

Estate Planning With Buy-Sell Agreements: Buy-Sell Plan Options, Key Provisions, Formulas, Valuation, Funding

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Today's faculty features:

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Is YOUR Buy-Sell Agreement Up to Snuff?: Things to Remember in Buy-Sell Agreements

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Quotes of the Day

Don't spend ten dollars' worth of energy on a ten-cent problem...

DONALD A. TUBESING, M.D.

The law of diminishing returns holds good in almost every part of our human universe.

ALDOUS HUXLEY

Agenda

- Introduction.
- Paul's *Fire Drill*©.
- The Basics.
- Triggering Events.
- Vexatious Valuation.

Agenda

- Funding/Related Properties.
- Disability.
- S Corporation Issues.
- Ownership Issues.
- Review/Checklists.
- Conclusion.

Paul's *Fire Drill*©

- In Paul's experience, while a lot of closely-held businesses have buy-sell provisions whether in a separate free-standing buy-sell agreement or in one of the entity governance documents, e.g., by-laws or LLC operating agreement, ***very few of them were well drafted and most won't work to the satisfaction of the owners.***
- Indeed, Paul estimates that ***approximately 90% of all buy-sell agreements are significantly deficient.***

Paul's *Fire Drill*©

- Paul's best advice to owners of closely-held business interests is to first pull their buy-sell agreement out and read it. This will immediately move them to the head of the class.
- Then conduct what Paul calls his buy-sell agreement ***fire drill***©. Imagine that an event that triggers application of the buy-sell agreement has occurred, e.g., death of an owner, divorce, etc.

Paul's *Fire Drill*©

- Work the transaction contemplated in and required by the current buy-sell agreement closely ***following exactly what the buy-sell agreement currently provides*** for every aspect of the transaction, e.g., valuation of the interest to be transferred hypothetically in the fire drill, including the determination of who is to value the interest for the purpose of the hypothetical transaction, the type and payment of the consideration required in the hypothetical sale, etc.

Paul's *Fire Drill*©

- Odds are ***someone has just been hypothetically screwed*** or the owner is going to find to his horror that ***significant ambiguity exists that would gum up the works for years in expensive and stressful litigation where only the lawyers win.***
- However, there's good news, at least today. ***This was only a fire drill and wasn't a real transaction. But the clock is ticking.***

Paul's *Fire Drill*©

- This means that the client now knows that his current buy-sell provisions that have been buried in his or her desk for years while he/she's played ostrich won't work or indeed do anything but cause problems. It's time for action.
- Have the client arm him/herself with Paul's book and immediately read it and seek competent professional guidance to save him/herself from disaster and get the good buy-sell agreement that he/she deserves while he/she still has time.
- Unfortunately, ***once a triggering event has occurred, the proverbial ox is in the ditch, and it's almost always too late to fix it. Please don't be in that camp.***

View From 30,000 Feet-What is a buy-sell agreement?

- It is an agreement between owners and others that provides for transfers of ownership of a closely-held business upon the occurrence of certain events, which we'll refer to as “**triggering events**,” which can include death, disability, and divorce.
- Virtually **every** closely held business should have some form of buy-sell agreement for a whole variety of reasons.
- Buy-sell provisions often are a part of the entity governance (articles, by-laws, operating agreements, etc.) documents, but usually are **best** placed in a separate agreement, if for only privacy reasons.

Types of buy-sell agreements

- **Redemption**-where the entity is the buyer-ownership increases **proportionately**.
- **Cross-purchase**-where another owner or another person is the buyer-ownership shifts per agreement structure-can be **disproportionate**.
- **Hybrid-mixes** redemption and cross-purchase elements.

Most of the buy-sell agreements that I drafted were **hybrid agreements** because of flexibility.

Who should be parties to the buy-sell agreement?

- Just the current owners?
- What about **prospective** owners who are known? **This is a real good idea.**
- **Spouses? Absolutely**, especially in community property states, **even if your client doesn't like it.**
- The **entity?** In our opinion, absolutely in **all** events.

Possible purposes of buy-sell agreements

- Limit transfers of ownership interests-do **you** want to be in business with your late partner's spouse?
- Create a market and orderly transition-how else does one find a buyer for an interest in a closely-held business?
- Provide liquidity source and/or equitable financing terms.
- Maintain control of entity.
- Restrain or impede subsequent competition.
- Ensure against deadlock.

Possible purposes of buy-sell agreements

- Retain key employees.
- Protect S election against loss.
- Provide for alternative dispute resolution.
- Preserve partnership tax treatment.
- Provide for regular distributions to owners.
- Prevent transfer to unwanted persons.

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Key Advantages of buy-sell agreements

- Provide for a process or “rules of the road” for **transfers** of entity interests.
- Gives an opportunity to consider funding options for various triggering events.
- Protects S election against loss.
- Provide for a process or “rules of the road” for **periodic distributions** to owners.

Disadvantages of buy-sell agreements

- Failure to carefully work out terms or liquidity/financing terms.
- Blow eligibility for IRC Secs. 303 and 6166.
- Cost of a really good buy-sell agreement may deflect capital away from other needs at the outset of an entity's existence.

Does the selection of form of buy-sell agreement matter?

- Yes, it does.
- The late Dr. Stephen Covey was **right—begin with the end in mind**-think of a buy-sell agreement as a **will** for a business-**death is certain**-it is a **certainty** that there will be a triggering event occurring.
- Some forms of buy-sell agreements **absolutely** should not be used in some situations.

One size of buy-sell agreement does not fit all

- We often have **different** triggering events for **different** owners of the **same** entity.
- We routinely have **different responses** to triggering events for **different** owners in the **same** entity.

Improper selection of form of buy-sell agreement

- Improvident redemption agreements can cause a **shift of control** of an entity-how redemption of a 50% owner in a 50-30-20 ownership structure can become a majority ownership for the 30% owner-60% $(30/50) > 40\% (20/50)$.
- Watch out for agreements that fail to provide tailored triggering events to address a situation where a **junior** generation owner predeceases a **senior** generation owner-the best laid plans...
- Watch out for cross-purchases where the insurance is held in the entity because there is a **mismatch** between the **source of the cash** and the person who has the **obligation** to purchase.

Need for Coordination of Buy-Sell Agreement with Other Documents-these **must** be reviewed!

- Articles of formation of entity.
- By-laws/Operating agreements.
- Loan/Security agreements.
- Franchise agreements.
- Leases.
- Other documents and contracts.
- ESOP documents.

Need for Coordination of Buy-Sell Agreement with Other Documents

- Failure to coordinate a buy-sell agreement with other documents could create **ambiguity or conflict** between the documents.
- In some states, if there's buy-sell language in the articles or by-laws and in a separate buy-sell agreement and the two conflict, the version in the articles or by-laws governs.
- Failure to coordinate a buy-sell agreement with other documents could create an **event of default** under other documents.
- Failure to coordinate a buy-sell agreement with other documents could create a **triggering event** under other documents.
- **Never, ever draft a buy-sell agreement without reviewing all other documents! In my opinion, this failure is malpractice per se.**

Beware of “formism” in buy-sell agreements

- These were the **hardest** documents to draft for me.
- The problem with prefabricated “specimen” forms is that the **purpose** for which the forms were drafted may differ **significantly** from the purpose(s) of a buy-sell agreement for your client.
- A lawyer who needs a prefab form to draft a buy-sell agreement is an **accident waiting to happen**-don't let him or her happen to your client.

Watch out for inflexibility in buy-sell agreements

- Failure to permit transfer of stock to a **revocable trust**.
- Failure to permit lifetime or testamentary transfers, even by sale, to **related persons**, even if it is a family company.
- Failure to give a shareholder continued control over his or her shares if a **divorce** occurs. This is a biggie given the incidents of divorce.
- Some owners get trapped if the mechanics are not in place to define the rules for accepting a third party offer.

The moral

A **bad** buy-sell agreement
often is **worse** than **no**
buy-sell agreement at
all--**Much** worse!

Triggering event possibilities (usually limited to the “big D’s”)

- Death.
- Disability.
- Divorce.
- Bankruptcy or seizure of interest.
- Termination of employment for cause.
- Termination of employment without cause.
- Competition with the entity.
- Sale of a majority of the company.
- Sale of property owned and used by the entity.
- Retirement.
- Sale of all or substantially all of the assets of the entity.

Triggering event possibilities

- Attempt to dissolve entity.
- Conviction of a serious crime, e.g., felony, etc.
- Malfeasance.
- Loss of S corporation status.
- Loss of qualification as owner.
- Gift/other disposition of interest.
- Public offering.
- Grant of proxy or other control rights.

Good boy v. bad boy events

- Paul divides triggering events into “good boy” events and “bad boy” events for purposes of responses to a triggering event.
- Good boy events can include **death, disability, retirement** and termination of employment **without** cause.
- Bad boy events can include **attempted transfer** of interest, termination of employment **for** cause, **bankruptcy, competing** with the company, **malfeasance** and an attempted **transfer** of S corporation stock to an **ineligible** shareholder.

Possible reactions/responses to a triggering event

- **Absolute prohibition** against transfer. If too restrictive, this might get struck down in court.
- **Qualified prohibition** against transfer, i.e., only to qualified owners.
- **Mandatory** purchase and sale.
- An option, or **“call,”** by the entity or other owners.
- An option, or **“put,”** by an owner to sell to the entity or other owners.

Possible reactions to a triggering event

- **Tag along puts** by minority owners.
- **Drag along calls** by majority owners.
- Right of **first refusal**.
- Coexistent **cross-options**.
- Drop dead, **Mexican standoff** or gauntlet provision.
- Mere **notice**.
- **No** action.

Improper selection of buy-sell agreement triggering event selection

- Triggering events can range from death to loss of qualification, e.g., as an S corporation.
- Failure to provide for **exceptions** to a triggering event, e.g., for permitted transferees, can inadvertently cause an unintended transfer.
- Disability triggers are **inappropriate** in passive-type entities or for passive owners- *Ehlinger v. Hauser*, 313 Wis. 2d 718 (Wis. Ct. App. 2008).

Reactions to occurrence of triggering event

- The selection of what happens on occurrence of a triggering event can run the **gamut**—from **no action at all** to **mere notice** to **mandatory buy-and-sell**—and all points in between.
- A **mismatch** between a triggering event and the rights and obligations that flow from the triggering event can cause **serious** problems.
- For example, if an entity is **always** forced to purchase an owner's interest on termination of employment—for **any** reason, even if the owner is competing with the entity—**the entity will be providing capital to a new competitor!**

Tag Along Put Rights

- A tag along put option right (also called a “co-sale right”) prevents majority owners from selling their interests alone and leaving the minority owners with a new majority owner that they may not like or approve of by allowing the minority owners to join in the purchase of the majority’s interest on the same terms and for the same per share consideration as the majority’s shares through exercise of a put option right.

Drag Along Call Rights

- A drag along call option right in a buy-sell agreement prevents a minority owner from holding up a sale of the company by giving the majority owner who receives what he or she views as a favorable offer to buy the interests in the company to force the minority owners to sell on the same terms as the majority owner through exercise of a call option right.

Avoid vexatious valuation!

- Example 1: Schedule A valuations.
- Example 2: Formula valuations.
- Example 3: Three appraiser approach.
- Example 4: Book value approach.
- Example 5: Failure to specify the standard of value or the specific level of value.
- Example 6: Failure to specify the qualifications of the appraiser.
- Example 7: Failure to specify the “as of” date.
- Example 8: Failure to specify whether and how life insurance is factored into the value.

Schedule A values are a red flag problem

- Most clients have no real idea what their business is really worth, so having them put a value on their own company is a **fool's errand**.
- Very **few** clients remember to update the Schedule A.
- At a bare minimum, a buy-sell agreement that uses this valuation method should include a **backstop** valuation by a qualified appraiser if Schedule A is not updated as scheduled in the buy-sell agreement--Give it a **short shelf life**.

Formula valuation clauses rarely deliver an accurate value

- Paul was never able to draft an accurate formula for such purposes, and **he tried very hard.**
- Formulaic valuations are easily susceptible of manipulation—use GAAP, **consistently applied.**
- What happens if the formula generates a **zero** or **negative value**?
- There have been reported cases of zero values being upheld. See, e.g., *Roth v. United States*, 511 F. Supp. 653 (E.D. Mo. 1981), rev'd sub nom *St. Louis County Bank, Executor of the Estate of Lee J. Sloan, Deceased, Appellee, v. United States of America, Appellant*, 674 F.2d 1207 (8th Cir. 1982).
- Avoid these like the plague.

The three appraiser approach

- The **“three appraiser”** approach is **awkward and very expensive**-“*you pick an appraiser, I pick an appraiser and they pick a third appraiser, and we average the three value conclusions.*” This is an appraiser’s annuity!!!
- Why not agree on **one** appraiser in the buy-sell agreement in **advance**, i.e., before any triggering event occurs, to value the interest?
- Alternatively, have the parties each pick an appraiser, and those appraisers pick a third appraiser, who could be either of those two appraisers, who will then **solely** value the interest.

Book value valuations

- **Book value valuations almost always punish the first owner who suffers a triggering event!**
- Book value often is far less than either fair value or fair market value.
- Courts will hold the owners to their agreements in this regard.
- Consider the stark difference in the recent New Jersey case of *Estate of Cohen v. Booth Comp.*, 421 N.J. Super. 134 (N.J. Super. 2011).

Cohen Estate v. Booth Computers

Cohen Estate v. Booth Computers, 421 N.J. Super. 134 (N.J. App. Div.), cert. den. 208 N.J. 370 (2011).

- Book value of estate's interest: **\$178,000**.
- Alleged fair market value of estate's interest: **\$11,526,162**.
- Trial court ***upheld*** the buy-sell agreement at ***book*** value.
- Appellate court ***affirmed***, and the Supreme Court denied writs.

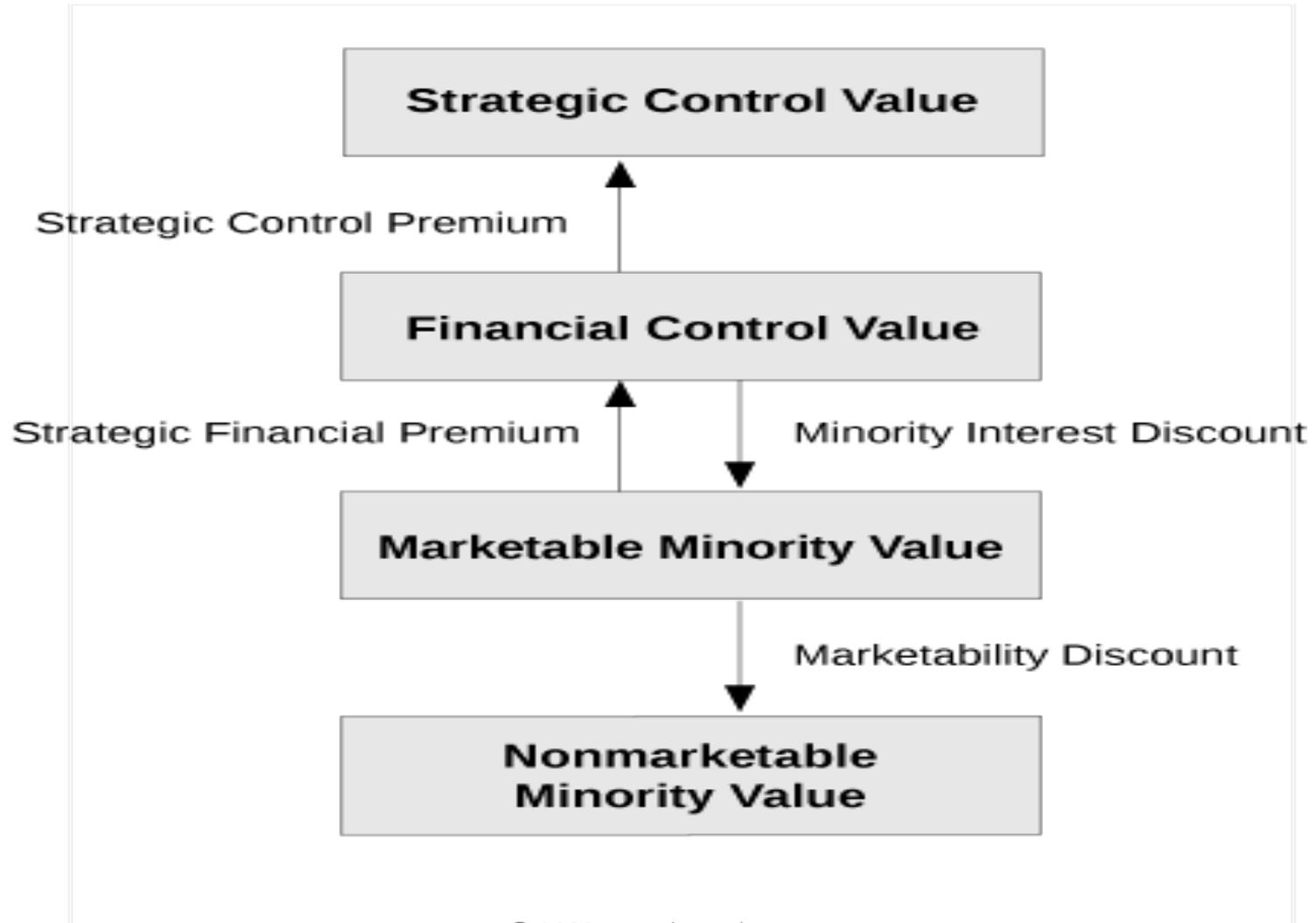
Book value valuations

Do you really want
to risk using book
value **ever**?

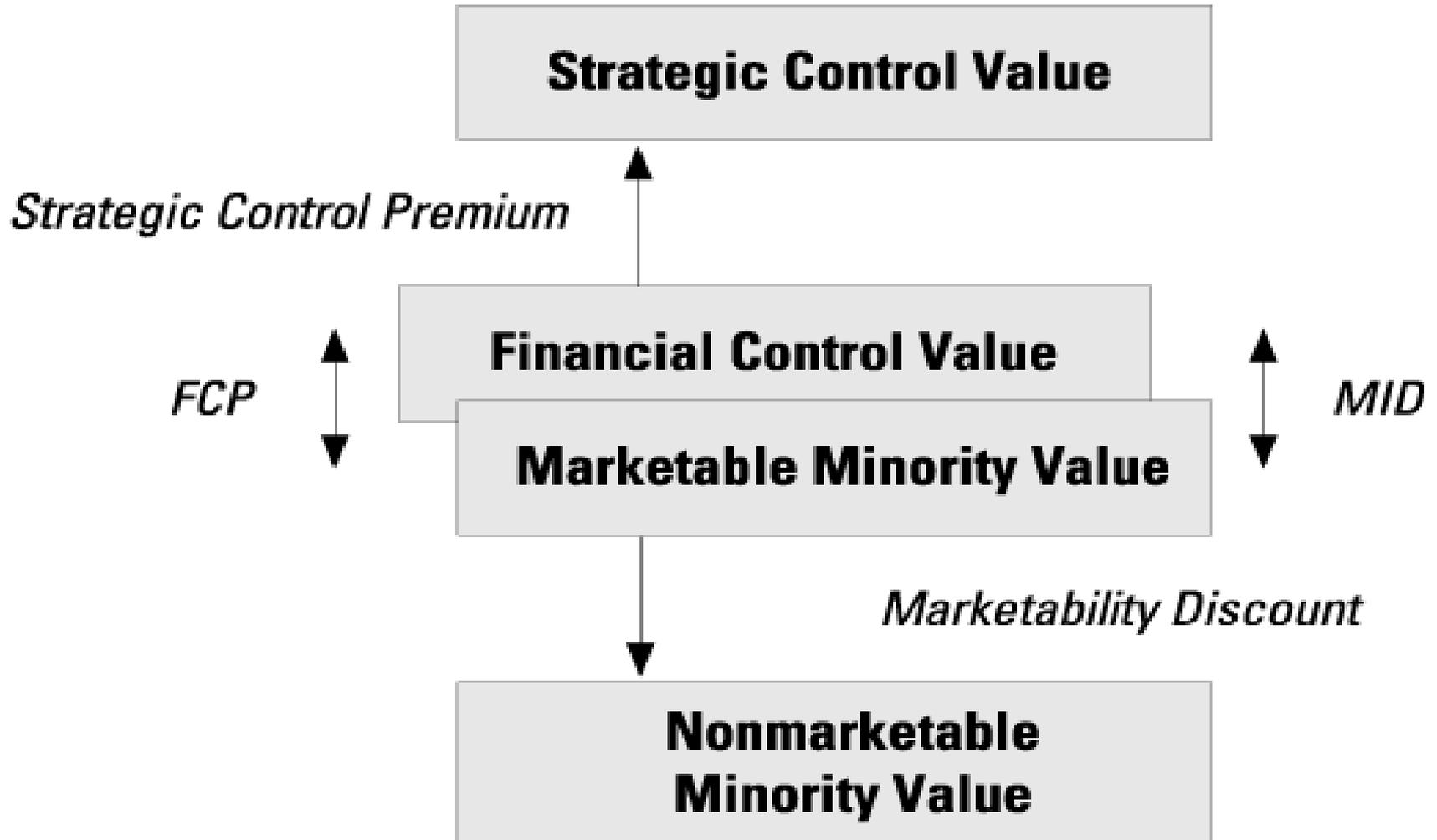
Standards and levels of value

- Failing to specify the **standard of value**, e.g., fair market value, fair value, intrinsic value, etc., or the **level of value**, e.g., nonmarketable minority value, i.e., what valuation discounts will apply, leaves a buy-sell agreement possibly **incomplete** and **ambiguous**.
- The standards of value produce **quite different** values.
- The same is true for different **levels** of value.

Classic Levels of Value



Another Depiction of the Levels of Value



Appraiser qualifications

Failing to properly specify the qualifications of the appraiser also risks ambiguity

- Caution: Very few CPAs are competent appraisers-this is **not** a job for the dabbler.
- Get someone who **regularly** performs business appraisals and who has obtained a **valuation certification** from one of the major credentialing associations: AICPA, ASA, CFA Institute, CICBV (Canada), or NACVA.

“As Of” Date

- One important provision that should be specified is the date on which the valuation is to be made, which I refer to as **the “as of” date**.
- The as of date should be very carefully explained for each of the various triggering events. The date of the business appraisal can make a significant difference in the conclusion of value, particularly for cyclical businesses.
- One tip for the as of date: Use the month end figure for the month **ending immediately before the occurrence of the triggering event** as this makes it a bit easier for the business appraiser and less expensive since special financial statements don't have to be prepared for an odd date, although for tax purposes the date of death or the date of a donation of interests, for example, is the generally employed “as of” date.

Life Insurance in Buy-Sell Agreements

- One issue that must be squarely addressed in the buy-sell agreement is whether or not to include any life insurance earmarked for buyout in the valuation of the entity.
- For tax purposes, the courts have held that life insurance doesn't add to the value of the entity as long as the entity is **required** to use all of the life insurance death proceeds to purchase the interest. However, if your buy-sell agreement could be triggered in ways that don't involve a tax controversy, then this must be described in detail in the agreement.

Life Insurance in Buy-Sell Agreements

- Treas. Reg. Sec. 20.2042-1(c)(6) provides for possible inclusion of the proceeds of a corporation-owned life insurance policy over which the decedent insured controlling interest shareholder held the indirect incidents of ownership. That regulation expressly applies to state law corporations. With respect to state law partnerships and limited liability companies (LLCs), the analysis will turn on who possesses the legal right or authority over the life insurance policy.
- Both partnership (both general and limited) and LLC default statutory law permit exclusion of an interested director, partner or manager from all rights and obligations relative to the life insurance policy that the entity owns and is the beneficiary of on the insured-owner's life. In PLR 200017051, the IRS National Office ruled that the insured-owner was properly excluded from any authority, responsibility or control over the life insurance on the owner-insured's life.
- Just be aware of the potential for indirect incidents of ownership where the insured-owner holds a controlling, i.e., majority, interest in the entity. As a practical matter, this is only a problem for state law corporations, which are declining in number, replaced by the LLC.

Life Insurance in Buy-Sell Agreements

- This was a hot issue in a recent federal estate tax case, *Connelly Estate v. United States*, the U.S. District Court for the Eastern District of Missouri determined that a buy-sell agreement did not set the value of the decedent's interest in a closely held corporation in which the decedent owned a majority interest, and the court further held that the life insurance proceeds that the subject company held that was used to redeem the decedent's shares from his estate had to be included in the calculation of the fair market value of the company for federal estate tax purposes.
- For more information about *Connelly* decision and the proper treatment of life insurance in redemption buy-sell agreements, see L. Paul Hood, Jr. and Edwin P. Morrow III, "Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After *Connelly v. United States*?" Steve Leimberg's *Business Entities Newsletter No. 247* (February 23, 2022), and their exclusive LISI Webinar on February 25, 2022 entitled "Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After *Connelly v. United States*?"

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- For tax purposes, the courts have held that life insurance doesn't add to the value of the entity as long as the entity is required to use all of the life insurance death proceeds to purchase the interest. However, if your buy-sell agreement could be triggered in ways that don't involve a tax controversy, then this must be described in detail in the agreement.
- The life insurance could be either counted or not counted, or the life insurance death proceeds could serve as a valuation floor (i.e., the value of a deceased owner's interest could never be less than the value of the life insurance policy death proceeds that covered the life of the deceased owner). This can matter a lot, as illustrated in the next slides. As you can plainly see, there's a \$2,500,000 difference in what the selling shareholder takes. Don't think that people won't fight over that chunk of change!

Life Insurance in Buy-Sell Agreements

- There are two ways to address life insurance in a buy-sell agreement: as an off-balance sheet item and as a separate corporate asset.
- The two examples, which Chris Mercer, FASA of Mercer Capital in Memphis TN (www.mercercapital.com) created, and which are used with his permission, illustrate an operating company, which we'll call Couyon, LLC, worth \$10,000,000 at the enterprise level, owned by two co-equal owners, Al and Betty, who have a redemption buy-sell agreement funded with life insurance on both owner's lives. Couyon, LLC is the owner and beneficiary of separate \$5,000,000 policies on the lives of Al and Betty. Let's assume that Al dies, survived by Betty.
- In the first scenario, the \$5,000,000 life insurance policies that Couyon, LLC owns on the life of Al is treated as an off-balance sheet item:

Life Insurance in Buy-Sell Agreements

Treatment 1 - Life Insurance as a Funding Vehicle			
Off-Balance Sheet			
Life Insurance Proceeds	\$5,000,000	Repurchase Liability	\$5,000,000
<i>(for 50% of FMV of Equity)</i>		<i>(for 50% of FMV of Equity)</i>	
Net Impact on Company			\$0

Value of Interest of Survivor	\$10,000,000
(Now Owns 100%)	

Life Insurance in Buy-Sell Agreements

- In the second scenario, the \$5,000,000 in life insurance proceeds, which metaphysically are received after Al's death, are added to Couyon, LLC's enterprise value as a corporate asset:

Life Insurance in Buy-Sell Agreements

Treatment 2 - Life Insurance as a Corporate Asset			
Market Value Balance Sheet (Before Repurchase)			
FMV Operating Assets	\$13,000,000	FMV Operating Liabilities	\$3,000,000
Life Insurance Proceeds	<u>\$5,000,000</u>		
		FMV Operating Equity	\$10,000,000
FMV of All Assets	\$18,000,000		
		Life Insurance Proceeds	<u>\$5,000,000</u>
		FMV of All Equity	<u>\$15,000,000</u>
		FMV of 50% Interest	\$7,500,000

Life Insurance in Buy-Sell Agreements

- It's clear beyond cavil that these two different treatments of life insurance with respect to inclusion in the enterprise value of the subject company produce entirely different end economic results that are significantly different.
- If life insurance is treated as an off-balance sheet item, at the end of the day after the redemption for \$5,000,000, Betty, the now sole owner of Couyon, LLC, owns a company worth exactly the same as it was before the redemption, i.e., \$10,000,000.
- In other words, the day before Al's death, Couyon, LLC was worth \$10,000,000. And the day after the redemption, Betty is the sole owner of Couyon, LLC, which is still worth \$10,000,000.

Life Insurance in Buy-Sell Agreements

- On the other hand, assume that the life insurance on Al's life is included in the value of Couyon, LLC at the enterprise level, Al's one-half interest in Couyon, LLC (forget valuation discounts for the nonce) is worth \$7,500,000, but Couyon, LLC only had \$5,000,000 in life insurance coverage on the lives of both Al and Betty.
- At the end of the day after the redemption of Al's LLC interest for \$7,500,000 (paid in part by the \$5,000,000 in life insurance proceeds and in part out of other assets of Couyon, LLC or with its promissory note), Betty, now the sole owner, owns a company worth 75% of what it was before the redemption, i.e., \$7,500,000, and Couyon, LLC now has either shrunk in total net assets or has taken on debt that it didn't have before the redemption.

Life Insurance in Buy-Sell Agreements

- These two different treatments produce real and substantially different economic results. In the latter instance, *Couyon, LLC* has significantly either actually shrunk on the asset side of the balance sheet, or it has taken on debt that must be repaid in an amount up to equal to 33% of its enterprise value.
- Parties should be able to contract for the economic result that they desire, which the tax law must respect, if tax truly respects and follows economics, as it must. The district court and some writers about the *Blount* case holding on the inclusion of the life insurance in the enterprise value of the subject company believe that the result in *Blount* is abusive and a too-good-to-be-true-result for taxpayers. But where is the abuse? Set aside the family relationships here.

Life Insurance in Buy-Sell Agreements

- Why shouldn't the tax law respect an agreement between unrelated taxpayers who are co-owners of a closely-held entity and parties to a buy-sell agreement to treat life insurance in a redemption buy-sell agreement as an off-balance sheet item and further to require that life insurance proceeds be used in the redemption transaction?
- And, if tax law respects an agreement between unrelated co-owners to treat life insurance proceeds in the context of a redemption buy-sell agreement as an off-balance sheet item, they why shouldn't related co-owners be permitted to do the exact same thing? What is the tax policy justification for different tax results in the cross-purchase v. redemption buy-sell arrangements?
- Some commentators have advised that closely-held business owners should avoid life insurance funded redemption buy-sell agreements, opting for a cross-purchase arrangement. In light of some of the district court's broad language and conclusions, this is somewhat understandable. However, there are practical problems with the cross-purchase arrangement that force many co-owners to reject it.

Life Insurance in Buy-Sell Agreements

- One significant problem with the cross-purchase arrangement is the quick proliferation of the number of life insurance policies needed as the number of owners grows. While the number of policies for a two-owner entity is only two, that number grows to six when you add just one owner, and it doubles to 12 when there are four owners. And it gets ridiculous quickly, i.e., at 15 owners, it requires 225 life insurance policies.
- Then there's the nettlesome problem of life insurance policy integrity, i.e., it's harder for an insured owner to make sure that their co-owners who own life insurance policies on the owner's life maintain the policies, pay the premiums, not pledge or otherwise encumber the policies, when it's easier to police when the entity owns the policies.
- Another practical problem is that the entity has the cash to pay the premiums, and it's often challenging to get the money necessary to pay the premiums out to the owners.
- In fact, cross-purchase agreements present so many practical problems that many use so-called trustee cross-purchase arrangements or even life insurance LLCs, which may suffer from some of the same issues as in *Connelly*. Therefore, cross-purchase arrangements aren't often attractive.

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- One significant problem with the cross-purchase arrangement is the quick proliferation of the number of life insurance policies needed as the number of owners grows. While the number of policies for a two-owner entity is only two, that number grows to six when you add just one owner, and it doubles to 12 when there are four owners. And it gets ridiculous quickly, i.e., at 15 owners, it requires 225 life insurance policies.
- Then there's the nettlesome problem of life insurance policy integrity, i.e., it's harder for an insured owner to make sure that their co-owners who own life insurance policies on the owner's life maintain the policies, pay the premiums, not pledge or otherwise encumber the policies, when it's easier to police when the entity owns the policies. Another practical problem is that the entity has the cash to pay the premiums, and it's often challenging to get the money necessary to pay the premiums out to the owners.
- In fact, cross-purchase agreements present so many practical problems that many use so-called trustee cross-purchase arrangements or even life insurance LLCs, which may suffer from some of the same issues as in Connelly. Therefore, cross-purchase arrangements aren't often attractive.

Life Insurance in Buy-Sell Agreements

- Another problem with the effect of the holding in *Connelly*, i.e., inclusion of the life insurance in the enterprise value of the subject company, is that inclusion essentially overvalues the subject company and greatly increases the cost of the premiums of life insurance, which actually could result in rejection of life insurance as a funding vehicle alternative.
- The practical problem is co-owners can't buy enough life insurance to cover the inflated value because the collective amount of life insurance on the lives of the co-owners significantly exceeds the enterprise value of the subject company when they obtain the life insurance policies.
- Take our example of Al and Betty. If life insurance is treated as a corporate asset, it would take \$15 million of life insurance to insure redemption for a subject company only worth \$10 million.
- Why would an insurance company insure imaginary value? They wouldn't.
- Why should insureds pay premiums for excess life insurance?

Life Insurance in Buy-Sell Agreements

- Another problem with the rationale of the *Connelly* holding, i.e., including life insurance in the enterprise value, essentially is an unwarranted expansion of IRC Sec. 2042, because under Treas. Reg. Sec. 20.2042-1(c)(6), indirect inclusion of incidents of ownership doesn't apply until the owner is a controlling owner, and even then only in certain circumstances.
- But under the *Connelly* rationale, it would indirectly apply the effect of IRC Sec. 2042 to all redeemed owners, including minority interest holders, even when the insurance is payable to the company.

Funding

- **Do not neglect buy-sell agreement funding obligations—more complex than you think.**
- **Avoid** funding mismatches, e.g., a cross purchase agreement where life insurance is held in entity.
- Have you given any thought to whether the entity in a redemption agreement can afford to make the prescribed installment payments? **You better.**
- Watch out for situations where an entity has to redeem out more than one owner close in time. What will you tell the second one? **Sorry?**

Related properties

What about related properties in a buy-sell agreement?

- Life insurance policies on a former owner in a lifetime buyout.
- Operating real estate held in a separate entity.
- If these properties will continue to be held as they are, how will the lease work on that property? **It better be for fair market value rent or there could be problems.**

Disability

Disability buy-sell clause issues

- Inappropriate for **passive** type entities.
- Problematic because, unlike death, disability is a **judgment call** that has to be made by someone.
- Disability buy-out insurance is **expensive** and **never** covers the entire purchase price.
- Buy-sell agreements **must** be tailored on terms and waiting periods in disability buy-out insurance policies.

Disability buy-sell issues

- The buy-sell agreement must spell out who is to **determine** disability-the board of directors, a physician, the insurance company?
- Carefully provide for **presumptive** disability where the allegedly disabled owner refuses to cooperate with seeing a doctor for purposes of making the disability determination.

Disability buy-sell issues

- A disability buy-sell trigger can be unfair where not all of the owners are **active** employees of the entity.
- What happens if the alleged disabled **recovers and returns to work** before being fully paid for his interest?
- What happens if the disabled owner **dies** before being fully paid for his interest?
- The buy-sell agreement **must** provide the answers to these questions.

S corporation buy-sell issues

- Buy-sell agreements, even with less than all of the shareholders, generally **don't** create a second class of stock-Treas. Reg. Sec. 1.1361-1(l)(iii.)
- Provide that transfers to ineligible shareholders are **null and void ab initio**, not merely voidable or subject to an automatic redemption.

S corporation buy-sell issues

- Have shareholders **represent** and **warrant** that:
 - They are the beneficial **owners**.
 - Receipt of stock will **not** prevent S election from being made.
 - They will take no action in any capacity that will cause the **termination** of the S election.

S corporation buy-sell issues

- Have shareholders **represent** and **warrant** that (cont.):
 - They will make no transfer to **ineligible shareholders** unless with prior written consent of all of the shareholders.
 - They will require trustees to execute a commitment **not** to file affirmative refusal to consent to the S election.
 - They will cause election to be **timely** made effective for first year and will agree to execute all necessary consents.

S corporation buy-sell issues

- Consider the following provisions:
 - Require shareholders whose stock is in trust to submit the **entire** trust instrument for advance review.
 - Require executors/personal representatives and successor trustees to **not** file affirmative refusals to continue to consent to the S election.
 - Require **supermajority** vote of all shareholders to terminate or to re-elect S corporation status.

S corporation buy-sell issues

- Require that all **transferees** and the **corporation** be parties to the buy-sell agreement.
- Have both all shareholders and corporation that any stock **subsequently issued or acquired** will be subject to the buy-sell agreement.
- Have the corporation agree **not** to acquire 80% or more of the stock of another corporation (would be eligible to file a consolidated tax return) unless it acquires 100% and becomes a qualified S corporation subsidiary.
- Have corporation agree **not** to issue a **second class of stock** (other than non-voting) or anything but **“straight debt.”** IRC Sec. 1361(c)(5).

S corporation buy-sell issues

- Have corporation agree to **not** issue stock to anyone but an “eligible S corporation shareholder.”
- Provide with respect to the following elections:
 - Cash distributions out of **AAA** (for S corporations that used to be C corporations only) during post-S corporation transition period. IRC Sec. 1371(e)(1), (2).
 - **Interim** closing of the books when a shareholder sells during a taxable year. IRC Sec. 1377(a)(2).

S corporation buy-sell issues

- Allocations of items during an S corporation **termination** year. IRC Sec. 1362(e)(3).
- AAA **by-pass** election. IRC Sec. 1368(e)(3).
- S corporation **tax matters shareholder** and **entity level audit procedures**.
- Shareholders should agree to report S corporation items **consistently** with how the entity does.
- One election can require consent of **former** shareholders. IRC Sec. 1377(a)(1).

S corporation buy-sell issues

- Be aware of the “wasted basis” situation in death time S corporation cash basis taxpayer redemptions-**Planning tip**: do the redemption for a short term note **before** the corporation receives the life insurance proceeds.
- If the S corporation was formerly a C corporation, consider **prohibiting** investments in passive assets, as too much passive income for three years in a row could cause **loss** of the S election.

Multiple control groups

- Does your client's entity have either a control group or two or more groups that desire to maintain status quo ownership between the groups?
- Does your client's buy-sell agreement accomplish this?
- Or could the buy-sell agreement cause a **shift in control** of the entity, despite the client's desires?

Dilution of ownership

- Does the client's buy-sell agreement prevent **dilution** of shares through new issuance?
- This is critical if your client owns **less** than half of the entity.
- The articles of incorporation may prevent this, but the buy-sell agreement also should **prevent** issuance of new shares without some sort of supermajority consent that includes your client's vote.

Age disparities

- What is the **age disparity** (if any) between the owners who are subject to the buy-sell agreement?
- Does the agreement treat these groups **equitably**?
- Or does the agreement **hinder** one group to the benefit of another group?
- Life insurance **premium disparities** can be vexing.

Active v. passive ownership

- Does your client's buy-sell agreement include persons who are **actively employed** by the entity and some others who **aren't**?
- Does the agreement distinguish between these different groups in areas such as **retirement** or **disability**, which it should?
- Or does the agreement treat all owners the **same**?
- If a **passive** owner dies, does the agreement give the active owners equal rights to buy the interest?

Distributions

- **Distributions** should be **specifically** addressed in the buy-sell agreement if the entity is an S corporation or is taxed as a partnership.
- Failure to do so could expose your client to a **terrible** plight: being taxed on income **without** receiving any cash with which to pay tax on that income.

Review of buy-sell agreements

- **When was the last time the client's buy-sell agreement was reviewed?**
- Too often, buy-sell agreements are signed at a time when everyone is on the **same page**, i.e., no triggering event is contemplated for a long time. Then the agreement is put into a drawer with the other corporate documents and **forgotten**.
- **Pretend** that a triggering event occurs-a fire drill of sorts. Does your client **like** what happens?

Checklists

Develop a good **buy-sell agreement checklist** and review **all** buy-sell agreements with it:

- One of the best is Chris Mercer's valuation checklist, which is available from Mercer Capital.
<http://www.mercercapital.com>
- Paul also has a number of checklists and specimen agreement language in Hood, *Buy-Sell Agreements: The Last Will & Testament for Your Business*, which is available at www.paulhoodservices.com as well as Amazon and all other major booksellers. And the forms, buy-sell options grid and checklists are downloadable from Paul's website, www.paulhoodservices.com.

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