

## **Alberty.com - Summer 2003 Newsletter**

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### **LLC Buy-Sell Agreements**

Almost all small businesses have buy-sell agreements (except those with only one owner). This is true whether they are organized as corporations or LLC. But while the functions of a buy-sell agreement are the same regardless of how a business is organized, the form and structure of buy-sell agreements of LLCs differ from those of corporations.

Buy-sell agreements serve two functions B they restrict transfers of interests in the business and create a limited market for the interests. Restricting transfers is important to prevent interests in a business from falling into the hands of outsiders who aren't active participants in the business or who lack a long-term commitment to the business. Although few people are interested in purchasing interests in closely held businesses, sales do sometimes occur. In addition, outsiders can acquire interests as a result of involuntary transfers in creditors' rights or marital dissolution proceedings involving a business owner, and business interests can be transferred by gift or by contribution to the capital of another business entity. Buy-sell agreements typically seek to restrict transfers of all types by giving the business or the other owners the right to purchase any interest that an owner wishes to transfer voluntarily or that has been transferred involuntarily.

The lack of a market for interests in small businesses can create an awkward situation when an owner retires, becomes disabled, or dies. The affected owner will no longer be employed by the business, and the owner, or his or her family, may need to liquidate the business interest to pay living expenses or to seek investments providing a greater current return. At the same time, the other owners may prefer not to have a co-owner who is no longer involved with the business B and very likely will be even less interested in having members of the former owner's family as co-owners. The interests of all parties can be accommodated if a buy-sell agreement requires the business or the other owners to purchase the interest of an owner on retirement, death, or disability. By specifying the price and terms of purchases, the buy-sell agreement can also streamline ownership transitions and avoid costly disputes at times when a business may already be vulnerable as a result of having lost one of its principals.

One difference between buy-sell agreements of corporations and those of LLCs is the identity of the purchaser of interests that are subject to transfers and of interests of retired, deceased, or disabled owners. Corporate buy-sell agreements typically give the other shareholders the right to purchase shares of stock subject to a transfer and impose the obligation to purchase the shares of a retired, deceased, or disabled shareholder on the other shareholders. Having the other shareholders make the purchase results in their acquisition of a tax basis in the purchased shares equal to the purchase price paid. This increased tax basis limits the amount of gain the shareholders must recognize when they sell their shares or when the corporation is liquidated. If the corporation purchases the shares, there is no increase in the tax basis of the corporation's shares.

Tax basis is less of a concern in the context of an LLC because section 734 of the Internal Revenue Code permits an LLC taxed as a partnership to adjust the tax basis of its assets to reflect the purchase price paid for a member's interest. If the LLC makes an election under section 754 of the Internal Revenue Code, the tax basis of its asset will often be increased when the LLC purchases the interest of a member in connection with a transfer of the interest or the retirement, death, or disability of the member, and this increased tax basis will reduce the gain that is passed through to the members when the LLC sells its assets (although it won't reduce the gain realized by members on a sale of their interests or on liquidation of the LLC). The increased tax basis in the LLC's assets can also increase the amount of depreciation and amortization deductions that can be passed through to members.

Because LLCs can step up the basis in their assets when they purchase members' interests, it is more common for LLC buy-sell agreements to designate the LLC, rather than the other members, as the purchaser of interests of transferring, retiring, deceased, or disabled members. Having the LLC make the purchase has the following advantages:

- The LLC is typically the source of the cash to make the purchase, and having the LLC make the purchase avoids the need make arrangements for the LLC's distribution of cash to members to enable them to fund a purchase;
- If an installment purchase is made, the LLC is generally in a position to deduct the interest paid, whereas interest paid by members may be nondeductible under the rules of sections 163(d) and (h) of the Internal Revenue Code relating to investment and personal interest;
- A purchase of a member's interest by the LLC isn't counted for purposes of determining whether there has been a sale or exchange of 50 percent or more of the members' interests in a 12-month period, which triggers a termination of the LLC for income tax purposes under section 708 of the Internal Revenue Code; and
- If the buy-sell agreement requires purchase of a member's interest on death or disability and the obligation is funded with insurance, the LLC can purchase a single life or disability policy, avoiding the multiple policies needed if the other members are required to make the purchase.

A second difference between corporate buy-sell agreements and those of LLCs relates to the form of the agreement. Corporate buy-sell agreements are generally separate from the corporation's organizational documents. Putting buy-sell provisions in a separate agreement imposes obligations on individual shareholders and protects minority shareholders against loss of their rights if the majority amends the corporation's organizational documents. It also avoids cluttering the corporation's articles of incorporation with buy-sell provisions. Although LLCs can have stand-alone buy-sell agreements, most LLCs incorporate buy-sell provisions into their operating agreements along with the other provisions defining the rights and obligations of their members.

Corporate buy-sell agreements also typically require notice of their transfer restrictions to be included on stock certificates, whereas LLC buy-sell agreements don't concern themselves with notice to third parties. This difference results because shares of stock are freely transferable under state corporation law and the Uniform Commercial Code provides that purchasers of shares are not bound by restrictions of which they had no notice. Although LLC members' economic

interests are transferable, transfers of voting or management rights are ineffective under state LLC statutes unless the other members agree to accept the transferee as a substituted member of the LLC. In addition, interests in LLCs are not typically represented by certificates or other documents.

It's important for LLC buy-sell agreements to impose transfer restrictions even though state law may limit members' ability to transfer anything but their rights to profits and to distributions made by the LLC. Many small businesses reinvest a large percentage of their profits or cash flow in the business, and a third party who acquires a member's economic rights may try to force the LLC to make larger distributions. In some states, a transferee of a member's interest who is dissatisfied with the return being received from the LLC can petition a court to dissolve the LLC.

### **Document Formatting**

While the content of a legal document is more important than its form, the way a document looks can have a significant impact on its readability. The more readable a document is, the greater the chance that the parties will understand their rights and obligations before they sign the document and will return to the document to answer questions that arise in the future.

Readability is influenced by such things as typeface selection, line length, contrast between headings and text, and leaving enough white space to avoid making the page look intimidating. Interestingly enough, the experts tell us that avoiding the use of capital letters also facilitates readability.

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