By Thomas M. Edens

Buy-Sell Agreements

Know the keys to managing the destiny of agency ownership

Most business advisors suggest that owners of closely held businesses implement a buy-sell agreement. This important agreement can ensure the orderly and acceptable transfer of business interests, while protecting the shareholders. Moreover, this agreement often serves as the core element of the succession plan of the company.

In order to avoid misunderstandings, buy-sell agreements should be documented in writing. Misunderstandings can arise in the future as to what the intent of the parties was and oral agreements are unenforceable in some states. As the saying goes, "The faintest ink is worth more than the fondest memory."

The following is a summary of the important elements and purposes of the buy-sell agreement, as well as valuation and tax considerations integral to these documents.

Purposes for buy-sell agreements

A properly drafted buy-sell agreement can be utilized and designed to accomplish any of the following goals:

- Provide liquidity and a buyer for a departing owner's shares.
- Avoid conflict and power struggles between surviving shareholders and/or heirs.
- Prevent unwanted persons from becoming shareholders.
- Protect S Corporation status regarding number of and type of allowable shareholders.
- Maintain stability of business operations. Property funded buy-sell obligations ease the potentially significant financial burdens of estate taxes.
- Fix the value of the business entity for estate purposes.

Common types of buy-sell agreements

Several specific types of buy-sell agreements can be used depending upon the financial resources of the shareholders and corporation, the bargaining strengths of the various shareholders and finally, tax considerations.

The most common types of buy-sell agreements are:

- Redemption agreements—A redemption agreement is a contract between the business entity (corporation, partnership, etc.) and its owners. The owner/shareholder agrees to sell his shares to the company at the price, terms and conditions specified in the agreement. Redemption agreements are most often funded by life insurance policies purchased by the corporation. After the corporation repurchases the shares of the deceased or selling shareholder, the surviving shareholders hold 100 percent of the remaining issued and outstanding shares of the company.

  Some states stipulate that a corporation can only redeem its stock to the extent of its earned surplus. Therefore, assurance must be made that the corporation will be legally able to redeem the full value of a shareholder's interest.
- Cross-purchase agreements—Cross-purchase agreements are contracts in which individual shareholders have agreed to purchase the shares of a selling shareholder or his estate. The purchase of these shares is usually funded by the proceeds from life and/or disability income insurance policies. Typically, each shareholder has a life insurance policy on the life of the other shareholders. If there are several shareholders, the number of insurance policies could become burdensome. For example, if there are four shareholders, then 12 insurance policies are required to facilitate the cross-purchase obligations. This is contrasted to a stock redemption agreement, which requires only four policies in this example.
- Hybrid agreements—A hybrid agreement can have one of two purposes. First, it can give certain shareholders the option to buy the shares of a selling holder. If this option is not exercised, the corporation is obligated to redeem the shares not purchased by the shareholders. Alternatively, a hybrid agreement can give a corporation the option to redeem the shares of a selling shareholder. If this option is not exercised, the remaining shareholders are obligated to purchase any residual shares.
- Other—Buy-sell agreements are also common in situations in which a non-family key employee is afforded an opportunity to obtain equity in a closely held business. In this instance, a key executive is granted a right of first refusal in the event one of the shareholders dies.

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The following illustrates the advantages and disadvantages of the two most common forms of buy-sell agreements.

Redemption agreement advantages:

1. Probably fewer policies required.
2. Policies safe from individual's creditors.
3. Cost of premiums paid by corporation and, therefore allocated evenly among owners.

Redemption agreement disadvantages:

1. Insurance proceeds could be preference item for larger corporations Alternative Minimum Tax. (The Taxpayer Relief Act of 1997 repealed the Alternative Minimum Tax for small businesses—certain corporations with revenues under $5 million.
2. Legal and tax issues regarding redemption are complicated.
3. There is no "step-up" in basis for surviving shareholders.

Cross-purchase agreement advantages:

1. Greater flexibility and simpler to set-up.
2. Policies safe from business creditors.
3. Basis is "stepped-up" at death by decendent's estate and surviving shareholders.
4. Avoids possible problems with Alternative Minimum Tax.

Cross purchase agreement disadvantage:

1. Possibility of disparity of premiums among owners of different ages.
2. May require a large number of policies.
3. Policy premiums are paid with after-tax dollars by the shareholders.

Important considerations

The proper drafting of a buy-sell agreement requires the consideration of a number of factors. Most agreements will address trigger events, valuation calculations, funding of obligations and dispute resolution.

Regarding triggering events, the most common events addressed in buy-sell agreements are:

1. Death or disability of a shareholder.
2. Retirement or termination of an owner.
3. Bankruptcy or insolvency of a shareholder.
4. Divorce of a shareholder, if the divorce decree specifies that corporate shares will be allocated to the shareholder's spouse.

The valuation provisions of buy-sell agreements describe the method upon which the buyout price will be calculated.

Most buy-sell agreements are funded with life insurance and/or disability insurance proceeds. The amount of insurance should be monitored regularly to verify that adequate coverage is in place as the value of the company rises. Other situations exist where the corporation is sufficiently strong to redeem the shares out of cash reserves, borrowing capacity or cash flow. Still other agreements specify that an installment plan is implemented whereby the selling shareholder is paid over a specified period of time (with interest). It would not be uncommon for the purchased stock to be held in escrow as security for the installment note.

The agreement should allow for flexibility as it relates to the rise and fall of business values, shareholder net worth, changing tax climates and personal goals of the parties. Agreements have a tendency to become outdated quickly.

Attorneys often draft agreements that require arbitration or mediation where a dispute arises in the operation of the agreement. Lengthy and costly disputes can be minimized with this provision.

Valuation considerations

Arguably, the valuation provisions are some of the most important elements in the agreements. Care and professional assistance in drafting this component are highly encouraged. The price set in the agreement will take into consideration the fundamental economics of the business, the financial goals of the shareholders and federal and estate tax considerations.

The most typical valuation provisions of buy-sell agreements specify that the buyout price will be determined by one of the following methods:

- A specific price per share as stated in the agreement
- A formula as described in the agreement (such as a multiple of earnings, cash flow, revenue or book value). Agency owners would probably utilize the multiple of revenue or cash flow if a formula approach is the desired component of the valuation provisions.
- A specific price as determined by a valuation report prepared by one or more qualified appraisers.

It is important that whichever method is used for determining value, that the valuation provisions are updated periodically to reflect current market conditions and changes in the value characteristics of the specific company. For example, it would not be uncommon for the shareholders to agree to update the valuation provisions on an annual basis.

The valuation provisions of buy-sell agreements should be specific as to value methodology as described above as well as to the standard of value and the level of value. Examples of standards of value are:

- Fair market value.
- Fair value.
- Investment value.

Levels of value are nonmarketable minority interest and marketable minority interest basis. The standards and level of value will determine the use of discounts in calculating the final value allocable to the interest to be purchased.

Most business valuation professionals will determine the fair market value of, for example, a 40 percent interest in a business utilizing a minority and/or lack of maketability discount. These discounts can range anywhere from 20 percent to in excess of 50 percent from the equivalent pro-rata share of the 100 percent value. In other words, a 40 percent interest in a $1 million business utilizing the fair market value standard, and based on a nonmarketable minority level could result in a combined discount of 30 percent.

This discount arises because of the minority interest and lack of marketability attributes and would result in a buyout price of $280,000 ($1 million x 40 percent less a 30 percent discount). Is that the intent of the parties? Or, was the intent for the value to be a direct pro-rata of the 100 percent value, or $400,000 ($1 million x 40 percent)?

It is best to get valuation advice at the time of drafting the agreement, versus coming to the realization later that significant valuation terminology mistakes were made when your heirs need the funds the most. Shareholders should not fall in the trap of inserting boilerplate valuation language in the buy-sell agreement. Vague or basic terms such as "earnings" or "cash flow" should be defined to prevent disputes or unintended valuations.

The valuation provisions should reflect that existing shareholders often want to maximize the value of their shares. Conversely, other individual shareholders of the corporation (in cases of a stock redemption agreement) redeeming shares may want to minimize the value of these shares. Additionally, a controlling shareholder may also want to have a lower valuation for a buy-sell agreement involving a non-family key employee (especially in cases where the employee is terminated for cause).

Tax considerations

Parties entering into most buy-sell agreements want the value determined pursuant to the agreement to be applicable for estate tax purposes. In order to accomplish this, the valuation provisions must meet several criteria promulgated by the Internal Revenue Service (IRS) under Section 2703 within Chapter 14 of the code. Section 2703 requires that the agreement:

- Is a bona fide business arrangement.
- Is not a device to transfer property to members of the descendant's family for less than full and adequate consideration in money or money's worth.
- The terms of the agreement (including valuation determination) are comparable to similar arrangements entered into by persons in an arm's length transaction.

Said in the most basic terms, Section 2703 provides that unless the buy-sell agreement satisfies all three criteria, the value determined pursuant to the agreement will not be taken into account in determining the fair market value for federal estate taxes. The IRS also considers that restrictions (including valuation guidelines) in the buy-sell agreements apply during the lifetime of the shareholders, as well as after death. The potential adverse consequences occur when a descendant's estate is forced to sell the business interest at a low rate determined in accordance with a buy-sell agreement and then later has to pay estate taxes based on a much higher value calculated by the IRS.

If greater than 50 percent of the business interest is owned by non-family members, Section 2703 does not apply. Therefore, greater flexibility is accorded the valuation provisions while remaining applicable to estate tax computations. However, the restrictions and valuation provisions should still be applicable during the shareholders life as well as at death.

Other tax considerations of the buy-sell agreements include stock redemption rules. Care should be taken to ensure that proceeds distributed out of a corporation in a stock redemption (involving a "C" corporation) are eligible for capital gains versus dividend treatment. Family attribution rules may have to be addressed by your tax advisor to ensure the capital gains treatment. Capital gains taxes are often zero or minimal because of the step-up basis upon death. Cross-purchase agreements circumvent this stock redemption dividend risk.

Summary

This article is not meant to offer legal or tax advise, but to expose agency owners to the many factors applicable to this important subject. A properly drafted buy-sell agreement can be the primary succession planning vehicle for an agency owner's business entity. This is especially true for businesses with multiple owners, but is also applicable to sole shareholders. The buy-sell document can also provide significant benefits as an estate planning utility. Most agency owners have done a great job of managing their businesses during their lives. Managing the destiny of their stock ownership is equally important. CM

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