

# THINK ABOUT IT

*Diversity of opinion helps us to be more successful! Your Success Matters! Therefore, Prudential is pleased to provide you with material that offers different views and opinions on various subjects. Please note that these opinions are not necessarily those of Prudential and the content may not apply to your role as a financial professional at Prudential. Leimberg's Think About It is distributed as a courtesy to our representatives at The Prudential Insurance Company of America. Prudential expressly disclaims responsibility for any content and has not approved other publications referenced. Clients should consult with their accountant, tax advisor and/or legal advisor to confirm the accuracy of these analyses and for advice concerning their particular circumstances.*

## **CHOOSING THE RIGHT BUY SELL STRUCTURE FROM A TAX PERSPECTIVE**

### **INTRODUCTION**

Our closely held business owner clients usually rely on their businesses for lots of things:

- To provide income for the owner's family
- To support the families of employees
- To leave a family legacy either
- By allowing family members to take over one day or
- To turn the business into money at death or retirement

Financial planning professionals work with business owner clients to protect the business, and make sure the owner's goals are met. A properly drafted and implemented buy sell agreement can act as a key tool for the professional and client.

Professional advisors are often asked to identify the best buy sell structure from a tax point of view. Picking the most efficient way to make a transfer happen from a tax perspective requires balancing multiple tax considerations, and making judgments about managing possible adverse results.

To make the right judgment, the advisor must first identify the relevant issues. In this article, we'll focus on laying out the main tax considerations that are relevant in the buy sell discussion. To keep the discussion short, we will also limit the considerations to what might happen in the event of the death of an owner.

### **BUY SELL STRUCTURES**

If the company itself is doing the buying in the event of an owner's death, the structure is a redemption, or entity purchase. If it's the owners who are buying, the agreement is probably a cross-purchase arrangement. If it's a non-owner employee or friendly competitor that is in line to make a purchase happen, then the arrangement is a one-way buy sell. And finally, if there are multiple optional methods of purchase inside the agreement, it's probably a wait-and-sell buy sell.



## Redemption

Here's how a redemption arrangement should work.

Say that Al and Bob are equal owners of ABC, Inc., a regular corporation with a fair market value of \$1 million. Al and Bob enter into an agreement, together with their company, under which the company agrees to do buying in the event of a triggering event.

To fund its obligation to buy the shares of a deceased owner, the corporation buys \$500,000 of insurance on the life of Al, and an equal amount on the life of Bob. The corporation is the owner and beneficiary of the policy.

At Al's death, ABC, Inc. receives \$500,000 of life insurance proceeds. It uses those proceeds to purchase Al's 50% interest in the company, and Al's heirs transfer Al's stock back to the company in exchange for the \$500,000 payment.

The company holds Al's former stock as treasury stock, and Bob now owns 100% of the outstanding shares in ABC, Inc.

What are the potential tax issues associated with a redemption arrangement? If the business is organized as a regular C corporation, there are plenty of reasons why a redemption agreement might not be the best fit:

1. There's a danger that a stock redemption will be treated as a taxable dividend to the heirs, particularly where one family owns the business.
2. The surviving owner—Bob in the example above—doesn't get the benefit of a step-up in basis for his interest in the business.
3. For certain bigger C corporations, the corporate alternative minimum tax (AMT) might cause 15% of the cash value growth or death benefit to be lost to the AMT.

For S corporation businesses, the first drawback above may also apply if it has undistributed earnings and profits from prior C corporation days. The second issue may be relevant in part, and the third is a non-factor for S corporations.

For non-corporations, such as partnerships or LLCs taxed as partnerships, only the second issue might be relevant.

## DIVIDEND TREATMENT OF REDEMPTION AMOUNT

The first potential tax problem in a corporate stock redemption agreement is that the redemption might be treated as a dividend distribution.

The Internal Revenue Code states that a partial redemption of stock by a C corporation will generally be taxed as a dividend, instead of as a capital transaction. Why is the difference important? Because dividends have been historically taxed at higher rates than capital gains rates, and also because capital gains transactions generally get full credit for the owner's basis, dividend treatment usually means higher taxes for the selling owner than dividend treatment.

If only partial redemptions run the risk of dividend treatment, what's the big deal? Because of the constructive ownership rules, also called attribution rules, even a redemption that feels like a complete redemption may be treated as a partial one.

In our prior example of Al and Bob, at Al's death, the corporation redeemed all of Al's stock from his estate. We would expect the result to be a total redemption, and to be taxed as a capital transaction.

However, under the constructive ownership rules, stock owned by a beneficiary of an estate is considered constructively owned by the estate. Under those circumstances, a redemption of all the stock actually owned by the decedent may still be taxed as a partial redemption.

There are two kinds of attribution that can cause unexpected dividend treatment of a stock redemption in a family situation:

1. Estate attribution rules state that any shares owned by the beneficiary of a decedent's estate are attributed to the decedent.
2. Family attribution rules state that stock owned by an individual shareholder's parents, spouse, children, and grandchildren—or owned by certain trusts or certain business entities in which those family members have an interest—will be attributed to the shareholder for purposes of determining the tax treatment of a redemption.

Say that in our example, Al and Bob are father and son. Bob is a beneficiary under Al's will. If the corporation redeems only Al's stock, the entire amount paid by the corporation for the stock may be taxed as a dividend to Al's estate. That's because Bob's shares are considered to also be owned by Al's estate through estate attribution rules.

Even if Bob is not a beneficiary of Al's estate, the family attribution rules might cause dividend treatment for the redemption. Say that Al's widow is the sole beneficiary under his will. Bob's shares are attributed to his mother under the family attribution rules. The widow's sale of shares to the corporation may be taxed as a dividend, unless other tax relief is available.

One path leading to tax relief is that in certain cases it may be possible to avoid the application of family attribution—and its accompanying dividend treatment of a redemption—by the stockholder whose stock is redeemed. That stockholder, after the redemption, must have no ownership in or control of the corporation and must commit not to acquire any such interest for ten years following the redemption.

Getting a selling family member to commit that he or she won't substantially participate in the business for ten years isn't always easy, or even possible.

Another path that can allow a family to avoid dividend treatment of partial redemptions is the Section 303 method. Section 303 of the Code provides relief under the following circumstances:

- The stock of a closely held corporation must be worth more than 35 percent of the adjusted gross estate, and
- The redemption amount is limited to the taxes—estate, inheritance and generation-skipping—plus final expenses of the deceased owner.

Any redemption in excess of the amount allowed under Section 303 is taxed as a dividend.

The rules surrounding constructive ownership, partial redemptions and family attribution are highly complex. Because of the dynamic nature of families and family-owned businesses, the potential application of partial dividend rules must be carefully considered when implementing a redemption arrangement.

The potential for dividend treatment of a redemption plan may cause many stockholders to opt for cross-purchase buy sell arrangements.

## **LACK OF STEP UP IN BASIS FOR SURVIVING OWNERS**

In most cases with a corporate structure, a redemption buy sell will not optimize the basis increases for the surviving owners of the business.

Using the example of Al and Bob described earlier, here's an illustration of the point. For the purpose of the example, let's say also that all of the equity that Al and Bob have in the business is based on sweat, and that each therefore has a \$0 basis in their company stock.

Assume that Al dies. The company gets \$500,000 of insurance proceeds, which it used to buy out Al's shares, and now Bob is the 100% owner of ABC's outstanding stock.

What's Bob's basis in the company? It's still \$0. If Bob finds a buyer for the company the next day, and sells it for \$1 million, Bob would have to pay capital gains tax on the whole \$1 million.

What if ABC, Inc. is an S corporation? In our example, Bob would normally get a partial step-up in basis for Al's shares. Here's how that works.

At Al's death, \$500,000 of life insurance proceeds are paid to the company. If the insurance was properly implemented—following Section 101(j) rules—the benefit would be income tax free.

Under S corporation tax rules, when tax-free money flows into an S corporation, the basis of the owners is increased by the tax-free money in proportion to the owners' stock. In the ABC, Inc. example, Bob's basis would increase from zero to \$250,000—half the \$500,000 death benefit. Al's estate would get the benefit of the other \$250,000 increase in basis.

In 2010, when Al's estate has a limited step-up in basis due to the one-year rule changes, it may benefit from getting an increase in basis due to the life insurance. Projected forward to 2011, a basis increase from life insurance may be wasted due to the reinstatement of the full death-time step-up.

Can Bob get a step-up in basis for 100% of the life insurance proceeds at Al's death in 2011? Maybe. If the S corporation is a cash basis taxpayer, the parties may be able to put together a special kind of redemption arrangement that takes advantage of short tax year rules and installment notes to maximize Al's basis increase.

For more information on this technique, there is an excellent summary at:

<http://www.lifeandhealthinsurancenews.com/Issues/2008/6/Pages/Advantages-Of-S-Corp--Stock-Redemption-In-Business-Continuation-Planning.aspx>

By the way, for partnerships and LLCs taxed as partnerships, it is usually possible to allocate the step-up due to the tax-free life insurance death benefit only to the surviving owners. This can be accomplished through proper drafting of the operating agreement or buy sell agreement.

## **CORPORATE ALTERNATIVE MINIMUM TAX**

In a funded redemption buy sell agreement, the life insurance proceeds are payable to the business. While death proceeds used to fund a buy sell agreement are normally income tax free, some life insurance may be subject to the corporate alternative minimum tax (AMT). The AMT is only imposed if the business is

- Organized as a C corporation, and
- Its average annual gross revenues are more than \$7.5 million

The AMT may impose a tax as high as 15% on the policy's annual cash value growth or its death benefit in excess of cash value.

The actual calculation of the AMT is fairly complex, and whether or not it might be relevant for a given C corporation can vary from year to year. If there is a fear that the AMT might apply, the C corporation owners may decide to buy a higher face amount to gross-up for the tax, or structure the buy sell agreement as a cross purchase arrangement.

## **DESIRE TO SPREAD TAX RESULT OVER INSURANCE OUTLAY EQUALLY**

After thinking about the downsides of structuring a buy sell agreement as a redemption arrangement, some might wonder why anyone would ever choose a redemption? A redemption arrangement does have several advantages:

- It's usually simpler to understand and implement.
- A redemption can allow the insurance cost to be easily spread proportionally among all the owners of the company.
- A redemption arrangement may provide some tax leverage if implemented in a C corporation with a lower tax bracket than its owners' personal tax rates.

If a corporation or LLC is buying the needed life insurance on its owners to fund a death-time buyout, the cost is borne by the company. Each of the company owners will usually feel that premium burden in proportion to the share of ownership in the company. If one of the owners is only insurable at a high price relative to the other owners, the equitable spreading of cost under a redemption plan can feel fairer than it might under cross purchase funding.

## **TAKE ADVANTAGE OF LOWER CORPORATE TAX RATE**

Let's return to the example of Al and Bob. Say that each of them is in a personal federal income tax bracket of 35%. Let's also say that their C corporation is in the 15% corporate tax bracket.

If the annual premium to buy life insurance to fund the buy sell arrangement is \$1,000 per year for each of them, does it make more sense to structure the buy sell agreement as a cross purchase or a redemption?

If they are most concerned with the cost of paying the premium, Al and Bob might opt for a redemption structure. Here's why. If the premiums are paid personally, as they would be under a cross purchase arrangement, Al has to earn \$1,538 (at a 35% tax rate) of taxable income to come up with the net \$1,000 premium for the policy on Bob's life.

On the other hand, if the corporation pays the premium for Bob's policy, it only has to earn \$1,176 (at a 15% tax rate) to net \$1,000. In this example, the company's money is cheaper to use.

## Cross Purchase

Here's how a cross purchase arrangement should work.

Say that we're still considering ABC, Inc., with Al and Bob as owners. Al and Bob enter into an agreement, under which each of the owners agrees to do buying from the other owner upon a triggering event.

To fund his obligation to buy Al's shares upon Al's death, Bob buys \$500,000 of insurance on the life of Al. To fund his obligation, Al buys a like amount on the life of Bob. Each shareholder is the owner and beneficiary of the policy on the other.

At Al's death, Bob receives \$500,000 of life insurance proceeds. Bob uses those proceeds to purchase Al's 50% interest in the company, and Al's heirs transfer Al's stock back to Bob in exchange for the \$500,000 payment. Bob now owns 100% of the outstanding shares in ABC, Inc.

Here are the reasons for a company to prefer a cross purchase agreement:

1. The surviving owners get a basis in the purchased stock equal to what they pay—making a subsequent sale less subject to capital gains tax.
2. Since the company doesn't own the life insurance, the corporate AMT is a non-issue.
3. There is no danger of dividend treatment of the purchase of stock, since the purchase is being made by the company co-owners, rather than having money come from the corporation.

There are also plenty of reasons why a cross purchase arrangement might not be a good fit:

1. If there are more than two owners of the company, it can be hard to place, manage and administer all the needed insurance policies in the correct way.
2. If there's a change to the company, configuration of ownership, or insurance, there may be plenty of opportunities for transfer for value problems to arise in corporate buy sell reconfigurations.
3. The owners have to write a personal check for the premium.

To expand a bit on the disadvantages, here's an example. Say that Davey, Mickey, Mike and Pete are the owners Prefab Music, Inc., an S corporation. They agree that the company is worth \$1 million, and they decide to enter into a cross purchase buy sell agreement.

To fund their obligations under the plan, each of the owners buys \$250,000 of insurance on the other three. For Davey, that means owning \$250,000 of coverage on Mickey, Mike and Pete. With four owners of the

company, this kind of implementation means that twelve policies are needed. Keeping track of that many policies might be a hassle.

Let's say that Pete dies. After each of the surviving owners collects \$250,000 of life proceeds, they use the money to buy Pete's interest from his estate. The surviving owners would also want to get the policies Pete owned on the others to fully fund the buy sell arrangement on a going-forward basis.

Well, if Pete's heirs transfer those policies to the non-insured owners of the company, it's a potential transfer for value problem. Code Section 101(a)(2) provides:

In the case of a transfer for a valuable consideration, ...of a life insurance contract ... the amount excluded from gross income ...shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

The transfer for value rule does not apply if the transfer is made to:

- the insured,
- a partner of the insured,
- a partnership in which the insured is a partner, or
- a corporation in which the insured is a shareholder or officer.

If the transfer of the policies formerly owned by Pete is to the co-shareholders of the insureds, the transfer does not fall under one of the exceptions to the transfer for value rule. Therefore, the death benefits would be taxable in the event of the subsequent death of one of the shareholders.

Sometimes, in order to keep from having multiple policies on each owner, the parties may have the insurance held by a trustee or escrow agent. That method can work well until one of the owners dies. However, if ownership in the policies is re-allocated after the death of one owner, that re-allocation may trigger an unintended transfer for value—and a tax problem.

To avoid transfer for value issues associated with funded cross purchase arrangements, many attorneys recommend putting together partnerships to be the conduits for funding and administering the buy sell agreements. If the owners are partners in a real, functioning partnership, arguably all potential transfer for value issues are solved, because any transfer would fall under the partner or partnership exception.

## **Wait and See**

The wait and see buy sell arrangement, also referred to as the optional buy sell, is sometimes implemented as a way for the owners of a business to hedge their tax bets.

Using ABC, Inc., here is how they might implement a wait-and-see buy sell:

1. Upon a triggering event (let's assume the death of Al once again), the business has the option of buying Al's shares from his heirs for 30 days.
2. If ABC, Inc. does not redeem Al's shares, Bob has 30 days after the business's option expires to buy Al's shares.

3. Finally, if Bob does not exercise his option, ABC, Inc., must redeem Al's shares from Al's heirs.

Life insurance may be owned by the company or by each shareholder on the other. The policy owner should also be the beneficiary.

To get money into the right hands at the death triggering event, the parties should anticipate the idea that money can be loaned to provide the needed cash. For example, if ABC, Inc. gets the death benefit, it might loan the money to Bob for the purchase of Al's shares.

Depending on the structure of the life insurance and the later structure of the buyout, there may be tax results to the parties consistent with redemption or cross-purchase.

### **One-Way**

One-way buy sell agreements are usually implemented in proprietorships or other single-owner entities. These agreements are usually between the owner and a key employee, or between the owner and a friendly competitor. They are called one-way agreements because they're only triggered in one direction—if something happens to the current owner of the business.

One-way buy sell agreements work in a manner similar to cross-purchase agreements, in that the death trigger is usually funded with life insurance owned by the key person or the friendly competitor. In the event of the single owner's death, the third party collects the proceeds and buys the business from the deceased owner's heirs.

### **Conclusion**

Each method of buy sell structure has its own advantages, disadvantages and proper market when thinking about the transfer of business at death.

Stock redemption plans work best when

- There are more than two shareholders,
- The corporation is in a low marginal tax bracket,
- Cost basis issues for surviving owners are not relevant,
- There are significant age differences among owners,
- The owners prefer to use a corporate check for the insurance purchase,
- There are significant differences in ownership percentages,
- There are no significant corporate creditors,
- There is no potential corporate AMT,
- There is no family attribution exposure, and
- If the company is an S corporation, it is a cash basis taxpayer.

Cross purchase plans work best when

- The company has two equal owners,
- The owners are close in age,
- A cost basis increase for the surviving corporate owners is important,

- The owners are willing to pay for the insurance, even through a bonus arrangement or split dollar plan, and
- If the business has more than two owners, they are willing to undertake the extra complexity of a buy sell partnership.

A wait-and-see buy sell agreement may be the right choice when the business owners and their advisors want to maintain flexibility until a triggering event—and when that flexibility is the most important objective. And a one-way buy sell arrangement is used when the buying party is not an owner of the company.

Finally, for those planning a business transfer at death, using insurance to fund a buy sell obligation has the following advantages:

- The income tax free money from insurance is delivered at the precise time needed – the death of an owner.
- Life insurance death proceeds can pay off a deceased owner's family and eliminates their further involvement with business, which is not the case with funding a buyout over time.
- Life insurance minimizes the need for creating a corporate sinking fund, which could trigger unintended accumulated or retained earnings excise tax for a C corporation.
- The cash value from permanent insurance can be used to help fund a living buyout—for example at retirement or disability.

*Linus is one of the principals of the ICS Law Group, PC. The ICS Law Group provides estate planning legal services to individuals, and non-litigation legal services to business owners. Its principal office is in Franklin, Tennessee.*

*Linus worked for a Chicago-based insurance company as their Director of Advanced Sales and most recently as their Chief Marketing Officer.*

*Linus also co-authors the publication Think About It with Steve Leimberg.*

This material is for internal use only and is provided courtesy of The Prudential Insurance Company of America, Newark, NJ. The discussion of planning techniques does not imply a recommendation that a specific planning concept should be implemented. References to legal and tax considerations are made but are not meant to provide advice in this regard. Please remind clients that legal and tax advice, including the preparation of legal and tax documents, should come from an attorney and/or a tax advisor such as an accountant. These advisors can determine how best to utilize such product or technique. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code.

Prudential Financial Planners can prepare financial plans. Financial Services Associates and producers can work as knowledgeable members of clients' professional teams to provide suitable products.

Securities are offered through Pruco Securities, LLC. Investment advisory services offered through Prudential Financial Planning Services, a division of Pruco Securities, LLC. The Prudential Insurance Company of America and Pruco Securities are Prudential Financial companies.

Stephan R. Leimberg is not affiliated with Prudential Financial and Prudential Financial makes no representation as to the accuracy of any cites mentioned in this piece.

**Securities and Insurance Products:  
Not Insured by FDIC or Any Federal Government Agency. May Lose Value.  
Not a Deposit of or Guaranteed by Any Bank or Bank Affiliate.**

Prudential, Prudential Financial the Rock logo, and the Rock Prudential logo are registered service marks of The Prudential Insurance Company of America, Newark NJ and its affiliates.