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Buy Sell for Business Owners

ADVANCED PLANNING CONCEPTS

One of the major concerns facing owners of family or closely held businesses is how to effect an orderly transfer of the business to the next generation or to a key employee.

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Business Succession Planning – Buy Sell

One of the major concerns facing owners of family or closely held businesses is how to effect an orderly transfer of the business to the next generation or to a key employee.

The main issue in succession planning is to achieve a smooth transition between the current owner and the future owner(s), while providing a way to turn the business interest into cash needed to pay for liquidity needs, such as retirement income, survivor income or estate settlement costs.

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Once a business owner has taken the critical first step and decided what he/she would like to have happen to the business and has a transition plan in mind, the next step is putting the plan in writing. With a written plan in place, there can be clear communication of expectations and future direction. A written plan, called a Buy Sell agreement, can help maintain stability and lessen the interruption in business operations in the event of an owner's death, disability or retirement. With a legally binding agreement in place, the terms and conditions of the sale are clearly outlined.

Once the agreement is in place, the parties should have a way to fund it. No one benefits from the financial duress caused by an improperly funded Buy Sell agreement and the consequent inability to carry out the terms of the agreement. Some options for funding the agreement include:

Sinking Fund – a sinking fund is dollars set aside by the buyer, accumulated in the years prior to the sale. These funds are often held in an interest-bearing account and may be subject to market fluctuations. Depending on the time frame, the sinking fund may or may not have accumulated the funds needed by the time the triggering event takes place. These funds are typically held in the buyer's name and are subject to the buyer's creditors.

Loans – at the time of the sale, the buyer may borrow money to meet the purchase price. Loans may be an advantage because they require no current outlay of cash. At the time of sale, however, the question of the buyer's creditworthiness may arise and credit lines may be reduced or existing loans may be called, further reducing the availability of loans. Additionally, loans increase costs of the purchase with interest and fees.

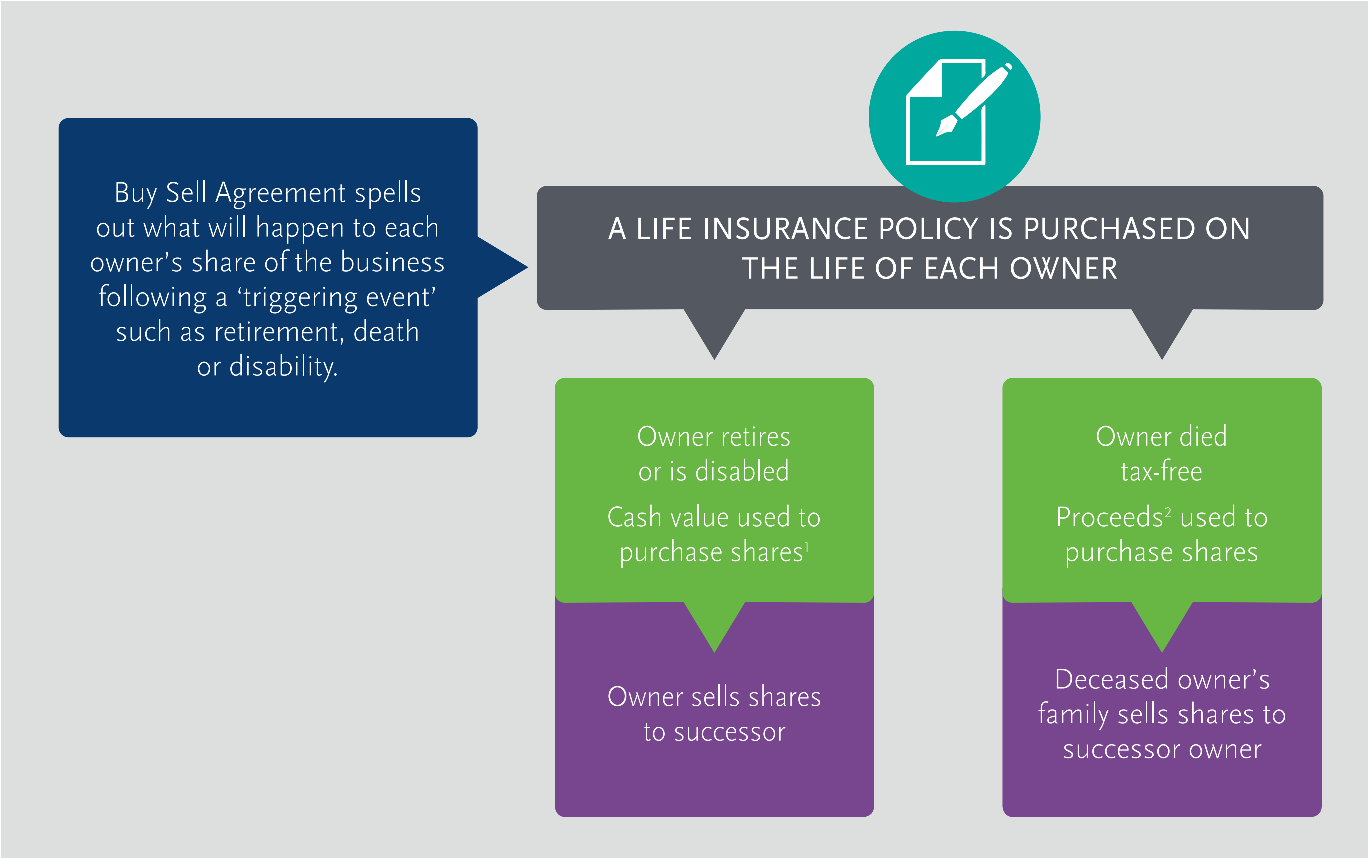
Cash – using cash to fund the purchase in a lump sum can be a drain on both business reserves and personal reserves of the buyer. Like the sinking fund, the buyer may not have cash available to use for the purchase at the time it's needed.

Installment Sale – the money used for the installment payments usually comes from operating income of the business. The departing owner no longer controls the business and he/she or his/her family is dependent on the new owner and his/her ability to run the business profitably. Additionally, the Seller's family doesn't get money up front when needed to pay taxes and other costs.

Life Insurance – often considered the preferred method of funding for many business owners. The funds are available immediately upon the death of the business owner. The family will receive the full purchase price to meet immediate needs, such as estate taxes and other settlement costs. The buyer will need to pay premiums, but the amount is stable and predicable.

Buy Sell agreements generally include provisions such as:

- An obligation to buy and an obligation to sell.
- The names of the individuals who are a party to the agreement.
- 'Triggering events' – events that will cause a sale to take place, such as death, disability, retirement, bankruptcy or loss of professional license.
- Current value of the business and the process used to establish the future value of the business, if necessary.
- When the sale will take place; for example 90 days or six months after the triggering event.
- How payment will be made; for example a lump sum or an installment sale.



Funding

Buy Sell and Life Insurance

If life insurance is used as the funding vehicle, the Buy Sell agreement s hould reference the policy or policies or life insurance in general, with a requirement for the buyer to maintain coverage after the policy has been issued. The buy sell agreement may also require periodic reviews of the amount of life insurance to ensure the funds are available to pay the full purchase price when needed.

Types of Buy Sell agreements

Which type of agreement is appropriate for a particular situation will vary depending on the parties involved and their goals with regard to the business. The four main types of agreements are stock redemption, cross purchase, wait and see, and one-way.

Stock Redemption Agreement

A stock redemption agreement is often referred to as an 'entity purchase' agreement. Under this type of agreement, the business itself is the buyer of the departing owner's business interest. At the time of the triggering event, the business redeems or buys back the outstanding shares/interest. These shares are retired as treasury stock and are not reissued to any remaining owners. As such, the remaining owners increase their ownership percentage, but the basis in their shares remains the same. If a stock redemption agreement is funded with life insurance, the business pays the non-deductible premiums and is the owner and beneficiary of a policy on the life of each owner.

Stock redemption agreements are most appropriate for a business with multiple owners, owners with disparate ages, or ownership interest, or unhealthy owners which require larger premiums to fund the agreement. One of the benefits of the stock redemption is that only one policy is needed per owner, and the funds used to purchase the policies come from the business. Since the business owns the policies on the lives of its owner-employees, the business is required to comply with the new employer owned life insurance rules in order to avoid taxation of the proceeds.[3]

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1 Assuming sufficient cash value has accumulated within the policy. Policy loans and withdrawals will reduce the death benefit and cash value and may result in a taxable event. Surrender charges may reduce the policy's cash value in early years.

2 Internal Revenue Code § 101(a)(1). There are some exceptions to this rule. Please consult a qualified tax professional for advice concerning your individual situation.

3 Employer must meet the notice and consent requirements and one of the exceptions listed under IRC Section 101(j) and reporting requirements of Section 6039I.

Cross Purchase Agreement

By comparison, a cross purchase agreement is an agreement between the individual owners of the business. At the time of a triggering event, the remaining owners are obligated to purchase the shares of the departing owner. If a cross purchase agreement is funded with life insurance, each owner purchases a policy on the life of each of the other owners. Under this type of agreement, the remaining owners receive a basis adjustment in the amount paid to the departing owner or his/her estate.

When the business has more than two owners, the number of policies needed to fully fund the agreement can be onerous. Each owner would need to purchase a policy on the life of each other owner. The formula for determining the number needed is 'N x (N-1)' where 'N' is the number of shareholders. For example, in a business with three shareholders, six policies are needed (3 x 2). If there are four owners, 12 policies are needed.

To avoid this problem, the owners may choose to use a 'trusteed' cross purchase agreement. This type of agreement is basically a cross purchase agreement with the addition of an impartial third party — the trustee. One life insurance policy is purchased on the life of each owner. The trustee makes sure that the policies stay in force and the premiums get paid on time. The trustee also takes care of filing a claim upon the death of a shareholder, collecting the proceeds and paying the deceased owner's family for his/her shares.

The Buy Sell agreement is a legally binding contract, so professional help is necessary. The business owner(s) should seek the counsel of an experienced business attorney to create a Buy Sell agreement.

Wait and See Agreement

The Wait and See Agreement is essentially a hybrid agreement — either the remaining owners or the business have the first option to purchase the interest of a departing owner. If the option holder declines, the other party purchases the shares. This allows the parties to the agreement to delay making a final decision on how the buy sell will be structured until the triggering event actually occurs. A Wait and See agreement is useful when the parties aren't sure of the best way to structure the sale and want to have some flexibility. When the triggering event occurs, the circumstances of both the remaining owners and the business itself may have changed. The buyer may be the business or the other owners, but either way, the departing owner will receive a specified price.

One-Way Agreement

A One-Way agreement is an agreement that is used when the buyer of the interest is a third party or key employee who doesn't currently have an existing ownership interest. Funding can be accomplished using a life insurance policy owned by the buyer on the life of the owner. Under the agreement, the buyer is legally obligated to purchase the owner's shares at the triggering event. A One-Way agreement is generally used for unincorporated businesses (like a sole proprietorship) and businesses that are owned 100% by one owner. The buyer is usually an unrelated third party or an employee. It's used in cases where the owner wants to sell the business as a whole, rather than selling the assets of the business individually.

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