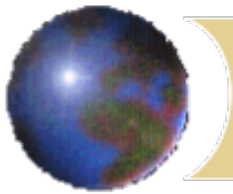


Buy-Sell Agreements Funding

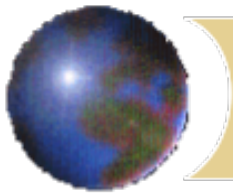
- **Installment Sale**
 - Seller or the seller's heirs essentially fund the transaction
 - Places the seller in less secure position
 - Business may fail and the payments stop
 - Seller remains dependent upon the business without a hand in its management

- **Current Cash Flow/Earnings**
 - Payments from earnings are projected into the future
 - Shareholders take the chance that when the time comes to implement the terms of the agreement, the business will have sufficient cash flow to make the necessary payments



Buy-Sell Agreements Funding

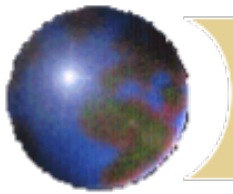
- **Life Insurance Owned by the Buyer**
 - Other Co-Owners or the Company Itself
 - Life insurance may be the most economical means of ensuring funds
 - benefits come to business owners untaxed, untouched and reliably on time
- **Advantages to life insurance in funding a buy-sell agreement:**
 - Complete financing guaranteed from the beginning
 - Death proceeds are generally free from federal income tax
 - Cash values can be used for a buyout due to retirement or disability
 - May be the most economical method in discounted dollars
 - Credit position of the company is strengthened



Buy-Sell Agreements

Valuation

- **Business valuations are detailed and varied**
 - Consume volumes of text
 - Professional appraisal is essential
 - Conceptually easy: as long as the parties agree
 - The valuation technique and application is justifiable
 - Parties can contract in whatever way they choose
 - Selection of any formula may be final
 - Extremely unlikely that a challenge of its result will be successful
if the parties have agreed to the formula

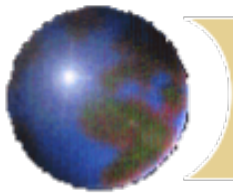


Buy-Sell Agreements

Valuation

- **Fixed price**
 - Owners simply agree on a price for the business and put that number in the buy-sell agreement
- **Fair market value**
 - “The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

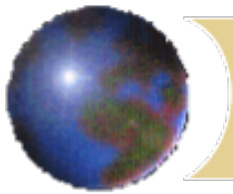
United States v. Cartwright, 411 U.S. 546 (1973)



Buy-Sell Agreements

Valuation

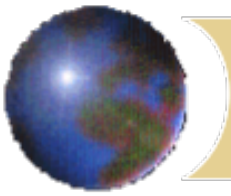
- **Fair value**
 - Typically defined by statute and case law
 - Commonly interpreted as what is fair or equitable
 - Delaware: discounts for lack of control or marketability
 - Others: typically a pro rata value of 100%
- **Formula pricing**
 - Objective and inexpensive to determine
 - But may miss subjective factors that influence fair market value
 - Business owners should revisit it periodically to make sure it's still representative of their intentions



Buy-Sell Agreements

Valuation

- **Book value**
 - Based on the net value of the company's assets minus its liabilities
 - Most recent year-end balance sheet
 - *Recorded in the entity's accounting records*
 - business's records, tax returns or under generally accepted accounting principles (GAAP).
 - Values are not typically indicative of fair market value and are likely to be significantly lower
- **Multiple of book value**
 - Takes into account intangible assets that add to a company's worth such as patents, copyrights, brand names and trade names.

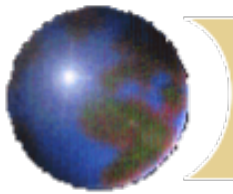


Buy-Sell Agreements

Valuation

- **Value based on insurance proceeds**
 - Amount of an owner's life or disability insurance policy proceeds
 - Simple method that may not approximate fair market value

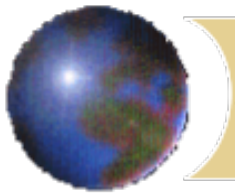
- **Capitalization of earnings**
 - Usually based on a weighted average of cash flow
 - Multiplying the average cash flow for a given period by a specified capitalization rate
 - Capitalization rate is based on the rate of return a hypothetical investor would expect where a good guide to determining a "cap rate" is the sales price for comparable companies



Buy-Sell Agreements

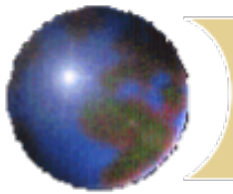
Valuation

- **Hybrid agreements**
 - “Wait-and-See” agreements
 - basically combine attributes of other formulas
 - require some definitive response from an interested or participating party
- **Discount Issues**
 - No ready market for interests in closely held businesses
 - Valuations frequently apply a “lack-of-marketability” discount
 - Non-controlling, minority-interest discounts also
 - Combined discounts typically range between 20% to 40%,
 - and as high as 60%
 - significant IRS issues



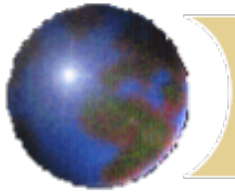
Buy-Sell Agreements Funding with Insurance

- **Choice of Whole Life vs. Term Insurance**
 - **Whole life premiums level throughout coverage**
 - cash values can build-up
 - policy's cash-value is liquid asset that can be secured
 - **Term life premiums increase**
 - money saved can be reinvested in business with greater return



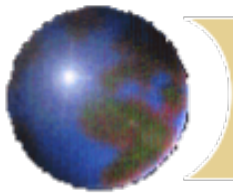
Buy-Sell Agreements Funding with Insurance

- **Considerations in Cross-Purchase vs. Stock Redemption**
 - **Cross-Purchase requires multiple overlapping coverage**
 - each shareholder owns policy – and is the beneficiary
 - more complete administration
 - insurance equal to value of insured's share
 - no change in business value
 - first triggering event may require insurance increases
 - tax basis transfer
 - must be based on legitimate valuation



Buy-Sell Agreements Funding with Insurance

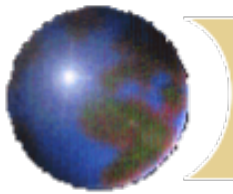
- **Other Issues**
 - **Uninsurable Shareholders** – use an existing policy if available
 - **Disability vs. Death** – avoid common mistake of only insuring “life”
 - **Survivorship Life Insurance** – family run business transitions
 - **Combination Funding** – incremental increased costs covered by business



Buy-Sell Agreements

Tax Implications

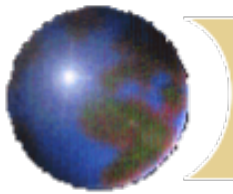
- **Transfers of Basis in Valuation**
 - The estate or its beneficiaries will have no income tax on the purchase of the decedent's interest
 - Basis of the interest will be equal to its sale price
 - If the agreement isn't fully funded and surviving owners borrow to fund the buyout, interest payments to the estate will be deductible on the entity's tax return
 - Cross-sell agreements in particular provide the buying shareholder or shareholders a step-up in basis
 - not so in a stock redemption
 - corporate entity is the beneficiary of buyout insurance, the proceeds of the policy may be subject to the alternative minimum tax



Buy-Sell Agreements

Tax Implications

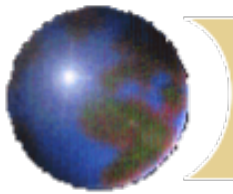
- **Estate Tax Implications and Control Issues**
 - **Proceeds from the life insurance in a cross-purchase plan are not included in the deceased shareholder's estate**
 - **deceased is not the owner of the policy and, therefore, the insurance proceeds payable at death are not included in the estate**
 - **Estate tax consequences can become more pronounced in a stock redemption when the deceased shareholder has a controlling interest**
 - **shareholder who owns more than a 50% interest either directly or indirectly is deemed to control a corporation under IRC § 267**
 - **the shareholder is deemed to have an ownership interest in the life insurance policy due to the shareholder's ability to designate a beneficiary**
 - **IRC § 302 requires a substantial reduction in ownership interest of an exiting corporate shareholder - distribution could be taxed as dividend income**



Buy-Sell Agreements

Tax Implications

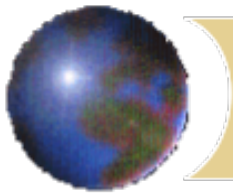
- **Constructive Dividends**
 - Shareholders should have an option to purchase the stock rather than an unconditional obligation to do so
 - If corporation instead purchases the stock under a secondary requirement in the buy-sell agreement
 - purchase is treated as a constructive dividend to the continuing shareholders
- **Deferred Compensation**
 - A nonqualified deferred compensation (NQDC) plan
 - Pay and receive compensation some time in the future



Buy-Sell Agreements

Tax Implications

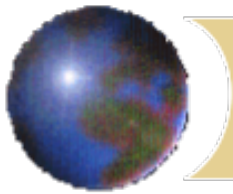
- **NQDC Plans Typically Fall into Four Categories:**
 - **“Salary Reduction Arrangements”**
 - simply defer the receipt of current compensation and allow the participant to defer receipt of a portion of their salary
 - **“Bonus Deferral Plans”**
 - resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses
 - **“Supplemental Executive Retirement Plans” or SERPs**
 - NQDC plans maintained primarily for a select group of management or highly compensated employees
 - **“Excess Benefit Plans”**
 - provide benefits to employees whose benefits under the employer's qualified plan are limited.



Buy-Sell Agreements

Tax Implications

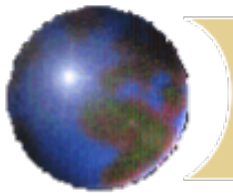
- **NQDC plans are either funded or unfunded**
 - **Most are intended to be unfunded because of the tax advantages**
 - where the employee has only the employer's "mere promise to pay"
 - employer may simply record the deferred compensation in bookkeeping account
 - employer may transfer funds into a trust as general asset
 - funds are subject to the claims of the employer's creditors if the employer becomes insolvent
- **Benefit of income tax deferral dependent on access**
 - **Important that the amounts are not set aside from the employer's creditors**
 - if so, employee may have currently includible compensation that is taxable



Buy-Sell Agreements

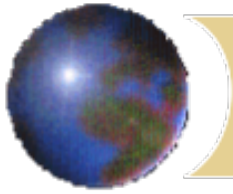
Tax Implications

- **Business Purchases Through SERPs**
 - Supplemental Executive Retirement Plans payable to a departing business owner
 - Only subject to one level of taxation because the new business owner is entitled to deduct the payments so long as they represent reasonable compensation
 - Departing business owner's payments are taxed as ordinary income
 - Cash-flow required to generate the funds can be substantially smaller because the company reaps the benefits of deductions



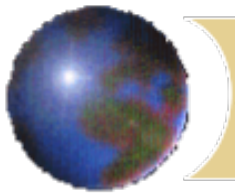
Buy-Sell Agreements Issue Spotting and Checklists

- Specify the type – “cross purchase” or “redemption”
- Specify the triggers
 - Death of a shareholder
 - Disability of a shareholder
 - Departure
 - Divorce
 - Deadlock or Disagreement among owners
 - Default of some performance requirement
- Specify valuation process or amount



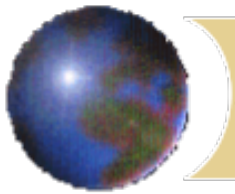
Buy-Sell Agreements Issue Spotting and Checklists

- **Devil is in the details**
 - How to update and renegotiate agreements
 - Whether the IRS accepts the valuation as fair market value
 - Whether the agreement anticipates the funding requirements
 - Unintentional incentive to cause a triggering events to gain unwarranted value
 - Penalty for leaving the business or for misconduct
 - Require purchase of a spouse's ownership interest resulting from a divorce



Buy-Sell Agreements Issue Spotting and Checklists

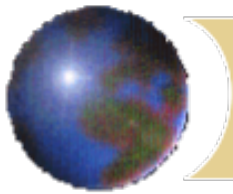
- **Establish other limits as required by the particular circumstances**
 - Personal guaranty of other shareholders or security interest in the assets
 - Terms of any outside financing requires
 - Limitations on mergers and acquisitions
 - Limitations on the disposal of assets, change of operations, etc
 - Business or owner rights of first refusal to sell to an outsider



Buy-Sell Agreements

Issue Spotting and Checklists

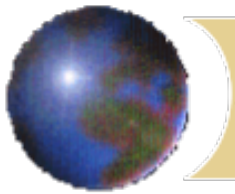
- **Deadlock - business unable to continue**
 - **Texas shoot-out**
 - Each party sends a sealed all-cash bid to an umpire
 - price at which they are willing to buy out the other party
 - highest sealed bid “wins”
 - **Dutch auction.**
 - sealed bids with minimum price owners would be prepared to sell
 - lowest bid “wins” and that bidder then sells to the “loser”
 - **Russian roulette**
 - parties serves notice on the other party - names an all-cash price
 - other party either buys or sells at that price, at that price



Buy-Sell Agreements

LLC Agreements

- **LLCs can step up the basis in their assets**
 - More common for LLC to be buying entity
 - IRC § 734 which permits an LLC taxed as a partnership to adjust the tax basis of its assets to reflect the purchase price paid for a member's interest
 - increased tax basis will reduce the gain that is passed through to the members when the LLC eventually sells these assets
 - does not affect the LLC's other assets
 - If an installment purchase is made, the LLC is generally in a position to deduct the interest paid, whereas interest paid by members may be nondeductible under IRC § 163(d) and (h) relating to investment and personal interest
 - Most LLCs incorporate buy-sell provisions into their operating agreements

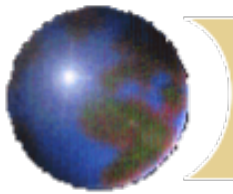


Buy-Sell Agreements

Case Study 1

- **Fact Pattern 1**

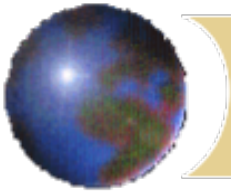
- Husband with a 50% interest in each of three businesses
- No buy-sell agreements
- No insurance on each member
- No professional business appraisals
- Husband became terminally ill and died in January
- The three businesses turned out to be worth about \$400,000
- Widow only received \$30,000 for her half
- Unbeknownst to the woman, her husband of 25 years—who most recently had been earning \$100,000 annually—had agreed at one point that \$30,000 would be paid for his share when he died



Buy-Sell Agreements

Case Study 2

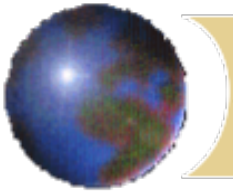
- **Fact Pattern 2**
 - A thinks his manufacturing firm was worth \$10 million,
 - Trusted business advisor is doubtful – appraisal only \$4 million to \$6 million
 - Attorney and advisor find ways to increase the business' profit margins
 - identified jobs that required less labor
 - reduced returns from defective parts
 - automated processes where possible
 - Result: increase his profit margins for cash-flow multiple to realize added value
 - Eventually sold the business for \$12 million
 - The proceeds from the sale are managed through a customized, tax-efficient, managed portfolio that generates income and capital growth for the client, who is now retired



Buy-Sell Agreements

Case Study 3

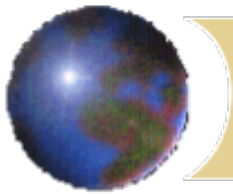
- **Fact Pattern 3**
 - Parents give equal shares in a business to their four children, but only one ends up working in the business. The other three eventually decide the business is providing them with no economic benefit because they get no dividends and there's no market for their minority interests. The disgruntled shareholders settle the dispute in a courtroom and need a business appraisal. Applying New Hampshire, Massachusetts or other state law could result in no action or liquidation of the company depending upon the state law, business agreements and causes of actions selected by the disgruntled minority owners.



Buy-Sell Agreements

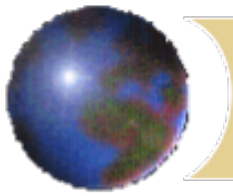
Case Study 4

- **Fact Pattern 4**
 - She is 90% owner of a beauty-related business in which she's worked for 27 years. Her sister, who doesn't work in the business, owns 10%. The parents left them the firm, and there was a verbal understanding that the 90% sister would buy out the 10% sister.
 - The majority owner did make an offer, but her sister is asking for seven times the offer.
 - First need is to hire a valuation firm to come up with a realistic price. The minority owner has threatened to sue her sister—as well as all of her advisors.



Buy-Sell Agreements Summary

- **Agree that the Inevitable Will Happen**
 - **Death, Disability, or Sale of the Business**
 - **Need an Exit Strategy**
- **Value the Business**
- **Agree on “Triggers”**
- **Agree on Process**
- **Understand Implications**
 - **Tax impacts on business**
 - **Controls and Limitations**



Buy-Sell Agreements

Questions Questions Questions Questions

Questions

Thank You!

3/27/2008

