FUNDING A BUY-SELL AGREEMENT

A buy-sell agreement obligates surviving owners, the business or a third party to purchase the business interest of an owner upon that owner's death. These transactions generally require the purchaser(s) to pay a significant sum of cash to the deceased owner's heirs or estate. "Funding" the agreement refers to the method of financing the purchase price for the deceased owner's business interest. The various options for funding a buy-sell agreement are discussed below.

Life Insurance

Advantages

- Generally considered the least costly method of funding
- Cash is available precisely when needed
- Life insurance proceeds are received income-tax free
- Minimizes financial strain on the buyer at time of business interest purchase
- Cash value accumulations can be used as a substantial down payment in the event of other triggering events, i.e. disability or retirement
- Life insurance cash accumulation is generally not available to buyer's creditors

Disadvantages

- Availability/cost depends upon insurability
- Premium payments are not a deductible expense
- Increases in future value of business may require additional purchases of insurance

Installment Payments

Advantages

- Seller may spread capital gain tax consequences from living buyout over time
- Allows flexibility for buyer

Disadvantages

- Seller or seller's heirs bear risk of business failure and resulting default on installment payments
- Total sales price may be included in seller's estate but transaction does not provide immediate liquidity to pay estate taxes
- Interest in addition to principal must be paid
- Payments reduce cash available for business cash flow
- Obligation may affect buyer's ability to borrow for other business needs
- Lacks certainty for seller or seller's heirs

Borrowed Funds

Advantages

- Cash can provide necessary funds in the event of any triggering event such as death, disability or retirement if business or surviving owner(s) can secure loan

Disadvantages

- Dependent upon buyer's ability to secure credit (death of an owner may make this especially difficult)
- Interest in addition to principal must be paid
- Payments reduce cash available for business cash flow
- Obligation may affect buyer's ability to borrow for other business needs
- Collateral and personal guarantees are generally required

Sinking Fund

Advantages

- Necessary cash will be available if owners have sufficient time to save full amount
- Cash can provide necessary funds in the event of any triggering event such as death, disability or retirement
- Owners can access cash if buy-sell agreement is terminated

Disadvantages

- May take significant time to save necessary funds
- Deposits made with personal or business after-tax dollars
- Earnings on the fund may be taxable
- Additional funds must be set aside to provide for increases in business value
- Fund may be subject to buyer's creditors
- Payments into fund are not tax deductible
- Funds must be managed and must achieve adequate rate of return to accumulate to required sums
- Access to funds could result in an unfunded agreement