What if… *I have a co-owner or partner*

If you have a co-owner or a partner, then you must have a buy-sell agreement!

A buy-sell agreement will spell out exactly what will happen with the ownership of the business in the case of certain “triggering events”. Most business owners think first of death as being a triggering event, but there are several others. Other triggering events are disability, divorce, bankruptcy, and transferring stock to a third party, retirement, termination and even how to handle disagreements between owners.

The buy-sell agreement will dictate what will happen to ownership interests in the event of a “triggering event.” Who is going to buy the ownership interest, for how much and in what way? This agreement should also include a formula or set price to determine the cost of the buyout. It will also dictate who cannot buy ownership interest. Typically, before you sell your interest to a third party, you have to offer it to your co-owner or partner.

This document should be drafted by a qualified attorney. It is often recommended that each owner have their own attorney involved in the process in case there is a dispute in the future.

The agreement can be either a cross purchase, an entity purchase or stock redemption plan. In a cross purchase agreement, the remaining stockholder or partner will be purchasing the stock or partnership interest. In an entity or stock redemption agreement, the entity itself will be purchasing the stock or partnership interest in the business.

By determining a purchasing price prior to the ‘triggering event,” you are avoiding any hassles in the future. All parties agree beforehand what the business is worth and for how much the ownership will be sold. The agreement will also detail exactly the terms of the buyout.

There is another important advantage of a having a properly drafted buy sell agreement. The value of the business can be pegged for estate tax purposes thus preventing the IRS from arbitrarily assigning a value.

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The IRS will look for certain provisions in the agreement. First, the estate of the deceased owner must be obligated to sell. The co-owner of partner must have first right of refusal to buy the ownership interest in the case of a living buy out. Lastly the agreement must be an "arm's length" transaction, the price of the ownership interest must be deemed reasonable. If the owners are family members, a certified valuation performed by an independent valuation firm is the best means to minimize the risk that the IRS will challenge the legitimacy of the sale price between family members.

The agreement should provide for funding the buyout. Without proper funding, is there really value in this agreement? There are four ways to do this.

Cash. Whoever is going to be the buyer, either the co-owner or entity, must accumulate enough cash to fund the agreement. Since no one can truly predict when a "triggering event" will occur, timing is a real issue here. Will there be enough time to accumulate the cash?

1. **Loan**. There are several concerns here. For example, will the buyer be able to obtain a loan? The loan and interest must be repaid. This can put a significant strain on cash flow.
2. **Installment Purchase**. This is a very simple method. The purchase price will be paid out in future installments. This can also be a real drain on the future cash flow of the business. If the business fails, the installment payments may stop.
3. **Life Insurance**. All of the above methods are viable in the event of most triggering events except death. Only life insurance can guarantee that the money will be there when an owner dies.

The buy sell agreement is one of the most important agreements a business owner can have. Failure to have one jeopardizes the future of the business as well as the future of the business owner's family.

Helping business owners protect, preserve and pursue more value from their business, more tax efficiently! ®

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