

Protecting your business

Why you need a buy-sell agreement

What would become of your business if something happened to you, your business partner or a fellow shareholder?

If an owner dies, becomes disabled, divorces, declares bankruptcy or simply retires, your business could be thrown into turmoil. Not only would family members and employees be affected, but the value of the business could fall.

There might even be a question of whether the business would survive at all. It is important to look to the future and realize that the value of a business built by long hours over many years can be significantly affected when ownership changes.

Do you and other key members of your business have an agreement describing what happens in the event of the death, disability or withdrawal from the business of one of the owners?

If you don't, develop one. If you do, keep it current.

What is a buy-sell agreement?

A buy-sell agreement is an essential part of succession planning. It is an agreement among the owners that sets down their rights with respect to each other and the business. It describes what would happen in the event of the death, disability or retirement of any of the owners.

The real benefits of a buy-sell agreement are to create the framework for choices about how to deal with shares of the company and to try to eliminate friction over price and terms.

Buy-sell agreements may ensure a fair price to the purchaser of the stock, generate liquidity to pay estate debts and taxes, and provide income to a surviving spouse. Buy-sell agreements can be funded by life insurance, and the agreement may provide the purchase price, or a substantial part of it, for the shares.

In some circumstances, the agreement may involve a future prospective buyer. A sole owner might negotiate an agreement with a prospective buyer to purchase the business under certain terms in the event of the owner's death or retirement.

Without a buy-sell agreement, the surviving spouse or other family members may have to deal with finding a prospective buyer as well as placing a value on the business.

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Why should businesses have a buy-sell agreement?

Buy-sell agreements are overlooked far too often. The lack of an agreement can cause unnecessary problems that can destroy a family business, such as uncertainty for next-generation owner-managers, friction with uninvolved family members and inadequate financial resources for estate taxes. Outdated agreements often cause the same problems.

But a properly structured agreement can ensure family harmony and business continuity for future generations.

One of the primary goals of a buy-sell agreement is to provide a plan in which the parties agree to terms for the sale of an asset that is notoriously difficult to value – an interest in a closely held business. The result can be to create a market for the owner's business interest.

A key part of the development of a buy-sell agreement is to look at how to fund the buying party. There is no market for the interest unless the buying party – whether another owner or the business entity itself – has the ability to buy out the selling party's interest.

Another reason to enter into a buy-sell agreement is to avoid undue disruptions in the business. Planning in connection with buy-sell agreements will often address issues of smooth management transition as well as changes in ownership. Buy-sell agreements may also help protect the jobs of your long-time employees and reduce disputes among owners and employees.

Estate tax planning is also a major factor. For example, a buy-sell agreement may contain a valuation for the business interest that will be respected for IRS valuation purposes. With little or no planning, it could be necessary to sell off assets just to pay estate taxes. A lack of planning may result in delays in administering the estate.

What are the types of buy-sell agreements?

The buyer may be an individual or the corporation, depending on tax consequences and funding availability at the time. The agreement should describe whether it will be funded, what the payment terms will be and how the price will be determined. It should also cover any other miscellaneous factors that are important to the provisions of the agreement.

There are three primary types of buy-sell agreements.

1. Cross-purchase agreements

In a cross-purchase agreement, two or more owners or entities purchase the ownership interest directly from the withdrawing party or from the estate of the deceased individual. Assume two shareholders enter into an agreement that the surviving shareholder will purchase the shares of the estate or trust. Each shareholder buys life insurance on the other owner and

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names himself or herself as beneficiary of the policy. Upon the death of one of the shareholders, the surviving shareholder buys the shares. The surviving shareholder then owns 100 percent of the corporation.

Cross-purchase agreements may become unwieldy if there are more than a few shareholders. The advantage of the cross-purchase agreement is that the purchasers have a higher basis in shares, which may reduce tax if they later sell the shares during their lifetime. Also, with a cross-purchase agreement, funding isn't subject to any claims of business creditors.

2. Entity-purchase agreements

In an entity-purchase agreement, the corporation and shareholders enter into an agreement that the corporation will purchase the interest of a deceased or departing owner. The corporation buys life insurance on each shareholder and names itself as beneficiary. The corporation receives the life insurance proceeds upon the death of one of the shareholders and so has liquid funds to buy the shares owned by the estate or trust of the deceased shareholder or departing shareholder.

The surviving shareholders own 100 percent of the corporation as a result of owning all the shares that remain outstanding after the corporation redeems the shares of the former shareholder. Funding is provided by the business, so the business takes out only one life insurance policy on each owner.

3. Hybrid agreements

If circumstances change or the owners don't know for sure whether the cross-purchase or entity-purchase approach will work better later, flexibility may be needed. The hybrid agreement employs a partial entity-purchase agreement and a partial cross-purchase agreement. It often leaves the option of who the buyer is until a triggering event occurs. A business may be given an option to buy all or part of the interest of a departing owner.

Another flexible approach is to give the other owners an option to buy shares or partnership interest, and then obligate the entity to buy any interest not purchased by the remaining owners. The parties may also consider periodic reviews and updates of the buy-sell plan.

What about sole proprietorships?

If your business is a sole proprietorship, the entity-purchase approach is not possible. In a sole proprietorship, if the owner dies, the business will be either sold or liquidated. However, the proprietor may plan this situation by obligating the estate to sell the business to a purchaser, typically an employee or competitor. Or, the buyer may be a family member.

There is no particular procedure for setting the price. The parties may set the price subject to review, determine a price established by a formula, or provide for an appraisal to determine a price. An important consideration is that the valuation should withstand IRS scrutiny.

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What are some issues that need to be addressed?

Structuring a buy-sell agreement is not a simple affair because of the estate and income tax issues, as well as the business and financial matters. There are issues of the relative tax brackets of the parties, the decision of whether to restrict gifts of interests in the business to family members, disparate costs of insurance due to age or health, alternative funding approaches, such as loans among the parties, and others. The possibility of a deadlock exists, as well as other concerns.

Special issues arise with the circumstances of the owners, including whether the parties are related family members. Planning also depends on whether the business is operated as a sole proprietorship, S corporation, C corporation, partnership or limited liability company.

For family businesses owned by groups such as sibling partners or cousin groups, other issues make buy-sell agreements more complex. Deadlock-breaking provisions are important should there be an even number of shareholders divided along family lines.

Provisions should address what happens if some shareholders have previously sold their shares and the company is subsequently sold to a third party. A claw-back provision would provide a method for participation in an after-event transaction by sharing some of the excess proceeds with those who previously had sold their shares.

Too often, buy-sell agreements describe only what happens if a shareholder dies. More often, shareholders retire without any provision for the company to repurchase its stock. Therefore, agreements should specifically address what happens in the event of retirement, termination or disability.

Another often-overlooked provision deals with a situation in which stock goes into trust for a decedent's spouse while the company continues to be run by one or more active family members. With the surviving spouse continuing to control the company, the next-generation owner-managers may become increasingly frustrated as they get closer to their own retirement unless the buy-sell agreement spells out when they will actually become owners of the company.

What are the negatives of having a buy-sell agreement?

About the only possible negative of a buy-sell agreement is that, if the agreement is poorly structured, it might not adequately anticipate future needs and changes in the family, marital or financial circumstances. If it is properly structured, a buy-sell agreement gives the flexibility needed to address the needs of young children, disabilities, fluctuations in value and other changes. Consult your CPA regarding a buy-sell agreement. Ideally, CPAs with knowledge of your business can work closely with attorneys to ensure that the best possible agreement is crafted.