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What to look for in an existing buy-sell agreement

Every successful business owner should know that a funded buy-sell agreement is a very important part of business planning. It ensures a way to convert business wealth to personal wealth; provides financial security to the owner and his or her family; and allows for the orderly transition or disposition of an ownership interest in a closely held business. Unfortunately, as a business owner, even if you have a buy-sell agreement, it's quite possible that it may not be adequate for your purposes today. How do you know if your buy-sell agreement is protecting you and your family?

A fully funded buy-sell agreement provides many advantages to a retiring or disabled owner, or the family of a deceased owner. Some of the advantages are: (1) guaranteeing a purchaser for the business interest; (2) assuring a fair price for the business interest, which can fix the value of the business for estate tax purposes; (3) turning an illiquid asset into a liquid asset to help fund retirement, or to pay estate taxes and facilitate estate administration; and (4) providing an income producing asset which will not be dependent upon the future success of the business.

Some of the advantages to the remaining or surviving owners are: (1) establishing triggering events to guarantee a sale at an agreed-upon price; (2) permitting uninterrupted operation of the business; (3) maintaining harmony and control without interference from the deceased owner's family or a disabled owner; and (4) providing funds necessary to purchase the business interest without causing an unnecessary financial strain on the business, or a need to borrow funds.

As personal or business circumstances change, it is vital to ensure that your buy-sell agreement is reviewed on a regular basis and that the agreement remains fully funded.

What to look for and to ask yourself and your financial professionals

Basic provisions: First, there are a number of fundamental questions to ask to test the basic effectiveness of the agreement. Does the agreement reflect current value? Is the agreement funded? Has the funding kept pace with current value? What type of agreement is it?

Does the form of agreement meet the needs of the business and the owners? Does the ownership of insurance match the type of agreement? Has the agreement been amended to include owners added after the original drafting?

This is just the beginning. The inclusion of the following items in your buy-sell agreement will cover other issues that could prevent disaster if any of these situations arise.

Gifts of stock: Does the agreement allow each shareholder to make gifts of stock to family members or to trusts for their benefit? Such gifts may be appropriate for a shareholder's individual estate planning needs. If such gifts are allowed, will a triggering event that causes the shareholder to sell stock, also cause the gift recipients to also sell stock ("drag-along rights")? Will the gift put the gift recipient in a "no win" situation as a minority shareholder with no dividends and no say in running the business? Also, would a gift of S corporation stock cause an unintentional termination of the "S" election? Although we are talking about stock in a corporation, similar principles apply with ownership interests in partnerships or limited liability companies.

Options to purchase: In some situations where an "offering shareholder (or business owner)" is required to offer his ownership interest to the business or other existing owners first (perhaps as a condition before selling to an outsider), must all of the ownership interest be purchased? For example, without such a provision, Owner A, who owns slightly less than a majority of the business, can buy just a few shares from the "offering owner," in order to become the majority owner without worrying about the remaining interest.

Identity of potential purchasers: Does the agreement provide that the identity of a potential purchaser be made known to the remaining owners before they need to make a decision? The remaining owners may be happy to become co-owners with Mrs. X, but not Mr. Y.

Right of first refusal: If one owner desires to sell his or her interest to a third party, do the remaining owners have the right to purchase the offered business interest at the price and terms set in the agreement, or at the price and terms offered to the potential outside purchaser? The first alternative is one of the requirements necessary for the price set in the agreement to fix the estate tax value. If the second alternative were used, the price set in the agreement would not fix the estate tax value.

Disability trigger: Does the agreement include a purchase provision triggered by the disability of one of the owners? If so, what is the agreement's definition of disability? Many agreements state that for an owner's disability to be sufficient to trigger the purchase provision it must have the opinions of two doctors -- one hired by the owner claiming to be disabled, and the other hired by the remaining owners. If these two doctors can't agree, they will mutually select a third doctor, who will make the final decision. Obviously, this process is unnecessarily time consuming, expensive and sometimes not satisfactorily conclusive.

It is far better to ensure that the buy-sell agreement is funded with disability buy-out insurance and to coordinate the definition of disability in the agreement with the definition used in the disability insurance policy. If a disability buyout policy can not be obtained, another alternative is to tie the definition of disability to a disability income insurance policy. If an insurance company determines that an owner is disabled enough to commence monthly disability income payments, it should be a sufficient determination to trigger the disability buyout provision.

Transfer of insurance policies: Does the agreement provide for the possibility that the insurance funding be unwound? For example: assume that we have a closely held corporation worth $3,000,000. The three stockholders A, B, C, have a "cross purchase" agreement funded with insurance that each owns on the others' lives (A owns a $500,000 policy on B and on C, B owns that same amount on C and on A, and C owns the same amount on A and on B). If A dies, B and C each collect a $500,000 death benefit from the respective policies they own on A's life, and they purchase A's interest from his estate. So far so good, but what happens to the $500,000 policies that A's estate now owns on B's and C's lives? If the agreement says nothing concerning this issue, and B has a medical condition which could result in a shortened life expectancy, A's estate could keep B's policy, pay a few more premiums, and profit from B's premature death. This, of course, could be seen as an unfair result.

What should the buy-sell agreement provide? What should A's estate be required to do with the policy it owns on B's and C's lives? After the purchase of A's stock from his estate, B's and C's interests in the corporation have increased to 50% each, now worth $1,500,000. They each own only $500,000 of insurance on the other's life, so they need a greater amount of funding. Should the agreement provide that A's estate sell the policy on B's life to C (and sell the policy on C's life to B)? Sounds logical, but unfortunately, this creates a situation known as a "transfer-for-value" trap which would result in a substantial portion of the death proceeds of those policies being received as taxable income. This would not apply if, instead of a corporation, we had a partnership or a limited liability company taxed as a partnership.

Perhaps, A's estate should be required to transfer the policies on B's and C's lives to the business for use as key person insurance or for some other business purpose.

Avoiding the “transfer-for-value” trap can be complicated but should be appropriately addressed in your buy-sell agreement. You should consult with your Guardian Financial Representative as well as your tax and legal advisor on this matter.

Business valuation: Another question to ask is “What valuation method is used to set the price for the business?” A commonly used method is the “agreed value” method, whereby the owners meet (usually annually) to confirm the existing value or to set a new value for the business. However, if the business is deemed to be family owned, the agreed value method will not be sufficient to fix the value of the business for estate tax purposes, and such value can be challenged by the Internal Revenue Service. Fixing the estate tax value is one of the advantages of a buy-sell agreement. The problem arises more frequently than one would think because, unlike other areas of the Internal Revenue Code, siblings are deemed to be family members for these purposes.

Conclusion

As you can see, while a buy-sell agreement is an important part of planning for the disposition of a business, there can be several areas where changes are needed for the agreement to be made more effective, and even to avoid potential tax traps. This document merely highlights a few areas that need to be addressed. There are many other provisions that may affect the appropriateness and effectiveness of your business continuation agreement.

Please consult with your Guardian financial professional if you have any questions concerning this document.

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guardianlife.com

New York, NY

Pub7766 (11/24) 7245511.1 (Exp. 11/26)

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