TAX AND WEALTH ADVISOR ALERT: BUY-SELL PLANNING: THREE MISTAKES TO AVOID

One of the critical planning tools a closely held business plan should have is a buy-sell plan. A plan that addresses what happens to ownership of the company upon certain "triggering events," such as the death, disability, or termination of an owner. A buy-sell plan is a common document for a closely held business, and these plans often contain the same design flaws.

1. **<u>It provides for a fixed price.</u>** At its heart, a buy-sell plan frequently requires someone (an owner) to purchase the stock of someone else (another owner) upon a specific event (the owner's death). Therefore, the agreement needs to establish the price and terms of the stock sale. Price can be established in one of three ways: (a) an agreement between the parties, (b) a formula, or (c) an independent third party appraisal. It is not uncommon for the business owners to agree between themselves on the value of the business and use that value in the buy-sell agreement. There is nothing inherently wrong with that strategy; if no one knows whether they will be the buyer or seller when a triggering event happens, both parties should negotiate a fair value. The problem comes when the owners fail to update their buy-sell plan and the so called "stipulated value" becomes stale over time. The solution is not to avoid a stipulated value; rather, it is to put a provision in the agreement that when the stipulation is too old (18 months is common), the business must be valued in an alternate fashion (such as by appraisal).
2. **<u>It is inconsistent with the succession plan.</u>** I work with a second generation company that has done a very good job of bringing the third generation into the business. The new generation had to work elsewhere first, come in on the ground floor, and now are in a position to take the company to the next level. If you asked the second generation, upon a "triggering event," they planned to bring in the third generation as owners. Indeed, most of the long term strategic planning was centered around making the third generation owners. All of that is awesome and well done. The problem? The buy-sell plan had the second generation owner-siblings buying each other's stock. If things played out the way they actuarially should, the youngest second generation sibling would end up owning 100% of the stock. Another problem? A second generation sibling has children in the business, and one of the main ownership transition strategies of using family gifting does not work under the plan.
3. **<u>It is not funded.</u>** Generally, the purchase terms of a buy-sell plan require the purchasing party to use cash or a promissory note to buy the equity. Consider a $5,000,000 business with two owners. If death is a triggering event, and one of the owners passes away, generally the other owner will not have $2,500,000 in cash lying

> around to purchase the deceased partner's equity. So, under most buy-sell agreements, this purchase would have to be made with a large long-term promissory note.

But let's take a quick look at that transaction post-death. Presuming both partners were critical to the business's success, the business is likely to suffer some economic loss following the death of a partner. If that partner had a large role in revenue generation, the loss could be dramatic. The surviving partner will be in a situation where a weakened company needs to support his household income and service a sizeable promissory note. On the other hand, the financial future of the deceased partner's family is dependent on a weakened company's ability to service the note. Not to mention the fact that there will be little or no capital available to invest in company growth.

It is largely for this reason that I insist my clients fund their buy-sell plans with life insurance. A $2,500,000 life insurance policy gives the survivor exactly what he needs (cash to purchase the decedent's equity), the decedent's family what it needs (risk free cash), and the business what it needs (full access to all of its capital to weather the storm and grow). While life insurance is not free, at least it can be paid for while both partners are alive and the business is not in a post-death weakened condition.

So, for closely held business owners, first make sure you have a plan of ownership and leadership succession. Then make sure the buy-sell plan effectively implements the succession strategy, provides for a fair price at transition, and is appropriately funded.

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