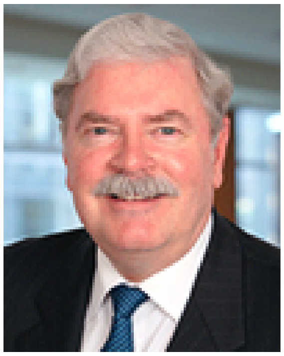

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Business Succession Planning Buy-Sell Agreements

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Summary:

A buy-sell agreement is a legally binding contract in which the owners of a business set forth the terms and conditions of a future sale or buy back of a departing owner's share of the business. Specifically, buy-sells control when owners can sell their interests, who can buy an owner's interest, and at what price.

Buy-sells can accomplish many objectives, but are primarily used to ensure the smooth continuation of a business after a potentially disruptive event, such as an owner's retirement, incapacity, or death.

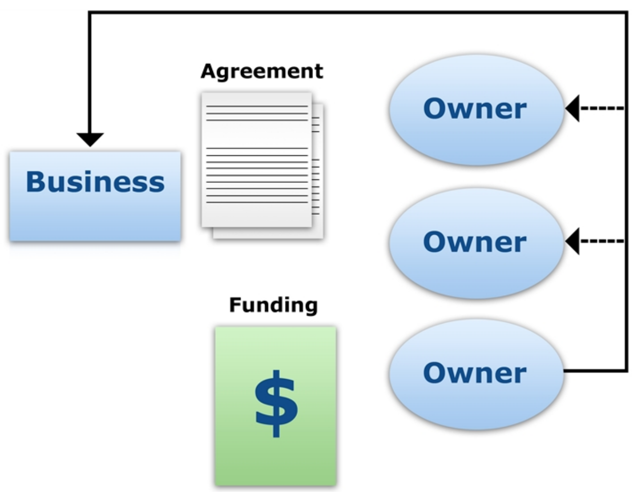
Also valuable estate planning tools, buy-sells can provide for the orderly succession of a family business, and for the liquidity needed for payment of a deceased owner's estate settlement costs and taxes. Further, if structured properly, a buy-sell can establish the purchase price as the taxable value of an owner's business interest, avoiding unexpected estate tax consequences at the owner's death.

What is a buy-sell agreement?

Buy-sell agreements are very important planning tools that can accomplish many things for a business with two or more owners. Sometimes referred to as a prenuptial or premarital agreement among business owners, a business continuation agreement, a stock purchase agreement, or a buyout agreement, a buy-sell is a legally binding contract that establishes when, to whom, and at what price an owner, partner, or shareholder can sell his or her interest in a business.

A typical buy-sell allows a business entity or other business owners the opportunity to purchase a departing owner's business interest at a predetermined price. This allows the business and the remaining owners to protect themselves from future adverse consequences, such as disruption of operations, entity dissolution, or business liquidation that might result if certain events, such as an owner's sudden incapacity or

Buy-Sell Illustration



1. *Buy-sell is established with a separate agreement or is created by including buy-sell provisions in a business' operating agreement.*
2. *The plan is generally funded in some manner.*
3. *Upon a triggering event (as defined in the agreement), an owner's interest is purchased by either the business itself or the other owners. Price is determined according to the terms of the agreement.*

death should occur. This can also minimize the possibility that the business will fall into the hands of outsiders.

The ability to fix the purchase price as the taxable value of a business interest makes this tool especially useful in estate planning. Agreeing to a purchase price while all parties are alive minimizes the possibility of unfair treatment to a deceased owner's heirs. And, the IRS' acceptance of this price as the taxable value can help minimize estate taxes on the deceased owner's business interest.

Additionally, because funding for buy-sells is typically arranged when the buy-sell is executed, the possibility that funds will not be available when needed is minimized, and a deceased owner's estate can be provided with needed liquidity for expenses and taxes.

Tip: *Buy-sells are also used to give a business and co-owners the right to buy out an owner (force an unwilling owner to sell), or to give an owner the right to force the business or co-owners to buy him or her out.*

How does a buy-sell agreement work?

A buy-sell can be a separate agreement or can be created by including buy-sell provisions in a business' operating agreement.

A buy-sell must clearly identify the potential buyers, any restrictions and limitations, and the conditions under which a sale will occur. Sale triggering events typically include:

- Death
- Long-term disability
- Retirement
- Divorce
- Personal insolvency or bankruptcy
- Criminal conviction
- Loss of professional license
- Resignation or termination of employment

A buy-sell should set forth the purchase price or a formula for determining the purchase price. Without establishing this price in advance, lengthy disputes and lawsuits can arise at the time the ownership interest must be bought back.

Fixing the estate tax value of a business interest

One of the advantages of buy-sells is the ability to fix the purchase price as the estate tax value of a deceased owner's business interest, which can help avoid future valuation problems with the IRS. When using a buy-sell to set the estate tax value of a business interest, careful drafting is essential. To pass muster, all buy-sells must pass the following four-part test:

1. The estate must be obligated to sell the business interest at the price set forth in the buy-sell
2. The buy-sell must place certain restrictions on lifetime transfers of the business interest
3. The value of the business interest must be fixed by, or determined from, the buy-sell
4. The buy-sell must be a bona fide business arrangement, and not a transfer for less than adequate consideration

When the buy-sell involves family members, it must also be proven that the transaction is comparable to arms-length sales between unrelated persons, and was entered into for a bona fide business purpose.

Caution: *Determining the fair market value of a business may require an independent business valuator. The IRS can impose harsh penalties for understating the value of an asset for estate tax purposes.*

Financing the buyout

For a buy-sell to be successful, funds must be available to carry out the terms of the buy-sell. Without a funding plan in place, the buyer(s) may be forced to sell assets, take out loans, or even file for bankruptcy.

There are several ways to fund a buy-sell, including:

- Cash
- Borrowings
- Installment sale
- Self-canceling installment note
- Private annuity
- Stock redemption
- Sale-leaseback
- Appreciated property bailout
- Deferred compensation
- Life insurance
- Disability insurance

Factors that generally influence the choice of funding method include:

- Business structure, size, and tax bracket
- Number of owners, their ages, tax brackets, and ownership percentages
- Levels of cash or credit available to the business or the owners
- Type of buy-sell agreement

Depending upon the specific details, there might be just one funding method that is appropriate, or there may be several funding methods that could be used.

Structuring buy-sells

Buy-sells can be structured to meet the needs

of both the business and the owners, taking into consideration tax consequences and individual goals. There are four basic structures for buy-sells, and some combinations are possible. Very brief descriptions of the four basic structures follow.

1. An entity purchase buy-sell obligates the business to buy the interests of each departing or deceased owner.
2. With a cross purchase buy-sell, each owner agrees to buy a share of a departing or deceased owner's interest. The business is not a party to this type of buy-sell.
3. A unilateral or one-way buy-sell is used when only one owner is selling an interest, and is typically used in sole ownership situations where the owner is arranging to sell the entire business to a family member or key employee.
4. A wait-and-see buy-sell is used when the parties are unsure whether the business or the owners will buy the business interest. Typically, the business is given the first option, and if it does not exercise the option, the remaining owners are given the opportunity. If the remaining owners do not exercise their option, the business is obligated to buy the interest, just as with an entity purchase buy-sell.

Tip: *It is not necessary that the same buy-sell apply to all the owners of a business.*

Suitable clients

- Business owners who do not want to be forced to work with or share control of the business with a stranger who buys an interest from a departing owner
- Business owners who do not want to be forced to work with a spouse or other family member of a deceased or divorced co-owner
- Business owners who do not want to end up co-owning the business with a bankruptcy trustee or creditor if a co-owner experiences personal financial difficulties
- Business owners who do not want their heirs to inherit a business for which they cannot get a fair price
- Business owners who do not want to engage in pricing disputes with heirs of deceased co-owners

Example

Steve and Jack are brothers who loved cars as teenagers. Steve could fix just about anything and Jack went to all the car shows and talked to anyone who would listen about the new models.

As soon as they graduated college, Steve and Jack borrowed some money and bought a car dealership. Over the years, they built a very successful business--Steve ran the operations while Jack took charge of sales and marketing.

While their business thrived, their personal lives flourished as well--each marrying and having several children. But then, one day, Jack unexpectedly had a heart attack and died. Jack's family was overwhelmed with shock and grief. After several weeks, Jack's widow, Norma, came by Steve's office. Norma was very nervous--she needed to broach the subject of her husband's interest in the dealership, but knew Steve was having a difficult time managing the business on his own. Norma was having her own financial difficulties, however, having a large mortgage to pay and two children in college. She couldn't put off this meeting, even if it resulted in tension and bad feelings.

To her delightful surprise, Norma soon discovered how much foresight her husband and brother-in-law possessed. They had executed a buy-sell agreement many years ago, just in case such an unfortunate event should occur, and financed the agreement with life insurance policies on each other's lives. Steve was in the process of claiming the proceeds and would pay Norma the agreed-upon purchase price.

Norma received her rightful share of the business, in cash, with which she was able to meet her family's needs. Steve was able to continue the business with no interference. And though it wasn't quite the same, he hired a sales and marketing manager to take over his brother's duties, and the dealership continued to operate successfully.

Advantages

- Assures continuation of a business
- Assures a smooth transition of a business
- May prevent loss of entity status due to restrictions on transfers of interests (S corporations and limited liability companies)
- Provides assurance to creditors, customers, and employees
- Guarantees a buyer for a departing owner's interest
- Can prevent outsiders from gaining control of business
- Establishes a taxable value in advance, minimizing estate taxes and potential valuation conflicts with IRS at time of owner's death
- Protects heirs from unfair treatment
- Ensures estate liquidity

Disadvantages

- Depending on the type of buy-sell, there could be adverse income tax consequences to the business and/or the owners
- Meticulous drafting is required--improperly drafted buy-sells can result in unintended consequences and tax code violations
- Valuations may need to be updated from time to time
- If funded with insurance, care must be taken to provide continuing coverage

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