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By Carolyn M. Glynn and Henry Montag March 10, 2021

A buy-sell agreement between the joint owners of a closely held business or professional practice is critical for the orderly continuation of the business following a "triggering event," such as the death, divorce, disability, bankruptcy, retirement or termination of an owner.

Such an agreement, which may be part of a shareholders agreement, operating agreement, partnership agreement or other agreement, is generally a legal contract among the owners that serves three main purposes:

1. It can facilitate the sale of shares in the business by providing a ready market of buyers and an ascertainable value of shares.

2. It can prevent the ownership by unwanted third parties or increased concentrations of current ownership by placing restrictions on the transferability of shares.

3. It can create a funding mechanism and source of liquidity as a result of the triggering event so the company is not forced to sell illiquid assets at an inopportune time.

In addition to maintaining control and promoting continuity and harmony, a sound buy-sell agreement can also mitigate a deceased owner's estate tax liability by precluding an IRS challenge that the decedent's sale of shares during their lifetime was a taxable, disguised gift instead of a bona fide sale for full and adequate consideration.

While specifying possible triggering events in a buy-sell agreement is relatively straightforward, establishing the value of the business is typically not. Owners can choose from a variety of valuation methods that differ in complexity, cost and accuracy. Some buy-sell agreements attempt to set a price annually, with each owner consenting to the agreed upon annual valuation. While this assures that a current and realistic business value is used, it is easy to overlook this annual price setting, and before long, the figure may become outdated. Alternatively, the value may be tied to the company's adjusted book value, or a capitalization of earnings, or a formula incorporating a multiple of several of these factors. As long as the methodology produces a reasonable price for the relevant time and is properly reviewed and documented in the buy-sell agreement, the owners will have a chance to either improve the valuation or prepare for the potentially devastating financial consequences down the road.

The buy-sell agreement must specify how the "buy-out" will be funded if a triggering event occurs. The central question is, how will the buyer afford to buy the departing owner's interest? Since most businesses do not maintain sufficient retained earnings to have the surviving owner pay out the value of the business to the heirs of the deceased owner's family in cash, the most effective alternate funding mechanism is a life insurance policy pegged to the percentage value of each owner's share in the business. The business owners have an important decision to make on this point: They can choose a permanent or term policy lasting for 10, 15, 20, 25 or 30 years, in the event of a death, depending on the age of the partners. Keep in mind that various insurance companies have limitations as to what ages they will allow an individual to purchase a particular term insurance policy. For instance, many insurers will not allow an individual over age 65 to purchase more than a 15-year policy as the majority of insurers will not provide coverage to an individual beyond age 82.

If a business or professional practice is fortunate enough to be flush with spare cash, it could purchase a life insurance policy for the purpose of providing a death benefit. It could use a permanent life insurance product capable of accumulating a large sum of cash value on a tax-deferred basis. This fund would grow over the years and be available for the shareholders or partners to use as a deferred compensation plan to supplement their retirement income. This type of a Supplemental Owners Retirement Plan (SORP) or Supplemental Executive Retirement Plan (SERP) can be established on a discriminatory basis for an owner or key person with minor administrative reporting. Of course, cost is always a factor and a term insurance policy is considerably less expensive than a longer-lasting permanent type of insurance policy that could remain in force beyond age 82. The point is that clients need to know that they can either use the life insurance in their buy-sell agreement for the traditional death benefit or for a "living benefit."

Since the odds of a disability occurring with one or more owners are greater than the likelihood of a death, funding for a potential disability buyout should be considered in all types of buy-sell agreements. In addition to insuring the owners, consideration should be given to also insuring a key person against a premature death or disability. Since a key person will rarely remain in the workplace into their late 70s, a term policy with 50 percent of the death benefit going to the business as a key person and the other 50 percent going to a key person's family can go a long way toward keeping the key person happy and tied to the business at a relatively low cost.

Redemption vs. cross-purchase agreements

A buy-sell agreement can be structured as a*redemption agreement*or a*cross-purchase agreement*. In some cases, the agreement might be a hybrid of the two. Under a redemption agreement, at the death of an owner, the entity will be the buyer (or the primary buyer) of the owner's interests in the entity. Therefore, the*entity*will own the life insurance policies insuring the lives of its owners. Upon an owner's death, the proceeds are paid to the entity, which in turn uses the proceeds to buy the interests of the deceased owner from his or her personal representative. Once the entity buys the shares, the shares are no longer outstanding, and the interests of the remaining owners in the entity are increased proportionately. A redemption is simple and provides centralized management to administer the policies and collect the death benefits. A redemption agreement is preferable because the policies are owned by the entity and, as such, are not subject to be attached by the deceased owner's creditors.
Under a cross-purchase agreement, in contrast, the surviving owners (not the entity) purchase (or at least have the first option to purchase) the deceased owner's interest in the entity. The owners individually own the policies insuring each other's lives. When a business owner dies, the

proceeds are paid to those surviving owners who hold one or more policies on the deceased owner's life, allowing these surviving owners to buy the shares from the deceased owner's personal representative.

A hybrid approach is often used where the owners want the flexibility for either the entity or the surviving owners to buy a deceased owner's interest, while requiring those receiving insurance proceeds at the death of an owner to be obligated to purchase the deceased owner's interest. In the example above, if the corporation receives insurance proceeds after a death, the corporation would first be required to purchase those shares with a value equal to the insurance proceeds received, and any remaining shares could be purchased by the surviving owners or by the corporation.

A redemption agreement has two primary benefits over a cross-purchase agreement. First, redemption agreements are simple. The entity buys the deceased owner's interest and the remaining owners do not have to worry about coming up with the funds to do so. Second, if an owner leaves the entity, it is relatively easy to administer the policies. However, the remaining owners do not receive the step-up in basis as they would under a cross-purchase agreement. This issue is particularly important at this time in light of President Biden's proposal to eliminate the carryover basis.

While several different options are available to the business owner or the owner of a professional practice, it's important for the advisor to stress the benefits of getting the partners or shareholders together to discuss the difficult "what-if" issues, including where will the money come from to redeem the deceased partner's or shareholder's percentage ownership for their family? A well thought out and sufficiently funded buy-sell agreement that provides for a key person payout to the remaining owners' as well as to the deceased partner's family will make it substantially easier for the remaining partners to continue to successfully operate the business as a going concern. The best time to discuss these issues is now, when everyone is calm and healthy, rather than in the middle of a medical, financial or legal crisis.

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