A buy-sell agreement can provide the liquidity to cover estate taxes

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If you own an interest in a closely held business, it's critical to have a well-designed, properly funded buy-sell agreement. Without one, an owner's death can have a negative effect on the surviving owners.

If one of your co-owners dies, for example, you may be forced to go into business with his or her family or other heirs. And if you die, your family's financial security may depend on your co-owners' ability to continue operating the business successfully.

Buy-sell agreement and estate taxes

There's also the question of estate taxes. With the federal gift and estate tax exemption currently at $11.4 million, estate taxes affect fewer people than they once did. But estate taxes can bring about a forced sale of the business if your estate is large enough and your family lacks liquid assets to satisfy the tax liability.

A buy-sell agreement requires (or permits) the company or the remaining owners to buy the interest of an owner who dies, becomes disabled, retires or otherwise leaves the business. It also establishes a valuation mechanism for setting the price and payment terms. In the case of death, the buyout typically is funded by life insurance, which provides a source of liquid funds to purchase the deceased owner's shares and cover any estate taxes or other expenses.

3 options

Buy-sell agreements typically are structured as one of the following agreements:

1. *Redemption*, which permits or requires the business as a whole to repurchase an owner's interest;
2. *Cross-purchase*, which permits or requires the remaining owners of the company to buy the interest, typically on a pro rata basis; or
3. *Hybrid*, which combines the two preceding structures. A hybrid agreement, for example, might require a departing owner to first make a sale offer to the company and, if it declines, sell to the remaining individual owners.

Depending on the structure of your business and other factors, the type of agreement you choose may have significant income tax implications. They'll differ based on whether your company is a flow-through entity or a C corporation. We can help you design a buy-sell agreement that's right for your business.

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