Has Your Buy-Sell Agreement Recently Been Updated?

A buy-sell agreement should be a critical part of your estate plan if you have an interest in a business that's closely held or family owned. The agreement provides for the disposition of each owner's interest after a "triggering event," such as death, disability, divorce, termination of employment or withdrawal from the business.

A properly drafted buy-sell agreement can help address a variety of issues business owners and their families may face when a triggering event occurs. But if yours doesn't include the appropriate provisions, it may not do its job.

Revisit The Valuation Provision

It's particularly important to revisit the agreement's valuation provision — the mechanism for setting the purchase price for an owner's interest — to be sure that it reflects the current value of the business. There are a couple of reasons why now is an appropriate time to review your agreement.

First, the COVID-19 pandemic may have affected the value of your business, so it's a good idea to ensure that your buy-sell agreement will produce a fair price. Second, absent congressional action, the federal gift and estate tax exemption is scheduled to be halved beginning in 2026, so a carefully drafted buy-sell agreement may soon be even more important than before.

As you review your agreement, pay close attention to the valuation provision. Generally, a valuation provision follows one of these approaches when a triggering event occurs:

1. Formulas, such as book value or a multiple of earnings or revenues as of a specified date,
2. Negotiated price, or
3. Independent appraisal by one or more business valuation experts.

Independent appraisals almost always produce the most accurate valuations. Formulas tend to become less reliable over time as circumstances change and may lead to over- or underpayments if earnings have fluctuated substantially since the valuation date.

A negotiated price can be a good approach in theory, but expecting owners to reach an agreement under stressful, potentially adversarial conditions is asking a lot. One potential solution is to use a negotiated price but provide for an independent appraisal in the event the parties fail to agree on a price within a specified period.

Establish The Business's Value

Business valuation is both an art and a science. Because the process is subjective, to an extent, there can be some uncertainty over the value of a business for estate tax purposes. If the IRS later determines that your business was undervalued on the estate tax return, your heirs may face unexpected — and unpleasant — tax liabilities.

A carefully designed buy-sell agreement can, in some cases, establish the value of the business for estate tax purposes — even if it's below fair market value in the eyes of the IRS — helping to avoid these surprises.

Generally, to establish business value, a buy-sell agreement must:

- Be a bona fide business arrangement,
- Not be a "testamentary device" designed to transfer the business to family members or other heirs at a discounted value,
- Have terms that are comparable to similar, arm's-length agreements,
- Set a price that's fixed by or determinable from the agreement and is reasonable at the time the agreement is executed, and
- Be binding during the owner's life as well as at death, and binding on the owner's estate or heirs after death.

Under IRS regulations, a buy-sell agreement is deemed to meet all these requirements if at least 50% of the business's value is owned by nonfamily members.

Choose The Correct Type Of Agreement

The type of buy-sell agreement you use can have significant tax and estate planning implications. Generally, the choices are structured either as "redemption" agreements, which permit or require the company to purchase a departing owner's interest, or "cross-purchase" agreements, which permit or require the remaining owners to make the purchase.

A disadvantage of cross-purchase agreements is that they can be cumbersome, especially if there are many owners. For example, if life insurance is used to fund the purchase of a departing owner's shares, then each owner will have to purchase an insurance policy on the lives of each of the other owners.

But cross-purchase agreements can also have significant advantages. For one thing, when the remaining owners purchase a departing owner's interest, they receive a stepped-up basis, reducing their taxable capital gains should they sell those interests in the future. Redemption agreements may trigger a variety of unwelcome tax consequences.

A cross-purchase agreement may also provide an estate planning advantage. Suppose, for example, that you own 35% of a business, your son owns 25% and two non-family members own 20% each. If the company redeems your shares, your family loses control over the business. But a cross-purchase agreement could be designed that gives your son the right to purchase enough of your interest to maintain control.

Review And Revise As Necessary

Your estate planning advisor and attorney can work with you to design a buy-sell agreement that helps preserve the value of your business for your family. It's an indispensable tool for protecting the business when owners die or exit the business and for providing liquidity for your heirs. After you have an agreement in place, review it periodically to be sure that it continues to meet your expectations.

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