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YOUR BUY/SELL MIGHT BE GREAT IF YOU DIE, BUT WHAT HAPPENS IF YOU DON'T?

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If you share ownership of your company with another person, you likely have a buy/sell (or business continuity) agreement. Generally, owners draft those agreements because they want to control the transfer of ownership should one of them die or become disabled. Most agreements are set up so that life insurance will fund the purchase of the deceased/disabled owner's interest if one of these events occurs.

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The typical buy/sell agreement also contains provisions governing lifetime (divorce, bankruptcy or retirement of a shareholder) transfers of ownership, often in the form of a first right of refusal, at a pre-determined price, in the event one owner wishes to transfer ownership to anyone.

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Few owners (or their advisors) give much thought or analysis to the likelihood of a lifetime transfer. Instead they focus all of their attention on dealing with the least likely event—an owner's death. Yet, in our experience, lifetime transfers occur much more frequently, and when they do can cause huge problems.

For that reason, owners create buy/sell agreements that may work well in the event of a shareholder's death, but forget that the same provisions will govern in the case of a lifetime transfer. Because these agreements are designed for one event and used for another and the result is at minimum, an impetus for re-negotiation, and at worst, a nightmare.

Let's look how two owners' exclusive focus on death, crippled them when the thing they least expected happened.

H&T Custom Tack almost didn't get out of the corral. Harry and Tom had talked about pooling their resources (Harry's thriving tack business and Tom's reputation as one of the best custom saddle makers in Texas) for years when Tom's twin brother had a

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heart attack at age 55. Tom realized that life was too short to keep talking about creating a partnership and the two decided to merge their talents at last.

Along with all of the other documents that Tom and Harry's attorney insisted on was a buy/sell agreement that established the price and the terms of the sale or purchase. Embedded in its creation was the assumption that one of them (probably Tom since he was eight years older than Harry) would die and Harry would purchase Tom's ownership using life insurance proceeds.

The good news was that Tom answered the wake up call to improve his life and lifestyle. He not only created a successful company, he replaced his daily drive across town to grab a chicken-fried steak or cheeseburger with brisk walks to the new vegetarian salad joint. He joined his wife for long bike rides on weekends and boasted that he'd never felt better.

The "bad" news was that before either of them rode off to join the Big Rodeo in the Sky, Harry began to think about retiring and selling out. A quick look at the buy/sell agreement told him that he had to sell his stock to Tom based upon the price they had established when they assumed that there would be more than adequate funding because of the existence of a life insurance policy.

Harry and Tom's problems were just beginning. Because the price established in their buy/sell agreement had nothing to do with the fair market value of the company when one of them wanted to sell out, the price the buyer would pay was likely to be substantially higher or lower than the company's current value. This means that one or the other partner would suffer.

Some owners resolve this problem by agreeing to ignore their buy/sell agreement and to hire a Certified Business Appraiser to establish a fair market value for the company. Harry suggested this route, but Tom insisted that they abide by their original agreement. First, Tom did not want to put a damper on the future growth of the company by siphoning off its cash flow toward Harry's buy out. Second, the value in the buy/sell agreement was significantly lower than the company's current value.

Harry felt he had proposed a fair alternative, resented Tom's intransigence and didn't want to sell his ownership interest for what he believed was an artificially low price. As you can imagine, the two partners stopped speaking.

Harry's issue with the price was just the first hurdle. Because Harry and Tom had presumed that only death would separate them, they had done no planning to minimize the tax consequences of a lifetime sale. Further, since they assumed the survivor would use life insurance proceeds (rather than company cash flow) to fund the buy out of the deceased shareholder's interest, they had established a very short—only four-year—timeframe to pay for the purchase. Finally, their buy/sell included no "forced buyout provision" to resolve irreconcilable differences between the owners.

In short, the only way for Harry to leave the company with the amount of cash he felt he was owed was to die. Until he could do that, he was left owning a company whose performance he had absolutely no reason to improve.

The best, and perhaps only, good way to prevent this impasse with your company is to address, right now, potential problems caused by a buy/sell agreement drafted years ago for a transfer event (death) that is not the event (lifetime transfer) most likely to occur. If you suspect that your agreement may be inadequate, review it today… before one owner decides it is time to ride off in the sunset. ❐

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VALUING FRACTIONAL INTERESTS IN REAL ESTATE

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Common sense dictates that a partial interest in real estate is worth less than the strict pro-rata share of the full value of the property. Determining an appropriate discount from that pro-rata value is more difficult. The IRS has long asserted that estimating the costs associated with a partition of the property is the proper method of determining that discount. However, partition costs represent only a portion of the factors considered in determining the discount for a fractional interest in property.

Legal cases are often cited by professionals that indicate that a discount could be as high as 60 percent, and that 40 percent is “normal”. This can lead to unrealistic expectations when an appraisal of a fractional interest is completed. Very high discounts often only apply when the value of the property is relatively low, and partition costs represent a substantial portion of the value of the real property. In addition, appraisers cannot cite court cases in the development of an appropriate discount. We must develop the discounts based on the facts and circumstances of each situation, and the overall discount must be supportable.

There are few transactions where fractional interests in real estate are sold. Since we have little transaction data to rely on, the appraiser must develop the discount. A fractional interest in real estate is not equivalent to a minority interest in a limited partnership or a limited liability company, and the application of discounts for lack of control and lack of marketability,

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essentially treating the fractional interest as if it were a legal entity are not appropriate. A fractional interest owner does not have the same protections, limitations or restrictions as a minority owner of an interest in a LP or LLC. An owner of an undivided interest in real property holds a direct interest in the real property in relationship to the percentage owned. This owner has several rights under real estate law: A voice in direct management of the property, a right to the pro-rata share of income and expenses, and the right to initiate a partition discussion with the other fractional interest owners and a subsequent partition action through the legal process, without a requirement of due cause.

Partition costs are a factor, as partitioning is one of the remedies a fractional interest owner has available. However, partition costs are only one factor in developing an appropriate overall discount. The appraiser must consider the value of the subject property. The higher the value, the more likely a fractional owner might pursue litigation in a partition action. The size of the subject interest, the number of other fractional interest owners, the location of the property, along with the condition of the improvements on the property are all factors that must be considered. Whether or not the property is income producing is also a factor. These and other relevant factors are considered to arrive at an appropriate discount for a fractional interest in a real estate property. ❒

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– Theodore Roosevelt

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