Buy-Sell Agreements

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1

Issues for Consideration

- **Buys-Sell Agreements are Shareholder Agreements**
- Ownership criteria
- Voting rights
- Under what circumstances can/should stock be bought or sold?
- Time horizon for payout
- Role of Successors in Interest
- Avoid surprise business partner

2

Issues for Consideration

- When and to whom may ownership be transferred?
- When must ownership be transferred?
  - Death
  - Disability
  - Bankruptcy
  - Retirement
  - Termination of Employment

3

Issues for Consideration

- Which party may compel the sale/purchase?
  - Company
  - Other shareholders
  - Estate
- How to value the purchased interest?
  - Agreement
  - Appraisal
  - Formula
  - Book value
  - Earnings

4

Types of Buy-Sell Agreements

- There are generally three types of buy-sell agreements:
- Redemption agreements under which the company buys the owner's interest;
- Cross-purchase agreements under which other owners buy the sellers interest; and
- Hybrid agreements that are some combination of redemption and cross-purchase.

5

Cross-Purchase v. Redemption

- The company buys the shares in a redemption arrangement. The surviving shareholders do so in a cross-purchase arrangement.
- In a cross-purchase arrangement the surviving shareholders will obtain a cost basis in the shares purchased from the decedent's estate.
- In a redemption arrangement, the individual surviving shareholders do not obtain any additional basis in their existing shares.

6

Triggering Events

7

Primary Planning Considerations

- Triggering Events
- Valuation
- Payment Terms

8

What is a triggering event?

- As the name implies, a triggering event is an event that creates an option or obligation to sell business interests.
- Upon the occurrence of a triggering event with respect to an owner, a Buy-Sell Agreement protects that owner, the other owners of the business, and/or the business itself, by ensuring ownership remains held on terms collectively agreed upon by the owners.
- Discussed in later slides, triggering events include voluntary transfers made during lifetime, involuntary transfers, and testamentary transfers. In addition, transfers can be defined to include encumbering business interests, cessation of employment, or other events.

9

Faultless vs. With Cause

- Faultless triggering events may include death, disability, and retirement.
- For cause triggering events may include bankruptcy or other creditors rights, competing with the business, termination of employment, walk out, and attempted transfer of the owner's interest.
- Faultless triggering events, particularly death, disability, and retirement, are inevitable and should be addressed.
- Discussion of for cause triggering events may cause discomfort, but should be discussed and planned for in crafting Buy-Sell Agreements.

10

Common Triggering Events

- Death
- Disability
- Retirement
- Voluntary and/or involuntary transfers (including encumbrances, divorces, etc.)
- Termination of employment, with or without cause
- Deadlock or similar events
- Tag-along Option
- Drag-along Option

11

Responses to a Triggering Event

- Depending on the triggering event, the Buy-Sell Agreement may have different responses or right/obligations created. Examples include:
  - Mandatory purchase/sale
  - Call option – right to require sale, but no obligation to purchase
  - Put option – right to require purchase, but no obligation to sell
  - Right of first Refusal
- Which response to a particular triggering event will largely depend on the nature of the trigger – for example, death is often a mandatory purchase/sale whereas walk-out may trigger a call option.
- These purchase and sale obligations or options may be tiered where, for example, the business entity has an option which, if not elected, the other owners are required to purchase. This is often done for tax flexibility at the time of the triggering event.

12

Transfer Restrictions

- Buy-Sell Agreements are often used to ensure that ownership of the business remains within the hands of those who have agreed to be business partners.
- Transfer restrictions help ensure the business remains owned by those who agree to be in business together.
- Transfers may be voluntary (gifts, sales, etc.) or involuntary (encumbrances, divorce, creditors' rights, etc.). In either event, a Buy-Sell Agreement should consider how those triggering events are handled.

13

Death

- A Buy-Sell Agreement typically should stipulate how business interests are transferred upon the death of an owner.
- Death may be a mandatory triggering event or create put/call options, depending on the circumstances and/or beneficiaries of the owner's estate.
- In active businesses, remaining owners typically do not intend to be business partners with the deceased owner's family. Likewise, that family may benefit more from cash than business interests.
- In passive businesses, it is perhaps less important to require purchase/sale at death.
- Often funded with life insurance.

14

Disability

- Disability of an owner is often overlooked or given insufficient consideration in buy-sell planning.
- Depending on the nature of the business and the nature of the disability, a disability can effectively be same as an owner's death or, alternatively, a non-event.
- In many cases, the disabled owner, unable to work, could lack a much-needed income stream, and the remaining owners, now growing the company without the disabled owner, would have to share appreciation with a non-contributing owner.

15

Special Issues Regarding Disability

- Unlike death, determination of disability is often subjective, and the Buy-Sell Agreement must expressly state who must make this subjective determination, whether that be a physician, the insurance company, or the other members of the company, and on what grounds (for example, unable to work full time for X months in a Y month period).
- Rights to compel medical exams and access to private health care information should be addressed.
- Disability buy-out insurance is costly and typically will only partially fund the buy-out.

16

Termination of Employment

- The Buy-Sell Agreement may deal with termination of employment of an owner-employee.
- Termination of employment, when due to death, disability, or retirement may be treated under those specific terms.
- What about the owner who is fired under the terms of a service agreement, voluntarily resigns pre-retirement, loses his or her license, etc.
- A Buy-Sell Agreement often should consider these triggering events and the proper handling of what rights/obligations are created along with valuation and payment terms.

17

Retirement

- A Buy-Sell Agreement contemplating retirement benefits both the retiring and remaining owners of the business in many ways similar to a disability trigger.
- Defining retirement is significant since it may be an important distinction between an unintended walk-out which may trigger different rights/obligations including valuation and payment terms.
- As with death, retirement may be something that is an important triggering events, such as particularly in an active business. However, it may not be as important in passive enterprises.
- Depending on the circumstances, retirement may create a mandatory purchase/sale or options to require a purchase or sale.

18

Tag-along

- A tag-along is a trigger whereby the minority owners can require the majority of the business owners to allow them to “tag-along” on a sale of interests typically on the same terms as the majority owners.
- Sometimes referred to as a co-sale right.
- This can protect minority business owners from being forced into business partnerships with new owners, particularly new owners who will control a majority of the voting interests in the business.
- Excluding such provision from the Buy-Sell Agreement leaves the minority owners vulnerable to a new majority owner who may have a different vision or direction for the business.

19

Drag-along

- A drag-along is the opposite side to the tag-along option.
- A drag-along provision will prove helpful when a third party offers to purchase the business on terms the majority owner deems favorable, but minority owners do not wish to sell their interest.
- In this instance, an exercise of a drag-along provision will force the minority owners to sell on the same terms as the majority owner.
- Important because buyers often will not buy fractional interests, even a majority interest, in the business.
- This protects the majority owners from being held hostage by minority owners.

20

Valuation

21

Specifying Value

- When executing a Buy-Sell Agreement, it is important the owners specify the appropriate standard of value at which the company and/or its owners may purchase interests upon the occurrence of a triggering event.
- These include fair market value, fair value, intrinsic value, enterprise value, and investment value. Each of these standards result in quite different valuations.
- Generally, the goal of the Buy-Sell Agreement should be to establish purchase price based on fair market value.

22

Important Valuation Considerations

- Certainty – Does the valuation method provide the parties with certainty as to how valuation will be determined rather than leave open questions which may be subject to dispute?
- Ascertainable – Does the valuation method provide a way to obtain an ascertainable result? For example, if using a formula valuation that relies on variables that are not maintained by the business, the valuation may not be ascertainable using the intended method.
- Reasonable – Courts may refuse to enforce wholly unreasonable valuation methods. As such, it may be important to codify a valuation method that results in a reasonable outcome.

23

Typical Valuation Methods

- Fixed dollar value
- Formula (earnings based, for example)
- Book or net asset value
- Appraisal
- Mixed approaches (such as fixed dollar value backstopped by appraisal)
- Minimum/Maximum Valuation (such as minimum value equal to life insurance funding agreement)
- May use different methods or have different variables depending on the relevant triggering event.

24

Premiums and Discounts

- Owners should also be conscience of what valuation discounts and premiums will apply.
- An interest in the business representing financial control will garner a premium, and an interest constituting strategic control even more so.
- Conversely, a minority interest in the company should be discounted, and if the business interest is not readily marketable, it will be further discounted.
- The Buy-Sell Agreement should consider whether premiums or discounts will apply to value.

25

Statement of Agreed Value

- One method of establishing the purchase price in a Buy-Sell Agreement is by the owners agreeing to a fixed value which may be updated on a periodic basis (every 2 years, for example).
- This approach is problematic for several reasons. Most business owners do not know how much their business is actually worth, and as the company grows and increases in value, oftentimes owners forget to update the agreed-upon fixed value.
- If this method is used in any capacity, the Buy-Sell Agreement may contain language requiring a different valuation method if this agreed value is not periodically updated or if one of the parties requires due to unreasonable valuation result.

26

Formula

- Using formulas, such as multiples of revenue, EBITDA, or book value, are easily manipulable and rarely arrive at a reliable valuation
- There have even been cases of courts upholding valuations of zero or negative value arrived at using certain formulas. Situations like this are disastrous to at least one of the parties of the agreement.
- To avoid these situations, avoid providing for specified formulas in the Buy-Sell Agreement. Instead, a third-party appraiser should be obtained to provide an unbiased valuation, and ideally, the Buy-Sell Agreement will provide for the name of the third-party appraiser.

27

Appraisal

- Providing for a third-party appraiser in the Buy-Sell Agreement is often the best way to value the business.
- Consideration should be given to who prepares the appraisal, whether any particular methodologies must be used, and how the costs of appraisal will be borne.
- If there are disagreements about selection of the appraiser or the results of the valuation, dispute resolution provisions should typically be included.
- In performing valuation, the agreement may need to address whether premiums/discounts will be applied, whether life insurance funding the buy-sell will affect value, whether the loss of a valuable business partner should be a factor, etc.

28

Common Appraisal Methods

- Market Approach: Use of recent mergers and acquisitions of comparable companies to derive baseline multiples to use for valuation. These multiples are then adjusted based on comparisons between similar company and the subject business.
- Income Approach:
  - Capitalization of Earnings: Used for established businesses, the earnings capacity of the company is divided by the difference between the cost of capital and the long-term growth rate
  - Discounted Cash Flow: Values the business based on the present value of projected earnings
- Asset Approach: Bases valuation on the business' assets. Best used when the business's value is inseparably tied to the business's assets.

29

Life Insurance

- It is important that the Buy-Sell Agreement expressly state whether company owned life insurance designated for buyout will be included in the valuation of the company.
- Life insurance can be treated two different ways: as an off-balance sheet item or as a corporate asset included on the balance sheet. Each result in very different valuations of the company.
- Also, the Buy-Sell Agreement should consider whether any excess life insurance proceeds (those above the valuation determined under the agreement) are retained by the business or, alternatively, payable as additional purchase price.
- Ownership of life insurance and payment of premium must be considered when using life insurance in funding.

30

Funding The

Buy-Sell

31

- Funding for Buy-Sell Agreements is typically planned for from a cash reserve, life insurance, borrowing the money from a third party, a promissory note, or some combination of those options.
- Each strategy has its pros and cons.

32

- A cash reserve is simple, straight forward and easy to track. As a practical matter it may be difficult to rely on as other needs of the business arise in operations. There is also a concern about the accumulated earnings tax in some cases.

33

- If accumulated earnings tax is not an issue then a “Rabbi Trust” type structure could be advantageous.

- Protects buy-sell funds from management misuse, but must remain subject to general creditor claims.

34

- Life insurance is often a popular solution for funding buy-sell obligations. The death benefit proceeds are typically income tax free and are available when needed in the case of an owner's death (or may accumulate sufficient cash value to fund a buyout while the insured is alive).

35

- Company is worth $4M
- A owns 75% of the company
- A's estate would want to be bought out for $3M (75% of $4M)
- Company then buys a $3M policy insuring A's life, so it could buy A's interest when A dies (if able to keep policy until then)

36

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- On A's death, however, the company is worth $7M ($4M normal value + $3M life insurance)
- Should the Company have to pay 75% of $7M for A's interest, because of this life insurance?
- Higher price certainly would not honor the parties' intent

37

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- If A's estate gets $3M instead of 75% of $7M, does that mean that A has bequeathed the difference to the company's other owners?
- Imposing estate tax on A's estate for money that the estate will never receive is certainly an unfair result

38

- On the other hand, if the company's other owner was A's son or some other natural object of A's bounty, then perhaps A's goal was essentially to bequeath the difference to that other owner

- In the latter case, A's estate should pay estate tax on the difference and – depending on A's intent – perhaps recover the extra estate tax from that other owner

39

Buy-Sell Planning

For S-Corporations

40

- Providing for the possibility of a trust owning S corporation stock after the death of a grantor who owns, directly or through a revocable or otherwise grantor trust, is an important pre-mortem planning tool. Example Trust Language:

Miscellaneous Governing Provision

Sub-chapter S Stock. Any trust created under this trust that is funded in whole or in part with stock of an S corporation, as defined in §1361(1) of the Code, is intended to qualify as either a "Qualified Sub-chapter S Trust," as in §1361(d) of the Code, or as an "Electing Small Business Trust" as defined in §1361(e) of the Code. Such trust is to be administered in such a manner as to qualify as an eligible shareholder of an S corporation under the provisions of §1361 of the Code. Grantor requests that the beneficiary of such trust, with the assistance of the Trustee, make the necessary election to treat such trust as an eligible shareholder of the S corporation; provided, however, that in no event will this request be construed as a condition upon, or prevent the absolute vesting of, the beneficiary's interest in such trust upon Grantor's death.

41

Trustee Powers Provision

Sub-chapter S Stock Election. To make any election under §1361 of the Code to enable an existing S corporation to maintain the status of an S corporation by holding S corporation stock in an eligible trust. Specifically, the Trustee is authorized to make the Electing Small Business Trust election under §1361(d)(3) of the Code. The Trustee may also assist the beneficiaries of any trust created by this Trust in making an election under §1361(d)(2) of the Code to qualify the trust as a "Qualified Sub-chapter S Trust" as defined by the Code.

42

- The articles, bylaws and Shareholder Agreement/Buy-Sell of the corporation should contain all the applicable restrictions necessary to qualify as an S corporation, specifically a limitation on the number and type of shareholders allowed, that only a single class of stock (as defined) is permitted to be issued and that shares may not be transferred to impermissible shareholders who would cause revocation of the S election.

43

- The shareholders of the corporation may also find it beneficial to enter into an agreement to preserve S status. This type of agreement is a contract under which the shareholders agree to certain restrictions on the transfer of shares in the corporation and that transfers in violation of the agreement are null and void.

44

- Sample language from an Agreement to Preserve S Status:

SECTION 1. RESTRICTION ON TRANSFER

1.1 Except as expressly provided for in this Agreement and in accordance with its terms and conditions, no Shareholder shall sell, transfer, assign, give, bequeath, devise, donate, exchange, pledge, hypothecate, encumber, distribute, or otherwise dispose of, either voluntarily or by operation of law, any of such Shareholder's shares of common stock in the Corporation or any rights or interests therein, whether now owned or hereafter acquired, without the prior written consent of both the Corporation and the other Shareholders. Any transfer in violation of the terms of this Agreement shall be null and void and without any force or effect. Any shares transferred by a Shareholder shall remain subject to the same restrictions which were applicable to such shares while they were held by such Shareholder.

1.2 The Corporation shall not, except in respect to transfers made in accordance with the terms and conditions of this Agreement, cause or permit the transfer of any shares of its common stock to be made on its books.

45

SECTION 2. VIOLATIONS

2.1 A transfer in violation of Section 1 will be null and void, and the Corporation will not be obligated to recognize the transfer of any shares of its stock in violation of Section 1.

2.2 Each Shareholder acknowledges that it would be difficult to measure damage to the Shareholders that could result from any breach of Section 1 by any Shareholder, and each shareholder acknowledges that monetary damages would be an inadequate remedy for any such breach. Accordingly, in addition to all other available remedies at law or in equity, each Shareholder will be entitled to an injunction or other appropriate order or orders to restrain or remedy any breach of Section 1 without showing or proving actual damage.

46

- Life insurance to fund a redemption agreement may be effective for a cash method taxpayer S corporation. The company issues a promissory note to the deceased shareholder's estate for the purchase price immediately after the shareholder's death. The shares are redeemed, the company closes the books on the current tax year and begins a new stub tax year. When the insurance proceeds are received from the carrier they increase the basis of the remaining shareholders even though the funds are received income tax free. IRC 1367(a)(1)(A).

47

- This strategy does not work for accrual basis taxpayer S corporations. PLR 200409010. The IRS rationale is that if the validity of the policy is not in question and the policy is outside the two year contestability period all acts subsequent to the death of the insured are ministerial in nature and the proceeds accrue at the time of death. As a result the accrual would result in a pro-rata amount of increased basis being attributable to the deceased shareholder's shares, not to the surviving shareholders.

48

Tax Considerations

49

IRC § 2703 and Estate Tax Value

- § 2703 was enacted to discourage taxpayers from depressing the value of business interests for transfer tax purposes by intentionally suppressing values in the Buy-Sell Agreement.
- If a Buy-Sell Agreement provides for the sale of interests at less than fair market value, and the §2703(b) exception does not apply, parties to the agreement will be left with a higher value for estate tax purposes than for transfer purposes.
- This means that the estate of the decedent could pay much more in estate taxes, yet receive less for the value of the business interests pursuant to the Buy-Sell Agreement.

50

IRC § 2703 Considerations

- Under § 2703(a), a Buy-Sell Agreement providing for the sale of interests at a price less than fair market value will be ignored for estate and gift tax purposes.
- § 2703(b) provides an exception to § 2703(a), stating it shall not apply if the following three requirements are met:
    1. It is a bona fide business arrangement,
    2. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
    3. Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction
- A Buy-Sell Agreement will be deemed to meet all three requirements if more than 50% of the business is owned by individuals who are not members of the transferor's family.

51

Fixing Value for Estate Tax Purposes

- Using Buy-Sell Agreements, owners may be able to affirmatively establish the estate tax value of their business interests.
- To do so, the Buy-Sell Agreement must fulfill certain criteria:
    1. The estate must have a binding obligation to sell the interests at the price established in the Buy-Sell Agreement (whether an offer or obligation).
    2. The owner must be restricted from selling during lifetime other than for the price set in the Buy-Sell Agreement.
    3. The price set in the Buy-Sell Agreement must be determinable and reasonable.
    4. The Buy-Sell Agreement must be a bona fide business arrangement, enforceable and adopted for valid business purposes.

52

Fixing Value for Estate Tax Purposes

5. The Buy-Sell Agreement must not be a device to pass the decedent's interests for less than adequate and full consideration in money's worth to the natural objects of the decedent's bounty.
6. The Buy-Sell Agreement must be comparable to similar arrangements entered into by persons in arms length transactions.

- These 6 requirements are derived from case law, IRC § 2703, and regulations under IRC § 2703. These additional resources are beyond the scope of this presentation, but provide much more guidance to these factors. See, e.g., one of the leading case *Estate of Lauder*, T.C. Memo 1992-736 as well as those specifically discussed here.

53

Fixing Value for Estate Tax Purposes

- Puts – A Buy-Sell Agreement that is expected to fix estate tax values should not include a put right exercisable at a price higher than the agreement price applicable to all other lifetime and testamentary transfers.
- A Buy-Sell Agreement does not fix estate tax values unless the parties cannot transfer their interest during life, except at the agreement price.
- A put right at a higher price than the ordinary agreement price allows a business owner to sell his or her interest at a higher price at any time, and the seller does not even have to find a willing buyer

54

Estate of True v. Commissioner

- In *Estate of True*, the Tax Court applied a four-prong test to determine if a purchase price included in a Buy-Sell Agreement was binding for estate tax purposes:
  1. The price was fixed and determinable under the agreement.
  2. The agreement was binding on the parties both during life and after death.
  3. The agreement was entered into for bona fide business reasons.
  4. The agreement was not a substitute for a testamentary disposition.
- In this case, the Tax Court found that the first three requirements were met, but the fourth was not based on the facts that there was no negotiation of the terms of the agreement, the parties relied on no professional advice in establishing the purchase price, material assets were excluded from the purchase price, and no appraisal was obtained.

55

Estate of True v. Commissioner

- On appeal, the U.S. Court of Appeals affirmed the Tax Court's decision and provided additional guidance when determining if a Buy-Sell Agreement served as a testamentary device:
  1. The age and health of the decedent when the agreement was executed.
  2. The regular enforcement, or lack thereof, of the agreement.
  3. The exclusion of significant assets from the agreement.
  4. How arbitrary is the manner in which the purchase price is established.
  5. Lack of negotiation between parties to the agreement.
  6. Whether the agreement allowed for revaluation of the purchase price.
  7. Whether all parties were equally bound to the agreement's terms.
  8. Any other facts indicating the agreement served as a testamentary device.

56

Estate of Blount v. Commissioner

- In *Blount*, the decedent entered into a Buy-Sell Agreement with the company to purchase his interests upon his death. The company held a life insurance policy to fund the mandatory buy-out.
- In its decision, the U.S. Tax Court added life insurance proceeds on the decedent's life in computing the fair market value of the company. The estate appealed this decision to the Eleventh Circuit.
- The Eleventh Circuit affirmed the Tax Court's decision that the Buy-Sell Agreement could not set the value of the company for estate tax purposes, but nonetheless held in favor of the estate.

57

Estate of Blount v. Commissioner

- In 1981, the company was held solely by the decedent and his business partner. They entered into a buy-sell agreement providing for the purchase of their stock in the event of one of their deaths.
- After his partner's death in 1996, the decedent executed a different buy-sell agreement providing for the redemption of his stock upon his death.
- The Tax Court found, and the Eleventh Circuit affirmed, that the subsequent agreement violated a requirement established in *Estate of True* that the agreement be binding during the decedent's lifetime.
- The courts found that for this reason, along with the fact that the buy-sell agreement was not comparable to similar arrangements, that the buy-sell agreement did not establish valuation for estate tax purposes, leading to an issue in valuation

58

Estate of Blount v. Commissioner

- As the court agreed that the buy-sell agreement did not establish valuation, it then turned to what the proper fair market valuation of the company would be.
- Here, the Eleventh Circuit found that the Tax Court erred in including in the valuation the life insurance proceeds, finding that the redemption obligation of the buy-sell agreement served as a liability offsetting the value of any death benefits.
- See how this taxpayer-friendly decision contrasts with the decision in *Connelly*.

59

Connelly Estate v. United States

- In *Connelly*, the deceased owner's estate was redeemed out of the business based on a valuation of the business at approximately $3.86 million.
- The business in question was owned by the decedent (77.18%) and his brother (22.82%).
- Years before the decedent's death, the brothers entered into a buy-sell agreement intended to keep the business in their family.
- The agreement required the brothers to attach a "Certificate of Agreed Value" annually which would set buy-sell values. If they failed to do so, the stock would be valued based on appraisal.
- The corporation received $3.5 million in death benefits following the decedent's death, and his estate agreed to a redemption price of $3 million based on an agreement between the estate and corporation rather than an appraisal. This value, as stipulated by the parties, represented the value of the company without considering the value of death benefits.

60

Connelly Estate v. United States

- The IRS argued that life insurance death benefits paid to the business to fund the redemption added to the business valuation, increasing the estate tax value from $3.86 million to $6.86 million.
- The Court initially analyzed whether the IRS could be bound to the valuation set in the buy-sell agreement. For a buy-sell agreement to control value, it must:
  1. Be a bona fide business arrangement;
  2. Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration;
  3. Contain terms that are comparable to similar arrangements at arms' length;
  4. Contain a purchase price that is fixed and determinable under the agreement;
  5. Be legally binding during life and after death; and
  6. Have been entered into for a bona fide business reason and not be a substitute for testamentary disposition for full and adequate consideration.
- If all these requirements are met, then the IRS will be bound by the valuation set forth in a buy-sell agreement. Failing to satisfy even one of these requirements opens the door for the IRS to adjust the valuation to fair market value under standard estate tax principals.

61

Connelly Estate v. United States

- The U.S. District Court found that the $3 million purchase price represented a device to pass wealth to family for less than full and adequate consideration.
- As a result, the IRS was free to argue for a higher value of the corporation.
- The court appears to have reached its conclusion by determining the life-insurance death benefits should be includable in the value of the corporation, and the parties did themselves no favors by not complying with the terms of the buy-sell agreement or documenting the change as a modification.

62

Connelly Estate v. United States

- After determining that the IRS was not bound by the buy-sell price paid to the estate, the court addressed whether the death benefits, as a matter of law, should be included in the corporation's value.
- Here, the Eight Circuit disagreed with the Eleventh Circuit's decision in *Blount*, which held that the redemption obligation of the buy-sell agreement served as a liability offsetting the value of any death benefits.
- Instead, the court held that life insurance proceeds that the Company used to redeem the decedent's shares from his estate were included in the fair market value of the company for federal estate tax purposes, as a arms' length buyer acquiring all the company's stock would receive the value of the death benefits with no corresponding obligation or liability to use such benefits to redeem the decedent.

63

Marital Deduction Considerations

- Buy-sell agreements can affect the availability of the estate tax marital deduction.
- If the buy-sell agreement provides for the purchase of business interests at a bargain price, the marital deduction will be limited to the bargain price, with the difference between the purchase price and fair market value disallowed.
- Additionally, if an interest in a business is left to a surviving spouse, but such interest is subject to be sold under a buy-sell agreement in exchange for a private annuity, the marital deduction for such business interest will be disallowed.

64

Income Tax Considerations

- Buy-sell agreements raise several tax considerations for the parties involved.
- For corporations, these concerns include:
  - Recognition of gain or loss on redemption of a shareholder's stock
  - The corporation's basis in such stock
  - The effect the redemption has on the corporation's earnings and profits
  - The effect of the redemption on corporate net operating loss carryovers
  - Accumulated earnings tax on amounts set aside to finance the redemption
  - Tax on the life insurance proceeds used to finance the redemption
  - Deductibility of the related premiums on the life insurance policy

65

Deductibility of Premiums

- Under § 264(a)(1), no deduction is allowed for premiums paid on any life insurance policy insuring the life of any officer or employee of a taxpayer, or any person financially interested in the taxpayer's business, if the taxpayer is directly or indirectly a beneficiary under the policy.
- This is true even if they would otherwise be deductible as an ordinary and necessary business expense.
- Additionally, § 162(k) precludes deduction for expenses by a corporation in connection with reacquisition of its own stock.

66

Tax on Accumulated Earnings

- As an alternative to using life insurance proceeds to fund a purchase under a buy-sell agreement, prospective buyers can instead accumulated earnings, on which income tax have already been paid, to fund such.
- § 531 taxes unreasonable accumulation of earnings above $250,000 by a C corporation. This tax is intended to compel corporations to distribute any earnings not needed for its business, so that shareholders will pay tax on the dividend distributions.
- Accumulated earnings are taxed at a rate equal to the highest individual income tax rate

67

Tax on Accumulated Earnings

- § 537 provides an exception to this tax, not subjecting a corporation to the accumulated earnings tax on earning accumulated to meet the reasonably anticipated needs of the business.
- The tax is also not applied to earnings accumulated after the death of a shareholder to the extent that a redemption of the shares of the deceased shareholder would be taxable as a sale or exchange under § 303.
- Therefore, a corporation may accumulate earnings after a shareholder’s death in order to redeem sufficient shares to pay the decedent’s estate taxes and administrative expenses, or to reimburse a corporate debt resulting from the redemption.

68

Income Tax Consequences

- There are also income tax implications for the shareholders involved in a buy-sell agreement. These implications vary depending on the type of buy-sell agreement.
- If the Buy-Sell Agreement is structured as a redemption agreement, the other owners of the company will receive no increase in their tax basis of the company.
- Conversely, if the Buy-Sell Agreement is a cross-purchase agreement, the other owners of the company will acquire the decedent's share individually and receive a corresponding increase in the tax basis of their stock.

69

Income Tax Consequences

- Under a redemption agreement, if payments fail to qualify as a stock sale under IRC §§ 302 or 303, they will be treated as nonliquidating corporate distributions, resulting in a taxable dividend to the recipient.
- § 303 will treat the transaction as a sale or exchange, regardless of § 318 attribution rules, if the redemption price is limited to the amount of the decedent's estate tax and deductible funeral and estate administration expenses.

70

Income Tax Consequences

- If an owner has a low basis in his or her interest, the income tax consequences may be immaterial if the redemption is treated as a taxable dividend or a stock sale, as the tax rate on dividends and long-term capital gains are equivalent.
- Owners with capital losses, either carried forward or for the tax year in question, would benefit from stock sale treatment, as the capital losses can be used to offset the capital gain from the deemed sale.
- Additionally, if the company redeems the decedent's interest at less than fair market value, the remaining owners can be deemed to have received a gift or a constructive dividend, depending on the language of the agreement.

71