

## Succession Planning and the Buy-Sell Agreement

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### OVERVIEW [[top](#)]

Preparing for ownership succession can prevent destructive tax liabilities as well as acrimony among potential successors. You must arrange a smooth transition to shift stock and responsibility to the next generation without delay, and thus avoid any emergencies that could make it harder still to carry out the transfer.

A smooth succession plan for small business owners is best achieved through a buy-sell agreement, such as a Stock Redemption Agreement or a Cross-Purchase Agreement, especially because changes in the laws in 1993 made them more advantageous. In each case, you should select a transaction format for your succession plans that best suits your needs.

In this Quick-Read you will find:

- Why a succession plan is vital.
- Why your plans for retirement must be reviewed before setting up a plan.
- Several ways to smoothly shift stock ownership to new owners.
- The benefits each approach offers.

### SOLUTION [[top](#)]

Preparing a company for a smooth succession when handing over the reins to a new generation requires difficult decisions. With a [plan](#) in place from the beginning, you and your successors can ensure the transition goes smoothly and minimize tax liability, even if an emergency speeds up the transition process.

Before setting up a program, your goals for succession and eventual retirement must be established. These typically center on one or more of four key needs:

1. Maintaining complete control of the company among the selected individuals. The purchase agreements listed below address options for allocating control of the company.
2. Providing adequate income or liquidity during retirement and for your family on your death to satisfy living expenses, debts,

estate-administration expenses and federal and state taxes. If liquidity is desired, then an agreement in which you are paid in cash will be most desirable (Cross-Purchase Agreement); if a stable income is desired, then an agreement that pays out over time will be preferable (Stock Redemption Agreement).

3. Minimizing estate- and gift-tax liabilities. Tax laws are constantly changing and your tax accountant can help structure a plan that takes tax implications into account. Currently, the Stock Redemption Agreement is more likely to have a lower tax implication.
4. Preserving the healthy "on-going concern" status of the business by providing sufficient cash flow, and so on. The agreement should be structured to ensure that the successors have a vested interest in having the business continue. The clauses mentioned below can help in this area.

### **Stock Redemption Agreement**

A Stock Redemption Agreement should be the most popular succession plan available for a privately held, family-owned company, but few owners understand its value and its advantages. A variation on a Corporate Buy-Sell Agreement, the Stock Redemption Agreement was made more favorable to small businesses thanks to changes in the tax law in 1993. Such a plan, signed by all stockholders, requires the return to the company of stock owned by anyone who leaves the company or dies, thus reducing the total amount of outstanding stock.

For instance, if four shareholders each own 25 shares of stock (giving each a 25% ownership stake), and one dies, those shares return to the company as Treasury stock, leaving 75 outstanding shares. This means that the three remaining owners each now own 33.3% of the company (one-third of the 75-share total). The company bylaws should state the rules for compensating a departing co-owner or inheritors.

There are several advantages to this approach:

- The agreement is an easy document to draw up.
- It saves money, especially because one agreement covers all owner obligations.
- It decreases the need for extensive insurance and legal counsel.

This approach requires a [valuation](#) of the company to ensure that a proper value for the stock is set.

### **Cross-Purchase Agreement**

A second popular option is a Cross-Purchase Agreement. In this plan,

each owner agrees to buy a stated number of shares from the selling owner in a specified time period. This requires more paperwork and doesn't reduce the number of outstanding shares, but it can allocate shares among the remaining shareholders in varying amounts (important if you don't want all the shareholders to receive the same number of shares). This approach also requires the buyers to have liquid cash available for the purchase of outstanding shares when they are available, which is not always possible.

Two key clauses should be included in these agreements:

- If any of the owners leave the company, they must sell their stock back to the other owners (at a discount). This prevents one of the stockholders from leaving the company for some reason and retaining that ownership stake. It also encourages them to stay, as they will take a financial hit for discounting their stock.
- Any owner must work in the day-to-day operations. This ensures that if heirs gain ownership of the stock, they must either work for the company or surrender the stock to those involved in its operation.

### **REAL-LIFE EXAMPLE** [\[top\]](#)

A Chicago-area electrical distributor wanted to slowly shift ownership of his company to his three sons. He'd given them occasional gifts of stock, but the process was moving too slowly, and the youngest son held far less stock than the others. The owner created a Cross-Purchase Agreement that allowed the youngest son to purchase a set amount of stock directly from the father.

Once the Cross-Purchase Agreement had evened the share allotment among the three sons, they instituted a Stock Redemption Agreement. This second step allowed the father's stock to return to the company in exchange for a note of redemption (held by the sons) for the stock's value. In the end, the three sons held equal ownership in the company.

The sons now are paying off that note, which includes an interest rate that will help the father finance his retirement. "You have to agree completely on the goals with all concerned," the owner says. "Generating the legal documents can take time. It's one thing to agree in principle and another to get it all written up. You just can't think of everything." If you don't agree in the first place, it becomes even more difficult.

### **DO IT** [\[top\]](#)

Settle key issues about your retirement:

1. Decide how involved you wish to remain in the business after your retirement. For instance, do you want to visit monthly or weekly to

- do paperwork and get updates, receive updates at home, be consulted only on key problems, or be totally uninvolved?
2. Discuss how much power and counsel the new owners want to give you.
  3. Determine if the new owners have the financial capability to provide you with the cash you need to take from the business.
  4. Decide if you want to slowly turn over control through gifts or purchases, or do it all at once when you retire.
  5. Learn how the prospective new owners intend to continue expanding the business and whether they intend to enter new markets.
  6. Consult a tax planner to ensure you are not missing out on key tax benefits by putting off planning or changing to a different transfer method.
  7. Find out how much your company's stock is worth by performing a valuation.

## RESOURCES [\[top\]](#)

### Books

[\*Family Business Succession Handbook\*](#) edited by Mark Fischetti (Family Business Publishing, 1997). Chapter 6: "Transferring Control and Ownership," and Chapter 9: "Estate Planning and Taxes."

[\*Sustaining the Family Business: An Insider's Guide to Managing Across Generations\*](#) by Marshall B. Paisner (Perseus Books, 1999).

[\*McGraw-Hill Guide to Acquiring and Divesting Businesses\*](#) by Edward E. Shea (McGraw-Hill, 1998).

### Internet Sites

[How to Create an Exit Strategy](#)

[How to Value Your Company](#)

[Fambiz.com](#)

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The Edward Lowe Foundation was created by Ed and Darlene Lowe in 1985 to "champion the entrepreneurial spirit." Headquartered near Cassopolis, Michigan, the foundation works with entrepreneur support organizations nationwide to encourage peer learning among second-stage business owners. Before his death in 1995, Ed Lowe, the creator of Kitty Litter, had become an advocate for entrepreneurship as the key to the success of the free-enterprise system.

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