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Five Fabulous Ways a Buy-Sell Arrangement Can Help the Business Owner

No business owner plans to fail. Often, they simply fail to plan. A business owner may find in the future he must sell the business. Without a plan, he must hope for a buyer and a fair price, even though his closely-held business interest is not readily saleable on the open market. A funded buy-sell plan can benefit the business owner in several ways.

Creates a market

The legally binding buy-sell agreement identifies a buyer of the business. The buyer agrees to buy the business under specific circumstances, such as on the death, disability, or retirement of the seller. The market for the business is in place when the seller may have neither the time nor the inclination to search for a buyer.

PROVIDES A WAY TO FIX THE PURCHASE PRICE

The agreement will generally set a binding price, either a specific dollar amount or a formula to set the price when the purchase is triggered. When the business is sold, there is no need to negotiate a price with anyone. This saves time and allows each party to plan accordingly.

CREATES A SOURCE OF INCOME TO THE OWNER'S FAMILY

Without a plan, on the death of a business owner, the business interest may pass to the decedent's estate and, perhaps, to the heirs of the estate. Surviving owners may find themselves in business with the heirs. The decedent's heirs may have experienced a loss of income with the death of the business owner and may want to take as much income from the business as they can. The surviving business owners may experience a loss of business income with the death of an owner. Money may be tight. The last thing the surviving owners may want to do is work to support the family of a deceased owner. A buy-sell agreement funded with life insurance helps avoid



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these pitfalls by passing the ownership of the business to the other owners, or to the business itself, and by providing some liquidity to the family.

TRANSFERS THE VALUE OF THE BUSINESS INTEREST TO A DEPARTING OWNER

A buy-sell agreement obligates the buyer to buy the business interest at an owner's death, disability, or retirement. A funded plan will provide a source of capital. If the agreement is funded with a life insurance policy, the death of an owner will create the cash needed to buy the business interest from the estate at the moment it is needed. If the owner is retiring or has become disabled, the cash value in the life insurance policy is available to help make installment payments to the seller in exchange for the business interest.

RETURNS A FAIR YIELD ON INVESTMENT

Without a plan in place, the death of a business owner immediately creates two fundamentally opposed parties. The estate, which now controls the business interest, would like to sell for the highest possible value. It may need the liquidity. The surviving owners would want to pay less because they continue to get substantial value from the business itself. A mandatory buy out with the price set at the start of the arrangement could prevent these opposed interests from devastating the company.

TYPES OF AGREEMENTS

There are basically two types of buy-sell arrangements. There is a cross purchase arrangement and there is an entity purchase arrangement.

Cross Purchase Agreement:

The Cross Purchase plan is an agreement among all the business owners to individually buy the business interest of a departing owner. The business is not a party to the agreement. An owner may depart because of death, disability, or retirement.

Entity Purchase Agreement:

The Entity Purchase plan, also known as a Stock Redemption in a corporate setting, is an agreement between the business owner and the business itself. The business agrees to buy the owner's interest, at the agreed upon price, when the owner departs. The business is a party to the agreement. The plan assumes the business will continue and function beyond the exit of the owner.

METHODS OF FUNDING

The buy-sell agreement is a contract between parties who promise to buy the business interest of a business owner who leaves the business because of a specified event. It is a known future obligation in an approximately known amount. Prudent business practice says that, if possible, this future liability should be funded by accumulating the cash needed over time. Therefore, the buyer will want to focus on setting aside the funds necessary to satisfy the obligation for cash. [Click here](#) for a link to a table discussing different financial alternatives, their advantages, and disadvantages.

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