BUY-SELL

AGREEMENTS

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WHY DO I NEED A BUY-SELL AGREEMENT?

Every shareholder in a corporation must consider how death or disability will affect his or her family and the operation of the corporation. Two primary areas of concern are typically:

* Providing income to the family and other heirs of the deceased stockholder, as well as the funds necessary for settlement expenses and death taxes.
* Establishing an arrangement which will dispose of the business interest in a manner most advantageous to both the surviving shareholders and the heirs of the deceased or disabled shareholder.

When a stockholder dies, a funded buy-sell plan assures the orderly transfer of stock ownership, the continuity of the corporation's management, and protects the stockholders family.

WHY BUY-SELL AGREEMENTS?

The legal existence of a corporation is not affected by the death or disability of an individual stockholder, regardless of his or her percentage of ownership or contribution to sound management. While the death or long-term disability of a stockholder in a close corporation leaves the legal structure intact, it always alters the corporations vital management structure, and it creates problems for the heirs of the deceased.

In a closely-held corporation, unlike a public corporation, the death of a shareholder/employee may, for practical purposes, threaten the very existence of the business as well as its profitability.

PURPOSES AT ODDS . . .

Surviving stockholders now must struggle with how to continue the corporation as a profitable business, having lost a contributing member of management. Heirs must concern themselves with how to replace the income that the deceased stockholder had earned.

The objectives of the surviving stockholders are frequently in conflict with those of the heirs. To minimize the areas of conflict and to effect a smooth transition after death, corporate owners should enter into an agreement while all are living -- a Buy-Sell agreement.

TYPES OF BUY-SELL ARRANGEMENTS

Stock Redemption plans are generally arrangements through which shareholders agree to sell their stock interest back to the corporation on the happening of certain events. These events are typically death, disability and, in some instances, retirement.

Under a Cross-purchase plan the shareholders, and not the corporation, agree to purchase the stock interest at death, disability, or retirement. The sale of the stock by the shareholder or his or her estate will increase the shareholders' cost basis.

CONSIDERATIONS IN DECIDING ON A BUY-SELL ARRANGEMENT:

TAX IMPLICATIONS

Federal and state death taxes are major liquidity needs in estates of most owners of closely held corporations. In addition, since the death taxes payable are a function of the value of the business interest, and that value is not as readily determinable as the value of stock in a public corporation, valuation of a closely held corporation can be a critical problem for the executor.

In fact, controversies about valuation are common between estates and the IRS. The estate, of course, wants to minimize the tax bite, and thus the value. The government obviously wants just the opposite. Court cases have dragged on for years, with their attendant legal fees, tying up estate assets and causing sizable increases in estate administration costs.

In contrast, when a properly drafted buy-sell agreement is in effect, the value of the stock for estate tax purposes will be fixed.

Income Tax issues regarding buy-sell agreements are not simple. While many corporations have the premiums paid for by the business, keep these points in mind:

* Premiums, whether paid by the corporation of the individual owners, are not tax deductible.
* Because premiums are paid with after-tax dollars, proceeds are received income-tax free.
* When the proceeds are used to buy stock, the purchase price is not tax deductible. It is merely an exchange for one form of property (cash) for another (stock).
* The transfer-for value rule comes into play if the insurance is owned by the corporation is a stock-redemption plan, and it is later decided to change to a cross-purchase type of arrangement.

It is not uncommon for accountants to desire a cross-purchase arrangement, but with the corporation paying tax-deductible premiums. Two possibilities are the use of salary increase or bonus ("Executive Bonus Plan"), or the use of split-dollar.

PERCENTAGE OF STOCK OWNERSHIP

A controlling interest in a successful corporation will usually maintain its value even after the shareholders death, except in those situations where the controlling shareholder was also the key to the profits. High percentage of ownership generally has one serious shortcoming -- the interest may comprise the bulk of the value of the estate, leading to substantial liquidity problems.

In contrast, a minority interest poses a different set of problems. Generally, most minority stockholders derive benefits from the corporation in the form of compensation (salary, rather than dividends). If the heirs of a minority stockholder are unable to assume an active role in the operation of the corporation, they will receive little, if any, direct economic benefit. For this reason, minority interests in a corporation makes it difficult for the heirs to sell their stock, except to the corporation or surviving shareholders.

EASE OF ADMINISTRATION

In any stock purchase plan, the creation of a sinking or insurance fund is essential, so that sufficient capital is available when needed to fulfill the intentions of the stockholders.

If there are only two shareholders, there is little difference in administration with either a stock redemption plan or a cross purchase plan.
Each requires the purchase of only two insurance policies, either by the corporation (stock-redemption) or the shareholders themselves (cross-purchase).

If there are three or more shareholders, the situation becomes more complicated. Under a stock redemption plan the corporation needs only purchase one policy for each shareholder. Under a cross-purchase, however, each shareholder would generally purchase a policy on each of the other shareholders. The total number of policies for 3 shareholders would be 6, with 4 shareholders it would require 12, and so on.

VALUATION OF THE CORPORATION

Since stock in a closely held corporation does not have a ready market, i.e. it is not traded on a stock exchange or over-the-counter, a determination of its value may prove to be difficult, and certain factors must be considered in arriving at a true market value for such stock.

Revenue Ruling 59-60 listed the following factors, stating that although not all-inclusive, they are considered to be fundamental in the determination of the fair market value of closely held corporate stock:

1) The nature of the business and the history of the enterprise from its inception.

2) The economic outlook in general and the conditions and outlook of the specific industry in particular.

3) The book value of the stock and the financial condition of the business.

4) The earning capacity of the company.

5) The dividend-paying capacity.

6) Whether of not the organization has good will or other intangible value.

7) Whether the stock to be valued represents a minority or majority interest.

8) The market price of stocks or corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

There are a number of methods for valuating a business. These include Agreed Value, Adjusted Book Value, Appraisal Value, and Formula Value. You should consult with your accountant regarding which will be the most advantageous and most accurate method for you circumstances.

FUNDING YOUR AGREEMENT

Even the best-drafted buy-sell agreement may fail in its purpose, if there is no provision made for adequate funds to implement it upon the death of a shareholder. Reasonable prudence suggests that a stock purchase agreement be funded. Although there are several funding alternatives such as the sinking fund method, serial notes, or personal funds (which usually means borrowing), the most satisfactory funding method is to fully insure the business interest with life insurance on the lives of the business owners. In this way, the event which activates the stock purchase plan, i.e. the death of a stockholder, will also produce the funds needed to effectively carry out the agreement, in the form of life insurance proceeds.

Life Insurance is an ideal funding vehicle for the stock purchase agreement for the following reasons:

1. The funds are instantly available on the death of an owner.
2. The proceeds are received free of federal income tax by the corporation or
3. owner, when payable in a lump sum.
3. The low premium cost can generally be paid out of current income.
4. Since the death benefit nearly always exceeds the premiums paid, a purchase with life insurance uses discounted dollars.
5. The plan can be self-completing in the event of disability.

DISABILITY BUY-OUT

Provisions should also be made for buy-outs in the event of long-term disability. The purpose of a disability buy-out is the termination of the corporate interest of shareholder employees who cannot return to a productive status in the business because of permanent disability.

Care must be taken in drafting these plans to avoid a buy-out inadvertently caused by a short-term disability. Thus the definition of disability, and the length of disability must be carefully considered.

A variety of lump-sum disability products are now in use which provide the requisite funding vehicle for this portion of your agreement.

(Appendix A)
Buy-Sell Needs Analysis

How is your corporation owned now?

If you died yesterday, who would have become the owner or owners of your corporation?

If you die tomorrow, who should become the owner or owners of your corporation?

Would the death of one or more stockholders have a significant impact on corporation operations?

Will the corporation be able to provide sufficient resources to your heirs?

Do the current stockholders wish to limit the number and identity of future shareholders?

Do your heirs wish to retain the stock interest?

If they retained stock interest, would they be able to effectively participate in the management and operation of the corporation?

Will there be sufficient estate liquidity to meet estate taxes, income taxes, and other settlement costs?

Will your heirs receive a controlling or minority stock interest?

Will the corporate interest be divided among several heirs, thus severely diluting the stock?