Business Succession Strategies

Alternative Buy-Sell Agreements

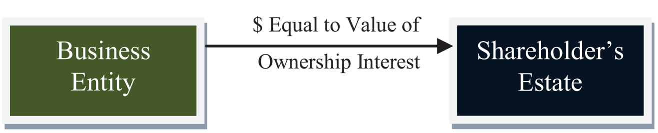
Buy-Sell agreements are commonly implemented by closely-held business owners in order to place legal limitations and guidelines on future transfers of their business interests. Properly documented buy-sell agreements help to assure the continued success of the business by avoiding conflicts between business owners.

There are numerous issues to consider when designing buy-sell agreements including valuation of the business, terms of a sale, events that will trigger a sale, whether these events should create an obligation or a right to purchase and sell a business interest, where the funds will come from to complete the sale, and how to minimize the tax implications of a future sale.

Basic Structure

The basic structure of the agreement will generally take one of two forms - either the business will purchase the ownership interests of a selling owner (often referred to as stock redemption or entity purchase agreements), or the other owners will purchase the interests (a cross-purchase agreement).

Entity Purchase

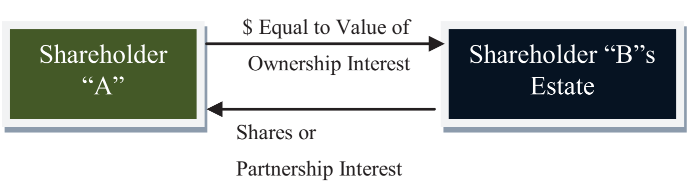


Business redeems ownership interest of deceased shareholder / partner

Advantages

- Only need one policy per owner
- Business retains control over policy
- No taxable distributions required

Cross-Purchase



Advantages

- Purchasing owner receives increase in basis
- Avoids family attribution and AMT tax issues

Both forms have their advantages and disadvantages. For example, if the business has been formed as a C corporation there are a number of negative tax implications in designing the agreement as a stock redemption:

- A redemption of C corporation shares between certain family members may not be taxed as a capital transaction due to family attribution laws.
- A surviving shareholder does not receive an increase in their basis which may cause additional taxes should they later sell their ownership interest.
- Life insurance owned by the corporation to fund the buy-sell obligations may subject the corporation to AMT.

Many of these concerns may be alleviated by designing the agreement as a cross-purchase agreement. However, cross-purchase agreements have a number of disadvantages of their own, specifically in situations where life insurance is acquired to fund the agreement and there are more than two shareholders:

- There is a risk of creating a "transfer-for-value" which will cause a majority of the death benefit to be taxed at ordinary income tax rates.
- A large number of policies may be needed to provide funding for all the potential transfers (for example, with 4 shareholders a total of 12 policies will need to be purchased).

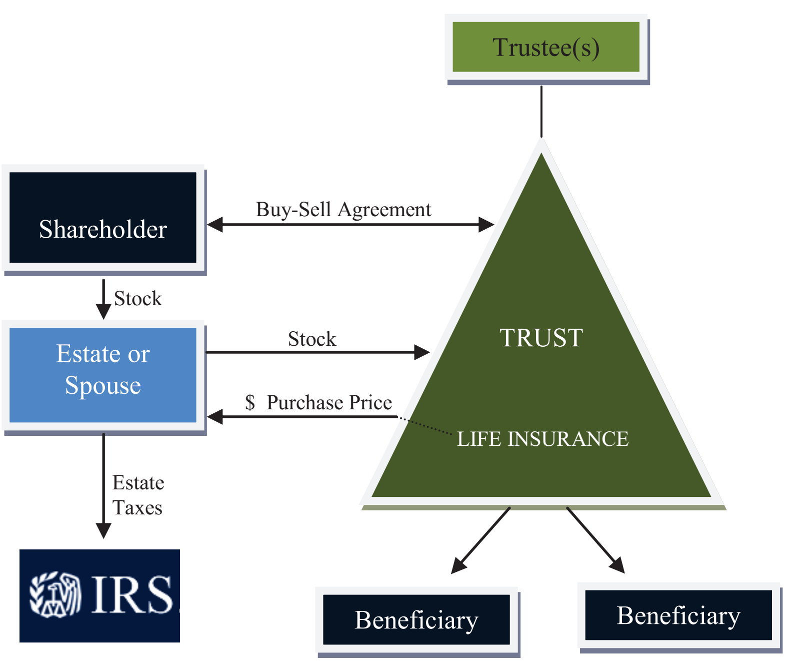
Alternative Designs

In situations where both the typical entity-purchase and cross-purchase agreements create unfavorable tax results, it may be appropriate to consider an alternative structure. There are a number of ways to design the agreement to achieve the positive results of both the entity-purchase and cross-purchase forms while avoiding the negative results. Two of the more common methods are the Trusteed Buy-Sell and the Partnership / LLC Buy-Sell.

Trusteed Buy-Sell

In a trusteed buy-sell agreement the owners of a business enter into a contractual agreement that places restrictions on the ownership of their business interests. The agreement will typically state what is to occur upon various triggering events such as death, disability, termination of employment (voluntary or involuntary), insolvency of an owner, divorce of an owner, etc. Trusteed buy-sell agreements are generally set up as cross-purchase agreements which call for the business owners to purchase the business interests of an owner when a triggering event occurs. The owners are obligated to purchase the business interests of a deceased shareholder. A trust is established and is the owner and beneficiary of life insurance policies covering the lives of the owners (one per owner). The trustee is responsible for carrying out the terms of the trust when a death occurs.

How it Works:



- A trust is established to carry out the terms of a buy-sell agreement. The trustee(s) may be family members, trusted professional advisors or corporate trustees.

- A buy-sell agreement is established between the current shareholders giving the trust the right to purchase the shares of a deceased shareholder.

- The trust acquires life insurance on the life of the shareholder(s). The Funds may be contributed to the trust by the business or personally by the shareholders.

- Upon the death of the shareholder the trust receives the life insurance proceeds. The trustee(s) have the right to purchase the deceased shareholder's stock from the estate.

- If the trustee(s) do not purchase the stock the funds may be held or distributed to the beneficiaries based on the terms of the trust.

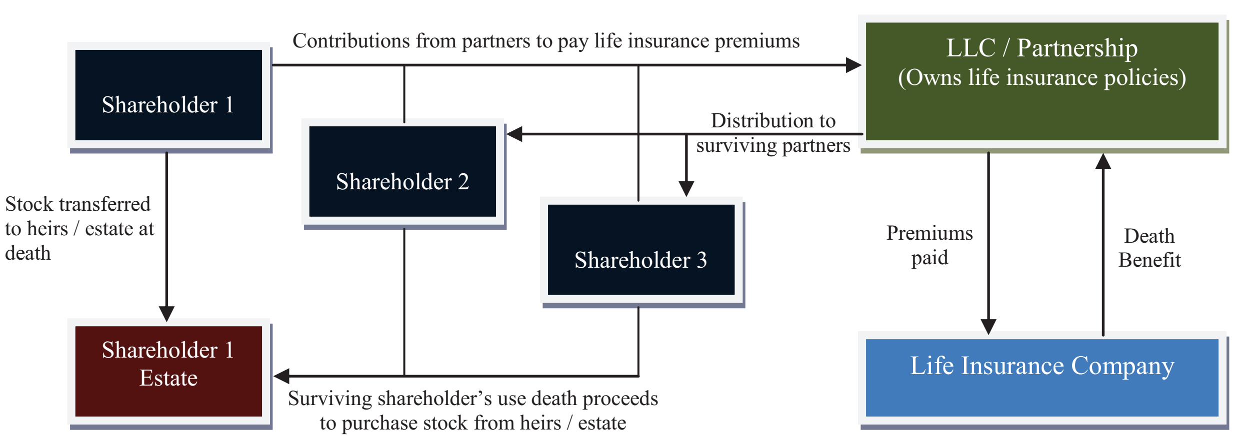
- If estate taxes are due the estate may use the sale proceeds to pay the estate tax.

Advantages:

- Policy death benefit and cash value increases are not subject to the alternative minimum tax
- Policy is not available to business creditors
- Family attribution rules do not apply
- Only requires one policy on each shareholder
- The trust may be drafted to allow the business to borrow money from the trust. This may be useful should the death benefits exceed the amount required to purchase a deceased shareholder's shares.
- If the buy-sell agreement is set up as a cross-purchase agreement the surviving shareholders will receive an increase in basis equal to the amount paid for a deceased shareholder's shares.

Partnership / LLC Agreement

- The owners of the business form a partnership or LLC taxed as a partnership (It may be possible to use a pre-existing entity). A provision allowing for a special allocation of life insurance death benefits should be included.
- Each business owner will own an interest in the partnership in proportion to their interests in the corporation.
- The partnership will purchase one policy on each business owner. Premiums are paid with contributions from the owners (they may take taxable distributions from business to pay premiums).
- If an owner dies prior to retirement, the partnership receives the insurance policy proceeds and distributes to the surviving owners who purchase the stock of the departing owner.
- At retirement, the life insurance policies may be distributed to each insured who may draw on the policy cash values to supplement retirement income.



Not intended to be accounting, legal, or tax advice. Clients should consult their legal, accounting and tax advisors about their particular circumstances before implementing any recommendations.

Advantages

- May be accomplished with one policy per member / partner
- AMT does not apply to an LLC taxed as a partnership
- Family attribution rules of IRC Sec. 318 do not apply to an LLC taxed as a partnership
- Survivors receive a increase in basis
- No transfer-for-value concerns
- Retirement payments - When a member redeems his entire interest the buy-sell may be set up so payments are tax-free up to basis then taxed as capital gains. (IRC Sec. 736(b) and Sec. 731)
- The life insurance death proceeds will be outside each member's gross estate for estate tax purposes as long as the proceeds are payable to the LLC. (Rev. Ruling 83-147) Proportional fair market value of the LLC would be included in the estate.
- Flexibility of LLC allows for changes in the agreement for new owners.