



## BUY-SELL PLANNING: PART I



**MOST AGENCY** owners understand and appreciate the need for a properly drafted buy-sell agreement, but too many still operate without one. The day-to-day operations relegate such planning to the “back burner.” I have also heard too many times from business partners / co-

owners that “when I die my partner will do the right thing.” Maybe so, but at death, the owner of this opinion will no longer be around to balance the relationship and there is typically a lot of money at stake... a time when people get “funny.”

Consider the following scenario: Joe Agent’s business partner died with a 1/3 ownership interest in a closely-held business. The business was worth about \$5,000,000. It was a good partnership to the end and the three owners were friendly outside of work. They planned to implement a buy-sell agreement that would cover the death of a partner but never completed the process. The agency did however purchase life insurance for each partner in anticipation of the agreement. The end result was a long legal battle that worked out fine, for the attorneys.

The other parties to the process have a different account. The deceased partner’s spouse trusted the remaining owners but none of them had agreed what the ultimate value should be. It was only prudent for that spouse to consult advisors. The

attorney advised that the value of the business needs to be determined and in addition, the insurance had nothing to do with the ownership interest. The remaining partners would not leave ownership with an unwanted party so ultimately there was a settlement that left the business paying \$1,000,000 in cash in addition to the insurance proceeds of \$1,500,000 already received, to buy back the interest of their deceased partner that they thought was pre-funded with insurance.

Lifetime buyout provisions are also best worked out when everyone gets along. Often a closely-held business is an individual’s single largest asset and the uncertainty created without an agreement can only bring trouble. After all, the key objective of a well-drafted buy-sell agreement is to create a definite and ready market for a closely-held business interest that might otherwise be very difficult to sell. It limits the owners’ ability to transfer ownership to unwanted persons, usually giving remaining owners or the business entity the “right of first refusal” at a predetermined price before an interest can be passed or sold to an outsider. Certain events such as death, disability, and retirement are typical triggers that would contractually obligate either remaining owners or the business to make the purchase. This assures the parting owner will be able to liquidate interests for him/herself or loved ones.

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## Planning Considerations

Buy-sell agreements typically come in two flavors: entity purchase and cross purchase – each with advantages and disadvantages. An entity purchase agreement binds the agency to purchase interests from a departing owner where a cross purchase binds remaining owners individually. The type of entity (S-Corp, C-Corp, LLC...) and the number of owners are key considerations to determine which is best.

Under an entity purchase, if owners individually buy interests from the departing owner, their tax cost increases as it would with the purchase of other assets. Generally when the agency is the purchaser, the tax cost of the remaining owners doesn't change. This however can be overcome depending on the type of entity and other considerations. There is no difference to the departing owner which type of agreement is in place, but the remaining owners could benefit greatly from an increase in tax cost if the business is later sold, reducing their taxable gain.

The more owners there are, the more cumbersome a cross purchase agreement becomes. Often agreements are funded for triggering events such as death or disability by purchasing insurance. Once the options are considered, insurance is typically the most cost effective way to assure liquidity is available when needed. A cross purchase would require each owner to purchase insurance on all other owners.

A combination of a cross purchase and entity purchase agreement brings flexibility to whether the individuals or the business will affect the buyout. One party is ultimately bound by the agreement to make the purchase under certain triggering events to bring certainty. These agreements need to be drafted carefully. If the language of the document binds the individuals and the entity ultimately makes the purchase, the owners will likely be treated as being relieved of an obligation for tax purposes. This could result in dividend treatment to the owners equal to the amount of the buyout, and commensurate ordinary income tax liabilities that otherwise would have been avoided

Closely-held businesses are characterized by the financial and emotional investments of their owners. The time



and energy needed to develop a sound buy-sell agreement is clearly well worth the effort.

Business relationships are dynamic and sometimes go sour unexpectedly. When one owner wants to leave or oust another owner, buy-sell provisions often lack guidance in this situation. Plans and funding can be put in place to assure liquidation of a party's interest at death, disability, or retirement so we often see the contractual obligations for these triggers. Disharmony among owners is not anticipated by all but a few agreements. An interesting provision often referred to as a push-pull or Russian roulette would dictate that if an owner makes an offer to buy, the potential seller is left with the decision to accept or decide to become the buyer at the same price and conditions in the original offer. This assures an offer will be well thought-out and fair because the instigator does not know if he/she will ultimately be the buyer or seller.

In our next newsletter, we will continue the discussion of this matter covering estate planning considerations. For more information on this or any tax or accounting concerns, please feel free to contact us.

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