TED PERKINS'

BUY-SELL BASICS

AN OVERVIEW
OF THE FUNDAMENTALS OF
BUY-SELL AGREEMENTS

by

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UNIT ONE - Introduction

I. Overview.

A buy-sell agreement is a contractual agreement among the owners of a business (i.e., the shareholders of a corporation, the partners of a partnership, or the members of an limited liability company) which restricts the right to transfer the ownership interests and establishes certain purchase and sale rights and obligations upon the occurrence of certain events. The agreement will generally provide that upon the occurrence of the triggering events, such as the death of an owner, the remaining owners will either have an option or an obligation to purchase the ownership interest of the affected owner.

II. Uses of the Buy-sell Agreement.

A buy-sell agreement may serve achieve one or more of the following objectives:

1. *Restriction of Transfer* - By restricting the transfer of an ownership interest except as provided within the terms of the agreement, a buy-sell agreement can insure that owners control and restrict who is part of the ownership group.

2. *Provides Liquidity* - If the agreement provides a purchase obligation in the event of the death of an owner and that obligation is funded with life insurance, the agreement can be used to convert the deceased owner's equity interests into cash.

3. *Fixes Value* - By fixing the price which applies in the event of a purchase under the terms of the agreement, the estate tax value of the equity can be fixed in the estate of a deceased owner.

III. Issues to be Addressed.

The agreement should address the following issues:

A. *The Form of the Agreement*.

The buy-sell agreement will generally be formed in one of the following ways: (1) a "Cross Purchase" Agreement; (2) a "Redemption Agreement"; or (3) a hybrid agreement. No matter what the form of the agreement, the objectives of the agreement are the same as discussed in section II, above. The differences lie in how the purchase options and obligations are allocated between the entity and the owners. [1]

Example: A and B are the shareholders of XYZ, Inc. Each owns 50% of the issued and outstanding stock of the corporation. A and B enter into an agreement which provides that neither shareholder may sell or otherwise transfer his or her stock without first offering it to the other shareholder at a price and terms set by the agreement. In addition the agreement provide that upon the death of either shareholder the corporation will redeem the stock of the deceased

[1] The alternative forms of the agreement will be discussed in detail in Unit Two.

owner for the fair value of the stock. The corporation purchases life insurance on both A and B, in order to fund this obligation.

B. *The Nature of the Restrictions on Transfer.*

One primary purpose of a buy-sell agreement is to insure that before an existing owner can transfer his or her stock, the other owners will have the opportunity to buy that interest at a predetermined price and terms. In order to make sure that this objective is realized, the agreement should provide that any transfer not made within the terms of the agreement is null and void.

C. *Defining the Triggering Events and the Purchase Rights.*

The agreement, of course, should define the precise events that will trigger the purchase rights. Generally these would include the death or disability of an owner, the termination of an owner's employment by the entity, or the attempt to voluntarily or involuntarily transfer the ownership interest of an owner. Once the triggering event has occurred, the agreement should also provide whether the other owners, or in certain cases the entity, have an option or obligation to purchase the ownership interest of the affected owner.[2]

D. *Determination of the Purchase Price.*

The agreement should provide either the price or a method for determining the price of the ownership interest to be purchased.[3]

F. *Payment Terms and Funding Mechanisms.*

Finally the agreement should set the terms of the purchase, i.e. when the closing will take place, and how the purchase price will be paid, whether lump sum or in installments. In addition the agreement should also address the source of the payment. For purchases triggered by the death of the owner, life insurance is often purchased in order to fund the buyout. [4]

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[2] This topic will be discussed in Unit Three.
[3] The various options available in determining price will be discussed in Unit Four.
[4] Terms of the purchase are discussed in Unit Four.

UNIT TWO – The Form of the Agreement

I. Overview.

Before addressing other issues we should first discuss the various forms Buy-sell Agreements might take. The buy-sell agreement will generally be formed in one of the following ways: (1) a “Cross Purchase Agreement”; (2) a “Redemption Agreement”; or (3) a hybrid agreement. No matter what form of agreement is used, the objectives of the agreement are the same as provided in subparagraph A. above. The difference generally lies in how the purchase options and obligations are allocated between the entity and the owners

II. The Cross Purchase Agreement.

A “Cross Purchase Agreement” is an agreement solely among the owners of the entity, i.e. the shareholders, partners, or members. The entity itself is not directly involved in the purchase rights or obligations. The funding of the obligation under this type of agreement must occur at the owner level.

Example: A and B are the sole shareholders of XYZ, Inc. They entered into a Buy-sell Agreement. Under the terms of the agreement A and B agree that neither will transfer his or her stock in XYZ without first offering to the other shareholder. In the event either of them dies the survivor has agreed to purchased the deceased shareholder’s stock at an agreed upon price.

III. Redemption Agreement.

A “Redemption Agreement” is similar to a Cross Purchase Agreement with the difference being that the purchase obligations fall to the entity rather than the owners. Under a stock redemption plan, the corporation must have sufficient assets to redeem the shareholder's stock when required under the stock purchase agreement. This may be accomplished through the retention by the corporation of liquid assets or by acquiring life insurance on the lives of the various owners.

Example: Same facts as in the Example in section II, above. In the event either of A or B dies, the Corporation has the obligation to purchase the deceased shareholder’s stock.

IV. Hybrid Agreement

Under a “Hybrid Agreement” the purchase rights and obligations are shared by the entity and the owners.

Example: Same facts as in the Example in section III, above. In the event either A or B dies, the Corporation has the first option to purchase the deceased shareholder’s stock at an agreed upon price; if the corporation does not exercise its option, the surviving shareholder has the obligation to purchase the stock of the deceased shareholder.

UNIT THREE – Determining the Nature of the Restrictions on Transfer, the Triggering Events and the Purchase Rights

I. Introduction.

This Unit will discuss the general nature of the restrictions that the Agreement should place on the transfer of the ownership interests, the events that trigger purchase options or obligations, and the nature of those purchase options and obligations.

II. The Nature of the Restrictions.

By restricting the transfer of an ownership interest outside of the ownership group, a buy-sell agreement can help the owners control and restrict who is part of the ownership group. The Agreement should therefore provide a general restriction on the transferability of the ownership interests. Here is some typical language:

> **"The Shareholders, agree that they will not, except as provided in this Agreement, sell, exchange, give, bequeath, assign, mortgage, pledge, alienate, hypothecate or otherwise transfer or encumber, in any manner whatsoever, (any such disposition being hereinafter referred to as a 'Transfer') the Stock Interests in the Corporation presently held, or hereafter acquired, by them, except in accordance with the terms of this Agreement."**

The Agreement should also provide that any transfer made or attempted contrary to the terms of the Agreement is null and void. Here is some typical language:

> **"Except as specifically provided herein, any Transfer by a Shareholder of all or any portion of the Stock Interests held by him, except in the manner specified in this Agreement, shall be null and void, and the Corporation shall not recognize or give effect to such Transfer on its books and records, or recognize the person or persons to whom such Transfer has been made as the legal or beneficial holder thereof.**
>
> **In the event of an attempted Transfer by a Shareholder, of all or any portion of the Stock Interests held by him, in violation of this Agreement, the Corporation shall have the right to purchase all (but not less than all) of the Stock Interests in the Corporation held by such Shareholder at a price of One Dollar ($1.00) per share."**

III. The Triggering Events.

A. *Overview.*

The occurrence of the events that trigger the purchase options or obligations must be defined in the Agreement.

B. *Death of an Owner*.

In the event of the death of an owner, the buy-sell agreement generally will provide that the ownership interest of the deceased owner must be sold and must be purchased. Here is some typical language:

> "(1) Upon the death of a Member (the 'Deceased Member'), the Deceased Member's personal representative shall sell and transfer such Deceased Member's entire Membership Interest owned by such Member (the 'Offered Interest'), according to the procedure provided in this subparagraph."

C. *Voluntary Transfers and Involuntary Transfers*.

The Agreement should provide that an attempted "transfer" of the ownership interest triggers a purchase right in the other owners and/or the entity. The term transfer should be given a broad definition such as the following:

> "The Members agree that they will not, except as provided in this Agreement, sell, exchange, give, bequeath, assign, mortgage, pledge, alienate, hypothecate or otherwise in any manner whatsoever transfer or encumber (any such disposition being hereinafter referred to as a "transfer") the Membership Interests of the Company presently held, or hereafter acquired, by them."

1. A *"voluntary transfer"* is an attempted or proposed voluntary lifetime transfer of the ownership interest by an owner—generally by sale or gift. The following definition

> "The term 'Voluntary Lifetime Transfer' shall be defined as any Transfer made during a Member's lifetime that is not an Involuntary Lifetime Transfer."

Sometimes transfers to so-called "permitted transferees" under the agreement are made exempt from the restriction. "Permitted Transferees" may be defined to include spouses and descendants, and trusts for their benefit.

2. An *"involuntary transfer"* is generally any transfer made on account of a court order or otherwise by operation of law, including any transfer incident to any divorce or marital property settlement and also including an owner filing a voluntary petition under any federal or state bankruptcy law.

The following definition could be used:

> "The term 'Involuntary Lifetime Transfer' shall be defined as any Transfer made on account of a court order or otherwise by operation of law, including any Transfer incident to any divorce or marital property settlement or any Transfer pursuant to applicable community property, quasi-community property or similar state law, and also including a Member filing a voluntary petition under any federal or state bankruptcy, insolvency or related law or a petition for the appointment of a receiver, or making an assignment for the benefit of creditors, or being subjected involuntarily to such a petition or assignment or to an

attachment or other legal or equitable interest with respect to his Interest in the Company and such involuntary petition, assignment, or attachment is not discharged within thirty (30) days after its effective date."

D. *Disability.*

Normally a buyout based on "disability" is only appropriate if the owner is employed by the entity and the individual service contributions of the owner are vital to the business of the entity. Defining when a condition of "disability" occurs to the degree which would result in a buyout of an owner's interest is a determination to be made by each ownership group.

As a guideline there are generally three stages of disability. First, a period during which the owner is not able to work but it is foreseeable that he or she will return to work in the short term. During this period wages are usually paid in full and ownership in not affected. In the second stage the condition has been prolonged to the point that full wages are no longer considered appropriate. During this period disability income insurance could take up some of the income short fall for the disabled owner. In this second stage the ownership interest is again left unaffected. Finally, the third level of disability occurs at the point the disability is considered permanent, at which the buyout is triggered. Again defining this point is difficult. If disability income or buyout insurance is in place, reference to the definition in those policies may be appropriate. Generally the determination of the condition of "disability" should not be made by the board of directors or managing partner or member. A better alternative is to have the condition determined or confirmed by one or more physicians.

"The term 'Total Disability' shall be defined as a Member being unable due to injuries or illness to perform the substantial and material duties of his employment by the Company or the Corporation, as the case maybe, for twelve consecutive months, and unless such care is of no further benefit, such Member is also receiving care by a physician which is appropriate for the condition causing the disability."

E. *Termination of Employment.*

Another triggering event may be the termination of employment of an owner by the entity for reasons other than death or disability. This may occur because an owner/employee retires voluntarily at a certain age, is involuntarily terminated for cause, or simply quits. Whether termination of employment is even included as a triggering event in an agreement is an interesting question. The answer depends on several factors including the basis for the termination and the nature of the owner's employment by the entity. If the termination is voluntary, then whether this is a reason to trigger a buyout depends on the owner's relationship to the company. If the owner's is an integral contributor to the day-to-day operation of

the business, then termination of employment may be considered a basis for a buyout. If, on the other hand, the owner is only a passive investor, then this type of restriction might not be appropriate.

A more difficult issue involves termination based on “cause”, where an owner-employee commits some act considered detrimental to the entity. Generally, most would agree that if such an act is extreme enough, it should constitute a fair basis for both termination of employment and the triggering of the buyout provisions. The difficulty comes in defining the term “cause” is such a way that it cannot be used as a carte blanche to force a buyout of an owner’s interest at the whim of the other owners. This may be a particularly contentious issue if the purchase price is affected adversely by the circumstances of the termination.

Just as critical is the question of how to define the term is the question of who is to make the determination of whether or not the definition has been fulfilled. The definition should be specific enough that it cannot be used as an arbitrary basis for terminating employment and triggering the buyout, but broad enough to encompass the full range of activity that would justify such termination.

Here is some sample language:

> “‘Cause’ is defined as conviction of or plea of guilty to a felony or misdemeanor, dishonesty, any other criminal conduct against the XYZ, Inc., a continued breach of the owner’s duties and obligations arising under an employment contract with XYZ, Inc. or any written policy, rule, regulation of XYZ, Inc., for a period of five (5) days following his or her receipt of written notice from any officer of XYZ, Inc.”

IV. The Purchase Rights.

“Purchase rights” are rights of purchase which are created by the Agreement in the other owners and/or the entity upon the occurrence of a triggering event. Generally, depending on the form of the agreement and the event which triggers the purchase right, the other owners or the entity will have either an option to purchase the affected ownership interest or the obligation to purchase that interest. In either case the the owner of the affected interest will have the mandatory obligation to sell the interest. In some cases an “either or option” clause might be used, i.e., the first option may fall to the other owners, with the second option or obligation following to the entity.

Here’s some sample language:

> “Each other Member shall have thirty (30) days from such notice of a Voluntary or Involuntary Lifetime Transfer in which to elect to buy all or any of the Offered Interest. The other Members may elect to buy the Offered Interest in proportion to their respective Membership Interests (excluding the Offered Interest) or in such other proportion, as they shall agree upon.
>
> If the other Members do not agree to buy in the aggregate all of the remaining Offered Interest within such option period, then the Company

shall have the obligation to purchase any of the Offered Interest not purchased by the other Members.

If the other Members and/or the Company does not agree to buy in the aggregate all of the Offered Interest within such option periods, such Lifetime Transfer may be completed."

UNIT FOUR - Determination of the Purchase Price

I. Overview.

There are several methods that can be used to determine the price at which an owner's interest is to be set under a buy-sell agreement. As a general premise, the apparent objective in all circumstances may appear the same: to determine a fair value for the interest which is the subject of the purchase. However, the nature of the triggering event may suggest different approaches to the valuation and even call for different purchase prices in different circumstances. For instance, if the triggering event is the death of a founding shareholder, the objective may be to buyout that individual at a figure which represents the full realization of the value created by years of that individual's hard work. On the hand, if the sale is to that same owner's family members who are going to take over and continue the business, the price may be set at a lower level in order to achieve an estate planning objective. And if the triggering event is the termination of employment for cause, a punitive price, well below fair market value, should be considered.

This section will review three of the most commonly used methods in determining the purchase price: (1) agreed upon price, (2) price determined by formula, and (iii) price determined by appraisal.

II. Agreed Upon Price.

The price may simply be agreed upon by the parties. This method assumes that the parties have a realistic idea of what the business is actually worth. In addition, the agreement should provide that the stated price will be reviewed and agreed to on at least an annual basis by the parties. Further, if the price has not been updated within the stated time frame, the price will be determined by an alternative measure, such as by an appraisal.

III. Price Determined by Formula.

A second method sometimes employed is a price determination based on a formula, such as the capitalization of net earnings determined by a stated capitalization rate. Alternatively, the net value of the enterprise might be used to determine the price. Normally if this method is used, certain assets are valued at book value and certain other assets, such as real estate and investment property, are valued at fair market value. Sometimes the owners will have their own formula which is completely unique to their company or their industry to determine the fair market value of the business. Whatever formula is used, the buyer and the seller will both have some assurance that the price will reflect a current value of the business. In addition, the use of a formula makes it easy to track the value by simply applying the formula to current economic data and making adjustments in the levels of insurance and other funding sources, such as sinking funds.

IV. Price Determined by Appraisal.

A. *In General.*

An appraisal of the business will generally provide an accurate assessment of the value of the business. However there are a number of issues which should be addressed in the agreement with regard to the appraisal and how it should be conducted.

B. Who Chooses?

One of the questions involved in using this method is who chooses the appraiser. Obviously the side that chooses the appraiser may have significant input into the result. Sometimes the agreement will provide that the buyer and seller will each choose his or her appraiser, with provision that if the two appraisals differ by a stated percentage a third appraiser, agreeable to both parties, will be engaged to make the final determination of value.

C. Who Pays?

The agreement should provide for who will pay for the appraisal; either the entity, the owner whose interest being appraised, or the costs are to be shared by all the parties.

D. What if there is a Short Fall?

One problem involved in using an appraisal, other than the expense, is that the value of the company is generally not determined until the event triggering the buy-sell obligations is triggered. This may create a situation where the source of funding may fall short of the actual purchase price.

E. *How is Value Determined?*

1. Life Insurance – In the case of a redemption agreement, the purchase obligation triggered on the death of an owner is usually funded with life insurance owned by the entity. A question which should be addressed in the agreement is how the life insurance itself should be taken into account for purposes of the appraisal. Specifically whether the life insurance value is to be included as an asset of the entity in determining its fair market value and, if included, whether it should be valued at its book value or at the face value of the policy. Generally, since the appraisal is measuring the value of the business, both the asset value of the life insurance and the liability represented by the obligation to the redeem the deceased owners interest should be disregarded by the appraiser in valuing the entity.

2. Other Factors – In valuing the an interest in a closely held business, whether it is a corporation, partnership, or limited liability company, two other possible approaches to determining the value of an interest should be considered. Under the one method, the value of the entire entity is determined and the percentage of ownership held by the owner is then applied to that figure to reach a pro

rata share of that value. Under a second, method the appraiser simply determines an appraised value of the particular interest actually held by the owner. It may on first blush appear that the two methods would arrive at the same figure—however under the second method there are several factors that could decrease, or in some cases increase, the value over its otherwise pro rata share of the value of the entire company. If the interest represents a "minority interest" in terms of vote, discounts of anywhere from thirty to forty percent could be justified. If the interest represents a controlling interest a "control premium" might be applied. If the owner represents an essential part of the management team or if he or she adds significantly to the goodwill of the entity, a "key man" discount could apply.

UNIT FIVE – Terms of the Purchase

I. Overview.

Once a purchase right has been exercised and the purchase price determined, the next question is upon what terms the transfer of the ownership interest is to be made. The determination of the terms of the purchase should address when the closing in the ownership interest will take place, and on what terms the purchase price is to be paid.

II. Closing.

The Agreement should specify when the closing on the transfer of ownership interests should take place. Here is some typical language addressing this issue:

"4. Closing.

Except as otherwise provided herein, the closing of a purchase pursuant to this Agreement shall take place at the principal office of the Company, within sixty (60) days of the date of the final acceptance of the Offer of Purchase."

III. Payment of the Purchase Price.

A. *Overview.*

Purchase obligations under a buy-sell agreement will occur either during the lifetime of the owner or at his or her death. The available options with regard to the source of funding will depend primarily on the triggering event. In the case of death, life insurance maintained on the lives of each of the owners can be an important source of funding. In the event of disability, disability buyout insurance is available as well. However, in all other cases—voluntary and involuntary lifetime transfers and termination of employment—the buyer must depend on his or her own current ability to fund the purchase. In many cases this may place an significant burden on the purchaser. In cases when the obligation is stated in terms of an option, inability to fund the purchase may cause the potential purchaser to decline the option altogether. To avoid placing an undue burden on the purchaser, the agreement should provide for a payment of the purchase obligation in installments over an extended period of time.

B. *Life Insurance.*

1. *Overview* – In a redemption agreement, life insurance is purchased by the entity on the lives of the owners in order to fund the purchase obligation. In a cross purchase agreement, each owner will individually purchase life insurance on the lives of the other owners.

2. *Number of Policies Required* – Under a redemption agreement when the entity purchases the life insurance, the number of policies required will equal the number of owners. On the other

hand, under a cross purchase agreement when the owners purchase the insurance, the number of policies required will increase exponentially. If there are two shareholders, two policies are all that are required; however, if there are three shareholders, six policies will be needed; and if there are four shareholders, then 12 policies will be needed, and so forth. In order to deal with a large number of policies, sometimes a trustee will hold the policies together in trust, one on each owner in a face amount equal to the aggregate buyout obligation of all the owners. On death of a particular owner, the life insurance on his or her life is paid to the trustee who pays out the proceeds to each of the surviving shareholders in direct proportion to their individual purchase obligation.

3. *Premium Payments* – The payment of the life insurance premiums will not be tax deductible in any circumstances, whether paid by the entity or the individual owners.

4. *Taxation of Proceeds* – The receipt of the proceeds of the life insurance will likely tax free whether paid to the entity under a redemption agreement or the individual owners under a cross purchase agreement. There is one exception for when life insurance is paid to a C corporation—the proceeds may in certain cases create alternative minimum tax consequences. Increases in cash surrender value and certain life insurance proceeds are among the benefits added to a corporation's ordinary taxable income in order to determine its alternative minimum tax liability.

C. Disability Buyout Insurance

Disability Buyout Insurance is insurance that pays a lumps sum payment in the event the insured is determined to be "disabled." The tax treatment of this type of insurance is rather straight forward—the premiums are not deductible and the benefit is not taxed.

D. Installment Note

Absent insurance funding, an installment note issued by the purchaser is the next most common form of payment. The note should provide a long enough term so that the purchaser is not placed in a difficult cash flow position. The note should also provide for adequate security. If the note is issued by the entity, it ideally should be guaranteed by the individual owners. On the other hand, if the purchase right falls to the entity it should be guaranteed by the owners individually. At the very least, the interest being sold should serve as collateral for the obligation. Therefore, in the case of a default the interest can be reclaimed. Interest should be provided at a level at least equal to the Applicable Federal Rate.

When stock or a partnership interest is sold in exchange for an installment note, the transaction will generally qualify for installment sale treatment under the Internal Revenue Code. In the case of the sale of

partnership interests, the portion of the gain that is attributable to substantially appreciated inventory or unrealized receivables will not qualify for installment sales treatment and will be treated as ordinary income.

UNIT SIX – Setting the Purchase Terms for Each Triggering Event

I. Introduction.

The nature of the purchase right, i.e. whether an option or obligation is created, the terms of the purchase, and perhaps even the purchase price, may be determined by the event which triggers the buyout. This Unit will discuss the terms which may be appropriate in terms of the triggering event.

II. Death of an Owner.

A. *The Event.*

The death of an owner.

B. *The Purchase Rights.*

The purchase right is normally stated in terms of a mandatory obligation to sell on behalf of the estate of the deceased owner, and a mandatory obligation to purchase on behalf of the surviving shareholder in the case of a cross purchase agreement or the entity in the case of a redemption agreement.

C. *The Price.*

The determination of the purchase price in the event of the death of an owner may depend on the context in which the agreement is adopted and the identity of the individuals holding the purchase option. For instance, if the triggering event is the death of a founding shareholder, the objective may be to buyout that individual at a figure which represents the full realization of the value created by years of that individual's hard work. On the hand, if that sale is to the owner's family members who are going to take over and continue the business, the price may be set at a lower level in order to achieve an estate planning objective.[5]

D. *Terms.*

1. If the triggering event is the death of an owner, the funding of the purchase obligation generally involves life insurance on the life of the owners.

> Example: Again consider, A and B are the sole shareholders of XYZ, Inc. In the event either of them dies the survivor has agreed to purchased the deceased shareholder's stock at an agreed upon price of $100,000. In order to fund the purchase obligation A has taken out an insurance policy on B life on the face amount of $100,000.

2. If life insurance funding is being maintained, the payment terms should require that an amount equal to the life insurance proceeds should be paid at the time of the closing of the

[5] See Section III in Unit II, for a further discussion of this issue.

transfer. If the purchase price exceeds that amount, the excess should be paid in the form of the purchaser's installment note over a stated period of time; e.g. in sixty equal monthly installments.

III. Voluntary Transfers and Involuntary Transfers

A. *The Event*.

The "voluntary transfer" or "involuntary transfer" of an ownership interest by an owner. [6]

B. *The Purchase Rights*.

A voluntary or involuntary transfer will generally result in an option to purchase by the other owners or the entity rather than an obligation. Sometimes an "either or option" clause might be used, i.e. the first option may fall to the other owners, with the second option following to the entity. Here's some sample language:

> *"Each other Member shall have thirty (30) days from such notice of a Voluntary or Involuntary Lifetime Transfer in which to elect to buy all or any of the Offered Interest. The other Members may elect to buy the Offered Interest in proportion to their respective Membership Interests (excluding the Offered Interest) or in such other proportion, as they shall agree upon.*
>
> *If the other Members do not agree to buy in the aggregate all of the remaining Offered Interest within such option period, then the Company shall have an additional thirty (30) days in which it may elect to buy any of the Offered Interest not purchased by the other Members.*
>
> *If the other Members and/or the Company does not agree to buy in the aggregate all of the Offered Interest within such option periods, such Lifetime Transfer may be completed."*

C. *Purchase Price*.

The purchase price should be based on the actual fair market value of the interest being transferred. Whether the figure is discounted may depend on how the parties view the circumstances which trigger the buyout. An attempt to voluntarily transfer an interest may be viewed as an attempt to abandon the enterprise and should not be rewarded with a full value cash out. In addition the owners who choose to carry on with their involvement may not want to be put in a position of choosing between buying out the owner or accepting an unknown third party as a business partner. On the other hand others, may feel that if they choose to sell their interest they should not be forced to accept less than full value for the interest.

D. *Terms.*

The form of payment should be in the form of the purchaser's installment note over a period long

[6] See section III.C in Unit Three for a discussion of the definition of these terms.

enough that the purchaser is not placed in a difficult cash flow position.

IV. Disability

A. *The Event.*

The "disability" of an owner.[7]

B. *The Purchase Rights*.

Whether the other owners or the entity should be obligated to purchase the ownership interest of the disabled owner is an individual choice. Sometimes the remaining owners are given an option with the entity given an obligation to the extent the other owners do not elect to pick up the option. Here is some sample language:

> *"If the other Members do not agree to buy in the aggregate all of the remaining Offered Interest within such option period, then the Company shall have the obligation to buy any of the Offered Interest not purchased by the other Members."*

C. *Purchase Price and Terms*

The purchase price should equal the actual fair market value of the interest being transferred and should be paid in the form of the purchaser's installment note over a period of stated time period.

V. Termination of Employment.

A. *The Event.*

The termination of an owner's employment by the entity.[8]

B. *Price.*

The price should be determined by the circumstances which result in the termination. In the case of termination of employment, other than retirement, the purchase right is generally stated in terms of an option. In the case of retirement the entity and/or the other owners should have an obligation to purchase the interest of the retiring owner.

If the termination occurs because of retirement based on an anticipated voluntary retirement, the price should equal full fair value. Unless the payment has been prefunded in some fashion the price should be paid over term of years so that an unfair cash flow burden is not placed on the entity or the other owners.

If the termination occurs because of termination based on "cause," the price is often at something significantly less than full fair value. Often in the case of voluntary and involuntary termination not for cause, the purchase price will be less than full value. If such termination occurs within a stated period, such as five

[7] See section III.D in Unit Three for a discussion of the definition of this term.
[8] See section III.E in Unit Three for a discussion of the definition of this term.

years from the date the ownership interest was acquired, the price may be limited to the amount invested by the owner in the ownership interest.

C. *Terms.*

The form of payment should be in the form of the purchaser's installment note over a period long enough that the purchaser is not placed in a difficult cash flow position.

UNIT SEVEN – Tax Consequences

I. Overview.

This Unit will discuss the tax consequences of the transfer of ownership interests to both the seller and the purchaser under the various forms of buy-sell arrangements.

II. Income Tax Consequences

A. *Tax Consequences of a Redemption Plan.*

1. *By a C Corporation.*

a. *To the Corporation* – Unless the C Corporation distributes appreciated property in exchange for its stock, the corporation will experience no gain or loss as the result of the redemption of stock.

b. *To the Shareholder* – Generally the transfer of stock by a shareholder in exchange for a corporate distribution in redemption of the stock will result in the treatment of the transfer as a dividend to the extent of the shareholder's allocable share of the corporation's earning and profits. To the extent the distribution exceeds such share, the excess will be treated as a return of basis to the extent that it does not exceed the shareholder's basis in his or her stock, and then treated as a capital gain to the extent of the excess. However, a redemption can be treated as an "exchange" if it is: (1) "not essentially equivalent to a dividend"; (2) a "substantially disproportionate" redemption of stock; (3) a "complete termination" of the shareholder's interest; or (4) a partial liquidation distribution.

2. *By an S Corporation*

a. *To the Corporation* – Like a C Corporation, unless the S Corporation distributes appreciated property in exchange for its stock, the corporation will experience no gain or loss as the result of the redemption.

b. *To the Shareholder* – Since the corporate earnings are taxed to the shareholders as earned, whether or not they are distributed, a redemption of S corporation stock will generally be treated as a sale or exchange of the shareholder stock.

3. *By a Partnership*

a. *To the Partnership* – A partnership generally does not recognize gain or loss on a distribution of property in redemption of a partner's interest in the partnership.

b. *To the Partner* – The tax consequences to the selling partner are dictated under Sec. 736 of the Code and the form of the agreement. Under 736 payments are either Sec. 736(b) payments or Sec. 736 (a) payments. Sec. 736(b) payments are treated as liquidating distributions. They fall into two categories the part attributable to appreciated inventory is treated as distributed to the shareholder and resold to the partnership – producing ordinary income. The balance is treated as made in exchange for the partnership interest – producing capital gain to the extent the cash received (including reduction of the partner's share of debt) exceeds basis.

The remaining payments are deemed to have been paid for unrealized receivable and goodwill. If the payments are in fixed amount they are deemed to be guaranteed payments (ordinary income to the partner, and deductible by the partnership). If they are not fixed in amount they are deemed to be a distribution of partnership profit – taxable to the redeemed partner, and also reducing the profits taxed to the remaining partner. The IRS will generally recognize an allocation between Sec. 736(b), and Sec. 736(a), distribution if agreed at arms length between the partners.

c. *To the Purchasing Partner* – The purchasing partner takes a cost basis in the acquired interest equal to the purchase price. Under Sec. 754 of the Code, the partnership may elect to adjust the basis of its assets with respect to the buying partner.

B. *Tax Consequences of a Cross Purchase Plan*

1. *Involving a C or S Corporation.*

a. *To the Corporation* – The corporation will not experience any gain or loss on the sale of its stock pursuant to a cross purchase obligation.

b. *To the Shareholder* – A shareholder that sells its stock to another shareholder pursuant to a cross purchase agreement will realize capital gain to the extent the purchase price exceeds the stockholders basis in the stock sold. If the sale is made by the estate of a deceased shareholder, the basis of the estate will be stepped up to fair market value at the date of death.

2. *Involving a Partnership*

a. *To the Partnership* – The partnership will not experience any gain or loss on the sale a partnership interest pursuant to a cross purchase obligation. The sale of more than 50 percent of the partnership interests within any twelve-month period will

cause the constructive termination of the partnership however. Normally this constructive termination will be without tax effect.

b. *To the Selling Partner* – A partner who sells his or her partnership interest to another partner pursuant to a cross purchase agreement will realize gain to the extent the purchase price exceeds the partner's income tax basis in the interest sold. To the extent of the partner's share of the partnership's share of substantially appreciated inventory and unrealized receivables, the gain will be considered ordinary rather than a capital gain. The purchasing partners will be allowed to obtain a step up in basis in both his or her "outside" basis in its partnership interest and his or her share of "inside" basis, the basis in the assets of the partnership.

c. *To the Purchasing Partner* – The purchasing partner takes a cost basis in the acquired interest equal to the purchase price. Under Sec. 754 of the Code the, partnership may elect to adjust the basis of its assets with respect to the buying partner.

C. *Life Insurance Funding*.

1. *Premium Payments* – The payment of the life insurance premiums will not be tax deductible in any circumstances, regardless of whether paid by the entity or the individual owners.

2. *Taxation of Proceeds* – The receipt of proceeds of the life insurance should be tax free whether paid to the entity under a redemption agreement or to the individual owners under a cross purchase agreement. One exception is when life insurance proceeds are paid to a C corporation—the proceeds may in certain cases create alternative minimum tax consequences. Increases in cash surrender value and certain life insurance proceeds are among the benefits added to a corporation's ordinary taxable income in order to determine its alternative minimum tax liability.

D. *Disability Insurance.*

The tax treatment of this type of insurance is rather straight forward—the premiums are not deductible and the benefit is not taxed.

III. Estate Tax Consequences.

A. *Fixing the Value for Estate Planning Purposes.*

As a general rule, if the owner dies owning an ownership interest in a closely held business, the value of that interest for federal estate tax purposes will be its "fair market value". That value will be determined based on a number of factors. However, if a buy-sell agreement is in place, the value provided

in the agreement may fix the value of the business interest for estate tax purposes. Generally in order for the agreement price to be determinative for estate tax purposes the following requirements must be met: (1) the decedent's estate must be obligated to sell, (2) the agreement must prohibit the owner during life from disposing of the interest stock without first offering it to the prospective purchaser at the contract price (i.e. a right of first refusal), and (3) the purchase price at death must have been established through an arm's length business bargain (and not as a device to pass the decedent's shares to the natural objects of his or her bounty for less than an adequate and full consideration in money or money's worth).

B. *IRC Sec. 2703.*

Under §2703, despite meeting the requirements stated above, any agreement may be disregarded for valuation purposes, unless the agreement: (1) is a bona fide business arrangement; (2) is not a device for transferring property to members of the transferor's family for less than full and adequate consideration; and (3) has terms that are comparable to similar arrangements entered into by persons in an arms' length transaction. See §2703(b); Regs. §25.2703-1(a), (b). These requirements are deemed satisfied if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. Regs. §25.2703-1(b)(3).

UNIT EIGHT – Miscellaneous Issues

I. Overview.

This Unit will discuss some of the collateral issues which should be addressed in the Buy-sell Agreement.

II. Legend.

In order to put potential purchasers on notice of the restrictions provided in the agreement, the following should be required:

> "8. Endorsement of Membership Certificates. Each certificate representing Membership Interests of the Company now or hereafter acquired by the Members shall be imprinted with a legend in substantially the following form:
>
> "The transfer or encumbrance of the Membership Interests represented by the within certificate is restricted under the terms of the Buy-sell Agreement dated the _____ day of ___________________, 2011, and any amendments thereto, a copy of which is on file at the office of the Company."

III. Disposition of Insurance Policies.

In a cross purchase agreement the document should provide that upon the buyout of an owner, the insurance owned by that owner on the lives of the other owners can be purchased by the insured or perhaps the other owners.

IV. Resignation as Officers and Directors.

In the event an owner's interest is purchased under the terms of a Buy-sell Agreement, the former owner should resign as an officer and member of the Board of Directors. Here is some typical language:

> "6. Resignation as Director and Officer. If a party to this Agreement ceases to be a Member, such party hereby resigns as a director and as an officer of the Company, effective as of the Closing Date, as defined above, or such earlier date if so provided in the Operating Agreement of the Company."

V. Covenant Not to Compete.

The agreement should provide that an owner whose interest is purchased is bound by a covenant not to compete with the entity for a reasonable time period after the sale.

VI. Preserving the S Election

The agreement should contain a provision that binds the owners to do nothing which will endanger the S Election.

VII. Conflicts of Interest

In drafting a buy-sell agreement, the attorney should recognize that there may be an inherent

conflict of interest. The parties should be asked to acknowledge and waive the conflict.

VIII. Spouses Signature

The same types of restrictions that can be used to restrict other transfers, including other involuntary transfers, can be applied to restrict transfers pursuant to a divorce or a division of community property. However, restrictions contained in a separate buy-sell agreement (as opposed to those contained in a corporate charter or bylaws or in a partnership or LLC agreement) may not apply to a spouse who never saw or approved of the agreement. Such a spouse was not party to the agreement and neither gave nor received consideration for participation in it. Therefore, it is useful for each party's spouse to sign a buy-sell agreement, acknowledging that he or she has read it and agrees to be bound by it. A spouse's signature on the agreement does not make the spouse a party to the agreement, but it will raise serious equitable arguments against the spouse's potential contention that the agreement should not apply to him or her.