The Business Library — **Resource Report #3**

Buy-Sell Agreements and Succession Planning

For Owners, Executives, and Family Members

- **Why You Should Have a Buy-Sell**
- **Buy-Sell Methods and Uses**
- **Structuring a Buy-Sell Agreement**
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Concepts and Terms to Know

- Cross-Purchase Buy-Out
- Stock Redemption Buy-Out
- Survivor Option
- Optional vs. Mandatory Purchase
- First Offer or Right of First Refusal
- Taxation of Life Insurance
- Joint Life or First Death Insurance
- Legended Ownership Certificate
- Valuation Methods
- IRS Revenue Ruling 59-60

For those who already have a buy-sell, use this report to be sure your current agreement is valid, complete, and up-to-date.

Reasons to Consider a Buy-Sell

It's been widely reported that 80% of the owners and executives of closely held businesses *have not effected* a buy-sell agreement to purchase their stock upon death or permanent disability. The best argument for having a buy-sell agreement is not the advantages of having one but rather the possible negative consequences of *not* having one. Here are situations which could occur in any form of business ownership, including C and S corporations, limited liability companies, partnerships, and even sole proprietorships if a successor hasn't been identified.

☐ *The plan:* The majority owner wanted his heirs' interests in the business converted to cash and the other stockholders to carry on the business. *The reality:* There was no formal buy-sell agreement in place and the remaining owners didn't have sufficient cash to buy the stock because they held no life insurance on the owner. The family had to sell its controlling shares to outsiders — and at a substantial estate discount. In this case, both the majority and minority owners lost out.

☐ *The plan:* The stockholders in a closely held corporation wanted to keep the corporation's dividends as low as possible in order to have capital to expand the business. *The reality:* The widow of the majority owner, inheriting 65% of the shares, installed her own board of directors who repeatedly voted for maximum dividends, leaving insufficient capital to finance the company's growth.

☐ *The plan:* Another owner planned to sell her 20% interest in the company at 150% of its book value per share to finance her retirement years. *The reality:* When the time came, all she could get for her minority ownership position was a low "distress" price. There wasn't a buy-sell agreement in place to establish the value and selling price or to contractually commit the company or majority owner to purchase back her 20% interest.

The death, disability, or retirement of an owner, co-owner, or minority stockholder is a possibility that should be protected against — or the owners, the company, and their families may have to pay the price. Too many owners' plans have gone awry because proper precautions weren't taken or the buy-sell wasn't properly thought out or legally drafted.

The questions that need to be considered in designing a buy-sell agreement:

- Should the buy-sell be a cross-purchase or stock redemption or a combination?
- Should the buy-sell be funded with the proceeds from life insurance on each owner's life and what cautions should the surviving owners take to assure payment?
- If insurance is the financing vehicle, who should pay the premiums: the company or the individual owners?
- How do you structure insurance policies to receive the proceeds free of income and estate taxes?
- What is the value placed on the business by the agreement and does it conform to IRS valuation guidelines?
- Does the buy-sell provide for *automatic* and *periodic* increases in the value of the company and in the financing provided?

What about your existing buy-sell agreement? Is it valid, up-to-date, all-inclusive? The checklist starting on page 6 will help you answer those questions and many more. Feel free to copy it and forward it to your advisers.

Now, on to how to use a buy-sell agreement to protect you, your family, and your business.

Thomas J. Martin, *Author*

In many cases, a buy-sell is the *only* way an owner can cash in.

Structuring a Buy-Sell

A buy-sell agreement protects the value of a business and assures its continuation beyond its current owners. Properly structured, a buy-sell can also provide additional income to the owners and their families on disability or retirement. *Note:* Although we principally use shares in a corporation as our example, the concepts apply to *all* ownership positions.

Buy-Sell Methods and Uses

There are two principal methods to effect a buy-sell agreement:

- *cross-purchase,* when existing stockholders or partners purchase each other's ownership interest, and
- *stock redemption,* when the corporation purchases the stock of any stockholders.

In some cases, a combination of both buy-sell methods is used.

The major reasons to effect a buy-sell agreement are to:

1. *Preserve control* by restricting transfers or sales of company stock or other ownership interests to persons outside the company or outside the owner's immediate family.

2. *Protect the business' assets and its ongoing operations* in case of the death, retirement, or disability of an owner.

3. *Provide cash or other assets* (e.g., life insurance proceeds or promissory notes) to the owner's family on his or her death.

4. *Establish a method for determining the value of a business* for estate tax purposes and for setting a fair market price for the future transfer, gift, or sale of company stock by an owner, family members, or others.

5. *Assure sufficient liquid assets* are available to an owner's family to pay potential federal and state estate taxes, and to meet the financial needs of surviving family members.

6. *Structure stock option incentives* to retain key employees, who also can be part of the buy-sell arrangement.

Sit with your stockholders and advisers to determine a buy-sell agreement's applicability to your specific *business* and *family* needs. If you already have a buy-sell, use the following checklist to be sure your existing agreement is valid, up-to-date, and complete.

Buy-Sell Checklist for New and Existing Agreements

Here are the major items to include in a buy-sell agreement.

- ☐ The names of the individuals, number of shares (percent ownership), purchase price, and the corporate or partnership entity involved in the buy-sell arrangement.
- ☐ When the agreement will become effective — death, termination of employment, retirement, and/or disability.
- ☐ What the method of stock purchase is: stock redemption, cross-purchase, a combination of both, or a *survivor's option* plan where the decision is not made until the death or retirement of the owner.
- ☐ How the selling owner(s) will get paid for the stock: life insurance proceeds, promissory notes, other owners' personal assets, company cash, or a combination.
- ☐ The circumstances under which the ownership position (e.g., actual shares of common stock) can be hypothecated or otherwise encumbered for loans or other purposes.
- ☐ Whether the buy-sell is a legal *obligation* or only an *option* to buy or sell the stock.
- ☐ The conditions under which the buy-sell is to be amended or terminated and whether it requires the written approval of all or just a majority of those involved.

- ☐ The state law governing the agreement and any arbitration provisions in case of a dispute.

- ☐ A "first-offer" or “right of first refusal” clause that states that, before a stockholder can sell his or her stock to another individual (or firm), it must first be offered to the corporation and/or to other stockholders.

- ☐ A clause binding *future* owners to the buy-sell agreement, e.g., covering stock options issued to key executives, which are later exercised for common stock.

- ☐ The buy-sell price and the method for updating the value over time, preferably every year or two. Keep in mind that the value of many closely held businesses can increase (or decrease) substantially from year to year.

  Valuation options: To the base valuation price in the buy-sell agreement, do the following: (a) plus or minus the annual increase in the company's reported net book value, *or* (b) apply a multiple, say 10 to 15, to the increased earnings since the buy-sell agreement was signed. *Note:* Other valuation methods are discussed below.

- ☐ A provision for an independent trustee if the purchase price of the shares is substantial and funded by life insurance. *Recommendation:* Use a law firm or financial institution to make sure the insurance proceeds are disbursed *directly* to your designated heirs/beneficiaries.

Value of Ownership Position

Be aware that the IRS can challenge the value placed on the business in the buy-sell agreement. It often does just that when no documentation exists to support the business' value and price per share. Documentation is particularly important if the buy-out is substantial; you don't want any hassle with the IRS over gift or estate taxes. You can support your valuation and buy-sell price by using the following valuation methods.

- *Reported book value:* This value is prepared by your accountant; it’s simply the company’s total assets less all liabilities. To determine *tangible net book value,* subtract intangible assets, e.g., goodwill and capitalized financing costs, from reported net book value.

- *Adjusted book value:* This method increases the company’s book value to the extent that the value of certain assets (principally real estate, equipment, and inventory) exceeds the cost basis of the assets as shown on the company's balance sheet. This approach usually increases the value of the assets and thus the company's book value.

- *Price-earning's multiple (p/e):* Here, you simply apply a multiple, say 12, to the company's net income. If the net income is $100,000, the value of the company is $1.2 million. The faster the company's growth, the higher the p/e. This is how most publicly held companies are valued.

- *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT (earnings before interest and taxes) and apply a multiple to it, usually 4 to 8, depending on the company's growth rate, its profit margin on each dollar of sales, proprietary products, and balance sheet substance. *Note:* Some appraisers and analysts add depreciation and amortization expenses to the formula for what is referred to as EBIT-DA.

- *Replacement value:* This method writes up all assets to their replacement value and then subtracts the liabilities. It can substantially increase a company's value and is principally used when selling a business to company executives or to another company which wants to get into your line of business.

- *Projected value of earnings:* This method applies a present value rate of about 15% to the company's projected net income. Basically, it is today's value of a company's future net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow value.* This method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is particularly appropriate for young companies with high growth rates.

Your accountant can help you apply the above valuation methods. But don't use only one method; to obtain an average value, calculate the value for several methods and then apply a "weight" to each method (e.g., 25% to each of four values). For the factors the IRS considers in valuing a business, please see pages 14 and 15.

How to Protect Ownership Position

There are other precautions you should take to assure the buy-sell agreement's validity and effectiveness. Again, these ideas apply to *both* existing and new buy-sell agreements.

1. To protect your right to acquire the shares, each ownership certificate subject to a buy-sell agreement should have a *written legend* stating so on the face of the certificate. *An example:*

   "These shares are subject to a buy-sell agreement dated ________."

2. If the company is to buy the shares, you will have to provide for that in the corporate minutes and obtain minority owners' approval. Check with your lawyer.

3. The signed buy-sell agreement must be bona fide, entered into in good faith, and effected on an arm's-length basis, particularly when transacting with family members. (You can't set a low value on a small portion of your company stock and expect that value to apply to your remaining holdings for estate tax purposes.)

4. The buy-sell price per share must be reasonable and legally binding. It *cannot* be a device to transfer ownership to family members at less than its *full* fair market value.

5. The owner or his or her estate must be restricted from selling the shares without first offering it at the buy-sell agreement price to the other stockholders or to the company.

Buy-Sell Taxation

The major questions are: (a) who pays the premiums and are they tax deductible, (b) will the life insurance proceeds be tax-free or taxable income, and (c) who owns the policy and who is the beneficiary?

As a general rule, life insurance premiums are *not* tax deductible and life insurance proceeds are *not* taxable income when received by the beneficiary. If the company is the owner and beneficiary of the life insurance policy underlying a stock redemption plan, there is usually no tax problem. It's straight-forward — the premiums *are not* tax deductible by the company, so the proceeds received *are not* taxable income.

Problems can occur when the company is not listed as the policy owner and the company owner is. When the company owner dies and the company uses the insurance proceeds it collects as the policy's beneficiary to acquire the stock from the deceased owner's estate or heirs, tax questions can arise. That's because the proceeds of the insurance policy will be included in the value of the estate if the deceased company owner is the owner of the policy.

Estate taxation has gotten increasingly complicated over the years. There's the unlimited marital deduction, the lifetime exemption of $1 million, the estate tax exemption of $3.5 million per taxpayer in 2009, complete repeal of the estate tax in 2010, and then expiration of the 2001 Tax Act with full estate taxation again in 2011. So you can see that careful planning is essential anytime company stock becomes part of an estate.

The best advice: Know the tax implications *before* structuring your buy-sell agreement *or* purchasing life insurance to fund the buy-sell. Also review *who* will own the policies and *who* will pay the premiums. Both your accountant and life insurance agent can help structure the buy-sell for the maximum tax advantage. If you currently have an executed buy-sell agreement, talk to your advisers about the many tax and estate changes that have occurred over the last 10 years. You may need to revise your buy-sell agreement.

Other Alerts

- *Disability buy-out:* When reviewing this **Resource Report** with your advisers, also discuss how to protect yourself if you or another owner becomes disabled. You may want to provide for each owner's disability in the buy-sell agreement.

- *Installment sale:* To defer taxes, you also might want to consider an installment sale of the ownership interest. But keep in mind that delaying receipt of payments to your beneficiaries or heirs also increases the risk of not collecting them at all or collecting them late.

- *Stock redemption:* Be careful if the corporation is buying the stock; you will have to provide for that in the corporate minutes and obtain other stockholders' approval.

- *Use more than one adviser:* Effecting or updating a buy-sell agreement can be complex. Be sure to obtain the advice of your accountant, lawyer, insurance agent, and estate planner.

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Remember that the protection provided by a legally binding buy-sell agreement is important protection — for a business, for its owners, and for the families of the owners. Take the time now to further discuss this protection with your advisers. ☐

References: Please see the following:

Exhibit 1: Financing the Buy-Out of Your Stock, page 12

Exhibit 2: How the IRS Will Value the Business, page 14

Exhibit 3: Place Controls on Who Owns Your Company Stock, page 16

Exhibit 1

Financing the Buy-Out of Your Stock

Establishing the procedure by which stock is bought and sold on the departure or death of a company owner is the first step in protecting the company. Providing the money to carry out the procedure is the second.

You can't assume that the surviving owners will have enough personal liquidity to finance the purchase on their own or that they will be eligible to borrow the required amount. The price tag on shares in a profitable, growing company can be substantial. Nor can you assume the company will have sufficient liquidity or access to capital to fund the purchase on its own. You might want to consider another approach for providing the needed money.

Consider life insurance. Life insurance on the life of each owner can supply all or part of the needed cash. If the corporation sets up a stock redemption plan, it buys the insurance and names itself as the policy's owner and beneficiary. Although this method does provide the required cash, be careful. The actual buy-out will usually *increase* the stock's value for the remaining owners, especially if the buy-sell uses a book value formula.

Example of increased value: Assume three stockholders each own one-third of a corporation. When one dies and the corporation buys his or her interest, the remaining two stockholders will each own 50%. Consequently, the value of their ownership position substantially increases, which can correspondingly *increase* their potential estate taxes and the need for more life insurance on each remaining owner's life.

When the owners are responsible for the buy-out, each may insure the life of the other. The insurance payout is then used to purchase the deceased owner's interest. Inexpensive term insurance can be used, but make sure it can be converted to permanent (whole life) insurance.

Also watch out for situations where the company ends up assuming the obligations of the remaining owners who are forced to buy the stock of a departing or deceased stockholder. If the company satisfies the personal obligations of the remaining stockholders, there could be horrendous tax consequences, e.g., the IRS could label the payments as dividends to the surviving shareholders. That's why expert tax and insurance advice is always needed before structuring *and* finalizing a buy-sell agreement.

How much insurance to buy. The shares to be covered by insurance on each owner's life represent a certain percentage of the company's value at the time the insurance purchase is made. For example, if there are four stockholders who each own 25% of a company valued at $1.2 million, then $300,000 life insurance must be purchased on each owner's life. To reflect *future* increases in the value of the stock, the dollar amount needed to purchase the shares should be adjusted periodically along with the amount of life insurance being relied upon to finance the purchase.

Joint life or first death: Another possibility, where several owners have roughly equal shares of the company, is *joint life* or *first death* insurance. The policy covers all of the owners, but pays the life insurance proceeds only when *any one of the group* dies. The insurance proceeds can be paid to the company or to the others in the group, depending on how the agreement was set up. Of course, if this type of insurance is used, it will be necessary to work out a new arrangement and take out a new policy after the death of one of the owners.

Covering a shortfall. Regardless of which buy-sell method is used, provisions should be made to make up any shortfall in the life insurance proceeds. For example, if only $200,000 insurance is available to buy, say, $300,000 of stock, then $100,000 additional cash should be provided for. The agreement can specify that such a shortfall be covered by an installment note payable over three to five years. In addition, provision should be made for the use of any *excess* proceeds if the amount of life insurance exceeds the buy-out price. □

Exhibit 2

How the IRS Will Value the Business

The factors below should be considered when valuing *any* closely held business for any reason, including sales, transfers, gifts to your children or other family members, and stock options granted to key executives.

These factors, taken as a whole, provide the basis for a comprehensive, defensible valuation. But they have added importance because they are the factors the IRS uses in valuing businesses, which were released in IRS Revenue Ruling 59-60.

- The nature of the business being valued, e.g., manufacturer, distributor, sales rep agency, or service business. *Example:* A manufacturer with proprietary products will command a higher multiple on its earnings than a distributor or service business.

- The economic outlook in general and, in particular, the condition and outlook of the specific industry. The faster the industry is growing, the higher the value since earnings should also grow at a faster rate.

- The net book value of the company (assets less liabilities) and the overall financial condition of the business.

- The historical and projected earnings of the company, particularly, its earning potential over the next three to five years. Again, the faster the growth rate of projected earnings, the higher the multiple applied to those earnings.

- Whether the stock is voting or non-voting. Non-voting stock cannot effect control or management changes.

- The company's ability/capacity to pay dividends and provide an annual return to its stockholders.

- The existence of goodwill or other intangible assets, such as licenses, patents, special niche in the industry, location, and an established salesforce and customer base, all of which can add to the value of a business.

- Prior sales, transfers, and gifts of shares to others (e.g., an employee, venture firm, or family members). *Note:* If the sale or transfer was effected on an arm's-length basis, this will help establish the fair market value of the stock.

- The size of the block of stock being valued, e.g., minority or controlling block. If it's a minority position, a discount of 20% to 40% can be applied to the value.

- The value and price-earning's multiple of companies engaged in the same or similar lines of business, whose shares are publicly traded in a *free* and *open* market.

- Restrictions on the sale of the stock, e.g., a buy-sell agreement which sets a price for the stock and restricts its sale to others. *Note:* The value in a buy-sell agreement will apply only if it was negotiated at arm's length and is reasonable.

Revenue Ruling 59-60 further states that "all *available* financial data" and "other relevant factors affecting the fair market value of the stock" also must be considered. With that wording the IRS opens the door to question *any* aspect of a business it deems relevant. ☐

Place Controls on Who Owns Your Company Stock

How would you like a 10% minority owner giving 2% of his ownership in your company to each of his five children? Or, your daughter's divorced husband owning part of your company? Or, a creditor becoming a stockholder? Or, someone you never met getting shares of stock in your business?

When either you *or* your company — be it a regular C or S corporation, partnership, or limited liability company — sell or transfer any ownership position, including gifts and options to buy stock, be sure the buyer (or recipient) represents that the stock is *being acquired or given for investment purposes only.* Also stipulate that the shares can't be sold or transferred without complying with the rules of the Securities and Exchange Commission and applicable state laws. *There's more —*

Precaution #1. An investment agreement should be prepared which specifies all of the terms, restrictions, and conditions of the stock sale, transfer, gift, or option to buy stock.

Precaution #2. Get the right of first refusal to buy back the stock if the new owner should decide for any reason to sell or transfer the stock in the future. This right should be exercisable by **both** you and your company.

Precaution #3. On the face of the actual stock certificate issued to the buyer (or recipient), print a legend alerting any potential buyer of your and your company's rights and other restrictions on the shares. Specifically, a typed or written notice should indicate that: (a) the recipient (owner, buyer, executive, giftee) cannot sell, encumber, gift, or otherwise transfer the shares, (b) the shares of stock are subject to an investment or buy-sell agreement, and (c) you and/or the corporation have the right of first refusal to purchase the shares. As previously noted, the legend also should include a reference to the Securities Act of 1933, noting that the shares can't be sold or transferred without complying with the rules of the Securities and Exchange Commission and applicable state (blue-sky) laws.

Precaution #4. If the stockholder has the right to sell, transfer, or gift stock to other individuals, indicate in the agreement that — if you don't exercise the right of first refusal — any **future buyer or recipient** will be bound by the investment agreement and by the written legend on the stock certificate. That way, if you have a buyer whose four children inherit shares of stock, each child will be bound by the terms of the investment agreement.

Precaution #5. Indicate in the agreement that the stock *can't* be encumbered, e.g., used as collateral for a personal bank loan. That way, a creditor of the stockholder can't confiscate your company's stock in foreclosing on a personal loan.

* * *

Remember, these precautions also apply to stock option agreements with key executives, as well as gifts of stock to your children. *Why?* That executive or family member may get divorced and you could wind up with his or her ex-spouse as a disgruntled and troublesome minority owner.

The final message: Get good legal advice before selling, transferring, or giving options on any ownership position, including warrants and convertible securities sold to investors to raise capital for your business. And, if you now have minority owners, check with your lawyer to be sure their stock or stock options comply with the five precautions. ☐

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

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