

In Focus: The Holy Grail of Buy-Sell Agreements

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In businesses where there are co-owners / partners, having a comprehensive buy-sell agreement in place is a crucial. However, in typical buy-sell agreements, it's usually much better for a co-owner to exit by death rather than to exit while they are alive. You may wonder why. The simple answer is that death is the only ownership exit event that is funded under most buy-sell agreements.

Reminds me, no surprise, of the iconic 'Bring out your dead' scene in the (hilarious) 1975 movie 'Monty Python and The Holy Grail'. I am sure many of you, like me, have been quoting the lines from this scene (and movie) for decades now. "Bring out your dead I'm not dead! ... Well, he will be soon. He's very ill. I'm getting better! No, you're not. You'll be stone dead in a moment.... I don't want to go on the cart! ... Oh, don't be such a baby."

Key Takeaway

Buy-sell agreements should contain provisions to govern all potential ownership transfer events. Transfers during the lifetime of co-owners are seldom addressed adequately because advisors recommending buy-sell agreements often focus on a transfer at death – and the juicy life insurance policy that goes along with it. In contrast, a good Exit Planning Advisor will highlight the other common scenarios and encourage owners to review and update their agreements to better address, far in advance, the full spectrum of possible outcomes. Their exit planning advisor will bring in other specialists, as needed, (e.g., CPA and attorney with tax expertise) to craft a comprehensive agreement now to help avoid the heartache and expense of a major dispute down the road. (Or paying 6 pence to an undertaker to cart away your not-quite-dead-yet co-owner



Consider that the typical boilerplate buy-sell agreement addresses only two ownership transfer scenarios: death of an owner or an owner's wish to sell to an outside third party. In the case of an owner's death, there is usually a mandatory sale and purchase at the value stated in the buy-sell agreement and the purchase is funded by life insurance. In the case of an owner wishing to sell his or her ownership to an outside third party, the agreement usually allows the remaining owners to purchase his or her interest at the price offered by the outside party, the price stated in the buy-sell agreement, or the lower of the two.

What is not adequately addressed is the — more common — situation where one co-owner wants to exit and sell their ownership to other co-owners or the company during their lifetime. The list of potential reasons for their exit include the other of the 5 D's exit planners speak of often (in addition to Death):

Disability | Disagreement | Divorce | Dissolution

Exit Planning Advisors that explain these common events to their clients and walk them through theoretical scenarios are more likely to get the owners motivated to review their current buy-sell agreements.

The typical buy-sell agreement provision (if any) provides an option to the company to purchase an owner's interest at the value agreed upon in the agreement. The form of payment is a multi-year promissory note. Depending on how valuation is determined in the agreement, the value may favor the buyer or the seller. Additionally, purchasing ownership in this manner creates a double tax on the income produced by the business.

So, what is the best approach to designing a buy-sell agreement to provide for the sale of an owner's interest to other owners, the company, or key employees?

A good Exit Planning Advisor will bring in other specialists as needed. In this case, a specialist who understands the tax consequences of such a transaction to the buyer and the seller. The sale needs to be structured to minimize the tax consequences to the departing owner and to the buyer.

If an exit planning advisor is engaged early on, they will look to structure buyout scenarios before any co-owner is contemplating an exit and before any tensions build between the owners. The goal should be to agree on the total net after-tax proceeds a departing owner will receive, and then determine the most tax efficient way to accomplish that. The exit planning advisor and the tax specialist will address with the owners' considerations such as:

- Method to establish value of company and value of a departing owner's interest.
- Income tax minimization planning such as using the lowest defensible value and making up the difference via tax-deductible payments to the departing owner.
- Payment terms: cash or terms of promissory note plus... Incremental sale of ownership or wage continuation plan and other recommendations to transfer ownership on a tax- deductible basis.

In the specific case of the disability of a co-owner a recommendation would be to include in buy-sell agreements a disability buy-out provision that is funded with insurance. This is a simple, but partial solution to both the disabled owner and the company. It's a partial solution because disability buy-out insurance seldom covers the entire value of the acquired ownership interest. The shortfall can be made up by installment payments between the company and the disabled owner.

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Founded in 2001, FocusCFO is the leading onsite fractional CFO services provider in the Midwest and Southeast. FocusCFO works closely with small to medium sized businesses helping business owners gain control over three key financial and operational areas: increasing cash flow, reducing business risk, and creating a platform for scalable growth. This allows business owners to then realize full financial control and increased value in their businesses.