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Guide to **Buy-Sell Planning**

OPPORTUNITIES | PARTNERS | EXPERIENCE

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, remaining owners, or a key employee(s).

The main goal of succession planning is achieving a smooth transition between the current owner and the future owner(s), while providing a way to turn the business interest into liquidity to apply toward needs, such as retirement income, survivor income, or estate settlement costs, to include any estate taxes owed.

Once a business owner has taken the critical first step and decided what they 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 disruption to business operations in the event of an owner's death, disability, retirement, or other identified and agreed upon triggering event. With a legally binding agreement in place, the terms and conditions of the sale are clearly outlined.

Options for **Funding a Buy-Sell Agreement**

Once an agreement is in place, the parties must consider how they will fund the future purchase obligation. No one benefits from the financial duress caused by an unfunded or improperly funded Buy-Sell agreement and the resulting inability to carry out the terms of the agreement.

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 at 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 obligation. Loans may be advantageous because they require no current cash outlay. 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 funds. 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 and personal reserves of the buyer. Like the sinking fund, the buyer may not have sufficient cash available 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 they or their family is dependent on the new owner and their ability to run the business profitably. Additionally, the seller's family doesn't get money up front when needed to pay taxes and other expenses.

Life Insurance

Life insurance is often considered the preferred method of funding for many business owners as 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 estate settlement costs. The buyer will need to pay premiums, but the amount is generally stable and predictable.

Buy-Sell agreements generally include provisions such as:

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

Buy-Sell and **Life Insurance**

If life insurance is used as the funding vehicle, the Buy-Sell agreement should reference the specific life insurance policies (or life insurance in general), including the requirement that the policies must be maintained 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.

A Buy-Sell agreement spells out what will happen to each owners' share of the business following a 'triggering event' such as retirement, death, or disability.

A LIFE INSURANCE POLICY IS PURCHASED ON THE LIFE OF EACH OWNER

Owner retires or becomes disabled

Cash value used to purchase shares[1]

Owner sells shares to successor

Owner dies

Tax-free proceeds used to purchase shares[2]

Deceased owner's estate sells shares to successor owner

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.

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 (also known as unilateral buyouts).

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 who 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 notice and consent rules in order to avoid taxation of the proceeds.[3]

Before funding a stock redemption agreement with life insurance, business owners should carefully assess the implications of Connelly v. United States.[4] In this unanimous decision, the Supreme Court ruled that when life insurance is used to fund a stock redemption, the resulting death benefit increases the company's value, thereby increasing the deceased owner's estate. This ruling underscores the need for business owners to evaluate potential estate tax exposure and explore planning strategies to mitigate any adverse consequences.

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 their estate for the shares of stock.

When the business has more than two owners, the number of policies needed to fully fund the agreement can become onerous. Each owner would need to purchase a policy on the life of each other owner. The formula for determining the number of policies 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 (also referred to as an escrowed Buy-Sell arrangement). This type of agreement is basically a cross purchase agreement with the addition of an impartial third party — the trustee (or escrow agent). One life insurance policy is purchased on the life of each owner. The trustee ensures 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 their shares.

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

4 Connelly v. United States, 114 S. Ct. 1406 (2024)

Wait and See Agreement

The wait and see agreement is essentially a hybrid agreement — either the remaining owners or the business has 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.

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.

One-Way Agreement

A one-way agreement (also referred to as a unilateral buyout) 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 sole proprietorships and corporations that are owned 100% by one owner. The buyer is usually an unrelated third party or an employee. It is 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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