



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Advising Clients on Buy/Sell Agreements

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Attorney CLE Series



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants



Robert J. Grossman
CPA/ABV, ASA, CVA, CBA



Melissa A. Bizyak
CPA/ABV/CFE, CVA



Brad W. Matthews
CPA, CVA

Business Valuation Services Group

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Advising Clients on Buy/Sell Agreements

INTRODUCTION



Advising Clients on Buy/Sell Agreements

INTRODUCTION

- ***Importance of a Buy/Sell Agreement***
 - Failure to address complex potential equity owner exit issues is one of the most prolific drivers of controversy and litigation among business partners
 - Many of these negative outcomes can be easily avoided with a properly crafted buy/sell agreement



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INTRODUCTION

- ***Timing of the Buy/Sell Agreement***
 - Inception/early stages of business lifecycle
 - Alignment of interests
 - During later stages of business lifecycle
 - Not always as smooth, but necessary
 - » Later modification as circumstances dictate



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INTRODUCTION

- ***Issues with no Buy/Sell Agreement***
 - No identification of applicable events
 - Lack of guidance
 - Lack of clarity



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INTRODUCTION

- *Arizona Tea*
 - Founded by two friends, John Ferolito and Dominick Vultaggio in 1992
 - Ended in 2014 after “a six year knock down, drag-out battle”



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INTRODUCTION

- *Arizona Tea Case*
 - Sells iced tea and related products
 - Initially,
 - Ferolito managed finance issues
 - Vultaggio managed warehouse operations
 - Mid 1990's
 - Vultaggio moved to front office
 - Trouble started between the two



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INTRODUCTION

- *Arizona Tea Case*
 - 1997 Ferolito ceded day to day control
 - ... via formal agreement



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INTRODUCTION

- *Arizona Tea Case*
 - In 2007 Ferolito started to explore a sale of his shares to Tata Global Beverages, Ltd.
 - Ferolito had given up day to day control to Vultaggio and the agreement required that both founders had consent to any sale of company stock to outsiders
 - Attempts to have the agreement deemed unenforceable were not successful
 - Vultaggio then elected to buy the shares, when the primary issue became valuation



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INTRODUCTION

- *Arizona Tea Case*
 - Valuation issues
 - Standard of value
 - Financial value versus strategic value



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INTRODUCTION

- *Arizona Tea Case*
 - Final resolution
 - Financial control value at \$2.4B



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INTRODUCTION

- *Arizona Tea Case*
 - Buy/Sell Agreements
 - Responsibility rests with attorney
 - Aided by valuers and financial advisors
 - Perhaps the take away from this case is that even business partnerships forged by friends over sweet tea can go sour.



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INTRODUCTION

- *Core planning elements in consideration of buy/sell agreements*
 - Identify the parties to the agreement and the rights granted each party thereunder
 - Identify the available structures to allow for the selection of the one that presents the most desirable transition and tax outcomes



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INTRODUCTION

- *Core planning elements in consideration of buy/sell agreements*
 - Identifying and defining all appropriate trigger events
 - Identifying and defining the proper manner to set the price of the equity interests
 - Identify and define the terms of payment and the mechanisms by which the consideration will be paid



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INTRODUCTION

- *Chapter II: Fundamental Considerations in Buy/Sell Agreement*
- *Chapter III: Structure Considerations*
- *Chapter IV: Valuation*
- *Chapter V: Case Law Examples of Problem Areas in Buy/Sell Agreements*
- *Chapter VI: Concluding Thoughts and Practical Considerations*



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FUNDAMENTAL CONSIDERATIONS OF BUY/SELL AGREEMENTS



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FUNDAMENTAL CONSIDERATIONS

- *Elemental causes of poorly crafted buy/sell agreements date to the creation of the business itself*
 - Parties are more likely to be agreeable to a fair and reasonable buy/sell agreement
 - Goals and objectives of the business are in their closest state of synchronization to those goals and objectives of the equity ownership group at inception



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FUNDAMENTAL CONSIDERATIONS

- ***Buy/Sell Agreement Fundamentals***
 - Buy/sell agreements generally provide for the following:
 - Timing of co-owner sales of their equity ownership interests
 - Whether the co-owner departure is mandatory or optional
 - What trigger events mandate the departure of a co-owner



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FUNDAMENTAL CONSIDERATIONS

- ***Buy/Sell Agreement Fundamentals***
 - Buy/sell agreements generally provide for the following:
 - How the value of the co-owner's equity ownership interest is to be determined
 - The terms under which the value of the co-owner's equity interest will be paid
 - The funding mechanism by which the exiting co-owner will be paid



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FUNDAMENTAL CONSIDERATIONS

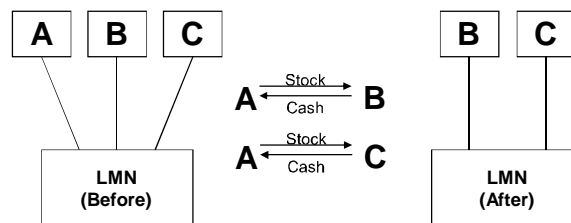
- *Types of buy/sell agreements*
 - Cross-Purchase Agreements
 - Entity Purchase or Redemption Agreements
 - Mixed, or Hybrid, Agreements



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FUNDAMENTAL CONSIDERATIONS

- *Cross-Purchase Agreement*

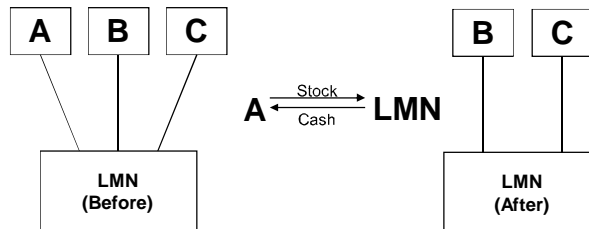




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FUNDAMENTAL CONSIDERATIONS

- *Entity Purchase or Redemption Agreements*



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FUNDAMENTAL CONSIDERATIONS

- *Critical Elements of Buy/Sell Agreements*

- Selecting the most appropriate type of agreement
- Setting restrictions on transferability of the equity interests
- Identifying the events which invoke the provisions of the buy/sell agreement
 - Trigger events: death, disability, default and divorce



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FUNDAMENTAL CONSIDERATIONS

- *Critical Elements of Buy/Sell Agreements*
 - Establishing a definition of value for the equity interests and those procedures necessary for valuation
 - Setting the terms of payment by which the departing equity owner will be paid
 - Setting forth the funding mechanisms from which payments will be made
 - Setting forth the means for dispute resolution



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STRUCTURE CONSIDERATIONS



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STRUCTURE CONSIDERATIONS

- **3 General Structure Alternatives**
 - Cross Purchase Agreement
 - Entity Purchase/ Redemption Agreement
 - Hybrid



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STRUCTURE CONSIDERATIONS

- **Cross Purchase Agreement**
 - Each equity owner is provided a right to acquire all, or a portion of, the departing equity owner's ownership interest
 - Generally, proportionate to remaining equity owners' interest(s)



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STRUCTURE CONSIDERATIONS

▪ *Cross-Purchase Agreements*

– Advantages

- Remaining equity owners of the departing equity owners will have a tax basis equal to their “cost”, presumably the amount they each pay for the equity interest
- If the trigger event is caused by death of an equity owner, any purchase of that equity interest will be “tax free” to the departing owner’s estate or heirs
- Life insurance proceeds received by the surviving equity owners are not subject to income taxation



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STRUCTURE CONSIDERATIONS

▪ *Cross-Purchase Agreements*

– Disadvantages

- Difficulty in administering the plan if there are numerous equity owners who are afforded the opportunity under the agreement to buy a departing equity owner’s interest as a result of the occurrence of a trigger event
- Age or insurability can create a disparity in the cost of insurance and the required premiums



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STRUCTURE CONSIDERATIONS

▪ *Equity Interest Redemption Agreements*

– Advantages

- More simple administrative process by putting responsibility for the acquisition of the departing equity owner's interest with a single buyer, i.e., the company
- The company bears the premium differences associated with age disparities among equity owners



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STRUCTURE CONSIDERATIONS

▪ *Equity Interest Redemption Agreements*

– Disadvantages

- The remaining equity owners do not get the benefit of a step-up to the cost of the equity interest in their bases when the company purchases the deceased equity owner's interest
- Redemption structure creates greater capital gains upon the ultimate disposition of shares if made before death of any of the remaining equity owners



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STRUCTURE CONSIDERATIONS

- *Estate Tax Considerations*
 - When a cross-purchase structure is used, the proceeds from the life insurance are not included in the deceased shareholder's estate
 - If an equity interest redemption structure is adopted, the estate tax implications can become more pronounced



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STRUCTURE CONSIDERATIONS

- *Estate Tax Considerations*
 - Values determined or set out in buy/sell agreements may not be found to be indicative of fair market value



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STRUCTURE CONSIDERATIONS

- *Estate Tax Considerations*
 - IRS requires that the buy/sell agreement constitute a “bona fide” agreement under IRC §2703
 - The agreement must not be device to transfer property to the decedent’s family for less than “full and adequate” consideration



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STRUCTURE CONSIDERATIONS

- *Estate Tax Considerations*
 - The agreement must have terms comparable to those of similar agreements entered into by persons in an arms length transaction



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STRUCTURE CONSIDERATIONS

- ***Funding Buy/Sell Agreements with Insurance***
 - Whole life vs. term
 - Equity owners should ensure that additional life insurance can be obtained over time to keep pace with the increasing value of the company's equity interests



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STRUCTURE CONSIDERATIONS

- ***Funding Buy/Sell Agreements without Insurance***
 - Equity owner groups that elect not to fund departing equity owner settlements with life insurance typically expect that all funding will come from operating cash flows generated by the company
 - Regardless of the corporate form, earnings may be strategically accumulated so they can fund needed buy/sell settlements



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STRUCTURE CONSIDERATIONS

- ***Combination Funding of the Buy/Sell Agreement***
 - Equity owners choose to have a portion of the buy/sell agreement funded with life insurance to guard against premature deaths, while funding the remainder from future operating free cash flows and corporate profits – perhaps an 80%/20% split
 - Alternatively, shareholders may elect to initially fund 100% of the buy/sell agreement with a cross-purchase structure funded by insurance



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STRUCTURE CONSIDERATIONS

- ***Other Funding of the Buy/Sell Agreement***
 - Seller funding
 - External funding
 - Sinking funds



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VALUATION



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VALUATION

- *Standards of Value*
 - Description of the “type of value” that is called upon by the buy/sell agreement
 - The complexities associated with fully understanding the standards of value often requires detailed advisor input from both legal counsel and the business valuator



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VALUATION

- *Standards of Value*
 - Fair Market Value
 - The key consideration in any determination of fair market value is that the hypothetical buyers include all possible buyers in the entire universe of potential buyers
 - Anticipates a value determination under prevalent economic and market conditions at a particular date of valuation
 - Assumes that payment in the hypothetical transaction will be made in cash or its equivalent at the date of valuation



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VALUATION

- *Standards of Value*
 - Fair Market Value
 - Incorporates all economic risks associated with an investment in the subject equity interest
 - Must allow reasonable time for exposure in the open market



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VALUATION

- *Standards of Value*

- Investment Value

- The specific value of an investment to a particular investor or class of investors based on individual investment requirements and attributes
- Also referred to as synergistic or strategic value
- In most instances, investment value will exceed fair market value



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VALUATION

- *Standards of Value*

- Intrinsic or Fundamental Value

- Represents a specific analyst's judgment of value based on the perceived characteristics inherent in the specific or particular investment
- Used sporadically in courts throughout the United States, and most often in marital dissolution proceedings, its overall use is extremely limited and rarely found in buy/sell agreements



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VALUATION

- *Standards of Value*

- Fair Value Under State Statutes

- In most states, fair value is the statutory standard utilized to resolve shareholder disputes for both dissenting shareholder and oppressed shareholder lawsuits and civil actions
- The majority of those offer little insight into its computation



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VALUATION

- *Standards of Value*

- Fair Value for Financial Reporting

- Driven by accounting literature and guidance
- FASB Accounting Standards Codification 820 provides guidance on the measurement of fair value as a market-based measurement



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VALUATION

- *Standards of Value*

- Hybrid Standards of Value

- Often buy/sell agreements are drafted with some variations of the concepts set forth above in various definitions, or standards of value
- Adopting a specific standard of value in the context of drafting a buy/sell agreement and adding language to modify it requires great care and consideration at the outset of the business when the agreement is created



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VALUATION

- *Standards of Value – Example Language*

- The price at which the remaining equity owners will acquire the ownership interest of any departing equity owner and the price at which the departing equity owner will sell his ownership interest will be equal to and based solely on the conclusion of value produced in the course of a business valuation performed in accordance with the mandates of this paragraph of the buy/sell agreement. No other provisions within this agreement should be interpreted to impose in any way a different process than that set forth herein.



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VALUATION

- *Standards of Value – Example Language*

- The standard of value to be used in this business valuation is fair market value, as that term is defined within the *International Glossary of Business Valuation Terms*, adopted in 2001. The term fair market value is intended herein to represent a financial value for the entire equity capital position of the company (not the underlying assets) on a control, marketable basis. All non-controlling or minority equity interest determinations of value will be prepared with consideration of necessary valuation adjustments for lack of control and lack of marketability, if applicable.



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VALUATION

- *Standards of Value – Example Language*

- The conclusion of fair market value will also be determined on a going concern premise of value, as that term is defined within the *International Glossary of Business Valuation Terms*, adopted in 2001. The going concern premise of value, as set forth herein, is intended to define the fair market value of the company as it is currently operating at the date of valuation with its specific complement of assets at any required date of valuation. No consideration is intended to be given to possible synergistic or strategic acquisition premiums in the course of the fair market value determination.



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VALUATION

▪ *Premise of Value*

- Five most common premises of value:
 - Value in continued use, as going-concern business enterprise
 - Value in place, but not in current use in the production of income
 - Value in exchange, as part of an orderly disposition of assets
 - Value in exchange as part of a voluntary liquidation of assets
 - Value in exchange, as part of an involuntary liquidation of assets



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VALUATION

▪ *Levels of Value*

- Traditional Model
 - Three levels are based upon a financial value
 - Envisions the same measurement type with varying equity ownership interest characteristics
- Expanded Model
 - The fourth level included in the expanded model is based upon strategic or synergist value



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VALUATION

- ***The Valuation Date***

- Various dates of valuation often include:
 - The date of notification
 - The date of equity owner departure
 - The date of transaction closing
 - The last quarter or year end
 - The date of specific trigger event



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VALUATION

- ***Business Valuation Protocol and Process***

- “Pre-Set” or “Fixed” Value
 - Many agreements reviewed by the presenters have a pre-set value that was agreed upon by all of the parties to the agreement
 - The important consideration in adopting a pre-set or fixed value lies within the means by which that number was determined



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VALUATION

- ***Business Valuation Protocol and Process***
 - Formulaic Determination of Value
 - Evaluating the credibility of any formula approach rests with carefully analyzing the underlying assumptions and the construct of the formula
 - No formula can adequately incorporate all facets of a business valuation process undertaken in consideration of professional standards



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VALUATION

- ***Business Valuation Protocol and Process***
 - No Process of Any Kind
 - The worst position is a buy/sell agreement that fails to address the valuation protocol or process in any manner



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VALUATION

- ***Business Valuation Protocol and Process***
 - A Full Business Valuation
 - Prepared by an accredited business valuator and undertaken in accordance with professional standards is clearly the best means by which to set a value that is defensible, appropriate and fair to all parties to the agreement
 - An accredited business valuator can accept a calculation engagement, which is a service well below the level of a full business valuation

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VALUATION

- ***Business Valuation Protocol and Process – Example Language***
 - The business valuation required under the prior provision (paragraph___) is to be conducted by an accredited business appraiser carrying one or more professional credentials issued by the American Society of Appraisers, the National Association of Certified Valuators and Analysts, or the American Institute of Certified Public Accountants. The business appraiser must be in good standing with the credentialing organization.

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VALUATION

- ***Business Valuation Protocol and Process – Example Language***
 - The business valuation is intended to be a “full” valuation (versus a calculation of value) as that term is defined in the professional practice standards for valuation services by the American Institute of Certified Public Accountants, (VS Section 100), the National Association of Certified Valuators and Analysts (NACVA) Professional Standards or the Uniform Standards of Professional Appraiser Standards (USPAP), issued by the Appraisal Foundation.



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VALUATION

- ***Business Valuation Protocol and Process – Example Language***
 - The procedures utilized by the selected business valuator/appraiser are to be conducted in accordance with the above-noted professional standards of practice.



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VALUATION

- *Appraiser Qualifications and Professional Standards of Valuation Practice*
 - American Institute of Certified Public Accountants (AICPA)
 - National Association of Certified Valuators and Analysts (NACVA)
 - American Society of Appraisers (ASA)
 - Institute of Business Appraisers (IBA)



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VALUATION

- *Scope of the Engagement*
 - Valuation Engagement
 - An appraiser performs a valuation engagement when the project calls for the valuator to opine on the value of the subject interest
 - Valuations involved an ongoing process of gathering, updating, and analyzing information



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VALUATION

- *Scope of the Engagement*

- In performing a valuation engagement the appraiser should:
 - Fully understand and analyze the subject interest
 - Consider and apply appropriate valuation approaches and methods
 - Prepare and maintain appropriate documentation



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VALUATION

- *Scope of the Engagement*

- Calculation engagement
 - The purpose of a calculation engagement is to estimate value, wherein the appraiser and the client agree on the specific valuation approaches and methods that the appraiser will employ and the extent of the valuation procedures that he or she will perform to estimate the value of the subject interest



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VALUATION

▪ *Scope of the Engagement*

- In performing a calculation engagement the appraiser should consider the following:
 - Identity of the client and the subject interest
 - Purpose and intended use of the calculated value
 - Intended users of the report and limitations on its use
 - Effective date of the calculation



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VALUATION

▪ *Scope of the Engagement*

- In performing a calculation engagement the appraiser should consider the following:
 - Applicable premise of value and standard of value
 - Whether or not the business interest has ownership control and its degree of marketability



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VALUATION

- *Scope of the Engagement*

- In performing a calculation engagement the appraiser should consider the following:
 - Sources of information used in the calculation
 - Valuation approaches and methods agreed upon with the client
 - Subsequent events, if applicable



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CASE LAW EXAMPLES OF PROBLEM AREAS IN BUY/SELL AGREEMENTS



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Matter of the Estate of Maurice F. Frink, No. 6-433***
 - Dispute concerns a 1974 amendment to the corporate by-laws of Flowerama of America, Inc., restricting the transfer of corporate stock upon the death of a shareholder
 - The purchase price at date of death was to be determined by the accountant who regularly prepares the balance sheets and profit and loss statements for the corporation



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Matter of the Estate of Maurice F. Frink, No. 6-433***
 - The corporation purchased the shares of two shareholders for the book value price at their respective dates of death
 - Upon the death of the majority shareholder the book value price was also determined; however the executor of his estate refused the offer and litigation ensued
 - Court enforced the buy/sell agreement



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Etienne v. Miller, No. F049110***
 - Matter before the court was whether a buy/sell agreement between two brothers should be enforced against a trust holding the brothers' businesses and business interests
 - Beneficiaries argued enforcement of agreements would create a significant estate tax burden as it provided for lower than market value prices



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Etienne v. Miller, No. F049110***
 - Court found that trustee should enforce the agreements as non-enforcement would negate the purpose of the trusts



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Tynes E. Mixon, III, M.D. v. Iberia Surgical, LLC, No. 06-878***
 - Case involves shareholders who dissented over the formula valuation provisions in the LLC agreement
 - Members of LLC executed an operating agreement providing members may be terminated without cause and on August 28, 2002, Dr. Mixon was terminated from Iberia Surgical by unanimous membership vote
 - Operating agreement contained a buy-out provision based on book value



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Tynes E. Mixon, III, M.D. v. Iberia Surgical, LLC, No. 06-878***
 - Mixon's interest was valued at book value in accordance with operating agreement
 - Mixon appealed and obtained his own CPA to value his interest who argued that book value and fair market value are not the same
 - Court agreed book value and fair market value are not the same but rejected Mixon's appeal



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Wood v. Wood, 361 S.W.3d 36***
 - Stephen Wood (husband) owned 30% interest in a privately held flooring store and Heidi Wood (wife) filed a petition for dissolution of marriage.
 - At the divorce trial, both husband and wife presented expert testimony on the value of the husband's interest in the business



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Wood v. Wood, 361 S.W.3d 36***
 - Wife's expert applied the valuation formula contained in company's buy/sell agreement while Husband's expert presented an opinion of fair market value
 - Trial court found wife's expert to be more persuasive
 - Appeals court concluded that trial court misapplied the law and reversed and remanded for proper determination of value



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***In re the Marriage of Barnes, No. 2006AP3020-FT***
 - Husband entered into LLP agreement with his parents; however the agreement did address divorce as a trigger event
 - Trial court adopted wife's proposed valuation using the formula in the withdraw provisions of the agreement
 - Husband appealed arguing liquidation valuation method
 - Court found Husband's argument flawed



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CASE LAW EXAMPLES OF PROBLEM AREAS

- ***Estate Planning Matters – Tax Court Cases***
 - Estate of Laude v. Commissioner, Estate of True v. Commissioner and Estate of Blount v. CIR
 - Buy/sell agreements can be critical for estate planning purposes and in some cases the fair market value of the interest for federal estate tax purposes may be defined in the agreement.



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CASE LAW EXAMPLES OF PROBLEM AREAS

- *Estate Planning Matters – Tax Court Cases*
 - The following factors must be true:
 - Price must be fixed and determinable under the agreement;
 - Agreement must be binding in life and death;
 - Agreement must have a bona fide business purpose;
 - Agreement must not be a testamentary device; and
 - Agreement must be similar to those entered into at arm's length

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CONCLUDING THOUGHTS
and
PRACTICAL CONSIDERATIONS

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CONCLUDING THOUGHTS AND PRACTICAL CONSIDERATIONS

- *How to best address client needs in this all important area?*



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CONCLUDING THOUGHTS AND PRACTICAL CONSIDERATIONS

- *Know the client*
 - Key concerns and goals
 - How to best ensure entity continuance during ownership group transition



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CONCLUDING THOUGHTS AND PRACTICAL CONSIDERATIONS

- ***Know the client***
 - Develop preliminary baseline recommendations
 - Meet with client
 - Refine recommendations with advisor groups input
 - Draft documents
 - Periodic reviews to ensure optimum confidence



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CONCLUDING THOUGHTS AND PRACTICAL CONSIDERATIONS

- ***Experience and Service Capabilities***
 - See page 59



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QUESTIONS?

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THANK YOU!

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