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Common Issues Found in Older Buy-Sell Agreements

FOR MORE INFORMATION

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A carefully constructed buy-sell plan can create a solid foundation for the future of a business and the people who depend upon it. A buy-sell agreement can create a market for a business when an owner exits, provide for the orderly transfer of a business interest, prevent unwanted transfers and provide a deceased or disabled business owner's family with liquidity, if properly funded. Therefore, it is important to review an existing buy-sell agreement periodically to ensure it is meeting the business owners' goals and objectives. This Advisor Update discusses common issues found in older buy-sell agreements.

Common Issues

Following are common issues found in buy-sell agreements:

1. Business owners may have changed since the buy-sell agreement was executed. For example, the terms of a buy-sell agreement may indicate the death or disability of a business owner is to be the trigger for a purchase and sale event. If a business owner is a revocable trust, the triggering events in the agreement may need to be clarified since a trust does not "die" or become "disabled" in the human sense.
2. Children may now be actively involved in the business. Business owners may wish to change the terms of the buy-sell agreement to allow the transfer of business interests to children who are actively involved in the business.
3. The stipulated buy-out price may not have been updated in years. If stipulating the buy-out price is inconvenient for the owners, changing to a third-party appraisal or formula-driven valuation might be more suitable. In any case, consider adding a back-up valuation process.
4. If the agreement relies on a formula valuation approach to establish company value, it may be helpful to periodically test the formula with current financial information to ensure the formula is not out of date. Also, ensure the inputs and terms of the formula are clear and concise.

5. The buy-sell agreement only addresses the death of an owner. The agreement does not address the disability, divorce, retirement, insolvency, loss of professional license and/or termination of a business owner.
6. The agreement does not identify the life and disability policies associated with the agreement. Many business owners have found it advantageous to list all life and disability insurance policies acquired for purposes of the buy-sell agreement on a separate schedule or exhibit attached to the agreement. Where life insurance policies are concerned, this practice has the advantage of not confusing whether death proceeds are to be used for key person needs of the business or to complete the purchase of a deceased owner's business interest.
7. The agreement does not include a mandatory buy-out in the event of death or disability of an owner. Without a mandatory buy-sell provision, there may not be a buyer for a deceased or disabled business owner's interest.
8. The spouses of the business owners have not consented to the terms in the agreement. The parties may wish to include a spousal consent provision with the spouses signing the agreement. This may be helpful in avoiding valuation disputes in the event of a divorce or the death of an owner.
9. The agreement does not address the future ownership of life insurance policies acquired for the buy-sell arrangement. Consider including dispositive provisions for the following circumstances: (1) termination of the buy-sell agreement; (2) occurrence of a triggering event; (3) sale of the company; or, (4) termination of the business owner's relationship with the company. If any of the preceding events occur, the business owner may be given the option to purchase his or her policy (however, a business owner exiting the business under a lifetime triggering event through an installment sale of his or her interest generally should not be afforded an option to purchase the life insurance policy on his or her life until the installment sale is completed). In addition, if the departing business owner holds a policy on the remaining business owners, the remaining owners should also be provided with the right to purchase their policies from the departing owner. A means of determining the purchase price of the policy should also be provided in the agreement.
10. The life insurance policies have not been reviewed for compliance with IRC Section 101(j). Life insurance death proceeds are only income tax-free to an employer if the insurance is properly structured and the employer complies with IRC Section 101(j). Section 101(j) applies to employer-owned life insurance issued or materially changed after August 17, 2006. To preserve the favorable income tax treatment of life insurance death proceeds, Section 101(j) compliance requires written notice and signed consent by the insured employee to the placement of life insurance coverage owned by the employer. Annual information reporting (Form 8925) on employer-owned policies is required by IRC Section 6039I.

11. The terms of the agreement do not match the terms in the disability buy-out policy. If the agreement is funded with disability buy-out insurance, the terms in the agreement should match the terms in the disability buy-out policy with respect to the definition of disability, waiting periods and payout terms. Oftentimes, the agreement will refer to the definition of disability in the disability buy-out policy.
12. The agreement is not funded with life and disability insurance. It is easy to look at the role of life and disability insurance in terms of how it helps satisfy a contractual requirement. However, insurance does more than provide essential funds for the business at a time when the business itself must recover from the loss of a key contributor. It can prevent unnecessary financial strain for the business and the surviving owners, and it can help assure that a deceased and/or disabled owner's family is treated fairly.

Summary

Buy-sell agreements can enhance business stability by providing a pre-arranged business succession plan. Once implemented, the buy-sell agreement should be reviewed periodically to avoid unintended tax consequences and to ensure the agreement is consistent with the business owners’ goals and objectives.

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