BUY/SELL AGREEMENTS

AND OTHER BUSINESS AGREEMENTS

PART II

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In the last issue we discussed the importance of a Buy/Sell agreement and gave a few examples of actual cases. These cases illustrated how the agreement along with an Estate Plan can help clients achieve their goals and objectives and keep their businesses thriving. This time we will discuss funding issues as well as some other agreements often used by business owners.

Life insurance is often the best tool for funding a buy/sell agreement. It provides the funds to effect the buyout at precisely the time they are needed- at the death of one of the owners. Life insurance allows businesses or business owners to fund the buyout amount over a long period of time via premiums and guarantees the amount will be available when needed.

The question invariably arises as to which life insurance product to use when funding a buy/sell arrangement. As we all know, the life insurance that is in force when the insured dies is the obvious best kind. However, many if not most clients will revert to term coverage early in the discussion because of its lower cost. Term insurance that is in force is a much better solution that a permanent policy that is not!

In the final analysis, the product that the clients or business can afford is the one that will be used. Remember, most term policies can be converted prior to some date in the future to permanent coverage, so don't be dismayed if your client only buys term.

Term insurance covers the agreement in the event of the death of an owner as well as permanent, but permanent is more cost effective in the long run. Possibly a combination of the two will be the best solution.

One thing many business owners do not think of is that the cash values of a permanent policy can help effect a living buyout at the retirement of an owner or other buyout event prior to death. Sometimes an owner wants out of the business for other reasons, and as we learned in the last issue, a valid buy/sell agreement must have a "first offer" commitment. This means that if Harvey wants out of the business he must "first offer" his interest to the remaining owners or to the business before he can dispose of his interest to another buyer. A permanent life policy can be used to at least partially fund this Harvey's buyout. The cash value would reduce the balance owed to Harvey.

Permanent policies can also funded over a set number of years to shorten the length of time premiums need to be paid. Business owned policies' cash values can really be used for any business purpose.

Once the client has selected the type of policy to use and the amount of coverage to purchase, it is vital that the policy be structured to match the buy/sell agreement.

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If the buy/sell is a Cross Purchase type- i.e., an agreement between two or more owners - the policies need to be cross owned between these owners. (If there are more than two or three owners, Cross Purchase arrangements become cumbersome since the number of policies needed is number of owners minus one times the number of owners. For example, with four owners, 12 policies would be necessary - 4 -1X4 equals 3 X 4 = 12! Entity type agreements - an agreement between the business entity and the owners - are much preferred when the number of owners exceeds three, since with an Entity agreement only one policy per owner is required.) The premiums are the responsibility of the owners for the policies they own on other owner's lives and the owners are also the beneficiaries.

In an Entity agreement (see above), conversely, the policies need to be owned by the entity and the entity is the beneficiary and premium payer.

It is critical that the buy/sell agreement match the life insurance or vice versa. For example, if the agreement is a cross purchase type and the policies are owned by the entity (i.e., the corporation), upon the death of an owner the entity would have the death benefits and the surviving owner(s) would be obligated to buy out the deceased's share with no money to effect the purchase!

Buy/Sell agreements may also be one way agreements. In this type of arrangement there is only one party to be bought out rather than two or more. For example, let's say that Harvey and his son, Tom, own a business. Tom does not need to purchase Harvey's interest at his death since in this case he will inherit Harvey's share. However, since Tom is married, Harvey may want to buy out Tom in the event of his death since he does not want Tom's wife as a co-owner. This also guarantees Tom's wife a market for her deceased husband's interest in the business.

Another type of agreement that business owners might use is a salary continuation or deferred compensation agreement. These documents are used to cover benefit programs for owners that are not available to rank and file employees. They typically outline a retirement benefit funded by the business for owners and sometimes other key employees over and above the regular 401(k), profit sharing or pension plan.

Deferred compensation plans may also be funded by employees (usually owners) deferring some of their salary until a future date such as retirement. These deferrals generally are not subject to current taxation but rather taxed when received. Care must be taken to set up these arrangements properly to avoid adverse tax consequences.

Salary continuation and deferred compensation plans do use permanent life insurance as funding options, however, since life insurance provides tax deferred growth and tax favored payout options. This market is very lucrative for those who can tap into it.

The last business agreement we will discuss is the employment agreement. These are used extensively in the executive employment area and in professional sports. The type that is not so well known, but which has great value to business owners is the employment agreement between their business and their children! A valid agreement between Harvey's business and Harvey's kids outlining their duties and responsibilities and compensation is a great way to validate the tax deductible "wages" paid to children. These "wages" up to certain limits are not subject to social security taxes either. The "wages" can be the basis of an IRA or Roth IRA contribution as well.

Informing your clients of this little item may not only generate good will but also some sales. Those "wages" can be used to pay life insurance premiums too!

If you have any questions on the topics covered, contact your Marketing Representative at Financial Markets, Inc.

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