

**W3 Wealth Management,
LLC**
Shelby Morgan
90 N. Miller Road
Akron, OH 44313
330-836-3805
Shelby@W3wealth.com

Using a Buy-Sell Agreement When Selling Your Business to Family

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What is a buy-sell agreement?

A buy-sell agreement is a legal contract common in closely held businesses. It is an agreement you can enter into now that provides for the future sale of your business interest. A buy-sell agreement is also referred to as a business continuation agreement, a stock purchase agreement, or a buyout agreement. When carefully drafted, your buy-sell agreement may be used to set the taxable value of your business interest.

Tip: This discussion focuses on issues specific to the use of a buy-sell agreement between family members. For more information on buy-sell agreements in general, please see [Transferring Your Business with a Buy-Sell Agreement \(General Discussion\)](#).

Does it matter if your buy-sell agreement is with a family member?

The IRS tends to scrutinize transactions between related parties, so almost any business transaction between you and a family member could be subject to the attention of the IRS. The definition of family member includes your spouse; parents of you and your spouse plus their lineal descendants, including spouses; and any other "natural objects of the transferor's bounty." There are rules in effect that can make the sale of an interest in a family business seem more difficult. However, you can take steps to ensure that your related party buy-sell agreement stands up to an IRS examination.

Considerations for buy-sell agreements with family members

Make sure your buy-sell agreement price represents fair market value

When setting the valuation method to be used under the buy-sell agreement, make sure that the transaction will represent fair market value (FMV). There are serious tax consequences that may result from using a price that the IRS determines to be higher or lower than FMV. To ensure that the IRS accepts your sale price, your buy-sell agreement must meet three requirements:

- It must reflect a bona fide business arrangement
- It must not be a device to transfer your interest to family members for less than full and adequate consideration
- Its terms must compare with those of agreements between parties in an arms-length transaction

Tip: A professional appraisal should be conducted to establish the FMV of your business interest. Please see the discussions [How Much Is Your Closely Held Business Worth?](#) and [Selecting an Appraiser](#) for more information on valuation and appraisers.

For additional information, see [Drafting a Buy-Sell Agreement That Establishes Taxable Value](#).

Attribution rules may apply and affect tax treatment when buyer is family corporation

If your buy-sell agreement is between you and the business entity itself (entity purchase buy-sell agreement), if shareholders are related to each other, and if your business is a corporation, the attribution rules of Section 318 must be considered. The definition of related shareholders includes spouse, parents of either spouse and their children and their spouses, and any natural objects of the transferor's bounty. The attribution rules can affect the tax treatment of a shareholder's stock redemption.

Depending upon the circumstances and the way the buy-sell is structured, the proceeds (payment) the seller receives from the redemption of the business interest may be classified as a sale or exchange of the seller's interest (subject to capital gains tax) or as a dividend distribution.

For tax years beginning on or after January 1, 2003 and before January 1, 2011, qualifying dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are taxed at long-term capital gains tax rates. For tax years prior to January 1, 2003, however, dividends were taxed at ordinary income tax rates; this generally resulted in significantly more tax due for redemptions that were treated as dividends.

Caution: Absent further legislative action, dividends will again be taxed as ordinary income beginning in 2011. This will obviously be an important consideration in structuring a buy-sell agreement.

Even for tax years beginning on or after January 1, 2003 and before January 1, 2011, however, there remains an advantage in classifying a transaction as a sale or exchange rather than as a dividend distribution, despite the fact that both types of transactions are subject to tax at long-term capital gains tax rates. That is, in the case of dividend treatment, the entire amount paid to the shareholder is subject to tax. In the case of sale or exchange treatment, however, the shareholder pays tax only to the extent that the amount paid by the company exceeds his or her basis in the stock.

Tip: If the sale or exchange of your shares occurs after your death, your shares will generally have a basis equal to the fair market value of the shares at the time of your death, and little or no tax may result.

In a family corporation, the sale of stock to the business under a stock redemption plan usually results in dividend treatment to the redeeming shareholder.

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