Entity Purchase Buy-Sell Agreement

Overview

A buy-sell agreement specifies how business interests will be transferred, to whom, and under what circumstances. An entity purchase agreement is structured so that the business agrees to buy the interests of any owner when he or she dies, becomes disabled, or retires. These plans are frequently funded with life insurance and disability buyout insurance.

Details & Operations

The business owners should visit with an experienced attorney to discuss a buy-sell agreement. Once they have decided on the entity purchase format, the attorney will draw up the agreement. The parties to the buy-sell agreement are the individual business owners and the business entity. In designing the agreement, several important issues are involved: buy-out events, valuation, funding, and buy-sell variations.

Buy-Out Events

Nearly all buy-sell agreements provide that the death or retirement of an owner triggers a buyout. The parties sometimes overlook the possibility of the disability or divorce of an owner. In the event of divorce, for example, the stock could end up in the hands of the ex-spouse, which the remaining owners may not want. Other triggering events can be the firing of a minority owner or the personal bankruptcy of an owner.

Valuation

One important requirement for a business purchase agreement to work is a consensus on the value of the business. An agreed-upon amount or method prevents valuation disputes between a departing owner or a deceased owner's estate and the remaining owners. An accurate valuation also allows the parties to anticipate how much funding will be necessary for a buyout.

There are several ways to address the valuation question.

- Valuation can be based on a formula detailed in the agreement.
- The agreement can require the parties to revalue the business every year. If the parties don't revalue the business within a given amount of time, the agreement can provide a valuation formula.
- The agreement can require a professional business appraiser to value the business. The appraiser can develop a valuation based on several factors, such as the annual earnings of the business.

Funding

There are several ways to fund a buyout.

- The company can simply create a sinking fund using a savings account or another conservative investment. The risk is that there may not be enough cash to fund the buyout. Also, the cash in the fund may be unavailable for other purposes.
- The company can borrow the money from a bank, but there will be interest costs. The bank also may be reluctant to lend money to a business if a key person has died or is leaving the company.
- Assuming the agreement allows, the company can make installment payments. This is often the only option where other liquid funds are not available, which is frequently the case with most businesses. When a buy-out event occurs, the company would pay the departing owner or a deceased owner's heirs a set amount each year determined by the language in the buy-sell agreement. The departing owner or his/her heirs may have a concern as to whether the surviving owners can profitably run the business.
- The most common funding option is for the company to obtain life and disability buy-out insurance on the owners. In the event of an owner's death, the company can use the death benefit proceeds to buy the deceased owner's interest. Disability buy-out insurance can serve the same function, if the owner leaves due to disability. In both cases, the funds are available at the precise time necessary. If life insurance is the chosen funding medium, the company would obtain policies on each of the business owners. To preserve the income tax free nature of the death benefits, the company must comply with the notice and consent requirements of Internal Revenue Code Section 101(j).

Buy-Sell Variations

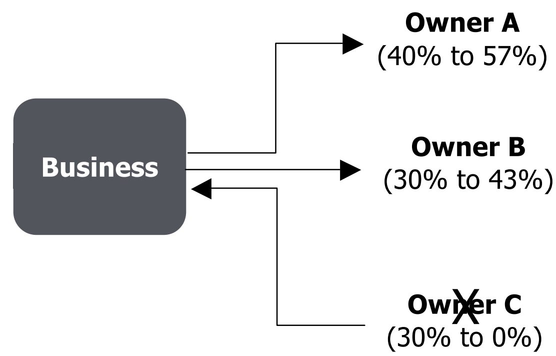
Another type of buy-sell arrangement is a cross-purchase buy-sell plan in which the remaining owners, not the entity, purchase the departing owner's interests. If insurance is used to fund a cross-purchase arrangement, it is owned by the owners other than the insured. So, if A, B, and C are owners, A would own policies on B and C, B would own policies on A and C, and C would own policies on A and B, for a total of six policies. Sometimes a trust or partnership is formed to own the policies, so that only one policy per owner is needed.

Another variation is known as a "hybrid" or "wait and see" buy-sell arrangement. This type of agreement provides flexibility for the owners to use an entity or cross-purchase buy-out, or a mixture of the two, depending upon the situation when an owner dies or is required to sell. Insurance for this arrangement is usually structured as for a cross-purchase arrangement, with the owners making loans or capital contributions to the business for an entity purchase.

Entity Buy-Sell Arrangement

1. A owns 40%, and B and C own 30% each.
2. Business and Owners execute entity buy-sell agreement.
3. Business buys insurance on A, B, and C.
4. C dies, and Business collects proceeds and purchases C's 30% from C's estate.
5. C's estate recognizes no gain because the value of C's interests is stepped-up to date-of-death value.
6. After the purchase, A will own 57% of the business, and B will own 43%.

Flow of Business Interests at Buy-Out



7. The remaining owners' basis in the business will not change. The entity purchase does not result in a basis step-up for remaining owners.

Insights and Caveats

- When no family members are involved, a binding buy-sell agreement with an "arm's length" valuation generally will be sufficient to set the value for estate tax purposes. If family members are involved, a valid recent business valuation by a professional business appraisal organization is recommended.
- In a corporate stock redemption, families must also be wary of attribution rules that could cause the purchase to be less than the selling shareholder's full interest, thereby causing the payment from the business to be treated as a dividend, instead of a sale and purchase of property.
- The entity plan is particularly appropriate when there are more than two business owners, and the buy-sell agreement is funded with insurance. In an entity plan, the business owns only one policy for each owner, thereby reducing the number of policies needed to a minimum. C corporations may be subject to corporate alternative minimum tax when owning life insurance.
- When the business owns the life insurance, it is critical to comply with the notice and consent requirements of IRS §101(j). If proper notice to and consent from the insured are not provided, the death proceeds will be subject to income tax.