Do you know the tax implications of your C corp.'s buy-sell agreement?

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Private companies with more than one owner should have a buy-sell agreement to spell out how ownership shares will change hands should an owner depart. For businesses structured as C corporations, the agreements also have significant tax implications that are important to understand.

Buy-sell basics

A buy-sell agreement sets parameters for the transfer of ownership interests following stated "triggering events," such as an owner's death, disability, loss of license or other legal incapacity, employment termination, retirement, bankruptcy or divorce. The agreement typically will specify how the purchase price for the departing owner's shares will be determined, such as by stating the valuation method to be used, and how the purchase price will be paid (e.g., full payment up-front or installment payments with adequate interest over a stated time period).

Another key issue a buy-sell agreement addresses is funding. In many cases, business owners don't have the cash readily available to buy out a departing owner. Insurance is commonly used to fund these agreements. This is where different types of agreements — which can lead to tax issues for C corporations — come into play.

Under a *cross-purchase* agreement, each owner buys life or disability insurance (or both) that covers the other owners, and the owners use the proceeds to purchase the departing owner’s shares. Under a *redemption* agreement, the *company* buys the insurance and, when an owner exits the business, buys his or her shares.

Sometimes a *hybrid* agreement is used that combines aspects of both approaches. It may stipulate that the company gets the first opportunity to redeem the shares and that, if the company is unwilling to buy the shares, the remaining owners then have the right or obligation to do so. Alternatively, the owners may be given the first opportunity to buy the shares, and if they are unwilling to buy the shares, the company then has the right or obligation to do so.

C corp. tax consequences

A C corp. with a redemption agreement funded by life insurance can face adverse tax consequences.

First, receipt of insurance proceeds could trigger corporate alternative minimum tax.

Second, the value of the remaining owners’ shares will probably rise without increasing the basis in their existing shares. The reason: the company is buying the departing owner's shares, not the remaining shareholders, so the remaining shareholders don't get "credit" for the amount of the purchase. This, in turn, could increase their income tax liability if they later sell their shares.

Heightened liability for the corporate alternative minimum tax is generally unavoidable under these circumstances. But you may be able to manage the second problem by revising your buy-sell to a cross-purchase agreement. Under this approach, owners will but the additional shares themselves - increasing their basis by the amount of the purchase.

Naturally, there are downsides. If owners are required to buy a departing owner's shares, but the company redeems the shares instead, the IRS may characterize the purchase as a taxable dividend to the owners. Your business may be able to mitigate this risk by crafting a hybrid agreement that names the corporation as a party to the transaction and allows the remaining owners to buy back the shares without requiring them to do so - accordingly, no party (e.g., the company)is assuming the purchase obligation of another party (e.g., the remaining shareholders).

For more information on the tax ramifications of buy-sell agreements, please contact us. If your business doesn't have a buy-sell agreement in place yet, we can help draft an appropriate buy-sell agreement and figure out which type of funding method will best meet your needs while minimizing any negative tax consequences.

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