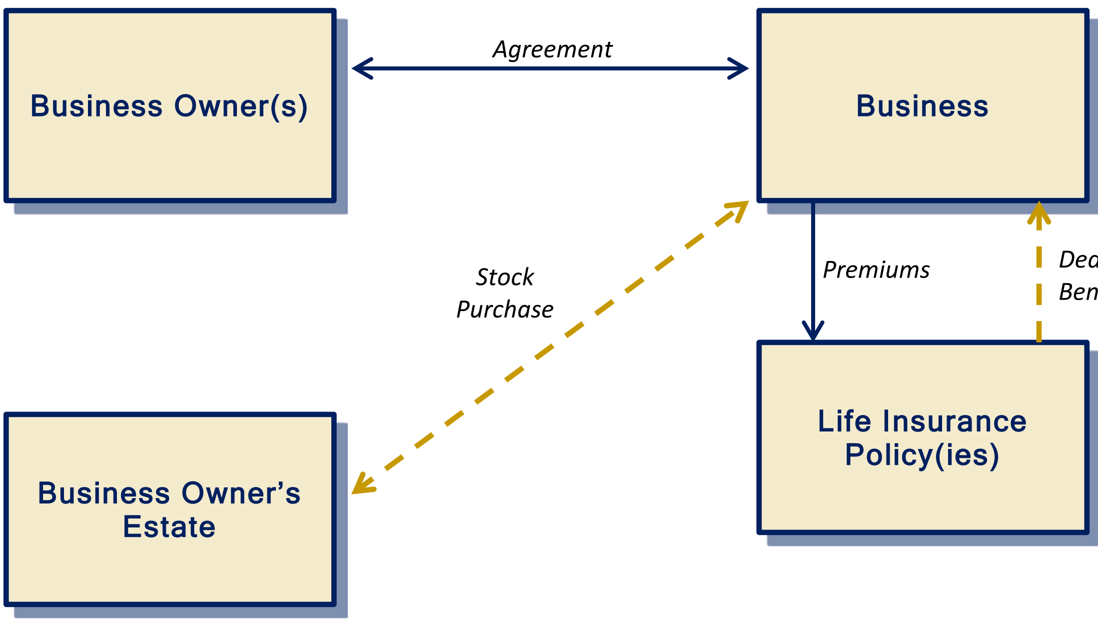
The Entity Purchase (Stock Redemption) Buy/Sell Arrangement

In an entity purchase arrangement, the business purchases the owner's interest when a triggering event (e.g. death, retirement or disability) occurs. If the arrangement is funded with life or disability insurance, the business is the applicant, owner, beneficiary and premium payer of the insurance on the lives of the owners. At the death of an owner, the policy's proceeds are paid to the business; then the business purchases the disabled or deceased owner's interest in the business from him or his estate. The surviving owners' percentage of ownership in the business increases proportionately.



1. Working with the business' legal, tax and financial advisors, the business owner(s) and the business enter into a stock redemption agreement. The agreement requires the business to purchase the business owner's interest in the business for an agreed upon price upon a triggering event (e.g. death, retirement or disability).
2. To fund its purchase obligation, the business purchases a life insurance (and/or disability) policy on each owner's life. Prior to the issuance of the policies, the business must provide written notice to each business owner that it intends to buy life insurance on the business owner's life. The notice must state that the business will be the beneficiary of the policy and may remain so even after the business owner is no longer with the business. Additionally, the notice must state the maximum amount of life insurance that the business will purchase on the business owner. After the business owner receives the notice, he or she provides the business with written consent to purchase the life insurance. The business pays the policy premiums and is the policy beneficiary.
3. Upon the death of an insured business owner, the business receives the life insurance death benefit income-tax-free*.
4. The business applies the death benefit proceeds towards the purchase of the decedent business owner's interest in the business from his or her estate.

* *For federal income tax purposes, life insurance death benefits are generally income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owed policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

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Advantages

- The number of policies that need to be purchases is limited to one policy for each owner.
- The business is pays all premiums; therefor, there is equalization of premium costs among owners. Factors such as age, smoker status and health ratings may be less of an issue.
- The business pays the premiums.
- The insurance policies' cash value buildup (if permanent life insurance is used) can be shown as an asset on the balance sheet of the business.

Disadvantages

- The insurance policies and their cash values are subject to the creditors of the business.
- The policy premiums are not deductible under IRC Sec.264(a).
- The life insurance proceeds may increase the value of the entity for estate tax purposes because the death precedes flow into the business.

C-Corporation Issues

- Both the cash value buildup and death benefits greater than basis are subject to the corporate Alternative Minimum Tax (AMT). This is a tax of up to 20 percent on the annual increase in cash value and up to 20 percent of life insurance death benefit greater than basis. (Note that the Taxpayer Relief Act of 1997 repeals the corporate AMT for "small business corporations" after 1997. IRC §55e generally defines a small business corporation as having annual gross receipts of less than $5 million.)
- The surviving owners' basis in their shares will not change because no credit is given for the corporation's redemption of stock from a selling shareholder. This is important if any of the surviving owners sell stock prior to death, since the capital gains tax will be paid on all proceeds greater than the shareholder's basis.
- In a family-owned corporation, the redemption may be treated as a dividend, which is taxed as ordinary income, rather than a sale, which is taxed at capital gains rates. This can be disastrous since in most cases where a shareholder has died; there will be little if any capital gain because of the death step-up in basis. One possible solution is to draft the agreement so that the sale is between actual family members rather than the estate, qualifying for the friendlier family attribution rules.
- If a corporation has a net operating loss (NOL), entering into a buy-sell agreement may trigger the immediate loss of some or all the NOL. Any company that has an NOL should consult a competent tax advisor when considering entering into a buy-sell agreement.

S-Corporation Issues

- Only a partial step-up in basis can be obtained by the remaining owners from life insurance death proceeds payable to an S-corporation (unless the business is a "cash basis" taxpayer and is willing to file a short-year election under IRC Sec. 1377).
- If an S-corporation has ever been a C-corporation, it may have the same dividends (ordinary income) vs. sale (capital gains) issues as a C-corporation, at least to the extent of locked-in earnings and profits.
- No corporate Alternative Minimum Tax (AMT) exposure.