National Life Group®
Experience Life®

Buy Sell

Bringing structure and security to business succession.

TC97223(0917)3

Cat No67847(0917)

National Life Insurance Company®
Life Insurance Company of the Southwest™

As the owner of your own business, there are many concerns that can keep you up at night. Some concerns can be pushed to tomorrow while others need to be addressed today. But what would happen to your business if you, or a business partner, or key person were to die or become disabled?

What can you do today to start putting your mind at ease?

First, think about the personal side – about you and your family.

You own your business. It provides you and your family with income, as well as valuable benefits (think health insurance, life insurance, perhaps a car, etc.). In essence, your business provides you and your family with the financial security to live the life you want to live. It also provides value to you as a capital asset and on your personal balance sheet. But if something happened to you what happens to that income flow, those benefits, to the business as a capital asset? A properly structured business succession plan can help you answer all of those questions.

Let's think about the business side.

As an owner, and probably one of the key employees of the business, your presence is a key element for the success of the business. Whatever your unique skill, if something happened to you – again, let's say you died – what happens to the business when your unique skill is gone? What do your co-owners need to do to have the business survive your passing? How can the business respond to the potential demands your family may have on the business for ongoing cash flow, benefits, or to convert the business interest into cash? A properly structured business succession plan can help you answer these questions.

This guide is designed to help you recognize the questions to ask and some of the possible choices you may have. Remember, having a business succession plan in place may allow for an orderly transfer of your business to the "right party" at the "right time" and will set your mind at ease.

One critical note – this guide is not designed to cover the questions that often come up when dealing with a family owned business.

A Written Buy Sell Agreement

The agreement spells out the terms of the business succession arrangement and obligates the parties to follow through on the arrangement. In this sense, it is a legal contract between the parties and must be drafted by an attorney. These agreements generally include provisions such as:

- Triggering Events – What events will cause a sale to take place, such as death, disability, retirement, bankruptcy, loss of a professional license, divorce.
- Business Valuation – This identifies the current value of the business and the process used to establish the future value of the business. This may be a set value or a formula.
- The Purchaser – Who will buy the business interest following a triggering event (i.e., the business or the co-owners).
- Payment Requirements – How the payments will be made (i.e., lump sum or installment sale).
- Funding – How the parties will fund the purchase.

Often, a team approach is taken when figuring out the terms of the arrangement. In doing so, your team should include the consultation of a CPA, Attorney and a Financial Planner or Insurance Agent.

Types of Buy Sell Agreements

The four common arrangements are:

1. Entity purchase (sometimes called a stock redemption)
2. Cross purchase
3. Wait and see
4. One-way (or key employee) buy sells

Entity Purchase (Stock Redemption)

In an entity purchase the business is the buyer of the departing owner's business interest. (In the case of a corporation, the entity purchase is called a stock redemption.)

An entity purchase is relatively simple. It's the business' obligation to make the purchase and the funding is coordinated through the business.

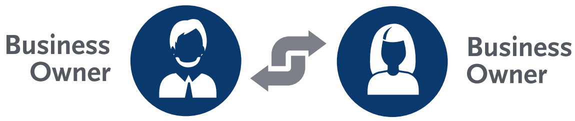
Are there any negative results to an entity purchase? Two negatives come to mind.

The basis of the remaining owner(s) will not increase. (If the business is a pass through entity, such as an LLC or an S Corporation it may be possible to receive a partial increase in basis.) Why is this important? With no increase in the surviving owner's basis, future sales of the business interest could result in an additional taxable gain.

For instance – let's say the business you own is worth $1,000,000 and there are two equal owners. You started the business a few years ago, putting in $10,000 apiece. That $10,000 is your initial basis. If your business' co-owner had died yesterday and your business purchased the shares for $500,000, what is your basis in the business as the surviving owner? Assuming no other adjustments had been made your basis remains $10,000. If you sell the business sometime in the future, your taxable gain will be on any amount over the $10,000. So, if you received $1,000,000, your taxable gain is $990,000.

Finally, any funding vehicle owned by the business will be subject to the claims of business creditors.

Cross Purchase



This is an agreement between you and your co-owners. The business, as an entity, will not play a role in the buyout. At the time of triggering event, the surviving owner(s) will purchase the business interest of the departing owner.

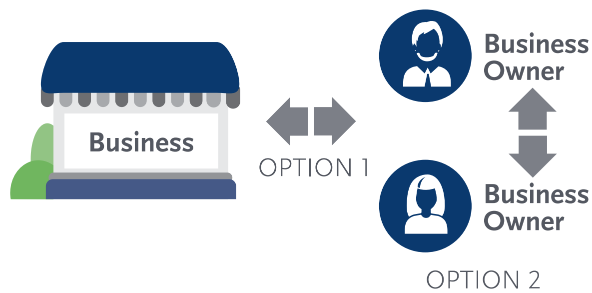
The funding vehicle for a cross purchase sits outside of the business – therefore those funds should not be subject to business creditors.

In a major difference from the entity purchase, the basis of the remaining owner will be increased as the surviving owner(s) have personally purchased the departing owner(s) interest. Why is this important? With an increase in basis, future sales of the business interest could result in a smaller taxable gain.

Let's look at the same set of facts that we looked at in the entity purchase. The business you own is worth $1,000,000 and there are two equal owners. You started the business a few years ago, putting in $10,000 apiece. That $10,000 is your initial basis. If your co-owner had died yesterday and you purchased the shares for $500,000, what is your basis in the business as the surviving owner? Assuming no other adjustments had been made your total basis is now $510,000. If you sell the business sometime in the future, your taxable gain will be on any amount over the $510,000. If you received $1,000,000, your taxable gain is $490,000.

Wait and See Buy Sell

This is a hybrid agreement that mixes the entity purchase and the cross purchase. The arrangement is really just a series of purchase options. Generally, the business will have the first option to purchase the interest of a departing owner. If the business declines, the other owners will have the option to purchase the business interest. (There may be additional options – the attorney drafting the document will advise you as to the most practical option plan.)



What are the benefits of a wait and see buy sell?

This arrangement allows the parties to the agreement to delay making a final decision on how the buy sell will be structured until the triggering event actually occurs (hence, the "wait and see" title). When the triggering event occurs, the circumstances of the remaining owners and the business will be known and the surviving owner(s) will be able to decide the best way to structure the actual purchase. In either case, the departing owner will receive the specified price.

One Way Buy Out

This is an agreement that is used when the buyer of the interest is a third party or key employee who doesn't currently have an existing ownership interest. Under the agreement the buyer is legally obligated to purchase the owner's business interest at the triggering event. A one way agreement is generally used for business' that are owned 100% by one individual.


office premises

Funding the Agreement

Having a buy sell agreement without arranging for funding may bring you only limited peace of mind. An unfunded or inadequately funded buy sell can cause financial duress and may result in the failure of the agreement. Some options for funding the agreement include: Sinking fund, third party loans, cash/surplus, installment sale (the family loan) and life insurance.

Sinking fund

The buyer will save the funds – hoping to be able to accumulate sufficient funds in the years prior to the sale. You can think of this almost as a savings account. Depending on the time frame, the sinking fund may or may not have accumulated the funds needed to fund the buy sell. For instance, what happens if the buy sell is triggered by a death or disability? Because these events happen without a known time frame – relying on a sinking fund may result in a severely underfunded agreement.

Cash/Surplus

Using cash on hand or surplus to fund the purchase may also leave you in an underfunded situation. Like the sinking fund, the buyer may not have cash available to use for the purchase at the time it is needed or the cash might be allocated for other business related purposes.

Loans

At the time of the sale, the buyer may borrow money from a third party, such as a bank. Loans may seem like a good alternative as the actual out of pocket outlays will happen over the term of the loan rather than all at once. However, will a loan be available and at what cost? The buyers' creditworthiness may be questioned as a key person has just died. The interest rate may be unattractive. And, of course, the cost of the buyout has increased because not only are you paying the purchase price, but now you are also paying the interest on the loan. Another concern is the addition of a new debt on the business' balance sheet and the impact the new debt service will have on the business.

Installment sale

Just as with a loan from a third party, an installment sale involves the buyer paying the purchase price over time. The installment sale will also include interest payments – increasing the overall cost of the buyout. Your family is dependent on the ongoing success of the business and the surviving owner's ability to manage the business profitably. Additionally, the Seller's family has to wait for the funds – hoping that the surviving owners can and will make the installment payments as they come due.

Life insurance

Life insurance is often considered the preferred method of funding for many business owners. The death benefit is available immediately upon the death of the business owner or cash values in the policy are accessible upon a triggering event other than death.[1] The family will receive the full purchase price to meet needs. The buyer will need to pay premium but the amount is stable and predictable.

If life insurance is used as the funding vehicle, the buy sell agreement should reference the policy or policies or life insurance in general, and may even require the parties to obtain and maintain coverage.

Generally, where life insurance is used the insurance will be owned by the party or parties obligated to make the purchase. So, in an entity purchase, the business will be the owner and beneficiary of the policy[2]. In a cross purchase, the co-owner(s) will be the owners and beneficiaries of the policy. In the Wait and See, it is usually recommended that the life insurance be owned by the co-owners – cross owned as if it were a cross purchase arrangement. In a one way buy out – the purchasing party (i.e. key person) should be the policy owner.

---

1 Accessing the policy's cash value using policy loans or withdrawals reduce the policy's cash value and death benefit and may result in a taxable event. Surrender charges may reduce the policy's cash value in early years.

2 Employer must meet the notice and consent requirements and one of the exceptions listed under IRC Section 101(j) and reporting requirements of section 603991.

Lots of Information – What's Next?

You now have lots of information at hand and you may be asking - what's next? Work with your team, CPA, Attorney and Financial Professional, to identify the right buy sell arrangement for you, your family, co-owners and business.

Stress Test

To help you organize your thinking – please take the Buy Sell Stress Test that follows. Be sure to ask questions on any point of interest and use the stress test when speaking with your planning team.

Your Buy Sell Stress Test

Structure of the Buy Sell Arrangement	Yes	No	D/K
1. Do you have an agreement in writing?	○	○	○
2. Does your agreement require the business buy your business interest?	○	○	○
3. Does your agreement require your co-owners buy your business interest?	○	○	○
4. Does your agreement provide for a series of buy sell options (a wait and see buy sell)?	○	○	○
5. Does your agreement provide for a key person buy out?	○	○	○
6. Does your agreement provide for a third party buy out?	○	○	○
Buy Sell Trigger Events			
7. Will the buy sell be triggered by the death of an owner?	○	○	○
8. Will the buy sell be triggered by the disability of an owner?	○	○	○
– a. If yes – is disability clearly defined?	○	○	○
9. Will the buy sell be triggered by the retirement of an owner?	○	○	○
10. Will the buy sell be triggered by the resignation of an owner?	○	○	○
11. Will the buy sell be triggered by the bankruptcy or divorce of an owner?	○	○	○
Valuation			
12. Have you established the business value in the agreement?	○	○	○
13. Have you reviewed the business value in the last 3 years?	○	○	○
14. Do you believe the value in the buy sell reflects the value of the business to you and your family?	○	○	○
15. Is there a difference in the value set in the agreement and the current value of the business?	○	○	○
16. Have you had a professional valuation (CPA or Appraiser)?	○	○	○
17. Are there different values depending on the trigger event?	○	○	○
Funding			
18. Are you depending on Savings/Surplus to fund the buy sell?	○	○	○
19. Are you depending on borrowing from a third party to fund the buy sell?	○	○	○
20. Are you depending on borrowing from the departing owner (or owner's family) in the form of an installment buy out?	○	○	○
21. Are you depending on insurance to fund the buy out? a. Life Insurance b. Disability Buy Out Insurance	○	○	○
22. Are you planning to use some combination of the above methods? Details: ______________________	○	○	○
23. Have you completed a review of the cost of funding the buy out?	○	○	○

This checklist may help you focus on select business succession matters and the decisions you have already made. Bring it with you to your next meeting or email the completed checklist to your financial representative and other members of your planning team to assure that your questions and concerns are addressed.

Notes

National Life Group®

Experience Life®