

Advising Clients on Buy-Sell Agreement Options



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Topics

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1. Restriction on Transfer
2. Trigger Events
3. Selected Tax Issues
4. Purchase Price
5. Method of Payment
6. Put Option
7. Spousal Consent

Restrictions on Transfer

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“Except as otherwise provided in this Agreement, each Shareholder agrees that such Shareholder will not Transfer any of his or her Shares.”

- Scope of restriction
 - Pledges and encumbrances
 - Estate planning transfers allowed
 - Eligible subchapter “S” corporation shareholders
 - Numerical restriction
 - Members of an LLC
 - Indirect transfers

Restrictions on Transfer

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Corporations – See URBCA Section 16-10a-627

- “[A]n agreement between one or more shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation”
- Existence of restriction is “noted conspicuously” on stock certificate
- Authorized if:
 - To maintain corporation’s status when dependent on number or identity of shareholders.
 - Preserve benefits under federal, state or local law.
 - Any “other reasonable purpose”.

Restrictions on Transfer

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LLCs – See RULLCA Section 48-3a-502

- “A transfer of a transferable interest in violation of a restriction on transfer contained in the operating agreement is ineffective as to a person having knowledge or notice of the restriction at the time of transfer.”
- A transfer does not entitle the transferee to:
 - “participate in the management or conduct of the limited liability company’s activities and affairs”; or
 - “have access to records or other information concerning the limited liability company’s activities and affairs.”

Buy-Sell Trigger Events

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- Death;
- Divorce;
- Disability;
- Termination of employment of an owner who is an employee;
- Disagreement among owners that cannot be resolved;
- Bankruptcy; or
- Change of control of an owner that is an entity.

Selected Tax Issues

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- Structuring
 - Corporations
 - LLCs
- Insurance
- Income allocation
- Subchapter “S” corporation issues
- Incident to divorce

Tax – Structuring for Corporations

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- **Redemption**
 - Exchange or Distribution? IRC Section 302: not essentially equivalent to a dividend, substantially disproportionate, complete termination.
 - IRC Section 311 - appreciated property
 - Constructive dividend (Rev. Rul. 69-608)
- **Cross-Purchase**
 - Purchaser obtains basis in acquired shares

Tax – Structuring for LLCs

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- **Redemption**
 - Section 736(a) – Guaranteed payments are deductible for remaining members; ordinary income to departing member.
- **Cross-Purchase**
 - Purchaser acquires outside basis step-up under IRC Section 742 and inside basis step-up under IRC Section 743(b) if a Section 754 election has been made by the LLC

Tax – Income Allocation

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- Income Allocation
 - Pro rata allocation
 - Closing of the books (Treas. Reg. 1.1368-1(g)(2))

Example: A and B are 50% shareholders in Corp, a subchapter “S” corporation. A terminates his interest on June 30th. As of June 30th, Corp incurred \$100,000 in net loss items. During the remaining six months, Corp earned \$200,000. Under the general allocation rules, A will be allocated \$25,000 of income and B will be allocated the remaining \$75,000.

Tax – S corporation issues

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- AAA, under Treas. Reg. Section 1.1368-2(a)(1), is a corporate level account not identified with any specific shareholder. Under a cross-purchase, the AAA and its tax-free benefits do not follow the departing shareholder. Rather, they are in effect “inherited” by any new and surviving shareholders. Thus, a transferee shareholder may take advantage of any AAA balance remaining after distributions to the terminating shareholder.
- Single Class of Stock - Treas. Reg. Section 1.1361-1(l)(2)(iii)(B) “bona fide agreements”.

Tax – Incident to a Divorce

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- Nonrecognition under Section 1041(a) of the Code – no gain or loss is recognized on a transfer of property from an individual to or in trust for a spouse or former spouse if the transfer is incident to a divorce even where the parties are acting at arms' length and the transferee pays full consideration for the property.

Purchase Price

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- Critical part of the Buy-Sell Agreement; clarity and specificity can avoid costly disputes in the future.
- Factors to be contemplated in determining a valuation method include:
 - Costs and expenses.
 - Use of a third-party.
 - Varying valuation method depending on the triggering event.
 - Marketability discounts?
 - Minority discounts?
 - How to value contingent liabilities.

Purchase Price

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- **Common approaches to determine purchase price:**
 - Fixed Price or Stipulated Value
 - Establish value when buy-sell agreement is executed
 - Revalue periodically with backup method
 - Inexpensive approach that may not be accurate
 - Formula Price
 - Owners agree to approach: EBITDA, book value, cash flow
 - Flexible and, if chosen well, more accurate
 - Appraisal
 - Costly but most accurate

Method of Payment

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- Lump-Sum Payment
 - Typically paid shortly after triggering event.
 - Potential cash flow issues if no insurance.
- Installment payments
 - Down payment or flexibility.
 - Length – should it be dependent on trigger event?
 - Interest
- Insurance
 - Life Insurance
 - Disability Insurance

Method of Payment – Life Insurance

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Advantages

- Lump sum available quickly after death.
- Generally not taxable (consider AMT).
- Cash value may be available for retirement or disability.

Disadvantages

- Premiums are generally after-tax dollars.
- Uninsurable owners/different aged owners.
- Premiums are an ongoing expense.
- If company owned policy then creditor's may pursue claims against value.

Put Option

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- In the event the company or other shareholders possess an option to purchase, consider a put option for a minority interest holder:

“In the event that [trigger event] has occurred and the Company has not delivered a notice pursuant to Section [call right section] within 30 days after such [trigger event], then, [minority interest holder], may elect to sell to the Company all or any percentage of the [equity] held by such Person on the terms and conditions specified in Section [purchase price and purchase mechanics sections].”

Spousal Consent

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- Spousal consent is required in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin).

Questions?

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