

Buy-Sell Agreements

A Buy-Sell Agreement can provide for the orderly disposition of a closely held business interest if an owner dies, becomes disabled, or sells. Buy-Sell Agreements have many advantages. They can:

- | Help transfer ownership of a business to the other owners or partners.
- | Provide the heirs with a buyer for the deceased's interest. This is especially important to the heirs where the deceased owned a minority interest.
- | Provide cash to buy out the deceased or disabled owner's interest by funding the agreement with life insurance and disability income insurance.
- | Be useful in establishing the value of a business for Federal Estate Taxes.

Problems Could Occur Without A Properly Written Buy-Sell Agreement

An owner in a closely held business will be well advised to plan for the orderly disposition of his or her interest at death or disability. Without proper planning, many problems can face the executor or heirs of the deceased owner. Some of these are:

- | If the decedent held a minority interest, what would the heirs do with the interest? Would the business or majority owners buy the deceased's interest, and if so, at what price? Since small companies usually don't pay dividends, the financial future and income of the deceased's family may be jeopardized.
- | If the decedent was an equal owner, the heirs will have a vote equal to the surviving owners. Heirs may want dividends paid to provide income, but the other owners may want to plow back profits to help the business grow. A conflict of interest could result and lead to costly litigation.
- | If the decedent held a majority interest, would the surviving owners be able to afford a buy-out? If any buy-out payments are notes, will the minority owners be able to run the business successfully and pay off the notes?
- | If the decedent were the sole owner, who would buy the business from the estate? Possibilities could include a key employee now active in the business, or a competitor. What price would be paid, and where would the money come from?

These potential problems can be taken care of during life by executing a binding, arms length Buy-Sell Agreement. Advantages include:

- | The deceased's heirs will receive a "pre-negotiated" price for the deceased's interest and will not have to worry about the future success of the business.
- | The buyer(s) of the deceased's interest can have complete control of the business; all future decisions can be made without interference from the deceased's family.
- | The value of the deceased's interest and the purchase terms are agreed upon by all parties in advance of an owner's death.

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- | If the agreement is funded by life insurance, a federal income tax-free death benefit is available to purchase the deceased's interest.
- | The agreement can also provide for a buy-out at an owner's disability. Funds can be made available through disability income insurance coverage.

There are two basic types of Buy-Sell Agreements. There are advantages and disadvantages to each.

- | **Entity Purchase Plan:** The corporation agrees to buy (redeem) the interest of a deceased owner.

Advantages: Entity Purchase plans are easily understood. Only one life insurance policy on the life of each owner is needed to fund the agreement. Premiums are paid by the company. Proceeds are generally received income tax-free.

Disadvantages: There is no step-up in basis for a surviving owners' interest in a C Corporation and generally only a partial step-up in S Corporations and Partnerships. Problems with the Accumulated Earnings Tax and the corporate Alternative Minimum Tax are possible. It is also possible that in a family owned business the purchase by a C Corporation of the decedent's stock will be considered a dividend which would be taxable.

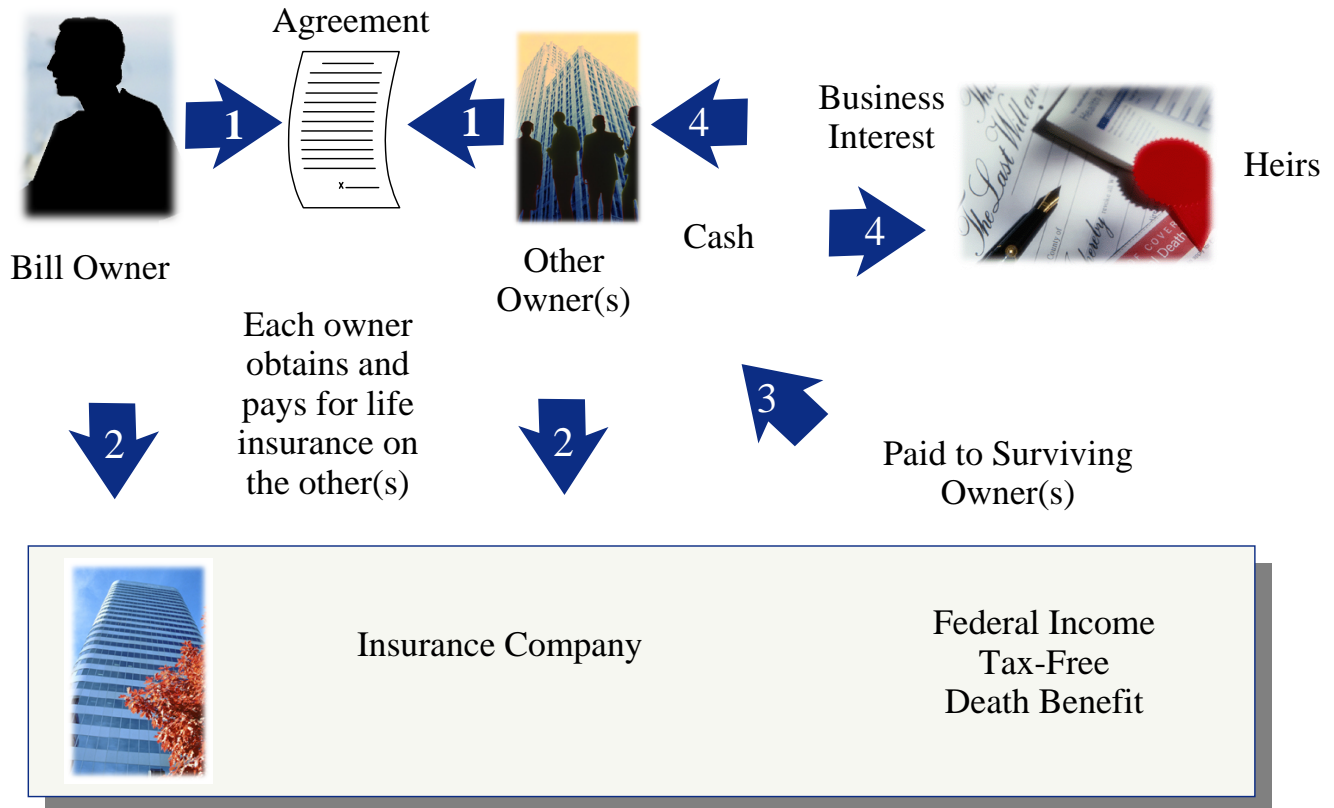
- | **Cross Purchase Plan:** Owners personally agree to buy the stock of a deceased owner.

Advantages: There are no problems with corporate Accumulated Earnings Tax or corporate Alternative Minimum Tax. The cash values and proceeds are not available to corporate creditors. Owners get a new cost basis for the interest purchased, which could save taxes at a later sale.

Disadvantages: If the plan is insured, it could require several insurance policies. For example, if there were 3 owners, 6 policies may need to be purchased. (The problem of multiple policies may be alleviated by using a "trusteed" type of cross purchase plan).

There are many variations on the two basic types of Buy-Sell Agreements. An attorney should always be consulted to draft the actual Buy-Sell document.

Buy-Sell Cross Purchase



A comprehensive buy-sell agreement can seem complicated because it is. This sequential chart may make it easier to understand:

1. The owners buy insurance on each other and pay the premiums on the policy on the other(s).
2. When an owner dies, the insurance company pays death benefits to the owner(s) of the policy.
3. Per the agreement, the owner's heirs transfer the deceased's interest in the business to the remaining owners for an agreed upon price.
4. The remaining owner(s) now own(s) the company, free and clear.

The heirs have cash equal to the value of the deceased's share in the business, all because the owners were smart enough to see the need, buy the life insurance, and establish a binding buy-sell agreement.