

Tax Considerations of Close Corporation Buy/Sell Agreements

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Valuation analysts are often involved in designing the valuation pricing formula included in close corporation and professional practice buy/sell agreements. In addition, valuation analysts are often asked to interpret or implement buy/sell agreements that call for a “fair market value” price or a price to be determined by “an independent appraiser.” In addition to quantifying the pricing aspects of close corporation buy/sell agreements, valuation analysts should be generally familiar with the taxation aspects of the common types of buy/sell agreements. This discussion summarizes the income tax implications of the common types of buy/sell agreements.

INTRODUCTION

A buy/sell agreement is a contract that restricts business owners from freely transferring their ownership interests in a closely held business. A buy/sell agreement is often used as a mechanism to provide for the planned and orderly transfer of a closely held business interest.

A buy/sell agreement may be used by the owners of a corporation, a partnership, a limited liability company, and many other forms of business entities. For simplicity purposes only, this discussion will refer to a closely held corporation and to its corporate shareholders. However, for the most part, this discussion also applies to other ownership structures for closely held businesses and professional practices.

There are taxation as well as nontaxation (e.g., operational) reasons why closely held business owners may want to implement a buy/sell agreement program. This discussion considers both the taxation reasons and the nontaxation reasons.

Some of the reasons why close corporation shareholders may want to implement a buy/sell agreement include the following:

1. To provide for business continuity upon the death, disability, or retirement of one of the corporation shareholders

2. To establish a market for the close corporation's stock that would otherwise be difficult to sell
3. To ensure that the ownership of the subject corporation remains with individuals previously selected by the current owners—or, at least, it remains closely held
4. To provide liquidity to the estate of a deceased shareholder in order to pay for the decedent's estate taxes and costs
5. To support the family of a deceased shareholder from the proceeds of the close corporation stock sale

One of the often-mentioned disadvantages of a buy/sell agreement is that the cash paid for the premiums on the shareholders' life insurance (that is typically used to fund the buy/sell agreement) is not available (1) for the payment of the close corporation's expenses or investments or (2) to make distributions to shareholders.

Of course, it may happen that either corporate or personal circumstances may change after the shareholder buy/sell agreement is adopted. Such a change may cause the remaining shareholder purchasers to regret the contractual obligation to buy a withdrawing owner's interests.

In the context of a closely held corporation, the buy/sell agreement is a contract either (1) between the shareholders or (2) between the shareholders and the corporation.

The contract provides that a shareholder's stock will be sold (or at least offered for sale) to the other shareholders—or to the close corporation—upon the occurrence of a contractually specified event. Such contractually specified events usually include death, disability, and retirement.

However, such contractual events may also include circumstances such as a shareholder divorce, personal bankruptcy, or the inability to practice one's profession.

The buy/sell agreement may also be designed as a right of first refusal in the event that a shareholder desires to sell his or her close corporation stock.

There are three common types of buy/sell agreements:

1. Redemption agreements
2. Cross-purchase agreements
3. Hybrid agreements

Each of these three types of buy/sell agreements is described below.

REDEMPTION BUY/SELL AGREEMENTS

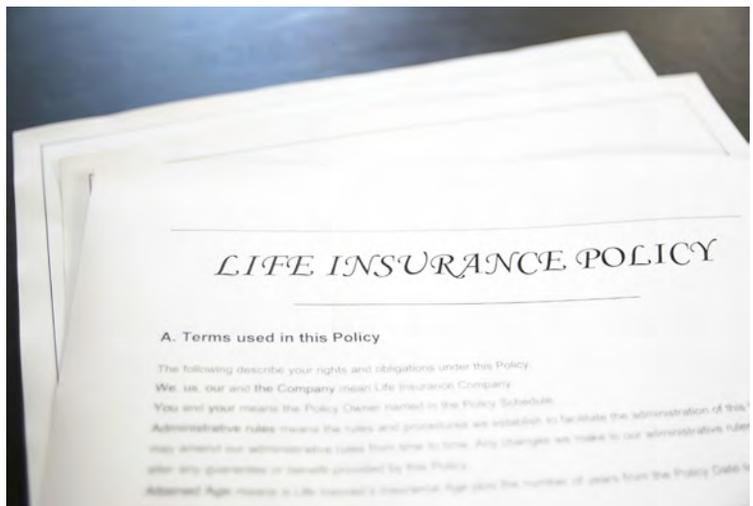
In a redemption buy/sell agreement, the shareholder and the close corporation enter into a contract. In that contract, the shareholder agrees to sell his or her shares to the close corporation according to the price, terms, and circumstances specified in the buy/sell agreement.

The redemption buy/sell agreement typically grants the close corporation the right of first refusal if there is an offer from a third party to purchase the shareholder's ownership interest.

Many close corporations have buy/sell agreements for valuing and purchasing the shares of (1) a deceased or disabled shareholder or (2) a shareholder whose employment with the corporation has terminated.

When more than two shareholders are involved, and particularly when life or disability insurance is issued to fund the buy/sell agreement, then these buyouts are often structured as stock redemptions (paid for with corporate dollars). In other words, the transaction is typically not a stock cross-purchase transaction between the shareholders.

A stock redemption buy/sell agreement is a contractual arrangement between the shareholders and



the close corporation. In that agreement, the close corporation is obligated to redeem the shares of the deceased or disabled shareholder.

Upon the death or disability of the shareholder, that shareholder's stock must be returned to the close corporation for payment, according to the terms established in the buy/sell agreement.

If the stock redemption agreement is funded with life insurance or disability insurance, then the close corporation pays the insurance premiums. Also, the close corporation owns the insurance policy, and the corporation is the policy's beneficiary.

The costs of the insurance premiums are then shared proportionately by all shareholders. This is because the close corporation is responsible for all of the insurance premium payments.

That is, a younger shareholder or a shareholder owning fewer shares is not required to pay larger insurance premiums to cover (1) other older shareholders or (2) other shareholders who own more shares.

The administration of such a buy/sell agreement is simplified because there is only one life insurance policy on each shareholder. In addition, the legal agreement can be drafted as a single document.

In contrast, under a stock cross-purchase agreement, each individual shareholder must carry a life insurance policy on all of the other corporation shareholders.

Nonetheless, the remaining shareholders do not receive any increase in their tax bases in the close corporation stock. This tax treatment contrasts with a stock cross-purchase buy/sell agreement. Under such agreement, the remaining shareholders acquire the shares individually and, therefore, receive a corresponding increase in their tax bases.

In addition, stock redemption payments that are treated as nonliquidating corporate distributions

may result in a taxable dividend for the shareholder recipient. This will be the case if the transaction fails to qualify as a stock sale under one of the Internal Revenue Code Section 302 or Section 303 exceptions.

Of course, the income tax results for a shareholder with little or no stock basis may be essentially the same whether the redemption is treated as (1) a taxable dividend or (2) stock sale proceeds.

This is because the federal income tax rates on qualified dividends and long-term capital gains are the same for 2011 and 2012.

However, if the shareholder has significant capital losses from other transactions, then sale treatment is preferred. This is because those capital losses can be used to offset the capital gain triggered by the stock redemption transaction.

Stock redemptions have (1) complex income tax implications and (2) a high potential for adverse income tax consequences. Such unfavorable income tax consequences may include the following:

1. If the close corporation pays more than the stock's fair market value (FMV), then the selling shareholder may have received (a) a gift from the remaining shareholders or (b) compensation from the corporation.
2. If the close corporation pays less than the stock's FMV, then the remaining shareholders may have received either a gift or compensation (Revenue Rule 58-614).
3. To qualify for either sale or exchange treatment, the stock redemption must meet the applicable requirements. For example, if the buy/sell agreement calls for the sale of less than 100 percent of the shareholder's ownership interest, then the complete termination or substantially disproportionate requirements of Section 302(b) may not be met. This result would cause the distribution to the shareholder to be taxed as a dividend. However, based on the 2011 and 2012 preferential tax rates on qualified dividends, this outcome may not be as disadvantageous as it used to be.
4. If the close corporation is the beneficiary of a life or disability insurance policy that funds the stock redemption transaction, then the insurance proceeds could trigger the corporation alternative minimum tax. This result is because the insurance proceeds would be included in the accumulated current earnings (ACE) adjustment (Regulations Section 1.56(g)-1(c)).

For example, let's assume that Family Corporation ("Family") has 1,000 shares of stock issued and outstanding. Alpha shareholder owns 800 shares. Beta shareholder and Gamma shareholder each own 100 shares. Alpha wants to retire and maintain a reduced ownership interest in Family.

Let's assume that Family redeems 600 of Alpha's shares. After the redemption, Family has 400 shares issued and outstanding. Alpha owns 200 of those shares, resulting in a 50 percent ownership interest.

This stock redemption does not qualify for sale or exchange treatment under Section 302. And, this redemption will be treated as a distribution of property under Section 301. To avoid this result, Alpha should restructure the transaction to qualify for capital gain treatment under Section 302.

CROSS-PURCHASE BUY/SELL AGREEMENTS

A cross-purchase buy/sell agreement is a contract between the shareholders of the close corporation. It is a contract to offer each shareholder's shares for sale to the other shareholders at the price and terms specified in the buy/sell agreement.

In the event of a shareholder's death, the estate is normally required to offer the decedent's ownership interest to the other shareholders at the contractually specified price and terms. If there is no third-party buyer, then the other shareholders are generally obligated to buy the shareholder's interest in the event of specified circumstances (such as death, disability, or retirement).

Cross-purchase agreements are normally funded with insurance. Therefore, these agreements function best when the close corporation has only two or three shareholders. As the number of shareholders increases, the cost of creating a workable cross-purchase arrangement can become too high. This is due to the larger number of insurance policies required.

Cross-purchase arrangements avoid the risk of dividend treatment for the selling shareholder's buyout payments. However, if the close corporation purchases the stock (even though the remaining shareholders were obligated to do so) because of a secondary agreement under the buy/sell agreement, the purchase could be treated as a constructive dividend to the remaining shareholders.

To avoid the constructive dividend tax treatment, the buy/sell agreement should be structured so that the remaining shareholders have an option, rather than an obligation, to purchase the departing shareholder's stock.

In addition, when the change in stock ownership qualifies as an ownership change under Sections

382 to 384, the close corporation's ability to use certain tax attributes, such as an NOL and capital loss carryover, may be reduced.

For example, let's consider Delta and his two brothers, Eta and Theta. Let's assume that these three brothers formed Close Corporation, Inc. ("Close") 10 years ago.

For the first eight years, the three brothers were equal shareholders. Let's assume that, within the past two years, the stock has been distributed (by gift and sale) to one son of Delta, two daughters of Eta, and three sons of Theta. Let's assume that all of the current shareholders are in good health.

When the three brothers founded the company, they signed a shareholder buy/sell agreement. That shareholder agreement gave the company an option to redeem the shares at a price to be annually agreed upon by the shareholders.

Since the existing buy/sell agreement does not include the children of the three founders, a new buy/sell agreement should be prepared and signed by all of the existing shareholders.

Future shareholders should also be required to sign the new buy/sell agreement as a condition for making a valid transfer to them of the stock.

Let's assume that Delta says that his estate will be split among his spouse, children, and any grandchildren. Delta adds that his two brothers have similar wills.

Sale or exchange tax treatment upon the redemption of stock from the Delta estate is unlikely. Sale or exchange tax treatment generally requires that the estate completely terminate its ownership interest in the company.

However, Delta's estate cannot completely terminate its interest in the company. This is because Delta's estate cannot waive family attribution when a beneficiary of the estate owns stock in the company in his or her own name (see Section 302(b)(3) and (c)). The redemption of the Delta estate's stock could have occurred when the three brothers were the only shareholders. This is because the family attribution rules do not apply to siblings.

Alternatively, the sale of stock from the Delta estate results in sale or exchange tax treatment if the shareholders use a cross-purchase agreement. In a cross-purchase agreement, one or more of the remaining shareholders agrees to purchase the stock (1) from the estate of a deceased shareholders or (2) from the departing shareholder.

The acquiring shareholders obtain a tax basis in the purchased shares equal to the acquisition price. And, the acquiring shareholders obtain a new holding period for the Close stock.

HYBRID BUY/SELL AGREEMENTS

Hybrid buy/sell agreements typically are used when there is no insurance to fund the purchase of ownership. This situation may be the case when the business owner is uninsurable.

A hybrid buy/sell agreement provides the shareholders with flexibility to decide who will make the stock purchase when a triggering event occurs. Some hybrid agreements provide that the shares will be offered:

1. first, to the close corporation and
2. second, to the other shareholders if the close corporation does not buy the shares.

In other hybrid agreements, the shareholders may have the first option to purchase the shares, with the close corporation required to redeem the shares if the shareholders decline to make that stock purchase.

Alternatively, part of the shares may be offered first to the close corporation and the remainder may be offered to the other shareholders.

Hybrid buy/sell agreements should be drafted carefully in order to avoid the situation where the remaining shareholders are obligated to purchase a withdrawing shareholder's stock, but the close corporation actually ends up making the purchase.

This situation may occur when the shareholders and the close corporation are both obligated under a mandatory purchase obligation.

If a close corporation discharges an obligation of a shareholder, then the shareholder can be treated as receiving a constructive dividend—up to the amount discharged. Giving the remaining shareholders a right of first refusal, with the close corporation obligated to purchase the seller's stock if the shareholders do not exercise that right, may avoid this unfavorable income tax consequence.

SUMMARY AND CONCLUSION

Close corporation owners use buy/sell agreements for a number of tax planning, estate planning, and ownership transition reasons.

Valuation analysts (and legal counsel) who work with closely held business owners should be generally familiar with the alternative structures—and the alternative income tax consequences—of close corporation buy/sell agreements.

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