

**BUY-SELL AGREEMENTS  
FOR OWNERS OF  
CLOSELY-HELD BUSINESSES:  
AN OVERVIEW**

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*This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

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**1. WHY BOTHER WITH A BUY-SELL AGREEMENT?**

1.1 To create a fair way for the shareholders to *cash out* of their investment in the business.

- The primary way to cash out is by requiring the other shareholders to buy a selling shareholder's shares at death or the termination of the shareholder's employment.
- The agreement can provide for the buy-out of a disabled shareholder and can require the company to maintain disability insurance to fund the buy-out.
- The time to put these arrangements in place is while all shareholders -- and their spouses -- are happy and healthy.

1.2 To be sure that only those *employed by* the business share in its *upside*.

- Shareholders who are not employees will want dividends, which a C corporation won't pay.
- When they consider their buy-sell agreement, the shareholders must decide whether they are more like **investors** who own the business and can retain their interests when they are not employed, *or* more like **employees** who receive the rewards of the business only while they are working to keep it going. One issue is whether the business can support "investors."

1.3 To *preserve* the relative *ownership ratios*.

Example: A, B and C each own one third of Corp X. If A sold all of his stock to C, C would own two-thirds of Corp X and B would still own one-third. Consequently, B would become a minority shareholder, not an equal shareholder, even though his ownership percentage has not changed.

Instead, A sells his stock to Corp X, preserving the relative ownership of B and C.

1.4 To assure that only those working in the business have access to *financial data* and other confidential information, and to keep this information from competitors.

- Shareholders are entitled to annual financial statements and lists of shareholders and their addresses. As shareholders they have no special duty to protect that information.
- Directors and partners are entitled to such information about the business as they deem appropriate. The only limitation on their use of the information is their special fiduciary duty to the company.

1.5 To avoid a *divorced spouse* becoming a shareholder and, possibly, a director.

- In a divorce, a judge is entitled to award stock to the spouse, and is likely to do so if all or a portion of the stock is community property and:
  - ⇒ The spouse has been treated as an employee of the business for tax purposes (even if the spouse's actual activity in the business has been minimal); or
  - ⇒ The value of the stock represents more than half of the value of their community property.

1.6 To assure that a *new spouse* is bound if a shareholder marries after the agreement is signed.

- Even if the shares are separate property going into the marriage, the new spouse may obtain a community property interest in the shares.
  - If stock is issued to “Mary and John” and Mary is the one in the business, the buy-sell agreement can specify that Mary is the one who controls and votes the stock, even if it is community property.
- 1.7 To avoid children or other *heirs* becoming shareholders (and, possibly, directors) when the employee-shareholder dies.
- 1.8 There are many special reasons why shareholders of an *S corporation* should have a buy-sell agreement.
- Preserve the S corporation status:
    - ⇒ By prohibiting a transfer to an ineligible shareholder.
    - ⇒ If stock is transferred to a trust, by requiring that the beneficiary make the “qualified subchapter S trust” (“QSST”) or “electing small business trust” (“ESBuT”) election necessary to retain the S corporation status.
    - ⇒ If the current income beneficiary of a trust changes, by requiring the new beneficiary to sign the agreement.
    - ⇒ If a resident alien becomes a *nonresident* alien, by buying back the shares as of the date that the residence changed.
    - ⇒ If a qualified plan becomes disqualified, by buying back the shares as of the date of the disqualification.
    - ⇒ If a tax-exempt charity loses its tax exemption, by buying back the shares as of the date the exemption was lost.
  - To address whether distributions will be required or left to the discretion of the board of directors:

- ⇒ The shareholders of an S corporation pay tax on their share of the corporation's earnings, whether or not they receive any cash from the corporation to pay the tax.
- ⇒ Required distributions protect minority shareholders who do not control the board from being squeezed out.
- To increase the buy-out price for the seller's share of the tax due between the valuation date and the closing (when it is unlikely that the board of directors will declare dividends) - and to reduce a formula or book value price by distributions made during that period.

1.9 To keep the shares *in the family*.

- Especially if the current shareholders are the founders or descendants of the founder.
- If it's an S corporation, the agreement can allocate issued shares among families to permit transfers of shares within the 100-family limit.

1.10 To provide liquidity at death for the *living expenses of the surviving spouse* who will no longer enjoy the decedent's salary (although the buy-sell, which might take a lawsuit to enforce, does not eliminate the need for life insurance).

1.11 To pay *estate tax*.

- Rates up to 40% of the value of the business.
- Generally due nine months after the date of death.

1.12 To set the *value* of the business *for estate tax purposes* so the shareholders know how much insurance to buy, eliminating nasty surprises for their heirs.

Note: To set the value of estate tax purposes, the right of first refusal must use the lower of the offer price or the formula price. Also, the

buy-sell agreement price will not set the value for estate tax purposes if all the shares are held by family members -- or if only family members are bound by the buy-sell agreement price.

1.13 To *retrieve shares from employees* who receive stock.

Note: The “buy-back agreement” for an employee who receives a small amount of shares can be a separate agreement from the principals’ “buy-sell agreement.”

1.14 To keep *departing owners* from *competing* with the business. If an owner with a substantial interest in the business agrees not to compete within a reasonable geographic area and for a limited time (such as five years), California courts generally will enforce the agreement if it is activated by a sale of all of his or her interest in the business.

- Payment terms can be extended and the downpayment reduced or eliminated if the terminated shareholder refuses to sign the agreement not to compete.

## 2. **WHEN TO CONSIDER A BUY-SELL AGREEMENT**

2.1 Soon after the corporation or partnership is *formed*. How soon? The morning after they first sleep through the night without waking up and wondering if the business will survive.

2.2 When the corporation makes an S corporation election.

2.3 When there is *a change* in the entity structure.

- Change in form (example: partnership to corporation, partnership to LLC, or vice versa).
- Change in capitalization (example: issuance or repurchase of a class of stock or of partnership interests).
- Sale or issuance of additional stock or partnership interests.

- Change shareholders (bring in employees as shareholders, grant options to employees, make gifts to children or have children buy out existing shareholders)
- 2.4 When the owners consider their *estate plans* and wish to determine their possible exposure to estate tax.
- 2.5 When the owners consider their plans for *successor ownership and management* of the business.

### 3. WHO SHOULD BUY THE SHARES?

- 3.1 Entity purchase (“redemption”) -- the cash is there, but it is seldom the best buyer.
- “Disappearing basis” problem for C corporations (see Section 3.2 below)
  - Possible tax treatment as a dividend (a “bad Section 302 redemption”) if detailed tax requirements are not satisfied.
- 3.2 Using Cross-Purchase Arrangements to Reduce Taxes on the Second Sale of Stock
- 3.2.1 When shareholders consider purchasing insurance to fund a buy-sell arrangement, they should seriously consider funding for a cross-purchase of the shares -- *rather than a redemption* -- at the death of a shareholder.

A “**cross-purchase**” is a purchase by the remaining shareholders, and a “redemption” is a purchase by the corporation.

**The bottom line:** The cross-purchase can *increase the after-tax cash position of the surviving shareholders* upon the *eventual* disposition of *their* shares.

- (a) At a shareholder’s death, his heirs will take a *basis* in the stock equal to the value of the stock at that time. (In some circumstances, the valuation formula in the

buy-sell agreement will determine the heirs' basis in their stock.)

- (b) Because the heirs will have a high tax basis in their stock, they will recognize *no gain* on the sale of the stock, whether it is all sold back to the corporation (subject to the tax rules for redemptions) *or* sold to one or more of the surviving shareholders. Accordingly, the decedent shareholder's spouse or heirs should not care whether the cash to buy the shares comes from the corporation or from the surviving shareholders.
- (c) But when the *surviving* shareholders sell *their* shares or liquidate the corporation during their lives, they will have a *higher tax basis* -- and so *less taxable gain* -- *if* they bought the decedent's shares, rather than allowing the corporation to buy them.

**Note:** If the survivors make *gifts* of stock, they can give the high-basis shares and retain the low-basis shares until their death, when it will get a basis step-up. (The gifts have a carry-over basis.)

**Example.** Assume a corporation with a value of \$100,000.

Shareholders A and B each holds 50 shares and each has a zero tax basis in his stock.

Shareholder A dies.

**Redemption.** The corporation redeems A's 50 shares with life insurance proceeds of \$50,000 and maintains a value of approximately \$100,000.

B then sells his 50 shares.

Because B still has a zero tax basis in his 50 shares (the \$50,000 that the corporation paid for A's shares did not

increase B's tax basis in B's shares -- *the "disappearing basis" problem*), B would recognize a gain of \$100,000 on the sale. The gain would be subject to federal and California tax of approximately \$24,000, leaving \$76,000 after taxes.

**Cross-Purchase.** In contrast, if B bought A's 50 shares for \$50,000, B would have a \$50,000 basis in his 100 shares.

When B sold his 100 shares, he would receive \$100,000 against his basis of \$50,000 resulting in a \$50,000 gain and a tax of approximately \$12,000.

The \$100,000 received less the \$12,000 tax would leave B with \$88,000 after taxes.

The \$12,000 (\$88,000 - \$76,000) of additional after-tax cash from the cross-purchase in this example results from B's use of the stock basis that would "*disappear*" in the redemption.

*Note:* If B held all of his shares until B's death, B's heirs would take a stepped-up basis in B's shares and B would derive no benefit from buying A's shares. However, if B gave some of B's shares to B's children, the children could benefit from the higher basis in the gifted shares.

3.3 **The insurance policy.** If no insurance is purchased, the "redemption v. cross-purchase" decision can be deferred until a buy-out event occurs. If *insurance* is purchased, a decision on this issue must be made *when the policies are acquired*.

3.3.1 To implement the cross-purchase plan for an insurance-funded agreement, the shareholders should *obtain insurance on each other's lives*. First-to-die and second-to-die policies should be considered, if available. But compare pricing to regular policies owned by each shareholder on the life of each other shareholder.

3.3.2 The *shareholders* should be the owners of the policy (or policies) for tax purposes.

3.3.3 *Payment* of premiums is easiest if made directly by the corporation, and treated as additional compensation or as dividends to the shareholders.

- If the payments are made by a C corporation (or an S corporation with undistributed C corporation earnings and profits) and are treated as a constructive dividend (or are characterized by the parties as dividends), an unnecessary *second level of tax* may apply.
- How the payments will be characterized should be reviewed with the corporation's tax advisor.
- An S corporation election allows cash to be distributed to the shareholders to enable them to *pay the premiums* on their policies to fund the cross-purchase.
- In an entity-purchase arrangement, the S corporation election eliminates *AMT* on the corporation's receipt of the life insurance proceeds. Even when an S corporation has an entity purchase arrangement, there is a "*disappearing basis*" problem when a shareholder dies.<sup>1</sup>

#### 3.4 **An Employee Stock Ownership Plan (ESOP) as the Purchaser**

3.4.1 An ESOP may purchase shares whether or not the corporation could purchase within the restrictions of Corp. Code §§ 500-510. See Section 7 below.

3.4.2 An ESOP has several tax advantages. Contributions to the ESOP to fund *principal payments are deductible* by the plan sponsor. It is particularly well-suited to purchase a

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<sup>1</sup> See our *Buy-Sell Agreements: Insurance Funding for C and S Corporations* available on [www.staley.com](http://www.staley.com).

minority interest. Implementation and operation are somewhat complex, but *the tax benefits are extraordinary*.

3.4.3 The tax advantages are much better for a C corporation, although an S corporation may have an ESOP.

#### 4. **MANDATORY BUY-OUTS, OPTIONAL BUY-OUTS (CALLS) AND PUT OPTIONS**

4.1 For a purchase event funded by insurance, a *mandatory* buy-out is best. Everyone is sure of the amount and timing of the payment and who will receive it.

**Note:** The *corporate distribution limitations* designed to protect creditors *do not apply* to distributions of *insurance proceeds* to the heirs of a shareholder under a buy-sell agreement. See Section 7 below. As a result, when compared to an uninsured buy-sell agreement, an insured agreement provides substantially *more certainty* that the heirs will receive their promised payments.

4.2 At termination of employment, the buy-out is often at the discretion of the company -- a *call option*.

4.3 Either at termination of employment or at death (especially if there is no life insurance funding) the shareholder or the shareholder's heirs could have a right to *require* the corporation to buy the shares -- a *put option*.

#### 5. **PRINCIPAL VALUATION METHODS**

5.1 Appraised Value

5.2 Book or Formula Value

5.3 Agreed Value

See our *Buy-Sell Agreement Checklist*.\*

## 6. OTHER VALUATION METHODS

### 6.1 The “shoot out”

When Sally names price, Bob *must* buy from Sally *or* sell to Sally at that price. Either party can shoot first (either anytime or after a specified triggering event occurs).

This is a good way to *avoid* dissolving the corporation in the event of *deadlock*.

### 6.2 “Baseball appraisal”

Julie names a price, Mark names a price. An arbitrator (or an arbitration panel) *picks one* of the two prices and *cannot adjust* either one. This forces both parties to offer a reasonable price.

This works best when the seller has (or can obtain) an intimate knowledge of both the business and the prices for businesses in the industry.

## 7. CORPORATE PURCHASE LIMITATIONS

7.1 **Key concept:** The same restrictions govern repurchases of shares as govern dividends. These restrictions are designed *to assure that creditors are paid before shareholders or partners*.

7.2 For corporations, *balance sheet* and *ratio tests* apply. Corp. Code §§ 500, 501. The funds must be present when the purchase is made.

**Note:** These restrictions *do not apply to* “a purchase or redemption of shares of a deceased shareholder from the proceeds of *insurance* on the life of such shareholder in excess of the total amount of all premiums paid by the corporation for such insurance, in order to carry out

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\* Available on [www.staley.com](http://www.staley.com).

the provisions of an agreement between the corporation and such shareholder to purchase or redeem such shares upon the death of the shareholder.” Cal. Corp. Code § 503.1. This is major reason why an insurance-funded buy-sell agreement offers more certainty that the decedent’s family will actually receive the sale price for the shares.

## 8. PERIODIC REVIEW OF THE BUY-SELL AGREEMENT

8.1 A buy-sell agreement becomes out of date and *potentially dangerous* if not regularly reviewed.

- Is the *price/valuation method* still appropriate?
- Is the *insurance coverage* adequate? Should the corporation add a key employee feature to cover the costs of hiring a replacement executive and bringing that person up to speed in the business? Or add *disability* coverage?
- Are the buy-back *terms* still right for the parties?
- Have the *parties* changed? Have their *shareholdings* changed?
- Has the corporation become an *S corporation* or terminated its S corporation status?
- Has any shareholder *married* or *divorced*?
- Do any of the shareholders wish to make *stock gifts* to their children?
- Has the corporation *issued shares* to any employees or started a *stock option plan*?
- Have the parties reviewed their overall *estate plan* and the effect of the buy-sell agreement on that plan?

- Have the parties developed a *succession plan* that involves the transfer of stock?

[End of outline.]

## ADDITIONAL INFORMATION

If you would like to receive additional information about these issues, please check the appropriate box below, provide your address (or attach your business card) and return this sheet to the speaker -- or FAX it to Susan Rognlie at (818) 936-2990.

1.  **Buy-Sell Agreements: Insurance Funding for C and S Corporations.**\*
2.  **Buy-Sell Agreement Checklist.** For those considering adopting or revising a buy-sell agreement.\*
3.  **Succession Planning: Transferring a Business to the Next Generation.** Case studies showing how various tax and legal techniques can be used.\*

Name \_\_\_\_\_

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\* Available on [www.staley.com](http://www.staley.com).