PALLAS
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Planning Commentary

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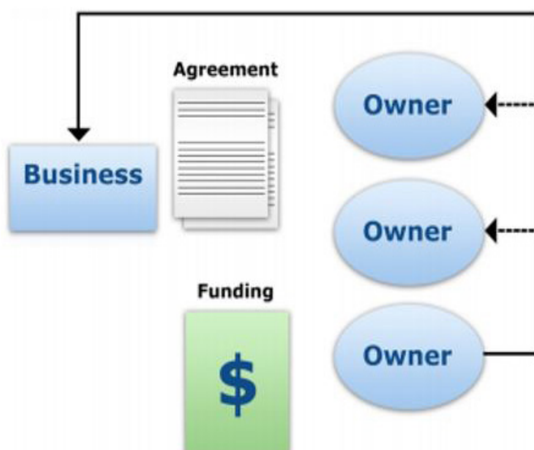
Structuring and Funding a Business Buy-Sell Agreement

As a partner or co-owner (private shareholder) of a business, a substantial portion of your family's net worth is undoubtedly tied to the value and success of your business. Most successful business owners, at some point, need to consider setting up a buy-sell agreement. Doing so will help to ensure their family a smooth sale of the business interest in the event of the owner's premature death, disability, or even retirement.

After establishing the agreement, the next natural decision will be how to fund the agreement. One of the first funding methods to consider is life insurance. Life insurance used to fund the buy-sell agreement can create a sum of money at death (and if structured accordingly at disability or retirement) that will be used to pay the owner, his/her family or estate the **full value** of the ownership interest.

FIRST THINGS FIRST- *WHAT IS A BUY-SELL AGREEMENT?*

Buy-sell agreements are very important planning tools that can accomplish many things for a business with two or more owners. Sometimes referred to as a business continuation agreement, a stock purchase agreement, or a buyout agreement, a buy-sell is a legally binding contract that establishes when, to whom, and at what price an owner, partner, or shareholder can sell his or her interest in a business.



- **Smooth Transition**: Buy-sells can accomplish many objectives, but are primarily used to ensure the smooth continuation of a business after a potentially disruptive event, such as an owner's retirement, incapacity, or death.

- **Liquidity When Needed:** Additionally, because funding for buy-sells is typically arranged when the buy-sell is executed, the possibility that funds will not be available when needed is minimized, and a deceased owner's estate can be provided with needed liquidity for expenses and taxes.

- **Key to Estate Planning:** The ability to fix the purchase price as the taxable value of a business interest makes this tool especially useful in estate planning. Agreeing to a purchase price while all parties are alive minimizes the possibility of unfair treatment to a deceased owner's heirs. The IRS' acceptance of this price as the taxable value can help minimize estate taxes on the deceased owner's business interest.

DIFFERENT TYPES OF BUY-SELL AGREEMENTS

In an ***entity purchase*** (*aka* ***redemption***) buy-sell agreement, the business itself buys separate life insurance policies on the lives of each of the co-owners. The business pays the annual premiums and is the owner and beneficiary of the policies.

In a ***cross-purchase*** buy-sell agreement, each co-owner buys a life insurance policy on each of the other co-owners. Each co-owner usually pays the annual premiums on the policies they own and are the beneficiaries of the policies. If your company has several co-owners, multiple policies must be purchased by each co-owner, which can be cumbersome – *see "trusteed cross-purchase agreement" below.*

A ***wait and see*** (*or* ***hybrid***) buy-sell agreement allows you to combine features from both the entity purchase and cross purchase models. The business can buy policies on each co-owner, the individual co-owners can buy policies on each other, or a mixture of both methods can be used.

A ***trusteed cross-purchase agreement*** can be used when the number of owners and thus the number of policies required to fund the arrangement makes a cross purchase agreement difficult to administer.

- An independent trustee purchases a life insurance policy on each one of the owners that is party to the agreement. Each owner contributes funds to the trustee to pay the life insurance premiums on the lives of the other owners.
- When an owner dies, the trustee will collect the policy proceeds and pay the deceased owner's estate in exchange for the business interest. The purchased business interest is reallocated to the surviving owners. The deceased owner's interest in the policies insuring the surviving owners can be reallocated to the surviving owners as part of the agreement (see notes considering Transfer for Value under Considerations).

A ***Business Acquisition Trust (BAT) or business continuity trust (BCT)*** is an irrevocable trust(s) used to purchase the business interest from the owner or from the owner's estate.

- The trustee may use the proceeds of the life insurance to purchase the decedent's share of the business. The surviving owner's irrevocable trust becomes a co-owner of the business.
- Can provide management structure to assure continued profitability and fair market value of business.

When using a buy-sell to set the estate tax value of a business interest, careful drafting is essential. To pass muster, all buy-sells must pass the following four-part test:

1. The estate must be obligated to sell the business interest at the price set forth in the buy-sell.
2. The buy-sell must place certain restrictions on lifetime transfers of the business interest.
3. The value of the business interest must be fixed by, or determined from, the agreement.
4. The buy-sell must be a bona fide business arrangement, and not a transfer for less than adequate consideration.

When the buy-sell involves family members, it must also be proven that the transaction is comparable to arms-length sales between unrelated persons, and was entered into for a bona fide business purpose.

Determining the fair market value of a business may require an independent business valuator. The IRS will impose penalties for understating the value of an asset for estate tax purposes.

LLC buy-out agreements utilize a separate LLC which is formed by the business owners to own life insurance for the cross-purchase agreement.

- For a retirement buyout, the life policy may be transferred to the departing owner as part of the purchase price. The departing policy owner can subsequently access policy cash value in retirement, potentially income-tax free.
- If the triggering event is death, the life insurance death benefit is paid to the LLC income tax-free. The LLC distributes the proceeds to the surviving owners, income tax-free. The LLC members then complete the purchase of both the LLC interest and underlying business interest from the deceased owner's estate.
- Each purchaser is generally able to increase his or her basis in the businesses based on the purchase price.

WAYS TO FUND AN AGREEMENT

The agreement can be funded by each owner purchasing a life and/or disability insurance policy on the life of the other owners. Insurance is often a very efficient method of funding a buy-sell arrangement. If insurance is not possible, other options include planning to borrow the necessary funds and/or installment buyouts. Each of these options has inherent weakness/limitations that may make them more costly to the business owners than insurance.

Factors that generally influence the choice of funding method include:

- Business structure, size, and tax bracket
- Number of owners, their ages, tax brackets, and ownership percentages
- Levels of cash or credit available to the business or the owners
- Type of buy-sell agreement

HOW FUNDING WITH LIFE INSURANCE WORKS

When using life insurance with a buy-sell agreement, either the company or the individual co-owners buy life insurance policies on the lives of each co-owner (but not on themselves). If all goes well, the deceased owner's family gets a sum of cash they can use to help sustain them after the owner's death, and the company has ensured its continuity.

ADVANTAGES OF USING LIFE INSURANCE

- Life insurance creates a lump sum of cash to fund the buy-sell agreement at death.
- Life insurance proceeds are usually paid quickly after the owner's death, ensuring that the buy-sell transaction can be settled quickly.
- Life insurance proceeds are generally income tax free.
- If sufficient cash values have built up within the policies, the funds can be accessed to purchase an owner's business interest following retirement or disability.

DISADVANTAGES OF USING LIFE INSURANCE

- Life insurance premiums are paid with after-tax dollars because the premiums are generally not a tax-deductible expense.
- Premium requirements are an ongoing expense.
- One or more co-owners may be uninsurable due to age or illness.
- If the co-owners' ages vary widely, younger co-owners will have to pay higher premiums on the lives of the older co-owners.

THE VALUE OF THE BUSINESS COULD CHANGE OVER TIME

After the buy-sell agreement is established and funded, hopefully the business value continues to grow. It is not unusual for the amount of insurance proceeds to turn out to be less than the value of the owner's business interest. In that case, surviving family members might end up getting less than full value for the business interest. The buy-sell agreement should specify how the valuation difference will be handled.

Conversely, the insurance proceeds might be greater than the value of the owner's business interest at death. The buy-sell agreement should address this potential situation upfront and specify whether the excess funds will belong to the business, the surviving co-owners, or the deceased owner's family or estate.

POSSIBLE NEGATIVE TAX CONSEQUENCES

- **IRS Code 101(j):** For policies issued after August 16, 2006, the death benefits of life insurance on the life of an employee payable to the employer/policy owner may be subject to income taxes unless an exception applies. IRS Code Section 101(j) requires employer owned life insurance contracts to have a signed Notice and Consent and annually file Form 8925 in order to qualify for exceptions to the general rule under this code section. and a portion of the proceeds received from the transferred policies may be taxable.

POSSIBLE NEGATIVE TAX CONSEQUENCES (CONT.)

- **Transfer for Value:** Assume your business is a corporation or is taxed as one. When one of the co-owners dies, his or her estate becomes the owner of the insurance policies covering the other co-owners of the business in a cross-purchase agreement. If these policies are then transferred to the surviving co-owners to pay for future buyouts, a transfer-for-value (gain) may occur, and a portion of the proceeds received from the transferred policies may be taxable.

- **Income Taxation on Gain of Policy Cash Values:** If a policy is canceled (surrendered) for cash to buy out an owner's interest while the owner is still living, any gain on the policy is subject to federal income tax for the policyowner. Gain includes all policy loans outstanding at the time of surrender. Also, the policy may carry surrender charges.

MONITOR THE LIFE INSURANCE

The buy-sell agreement should include a feature requiring ongoing proof of payment. Also, review the amount of insurance regularly. The insurance coverage may have to be increased periodically to reflect increases in the value of the business. If additional insurance is not possible, another funding method should be established.

CONCLUSION - A BUY-SELL FUNDED WITH LIFE INSURANCE CAN MAKE A BIG DIFFERENCE

At the death of an owner:

- **Advantages to Surviving Owners:** May require the decedent's estate to sell, may establish the purchase price, may provide the cash to buy, keeps ownership in hands of surviving owners (or intended purchasers), or permit uninterrupted operations and control of the business.

- **Advantages to Departing Owner:** May obligate surviving owners to purchase the business, may establish the value of the business interest for estate settlement purposes, or create a market for the business interest.

While all owners are living:

If utilizing life insurance, may create a reserve fund in the form of insurance cash values which may be used to fund a buy-out during life or to supplement the policy owner's retirement.

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