

Helping a Business Survive a Co-Owner's Death or Disability

By Sidney Kess and Edward Mendlowitz

Co-owners of privately owned businesses often do not make a plan to assure business continuation upon their or their partner's death or disability, although it is an essential point of concern. One important way to ensure the continuity of a business is for the owners to execute a buy-sell agreement: a contract that provides for the sale of ownership in the business upon the occurrence of a specified event. This is often the death or disability of one of the owners, and may also provide for sale upon the retirement or exit of one of the parties. These are areas where a CPA financial planner can provide great assistance to small business owners.

Getting Started

To get started, here are several key questions to ask the co-owners:

- Do you want your or your partners' widow and heirs to continue as owners and work in the business, and will they be able to?
- If you were the surviving owner, do you want to continue the business, or liquidate it?
- How will the value of your or your partner's interest be determined?
- How will you pay for your co-owner's share if he dies first? Or vice versa?

For the sake of brevity, this article will refer to buy-sell agreements, but there are various types of specifically titled agreements that share the same principles (e.g., a corporation would have a shareholders' agreement; an LLC would have a member's agreement; and a partnership would have a partnership agreement). This article refers to owners, partners, members, and shareholders interchangeably.

Any such agreement is a legal document with serious consequences, so it may be advisable to include an attorney, insurance representative, and valuation expert early on in the planning. But it is the CPA financial planner's duty to initiate and lead the project and team. Many negative consequences can be averted during an unpleasant period by making definite arrangements for provisions *before* death or disability becomes a reality. These issues involve the sale of shares, succession, transition, funding, payment terms, valuation, and taxation.

Why a Buy-Sell Arrangement Is Desirable

A buy-sell agreement can benefit a closely held business in many ways:

Avoids uncertainty. The agreement will eliminate the uncertainty of who will acquire the deceased's ownership interest. A proper agreement would arrange for the remaining owners or business to acquire the shares, rather than the widow, family, or other heirs of the deceased. It would also keep people unfamiliar with the business's operations from being forced to make decisions, such as the value of professional fees or the need to make a forced sale.

Creates a ready buyer. An agreement would mean a ready buyer, and both parties would already know the price and terms, reducing or eliminating the uncertainty about the process.

Valuation issues. The valuation and price would be decided by the co-owners in the process of preparing the agreement, not afterwards upon a death or disability. At that time, this would become a costly, time-consuming process subject to disagreement, as well as potential litigation and tax audits.

Source of funds. The decedent's estate would receive payment in cash and notes with clear terms in exchange for the business' ownership interest. Most businesses do not have the ready cash to pay for a co-owner's shares, so payment terms would be settled upon in the agreement.

Creates an understanding of liquidity. An estate's liquidity depends upon many issues. If the source of funds from the business is not sufficient—a common issue, as most businesses do not have excess cash on hand—the planning would provide the co-owners with the time and ability to make other arrangements. Liquidity would also be needed for family cash flow, estate taxes, and to settle any obligations of the deceased.

Corporate succession. A buy-sell agreement would provide for corporate succession and control of the business according to the parties' desires. This could involve key employees already in place.

Stabilizes the corporation. The buy-sell agreement dispels fears that the business would end upon the death of one of the owners. It is also a morale booster for key employees who might otherwise fear the loss of their jobs.

Tax issues. Disagreements with the IRS over the value of the business for estate tax purposes would be eliminated or minimized

and the source of funds to be used in paying the estate tax can be established during the process.

How a Buy-Sell Agreement Works

There are three types of buy-sell agreements:

Cross-purchase agreement. This is a buy-sell agreement that exists among the owners themselves.

Example. A corporation has two shareholders, A and B, who each agree that upon one of their deaths, their estate must sell and the survivor must purchase his stock.

Stock redemption agreement. This is an agreement to which the corporation, as well as the shareholders, is a party. The corporation agrees to buy (redeem) the decedent's stock.

Example. A corporation has two shareholders, A and B, and the corporation agrees to buy the shares of the first shareholder to die. A and B each agree that his estate will sell the shares he owns to the corporation.

Hybrid or combination agreement. This type of agreement is a combination of the other two; here, the business and owners agree to buy the deceased's stock. Such an agreement consists of both a cross-purchase and a redemption agreement.

Example. A corporation has two shareholders, each owning 100 shares. There is a cross-purchase agreement for 50 shares of stock, and a stock redemption agreement for the remaining 50. This agreement would be primarily used if there were more than two stockholders, and the new ownership percentages would be in a different proportion than it would be with a corporate redemption.

Funding

Despite careful attention to the preparation of a buy-sell arrangement in terms of valuation and succession, inadequate funding may frustrate an agreement. Funding can be accomplished through 1) life insurance, 2) periodic contributions by the business into a sinking fund, 3) borrowing, or 4) the sellers. The latter three methods are particularly valuable where a stockholder is uninsurable. The sinking fund is the most practical, but least popular, because it requires the owners to leave fully taxed funds in the business rather than currently withdrawing and investing them. Life insurance is frequently used to fund a buy-sell agreement, because the premiums are low compared to the benefits, and can usually be paid quite easily. Borrowing the funds to pay a departed owner is unlikely, because lenders prefer the funds to remain in the business to be used for growth. This leaves deferred payments to the heirs. The business can make a reasonable down payment and use earnings to fund the payout: Depending upon the projected cash flow, five- to 10-year payment periods are usual. Interest is added at current rates.

When the cross-purchase approach is used, each stockholder owns an insurance policy on the life of each of the other stockholders. If the agreement provides for redemption of the stock by the corporation, the corporation carries a life insurance policy on each stockholder whose stock is to be purchased. Upon the death of a stockholder, the corporation or surviving stockholders (depending upon the type of agreement) collects the insurance proceeds and uses that to purchase the stock of the deceased stockholder.

Tax Consequences of Buy-Sell Agreements

The tax consequences under the various agreements are as follows:

For a cross-purchase agreement funded by insurance:

- Premiums paid by the shareholders are *not* deductible.
- Payments of dividends or additional salary so the shareholders have the funds to pay the premiums are taxable to the shareholders.

- Insurance proceeds used to pay for the stock purchased from surviving stockholders' family after death escape income taxation because of the step-up in basis rules, but the proceeds are includible in the gross estate for estate tax purposes.

- The remaining owners get a step-up in basis for the acquired shares, which they do not get with a stock redemption agreement.

For a stock redemption agreement funded by insurance:

- Premiums paid by the corporation are *not* deductible.
- The insurance proceeds received by the corporation upon the death of a stockholder are not taxable to it.

- The receipt of the payment for the stock would not be taxable, as the estate would get a step-up in basis usually equivalent to the sale proceeds. The proceeds are includible in the gross estate for estate tax purposes.

- If the incidents of ownership of the policies are attributed to the deceased, the insurance proceeds might be includible in the estate. Though beyond the scope this article, the implications merit serious consideration.

- The premiums paid on an insurance policy covering the life of one stockholder are not taxable as a dividend to the other stockholders, but the corporate ownership of a policy would cause some ordinary income to be attributed to the insured each time a premium is paid.

For a cross-purchase agreement not funded by insurance:

- Transfer of shares between the shareholders has no tax effect upon the business.

- Sale of the decedent's stock by his heirs or estate has no significant tax result because the heirs acquire a step-up in basis for the shares.

- Sellers of the decedent's stock, including the estate, must include in income any interest received on the deferred part of the selling price.

- The basis of the surviving shareholders in the additional ownership shares they buy is equal to their purchase price.

For a stock redemption agreement not funded by insurance:

- Redemption of the deceased's stock has no tax consequences to the surviving stockholders; their basis is unchanged. This is a disadvantage when compared to a cross-purchase agreement.

- Corporations realize no gain from the redemption unless it distributes property with a greater value than its tax basis (appreciated property). The estate's basis in the property is stepped up to the value at that time.

Selecting a Type of Buy-Sell Agreement

Each type of buy-sell agreement has its advantages and disadvantages. A careful study and analysis of the pros and cons should precede any decision. Some of the key factors are listed below.

Cross purchase agreement. This type of agreement is quite satisfactory when the number of stockholders is small, but it can

become burdensome when there are many. For example, if there are five stockholders at the time a buy-sell agreement is executed, 20 policies would be needed; each stockholder would need to purchase a policy of the other four. If the plan is not funded with insurance, each remaining owner would have to assume the obligation to purchase the shares individually. Occasionally, a trust is used to own the policies and acquire the shares. This should be considered if circumstances warrant it. The obligation to purchase generally falls upon younger owners, and they are frequently the least financially able to buy.

Stock redemption agreement. This agreement is much simpler to execute when there are several stockholders. The business—not the owners—pays the insurance premiums if the parties are insurable. If insurance is not used as a funding device, a problem may arise if the corporation does not have sufficient surplus to redeem the shares when the deceased stockholder's shares are tendered for redemption. The redemption by the business will appear on the company's balance sheet, reducing its capital and creating a liability for any deferred payout. This might violate bank loan covenants and cause the loan to become due or subject the business to further restrictions by the bank. Even if there is sufficient surplus, if there are no insurance proceeds, the corporation may not be in a position to redeem and continue to operate efficiently and effectively. Payment of the purchase price via installment payments may be the solution. This creates a problem of security and interest, however. The type of agreement to use depends on the dynamics of the client's situation and its owners, and this is an area in which a CPA financial planner can render valuable service.

How Stock Is Valued

An effective, properly, and carefully drafted buy-sell agreement will generally achieve its goal of favorable tax results and minimal disruption of a business. Such an agreement will ensure that the estate of the deceased shareholder will receive a fair price for the shares of stock. There are several methods of valuation, but regardless of the method chosen, the price set forth in the agreement should be a fair, adequate, and current one. From a practical standpoint, a buy-sell agreement is valuable only if it reflects a current value that all the parties to the agreement would be willing to receive and able to pay, depending upon who dies first. Furthermore, the valuation may establish value for estate tax purposes.

Generally, valuation is determined under one of the following methods:

- Book value at date of death or as of end of preceding accounting period
- Fixed price provided for in the agreement and agreed upon by the stockholders (this method is effective only if it is reviewed periodically and updated at least every two years)
- Price determined by appraisal, using an appropriate standard of value, after death (The disadvantage of this method is the delay in choosing the appraiser and then in obtaining the appraisal. Consequently, the price may not be known for a significant period after the death. Delay is a normal experience under this method. Unless the agreement provides for no contesting of the valuation amount, litigation could result and further alternative appraisals might occur and there will be added costs, legal fees, and delays.)

- Self-adjusting formula using a value determined when the agreement was executed, which is adjusted annually based on a formula such as increase in book value, weight based on a capitalization of earnings, or percentage-of-sales increase.

Terms that Should Be in the Agreement

CPA financial planners should make their clients aware of the importance of a buy-sell agreement, and they should be consulted before a client enters into one. The agreement should provide the following terms:

- The events that would trigger the transfer of ownership, such as death and disability, but also retirement, personal bankruptcy, conviction of a felony or loss of license to practice, if applicable
- That, upon the death of a stockholder, his estate will be obligated to sell his shares, and either the corporation or the surviving stockholders, or both, will be obligated to purchase the shares
- The purchase price and terms of payment, such as lump sum or down payment with installments, as well as the interest rate (note that if interest is not provided for, the IRS may impute interest on the deferred payments)
- Security on the deferred portion of the purchase price
- Personal guarantees by remaining owners on installment payments
- The price, or formula for the determination of price, and method of updating the value
- The rights of sellers in case there is a default.

Disability Provisions

Although planning for buy-sell agreements primarily contemplate provisions for an owner's death, disability can and does disrupt many businesses, and is much more common for younger owners. Disability insurance policies can be used for funding, and the disability definition in the buy-sell agreement can be tied into the one in the insurance policy. Provisions can be made for the acquisition of the stock of the disabled stockholder after a period of six months, one year, or longer.

There is an important and different tax result for the sale of stock by a disabled stockholder versus a deceased stockholder. A disabled stockholder will realize a capital gain on the stock sold to extent of the appreciation in value, while the estate does not, because it will get a step-up in basis. Similar to the life insurance premiums, the disability buyout policy premiums are not deductible, and the proceeds are not taxable income.

A properly considered buy-sell agreement is essential to avoid the many problems that can arise with the untimely death or disability of a business owner. CPA financial planners should be alert to whether their clients have these agreements, if they are kept current, and whether they reflect up-to-date realities. □

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