ARK FINANCIAL GROUP

Cross Purchase Buy-Sell Agreement

Overview

A buy-sell agreement specifies how business interests will be transferred, to whom, and under what circumstances. In a cross purchase buy-sell agreement, each business owner agrees to buy the business interests of an owner who dies, becomes disabled, retires, or otherwise leaves the business. These plans are frequently funded with life insurance and disability buy-out insurance. A cross purchase agreement may be appropriate any time there is more than one business owner.

Details & Operations

The business owners should visit with an experienced attorney to discuss a buy-sell agreement. Once they have decided on the cross purchase format, the attorney will draw up the agreement. In designing the agreement, several important issues are involved: buy-out events; valuation; funding; and buy-sell variations.

Buy-Out Events

Nearly all buy-sell agreements provide that the death or retirement of an owner triggers a buyout. The parties sometimes overlook the possibility of the disability or divorce of an owner. In the event of divorce, for example, the stock could end up in the hands of the ex-spouse, which the remaining owners may not want. Other triggering events can be the firing of a minority owner or the personal bankruptcy of an owner.

Valuation

One important requirement for a business purchase agreement to work is a consensus on the value of the business. An agreed-upon amount or method prevents valuation disputes between a departing owner or a deceased owner's estate and the remaining owners. Also an accurate valuation allows the parties to anticipate how much funding will be necessary for a buyout.

There are several ways to address the valuation question.

- Valuation can be based on a formula detailed in the agreement.

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- The agreement can require the parties to revalue the business every year. If the parties don't revalue the business within a given amount of time, the agreement can provide a valuation formula.
- The agreement can require a professional business appraiser to value the business. The appraiser can develop a valuation based on several factors, such as the annual earnings of the business.

Funding

There are several ways to fund a buyout.

- The company can simply create a sinking fund using a savings account or another conservative investment. The risk is that there may not be enough cash to fund the buyout. Also, the cash in the fund may be unavailable for other purposes.
- The company can borrow the money from a bank, but there will be interest costs. The bank also may be reluctant to lend money to a business if a key person has died or is leaving the company.
- Assuming the agreement allows, the company can make installment payments. This is often the only option where other liquid funds are not available, which is frequently the case with most businesses. When a buy-out event occurs, the company would pay the departing owner or a deceased owner's heirs a set amount each year determined by the language in the buy-sell agreement. The departing owner or his/her heirs may have a concern as to whether the surviving owners can profitably run the business.
- The most common funding option is for the business owners to obtain life and disability buy-out insurance on the other owners. In the event of an owner's death, the surviving owners can use the death benefit proceeds to buy the deceased owner's interest. Disability buy-out insurance can serve the same function, if the owner leaves due to disability. In both cases, the funds are available at the precise time necessary.
- If life insurance is used to fund a cross-purchase arrangement, it is owned by the owners other than the insured. So, if A, B, and C are owners, A would own policies on B and C, B would own policies on A and C, and C would own policies on A and B, for a total of six policies. Sometimes a trust or partnership is formed to own the policies, so that only one policy per owner is needed.

Buy-Sell Variations

A variation of the cross purchase buy-sell is the "**trusteed**" buy-sell arrangement, in which a trust owns the life insurance. The trust must be carefully drafted to ensure that the owners do not have incidents of ownership in their own policies. A similar arrangement is a **partnership** buy-sell arrangement, in which a partnership owns the policies. The benefit to either of these arrangements is that only one policy per owner is required.

Another type of buy-sell arrangement is an **entity** buy-out in which the business is required to purchase the departing owner's interest in the business, and the business owns any insurance used to fund the buyout.

Another variation is known as a "**hybrid**" or "**wait and see**" buy-sell arrangement. This type of agreement provides flexibility for the owners to use an entity or cross-purchase buy-out, or a mixture of the two, depending upon the situation when an owner dies or is required to sell. Insurance for this arrangement is usually structured as for a cross-purchase arrangement, with the owners making loans or capital contributions to the business for an entity purchase.

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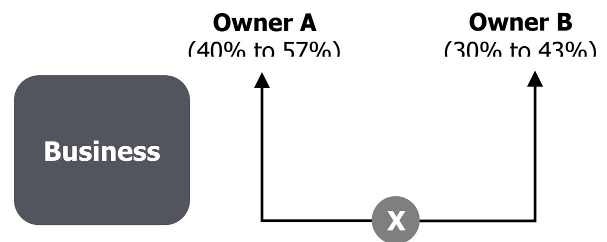
1. A owns 40%, and B and C each own 30%.
2. Owners execute cross-purchase buy-sell agreement.
3. Owners A, B, and C buy insurance on each other.
4. C dies; A and B collect proceeds and purchase C's 30% from C's estate.
5. C's estate recognizes no gain because the value of C's interests is stepped-up to date-of-death value.
6. After the purchase, A will own 57% of the business, and B will own 43%, provided they want to keep their current ownership ratio.
7. The remaining owners' basis in the business will increase by the purchase price they paid.

Flow of Business Interests at Buy-Out



Insights and Caveats

- When no family members are involved, a binding buy-sell agreement with an "arm's length" valuation generally will be sufficient to set the value for estate tax purposes. If family members are involved, a valid recent business valuation by a professional business appraisal organization is recommended.
- Generally, the value of insurance owned by a surviving business owner on a decedent business owner's life will not be included in the decedent's estate for federal estate tax purposes. This is because the decedent has no incidents of ownership in the policy. The life insurance the decedent owns on the lives of the other business owners will be included in his/her estate, although the value is roughly the cash value, not the full death benefit.
- Care should be taken to avoid the transfer-for-value rule when policy interests are transferred from one owner to another owner who is not the insured. Failure to do so might subject the death benefits to income tax.

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