

## **THE LITTLE BUY-SELL PLAN THAT COULDN'T**

### **(or Why Your Clients Need Life Insurance to Fund their Buy-Sell Agreement)**

Why should your clients buy life insurance when they set up a buy-sell? Read a true story from a Tax Court case about a family business that had a buy-sell agreement, but no life insurance to fund it.<sup>1</sup>

Arthur C. Smith, Sr. (Senior) ran a successful moving and storage business. His son, Arthur Jr. (Junior), was general manager and eventual president. Senior's daughter, Elizabeth, took an active interest in the family business, and became a vice-president. Senior's wife had died before him.

Senior held a majority of voting stock in the family business all his life. Although he wanted to split the value of his estate equally between Junior and Elizabeth, he wanted Junior alone to control the business. To make sure this happened, Senior and Junior entered into a cross-purchase buy-sell agreement.

#### **THE AGREEMENT**

The agreement required the estate of whoever died first, Junior or Senior, to sell all its stock in the business to the survivor. It set the price at adjusted book value to be paid over ten years. The agreement also said that if, during that time, Elizabeth or her heirs wanted to sell their stock to the survivor, the survivor had to buy that stock on the same terms. However, Senior did not want Elizabeth to know about the buy-sell agreement, so she was never told. Nor does it appear from the facts of the case that either Senior or Junior ever took out life insurance to fund their agreement.

#### **THE RESULT**

Elizabeth died first. She left her stock equally to her two children. Since Elizabeth's estate consisted mostly of stock in the family business, her estate needed cash to pay estate taxes and administration expenses. Elizabeth's children asked the business to redeem their shares, but received an offer they did not accept.

Around the same time, Senior died. His will gave Junior enough stock to control the family business; Junior did not have to buy stock using the buy-sell agreement. Elizabeth's children still held their minority interest.

Elizabeth's children concluded that Senior's will left them in a bad spot. No one, they thought, would want to buy a minority interest in a closely held family business. Nor could they exercise any influence over corporate affairs. But they still needed cash. They therefore filed suit to contest Senior's will. If the court ruled Senior's will invalid and ordered that all the assets in Senior's estate, including the shares in the family business, be split 50/50 between them and Junior, Junior would be forced to buy their shares to regain control of the company.

State law required that someone be appointed to oversee collection and accounting for Senior's estate. Over Junior's objections, the court appointed an independent administrator. Junior then disclosed the existence of the buy-sell agreement in an (unsuccessful) attempt to replace the independent administrator.

The family went back to the bargaining table. Unfortunately, though, Junior did not have enough money to buy Elizabeth's children's shares and Elizabeth's children did not want to rely on Junior's credit so he could pay them over time. Further, they thought the interest rate set in the agreement was too low, and they disagreed with the formula the agreement used to value the business.

After much wrangling, the parties eventually settled. Rather than having Junior buy their shares, Elizabeth's children agreed to have the business redeem their shares using notes secured by mortgages on real estate it owned. In effect, the buy-sell agreement became a stock redemption agreement.

But no one ever got much money from the settlement. Within five years after Senior's death, the business failed and was sold to another company for a token amount.

### **ADDING INSULT TO INJURY**

This result was bad enough, but there was worse to come for Junior. The IRS reviewed the settlement and decided that the stock redemption was a constructive dividend from the business to Junior because the business had satisfied Junior's obligations under the stock purchase agreement.

The Tax Court partially agreed with the IRS. It said the family business did pay a constructive dividend to Junior to the extent it redeemed shares from Senior's estate. Junior, the court reasoned, was personally and unconditionally obligated to buy those shares. But Junior was not unconditionally obligated to buy Elizabeth's shares, so the redemption of her stock was not a constructive dividend to him.

After the dust settled, Junior owed a lot of money to the IRS for tax on the constructive dividend, the business Senior had worked a lifetime to build was gone, and neither Junior nor Elizabeth's children ever got much money for it.

### **THE MORAL OF THE STORY**

No one ever seems to have asked: "Where will we get the money to pay for the obligations we are creating?" Instead, they assumed the business' cash flow would be enough to handle it. Even though the business was successful, and this may have seemed like a reasonable risk to take, it was still a risk, and one that life insurance could have reduced or eliminated.

No one will ever know to what extent the lawsuit and ill will distracted Junior from running the family business, and contributed to its failure. But if your clients want a smooth transition, why take a chance? If they create an obligation to buy a business when someone dies, why not use life insurance to make sure the money is there when the time comes to pay?

### **Disclaimer**

The Genworth Financial companies wrote this content to help you understand the ideas discussed. Any examples are hypothetical and are used only to help you understand the ideas. They may not reflect your client(s)' particular circumstances. Your clients should carefully read their contract, policy, and prospectus(es), when applicable. What we say about legal or tax matters is our understanding of current law; but we are not offering legal or tax advice. Tax laws and IRS administrative positions may change. We did not write this material for use in avoiding any IRS penalty and neither you nor your clients may use it for that purpose. Your clients should ask their independent tax and legal advisors for advice based on their particular circumstances.

If this material states or implies that it was prepared or distributed to promote, market or recommend an investment plan or arrangement within the meaning of IRS guidance, or such use may be reasonably expected, then, as required by the IRS, the following applies:

The tax information in this material was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in this material.

---

<sup>1</sup> Smith v. Commissioner, 70 T.C. 651, 1978