MILNER UNIVERSITY

Buy-Sell Agreements

What and Why?

A buy-sell agreement is a legal arrangement between business owners where they agree to purchase each other's shares upon the occurrence of a triggering event such as death, disability, or retirement. The agreement creates future financial obligations that are typically funded with life and disability insurance. A properly structured buy-sell agreement provides several benefits to business owners including establishing a buyer, setting a selling price, creating estate liquidity, fixing the business value for estate purposes and insuring a proper transfer of ownership. The three main types of buy-sell agreements are entity purchase, cross purchase, and one way arrangements.

Types of Agreements

Entity Purchase (a.k.a. Stock Redemption) Agreements are structured such that the business entity agrees to buy out individual owners. When an owner's share is purchased by the business entity the remaining owners' ownership percentages increase correspondingly. To fund the agreement the business entity would purchase life and disability policies on each owner and name itself as the owner and beneficiary of the policies. There are two main advantages to this type of arrangement. First, it minimizes the number of policies needed since there is only one of each type per owner. Second, since premiums are paid by the business any large discrepancies in premiums between owners are spread out across the company instead of being borne by the younger and healthier owners. A major disadvantage of entity purchase agreements is the inability of remaining owners of a C-Corp to receive a stepped-up basis equivalent to the purchase price of the deceased owner's shares. This will increase their tax liability when they choose to sell their portion of the business. S-Corp owners using a cash basis accounting can receive the favorable stepped-up basis treatment by electing to divide the current tax period into two short tax years immediately following an owner's death. They can then get a loan to purchase the deceased owner's shares during the first short tax year and then use the death benefit proceeds to pay off the loan during the second short tax year. It is important to note that insurance premiums paid by the business are not deductible.

Cross Purchase Agreements are structured such that each business owner purchases insurance policies on the other owners and names himself as the owner and beneficiary of the policies. Upon the death or disability of an owner the remaining owners use the insurance proceeds to purchase the deceased owner's shares. This structure has the advantage of giving the remaining owners a stepped-up basis when they purchase a deceased owner's shares. There are two main disadvantages. First, this structure is not feasible when there are a large number of owners since the number of policies required is exponential (N x (N-1) where "N" = number of owners). A good rule of thumb is to consider moving to an entity arrangement when there are more than 4 owners. The second disadvantage is the potential for large premium discrepancies between younger and healthier owners versus older and unhealthier owners. The owners that are required to pay higher premiums for the same coverage will often feel that the arrangement is inequitable.

One-Way Buy Sell Agreements are useful when there is only one owner of a business especially when the current owner has no succession plan in place. They are typically structured such that a key-person agrees to buy out the current owner. The agreement is funded with insurance where the key-person is the owner and beneficiary of the contract. The premiums can be paid either by the business or the key-person. It often makes sense for the business to pay the premiums as a bonus to the key-person as a way to retain a talented employee and also create a market for the business interest at the same time. In this case the premiums would be deductible to the business and taxable as income to the key-person.

Appropriate Types of Insurance

Buy Sell Agreements create a financial obligation upon death, disability, or retirement. It is important to use the correct types of insurance to fully cover these obligations. Disability income insurance is appropriate to cover the disability buyout portion. The life insurance selection can be more complicated as there are many types of life insurance that are appropriate to cover the death and retirement buyout portions. The simplest and cheapest would be a level term policy. There are several potential issues with this approach. The first issue is that the coverage has a limited time span. Ideally this should be matched to the owner's planned retirement date but often, especially in small businesses, this date is unknown and unplanned. Term insurance is also ineffective in addressing the retirement funding as it does not build any value. This can be partially mitigated by using a return of premium (ROP) term policy combined with a side fund. At the set retirement date the ROP proceeds can be combined with the side fund to purchase a retiring owner's share. A cash value life insurance policy can be designed to address both the uncertain retirement date and the need for cash to fund the retirement buyout. These policies are permanent and can be designed to build large amounts of cash value that is tax-deferred and can be withdrawn to fund the retirement buyout. In addition, many permanent contracts have the option to add an LTC rider that allows access to the death benefit if the insured is unable to perform two ADLs or has a severe cognitive impairment. For a relatively small cost this benefit could aid in funding the disability buyout component.

Business Valuation

A business valuation is an essential component to a properly structured and insured buy sell agreement. It is important that the business value is known so that the agreement is equitable and the proper amount of insurance is purchased. It is equally important to review agreements regularly to ensure that they are up to date. Every five years is a good rule of thumb. The Milner Group has the resources to provide these valuations, recommend the correct arrangement and get the insurance planning and underwriting underway.