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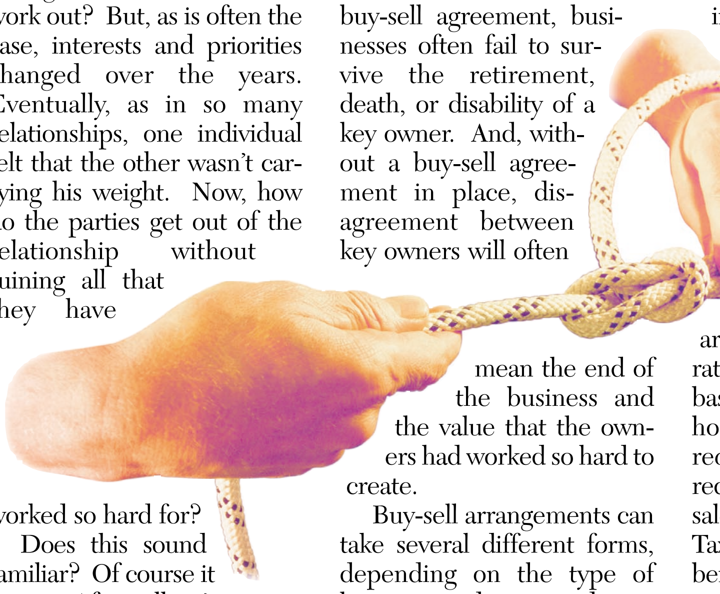
BUSINESS PLANNING

Buy-Sell Planning: The Pre-Nuptial For Business Owners

By **Randy L. Zipse**

They were best friends. Both of them were from good families. At the time, the future looked unlimited. And, for the first 10 years, everything was great. Who could have ever guessed that it wouldn't work out? But, as is often the case, interests and priorities changed over the years. Eventually, as in so many relationships, one individual felt that the other wasn't carrying his weight. Now, how do the parties get out of the relationship without ruining all that they have worked so hard for?

Does this sound familiar? Of course it does. After all, it's a story that many of us have personally lived. And, no, I'm not talking about the 50% of marriages that eventually fail. I'm talking about a great business relationship that couldn't handle the test of time. So often, business owners fail to plan for the one inevitability of every business–changes in ownership.



To plan for changes in business ownership, every closely-held business should have a buy-sell agreement. In my opinion, failure to have a well-conceived and adequately funded buy-sell agreement is the number one cause of business failure. Without a buy-sell agreement, businesses often fail to survive the retirement, death, or disability of a key owner. And, without a buy-sell agreement in place, disagreement between key owners will often mean the end of the business and the value that the owners had worked so hard to create.

Buy-sell arrangements can take several different forms, depending on the type of business and proposed succession plan. The best type of arrangement for a particular situation depends upon several factors, including the type of business structure and the number of owners. The two most common forms of buy-sell arrangements are entity purchase and cross-purchase. Each type has its own advantages and disadvantages, and is discussed below.

An entity buy-sell arrangement (or "stock redemption arrangement") is an agreement among the owners and the entity. The entity agrees to purchase (or redeem) the business interest of a departing owner and the owners agree to offer their interests to the entity upon a triggering event, such as retirement, disability, or death.

From a tax perspective, an entity arrangement with a C-corporation will not increase the basis of the remaining shareholders' stock. If certain requirements are met, the redemption can be taxed as a sale (rather than a dividend). Taxation as a sale is usually beneficial because only the gain is subject to taxation at capital gain rates.

When a redemption that is taxed as a sale occurs at death, there is generally no gain for the beneficiaries to report because the deceased shareholder's estate receives a step-up in basis.

While an entity buy-sell agreement offers simplicity as its primary benefit, there are several disadvantages of an entity purchase agreement that should be considered. As mentioned above, the remaining business owners will not receive a step-up in basis when the entity redeems the interest. Life insurance owned by a business will be subject to the claims of the business' creditors. Moreover, state law may prohibit redemption if a business is insolvent or lacks adequate capital.

In addition, premium payments are typically not deductible by the business. Although the life insurance proceeds are ordinarily received income tax-free, in some instances, life insurance proceeds received by a C-corporation can cause a 15% alternative minimum tax

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(AMT). But, because the AMT will not be applicable in many instances or will be a nominal amount, the possible application of the AMT should be considered on a case-by-case basis.

In a cross-purchase buy-sell arrangement, the owners (or their estates) are obligated to sell their interests to each other. This differs from an entity arrangement in which the business will be obligated to purchase the business interests. The business entity is not a party to the cross-purchase agreement.

For all types of business entities, including both C and S corporations, the purchase of the selling owner's business interest will increase the purchasing owner's basis in his or her total holdings. This is usually considered the primary advantage of a cross-purchase arrangement.

In addition, because the business is not a party to a cross-purchase agreement, there are no potential AMT and accumulated earnings tax problems. With a lifetime sale, a selling owner will recognize capital gain to the extent the purchase price exceeds his or her basis. Upon an owner's death, there is ordinarily no capital gain because the value of the business interest receives a basis step-up to reflect fair market value–hopefully the same price received under the buy-sell agreement.

Ordinarily, in a cross-purchase arrangement, each business owner purchases a life insurance policy on the life of each of the other owners. Upon the death of the first owner, each of the remaining owners will use the proceeds of the policy they own on the life of the deceased owner to carry out their obligation to purchase a pro-rata share of the deceased owner's interest.

After this, the remaining owners will need to acquire additional insurance on each other to fully fund their continuing obligations under the agreement because each remaining owner will now own an increased portion of the business.

If the business is not one that is taxed as a partnership and the remaining owners purchase the policies held by the estate of the deceased owner, the owners need to be careful to avoid application of the "transfer for value rule." A death benefit paid on a policy subject to the transfer for value rule will be subject to income tax to the extent that the death benefit exceeds the owner's cost basis in the policy.

The two most common forms of buy-sell arrangements are entity purchase and cross-purchase

A main disadvantage of a cross-purchase agreement is that when there are more than three or four owners, a cross-purchase buy-sell agreement funded with life insurance can be complicated. Because of the necessity of purchasing multiple policies, the cross-purchase buy-sell is generally not used in situations where there are more than three or four owners.

How can a plan combine the advantages of a cross-purchase plan (step-up in basis) with the simplicity of an entity plan? Fortunately, creative attorneys have created alternatives to the standard cross-purchase agreement. Two such arrangements are the "trusteed" cross-purchase arrangement and the "partnership" cross-purchase arrangement.

In a "trusteed" arrangement, a trustee purchases life insurance on the life of each owner that is a party to the agreement. Upon the death of an owner, the trustee collects the insurance proceeds, purchases the business interest (often stock in a corporation) from the estate of the deceased owner, and distributes the stock to the surviving owners.

The trustee may facilitate the transfer by holding the shares of each shareholder subject to the agreement. It is uncertain whether the use of a trusteed agreement avoids the transfer for value problem. The death of a shareholder could be construed as causing a transfer of the deceased shareholder's beneficial interest in the policies on the lives of the survivors to the surviving shareholders for value.

While the IRS has not previously applied the transfer for value rule to a trusteed buy-sell arrangement, some commentators believe that the transfer for value rule may apply to a trusteed arrangement. Because of this concern, the "partnership" buy-sell arrangement has become popular. This arrangement is similar to the trusteed agreement. However, instead of creating a trust, the shareholders form a partnership and fund the partnership with "active" assets. The partnership then purchases a single life insurance policy on each shareholder.

The partnership arrangement should avoid transfer for value problems because the transfer of a life insurance policy to a partnership in which the insured is a partner is an exception to the transfer for value rule.

Another exception to the rule is a transfer to a partner of the insured. No exception to the transfer for value rule exists for a transfer between common shareholders.

There are many different ways to fund a buy-sell arrangement. The most common funding choices are life insurance, borrowing funds, sinking funds, and an installment purchase. When funding a buy-sell arrangement, it needs to be remembered that the triggering event for the buy-sell obligation will often be something other than death. As noted earlier, the triggering event could be disability, retirement, or disagreement between the owners.

Borrowing funds or making an installment purchase can put a strain on the cash flow of a business, while sinking funds can result in income tax on investments and retained earnings. Purchasing life insurance on the lives of the business owners is one of the most common methods of funding a buy-sell agreement.

In addition to being cost effective, a primary advantage of life insurance is that it makes a predictable amount of cash available upon the death of an owner, usually free of income tax. Moreover, if the agreement is funded with permanent life insurance, the policy's cash value may be sufficient to fund a buy-out prior to death.

To mitigate the cost to the shareholders of funding a cross-purchase agreement, life insurance is sometimes purchased on a split dollar basis.

An important consideration that is often overlooked when structuring a buy-sell agreement is the method by which the business will be valued. Common methods of business valuation include fixing the purchase price periodically by agreement;

book value on the date of death or on the close of the last fiscal year preceding the date of death; capitalization of earnings; using a valuation formula combining several factors; an independent appraisal; or the parties determining the purchase price on a "cut-throat" basis at the time of sale.

While each method has its own advantages and disadvantages, the most important issue is whether the IRS accepts the valuation as a fair value of the business owner's interest. In order for the valuation to be binding on the IRS for estate tax purposes, the buy-sell agreement must be a bona fide business arrangement, not a device to transfer property to family members at less than full value, and the agreement must have terms comparable to an arms length transaction.

A well-drafted and adequately funded buy-sell agreement is an important piece of a business owner's succession and estate plan. Without a buy-sell agreement, a business owner (or his or her family) can lose much of the equity that the owner worked a lifetime to create.

When I was a private practice estate and business-planning attorney, I saw the impact on businesses and families caused by a failure to implement buy-sell arrangements. The impact from failure to adopt and adequately fund a buy-sell arrangement is often more than economic. It can be emotionally devastating to watch the collapse of a business that you have worked a lifetime to build. In addition to the loss of a parent, I have seen the child of a deceased business owner suffer the emotional burden of watching their parent's business fail.

Without adequate planning, the owners of a closely held business are setting themselves and their families up for problems. Unfortu-nately, not every bright beginning has a happy ending. But, with the appropriate buy-sell planning, happy endings can be achieved. NU