Cross Purchase V. Stock Redemption

Within a closely held corporation, shareholders are often concerned about what might occur if one of the owners dies. Will the deceased shareholder's family retain the economic value of the corporate interest? Can the surviving owners avoid interference from the deceased shareholder's family? Will the survivors have the economic resources to redeem the deceased owner's interest? Given these concerns, corporate owners are best served by entering into a buy-sell agreement while they are all alive.

Forms of Buy-Sell Agreements and Tax Implications

Owners usually choose from two basic types of buy-sell agreements. With a cross-purchase agreement, each owner of the corporation purchases an insurance policy on the other shareholders. The purchaser is both owner and beneficiary of the policies. Upon the death of a shareholder, the other shareholders are then able to use the life insurance proceeds to purchase the deceased owner's shares. Another commonly used type of agreement is a stock redemption agreement, in which the corporation owns policies on the lives of the shareholders. When a shareholder dies, the corporation buys the deceased shareholder's interest in the company with the insurance proceeds.

Cross-purchase agreements. The cross-purchase form of the buy-sell agreement offers several advantages. The family of the deceased owner will have a tax basis equal to the fair market value of the decedent's stock at the date of death, thus avoiding any income tax consequences as a result of the sale. The fair market value of the shares should be defined by the buy-sell agreement (see the Exhibit).

The life insurance proceeds received by the surviving owners are not subject to income taxation. For newly purchased shares, the

corporate shareholders will be entitled to a tax basis equal to the purchase price. The stepped-up basis should reduce future income taxes if the surviving shareholders later sell their interests. The insurance proceeds are not subject to the corporate alternative minimum tax (AMT) and are also not subject to the claims of corporate creditors. The AMT avoidance and creditor protection exist because the proceeds are paid directly to the individual shareholders.

The cross-purchase form of the buy-sell agreement carries several disadvantages. The plan is difficult to administer if there are numerous shareholders that must buy a plan for each other. For example, for seven owners to cross-purchase life insurance would require 42 (7 ¥ 6) policies. The number of policies can multiply even further if disability coverage is also part of the buy-sell agreement.

Another disadvantage of the cross-purchase agreement is that age or insurability can create a disparity in premiums. Younger or healthier owners may incur higher premiums to cover older and less healthy owners. A possible solution to this drawback is to have the corporation raise salaries to cover the premiums incurred by the owners. Inequities may persist, however, if owners' marginal tax rates applied to the salary reimbursements are different. Additionally, cross-purchase agreement adopters should recognize that the cost of funding the buy-sell agreement will be greater if the shareholders have a higher tax rate than the corporation.

Stock redemption agreements. Under a stock redemption agreement, the corporation owns policies on the lives of the shareholders. When a shareholder dies, the corporation buys the deceased shareholder's interest in the company with the insurance proceeds. A prime advantage of the stock redemption agreement is that it is easier to administer for multiple shareholders. An additional advantage to the stock redemption structuring of the

buy-sell agreement is that the corporation will bear the premium differences associated with age disparities among shareholders.

The corporation will not recognize income for tax purposes when it receives the insurance proceeds. The corporation must, however, heed the effect of the entire transaction (proceeds received and redemption accomplished) on the earnings and profits of the corporation. The earnings and profits will increase with the life insurance proceeds received and decrease as a result of the stock redemption, so the corporation must attend to the overall net effect on earnings and profits and consider how that might affect the dividend policy to shareholders. For example, in the Exhibit's Scenario 3, the corporation may have to issue dividends to avoid the accumulated earnings tax on earnings and profits, assuming that the reasonable needs of the business do not justify maintaining earnings and profits above the $250,000 credit (IRC section 535). These dividends would be taxed to the remaining shareholders at ordinary income rates.

A significant disadvantage of the stock redemption form of the buy-sell agreement is that the remaining shareholders do not get the benefit of a step-up in basis when the corporation purchases the deceased shareholder's interest. The continuing shareholders retain their original bases in the company. Compared to the cross-purchase agreement, the stock redemption structuring will create greater capital gains upon the ultimate disposition of shares if made before death. After the stock redemption is accomplished, however, the corporate assets should be relatively unchanged (the insurance proceeds have been used to purchase the deceased's interest), but each owner now enjoys a greater percentage of ownership.