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planning arrangement to look at theirs.

Aug. 04, 2023

By John M. Goralka, Kiplinger Consumer News Service (TNS)

A buy-sell agreement is a key component of business succession planning, particularly for small businesses with two or more family groups in the ownership structure. This issue is applicable for both corporations and limited liability companies (LLCs).

A buy-sell agreement provides for the possible or mandatory buyout of an owner's

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- The surviving business owner may have to hire additional staff to cover the work done by the deceased partner.
- The surviving partner may be less enthusiastic about sharing ownership, decisions, control and profits with a passive, non-working partner.
- The deceased partner's spouse and children often do not work in the business.
- The deceased partner's family needs cash to take the place of the lost income from the deceased partner.

A properly drafted buy-sell agreement can solve all of these problems, particularly if funded with life insurance. The agreement sets the value or the process to determine values, terms or payment and other business terms for the surviving partner to acquire the business interest of the deceased partner.

Buy-sell agreements are prepared in either a cross purchase or redemption format.

A cross purchase:

- Provides for the surviving partner to individually acquire the interest of the deceased partner from his or her family or other heirs.
- Provides a step-up in income basis in the shares or business interest for the amount paid.
- Avoids any corporate or state law that may restrict distributions directly from the business.
- Helps avoid a conflict of interest in the negotiations as described in the tax case below for the redemption format.
- Helps to avoid the issue as to whether the value of the business should include the death benefit paid for tax and business purposes.

A cross purchase can be more complicated because each owner holds a life insurance policy on the other owner. For a two-person ownership structure, only two

insurance policies are owned—one held by each owner on the life of the other. If we

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Corporate law distribution restrictions may interfere with the payment of the purchase price.

In *Thomas Connelly v. United States*, the IRS successfully argued that the value of the company for estate tax purposes was $3.5 million more than the amount agreed to be paid in the buy-sell agreement. In other words, the seller was taxed for estate tax purposes for a value of $3.5 million more than was received in the sale. This is a net cost of almost $1 million in additional tax to be paid.

This is particularly important because this buy-sell agreement was a very typical arrangement and was almost certainly very similar to many other agreements in place today. As a result, a careful review of your buy-sell agreement is recommended.

To understand the risk, here's a review of what happened in this case, an all-too-common scenario.

Michael and Thomas, two brothers, were the sole shareholders of Crown C Supply Inc., a closely held family business that sold roofing and siding materials. Michael was the majority shareholder, owning 77.18% of the outstanding stock, while Thomas owned the remainder (22.82%).

Thomas and Michael entered into a classic "wait-and-see" buy-sell agreement. The brothers would meet annually to determine value. If not within a stated time frame, such as two years, then a backup appraisal process was established in the agreement. The brothers' buy-sell agreement required the company to buy back the shares of the first brother to die, and the company bought life insurance to ensure it had enough cash to satisfy the redemption obligation. The buy-sell agreement didn't expressly require that the life insurance be used in the redemption.

Michael died in October 2013. Pursuant to the buy-sell agreement, the company

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receive the life insurance proceeds to fund the purchase of Michael's shares. The court held that Crown C was worth roughly $3.5 million more than it was worth the day before Michael's death and included the death benefit in the company valuation. This was despite the obligation for the company to pay the funds to purchase the shares of the deceased partner.

Lessons for us all

First, the value of an interest in any closely held business entity, irrespective of whether it's a family-owned or controlled business, should be as finally determined as the fair market value for federal estate and gift tax purposes. This is a term of art defined in the Internal Revenue Code. Treas. Reg. Sec. 20.2031-1(b) defines the term "fair market value" as:

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

The Connelly seller received the value stated in the agreement and isn't entitled to any more compensation. That said, if the case isn't reversed, then the estate will pay the additional federal estate tax of $1 million based on a value $3.5 million higher than the purchase price received. This in turn will significantly reduce the net to Michael's heirs and legatees. In essence, the IRS included the death proceeds in the value of the company despite the obligation for the company to pay the death benefit to the deceased partner's family.

If you establish a valuation procedure in a buy-sell agreement, follow it. The subject company and Michael's estate disregarded the valuation procedure in the sales transaction, but then tried to assert it on the estate's behalf in the litigation, which the court refused to consider.

The court observed that "The parties' own conduct demonstrates that the Stock

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20.2031-2(f)(2), resulting in a $6.86 million fair market value for Crown C."

26 C.F.R. § 20.2031-2(f)(2) provides, in pertinent part, as follows:

In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. The primary remaining valuation issue was whether to include the $3 million in life insurance death proceeds.

The court determined that the buy-sell was not truly binding during life and after death.

Don't rely upon the Schedule A valuation method, and if you do, give that method a very short shelf life and build in a backup appraisal method.

If the agreement is a redemption agreement, and the parties intend to obtain life insurance to be held by the entity as the owner and beneficiary, the buy-sell agreement must clearly define the rules. In particular, the buy-sell agreement must clearly state whether the insurance death proceeds are to be counted in the determination of the enterprise value. Similarly, whether the requirement that all of the life insurance proceeds must be paid as part of the redemption price should be considered in that valuation.

ABOUT THE AUTHOR

John M. Goralka is founder of The Goralka Law Firm. He is one of few California attorneys certified as a Specialist by the State Bar of California Board of Legal Specialization in both Taxation and Estate Planning, Trust and Probate.

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