



BUSINESS PLANNING

Entity-Purchase Buy-Sell Agreement

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ENTITY-PURCHASE BUY-SELL AGREEMENT

SUMMARY

WHAT IS A BUY-SELL AGREEMENT?

A buy-sell agreement is a legally binding contract that establishes the circumstances under which the sale of a business interest will occur (an owner's death, disability or retirement), who will purchase the business (typically the business itself or the other owners), and the valuation method to be used at the time of the sale. An entity buy-sell agreement provides that the business will buy a deceased owner's interest.

There are two additional types of buyouts. A cross-purchase agreement provides that each surviving owner purchase a portion of the deceased owner's interest, and a one-way agreement can be used by a sole owner to identify a potential buyer, such as a key employee.

WHY IS AN AGREEMENT NEEDED?

A buy-sell agreement helps ensure that a business will continue after an owner dies. When adequately funded with life insurance, the agreement ensures that control of the business will remain with the surviving owners and that the heirs will receive a fair price for their interest.

HOW DOES AN ENTITY BUYOUT WORK?

To provide funding for the buyout, the business purchases life insurance on each owner, with the business entity as the owner and beneficiary of each policy. The business must give notice that it intends to insure the owner-employees and must also secure each owner-employee's written consent.

The amount of insurance approximates the agreed-upon purchase price for each owner's interest. The agreement stipulates either a specific purchase price or a formula for determining the purchase price. Life insurance proceeds provide the funds to buy the deceased owner's interest.



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Although premiums paid for the insurance are not tax deductible, death benefits are generally excluded from federal income tax when the notice and consent requirements have been met. Redemptions that meet certain requirements can avoid being taxed as dividend distributions.

WHEN IS AN ENTITY AGREEMENT PREFERRED?

An entity buy-sell agreement is preferable when there are many owners, since this arrangement requires that the business purchase only one policy on each owner. A cross-purchase agreement requires that every owner buy a policy on every other owner. An entity agreement may also be preferred when there is a wide age disparity among the owners, since younger owners would bear a greater premium burden to insure older owners under a cross-purchase agreement. If the business wants access to policy cash values, the business must own the policy. This is not possible in a cross-purchase agreement, where individuals are the policy owners.

WHAT ARE THE BENEFITS?

With an entity buy-sell agreement adequately funded with life insurance, the business is assured the funds are available to buy out a deceased owner. The surviving business owners maintain control of the business and the deceased owner's estate will be provided needed liquidity for expenses and taxes. All the terms of the sale—the purchase price, when the purchase will occur and funding arrangements—are decided in advance. In addition, a properly drawn agreement can fix the value of the business interest for federal estate tax purposes.

When written agreements are made in advance and adequate funding is in place, the benefits are substantial. By setting a fair price for the business interest and establishing a willing seller and a willing buyer with the needed liquidity to make the purchase, owners can be confident of a seamless transfer when the time comes.



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