Buy-sell agreements

# Will the right funding be there when you need it?

## Best practices for structuring and funding a buy-sell agreement for your business

An effective buy-sell agreement can allow you to have the right amount of money, in the right place, at the right time. A properly funded, well-drafted agreement that reflects your goals can help protect you during both planned and unplanned events, including retirement, death, disability, divorce, or termination.

As you work with your financial professional to discuss creating or updating your buy-sell agreement, consider these best practices.

## Determine a fair purchase price and value for your business

To help guide you, ask yourself these questions:

- Is the purchase price based on the right methodology or formula for your business?
- Will the methodology or formula used result in a purchase price you would accept?
- Would the Internal Revenue Service (IRS) accept that value?

Below are examples of how the purchase price is determined based on our review of hundreds of buy-sell agreements.[1] There's not just one provision that's right for every business. In fact, some of the provisions in the table below wouldn't be recommended.

| PURCHASE PRICE PROVISION | PERCENTAGE OF BUSINESS CLIENTS |
|---|---|
| Determined annually | 23% |
| Mutual agreement of the parties | 17% |
| Agreed-upon formula | 11% |
| Determined by an appraisal or company accountant | 10% |
| Based on agreement provisions that are blank | 8% |
| Amount of life insurance death benefit | 6% |
| Book value/adjusted book value | 4% |
| Other methods | 21% |

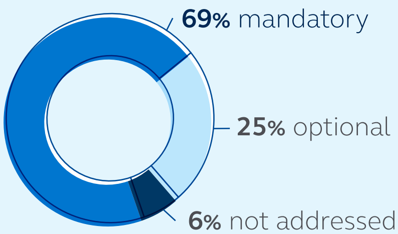
**53%** of businesses **have a back-up method** for determining purchase price at death.[1]

**47%** of businesses **don't address** a back-up method for determining purchase price at death.[1]

## Determine if funding will be readily available when you need it

The ideal situation is for the buyer to have the money available at the time it's needed. This can be impacted by the ownership structure and funding vehicle(s) used to fund your buy-sell agreement.

The most common trigger included in buy-sell agreements is death. However, the buy-sell agreement doesn't always require the buy-out to be mandatory at a triggering event. In fact, of the agreements we've reviewed, we found:[2]




**TIP:** *Life and/or disability insurance policies should generally be owned by the party holding the obligation to purchase (not the insured). For example, if the company holds the purchase obligation, then the company should be the beneficiary of any policy it owns.*

### Options for funding the buy-sell agreement

Buy-sell agreements involve the selling and buying of the departing owner's business interests according to the terms of the formal agreement. This means money will be needed to complete the transaction when a triggering event occurs. So, it's best to have a plan that specifies where that money will come from. Consider these options:

**Cash & sinking fund.** Requires cash flow from the business, and available funds may not be sufficient for unplanned events, such as a death or disability

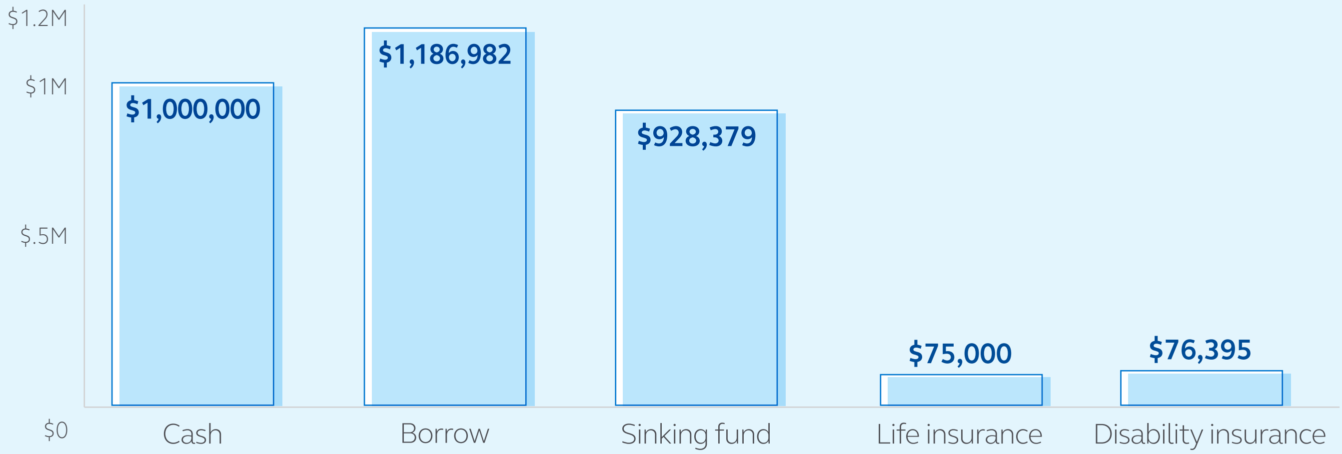
**Loan.** Involves unknown factors, such as future credit availability and cost of borrowing; must repay borrowed funds (with interest) from earnings; a down payment is generally required

**Installment sale.** Requires repayment from earnings and is contingent on the future success of the business

**Insurance.** Purchased upon implementation of the agreement and provides liquidity when needed, even for the unpredictable nature of both death and disability

How do you decide which method is appropriate for your situation? Timing of liquidity and cost are typically key considerations. Compare these hypothetical protection costs for a $1,000,000 purchase price.

Hypothetical funding method cost at end of 15 years[3]



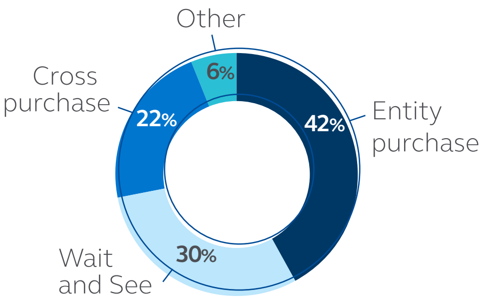

*Assumptions:*

**Cash:** $1,000,000.
**Borrow:** Represents five equal annual payments of $200,000 plus interest at 6%.
**Cash & sinking fund:** Sinking fund of $146,621 (annual deposits equal to the life insurance premiums growing at 8%) plus the balance necessary of $853,379 in cash.

**Life insurance:** Estimated premiums of $5,000 for Male, 45, Preferred, Non-tobacco, UL Flex III policy.
**Disability Buy-Out (DBO) insurance:** Estimated premiums of $5,093 for Male, 45, Executive Occupation class DBO policy. Insurance premiums paid for 15 years. Not valid without accompanying insurance illustrations. See illustrations for important information.

## Determine the agreement type that's best for you

Some of the most common buy-sell arrangements are:[2]




### Entity purchase

Entity purchase can be beneficial for businesses with three or more owners, since the business owns one policy on each owner.

**What wording might be in my agreement?**

*Upon the death of any Shareholder, the Corporation shall purchase, and the estate of the deceased Shareholder shall sell, all of the deceased Shareholder's stock in the Corporation, now owned or hereafter acquired.*

### Cross purchase

Best practices would suggest using this approach with three or fewer owners, since each owner must own a policy on each other owner.

**What wording might be in my agreement?**

*Upon the death of a Shareholder, the surviving Shareholder(s) shall purchase, and the estate of the deceased Shareholder shall sell, all of the deceased Shareholder's stock in the Corporation, now owned or hereafter acquired.*

### Wait and See

Many business owners choose to structure their buy-sell as a Wait and See agreement. It's important to note if owners apply the "wait and see" approach to funding the agreement too, it can create challenges in having access to the funding when it's needed.

## Determine the timing of the buy-out

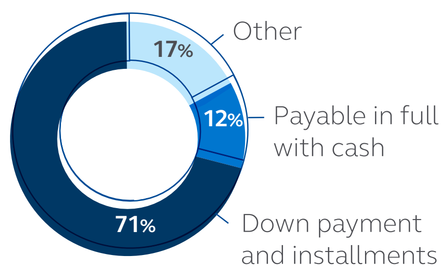
The buy-sell agreement provisions control the payment terms. It's a good idea to have your agreement written in a way that helps ensure you'll have the right amount of money available when you need it. Some of the most common triggering events are unplanned, like death or disablity.

Ask yourself these questions:

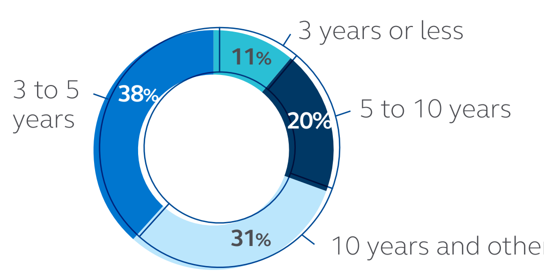
**Will the purchase price need to be paid in a lump sum, or a down payment with installments?**

**How confident am I the buyer can come up with the required lump sum, or down payment and installments when I'm ready to exit the business?**

Even though payment in a lump sum is preferred, very few agreements we've reviewed require payment in full upon a triggering event. The majority require a down payment with the remainder to be paid in installments.




It's important to consider whether your buyer will be prepared to make short-term installments. Based on the buy-sell agreements we've reviewed, almost half of agreements had installment periods of five years or less.



As you consider protecting the future of your business, a buy-sell agreement can be an important part of your plan. Talk with your financial professional and other advisors about what type of buy-sell agreement is right for you and your business.

[1] Based on 684 records of buy-sell agreement reviews completed January 1, 2018 to June 30, 2021

[2] Based on 2245 records of buy-sell agreement reviews completed January 1, 2014 to June 30, 2021

[3] The amount of insurance available to purchase depends upon the value of the business. Underwriting standards for life insurance and disability coverage are different. Disability buy-out insurance may not be available for every business.

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