CORPORATE law | Buy Sell Agreements

Redemption Agreement

Generally: A stock redemption plan provides that a corporation will buy back a departing (deceased) owner's interest, often using the proceeds from life insurance owned by the corporation on the owner's life. This plan is simple and provides an easy method to fund the premiums - they are paid directly by the corporation.

A redemption plan does not take full advantage of the step up in basis which occurs at the owner's death. Consequently, capital gains tax is paid unnecessarily at the time of sale of the remaining owners because the surviving shareholders' basis in their stock remains the same, although the value of their ownership increases. Furthermore, the proceeds of the policy are available to the claims of the *corporation's* creditors at the time of the owner's death and therefore may not be available for use by the corporation.

Entity Cross Purchase

In an entity-owned cross-purchase buy-sell agreement, the entity (oftentimes an escrow) maintains an insurance contract on each of the owners' lives. They, in turn, would endorse their stock certificates in the company to the entity. The individuals would periodically contribute funds to the entity to allow it to pay the premiums on the policies. When an owner later dies, the entity collects the insurance proceeds on the decedent's life and pays them to his estate.

The remaining shareholders receive the decedent's shares with a stepped up basis. The entity would then see that the corporation issues new shares to each of the remaining owners in exchange for the shares which belonged to the deceased owners.

The Restructuring Process

Attention should be given to the type of insurance used to fund the plan. Oftentimes, term insurance is used for redemption. Although less expensive, term does not build up a cash value. Consequently, the dollars placed in the contract are lost. If permanent insurance is used, cash value is created in the policies. Unlike term contracts, these amounts can be used for a buy-out due to retirement or disability, in addition to death. Furthermore, these amounts are built up in the contracts using discounted dollars: the amounts obtained at death cost only a fraction of that today.

*The purpose of this document is to provide general information, not legal advice. A qualified attorney should be consulted before implementing any plan.

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Limited Liability Companies

There is a creative way of doing business that combines the advantages of a partnership and the liability protection of a corporation. It's called a limited liability company (or LLC).

A business can be conducted in a number of forms, such as a proprietorship, partnership, a regular corporation, or an S corporation. Doing business as a partnership has many tax advantages. Income is taxed only once, and there is great flexibility in how income and deductions are passed through to the partners. But the partners' assets are put at risk, since each general partner is personally liable for the partnership debts and obligations.

Corporations don't have the liability problem, since shareholders aren't responsible for debts of the corporation. However, a corporation's income may be taxed twice, once when the corporation earns it and once when it is distributed to the shareholders in the form of dividends.

Corporations are also required to maintain corporate records including the issuance of shares, board of director meetings as well are shareholder minutes. Limited liability companies are governed by a document called an Operating Agreement; therefore, less paperwork is required for an LLC.

Electing to be an S corporation oftentimes avoids double taxation. But S corporations have many restrictions on structure and possible disqualification as well as the need to maintain corporate records.
The limited liability company, which is recognized by almost every state, offers a way out of this dilemma. Investors, known as members, own an LLC. It is managed either by the members themselves or by designated managers, usually entitled Managing Members.

Like shareholders of a corporation, the members' liability is limited to the amount of their investment.
Yet, if the LLC is structured properly, it will be treated as a partnership for tax purposes. And there are no restrictions on the number and type of members, as there are with the shareholders of an S corporation.

If you are already doing business as one of the other entities, it may make sense to consider converting to an LLC.

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