Buy-Sell Agreements

The Important Role they Play in Succession Planning

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What is a Buy-Sell Agreement?

A buy-sell agreement is a legally binding agreement that requires one party to sell and another party to buy a particular ownership interest in a business. A buy-sell agreement can be designed to protect the business from certain triggering events, the most common of which are often referred to as the five D's—death, disability, divorce, departure (either voluntary or involuntary), and disqualification (pertains to malfeasance that would require an individual to be removed from an ownership position). Without a written buy-sell agreement in place, any of these triggering events could create significant turmoil amongst ownership and have an adverse effect on the continuity of the business long-term. A buy-sell agreement can help avoid:

- Remaining partners or stockholders being forced to sell or dissolve the business.
- The business having to decide how it will compensate the departing owner's family for his/her ownership interest.
- The departing owner or his/her estate not receiving a fair price for the business interest.
- The uncertainty that comes with losing the services of a significant member of the business.

What are the methods of funding buy-sell agreements?

- Cash

There are different methods of funding a buy-sell agreement. One method is to use cash, which has the advantage of being simple and requiring no immediate outlay. The problem is the owners don't know when the cash will be needed. As a result, the owners must always keep an adequate cash reserve available. Instead, some business owners opt to establish a "sinking fund, " which involves depositing a certain amount of cash into an account at set periods of time. Sinking funds tend to be inadequate because triggering events, like death and disability, cannot be predicted so all too often there isn't enough time to build up and maintain a sufficient account balance in the fund. Not to mention, the cash being put into the sinking fund may strain or deplete the business' working capital and may even create an accumulated earnings tax problem.

- Borrow

Another method, borrowing, is similar to the cash approach in that there are the advantages of being simple and requiring no outlay until the triggering event occurs. However, many banks may not lend money to a business that has just lost one of its most important assets—an owner. If a bank does lend the money, the remaining owners must consider the cash flow demands that repaying the loan will have on the operation and credit-worthiness of the business.

What are the methods of funding buy-sell agreements? Cont.

- Installment Sale

An installment payout is another method that comes with substantial risk for all parties involved. An installment sale merely spreads out the obligation, but does not provide the cash to fully execute the buy-out at the point in time the trigger event occurs. An installment payout does not provide the large sums of cash often needed for estate settlement costs and debts, and thus, may not adequately provide the shareholder's family with the desired financial security.

- Insurance

Funding buy-sell agreements with insurance products, specifically life insurance and disability buy-out insurance, is often the most effective method. The generally tax-free death benefit provided by life insurance makes it possible for the remaining owner to purchase the business interests of the departed owner's family without liquidating business assets or taking cash out of the business. This allows the family to immediately receive full fair market value for the business and allows the remaining owner to continue the business operations. In addition, if a buyout occurs during an owner's lifetime (for example, in the instance of a divorce or retirement), the accumulated cash values of a permanent life insurance policy may be used to provide a portion of the buy-out price.

What are the different types of buy-sell agreements?

1. Entity (stock redemption) Plan

Under this plan, the business purchases an owner's entire interest at an agreed upon price if a triggering event occurs. If the business is a corporation, the plan is referred to as a stock redemption agreement. In a partnership context, the plan is called a liquidation of interest. If life insurance is used to fund the agreement, the corporation would own life insurance on the lives of each of the stockholders and use the proceeds to purchase (redeem) their stock at death. This method is fairly simple and straight-forward since the corporation is the owner, premium payer and beneficiary of the policy and the cash value is recorded as an asset of the business on the balance sheet.

2. Cross Purchase Plan

Under this plan, the remaining owners purchase the withdrawing owner's entire interest at an agreed upon price. It is also possible that individuals who are not currently owners (such as employees, outsiders or family members) may be parties to the agreement. This plan requires that each stockholder own insurance on the remaining stockholders. This plan may become cumbersome if there are more than two shareholders. To address this issue, the owners could use a "trusteed" cross-purchase arrangement where a trust would own one policy on each shareholder and represent the shareholders in the transaction, eventually distributing the deceased shareholder's stock to the surviving shareholders.

What are the different types of buy-sell agreements? Cont.

3. One-Way Buy-Sell

The sole owner of a business faces a unique problem—there are no co-owners to buy out the owner's interest when a triggering event occurs. If a potential buyer of the business can be identified, perhaps a family member or a key employee, a special version of the buy-sell agreement can be adapted for the sole-owner situation. This is called the "one-way" buy-sell because only one party (a non-owner) is obligated to purchase the business when a triggering event occurs. The benefit of using a one-way buy-sell is it allows the sole owner to exit the business, say for retirement, and still receive fair market value for the business from another party looking to assume ownership in the future.

How to avoid the seven red flags of buy-sell agreements?

1 **Established incorrectly based on entity type.** Depending upon the entity type of the business, whether it's a C Corporation, S Corporation or LLC, attention must be paid to the type of buy-sell agreement that is used. For example, entity purchase arrangements can be problematic for C Corporations. They can create step-up in basis issues, which can lead to a significant taxable event later on when the remaining owner attempts to exit the business. Plus, if life insurance is used to fund the agreement, the death benefit paid to the company may be subject to the alternative minimum tax, which is unique to C Corporations. This underscores the importance of leveraging a team of experts to draft, execute, and periodically review your buy-sell agreement.

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2 **Established incorrectly based on the number of business owners.** Let's assume a business has five shareholders, and they have agreed to the cross purchase arrangement and each will fund the agreement with life insurance. The question now becomes: how many policies will they need to completely fund the purchase obligations at death? The answer is 20. Needless to say, this is not an appealing situation. When an entity purchase agreement doesn't make sense (see C Corporations above), there is another option called a "trusteed" cross-purchase plan. It's a sensible approach to dealing with multiple policies and works like this: The trustee of the trust holds the insurance policies and the stock certificates. Each stockholder only has an interest as a beneficiary in the four policies not on his or her own life. The trustee makes the premium payments with cash contributed to the trust by the stockholders. The trust owns one policy on each stockholder, just like an entity purchase plan. But the tax results of this plan are the same as a cross purchase plan.

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3 **There are transfer-for-value issues.** This red flag has to do with the relationship amongst the ownership. Life insurance proceeds paid at the death of the insured are usually income tax free. But, the proceeds may be taxable if there has been a transfer-for-value of the policy and the beneficiary is not a "protected party." Protected parties include a corporation in which the insured is a stockholder or officer, a partnership in which the insured is a partner, a partner of the insured, or the insured him/herself. A transfer for value to a co-stockholder is not a protected transaction; therefore a change from a stock redemption plan to a cross purchase plan where the stockholders own each other's policies will subject the proceeds to income tax.

Due to changes recently made as of October 31, 2019, under the Tax Cuts and Jobs Act (TCJA) 2017 regarding the Transfer-For-Value rule, you should consult your personal tax and legal advisor before transferring a life insurance policy.

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How to avoid the seven red flags of buy-sell agreements?

4 | **Doesn't account for all five D's** (death, disability, divorce, departure, disqualification). Every business owner will exit his/her business—either by design or by default. And as we discussed earlier, there are numerous triggering events buy-sell agreements can protect the business from, but at the very least, all buy-sell agreements should at least cover these five.

How to avoid the seven red flags of buy-sell agreements?

5 | **The agreement isn't funded, or even signed.** A lot of good buy-sell agreements have in a sense "gone bad" because they were either never funded or became underfunded as time went on and the value of the company grew. Agreements that were never funded are called "dry" buy-sell agreements. But even more basic than the funding, it's also not uncommon to see good buy-sell agreements never even signed by the owners. A recent case, Selzer v. Dunn (Ct. App. Texas Jan. 31, 2014), illustrated the impact an unsigned agreement can have on a business.

a. Owner A and Owner B were 50% owners in a cleaning business. They discussed entering into a cross purchase buy-sell arrangement numerous times, and even purchased the life insurance policies to fund the agreement, but never executed a written agreement. Each owner paid the policy premiums and each was the sole beneficiary on the other's policy. Owner B died and the life insurance death benefit was paid to Owner A. The trial court and appeals court both concluded that Owner A did not have to use the life insurance proceeds to buy-out the decedent's shares of the business from his estate due to the fact that there was no binding buy-sell agreement signed by both parties. So in the end, Owner A received the death benefit proceeds while Owner B's estate received nothing for the deceased owner's shares in the business.

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How to avoid the seven red flags of buy-sell agreements?

6 | **Inconsistent definition of what is considered "disabled."** Many buy-sell agreements don't define disability, meaning the definition of what is considered disabled is left up to the owners themselves. Another important question to address in the buy sell agreement is exactly who will determine if the person is disabled or incompetent. As previously mentioned, by funding a buy-sell agreement with disability buy-out insurance, you allow the insurance company to define what is considered disabled.

How to avoid the seven red flags of buy-sell agreements?

7 | **No proper valuation has been placed on the business.** If a proper business valuation is not done, the Internal Revenue Service (IRS), or the surviving family members of the deceased owner, may challenge the value that the surviving owners have placed on it. In turn, this could lead to litigation. Determining business valuation is not an easy process, and it is generally recommended that it be done by a professional appraiser. There are a variety of methods and factors to consider when determining business valuation. For most businesses, a simple formula of assets minus liabilities (a book value formula) is not a complete assessment of value. To avoid conflict when the buy-sell agreement is triggered, it is important that all parties involved—owners, spouses, and any other family members—agree on the valuation method that is used. Such a conflict was brought to light in the matter of the Estate of Maurice F. Frink (Iowa App. October 25, 2006).

Once the initial business valuation has been done, it should be adjusted or updated as needed to reflect any dramatic change in business operation or value. A common recommendation is to review a valuation typically every 2-3 years or after a 25% change in revenue, but each case is different and should be discussed with the client's legal advisor.

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Questions?

Thank You