Business Transaction Marketplace

Information about Business Valuations, Acquisitions, & Sales **December 2009**

Selling to Other Owners

Many business ownership transfers occur "internally" in lieu of a sale to a third party. The four most common internal transferees (buyers) are family members, management, ESOPs and other owners. In multi-owned privately held businesses (particularly at formation), it's common to see owners entering into a *buy-sell agreement*.

These agreements tend to serve two primary purposes: a) restrict transferring ownership interests to third parties, and b) provide liquidity to the departing owners arising out of a future triggering event. In this issue of *Business Transaction Marketplace*[SM], we'll discuss buy-sell agreements as a business ownership transfer strategy.

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Five Questions Buy-Sell Agreements Should Answer

1. <u>Who is the purchaser</u>?

Generally, there are three types of buy-sell agreements:

a. A *redemption agreement* is when the company buys out a departing owner's interest. If there are several owners of a company, this may be the best method. If the company purchases life insurance to fund a buyout at death, it will only have to own and pay premiums on one policy for each owner – as opposed to all owners having to own policies on all the other owners, which can add up to dozens of policies.

b. A *cross purchase agreement* provides for the remaining owners to buy out a departing owner's interest. The sale of a partial ownership interest is not considered a dividend, so it will be taxed at capital gains tax rates. The purchasers also get a "step-up" in their income tax basis equal to the seller's gain (that way, they reduce capital gains tax on a later sale). Again as stated above, this method may be a disadvantage if there are several owners, and the agreement is funded by life insurance; insurance policies will have to be purchased by each owner to cover every other owner in the company.

c. A *hybrid agreement* is a combination of the above two methods. Upon an owner's departure, the ownership interest is first offered to the other owners of the company (cross purchase). If they do not wish to buy the interest, the company is then given the option to purchase it (redemption). Alternatively, a hybrid agreement may be structured so that part of the ownership interest is redeemed by the company and the remaining interest is purchased by the other owners.

2. <u>What are the "triggering" events</u>?

A buy-sell agreement could be tailored so that it is triggered when specific voluntary and involuntary events occur:

Triggering Events	
Employee-Owner	*Non-Employee-Owner*
quits, retires, is fired, becomes disabled, dies, divorces, goes bankrupt	dies, divorces, goes bankrupt

3. How will the business be valued?
One of three general approaches is often used to value a departing owner's interest:

Agreed Upon Value	*Valuation Formula*	*Independent Valuation*
• Owners are active in the business • Owners understand the economics and effects of fixing a value • Desire to fix the estate value	• Stable Operations: - Industry and economy - Management - Sales/profitability • Desire to fix the estate value	• Complex capital structures • Changing economic environment • Emerging industry (high risk/returns) • Diverse circumstances (death, disability, divorce, retirement, etc.)

The owners may also agree to follow a process under a "shotgun agreement". This is where one owner offers to purchase (or sell) an interest to the other owner at a specific price. The other owner then has the right (or the obligation) to sell (or purchase) the interest at that specific price.

4. How will the buyout be financed?
Sometimes payments are made directly from the business's normal operations; or, life insurance is payable upon an owner's death. Life insurance can help prevent the business from being crippled because of a large payout.

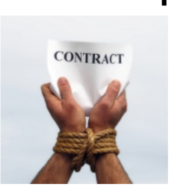
5. What is the method of payment?
As described above, a lump-sum payment is possible if life insurance is involved. Lump-sum payments may be impossible if the company is buying out departing owners during their lifetimes (which is more common). Instead, installment payments are made under a promissory note over a specified amortization period. There is often no assurance that the company or other owners will have sufficient funds in the future to satisfy the note payments. Therefore, collateral should be addressed in securing the note.

Fixing Value for Estate Purposes

It is important to consider the estate tax requirements under the Internal Revenue Code relating to buy-sell agreements. A buy-sell agreement will "fix" the value for estate tax purposes if it is binding during life as well as at death, and results in the interest being transferred at *fair market value*, meeting the following requirements:

- It is a bona fide business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than full and adequate consideration.
- Its terms are comparable to similar arrangements entered into by persons in an arms-length transaction.

Three Tips When Drafting Buy-Sell Agreements



1. Recognize How Each Owner's Characteristics May Differ. These particular owner characteristics should be addressed when drafting buy-sell agreements: younger vs. older; controlling vs. non-controlling; employee vs. non-employee; sweat equity vs. cash equity; personal guarantee on company debt vs. no personal guarantee on company debt.

2. Define Accounting and Valuation Terms. Disputes often arise out of buy-sell agreements simply because terms are not well defined. For example, the accounting terms *book value* and *generally accepted accounting principles* (GAAP) have special meaning that can affect how financial statements are interpreted. Likewise, a valuation term like *fair market value* is well recognized to include discounts when valuing minority interests. For a glossary of business valuation terms go here.

3. Seek Out Legal, Valuation and Tax Advice. A buy-sell agreement is a legal document with specific business objectives, as well as a valuation and potential estate planning document. Obtaining the advice from competent professionals is critical in achieving the goals surrounding this transfer strategy.

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