ESTATE PLANNING FOR SMALL BUSINESS OWNERS: BUY-SELL AGREEMENTS

Many of our clients are partners in partnerships, members in limited liability companies or stockholders in smaller closely held businesses. They often are concerned about the continuation of the business after their retirement as well as the disposition of their ownership interests after their death. A buy-sell agreement is advisable for such owners which will dictate not only their ownership dispositions, but their partners or co-owners interests as well.

Buy-sell agreements accomplish several objectives. The agreement provides a mechanism for the business succession in the event of the retirement or other unexpected event such as a death, disability, incompetence or even divorce or bankruptcy of an owner. Buy-sell agreements usually restrict transfers of ownership interests to certain agreed upon new owners. The agreement will provide a defined purchase price, often as a stated value which can be obtained via valuation from an accountant at regular timely intervals such as every one (1) to three (3) years; or, as a formula purchase price that can be calculated by an accountant or business appraiser for the withdrawing owner's interest to be paid by the business to the withdrawing owner or the owner's family in the event of death. Sometimes, even when on the outset all interested parties in the business agree to the buy-sell terms, there may be instances when the terms, especially the purchase price terms, can be subject to different interpretations. Therefore, many buy-sell agreements include provisions for overcoming this potential future disagreement such as internal mediation clauses or utilizing multiple appraisers to establish an average price. Buy-sell agreements can be funded by life insurance or disability insurance policies and the face value of these polices can be agreed to as the price for the death or disability buy-out to avoid future price disagreements. Having the agreement in place is the first and most important step to establish the mechanism for the buy-out of an owner.

The Buy-sell agreement can also specify the terms of the buy-out of the withdrawing owner. The agreement can provide for a down payment of the purchase price with the remaining amount to be paid by installments via a promissory note. An interest rate would be added to the installment such as the prime banking rate or the Libor rate.

Buy-sell agreements usually involve the payment for the withdrawing owner's interest by the business itself (known as a redemption) or via a cross purchase arrangement whereby the payment for the withdrawing owner's interest is paid by the remaining owners individually. Some favor the redemption strategy as deemed easier and less complicated to effectuate, but the cross purchase arrangement allows for the remaining owners to receive an increased tax basis for the interest acquired. There could be a hybrid approach whereby the owners are first offered the right to purchase the withdrawing owner's interest and if they choose not to, the business will effectuate the purchase.

Hopefully, it is apparent that the buy-sell agreement is an effective way to effectuate the disposition of a withdrawing owner's interest in a partnership or closely held business.