BORAKOVE | OSMAN LLC

ESTATE PLANNING ▪ BUSINESS LAW ▪ ELDER PLANNING ▪ ESTATE ADMINISTRATION

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BUY-SELL AGREEMENT MECHANICS

Stock Redemption vs. Cross Purchase

STOCK REDEMPTION BUY-SELL AGREEMENT

Under a redemption arrangement, your Company agrees to redeem the shares/interest of a deceased owner at his death, and the owner agrees prior to death that his estate will transfer the shares back to the Company for an agreed-upon price. An advantage of this arrangement is the simplicity of only one life insurance policy per owner. Premium costs are allocated to the owners according to their percentage ownership in the Company, or as otherwise determined by the Company's CPA.

The primary disadvantage of a redemption is the loss of the step-up in basis. Thus, upon a lifetime liquidation of your interest, the surviving owner will owe a larger capital gains tax. As an S-Corp., the owner has some basis in the policy. Nevertheless, any tax-deferred gains within the policies (cash value in excess of premiums paid) would be converted to taxable income when paid to a retired owner or upon the distribution of the policy from the Company to the owner.

In addition, Company ownership of the insurance policies means that the cash values of the policies are subject to attachment by the Company's creditors. Finally, if Company-owned buy-sell policies are over-funded to provide non-qualified retirement benefits to the owners, the benefits are generally taxable. "Over-funded" means the life insurance obtained to redeem the stock is in excess of the value of the owner's interest in the Company.

CROSS PURCHASE BUY-SELL AGREEMENT

Due to the loss of basis step-up that can result from a redemption buy-sell, many opt for a cross purchase buy-sell arrangement. Under a cross purchase arrangement, each surviving owner buys the deceased owner's stock directly from his estate. To fund this obligation, each owner typically owns an insurance policy on the life of each of the other owners.

Because individuals own the policies and receive the income tax-free death benefit, they can obtain a full basis step-up by buying the stock directly from the deceased business owner's estate. Hence, upon the ultimate liquidation of their ownership interest, they will have a higher basis that will reduce the resulting capital gains tax. Additionally, the common "wait-and-see" approach allows surviving owners to keep the insurance proceeds for themselves and use any retained corporate earnings to effectuate a redemption.

Like a redemption, a cross purchase also has drawbacks. The most obvious disadvantage is the number of policies required to accomplish the funding. Since each owner must own a policy on each other owner, multiple policies are required if there are more than two owners.

Another possible negative to a cross purchase is that if the policy is over-funded for the purpose of retirement accumulations, the exchange of the policy will trigger the recognition of any built-in gain in the policies, making what would otherwise be tax-deferred income taxable.

Whichever approach is chosen, a knowledgeable CPA and attorney should work together to help you chose the best buy-sell strategy.

Lastly, having a buy-sell agreement does not supplant the need for each business owner to have an estate plan. A buy-sell agreement is not an effective way to require any business owner's shares (or the value of those shares) to be distributed to his or her family. Only a properly executed Will, or preferably a revocable living trust, can achieve the business owner's goals at death.

COURTESY OF:

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