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The Elements of Buy-Sell Planning For Business Owners

By James C. Mulder

This article will lay out the basics for business succession planning - specifically, the use of cross-purchase and Equity Redemption buy-sell agreements.

Background

For many business owners, the business itself is their primary source of income both during working years and in retirement. Thus, buy-sell planning is critical for not only death planning but also disability and retirement planning during lifetime. Additionally, any business that has more than one owner needs a buy sell agreement to restrict the transfer of the owner's equity in the business to a limited and qualified group of potential owners.

The time to set up a buy sell arrangement is when the business starts and all owners are in a good, agreeable mood. Once you have the business formed and are running down the track it becomes more and more difficult to get all owners to sit down to agree on the terms of a buy sell agreement.

There are two traditional types of buy-sell agreements: ((1) stock (equity) redemption (aka entity purchase) and (2) cross-purchase agreements).

Stock (Equity) Redemption (Entity Purchase)

Since most businesses in the past have been corporations, these agreements were called "stock" redemption agreements. With the advent of LLCs as the preferred entity of choice for a business owner, I call these "Equity Redemption" agreements.

With an Equity Redemption arrangement, the business has the obligation to repurchase the equity of the owner who has had a triggering event. It owns any life or disability buy out insurance and agrees to redeem the equity of a deceased or disabled owner at that owner's death or disability. It also agrees to repurchase an owner's equity upon the happening of any other "triggering" event, such as retirement, termination of employment for other reasons, or bankruptcy. The owner in turn agrees that her or his estate or representative will transfer the equity back to the business for an agreed-upon price. These prices can vary depending on the triggering event.

The advantages of this arrangement are:

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- The company usually has most of the money;
- The simplicity of only one life or disability insurance policy per owner;
- The owners allocate all premium costs according to their percentage ownership in the business; and
- This arrangement ensures compliance with the terms of the buy-sell agreement.

The disadvantages of Equity Redemption arrangements are many:

- There is no change to the remaining owners' basis so the remaining owners may incur larger capital gain tax upon a lifetime disposition;
- The insurance policies and sinking funds set up to purchase the equity of a selling owner are subject to attachment by the business's creditors;
- If the business is a C corporation, death proceeds may also be subject to the alternative minimum tax (AMT);
- If business-owned buy-sell policies are over-funded to provide non-qualified retirement benefits to the owners, the benefits are generally subject to income tax; and
- Potential taxation on redemption of the equity if the business is a C corporation to the extent of earnings and profits.

If the business is an S corporation, the results of an Equity Redemption arrangement are better, because the AMT and attribution rules do not apply where the business has always been an S corporation.

Also, the life insurance cash value and death proceeds give the owner some stock basis adjustment, reducing the amount of capital gain tax that may be triggered on a sale during life or at death.

Cross-Purchase

Under a cross-purchase arrangement, each owner is individually obligated to purchase the equity of the owner who has had a triggering event. (i.e. death, disability, retirement, etc.) When life or disability buyout insurance is involved, each owner owns a policy on every other owner.

The advantages of this structure are:

- The survivors use income-tax-free death or disability benefits to buy equity directly from the selling owner or his estate, thereby increasing their basis in their overall ownership equity; and

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- Policies or other assets that will be used to purchase the selling owner's equity are protected from the business's creditors and can be set up to protect them from the purchasing owners individual creditors.

The disadvantages of cross-purchase arrangements are:

- The number of policies required to accomplish funding (each owner must own a policy on each other owner) quickly becomes unwieldy as the number of owners increases;
- An owner may fail to pay premiums or refuse to pay death or disability proceeds when received, so you have no assurance of the selling owner getting paid;
- The premium burden is allocated based on the cost of insurance of each other owner, thus a younger owner who owns policies on the lives of older owners has much more in premium to pay; and
- Potential income tax on life insurance received when surviving owners purchase from the deceased owner's estate the policies on the other surviving owners) or need to buy new policies to cover increased values.

Other Issues

Under either kind of agreement, you should address other issues. These are:

- Divorce of an owner – make sure you don't become partners with a divorced spouse of an owner. In order to accomplish this, if the owner is married when the business is formed, it is presumed community property, so the spouse must agree and sign the agreement too;
- Bankruptcy or attachment – if one owner gets into financial trouble, make sure that the business can buy out the interest before becoming partners with a creditor or Trustee in bankruptcy;
- Disagreement that can't be resolved – consider a triggering method to allow an equal owner to either force a sale or purchase of another equal owner's interest if there is an impasse and the business is suffering; and
- Owner leaves the business.

Conclusion

Buy-sell planning and equity restriction is critical for business owners, but many defer implementation of it because they just want to run their business and make money. It's the same in asset protection, if you don't plan now, it may be too late to plan later.

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