



S CORPORATION OWNERS' NEEDS IN THEIR BUY-SELLS

For years you've heard us at Abo and Company / Abo Cipolla Financial Forensics tout the critical importance of buy/sell agreements. Such are almost always advisable for closely held businesses with more than one owner. These agreements can (1) prevent unwanted persons from becoming members of the ownership group, (2) provide a market for closely held ownership interests, (3) provide procedures for transferring an interest in the business if the owners have a falling-out, and (4) determine how ownership will be transferred at certain events, such as the owner's disability, divorce, insolvency, or incapacity.

Buy/sell agreements are sometimes also referred to as business continuation, redemption, or cross-purchase agreements. While they are appropriate for all closely held businesses, whether conducted as corporations, limited liability companies or partnerships, here we are focusing on buy/sell agreements for S corporation shareholders. Some of the issues that are commonly addressed in a buy/sell agreement for S corporation shareholders are as follows.

- Transferring Stock to Someone outside of the Current Ownership Group. A group of owners may be happy doing business with each other but would prefer not to be in business with one of the other owner's ex-spouse or children. A buy/sell agreement can prevent this by restricting transfers outside of the ownership group or by offering the owners a right of first refusal (the ability to purchase a departing owner's interest under specified terms) that can be exercised before an owner can sell stock to an outsider. Often, the other owners are able to purchase the shares at the same amount as any bona fide offer to purchase made by an interested buyer.
- Creating a Market for a Closely-held Business Interest. An agreement can require the other owners, or the business itself, to purchase stock at certain events (for example, when an owner dies, becomes disabled, or divorces). In this case, the agreement also should specify how the price will be determined and address how the mandatory purchase will be funded. For purchase triggered by an owner's death, life insurance can be obtained as a funding source. In other situations, the purchasing owners often give an installment note to the seller. The terms of the note should be specified in the agreement.
- Preserving S Status. A buy/sell agreement can be used to restrict the type and number of persons who can be shareholders, and to restrict ownership to those persons who are eligible shareholders. The buy/sell agreement should require shareholders to notify the corporation when a prospective transfer is contemplated. In addition, a transfer agent should be appointed to verify that a prospective transfer does not violate the S election. Notice requirements enable the owners to review a proposed transaction to ensure that it will not terminate the corporation's S status.
- Another important S corporation requirement to consider in a buy/sell agreement is the one-class-of-stock rule. Under this rule, an S corporation is prohibited from having more than one class of stock. If it does, the corporation's S election is automatically terminated. If restrictions are placed on some shares (e.g., those held by employees) the one-class-of-stock requirement may be violated.

Conclusion

Buy/sell agreements are important tools for S corporation shareholders. These legal documents should be prepared with the help of an attorney. However, we at Abo and Company / Abo Cipolla Financial Forensics (or tax attorneys brought in for more technical input) are well-positioned to advise our clients of the need for an agreement and of the tax and non-tax consequences of various transactions that it could trigger. For example, we would envision “rounding out the professional team” where the owners agreed that they want to create a market for the shares of a deceased owner. The tax consequences of having the S corporation redeem the shares could be very different than a mandatory purchase by the remaining shareholders. So, we believe tax practitioners (that includes us) should provide input when the agreement is drafted and review any agreement before it is signed. [Attached is a Checklist](#) from one of our research services we believe will help ensure that many of the important issues are addressed.

Marty Abo, in presentations to the New Jersey Bar Association, the Pennsylvania Bar Institute, the New York City Bar Association and other venues, shared our firm's "122 Point Checklist on Shareholder Agreements". The checklist allows us, as CPAs, to assist our business owner clients and their attorneys in addressing fundamental issues relating to the continuity of their venture and an orderly transition of ownership. It hopefully identifies key areas of substantive business, tax and estate planning for all such closely held businesses.

Those wanting our 122 point checklist for reviewing buy-sell agreements, should request a copy by calling us at 856-222-4723 or visiting our website www.aboandcompany.com.

Again, we would be pleased to provide guidance in working with our lawyer colleagues in setting up a buy-sell agreement and ensuring that you don't forget to consider all of the options. We're available to confer with your attorney or, if need be, recommend one seasoned in this arena.

Abo and Company, LLC
Abo Cipolla Financial Forensics, LLC
Certified Public Accountants / Litigation & Forensic Consultants

New Jersey Office

307 Fellowship Road, Suite 202, Mt. Laurel, NJ 08054
Phone: 856-222-4723 Fax: 856-222-4760

Pennsylvania Office

449 North Pennsylvania Avenue, Morrisville, PA 19067
Phone: 215-736-3156 Fax 215-736-3215

www.aboandcompany.com

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