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Entity Purchase (Stock Redemption) Buy-Sell Agreement

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What is it?

Legal contract--a form of buy-sell agreement

An entity purchase agreement is a form of buy-sell agreement, a legal contract established between a closely held corporation, partnership, or limited liability company (LLC) and its owners. The term entity purchase agreement broadly applies to a buy-sell agreement between the business itself and the owners. In the case of a corporation, it might be referred to as a stock redemption agreement, a corporate purchase agreement, or an entity redemption agreement. In the case of a partnership, the entity purchase agreement might be referred to as a partnership liquidation plan.

Establishes buyer for your business interest

Under the terms of an entity purchase buy-sell agreement, the business entity is legally obligated to buy your interest in the business from you (or your estate), and you (or your estate) are legally obligated to sell your interest to the business at the occurrence of a specified event. Once you are bound under an entity purchase buy-sell agreement, you can't sell your interest in the business to any party except the business itself.

Defines events triggering sale of business interest

The business entity agrees to buy your ownership interest at the occurrence of some 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 are one of the co-owners of a closely held business

A closely held business can be organized as a partnership, C corporation, S corporation, limited liability company (LLC), or professional corporation and has a small group of owners. An entity purchase agreement can't be used with a corporation with only one stockholder since the corporation can't own itself. An entity purchase agreement can't be used with a sole proprietorship because the sole proprietorship is not a separate entity that can make the purchase.

Strengths

Includes all the strengths of a buy-sell agreement

The entity purchase agreement, like other buy-sell agreements, can:

- Provide a guaranteed buyer for the business interest
- Provide liquidity for payment of estate taxes and settlement expenses, especially if agreement is funded
- Avoid potential conflicts of interest
- Establish taxable value of the business, if structured properly

- Maintain stability of business operations
- Improve creditworthiness of the business
- Maintain legal status of your S corporation, partnership, or professional corporation (if relevant)

Efficient and easier to administer when multiple shareholders are involved

An entity purchase agreement is an especially efficient form of buy-sell agreement when there are more than four or five shareholders. The buy-sell transaction occurs between the corporation and the withdrawing owner only.

For instance, say your business is an S corporation, with a maximum allowable 100 shareholders. When you die, a stock redemption plan would require only one transaction for the business to buy your interest from your estate. A cross purchase plan (another form of buy-sell agreement) could require as many as 99 transactions between the surviving co-owners and your estate.

Can be easier to fund

Entity purchase agreements can be easier to fund (get the cash for) than other forms of buy-sell agreement. Owners in closely held businesses very often reinvest profits in the business. The reinvestment increases business assets but leaves less personal cash for the owners to make the stock purchase on their own. Under an entity purchase plan, the money (or access to the money) comes from the business, not the personal cash of the shareholders.

Proceeds subject to favorable tax status under certain conditions

Depending upon the circumstances and the way the buy-sell is structured, the proceeds (payment) the seller receives from the redemption of the business interest may be classified as a sale or exchange of the seller's interest (subject to capital gains tax) or as a dividend distribution.

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, dividends and 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 net 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.*

However, 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.

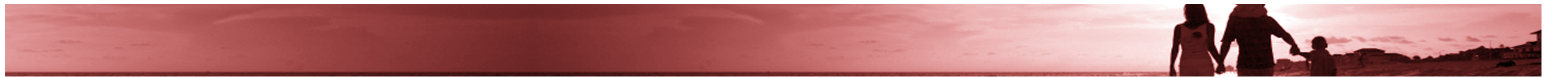
Tip: *If the sale or exchange of your shares occurs after your death, your shares will generally have a basis equal to the fair market value of the shares at the time of your death, and little or no tax may result.*

Your estate receives increase in basis for your stock or business interest when you die

When your estate sells your stock or business interest, the shares sold have a step-up in basis equal to the sale price, so that no capital gain is realized if the redemption is not treated as a dividend.

Example(s): *Assume you paid $50,000 for your share of the business (your basis). You die in 2012. Your estate sells your business interest to the business and receives $150,000, representing the sale price for your interest under the agreement. This value is accepted by the Internal Revenue Service as your tax basis ("stepped-up basis") for taxation. The basis of your interest is increased from your original $50,000 to the new value of $150,000, 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	$150,000	$150,000
Basis	$50,000	$150,000
Capital Gain	$100,000	$0

Even though this may seem clear-cut, you should still consult a tax advisor.

Remaining shareholders receive percentage increase in ownership without additional investment

When the business buys shares from a shareholder's estate, those shares are generally retired (nobody else can buy them unless they are reissued) or held as treasury stock (could be retired or resold, not considered outstanding stock). When this happens, the remaining shareholders automatically own larger percentages of the outstanding shares.

Example(s): *You and your three co-owners, Mack, Jack, and Zack, own a business with 400 total shares. Each of you owns 100 shares (one-fourth) of the business. Zack dies. The business buys the 100 shares from Zack's estate and retires them. You, Mack, and Jack still own 100 shares each, but now there are only 300 outstanding shares in the business, so your ownership percentage has increased from one-fourth to one-third.*

Tradeoffs

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

Gifting strategies are important tools in estate planning 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 entity 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 buy-sell, therefore, must consider whether to restrict transfers by gift.

Tip: *If your entity purchase 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 entity 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 entity and/or other owners. Without the ability to pledge your business interest, a lender might turn you down for a loan.

Tip: *If the entity purchase agreement is set up to include a right of first refusal, the owners could 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 business before it could be sold to a third party. Under the right of first refusal, the business would have the right to buy (or refuse to buy) the shares held by the creditor. The lender must be notified that the shares are subject to a right of first refusal, and the loan probably could not exceed the shares' fixed purchase price. This restriction should be indicated on the stock certificate (many states have laws requiring this).*

Tax treatment of stock redemption may differ for family corporations

If shareholders under the entity purchase agreement are related to each other (including spouse, parents of either spouse, and their children) and the business is a corporation, the attribution rules [Internal Revenue Code Section 318] must be considered. The attribution rules can affect the tax treatment of a shareholder's stock redemption. In a family corporation, the sale of stock to the business under a stock redemption plan may result in dividend treatment to the redeeming shareholder.

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, dividends and 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 net 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..

Strain on corporate funds

If a corporation or other entity is required to purchase shares under an entity purchase agreement, funds available to run the business may be significantly reduced and the business significantly hampered. Providing a source to fund the purchase is critical.

Local laws could prevent corporate redemption

In all states, corporate law allows a corporation to buy its own shares only from surplus funds. The specifics of the laws vary by state, but generally the rule is that a corporation must have funds in excess of the minimum capital requirement to redeem stock.

Tip: *Possible solutions to this problem are: (1) a revaluation of assets, (2) shareholder contributions to increase corporate capital, or (3) fund the buy-sell agreement with life insurance.*

How to do it

There are certain steps required in every buy-sell agreement. There are also some levels of detail that are not required but could save you trouble if they are included. Remembering Murphy's Law, consider the following:

Things to Do Now

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

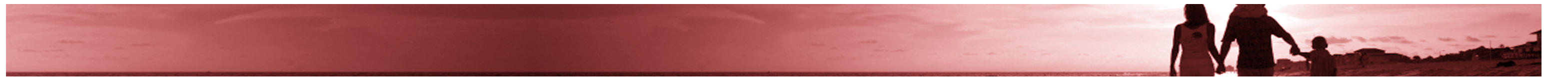
You should consider all of your financial, tax, and estate planning goals. If you have co-owners who will be part of the agreement, you will need to talk to them about it. Whoever has the authority to legally bind the company by contract needs to be part of the discussion so that the business will be obligated under the entity purchase agreement.

Consider terms of agreement

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

Components of Entity Purchase Buy-Sell Agreement	Description
The parties	The owners and the business itself
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, if any, will influence your choices in setting up your entity 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, where the purchase 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 under whatever terms he or she wants. Restrictions in a buy-sell agreement that are absolute will generally be viewed as unreasonable and therefore unenforceable.

Consult your tax advisor

Depending on the size of your business interest relative to your entire estate, and if your co-owners are related to you, a partial sale of your interest might qualify for favorable tax treatment as a Section 303 stock redemption. Your sale might also qualify for favorable tax treatment as a Section 302 stock redemption. You might even qualify for favorable tax treatment under both. Each of these types of stock redemption has specific tests to be met and may require advance planning, so you should obtain professional tax advice. However, the results may be worth the effort.

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 shareholder should have his or her own attorney.

Fund the agreement

Have the corporation 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 the restrictions 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. Ask your attorney.

Things to Do Later

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 fair market value after the change.

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

Tax considerations

Income Tax

Redemption of shares is not a tax-deductible event to business

When the business redeems the shares of a shareholder, it is not an income tax-deductible expense of the business. When cash is distributed in exchange for the stock, the business recognizes no gain or loss on the transaction.

Complete redemption results in capital gain

When a corporation other than an S corporation partially redeems the stock of a shareholder, it may be treated as a dividend. An exception to this applies when the corporation redeems all of its stock held by your estate (complete redemption--see Section 302 Stock Redemption for more). A complete redemption is generally treated as a sale or exchange, subject to capital gains tax.

Caution: *If your family members (by blood or marriage) are also shareholders, the favorable tax treatment can be complicated or even eliminated by the attribution (constructive ownership) rules.*

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, dividends and 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 net 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.*

Stock sold by estate has step-up in basis

The stock included in your estate receives a new basis equal to the fair market value (FMV) typically determined at the date of death. When the sale price under a stock redemption is equal to the FMV, no capital gain or loss is realized by your estate.

Remaining shareholders do not receive increase in basis

When the corporation buys out the interest of a deceased owner, the surviving owners do not receive an increase in basis for income tax purposes. This means that if you are a surviving owner and you sell your interest in the business during your lifetime, you will realize a larger capital gain.

Example(s): *You and your two co-owners, Dick and Jane, originally invested $100,000 each in the business (original tax basis $300,000). The FMV of the business is now $600,000.*

	You	Dick	Jane	Business
Original Basis	$100,000	$100,000	$100,000	$300,000
Current FMV	$200,000	$200,000	$200,000	$600,000

Example(s): *Dick dies. The company buys back Dick's interest under the stock redemption plan and pays Dick's estate $200,000, representing the FMV of his interest in the business. Now, you and Jane each own half of the business valued at $600,000 ($300,000 each). Because there is no step-up in basis to the remaining shareholders under a stock redemption plan, your basis is still the original $100,000 you paid for your interest.*

	You	Jane
Current FMV	$300,000	$300,000
Basis	$100,000	$100,000
Potential Capital Gain	$200,000	$200,000

Example(s): *If you sell your interest during your lifetime (let's say now), you recognize a taxable capital gain of $200,000.*

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 may 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 of the agreement 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 new shareholders, can they be included under the entity purchase agreement?

Yes, new shareholders can be added by amending the agreement or by drafting the original agreement to accommodate the future addition of shareholders.

IMPORTANT DISCLOSURES

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