

BUY-SELL AGREEMENTS

A buy-sell agreement is a legally binding contract that can be used with all types of businesses. It stipulates that upon a triggering event, such as the death, retirement, disability, or other withdrawal of a business owner, his or her share of the business must be sold to the remaining partners or shareholders, or to the business itself. The agreement helps to prepare for the owner's withdrawal from the company.

KEY PROVISIONS OF A BUY-SELL AGREEMENT

The buy-sell agreement, regardless of form, must be drafted by an attorney and should specify certain key provisions. It is critical that the buy-sell agreement set out the intent of the parties in a manner that meets all legal requirements. The following information must be known for insurance planning and must be clearly explained in the buy-sell agreement:

Parties:

Who will be selling and who will be buying?

What is to be purchased:

This differs with each business type. For instance, it could be partnership interests, membership interests, stock; or for a sole proprietorship, the business's assets.

Timing of the sale:

For all parties involved, timing of the sale is critical.

Changes to the agreement:

A buy-sell agreement usually exists for a number of years. A process to update insurance coverage should be established.

Must mandate sales and purchase:

The buy-sell agreement must state that it is mandatory for the seller to sell and for the buyer to buy the business interest.

Business valuation (price):

How much does the owner or the owner's estate get for his or her business interest and how much does the buyer have to pay for this business interest?

Law:

Which state law(s) will apply?

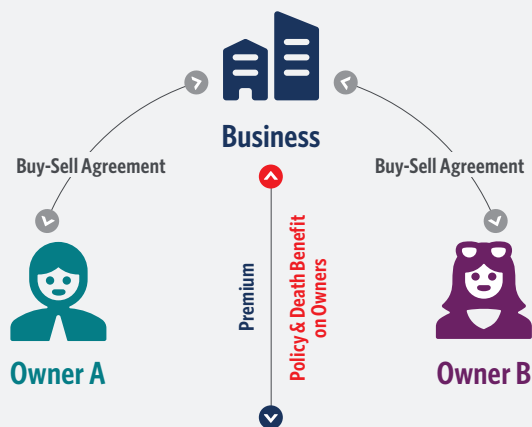
Termination of the agreement:

Valid reasons to terminate the buy-sell agreement should be stipulated in the agreement.

Types of Buy-Sell Agreements

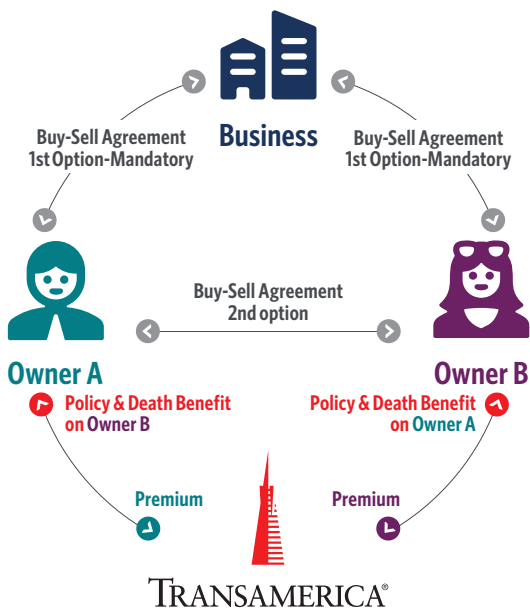
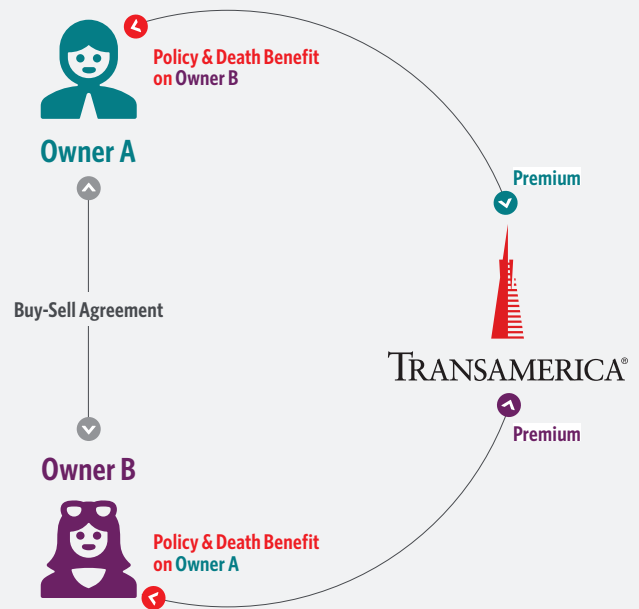
ENTITY (REDEMPTION) BUY-SELL AGREEMENT

- Generally used with businesses that have multiple owners, the business acts as the intermediary to execute and fund the agreement
- Business is the purchaser, owner, premium payor, and beneficiary on each owner's life
- Business receives death benefit when owner dies; uses it to buy the business interest at the agreed-upon price
- The business will follow all notice and reporting requirements under IRC § 101(j) and IRC § 6039I and show the policy cash value as a business asset



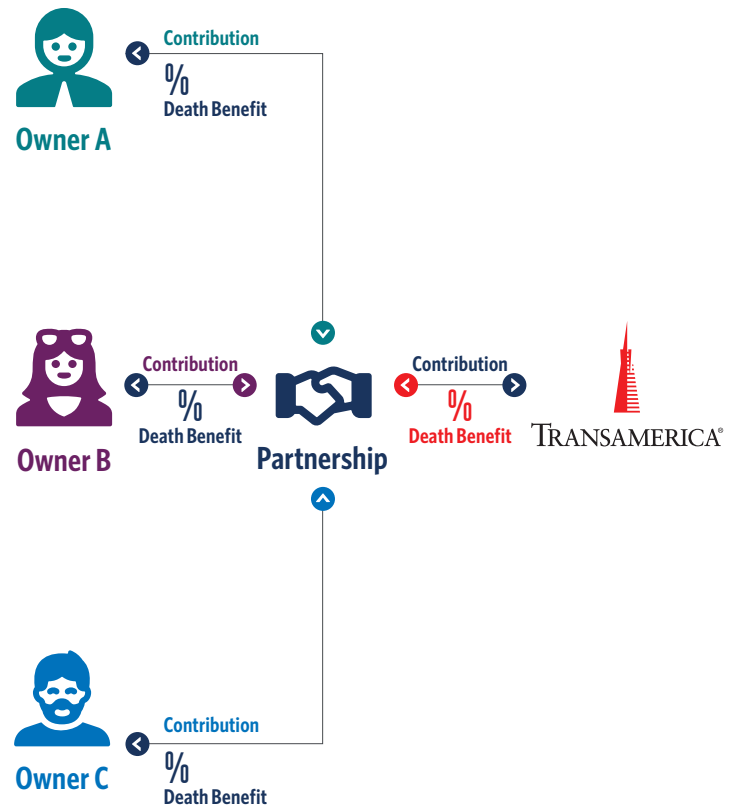
CROSS-PURCHASE BUY-SELL AGREEMENT

- Each business owner purchases life and/or disability insurance on the other business owner(s); each owner is the beneficiary of his or her respective policy(ies)
- The agreement is between the business owners, not the business itself
- Upon the disability, death, or withdrawal of one owner, the other(s) can use policy proceeds or cash value to purchase their pro rata shares of the withdrawing owner's interest



WAIT-AND-SEE BUY-SELL AGREEMENT

- Primary advantage is flexibility; with cross-purchase and entity buy-sell agreements, there's an inability to predict the future and determine which plan will be better for all parties
- Wait-and-see agreement can adjust to future tax law changes, fluctuating economic times, or owner uncertainty
- Is a hybrid agreement with language of buy-sell agreements that allows surviving owner or the the business to purchase the withdrawing owner's interest

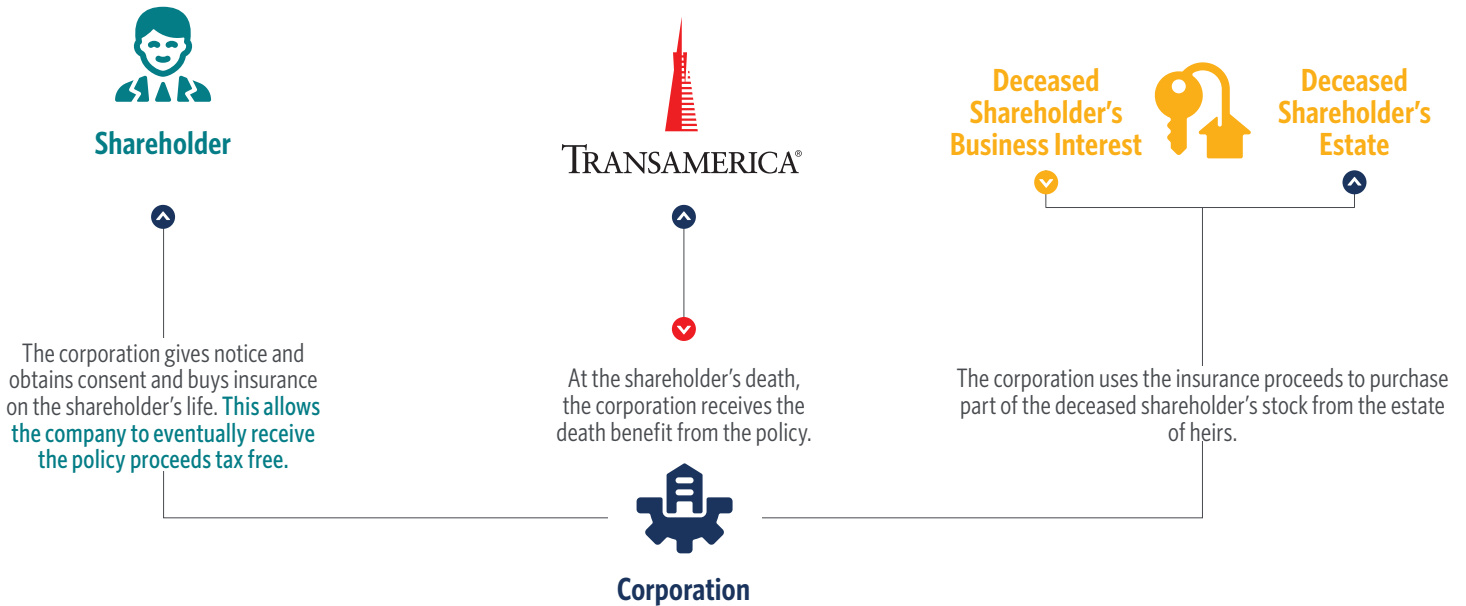


COMBINATION BUY-SELL AGREEMENT

- A general partnership is used to structure and fund a business buy-sell
- Combines the benefits of a cross-purchase and stock redemption/entity purchase while avoiding their negative aspects
- Establishes a traditional buy-sell agreement for the business, and the owners of the business establish a separate general partnership that owns and names itself beneficiary of life policies insuring the lives of the owners

SECTION 303 STOCK REDEMPTION

- Used for family corporations or closely held businesses the owner wishes to keep in the family
- If the deceased owner's shares are valued at greater than 35% of the gross estate, IRC § 303 will allow his or her estate or heirs to sell to the closely held business enough stock to pay certain taxes and costs



BUSINESS VALUATION

The most important component of a buy-sell agreement is the valuation of the business. The different ways to value a business are as unique as businesses themselves. The IRS has provided guidance in *Revenue Ruling 59-60* for the eight factors involved in determining valuation of a closely held business:

1. The history of the company and the nature of the business
2. The economic environment in which the business will operate
3. The book value of the stock and the financial condition of the business
4. The earnings capacity
5. The dividend paying capacity
6. The existence of good will or other intangible values
7. The sale of the stock or size of the block of stock to be valued
8. The fair market value of publicly traded stock of comparable businesses

The purchase price or formula used to determine the value should result in a fair market value at the triggering event for the buy-sell agreement.

OPTIONS FOR FUNDING A BUY-SELL AGREEMENT

Pay Cash

This requires large sums of liquid assets that may not be readily available, particularly when an unforeseen event occurs. The business may have to liquidate their valuable personal or business assets at below-market value to quickly raise enough cash.

Borrow the Money

The loss of an owner or key person may significantly impact the credit rating of the business and its ability to borrow. Additionally, the business owners must pay principal plus interest. This could be a tremendous strain on the business budget.

Installment Sale

Under an installment plan, the remaining owners of the business make regular payments to a departed owner or a deceased owner's heirs in exchange for their share of the business. Deceased or departed owner/shareholder's family would receive compensation over time rather than a lump sum and may rely on continued success of business to receive payment, which cannot be guaranteed.

Purchase a Life Insurance Policy

With a life insurance policy, money is available from the policy cash value or death benefit for the purchase of the business interest. This liquidity is available at the time it is needed without the need to raise funds by either selling the business or borrowing funds. Policy cash values grow tax deferred and death benefits are free of federal income tax.



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