



A Primer on Buy-Sell Agreements

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A chief concern of the owners of a closely held business is what would happen to the business if one of the owners could no longer continue. Surviving owners generally want to ensure a continuity of ownership and management without having the departing owner's successor thrust upon them. Nor do they want to unduly compromise the liquidity needs of the business by funding a significant buyout. Disabled or deceased owners would want their families compensated fairly for their share of the business. A properly drafted buy-sell agreement can achieve all of these goals by:

- Providing that upon the occurrence of a specified "triggering event," owners are guaranteed that their interest in the business will be purchased;
- Providing that the owner's interest must be sold to the company, the remaining owners, or a combination of the two;
- Providing a mechanism whereby the purchase price may be determined by market conditions in existence upon the occurrence of the event;
- Providing a funding source, primarily through insurance policies, so that the liquidity needs of the business or its owners will not be onerous; and
- Establishing a valuation of a deceased owner's interest in the business for estate tax purposes.

Triggering Events

An integral part of any buy-sell agreement is to specify what type of situations will cause a mandatory or optional buyout of an owner's interest by the other owners or the entity itself. The most common of these triggering events are described below.

Death or disability. This event is almost universally provided for in the buy-sell agreement. Terms of this buyout will include the determination of disability, the time for payment to the owner or the owner's estate, whether the entity or the surviving shareholders have the obligation to purchase the interest, and whether a funding mechanism, such as life or disability insurance, should be maintained by the entity or the owners personally.

Desire to sell the interest to a third party. The agreement should provide that the terms of the potential sale be presented to the other owners, and that they be given the option of:

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- matching the offer made by the outsider;
- purchasing the shares in accordance with the valuation method and payment terms provided for within the agreement;
- having the entity repurchase the shares issued in accordance with the valuation method provided for within the agreement; or
- allowing the sale to be effectuated to the third party.

Retirement of an owner. While a sale to a third party would provide the other owners an optional right to purchase the selling owner's interest, an owner's retirement will generally trigger a mandatory buyout. Of course, the conditions under which an owner may have the right to retire so that the remaining owners, or the entity, would be compelled to buy that owner out are often a point of negotiation. Once again, valuation methods and payment terms will be important issues, because there are no outside funding mechanisms, such as life or disability insurance, available to bear the cost.

Owner's divorce or bankruptcy. Either of these events can subject the business to interference from outsiders. To prevent this, the other owners should have the option to compel the affected owner to sell his shares to the remaining owners or the entity itself, in accordance with the payment terms and valuation methods (to be discussed later.)

Funding Upon an Owner's Death

Entity redemption arrangement. Under this plan, the business entity is obligated to purchase the owner's interest. To minimize the impact this might have on the entity's liquidity needs, the entity can purchase life insurance policies on each owner. The business names itself as the beneficiary of each policy, and the face amount of the policy will be equal to the agreed-upon purchase price set in the buy-sell agreement. The proceeds should be received by the entity free of ordinary income taxes, pursuant to IRC section 101. This would be followed by a purchase of the owner's interest by the entity with the life insurance proceeds.

This type of arrangement has the following disadvantages:

- The value of the insurance policies and proceeds would be subject to the entity's creditors.
- If the entity is a C corporation, the life insurance proceeds might subject the corporation to the alternative minimum tax (AMT).
- If the entity is a C corporation, the surviving owners' basis in their stock will not increase as a result of this arrangement. Should the entity be treated as a flow-through entity for tax purposes, the surviving owners' basis will partially increase, because all items of income, whether taxable or not, will cause all of the owners' basis to increase in proportion to their profit-sharing interest.
- If an entity is a family-owned C corporation (or an S corporation with accumulated earnings and profits), family attribution rules may cause the redemption of the owner's shares to be treated as a dividend. This might prevent an owner from receiving a basis offset against the proceeds received. Assuming that the owner's interest is completely redeemed by the corporation, however, the

- owner only needs to file an agreement with the IRS under which she may not reacquire any interest, nor participate in corporate affairs, for the next 10 years.
- Should an owner have more than a 50% ownership stake in the entity, this would allow him to change the beneficiary(ies) of the policy during his lifetime. Therefore, should the life insurance policy proceeds be payable upon the owner's death, such proceeds would be included in his estate.

Cross-purchase arrangements. Under this plan, each surviving owner of a business becomes personally obligated to purchase the departing owner's interest. To provide the surviving owners with liquidity, each owner would own an insurance policy on the lives of the other owners. The proceeds of the life insurance policy would be received tax-free by the survivor and then used to purchase the deceased owner's interest so that the survivor's ownership interest remains the same in relation to the other surviving owners.

This method addresses all of the disadvantages associated with the entity redemption arrangement, including shielding the insurance policies and proceeds from the entity's creditors, not subjecting the insurance amounts to the corporate AMT, and giving the acquiring owners additional basis for the total purchase price of the deceased owner's shares. It carries some disadvantages of its own as well:

- If there are more than two owners, more insurance policies would have to be acquired than in the entity redemption arrangement.
- If the entity is a corporation, a buy-sell agreement providing that the surviving shareholders purchase the life insurance policies that the deceased previously owned on the surviving owners' lives may have future income-tax implications. More specifically, any future proceeds received by a surviving shareholder in excess of the purchase price and the subsequent premiums paid on these policies would result in taxable income to the new owners of the purchased policies. This is known as the "transfer for value" rule.

This rule does not apply if the entity is unincorporated. Moreover, if the corporation itself acquired the policies, the transfer for value rules would not apply. There would, however, be an entity redemption arrangement in addition to the original cross-purchase arrangement upon the surviving owners' death.

Although it has not been tested in the courts, it is possible that the "trusteed" cross-purchase arrangement described above may allow the surviving corporate shareholders to circumvent the "transfer for value" problem should the surviving shareholders acquire additional rights as beneficiaries of the other surviving shareholders' policies.

- Should the owners of a business differ significantly in age, the younger owners' premium payments on the older owners' lives will be significantly higher. Because the entity pays for all of the policies in an equity redemption arrangement, this problem would not exist.

One way to minimize the insurance costs to individual owners would be to obtain a split-dollar policy, where the premium payments are shared by the entity and its owners. Upon

payment of the proceeds, the entity would be entitled to reimbursement of the premiums it paid. Each surviving owner would receive the balance and pay for the deceased owner's shares with the proceeds. In this way, the surviving owners would realize additional basis because they are purchasing the deceased owner's interest directly. The proceeds would still be nontaxable because there would be no "transfer for value" issues. A split-dollar policy may, however, produce the following income tax consequences:

- To the extent an entity pays the premium on the owners' policies, such premiums shall be treated for tax purposes as an interest-free loan, and the owners must include an amount equal to the premiums paid by the entity multiplied by the market rate of interest (as determined by the IRS) in their taxable income each year.
- Should the owner also be an employee of the entity, the entity's payment of the policy owned by the employee-owner may be viewed as additional compensation that should be included in the employee-owner's taxable income and be tax-deductible for the entity.

The wait-and-see arrangement. This situation, also known as a "mixed agreement," attempts to give the entity and its owners maximum flexibility at the time of the triggering event (e.g., retirement, disability, death). Generally, the entity has the initial option to purchase the shares from the departing owner in an entity redemption format. The entity may or may not carry life insurance on its owners. Should the advantages of an entity redemption listed above outweigh the disadvantages, then the entity shall exercise its right to purchase the owner's interest. If the entity fails to exercise its option, or purchases only part of the owner's interest, then the surviving owners have an option to purchase the departing owner's interest in a cross-purchase format. The owners may or may not carry insurance for this purpose. To the extent that this second option does not result in a complete purchase of the departing owner's interest, then the entity must complete the purchase.

In an interesting variation on this theme, the entity redeems the shares by using the proceeds of life insurance policies obtained by the surviving owners. These proceeds are contributed to the corporation by the survivors in exchange for an additional ownership interest in the entity. This potentially solves many of the disadvantages associated with the first two forms of funding the buy-sell agreement as follows:

n Because the entity does not own the insurance policy, there is no possibility of a corporate AMT, or of corporate creditors' claims against the policies.

- Surviving shareholders will receive an increase to their basis because they contribute the proceeds for additional shares from the entity.

The entity may not need all of the insurance proceeds to redeem the departing owner's interest. To that extent, the remaining owners may keep the proceeds tax-free.

Valuation Methods Employed

The goal of a valuation method is to best approximate the business's actual fair market value. Fair market value has been defined as the price at which property passes between a willing buyer and seller, neither under any compulsion to buy or sell, and both with knowledge of all relevant facts. Of course, where less than the entire ownership interest is being acquired, there might be discounts to reflect the lack of control or lack of marketability. Some of the more common business valuation methods are summarized below.

Book value. This method, also known as the net asset value method, is based on the net worth (assets -- liabilities) of a business on a company's books and records for accounting purposes. While this method is easy and relatively inexpensive to ascertain, book values are based on historical-cost principles, which frequently become unrealistic over time, especially for assets such as real estate, patents, and goodwill. Some modifications of the book value method include the tangible book value method, which basically includes only assets, such as cash, inventory, equipment, and real estate. Economic book value would entail an appraiser in an effort to update the value of assets to their current market value.

In our view, this method represents a baseline value of any company, thus we seldom use it in the case of "willing buyers and sellers", as it is more applicable under other basis of value.

Capitalization of earnings. This method attempts to value a business by estimating an acceptable rate of return on a purchaser's investment in light of the risk associated with the particular business, and then applying such a rate of return to the anticipated earnings stream of the business, based on its average net earnings (after operating expenses) over the last few years. Any potential buyers would obviously be looking at a rate of return on their investment well in excess of the rate of return on a much safer alternative, such as a certificate of deposit or a blue-chip stock. Rates of 20% or more are not uncommon for small closely held businesses. An interesting variation on capitalization of earnings is known as the excess earning method. This method, frequently used when a business has substantial receivables, inventory, property, and plant and equipment, seeks to separate a desired rate of return on a company's tangible assets from its total earnings in order to derive "excess earnings." The excess earnings is then multiplied by a factor (the higher the risk, the larger the factor), and this amount is then added to the fair market value of the tangible assets to determine the purchase price.

This method is generally equivalent to the following method (Discounted cash flow), and is best suited for financial firms, such as banks and credit unions.

Discounted cash flow. This method seeks to adjust earnings for any non-cash expenses (e.g. depreciation, amortization, gains and losses), and subtract a reasonable amount for future capital expenditures (e.g., equipment replacement), and liability payments to project the future net cash flow over a period of time. Then, using present-value concepts, based on an estimated discount rate over the term, an acceptable purchase price is determined for that future cash flow.

This method is at the heart of any quality valuation. Unlike many other methods, the discounted cash flow framework requires the analyst to make explicit assumptions about factors such as growth and risk. This results in a better understanding of the factors driving a firm's value today and tomorrow, in addition to a more defensible conclusion.

Sales-multiple valuation. This method, commonly used in establishing a fair price for a service business where tangible assets are not significant, merely seeks to attach an industry multiplier to an average stream of revenue over several years. The multipliers used are generally very industry specific, with certain rules of thumb based on the performance of the "average" business within an industry. The problem with these formulas, however, is that they don't take company-specific situations into account. Therefore, if the particular business being considered for purchase has a niche that distinguishes it from the industry average, the rules of thumb may not be appropriate. Variations of this technique may be based on multiples of gross margin or net profit. Obviously, the multiplier based on gross revenue will be much smaller (anywhere from 25% to 200%) than multipliers based on profit, which may be as high as 500%.

This method, often called the "rule of thumb" approach, has gained favor because of its simplicity. It has, however, come under intense scrutiny by the IRS over the last few years because of its highly subjective nature.

Security Against Unforeseen Events

Executing a carefully planned buy-sell agreement can assure owners in a closely held business that their interest in the business they built is secure regardless of any unforeseen circumstances. In many cases this can be accomplished without putting excessive strain on the business's cash flow, ensuring that the business and its remaining owners continue to succeed as well.

Other provisions to consider in a buy-sell agreement might be a non-competition clause and a clause providing for the termination of the buy-sell agreement itself. Competent and experienced legal counsel should draft the agreement and advise each owner regarding their individual interests. In addition, a large number of valuations performed for buy-sell agreements, and the underlying estate planning, come under IRS scrutiny, so it is vital that the valuation conclusion come from a qualified party experienced in dealing with these cases.

If there are any additional questions, please contact us at:

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