



Buy-Sell Agreements: What You Need to Know About Their Effect on Value

According to the Wharton School of the University of Pennsylvania, only about one-third of closely held businesses survive into the second generation. Lack of planning is often the reason for failure — and a good buy-sell agreement can make all the difference.

If an owner dies, retires or becomes disabled, the buy-sell agreement will dictate what happens to his or her interest in the company. Making these decisions early ensures that shareholders and family members will have the benefit of practical guidance in a time of crisis.

A buy-sell agreement can create a “private market” for valuable but unmarketable shares in a privately held company. And if the agreement follows certain provisions, the stated purchase price can establish the value of the interest for tax purposes. Also, buy-sell agreements can be valuable in shareholder disputes.

Two Types of Agreements

There are two basic types of buy-sell agreements, each with its own tax and valuation implications. These agreements often use life insurance as the funding mechanism for the buy-sell transaction.

Cross-purchase agreements: Under a typical cross-purchase agreement, each owner buys an insurance policy on the other owner, naming himself or herself as beneficiary. If one owner dies, the life insurance proceeds are used by the other owner to purchase the deceased owner’s shares in the company.

The upside of a properly formulated cross-purchase agreement is that it establishes the fair market value of the decedent’s stock, and the insurance proceeds do not affect the value of the estate since the beneficiary is a third party.

Stock redemption agreements: In a stock redemption agreement, the corporation owns life insurance policies on the owners. If an owner dies, the corporation buys his or her company stock with the insurance proceeds. However, because the corporation is the beneficiary of the insurance policy, the insurance proceeds can affect the earnings and profits of the corporation

The IRS & Fair Market Value

The IRS has had some success challenging the valuation established by buy-sell agreements, particularly in family-owned companies. The trouble centers on the question of fair market value.

The IRS wants to ensure that the buy-sell agreement isn't used as a device to avoid taxes by transferring business interests to family members for less than "full and adequate consideration." Plus, it is the responsibility of the estate to prove that the buy-sell terms are reasonable and in line with a typical arm's length business transaction.

One of the keys to avoiding IRS scrutiny is creating a formula to establish the fair market value at the time of the shareholder's death — not a fixed price established at the time the buy-sell agreement was negotiated. And of course, the formula must be consistent with established business valuation formulas used in typical arm's length transactions.

Our firm is very familiar with buy-sell agreements and the valuation issues associated with them. If you have questions about these arrangements, please contact us.

Older Agreements More Lax

Buy-sell agreements entered into before October 9, 1990 (and not substantially altered since then) have different, less stringent requirements relative to the Internal Revenue Code. Before updating or changing a buy-sell agreement from this time period, be sure to consult a financial advisor familiar with these requirements so you can avoid harmful tax consequences.