less than complete. But if the trust and all three brothers waive attribution and break the link connecting the mother’s stock to the sons, the redemption would be complete. But what if one or more of the sons actually owned stock in the corporation? In that case the trust could break the link from Debbie Green to her children (the family attribution) but not the link between the children and itself (the entity attribution).

4. A purchase (either through stock redemption or cross-purchase) of a decedent-shareholder’s interest generally means that the estate of a decedent will not realize any taxable gain for income tax purposes. The stock purchased from the estate obtains a “stepped-up basis,” i.e., a new “cost” in the executor’s hands equal to its value for federal estate tax purposes. Because the purchaser generally pays a price equal to the value of the stock at the applicable federal estate tax valuation date, there is not any gain realized by the estate; the amount paid for the stock equals the basis of the stock in the hands of the executor.

*Example.* On January 1st Herb and Steve, who are unrelated, each invested $50,000 in a corporation that is worth $5,000,000 (each shareholder’s interest is worth $2,500,000) at Herb’s death. If the corporation paid Herb’s estate $2,500,000 in complete redemption of his stock, there would be no income tax consequences to his estate because the estate’s basis in the stock is “stepped up” from $50,000 to $2,500,000 (the value of the stock for death tax purposes) and this was the amount received by the estate under the redemption. The “amount realized” ($2,500,000) by the estate did not exceed the estate’s basis ($2,500,000) and so there is no taxable gain.

Note that the surviving shareholder (Steve) does not receive an increase in basis for income tax purposes since the corporation is redeeming Herb’s stock. In a cross purchase arrangement, if Steve had purchased Herb’s stock from his estate, Steve would receive an increase in basis by the amount of the price paid. This is an important factor in the considerations of whether a buy-sell should be structured as a cross purchase rather than stock redemption arrangement.

5. Congress was concerned corporations would be able to report large profits for financial accounting purposes but report little profit (and therefore pay little or no tax) for income tax purposes. So it imposed a revenue raising measure called the corporate alternative minimum tax (AMT). This is based on a variety of adjustments to the taxable income of the corporation to arrive at an amount defined as alternative minimum taxable income (AMTI).[[10]](#endnote-10)

For tax years beginning after 1997, this AMT does not apply to “small corporations.” These are defined as corporations that had average gross receipts of less than $5,000,000 for the previous three years. A corporation that meets the $5,000,000 gross receipts test will continue to be treated as a small corporation as long as its average gross receipts do not exceed $7,500,000.[[11]](#endnote-11)

Note that a corporation that does not qualify as a small corporation for 1997 (or for its first tax year, if it was formed after 1996) will never be eligible for small corporation treatment. A corporation that fails to meet the $7,500,000 gross receipts test becomes subject to the corporate AMT only with respect to preferences and adjustments that relate to transactions and investments entered into after the corporation loses its status as a small corporation. The cost of protection from the AMT afforded to small corporations is that the alternative minimum tax credit allowable to a small corporation is limited. Generally, the corporation’s regular tax liability (reduced by applicable credits) used to calculate the credit is reduced by 25% of the amount that such liability exceeds $25,000.

Roughly speaking, “C” (regular) corporations that do not qualify as small corporations must pay AMT at a 20% rate on an amount equal to 75% of the excess of certain earnings and profits (technically called “adjusted current earnings,” or “ACE.”) over alternative minimum taxable income.

Here’s a simplified example of how this extremely complex law works with respect to

A. Death Benefits from corporate owned life insurance:

|  |  |  |
| --- | --- | --- |
| Step 1: | State the total death benefit | $\_\_\_\_\_\_\_\_\_\_\_\_ |
| Step 2: | State the cash value | $\_\_\_\_\_\_\_\_\_\_\_\_ |
| Step 3: | Subtract to find the Net Amount at Risk | $\_\_\_\_\_\_\_\_\_\_\_\_ |
| Step 4: | Multiply Step 3 Result by | .75 |
|  | Amount Taxable | $\_\_\_\_\_\_\_\_\_\_\_\_ |
| Step 5: | Multiply by AMT rate | .20 |
|  | Alternative Minimum Tax | $\_\_\_\_\_\_\_\_\_\_\_\_ |

For instance, if a C corporation receives $1,200,000 of (otherwise income tax free) life insurance proceeds at the death of its key person, assuming the cash surrender value of the policy was $200,000 the day before the key person’s death, the net amount at risk would be $1,000,000. Because only 75% is taxable, $750,000 (.75 x $1,000,000) would be exposed to tax at a 20% rate. This means the net alternative minimum tax is $150,000 (.20 x $750,000).

The amount necessary before the AMT to net a rough “target amount” (the amount the corporation wants to net after any possible AMT tax) can be quickly computed by multiplying the target amount by 118%. For example, suppose the target amount is $1,000,000. To net this much after any possible AMT, the corporation should purchase $1,180,000 ($1,000,000 x 118%). Using the five step formula above, out of $1,180,000, $885,000 would be subject to the AMT. The AMT, at a 20% rate, would be $177,000. The net result, $1,003,000, is just slightly more than the $1,000,000 target amount. (To be precise, multiply the target amount by 117.7%).

It is important to understand that the AMT is truly an *alternative* tax, not an additional tax. Once the total AMT is computed, as in the above example, that amount is compared to the “regular” tax on the corporate income for the year in question. The alternative amount is paid only if it is higher than the regular tax.

Keep in mind that payments of AMT are more like prepayments of a future tax than a separate tax; what a corporation pays as an AMT can be used in future tax years as a dollar for dollar reduction (credit) against the corporation’s regular income tax liability (but not below the alternative minimum tax in any given year).

B. Cash Values

The inside buildup on a corporate owned life insurance policy is included in adjusted current earnings (ACE). Therefore, to the extent the policy cash value increase exceeds the premium paid in a given year, exposure to the AMT increases.

C. Premiums

A deduction for AMT purposes is allowed for the portion of any premium that is attributable to insurance coverage. Therefore, to the extent the premium paid is greater in a given year than the policy’s cash value increase, exposure to the AMT is reduced.

The bottom line is no surprise: both (otherwise income tax free) death benefits and the (otherwise income tax free) inside buildup in a life insurance contract are includable in the amount upon which the corporate AMT is based.

So what advice should be given to clients?

First, tell clients that the corporation needs the insurance, “BUY IT! Buy enough – after the AMT – to meet the need!” An easy way to estimate this need is to purchase life insurance equal to 120 percent of the "target amount." There is no question that even considering a “worst case” scenario, there is no more cost effective means of creating surplus to protect both the corporation and its creditors in the event of a shareholder or key employee’s death than corporate owned life insurance. Likewise, in most cases nonqualified deferred compensation, Death Benefit Only (DBO) plans, and corporate debt reduction should be funded with corporate owned insurance “grossed up” enough to net the target amount.

Second, where it is possible and appropriate in the opinion of the firm’s advisers to purchase necessary life insurance outside the corporation, do so. Other factors being equal, buy-sell agreements of almost all family-owned businesses and most closely–held non-family corporations should be set up on a cross purchase basis.

Third, remember that the AMT does not impact S corporations, LLCs, FLPs, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, or financial asset securitization investment trusts.

Fourth, no AMT is imposed until the corporate exemption of $40,000 is used up. (This exemption is reduced by 25% of the amount by which alternative minimum taxable income exceeds $150,000, but not less than zero). Therefore, small amounts of tax preference in a given year will typically have no effect.

Finally, remember that many - if not most - family-owned and closely-held corporations will be “small corporations” and thus exempt from the AMT.

6. Ordinarily, other than AMT issues, the receipt of policy proceeds – regardless of amount - is income tax free to the entity or in the case of an S corporation or partnership, to the owner, however, see Chapter 30 for a discussion of Section 101(j) which may cause the proceeds to lose their income tax free status if a company is the owner and beneficiary of life insurance purchased after August 16, 2006 and the requisite notice was not given to the insureds, including certain owners – and timely consent was not obtained.

Cross-Purchase Agreements

1. The value of life insurance owned on a decedent-shareholder’s life by a surviving co-shareholder will not be included in the decedent’s estate for federal estate tax purposes. This is because the decedent-shareholder insured has no incidents of ownership in the policy his co-shareholder owns. However, the value of life insurance the decedent owned at the time of death on the lives of co-shareholders will be includable.[[12]](#endnote-12) (Generally, the includable amount is equivalent to the policy’s interpolated terminal reserve plus unearned premiums but may be much higher if the insured is terminally ill at the time of the owner-co-shareholder’s death.)

As with the stock redemption agreement, a properly drawn cross-purchase agreement will, generally, be effective in helping to establish the value of the business for federal estate tax purposes providing: (1) the estate is obligated to sell at the decedent-shareholder’s death, or the estate is obligated to offer the decedent’s shares at his death at the agreement price; (2) there is a lifetime “first offer” provision prohibiting a shareholder from disposing of his stock interest without first offering it to the other shareholders at no more than the contract price; (3) the price was fair and adequate when made and resulted from a bona fide arm’s length transaction; and (4) the price is fixed by the terms of the agreement or the agreement contains a formula or method for determining the price. (But where family members are involved, the requirements are much more onerous. See discussion below on Family Business Enterprises).

2. Life insurance or disability income premiums paid to fund the agreement are not deductible by the co-shareholders. The death proceeds or disability benefits will be received by the respective co-shareholders income tax free. There will be no AMT regardless of the size of the policy.

3. Assuming the corporation does not directly or indirectly take over the buying shareholder’s existing liability once it becomes fixed, there is no possibility under a cross-purchase agreement that the purchases of stock by the remaining shareholders will be treated as dividends and there can be no attribution problems because there are no redemptions; there should be no transaction between the corporation and its shareholders in a cross-purchase agreement. By definition, in a cross-purchase plan the entire transaction is between the co-shareholders.

4. Under a cross-purchase agreement, if the price paid for the stock is more than its basis (cost) in the selling shareholder’s hands, the difference is usually taxable at capital gain rates. Under a stock redemption, the distribution for the stock is generally treated as a dividend unless certain strictly construed and difficult to meet exceptions apply.

5. Under a cross-purchase agreement, the surviving shareholder has the advantage of increasing his basis in the company for income tax purposes by the amount of money he or she pays for the stock. This is not available under a stock redemption. This will result in a reduced gain, in the event of a subsequent lifetime sale, to the surviving shareholders.

6. Where more than one shareholder is involved, the implications of the transfer for value rule[[13]](#endnote-13) (see Frequently Asked Questions below), must be analyzed if there are life insurance policies that could be transferred among the shareholders or from the corporation to the shareholders

Business Continuation Plans for S Corporations

Where the entity or cross-purchase plan is structured for a corporation electing to be taxed under subchapter S of the Internal Revenue Code, there are additional issues that must be considered. The tax characteristics of S corporations are discussed in Chapter 46.

Most practitioners favor the cross-purchase buy-sell type plan for an S corporation. There is some concern that a stock redemption plan under which the corporation will purchase stock of shareholders would create a second class of stock, which would disqualify the corporation for the S election. However, rulings and regulations indicate the IRS will rarely take this position. More practical reasons for preferring the cross-purchase plan include the fact that any life insurance owned by the corporation to fund a stock redemption agreement is really paid for with shareholder dollars, because the dollars used to pay premiums are dollars taxed to the shareholders. Also, the impact of the life insurance premiums and proceeds on the income tax basis of the shareholders’ stock is unclear. If the S corporation has corporate earnings and profits accumulated before the S election is made, the insurance may affect the amount the corporation can distribute to shareholders without dividend consequences. The impact of life insurance on S corporation shareholders is discussed further in Chapter 46.

On the other hand, life insurance in an S corporation, no matter how large, does not trigger alternative minimum tax problems. A stock redemption decreases any of the S corporation’s earnings and profits, which could someday give rise to dividends. And because most S corporations have little or no earnings and profits, all the complex dividend issues under the redemption-family attribution rules are generally not an issue, because a redemption cannot create a taxable dividend if there are no earnings and profits.

In structuring a buy-sell agreement for an S corporation, note that corporate profit and loss is allocated on a daily basis to all shareholders, including a deceased shareholder, to the date of death, or a selling shareholder to date of sale. An election can be made to actually close the tax year on the date of death or sale and allocate income or loss between two tax years. The agreement should spell out which approach is to be used. Remember that a shareholder’s pro rata share of corporate profit or loss will increase or decrease the income tax basis of the shareholder’s stock, which would have an impact on the gain or loss realized on the sale.

One of the purposes of a buy-sell agreement in an S corporation is to prevent the stock from falling into the hands of a disqualifying shareholder, such as a trust that cannot own S stock or a nonresident alien. The agreement should be structured so that the sale is complete before any such disqualifying transfer is made and should specifically bar sales to any disqualifying party.

Business Continuation Plans for Partnerships

Partnership buyouts present several different problems and solutions. Unlike a corporation, if more than 50% of the total partnership capital *and* profits are sold within a 12-month period, the partnership is dissolved under IRC Section 708. However, the regulations under Section 708 indicate that if the interest of a partner is liquidated rather than sold, there is no dissolution even if that interest exceeds 50%. If the buyout does terminate the partnership, it is treated as having made a pro rata liquidating distribution of all of its assets to the partners, which are then treated as re-contributed to the partnership. Both functional transactions are generally tax free.

If a partnership buy-sell agreement involves the sale of a partnership interest to other partners (or even a third person, such as an employee), any gain or loss realized by the selling partner is treated as a gain from sale or exchange of a capital asset, except to the extent it is attributable to so-called “hot assets” as defined in IRC Section 741 (generally, unrealized receivables and inventory items). Note that in the case of a sale of a deceased partner’s interest, the stepped-up basis at death will eliminate most of this gain, except that attributable to items of income in respect of a decedent owned by the partnership. The purchaser acquires the cost basis in the partnership interest under IRC Section 742, and in addition, may seek to adjust the basis of the partnership assets to reflect the purchase price under IRC Sections 743(b) and 754.

Consideration should always be given to the use of a liquidation plan that meets the requirements of IRC Section 736, so that part of the payment can take the form of a tax-deductible guaranteed payment that can be spread over a period of several years. Under that section, payments in *complete* liquidation of a retiring or deceased partner’s interest are broken into two categories, 736(b) payments and 736(a) payments.

Section 736(b) payments are those made in exchange for a deceased partner’s interest in partnership property, including goodwill if specified as such in the agreement, and will result in taxable gain to the selling partner only if cash received, including relief from liabilities, exceeds the basis of the partner’s interest in the partnership.

Section 736(a) payments made to successors of a deceased partner are classified as guaranteed payments, or represent an interest in future partnership income. Either way, they are tax-deductible to the partnership and taxable income to the recipient as income in respect of a decedent under Code Section 691. Payments for receivables are always characterized as 736(a) payments. Payments for goodwill can be 736(a) payments unless the partnership agreement specifies they are for goodwill.

In summary, liquidation plans prevent termination of the partnership because the over 50% sale rule will not apply, so long as there are at least two partners remaining after the liquidation is complete. Part of the liquidation payment can be made tax deductible to the remaining partners, and payments for goodwill can specifically be made tax deductible by bringing them under Section 736(a).

However, the use of guaranteed payments under Section 736(a) has been severely curtailed in the case of partnership agreements entered into after January 4, 1993. Section 736(b) has been amended to provide that payments for unrealized receivables and goodwill of the partnership cannot be characterized as guaranteed payments under Section 736(a) unless capital is not a material income producing factor for the partnership, and the partner who is retiring or deceased is (or was) a general partner. This rule will not apply to partners retiring under an agreement that was binding on the parties on January 4, 1993. This change effectively limits the use of Section 736(a) guaranteed payments to service partnerships, such as professional practices.

If life insurance is used to provide funding in the case of the liquidation plan, the insurance is owned by the partnership and used to make liquidation payments. The IRS could argue that each partner has incidents of ownership in the policy on his life because of his management rights as partner. However, the IRS has taken this position only where the insurance proceeds were payable to a party outside the partnership.[[14]](#endnote-14)

Note that the receipt of the insurance proceeds increases the income tax basis of the partnership interests of all partners, including the interest owned by the decedent. It may be possible to change this by a provision in the partnership agreement.

Where insurance on the life of each partner is owned by other partners under a cross-purchase plan, the policies can be transferred between the partnership and partners without fear of the transfer for value rule under IRC Section 101(a)(2)(B). This is because there is an exception to the transfer for value rule if the transferee is either a partnership in which the insured is a partner or a partner of the insured. If an LLC is taxed as a partnership, the same exception should apply. Partnerships are subject to the same notice requirements for life insurance on the lives of partners as discussed above under Code Sec. 101(j) in order to prevent income taxation of the proceeds. See Notice 2009-48.

Cross ownership should not be the basis for an IRS claim that each partner has incidents of ownership in the policy on his life owned by the other partner by reason of the agreement.[[15]](#endnote-15)

Special Rules for Family Business Enterprises

IRC Section 2703, applicable to options or agreements created or substantially modified after October 8, 1990, raises a host of additional problems in planning business continuation agreements for family businesses. It provides that any restrictions that result from options or agreements permitting *any* person to acquire any property at less than fair market value, or any such restriction on the right to sell or use the property, are disregarded in valuing that property. However, there is an exception for options, agreements, etc., that meet the following three tests:

* They are bona fide business arrangements;
* They are not devices to transfer property to the decedent’s family or the natural objects of the decedent’s bounty for less than full and adequate consideration; and
* The terms are comparable to similar arrangements entered into by persons in arm’s length transactions.

While the first two requirements are not really new, the third requirement, requiring that the terms and conditions of the agreement must be comparable to others entered into by unrelated persons, is very difficult to meet in most planning situations. Comparable agreements are very hard to find and are generally not available for comparison. Both the congressional committee reports and the regulations under Section 2703 indicate that there are four factors in such agreements:

* the present fair market value of the property or business,
* its expected value at the date of exercise of rights under the agreement,
* adequacy of any consideration offered for the option or agreement, and
* the expected terms of the agreement.

According to the congressional committee reports, the third test is not met simply by showing isolated comparables but requires a demonstration of the general practices of unrelated parties. Expert testimony would be evidence of such practice. In unusual cases where comparables are difficult to find because the taxpayer owns a unique business, the taxpayer can use comparables from other businesses.

The Senate report also emphasizes that the law does not alter other preexisting requirements for buy-sell agreements, such as a requirement of lifetime restrictions if the agreement is to be binding at death. In other words, all the tests that must be met by unrelated parties must be met here – as well as the requirement that the terms and provisions in the buy-sell in question be comparable to the terms and provisions of buy-sells of similar businesses.

According to the regulations, the restrictive agreement will meet the requirements of the statute to control valuation if it is a binding agreement and if more than 50% of the value of the property or business is owned by persons who are not family members (or natural objects of the transferor’s bounty).

However, the use of the term “natural objects of the transferor’s bounty” is broadly defined and means that the provisions of Section 2703 may apply even where the shareholders are unrelated. The final regulations do not say this, but they do say that members of the family include persons described in IRC Section 2701, covered in Chapter 60, and other persons who are natural objects of the transferor’s bounty. The preamble to the final regulations also states that natural objects of bounty may include persons not “related by blood or marriage.”

Similar arrangements among unrelated parties in the same business are generally comparable, if they consider the term of the agreement, present and anticipated fair market value of the property, and adequacy of consideration. General business practice of unrelated parties is comparable, but again, isolated comparables are insufficient, and if two or more valuation methods are generally used, the fact that the agreement falls within one of them is not sufficient.

It is important to note that the requirement of finding comparable buy-sell agreements, which is very difficult in most cases, appears to have been replaced in the regulations by a requirement of proof that unrelated persons dealing at arm’s length would have entered into the same agreement. Thus, in setting the terms of a business continuation agreement where family members are involved, remember to consider the key factors – present and anticipated future value of the business, the expected term of the agreement, and consideration. Obtain evidence and expert opinions to establish that the terms and conditions of this buy-sell agreement would be acceptable to unrelated persons. Under no circumstances should a client be allowed to arbitrarily set prices or values, such as, for example, a price based on the face value of the life insurance. Finally, consider a provision requiring periodic review and adjustment of the price, or preferably, a formula.

If a business continuation agreement was in place before the effective date of Section 2703, it is not covered by the requirements of Code Section 2703 - unless it is substantially modified thereafter.

The following are *not* considered substantial modifications:

* a modification required by the instrument;
* a discretionary modification containing a right or restriction that does not change the right or restriction, or results in only a de minimis change;
* a modification of a capitalization rate tied to a market rate; or
* a modification to a price that more adequately reflects fair market value.

The following *are* considered substantial modifications:

* failure to update an agreement that by its terms requires periodic updating; and
* the addition of a family member to the agreement, unless mandated by the terms of the agreement, or unless the new family member is assigned to a generation no lower than that of existing parties to the agreement (generation assignment is determined under the generation-skipping rules, discussed in Chapter 18).

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Several problems can arise in connection with buy-sell agreements as a result of community property rights. If all or part of the stock is subject to a buy-sell agreement, careful planning is required (1) to protect against the risk that the shareholder’s spouse may predecease the seller and leave the spouse’s community property interest in the stock to third parties, (2) to protect against attachment by creditors of the shareholder’s spouse, and (3) to protect the agreement from attachment by the stockholder’s spouse if the spouse survives the stockholder and seeks to claim his community property interest in the stock free of the agreement. If all or part of the stockholder’s interest is quasi-community property, care should be taken to protect against the spouse’s claim, if the spouse survives the stockholder, that the spouse is entitled to a community property interest in the stock free of the agreement. Appropriate written consents should be obtained in the above situations.

The impact of divorce in a community property state must be considered. If a spouse who is not active in the business should receive stock in the closely held corporation, or a partnership interest, as part of the property settlement, this may not be covered by the buy-sell agreement.

Consideration should be given to making provisions in the buy-sell agreement for such an eventuality. One solution is to grant the remaining shareholders or partners, particularly the other spouse in the divorce action, a right to purchase the interest of the soon-to-be ex-spouse. Alternatively, the corporation or partnership could have at least an option to purchase the interest. If the spouses are all made parties to such an agreement, great care must be taken to assure these provisions are fair, or else they may be unenforceable.

It is important to determine the nature of the interest held by the stockholder, not only for purposes of determining whether consents need to be obtained and wills reviewed, but also to evaluate the tax consequences. If all of the stock is community property, the community property interest of the stockholder’s spouse will be included in the spouse’s estate if the spouse predeceases the stockholder, and will be excluded from the stockholder’s estate if the stockholder dies first. If all of the stock is the separate property of the stockholder, it will be included in the stockholder’s estate only (unless the stockholder passes the stock to the spouse and then dies). If all of the stock is quasi-community property, the stockholder’s spouse will have no interest if the spouse dies first, and the full value of the stock will be in the stockholder’s estate for federal estate tax purposes.

The basis of property acquired from a decedent is subject to a peculiar set of rules.

Generally, the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent’s death. (EGTRRA 2001 replaced the step-up in basis with a modified carryover basis for one year for property received from a decedent dying in 2010 but the 2010 Act reinstated the old basis rules under Section 1014 for decedents dying after 2009. For 2010 only however, the executor may elect instead to apply the EGTRRA 2001 carryover basis rules and opt out of the estate tax). IRC Section 1014 defines which property is deemed “acquired from a decedent” and therefore subject to these special basis rules. Generally, Section 1014 applies to all property includable in the gross estate.

The surviving spouse is deemed to have acquired her one-half share of the community property from the decedent spouse. This gives the surviving spouse a new basis even though her one-half of the community property was not included or taxed in the decedent spouse’s estate. The new basis for the surviving spouse’s one-half will therefore be equal to the fair market value of the property at date of death. This rule operates, however, only if the decedent’s one-half is fully included in the gross estate.[[16]](#endnote-16) If the property’s fair market value is greater than its adjusted income tax basis, the basis will receive a “step-up” free of income taxes. If the fair market value is less than the adjusted basis, the new basis will actually be a “step-down.”

This “step-up” or “step-down” in basis for both spouses’ halves of the community property does not apply to property held as joint tenancy or tenancy in common property. Even though the original nature of the property was community property (e.g., a spouse’s earnings in a community property state), taking the title as joint tenants or tenants in common will change its nature so that it no longer has the attributes of community property. However, in most states with community property laws, it is possible to re-establish the property as community property by an agreement between the spouses without actually changing the recorded title to the property.

The ability of the surviving spouse to sell immediately the entire community interest of corporate stock, either under a buy-sell contract to other shareholders or to redeem some or all of it within the scope of IRC Section 303 (avoiding dividend treatment), can often be the most significant estate planning step taken by husband and wife shareholders in community property states.

Problems can occur when attempting to determine whether stock held by a married person in a community property state is community property. A portion of the stock can be separate property and a portion community property. A common example is a man who owns a business prior to marriage.

Let us examine the setting in which this issue frequently arises. Assume that Mr. Jones owns all of the stock in Jones Manufacturing Company, Inc. The company was incorporated prior to his marriage to Mrs. Jones. At the time of the marriage, the company was worth $100,000. However, during the marriage the value of the company appreciates rapidly. If Mr. Jones dies, will the stock in the company, or, in the alternative, the appreciation in value of the stock, be deemed his separate property or will it be community property?

Court decisions characterizing appreciation in closely-held businesses arise in only three settings: (1) a claim by a creditor that the business should be made available for the payment of a debt, (2) divorce and the division of property pursuant to divorce, and (3) the death of one of the spouses.

Most states use some form of an “apportionment rule” to characterize the increase in value of closely-held business interests during marriage which were originally held as a spouse’s separate property. Under the apportionment rule, if one of the spouses invests separate property in a business and conducts that business during the marriage, the resulting projects or increases in value of the business will be apportioned or allocated between the community estate and the spouse’s separate estate according to the amount attributable to the spouse’s personal efforts on the one hand (inuring to the benefit of the community), and to the capital improvement on the other (inuring to the benefit of the spouse’s separate estate).

The possibility of creating such a community property interest in a corporation originally held as the separate property of one spouse can be determined only by a court in the absence of a written agreement. Thus, it is advisable for the spouses to agree, in writing, on the nature of their interests and the proportion of community and separate property.

There are other possible combinations of interest, such as combinations of community property and quasi-community property, combinations of separate property and quasi-community property, or combinations of all three types of property. In any event, the exact nature of stock ownership and their respective proportions should be identified and agreed upon in writing. In many situations it may be advisable to incorporate the property agreement into the buy-sell agreement.

In all of the community property states, appreciation in value of separate property is separate property, unless the appreciation in value is attributable to the personal services of one of the spouses or due to the application of community property funds. For example, market appreciation of publicly traded stocks held as separate property is also separate property. If, on the other hand, a house is owned as separate property, and one of the spouses is a carpenter and builds an addition with materials acquired with community property, any increase in value due to the addition is either community property or creates a right to reimbursement of the community. Community property states do vary in their treatment of these issues. For example, Idaho characterizes the appreciation in value of separate property as separate property, unless a portion is derived from community property. If so, an allocation must be made. A federal tax lien attaches to the right to reimbursement. Similarly, Arizona characterizes the appreciation as separate property if a spouse's labor or community property funds are used to acquire or improve the asset, a right to reimbursement exists, but this does not change the character of the asset.[[17]](#endnote-17)

FREQUENTLY ASKED QUESTIONS

**Question** – Under what situations would a business buy-out by a third party be indicated?

*Answer* – There are certain situations in which an owner of a business interest is either unwilling or unable to enter into a conventional stock redemption or cross-purchase agreement. Usually, such a business owner will have problems such as estate liquidity or lack of management skills or interest by members of his family, or desires the value of the business to be persuasive for federal estate tax purposes.

A typical example is where an individual is married and has three children, only one of whom he desires or expects to be able to take over the business. He would like to treat his children as equally as possible. One way he could do this is by entering into a buy-sell agreement with the one child he expects to take over the business. That child will take over the business through the buy-sell agreement. The funds paid by that child to the decedent’s executor in return for the business interest could provide the client’s widow and remaining children with cash for their living needs and estate settlement costs.

The client could create a trust for the other children. That trust could be funded by life insurance to help “equalize” the estate. Alternatively, the client could make annual gifts to the adult financially responsible children who don’t work in the business and they could use those amounts directly to purchase life insurance on his life. At his death, they would receive the policy proceeds to help make up for the business interest they will not receive.

Another example is where two individuals are in business together but, at the death of one, the other wants a child who presently owns no stock to come into the business. In other words, the agreement can be structured to require a sale to and purchase by someone who presently owns no interest in the business. This could be a relative, employee, or competitor.

**Question** – What are some of the various methods of establishing the purchase price of a business?

*Answer* – The purchase price to be paid for the stock of a shareholder may be set by a variety of methods. One method is to provide for the exact purchase price in advance with the further provision that the parties may change the price at any time upon mutual agreement.

Another method of fixing the price is to use book value based on the company’s financial statements.

A third and more preferred method of valuation is a formula approach. Formula valuation methods are often used to take into account net profits and, to some degree, goodwill. An example of “a simplified place to start” would be straight capitalization of the adjusted average net profits of the business at a definite rate. For instance, as the NumberCruncher (http://www.Leimberg.com) illustration below shows, at a 12% rate, a business producing adjusted average net after-tax profits of $100,000 would be worth about $833,333 using this approach ($100,000 divided by .12). A 50% interest in such a business would be worth $416,667, half of $833,333. Combinations of these three methods can also be used as a starting place to derive a price in a buy-sell agreement. (See Chapter 59 on Valuation Planning).

|  |
| --- |
| **CAPITALIZATION OF INCOME** |
|  |  |
| Input: Capitalization Rate .120 |
| Input: Adjusted Earnings 100,000 |
|  |  |
| **Expected Rate of Return** | **Value of Asset or Business** |
| 0.08 | $1,250,000 |
| 0.09 | $1,111,111 |
| 0.10 | $1,000,000 |
| 0.11 | $909,091 |
| 0.12 | $833,333 |
| 0.13 | $769,231 |
| 0.14 | $714,286 |
| 0.15 | $666,667 |
| 0.16 | $625,000 |
| 0.17 | $588,235 |

**Question** – What is the goodwill method of valuation and how is it applied?

*Answer* – A closely-held business should (and often does) produce an income in excess of the amount that could be expected from the mere employment of the capital its shareholders have invested. That additional amount of income is derived from an intangible value in the business, a value in excess of the total value of the tangible assets. This is called “goodwill.”

By capitalizing this “earnings attributable to intangibles,” i.e., by dividing the additional profits generated by the firm’s goodwill by an appropriate rate, it is possible to estimate goodwill value. If this amount is then added to book (net tangible asset) value, an estimated total business value can be found.

Some of the elements that may comprise a firm’s goodwill include:

(1) location of the business,

(2) reputation of the business,

(3) public recognition of the company’s name,

(4) list of customers and prospects owned by the business,

(5) management effectiveness and depth,

(6) sales, operations, and accounting skills,

(7) employee morale,

(8) position of the business relative to competitors,

(9) other factors that generate income in excess of that amount which could be expected after multiplying the value of tangible assets by a reasonable rate of return.

Note that goodwill does not include the portion of profits attributable to the corporation’s ownership of patents, copyrights, formulas, or trademarks, even though they are intangible, since these are all specifically identifiable.

Goodwill, as is the case with other valuation formulas and procedures, should be used only as a guideline along with other valuation methods and not as the sole determinate of value. Goodwill has minimal relevance to the valuation of most investment companies since they usually do not have large amounts of intangibles. Officially, the IRS does not give strong credibility to goodwill (although the IRS still insists that goodwill must be taken into account in the valuation process). It can still serve as a guideline. The NumberCruncher (http://www.Leimberg.com ) illustration below shows the operation of this method.

|  |
| --- |
| **GOODWILL VALUATION** |
|  |  |  |  |  |  |
| Average Annual Earnings: $100,000 |
| Estimated Capitalization Rate: 0.2000 |
| Average Annual Asset Value: $500,000 |
| Rate of Return on Tangible Assets: 16.000% |
|  |  |  |  |  |  |
| **Option** | **Return on****Tangible****Assets** | **Earn from****Tangible****Assets** | **Earn from****Intangible****Assets** | **Goodwill****Value** | **Total****Business****Value** |
|  |  |  |  |  |  |
| 1 | 16.000% | $80,000 | $20,000 | $100,000 | $600,000 |
| 2 | 17.000% | $85,000 | $15,000 | $75,000 | $575,000 |
| 3 | 18.000% | $90,000 | $10,000 | $50,000 | $550,000 |
| 4 | 19.000% | $95,000 | $5,000 | $25,000 | $525,000 |
| 5 | 20.000% | $100,000 | $0 | $0 | $500,000 |

**Question** – What can be done if one of the persons involved in a business continuation agreement is uninsurable?

*Answer* – First, planners should remember that with modern underwriting techniques and companies that specialize in placing coverage on individuals with certain medical conditions or hazardous occupations or avocations, few individuals are truly “uninsurable”. Almost all individuals, except those in “exceptionally” ill health or in an exceedingly dangerous occupation or avocation, can obtain life insurance, albeit at a rate higher than the rate the standard insured would pay. Life insurance may be used for the insurable stockholders, and for the uninsurable stockholders, a sinking fund method should be used to at least accumulate enough money for a down payment. Often an amount equivalent to the appropriate insurance premium on the uninsurable person’s life (given that person’s age) is deposited into some type of segregated reserve account. Such an account might be invested in bonds, mutual funds, a fixed or variable annuity, or merely left in a savings account until the death of the uninsurable.

Typically, the agreement will provide that installment payments covering the remainder of the purchase price can be spread over a relatively long period of time.

Several life insurance companies are offering guaranteed issue type contracts even on those stockholder-employees previously thought to be uninsurable as long as the stockholder-employee is actively at work full time. One type of policy provides that if a death occurs during a certain initial period of time, e.g. three years, only premiums paid plus interest are payable as a death benefit. After the initial period the full death benefit is payable. A second type policy provides for a graded death benefit, i.e., one that increases over a period of time to the full death benefit.

**Question** – Will an agreement giving a surviving stockholder or the corporation an *option* to buy the deceased shareholder’s stock usually fix the value of a business interest for federal estate tax purposes?

*Answer* – Yes, if there is a “first offer” provision and the price was fair and adequate when made. (A “first offer” provision requires the selling shareholder [or his executor] to offer the interest to the specified purchaser at an agreed upon price [fixed or set by formula] both during lifetime and after death before offering it to others.) Although the estate must be either obligated to sell at death or obligated to offer at death at the agreement price, the survivor(s) or the corporation need not be obligated to buy. An option in their hands would be sufficient. However, agreements involving substantially only family members may be determined not to be made at arm’s length and therefore not effective in pegging the value for federal estate tax purposes. (See discussion above – Family Business Enterprises).

**Question** – Assume that there are three stockholders of a corporation and all stockholders have entered into a cross-purchase agreement. One of the stockholders dies and the other two stockholders purchase the decedent’s stock using the life insurance proceeds under which the decedent was the insured and the remaining two stockholders were the policyowners and beneficiaries.

The decedent’s personal representative now owns an insurance policy on the life of each of the surviving shareholders. They purchase their respective policies from the personal representative. Are there any potential tax problems?

*Answer* – No. This situation brings into play the “transfer-for-value” rule.[[18]](#endnote-18) This tax trap creates an exception to the general rule that the proceeds of an insurance policy are exempt from federal income tax.

The transfer-for-value rule provides that if insurance policies are transferred for value (consideration in money or money’s worth has been given for such transfer) then the owner-beneficiary of that policy will have taxable income when the insured dies. The difference between the proceeds of the policy and the sum of (a) the value paid and (b) the premiums paid by the new owner-beneficiary after receipt of the policy will be taxable as ordinary income.

There are exceptions to the transfer-for-value rule where the transfer for value is made:

(1) to the insured (as is the case here),

(2) to a corporation in which the insured is an officer or stockholder,

(3) to a partner of the insured,

(4) to a partnership in which the insured is a partner,

(5) where the new owner’s basis (cost) is determined in whole or in part by reference to the transferor’s basis, or

(6) where a transfer of a policy or an interest in a policy is made between spouses or between spouses incident to a divorce. For instance, if a divorce decree requires one spouse to transfer a policy to another, the transfer will be considered a nontaxable event that results in a carryover basis in the policy and avoids the transfer-for-value tax trap.

**Question** – Assume that there is a stock redemption agreement funded by life insurance. The amount of the life insurance on the date of the death of one of the stockholders exceeds the corporate obligation under the redemption agreement. Are there any tax consequences?

*Answer* – The proceeds of corporate-owned life insurance will generally not be taxable to the corporation when it receives the same (except for potential exposure of certain corporations to a corporate level alternative minimum tax). However, the earnings and profits of the corporation will be increased by the amount of the proceeds and then reduced when a portion of the proceeds is used to redeem the shares of stock.

If the entire amount of the proceeds has not been used to redeem a decedent-shareholder’s interest, there will be a permanent increase in corporate earnings and profits, which means that there should be additional dollars available for the payment of dividends; because of this, the potential exists for imposition of the accumulated earnings tax penalty, as well as dividend treatment on any distribution made by the corporation to its shareholders.

**Question** – Assume that the parties enter into either a redemption agreement or a cross-purchase agreement. Should anything be done to protect their rights with respect to a possible transfer to third parties?

*Answer* – The stock certificates owned by the parties to either the redemption agreement or the cross-purchase agreement should bear a legend (stamp) indicating a restriction on the ability to transfer those shares of stock as a result of the redemption or cross-purchase agreement.

**Question** – Why is a cross-purchase plan often preferred over a stock redemption arrangement?

*Answer* – Where a corporation purchases the stock of a withdrawing, disabled, or deceased stockholder, the surviving shareholders cannot increase their basis (cost for purposes of determining gain) by the amount paid. For example, assume Steve, Roberta, and Lee each own an interest in the SRL Corporation worth $100,000. Each invested $10,000 in 1977 when the corporation was formed. If Lee dies and the corporation (pursuant to a fully funded buy-sell agreement) pays his executor $100,000 for his stock, Steve’s basis and Roberta’s basis remain at $10,000. But if Steve and Roberta had been the purchasers and had each *personally* paid $50,000 to Lee’s executor, their individual basis would have increased by that $50,000 amount. The distinction is important because, in this simplified example, the taxable gain on a future sale of Steve’s stock or Roberta’s stock could be as much as $50,000 less using a cross-purchase arrangement.

It is important to recognize, however, that this does not mean a cross-purchase plan will always be better than a stock redemption. In some cases, a stock redemption will be preferred:

(1) The basis increase may be higher when a stock redemption is used if

(a) surviving shareholders intend to retain the stock they own until death, and

(b) there is high appreciation in the value of the stock.

(2) Shareholders will often prefer, for both psychological and cash flow reasons, that corporate dollars be used to pay premiums.

(3) Premium payments by a corporation may be indicated when the corporation is in a lower income tax bracket than the individual shareholders.

(4) Where there are more than 3 shareholders involved, administrative inconvenience and cost generally make corporate-owned life insurance preferable over the multiplicity of policies required in a cross-purchase arrangement. For example, if there were 5 shareholders, 20 separate policies would be required. (The formula for determining the number of policies is N x (N - 1) with N being the number of shareholders.)

Other factors to consider in deciding between a cross-purchase and stock redemption include:

(1) possibility of dividend treatment because of constructive ownership (attribution) rules in family-owned corporations;

(2) state law restrictions on a corporation’s right to purchase its own stock in the absence of sufficient surplus;

(3) transfer-for-value problems at the death of a shareholder if estate-owned policies are transferred to individuals other than the insureds;

(4) stock ownership desired after the purchase occurs;

(5) premium outlay differences due to differences in age and ownership interests between shareholders; or

(6) possible alternative minimum tax problems where life insurance is used to fund a stock redemption and the corporation is not “small” and therefore not exempt from the alternative minimum tax.

**Question** – Is there a solution to the dilemma of the cross-purchase vs. stock redemption decision?

*Answer* – One technique that may avoid or minimize problems inherent in a buy-sell of either the cross-purchase or the stock redemption type is the “Wait and See” (also known as the option or hybrid) Buy-Sell approach.

Under a Wait and See type agreement, the estate of a deceased shareholder is bound to sell at an agreed-upon price or according to a predetermined formula, but the parties *wait* a specified length of time after the death of a shareholder to *see* if – and see to what extent – a cross-purchase or stock redemption or combination (perhaps even coordinated with an IRC Section 303 stock redemption) should be used.

The suggested method is for the corporation to have a first option to purchase any or all of a deceased shareholder’s interest. Surviving shareholders have a secondary option to purchase any or all stock remaining. If, at this point, some stock still remains in the executor’s hands, the corporation is *required* to purchase the entire balance.

Life insurance could be purchased by the corporation, by the surviving shareholders, or by both. (The corporation might, for example, purchase permanent life insurance while the shareholders might purchase term insurance.) If the corporation is owner and beneficiary of the insurance it can apply proceeds directly to the extent a stock redemption is indicated or make loans to the extent necessary to shareholders who will be purchasing stock on an individual basis. If life insurance is owned by and payable to shareholders on an individual basis, they could apply proceeds directly to the extent a cross-purchase is indicated or make loans or capital contributions to the corporation to enable it to effect a stock redemption.

The Wait and See approach provides an infinite variety of options and a maximum in planning flexibility.

**Question** – If a cross-purchase agreement funded with life insurance is changed to a stock redemption agreement, and the insurance that was owned by the individuals on each other is transferred to the corporation, will there be any income tax consequences as relates to the insurance?

*Answer* – No. Changing insurance from a cross-purchase agreement to a stock redemption agreement will not violate the transfer-for-value rule, because policies can be transferred from a stockholder to a corporation of which the insured is a stockholder. This will qualify as an exception to the transfer-for-value rule. Note, however, that the reverse, i.e., change from a stock redemption to a cross-purchase, will be a violation of the transfer-for-value rule if insurance is transferred from the corporation to a stockholder other than the insured.

**Question** – Can a buy-sell agreement “peg” the value of a business interest for federal gift tax purposes?

*Answer* – Although a buy-sell agreement will probably not be absolutely controlling for federal gift tax purposes, it should carry strong evidentiary weight as to the business value and will be considered along with other relevant factors. An agreement will probably be successful in establishing value if:

(1) the price (or formula) is reasonable at the time the agreement is signed;

(2) the agreement is negotiated by parties knowledgeable of relevant facts and at arm’s length;

(3) the price (or formula) agreed upon is as binding during lifetime as at death, i.e., the lifetime price permitted cannot be higher than the sale price at a shareholder’s death; and

(4) the price is fixed by the terms of the agreement or the agreement contains a formula or method for determining price.

Where family members own at least 50% of the business, additional requirements will probably apply. See discussion above – Family Business Enterprises.

**Question** – What is the advantage of using a trustee in a buy-sell agreement?

*Answer* – Potential difficulty can be avoided through use of a trustee in carrying out the terms of the agreement. Prior to death of one of the parties to the agreement there are many duties to be performed. The trustee can obtain the premiums on insurance used to fund the agreement from the appropriate parties and can pay the premiums when they become due. The trustee can also serve as custodian of the policies subject to the agreement.

After death of a party to the agreement, the trustee will receive proceeds of the insurance on the life of the deceased business owner. The trustee can then act as a disinterested middleman in paying the purchase price for the decedent’s business interest to the legal representative of the decedent’s estate and in transferring the business interest to the purchaser.

**Question** – What is the potential tax trap in using a trusteed buy-sell approach?

*Answer* – Note that although the law is not entirely clear, the use of a trustee will probably not eliminate a transfer for value problem as to life insurance acquired by the trustee. For example, assume a corporation has three equal shareholders who enter into a cross-purchase plan. A trustee is named to act under the agreement and purchases insurance on all three shareholders to fund the agreement. After the death of the first shareholder, the agreement continues for the remaining two shareholders. The authors believe that the shift of economic interests in the insurance policies on the remaining shareholders will constitute a transfer for value. This is not a problem in a partnership buy-sell. In fact, if shareholders in a buy-sell are also partners in an unrelated business, even though there is a transfer of an interest in a policy and even if there is valuable consideration, the insurance may still be income tax free at death because of the “partnership safe harbor” to the transfer for value rules, discussed below.

**Question** – Is it possible to be certain the price established in a business continuation agreement involving family members will establish the estate tax value of the interest of a deceased partner or shareholder?

*Answer* – No. Assuring that values in a family buy-sell agreement will be accepted by the IRS and the courts has become much more difficult since the adoption of IRC Section 2703. Because related persons are by definition not dealing at arm’s length in establishing the terms and price of their business continuation agreement, the price may not determine value for tax purposes unless it can be shown that the terms and price of the agreement could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm’s length.[[19]](#endnote-19) This standard, which is from the regulations, appears to be more demanding than the one Congress intended, which mandates a showing that the agreement could have been obtained in a hypothetical arm’s length agreement.[[20]](#endnote-20)

Careful planning, arms’ length bargaining between the parties, and the use of an independent professional valuation expert, however, should significantly increase the likelihood that the agreement will be persuasive with respect to the federal estate tax value. . Using a formula approach, rather than a stated dollar value, has a better chance of accomplishing this goal.

**Question** – Four shareholders in a closely held corporation want to enter into a cross purchase plan to acquire the stock of a deceased shareholder, fully funded with life insurance. You have explained to them the problems that will occur upon the death of any shareholder under the transfer for value rule if economic interests in the insurance policies on the remaining shareholders are shifted so that the agreement may remain in effect. Can you offer any solutions to this problem?

*Answer* – Other than canceling existing policies and acquiring new ones, there are at least two other techniques to deal with this problem. The first is to have all of the remaining shareholders transfer their interests in policies on the other shareholder to the corporation, and substitute a stock redemption plan for the cross purchase plan. Since they are all shareholders in the corporation, the transfer of the policies to it falls within a safe harbor exception to the transfer for value rule.

Another solution, which has been the subject of a series of private letter rulings, is to consider the establishment of a partnership among all of the shareholders. As discussed above, transfers of policies among partners is one of the safe harbor exceptions to the transfer for value rule. Frequently the shareholders are involved in other business or investment activities, such as the ownership of property leased to the corporation, which could be the basis for the formation of a partnership. One private letter ruling held that the mere ownership of the life insurance policies would be a sufficient business or investment activity to justify formation of a partnership. However, cautious practitioners should not rely on this ruling, and advise the parties that they should carry out some legitimate business or investment activity in such a partnership to assure its validity.

**Question** – Are the costs involved in a stock redemption deductible to the corporation?

*Answer* – No. Tax law prohibits a deduction for the costs involved in a stock redemption.[[21]](#endnote-21) This prohibition applies even if the purchase of the interest is necessary to save the corporation’s business life. The purchase of a corporation’s own stock is a capital transaction and no deduction is allowed for either the purchase price or the expenses associated with the purchase.

CHAPTER ENDNOTES

1. . The “Wait-and-See” Buy Sell name was coined by Stephan Leimberg and Morey S. Rosenbloom in the book by that name available from http://www.leimberg.com. [↑](#endnote-ref-1)
2. . IRC Sec. 2042; See *Newell v. Comm.*, 66 F.2d 102 (7th Cir. 1933); *Est. of Blount v. Comm.*, 2005-2 USTC ¶60,509 (11th Cir. 2005), rev’g TC Memo. 2004-116; *Huntsman v. Comm.*, 66 TC 861 (1976). [↑](#endnote-ref-2)
3. . Treas. Reg. §20.2031-2(h); *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child’s Est.*, 147 F.2d 368 (3rd Cir. 1945); *Est. of Mitchell*, 37 BTA 1 (1938). See also Rev. Rul. 59-60, 1959-1 CB 237. [↑](#endnote-ref-3)
4. . IRC Sec. 264(a)(1). [↑](#endnote-ref-4)
5. . IRC Sec. 101(a)(1). [↑](#endnote-ref-5)
6. . IRC Secs. 302(c)(1), 318. [↑](#endnote-ref-6)
7. . IRC Sec. 318(a)(3). [↑](#endnote-ref-7)
8. . IRC Secs. 318(a)(1), 318(a)(2). [↑](#endnote-ref-8)
9. . IRC Sec. 302(c)(2). [↑](#endnote-ref-9)
10. . IRC Secs. 55, 56. [↑](#endnote-ref-10)
11. . IRC Sec. 55(e). [↑](#endnote-ref-11)
12. . IRC Secs. 2042, 2033. [↑](#endnote-ref-12)
13. . See Brody and Leimberg, "Avoiding the Tax Trap of the Transfer for Value Rule," *Estate Planning*, Vol. 32, No. 10, p. 3 and Brody and Leimberg, "Using a Transactional Analysis to Avoid the Transfer for Value Rule," *Estate Planning*, Vol. 32, No. 11, p. 3. (A PDF of these articles is available by e-mailing Steve Leimberg: Steve@Leimbergservices.com). [↑](#endnote-ref-13)
14. . Rev. Rul. 83-147, 1983-2 CB 158. [↑](#endnote-ref-14)
15. . See *Est. of Infante*, TC Memo 1970-206. [↑](#endnote-ref-15)
16. . IRC Sec. 1014(b)(6). [↑](#endnote-ref-16)
17. . IR Manual §§ 25.18.1-1, 25.18.1.2.21 (02-15-2005), Community Property: Capital Gains from Separate Property. [↑](#endnote-ref-17)
18. . See Brody and Leimberg, "Avoiding the Tax Trap of the Transfer for Value Rule," *Estate Planning*, Vol. 32, No. 10, p. 3 and Brody and Leimberg, "Using a Transactional Analysis to Avoid the Transfer for Value Rule," *Estate Planning*, Vol. 32, No. 11, p. 3. [↑](#endnote-ref-18)
19. . Treas. Reg. §25.2703-1(b)(4). [↑](#endnote-ref-19)
20. . *Explanation of Revenue Provisions for Inclusion in Fiscal Year 1991 Budget Reconciliation Package as Approved by Committee 10/13/90*, Senate Finance Committee, 101st Cong., 2nd Sess., 136 Cong. Rec. S 15679, S 15683. [↑](#endnote-ref-20)
21. . IRC Sec. 162(k). [↑](#endnote-ref-21)