

The Buy-Sell Agreement: For the Heart and Soul of Business Succession Planning **The Key is Funding**

The Shareholder Agreement, or buy-sell agreement as it is commonly referred to, may very well be the most important component in providing for the orderly succession of control in a closely held business enterprise upon the death of a shareholder. Recent case law indicates that the buy-sell agreement may or may not be controlling for purposes of fixing value for federal estate tax purposes and depends on whether the formalities of Section 2703 are satisfied.¹ However, of even greater concern in many close corporate settings is to provide for, or enhance the ability of those who are to succeed to the controlling position, to actually carry out the purchase of the decedent's stock from his or her estate.

Even the most well drafted and well intentioned of shareholder agreements will fail to carry out its intended objective if the parties cannot carry out the purchase transaction. Obviously, the parties to the agreement will be best served if the agreement provides a source for there to be adequate funding of the purchase price. Generally, the source for funding the buyout of a decedent's stock comes from (1) an outside source of capital such as life insurance; (2) the surviving shareholders' personal funds; or (3) corporate cash flows and/or corporate capital in the form of redemption payments or dividend distributions to the purchasing shareholders to secure the payment of the purchase price.

In an era of business and economic uncertainties, a key to survival in business (an obvious goal of succession planning) is the preservation of the enterprise's capital for up and down business cycles and potential expansion. In general, the best interests of the business are best served when that precious capital is utilized to purchase the stock interest of a deceased shareholder. It is based upon the understanding of this basic business reality that provisions such as Code Sections 303 and 6166 have been enacted by Congress and fostered by the Internal Revenue Service ("IRS").

Buy-Sell Agreements can be as diverse as the businesses adopting them. As a result of the diverse nature and objectives of the owners of most closely held companies, this article will address only one of the primary needs that must be addressed in a shareholder agreement (or buy-sell agreement), namely: the funding of a buy-out at death. We are not going to focus on the drafting of the provisions of the buy-sell agreement (or even an outline of what a standard agreement should contain). Rather, it is our goal to concentrate on the process of reviewing the death-time buyout provision that are in effect, or are being proposed to a business owner for implementation and to make a determination as to whether or not it is feasible for the enterprise to adopt a welfare benefit plan² as a mechanism for lowering the after tax funding costs for providing the death benefit buyout.

¹ See Blount v. Commissioner.

² Under IRC Section 419.

What Form of Agreement is Appropriate?

One of the critical elements of the death buyout is how the buy-sell is structured in terms of which party has the right to purchase the shares of a deceased shareholder. In most cases, it is advisable that a so called “cross-purchase agreement” be implemented because of adverse alternative minimum tax consequences to a C-Corp with respect to the receipt of death benefit proceeds and for surviving shareholders’ stock bases issues in the event of a C-Corp, S-Corp, or LLC situation.

A cross-purchase type of arrangement is one in which the surviving shareholder or shareholders have the right to purchase the interests or shares of a deceased shareholder. In contrast, a redemption or entity purchase type of arrangement provides that the Corporation will have the right to purchase the deceased owner’s shares or interest. Some advisors prefer a hybrid type of arrangement, which is sometimes referred to as a “wait-and-see” agreement where the corporation and the surviving shareholders have the right, in some specified order, to purchase the interests of the deceased owner. In other words, the identification of who is the purchasing party may not be absolutely determined until after the shareholder/owner’s death. In some situations, this hybrid arrangement may provide that the surviving shareholders have the right to purchase the stock of the deceased up to the point of the value provided by the life insurance funding that the parties have undertaken.

Where it is desired by the parties to have the corporation situated as the premium payer of the life insurance, but the parties wish for the shares to be purchased by the surviving shareholders up to the level of the life insurance proceeds, it may be advisable to consider the implementation of a death benefit only welfare benefit plan buy-sell arrangement (“DBP-WBP” Buy-Sell). This type of arrangement will provide the surviving co-shareholders with a death benefit upon the death of a deceased shareholder which will be used by them to carryout their purchase obligations under their shareholder agreement. The death benefit will be received income tax free by the surviving co-shareholders and the DBO-WBP payment arrangement will provide the corporation with an income tax deduction for the premiums paid. The effect of such an arrangement is a lowering of the after-tax cost of funding the buy-sell agreement death benefit.

One of the primary obstacles confronting our clients to fund their buy-sell agreements on a permanent basis is the cost of the insurance. The 419 DBO-WBP Buy-Sell Agreement is an alternative which must be considered in any situation where the parties want the benefit of corporate dollars for the provisions of the death benefit to fund the buy-sell obligation, but they don’t want the corporation to redeem the shares of the deceased shareholder for some reason or another. With proper planning, the arrangement of reciprocal beneficiary designations and the implementation of provisions dealing with the redemption of shares in excess of the value provided by the life insurance death benefit, the business owner can provide himself or herself with a much lower effective cost of securing a death benefit buy-out. Likewise, it may be feasible under such a framework to establish a fully insured buy-sell agreement as opposed to one, which is only partially funded. The benefits of such a fully funded arrangement are significant for

the surviving shareholders in that they significantly lessen the corporation's cash flow drain following the death of a shareholder. In some cases the after-tax cost of an unfunded installment redemption obligation on the part of the corporation can be enough to prevent the corporation from surviving. This creates adverse consequences for the family of the deceased shareholder (no more payment stream), the surviving shareholders (no more business) and the employees of the corporation (no more jobs). Clearly full funding has its advantages.