TAX YEAR
2019

Buy-Sell Agreements

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Buy-Sell Agreements

Buy-sell agreements are usually part of a succession plan put in place to protect the financial interests of the owners of closely held companies and their heirs and to protect the company's stability in case of a major event. Funding buy-sell agreements is frequently accomplished using insurance policies under (1) a cross purchase agreement, or (2) a stock redemption agreement.

Cross purchase agreement. Each owner of the company takes out, and is beneficiary of, an insurance policy on each of the other owners. In the event of an owner's death, the other owners use the insurance proceeds to buy out the decedent's ownership share in the company from the decedent's beneficiaries.

Cross Purchase Agreement

Advantages	*Disadvantages*
Simple to set up.	The number of polices needed can be cumbersome with multiple owners.
Life insurance proceeds are not taxable to the beneficiary, and the decedent's estate gets stepped-up basis in the ownership interest. The transaction does not result in tax liability for either party.	Because older owners' life insurance premiums will be higher, a disparity in cost is created between older and younger owners.
The transactions occur outside the company. The life insurance proceeds are not subject to claims of the company's creditors.	The agreements must bind the beneficiaries to the agreed-upon transactions, such as selling the deceased owner's interest.
The basis of the remaining owners is increased by the FMV of the interest acquired.	Control can shift when ownership transfers occur under a cross purchase agreement.

Stock redemption agreement. The company takes out life insurance policies on each of the owners. When an owner dies, the company buys out the deceased owner's interest.

Stock Redemption Agreement

Advantages	*Disadvantages*
Simple to administer with fewer policies required than with a cross purchase agreement.	For a C corporation, insurance proceeds increase E&P, resulting in taxation upon distribution to shareholders.
Cost of policies is split evenly among owners.	Rules about stock redemptions can be complex. Related-party rules can cause unintended consequences.
For a C corporation, the proceeds are not taxable income.	Remaining owners do not benefit from a step-up of basis.
Policies are not subject to the claims of owner's creditors.	Those with the highest shares of ownership pay the most for premiums.

Valuation. Valuation of a company can change significantly in a relatively short time. The buy-sell agreement should be flexible in its ability to accurately reflect changes in value.

In a cross purchase agreement, the company has no interest in the decedent's life insurance proceeds, whereas in a stock redemption, the interest is included with the value of the business. Typically, the redemption price of a stock redemption includes a portion of the life insurance proceeds.

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Example #1: *Abe and George each own 50% of Cherry Tree Inc., a C corporation. The company is currently valued at $250,000. Under a cross purchase agreement, Abe takes out, and is beneficiary of, a $125,000 life insurance policy on George. George takes out a similar policy on Abe. The cross purchase agreement is structured so that additional policies can be taken out over time as the value of the company increases.*

George dies and Abe collects $125,000 in tax-free proceeds from the life insurance policy. Under the terms of the cross purchase agreement, George's beneficiaries are required to sell his interest in the company to Abe for $125,000. Since the basis of George's interest is stepped up to FMV on the date of death, George's beneficiaries do not realize taxable income.

After the transaction, Abe owns 100% of the company. George's beneficiaries receive $125,000 cash, which is not taxable to them.

Example #2: *Assume the same facts as Example #1, except the buy-sell agreement is funded by a stock redemption agreement. Cherry Tree Inc. takes out, and is beneficiary of, a life insurance policy on Abe in the amount of $125,000, and a similar policy on George.*

When George dies, Cherry Tree Inc. receives $125,000 in life insurance proceeds. The proceeds are not taxable to Cherry Tree Inc., but the $125,000 in life insurance proceeds do increase the corporation's earnings and profits (E&P) so the amounts will be taxable if distributed to shareholders as dividends. Cherry Tree Inc. uses the proceeds to purchase George's ownership interest from his beneficiaries. George's ownership interest was stepped up at his date of death so his beneficiaries do not realize taxable income on the transaction. Abe now owns 100% of the outstanding stock of the corporation.

Insurance. There are several other insurance policies which should be considered by every business owner.

Key person life insurance. Many business owners are required to sign personal guarantees to secure business debt. In the event of an owner's death, these debts will remain and, if unpaid by the business, will become the responsibility of the owner's heirs. By taking out life insurance on the owner, proceeds can be used to retire the debt. The proceeds can also be used to fund the search for a replacement to the deceased business owner or to fund obligations to the owner's spouse, such as continuing medical insurance coverage or salary payments. The premium payments by the business are not deductible, and the proceeds from the policy are not taxed as income.

Disability insurance. Disability insurance protects the earnings of employees and business owners by providing a stream of payments when a disability resulting in the loss of ability to work occurs.

Typical Disability Insurance Features

	Short-Term Disability	*Long-Term Disability*
Delay from date of disability to benefits	0 to 14 days	3 weeks to 3 months
Coverage term	Up to 2 years	Generally to age 65
Benefit amount	50–70% of salary	50–70% of salary

Professional liability insurance. Professional liability insurance provides coverage for claims arising from professional error or malpractice. It is most commonly used by physicians, attorneys, architects, and accountants. The costs of this coverage are deductible to the business owner and augments the liability protection of incorporating.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.