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For Trusted Advisors

Business Planning

Buy-Sell Agreements: Why every business with multiple owners should have one.

By Eva Stark, JD, LL.M.

Many closely held businesses are owned by two or more co-owners. Individuals who co-own businesses may have known each other for years and are generally comfortable and successful in working with each other. But as they focus on day-to-day business operations, the tendency is to neglect important long-term planning such as establishing and funding a buy-sell agreement.

What is a buy-sell agreement?

A buy-sell agreement is a formal, written understanding among co-owners of a business detailing how ownership and control of the business can be transferred. It can help ensure that potentially undesirable and disruptive outsiders can be prevented from having ownership or voting rights in the business. A buy-sell agreement can additionally benefit a departing owner (or his or her estate or heirs) by providing a market for the sale of the departing owner's business interest where no market would otherwise exist.

Why is a buy-sell agreement important?

In the absence of a buy-sell agreement, a business owner is generally free to transfer his or her business interest to virtually anyone during lifetime or at death. A court also could award a co-owner's business interest to a creditor or ex-spouse upon divorce without the consent of the other co-owners. If such an event occurs, the remaining co-owners would then have to contend with running the business with the new co-owner. Depending on the entity type, ownership structure and state law, this new co-owner also may hold significant voting power or control, lack necessary skills or work ethic, be significantly disruptive, and threaten the future success of the business along with the livelihood of the remaining owners and their families.

A departing owner's family also may be negatively impacted in the absence of a buy-sell agreement. An interest in a closely held business is typically very difficult to sell. Without a funded buy-sell agreement, a deceased or permanently disabled owner's family may continue to have a substantial portion of their wealth tied up in the closely-held business in which they may desire no participation. Their livelihood will depend on the future success of the business—an often undesirable result.

What are some of the key provisions of a buy-sell agreement?

BUY-SELL METHOD

Most buy-sell agreements will incorporate one of three buy-sell methods: cross-purchase method, entity purchase method (stock redemption in case of a corporation) or a hybrid method. Under the cross-purchase method, business owners agree to purchase a departing owner's interest directly from the departing owner (or his/her estate). Under the entity purchase method, the business agrees to purchase the departing owner's interest. Under a hybrid method, the combination of first two methods may be utilized. For example, the agreement may provide that the business may elect to purchase the departing owner's interest, and to the extent it does not, the remaining owners will purchase it.

TRIGGERING EVENTS

A buy-sell agreement also will define a list of "triggering events" that give the remaining owners or the business the right to purchase an owner's interest. Triggering events typically include voluntary transfers, such as a contemplated sale by an owner to a third party, as well as involuntary transfers, such as transfers at death or transfers to a creditor (by judgment, divorce, bankruptcy or any other method). If the business's operations require that each owner actively participate in the business, triggering events may additionally include an owner's disability, retirement, loss of a professional license, or failure to remain "active" in the business by failing to provide services to the company or its clients. Such a provision may be critical for a business that is a professional practice but may be less important for a manager-managed real estate investment company, for example.

PURCHASE PRICE

The buy-sell agreement typically outlines how the purchase price is to be determined following a triggering event. The method for determining the buyout price and whether discounts may be utilized may vary depending on the specific triggering event and whether it is voluntary or involuntary.

For example, many buy-sell agreements provide that the remaining owners or the company will match the price and terms of a third party offer if a voluntary sale to a third party is contemplated, or pay fair market value (FMV) for an owner's interest upon death. The same agreements, however, may provide that only book value will be paid or the FMV will be discounted by a number of percentage points in the event of an involuntary transfer—such as a transfer to a creditor—which may offer additional protection for the remaining owners. However, when different values are used for different triggering events, it will be important to ensure that the IRS will respect such valuations. Where an owner can dispose of his or her interest during life for a different price than what is provided in the buy-sell agreement in the event of death, the IRS may not respect such valuation for estate tax purposes and may re-calculate the value (usually to the taxpayer's detriment).

Many buy-sell agreements also establish a procedure for determining the FMV of a business interest. For example, the document may provide that the owners will execute a certificate of agreed value on an annual basis on which buyout prices are to be based. The owners may also agree that the FMV is to be determined by one or more qualified appraisers.

Where qualified appraisers are utilized, the documents often provide that the qualified appraiser will be selected jointly by the departing owner and the remaining owners; or if an agreement cannot be reached, a qualified appraiser will be selected by each owner and the two appraisers' valuations are reconciled by a pre-selected method.

For example, the agreement may provide that if the values determined by the buyer's appraiser and the seller's appraiser vary by less than a certain number of percentage points based on the lower of the two appraisals, the appraisals are to be averaged; and if they vary by more than the set number of percentage points, the two appraisers are to select a third appraiser whose valuation will be final.

PAYMENT TERMS

Some buy-sell agreements require the payment for an owner's interest in cash (or by matching the terms of a third-party offer). This is an attractive solution for business owners who do not want their families' security dependent on the future success of the business. Other buy-sell agreements provide for installment payments over a certain number of years, with interest and the business interest offered up as security. Yet others utilize a combination of the two by requiring cash payments to the extent of insurance proceeds with note payments for the rest. Payment terms can also vary depending on whether the buyout was triggered by a voluntary or involuntary transfer.

How are buy-sell agreements typically funded?

Life insurance has become a popular funding mechanism for buy-sell agreements. For many business owners, it is likely to be one of the more cost-efficient funding mechanisms.

With life insurance, funding automatically becomes available when it is needed the most to carry out a buyout—upon an owner's death. Where permanent life insurance is used, cash values may often be accessed to make a buyout more feasible in the event of an owner's retirement, disability or upon the occurrence of other triggering events. (Policy cash values are typically accessed through policy loans that accrue interest and reduce death benefits.)

Where life insurance is used, it will be important to ensure that policy ownership matches the buy-sell method used. To fund a cross-purchase agreement, each owner will generally purchase life insurance on the life of every other owner. To fund an entity-purchase, the business will typically purchase a policy on the life of each owner.

ARE THERE ADDITIONAL METHODS OF FUNDING A BUY-SELL AGREEMENT?

The co-owners and/or the business also could establish some type of sinking fund for a buyout. However, there is no guarantee that sufficient funds will be accumulated by the time a triggering event occurs. Additionally, sinking funds must generally be kept in conservative, low-return investments at significant opportunity cost.

Loans also could be an option. With loans, interest is an additional cost. There also is no guarantee that a remaining owner or the business will qualify for the desired loan amount at an affordable interest rate when the need for a loan arises. Some buy-sell agreements provide for payments over time in the event of an owner's death. This can be a significant drag on the cash flows of a business or the remaining owners while making the deceased owner's family dependent on the future success of the business. Whatever funding method is selected, business owners should periodically review what funding is in place and ascertain whether it corresponds with changes in the value of the business as well as changes in business needs or personal circumstances of the owners.

Conclusion

A buy-sell agreement is a critical tool for the long-term success of a business with two or more co-owners because it can help ensure that ownership and control of the business is kept out of the hands of potentially disruptive successor co-owners.

It also can create a market for the sale of a deceased owner's interest where no market would otherwise exist.

There are many ways to structure a buy-sell agreement and clients should consult with their attorneys and other professional advisors to determine the best buy-sell method and provisions considering their particular circumstances.

Of course, a buy-sell agreement also may only be as good as the ability to carry it out. As a result, it is important to ensure that sufficient funding is always in place. Business owners should periodically review their buy-sell agreements and available funding with their professional advisors to ensure that their existing agreement and funding meets their changing needs.

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ABLE accounts: Powerful planning tool.

By David R. Toups, JD, MBA, CFA®, CFP®

"Failing to plan is planning to fail."

This time-tested maxim used by financial professionals certainly applies—with sometimes disastrous consequences—for families that include a person with special needs.

Without purposeful planning to navigate the labyrinth of governmental regulations, the likelihood of tripping a provision that would disqualify a special needs individual for or from public benefits is rather high.

Even a well-meaning gift or inheritance from a loved one can create a whole host of problems for a person with special needs. However, tools exist that may help.

Overview

Enacted in 2014, the Stephen Beck, Jr., Achieving a Better Life Experience (ABLE) Act permits eligible individuals to save up to $100,000 to pay disability related expenses, without losing their eligibility for public benefits. The person's disability must have begun before age 26 to be eligible for an ABLE account, which enjoys tax-free growth but lacks any tax deduction for contributions.

Eligible disability expenses that may be paid from an ABLE account vary under each state's regulations, but usually include health, education, housing, transportation, assistive technology, services for personal support, financial, administrative, and legal services, and funeral and burial expenses.

Benefits

The following summarizes the primary benefits of using an ABLE account.

- **ROLLOVER ELIGIBLE.** A relatively recent expansion of the law permits §529 education savings accounts to be rolled over or transferred into an ABLE account. Absent such a transfer, the 2018 cumulative annual contribution limit to an ABLE account is $15,000 per year, which is adjusted annually for inflation and excludes the person's annual earned income, as long as it falls below the federal poverty level ($12,060 in 2018) with no participation in an employer retirement plan.
- **ASSETS DISREGARDED.** Public benefit programs, such as Medicaid and Supplemental Security Income, do not include ABLE account assets in the calculation of asset or resource based limits for benefit eligibility. Also, if the account exceeded the $100,000 ABLE limit, it would not disqualify the person but just suspend his or her benefits until the amount is reduced to within applicable limits.
- **SIMPLE INITIATION.** The ease and cost in establishing an ABLE account is another benefit. This is especially true when compared with the costs of drafting, funding, and administering a special needs trust. ABLE accounts can be opened in states that have adopted them with varying annual service fees that often fall below $100 annually, while the costs for obtaining and funding a well-drafted trust can exceed $1,000.
- **BEQUEST FRIENDLY.** By using an ABLE account, a special needs individual who receives a modest gift or inheritance (less than $15,000 in 2018) can avoid a protracted ordeal to receive the windfall, since disclaiming assets as a person with special needs is considered a disqualifying event under most state's statutes.
- **ACCOUNT FLEXIBILITY.** Flexibility and control are other perquisites of an ABLE account. The accounts can function much like a bank account, and some even permit a card that functions like a debit card. Many states permit nonresidents to establish ABLE accounts, so special

needs persons residing in states with slow acting legislatures can obtain an account from another state, with features and benefits best suited to their needs.

- **EXPENDITURE DOCUMENTATION.** Also, the funds in the ABLE account may be invested in a set of predetermined investment options that can produce a range of expected rates of return; however, an owner may only have one ABLE account at a time. Since the account can function like a bank account, if utilized with an eye toward administration and record keeping, the account's statements can document that all expenditures were eligible.

Pitfalls

The major drawback or disadvantage of an ABLE account is that the funds remaining in the account at the death of the ABLE account's owner are subject to governmental reimbursement of expenses.

Summary

ABLE accounts are useful tools to address multiple issues that a family with a special needs person experiences. Used alone or paired with other special needs planning tools, ABLE accounts can help with financial and administrative burdens.

As always, a trusted financial professional is best able to provide up to date information about features and benefits ABLE accounts provide in your state.

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Prior to joining The Nautilus Group in 2016, David spent more than 14 years in the private practice of law, focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. As a member of the Nautilus case development team, David contributes his training and experience in the analysis and explanation of multi-faceted estate, trust, and business planning strategies. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David also served in the U.S. Marine Corps as an artillery and infantry officer.

Social Security benefits: Start early, or delay receipt?

By Robert Ahern, BSBA, JD, LL.M., CFP®, CLU®, ChFC®, CRPC®

For many U.S. workers, Social Security benefits will be a critical component of their retirement income, and for most of those workers, their primary retirement income source. Deciding when to claim benefits, however, can be a confusing exercise, making the ultimate decision very difficult.

Although U.S. workers eligible for Social Security may begin accepting benefits as early as age 62, Social Security will pay 100% of benefits to which a worker is entitled only if he/she waits to file a claim until attaining full retirement age (FRA), an age that varies among workers based upon year of birth.

If benefits are claimed earlier than FRA, then Social Security will reduce the benefit paid, often as much as 30%. (Social Security calculates a worker's monthly FRA benefit using a complex formula that averages his/her greatest 35 years of income, adjusted for inflation annually according to the National Average Wage Index for each year among the greatest of those 35, and then reduces that average at specific income markers referred to as bend points.) To obtain the greatest monthly benefit possible, a worker must delay taking Social Security benefits up to age 70.

Age is relative

As referenced earlier, 100% of a worker's benefit will be paid only if he/she waits to receive Social Security at his/her FRA, and FRA will vary based upon birth year. If a worker was born during 1937 or earlier, his/her FRA is 65. If born during 1938 but before 1943, his/her FRA ranges from age 65 and 2 months to age 65 and 10 months. (Since these persons have all already attained age 70, this article does not pertain to them.)

If a worker was born during 1943 and before 1954, his/her FRA is 66, and if he/she was born during 1955 but before 1960, FRA ranges from between age 66 and 2 months and age 66 and 10 months. If born during 1960 or later, his/her FRA is 67.

If a worker retires at FRA and makes his/her claim, then he/she will receive 100% of the amount he/she is due in Social Security benefits. If, however, he/she elects to claim later than FRA, then he/she could receive up to almost one-third more due to what are known as delayed retirement credits.

The exact amount in extra benefits that will be received from Social Security is dependent upon the number of months receipt is delayed. The exact benefit increase is equal to two-thirds of 1% for each month receipt is delayed past FRA, up until age 70.

If the worker was born during 1943 or after, then these monthly increases calculate to an 8% annual increase in that worker's Social Security payment. A guaranteed 8% annual return is most certainly attractive.

For example, if a worker was born during 1943 and before 1954, by waiting until age 70 to claim Social Security benefits, that worker would qualify for 4 years of delayed retirement credits at 8% per annum. Therefore, if his/her monthly full retirement benefit was $1,500, waiting would result in a monthly increase of $480.

If instead he/she was born during 1957, then his/her FRA is age 66 and 6 months, and he/she can accumulate only 3½ years of credits by age 70, and therefore, his/her monthly full retirement benefit of $1,500 would be increased only $420 per month by waiting.

Finally, if he/she was born during 1960 or later, he/she can accumulate only 3 years of credits by age 70, and his/her monthly full retirement benefit of $1,500 would be increased only $360 per month by waiting.

Benefits available at age 62

Social Security can be claimed as early as age 62, but there exists a substantial penalty in the form of a lower monthly benefit if done.

The exact amount in benefits received when claim is made at age 62 is dependent upon how many months prior to FRA benefits are received. The benefit is reduced by five-ninths of 1% for each month the claim is made prior to FRA, up to 36 months. If the claim is made earlier than 36 months, then the benefit is reduced by an additional five-twelfths of 1% per month. For example, if a worker who was born in 1960 decides to retire at age 62 instead of at 67 (which is his/her FRA), then his/her Social Security claim is made 60 months early and, according to the percentages set forth above, his/her payment would be 30% less at age 62 than at age 67.

Comparison shoppers

Some argue that by claiming early, benefits are received for a longer period. While this is true, at some point receiving a greater benefit, even over a shorter period, will result in greater overall benefits received. This point in time is referred to as the flip point.

For example, assume the worker from the example above could receive a $1,500 monthly benefit at his/her FRA, but instead elects to begin receiving benefits at age 62. With a modest annual cost of living adjustment of 1%, at what age would waiting until his FRA of age 67 have resulted in greater overall amount received? For the worker above who was born in 1960, his/her flip point will occur before his/her 80th birthday. (See table 1.)

If the worker lives just six additional years to age 85, then that worker will receive almost $35,000 more in Social Security benefits, and if benefits are postponed until age 70, the amount is even greater. (See table 2.)

Pay now, receive later

Policymakers refer to Social Security as a pay-as-you-go system, in the sense that current Social Security recipient benefits are funded by payroll taxes on current workers, which means there's no individual account at the Social Security Administration in a worker's name.

Rather, the worker has a promise that benefits will be paid to him/her in the future. Furthermore, payroll taxes only apply up to a certain amount of income, set annually. In 2018, the maximum taxable earnings limit is $128,400. No credit is given for any earnings above the taxable limit when Social Security determines the retirement benefit amount.

Thus, regardless of income, there exists a maximum amount that can be received in Social Security benefits. For a person attaining age 70 during 2018, the maximum benefit amount he/she can receive in benefits if he's at the maximum taxable earnings limit and waits to claim until age 70 is $3,698.

If, however, FRA is attained during 2018, which would be age 66 for someone born during 1952, then that someone could elect to receive $2,801.

TABLE 1

Age	Cumulative Benefit		
	At age 62	At FRA	At age 70
62	$ 12,600		
63	25,326		
64	38,179		
65	51,161		
66	64,273		
67	77,516	$ 18,000	
68	90,891	36,180	
69	104,400	54,542	
70	118,044	73,087	$ 22,320
71	131,824	91,818	44,863
72	145,742	110,736	67,632
73	159,799	129,844	90,628
74	173,998	149,142	113,854
75	188,338	168,633	137,313
76	202,821	188,320	161,006
77	217,449	208,203	184,936
78	232,224	228,285	209,106
79	247,146	248,568	233,517

TABLE 2

Age	At age 62	At FRA	At age 70
80	$262,217	$269,054	$258,172
81	277,439	289,744	283,073
82	292,814	310,642	308,224
83	308,342	331,748	333,626
84	324,025	353,065	359,283
85	339,866	374,596	385,196

Bridge planning

Every worker's situation differs from that of another. Many factors determine the proper time for an individual's retirement, including health, income sources, and expenses.

It cannot be ignored, however, that a person born during 1943 and before 1955 who is at the maximum taxable income limit could collect approximately 65% greater annual benefit by waiting until age 70 to claim rather than claiming at age 62. That difference can be significant, and consideration must be given to delaying Social Security benefits until age 70.

If Social Security benefits are delayed until age 70, then it is possible to bridge the gap from FRA to age 70 by utilizing short term trust planning, such as funding a grantor retained income trust or a charitable remainder trust with assets, or through term-of-years annuities.

Carefully review your options with a financial professional to determine the best plan for your situation.

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