

A valuable business tool: Buy-sell agreements

When you own a company, by yourself or together with one or more partners, you pour heart and soul into making it a success. Indeed, the process of bringing a business into existence and then nurturing it and building upon its success is so engrossing and exhilarating that it's easy to lose sight of one sobering fact: You and each of your co-owners (partners or shareholders) one day will take leave of the company. It may be by retirement, disability or death. Someone may feel the need to move on. A partner may be tempted by a third party's offer for his or her share of the enterprise.

Potentially, any of these situations can throw a going business and/or the family of a deceased owner into chaos. A family may be forced to sell its share to cover taxes on the estate—if it can find a willing buyer. Remaining partners may not be able to get along with an interloper who comes into the business through purchase or inheritance. In an S corporation, the new shareholder may not be of a class eligible to hold such shares, thus forcing a reorganization.

A versatile tool

Buy-sell agreements provide a powerful business succession tool that owners of small-to-medium-sized companies can use to address any or all of these eventualities. A form of shareholder agreement, the buy-sell agreement is a contract spelling out what will happen to the equity of a departing shareholder when a “triggering” event occurs. Buy-sell agreements will generally fall into one of two categories:

- In a *cross-purchase agreement*, the shares or interest of the departing partner are to be bought by the surviving or remaining partners. In a sole proprietorship, the designated purchaser would be the owner's chosen successor, whether a family member involved in the business or a key employee vital to its continuation.
- In a *stock redemption plan*, the equity or shares are bought and retired by the corporation or partnership, thereby increasing the remaining shareholders' share of the company's equity.

The choice between these options will depend on the company's structure and the resources available to fund the purchase. Agreements may set varying terms for different triggering events. For example, a lower price may be paid to a partner leaving to set up a competing business. Purchases might be mandatory upon the death or disability of a partner, whereas voluntary or forced withdrawals might give the business only “the right of first refusal”—to match a first legitimate outside offer, if it so chooses.

Funding choices

Often life insurance and, less frequently, disability insurance are used to fund buy-sell agreements. The contractual buyer purchases a policy on the prospective seller's life. The proceeds are earmarked to purchase the business interest from the heirs of the deceased owner, and the cash value is available to fund purchases in other situations. In cross-purchase agreements each owner needs to have a policy on the life of each of the other owners.

Because this process can be quite cumbersome when there are multiple owners, a stock redemption plan may be more workable. In that case, the business owns and funds a single policy on each owner's life. Life insurance cash value is carried as an asset on the corporate balance sheet and will not be considered an excess accumulation of earnings if it does not exceed the reasonable needs of the business.

The hard part

Placing a value on a closely held business can be a challenge. Placing a future value is nigh on impossible. For this reason it may be best to specify a reasonable method that will be used to determine the price to be paid, or to recalculate the price periodically.

Methods that may be appropriate, depending on the nature of the business, can be to: capitalize average earnings over a period of years; calculate the loan amount that the company's cash flow will support; total the tangible assets on the balance sheet; place a value on the business' intangible assets (often its customer base); or simply apply an industry rule of thumb. Any method specified in a buy-sell arrangement that represents a true arm's length valuation will be binding on the IRS for estate tax purposes.

The payoff

A well-structured buy-sell agreement can provide a panoply of benefits:

- ensuring an orderly transfer of business interests, preventing forced liquidation;
- protecting the heirs of minority owners who otherwise might end up with a holding of restricted, non-dividend-paying stock;
- preventing a sale to outsiders or inheritance by someone not active in the business;
- persuading a key employee to remain in the business;
- establishing the value of a deceased owner's shares for estate tax purposes.

If you run a business, we're always ready to work with you and your advisers to develop buy-sell agreements and all other financial services available to help your enterprise thrive.