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Cross Purchase (Crisscross) Buy-Sell Agreement

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What is it?

Legal contract — a form of buy-sell agreement

A cross purchase agreement is a form of buy-sell agreement, a legal contract between the owners of a closely held business. The cross purchase agreement is also referred to as a crisscross.

Establishes buyer for your business interest

Under the cross purchase agreement you and your co-owners agree to buy each other's business interests under the terms and conditions set forth in the agreement. This creates a market and guarantees a buyer for your business interest. Here's how it works: You are a business owner bound under a cross purchase buy-sell agreement and you die, in which case the buyer named in the agreement is legally obligated to buy your interest in the business from your estate, and your estate is legally obligated to sell your interest to the buyer. Once you are bound under a cross purchase agreement, you can't transfer your share of the business to anyone except the buyer named in the agreement. Certain transfers may be excepted (spouse, trust, another owner).

Very often, a buy-sell agreement will combine the entity purchase and cross purchase options by providing a right of first refusal to either the entity or the other owners first, and then to the other. The options are many, and which are appropriate for you and your business will depend on a number of different circumstances. You should consult your attorney for a description of the full range of possibilities. This discussion focuses on one form of buy-sell agreement.

Defines events triggering sale of business interest

The buyer named in the agreement (and there could be more than one buyer) is obligated to purchase your interest in the business at the occurrence of some specified triggering event and your estate is obligated to sell your interest. Likewise, you are obligated to buy all or part of a selling owner's business interest after a triggering event. You, your advisors, and the other parties to the agreement will determine the triggers appropriate for your business situation. Possible triggering events include those shown in the following table:

Typical Triggering Events	Other Possible Triggers
• Death • Long-term disability • Retirement • Divorce	• Personal insolvency or bankruptcy • Conviction of a crime • Loss of professional license • Withdrawal prior to retirement • Termination of employment

When can it be used?

You own a business

You are an owner of a closely held business. The business can be organized as a sole proprietorship, partnership, C corporation, S corporation, limited liability company (LLC), or professional corporation.

Tip: *If you are a sole proprietor you might be interested in the one-way buy-sell agreement, a variation of the cross purchase.*

Strengths

Includes all the strengths of a buy-sell agreement

The cross purchase agreement, like other buy-sell agreements, has the following strengths:

- Can provide a guaranteed buyer for the business interest
- Can provide liquidity for payment of estate taxes and settlement expenses (especially if agreement is funded)
- Avoid potential conflicts of interest
- Can establish taxable value of the business, if structured properly
- Can maintain stability of business operations
- Can improve creditworthiness of the business
- Can maintain legal status of your S corporation, partnership, or professional corporation (if relevant)

The transaction is not considered a dividend

When a corporation distributes money to a shareholder, it is generally considered a dividend to the shareholder. There are exceptions to dividend treatment when certain conditions are met, but with a cross purchase plan, dividend treatment is avoided. Individuals are the parties to the sale and no company money is used, so there is no risk of the transaction being considered a dividend payment.

Tip: *In general, the American Taxpayer Relief Act of 2012 permanently extended the preferential income tax treatment of qualified dividends and capital gains. Capital gains and qualified dividends are generally taxed at 0% for taxpayers in the 10% and 15% tax brackets, and at 15% for taxpayers in the 25% to 35% tax brackets. However, capital gains are generally taxed at 20% for taxpayers in the 39.6% tax bracket. Also, as a result of the Affordable Care Act of 2010, an additional 3.8% Medicare tax applies to some or all of the investment income for married filers whose modified adjusted gross income exceeds $250,000 and single filers whose modified adjusted gross income is above $200,000.*

Tip: *There remains an advantage in classifying a transaction as a sale or exchange rather than as a dividend distribution, despite the fact that both types of transactions are subject to tax at long-term capital gains tax rates. That is, in the case of dividend treatment, part or all of the distribution is first treated as a dividend, any remaining distribution is then received tax-free to the extent of basis, and any distribution still remaining is taxed as capital gains. In the case of sale or exchange treatment, however, the shareholder pays tax only to the extent that the amount paid by the company exceeds his or her basis in the stock. Thus, more may be subject to tax with dividend treatment than with sale or exchange treatment.*

Tip: *If the sale or exchange of your shares occurs after your death, your shares will generally have a basis equal to the fair market value of the shares at the time of your death, and little or no tax may result.*

Transactions not subject to attribution rules

There are additional tax rules (known as attribution rules) that apply to company payments. The attribution rules can eliminate possible favorable tax treatment of distributions from a corporation when the corporate shareholders are related.

The cross purchase agreement avoids application of the attribution rules in the same way it avoids general dividend treatment — no company money is involved.

Transactions not subject to state laws governing corporate stock redemption

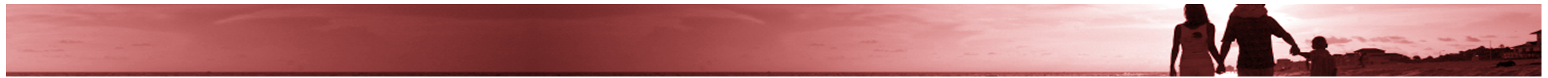
In all states, corporate law allows a corporation to buy its own shares only under certain conditions. The cross purchase agreement avoids the corporate stock redemption rules because no company money is involved.

Tradeoffs

Restrictions can affect personal estate planning (you may not be allowed to give away your share of the business)

Gifting strategies are important estate planning tools for owners of closely held businesses. Lifetime gifts of your interest in the business to your children may be part of your estate planning strategy to pass your business interest to your heirs and reduce the total value of the estate. Restrictions in the cross purchase agreement could prevent you (and your co-owners) from passing all or part of your interest in the business as a gift. The parties to the agreement, therefore, must consider whether to restrict transfers by gift.

Tip: *If your buy-sell agreement allows gift transfers, the group of permissible donees should generally be defined. The donee*



group should probably be subject to the terms of the buy-sell agreement.

Restrictions could limit your access to outside credit

Restrictions within the cross purchase agreement could prohibit you from pledging your own interest in the business as collateral for outside credit, or could require the consent of the other owners. Without the ability to pledge your business interest, a lender might turn you down for a loan.

***Tip:** If the cross purchase agreement is drafted to include a right of first refusal, the owners would be allowed to pledge their individual business interests as loan collateral. If a foreclosure occurs, the stock acquired by the creditor would have to be offered for sale to the other parties under the agreement before it could be sold to a third party. Under the right of first refusal, the buyer under the agreement would have the right to buy (or refuse to buy) the shares held by the creditor. The lender must be notified the shares are subject to a right of first refusal, and the loan amount probably could not exceed the shares' fixed purchase price. This restriction should be indicated on the stock certificate (many states have laws requiring this).*

Agreement becomes complex with more than three or four owners

The cross purchase agreement generally works best for a business with only two or three owners. When there are more owners than that, the agreement can become very complex. At the occurrence of the triggering event, there could be multiple buyers of your interest in the business.

For instance, say your business is an S corporation, with a maximum allowable 100 shareholders. When you die, the cross purchase plan could require as many as 99 transactions between the surviving co-owners and your estate.

***Tip:** If there are more than three or four owners in your business, you might consider using an entity purchase (stock redemption) agreement or a trusteed cross purchase agreement, both of which can be less complex when there are many owners.*

How to do it

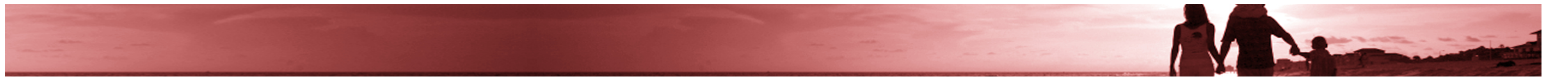
Decide what you want to happen to your share of the business

You should consider all of your financial, tax, and estate planning goals. Since you have co-owners who will be part of the agreement, you will need to talk with them about it.

Consider terms of agreement

You should consider possible components to the agreement, some of which are shown in the following table:

Components of Cross Purchase Buy-Sell Agreement	**Description**
The parties	The seller(s) (business owners)
Triggering events	Could include death, disability, retirement, divorce, bankruptcy, or other events
Obligations	Is purchase mandatory or optional?
Restrictions	Could include first-offer provisions or rights of refusal, ability (or lack of) to pledge shares for collateral, ability (or lack of) to use shares in gifting strategy, or other restrictions
Price (or method of determining)	Could be agreed upon dollar value or a valuation method based on formula, appraisal, adjustment, or percentage of book value
Sale terms	Lump-sum cash, installment payments, combination, or other
Time period for transaction	For example, how soon after death should sale occur? Should there be a waiting period before sale for disability? How long should installment payments continue?



Funding method	Could be cash, borrowings, life insurance proceeds, or other method
Modification provisions	Could be used to provide for valuation update or changes to or termination of agreement

Factors such as the size, structure, and tax bracket of your business, and the number of co-owners will influence your choices in setting up your cross purchase buy-sell agreement. This is where your tax advisor, financial planner, and/or attorney can be helpful.

Pay special attention to these agreement clauses

You may want to pay special attention to the following parts of the agreement:

Price: You don't necessarily have to name a dollar value. There are several ways to set the value of the business. For instance, there may be a valuation method commonly used in your industry that you could easily use in the agreement.

Caution: *It is important that the valuation method used in the agreement represent the fair market value (FMV). The agreement is a legal contract, and the price (or method of determining price) specified will lock in the sale price. Unless the agreement is drafted carefully, the sale price could be different from the taxable value. The IRS is not obligated to accept the sale price as the FMV for taxation. If the IRS determines that the sale price is less than FMV, your estate will be taxed on the FMV. This means it is possible that the estate could be required to pay tax on value it did not (and never will) receive.*

Sale Terms: The specific triggering events in your agreement may influence the terms of the sale. For instance, a lump-sum payment is appropriate in the event of a death, if payment is funded by life insurance, while an installment payment plan over some specified period of time may be suitable for retirement.

Restrictions: State property laws favor the right of a business owner to transfer an interest in a business to whomever he or she wants, at whatever time, and according to whatever terms. Restrictions in a buy-sell agreement that are extreme will generally be viewed as unreasonable and therefore unenforceable.

Meet with your attorney

Setting up a buy-sell agreement can be very complex because it involves legal and tax issues, so you should consult an attorney. Each party under the agreement should have his or her own attorney. Your attorney can help ensure that conditions in the agreement will be reasonable and enforceable under state law.

Fund the agreement

Have the shareholders set up the cash fund, buy the life insurance policies, and make arrangements for whatever method has been chosen to fund the buy-sell agreement. Without the funding to back it up, the agreement may not be effective.

Indicate buy-sell agreement restrictions on stock certificates

It is important to indicate the restrictions under the buy-sell on the stock certificates representing shares subject to the buy-sell, or they may be unenforceable under state law. State law governs the level of detail needed. It may also be advisable to include the buy-sell agreement restrictions in the corporate charter.

Periodically review the agreement

You and your buy-sell participants should review the agreement on a regular basis, perhaps yearly. You want to be sure that the agreement still meets your objectives. The valuation provisions may specify an annual valuation of the business, which should be conducted. You should review the pricing method if there is a significant change in the business. It is hard to say exactly what type of change is considered significant and will require a price change, especially when the courts use language like "unusual intervening events or circumstances," but there is a chance your price might not set FMV after the change.

Caution: *Failure to update an agreement when called for within the agreement could lead to problems.*

Change percentages of ownership when making purchases under the cross

purchase agreement, if desired (and agreed upon)

With a cross purchase agreement, the buyers can purchase the business interest in any agreed-upon proportions, and the percentages of ownership can be adjusted to whatever ratio the owners agree upon.

Example(s): *You own a business with two co-owners, Bert (your son), and Ben (no relation). You own 40%, Bert owns 40%, and Ben owns 20%. All of you are bound under a cross purchase agreement. You die. The fair market value (FMV) of the business when you die is $100,000. The FMV of your 40% interest equals $40,000. Bert buys one-fourth of your interest from your estate at the FMV price of $10,000. Bert's interest in the business is now valued at $50,000, and has increased from 40% to 50%. Ben buys the remaining three-fourths of your interest at the FMV price of $30,000. Ben's interest is now valued at $50,000, and has increased from 20% to 50%.*

Tax considerations

Income Tax

Normally no capital gain to seller's estate

If you die and your estate receives your business interest, the stock receives a new basis equal to the fair market value (FMV) typically determined at the date of death (called a step-up in basis). When the sale price under the cross purchase plan is such fair market value, there shouldn't be any capital gain or loss realized by your estate upon the sale of the business interest.

Example(s): *Assume you paid $50,000 for your share of the business (your basis). At the time of your death, the FMV of your interest is $150,000. Your estate sells your business interest to your co-owners and receives $150,000, representing the sale price for your interest under the agreement. This value is accepted as the FMV for taxation. The basis of your interest is stepped-up from your original $50,000 to the new value of $150,000 at death, and your estate does not need to recognize any capital gain.*

Capital Gain with and without Step-Up		
	No Step-Up	Estate Receives Step-Up
FMV/Sale Price Basis Capital Gain	$150,000 $50,000 $100,000	$150,000 $150,000 $0

Caution: *If the estate of a person who died in 2010 elected out of the federal estate tax, estate property may have received a carryover or modified carryover basis and not a stepped-up basis.*

Buyers receive increase in basis

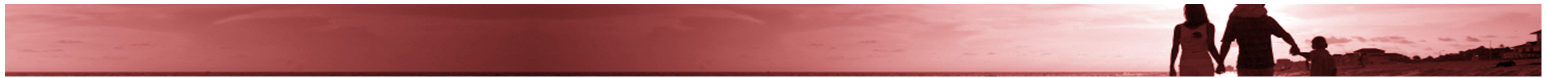
When surviving co-owners buy a business interest under the cross purchase agreement, their basis (investment) in the stock is increased to the amount of the purchase price. This leads to a reduced capital gain if the stock is later sold.

Example(s): *You and Noah originally invested $100,000 each in your boat-building business (original value $200,000, basis is $100,000 each). The FMV of the business is now $1.5 million. Noah dies. You buy Noah's interest in the business from his estate for $750,000, representing the FMV of his half. Your basis is $850,000 as shown in the following table:*

Your Original Basis	$100,000
Purchase	$750,000
Stepped-Up Basis	$850,000

Example(s): *You are now the sole owner of the business valued at $1.5 million. If you sell your interest during your lifetime for $1.5 million, you will recognize a capital gain of $650,000.*

	Basis Step-Up	**No Step-Up**



Current FMV	$1,500,000	$1,500,000
Basis	$ 850,000	$ 100,000
Capital Gain	$650,000	$1,400,000

Example(s): *As you can see, without the step-up in basis, your taxable gain on the sale during your lifetime would be $1.4 million.*

Gift and Estate Tax

Amount seller's estate receives from sale sets value in gross taxable estate

When your estate sells your business interest under the cross purchase agreement, the amount received from the sale usually sets the value of the business interest that is included in your gross taxable estate.

Caution: *If the price received is determined to be less than the fair market value (FMV), the estate will also be taxed on the difference between the sale price it received and the FMV determined by the IRS. This means it is possible that the estate could be required to pay tax on value it did not (and never will) receive.*

Questions & Answers

What would be considered an unreasonable (and therefore unenforceable) restriction?

A restriction that may be viewed as extremely prohibitive (thus unreasonable) is one that permanently and absolutely bans lifetime transfers of shares of a business's stock, along with a mandatory resale of the shares to the corporation at death for the original purchase price. A restriction like this could be viewed as a forfeiture, unreasonable, and therefore unenforceable. If the only condition for a profitable transfer of stock is a pure right of first refusal that requires the offer of the stock at the same price to the other parties, it does not restrict the transfer of stock, only the persons who may buy the stock. In this case, the restriction is not extremely prohibitive and would almost always be enforceable.

In general, if the terms of the restrictions were reasonable when the agreement was executed, such as rights of first refusal and rights to buy interests in the business based on a formula set price, then the restrictions would be enforceable. Whenever a buy-sell agreement is ambiguous, there is a risk that the courts may not uphold the enforceability of the restrictions. However, a carefully drafted, clearly outlined buy-sell agreement containing reasonable terms of restriction should be able to avoid any issues with state law.

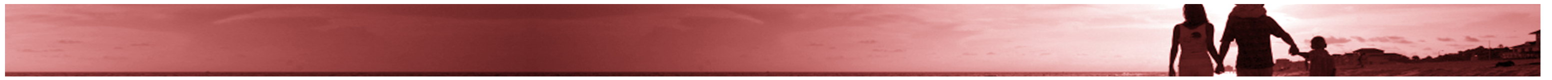
What happens if the existing agreement calls for periodic updating and it isn't done?

If the agreement requires an update, the failure to do the updating could have serious consequences. For example, if the agreement calls for a revaluation of the business at specified intervals and the revaluation is not calculated, the value set under the agreement may be lower than the taxable value set by the IRS. If you die, your estate would be bound under the agreement to sell your shares at the agreement price. The taxable value assigned by the IRS could be higher, subjecting your estate to taxation on value it didn't receive.

In addition to the potential tax consequence, the failure to update the agreement when called for in the terms could affect the ability of the agreement to stand up in a court case. Often, a default clause is inserted into the buy-sell agreement when it is drafted. The default clause is intended to establish a back-up valuation procedure to be used in the event the periodic updates don't occur as agreed.

If your company adds more shareholders, can they be included under the cross purchase agreement?

It is possible to add new participants under a cross purchase agreement, but it can get complicated, depending on the funding method chosen. Because the transaction is designed to occur between the participants, the larger the number of participants, the larger the number of cross transactions that follow. When a new shareholder is added to the business, the proportions of ownership are affected. This can cause a need for the alteration of the amounts of purchase under the agreement. If life insurance



is the chosen funding method, the existing participants would need to buy new policies to cover the new participants. The cross purchase is a commonly used form of buy-sell agreement, and these issues can be handled when the agreement is drafted.

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