Buy-Sell Agreements Vital Business Succession Plans

YOU AND your business partner or partners have a clear vision of how to run your business, where it's going, and how it's going to get there. You've worked together to share the daily demands and shape the success of your business.

But, have you thought about what would become of the business and all your hard work if you or one of your partners became ill, was seriously injured or died?

A business doesn't have to run into troubles just because one of the owners retires, dies or becomes too sick or disabled to work. Whether the transition of business management or ownership needs to take place after death or during life, it can be accomplished in an orderly fashion through appropriate business succession planning.

A buy-sell agreement is a tool commonly used in business succession planning. This planning feature, when correctly funded and designed, can orderly establish the value at which the business will be taken over and who will be doing the taking over.

The owner can have peace of mind knowing that the business has a predetermined basis for which it can be sold in a ready market, thereby giving the owner a source of funds when they need it, such as when they are ready to retire. If the owner was to die prior to the above-predetermined basis occurring, then the buy-sell can be used to meet the survivor's needs.

While there are several ways that a buy-sell agreement can be established, an entity purchase agreement and cross-purchase are the two most often used.

Cross-purchase

Due to favorable tax results, this is a highly used approach by many small businesses. It's generally used by operations that only have a small number of owners. The cross-purchase is typically funded with a life and/or disability insurance policy that each of the owners must maintain on their co-owners.

The death benefits from the life insurance policy aren't subject to taxation since the owners, not the business, actually own the individual life insurance policies. Each of the business owners is legally obligated to purchase the ownership interest of the other co-owner(s) upon death.

The deceased owner's estate sells the owner's interest to the surviving owners in exchange for the proceeds from the life insurance policy. The surviving owners will get a step-up in the business's tax basis.

Alternatively, the insurance cash value can also be used if one of the co-owners needed to fund a buyout during their lifetime.

Administrating a cross-purchase is easiest to pull off when there are a limited number of owners, and becomes increasingly difficult to administer as the number of owners increases.

Entity purchase agreement

This type of buy-sell agreement works somewhat like the cross-purchase, but it's the business, not the owners, that will maintain an insurance policy on each owner and agree to purchase any deceased owner's interest in the business. As such, the taxation is different.

The death benefits under both an entity purchase and cross-purchase agreement, whether being paid to the business or an individual, are exempt from federal income taxation.

However, unlike with the cross-purchase, there are certain situations in which a C corporation can be subject to the corporate alternative minimum tax under an entity purchase. There's also no step-up in basis under the entity purchase plan.

The takeaway

Hopefully, this brief overview of the entity purchase and cross-purchase types of buy-sell agreements has spurred you to think about how vitally important business succession planning is to your business.

Of course, this short article couldn't possibly cover all the factors to consider when developing a business succession plan. As you begin the preparations for your succession plan with your attorney, accountant and us. They should be able to answer any additional questions or concerns you might have. ❖