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# Buy-Sell Agreements for Partnerships and Closely Held Companies

## Crafting Agreements for Transfer of Ownership

**A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Bruce D. Steiner, Of Counsel, **Kleinberg Kaplan Wolff & Cohen**, New York

Michael D. Cross, Partner, **Briskin Cross & Sanford**, Alpharetta, Ga.

**Tuesday, January 26, 2010**

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**Buy-Sell Agreements for  
Partnerships and Closely Held  
Companies: Crafting  
Agreements for Transfer of  
Ownership**

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# Drafting Buy-Sell Provisions: Introductory Concepts

## Types of Entities

- Corporation (taxed as a “C” corporation)
- Corporation (taxed as an “S” corporation)
- Limited Liability Company (taxed as a partnership)
- Limited Liability Partnership (taxed as a partnership)
- Other partnership forms (i.e., general partnership, limited partnership, or limited liability limited partnership – also taxed as a partnership)

# Drafting Buy-Sell Provisions: Introductory Concepts

## Where Do Buy-Sell Provisions Appear?

- In a free standing “buy-sell agreement” that focuses solely upon buy-sell issues
- In a shareholders’ agreement
- In an operating agreement
- In a partnership agreement

# Drafting Buy-Sell Provisions: Structuring the Buy-Out

## Cross Purchase Agreement

- Definition:
- A contract among partners or shareholders to purchase the shares (or ownership interest) a deceased partner/shareholder held in a business entity.
- Typically, the ownership interest is distributed among the survivors either (i) in proportion to the survivors' relative ownership interest or (ii) according to a specified formula.

# Drafting Buy-Sell Provisions: Structuring the Buy-Out

## Entity Purchase Agreement

- Definition:
- A contract among partners or shareholders to purchase the shares (or ownership interest) a deceased partner/shareholder held in a business entity.
- The ownership interest of the deceased/departing owner is conveyed to the company.
- Sometimes referred to as a company purchase or corporate purchase agreement

# Drafting Buy-Sell Provisions: Structuring the Buy-Out

## Buy-Sell Agreements

- Cross purchase and entity purchase agreements are entered PRIOR to knowing who will be the buyer, who may be the first seller, or when (if ever) the agreement will be used
- Often funded by life insurance.
- The purchase provisions may relate to methods of departure other than death (i.e., disability, retirement, withdrawal, termination of employment for various reasons, etc.).

# Drafting Buy-Sell Provisions: Essential Terms

## Issues to address:

- Identifying the value of the company
- Identifying the value of the ownership interest
- Determining whether the survivors / remaining owners have the **OPTION** to purchase or the **OBLIGATION** to purchase
  - Make sure everyone knows who your client is.
  - Your advice may change based upon who you represent.

# Drafting Buy-Sell Provisions: Essential Terms

## Issues to address (cont.)

- Determining when payment(s) will be made
- Whether to fund the purchase obligation/option

# Drafting Buy-Sell Provisions: Essential Terms

## Valuing the Business

- Common ways of identifying the value of the company:
- Business appraisal
- Agreement of the parties
- Formula
- Combination of one or more of the foregoing

# Drafting Buy-Sell Provisions: Essential Terms

## Business Appraisals

- Can be done by anyone, though some appraisers have certifications (e.g., CVA, CBV, etc.)
- Typical costs:
  - Preliminary Analysis: \$3,000 to \$10,000
  - Appraisal w/ Real Estate: \$5,000 to \$10,000
  - Comprehensive: \$7,500 to \$35,000

# Drafting Buy-Sell Provisions: Essential Terms

## Business Appraisals (cont.)

- How many appraisals?
  - Possible to have only one
  - Some desire two appraisals, with value based on the average
  - Some desire three appraisals, with value based on mean or median
- Who chooses the appraiser?
- Who pays?

# Drafting Buy-Sell Provisions: Essential Terms

## Valuing by Agreement of the Parties

- May “agree to agree” in the future as to value (may not be a legal agreement)
- May agree to determine on a periodic basis the value of the company (annually, quarterly)
- Must have a “fail safe” if there is no agreement
- Watch out for “stale” values

# Drafting Buy-Sell Provisions: Essential Terms

## Valuing by Formula

- Commonly based on revenue or asset value
- Asset Based Valuation Formulas
- If based on value of assets, consider balance sheet entry for “shareholders’ equity”
- Basing business value on assets makes little sense for service based businesses

# Drafting Buy-Sell Provisions: Essential Terms

## Revenue Based Formulas

- Often refer to “Cash Flow Statement” or “Income Statement”
  - Often based on gross revenues, sometimes with a reduction for the costs of goods sold
  - Formula often includes averaging for multiple years to avoid substantial change in value from year to year
  - Formula usually includes some sort of multiple (or percentage) of most recent annual earnings or average annual earnings

# Drafting Buy-Sell Provisions: Essential Terms

## Revenue Based Formulas (continued)

- Formula should not be based on taxable income in most circumstances.
- If owners desire to base value upon income, focus upon “discretionary revenue”.
- **I’ve never yet met a business owner who sought to maximize taxable income.**

# Drafting Buy-Sell Provisions: Essential Terms

## Example of Potential Combinations of Business Valuation Formulas

- Base 25% of business value on shareholders' equity
- Base 25% of business value on total value of assets
- Base 25% of business value on average annual gross revenue for past three years, multiplied by 3
- Base 25% of business value on average gross revenue for the past three years, less costs of goods sold, with double weight to most recent year, multiplied by 5

# Drafting Buy-Sell Provisions: Essential Terms

## Identifying the value of the ownership interest

- No requirement that we simply multiply the value of the company by the percentage of ownership interest
- May factor in discounts (i.e., minority interest discount, lack of control discount, lack of marketability discount, etc.)
- May factor in increases (to reward or incent long-time service, etc.)

# Drafting Buy-Sell Provisions: Essential Terms

## Option or Obligation

- A departing owner may want the company or remaining owners to be **REQUIRED** to purchase the interest immediately and for full value.
- The company and remaining owners desire flexibility and (probably) fewer up front costs.
  - Option to purchase – Allow company or remaining owners (as applicable) to choose
  - Payments over time – Many agreements require application of available life insurance proceeds immediately; payments made on monthly or quarterly basis over 2 to 5 years with 10% paid immediately.

# Drafting Buy-Sell Provisions: Essential Terms

## Option or Obligation (cont.)

- Payments over time increase risk to departing owner, especially if no one is personally liable.
- Immediate payment may cripple company or remaining owners.
- Causing the transaction to take place over years also increases the risk of adverse tax treatment of the transaction.

# Funding Mechanisms: Insurance Products

## Insurance Products

- Purchase obligations arising out of cross purchase and entity purchase agreements are often funded using life insurance.
- Term life insurance products are often used
- If “permanent” life insurance products are used (i.e., whole life, variable life, etc.), then the policy may build value that can be used for other purposes.

# Funding Mechanisms: Insurance Products

## Insurance Products – Entity Purchase

- In an entity purchase agreement, the entity owns one or more life insurance policies on each owner.
- If an owner dies, the entity receives the life insurance benefit, which it then uses to purchase the deceased owner's interest.

# Funding Mechanisms: Insurance Products

## Insurance Products – Entity Purchase (cont.)

- If the proceeds exceed the purchase price, the entity may retain the excess.
- If the proceeds are less than the purchase price, the entity must pay the remainder according to the terms of the buy-sell agreement.
- To fully fund an entity purchase agreement, there must be at least one policy for each owner.

# Funding Mechanisms: Insurance Products

## Insurance Products – Cross Purchase

- In a cross purchase agreement, each owner owns one or more life insurance policies on each other owner.
- If an owner dies, each owner holding a life insurance policy on the deceased owner the life insurance benefit, which he/she/it then uses to purchase the deceased owner's interest.
- If the proceeds exceed the purchase price obligation for an owner, the remaining owner may retain the excess.

# Funding Mechanisms: Insurance Products

## Insurance Products – Cross Purchase (cont.)

- If the proceeds are less than the purchase price, the remaining owner must pay the remainder according to the terms of the buy-sell agreement.
- To fully fund a cross purchase agreement, there must be at least one policy for each owner.
  - Two owners = two policies
  - Three owners = six policies
  - Four owners = twelve policies

# Funding Mechanisms: Insurance Products

## Comparing Cross & Entity Purchase Insurance Needs

- Too many policies = too much administration
- Why not just have an entity purchase agreement every time?
- Answer: taxes – no step up in basis upon death

# Funding Mechanisms: Other Mechanisms

## Other Mechanisms for Funding Buy-Sell Provisions

- Basing payment obligation on company's cash flow: can allocate funds exceeding X (either \$X or X%) toward obligation
- Asset sales: May require the sale of a significant asset or operating division to fund payment, especially if deceased/departing owner was responsible for running the division
- Loans: Company or remaining owners may borrow funds to discharge purchase obligation/option

# Funding Mechanisms: Other Mechanisms

## Other Mechanisms for Funding Buy-Sell Provisions

- Reserves: setting aside reserves from time to time
- Sinking funds: requiring funds be set aside, but allowing the required amount to be reduced over time
- Installment payments: paying periodic payments (see above)
- Selling an interest in the company to an “investor” or new partner
- Selling the company

# Funding Mechanisms: Other Mechanisms

## Other Mechanisms for Funding Buy-Sell Provisions

- Consider funding disability buy-outs with disability insurance
  - Identify price to be paid (company value, value of interest, etc.)
  - Make sure disability policy in place for each owner
  - Take into account the present value of the disability benefits to be paid
- Remember, “permanent” life insurance policies may be surrendered for cash value

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**DRAFTING BUY-SELL  
AGREEMENTS  
INCLUDING ESTATE PLANNING  
CONSIDERATIONS**

**January 26, 2010**

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# Bruce D. Steiner

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Bruce D. Steiner is an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York City, and is a member of the New York, New Jersey and Florida Bars and the Society of Trust and Estate Practitioners.

Mr. Steiner has over thirty years of experience in the areas of taxation, estate planning, business succession and wealth transfer planning, and estate and trust administration.

Mr. Steiner has lectured for the American Bar Association, the New York State Bar Association, the New York City Bar Association, the New Jersey Institute for Continuing Legal Education, BNA Tax Management, the Essex and Middlesex County Bar Associations, the New York and New Jersey State CPA Societies, the New York City, the Rockland County, the Hudson Valley, the Western Connecticut, the Northern New Jersey, the Middlesex-Somerset, the Central New Jersey, and the Greater New Jersey Estate Planning Councils, the Financial Planning Association, the New York University and Baruch College Schools of Continuing Education, the C.W. Post Tax Institute, the Fairleigh Dickinson Tax Institute, the New York City, the Greater Newark and the Fairfield County CLU Chapters, JP Morgan Chase Bank, Bank of America, Wachovia Bank, Merrill Lynch, Metropolitan Life, Cornell University, Consumers Union, THE Committee of Banking Institutions on Taxation and many other professional and community groups.

Mr. Steiner has written articles for *Estate Planning*, *BNA Tax Management*, *Trusts & Estates*, the *Journal of Taxation*, the *CPA Journal*, *Probate & Property*, *TAXES*, the *Journal of Corporate Taxation*, the *CLU Journal*, and other professional journals.

Mr. Steiner writes a column for the *CCH Journal of Retirement Planning*, and is a commentator for Leimberg Information Services, Inc., a technical advisor for *Ed Slott's IRA Advisor*, a member of the editorial advisory board of *Trusts & Estates*, and a deputy editor of the *Bergen Barrister*. He has served as a director of the Estate Planning Council of New York City, and on the professional advisory boards of several major charitable organizations.

Mr. Steiner has been quoted in various publications including *Forbes*, the *New York Times*, *Lawyers Weekly*, *Bloomberg's Wealth Manager*, *Financial Planning*, *Kiplinger's Retirement Report*, *Medical Economics*, *Newsday*, the *New York Post*, the *Naples Daily News*, *Individual Investor*, *TheStreet.com*, and *Dow Jones (formerly CBS) Market Watch*.

Mr. Steiner received an A.B. from Cornell University, a J.D. from the State University of New York at Buffalo, and an LL.M. in taxation from New York University, where he was a Gerald L. Wallace scholar.

# I. Keeping the Stock Out of the Client's Estate

- A. Have the children or a trust be the initial purchaser.
- B. The spouse can be a beneficiary of the trust.
- C. In some states, such as Alaska, Delaware, Nevada, Oklahoma, Rhode Island, South Dakota, and Utah, the grantor can be a beneficiary of the trust.
- D. The client's parent can create a trust for the client's benefit.

## II. The Power to Change Trustees.

- A. A grantor can retain the power to remove the trustees and appoint a replacement not related or subordinate to the grantor within the meaning of Section 672(c) without adverse tax consequences. *Vak v. Commissioner*, 973 F.2d 1409 (8<sup>th</sup> Cir. 1992), *rev'g T.C. Memo 1991-503*; *Estate of Helen S. Wall*, 101 T.C. 300 (1993); *Rev. Rul. 95-58, 1995-2 Cum. Bull. 191*.
- B. It is not clear whether the Service can incorporate the income tax concept of “related or subordinate” into the estate tax. However, the conservative approach is to stay within the safe harbor of *Rev. Rul. 95-58*.
- C. The Service went a step further in *PLR 199909016*.
  - 1. In *PLR 199901016*, the Service held that, assuming that under applicable state law a trustee cannot exercise discretion in favor of herself, the power of a beneficiary to remove a trustee and appoint herself as a trustee is not a general power of appointment.
  - 2. The Service further held in *PLR 199909016* that if a beneficiary removes and replaces a trustee, this will not be the exercise of a general power of appointment, so long as there is no express or implied undertaking between the successor trustee and the beneficiary that the trustee will exercise the discretionary powers other than independently.
  - 3. Notwithstanding *PLR 199909016*, the conservative approach is to require that a beneficiary who removes and replaces a trustee must select a replacement trustee who is not related or subordinate to herself.

### **III. The Use of Beneficiary Controlled Trusts Makes GST Planning More Acceptable.**

- A. The beneficiary can be a trustee.
- B. The beneficiary-trustee cannot exercise discretion in her own favor (except as limited by an ascertainable standard).
- C. The beneficiary can have a broad special power of appointment.
- D. The beneficiary can have the power to remove and replace the trustees. To be consistent with Rev. Rul. 95-58, the replacement trustee should have to be someone who is not related or subordinate to the power holder within the meaning of Section 672(c).
- E. It may be possible to create an intentionally defective grantor trust as to the beneficiary for income tax purposes under Section 678 by giving the beneficiary a power of withdrawal (either a 5 and 5 power, or a complete withdrawal power that lapses to the extent of the greater of 5 and 5 each year).

## **IV. Advantages of Dispositions in Trust.**

- A. Creditors, including Medicaid for this purpose.
- B. Predators.
- C. Spouses.
- D. Taxes.

## V. The Rule Against Perpetuities

- A. The common law rule against perpetuities effectively limited trusts to lives in being plus 21 years.
- B. About a dozen states, including New Jersey, have repealed the rule against perpetuities. N.J.S.A. § 46:2F-9.
- C. Florida has lengthened its rule against perpetuities to 360 years. F.S.A. § 689.225.

## VI. State Income Taxation of Trusts

- A. Different states have different ways of determining whether a trust is a resident trust.
- B. Some states, such as New York or New Jersey, determine the residence of a trust is based upon the residence of the grantor or decedent.
  - 1. New York exempts resident trusts from state income taxation where there are no trustees or assets in New York and no New York source income. N.Y. Tax Law § 605(b)(3)(D); *Mercantile Safe Deposit & Trust Co. v. Murphy*, 242 N.Y.S.2d 26 (3d Dept. 1963), *aff'd*, 255 N.Y.S.2d 96 (1964); Reg. § 105.23.
  - 2. New Jersey exempts resident trusts from state income taxation where there are no trustees, beneficiaries or assets in New Jersey and no New Jersey source income. *Pennoyer v. Director, Division of Taxation*, 5 N.J. Tax 399 (1983) (*testamentary trusts*), and *Potter v. Director, Division of Taxation*, 5 N.J. Tax 399 (1983) (*inter vivos trusts*). *It is not clear whether the absence of New Jersey beneficiaries is necessary (and, if so, what a “beneficiary” is for this purpose). However, the instructions to the New Jersey fiduciary income tax return (Form NJ-1041) do not require the absence of a New Jersey beneficiary to avoid being subject to New Jersey income tax.*
- C. Some states determine the residence of a trust based upon the residence of the trustees, or where the trust is administered.
- D. Whether a trust is a resident trust for income tax purposes is independent of the governing law.

## VII. Special Chapter 14 Valuation Rules.

- A. Section 2701 generally applies for gift tax purposes to preferred interests.
  - 1. Upon death, the unpaid preferred payments, plus an interest factor, are generally included in the estate. Section 2701(d)(1)(A).
  - 2. There is an exception where the spouse succeeds to the taxpayer's position. Section 2701(d)(3)(B).
- B. Section 2702 applies for gift tax purposes.
  - 1. It disregards most retained interests involving family members other than annuity interests (*e.g., grantor retained annuity interests ("GRATs")*) or unitrust interests.
  - 2. Qualified personal residence trusts ("QPRTs") are an important exception. Section 2702(a)(3)(A).
- C. Section 2703 disregards certain rights and restrictions.
  - 1. Section 2703 applies to the estate tax.
  - 2. In general, the value of property is determined without regard to:
    - (a) Any option, agreement or other right to acquire or use the property at less than fair market value; or
    - (b) Any restriction on the right to sell or use the property.
  - 3. The option, agreement, right or restriction is given effect if:
    - (a) It is a bona fide business arrangement;
    - (b) It is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and
    - (c) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

## **VII. Special Chapter 14 Valuation Rules.**

4. Section 2703 is effective for agreements, options, rights or restrictions entered into, granted or substantially modified after October 8, 1990.
- D. Section 2704 deals with the treatment of certain lapsing rights and restrictions.
1. A lapse of a voting or liquidation right is subject to estate or gift tax where the holder and his or her family control the entity.
  2. Certain restrictions on liquidation are disregarded.
    - (a) In valuing the transfer of an interest in a family controlled corporation or partnership to or in trust for a family member, an “applicable restriction” is disregarded.
    - (b) An applicable restriction limits the ability of the entity to dissolve, and after the transfer either the restrictions or the transferor or a family member or members can remove the restriction.
    - (c) An applicable restriction does not include a commercially reasonable restriction arising as part of a financing with an unrelated person.
    - (d) An applicable restriction also does not include a restriction imposed, or required to be imposed, by Federal or state laws.
  3. The Service is authorized to issue regulations providing that other restrictions shall be disregarded if they have the effect of reducing the value of the transferred interest but do not ultimately reduce the value of such interest to the transferee.

## VIII. Estate Planning With S Corporation Shares

- A. S corporation stock is often a good asset for lifetime transfers.
- B. There is usually enough cash flow to pay the income tax, since the corporation would have paid income tax if it did not elect S status.
- C. There is often additional cash flow beyond the amount needed to pay the income tax.
- D. During the grantor's lifetime, trusts can be grantor trusts for income tax purposes.
- E. After the grantor's death, or if grantor trust status is no longer desired, the trust can be a QSST or an ESBT.
- F. Advantages and disadvantages of the QSST:
  - 1. Only one current beneficiary.
  - 2. No lifetime special power of appointment.
  - 3. Can accumulate income in the S corporation, but not in the trust.
  - 4. There can be either an estate planning opportunity or a cash flow problem for the beneficiary if the corporation does not distribute enough money for the beneficiary to pay the income tax.
  - 5. Protection against the beneficiary's creditors.
- G. Advantages and disadvantages of the ESBT:
  - 1. The ESBT pays tax at the highest rate.
  - 2. Lifetime powers of appointment are limited.
  - 3. Income can be accumulated in the trust.
- H. The trustees can convert an ESBT to a QSST by distributing the shares to a new trust.
- I. A QSST can change its status to an ESBT, but cannot distribute the shares to a sprinkling trust.

## **IX. Estate Tax Apportionment**

- A. Be careful not to distort the estate plan by charging the estate taxes against the residuary estate if there is a preresiduary bequest of the stock.
- B. If the sale price under the agreement is not respected for estate tax purposes, you may want to charge a pro rata portion of the estate tax against the purchaser.

## **X. Additional Valuation Considerations**

- A. Under Section 2703(b), an agreement entered into or substantially modified after October 8, 1990, is disregarded unless it is a bona fide business arrangement, not a device to transfer the property to family members for less than full and adequate consideration and its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.
- B. Pre-Chapter 14 case law has also become more restrictive. *Estate of Joseph H. Lauder, T.C. Memo 1992-736.*

## **XI. Section 6166**

- A. There is a special lien on the shares. Section 6324A.
- B. The estate must use its undistributed income toward the payment of the estate tax to avoid acceleration of the estate tax. Undistributed income of the S corporation is treated as income for this purpose. Section 6166(g).

## **XII. Purposes of the Buy-Sell Agreement**

- A. To restrict transfers of shares.
- B. To provide a source of liquidity.
- C. To facilitate the shareholders' estate planning.
- D. To achieve simplicity and *certainty of result upon the death of a shareholder or other specified events*.
  1. The deceased shareholder's family receives cash.
  2. The remaining shareholders obtain the deceased shareholder's shares.
  3. If there is an agreed price, each shareholder will know the amount that his or her family will receive upon death.
  4. The chance of litigation is reduced.
- E. To fix the value of the shares for estate tax purposes.
- F. To preserve S corporation status.

# XIII. Conflicts of Interest and Ethical Considerations

- A. An attorney cannot represent parties with different interests, unless:
  - 1. The differences are not so great as to prevent the attorney from adequately representing all of the parties, and
  - 2. The parties give their informed consent.
- B. An attorney who is representing only the corporation should so inform each shareholder, and advise him or her of his or her right to retain separate counsel.
- C. In some cases, a minority shareholder should have separate counsel.
- D. There can be a conflict of interest even if the shareholders are equal.
  - 1. If there is a significant difference in age, the older shareholder is more likely to be the seller and the younger shareholder is more likely to be the buyer.
  - 2. A shareholder who is in poor health is more likely to be the seller.
  - 3. New shareholder *v. existing (or closely related) shareholders*.
  - 4. One shareholder may have a child or other successor in the business.
  - 5. One shareholder may have assets or income from other sources.
- E. If the executors of the deceased shareholder's estate have choices or options, the surviving shareholder has a conflict of interest if he or she is also the executor of the deceased shareholder's estate.
- F. If the executors of the deceased shareholder's estate have choices or options, an attorney representing the corporation and the deceased shareholder's estate has a conflict of interest.

# **XIV. Corporate Management Issues and Special Concerns of the Minority Shareholder**

- A. Consider provisions dealing with the management of the corporation.
  - 1. Election of officers and directors.
  - 2. Capitalization of the corporation,
    - (a) Capital calls. Note that this is more often an issue in a partnership.
    - (b) Pre-emptive rights.
  - 3. Super-majority voting requirements.
    - (a) Engaging in a new or different business.
    - (b) Sale, liquidation or merger.
    - (c) Compensation of insiders.
  - 4. Limitations on the scope of business activities.
- B. Note that shareholders can agree as to how they will exercise their rights as shareholders, while directors have a fiduciary duty to the corporation.
- C. Note that you may be able to give the shareholders management powers in the certificate of incorporation.
- D. Put options.
- E. Employment agreements.
- F. Bring-along/come-along.
  - 1. Majority shareholder may want to be able to sell the entire business.
  - 2. Minority shareholder may want to participate in a sale on the same terms as majority shareholder.

## XV. General Outline of the Buy-Sell Agreement

- A. Recitals (*e.g.*, *shareholdings*).
- B. Definitions.
- C. Termination of prior agreements.
- D. Restrictions on lifetime dispositions.
  - 1. “Reasonable” restrictions on transfer are permitted under corporate law.
  - 2. *First Offer. A shareholder wishing to dispose of his or her shares is generally required to first offer his or her shares to the corporation and the other shareholders at a price determined pursuant to the agreement.*
    - (a) In order for the death price to fix the value for estate tax purposes, the shares must be subject to a restriction limiting the lifetime price to an amount no greater than the death price. A right of first refusal is not sufficient for this purpose.
    - (b) The shareholder can be given a put option, in which case the corporation or the other shareholders must purchase the shares.
    - (c) The corporation can be dissolved if the offer is not accepted.
    - (d) The remaining shareholders can be required to offer their shares at the agreed price if they do not accept the offer.
  - 3. *Right of First Refusal. If the offer is not accepted, the shareholder is generally required to give the corporation and the other shareholders the right of first refusal to match a third party’s offer.*

## **XV. General Outline of the Buy-Sell Agreement**

4. If the right of first refusal is not exercised, the shareholder can then generally sell his or her shares to the third party, at the price and upon the terms set forth in the third party's offer. The right of first refusal is necessary, since the corporation and the other shareholders may refuse to accept the offer at the agreed price if they feel that the agreed price is too high.
  - (a) The third party purchaser can be given the status of a shareholder under the agreement.
  - (b) Alternatively, the agreement can terminate upon a sale of shares to a third party.
5. *Permitted Transfers. Certain transfers may be permitted under the agreement. Note that this adds substantial complexity.*
  - (a) A shareholder may be permitted to transfer shares to or in trust for the benefit of his spouse or issue, or other permitted transferees.
  - (b) The transferee may be treated as a shareholder under the agreement for all purposes.
  - (c) Alternatively, the transferee may be treated as a permitted transferee with respect to the transferor shareholder.
    - (i) If the permitted transferee dies or wants to dispose of his or her shares, the original transferor shareholder can be given the first option to purchase the shares.
    - (ii) Alternatively, the original transferor can be required to purchase the shares. This is simpler.
    - (iii) If the permitted transferee is a trust, similar provisions may apply if ever there is a successor beneficiary or trustee who is not a member of a permitted class.
    - (iv) If the original transferor transfers his or her remaining shares, the permitted transferee can be required to sell his or her shares to the new transferee.

## **XV. General Outline of the Buy-Sell Agreement**

### E. Disability.

1. Disability is an optional provision in a buy-sell agreement.
2. Definition of disability.
  - (a) Absence (inability to perform one's usual duties) for a specified period of time, either consecutive or nonconsecutive.
  - (b) Reference to the definition of disability in a disability buyout insurance policy.
  - (c) Arbitration.
  - (d) Combination of absence for a specified period of time and arbitration.

### F. Death.

1. The deceased shareholder's estate can be required to sell the deceased shareholder's shares, and the corporation or the remaining shareholders can be required to purchase the shares.
2. If a redemption is desired, but a redemption from the deceased shareholder's estate would be taxable as a dividend (due to the attribution rules), the corporation may be able to redeem the shares from the legatees.
3. A shareholder can be permitted to bequeath shares to or in a trust for his or her spouse or issue, or other permitted transferees.

## XV. General Outline of the Buy-Sell Agreement

- G. Determination of purchase price.
  - 1. Consider whether the purchase price reflects a minority discount or control premium.
  - 2. Book value. Note that book value may not reflect actual fair market value.
  - 3. Agreed value.
    - (a) Agreed value provides greater certainty of result than book value.
    - (b) The agreed value can be updated periodically by a new certificate of value.
    - (c) Consider an automatic adjustment (*e.g., for changes in the book value*) if more than a certain amount of time elapses between the last agreed price and the triggering event. This is commonly called a “stale certificate adjustment”.
    - (d) The stale certificate adjustment can bring the value up to the end of the last fiscal year, quarter or month, up to the date of the death or other triggering event or up to the closing date.
      - (i) Consider the effect of seasonal variations in income, expenses, dividends and bonuses.
      - (ii) Consider the cost of determining the amount of the adjustment.
    - (e) The stale certificate adjustment must be defined clearly in order to avoid a dispute as to the amount of the adjustment.
    - (f) Note that it is difficult to update the agreed value after a shareholder becomes seriously ill or is otherwise more likely to be the seller.
    - (g) Note that book value is a form of agreed value with a stale certificate adjustment.

## **XV. General Outline of the Buy-Sell Agreement**

- (h) Advantages of using an agreed value with a stale certificate adjustment rather than book value.
    - (i) It is easier to make changes in the agreed value.
    - (ii) There is less chance of a dispute as to the calculation of the price.
  - (i) In agreeing upon a price, consider the effect of an overfunded or underfunded defined benefit pension plan.
4. Formula.
- (a) A formula provides less certainty of result than an agreed price. However, it is more likely to reflect fair market value than an agreed price, especially after enough time has passed.
  - (b) The formula should be industry-specific.
  - (c) Multiple of sales.
  - (d) Multiple of earnings. Note that earnings may fluctuate.
5. Appraisal or arbitration.
- (a) Appraisal or arbitration provides the least certainty of result, since the parties do not know what the price will be. However, it is most likely to reflect fair market value.
  - (b) Consider whether the appraiser or arbitrator is to consider minority discounts or control premiums.
  - (c) Consider fixing how the appraiser or arbitrator is to consider goodwill, the receipt of life insurance proceeds and the value of specific assets.

## **XV. General Outline of the Buy-Sell Agreement**

- (d) This method is often used for real estate.
  - (e) Consider using the Real Estate Valuation Arbitration Rules of the American Arbitration Association for real estate.
  - (f) Consider using baseball arbitration.
  - (g) Consider the cost of arbitration.
6. Factors to consider in determining the price.
- (a) Minority and marketability discounts.
  - (b) Control premium.
  - (c) Goodwill and earning capacity.
  - (d) Completed contract and installment method of accounting.
  - (e) Subsidiaries carried at cost.
  - (f) Outstanding options, warrants and other convertible securities.
  - (g) Value of real estate and other fixed assets.
  - (h) LIFO inventory.
  - (i) Income tax consequences upon depreciation on sale of assets; basis of assets; unrealized gains and losses.
  - (j) Loss of key person.
  - (k) Life insurance proceeds.
  - (l) Corporate taxes if the corporation is a C corporation.

## **XV. General Outline of the Buy-Sell Agreement**

7. Under Treas. Reg. § 20.2031-2(h), Rev. Rul. 59-60 and Chapter 14, in order for the buy-sell agreement to fix the value for estate tax purposes:
  - (a) The agreement must fix the price.
  - (b) The estate must be required to sell.
  - (c) There must be lifetime restrictions whereby the shareholder was not free to sell for a higher price during his lifetime. This is the reason for requiring the first offer during lifetime at the agreed price -- a right of first refusal by itself does not accomplish this.
  - (d) The agreement must be a bona fide business arrangement, and not merely a device to pass the stock to one's heirs.

*Query -- were Section 2036(c) and Chapter 14 necessary? The Tax Court rejected book value in Estate of Lauder, 64 TCM 1643 (1992).*
  - (e) The lifetime price cannot be higher than the death price. However, the death price can be higher than the lifetime price.
  - (f) Consider who pays the estate tax if the agreement fails to fix the value for estate tax purposes.
8. Payment upon death.
  - (a) If the death price is funded by life insurance, the buyer can more easily pay for the stock upon death.
  - (b) The death price may be higher to take into account the "windfall" upon the receipt of the life insurance proceeds.

## **XV. General Outline of the Buy-Sell Agreement**

- (c) The death price may be arbitrary, so long as it is funded by life insurance.
- (d) There is an estate tax disadvantage to having a high death price, since the death price is included in the estate.
  - (i) Alternatively, the death price can be low, and each shareholder can buy his or her own insurance, which can be kept out of the shareholder's estate.
  - (ii) However, there is greater certainty of result with a death price funded by life insurance.

### 9. Disability.

- (a) The disability price can be equal to the lifetime price. The disabled shareholder can be given the right to take over the insurance on his or her own life.
- (b) The disability price can be equal to the death price. The buyer can then continue the life insurance on the disabled shareholder, and thus recover the purchase price upon the disabled shareholder's subsequent death.
- (c) The disability buyout can be funded by disability buyout insurance.

### H. Terms of payment.

- 1. All cash.
- 2. Down payment plus installments.
  - (a) The down payment for a sale upon death is often at least equal to the life insurance proceeds. However, it can be less than the life insurance proceeds if some of the life insurance is key person insurance.

## **XV. General Outline of the Buy-Sell Agreement**

- (b) You can provide for a larger down payment and a faster payout for a sale upon death than for a lifetime sale.
  - (i) There can be life insurance.