



10 Most Important Things to Know about Buy-Sell Agreements

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I. Purposes of Buy-Sell Agreements

- Facilitate the transition of a business.
- 100% of business will experience a transition of ownership through one means or another.
- Help family members consider the future management of a family business and preserve family ownership.
- Provide a means to sell control to one or more children, employees, and partners.
- Serve as a stand-alone document or as part of a more comprehensive document such as a Shareholders Agreement, LLC Operating Agreement, or Partnership Agreement.

Purposes of Buy-Sell Agreements

- Establish a forum for the resolution of disputes between owners.
- Provide a market for the sale or redemption of the business.
- Allow the owners of a business to determine how the price of the company will be calculated in advance, and when the parties presumably have less leverage over each other.
- Without a Buy-Sell Agreement, owners face significantly greater uncertainty in the business, which could even result in a forced sale or litigation.

II. Types of Buy-Sell Agreements

- There are **3 ways** to structure the Buy-Sell Agreement depending on which party purchases the selling owner's interest:
 1. Redemption
 2. Cross-Purchase
 3. Hybrid

*The structure largely depends on **(i)** tax considerations, **(ii)** the source of funds, and **(iii)** the surviving owners' willingness to personal guarantee the purchase price.*

Types of Buy-Sell Agreements

- In a **redemption**, the company pays the purchase price and acquires the selling owner's interest.
- In a **cross-purchase**, the surviving owners pay the purchase price and acquire the selling owner's interest, not necessarily *pro rata*.
The surviving owners will obtain basis in the purchased interest.
- In a **hybrid** agreement, the surviving owners and the entity each have successive options to purchase the selling owner's interest. Typically, the entity has the first option to acquire the interest, and the surviving owners have the option if the entity does not exercise its option.
The hallmark of the hybrid approach is flexibility.

III. Restrictions on Transfer

- Most Buy-Sell Agreements provide for transfer restrictions.
- Absolute restrictions may be held *unreasonable, unconscionable, and without corporate purpose*.
- Generally, there are **4 classes** of permitted transferees:
 1. Other owners
 2. Family Members
 3. Permitted owners of S corporations
 4. Estate Planning Entities
- The Buy-Sell Agreement may provide for tag-along/drag-along rights.
- Legends should appear on the face of any membership or share certificates.

IV. Triggering Events

Triggering Events are the circumstances in which the option or requirement to purchase and sell an owner's interest become enforceable. Talking about triggering events gives owners an opportunity to think about the future of the business. Common triggering events include:

1. Death
2. Disability
3. Termination of Employment
4. Retirement
5. Insolvency
6. Divorce
7. Pledges of ownership interests
8. Attempts to sell to an outsider

Death

At death, there are **3 typical scenarios**:

1. The owner passes his or her interest to the spouse, children, or an estate planning entity (e.g., trusts or FLLC's).
2. The estate is required to sell its interest to the company and/or other owners, and the company and/or other owners are required to purchase the estate's interest.
3. The company and/or other owners have the option, but are not required, to purchase the estate's interest.

Disability

- “*Disability*” must be defined.
- Should it be determined by a disability insurance policy, or by a physician’s evaluation?
- Should the triggering event be measured from the onset of disability or from when the waiting period to determine disability ends?

Termination

Should employment be a precondition for owning shares in the company?

Issues to consider include:

1. Should children who do not work in the business have non-voting stock?
2. Does it matter if the owner's employment ends as a result of resignation, termination for cause, or termination without cause?
3. Is it a problem if confidential information is shared with owners who do not work in the business?
4. Will owners who do not work in the business be sufficiently motivated to see the business succeed (i.e., have "skin in the game")?
5. If all the owners do not work in the business, will there be sufficient profits to distribute?
6. Should the company demand a release of claims as a condition to payment of the purchase price? Any release should be drafted in advance and be attached as an exhibit to the agreement.

If the ownership interest was received in connection with the performance of services, and the interest is restricted, then IRC §83 may apply.

Retirement



Retirement is often treated separately from other terminations of employment. Owners should consider issues, such as requirements for a minimum age, minimum years of employment, advance notice, and restrictive covenants.

Bankruptcy



If creditors of an owner become co-owners, the company may want the option to buy-out the interests of the bankrupt/insolvent owner.

Divorce



If divorce is not specifically mentioned as a triggering event, then general restrictions on transfer may not be enough.

Should the divorced owner have the first option to purchase the interest awarded to his or her ex-spouse?

Depending on the way the option is structured, IRC §1041 applies.

Pledge of Ownership

Many Buy-Sell Agreements permit an owner to pledge his or her shares, but the triggering event would be the foreclosure on the pledged interest.

Attempted Sale to an Outsider

Buy-Sell Agreement may provide for rights of first offer, first refusal, or preemptive rights?

V. Fixing the Purchase Price Generally

The standard definition of **fair market value** is the price at which an ownership interest would change hands between a willing seller and willing buyer, neither side being under any compulsion to sell and buy, and both having reasonable knowledge of all relevant factors concerning the ownership interest (Treas. Reg. §20.2031-1(b)).

The IRS considers **8 factors** in determining the FMV of a closely-held business (Rev. Rul. 59-60):

1. Nature and history of the business since inception
2. Economic outlook
3. Book value of the stock and the company's financial position
4. Earning capacity of the company
5. Dividend paying capacity of the company
6. Existence of goodwill and other intangible assets
7. Sales of stock and the block of stock to be valued
8. Market price of similar stocks

Fixing the Purchase Price Generally

There are at least **4 methods** to value a closely-held interest:

1. Periodic Agreement
2. Formula Approach
3. Appraisal
4. “Russian Roulette”

Should the Buy-Sell Agreement provide for valuation discounts or purchase price protection?

VI. Fixing the Purchase Price for Transfer Tax Purposes

The IRS has never conceded that a Buy-Sell Agreement is binding for transfer tax purposes.

Courts have accepted the valuations in Buy-Sell Agreements where the following **4 factors** are met:

1. The price must have been fixed by formula.
2. The estate must be obligated to sell at the price determined under the agreement.
3. The obligation to sell at the price determined under the formula must have been binding on the shareholder during his lifetime and not just at his death.
4. The agreement must have been “a bona fide business arrangement and not a device to pass shares to the natural objects of decedent’s bounty for less than full and adequate consideration (Treas. Reg. § 20.2031-2(h)).

Fixing the Purchase Price for Transfer Tax Purposes

As the Tax Court in *Estate of Joseph H. Lauder* stated:

“It is axiomatic that the offering price must be fixed and determinable under the agreement. In addition, the agreement must be binding on the parties both during life and after death. Finally, the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition” (T.C. Memo 1991-736).

Congress has viewed Buy-Sell Agreements as having the potential to be artificial devices to transfer family assets for less than FMV.

Fixing the Purchase Price for Transfer Tax Purposes

IRC §2703(a):

“The value of any property shall be determined without regard to:

- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.”

IRC §2703(b):

“Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms’ length transaction.”

Fixing the Purchase Price for Transfer Tax Purposes

There is also an exception when the closely-held business is “more than 50% owned by individuals who are not members of the transferor’s family.” Treas. Reg. §25.2703-1(b)(3).

Meeting the requirements of IRC §2703 does not guarantee that the IRS will respect the Buy-Sell Agreement. It only means that any restrictions in the agreement will not be disregarded in determining the transfer value. Before the agreement can fix the value, it must still meet the 4 factor judicial test listed on Slide #18.

Why is it important that the price set forth in the Buy-Sell Agreement is binding for transfer tax purposes?

VII. Funding Buy-Sell Agreements

If insurance is not available to fund a buy-sell provision, how might the purchase price be funded?

1. Setting aside earnings
2. A split-up or split-off under IRC §355
3. Company loan
4. Promissory Note

There are several factors to consider when a *Promissory Note* is used:

1. Down payment
2. Interest Rates
3. Term
4. Frequency of Payments
5. Security
6. Acceleration

Even if insurance is available, there may be issues with holding, paying for, and transferring policies.

VIII. Special Issues with C-Corps

- When dealing with C-corporations, consider the effect of earnings and profits on distributions.
- IRC §§ 302, 303, and 318 all impact whether a distribution is treated as a dividend or a redemption payment.
- Redemptions are more difficult to structure with C-corporations.

IX. Special Issues with S-Corps

- One of the most important functions of a Buy-Sell Agreements with an S-corporation is avoiding the inadvertent termination of the S-election.
- Make sure that the redemption payments from the company do not create a *second class of stock* which terminates the S election.
- **IRC §1361(c)(5)** provides a straight debt safe harbor:
 1. The debt is not subordinate to general creditors.
 2. The debt is evidenced by a written unconditional demand to pay a fixed amount on demand or a specified date.
 3. The interest rate and the interest payment dates are not contingent upon profits, the corporation's discretion or other similar factors.
 4. The debt is not convertible into stock.
 5. The creditor must be an individual, estate, or trust that is a permissible S-Corporation shareholder.

Special Issues with S-Corps

- With an S-corporation redemption upon a shareholder's death, pay attention to basis considerations.
- In certain circumstances, it is possible to preserve a step-up in basis for the surviving shareholders.
- If an LLC has an S-election, make sure that its *LLC Operating Agreement* is consistent with the election. Before making the S-election, evaluate the differing effects under the corporate tax provisions.

Special Issues with S-Corps

- The Buy-Sell Agreement should provide for damages against any owner who jeopardizes the S-election and also provide the immediate option to purchase such owner's interest.
- If the Buy-Sell Agreement provides for transfers to estate planning entities, only allows trusts that qualify as S-corporation shareholders (e.g., QSST's and *ESBT's* under IRC §1361(d) and (e))
- The Buy-Sell Agreement may require a *closing of the books election* under IRC § 1377(a)(2).

X. Special Issues with Partnerships

There is greater flexibility structuring buy-sell provisions for partnerships (including LLC's taxed as partnerships) than for C-corporations and S-corporations.

Special issues in partnership agreements include:

1. IRC §754 elections
2. Partnership Representatives
3. Tax Distributions (equally an issue with S-corporations)

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