Buy-Sell **Planning**

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Business Planning

Why a business needs a Buy-Sell agreement

General overview

A buy-sell agreement is a legally binding contract that requires one party to sell and another party to buy a particular ownership interest in a business in the event of the death, disability or retirement of a partner or stockholder or upon certain other triggering events.

These agreements are often among co-owners or between owners and the business entity itself. It is also possible that individuals who are not currently owners (such as an employee, an outsider or a family member) may be a party to the agreement. These agreements may be used by any type of business entity, sole-proprietor, corporation, partnership, or limited liability company (LLC).

A buy-sell agreement is a separate legal document that ensures that any ownership transition will occur as planned. To provide the cash needed to make the transition work, life insurance is used.

The need for a buy-sell agreement

Small-business owners should have a formal written plan to transfer their share of the business at their death. But not having a plan in place creates a number of problems. Without a buy-sell plan:

- Surviving partners or stockholders may be forced to sell or dissolve the business.
- The business may be placed in the difficult position of having to decide how it will compensate the decedent's family for the decedent's ownership interest.
- The decedent's estate cannot be guaranteed it will receive a fair price for the business interest.
- The business will also be confronted with the uncertainty that comes with losing the services of a significant member of the company.

Active business owners typically focus on the tangible, day-to-day operations of the business such as quarterly earnings, distribution conflicts and inventory – not the consequences of a premature death. But the short-term and long-term consequences of losing an owner should not, and cannot, be overlooked. The loss of an owner creates a void in both management and operation and hence creates a significant challenge to business continuation. A properly designed and funded buy-sell agreement can help solve this problem. First, it can provide liquidity for the purchase of the departing owner's interest. Second, it can help establish a fair price for that interest. A formal buy-sell agreement can also help ensure that the business and the careers that depend on it will continue.

Laying the foundation

A person does not build a successful business, through years of effort, in order to have it sold for the best offer that the executor may receive following his or her death. There are too many contingencies to leave to chance – the disposition of a business interest after the owner's death, available purchasers, available funds to make the purchase, and the necessity for liquidation to pay debts and close the estate. If the owner has a family member able to carry on, and that person is acceptable to the surviving partners or stockholders in the business, he or she is indeed fortunate. But assuming the usual case, where the owners of the business do not desire to liquidate it on the death of one of the owners, and it is not desired to have members of the family of a deceased owner in the business, a proper business purchase agreement becomes a necessity.

There are essentially three risks facing the business owner: death, disability and retirement. Likewise, upon the business owner's death, disability or retirement, only one of three things is going to happen: the business will be continued, sold or liquidated. The planning process should reveal the answers to these questions:

- Will successor management be available and willing to operate the business? Such a person could be either a family member or a key employee, but it is important to be realistic about both their abilities and commitment to staying with the business.
- Would a satisfactory return on business capital be provided for the family? The decision as to what is "satisfactory" is a highly subjective determination, but it usually falls within the range of 6 to 20 percent.
- Could tax-favored profits be withdrawn for the family? If the business is a corporation, then payment of a salary to the stockholder-employee is "tax-favored" as a deductible business expense. However, the same payments to a surviving spouse might be characterized as nondeductible dividends.

If the answer to all three of these questions is "yes," then it is likely that the business could be successfully continued. However, if the answer to any one of the questions is "no," then further investigation is necessary.

- Is there a strong desire for continuing family involvement in the business? A "yes" answer to this question is often the result of a strong sense of family pride in the business, despite one or more "no" answers to the previous questions. Under such circumstances, the business might well be continued, provided steps are taken to assure that continuation is possible.
- If continued family involvement is not an option, would a buyer be readily available? If the answer is "yes," then the business should be sold with a binding agreement and adequate funding in order to assure that the sale takes place. A "no" answer to this question means that the business is likely to be liquidated, and its assets sold for pennies on the dollar.

Outlining a buy-sell agreement

Business valuation

Valuation is a key element in the buy-sell agreement process, not only to assure that the business interest is transferred at a fair price but also to help establish a value for estate tax purposes. If a proper business valuation is not done, the Internal Revenue Service (IRS) may challenge the value that the owners have placed on it. In turn, this could lead to litigation. If the courts rule in favor of the IRS, there could be additional taxes both at the business and the personal level.

Determining business valuation is not an easy process, and it is generally recommended that it be done by a professional appraiser. There is a variety of methods and factors to consider when determining business valuation. For most businesses, a simple formula of assets minus liabilities (a book value formula) is not a complete assessment of value. Other important factors to consider include:

- Average annual earnings.
- Number of years a business has been in existence.
- Nature of the business.
- Ownership control.
- Goodwill or the earning power of a business in excess of a fair return on the business's tangible assets.
- Price earnings multiples of comparable public companies.

Once the initial business valuation has been done, it should be adjusted or updated as needed to reflect any dramatic change in business operation or value.

Estate taxes, business valuation and Internal Revenue Code Section (IRC Sec.) 2703

The value of a business interest, like any other property included in a decedent's estate, is assessed at fair market value for estate tax purposes. Fair market value is the hypothetical price that a willing buyer would pay and that a willing seller would accept when neither is under any compulsion to buy or sell and both have reasonable knowledge of the relevant facts. Regulations Section (Regs. Sec.) 20.2031-2(a), Revenue Ruling (Rev. Rul.) 59-60, 1959-1 Cumulative Bulletin 237. An advantage of a buy-sell agreement is the ability to set or predetermine the estate tax value of a business interest and to not leave an estate open to the long, expensive and often losing process of trying to prove a lower value against a higher assessment by the IRS. In general, this can be done with buy-sell agreements entered into by unrelated parties.

Agreements among family members are subject to three requirements set forth in IRC Sec. 2703 and the Regulations thereunder

The three requirements are:

- The agreement must be a bona fide business arrangement;
- It must not be a device to pass the business interest to members of the decedent's family for less than adequate consideration; and
- The terms must be comparable to similar arrangements made by unrelated parties in an arm's length transaction.

Prior to IRC Sec. 2703 (effective for agreements made or substantially modified after October 8, 1990), the tax cases generally allowed related parties to fix the estate tax value to a price that was fair and reasonable when made as long as the first two requirements above were also met. Another requirement is that the buy-sell price is binding during lifetime on any attempted sale as well as at death (either a mandatory buy-sell, or an option to be exercised by the business or the other owners). For a discussion of the cases and factors that were considered by the courts, see: Estate of Joseph Lauder (Estee Lauder), 64 TCM 1643 (1992) and Estate of Joyce Hall (Hallmark cards), 92 TC 312 (1989).

The rules under IRC Sec. 2703 make it difficult, if not impossible, to predetermine the estate tax value of family-owned businesses with a buy-sell agreement. It must be shown that it is comparable in price and terms to those that would be entered into by unrelated parties. That requires consideration of the expected term of the agreement, the current fair market value of the business and anticipated changes in value during the term of the agreement. Regs. Sec. 25.2703-1(b)(4). Thus, it is no longer possible to freeze the value of a family-owned business to a fixed buy-sell price.

The Regulations provide a safe harbor to "Smith-Jones" corporations (those that are not owned by family members). Agreements are deemed to meet the three requirements of IRC Sec. 2703 if more than 50 percent in value of the business is owned by persons who are not members of the decedent's family and are subject to the same terms. Regs. Sec. 25.2703-1(b)(3). However, the Regulations also expand the definition of family to include lineal descendants of the parents of the decedent or spouse (siblings, in-laws) and anyone who is a natural object of the decedent's bounty.

Funded versus unfunded buy-sell agreements

A funded buy-sell agreement provides that the funds will be available when they are needed to pay for the decedent's business interest. There are a variety of ways that a buy-sell plan can be funded, including life and disability income insurance, installment payments (payments are taken either from company cash flow or in the form of loans), and/or a savings account. Each option has its advantages and disadvantages, and each will be discussed later in greater detail. An unfunded buy-sell agreement could create complications and delays, adding to the uncertainty that typically surrounds the death of an owner.

Types of Buy-Sell agreements

Entity plan

An entity purchase buy-sell agreement is a legal agreement between a business entity and its owners. To illustrate how it works, assume a business is owned equally by A and B. They each enter into an agreement with the business for the purchase and sale of their respective interests. Typically, the agreement is binding in that it obligates both A and B, and their estates, to sell, and the business to buy, upon the death, disability or retirement of either one of them.

The agreement establishes the value of the business for estate tax purposes. In the event of an owner's death, disability or retirement, the agreement provides for the transfer of the ownership interest in exchange for cash. Once the cash is received by the departing owner's estate, the business interest is transferred to the business. Although an entity plan may be funded by other means, it is generally accomplished through the use of life insurance. Life insurance can guarantee that the necessary funds will be available at the disposition of the business interest.

- **Entity plan funded with life insurance:** The business entity obtains a life insurance policy on each owner. The business is the owner, beneficiary and premium payer of each policy. At the death of an owner, the proceeds are received by the business. The business then uses the funds to purchase the interest of the deceased owner. The value of the remaining ownership interests is increased by the percentage amount of the purchase price. If the business is a corporation, the plan is generally known as a stock redemption agreement. In a partnership context, the plan is called a liquidation of interest.

- **Advantages of entity plan:** Generally, only one life insurance policy per owner is needed to fund an entity plan. The business is responsible for the premium, thus removing the burden of premium payment from the owners. At the death of an owner, the value of the interests held by the remaining partners or stockholders is increased by the purchase price. Policy proceeds are received income tax-free by the business.

- **Disadvantages of entity plan:** Policy proceeds and accumulated values are available to creditors of the business. At the death of an owner, the life insurance proceeds "balloon" the value of the business prior to the buyout. For C corporations, policy proceeds could be exposed to the alternative minimum tax (AMT). At the death of an owner, the value of the remaining ownership interests is increased by the purchase price. However, the cost basis is not adjusted, and there is greater potential for taxable gain to be realized upon a subsequent sale of the business.

Cross purchase plan

A cross purchase buy-sell plan is a legal agreement among the owners that provides for the planned disposition of their interests in the event of a death, disability or retirement. To illustrate how this works, assume a business is equally owned by two individuals, A and B. They enter into an agreement providing for the purchase and sale of their respective interests. Typically, this agreement is binding and obligates both parties, or their representatives, to either buy or sell upon the death, disability, or retirement of either one of them.

- Using life insurance in a cross purchase plan: Under the cross purchase agreement, each owner is required to purchase a proportional share of the deceased owner's interest. The number of policies required is based on the formula n(n-1), where n equals the number of owners. Each owner purchases a life policy on the life of the other owner in the amount of their respective ownership interest, and names him or her as the beneficiary. Upon the death of an owner, the surviving owner receives the insurance proceeds from the deceased's policy. These proceeds are received income tax-free. Pursuant to the agreement, the deceased's estate transfers the business interest to the remaining owners, in exchange for a payment equal to the value of the interest. The insurance proceeds are used as the cash payment to fund the cross purchase agreement. If there is an increase in the value of the business since the initial valuation, the original life insurance policies may be inadequate to provide consideration for the appreciated business interest. In this circumstance, additional funding should be considered.

- Advantages of a cross purchase plan: A well-designed plan will guarantee that the deceased owner's estate will receive a fair price for the business interest. The control of the agreement is in the hands of the owners. The purchase price provided by the buy-sell agreement becomes part of the remaining owner's cost basis. This should result in a lower taxable gain if the business is sold later.

  Unequal ownership interests may be retained or modified, unlike the entity purchase plan where the survivors' interests automatically increase in proportion to their ownership. For example, in a business with two 40 percent owners (A and B) and one 20 percent owner (C), the death of A would result in C's interest increasing to 33 percent in an entity purchase plan. In a cross purchase plan, it is possible to have A's entire interest go to B, thus making B an 80 percent owner while C remains a 20 percent owner.

- Disadvantages of a cross purchase plan: The agreement becomes complicated when there are more than a few owners involved. The partners or stockholders use their personal funds to pay for the insurance. In a corporate context, where multiple stockholders are involved, there may be a transfer-for-value issue, discussed on page 20.

Trusteed cross purchase plan

A trusteed cross purchase plan is a legal agreement between a third party (escrow agent) and the partners or stockholders that provides for the planned disposition of their ownership interests in the event of a death, disability or retirement. The trustee or escrow agent acts to carry out the obligations of the partners or stockholders.

- Using life insurance in a trusteed cross purchase plan: An impartial third party is appointed and acts as custodian for the insurance policies. To guarantee the continued existence of the third party, a corporate trustee or escrow agent may be selected. Typically, the trustee should be the owner and beneficiary of the policy. The agreement may provide that the trustee collects the premiums from the insureds. At the death of a partner or stockholder, the trustee distributes the proceeds to the deceased partner's or stockholder's estate in exchange for the ownership interest.
- Advantages of using a trusteed cross purchase plan: An impartial third party is used to oversee the agreement. If a funding problem arises with one of the owners, the trustee can notify the remaining partners or stockholders to alert them of the situation. The policy proceeds are received tax-free by the trustee. Pursuant to the agreement, the trustee distributes the proceeds from the insurance policy to the decedent's estate in exchange for the ownership interest. A well-designed plan will guarantee that the partner's or stockholder's family will receive a fair price for the business interest.
- Disadvantages of using a trusteed cross purchase plan: Finding a responsible, impartial third party may be difficult. In the event of policy surrender, the disposition of the values may cause a taxable event. This is the case when the cash surrender value of the policy exceeds the computed cost basis.

If a funding problem arises with one of the owners, the trustee can notify the remaining partners or stockholders to alert them of the situation.

“Wait-and-see” approach

The “wait and see” approach is similar to other types of buy-sell agreements. The difference is that the buyer is not predetermined. This sort of buy-sell agreement provides that the business has a first option to purchase the departing owner’s interest. If the business elects not to purchase the interest, the option is then presented to the remaining partners or stockholders. If the partners or stockholders choose not to buy all of the interest, the business is then required to purchase the remaining interest.

- Advantages of the “wait-and-see” approach: This plan provides for business continuation without intrusion from outside parties. Partners or stockholders are certain that they will receive a specified price for their business interests. It provides for greater flexibility by allowing the business to postpone the decision to select the form of the agreement until after the loss of the first partner or stockholder. It also allows for the most tax advantageous agreement to be chosen when the agreement is exercised.

Key person or one-way buy-sell plan

A one-way buy-sell plan is a legal agreement between a key person and a partner or stockholder. The agreement provides for the planned disposition of the owner’s interest to the key employee in the event of an owner’s death, disability or retirement.

- Using life insurance in a one-way buy-sell plan: The key employee purchases a life policy on the owner. The key employee is the owner, the beneficiary and the premium payer of the policy. The business owner may consider increasing the employee’s salary to offset the cost of the premiums. At the death of the partner or stockholder, the key employee buys the business interest from the decedent’s estate.

- Advantages of key person buy-sell plan: The agreement provides that the key employee will have a vested interest in the business and its continued prosperity. Because of the limited number of parties involved, the structure of this agreement promotes a high level of control with little administration. A well-designed plan will guarantee that the partner’s or stockholder’s estate will receive a fair price for the business interest.

- Disadvantages of key person buy-sell plan: The key employee is responsible for the life insurance premiums. Depending on the age and health condition of the partner or stockholder, the life insurance premiums could be cost prohibitive. The insurance premiums are not a tax deductible expense.

Methods of funding a Buy-Sell agreement

Life insurance

At the death of a partner or stockholder, the estate receives a payment in the amount of the ownership interest. In exchange for the cash payment, the decedent's estate transfers the ownership interest to the remaining partners or stockholders. Depending on the agreement chosen, the insurance policy is either owned by the remaining partners or stockholders (cross purchase), business (entity plan) or escrow agent (trusteed cross purchase).

- **Advantages of life insurance:** Life insurance is the most certain method of funding the buy-sell agreement. The amount of the premiums paid is normally far below the purchase price as the cumulative premiums are generally a small percentage of the total death benefit. The benefit is paid at the death of a partner or stockholder and, if structured properly, is equal to the amount required under the agreement. A variety of insurance products exists to match the client's premium paying ability, risk tolerance and time horizon.
- **Disadvantages of life insurance:** The insurance premium is not tax deductible. If the 7partners or stockholders are advanced in age, or are in poor health, the cost of the insurance can be high.

A variety of insurance products exists to match the client's premium paying ability, risk tolerance and time horizon.

Installment payments

The surviving partners or stockholders make a series of installment payments in the amount of the ownership interest to the decedent's estate. The amount of the payments include principal and interest. The Internal Revenue Code provides for a minimum interest rate on installment obligations under IRC Sec. 483, and original issue discount rules under IRC Sec. 1274.

- Advantages of installment plan: The decedent's interest is received immediately by the surviving partners or stockholders. The interest incurred on the installment payments is fully deductible as a business expense.
- Disadvantages of installment plan: The surviving partners or stockholders will be hampered by the need to make future installment payments. The decedent's estate will not receive an immediate full payment for the business interest. Also, the heirs must rely on the ability of the surviving partners or stockholders to make installment payments.

Options for Funding the Buy-Sell Agreement

- Life insurance
- Installment payments
- Savings fund

Savings fund

Annual deposits are made to a savings account. Under the savings fund plan, deposits are assumed to accumulate to an amount equal to the purchase price of the individual business interests. In a cross purchase plan, the amount of the savings should equal the value of the other ownership interests. In an entity plan, the business provides the deposits to the savings account in an amount equal to the individual ownership interests.

- Advantage of savings fund: Can be used if one of the owners is uninsurable.
- Disadvantages of savings fund: The savings amount may be inadequate in an early-death contingency. To maintain the safety of the principal, a low-risk, low-yield investment vehicle must be used. Under both the cross purchase and entity plans, the annual earnings on the account may be subject to income tax and would be attributed to the account owner. Under the entity plan, the savings account is considered a business asset and is subject to the claims of creditors.

Factors to consider

Stock redemption or cross purchase

Number of stockholders

With a stock redemption plan, only one life insurance policy per stockholder owned by the corporation is needed. Multiple policies are needed with a traditional cross purchase plan. The number of policies required is calculated using the formula n(n-1), where n equals the number of stockholders. For example, six policies would be needed for a traditional cross purchase plan for three stockholders; A, B, and C. A would own policies on B and C; B would own policies on A and B; and C would own policies on A and B. Alternatively, a trusteed cross purchase plan could be used, so there is only one policy per stockholder owned by the trustee as conduit for the cross stockholders. However, this may cause some transfer-for-value problems after the first death.

Ages/ownership of stockholders.

Closely related to the above is the problem with differences in age, insurability and proportionate stock interest. A stock redemption plan tends to even out these differences because the premiums are paid from the single corporate pot. A cross purchase plan exacerbates the differences, unless some leveling method is used, in as much as the youngest and smallest share stockholders are paying premiums on the oldest and biggest share stockholders. Split dollar funding of cross purchase plans can level the costs somewhat.

Creditors.

In a stock redemption plan, the insurance policies are subject to corporate creditors. In a cross purchase plan, the policies are subject to personal creditors. State law creditor exemptions for life insurance owned by the insured for the benefit of his/her family do not apply to buy-sell plans.

Relative tax brackets.

Neither the corporation (IRC Sec. 264(a)(1)) nor the stockholders (Rev. Rul. 70-117, 1970-1 CB 30; Whitacker, 34 TC 106 (1960)) can deduct the premiums paid for life insurance used to fund buy-sell plans. Therefore, it costs less to use the lowest tax bracket. The corporation's phased-in brackets (15 percent on the first $50,000, 25 percent on the next $25,000) may be lower than the stockholder's personal brackets, but often the brackets are so close, say 34-35 percent corporate bracket to 30-35 percent personal, that this is not a major factor. The corporation may be used to pay most or all of the cross purchase premiums for the stockholders through a split dollar life insurance plan, or as additional compensation. Of course, this is immaterial with S corporations because all the business income is taxed directly to the stockholders.

Premiums paid by a corporation for policies owned by it to fund a stock redemption plan are not taxable to the insured stockholder even if the policy is payable to the insured's estate, trust or spouse. Casale, 247 F2d. 440; Sanders, 253 F2d. 860; Prunier, 248 F2d. 818; Rev. Rul.

59-184, 1959-1 CB 65. However, if the policies are owned by the stockholders for a cross purchase plan, the premiums paid by the corporation would be taxable to the owner. Paramount-Richards Theaters, 153 F2d. 602; Bonwit, 87 F2d. 764; Yuengling, 69 F2d. 971; Atlas Heating, 18 BTA 389. In fact, the premium payments could be taxed to the stockholders as dividends. Regs. Sec. 1.162-7; Rev. Rul. 59-184, 1959-1 CB 65; Doran, 246 F2d. 934.

Income tax on insurance proceeds and alternative minimum tax (AMT)

Generally, insurance proceeds paid at the death of the insured are income tax-free to either the corporation or stockholder beneficiaries unless there has been a "transfer-for-value." IRC Sec. 101(a)(1). However, insurance proceeds payable to a corporation are considered "earnings and profits" and may be subject to the AMT. IRC Sec. 56(g)(4)(B). Depending on other income of the corporation, the insurance proceeds may be subject to the AMT. Because only 75 percent of the proceeds in excess of the cash values is included in adjusted current earnings (ACE), the effective tax is at most 15 percent (75 percent of 20 percent) of the death proceeds. IRC Sec. 56(g)(1). Payment of the AMT can be easily handled by purchasing more insurance. To calculate the total face amount required, multiply the net insurance proceeds needed by 1.1765 (e.g., $100,000 net x 1.1765 = $117,650 total).

A corporation subject to the AMT in one year may be allowed a minimum tax credit against regular tax liability in subsequent years. The credit is equal to the excess of the adjusted net minimum tax credits allowable in prior years. IRC Sec. 53(b). However, the amount of the credit cannot be greater than the excess of the corporation's regular tax liability (reduced by certain credits such as certain business related credits and certain investment credits) over its tentative minimum tax. IRC Sec. 53(c).

Accumulated earnings tax

The accumulated earnings tax is governed by the provisions of IRC Sections 531537. The tax rate is 15 percent and will be imposed upon accumulated earnings in excess of $250,000 ($150,000 for personal-service corporations) unless the corporation can show than such earnings are being retained for the "reasonably anticipated needs" of the business.

Life insurance proceeds payable at death are not taxable income, and thus are not subject to this tax. Theoretically, it could apply to the premiums paid by the insurance and maintaining management control are generally considered reasonable business needs. Emeloid, 189F2d 230; General Smelting, 4TC 313; Mountain St. Steel, 284 F2d 737.

An S corporation is not subject to the accumulated earnings tax.

Dividends and attribution

All distributions from a corporation to a shareholder with respect to its stock are considered dividends to the extent of earnings and profits. IRC Sec. 301(a). Dividends are taxed at ordinary income rates. This applies even if the recipient shareholder gives up stock in the transactions.

Although life insurance proceeds paid to a corporation are generally income tax-free, the proceeds are "earnings and profits" (E&P). A "dividend" is any distribution of property made by a corporation to its shareholders out of its earnings and profits. IRC Sec. 316(a).

Some distributions, however, are deemed "amounts received in exchange" for the stock, rather than dividends. In this case, the seller pays tax only on the difference between the "amount realized" and the "adjusted basis." To qualify for "sale or exchange" treatment, the transaction must satisfy the requirements of one of several tests. Internal Revenue Code Section 302 identifies the following transactions for "sale or exchange" treatment:

1. Redemptions not essentially equivalent to a dividend (i.e.not prorata);
2. Substantially disproportionate redemptions (a significant relative change in the stockholder's control, share of profits, and share of assets in case of a sale or liquidation); and
3. A complete redemption of all of the estate's stock (a complete termination of interest).

Note: A redemption is substantially disproportionate if it meets the following three criteria:

- After the redemption, the stockholder owns less than half of the total combined voting power of all classes of outstanding stock entitled to vote;
- After the redemption, the stockholder's percentage of total outstanding voting stock is less than 80 percent of pre-redemption ratio; and
- The stockholder's post-redemption percentage ownership of outstanding common stock (voting or non-voting) is less than 80 percent of pre-redemption ownership.

While these rules appear to be easily and mechanically met, they are complicated by the constructive ownership rules that attribute stock ownership to and through family members, trusts, estates, corporations and partnerships. IRC Secs. 302(c), 318. For example, if parents and children are stockholders and the corporation redeems all of a deceased parent's stock from his/her estate, the redemption will be treated as a dividend distribution because the family (children) still owns the corporation. Dividend treatment may be avoided if the children are not beneficiaries of the estate and the estate files a "waiver of attribution" that cuts the constructive ownership line between the estate and children. IRC Sec. 302(c)(2)(c).

Internal Revenue Code Section 303 is another way to avoid dividend treatment on a redemption from an estate. Internal Revenue Code Section 303 is particularly useful when the stockholder's family wants to retain control of a family corporation after the stockholder's death, the stock is the estate's primary asset, and the family is unable to pay death taxes and other expenses without a forced liquidation of the business. To qualify for "sale or exchange" treatment here, the stock's value must be more than 35 percent of the decedent's adjusted gross estate. Additionally, the amount redeemed can be no more than the total of (a) federal estate, state death, and generation-skipping transfer taxes and the interest on those amounts, and (b) funeral and administration expenses (whether or not claimed as a deduction on the federal estate tax return). If there are no estate taxes at the death of one spouse because of the unlimited marital deduction, the Sec. 303 redemption may have to be delayed until the death of the other spouse.

A cross purchase plan avoids any dividend concern because the purchase is made by the surviving stockholders, not the corporation. Also, in most cases, this will not be a concern to S corporations because they do not have earnings and profits (E&P), except for carryovers from prior C years. IRC Sec. 1368.

Transfer-for-value

Life insurance proceeds paid at the death of the insured are usually income tax-free. IRC Sec. 101(a)(1). However, if a life insurance policy or any interest in a policy is transferred to another person for a valuable consideration, death proceeds can lose their tax-exempt status, in whole or in part. IRC Sec. 101(a)(2). Under the transfer-for-value rule, if a policy is transferred for a valuable consideration, the death proceeds will be taxable as ordinary income, except to the extent of the consideration, the net premiums and certain other amounts paid by the transferee. A transfer-for-value does not require money or money's worth to be exchanged, and there does not have to be any cash value in the policies. The legal consideration in the mutual benefits and obligations of a buy-sell agreement is enough. Monroe v. Patterson, 197 F. Supp. 146 (1961) (group term insurance).

Specific exceptions to this rule allow a transfer for consideration to be made to the following, without jeopardizing the income tax-free nature of the death benefit:

1. Transfers to the insured.

2. Transfers to a partner of the insured.

3. Transfers to a partnership in which the insured is a partner.

4. Transfers to a corporation in which the insured is a stockholder or officer.

5. Transfers between corporations in a tax-free reorganization if certain conditions exist.

A bona fide gift is not considered to be a transfer-for-value and subsequent payment of the proceeds to the donee will be income tax-free.

A transfer-for-value to a co-stockholder is not a protected transaction; therefore, a change from a stock redemption plan to a cross purchase plan where the stockholders own each other's policies will subject the proceeds to income tax. Lambeth, 38 BTA 351.

To build in flexibility for future changes, attorneys may have the stockholders also form a partnership (such as to own buildings/equipment to lease to the corporation) to allow for a change from stock redemption to cross purchase. There have been several favorable Private Letter Rulings on this issue, including partnerships formed for the specific purpose of avoiding the transfer-for-value problem. PLRs 9347016, 9309021, and 9045004.

The transfer-for-value problem can arise in cross purchase plans, even trusteed plans, after the first death. For example, assume A, B, and C are equal stockholders in a corporation with a funded (one policy per owner) trusteed cross purchase plan. Under this arrangement, each stockholder is the beneficial owner of a one-half interest in the policies insuring the other two stockholders. Now assume A dies. A prohibited transfer-for-value could occur if A's proportional interest in the outstanding policies, insuring B and C, pass to the surviving stockholders upon A's death. This is a transfer-for-value that would make half the proceeds taxable. The result would be the same with a non-trusteed plan.

There are two solutions:

(a) Transfer the decedent's interest in the policies to the corporation, contemplating the use of the death proceeds to finance a partial stock redemption, partial cross purchase plan; or

(b) Form a partnership among the stockholders, in-as-much as transfers to a partnership in which the insured is a partner or transfers to partners of the insured are exceptions to the transfer-for-value rule.

"Wait-and-see" flexibility

The "wait-and-see" approach to designing a buy-sell agreement adds tremendous planning flexibility.

The flexibility to go from a cross purchase plan to a stock redemption plan without transfer-for-value problems is a plus for cross purchase. This advantage, plus the step-up in basis for survivors (see next page), no possible dividend treatment and usually relatively equal tax brackets for stockholders and corporation, make cross purchase plans the usually favored approach for closely held corporations. This is often combined with a "wait-and-see" option in a cross purchase agreement so that, if a stock redemption looks more favorable when a stockholder dies, the survivors can lend their insurance proceeds to the corporation to make the redemption.

Conversely, a corporation could own the policy and lend the proceeds it receives to the stockholders to make a cross purchase. But the corporate ATM may apply and the loan (or unstated interest) could be treated as a dividend to the stockholders.

Care must be exercised that the corporation's stock redemption is not treated as a dividend to the stockholders as relieving them of their cross purchase obligation. Generally, a stock redemption plan is not a constructive dividend to the stockholders even though it increases the percentage interests of the survivors. Rev. Ruls. 58-614, 1958-2 CB 920; 59-286, 1959-2 CB 103; Holsey, 258 F2d. 865 (1958). But, if the redemption satisfies a cross purchase obligation, it may be a dividend. Sullivan, 363 F2d. 724; Zipp, 259 F2d. 119; Wall, 164 F2d. 719; Holloway, 10 TCM 1257.

It is possible to have both a stock redemption and cross purchase plan without causing problems if each is optional. It is better to exercise the cross purchase first and then the redemption to avoid IRC Sec. 302 dividend concerns as it would be a complete termination of interest. Zenz v. Quinlivan, 213 F2d. 914; Auto Finance Co., 24 TC 416; Ray Edenfield, 19 TC 13; Rev. Ruls. 54-328, 1954-2 CB 167; 55-745, 1955-2 CB 223.

Step-up in basis to surviving stockholders

In a stock redemption plan, a C corporation's purchase of a decedent's stock does not affect the surviving stockholders' basis in their stock. In a cross purchase plan, the surviving stockholders receive a step-up in basis equal to the purchase price they paid for the stock. IRC Sec. 1012. This reduces the potential capital gains tax on a later sale of the stock by the survivors during their lifetime. This is immaterial if the stock is not sold until death because of the estate's step-up in basis. IRC Sec. 1014.

In most cross purchase plans, the stockholders own and are the beneficiaries of the insurance on each other. Sometimes the stockholders want to own the insurance on their own lives, name their own spouses or children as beneficiaries, and have the cross stockholders pay the premiums. This is tenuous as one tax case held that the cross stockholders would not get a step-up in basis in that situation. Victor Mushro, 50 TC 43, cf. Paul Legallet, 41 BTA 294.

If the agreement provides that the policy owned by the decedent on the survivor is to be assigned to the survivor at the decedent's death, the survivor's basis in the stock acquired from the decedent is reduced by the value of the insurance policy transferred to the survivor. Storey, 305 F2d. 733. There is no transfer-for-value problem with this because the transfer is to the insured. The value (interpolated terminal reserve) of the policy owned by the decedent on the survivor is included in the decedent's estate. IRC Sec. 2033; Regs. Sec. 20.2031-8; Dupont's Est., 233 F2d. 210; Donaldson, 31 TC 729; Rev. Ruls. 63-52, 1963-1 CB 173; 56-397, 1956-2 CB 599; 55-379, 1955-1 CB 449.

Usually there is no taxable gain or loss to the decedent's estate on the sale of his/her stock since under existing law the estate's basis is stepped-up (or possibly down) to the fair market value of the stock at the date of death. IRC Sec. 1014. This assumes that the buy-sell price paid is equal to the estate tax value of the stock. This can be a problem for family businesses due to IRC Sec. 2703.

S corporations

S corporations are "pass through" entities: the stockholders are taxable on the business earnings, not the corporation. Buy-sell plans for S corporations protect the control and value of the business just as do plans for C corporations. In fact, a buy-sell agreement has an additional use for S corporations to prevent the stock from being transferred to ineligible persons (e.g., more than 100 individuals, non-resident aliens) or entities (e.g., corporations, partnerships, certain trusts) that would cause termination of the election. And, the pass-through tax status has certain advantages in structuring a buy-sell plan.

One advantage is that an S corporation, unlike a C corporation, is not subject to the AMT on insurance proceeds paid to it. Also, the insurance proceeds paid to an S corporation are not treated as E&P that could cause a dividend problem with a C corporation. (See discussion on Dividends and Attribution on page 18.) While an S corporation's redemption of stock from a deceased stockholder's estate could be a dividend to the extent of E&P left over from prior years as a C corporation, this is not a concern if it has always been an S corporation.

However, despite the fact there are fewer tax problems with a stock redemption plan for an S corporation than with a C corporation, a cross purchase arrangement is usually recommended. The main reason is to provide an increase in basis to the stockholder buyers for the insurance proceeds as with a C corporation.

It is possible to achieve a step-up in basis for S surviving stockholders with a stock redemption plan if the corporation uses cash basis accounting. This is done by the survivors electing a short fiscal year when a stockholder dies. IRC Secs. 1377, 1367(a).

For example, the AB corporation is worth $1,000,000, and the corporation owns $500,000 of insurance on A and B. If A dies on May 10, the corporation can purchase the stock from his executor by the use of a promissory note. Then B can elect a new fiscal year starting June 1 and will be the only stockholder when the insurance proceeds are paid to the corporation sometime thereafter. This gives B a step-up in basis of $500,000 for his stock. The corporation then uses the proceeds to pay off the note.

With an accrual basis S corporation, the proceeds are taken into account as soon as A dies. Therefore, they increase the basis of both A and B's stock by $250,000. This wastes half the potential basis increase because, under current law, A's estate gets a step-up in basis equal to the $500,000 value anyway. IRC Sec. 1014. Therefore, a cross purchase plan should be used so B gets a $500,000 increase in basis.

There is also some question as to the effect of premiums paid by an S corporation for insurance it owns on the stockholders' basis. In general, the S income used to pay premiums is taxable to the stockholders under the usual "per share per day" rule. IRC Sec. 1366(a). In general, the stockholders increase the basis in their stock by the S income taxed to them. IRC Sec. 1367(a). But, the IRS has said that the stockholders only increase their basis by the increase in cash value of the insurance, not the whole premium. FSA 1999-832 interpreting IRC Sec. 1367(a)(2)(D). This position appears to be in direct conflict with IRC Sec. 72(e)(6), which provides that the full amount of the premium is the basis for an insurance policy.

Three tax traps in family-owned businesses

There are three potential tax traps that must be considered when structuring buy-sell agreements for family-owned businesses.

First, under IRC Sec. 2703 a buy-sell price between family members will be disregarded, and the business will be estate taxed at fair market value unless the agreement meets the comparability test.

Second, a business interest that is subject to a buy-sell option price less than fair market value will not qualify for the marital deduction because someone other than the spouse has a power of appointment. Estate of Rinaldi, 80 AFTR 2d. 97-5324; PLRs 9147065, 9139001. Thus, the business may be taxed at fair market value in the stockowner's estate and not qualify for the marital deduction even though it forms part/most of the planned marital trust.

Third, if the optionees (e.g., children) fail to exercise their option to buy at less than fair market value, they may be treated as having made a gift (e.g., to mother) of the excess value. PLRs 9315005, 9117035.

In light of these possible tax traps with a family business buy-sell plan, some alternatives should be considered:

1. Leave the buy-sell price open to whatever may be the fair market value at death, and take out extra life insurance to try to cover the possible higher value;

2. Similarly, if the stockholder is married, leave the buy-sell option open until the second death, and fund the buy-out with second-to-die life insurance; or

3. If children are to be the ultimate owners, do not use a buy-sell agreement, but leave the business to them and have insurance (individual or second-to-die) owned by them, or a trust, to cover the estate taxes on the business.

Life insurance funding

Insurance owned by a corporation to fund a stock redemption plan is not directly included in the insured stockholder's estate unless he/she has incidents of ownership in the policy. In the absence of a binding buy-sell price, the proceeds would be a factor to consider in the valuation of the business and may increase the estate tax value of the decedent's interest. Regs. Secs. 20.2042-1(c)(2); 20.2031-2(f). If so, businesses valued by earnings multiples are less affected than businesses valued on assets. Also, it may be possible to show that the loss of the insured stockholder as a key person is an offset. Huntsman, 66 TC 861 (1976); Newell 66 F2d. 102 (1933); Want, 29 TC 1223 (1957); Levenson, 282 F2d. 581 (1960); Rev. Rul. 59-60, 1959-1 CB 237. Buy-sell agreements usually exclude life insurance in the buy-sell price, or reflect only the cash values.

If the insured stockholder does have incidents of ownership in the life insurance policy on his/her life, the question of double taxation arises. For example, the IRS has said that the insured's right to buy the policy from the corporation, if the corporation decides to discontinue the coverage, is an incident of ownership. Rev. Rul.79-46, 1979-1 CB 303. The Tax Court disagrees. Smith Estate, 73 TC 307. The question is: Is the insurance included in the estate of the insured under IRC Sec. 2042 and also under IRC Sec. 2033 in the valuation of the business? Fortunately, several cases indicate that the buy-sell agreement governs, and there is no double inclusion. Boston Safe, 30 BTA 679 (1934); Dobrzensky, 36 BTA 305 (1936); Mitchell, 37 BTA 1 (1938); Thompson, 13 TC 1054 (1949); Ealy, 10 TCM 431 (1951).

Similarly, if in a cross purchase plan the insureds are the policy owners, or have incidents of ownership in their own policies, the legal obligations of the buy-sell agreement override the inclusion due to policy ownership. Fuchs, 47 TC 199 (1961); First Nat'l Bk of Birmingham, 358 F2d. 625 (1966); see also, PLR 9026041.

Community property ownership

If the business interest is community property, both spouses should sign the buy-sell agreement to bind the community interest. Generally, the total community interest would be bought out at the death of the "active" stockholder. There would be no capital gains tax to the spouse as the community interest receives a step-up in basis at death. IRC Sec. 1014(b)(6). However, in common law states the purchase of a surviving spouse's separate or joint interest could result in a capital gains tax because it does not receive a step-up in basis. IRC Sec. 2040(b).

Miscellaneous

Stock redemption and cross purchase agreements are generally accepted as valid, binding and specifically enforceable, despite objecting minority stockholders. 18 Am.Jur. 2d. Corporations 381; 61 ALR 2d. 1318. The transfer restriction should be indicated on the face of the certificate or it may not be enforceable against a purchaser in good faith. UCC 8-204; USTA 15; 29 ALR. 2d. 901. State laws (Model Business Corporation Act) generally provide that a corporation can redeem its stock out of available surplus as long as it does not prejudice creditors or render it insolvent. 18 Am.Jur. 2d. Corporations 285. It is immaterial that there is no available surplus at the time the agreement is made as long as it exists at the time of redemption. Murphy v. George Murphy, Inc. 166 NYS 2d. 290; Steinbugler v. Atwater, Inc. 47 NE 2d. 432. Life insurance paid to the corporation creates the surplus at the time needed to make the redemption. If the agreement calls for the purchase of life insurance to fund the plan and none is purchased, the agreement may be unenforceable. Cerceo v. DeMarco, 137 A.2d. 296. Mortgage or loan agreements should also be checked since these may restrict the ability of the corporation to pay dividends, redeem stock, or increase compensation. The buy-sell agreement is valid and specifically enforceable regardless of the disparity between price and value. 18 Am. Jur. 2d. Corporations 381; 61 ALR 2d. 1318; In re Mather's Estate, 189 A2d. 586; Cutter Laboratories, 221 CA 2d. 302.

Partnership or limited liability company (LLC) Buy-Sell

Death of a partner or LLC member dissolves the entity

Unless otherwise provided in the partnership articles of operation or separate buy-sell agreement, the death (bankruptcy, expulsion) of any owner causes a technical dissolution of the partnership. Depending on state law, this technical dissolution may also apply to a limited liability company (LLC). If dissolved, the remaining owners must wind up the business, collect accounts receivable, pay debts and liabilities, and distribute cash and assets to the surviving owners and the decedent's estate. While dissolution can be avoided by providing that the survivors will continue the partnership/LLC, the decedent's estate is entitled to an accounting and distribution and is not bound to continue as an owner.

While theoretically the decedent's estate could continue as a member, this is usually not a practical alternative. A buy-sell agreement providing that the partnership, LLC or surviving owners will buy out the decedent's interest at a fair price is the practical solution for all parties. Such agreements are valid and specifically enforceable. See generally: 68 CJS Partnerships; 81 CJS Specific Performance; 60 Am.Jur. 2d. Partnerships; and Uniform Partnership Act, Part VI.

Factors to consider: liquidation vs. cross purchase

Number of insureds.

Only one life insurance policy per insured owned by the partnership/LLC is needed with an entity plan, whereas multiple policies per insured are needed with a traditional cross purchase plan. For example, it would require six policies to cover three owners in a cross purchase plan. In other words, with owners A, B, and C, A would own a policy on B and C, etc. A trust arrangement can be used to avoid multiple policies in a cross purchase plan, so there is only one policy per insured owned by the trustee for the benefit of the other insureds.

Ages/ownership of the insureds.

Closely related to the above is the problem with differences in ages, insurability and proportionate interests. An entity plan tends to even out these differences since the premiums come out of the single partnership/LLC pot. A cross purchase plan exacerbates the differences, unless some leveling method is used, because the youngest and smallest share owners would pay premiums on the older and bigger share owners.

Creditors.

If an entity plan is used, the insurance policies are subject to the creditors of the partnership/LLC. If a cross purchase plan is used, the policies are subject to personal creditors. The state law exemptions for life insurance owned by the insured for the benefit of his/her family would not usually apply to policies owned by business associates.

Premiums are not deductible.

Neither the partnership/LLC nor the members can deduct the premiums for life insurance used to fund buy-sell plans. IRC Sec. 264(a)(1); Rev. Rul. 70-117, 1970-1 CB 30; Whitacker, 34 TC 106 (1960).

A partner's/member's distributive share of any item of income, gain, loss, deduction or credit is generally determined by the partnership/LLC agreement. The distributive share is usually the same as the partner's/member's percentage of ownership in the partnership/LLC. IRC Secs. 701, 702, 704. This means that the owners with larger interests would pay tax on a larger share of the premiums in an entity plan. However, the partnership/LLC agreement can allocate income, gain, loss, deduction, or credits to individual partners/members in a different manner provided the allocation method has "substantial economic effect."

An allocation generally has substantial economic effect if both of the following apply:

- There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners'/members' share of partnership/LLC income or loss, independently of tax consequences; and
- The partner/member to whom an allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

For example, A and B are allocated the premiums and proceeds of C's policy, etc. IRC Sec. 704(a); Regs. Sec. 1.704-1(b).

Specific allocation of the life insurance proceeds to the capital accounts of the surviving members also provides a full step-up in basis to the survivors (A & B) for the partnership/LLC's purchase of the decedent's (C's) interest. IRC Sec. 705(a)(1)(B).

Income tax-free insurance proceeds and transfer-for-value

The life insurance death proceeds are income tax-free to either the partnership/LLC or surviving owners. IRC Sec. 101(a)(1). The proceeds are not subject to the alternative minimum tax. Also, the partnership/LLC and the owners are exempt parties to the "transfer-for-value" rule. Thus, they have more flexibility in using existing life insurance policies, or transferring interests in policies, than with corporations and stockholders. Internal Revenue Code Section 101(a)(2) provides that life insurance proceeds may be taxable if there has been a transfer-for-value of the policy. But IRC Sec. 101(a)(2)(B) provides that transfers to a partnership in which the insured is a partner, or transfers to a partner of the insured, are excepted. There have been several favorable PLRs covering the issue of avoiding the transfer-for-value problem with transfers to partnerships/LLCs. PLRs 9347016, 9309021, 9045004.

Step-up in basis to surviving owners

Whether the buy-sell agreement is structured as an entity or a cross purchase plan, the surviving partnership/LLC owners receive a step-up in basis for the purchase of the decedent's interest. With an entity plan, this is achieved by allocating the insurance proceeds received by the partnership/LLC to the capital accounts of the surviving owners which increases their basis in the partnership/LLC. IRC Sec. 705(a)(1)(B). With a cross purchase plan, the surviving purchasing partners/members get a direct increase in basis equal to the price they paid for the purchased interest with the insurance proceeds. IRC Secs. 742, 1012.

In a cross purchase plan, the owners usually own the insurance on each other. If the agreement provides that the policy owned by the decedent on the survivor is to be assigned to the survivor at the decedent's death, the survivor's basis in the partnership interest acquired from the decedent is reduced by the value of the life insurance policy transferred to the survivor. Storey, 305 F2d. 733. There is no transfer-for-value problem because this is a transfer to the insured. The value (interpolated terminal reserve) of the policy owned by the decedent on the survivor is included in the decedent's estate. IRC Sec. 2033; Regs. Sec. 20.2031-8; Dupont's Estate, 233 F2d. 210 (1956); Donaldson, 31 TC 729 (1959); Rev. Ruls. 63-52, 1963-1 CB 173; 56-397, 1956-2 CB 599; 55-379, 1955-1 CB 449.

If the insureds own the policies on their own lives and the proceeds are payable to the insured's beneficiary, the cross partner/member who paid for the insurance may not be able to use the proceeds to step-up his basis in the partnership. Victor Mushro, 50 TC 43 (1968), cf. Paul Legallet, 41 BTA 294 (1940).

The surviving partnership/LLC owners receive a step-up in basis for the purchase of the decedent's interest.

Partnership/LLC income taxed to the decedent

In a cross purchase plan, the partnership/LLC year closes for the deceased owner as of the date of the buy-out. This can cause a bunching of income in the decedent's final return for the income from the partnership/LLC year that normally ends in the decedent's last year and from the truncated final year. This may be avoided by delaying the buy-out until the end of the decedent's year. IRC Sec. 706; Regs. Sec. 1.706-1(c)(3).

In an entity plan, the partnership/LLC year does not close as to the deceased owner or the estate until all liquidation payments are completed. IRC Sec. 706(c)(2). The partnership/LLC year ends for the surviving owner(s) if the decedent had more than a 50 percent interest in partnership capital and profits. IRC Secs. 708(b)(1), 706(c)(1).

Generally, the decedent's estate gets a step-up in basis for its partnership/LLC interest. IRC Sec. 1014. Accordingly, there is generally no capital gain to the estate with either an entity or cross purchase plan. But, the purchase price allocable to unrealized receivables and substantially appreciated inventory may be taxable as ordinary income as well as payments for unstated goodwill in entity plans.

Tax effects of partnership/LLC entity buy-sell plan – IRC Sec. 736

An entity plan where the partnership/LLC buys the decedent's interest is governed by the IRC Sec. 736 partnership liquidation rules. This section divides the amount paid into two parts:

- Internal Revenue Code Section 736(a) payments taxed as income to the decedent's estate. These amounts include both non-guaranteed payments based on a share of the partnership/LLC profits and guaranteed payments that are payable regardless of profits. These are income to the decedent's estate and deductible to the partnership/LLC owners. IRC Sec. 707(c).

- Internal Revenue Code Section 736(b) payments for the decedent's share of partnership/LLC property or goodwill that may be taxable or not. Payments in exchange for the decedent's share of partnership/LLC assets (except for unrealized receivables and substantially appreciated inventory) are not taxable to the estate due to the estate's step-up in basis, nor deductible to the surviving owners. This includes payments for goodwill.

Amounts attributable to the decedent's share of "unrealized receivables" (i.e., rights to payments for services rendered or to be rendered or for goods delivered or to be delivered) are income taxable. IRC Secs. 736(b)(2)(A), 751(c). Amounts paid for the decedent's interest in "substantially appreciated inventory" (i.e., the inventory value is 20 percent more than its basis) are also income taxable to the estate. IRC Secs. 751 (a)(2), (d). It appears that this may be avoided if the partnership makes the election to adjust basis. IRC Secs. 754, 743.

Flexibility for professional service firms

For professional or personal service type firms, Internal Revenue Code Section 736(b)(2) provides the flexibility to treat amounts paid for goodwill (i.e., payments in excess of the decedent's interest in partnership property) as either income or capital. If the agreement specifies that amounts in excess of the decedent's interest in firm property are for goodwill, those amounts are neither taxable to the estate nor deductible to the partners. But, if the excess amounts are not specified for goodwill, they are taxable to the estate and deductible to the partners.

This flexibility in making goodwill payments either non-taxable or taxable is only available for general partners in partnerships where capital is not a material income producing factor. IRC Sec. 736(b)(3). It is unclear if it applies to LLC members also, but it should. Generally, any allocation made by the partners in the agreement between income or goodwill payments will be given effect provided the amounts allocated to property (including receivables and inventory) is proper. Regs. Sec. 1.736-1(b)(3).

While the relative tax brackets of the partners and estate/heirs are factors in making this decision, the fact that life insurance proceeds are tax-free to the partnership/LLC provides some selling advantages. If the payments are non-taxable and non-deductible, it makes sense to have tax-free money to the partnership/LLC to make them. If the payments are income to the decedent's estate (spouse) and deductible to the surviving owners, then the tax-free insurance proceeds provide tax leverage so the surviving owners recover their costs.

Tax effects of cross purchase plan

In a cross purchase plan, the surviving partners buy the deceased partner's/member's interest from the estate. Except for amounts attributable to unrealized receivables and substantially appreciated inventory, this is a capital transaction. The payments are considered in exchange for property and are not taxable to the estate due to the estate's step-up in basis. IRC Secs. 741, 742, 1014. The surviving partners cannot deduct their payment, but do have an increase in their basis for their partnership interests equal to the cross purchase price they paid, and the partnership can elect to increase its basis in partnership property by that amount. IRC Secs. 742, 754, 743.

Although receivables and inventory are not treated as capital assets, and therefore any allocable gain would be taxed as ordinary income, the estate may obtain a step-up in basis which avoids any gain and tax on these items if the buy-out occurs within two years of death or the partnership had made the special election to adjust basis. IRC Secs. 751(a), 732(d), 754.

Insurance funding of liquidation of interest plan

There is a question about the effect of life insurance proceeds paid to a partnership/LLC in an entity plan. The insurance is not directly included in the insured owner's estate unless the insured has incidents of ownership in the policy. The proceeds are included in the value of the partnership. Estate of Knipp, 25 TC 153 (1955); Regs. Secs. 20.2042-1(c)(2); 20.2031-2(f). The proceeds are not simply added to whatever the value of the partnership may be without them; they are a factor to consider with the other assets. Businesses valued by earnings are less affected than businesses valued on assets. It may be possible to prove a financial loss from the death of the partner/member as an offset. Huntsman, 66 TC 861 (1976); Newell 66 F2d. 102 (1933); Want, 29 TC 1223 (1957); Levenson, 282 F2d. 581 (1960); Rev. Rul. 59-60, 1959-1 CB 237.

Because the common practice is to exclude the insurance proceeds in excess of cash values in the buy-sell price, even with unrelated parties, this practice may continue for family businesses.

Double taxation: insurance and business value

The question of double taxation arises when an insured has incidents of ownership in the buy-sell policy on his/her life. This may be because the insured owns the policy or has the right to buy the policy from the partnership (Rev. Rul. 79-46, 1979-1 CB 303; cf. Smith Estate, 73 TC 307). Will the insurance be included in the estate of the insured under IRC Sec. 2042 and also in the valuation of the business? Fortunately, several cases indicate that the buy-sell agreement governs, and there is no double inclusion. Boston Safe, 30 BTA 679 (1934); Dobrzensky, 36 BTA 305 (1936); Mitchell, 37 BTA 1 (1938); Thompson, 13 TC 1054 (1949); Ealy, 10 TCM 431 (1951). The legal obligations of the buy-sell agreement override the inclusion due to IRC Sec. 2042. Fuchs, 47 TC 199 (1961); First Nat'l Bk of Birmingham, 358 F2d. 625 (1966); see also PLR 9026041. The cash value of the life insurance policies owned by the decedent on the other partnership/LLC owners in a cross purchase plan would be included in the decedent's estate. IRC Sec. 2033.

Remind client of community property considerations

Spouse or community property ownership

If the partnership/LLC is community property, then spouses should sign the buy-sell agreement to bind the community interest. Generally, the total community interest would be bought out at the death of the "active" partner/member. Thus, if the husband is the active partner/member and dies first, both his and his widow's community interest would be bought. Because the community interest receives a step-up in basis under current law to fair market value (FMV) at death, there usually would be no capital gains tax to the surviving spouse. IRC Sec. 1014(b)(6). However, in common law states, neither the separate nor joint tenancy interest (IRC Sec. 2040(b)) of a surviving spouse gets a step-up in basis at the other's death. Therefore, a purchase of the spouse's interest could result in capital gains tax.

The spouse should be a party to the agreement to bind his/her separate interest and any interest derived from joint tenancy with right of survivorship, which passes outside of the decedent's estate. Provision should also be made in case of the death of the "inactive" spouse first. This usually would not trigger a buy-sell, and it should be provided that the spouse can transfer his/her interest to the other.

If the partnership/LLC is community property, then spouses should sign the buy-sell agreement to bind the community interest.

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