Legacy Advisors Group

M & A UPDATE®

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The Buy-Sell Agreement:

More than Just a Good Idea, a Necessity in Multi-Owner Businesses

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Introduction

A buy-sell agreement is the most important legal document a closely-held or family business can hold. Without a buy-sell agreement, businesses face peril upon a triggering event such as an owner's death, incapacitation, divorce, filing bankruptcy, desire to sell, or retire. The consequences of not having a buy-sell in these situations can and usually does lead to expensive litigation. The ultimate end includes the potential of losing the business during the personal and legal conflict. In general, the best time to create a buy-sell agreement for any business is before the first dollar of revenue is ever transacted; however, if a business does not have a valid buy-sell agreement, a buy-sell agreement can be created and agreed to at any time once the business is in operation.

Stock Redemption Agreement

A stock redemption agreement provides for the purchase of an interest by the entity itself, as distinguished from business associates. A corporate stock redemption plan, utilized mainly in closely-held corporations, provides for the corporation to redeem or retire the affected shares. A partnership redemption plan, referred to as an entity plan, provides for the partnership to retire the exiting partner's interest under specific conditions.

Cross-Purchase Agreement

The cross-purchase agreement takes the form of a contract among stockholders, wherein the stockholders purchase an exiting shareholder's share of the business interest on an individual basis. Thus, a cross-purchase agreement among partners/shareholders provides that if one of the partners exits, the remaining partners/shareholders will receive the exiting partner's interest in exchange for the price specified in the agreement.

Mixed Agreement

In a mixed agreement, the entity is given the first option to purchase the shares of a stockholder. To the extent the shares are not purchased by the entity, they can be purchased by other shareholders usually in

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A CASE STUDY

A United States District Court found a commercial tax return preparer not liable for a violation of improper disclosure. In the case, a taxpayer alleged that her commercial tax return preparer threw her 2005 federal and state tax returns in a public dumpster where they were later found by someone else. The returns had not been shredded. While the taxpayer was concerned about identity theft, there was no evidence that such theft had actually taken place. The taxpayer sued the preparer, claiming that the disclosure of information by improperly disposing of the returns was a violation of the Internal Revenue Code. However, the Court found that a commercial return preparer is not held to the same standard under the Code regarding information disclosure as IRS employees, state employees and private persons receiving authorized disclosures from the IRS. As a result, the preparer was not held liable.

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Cover Story

direct proportion to the ownership.

Basic Valuation Issues

When multiple owner businesses dissolve, under the default rules of the applicable state business laws, one owner or the entity must fairly compensate the exiting owner for his/her interest based upon the fair market value of that interest. Fair market value has been defined as the price at which property passes between a willing buyer and seller, neither under any compulsion to buy or sell, and both with knowledge of all relevant facts. This definition is extremely vague and has historically led to a great deal of expensive litigation in this country. Defining the actual method for valuation diminishes conflict regarding valuation when a triggering event happens and can lessen the impact of estate taxes when the buy-sell agreement is authored at arm's-length. In any buy-sell agreement, there should be guidance regarding how the entity will be valued.

Common Triggering Events

Death: This event is nearly always provided for in any buy-sell agreement. The terms in this triggering event will provide for time of payment to the owner's estate.

Disability: These terms will include determination of disability, time of payment to the owner, funding mechanism, and disability insurance.

Retirement of an owner: Generally, retirement triggers mandatory buyout of the retiree's stock. In this case, funding and valuation are critical. Funding is critical in these cases in that no life insurance is available for the event.

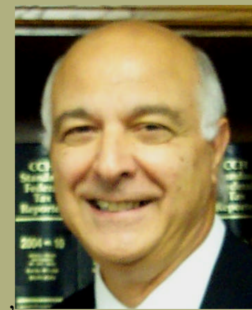
Owner's divorce or bankruptcy: Either of these legal actions can lead to problems and legal challenges from outside the entity.

Termination of the Employee: From time to time, employees are terminated from employment whether they are owners or not. Once again, a valuation method and payment terms should be listed.

Conclusion

A buy-sell agreement provides for smooth transition of a business interest by identifying triggering events, specifying to whom or to what the business interest must be sold, providing a mechanism to determine the purchase price, providing a funding source, and establishing a valuation for estate tax purposes. If your company does not have a buy-sell agreement, now is a great time to get one.

Dr. Basi has just completed a course on buy-sell agreements. It is being developed into a program for distribution to business owners. The program is one hour in length and contains a DVD and a workbook. Contact Trish at The Center for details on obtaining this program.



Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: Under the Internal Revenue Code, tax returns and return information can be disclosed to any person, to the extent necessary in connection with the processing, storage, transmission, and reproduction of such returns and return information, the programming, maintenance, repair, testing, and procurement of equipment, and the providing of other services, for purposes of tax administration. However, in this case, the Court found that because this statute did not govern commercial preparers, the defendant could not be found to have violated it.

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Points of Interest

- Without a buy-sell agreement, businesses face peril upon a triggering event such as an owner's death, incapacitation, divorce, filing bankruptcy, desire to sell, or retire.
- . . . if a business does not have a valid buy-sell agreement, a buy-sell agreement can be created and agreed to at any time once the business is in operation.
- A buy-sell agreement provides for smooth transition of a business interest by identifying triggering events

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ESOP Can Be A Win-Win-Win for You & Your Company and Your Employees

Mike Ertel, CBI/ M&AMI/ CM&AA

Employee Stock Ownership Plans (ESOP) have been around for 35 years, and many well known, national companies have them, but many misconceptions still exist, such as: (1) Employees will directly own the company's stock [FALSE], or (2) Employees will directly ratify everything from executive compensation to capital spending plans [FALSE], or (3) Employees will have complete access to all of the company's trade secrets and financial data [FALSE].

Employee Stock Ownership Plans (ESOP) have been around for 35 years. Today, there are over 10,000+ ESOP's in the US covering 10.5 million employees (10% of the US private workforce). Total assets owned by ESOP companies is approximately $675 billion. Well-known examples of ESOP companies include Proctor & Gamble, Anheuser Busch, Sherman Williams, United Airlines, and Publix.

Creating an ESOP trust to purchase your shares in your company can have many advantages for the Seller, the Company, Management and Employees. For example:

<u>Advantages for Selling Shareholder(s)</u>

- Liquid market for shares at fair market value
- Tax deferred (or tax free) sale of company stock
- Qualify for lower capital gains tax rates when paid
- Achieve full or partial liquidity
- Partial sale allows for retaining voting control
- Diversification of assets and net worth

<u>Advantages for Employees</u>

- Provides tax deferred retirement plan
- Equity participation may increase productivity
- Employees build wealth without personal investment

<u>Advantages for Management</u>

- Ensures smooth transition of ownership
- Provides increased ownership opportunities
- Enhances overall morale throughout company

<u>Advantages for Company</u>

- Tax deductible contributions to the ESOP
- Tax deductible dividends paid on ESOP stock
- Provides substantial tax savings
- Ability to use pre-tax dollars to repay debt

Legacy Advisors Group has experience working with ESOP financial advisors, bankers, attorneys, appraisers, etc., and can help you decide if an ESOP is right for your company. To learn more about ESOPs and qualify for a FREE, preliminary feasibility study, contact me at mertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: In the past, you have talked about buy-sell agreements. Is there a "best way" to value a business for purposes of a buy-sell agreement?

A: Unfortunately, for business owners, there is no one size fits all method of business valuation. Each business is unique in it's operations, investment, and finances, etcetera. The subject is often subject to litigation in court; therefore, it is often best to pick a method during the creation and drafting of the buy-sell agreement.

Q: I am selling rental property which I have owned for many years. However, I have not taken a depreciation deduction for the property during the time I have owned it. What will my taxes be on this exchange?

A: When selling depreciable property, you are required to recapture and pay ordinary income taxes as required by law on depreciation taken or allowable. This means that even though you may have not claimed a depreciation deduction (thus paying higher taxes), you must still pay ordinary taxes to some extent in addition to the capital gains taxes due. To solve the dilemma, the IRS allows you to amend you tax return for up to 3 tax years. If you have not taken depreciation beyond 3 years, taxpayers can file for a change of accounting method to adjust for not taking depreciation on the rental asset.

Q: How does the situation proceed when a named person in a buy-sell agreement cannot produce the cash necessary to purchase a named interest in a company ?

A: When the named purchaser in a buy-sell agreement does not or cannot come up with the necessary cash to purchase the business interest, severe consequences can follow for the business. Ultimately, the business can be broken up or its profitability can be affected to a large extent. Therefore, it is important to provide for flexible terms in the buy-sell agreement so the purchaser will have more options and less of a chance for the buy-sell agreement to fail.