Buy Sell Planning – Part 3: Who Buys the Business Interest

Part of any good business plan is an exit strategy if the unexpected happens. A good Buy-Sell Agreement should anticipate certain unfortunate but foreseeable events, and make sure a plan is in place that is fair and reasonable for the owners and the business itself. One important detail to include in any Buy-Sell Agreement is: Who has the right to buy an owner's interest after a triggering event occurs? There are a few main options discussed below.

Redemption. In a Buy-Sell Agreement using the Redemption structure, the business agrees to purchase ("*redeem*") the interest of an owner after a triggering event. The owner agrees that he, or his estate, will sell the business interest back to the business for the agreed price. The main advantage of the Redemption approach is that it is usually the simplest form of buy-sell transaction, and when there are many owners involved, the simplest structure can sometimes be the best.

However, there are certain key disadvantages to a redemption structure. Depending on the type of business entity involved, the other business owners may not get a "step-up" in the cost basis of their increased business ownership after the redemption. This means the other business owners would incur larger capital gains tax if they sell their interest during their lifetime. If a "step-up" in basis is possible for the other owners, you'll need a good CPA to help you make the right tax elections. There are other income and estate tax disadvantages to a redemption structure, especially for majority owners and family owned businesses – another good reason to have reliable tax and legal advisors pointing you in the right direction.

Cross-Purchase. In a Cross-Purchase structure, each remaining owner of a business has the right or obligation to purchase the departing owner's interest. This method addresses many of the disadvantages of the Redemption structure such as giving the acquiring owners additional basis for the purchase of the departing owner's interest. There are disadvantages to a Cross-Purchase structure, though. The planning is generally more complicated, especially if there are more than a few owners. If insurance will be used to fund buyouts, then more insurance policies must be purchased than in the Redemption arrangement. If the owners of a business differ significantly in age or insurability, there can be inequality in expense between high and lower risk owners. In a Redemption structure, some of these complexities don't exist. The good news is, there are planning solutions to most of these potential disadvantages, but the bad news is, the solutions can further increase the complexity of a Cross-Purchase structure. The real question is often whether the tax benefits justify some increased cost and complexity up front.

Hybrid Approach. It is possible for a Buy-Sell Agreement to have a Hybrid structure to give the entity and its owners the maximum flexibility at the time of the triggering event (e.g., retirement, disability, death, etc.) to determine the most appropriate way to purchase the departing owner's interest. Generally, the entity has the first option to buy a departing owner's interest in a redemption format. If the entity fails to exercise its option, or purchases only part of the owner's interest, then the other owners have an option or obligation to purchase the departing owner's remaining interest in a cross-purchase format. In some cases, this second option held by the other owners does not result in a complete purchase of the departing owner's interest, and the entity may reenter the picture with an obligation to complete the purchase.

There are different ways to structure a Buy-Sell Agreement for your business and each has pros and cons. Be sure to work with good tax and legal advisors so that the plan you put in place for your business is fair, reasonable, and tax-efficient.

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