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Transferring Your Business Interest with a Buy-Sell Agreement

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What is a buy-sell agreement?

Business succession tool

Events like the death, disability, or retirement of an owner don't have to mean the end of the business. Business succession planning can provide for an orderly transition of ownership and business management, during lifetime or at death. One tool used in business succession planning is the buy-sell agreement. A properly designed buy-sell agreement can allow you to keep control of your business until death, disability, retirement, or other specified event. This discussion will provide an overview of buy-sell agreements in general, reasons why you might want to have a buy-sell agreement, and a brief description of each specific type of buy-sell agreement.

Legal contract

A buy-sell agreement is a legal contract, common in closely held businesses. It is an agreement you can enter into now that provides for the future sale of your business interest. A buy-sell agreement is also referred to as a business continuation agreement, a stock purchase agreement, or a buyout agreement.

Establishes buyer for your business interest

A buy-sell agreement identifies a buyer or potential buyer of your business interest and the conditions under which a sale will occur. The buyer could be an individual or an entity, and there can be more than one buyer. Typically, once you are bound under a buy-sell agreement, you can't sell your interest in the business to any party except the buyer named in the agreement. More frequently, the agreement involves rights of first refusal, so the potential to sell to a third party is possible.

Defines events triggering sale of business interest

Under the terms of a buy-sell agreement, the buyer may be legally obligated to buy your interest in the business from you (or your estate), and you (or your estate) may be legally obligated to sell your business interest at the occurrence of a specified triggering event. You, your advisors, and the other parties to the agreement will determine the triggers appropriate for your business situation. Possible triggering events include those shown in the following table:

Typical Triggering Events	Other Possible Triggers
• Death • Long-term disability • Retirement • Divorce	• Personal insolvency or bankruptcy • Conviction of a crime • Loss of professional license • Withdrawal prior to retirement • Termination of employment

Why would you want one?

There are several benefits to having a buy-sell agreement. Some of these benefits affect you, your family, or your estate, while others affect the business itself in terms of stability and how it is viewed by outside parties, such as bankers. When an owner of a closely held business dies and there is no continuation plan, the seller (for instance, your estate) is generally at a disadvantage and may be forced to accept a low price for the business interest, assuming a buyer can be found. A properly designed buy-sell agreement can protect your heirs by eliminating the possibility of a forced sale or the need for your family to rely on the business for income. The buyer and sale price are prearranged under the buy-sell agreement.

What happens when an owner dies?

Corporate law dictates that certain forms of business organizations terminate at the death of an owner. A buy-sell agreement can prevent the termination of your business at your death. The following table lists the common business forms, and what would happen at the death of an owner if there is no buy-sell agreement in place:

What Happens When an Owner Dies?	
Business Form	Law Says
Sole Proprietor	• Business enterprise terminates by operation of law at death of owner • Employees have no authority to continue operations • Executor can continue business but is not allowed to benefit from activities needed to continue business and may be personally liable to estate beneficiaries for losses incurred during continuation
Partnership	• Partnership dissolves upon death of a partner (business may continue) • Surviving partner responsible for dissolving and liquidating business, if appropriate
Professional Corporation	• Many states limit ownership to members of same profession--heirs or personal representative could not assume ownership of stock
Corporation	• Business entity does not terminate (but is generally disrupted by loss)

Personal considerations

Provides a guaranteed buyer for your business interest (or how to avoid a fire sale)

When you die, your estate does not have to search for someone who is willing to buy your share of the business. Your estate will not be forced to sell your business interest at an unfairly low price to get the cash needed if your estate must pay estate taxes. Under the terms of the agreement, when any of the triggering events occur, there is a ready buyer for the share of the business. A buy-sell agreement spells out exactly who will buy your interest in the business, under what circumstances, and at what price.

Tip: *For this to work, you must fund the buy-sell agreement.*

Provides liquidity for the payment of estate taxes and other estate settlement expenses (but only if the agreement is funded)

Estate taxes, if owed, are due to the federal government nine months after death. In some states, the death taxes are due even sooner than that. The buy-sell agreement not only provides a buyer for the business interest but also specifies the value or valuation method, if the payment will be in a lump sum or installment, and when it will happen. If your estate is large and subject to estate taxes, your family will need enough cash to pay them. You want to be sure that they will be able to convert your portion of the business into cash quickly and at a fair price. Under a buy-sell agreement, the sale of the business interest can occur quickly, and your family can be spared the panic of just how to pay the estate taxes.

Caution: *If the buyer does not have the cash or access to cash when needed for the buyout, the agreement won't serve any useful purpose. Make sure that the agreement specifies the plan to fund the buy-sell agreement and, even more importantly, that the funding takes place.*

Tip: *The applicable exclusion amount effectively exempts a certain amount of your gross estates from federal estate tax liability ($5,340,000 in 2014). If your estate is worth less than this amount, you may not owe estate taxes, and the benefit of a buy-sell agreement to provide liquidity for estate taxes would not be of much importance to you. However, you still may want the other benefits of a buy-sell agreement such as a guaranteed buyer.*

Avoids potential conflicts of interest between surviving owners (if any) and your heirs

At your death, there is a natural conflict of interest between your surviving co-owners (if any) and your heirs. Generally, it is in your heirs' best interest to receive the largest amount of cash possible from the business. Likewise, it is generally in the surviving co-owners' best interest to continue the business operation without interruption and to keep liquidation costs to a minimum. Without a prearranged agreement, the differing needs of your heirs and your surviving co-owners are likely to result in a dispute. A buy-sell agreement can ensure that your plans for your business and for your heirs are carried out as you intended and are not met with resistance.

Can establish the value of the business for estate tax purposes, if structured properly

The buy-sell agreement may, under the right circumstances, set the fair market value (FMV) of an interest in the business when the agreement is executed. When the agreement is structured properly, the IRS will accept the FMV as the taxable value if certain conditions are met.

Caution: *Buy-sell agreements between family members or related parties can be subject to close scrutiny by the IRS. The definition of "family member" includes your spouse, parents of you and your spouse plus their lineal descendants including spouses, and any other "natural objects of the transferor's bounty."*

Business considerations

Maintains stability of business operations

The buy-sell agreement specifies exactly who will continue as owners in the business. The agreement can be used to ensure that the people who have been running the business can continue to do so. It can ensure that the surviving co-owners will not be forced to accept outsiders into the business.

Improves creditworthiness of the business

A buy-sell agreement may increase the probability of the business continuing successfully after the death or withdrawal of an owner. From a creditor's viewpoint, the continued existence of the business means the continued ability to meet outstanding loan payments. Creditors may view the business as more stable and the owners as responsible businesspeople, and may be more likely to extend credit to the business.

Maintains legal status of your S corporation, partnership, or professional corporation (if relevant)

A buy-sell agreement can protect S corporation status by preventing ineligible shareholders from buying shares of the corporation, preventing ownership by more than the maximum allowable number of shareholders, and complying with the one class of stock requirements. It can protect partnership status by avoiding liquidation at the death of a partner. In most states, nonprofessionals are not allowed to be stockholders in a professional corporation. Use of a buy-sell agreement can prevent a nonprofessional from becoming a stockholder in your business in violation of the law.

Does size matter?

Buy-sell agreements can be set up for companies with one owner or many. The size of your company will affect your choices in setting up your specific form of buy-sell agreement and may cause one form to be more appropriate than another, but it would not generally prohibit you from having a buy-sell agreement. Just as there are different business ownership arrangements, there are different forms of buy-sell agreements. One of the distinguishing features between the different buy-sell agreement forms is the buyer to the transaction. The buyer could be any or all of the current co-owners, an outside third party, or the business entity itself. There can be more than one buyer.

The following table illustrates the various types of buy-sell agreements that are commonly found, the typical buyer, and what forms of business organization and size each form is best suited for.

Within the basic forms of agreement, you can custom-fit your buy-sell agreement to your particular business through the use of various clauses, options, and requirements.

Overview of Buy-Sell Agreement Forms			
Agreement Form	Buyer	Works Well With	Unsuitable For
Wait and See	Business entity, co-owner, or both	Business with two or more owners	Sole proprietor and single shareholder corporation
Trusteed Cross Purchase	Co-owner Transaction overseen by trustee	Business with two or more owners Simplifies plan when large number of owners	Sole proprietor and single shareholder corporation
Entity Purchase (Stock Redemption)	Business entity	Business with two or more owners	Sole proprietor and single shareholder corporation
Section 302 Stock Redemption	Business entity	Business with two or more owners	Sole proprietor and single shareholder corporation
Section 303 Stock Redemption	Business entity	Business with two or more owners, especially family business	Sole proprietor and single shareholder corporation
Reverse Section 303 Stock Redemption	Business entity	Business with two or more owners, especially family business	Sole proprietor and single shareholder corporation
Cross Purchase (Crisscross) Agreement	Co-owner	Business with two or more owners	Sole proprietor and single shareholder corporation Large number of owners (gets complicated with four or more)
Option Plan	Business entity, co-owner, or any eligible third party Sale not guaranteed	Business with any number of owners, including sole proprietorship and single shareholder corporation	Any scenario where guaranteed sale is needed
One-Way Buy-Sell	Business entity, co-owner, or any eligible third party	Business with any number of owners, including sole proprietorship and single shareholder corporation	Sole proprietor with no willing buyer

What are the tradeoffs of having a buy-sell agreement?

In exchange for the guarantee of a buyer for your business interest, you must accept certain restrictions on your ability to transfer your interest to parties outside the agreement. Careful structuring of your buy-sell agreement and coordinating it with your personal estate and tax planning goals can minimize and possibly eliminate the impact of the following tradeoffs.

Restrictions can affect personal estate planning

Gifting strategies are important estate planning tools for owners of closely held businesses. Lifetime gifts of your interest in the business to your children could be part of your estate planning strategy to pass your business interest to your heirs and reduce the total value of your estate. Restrictions in the buy-sell agreement could prevent you (and your co-owners) from passing all or part of your interest in the business as a gift. The parties to the agreement, therefore, must consider whether to restrict transfers by gift.

Tip: *If the ownership group decides to allow gift transfers, the group of permissible donees should generally be defined. The donee group should probably be subject to the terms of the buy-sell agreement.*

Restrictions could limit your access to outside credit

Restrictions within the buy-sell agreement could prohibit you from pledging your own interest in the business as collateral for outside credit, or could require the consent of the other owners. Without the ability to pledge your business interest, the lender might turn you down for a loan.

Tip: *If the buy-sell agreement is set up to include a right of first refusal, the owners would be allowed to pledge their individual business interests as loan collateral. If a foreclosure occurs, the stock acquired by the creditor would have to be offered for sale to the other parties to the agreement before it could be sold to a third party. Under the right of first refusal, the buyer under the agreement would have the right to buy (or refuse to buy) the shares held by the creditor. The lender must be notified the shares are subject to a right of first refusal, and the loan could not exceed the shares' fixed purchase price. This restriction should be indicated on the stock certificate (many states have laws requiring this).*

Restrictions may be unenforceable under state law

State property laws favor the right of business owners to transfer their interest in a business to whomever they want, whenever they want, at whatever terms they want. Restrictions in a buy-sell agreement that are extreme will generally be viewed as unreasonable and therefore unenforceable. For instance, a restriction that may be viewed as extremely prohibitive (and therefore unreasonable) is one that permanently and absolutely bans lifetime transfers of shares of a business's stock, along with a mandatory resale of the shares to the corporation at death for the original purchase price. A restriction like this could be viewed as a forfeiture; unreasonable, and therefore unenforceable. If the only condition for a profitable transfer of stock is a pure right of first refusal that requires the offer of the stock at the same price to the other parties, it does not restrict the transfer of stock, only the persons who may buy the stock. In this case, the restriction is not extremely prohibitive and would almost always be enforceable.

In general, if the terms of the restrictions were reasonable when the agreement was executed, such as rights of first refusal and rights to buy interests in the business based on a formula set price, then the restrictions would be enforceable. Whenever a buy-sell agreement is ambiguous, the courts will not uphold the enforceability of the restrictions. However, a carefully drafted, clearly outlined buy-sell agreement containing reasonable terms of restriction should be able to avoid any issues with state law.

What should you do to set up a buy-sell agreement?

Decide what you want to happen to your share of the business

You should consider all of your financial, tax, and estate planning goals. Think about the questions in our separate Buy-Sell Planning Questionnaire.

Get help

Setting up a buy-sell agreement can be very complex because it involves legal and tax issues. Don't try to tackle this alone--get professional help from your attorney, tax advisor, and/or financial planner. Each party to the agreement should have his or her own attorney and advisors.

Periodically review the agreement

Once you have drafted your buy-sell agreement, don't just put it away and forget about it. You and your buy-sell participants should review the agreement on a regular basis, perhaps yearly. You want to be sure that the agreement still meets your objectives. The valuation provisions may specify an annual valuation of the business.

Is there anything you should try to avoid?

Probably the biggest error that might be made in structuring your buy-sell agreement is thinking that your agreement has to look like another company's buy-sell agreement. The nature of your business and your ownership structure and relationships should be considered when drafting your buy-sell agreement. One size does not fit all!

The key is to analyze the ownership of your business. The following table shows some common characteristics of business ownership:

Ownership Characteristics	Participation in the Business

Active--Owners hold equal percentages	All owners are active in the business
Active--One majority owner, one or more minority owners	Majority owner controls business Minority owners have no significant control
Passive ownership	All owners are "outsiders" and none work in the business
Combination of passive and active ownership	Some owners work in the business
Family owned	All or most of the owners are family members

Common errors

Errors and oversights can occur when drafting a buy-sell agreement. Some of these can be the result of trying to treat all owners equally, when they may not be equal. Other errors might come about as a result of an accidental oversight. Common errors include:

Equal application of rights and restrictions

In an attempt at fairness and equality, the buy-sell agreement might apply the same level of rights and restrictions to all owners. But should a majority shareholder be subject to the same restrictions as an owner who has contributed far less to the business? Rights and restrictions under a buy-sell agreement can be structured to cover different ownership ratios and do not have to apply equally to all owners. Sometimes, a buy-sell agreement that attempts to treat all shareholders as equals has the unintentional result of unfairly restricting a majority shareholder who is forced to give up control and flexibility. It could also unduly burden a minority shareholder who may need to come up with a large amount of cash to fund the obligation.

Using an inappropriate valuation

The valuation of the business under the buy-sell agreement is of great importance. The agreement is a legal contract, and the price (or method of determining price) specified will lock in the sale price. When done correctly, the buy-sell agreement will set a sale price that will be accepted by the IRS as the fair market value (FMV). The IRS is not obligated to accept the sale price as the FMV for taxation. When the value set in the agreement is determined to be less than FMV, there can be an unfortunate and expensive consequence--the selling estate will be taxed on the difference between the sale price and the FMV. Consult your attorney or tax advisor for more information.

Failure to conduct a valuation update

Another potential problem in the business valuation under the buy-sell agreement is neglecting to update the agreement. Buy-sell agreements are often written to provide for periodic updates of the value of the business, the intention being to reflect changes in the business. The potential problem can arise when the revaluation is not done, the triggering event occurs, a sale must take place, the price ends up being declared too low by the IRS, and the seller has to pay a big tax bill.

Tip: *One solution is to provide a backup method of valuation in the agreement, with the conditions under which it will be used. This can provide a safety net in case the periodic valuation isn't done. Your tax advisor can help you set this up.*

Failure to include enough triggering events

A buy-sell agreement specifies triggering events, generally including death, disability, retirement, divorce, bankruptcy, criminal activity, or loss of professional license. When an event specified in the agreement happens, it triggers a sale of the owner's business interest. Some buy-sell agreements limit the triggering events to death, failing to provide for a sale after another disruptive event such as an owner's divorce, where the courts could award part of an ownership interest to a spouse. An event such as disability can cause an owner's withdrawal from the business and create a liquidity problem as the business tries to provide income to the owner or buy out the owner's interest.

Failure to provide funding

Too often, the triggering events named in a buy-sell agreement are believed to be far off in the future, when the company is wildly successful and experiencing no cash flow problems. Sadly, the events often happen much sooner than expected and may catch a company before it has taken the steps to fund the buy-sell agreement. The method of funding the buyout should be established at the same time the agreement is drafted.

Choosing the right type of buy-sell agreement

A buy-sell agreement can be a powerful tool in a business continuation plan. When coordinated with your estate and tax planning, a buy-sell agreement can provide a smooth transfer of your ownership interest. In addition to looking at your own personal goals for estate and tax planning, you must consider factors specific to your business before you can decide on a particular type of buy-sell agreement. For instance, the number of owners in your business may make some types of buy-sell agreements cumbersome or even impossible. The form of business organization may point to one ideal solution or several good solutions. Work with your attorney and tax advisor to draft an agreement that meets your goals, covers the necessary bases, and works with your estate and tax plans.

Questions & Answers

Can you use a buy-sell agreement if your irrevocable trust owns the shares of your business?

If your estate planning includes the use of an irrevocable trust that owns your business interest, you must coordinate the trust ownership of your business interest with your buy-sell agreement. The trust would be bound by the terms of the buy-sell agreement.

Can the buy-sell agreement be changed?

Generally, the buy-sell agreement can be amended, as long as all of the parties agree to the changes.

Do you have to write another buy-sell agreement when one of the owners dies?

That depends on the type of buy-sell agreement. If your business has more than two shareholders, and you want the agreement to continue beyond the first death, use of an entity purchase (stock redemption) buy-sell agreement can allow this to happen more easily than a cross purchase (crisscross) agreement.

What if the number of shareholders increases?

If you anticipate an increase in the number of shareholders and want to be able to include the new shareholders in the buy-sell agreement, the entity purchase (stock redemption) agreement can allow this to occur more easily than a cross purchase (crisscross) agreement.

What can be done if one of the parties to the buy-sell agreement refuses to carry out the obligation previously agreed to?

A buy-sell agreement is a legal contract. The courts can grant specific performance of the contract, forcing the reluctant party to comply with the terms.

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