Plan ahead for peace of mind

The benefits of using a buy-sell agreement

If you're an owner of a closely held business, consider creating a buy-sell agreement. It provides the means for an orderly transfer of ownership at your death, whether to family members or to remaining owners.

It also can establish what will happen to your interest in the event of other triggering events, such as disability, retirement, withdrawal or other specified event. Moreover, it details the terms of the future sale — such as who will have the obligation or option to buy your interest and how the sale price will be established.

Buy-sell agreement objectives

A buy-sell agreement sets a value for your ownership interest (generally based on an independent appraisal of your business or an appropriate valuation formula) and provides a market for the interest. It also can help set the value of the interest for federal estate tax purposes, which reduces the likelihood of challenges by the IRS. (See "Determining value" below for more on valuation methods.)

Two types of agreements

The two basic types of buy-sell agreement — cross purchase and redemption — are typically funded by life insurance. Using life insurance to fund the agreement helps ensure that your business partners will have adequate liquidity to cover the full buyout of your ownership interest. This, in turn, provides your heirs and your estate with liquidity that might otherwise be lacking if there were no ready buyer for the shares.

Let's take a closer look at each agreement type:

Cross purchase agreement. With this agreement, each owner owns life insurance policies on the other owners' lives. When an owner dies, the surviving owners buy his or her interest.

Cross purchase agreements can offer several tax advantages. For example, the surviving owners receive a stepped-up basis equal to the purchase price, which reduces income taxes in the event they later sell their shares. Also, because the insurance proceeds bypass the company, the surviving partners avoid corporate alternative minimum tax (AMT) issues.

On the down side, this agreement can be tedious when there are more than a few owners. Why? Because the number of policies required expands so quickly. For example, a company with three owners would require six policies, but a company with double the owners (six) would require five times as many policies (30).

This issue can be avoided by using a trusteed cross purchase agreement, whereby the trustee is the owner and beneficiary of one policy on each life. The trustee is required to fulfill the obligations under the agreement.

There also can be issues with how premiums will be paid — especially if there are significant age differences between the owners. In such a situation, the premiums on the policies for the older owners likely will be much higher.

Redemption agreement. In this agreement, the company owns the life insurance policies on the owners' lives. After an owner dies, the company buys back that owner's shares. Because the company is the sole policy owner, fewer policies are needed and the payment of premiums is simpler.

A redemption agreement may be easier to administer than a cross purchase agreement, but it also can create tax problems. Remaining owners may not receive a stepped-up basis, and the company may be subject to corporate AMT on the life insurance proceeds.

In certain situations, combining elements from both a cross purchase agreement and a redemption agreement to create a hybrid agreement may be the ideal solution for all involved parties.

Tailoring the agreement

There's no "one-size-fits-all" buy-sell agreement; it must be customized to meet your company's and its owners' needs. Specifically, the agreement should:

- Stipulate the triggering events for the sale of an owner's interest in the company,
- Set a method for valuation, and
- Outline the purchase price for the owner's interest and determine funding.

Regularly review the buy-sell agreement to ensure it meets all requirements and tax laws, as well as the evolving needs of your business.

Plan for your heirs' financial future

A buy-sell agreement can ensure the value of your business interest transfers according to your wishes. By making preparations today, you can help alleviate potential discomfort between the company's remaining owners and members of your family — and also help contribute to your heirs' financial well-being.

Determining value

There are several methods for valuing a business interest when drafting a buy-sell agreement, such as:

Formula pricing. This method provides a means to estimate fair market value. Formulas are objective but they may not consider factors that influence fair market value. When using a formula price, regularly review it to ensure that it remains in line with your objectives.

Book value. This is the net book value determined by the entity's records or tax returns or as deter-mined under Generally Accepted Accounting Principles (GAAP). This value may be based on your company's financial statement, audit or tax return. Net book value is not typically indicative of fair market value.

Certificate of agreed value. Sometimes the purchase price of an interest in a closely held company is based on an amount agreed on by the owners, which often is predicated on the amount of an owner's life insurance policy proceeds. This method may be simple, but it may not reflect fair market value.

The method you choose can affect whether the value will apply for estate tax purposes. After you've determined which method is best for you, be sure to periodically review and update it as needed.

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