

Switch To The Charter Business Bundle\* **SAVE 38%** on fast internet and reliable phone service\*  
\*38% savings off standard monthly rates with 24 month agreement to both internet and phone service

Charter Business

**BusinessWest Online**  
 THE BUSINESS JOURNAL OF WESTERN MASSACHUSETTS  
 Published Bi-Weekly

April 26, 2010 Edition

**BusinessWest**  
 Western Mass. **COMMERCIAL REAL ESTATE**  
 For Sale and For Lease  
 Click Here to Search

Home  
 Departments

- ❖ [10 Points](#)
- ❖ [Agenda](#)
- ❖ [Bankruptcies](#)
- ❖ [Briefcase](#)
- ❖ [Building Permits](#)
- ❖ [Chamber Corners](#)
- ❖ [Company Notebook](#)
- ❖ [Court Dockets](#)
- ❖ [DBA Certificates](#)
- ❖ [Incorporations](#)
- ❖ [People on the Move](#)
- ❖ [Real Estate](#)

Search Commercial Real Estate  
 Contact Us

- ❖ [Subscriptions](#)
- ❖ [Sales Department](#)
- ❖ [Editor](#)

Archives  
 Search This Website

**Supplements**

**Business Planning with Buy-sell Agreements**

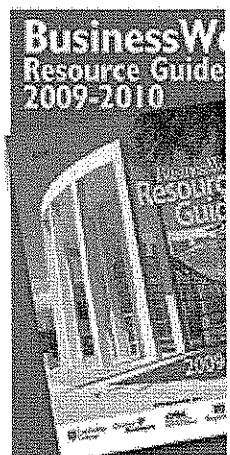
**A Well-crafted Document Can Serve as a Road Map for All Parties**

By **KEVIN E. HINES, CPA, MST, CVA, CSEP**

Within closely held businesses, owners are often concerned about what might occur if they should become ill or die before their retirement years. If there is an unexpected event, will the owner be able to retain the economic value of the business? Can the surviving owners avoid the unwanted involvement of other family members of the deceased or disabled? Will the surviving owners have the resources to buy out the deceased owner's interest or continue to pay some form of retirement allowance?

Given these concerns, business owners are best served by setting up a buy-sell agreement before the unexpected happens. Throughout this article, I will reference my discussion from a corporate structure, but this may be applied to any closely held business entity such as a partnership, LLC, or sole proprietorship.

Whether the owner's intent is to transition a business to another current partner/shareholder or another individual or family member, a buy-sell agreement can be a road map for both parties. It will establish amounts to be exchanged, terms of the deal, and expectations of both parties to the transactions. It will become a contract once all parties agree to the terms, and can give comfort to all involved, knowing that there is a plan in place. This agreement should include who will take over the business,



Click logos to view our Sponsor



PeoplesBar



Please enter a word or a phrase



when this is to occur, and the price that will exchange hands to provide plans in the case of retirement from the business, death of the owners, or disability of the owners.

Buy-sell agreements may also be used to restrict disposition by owners to unintended third parties such as outside investors, gifts during the lifetime of the owners, and transfers at death. Thus, a buy-sell agreement can effectively retain or transfer control among shareholders during their lifetime or at death. Such agreements are sometimes funded by life-insurance policies on the lives of the owners, and may take the form of a corporate redemption or cross-purchase plans among the owners.

### **Intended Purpose of the Buy-sell**

Before anyone sets pen to paper in drafting any agreement, you should establish the intended goals of the agreement. Things you should consider would be:

- What life events is this agreement to handle (disability, death, termination, and/or retirement of key owners)?
- Which owners should this agreement cover (e.g., all owners, or owners with more than 50% ownership)?
- What is an approximate value of the business? What is the strength of the cash flows? What assets and liabilities are held by the entity?
- What type of industry is the main source of income? Are there limitations on who can own the business? Are there special skills needed to operate the business?
- Will you allow other owners or family members to take over the ownership of the business interest through sale to an outside party, gift to a family member, etc.?
- Will the proceeds from the transfer of the business interest be needed by the seller to fund retirement/disability, or will the business interest be transferred for less than market price?

The answer to these and similar questions will give you guidance on the form, structure, and funding of the buy-sell agreement.

### **Funding of the Plan**

The three main methods of funding buy-sell agreements are life-insurance proceeds, future earnings of the

business, and financing through a bank, other lending agency, or other funds of the current owners. In establishing your plan of funding, you must consider the earnings stream of the business, both current and future earnings.

Funding the agreement through life insurance may give you confidence that the funds will be available when they are needed to enact your buy-sell agreement, but you will be forced to forego current earnings to pay for the life-insurance premiums. These premium costs can be significant to the business depending on a number of variables, such as type of insurance (e.g., whole life or term insurance), insurability of the owners, and face value of the policies.

A plan may be funded through a combination of future earnings as well as setting aside current earnings as 'retained earnings.' When looking to future earnings for funding, you need to review financial operations to see what is available to pay the former owner without putting the health of the business in jeopardy. You may want to set aside current earnings and pay the taxes currently so it is available from current operations. What about maximizing retirement plan contributions from current operations and deferring the payment of income taxes until later? There are a number of options to consider here.

Consideration should also be given to financing the buy-sell agreement through a lending institution or even out of other funds held by the owners. There is value to the business as decided by the owners and made part of your agreement. It may be logical to look to a bank for financing and to use the value of the business as collateral for the loan. The business would repay the loan out of future earnings. Of course, any combination of these three options would work well, given that proper planning has taken place.

### **Forms of Buy-sell Agreements**

Owners usually choose from two general types of agreements. With a redemption agreement, the business will purchase back from the seller their business interest. A second type of agreement is the cross-purchase agreement, where two individuals enter into an agreement for one or the other to purchase the business interest on the occurrence of an event. Either of these agreements can be funded by life insurance, future earnings, or bank financing.

The cross-purchase form of agreement holds certain tax advantages over the redemption plan. By purchasing the stock outside of the corporation, you will get a high income-tax basis. This allows for future benefits of

ultimately fewer income taxes and other advantages of higher basis. If this purchase is funded by life insurance, you have the added advantage of not paying income tax on the insurance proceeds.

There are disadvantages to this plan too. If there are multiple owners, you might be required to purchase insurance policies on a number of individuals, which may be cumbersome. Additionally, there may be inequities regarding the pricing of policies upon individuals and income-tax brackets for different owners, and how to pay for these inequities may make this plan less appealing.

In a redemption-agreement plan, the business entity will be mandated to purchase back the ownership interest from the seller. If this is to be funded by life insurance, the business will own the policies. As you can see, this plan will be easier to administer if there are multiple owners. In addition, the business will bear the brunt of any income-tax and premium-cost differences.

One advantage of this plan is that the business will not recognize taxable income on the life-insurance proceeds since these are exempt from tax. There will also be an increase in ownership percentage with fewer owners. In this agreement, the remaining owners will increase their ownership proportionately. A disadvantage is the loss of a higher tax basis in the stock redeemed.

### **Benefits of Buy-sell Planning**

Buy-sell agreements are effective means of keeping and ultimately transferring ownership and control of a family corporation within the family. They can also serve other important goals, such as:

- Assure a market for the sale of the business interest if and when the shareholder retires, becomes disabled, or dies;
- Assure an employee/shareholder, if they are terminated from employment, that there will be a market for the business interest;
- Prevent the transfer of shares to other owners that are not compatible with the present owners;
- Preserve favorable tax treatment (i.e., S corporate favored tax status);
- Establish a value of the business interest through an agreed formula or value;
- Become part of one's estate or gift-tax planning through the establishment of the value and/or future

ownership; and

- Assure that persons no longer active in the business do not continue on as shareholders — essentially, by mandating the transfer of shares upon retirement.

There are some limitations with regard to transfers to and from family members as established by the Internal Revenue Service. These agreements should be looked at as if they were an arms-length transaction with a third party. Otherwise, the intended goals may not be achieved, such as establishing the value of the business interest for gift and estate purposes.

You should always consult your tax and legal professionals to help you with setting up goals and writing and maintaining these buy-sell arrangements.

Kevin Hines is a certified public accountant with Holyoke-based Meyers Brothers Kalicka; (413) 536-8510.