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THINK ABOUT IT

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Funding Buy-Sell Agreements

A corporate buy-sell agreement should be funded by a method that will facilitate a trouble-free transfer of a business interest in the following four contingencies:

1. At the withdrawal of an owner before retirement, or
2. At his/her normal retirement age,
3. In the event of a stockholder's long-term disability, and
4. At a stockholder's death.

Ideally, the method used to provide funds to meet one or more of these contingencies would

- have a relatively low cost,
- be simple to understand,
- be easy to establish and/or administer, and
- not adversely affect the working capital or credit position of the business.

Although a properly drafted buy-sell agreement should consider the possibility and implications of a buy-out due to a number of events (including loss of professional license, insolvency, bankruptcy, and in some cases legal separation, or divorce), this commentary focuses primarily on the ramifications of funding a purchase that is triggered by a shareholder's death or long-term disability.

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Probability of Death

The probability of death of at least one of two business owners at an age prior to 65 is surprisingly high. Expressed as the number of chances out of 100 that at least one of two business owners in relatively good health (able to qualify for standard insurance rates) will die before age 65, are as follows, (courtesy of Number Cruncher Software):

Ages	Chances out of 100
30/30	37.5
35/35	36.4
40/40	35.0
45/45	33.0
50/50	29.9
55/55	24.7
30/35	44.5
35/40	43.4
40/45	42.0
45/50	39.7
50/55	36.1

Funding Alternatives

Although most buy-sells are funded with life insurance, there are, of course, alternatives, which can be used to create the needed liquidity to purchase a business interest. Each of these options should be carefully considered in every case with the client and his/her advisors.

The most common and widely used alternatives are cash, sinking fund, borrowing, installment payments, private annuity, and life insurance.

Cash

The first alternative is cash, which has the apparent advantage of being simple and requiring no immediate outlay.

The problem is that the purchaser does not know precisely when or how much cash will be needed, or who the survivor(s) will be (if there are multiple owners/shareholders). As a result, the purchaser must always keep an adequate cash reserve available.

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In the case of a cross-purchase agreement, where each surviving shareholder agrees to buy the interest of a deceased shareholder, after the purchase of the decedent-shareholder's interest, the survivor's personal liquid assets would be severely depleted. Where the agreement is in the form of a stock redemption and the corporation purchases the departing or deceased shareholder's stock, corporate surplus, operating capital, or current income would often be drained.

Regardless of the identity of the purchaser, after-tax dollars must be used to accomplish the buy-out. This means (depending on the purchaser's federal and state income tax brackets) that much more than one dollar must be earned to net a dollar of purchase price. And monies, which have to be held in reserve, will likely not be earning a return (or as high a return) as if invested personally, or by the corporation in the business.

Unfortunately, at the death of an owner, the drain on the buyer's cash flow almost always seems to occur at the worst possible time. And if the corporation were to accumulate a large amount of cash in anticipation of the need to effect a buy-out, would the extra liquidity trigger an accumulated earnings tax? If the surviving shareholders were to be the purchasers, would the corporation have the cash to increase their salaries in order for them to make payments of both principal and interest, and would these increased salaries be considered "reasonable" compensation, and not dividends?

Sinking Fund

If the potential purchaser decides to use cash and establishes a "sinking fund" to meet his/her/it's obligations under the agreement, can a determination be made as to how much to deposit each year? Inevitably, sinking funds are inadequate, because death or long-term disability of a working shareholder is almost always "premature." All too often, there just isn't enough time (or will-power) for a business (or an individual) to build up and maintain a sufficient cash reserve.

When business assets are to be used, the development of a sinking fund may strain or deplete the corporation's working capital, and may even aggravate or trigger an accumulated earnings tax problem.

(Note that from the standpoint of the deceased shareholder's heirs, the above problem often makes both the risks involved in the sinking fund approach and the post-death installment payout method unacceptable.

The deceased shareholder's family must rely on the financial ability as well as the moral responsibility of the purchaser(s) who must carry on the business without the aid and support of the former employee-shareholder.)

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Borrowing

ISimilar to the "cash" alternative, borrowing has the advantages of being simple and requiring no outlay until death or disability occurs. The question is: will a bank lend money to a business that has just lost its most important asset, the person who made the corporation what it was? If the bank lends the money, will the terms and/or rates of the loan arrangement be reasonable and affordable from the borrower's viewpoint? What impact will the cash flow demands of repaying the loan have on the operation and credit-worthiness of the business?

The cost to borrow $1,000,000 over a given period of time is substantial, as shown by the following figures, which assume the buyer is in a 35 percent combined federal and state income tax bracket and is able to deduct interest payments:

Cost to Borrow $1,000,000		
Total Combined Cost at	5-Year Loan	10-Year Loan
10%	$1,300,000	$1,550,000
Earnings Required at		
10%	$1,838,460	$2,088,460

Interest incurred in an installment cross purchase may not qualify as investment interest; if it is not, the entire deduction could be lost.

Installment Payouts

An installment payout is often thought to be a feasible means to purchase a deceased shareholder's interest. The apparent advantage of an installment sale from the buyer's perspective is that it is simple, and a relatively small outflow is required each year. Nothing is needed until the seller's death, so action can seemingly be put off for many years.

The decedent-shareholder's heirs appear to profit because they will receive interest on the unpaid balance. Assuming the seller is a cash-basis taxpayer, gain on the sale can be spread over a number of years. Furthermore, the heirs are creditors of the buyers rather than shareholders of what may be a financially shaky business. This puts them in a slightly more financially secure position.

However, keep in mind that the installment payout method merely delays the pain and obfuscates the problem. Why?

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For the buyer, an installment sale merely spreads out the obligation but does not provide the cash to effect the buy-out. The longer the term of payments and, therefore, the greater the obligation, which in turn will have more adverse effect on the credit rating of the business. From the standpoint of the seller (e.g., the deceased's estate), an installment payout does not provide the large sums of cash often needed for estate settlement costs and debts. Furthermore, it leaves substantial sums at the risk of a business (or rather, its success or failure), which has just lost a key employee/shareholder. So an installment sale may not adequately provide the deceased shareholder's family with the desired financial security.

Ironically, from the surviving shareholders' viewpoint, an installment payout doesn't sever the ties between the business and the family of the departed shareholder. To the contrary, it creates almost as much nuisance value as if the surviving spouse still owned the stock. (These may be some of the very problems the buy-sell arrangement was implemented to avoid.)

The terms and interest rate under an installment sale agreement could pose problems and be challenged by the IRS. For example, if payments are stretched out too long (say more than 15 years), the IRS may argue that in reality, the seller has remained an equity owner, i.e., a shareholder rather than a creditor. That classification would mean payments received from the corporation are dividends rather than payments for stock.

Similarly, the interest rate on the unpaid balance must reflect real and prevailing economic and market conditions. As an example, in a closely-held business, would the parties be able to pass the stock from one generation to another by setting a fair price but assessing an ultra low interest rate (or no interest at all) and spreading payments over many years? The answer is "NO." Reasonable rates of interest must be paid on the outstanding balance.

In fact, if a buy-sell agreement allows for deferred payments but does not provide for an "adequate" rate of interest on the unpaid balance the buyer owes, the IRS will "impute" an interest rate. In other words, the IRS will treat the parties as though they had agreed upon a fair-market rate for the right to defer part of the sales price.

That payment (the imputed interest) will be set by reference to the "original issue discount" rules, which reflect current market rates. The rate is ascertained based on the time the buy-out becomes effective, rather than the date the agreement is entered into. That rate might be much higher than the parties anticipate.

A seller allowing the buyer to defer payments will (and should) inevitably insist on security for the unpaid amounts. Corporate assets can secure the unpaid balance, but this security may hinder the

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firm's ability to borrow money from other sources to finance expansion or even raise working capital. Corporate assets may not be sufficient to satisfy the seller (now a creditor) and the seller may insist upon the personal guarantees of the remaining shareholders in addition to the securing of corporate assets.

Of course, if the agreement was structured as a cross purchase, the corporation's assets could not serve as collateral for the unpaid balance (such an agreement would be void for lack of consideration) and, therefore, the purchasing shareholders would be personally liable. In that case, how and where will they obtain sufficient after-tax liquidity to pay both principal and interest?

An installment sale can be incredibly expensive. Interest paid personally by shareholders on the deferred portion of the buy-out price is "investment interest" which will be non-deductible to the extent that there is not enough investment interest. The loss of an interest deduction would significantly increase the cost of a deferred payment buy-out.

Because the "debt" takes on the characteristics of equity as it's maturity date extends outward, an installment obligation of longer than 15 years may not be possible with a corporate purchaser. When the debt is reclassified as equity, if the redemption cannot meet certain safe harbor tests, payments to the selling shareholder will be taxed as a dividend at ordinary income rates.

The bottom line is that, generally, deferred payments should be used as a last resort "escape valve" in case there is an inadequate amount of insurance, rather than as the primary means of financing a buy-out at a shareholder's death.

Private Annuity

In exchange for stock, a withdrawing or retiring shareholder can agree to receive a private annuity in lieu of a lump sum. Basically, this is an agreement that the corporation or the purchasing shareholders will pay a fixed amount each year to the selling shareholder for the remainder of his or her life (or the remainder of his/her life and his/her spouse's life). This technique works best when the seller, during his/her lifetime, wants to divest all of his/her stock and the successor shareholders are family members and/or loyal employees.

A major problem with the use of a private annuity as a funding device is that it cannot be "secured." In other words, no collateral can be required and no escrow account can be demanded without the seller losing the two major advantages of a private annuity: (1) the removal of the stock's current value and future appreciation from the seller's estate, and (2) the spreading out of gain over the lifetime of the seller.

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This means that the private annuity as a method of financing a stock purchase can only be used where the seller has extreme trust in the personal reliability of the purchaser(s) and the financial management capability of successor management after his/her withdrawal or retirement from the corporation. Since annuity payments will probably be made out of the corporation's profits, the seller may not receive all (or any) of the payments if the corporation is unable (or unwilling) to make them.

The use of a private annuity does not change the rules that must be met for a "safe harbor" (favorable tax treatment) redemption. Typically, the seller will have to sell all of the shares he or she actually owns. If any stock is still owned after the sale by seller's spouse, children, grandchildren, or parents, successful "waiver" of family attribution rules will be necessary to avoid dividend treatment.

There are yet other potential downside costs and risks. For example, interest paid by the corporation is not deductible in a private annuity, and will indirectly increase the overall purchase price. There is a risk that the seller might die prior to reaching his/her life expectancy and therefore not obtain as much as expected from the sale; whereas, the reverse holds for the buyer, that is, if the seller lives beyond normal life expectancy the total payments could exceed the purchase price and be much more than anticipated. Another downside is if payments are not properly calculated, or if the valuation of the stock (a difficult task to accomplish either accurately or objectively) is revised (i.e., increased) by the IRS, there could be unexpected but serious gift or income tax consequences.

Mortgaging The Business

Can business assets be mortgaged to raise cash for the buy-out? That may depend on when the buy-out must be executed. Certainly, if there are assets that can easily be mortgaged, the debt will affect the firm's credit standing, and servicing the debt will be a drain on the financial strength of the business.

Life Insurance

Funding with life insurance is the only means of guaranteeing that death, which triggers the need for cash, will--through the insurance proceeds--provide the cash to satisfy that need. This makes it possible for a stockholder's surviving spouse and/or heirs to receive the full fair-market value of the business interest, and bail out of the business before it loses value. A buy-sell funded with life insurance is excellent evidence to bank loan officers and other creditors that the shareholders are financially responsible. Premiums can be viewed analogically as "advance installment payments" which can be budgeted, so that the inevitable but unpredictable event of the buy-out does not hurt the cash flow of the business.

There are, of course, disadvantages to the use of life insurance. "Up front" dollars spent on premiums and the income they might otherwise have earned are the real "costs." Some clients may be

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psychologically offended by an outlay without an apparent, immediate economic benefit. Of course, to most individuals, the benefit of peace of mind, attained by all parties when the buy-sell is fully and properly funded, will more than justify these costs.

If the buy-out occurs during lifetime, the cash values of a life insurance policy can be used to help provide a portion of the purchase price. The policy owner can access the cash values on a tax-favored basis. Generally, if the policy is not a MEC (modified endowment contract), policy loans are income tax-fee, and amounts received from withdrawals, or partial surrenders are income tax-free up to the policy-owner's basis. However, certain withdrawals or partial surrenders during the first 15 policy years may be taxable (under the so-called 15-year rule).

[NOTE: Discussions of income taxation of living proceeds from life insurance policies are beyond the scope of this commentary. Clients should be cautioned to seek competent advice regarding the tax consequences of their particular situation.]

How Much Insurance Should Be Purchased?

Ideally, buy-sell agreements should, if possible, be fully funded (at least sufficient to pay off the entire selling price) from inception and the amount of coverage should be continually updated. This is because the value of a business interest (and therefore the liability of the purchaser of a withdrawing shareholder's stock) will hopefully increase because of real growth. Inflationary pressures will also push the purchase price up.

If the value of stock grows at only 5 percent per year, the value of the stock will double every 14.4 years. At a 10 percent growth rate, the purchase price doubles every 7.2 years. (The years it takes for stock to double in value can be found by dividing the growth rate into 72, a formula appropriately called The Rule of 72.)

As the following figures illustrate, the price the purchaser must pay for stock can quickly become greater than the insurance available to finance the obligation.

Present value of corporation..$1,000,000
With annual growth of 5%
10 years from now...$1,628,895
20 years from now...$2,653,298

With annual growth of 10%
10 years from now...$2,593,742
20 years from now...$6,727,500

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If for no other reason than to keep up with inflation, full funding at the outset is imperative. Secondly, after each corporate redemption or purchase by shareholder(s) upon the death of another shareholder, the value of the surviving shareholders' stock increases.

In the case of a cross purchase plan, each surviving shareholder ends up with a larger percentage interest in the same size corporation. Where the corporation is the purchaser, insurance proceeds prevent corporate assets from shrinking proportionately to the stock purchased. This means that insurance coverage must often be increased after every redemption or purchase. Unfortunately, a later purchase–if it is feasible or possible–is almost always at a significantly increased cost.

When the Purchase Price Is Prohibitive

What do you do when the value of the shares to be purchased is so high that–even with insurance and/or an installment purchase "escape valve"–the price seems prohibitive? One solution might be dilution: a reduction in the value of the common stock through a preferred stock dividend or recapitalization. Here's an example:

Doug and Barbara are equal (and unrelated) shareholders of the Lankford Bay Marina Corporation. They want to enter into an agreement with Lankford Bay Marina Corporation obligating the business to redeem (buy back) the shares of the first of them to die. The corporation is presently worth $1,000,000 and almost certain to increase in value.

Doug and Barbara agree that a required payout of one-half of the value would seriously jeopardize the business. Accordingly, they cause the corporation to authorize and issue to them a preferred stock dividend worth a total of $600,000. The redemption agreement calls for a purchase by the corporation of only the common stock, now worth only $400,000. Doug and Barbara and their respective families, will retain the preferred stock until the corporation exercises a separate option to redeem it.

There may be other situations where the perpetuation of voting control in a particular shareholder group is important but the proportionate ownership of the underlying equity ownership is not as vital. A recapitalization in which a class of nonvoting common stock was issued may be a viable solution. For example:

Fred Thum and Walter Simmons each own 30% of the outstanding common stock of Sundancer Corporation. They constitute the top management of Sundancer and are responsible for it's founding and growth. The other 40% is owned by a number of unrelated individuals, none of whom is employed by the corporation.

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It is essential to Fred and Walter, and to the economic well being of the Sundancer Corporation that the survivor should retain voting control. However, the value of their common stock is so high that, absent some planning technique, neither Fred nor Walter could conceivably purchase the shares of the first to die. If Sundancer were to redeem the decedent's stock, the survivor's stock interest would be reduced to 3/7, thus he would not have absolute control.

To retain control, Fred and Walter cause Sundancer to authorize and issue as a stock dividend a class of nonvoting common stock. Fred, Walter, and Sundancer enter into an agreement under which the survivor of Fred and Walter is given an option to purchase the voting common stock of the first decedent. This makes it possible for the surviving shareholder to retain control. Sundancer is obligated to redeem the nonvoting common stock and all un-purchased voting common stock owned by the decedent's estate.

Although complete funding through an installment payout is seldom indicated, partial funding of the purchase obligation through this method is sometimes required or desirable. The survivors can use insurance proceeds to cushion the financial shock of the key individual's death, ease cash flow problems, and help find and train a successor. The cash can be placed into the profit stream of the corporation and the unpaid balance may earn 20% or more, a rate that may be substantially in excess of the (tax-deductible) interest that the purchaser would have to pay the seller for the use of the unpaid balance.

An installment payout may prove advantageous to the sellers, the decedent's estate, or heirs. Deferring receipt of payments translates into deferring payment of income taxes on the inherent gain (if any). Rather than bunching income and exposing gain to an abnormally high rate, the seller's heirs, by spreading it through receipt of installment payments, may lower the total tax by shifting income to years when their tax brackets may be lower.

One note of warning: if an estate sells stock and receives the right to installment payments in return, upon distribution of that right to a beneficiary, the installment sale reporting privilege may be lost. In other words, if the estate distributes the right to receive the balance of installment payments to a beneficiary, that disposition triggers a taxable event; the distribution of an installment obligation causes an acceleration of recognition of gain.

It might be best to anticipate this potential tax trap by providing in the agreement that the estate can pass a decedent's stock to his or her heirs and the redemption (followed by the installment payout) would be made from the heirs – this avoids the "disposition-acceleration" problem. However, if the beneficiary-seller is in a much higher income tax bracket than the estate, much of the tax advantage of the installment payout may be lost.

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The buy-sell agreement might provide, in the case of an installment payout, that the stock to be transferred will be held in escrow until payment is received. Periodic releases can be made as payments are made or the entire block of stock can be held until the final payment. Typically, the purchaser will have the right to vote the stock as long as payments are made on a timely basis.

A cross-purchase agreement can be strengthened by providing that the individual shareholders' obligations are -in the event of default only- guaranteed by the corporation. Likewise, where the corporation is the purchaser, the agreement should provide that individual shareholders must personally guarantee to pay corporate installment obligations in the event of a default by the corporation.

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