Buy-Sell Agreements – Part One

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Overview

In today's post, I look at the various types of buy-sell agreements, common triggering events and how they are funded. In a later post, I will examine the impact of a buy-sell agreement on corporate valuation and discuss a recent federal appellate court decision that has opened the potential that a buy-sell agreement, if not adhered to during life, could result in enhanced estate value at death.

Buy-sell agreements – Part one of a two-part series. It's the topic of today's post.

Buy-Sell Agreements in General

A buy-sell agreement is a frequently used mechanism by a closely-held farming or ranching business (as well as many non-farm businesses) to integrate the needs and capabilities of the business with the succession planning/transition objectives of the owners. A well-drafted buy sell agreement can be a very useful document to assist in the transitioning of a family business from one generation to the next. It can also be a useful device for assisting in balancing out inheritances among heirs by making sure the heirs interested in running the family business end up with control of the business and other heirs end up with non-control interests. In addition, utilized properly, a buy-sell agreement may also provide estate tax valuation discounts.

A buy-sell agreement is typically a separate document, although some (or all) of its provisions may be incorporated in its bylaws, the partnership agreement, the LLC operating agreement and, on occasion, in an employment agreement with owner-employees. For many small businesses, a well-drafted buy-sell agreement is perhaps just as important as a will or trust. It can be the key to passing on the business to the next generation successfully.

Types of Agreements

There are two basic types of buy-sell agreements – a cross-purchase agreement or a redemption agreement.

Redemption. A redemption agreement is also known as an "entity purchase" agreement. It is a contract between the owners of the business and the business whereby each owner agrees to sell his interest to the business upon the occurrence of certain events. For redemption agreements, if I.R.C. §§302(b)-303 are not satisfied, the redemption is taxed as a dividend distribution (ordinary income without recovery of basis) to the extent of the stockholder's allocable portion of current and accumulated earnings and profits, without regard to the stockholder's basis in his shares. This can be a

significant problem for post-mortem redemptions - the estate of a deceased shareholder would normally receive a basis in the shares equal to their value on the date of death or the alternate valuation date. Thus, dividend treatment can result in the recognition of the entire purchase price as ordinary income to a redeemed estate, whereas sale or exchange treatment results in recognition of no taxable gain whatsoever.

Cross-purchase. This type of agreement is a contract between or among the owners (the business is not necessarily a party to the agreement) whereby each owner agrees to sell his shares to the other owners on the occurrence of specified events. With a cross-purchase agreements, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets. *I.R.C. §1221.* For the estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value. *I.R.C. §§1014; 2032.* The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are paid for with tax-free life insurance proceeds.

Other types. Sometimes a "hybrid agreement" is utilized. This type of agreement is a contract between the business and the owners whereby the owners agree to offer their shares first to the corporation and then to the other owners on the occurrence of certain events. Under a "wait and see" type of buy-sell agreement, the identity of the purchaser is not disclosed until the actual time of purchase as triggered in the agreement. The corporation will have first shot at purchasing shares, then the remaining shareholders, then the corporation may be obligated to buy any remaining shares.

Note: If an S election is in place, the corporate income is taxed to the shareholders and can be withdrawn from the corporation to fund a cross-purchase agreement without triggering additional tax. If the triggering event is something other than death, a cross-purchase agreement is required to achieve an increased cost basis to the purchasing shareholder(s). A hybrid agreement requires the corporation to redeem only as much stock as will qualify for sale or exchange treatment under I.R.C. §303, and then requires the other shareholders to buy the balance of the available stock. This permits the corporation to finance part of the purchase price, to the extent required to pay estate taxes and expenses and assures sale or exchange treatment on the entire transaction*. I.R.C. §303(b)(3).*

A buy-sell agreement that imposes employment-related restrictions may create ordinary compensation income (without recovery of basis). *I.R.C. §83.* However, an agreement containing transfer restrictions that are sufficient to render the stock substantially non-vested (substantial risk of forfeiture) may prevent the current recognition of ordinary income.

Triggering Events

Common events that trigger the buy-sell agreement are death, disability, divorce, bankruptcy, termination of employment, resignation, or retirement. Upon the occurrence of a trigger event, the purpose of the buy-sell agreement is to, among other things, prevent a departing shareholder from creating conflict over future policies of the business, eliminate the potential for the departed shareholder (or a surviving spouse) to benefit from the future success of the business and selling shares to "undesirable" parties to facilitate an inter-family transition of the business.

Regardless of the event that triggers the buy-sell agreement, the departing shareholder (if the agreement is drafted properly) has certainty that his shares have a ready market. This is important to shareholders in a closely-held farming (or other) business. The issue (discussed in Part Two) is the valuation of the selling shareholder's (or estate's) shares. Nevertheless, a buy-sell agreement can effectively provide a market for the ownership interests, limit transferability of those interests outside the immediate family and establish a procedure for buying a deceased owner's interests which, in turn, can aid in establishing certainty as to the value of the shares for federal estate tax purposes.

Conclusion

Part Two in this series will discuss valuation issues with a buy-sell agreement in the context of a small, closely-held business, focusing on the impact on corporate value when corporate-owned life insurance is used to buy out a deceased (or departing) shareholder.

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