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How Can a Buy-Sell Agreement Help a Business Owner?

Buy-sell agreements are one of the most efficient means of transferring your business interest. They are primarily used to make sure that there is a smooth continuation of a business after a potentially disruptive event, such as an owner’s retirement, incapacity or death. A buy-sell agreement is a valuable planning tool that can provide for the orderly succession of a family business. Proper funding of the agreement can provide liquidity when it is most needed — during disability, retirement or at death. Further, a buy-sell agreement can establish the purchase price of an owner’s business interest, avoiding potentially expensive and time consuming delays due to disagreements over value and possibly helping to establish a value for estate tax purposes at death.

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Understanding Buy-Sell Agreements

Q. What is a buy-sell agreement?

A. This type of legal document is sometimes referred to as a business continuation plan, a stock purchase agreement, a buyout agreement or a buy-sell agreement. It is a legally binding contract that establishes under what conditions, to whom and at what price an owner, partner or shareholder can or must sell his or her interest in a business as well as identifying who or what is obligated to purchase those interests.

Q. Why would I want to establish such an agreement?

A. A typical buy-sell agreement allows the business entity itself or other business owners the opportunity to purchase a departing owner's business interest at a predetermined price or pursuant to a determined formula. This allows the business and the remaining owners to protect themselves from future adverse consequences, such as disruption of operations, entity dissolution or business liquidation, that might result if certain events, such as an owner's sudden incapacity or death, should occur. This can also reduce the possibility that thebusiness will fall into the hands of outsiders.

The ability to fix the purchase price of a business interest makes this tool especially useful in estate planning. Agreeing to a purchase price while all parties are alive reduces the possibility of unfair treatment to a deceased owner's

family members. It can also provide certainty that upon an owner's retirement, he or she will be receiving the agreed-upon value in exchange for the business interests, which can be used for retirement liquidity needs. Because funding for buy-sell agreements is typically arranged when the buy-sell agreement is executed, both the placement of additional financial strain on the business and the possibility that funds would not be available when needed are reduced, ensuring the owner receives a set price resulting in liquidity for the owner or the owner's estate.

Q. What events trigger a buy-sell?

A. A buy-sell agreement must clearly identify the potential buyers, any restrictions and limitations, and the conditions under which a sale will occur. Sale triggering events may include:

- *Death*
- *Disability*
- *Retirement*
- *Divorce*
- *Voluntary or involuntary transfer of interest in the business*
- *Criminal conviction*
- *Loss of professional license*
- *Resignation or termination of employment*

Q. What are my options to fund a buy-sell agreement?

A. For a buy-sell agreement to be

successful, the parties should arrange for proper funding to carry out the terms of the buy-sell agreement. Without a funding plan in place, the buyer(s) may be forced to sell assets, take out loans or even file for bankruptcy. There are several ways to fund a buy-sell agreement and several factors that may influence the choice of the funding method. Funding methods include:

- *Cash*
- *Borrowing*
- *Installment sale*
- *Self-canceling installment note*
- *Sale leaseback*
- *Deferred compensation*
- *Life insurance*
- *Disability insurance*

Factors that generally influence the choice of the funding method include:
Business structure; size and tax bracket
Number of owners and their age, tax bracket and ownership percentages
Levels of cash or credit available to the business or the owners
Type of buy-sell agreement

Life Insurance Funding

Insurance is generally the most cost-efficient way to fund a buy-sell agreement. It is the funding element that makes carrying out the requirements of the agreement possible by providing the necessary funds just when they are needed. It obligates the money for the stated purpose, thus assuring it is available to implement the terms of the agreement.

Q. How does a buy-sell agreement that is funded with life insurance work?

A. After a document that meets the needs of the business owners is drawn up by a legal professional, life insurance (and disability buyout insurance, if desired) is purchased on the lives of the business owners. The owner and beneficiary of the insurance coverage may be an individual, (a so-called cross-purchase arrangement), or it may be the business itself (an entity-purchase agreement). Upon the death, disability or retirement of an owner, the buy-sell agreement can:

- *Identify the purchaser, price and payment terms for the sale of the business.*
- *Utilize any policy cash values or death benefits consistent with the buy-sell agreement* [(1)]

Q. What are the business advantages of a buy-sell agreement that is funded with life insurance?

A. A buy-sell agreement funded with life insurance offers several benefits to you and your successors when you transfer your business ownership including:

- **Immediate liquidity:** Permanent life insurance cash values and death benefits are readily available to fund business sales whether the sale occurs during the owner's lifetime, such as in retirement, or at the owner's death.
- **Cost efficiency**: Life insurance is a cost-efficient vehicle compared to other funding options. Premiums can be significantly lower than the cost of a loan.
- **Stability:** Life insurance death benefit options will guarantee there will be money paid in the event of the policy owner's death. If the policy is structured to accumulate cash value, those values can be used to provide a down payment for a lifetime buyout, with the remainder structured as an installment sale. The owner will receive a predictable income stream in the form of principal and interest payments that can be used for additional liquidity needs during retirement.[(2)]

In the case of disability buyout insurance, additional benefits include the following:

- **Reduced financial strain on the business:** Nondisabled owner(s) can avoid dipping into personal savings or business funds through the purchase of a disability buyout insurance product that will help provide the funding to buy the ownership interest of the disabled owner.
- **Prevention of disagreements on timing of departure:** The agreement objectively lays out under what conditions the disabled owner must exit the business and accept his or her share of the business interest, thus preventing a situation in which the disabled owner "hangs on" even though he or she can't handle former duties.

Q. Are there advantages for my beneficiaries?

A. A buy-sell agreement funded with life insurance can safeguard the interests of your beneficiaries in the event of your death. For example, it can:

- **Help protect your investment:** Your business interest is disposed of per the terms of the agreement. For example, it may be converted into cash, or it may be transferred as is to your beneficiaries.
- **Help provide a tax-advantaged source of funding:** Death benefit proceeds are generally income tax free to the policy owner, and the sales proceeds should be received tax free by the estate since the business assets would receive a step-up in basis upon the owner's death.
- **Help protect your family:** Buy-sell proceeds can be used for family income needs and estate settlement costs, providing a more immediate benefit.

[(1)] Assuming a life insurance policy is not a Modified Endowment Contract (MEC), access to policy cash value through loans is generally free from current federal income taxes, and withdrawals are taxed only to the extent that they exceed the policy owner's basis in the policy. Withdrawals or loans from MECs are subject to federal income tax to the extent of the gain in the policy, and if taken before age 59 ½, may be subject to an additional 10% tax penalty. Loans and withdrawals from a life insurance policy will reduce the policy's cash value and death benefit. A policy lapse or surrender while loans are outstanding may result in the recognition of taxable income. There may be penalties and fees associated with the use of loans and withdrawals.

[(2)] All guarantees are based on the claims- paying ability of the issuing insurance company.

Structuring Buy-Sell Agreements

Q. How do I make sure the agreement meets the needs of the business and the owners?

A. Buy-sell agreements can be structured to meet the needs of both the business and the owners, taking into consideration tax consequences and individual goals. It is not necessary that the same buy-sell agreements apply to all the owners of a business.

There are four basic structures for buy- sell agreements, and some combinations are possible. A very brief description of the four basic structures follows:

- An entity-purchase buy-sell obligates the business to buy the interests of each depart- ing or deceased owner.
- With a cross-purchase buy-sell, each owner agrees to buy a share of a departing or deceased owner's interest. The business is not a party to this type of buy-sell agreement.
- A unilateral or one-way buy-sell is used when only one owner is selling an interest, and is typically used in sole ownership situations whereby the owner is arranging to sell the entire business to a family member or key employee.
- A wait-and-see buy-sell is used when the parties are unsure whether the business or the owners will buy the business interest. Typically, the business is given the first option, and if it does not exercise the option, the remaining owners are given the opportunity. If the remaining owners do not exercise their option, the business is obligated to buy the interest, just as with an entity-purchase buy-sell.

Q. How do I determine the value of the business?

A. This is perhaps the most difficult thing to consider in setting up a buy-sell agreement. Establishing the worth of the business is essential to making the agreement work. For example, if you are a surviving partner, you want to be fair to the decedent's partners' beneficiaries, but you wouldn't want to pay out more than is necessary for the deceased owner's share. However, the deceased owner would have wanted his family to receive the maximum amount possible for his business interest. Of course, neither party knows the position he or she will be in, so by setting an objective dollar amount in advance — or by establishing an objective procedure for determining the amount — fair play is assured.

There are many different ways to determine the fair market value of an ongoing business. Which method is selected should be a care- fully studied, professionally advised process. Some methods work better for certain types of businesses. Depending upon the primary function of the business, methods of valua- tion could include the following categories:

- The market for businesses of a similar nature, including comparable sales, industry rule of thumb, and P/E ratio methods.
- Historical earnings, including capitalization of earnings or cash flow, debt-paying ability, gross income multipliers and dividend paying ability methods.
- A combination of assets and earnings, often called the excess earnings method.
- Future earnings, including discounted future cash flow or earnings methods.

Business valuation can be complex and caution is necessary. Determining the fair market value of a business may require an independent business appraiser. The IRS can impose harsh penalties for understating the value of an asset for estate tax purposes.

Q. If I set up a buy-sell agreement a few years ago, am I good to go?

A. It is important to periodically review the provisions of your agreement. Many buy-sell agreements address only death as a triggering event, but it is important to address issues such as retirements, bankruptcy, divorce, and disability. You should review your agreement to ensure all contingencies are covered. In addition, business valuations may need to be updated from time to time.

Q. What should I do if I have questions?

A. Contact your Morgan Stanley Financial Advisor. At Morgan Stanley, we review carefully every aspect of your wealth with the goal of helping you manage your lifestyle, control your risks and take a strategic approach to what you own as well as what you owe. Your Financial Advisor can tap a vast pool of knowledgeable professionals, including specialists in family dynamics, estate planning, insurance and liabilities management as well as portfolio analysis, traditional and alternative assets, and tax-sensitive investing. Our specialists will review information provided by you to help identify the strategies most appropriate for you and your family. Morgan Stanley also has access to carriers that can offer complementary business valuations through our General Agency partners. Our recommendations are objective, without bias toward one product or another, and are designed to work in concert with other strategies you may already have in place. Your Morgan Stanley Financial Advisor is committed to helping you prepare for the future. We look forward to working with you.

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