Tax Issues in Buy-Sell Agreements
Structuring Agreements for Optimal Income and Estate Tax
Results for Partners and Shareholders

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

Today’s panel features:
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Buy-Sell Agreements: Structuring Agreements for Optimal Income and Estate Tax Results for Partners and Shareholders

Allen M. Silk, Esq.

Shareholder, Stark & Stark’s Business & Corporate Group

August 11, 2010
Allen M. Silk is a Shareholder and Chair of Stark & Stark’s Business & Corporate Group. Mr. Silk works with the tax and legal aspects of business organizations and their owners. His experience includes a broad range of tax, trusts and estates and general corporate matters including sophisticated estate planning, the administration of estates and trusts, closely-held business counseling and business succession planning, the structuring of business entities and joint ventures, the acquisition and sale of business interests, and various corporate, partnership and individual income tax matters.

Mr. Silk counsels individuals and families regarding federal and state, estate, gift and generation skipping transfer tax issues, and the development of complex estate plans. He is experienced in drafting estate planning instruments including: wills, insurance trusts, dynasty trusts, charitable trusts, grantor retained annuity trusts, family limited partnership agreements, limited liability company operating agreements, durable powers of attorney and advance directives for health care.

Education
LL.M. – Taxation; New York University School of Law (1974)
J.D. – Villanova University School of Law, cum laude (1973)
B.S. – Pennsylvania State University (1969)
Purpose of a Buy-Sell Agreement

• To restrict transfers of shares

• To provide a source of liquidity

• To facilitate the shareholders’ estate planning

• 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

• To fix the value of the shares for estate tax purposes

• To preserve “S” corporation status

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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 company 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.
Ethical Considerations

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 company and the deceased shareholder’s estate has a conflict of interest.

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Concerns of the Minority Shareholder

A. Consider provisions dealing with the management of the company.
   1. Election of officers and directors.
   2. Capitalization of the company,
      (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.
Concerns of the Minority Shareholder

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. Tag-along/drag-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.
Buy-Sell Provisions

Types of Entities:
• “C” corporation
• “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)
Buy-Sell Provisions

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
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.

• Determining when payment(s) will be made

• Whether to fund the purchase obligation/option

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Buy-Sell Provisions: Essential Terms

Valuing the Company

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

• 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?
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
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.
• Payments over time increase risk to departing owner, especially if no one is personally liable or appropriate security documents are not in place.
• 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.
General Outline of the Buy-Sell Agreement

A. Recitals (e.g., shareholdings).

B. Definitions:

1. Cross Purchase Agreement - 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.

2. Entity Purchase Agreement - 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

   - 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. The purchase provisions may relate to methods of departure other than death (i.e., disability, retirement, withdrawal, termination of employment for various reasons, etc.).

C. Termination of prior agreements.

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General Outline of the Buy-Sell Agreement

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 company 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 company or the other shareholders must purchase the shares.

   (c) The company 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 company and the other shareholders the right of first refusal to match a third party’s offer.
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 company 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.
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 company 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 company 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.
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.
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.
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 loses.
   (j) Loss of key person.
   (k) Life insurance proceeds.
   (l) Corporate taxes if the corporation is a C corporation.
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.
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.

   (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.
General Outline of the Buy-Sell Agreement

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.
      (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.
Funding Mechanisms

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 – 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.

• 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.

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Funding Mechanisms

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 receives 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.
• 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

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Funding Mechanisms

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 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
• 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
Funding Mechanisms

Other Mechanisms for Funding Buy-Sell Provisions

- Installment payments: paying periodic payments (see above)
- Selling an interest in the company to an “investor” or new partner
- Selling the company
- 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
Thank you.

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Tax Issues and Buy–Sell Agreements

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Redemption vs. Cross-Purchase

- Redemption
  - Agreement between Corporation and its Shareholders.
  - Company Agrees to Purchase Shares upon Certain Triggering Events

- Cross-Purchase
  - Agreement between Corporation and its Shareholders.
  - Other Shareholder(s) Agree to Purchase Shares upon Certain Triggering Events
Hypothetical

- Corporation with two shareholders
- Value of the Company = $2,000,000.00
- Shareholder A’s Basis = $10,000.00
- Shareholder B’s Basis = $10,000.00
Lifetime Transfer—Tax Consequences to Transferor

- Shareholder A Shares purchased for $1,000,000.00

- Gain on transfer = $990,000.00
  - Amount realized ($1,000,000.00) minus basis ($10,000.00)
  - Capital gain (generally)
  - Tax = $148,500.00 (assuming 15% long-term capital gains rate)
Lifetime Transfer – Tax Consequences to Remaining Shareholder

**Redemption**

Company worth $2,000,000

Shareholder B Basis = $10,000

Gain = $1,990,000

Tax = $298,500

Assuming a 15% Capital Gains Rate.

**Cross-Purchase**

Company worth $2,000,000

Shareholder B Basis = $1,010,000

Gain = $90,000

Tax = $13,500

Assuming a 15% Capital Gains Rate.
Deemed Dividend in Case of Redemption

- With termination of preferred dividend tax rate need to remember §302.

- §302(a) provides that redemption of stock generally constitutes a capital event
  - Exception: Only where the redemption is in complete redemption of stock owned by shareholder
    - Family attribution rules under §318(a) apply
Family Attribution Example

- Father owns 60% of stock in corporation
- Son owns 30%
- Mother owns 10%
- Father's stock is redeemed by the corporation
- Son and Mother’s stock is attributed to Father, thus redemption is not a complete redemption and proceeds taxed as dividend
- Dividends scheduled to be taxed at ordinary rates beginning in 2011
Exception to Family Attribution Rules

Family attribution rules do not apply where:

- Immediately after the distribution, the distributee has no interest in the corporation including an interest as officer, director or employee, other than an interest as a creditor.
- The distributee does not acquire any such interest other than stock acquired by bequest or inheritance within ten years from the date of such distribution.
- The distributee at such time and in such manner as the secretary by regulations prescribed, files an agreement to notify the IRS of any acquisition described (in clause 2).
Tax Issues in Life Insurance Funded Buy–Sell Agreements
Redemption Agreement

- Corporation buys insurance on the lives of its shareholders.
  - Corporation is owner and beneficiary

- At death, Corporation receives life insurance proceeds

- Proceeds are used to purchase shares of deceased owner
Issues Related to Corporately Owned Insurance

- Premiums are non-deductible to the corporation – I.R.C. §264(a)(1)

- Proceeds are income tax free to the corporation – I.R.C. §101(a)(1)
  - Exception for a C Corporation which is subject to the Alternative Minimum Tax

- Proceeds are not includable in the Estate of the Decedent – Treas. Reg. 20.2042-1(c)(6)
Corporate Alternative Minimum Tax

- Insurance proceeds may be subject to AMT in case of C Corporation

- AMT Income is computed by adding certain items of book income to taxable income, including life insurance – §56(g)

- Tax rate is 20%

- Small corporations are exempt from Corporate AMT
Issues Related to Corporately Owned Insurance

- COLI Best Practices Act
- I.R.C. §101(j)
- Applies to employer-owned policies issued after August 17, 2006 and previously issued policies in event of material change
Issues Related to Corporately Owned Insurance

Death benefits of employer-owned policies will generally not be taxable if:

- Employer gives employee written NOTICE and gets written CONSENT from employee before policy issue
- Insured employee fits SPECIFIED EXCEPTIONS

AND

- OR
- Death benefits fit SPECIFIED EXCEPTIONS
Transfer at Death – Tax Consequences to Estate

- Assume company had $1,000,000 life insurance policy

- Shareholder A Shares purchased for $1,000,000.00

- No capital gain due to step up to fair market value at death – I.R.C. §1014
  - Modified step up rules in 2010
Cross Purchase Agreement

- Each shareholder purchases life insurance on the lives of each other shareholder
  - Shareholders are owners and beneficiaries

- At death, surviving shareholder receives life insurance proceeds from policy insuring life of deceased shareholder

- Surviving shareholders buy shares from estate of deceased shareholder
Issues Related to Insurance in Cross Purchase Agreement

- Premiums must be paid by the owner and not the corporation
  - Potential equity problem due to cost differences in underwriting
  - Payments from company are regarded as taxable compensation or distribution of S corporation profits
  - Split dollar still an option to consider

- Premiums are non-deductible – I.R.C. §264

- Proceeds are income tax free

- Purchase of shares increases cost basis of surviving shareholders reducing capital gains at time of future sale.
Tax Consequences to Remaining Shareholder

**Redemption**

- Company worth $2,000,000
- Shareholder B Basis = $10,000
- Gain = $1,990,000
- Tax = $298,500

Assuming a 15% Capital Gains Rate.

**Cross-Purchase**

- Company worth $2,000,000
- Shareholder B Basis = $1,010,000
- Gain = $90,000
- Tax = $13,500

Assuming a 15% Capital Gains Rate.
Fixing the Value of the Estate

- Special Valuation Rules – I.R.C. §2703

- Buy–Sell Agreement must satisfy the following rules
  - Be a bona fide business arrangement – §2703(b)(1)
  - Not be a device to transfer business interest to family members for less than full and adequate consideration – §2703(b)(2)
  - Be comparable to similar arrangements entered into by unrelated parties bargaining at arm’s length – §2703(b)(3)
Fixing the Value of the Estate

- Cannot fix price between family members

- Bottom Line: Purchase price needs to be Fair Market Value or based upon a formula which approximates Fair Market Value

- Whipsaw Potential
  - State law will likely declare a sale for less than Fair Market Value to be binding
Transfer for Value Issues

- Conversions from Redemption to Cross Purchase Agreements could result in negative income tax consequences
  - Proceeds may be taxable income – I.R.C. §101
Tax Issues and Buy–Sell Agreements

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Valuation Aspects of Tax Issues in Buy-Sell Agreements

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Valuation Timing

- **Initially** – At inception of signing agreement
- **Thereafter** – Annually
- **Important** – Annual valuation can be avoided *IF*
  - All owners re-ratify prior valuation
- **However!**
  - Agreement should call for annual update even if only one owner deems it necessary.
Fair Value vs. Fair Market Value of Each Owner’s Interest in Business

• **Difference - Simplified**
  - Fair Value = No premiums/discounts (e.g. control premium or minority, limited marketability discounts)
  - Fair Market Value = Premiums/discounts apply, if applicable based on facts and circumstances

• **Most Buy-Sell Agreements**
  - No premium/discount applied when valuing each owner’s share of total business value
Fair Value vs. Fair Market Value

• **Discounts for Lack of Marketability**
  – May apply to entity as a whole
  – If so, applies to entire entity, not to individual owner’s interest
  – Therefore – no need to specify in agreement for redemption of individual owner, as analyst will include as/if appropriate at entity level

• **Overall**

  FMV approach to entity, but FV to partial interests therein, keeping in mind that there may be deviations from the norm.
Business Value/Labor Value

• **Categories of Goodwill**
  – Business Goodwill
  – Personal/Professional Goodwill

• **Reported Compensation = Not Always Indicative of Appropriate Arm’s-Length Amount**
  – May not include fridge benefits
  – May be tax motivated
  – Overall – Needs to be evaluated and adjusted as needed when valuing the business

• **Overall** — All payments to owners or related parties must be adjusted to ensure we are analyzing arm’s-length numbers.
Addressing Labor Value in Agreement(s)

• Particularly Important if Redemption is Occurring Due to Pre-retirement or Sudden Departure of Owner

• If Due To Deferred Compensation
  – Portion of value may be allocated to separate deferred compensation agreement

• If Deemed Due to Personal Goodwill –
  – Documentation of Personal Goodwill
  – Martin Ice Cream Tax Court Case – 110 TC189 (1998)
  – Excellent article on this topic by Darrell Arne, Arne & Co., Albuquerque, NM in IBBA News, Fall 2000, published by International Business Brokers Association, Inc.

Martin case provides a mechanism for addressing situation wherein owner/employee value is different than ownership percentages, but buyout can still be as purchase/sale of capital asset should the facts and circumstances support this position.
Labor Value Inclusion

• Tax impact

**Buyer/Payor**
Ownership interest sale = May be deductible over time or not depending on structure
Deferred Comp Agreement = Deductible

**Seller/Payee**
Ownership interest sale = Capital Gains
Deferred Comp Agreement = Ordinary Income
Insurance

• Applicability
  – Fund death or disability buyout
  – Shouldn’t change the valuation or buyout amount

• Earlier in this webinar
  – Different structures for entity owned or owner owned insurance funded buyouts.
Sanity Check

Once an agreement is drafted/signed, all parties should go through the various scenarios called for in the agreement (death, disability, retirement, etc.) in an effort to make sure the buyout figures called for in the valuation, and the payment terms, seem fair and can be handled without crippling the business.

Related considerations include whether seasonal cash flow considerations need to be taken into account when structuring payment terms, future changes in business need to allow for variability/deferral of payments, etc.
Summary

• Timing
• Fair Value vs. Fair Market Value
• Corporate Goodwill & Personal Goodwill
• Labor Value
• Insurance
• Sanity Check
Thank you!

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