Buy-sell agreements

Principal®

Will the **right funding** be there when you need it?

Best practices for structuring and funding a buy-sell agreement for your business

An effective buy-sell agreement can allow you to have the right amount of money, in the right place, at the right time. A properly funded, well-drafted agreement that reflects your goals can help protect you during both planned and unplanned events, including retirement, death, disability, divorce, or termination of employment..

As you work with your financial professional to discuss creating or updating your buy-sell agreement, consider these best practices.

Determine a **fair purchase price** and **value** for your business.

To help guide you, ask yourself these questions:

- Is the purchase price based on the right methodology or formula for your business?
- Will the methodology or formula used result in a purchase price you would accept?
- Would the Internal Revenue Service (IRS) accept that value?

Below are examples of how the purchase price is determined based on our review of hundreds of buy-sell agreements.[1] There's not just one provision that's right for every business. In fact, some of the provisions in the table below wouldn't be recommended.

Purchase price provision	Percentage of business clients
Determined annually	20%
Mutual agreement of the parties	19%
Determined by an appraisal or company accountant	11%
Agreed-upon formula	10%
Based on agreement provisions that are blank	9%
Amount of life insurance death benefit	6%
Book value/adjusted book value	5%
Other methods	20%

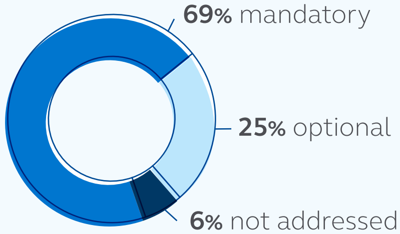
53% of businesses **have a back-up method** for determining a purchase price at death.[1]

47% of businesses **don't address** a back-up method for determining a purchase price at death.[1]

Determine whether **funding** will be there when you need it.

The ideal situation is for the buyer to have the money available at the time it's needed. This can be impacted by the ownership structure and funding vehicle(s) used to fund your buy-sell agreement.

The most common trigger included in buy-sell agreements is death. However, the buy-sell agreement doesn't always require the buy-out to be mandatory at a triggering event. In fact, of the agreements we've reviewed, we found:[2]



TIP: *Life and/or disability buyout insurance policies should generally be owned by the party holding the obligation to purchase (not the insured). For example, if the company holds the purchase obligation, then the company should be the beneficiary of any policy it owns.*

Options for funding the buy-sell agreement

Buy-sell agreements involve the selling and buying of the departing owner's business interests according to the terms of the formal agreement. This means money will be needed to complete the transaction when a triggering event occurs. So, it's best to have a plan that specifies where that money will come from. Consider these options:

Cash & sinking fund. Requires cash flow from the business, and available funds may not be sufficient for unplanned events, such as a death or disability

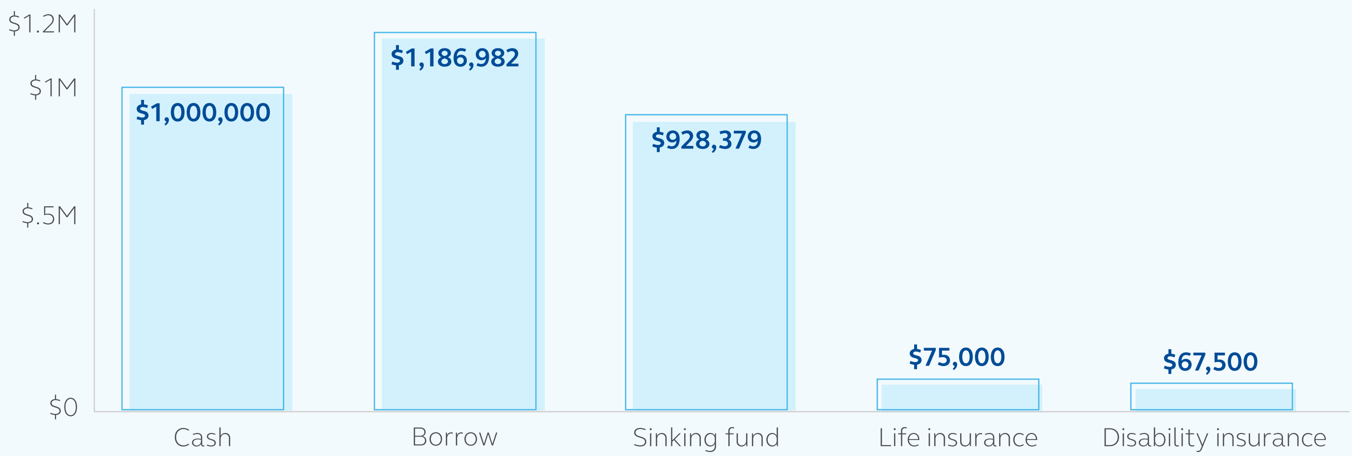
Loan. Involves unknown factors, such as future credit availability and cost of borrowing; must repay borrowed funds (with interest) from earnings; a down payment is generally required

Installment sale. Requires repayment from earnings and is contingent on the future success of the business

Insurance. Purchased upon implementation of the agreement and provides liquidity when needed, even for the unpredictable nature of both death and disability

How do you decide which method is appropriate for your situation? Timing of liquidity and cost are typically key considerations. Compare these hypothetical protection costs for a $1,000,000 purchase price.

Hypothetical funding method cost at end of 15 years[3]



Assumptions:

Cash: $1,000,000.
Borrow: Represents five equal annual payments of $200,000 plus interest at 6%.
Cash & sinking fund: Sinking fund of $146,621 (annual deposits equal to the life insurance premiums growing at 8%) plus the balance necessary of $853,379 in cash.

Life insurance: Estimated premiums of $5,000 for Male, 45, Preferred, Non-tobacco, UL Flex III policy.
Disability Buy-Out (DBO) insurance: Estimated premiums of $4,500 for Male, 45, Occupation class 6A DBO policy. Insurance premiums paid for 15 years. Not valid without accompanying insurance illustrations. See illustrations for important information.

Determine the **agreement type** that's best for you.

Some of the most common buy-sell arrangements are:[2]

#1 ENTITY PURCHASE (41% of agreements)

An entity purchase agreement arranges for the business (rather than the other owners) to purchase the interest of a departing owner. Business owned insurance is often used to provide funds to carry out the terms of the agreement.

The U.S. Supreme Court in *Connelly v. US* (2024) held that if the buy-sell agreement does not successfully lock in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation. If any owner anticipates being subject to the federal estate tax, the owners might wish to consider a different buy-sell design. Alternatively, additional life insurance (likely owned in an irrevocable trust) may be needed to provide liquidity to pay any estate tax that may be due.

What wording might be in my agreement?

Upon the death of any Shareholder, the Corporation shall purchase, and the estate of the deceased Shareholder shall sell, all of the deceased Shareholder's stock in the Corporation, now owned or hereafter acquired.

#2 CROSS PURCHASE (31% of agreements)

A cross purchase agreement arranges for the remaining owners (rather than the business) to purchase the business interest from a departing owner.

To make sure funding is available when needed, each owner might purchase an insurance policy on the others.

What wording might be in my agreement?

Upon the death of a Shareholder, the surviving Shareholder(s) shall purchase, and the estate of the deceased Shareholder shall sell, all of the deceased Shareholder's stock in the Corporation, now owned or hereafter acquired.

#3 WAIT AND SEE (21% of agreements)

Many business owners choose to structure their buy-sell as a Wait and See agreement, which is a hybrid between the entity purchase and the cross purchase agreements. The purchaser is not determined until the triggering event occurs.

Because the buyer is unknown, this type of agreement may be more challenging to fund.

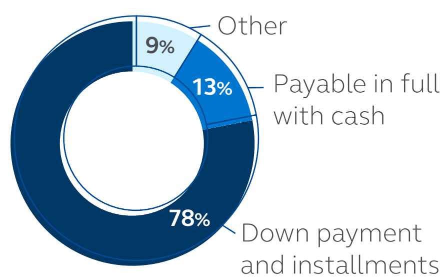
Determine the **timing** of the buy-out.

The buy-sell agreement provisions control the payment terms. It's a good idea to have your agreement written in a way that helps ensure you'll have the right amount of money available when you need it. Some of the most common triggering events are unplanned, like death or disablity.

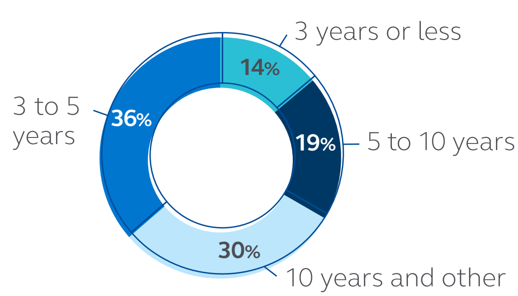
Ask yourself these questions:

- Will the purchase price need to be paid in a lump sum, or a down payment with installments?
- How confident am I that the buyer can come up with the required lump sum, or down payment and installments when I'm ready to exit the business?

Even though payment in a lump sum is preferred, very few agreements we've reviewed require payment in full upon a triggering event. The majority require a down payment with the remainder to be paid in installments.



It's important to consider whether your buyer will be prepared to make short-term installments. Based on the buy-sell agreements we've reviewed, almost half of agreements had installment periods of five years or less.



As you consider **protecting the future of your business,** a buy-sell agreement can be an important part of your plan. Talk with your financial professional and other advisors about what type of buy-sell agreement is right for you and your business.

(1) Preparer of thousands of informal business valuations since 2011.

(2) Reviewer of more than 2,600 buy-sell agreements since 2011.

(3) The amount of insurance available to purchase depends upon the value of the business. Underwriting standards for life insurance and disability coverage are different. Disability buy-out insurance may not be available for every business.

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