

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.