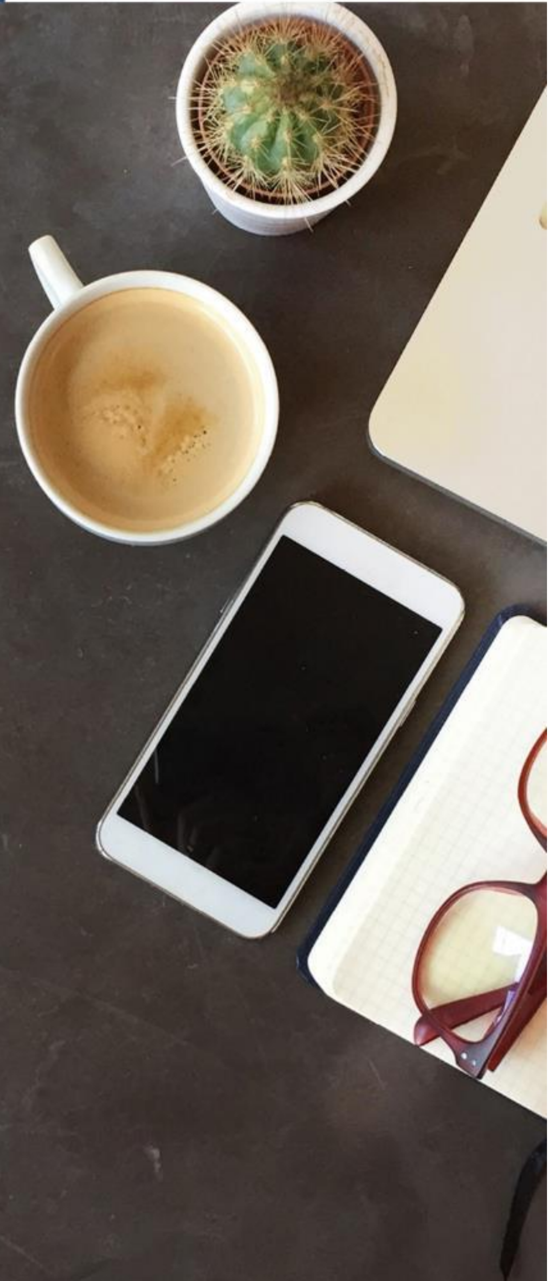
GUIDEPOST

# Buy-Sell Agreements

Prepared for
Business Clients



# Buy-Sell Agreements

A buy-sell agreement specifies how business interests will be transferred, to whom, and under what circumstances. There exist two basic types of buy-sell agreements: the cross-purchase agreement and the entity purchase agreement. In a cross-purchase buy-sell agreement, each business owner agrees to buy the business interests of an owner who dies, becomes disabled, retires, or otherwise leaves the business, whereas an entity purchase agreement is structured so that the business agrees to buy the interests of any owner when he/she dies, becomes disabled, or retires. Frequently, these agreements are funded with life insurance and disability buy-out insurance.

## Structuring a Buy-Sell Agreement

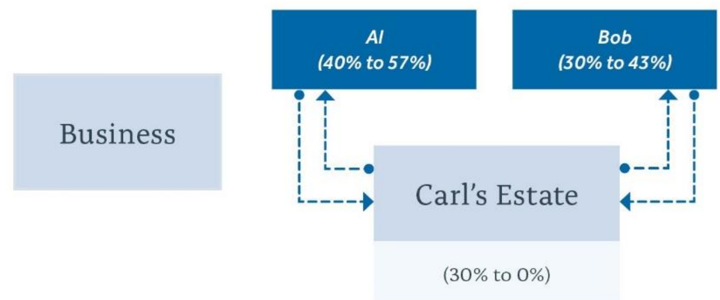
### Cross-Purchase Buy-Sell Agreement

A cross-purchase agreement is a document that allows owners of a business (i.e., members, partners, shareholders, etc.) to purchase the interests/shares of an owner who dies, becomes incapacitated or retires. A cross-purchase agreement is used in business continuation planning. The document outlines how the interests/shares can be divided or purchased by the remaining owners, such as a proportional distribution according to each owner's stake in the business.

In most situations where there are just a few owners who are roughly similar in age, a cross-purchase agreement can be ideal. Where there are multiple owners who must purchase insurance policies on each other, the agreement can become unwieldy. Additionally, if there exists a significant age disparity among owners, then the younger owners will be saddled with higher premium payments on the policies on the lives of older owners.

*Example of a Cross-Purchase Buy-Sell Agreement*

- Al owns 40%, and Bob and Carl each own 30%.
- Owners execute a cross-purchase buy-sell agreement.
- Owners Al, Bob, and Carl buy insurance on each other.
- Carl dies; Al and Bob collect proceeds and purchase Carl's 30% from Carl's estate.
- Carl's estate recognizes no gain because the value of Carl's interests/shares is stepped-up to date-of-death value.
- After the purchase, Al will own 57% of the business, and Bob will own 43%, provided they want to keep their current ownership ratio.



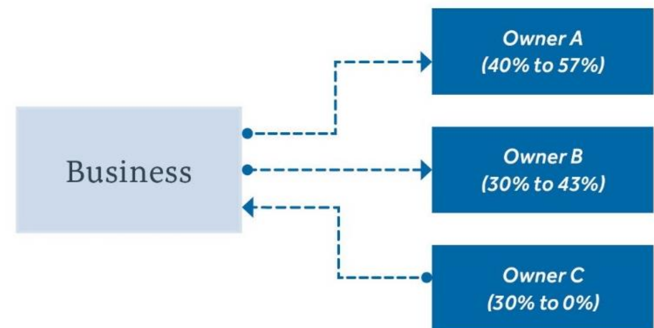

- The remaining owners' basis in the business will increase by the purchase price they paid.

### Entity Purchase Buy-Sell Agreement

An entity purchase agreement is a type of business succession plan utilized where a business has several owners. A succession plan of this sort, which is funded by the business, allows the owners to avoid any out-of-pocket expenses while also looking after their families in the event of death. The plan involves having the business purchase insurance policies on the lives of each owner in the amount equal to that owner's interest in the business. In the event of death, the amount collected by the business from the insurance, which is equal to the deceased owner's stake, is used to pay the deceased's estate for its share of the business. (When the entity in question is a corporation, an entity-purchase agreement may be referred to as a stock redemption agreement.) In such cases, the business itself will enter into an agreement with each owner to purchase a

deceased owner's interest in the business. The agreement can require that a deceased owner's estate must sell the business interest and that the business entity must buy the deceased owner's business interest.

*Example of an Entity Purchase Buy-Sell Agreement*




- Al owns 40%, and Bob and Carl each own 30%.
- Business and owners execute an entity purchase buy-sell agreement.
- Business purchases insurance on Al, Bob, and Carl.
- Carl dies; business collects proceeds and purchases Carl's 30% from Carl's estate.
- Carl's estate recognizes no gain because the value of Carl's interests is stepped-up to date-of-death value.
- After the purchase, Al will own 57% of the business, and Bob will own 43%.
- Each of Al's and Bob's basis in the business does not change, as the entity purchase typically does not result in a basis step-up for continuing owners; pass-through entity purchases funded with life insurance may result in a basis increase in certain circumstances.

## Trigger Events

Nearly all buy-sell agreements provide that the death or retirement of an owner triggers a buyout, and many buy-sell agreements often also include disability and divorce as trigger events. Other triggering events can be the firing of a minority owner or the personal bankruptcy of an owner.

## Valuation

One important requirement for a business purchase agreement to work is a consensus on the value of the business. An agreed-upon amount or method prevents valuation disputes between a departing owner or a deceased owner's estate and the remaining owners. An accurate valuation also allows the parties to anticipate how much funding will be necessary for a buyout.

There are several ways to address the valuation question.

- Valuation can be based on a formula detailed in the agreement, such as a percentage of sales.
- The agreement can require the parties to revalue the business every year. If the parties don't revalue the business within a given amount of time, the agreement can provide a valuation formula.
- The agreement can require a professional business appraiser to value the business. The appraiser can develop a valuation based on several factors, such as the annual earnings of the business.
- The agreement can specify that value is determined by multiplying earnings by a capitalization factor, typically obtained by analyzing the price-to-earnings ratio of comparable businesses in the same industry.

## Funding

There are several ways to fund buy-sell agreements.

- The company can simply create a sinking fund using a savings account or another conservative investment. The risk is that there may not be enough cash to fund the buyout.
- The company can borrow the money from a bank, but there will be interest costs. The bank also may be reluctant to lend money to a business if a key person has died or is leaving the company.

- Assuming the agreement allows, the company can make installment payments. This is often the only option where other liquid funds are not available, which is frequently the case. When a buy-out event occurs, the company would pay the departing owner or a deceased owner's heirs a set amount each year determined by the language in the buy-sell agreement. The departing owner or his/her heirs may have a concern as to whether the surviving owners can profitably run the business.
- The most common funding option is for the company or other owners to obtain life and disability buy-out insurance on the owners. In the event of an owner's death, death benefit proceeds can be used to purchase the deceased owner's interest. Disability buy-out insurance can serve the same function if the owner must leave due to disability. In both cases, the funds are available at the precise time necessary. If the company will own the life insurance policies, to preserve the income tax free nature of the death benefits, the company must comply with the notice and consent requirements of Internal Revenue Code Section 101(j). In successful businesses, additional insurance is purchased as the business continues to increase in value.

## Buy-Sell Variations

A variation of the cross-purchase buy-sell agreement is the "trusteed" buy-sell arrangement, in which a trust owns the life insurance. The trust must be carefully drafted to ensure that the owners do not have incidents of ownership in their own policies. A similar arrangement is a partnership buy-sell arrangement, in which a partnership (or a limited liability company) owns the policies. The benefit to either of these arrangements is that only one policy per owner is required.

Another variation is known as a "hybrid" or "wait and see" buy-sell arrangement. This type of agreement provides flexibility for the owners to use an entity or cross-purchase buy-out, or a mixture of the two, depending upon the situation when an owner dies or is required to sell.

## Insights and Caveats

- When no family members are involved, a binding buy-sell agreement with an "arm's length" valuation generally will be sufficient to set the value for estate tax purposes. If family members are involved, a valid recent business valuation by a professional business appraisal organization is recommended.
- Generally, the value of insurance owned by a surviving business owner on a decedent business owner's life will not be included in the decedent's estate for federal estate tax purposes. This is because the decedent has no incidents of ownership in the policy. The life insurance the decedent owns on the lives of the other business owners will be included in his/her estate, although the value is roughly the cash value, not the full death benefit.
- Care should be taken to avoid the transfer-for-value rule when policy interests are transferred from one owner to another owner who is not the insured. Failure to do so might subject the death benefits to income tax.
- In a corporate stock redemption, families must also be wary of attribution rules that could cause the purchase to be less than the selling shareholder's full interest, thereby causing the payment from the business to be treated as a dividend, instead of a sale and purchase of property.

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Joyce J Yoo

Wisely Financial Strategies & Insurance Solutions

425 Market Street, Suite 1600
San Francisco , CA 94105
☏ (415) 895-0080
joyce@wiselysolutions.com
https://www.wiselysolutions.com
CA Insurance License Number 0H23562



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