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Funding Your Buy-Sell Agreement

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What does it mean to "fund the buy-sell agreement?"

"Funding the buy-sell agreement" refers to the specific way that the transfer of the business interest will be paid for. There are two major strategies that can be used for funding a buy-sell agreement. One strategy is to fund the buy-sell agreement with insurance policies. The second strategy is to fund the buy-sell agreement with tools other than insurance. Each of these funding strategies has merits and drawbacks. Some methods are more convenient for the buyer, while others may be better for the seller. The specific type of buy-sell agreement is an important consideration in the funding decision. Funding can be accomplished using more than one method. Whatever funding method (or combination) is chosen should be specified in the buy-sell agreement.

Insured funding options

Under the insured funding options, the two major types of insurance are:

- Life insurance
- Disability insurance

Noninsured funding options

The methods of funding a buy-sell agreement that do not use insurance policies include:

- Cash
- Borrowings
- Installment payments
- Private annuity
- Stock redemption
- Sale-leaseback
- Appreciated property bailout
- Deferred compensation

Why worry about funding at all?

It may be tempting to ignore funding when your buy-sell agreement is being established, because the triggering events are perceived as being far off in the future. Without advance funding arrangements, there is a risk that the sale of your interest could be delayed, or even worse, you or your estate may never get the money. This is especially critical if the reason you set up your buy-sell agreement was to provide your estate with liquidity. The use of prearranged funding can help to eliminate any potential uncertainty that could come up at the time of the actual transaction.

Factors in the funding decision

Factors that will generally influence the choice of funding method include business structure, size, and tax bracket; number of owners, their ages, tax brackets, and ownership percentages; levels of cash or credit available to the business or the owners; and type of buy-sell agreement. Depending upon the specific details, there might be just one funding method that is appropriate, or there may be several funding methods that could be used. Important considerations in choosing a funding method for the buy-sell agreement may include:

Cost of implementation

These would include interest costs, opportunity costs, and any legal and setup fees. The general interest rate levels affect the cost and attractiveness of borrowing at any point in time. Cash that is being held in a sinking fund may cause the company to miss out on a more profitable business investment or expansion opportunity. Legal and setup fees can arise from the use of trustees or special funding accounts. Some funding methods require an immediate outlay of cash, such as an initial deposit or premium payment, while others do not need a payment until the time of the transaction.

Time frame for funding

The time frame is the big unknown factor under a buy-sell agreement. There could be many years to accumulate the money for the purchase of a business interest, or it could be needed next week. If retirement is a triggering event, the time frame might be somewhat more predictable, but a death or disability can happen at almost any time.

Tax consequences

Generally, when a company buys back the stock of an individual shareholder, the payment is not tax deductible. It is possible, however, to structure the buy-sell funding so that some (or all) of the payments for a shareholder's stock are tax deductible. This may be possible when borrowings, deferred compensation, or sale-leasebacks are used. From the seller's point of view, installment payments or private annuities may allow gain from the sale of the business interest to be spread out over a period of time. Some methods might lead to unintended estate or gift tax consequences. In the case of a family corporation, the seller could have difficulty receiving favorable tax treatment for the sale of stock to the corporation itself.

If the business is a corporation, both the business entity and the individual owners may be subject to tax on corporate profits--the corporation when the profits are earned, and the shareholders if the profits are distributed as dividends. When the owners (or an outside individual) are in a lower tax bracket than the business itself, it may make sense for the individuals to buy the business interest. Sometimes, it is less expensive for the business to pay for the purchase of a business interest. The difference in tax rates between the business and the owners should be considered when deciding on the form of buy-sell agreement and the funding method. When a company attempts to accumulate cash for a buy-sell transaction before a shareholder has died, it could be faced with the accumulated earnings tax. If life insurance is used, the company could be exposed to the alternative minimum tax if the proceeds are paid to the company.

Risk of failure of funding method

Ideally, parties to the buy-sell agreement want to minimize the risk that the funding method will fail to provide the cash when needed. Some funding methods, such as cash reserves, or the cash value buildup in a life insurance policy, may be subject to claims from creditors and therefore may not be available to fund the buy-sell agreement at the appropriate time.

Disparity in ages, ownership, health, or income of owners

Wide differences in the age, ownership levels, health, or income of the owners can affect the choice of funding. Often, the owner with the largest share is also the oldest. In a cross purchase, the younger owners, with presumably lower incomes, are purchasing a larger interest and must come up with more money to fulfill their obligations under the agreement. An older owner in poor health may be more difficult to insure (or be

uninsurable) and could cause a triggering event sooner than a younger owner. See Alternatives for the Uninsurable for more information.

When should funding be established?

Some funding methods require action at the time of execution of the buy-sell agreement. In all cases, it is better if funding is established immediately. The value of the business interests and the corresponding liability of the buyer could increase over time due to real growth and inflation. Full funding from the start can help your plan to keep up with inflation and growth. You should periodically review the buy-sell agreement to determine whether the funding method is keeping pace with the value of the business interest.

How much funding?

Ideally, the buy-sell agreement should be fully funded from the beginning. In other words, the full purchase price should be covered under the funding arrangement. But remember, even partial funding is better than no funding. If it is impossible to fully fund the entire value of a shareholder's interest, you can combine multiple methods, such as a cash down payment with borrowings or installment payments to cover the balance. You can also combine the use of insurance with noninsurance methods.

The consequences of not funding the agreement--a tragic tale

Let's say you have drafted the greatest buy-sell agreement in the business world. Business is a little slow right now, though, so you and your co-owners decide to wait a little while to fund the agreement. Some years pass, and business improves; in fact, it is so good that you and your co-owners do not have time for much else beside filling the tidal wave of orders that keeps pouring in. You are so busy and focused on the incredible pace of your business that you forget your own name, never mind the buy-sell funding you put off. In all this excitement, you die. Your family turns to the buyer under your buy-sell agreement, expecting a quick sale of your business interest so that your estate expenses can be settled. But guess what? There isn't any money for the purchase of your interest, because the funding was not established. Your buyer has no money, so neither does your family. Your family can take the buyer to court to enforce the agreement, but this could take a lot of time, and your estate taxes are due soon. And the whole situation could have been avoided by setting up the funding at the same time as the agreement. (We said this was tragic.)

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