Business Transfer Issues

Overview

A will directs the disposition of your assets; but, when you do not want to leave your business to your heirs, you may also need a business purchase agreement (also known as a "buy-sell") to outline the terms by which successor owners will acquire and continue the business. A buy-sell agreement is most helpful:

- To create a guaranteed market for the sale of a business interest in the event of certain triggering events, such as death, disability, retirement, divorce, or bankruptcy;
- If an owner would be unable or unwilling to continue running the business with the family of a departing owner;
- Where the business involves a high amount of financial risk for a deceased's owner's family and it is preferable for the family to convert the business interest into cash at death;
- To prevent all or part of the business from falling into the hands of "outsiders;" and
- To help establish the value of the business for federal and state estate tax purposes.

Description & Operation

Types of Buy-Sell Agreements

Buy-sell agreements may take a number of forms and can be entered into by:

- The individual owners;
- The business;
- One or more trusts established by the individual owners;

- ♦ Another separate entity owned by the individual owners;
- ♦ Key persons, family members, or outside parties; or
- ♦ A combination of the above.

The most common types of buy-sell agreements are the **cross purchase plan** (between the owners) and the **entity purchase** or—if the business is incorporated—stock redemption plan (between the owners and the business). The distinguishing feature is the party that agrees to buy the interests of the withdrawing or deceased owner. In a cross purchase plan, the individual owners themselves agree to buy the interest of a withdrawing or deceased stockholder; in an entity purchase, the business itself buys (redeems) the departing owner's interest.

Agreement Details

A written agreement states the purchase price, terms, and funding arrangements. The agreement obligates the departing owner or owner's estate to sell the business. Typically, either the business itself or the surviving owner(s) is obligated to buy the seller's interests. Occasionally, an agreement gives the remaining individual owners an option to buy the seller's interests, but provides that, if the remaining owners fail to exercise the option, the business must buy them. This arrangement is referred to as a "wait and see" agreement.

The agreement specifies the events triggering the respective obligations and the sale price, or when and how the price is to be determined. Generally, triggering events usually include the death, disability, or retirement of the owner. The sale price should be the fair market value, which can be determined according to a formula or periodic appraisal. It can be paid in a lump sum, installment payments, or both.

Often, the owners choose to pre-fund the agreement. Usually, in a cross purchase agreement, each owner/prospective buyer will buy, own, and be the beneficiary of life and disability income insurance on each other owner. In the case of an entity purchase agreement, the business buys, owns, and is beneficiary of policies on each owner.

Choice of Buy-Sell Agreement

Your attorney is in the best position to help you decide on the right agreement for you. There are advantages and disadvantages to both types.

Advantages of a Cross Purchase:

- ♦ A surviving owner acquires interests with a stepped-up cost basis, which can reduce the tax impact if/when he/she sells.
- ♦ When life insurance is used:
  - If your business is a limited liability entity, policy values are generally not subject to company creditors.
  - There are typically no "transfer for value" problems upon a later change to an entity purchase plan.
  - Insurance proceeds are generally received by surviving owners income tax-free and not included in the deceased owner's estate.

Disadvantages of a Cross Purchase:

- ♦ When life insurance is used:
  - When there are a large number of owners who are parties to the agreement, more policies are needed to fund a cross purchase than are needed for an entity purchase. For example, if there are four owners, each owner would own a policy on each of the other three owners, resulting in the need for twelve separate policies. Alternatively, only four would be needed to fund an entity purchase agreement. However, options exist such as a "trusteed cross purchase" or the use of a partnership to own the life insurance.
  - If the business is a corporation and a policy needs to be transferred (due to, say, a change in the ownership structure), a "transfer for value" occurs if the policy is transferred to a co-shareholder (other than the insured). Thus a portion of the death benefit proceeds becomes subject to income tax when received.

Advantages of an Entity Purchase:

- ♦ Subject to the family attribution rules mentioned below, amounts paid by a corporation to redeem a deceased owner's stock are not considered dividends to the remaining stockholders.
- ♦ When life insurance is used:
  - A minimal number of life insurance policies are needed.
  - The business owns the policies and pays the premiums, which can minimize disputes as to the amount and payment of the costs to fund the agreement.
  - Premiums paid by the business are not considered to be taxable income to the insured owner/employee.
  - There is no need to transfer policies insuring surviving owners.

Disadvantages of an Entity Purchase:

- ♦ When family members are continuing in the business, attribution rules apply which can result in the redemption being treated as a dividend to the estate, versus as a capital sale.
- ♦ Surviving shareholders in a C corporation are not entitled to a basis step-up on their increased ownership interests, which may result in a higher taxable gain on the sale proceeds.
- ♦ State laws may affect how and whether a corporation may buy its own shares.
- ♦ Ownership of life insurance by a C corporation may increase exposure to the corporate alternative minimum tax (AMT).
  - Note, if a stock redemption agreement is otherwise the best solution, alternatives exist to deal with some of the disadvantages.
  - First, each shareholder could own policies on the co-shareholders, and the shareholders could then loan or contribute the money to the corporation.
  - Second, since partnerships are not subject to AMT, a separate partnership of the shareholders could own the insurance and the proceeds would be free from income tax. At the death of a shareholder, the other shareholders or the partnership would collect the death benefit proceeds and loan them to

the corporation to make the redemption, or the surviving shareholders could contribute the proceeds to the corporation as a capital contribution.

- When life insurance is used:
  - The life insurance policies funding the agreement are subject to the company's creditors.
  - Life insurance proceeds may increase the value of a deceased owner’s interest for estate tax purposes.
  - Ownership of life insurance by a C corporation may increase exposure to the corporate alternative minimum tax (AMT).

Is the Agreement Effective?

There are five primary areas that could potentially cause considerable difficulties when the terms of the agreement are to be carried out. They are:

1. Inadequate triggering events;
2. Insufficient contingency plans if the right of first refusal is elected;
3. Failure to provide for the special considerations involved with minority ownership interests;
4. Improper valuation; and,
5. Lack of funding.

Triggering Events

Nearly all buy-sell agreements provide for a sale upon the death or the retirement of an owner. But the disability or divorce of an owner is sometimes overlooked. Since the purpose of the agreement is to protect the business, its owners, and their families in the event a principal is unable to contribute, it is important to have protection in the event that person cannot carry out the duties of the job for whatever reason.

Upon an owner’s disability, the remaining owners may have to perform an increased share of the work, but may not receive a proportionate increase in their shares of company profit.

In the event of a divorce, the stock could end up in the hands of the ex-spouse, which the remaining owners may not want. Other triggering events could include the firing of a minority owner or an owner’s personal bankruptcy.

The Right of First Refusal

A common provision in many buy-sell agreements is the right of first refusal. Such a provision would not allow the departing owner to sell to an outsider without first offering the remaining owners the opportunity to buy. An owner of a minority interest in a small business, for example, will probably have a hard time finding an outside buyer willing to pay fair market value for that interest. If the departing minority owner does find a buyer, the remaining owners may find it difficult to come up with the money to buy the owner out in order to avoid bringing in a new, undesirable co-owner.

Inequitable Ownership Interests

Business purchase agreements are usually easier to develop if the owners have equal shares of the business. What if there is a majority owner? The majority owner may not want to sell to the minority owners,

preferring to have family members or a key employee take over. A standard buy-sell agreement may not allow this to happen. Instead, the agreement might call for a minority owner's interest to be sold to the majority owner(s), yet allow the majority owner to transfer interests to family members.

Valuation Issues

Valuation may seem easy in the beginning—when the business is new, its value can be readily determined, and owners mutually agree. But what happens several years down the road? How will the business be valued? By whom? If there is an appraisal, should it include intangible assets such as goodwill? Is the appraisal enough? What is an acceptable valuation to the Internal Revenue Service? A properly drafted agreement addresses these issues so problems don't arise at the time of a buy-out.

The Internal Revenue Service will, in most cases, honor the valuation of a business as determined by a business purchase agreement which (1) is a bona fide business arrangement, (2) is not a device to transfer the property to members of the decedent's family for less than full or adequate consideration, and (3) has terms comparable to those entered into by persons in an arm's length transaction. However, if an owner dies and there has not been a value determined, the IRS will do it. Because the Service will likely select the method of valuation to create the highest value possible for estate tax purposes, this situation is rarely advantageous for the taxpayer. Moreover, in an entity purchase agreement where the business receives death benefit proceeds, failure to peg the value of the business allows the IRS to include the value of the death benefit proceeds in the value of the business.

Valuation becomes critically important in **family scenarios**. While buy-sell agreements can be helpful in protecting the interests of unrelated owners and their families, oftentimes an agreement can be used to transfer a business interest from one family member to another, e.g., from a parent to a child, between siblings, etc. Even if the agreement establishes a price for the interest being transferred, Internal Revenue Code §2703, which applies to related parties, prevents related owners from pegging the value at less than fair market value. For example, assume the buy-sell agreement places the value of Dad's business at $1 million. Upon Dad's death, Son—who owned a $1 million policy insuring Dad's life—receives the proceeds and uses them to buy the business. Dad's estate receives $1 million. But the IRS successfully contends that the fair market value of the business was $3 million. As a result, federal estate tax would be assessed at the $3 million amount. Assuming a federal estate tax rate of 40%, a taxable estate would owe more in taxes than it received in sale proceeds.

Two major valuation considerations are (1) market value and (2) intrinsic value factors. Intrinsic value factors are further broken down into (a) earnings capacity and (b) other considerations. The courts have looked at a combination of factors, including earnings, dividends, book value, and a discount for lack of marketability. Minority interests, due to a lack of value to others, have received discounts ranging from 20 percent to 66 percent of the net asset value per share.

(1) Market Value

Market valuation is the preferred method. The greater the market activity for a company's stock, the more weight can be placed on its market value. If the stock is traded over-the-counter or through an exchange, those prices will typically prevail. (The only exception is if the amount of stock added to the buyer's other holdings will constitute a controlling interest. That would increase the value of the shares.) If both bid and ask prices are available, the mean price is used. The market valuation

method is not applicable to corporations or partnerships where there has been no trading activity. Even with traded companies, there can be serious limitations including:

- Lack of transactions near the valuation date;
- Chance of a manipulated market (one controlled by major shareholders for their own benefit);
- Effect of a boom or depression on the market price; and
- Inability to obtain control, usually due to the unavailability of sufficient stock in the marketplace

(2) Intrinsic Value

If the fair market value cannot be determined by reference to market transactions or to values set by an arm's length agreement (e.g., a buy-sell agreement, etc.), then intrinsic factors must be taken into account.

(a) Earnings Capacity

Market analysts use price/earnings ratios as one of the major indicators of the value of a stock. A buyer will be particularly concerned with the future earning power of the company. Historical earnings is one factor that may be considered in estimating future earning power. Also:

- Five or more prior years' earnings should be taken into account to predict earnings.
- Earning trends (the progressive increase or decrease in net income) should be given more weight than the average earnings for a five-year period.
- If previous years show a loss, the loss should be computed into the average.
- Determination of earnings in both the year in which the valuation occurs and in later years is appropriate.
- Abnormal economic periods should be considered.
- Abnormal or nonrecurring factors, such as a change in accounting methods, unusual capital gains or losses, or heavy retirement plan contributions, must be weighted.
- The salaries, employee benefits, and other perquisites of shareholders and officers and their effect on earnings must be weighted.
- The loss of a key person can have a dramatic effect on future earnings.
- Once the average earning power is computed, the proper multiplier to capitalize that power must be determined and applied. The multiplier is inversely proportional to the risk factor–the greater the risk, the smaller the multiplier. The best guide in determining a multiplier is comparable multipliers of publicly traded companies. If this is not possible, you might use comparable non publically traded companies. After comparable companies have been located, the average price earnings multiplier of their shares can be applied to the earnings of the stock to produce a valuation.

(b) Other Considerations

In order to place the burden of proof concerning the actual value of a business in the hands of the owner, the Service has intentionally left the regulations vague. According to the Service, factors that will affect arrival at a fair market value include:

- Nature and history of the business;
- Conditions and outlook for the specific industry and the general economic outlook;
- Financial conditions and book value of the business;
- Earnings and dividend paying capacity of the corporation;
- Previous sales of stock and the size of the block to be valued, as compared to the total outstanding stock;
- Comparison of stock prices of corporations in the same or similar lines of business being actively traded in a free and open market, either on an organized exchange or over-the-counter; and
- Existence of goodwill or the presence of other intangible value.

Also:

- Dividend-paying capacity rather than previous dividends actually paid is another primary consideration of the Service. This is quite close to an earnings factor.
- Book value or book value net asset factor can only be considered after it is determined the asset values on the books are close to their fair market value.
- Lack of marketability can arise with either a minority or majority interest. Too small a block or too large a block may result in a limited ability to sell. Legal or contractual restrictions on a sale may also contribute to a lack of marketability. There is no general rule on how large a marketability discount will apply to a stock value.

The best solution to this complex problem is to have a business valuation computed yearly to adjust for market and ownership conditions. Determining the market value is the next best option, followed by earnings capacity, then other intrinsic factors such as dividend-paying capacity, book value, marketability, and goodwill.

Proper Funding

One of the most common mistakes business owners make is failing to properly fund a buy-sell agreement. Assume two partners, each owning half of the business, agree to buy the other out in the event of death. How will the surviving partner pay for the other half of the business?

Few owners will have the cash, or the collateral to obtain a loan, especially if the business is still young and unproven, and now without a key person. A new partner could be brought in, but the surviving partner may not want to work with the new partner.

The most common solution, though not the only one, is for a life insurance policy to be obtained on each partner in the amount of the value of each partner's interest. There are many different methods of structuring the policies, so business owners should work with a qualified insurance professional in

conjunction with the attorney drafting the agreement to assure policies used for funding purposes will accomplish the set objectives.

Rodney Ferguson, CLU®, ChFC®, Member Agent of The Nautilus Group®, a service of New York Life Insurance Company, Registered Representative offering securities through NYLIFE Securities LLC (Member FINRA/SIPC), a Licensed Insurance Agency, 11701 Borman Drive, Suite 295 - St. Louis, MO 63146 (314) 821-0500, Financial Adviser offering investment advisory services through Eagle Strategies LLC, a Registered Investment Adviser. Ferguson Financial Group is not owned or operated by NYLIFE Securities LLC or its affiliates. Ferguson Financial Group as well as NYLIFE Securities LLC and its affiliates do not provide legal, tax or accounting advice.

This material includes a discussion of one or more tax-related topics. This tax-related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. Taxpayers should always seek and rely on the advice of their own independent tax professionals. Please understand that New York Life Insurance Company, its affiliates and subsidiaries, and agents and employees of any thereof, may not provide legal or tax advice to you.

© 2016 New York Life Insurance Company, all rights reserved. SMRU:523065 exp: 12.24.2017

California License No.: 0F24494