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Buy-Sell Agreements: Protecting Your Multi-Owner Business

By Grafton "Cap" Willey, CPA

What would happen to your company if one of the other owners left or passed away? Would there be a smooth, preplanned transition of ownership or might you face uncertainty, financial difficulties and possibly expensive litigation?

With the loss of a co-owner such a potentially difficult issue, every business with multiple owners should have a buy-sell agreement. If you already have one, it should be kept up to date.

General Priorities

The primary purpose of every buy-sell agreement is to legally confer on the owners of a business or the business itself the right or obligation to buy a departing owner's interest in the company. But there are other benefits you may have had in mind when creating yours.

For example, perhaps you want to ensure that control of the business is restricted to specified individuals, such as current owners, select family members or upper-level managers. Does your current agreement secure the company in this regard?

Another common purpose of a buy-sell agreement is to establish a price for the ownership interests. When reviewing yours, you should engage a qualified appraiser to estimate the value of those interests. In fact, your agreement may require doing so regularly.

Estate planning is also a key priority for many buy-sell agreements. If this is the case for yours, bear in mind that some important changes have taken place in this realm. For 2013 and beyond, the American Taxpayer Relief Act of 2012 raised the top rate for the gift, estate and generation-skipping transfer (GST) taxes to 40%. But it also retains the high $5 million gift, estate and GST tax exemptions, annually indexing them for inflation (to $5.25 million for 2013). Does (or should) your agreement account for these developments?

Triggering Events

A buy-sell agreement can lie dormant for years. What can quickly bring it to life is a "triggering event," which is when many companies unfortunately realize that the agreement should have been updated.

The standard triggers for a buy-sell agreement are an owner's voluntary desire to leave the company and, more tragically, an owner's abrupt death or disability. Presumably yours covers these triggers, but it may not cover others. For instance, changes in one or more owners' marital status could affect the company, so risk of divorce should also be addressed in the agreement.

More and more buy-sell agreements are also being updated to combat the risk of fraud or inappropriate behavior. You might add as triggering events: “conviction for committing a crime, losing a professional license or certification, or becoming involved in a scandal.” You could restructure your arrangement to require an owner guilty of such indiscretions to sell at a lower price.

Structure Status

When you established your buy-sell agreement, it more than likely conformed to one of three common structures:

- A *redemption agreement*, which permits or requires the business as a whole to repurchase an owner’s interest,
- A *cross-purchase agreement*, which permits or requires the remaining owners of the company to buy the interest on a typically pro rata basis, or
- A *hybrid agreement*, which combines the two preceding structures — for example, by requiring a departing owner to first make a sale offer to the company and, if it declines, then selling to the remaining owners as individuals.

Naturally, any review of your agreement should reassess its structure and consider whether a change is warranted. Tax implications are also important to consider, and they’ll differ based on whether your company is a flow-through entity or a C corporation. You’ll also need to weigh the time and expense of a major revision to your agreement against the risk of a potentially ineffective structure.

Funding Approaches

Look closely at how your buy-sell agreement is funded. Your business may use life insurance as a go-to source for funds to buy out a departing owner. This is generally a prudent approach.

But there are alternatives. If your company is particularly cash-rich and confident in its ability to remain so, you could simply rely on your reserves to fund your agreement. Obviously, however, this would leave the business vulnerable to a major problem should an owner leave when cash flow is low.

Yet another option is creating a “sinking fund” by periodically setting aside money for paying out the agreement. But, again, if your cash flow *ebbs* more than *flows*, you may not have enough funds to buy out a departing owner when the time comes.

Tax Considerations for C Corporations

Buy-sell agreements are typically structured as a redemption agreement, cross-purchase agreement or hybrid of the two. For C corporations, redemption agreements funded by life insurance can lead to a couple of potentially undesirable tax consequences:

- The company’s receipt of insurance proceeds might trigger corporate alternative minimum tax, and
- The value of the remaining C corporation owners’ shares will likely go up without increasing their basis, which may escalate their tax liability if they sell their interests.

The first point is generally an unavoidable consequence of using life insurance to fund an agreement. But the second point can be mitigated by using a cross-purchase agreement, rather than a redemption agreement. Under a cross-purchase, owners buy additional shares themselves, therefore increasing basis.

The downside to a cross-purchase agreement for C corporations? If it requires the remaining owners to buy the departing owner's shares, but the company redeems the shares instead, the IRS may view the purchase as a taxable dividend. A way to cope with this is to construct a hybrid agreement, under which the corporation is a party to the transaction and the remaining owners are permitted, but not required, to buy back the stock.

Top Priority

Having an outdated or ineffective agreement in place is almost as dangerous as not having one at all. So be sure to regard yours as a living document that keeps up with the internal and external changes your company faces.

If you have any questions about buy-sell agreements and your business, please contact your CBIZ Tofias tax advisor, or you may also contact Grafton "Cap" Willey, Tax Managing Director, at GWilley@cbiztofias.com and 401.626.3213. You may also reach us at TheBottomLine@cbiztofias.com and 617.761.0600.