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# Buy-Sell Agreements in Estate Planning: Overcoming Suitability, Tax, Valuation and Funding Issues

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TUESDAY, AUGUST 19, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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Donna Ray Berkelhammer, Counsel, **Sands Anderson**, Raleigh, N.C.

Gregory F. Monday, Shareholder, **Reinhart Boerner Van Deuren**, Madison, Wis.

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# Buy-Sell Agreements in Estate Planning: Overcoming Suitability, Tax, Valuation and Funding Issues

## Drafting Issues

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# Types of Buy-Sell Agreements

- Existing Owners: Often called a shareholders agreement or an operating agreement
  - Redemption: The company buys back the ownership interest of a withdrawing owner.
  - Cross-Purchase: A withdrawing owner sells his interest to the remaining owners. It is suitable especially for the small business with only a few owners.

# Types of Buy-Sell Agreements

- Outsiders
  - Asset Purchase: Substantially all of the assets of the business as a going concern are purchased by another entity.
  - Stock Purchase: A withdrawing owner sells his ownership interest to a third party (not an existing owner)

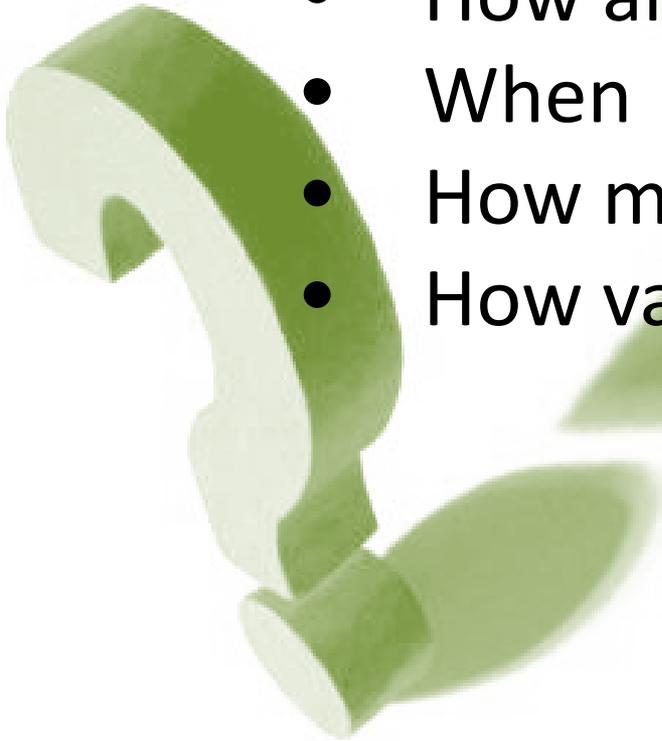


- Choice of structure requires analysis of:

- Tax
- Accounting
- Known liabilities
- Risk of unknown liabilities
- Right to assign contracts
- Dissenting shareholder rights

# A proper buy-sell agreement:

- How an interest will be sold
- When
- How much
- How valued



# Devil is in the Details

- Triggers to sale:
  - Death
  - Disability
  - “Retirement”
  - Voluntary
  - Incompetency/Involuntary
  - Bankruptcy
  - Divorce
  - Termination of employment
  - Deadlock
  - Loss of professional license



# Deep Thoughts

- Are all buy-outs mandatory?
- Do different triggers need different valuation methods?
- Company indebtedness
- What is a “disability”?
- Compliance with internal company documents
- Preservation of S status
- Securities law compliance
- Security for funding mechanism



# Stock/Membership Interest Purchase Issues

- Buyer will inherit all liabilities of the company
- No retitling of assets
- No contract assumption or transfer issues
- Same EIN/account numbers
- Goodwill amortization
- Potential capital gains to Seller



# Asset Purchase Issues

- Buyer can pick and choose liabilities to some extent
  - Beware “continuity of enterprise” and “product line extensions”
- Assets must be retitled
- Contracts must be assigned or transferred
- New employment agreements
- New permits and licenses



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# OVERVIEW OF BUSINESS VALUATIONS

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# *Roadmap*

- What is a Business Valuation?
- Why Conduct a Business Valuation?
- Methodologies of Business Valuations.
- Preparing for a Business Valuation.

# *What is a Business Valuation?*

- A process by which the value of a business is determined.
- The concept of fair market value (FMV) is central to the process.
- A business valuation utilizes different and additional methodology than a financial statement in order to determine FMV.
- What will my business sell for in the market?

# *Why Conduct a Business Valuation?*

- To prepare for a sale or transfer of business assets.
  - Asset Purchase Agreements
  - Mergers and Acquisitions
- To prepare for selling shares or membership interests in the business and drafting Buy-Sell Agreements.
- To prepare for retirement and/or winding down and dissolving the business.
- To plan and prepare for current and future income, gift, and estate tax.

# *Why Conduct a Business Valuation?*

- To prepare for the future development of your business by tracking market value over time.
- To adequately determine insurance needs.
- To prepare for offering employee stock plans.
- To prepare for divorce.
- To prepare for litigation.
  - External and Internal
- To prepare for compliance reporting.

# *Why Conduct a Business Valuation?*

- What is common to all of these circumstances:
  - Business valuations are utilized in the course of preparation and planning for the future of a business.
  - Business valuations are in indispensable tool in planning the fundamental development of a business and preparing for key events, such as interest transfers and sales.

# Methodologies of Business Valuations

## Three Primary Approaches:

- Asset Approach
- Market Approach
- Income Approach

# Asset Approach

- Adjusts assets and liabilities to FMV.
- $\text{Assets} - \text{Liabilities} = \text{Net Asset Value}$ .
- Include all assets in determination.
  - Not just assets on financial statement.
  - However, calculation of intangible assets is difficult.
- Perhaps not the best method for calculating going business concerns (value of business looking forward).

# Market Approach

- Seeks to establish value of business by utilizing market comparisons.
- What have similar businesses sold for relative to a comparable variable (sales, net income, earnings, etc.)
- Requires the existence of other like-kind business for proper comparative calculations.
- Utilize database and trade organization information.

# Income Approach

- Values company by estimating future earnings and converting the estimate into a present value.
  - Based upon investor's required rate of return and risk of investment.
  - Net cash flow is typical measure of earning power.
- Attempts to quantify the concept that the true value of a business lies in part upon future earnings and wealth.

# Preparing for a Business Valuation

- Allocate sufficient time prior to the need of the business valuation.
- Locate a certified and accredited professional.
  - Attorney
  - CPA
  - Certified Valuation Analyst
- Bookkeeping and accounting should be in order.
- Be prepared to educate the professional regarding the unique characteristics of the business.
- Work with your professional in a transparent and forthright manner.

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# FUNDING SOURCES FOR BUY-SELL AGREEMENTS

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# *Roadmap*

- What is a Buy-Sell Agreement? (Review)
- What Triggers Action in a Buy-Sell Agreement?
- Importance of Funding Sources for Various Contingencies.
- Funding Sources.

# *What is a Buy-Sell Agreement?*

- A binding executory agreement amongst co-owners requiring a departing owner to sell his interests in a business and the remaining owner to buy the departing owner's interests.

# *What Triggers Action in a Buy-Sell Agreement?*

- Whenever a co-owner departs the business.
- Examples:
  - Withdrawal of a co-owner at a time before retirement.
  - Retirement
  - Disability
  - Death
  - Bankruptcy
  - Divorce or Familial Separation
  - Loss of necessary license

# *Importance of Funding Sources for Various Contingencies*

- At a fundamental level, a Buy-Sell Agreement is inherently useless if there is no available method for the remaining owner to purchase the departing owner's interest.
- A business owner should consider various sources of funding for the various contingencies that could trigger action under a Buy-Sell Agreement.

# *Funding Sources*

- Savings
  - “Cash is King.”
  - Best source of funding because it can cover all triggering events.
- Life Insurance Policies
  - Generally, each co-owner will own policy and pay premiums.
  - Payable upon death, therefore is intended to assist with only one of the triggering events.
  - Benefits may be distributed free from income tax.
  - Certain types of policies may generate cash-value, which could be utilized for other triggering events.

# *Funding Sources*

- Disability Insurance
  - Generally, each co-owner will own policy and pay premiums.
  - Payable upon occurrence of disability.
    - Ensure that covered disabilities match definition in Buy-Sell Agreement.

# *Funding Sources*

- Bank Loans
  - If co-owner is credit worthy, bank loans provide flexibility to fund all triggering events.
  - More difficult to obtain in this economy.
  - Will likely require securitization of business and perhaps personal assets.
  - A co-owner needs to re-visit his ability to obtain a bank loan on a yearly basis to ensure ability to obtain, or otherwise obtain and maintain a revolving line of credit.

# *Funding Sources*

- Promissory Note/Installment Payments
  - If allowed, terms should be set forth in the Buy-Sell Agreement.
  - Beneficial to the remaining owner.
  - May not be beneficial to remaining owner or remaining owner's estate.
  - Promissory Note should be secured with business and/or personal assets of remaining owner.

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# BUY-SELL AGREEMENTS

## Tax Effects and Issue Spotting

- **INCOME TAXES**
  - C Corporations
  - S Corporations
  - Partnerships and LLCs
- **ESTATE, GIFT, AND GST TAX**
- **LIFE INSURANCE**

Confer with tax counsel or appropriate accountant when you draft, fund, amend, or implement these arrangements

# INCOME TAX FOR C CORPORATION BUY-SELL

## 1. CROSS PURCHASE AGREEMENT

### a. **Withdrawing Shareholder**

- i. General Rule: Capital Gain Tax
- ii. At death, new basis so no cap gains

### b. **Purchasing Shareholders**

- i. General Rule: New Basis in Purchased Shares
- ii. If subject corp helps, may be dividend to remaining SHs unless pursuant to prior agreement
- iii. If new corp held by SHs purchases, may be dividend and/or capital gains tax

continued... **INCOME TAX FOR  
C CORPORATION BUY-SELL**

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## 2. REDEMPTION

### a. **Withdrawing Shareholder**

- i. General Rule: Capital Gains Tax
- ii. At death, new basis
- iii. Beware: Dividend treatment for partial redemption (except s. 303 at death)
- iv. Beware: Dividend treatment for family attribution

### b. **Continuing Shareholders**

- i. General Rule: No Tax Effect

continued... **INCOME TAX FOR  
C CORPORATION BUY-SELL**

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### 3. PURCHASE BY SUCCESSOR

#### BEWARE SPECIAL RULES UNDER:

- s.83 (possible income to successor) OR
- s.7872 (possible income to successor & corp)

### 4. PURCHASE BY EMPLOYEE

#### STOCK OWNERSHIP PLAN:

- Can defer capital gains taxes for seller

# INCOME TAX FOR S CORPORATION BUY-SELL

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## 1. CROSS PURCHASE AGREEMENT

### a. Withdrawing Shareholder

- i. General Rule: Capital Gains Tax
- ii. Beware: Assigned *pro rata* share of corporation's income tax attributes

### b. Purchasing Shareholders

- i. General Rule: New Basis in Purchased Shares
- ii. If new corp held by SHs purchases, may be capital gains tax

## 2. REDEMPTION

### a. Withdrawing Shareholder

- i. General Rule: Capital Gains Tax
- ii. If dividend treatment, effect may be non-taxable return of capital, capital gain and/or ordinary income

# INCOME TAX FOR PARTNERSHIP & LLC BUY-SELL

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## 1. CROSS PURCHASE AGREEMENT

### a. Withdrawing Shareholder

- i. General Rule: Capital Gains Tax
- ii. Beware: Share of company's income tax attributes, limited by closing of tax year

## 2. REDEMPTION

### a. Withdrawing Shareholder

- i. General Rule: Capital Gains Tax

# ESTATE, GIFT, AND GST TAX

## 1. VALUATION UNDER SECTION 2703

- a. **General Rule:** Estate, Gift, and GST tax value will be determined without reference to restrictions in buy-sell agreement unless
  - i. Bona fide business arrangement
  - ii. Not a device to transfer property for less than full and adequate consideration
  - iii. Terms are comparable to arms-length transactions
- b. **Applies to agreements signed or changed after Oct. 8, 1990**
- c. **Does not apply if more than 50% by value is owned by non-family members**

continued... ESTATE, GIFT, AND GST TAX

## 2. MARITAL DEDUCTION

### a. Beware:

Stock subject to option rights for less than fair-market value may not qualify for marital deduction

# LIFE INSURANCE

## 1. SPLIT DOLLAR INSURANCE ARRANGEMENTS

### a. General Rule:

Since 2003, split dollar taxed as either

- i. Transfer of economic benefits
- ii. Series of loans

## 2. INCIDENTS OF OWNERSHIP

### a. General Rule:

Avoid Corporation having incidents of ownership in policy on controlling shareholder (or may lead to estate inclusion)

### 3. DEDUCTIBILITY OF PREMIUMS

a. **Cross Purchase:**

Premiums paid by co-owners may not be deducted

b. **Redemption Agreement:**

Premiums paid by corporation are non-deductible capital expenditures; exception for key-person coverage

continued... **LIFE INSURANCE**

## 4. LIFE INSURANCE PROCEEDS

### a. Lifetime:

Amounts in excess of investment in contract are received as ordinary income; may cause C corporation to have Alternative Minimum Tax

### b. Death of Insured

- i. General Rule:  
Proceeds not taxed as income
- ii. Beware of Income taxation under transfer-for-value rule if in force policy was acquired for valuable consideration
- iii. Beware of estate tax on life insurance proceeds received by company in excess of redemption price
- iv. Alternative minimum tax risk for proceeds received by C corp.