The Benefits of a
BUY-SELL AGREEMENT

Benefits to the:

- **Business Entity**
- **Surviving Owners**
- **Deceased Owner's Estate/Heirs**

Benefits of a Buy-Sell Agreement

What are the benefits to the business and its owners when a Buy-Sell arrangement is in place?

Benefits to the Business

The business is able to conduct a smooth transition of the control and ownership of the entity, allowing your business to remain in good standing with your clients, creditors, and employees.

The death, disability or retirement of an owner can throw a business into turmoil because the person who was the driving force...the rainmaker...is no longer there. A carefully structured buy-sell arrangement will permit the owner to begin the process of transferring ownership and control before the triggering event...facilitating a smoother transition. Emotions are not high, pricing parameters have been set prior to the event, but flexible drafting can also give "first rights of purchase" to family members, ensuring that they are given priority over 3rd party buyers.

Helps avoid transfers that could have a negative impact on the business' formation or tax status.

For example, there are existing tax rules that dictate what types of individual or entities can have an ownership interest in a business structured as an S corporation. If shares are transferred to a prohibited shareholder it can terminate the S corporation's tax status, causing it to be taxed as a regular C corporation. A buy-sell agreement can prevent this by requiring that stock be transferred only to eligible S corporation shareholders.

For the Surviving Owners

Helps prevent disputes between the heirs of the deceased owners, who often favor short-term goals vs. the long-term goals of the business.

For the Deceased Owner's Estate/Heirs

Creates a market for the deceased owner's interest. Closely held business owners often have difficulty finding a buyer for their interest, forcing an estate to sell the interest for less than it is worth. An enforceable buy-sell agreement ensures that a buyer is available and that the "price is right."

Prevents unwanted parties from acquiring an ownership interest. A properly drafted agreement helps prevent inappropriate family members from becoming involved in the daily decision-making of the business or, third party competitors from acquiring the business.

Provides an independent mechanism for determining the price or pricing formula for the business interest, decreasing the potential for disputes. It is simpler for all parties involved to negotiate payment terms before the fact, when no party is operating from a position of weakness. It also avoids delays in the administration of the estate and alleviates disputes between the deceased owners' heirs and the surviving business owners.

Relieves the heirs of the estate from the affairs of the business. Heirs who are not participating in the business generally will not want to be exposed to the on-going risks of operating a business. A funded buy-sell arrangement can ensure that disinterested heirs are bought out and protected from any business risks.

Ensures that the estate receives cash for estate liquidity, survivors' income, or other family needs. Often, the bulk of an owner's estate is tied up in non-liquid assets. Without a buy-sell arrangement in place, the personal representative may have to sell assets under less than favorable conditions to pay estate taxes or provide a living allowance for the surviving spouse/minor children.

Avoids negotiating price and terms when the estate may be in a weak bargaining position. The lack of a valid buy-sell agreement at an owner's death alters the negotiation field. When an estate is facing administrative and tax costs and has few liquid assets, a "fire sale" may be the result.

Establishes the value of the interest for federal estate tax purposes. An "arms length" negotiated value documented properly in the buy-sell agreement helps to establish a value at an owner's death, reducing the possibility of IRS challenge.

Provides for increased efficiency in the administration of the owner's estate. Since the terms of the sale have been completed during the life of the owner, a buy-sell arrangement can help prevent argument if a funded buy-sell arrangement is in place and inactive heirs are bought out.

Helps avoid a moral dilemma that could arise from negotiating with the spouse and children of a deceased owner. While the personal feelings of the surviving owners might lean towards "generosity," the fact remains that the remaining owners have a fiduciary duty to the business and an obligation to their creditors. One solution is a prearranged, funded buy-sell arrangement to ensure that all parties to the transaction receive the needed funds to continue.

Funding a Buy-Sell Agreement

Life Insurance

Purchasing life insurance on the lives of the business owners is one of the most common ways to fund a buy-sell arrangement. Besides being cost effective, the primary advantage is that it makes cash available upon the owner's death. Plus, if the arrangement is funded with permanent life insurance, the policy's cash value may be sufficient to fund a buy-out at retirement. In a cross purchase arrangement, life insurance is sometimes purchased on a split dollar basis or with a bonus to mitigate the cost to the shareholder.

Borrow Funds

If the business or its owners plan to fund a buy-sell arrangement by borrowing the funds after the death or retirement of the owner, areas of concern are:

- **a.** The business or remaining owners may have difficulty obtaining a loan after the death or retirement of a key owner.
- **b.** Even if they are successful in obtaining a loan, the ability to get additional loans for working capital may be impaired.

Sinking Funds

A buy-sell arrangement can be funded with a sinking fund in which the earnings of the business are retained to fund the arrangement. If an owner dies too soon after the arrangement is put in place, this strategy will not enable the business to accumulate the necessary funds to fulfill its redemption obligation. Plus, retention of assets in a C corporation can trigger accumulated earnings tax.

Installment Purchase

A buy sell arrangement can be funded by structuring the purchase as an installment purchase. This may put a strain on the cash flow that can be especially difficult when the interest being purchased belonged to a majority or key owner. Although the business may be pushed into a transition period during which profitability may be reduced, increased cash flow is needed to fund the buy-sell installment. Such a cash flow strain can result in business failure.

	Cross Purchase	Entity Purchase
What is It?	An arrangement in which each owner agrees to buy the business interest of another owner.	An arrangement between the business entity and individual owners.
How Does It Work?	Owners enter into a business continuation arrangement among themselves.	Business entity and each owner enter into a redemption arrangement.
Funding Methods	Life insurance, sinking funds, borrowed funds, installment purchase.	Life insurance, sinking funds, borrowed funds, installment purchase.
Funding With Life Insurance	Each owner purchases a life insurance policy on the others. E.g., if there are 3 owners, then there will be 6 policies.	Corporation buys a policy on the life of each owner. E.g., if there are 3 owners, then there will be 3 policies.
Is Life Insurance Subject to Corporate Creditors?	No	No
Alternative or Minimum Tax	No potential corporate alternative minimum tax (AMT) or accumulated earnings tax.	For C corporation, the AMT and accumulated earnings tax may apply.
Does Life Insurance Increase the Value of the Business?	No	No
Best for	Businesses with five or fewer owners.	Businesses with several owners of the business will only need to purchase one policy on each owner.

When structuring a buy-sell arrangement, it's important to determine which method of valuing the business will be used (the valuation methodology). Here are several common ones:

Specific Fixed Price

Shareholders fix the price periodically by arrangement.

Primary disadvantage: Shareholders often fail to adjust the price for changes in value. This may prove to be completely unfair to the selling shareholder. Plus, the IRS may disregard the actual selling price and attribute a higher value to the business interest.

Primary advantage: It is simple.

Book Value

The value of the business equals its book value on the date of death or on the close of the last fiscal year preceding the death of the owner.

Primary disadvantage: The book value is seldom an accurate reflection of the value because it reflects depreciated historic values and ignores the business's earnings potential.

Primary advantage: It is simple.

Capitalization of Earnings

The value of the business is determined by multiplying earnings by a capitalization factor, which is usually obtained by analyzing the price-earnings ratio of comparable businesses in the same industry. Using this method, earnings over several years should be examined to alleviate the consequences of economic cycles.

Primary disadvantage: The earnings of closely held businesses are often manipulated (through salaries) for personal tax planning purposes instead of the business needs of the entity.

Formula

The value of the business is determined by a number of factors. Often the sales price is based on both the book value and capitalization of earnings. Sometimes a combination of these approaches is incorporated into a formula to offset the disadvantages of each approach.

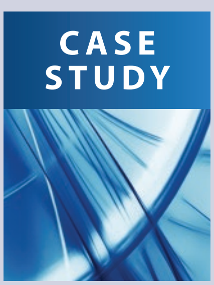
Appraisal

The value is determined by an independent appraisal at the time of the sale. Often the appraiser is selected at the time the agreement is written. Or, both the selling shareholder and the remaining shareholders are allowed to pick an appraiser, and the value is an average of the appraisals. This approach probably provides the value that most approximates fair market value.

Primary disadvantage: Obtaining an appraisal can be expensive and can delay the settlement process.

Cut Throat

The purchase price is determined by the shareholders at the time of sale. A shareholder at the time of sale will offer his or her shares to the other shareholders at a price determined by the offering shareholder. If the other shareholders do not purchase the shares at this price, the shareholder who made this offer must buy the other shares at this price. This approach theoretically sets a fair market price, but it favors the shareholder with the "deepest pockets." This is primarily used for lifetime sales and usually in businesses that are owned equally by 2 parties.



Situation:
Investment Banking firm with 8 shareholders is seeking insurance funding in the event of death, rather than funding the insurance from current surplus or future earnings.

Objective:
Procure 20-year term on each of the principals. The clients believe in buying term and investing the difference.

Analysis and Solution:
Acquisition of 20-year term in the amount of $10,000,000 each for a combined premium of $225,000.

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