

ACTEC®

**SHAREHOLDERS AGREEMENTS
FOR CLOSELY-HELD CORPORATIONS
OUTLINE**

Authors:

Nancy Schmidt Roush
Kansas City, MO
nroush@lathropgage.com

Steven B. Gorin
St. Louis, MO
SGorin@ThompsonCoburn.com

Richard S. Scolaro
Syracuse, NY
RScolaro@Scolaro.com

Dale B. Stone
Birmingham, AL
dstone@dfhlaw.com

Farhad Aghdami
Richmond, VA
Aghdami@WilliamsMullen.com

Disclaimer: The Outline is not intended as a definitive resource or primary research tool regarding the tax or legal issues discussed. Rather it is intended to highlight issues for consideration by knowledgeable attorneys.

IRS Circular 230 Disclosure: Pursuant to Internal Revenue Service rules of practice, any tax advice set forth in this outline is not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties that may be imposed under the Internal Revenue Code or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein.

© 2006, 2011 The American College of Trust and Estate Counsel – All Rights Reserved
“ACTEC” is a registered trademark of the American College of Trust and Estate Counsel

Table of Contents

I.	INTRODUCTION	1
A.	General Purpose	1
B.	Non-Tax Objectives	1
C.	Tax Objectives	2
II.	RESTRICTIONS ON TRANSFERS	3
A.	Outright Prohibition on Transfers	4
B.	Right of Refusal	4
C.	Exceptions (Permitted Transfers)	5
D.	Transferee Subject to the Agreement	5
E.	Recapitalization Upon Transfer Without Consent	6
F.	Issuance of Stock	6
III.	TYPES OF BUY-SELL AGREEMENTS	6
A.	Corporate Redemption Agreements	6
B.	Cross-Purchase Agreements	12
C.	Hybrid Agreements	13
D.	Sale to Purchaser Not a Current Owner	13
E.	Mandatory Sale Versus Option	13
F.	Other Types of Agreements (Related Agreements)	14
IV.	BUY-SELL TRIGGERS	14
A.	Non-Permitted Transfers	15
B.	Death	15
C.	Disability	15
D.	Termination of Employment	17
E.	Reaching a Certain Age	17
F.	Bankruptcy, Insolvency, Creditor Attachment	17
G.	Divorce or Separation	22
H.	Community Property & Spousal Consents	22
I.	Breach of Agreement	24
J.	Call Upon Specified Vote	24
K.	Protecting Loss of S Election	24
L.	Tag-Along & Drag-Along Rights	24
V.	SPECIAL ISSUES FOR S CORPORATIONS	25
A.	Termination of S Election	25
B.	Single Class of Stock Requirement	26
C.	Resident Aliens	28
D.	Trusts as Shareholders	29
E.	Avoiding Transfers that Would Cause Termination	32
F.	Other Provisions to Protect S Election	34
G.	Damages for Causing Loss of S Election	34
H.	Declare Dividends Equal to Tax Burden	35
I.	Income Allocation for Year of Sale	36

J.	Insurance Proceeds Effect on Basis	37
K.	Basis at Death	38
L.	Tax Effects of Redemptions.....	39
M.	Other Income Tax Issues	40
VI.	PURCHASE PRICE	40
A.	Identifying the Goal	40
B.	Certificate of Value.....	41
C.	Set By Appraiser	42
D.	Valuation Formula	42
E.	Life Insurance	45
F.	Price Offered by Bona Fide Purchaser.....	45
G.	Reciprocal Purchase Options (Australian Lottery)	45
H.	Discounts & Premiums	46
I.	Adjustment Upon Subsequent Sale of Corporation	46
J.	Adjustment Due to Different Estate Tax Value.....	47
K.	Defined Value Clauses.....	49
L.	Taxable Income as Liability in Valuation.....	52
VII.	ESTATE TAX ISSUES REGARDING VALUATION	53
A.	Fixing Value For Estate Purposes.....	53
B.	Rules Subsequent to October 8, 1990	55
C.	Summary of Current Test to Fix Value.....	56
D.	Chapter 14 Also Contains §2704	59
E.	Controlling Date.....	59
F.	Gift Upon Execution of Agreement.....	59
G.	Undesired Results (Traps).....	59
VIII.	MARITAL DEDUCTION CONSIDERATIONS	60
A.	Sale of Stock At Less Than Fair Market Value Destroys Marital Deduction.....	60
B.	Non-Productive Assets in Marital Trusts.....	62
C.	Sale of Stock For Terminable Interest	62
D.	Marital Deduction for Undervalued Stock.....	63
E.	Valuation for Inclusion Purposes v. Deduction Purposes.....	63
IX.	TERMS OF PURCHASE & CLOSING.....	65
A.	Dates	65
B.	Debt Financing.....	66
C.	Self-Executing.....	69
D.	Paying the Purchase Price into Escrow	70
X.	INSURANCE.....	70
A.	Need for Insurance	70
B.	How Much	72
C.	Income Tax Issues.....	72
D.	Policy Owner	73

E.	Insurance as Part of Gross Estate	74
F.	Transfer for Value Rule	75
G.	Trustee or Escrow Arrangement to Hold Insurance	76
H.	Partnership to Own Insurance	76
I.	Irrevocable Trusts as Partners of a Partnership to Own Insurance	88
J.	Employer-Owned Life Insurance Rules.....	88
XI.	VOTING & GOVERNANCE.....	91
A.	General.....	91
B.	Cumulative Voting.....	92
C.	Multiple Classes of Stock	92
D.	Supermajority Voting Rights	93
E.	Voting Agreements	93
F.	Irrevocable Proxies	94
G.	Deadlock of Shareholders or Directors.....	94
H.	Governance Issues	94
XII.	MISCELLANEOUS	95
A.	Parties.....	95
B.	Founders Rights	95
C.	Rights to Use Shareholder's Name	95
D.	Personal Guarantees by Selling Shareholder	95
E.	Termination & Amendment.....	95
F.	Remedies & Governing Law	96
G.	Attorney Conflict of Interest & Ethical Issues.....	96
H.	Notice.....	97
I.	Incorporation of Exhibits	97
J.	Counterparts & Date of Execution.....	97
XIII.	RELATED AGREEMENTS	97
A.	Noncompetition & Proprietary Information Agreements	97
B.	Non-Qualified Deferred Compensation Plans	98
C.	Corporate-Owned Life Insurance	103
D.	Death Benefit Only Plans.....	106
E.	Section 162 Plans.....	108
XIV.	ADDENDUM REGARDING PARTNERSHIP ENTITIES	110
A.	Partnerships & LLCs in General.....	110
B.	Documentation of the Agreement.....	112
C.	Tax Treatment of a Sale.....	112
D.	Tax Treatment of Redemption	115
E.	Sales vs. Redemptions	117
XV.	CREDITS & BIBLIOGRAPHY	120

I. INTRODUCTION

A. General Purpose

Shareholder agreements, often referred to as “buy-sell” agreements, contain contractual rights and obligations between shareholders and the corporation to buy and sell stock, as well as other provisions dealing with matters such as governance and tax issues. This outline is intended to explain the use and characteristics of agreements between shareholders and the corporation. The focus is on corporations with active businesses (but does not include provisions unique to professionals) that are owned either by family members or unrelated owners (but not specifically ESOPs). Selected issues relevant to S and C corporations are covered, but this outline is not intended as a comprehensive treatment of corporate tax issues. Variations in state laws are not addressed, except in general reference, and so practitioners should check applicable state law.

The ACTEC Shareholders Agreements For Closely-Held Corporations Sample Agreement¹ contains sample provisions for a shareholders agreement discussed in this Outline.

The articles of incorporation can also contain restrictions on transfer, which would be binding on all shareholders. A shareholders agreement is a private contract between shareholders (all or less than all) and often the corporation as well, and thus may contain agreements to undertake future actions and more flexibility in the terms.

Since a shareholders agreement is a contract, it needs consideration to be enforceable. Generally the benefits and burdens of the agreement run to all parties and that is sufficient consideration. If the agreement is one-sided only, specific consideration may need to be included.

B. Non-Tax Objectives

- (i) Protect the shareholder/employees and/or their families from having to maintain an interest in a closely-held business, which may not provide a source of revenue, by creating a market for the stock.
- (ii) Preclude shareholders from selling or hypothecating their interests in the business without the consent of the other shareholders, thus limiting unrelated third-party access to ownership.
- (iii) Insure continuation of the business by providing for a smooth and orderly transfer of ownership, governance and control upon the occurrence of a “triggering event” (such as the death, disability, retirement, divorce, insolvency and/or termination of employment, whether voluntarily or involuntarily, of a shareholder).
- (iv) Provide a “known” buyer upon the occurrence of a triggering event.

¹ <http://meetings.abanet.org/webupload/commupload/RP519000/relatedresources/Actec2.pdf>

- (v) Avoid controversy, particularly among family members of a former shareholder.
- (vi) Avoid the need for negotiations with the family or a fiduciary representing the former shareholder's interest by (i) establishing a price or method of valuing the ownership interest which is to be transferred, such as by an appraisal or formula, (ii) establishing the terms of payment, and (iii) providing a method of funding for the payment of the purchase price.
- (vii) Consider the use of lack of marketability or minority interest discounts in determining value.
- (viii) Provide liquidity to the family of a deceased, disabled or terminated shareholder, particularly with sufficient cash to provide for the payment of estate taxes and other family needs, and eliminate exposure to future risks inherent in the business.
- (ix) Provide the remaining shareholders and/or the corporation with access to funds for the purchase of stock, often without adverse tax consequences.
- (x) Restrict the use of proprietary or confidential information and competition by a former shareholder.
- (xi) Provide voting agreements where necessary to protect various interests.
- (xii) Avoid disputes pertaining to any excess of insurance proceeds over the purchase price upon the death of a shareholder.
- (xiii) Determine what happens to insurance policies on the life of a terminated but surviving shareholder.
- (xiv) Establish a dispute resolution process such as arbitration, selection of one or more independent directors or possible injunctive relief.
- (xv) Allow for efficient and orderly estate administration when the triggering event is death.
- (xvi) Avoid conflict among shareholders who are not employed by or otherwise active in the operation of the business.
- (xvii) Establish a means to void transfers, whether voluntary or involuntary, which may be inconsistent with the succession to ownership rights agreed to by the shareholders.

C. Tax Objectives

- (i) Allocate the consideration paid for the transferred interest and other agreements in a manner that will result in capital gain (or loss), ordinary income or some combination thereof for income tax purposes.

Also available as part of the eCourse

[Understanding How Different Allocation Methods Affect the Partners; Avoiding Pitfalls in Buy-Sell Agreements; plus Federal Income Tax Considerations in Acquisitions and Dispositions of S Corporations](#)

First appeared as part of the conference materials for the

60th Annual Taxation Conference session

"Avoiding Pitfalls in Buy-Sell Agreements"