

Concept Profile

BUY-SELL ARRANGEMENTS

Keeping the Doors of the Business Open

Many small, closely held businesses do not continue after the first generation, often due to a lack of succession planning. A buy-sell arrangement can be an excellent way to provide for the future of the business.

WHAT IS A BUY-SELL ARRANGEMENT?

A buy-sell arrangement is an arrangement for the sale of a business interest upon a triggering event, such as the owner's death, disability, or retirement. A well-drafted and properly funded buy-sell arrangement can protect the interests of the business owners and help facilitate the continuation of the business.

HOW DOES A BUY-SELL ARRANGEMENT WORK?

Buy-sell arrangements can take different forms, including: (1) entity purchase or stock redemption, (2) cross-purchase, and (3) wait and see. The best type of arrangement depends upon several factors, including the type of business structure and the number of owners. An entity purchase arrangement allows a company to buy out its deceased owners, while a cross-purchase arrangement allows owners to buy out each other. A wait and see arrangement is a combination of the others.

BENEFITS OF BUY-SELL ARRANGEMENTS

Create Liquidity. Upon a business owner's disability, retirement, or death, his or her family continues to need cash to pay ordinary living expenses as well as any potential estate tax liability. Estate taxes are usually due nine months after date of death. Selling a business under these circumstances can result in the family receiving less than fair market value.

Set a Fair Selling Price. A business valuation strategy, while all owners are active, remains subject to arm's length negotiations. Once a business owner has left the business, negotiating a fair sales price becomes more difficult for the owner (or the owner's estate) because the remaining owners hold most of the cards.

Fix Value. A buy-sell arrangement ordinarily sets the valuation for estate tax purposes. This allows the owners to plan their estates and reduce the risk of costly valuation disputes among business owners or upon estate tax audit.

Maintain Harmony. Because of the pressures of business ownership and everyday life, it is often difficult for owners of a closely held business to maintain friendships and camaraderie. Maintaining harmony becomes more difficult after the family of a deceased owner enters the business. A buy-sell arrangement can protect the remaining owners from problems arising when a deceased owner's family joins the business.

FUNDING A BUY-SELL ARRANGEMENT

Life insurance is generally one of the most advantageous ways to fund a buy-sell arrangement. Other possible funding methods include borrowing funds, using a sinking fund, or employeeing an installment purchase. Life insurance has income tax advantages and does not put a strain on the cash flow of the corporation after the death, disability, or retirement of a key owner.

METHODS OF VALUING A BUSINESS

One of the most important benefits of a buy-sell arrangement is to fix a value for the business. In order for a buy-sell arrangement to be sufficiently funded, the parties involved should try to have life insurance coverage sufficient to cover the date of death value of the deceased owner's interest in the business. The most common methods of valuing a business in a buy-sell arrangement are:

Specific Fixed Price – Shareholders periodically fix the price by agreement.

Book Value – Value reflects the book value on the date of death.

Capitalization of Earnings – Value is determined by multiplying earnings by a capitalization factor.

Formula – Value is determined by a formula that incorporates several factors.

Appraisal – Value is determined by an independent appraisal at the time of sale.

EXAMPLE

James and Arnold are owners of a very successful chain of coffee shops. They each agree that in the event of death they would like the other to have their share of the business. To fund this arrangement, they decide to draft a cross purchase buy-sell arrangement and fund it with life insurance. James and Arnold purchase life insurance on each other. Each one is the owner and beneficiary of the policy on the other. Arnold dies unexpectedly and James receives the death benefit from the life insurance company. He uses the proceeds to purchase Arnold's share in the coffee shops from Arnold's estate. James now owns Arnold's shares and the business continues. Arnold's family has the insurance proceeds to help them maintain their standard of living.

SUMMARY

A buy-sell life insurance arrangement gives the company liquidity, fixes a value, and maintains harmony. A buy-sell arrangement also provides business protection in the case of an owner's sudden death and helps to ensure the business will continue to operate.

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