

Buy-Sell Agreements -- An Owner's Checklist

Buy-sell agreements among co-owners or present and future owners of a closely-held business are intended to assure the smooth future transition of its ownership. They provide the mechanism, and, if properly funded, the means, to effect a change in control and transfer of interests upon the occurrence of a number of events, beginning with death, disability and retirement.

Where a business has reached a meaningful value, or looks like it will, owners of a closely-held business should understand the need for a buy-sell agreement and the funding to assure that it can be implemented. This checklist is not intended to provide all of the answers, but rather to stimulate owners to recognize the questions they should be asking of themselves and their advisors.

For a full discussion of these issues, see our separate article, [“Buy-Sell Agreements: Why and How to Fund Them.”](#)

<u>Existence of Agreement</u>	<u>Yes</u>	<u>No</u>
Do you have a buy-sell agreement?	___	___
If you have no agreement currently, might you consider one with one or more of the following? (check any that apply):		
Co-owners	___	___
Key employees	___	___
Another company in your industry	___	___
A major supplier or customer	___	___

Reasons for Buy-Sell Agreements

Which of the following is or might be a reason for you to have a buy-sell agreement for your business? (check all that apply):

- ___ To provide a market for the business interest of a deceased, disabled, or retired owner.
- ___ To restrict transferability, both during life and at death, of ownership interests by defining
- ___ To fix the value of, or at least the method of valuing, the business during life and at death.
- ___ To define the events that trigger the right or obligation to buy or sell the business.
- ___ To give incentives to one or more younger owners or key executives to join or remain with the business rather than leaving for a better opportunity that offers an equity stake.
- ___ To protect the status of an S corporation by prohibiting ineligible shareholders.

Does your agreement cover or should it cover the following events? (check all that apply):

- ___ Death?
- ___ Permanent disability?
- ___ Retirement?
- ___ Other voluntary separation?
- ___ Divorce?
- ___ Bankruptcy?
- ___ Irreconcilable business disputes?

Valuation

Yes No

Are the business and the partial interests in it properly valued, and is there a procedure for revaluations on an annual or other regular basis?

Is any insurance funding sufficient to cover the current valuation, and are there plans to adjust this coverage periodically in the future?

In the case of a family business, is the buy-sell valuation too low to pass strict IRS scrutiny?

Source of Buyout Funds

Without a secure source of money to implement a buy-sell agreement, its provisions will be largely empty and unenforceable. What, then, will be the source of capital to fund a purchase upon an event -- e.g., death, disability, retirement -- which triggers the buy-sell obligation?

- Insurance?
- Installment payments?
- A loan?

Yes No

If installment payments, will they cost more than insurance?

Will they drain needed capital?

Will they be affordable if many owners must be bought out at the same time?

If a loan, could it be obtained after an owner who is key to running the business has died or otherwise departed?

Would the cost of the loan's principal and interest payments exceed the cost of insurance?

Would these payments consume needed capital?

Should the buyout be funded on a regular pay-as-you-go basis rather than incurring this expense all at once when the buyout event suddenly occurs?

Will insurance be available to cover a buyout triggered by a permanent disability as well as death?

If insurance is in place to fund an existing agreement, has there been a recent analysis of the adequacy of the existing policies and the company providing them?

Does the company have all of the top ratings from the agencies that grade life insurers' financial strength?

Is the existing agent an expert on buy-sell agreements?

If funded by installment payments or a loan, how much additional gross revenue will be needed by the business when the buyout event occurs in order to afford the extra expense, after taxes, of either installment or principal and interest payments? \$_____

How much is this extra gross revenue as a percentage of existing revenue? _____%

	<u>Insurance</u>	<u>Installments</u>	<u>Loan</u>
Which funding alternative works best if multiple buyout events occur at or near the same time and more than one owner needs to be bought out simultaneously?	_____	_____	_____
Which alternative will make retiring, deceased, or disabled owners and their families feel most secure?	_____	_____	_____
Which plan will make the business more credit-worthy in the future?	_____	_____	_____
Which option can provide a ready-made source for at least a substantial portion of the buyout price upon an owner's natural retirement?	_____	_____	_____

Ownership and Beneficiary Arrangements of Buy-Sell Insurance Policies

The ownership and beneficiary arrangements for insurance policies funding the buy-sell agreement should be structured to minimize taxation. Which of the following issues have you and your advisors not discussed? (check all that apply):

- ___ Escaping the possible imposition of the corporate alternative minimum tax on the insurance proceeds received by a C corporation.
- ___ Increasing the capital gains tax cost basis for the surviving owners by the amount of the insurance proceeds in order to reduce or avoid capital gains taxes on a subsequent sale.
- ___ Structuring any C corporation stock redemption to assure, if possible, its treatment as a sale of a capital interest rather than the distribution of a dividend or ordinary income.
- ___ Avoiding extra taxes on excess accumulations of retained earnings by a C corporation which are not justified by reasonable needs.
- ___ Arranging any changes in the ownership of policies to avoid "transfers-for-value" that subject otherwise tax-free life insurance proceeds to income taxation.
- ___ Considering the possible tax advantages of having the business pay for buy-sell policies which are owned individually.
- ___ Planning the eventual ownership and use of the insurance policies so as to reduce both income and estate taxes.
- ___ The possible advantages of using cash value life insurance, rather than just term insurance, so as to have a tax-deferred means of funding a buyout at natural retirement, and not just at death.

Distinguishing Buy-Sell from Key Person Insurance

Separately examine whether the business would suffer an unacceptable financial loss as the result of the death or disability of one or more key employees who may or may not be owners.

	<u>Yes</u>	<u>No</u>
Has key person life or disability insurance owned by the business been considered to cover this potential loss?	_____	_____
Have you figured the value of the key people who have a special worth to the company as the result of their knowledge of its operations, important customer contacts, vital research they perform, or other hard-to-replace functions they serve?	_____	_____
Is there any confusion as to whether insurance owned by the company will be used for buy-sell funding or key person coverage?	_____	_____
Is both life and disability insurance adequate for both purposes?	_____	_____
Does the buy-sell agreement make specific reference to those policies used for buy-sell coverage?	_____	_____