Stock Buy-Sell Agreements

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Typically for closely held companies and corporations as well as other types of business entities, the owners have a buy-sell agreement among themselves regarding the transfer of stock to other people outside the business. Such agreements also define the first-refusal mechanism the business must use when one or more of the owners wants or needs to be bought out.

PERIODIC REVIEW

When you associate with one or more other people to form a company or corporation, you probably do not want spouses, ex-spouses, children and/or creditors of your co-shareholders ending up owning some of the stock in the business. Buy-sell agreements can help prevent this from happening.

Once you have such an agreement in place, make sure to review and, if necessary, revise it periodically. The business may have acquired new shareholders or lost original shareholders since it was formed and you and your co-shareholders may have forgotten to add or delete them to the buy-sell agreement. Or, certain mechanisms of the buy-sell agreement may have become outdated, such as a fixed price which may no longer make sense.

For example, I am hypothetically a shareholder in a business. I die, or want out of the business. The original buy-sell agreement calls for the business to pay me or my heirs to receive $12 a share for my stock. However, the stock is now worth $200 a share and the agreement was never revised to reflect that increase in market value. As a result, I or my heirs get severely shortchanged.

Here's another good example of the need for periodic review of a buy-sell agreement. When the buy-sell agreement was originally written, the shareholders prohibited themselves from leaving their shares to their children. However, the shareholders realize now that they want the son or daughter of one of the shareholders to eventually take over the business. Therefore, the shareholders may want to modify the buy-sell agreement to permit such an exception.

Buy-sell agreements can be funded by life-insurance policies. If they are, the shareholders would be wise to examine the tax implications of a life-insurance payout.

THREE FORMS

Typically, a buy-sell agreement can be structured in one of three forms: stock redemption; cross purchase; and irrevocable life-insurance trust.

Stock redemption: The shareholders execute an agreement with the corporation, which provides that the corporation may/will purchase the stock of a decedent shareholder. The corporation purchases life insurance on each of the shareholders and the insurance proceeds are used to acquire the stock. From an estate-tax standpoint, the corporation's value is increased by the insurance proceeds, and the decedent shareholder's estate may incur additional estate taxes on his/her share of this value. Since the corporation is purchasing the decedent shareholder's stock, the remaining shareholders also do not receive any increase in the cost basis of their shares.

Cross purchase: The shareholders execute an agreement among themselves providing for rights and first refusal (lifetime and upon death) regarding the stock of their co-shareholders. Insurance proceeds are received by the surviving shareholder(s) and they are used to acquire the decedent shareholder's stock. Increased stock basis is achieved and additional estate taxes on the insurance proceeds is avoided.

Cross purchase through an irrevocable life-insurance trust: This variation involves a cross-purchase agreement between a shareholder and the shareholder's irrevocable life-insurance trust (to remove insurance proceeds from the decedent shareholder's taxable estate). The trust acquires the shares from the decedent shareholder's estate (with the insurance proceeds) and typically distributes the acquired stock to certain children. This provides liquidity to the estate either to pay estate taxes or to make distributions of cash to other children in order to equalize among the children.

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