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METHODS OF FUNDING A BUY-SELL AGREEMENT

1. **Personal Funds of Buyers**
   Most successful businessmen do not keep large sums of liquid assets on hand. They have their money working in their business.

2. **Sinking Fund in the Business**
   Such a fund will be inadequate if death is **premature**, and the time of need is uncertain. A Corporation may develop an accumulated earnings tax problem.

3. **Borrowed Funds**
   Loss of key person may **impair the credit worthiness** of the business and other partners or shareholders. Interest costs may be excessive and interest expense of shareholders or partners may not be deductible.

4. **Installment payments to Heirs by Buyer**
   The business may fail and the payments stop. The principal and interest payments may be too burdensome.

5. **Life Insurance Owned by the Buyer**
   A. Complete financing **guaranteed** from the beginning.
   B. Proceeds are **free from income tax**.
   C. **Cash values** can be used for a buy out due to retirement or disability.
   D. It is the **most economical method — Discounted Dollars**.
   E. **Credit position** is strengthened.

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BUY-SELL AGREEMENTS

Cross-Purchase versus Stock Redemption

There are three basic types of Buy-Sell Agreements for Corporations:

1. The **Cross-Purchase** plan between the shareholders themselves,
2. The **Stock Redemption** plan between the corporation and the stockholders, and
3. The **"Wait and See"** plan.

CROSS-PURCHASE PLAN

Advantages:

1. Purchasing stockholders get a **new basis** in acquired stock. (This could mean a savings in taxation of the capital gain at a later sale.)
2. No problem with **laws restricting corporate redemptions**.
3. No problem with **Family Attribution rules**.
4. **Corporate creditors cannot reach** the insurance proceeds.
5. Premiums can be paid by the corporation, if treated as additional compensation by the stockholders.
6. Policies can be later transferred to the corporation without a transfer-for-value problem.
7. Insurance proceeds can be lent to the corporation.

Disadvantages:

1. The plan becomes more difficult to administer if there are more than two stockholders.
2. Insured plans need more policies.

FORMULA = Stockholders x (Stockholders minus 1)

Examples:	3 Stockholders	3 x (3-1)	=	6 Individual policies
	4 Stockholders	4 x (4-1)	=	12 Individual policies
	5 Stockholders	5 x (5-1)	=	20 Individual policies

3. Insurance may cost more if the corporation is in a lower tax bracket than the individuals.
4. Stockholder may have trouble paying the premium.

STOCK REDEMPTION PLAN

Advantages:

1. It is **easier to understand**.
2. There is **less accounting** — fewer insurance policies.
3. The premium dollars are cheaper if the corporation is in a lower tax bracket than the owners.
4. It permits the **pooling of premium obligations**. When one stockholder is older

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and/or the majority owner and the other is younger and/or a minority owner, the insurance premiums may be vastly different.

5. No question arises as to "unreasonable compensation," as it often does when salaries are increased to pay the premiums for life insurance used to fund a cross-purchase agreement.

Disadvantages:

1. There are **possible accumulated earnings tax problems**.
2. The buyout may be considered a taxable dividend because of the **Section 318 Family Attribution Rules.**
3. The **voting power could be altered** in an undesirable way.
   Example: Father owns 30%, son owns 30% and unrelated key man owns 40%. A combined vote of father and son controls the business. If father's stock is redeemed at his death, the unrelated key man would own a majority of the outstanding stock and control the business.
4. **State law often restricts redemptions** unless from surplus.
5. Insurance cash values and proceeds are available to creditors.
6. The surviving stockholders' **basis in the stock remains the same**, even though the value of their ownership increases. This means that a later sale of the stock will result in a higher capital gain to the surviving stockholders.
7. Life insurance proceeds are included in **Adjusted Current Earnings** for purposes of the **Corporate Alternative Minimum Tax**.

"WAIT AND SEE" BUY-SELL AGREEMENT

1. Stockholder and corporation agree:
   A. The remaining shareholders have the option* to purchase the shares of the deceased shareholder, and
   B. The Corporation has the obligation to redeem the shares to the extent they are not purchased by the shareholders.
2. Funding should be as in a Cross-Purchase Plan.
3. At the death of a shareholder, the survivors elect either to:

A.		B.
(1) Collect insurance proceeds,	OR	(1) Collect insurance proceeds
(2) Buy the shares individually.		(2) Lend proceeds to corporation,
		(3) Cause the corporation to redeem shares,
		(4) Corporation issues interest bearing notes to repay loans.

*The "Wait and See" plan is generally most desirable. However, if shareholder is "obligated" to purchase stock and does not, a later purchase by the corporation would likely be a dividend.

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MAKING A BUY-SELL AGREEMENT BINDING ON THE IRS (IRC Sec. 2703*)

1. The agreement must be a bona fide business arrangement;

2. It must not be merely a device to transfer the business interest to family members for less than full and adequate consideration; and

3. The terms of the agreement must be comparable to those found in similar arrangements entered into at arm's length.

NOTE: The Conference Committee Report for the Revenue Reconciliation Act of 1990 recognizes that there is more than one method of valuing a business (even in the same industry) and it does not require that the method producing the highest value be used.

*This is a new provision to the Internal Revenue Code and has not yet been interpreted by case law. Technically, it does not "bind" the IRS or the courts but it could be persuasive if all of the requirements are met.