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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

CHOOSING THE RIGHT BUY-SELL STRUCTURE FROM A TAX PERSPECTIVE

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Our closely held business-owner clients usually rely on their businesses for lots of things:

- To provide income for the owner's family
- To support the families of employees
- To leave a family legacy either
  - By allowing family members to take over one day or
  - To turn the business into money at death or retirement

Financial planning professionals work with business-owner clients to protect the business and make sure the owner's goals are met. A properly drafted and implemented buy-sell agreement can act as a key financial tool for the professional and client.

We have written about buy-sell arrangements many times in the past. For those looking for a more robust analysis of buy-sell planning and its associated issues, here's a list:

- We first wrote about tax considerations connected to buy-sell arrangements in 2010.
- In June 2012, we discussed court cases relevant to buy-sell planning.
- In October 2018, we suggested a methodology for approaching buy-sell discussions with business owners.
- In December of last year, we discussed some common mistakes business owners make in their business continuation plans.

In addition to those articles, we have written about multiple buy-sell situations in connection with professional sports franchises—most recently with the Denver Broncos earlier this year. These articles demonstrate that we think buy-sell planning is an important issue for business owners, and the business continuation realm provides fertile ground for financial professionals intending to serve their clients.

Professional advisors are often asked to identify the *best* buy-sell structure from a tax point of view. Picking the most efficient way to make a transfer happen from a tax perspective requires balancing multiple tax (and practical) considerations and making judgments about managing possible adverse results.

To make the right judgment, the advisor must first identify the relevant issues. In this article, we'll focus on laying out the main tax considerations that are relevant in the buy-sell discussion. To keep the discussion short, we will also limit the considerations to what might happen in the event of the *death* of an owner, as opposed to a lifetime buyout.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

CHOOSING THE RIGHT BUY-SELL STRUCTURE FROM A TAX PERSPECTIVE

BUY-SELL STRUCTURES

If the company itself is doing the buying in the event of an owner's death, the structure is a redemption, or entity purchase. If the owners are buying, the agreement is probably a cross-purchase arrangement. If it's a nonowner employee or friendly competitor is in line to make a purchase happen, then the arrangement is a one-way buy-sell. And finally, if multiple optional methods of purchase are inside the agreement, it's probably a wait-and-sell buy-sell.

Redemption

Here's how a redemption arrangement—sometimes also referred to as an entity purchase arrangement—might work.

Say Al and Bob are equal owners of ABC, Inc., a regular corporation with a fair market value of $1 million. Al and Bob enter into an agreement, together with their company, under which the company agrees to do buying in the event of a triggering event. The company's obligation to buy the stock at death—rather than the surviving shareholder—is what makes the arrangement a redemption.

To fund its obligation to buy the shares of a deceased owner, the corporation buys $500,000 of insurance on the life of Al and an equal amount on the life of Bob. The corporation is the owner and beneficiary of the policy.

At Al's death, ABC, Inc. receives $500,000 of life insurance proceeds. It uses those proceeds to purchase Al's 50 percent interest in the company, and Al's heirs transfer Al's stock back to the company in exchange for the $500,000 payment.

The company holds Al's former stock as treasury stock, and Bob now owns 100 percent of the outstanding shares in ABC, Inc.

What are the potential tax issues associated with a redemption arrangement? If the business is organized as a regular C corporation, there are plenty of reasons a redemption agreement might not be the best fit:

1. There's a danger that a stock redemption will be treated as a taxable dividend to the heirs, particularly where one family owns the business.
2. The surviving owner—Bob in the example above—doesn't get the benefit of a step-up in basis for his interest in the business.

For S corporation businesses, the first drawback above may also apply if it has undistributed earnings and profits from prior C corporation days. The second issue *may* be relevant in part.

For noncorporations, such as partnerships or LLCs taxed as partnerships, only the second issue *might* be relevant.

DIVIDEND TREATMENT OF REDEMPTION AMOUNT

The first potential tax problem in a corporate stock redemption agreement is that the redemption might be treated as a dividend distribution.

The Internal Revenue Code states that a partial redemption of stock by a corporation will generally be taxed as a dividend instead of as a capital transaction. Why is the difference important? Because dividends have been historically taxed at higher rates than capital gains rates and also because capital gains transactions generally get full credit for the owner's basis. Dividend treatment usually means higher income taxes for the selling owner than dividend treatment.

If only partial redemptions run the risk of dividend treatment, what's the big deal? Because of the *constructive ownership* rules, also called *attribution rules*, even a redemption that feels like a complete redemption may be treated as a partial one.

In our prior example of Al and Bob, at Al's death, the corporation redeemed all of Al's stock from his estate. We would expect the result to be a total redemption and to be taxed as a capital transaction.

However, under the constructive ownership rules, stock owned by a beneficiary of an estate is considered constructively owned by the estate. Under those circumstances, a redemption of all the stock actually owned by the decedent may still be taxed as a partial redemption.

Two kinds of attribution can cause unexpected dividend treatment of a stock redemption in a family situation:

1. *Estate attribution* rules say that any shares owned by the beneficiary of a decedent's estate are attributed to the decedent.
2. *Family attribution* rules state that stock owned by an individual shareholder's parents, spouse, children, and grandchildren—or owned by certain trusts or certain business entities in which those family members have an interest—will be attributed to the shareholder for purposes of determining the tax treatment of a redemption.

Say that in our prior example Al and Bob are father and son. Bob is a beneficiary under Al's will. If the corporation redeems only Al's stock, the entire amount paid by the corporation for the stock may be taxed as a dividend to Al's estate. That's because Bob's shares are considered to also be owned by Al's estate through *estate attribution* rules.

Even if Bob is not a beneficiary of Al's estate, the *family attribution rules* might cause dividend treatment for the redemption. Say Al's widow is the sole beneficiary under his will. Bob's shares are attributed to his mother under the family attribution rules. The widow's sale of shares to the corporation may be taxed as a dividend unless other tax relief is available.

One path leading to tax relief is that in certain cases it may be possible to avoid the application of family attribution—and its accompanying dividend treatment of a redemption—by the stockholder whose stock is redeemed. That stockholder, after the redemption, must have no ownership in or control of the corporation and must commit not to acquire any such interest for ten years following the redemption.

Getting a selling family member to commit that he or she won't substantially participate in the business for ten years isn't always easy or even possible.

Another path that can allow a family to avoid dividend treatment of partial redemptions is the Section 303 method. Section 303 of the Code provides relief under the following circumstances:

- The stock of a closely held corporation must be worth more than 35 percent of the adjusted gross estate, and
- The redemption amount is limited to the taxes—estate, inheritance, and generation skipping—plus final expenses of the deceased owner.

Any redemption in excess of the amount allowed under Section 303 is taxed as a dividend.
The rules surrounding constructive ownership, partial redemptions, and family attribution are highly complex. Because of the dynamic nature of families and family-owned businesses, the potential application of partial dividend rules must be carefully considered when implementing a redemption arrangement.

The potential for dividend treatment of a redemption plan may cause many stockholders to opt for cross-purchase buy-sell arrangements.

LACK OF STEP-UP IN BASIS FOR SURVIVING OWNERS

In most cases with a corporate structure, a redemption buy-sell will not optimize the basis increases for the surviving owners of the business.

C Corporation

Using the example of Al and Bob described earlier, here's an illustration of the point. For the purpose of the example, let's say also that all of the equity Al and Bob have in the business is based on sweat, and each therefore has a $0 basis in their company stock.

Assume Al dies. The company gets $500,000 of insurance proceeds, which it used to buy out Al's shares, and now Bob is the 100 percent owner of ABC's outstanding stock.

What's Bob's basis in the company? It's still $0. If Bob finds a buyer for the company the next day and sells it for $1 million, Bob will have to pay capital gains tax on the whole $1 million.

S Corporation

What if ABC, Inc. is an S corporation? In our example, Bob would normally get a partial step-up in basis for Al's shares. Here's how that works.

At Al's death, $500,000 of life insurance proceeds is paid to the company. If the insurance was properly implemented—following Section 101(j) rules—the benefit would be income tax free.

Under S corporation tax rules, when tax-free money flows into an S corporation, the basis of the owners is increased by the tax-free money in proportion to the owners' stock. In the ABC, Inc. example, Bob's basis would increase from zero to $250,000—half the $500,000 death benefit. Al's estate would get the benefit of the other $250,000 increase in basis.

In 2010, when Al's estate has a limited step-up in basis due to the one-year rule changes, it may benefit from getting an increase in basis due to the life insurance. Projected forward to 2011, a basis increase from life insurance may be wasted due to the reinstatement of the full death-time step-up.

Can Bob get a step-up in basis for 100 percent of the life insurance proceeds at Al's death in 2011? Maybe. If the S corporation is a cash basis taxpayer, the parties may be able to put together a special kind of redemption arrangement that takes advantage of short tax-year rules and installment notes to maximize Al's basis increase.

Partnership

For partnerships and LLCs taxed as partnerships, it is usually possible to allocate the step-up due to the business's receipt of tax-free life insurance death benefit only to the surviving owners. This can be accomplished through proper drafting of the operating agreement or buy-sell agreement.

As with an S corporation, when tax-free money flows into a partnership, the basis of the owners is usually increased by the tax-free money in proportion to the owners' ownership interests. However, the partners can change that result with advance planning if their operating agreement includes *special allocation* language. In this example, the operating document would allocate any life-insurance proceeds collected to only the surviving shareholders—not to the deceased one.

The IRS has honored similar special allocation language in a variety of circumstances. However, the Service has also recognized that certain kinds of special allocations—not necessarily those connected to redemption buy-sells—have the potential for tax abuse. Therefore, we recommend that business owners who operate partnerships work with experienced lawyers and CPAs to ensure that any special allocations are implemented and administered with care.

DESIRE TO SPREAD TAX RESULT OVER INSURANCE OUTLAY EQUALLY

After thinking about the downsides of structuring a buy-sell agreement as a redemption arrangement, some might wonder why anyone would ever choose a redemption. A redemption arrangement does have several advantages:

- It's usually simpler to understand and implement than a cross-purchase arrangement.
- A redemption can allow the insurance cost to be easily spread proportionally among all the owners of the company.
- A redemption arrangement may provide some immediate tax leverage if implemented in a C corporation with a lower tax bracket than its owners' personal tax rates.

If a corporation or LLC is buying the needed life insurance on its owners to fund a death-time buyout, the cost is borne by the company. Each of the company owners will usually feel that premium burden in proportion to the share of ownership in the company. If one of the owners is only insurable at a high price relative to the other owners, the equitable spreading of cost under a redemption plan can feel fairer than it might under cross-purchase funding.

TAKE ADVANTAGE OF LOWER CORPORATE TAX RATE

Let's return to the example of Al and Bob. Say that each of them is in a personal federal income tax bracket of 37 percent. Let's also say that their C corporation is in the 21 percent corporate tax bracket.

If the annual premium to buy life insurance to fund the buy-sell arrangement is $1,000 per year for each of them, does it make more sense to structure the buy-sell agreement as a cross-purchase or a redemption?

If they are most concerned with the cost of paying the premium, Al and Bob might opt for a redemption structure. Here's why. If the premiums are paid personally, as they would be under a cross-purchase arrangement, Al has to earn $1,587 (at a 37 percent tax rate) of taxable income to come up with the net $1,000 premium for the policy on Bob's life.

On the other hand, if the corporation pays the premium for Bob's policy, it only has to earn $1,266 (at a 21 percent tax rate) to net $1,000. In this example, the company's money might be cheaper to use.

Cross-Purchase

Here's how a cross-purchase arrangement might work.

Say we're still considering ABC, Inc., with Al and Bob as owners. Al and Bob enter into an agreement, under which each of the owners agrees to do buying from the other owner upon a triggering event.

To fund his obligation to buy Al's shares upon Al's death, Bob buys $500,000 of insurance on the life of Al. To fund his obligation, Al buys a like amount on the life of Bob. Each shareholder is the owner and beneficiary of the policy on the other.

At Al's death, Bob receives $500,000 of life insurance proceeds. Bob uses those proceeds to purchase Al's 50 percent interest in the company, and Al's heirs transfer Al's stock back to Bob in exchange for the $500,000 payment. Bob now owns 100 percent of the outstanding shares in ABC, Inc.

Here are the reasons for a company to prefer a cross-purchase agreement:

1. The surviving owners get a basis in the purchased stock equal to what they pay—making a subsequent sale by any survivor(s) less subject to capital gains tax.
2. There is no danger of dividend treatment of the purchase of stock, since the purchase is being made by the company co-owners, rather than having money come from the corporation.

There are also plenty of reasons a cross-purchase arrangement might not be a good fit:

1. If the company has more than two owners, it can be hard to place, manage, and administer all the needed insurance policies in the correct way.
2. If there's a change to the company, configuration of ownership, or insurance, there may be plenty of opportunities for transfer for value problems to arise in corporate buy-sell reconfigurations.

To expand a bit on the disadvantages, here's an example. Say Davey, Mickey, Mike, and Pete are the owners Prefab Music, Inc., an S corporation. They agree that the company is worth $1 million, and they decide to enter into a cross-purchase buy-sell agreement.

To fund their obligations under the plan, each of the owners buys $250,000 of insurance on the other three. For Davey, that means owning $250,000 of coverage on Mickey, Mike, and Pete. With four owners of the company, this kind of implementation means twelve policies are needed. Keeping track of that many policies might be a hassle.

Let's say Pete dies. After each of the surviving owners collects $250,000 of life proceeds, they use the money to buy Pete's interest from his estate. The surviving owners would also want to get the policies Pete owned on the others to fully fund the buy-sell arrangement on a going-forward basis.

Well, if Pete's heirs transfer those policies to the noninsured owners of the company, it's a potential transfer for value problem. Code Section 101(a)(2) provides:

> In the case of a transfer for a valuable consideration, . . . of a life insurance contract . . . the amount excluded from gross income . . . shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

The transfer for value rule does not apply if the transfer is made *to*:

- The insured,
- A partner of the insured,
- A partnership in which the insured is a partner, or
- A corporation in which the insured is a shareholder or officer.

If the transfer of the policies formerly owned by Pete is to the *co-shareholders* of the insureds, the transfer does not fall under one of the exceptions to the transfer for value rule. Therefore, the death benefits would be taxable in the event of the subsequent death of one of the shareholders.

Sometimes, in order to keep from having multiple policies on each owner, the parties may have the insurance held by a trustee or escrow agent. That method can work well until one of the owners dies. However, if ownership in the policies is reallocated after the death of one owner, that reallocation may trigger an unintended transfer for value—and a tax problem.

To avoid transfer for value issues associated with funded cross-purchase arrangements, many attorneys recommend putting together partnerships to be the conduits for funding and administering the buy-sell agreements. If the owners are partners in a real, functioning partnership, arguably all potential transfers for value issues are solved because any transfer would fall under the partner or partnership exception.

Wait-and-See

The wait-and-see buy-sell arrangement, also referred to as the *optional buy-sell*, is sometimes implemented as a way for the owners of a business to hedge their tax bets.

Using ABC, Inc., here is how they might implement a wait-and-see buy-sell:

1. Upon a triggering event (let's assume the death of Al once again), the business has the option of buying Al's shares from his heirs for 30 days.
2. If ABC, Inc. does not redeem Al's shares, Bob has 30 days after the business's option expires to buy Al's shares.
3. Finally, if Bob does not exercise his option, ABC, Inc. must redeem Al's shares from Al's heirs.

Life insurance may be owned by the company or by each shareholder on the other. The policyowner should also be the beneficiary.

To get money into the right hands at the death triggering event, the parties should anticipate the idea that money can be loaned to provide the needed cash. For example, if ABC, Inc. gets the death benefit, it might loan the money to Bob for the purchase of Al's shares.

Depending on the structure of the life insurance and the later structure of the buyout, there may be tax results to the parties consistent with redemption or cross-purchase.

One-way buy-sell agreements are usually implemented in proprietorships or other single-owner entities. These agreements are usually between the owner and a key employee or between the owner and a friendly competitor. They are called *one-way* agreements because they're only triggered in one direction—if something happens to the current owner of the business.

One-way buy-sell agreements work in a manner similar to cross-purchase agreements in that the death trigger is usually funded with life insurance owned by the key person or the friendly competitor. In the event of the single owner's death, the third party collects the proceeds and buys the business from the deceased owner's heirs.

CONCLUSION

Each method of buy-sell structure has its own advantages, disadvantages, and proper market when thinking about the transfer of business at death.

Stock redemption plans work best when

- There are more than two shareholders,
- The corporation is in a low marginal tax bracket,
- Cost basis issues for surviving owners are not relevant,
- There is a significant age differences among owners,
- The owners prefer to use a corporate check for the insurance purchase,
- There is a significant difference in ownership percentages,
- There are no significant corporate creditors,
- There is no family attribution exposure, and
- If the company is an S corporation, it is a cash basis taxpayer.

Cross-purchase plans work best when

- The company has two equal owners who are close in age,
- A cost basis increase for the surviving corporate owners is important,
- The owners are willing to pay for the insurance, even through a bonus arrangement or split-dollar plan, and
- If the business has more than two owners, they are willing to undertake the extra complexity of a buy-sell partnership.

A wait-and-see buy-sell agreement may be the right choice where the business owners and their advisors want to maintain flexibility until a triggering event and where that flexibility is the most important objective. And a one-way buy-sell arrangement is used where the buying party is not an owner of the company.

Finally, for those planning a business transfer at death, using insurance to fund a buy-sell obligation has the following advantages:

- The income tax free money from insurance is delivered at the precise time needed: the death of an owner.
- Life insurance death proceeds can pay off a deceased owner's family and eliminate their further involvement with business, which is not the case with funding a buyout over time.
- The cash value from permanent insurance can be used to help fund a living buyout—for example, at retirement or disability.

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Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.