BUY-SELL AGREEMENTS

prepared by Attorney Mark H. T. Fuhrman
Bell, Gierhart & Moore, S.C.
44 E. Mifflin St.
P.O. Box 1807
Madison, Wisconsin 53701-1807
(608) 257-3764
(mfuhrman@bgmlaw.com)

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I. INTRODUCTION

A. Business Succession Planning and Buy-Sell Agreements

1. <u>Business Succession Planning</u>.

Business succession planning refers to the long-term process by which business owners devise a system for transferring the value of their business to themselves at an appropriate time and price while allowing for the continuity of the business. This involves two steps:

a) the creation of business value, and
b) the creation of a plan for transferring that value.

One of the most common and important succession planning tools is the <u>Buy-Sell Agreement</u>.

2. <u>Buy-Sell Agreements</u>.

A buy-sell agreement is a contract that creates a marketplace for a business where one often does not exist. More specifically, it is an agreement to purchase an owner's interest in a business upon a specified triggering event and at a specified price. The agreement can be made between individual business owners who collectively own the business or it can be an agreement between the business itself and each of its owners or it can be a combination of the two. Because of the lack of marketability for most closely held businesses and other issues relating to the business's successful continuation, business disputes, tax savings, and retirement concerns, there is rarely a good reason for not having some type of buy-sell agreement in place.

B. Why Are Buy-Sell Agreements Important?

1. **Creation of Ready Market Under Certain Conditions**. Every business owner is faced with a common reality: leaving the business. This may happen for a variety of reasons, such as: retirement, termination of employment, death, disability, divorce, ownership disputes, etc. Without a buy-sell agreement, there is no ready market for the sale or transfer of most closely held businesses in such an event.

2. **Fixing Business Value for Estate (Death) Tax Purposes**.

   a) **$2,000,000 Exemption Equivalent**. Currently, every individual/owner is entitled to leave up to $2,000,000 at death (offset by any taxable lifetime gifts) without incurring any federal estate taxes. Amounts beyond $2,000,000 are taxed at rates as high as 46%. In addition, taxpayers may face state estate taxes. In Wisconsin, the exemption equivalent is only $675,000, meaning that amounts beyond this may be subject to Wisconsin's estate tax.

   b) **Estate Tax Dilemma for Business Owners**. When a business owner dies, the value of the deceased's business will be included in his/her estate[1] which will be subject to potential federal estate tax liability. What is the deceased's business worth for federal estate tax purposes? That question is

[1] *An individual's estate for estate tax purposes includes the value of anything in which the deceased owned at death. This would include, for example, your real estate, stocks, bonds, retirement accounts, life insurance proceeds and annuities, closely held businesses, vehicles, collections, jewelry, boats, etc.*

important because if the value placed on a business at an owner's death is the subject of an estate tax audit, the business and other assets of the deceased owner can be put at risk if the I.R.S. places a higher value on the business. Fortunately, business value meeting I.R.S. requirements can be fixed in advance for estate tax purposes with a buy-sell agreement. However, without a proper valuation, the claimed value of the business may not hold up.

<u>Example</u>: A closely held business owner dies without a buy-sell agreement and no proper valuation of his/her business. The deceased's estate is then appraised for federal estate tax purposes and it is determined that the deceased has substantial estate tax liability and insufficient nonbusiness property to pay for the tax. Absent an effective buy-sell agreement, there is rarely a good market for closely held businesses. Nevertheless, funds to pay the estate taxes would have to come from someplace. In such a case, the deceased's estate has several choices, all of which are rarely favorable to an effective buy-sell agreement:

i. Liquidation of the business.
ii. I.R.C. §6166 allows estates a 14 yr. payment plan for estate taxes attributed to a closely held business if certain conditions are met.
iii. I.R.C. §303 allows estates to sell stock to the deceased's business (redemption) up to amount of the estate tax if certain conditions met.
iv. Obtain a loan to pay the tax.

3. **<u>Continuity of Management</u>**. Provides for smooth transition so that new owners are trained and business relationships maintained.

4. **<u>Providing Retirement Assets and Protecting Inheritance</u>**. Selling owners will get money for retirement. Remaining family members

of deceased owners are also ensured that they will receive the value of the deceased owner's business.

II. THE ABC'S OF BUY-SELL AGREEMENTS

Once again, a buy-sell agreement is an agreement to purchase an owner's interest in a business upon a specified triggering event and at a specified price. The agreement can be made between individual business owners who collectively own the business or it can be an agreement between the business itself and each of its owners or it can be a combination.

A. Who Can Use a Buy-Sell Agreement?

An effective buy-sell agreement can be established by the owners of virtually any type of business, whether it's a corporation (C or S corporation), limited liability company, limited liability partnership, limited partnership, general partnership, or even a sole proprietorship[2]. The agreement can also be established between the owner and a key employee.

B. Types of Buy-Sell Agreements

1. **Redemption Agreement** (Entity Purchase Agreement).

   This is an agreement, generally between a corporation (C or S corporation) and its owner(s), in which the corporation agrees to redeem or purchase the owner's stock upon the occurrence of a specified triggering event and for a specified price.

2. **Cross-Purchase Agreement**

   This is an agreement between business owners in which the owners

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[2] Sole Proprietorships. *Buy-sell arrangements can even be established for sole business owners, although it is usually more of a challenge. One method is to find one or more other sole business owners, usually in the same industry, and enter into a collective buy-sell agreement. Another option is to develop a buy-sell arrangement with a key employee(s).*

collectively agree to purchase a departing owner's business interest (stock, partnership interest, membership units in an LLC, etc.) upon the occurrence of a specified triggering event and at a specified price.

3. <u>Hybrid Agreement</u>

Has elements of redemption and cross-purchase agreement. Can be more flexible by providing both owner(s) and corporation with option to purchase stock upon a designated triggering event.

C. Triggering Events

A buy-sell agreement is triggered by an event specified in the agreement. Upon the occurrence of such an event, the buyers are either contractually obligated to purchase the seller's ownership interest in the business at a specified price or are given the option to purchase at that price for a certain period of time.

The following is a list of common events that can trigger the buy-out of an owner's business interests:

1. Offer to purchase the owner's stock by an outside party (third-party),
2. Death of the owner,
3. Disability of the owner,
4. Divorce of the owner,
5. Termination of Employment,
6. Retirement,
7. Disputes among owners, and
8. Owner's bankruptcy.

D. Valuation

The buy-sell agreement establishes a mechanism for valuing the business. That value is used to set the sales price upon a triggering event.

1. **<u>Importance of Establishing Value</u>**.

a) Ensures that owner or his/her estate gets a fair price upon leaving the business.

b) *If properly structured and implemented*, the buy-sell agreement can establish the value of the business for estate tax purposes. This is a first step in effective succession and personal estate planning for business owners with estate tax concerns.

2. **<u>Methods of Establishing Value</u>.**

a) **<u>Rule-of-Thumb Methods</u>**. These can normally be used to establish a value at a low cost. However, may not provide as fair a value as an independent appraisal and may not be effective in properly establishing value for estate (death) tax purposes–especially for family owned businesses. Some common methods include:

i. Net Book Value
ii. Net Book Value with Adjustments
iii. Multiple of Earnings
iv. Specifically Stated Value/Revised Annually
v. Solomon's Choice–for use with owner deadlocks

b) **<u>Independent Appraisals</u>.**

Although expensive, independent appraisals rather than rule-of-thumb valuations, are becoming more advisable, especially for family owned businesses who want to fix business value for estate tax purposes. The legal, accounting, and tax expense of an unsuccessful attempt at defending a rule-of thumb valuation normally far outweighs the cost of professional appraisal. When a defense is unsuccessful and a higher value adopted, increased estate taxes can wipe out a significant portion of deceased owner's estate.

i. In order to fix the value of a business in a buy-sell agreement for estate tax purposes, the following standards set forth under I.R.C. §2703 must be met:

* Provides ascertainable value,
* Provides obligation to sell at death,
* Provides lifetime restrictions on transfer,
* Represents a bona fide business arrangement and not a device to transfer property for less than adequate value,
* Provides terms comparable to similar arrangements entered into by persons in arm's-length transactions ... Since repeal of I.R.C. §2036(c) (valuation freezes) in 1990, §2703 added this fifth requirement. Satisfying this new requirement (as well as the bona fide business purpose reqt. above) is one of the main reasons for obtaining an independent appraisal–especially for family owned businesses.

E. Funding Buy-Sell Agreements

There are many creative ways to fund or finance a buy-sell agreement. The following are some common methods:

1. **Certified Check or Cashier's Check at Closing**.

2. **Insurance**. Life insurance is a common method of funding the purchase of an owner's interest in the event of his/her death. In a redemption agreement, the corporation purchases one policy on each owner. In a cross-purchase agreement, each owner purchases one policy on each of the other owners.

3. **Sinking Fund.** Sometimes established by corporations to provide sufficient funds to purchase an owner's stock under a redemption agreement. May be useful option if an owner is uninsurable.

4. **Loan: Negotiable Promissory Note to Seller at Closing.** Be very careful that the buyers can meet the buy-out terms without threatening the business (for example, often installment obligations are funded by increasing the salary to remaining owners). There are many ways to set up the terms of the note:

    * Interest at the minimum rate to avoid imputed interest;
    * Interest at prime rate, or prime plus premium;
    * Fixed interest rate or floating interest rate;
    * Amortization of principal/interest over fixed period;
    * Fixed periodic payments with balloon payment at end of term;
    * Personal guaranty by note maker(s);
    * Secured by collateral, such as business's stock;

5. **Buy-out funded partially with insurance proceeds and installment note.**

F. Selecting the Appropriate Agreement–Advantages & Disadvantages

1. **Redemption Agreement.**

    a) **Advantage.** If funded with life insurance, avoids problem of life insurance being marital property of owner's surviving spouse because insurance owned by the corporation.

    b) **Advantage.** Easier to fund with life insurance than a cross-purchase agreement when there are more than three owners. This is because the corporation only has to buy one policy for each owner, whereas with a cross-purchase, each owner has to purchase one policy on each other owner.

c) **<u>Advantage</u>.** If entity is a C corporation, after tax cost of nondeductible insurance premiums may be less if C corporation in lower tax bracket.

d) **<u>Disadvantage</u>.** Because it's a redemption, the remaining shareholder's do not receive a step-up in the cost basis of their stock.

e) **<u>Disadvantage</u>.** If the shareholders are related, the attribution-of-ownership rules can cause the redemption to be treated as a dividend and taxed to the seller as ordinary income, rather than preferably treated as a sale or exchange which would be taxed to the seller as a capital gain to the extent sales price exceeds the seller's cost basis. (See I.R.C. §§301,302, 318). Even if the shareholders are not related, a redemption can still be treated as a dividend–although avoiding such treatment is generally much easier to accomplish.

f) **<u>Disadvantage</u>.** If life insurance funding is used, a percentage of the proceeds in excess of cash surrender value may result in alternative minimum tax (AMT) liability.

2. **<u>Cross-Purchase Agreement</u>.**

a) **<u>Advantage</u>.** Because business interests are being purchased by remaining owners rather than the business, the remaining owners receive a step-up in the cost basis of the ownership interests purchased, thereby reducing their future capital gain taxes.

b) **<u>Advantage</u>.** Because a redemption is not involved, adverse tax consequences that can result by application of the attribution-of-ownership rules are avoided.

c) **Advantage.** Potential AMT liability that can arise from corporate owned life insurance is avoided.

d) **Disadvantage.** If life insurance is used and there are more than three owners, the standard cross-purchase becomes less manageable because each owner is required to purchase a separate policy on the other owners. If there are four owners, for example, 12 policies would have to be purchased. However, in some cases it may be possible for a trustee to purchase the policies which can make this characteristic less of a disadvantage. One of the disadvantages with a trusteed cross-purchase agreement is the increased complexity and expense.

e) **Disadvantage.** Any after tax savings that may be available with corporate owned insurance cannot be achieved with a cross-purchase agreement.

f) **Disadvantage–Marital Property Issues.** If life insurance is used, marital property issues arise. In the event an owner dies, part of the life insurance proceeds received by the remaining owner(s) may be the marital property of the remaining owner's spouse. Wis. §§ 766.31 and 766.63, Stats. Because of this, there is the risk that a spouse may claim that interest and not agree to use his/her share of the proceeds to fund the buy-sell. Also, if a component of an owner's policy is marital property and if that owner's spouse predeceases that owner, then there is the risk that the deceased nonowning spouse may leave his/her interest in the policy to someone other than the surviving spouse, such as his/her children. Solution: Have spouses consent to relinquishing any ownership interests in the policies and/or execute a marital property agreement reclassifying the life insurance as the individual property of the owning spouse. However, separate legal representation for both spouses may be required, thereby increasing costs.