

Buy Sell Agreements

Establishing a buy-sell agreement is one of the most important steps you can take to help ensure the continuation of your business. A buy-sell agreement can cover a buy-out due to retirement, death, or disability, and helps "peg" the value of your business for estate tax purposes, so long as the value of the business represents a fair market value in an arms length standard of valuation required by Section 2703 of the Internal Revenue Code.¹

There are a number of buy-sell plans to choose from: the cross purchase, entity, and trustee plans are among the most popular.

Cross Purchase Plan

The cross purchase plan is one of the easiest to administer and can be ideal for businesses with three or fewer owners. In this plan, the business owners enter into an agreement with one another. The surviving owners purchase the deceased or withdrawing owner's interest. For example, you and your partner (or coshareholder) each have an investment basis of \$50,000. The business value now is \$200,000. Upon your partner's death, you purchase the deceased's share of the business for \$100,000. Your new basis is now \$150,000. If you sell the business years down the road, in this case for \$200,000, you realize a gain of only \$50,000. This step-up in basis would result in a lower capital gains tax and, essentially, reduce your income taxes. If you use life insurance as a funding vehicle, the number of policies needed to fund the plan will increase as the number of

shareholders increases. The formula is: Total Number of Policies Needed = Number of

Shareholders x (Number of Shareholders - 1).

A business with four shareholders requires 12 individual policies to fund the plan. With five shareholders, the plan would need 20 individual policies. In our example, you need two policies; one where you are the applicant, owner, and beneficiary on your partner's life — and vice versa.

Entity Plan

The entity plan can be ideal for businesses with three or more owners, or when a large discrepancy in the age or percentage ownership of shareholders exists. In an entity plan, the shareholders enter into an agreement with the business. The business purchases the deceased or withdrawing owner's interest. Family & estate attribution rules must be considered.

Using the previous example, the surviving owner's original cost basis of \$50,000 will not increase to \$150,000 at the death of an equal shareholder because the business, in essence, buys back the deceased's interest. If the business is later sold for \$200,000, the owner would realize a gain of \$150,000.² As opposed to the cross purchase plan, where 12 policies were required for four shareholders, the entity plan only requires four policies in total. The business is purchasing the policies, not the individual shareholders.

Trustee Plan (or Escrow Agent Plan)

Although the trustee plan may be more cumbersome to set up, it may provide business owners with the best of both worlds. With this plan, shareholders have a buy-sell plan utilizing a trustee or escrow agent. Each shareholder endorses his/her stock certificates in blank and delivers them to the trustee. At the death of an owner, the trustee purchases the deceased's interest. The trustee, according to the terms of the agreement, sees that the business issues new shares to each surviving owner in exchange for the shares that belonged to the deceased or withdrawing owner. And the trustee, as the life insurance policy beneficiary, sees that the deceased's estate receives the proceeds.

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¹Section 2703 of the Internal Revenue Code applies to buy-sell agreements entered into after October 8, 1990, or substantially modified after this date, and applies only to family-owned companies.

²In a C corporation, you must be aware of alternative minimum tax considerations.

³Life insurance proceeds and inside buildups of available cash values are included in adjusted current earnings for purposes of the corporate alternative minimum tax.