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PLANNING FOR SUCCESSFUL BUSINESS SUCCESSION WITH BUY-SELL AGREEMENTS

By Spencer M. Baxter

It is an all too common mistake for new business owners (and even long-time business owners) to focus their energy exclusively on day-to-day operations and fail to implement the right business planning. One occurrence that emphasizes the importance of having the right business plan in place is the death of a business partner. In most situations, decedents leave their business interest to their spouse or children. This can be a problem for the other partners because they are forced into business with the spouse and/or children of their deceased partner. The solution to this sticky situation is a properly drafted Buy-Sell Agreement created before the death of a partner. The Buy-Sell Agreement can lay out the precedence of business interest succession; whether it be to existing shareholders, the business itself, or even family members of the deceased shareholder.

Buy-Sell Agreements, also known as "Business Pre-Nups", can be integrated into the business operating agreement/corporate by-laws or they can be a stand-alone document. It is very important that the Buy-Sell restrictions be listed not only in the business operating agreement/corporate by-laws, but also on the individual ownership certificates held by the business owners. All Buy-Sell Agreements should establish the value of the business ownership interest at the time of the shareholder's death; whether it be a predetermined amount, or a certified appraisal. Many Buy-Sell Agreements are fueled by life insurance to solve the problem of liquidity for the purchase of the deceased partner's shares from their family. Another option for the share purchase is to structure an installment agreement with payments over time.

CROSS PURCHASE BUY-SELL AGREEMENT

One of the two common types of Buy-Sell Agreements is the Cross Purchase Agreement. This agreement gives the individual shareholders of the business a specified priority to purchase the shares of another shareholder no longer in the business. Life insurance policies are typically owned and paid for by each shareholder, individually, on the lives of each of their shareholder partners.

Cross Purchase Agreements can be very income tax efficient because the family of a deceased shareholder will have the full step-up in cost basis to the value the shares were worth on the date of the shareholder's death. When the family then sells the shares to the other shareholders; they can have little or no capital gains taxes. The purchasing shareholders are also able to purchase the shares at a higher cost basis with the liquidity hopefully provided by the life insurance. This is important because if at some point in the future the purchasing shareholder sells the more recently acquired business shares, they would likely have less capital gains taxes, than if they sold their original shares with a lower cost basis.

Unfortunately, the more shareholders involved, the more complicated Cross-Purchase Agreements can be due to the higher number of life insurance policies that must be coordinated. There is also the potential for unequal life insurance premiums because some shareholders may be older or have adverse health conditions.

SHARE REDEMPTION BUY-SELL AGREEMENT

The second commonly used type of Buy-Sell Agreement is known as a Share Redemption Buy-Sell Agreement. In this type of Buy-Sell the business has the first purchasing priority on the shares of the shareholder leaving the business. Conversely to the Cross-Purchase agreement, in a Share Redemption Buy-Sell, the business owns life insurance policies on the lives of the shareholders and upon the shareholder's death, the influx of the death benefit paid to the business is used to purchase the shares from the estate/family of the deceased shareholder.

One of the key benefits of a Share Redemption Buy-Sell is the simplicity. The business only has to own one life insurance policy on each shareholder, as opposed to having multiple polices owned by multiple shareholders. Since the business pays the premiums on the life insurance policies, unequal premium payments are not felt among the individual shareholders.

Unfortunately, in a Share Redemption Buy-Sell there is no step up in cost basis for the shareholders still involved in the business. A business typically merges the deceased shareholder's interest back into the business, not allowing for the higher cost-basis shares to be purchased by the remaining shareholders individually. The end result is that the future sales of shares will likely incur greater capital gains.

HYBRID BUY-SELL AGREEMENT

A third Buy-Sell option is available where the business owners find it appropriate to have the language of both Cross-Purchase and Share Redemption Buy-Sell Agreements combined into a Hybrid agreement. For example, the Shareholders may have the first priority to buy the deceased shareholders' shares. If they choose not to exercise their first priority right, the business may have the next option to purchase the shares.

CONCLUSION

The decision on how to structure a Buy-Sell Agreement depends on a variety of factors, all of which result in a Buy-Sell Agreement customized for the given business and shareholders. The attorneys of Johnson, Gasink & Baxter, LLP regularly consult with their clients regarding the proper structure of their business, Buy-Sell Agreements, as well as making sure that the client's Business Planning and Personal Estate Planning are fully integrated.

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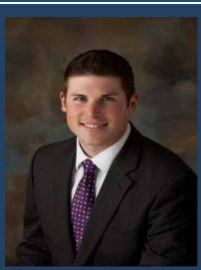

About the Author:

Spencer Baxter is an experienced problem solver who helps individuals and businesses achieve and protect their goals of prosperity, stability and growth through appropriate planning. Spencer takes great pride in making sure that his work for clients is always reliable, correct, and on time.