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Mandatory Versus Option Buyouts in Buy-Sell Agreements

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To get a better idea of the role of buy-sell agreements in the overall Exit Planning Process, we will discuss the pattern of a typical business continuity agreement and the most important provisions of the agreement. The first consideration we will look at is the difference between mandatory and optional buyouts.

Mandatory vs. Optional Purchase or Sale

Before looking at the different types of events that can trigger a stock transfer, it is important to consider what type of purchase or sale obligation, if any, you want to impose on the transaction. For example, if a shareholder terminates his or her employment, the buy-sell agreement could require the shareholder to sell – and require the company to buy – his or her stock. Alternatively, it could also require the company or remaining shareholders to purchase the stock of a departing shareholder only at the option of that shareholder. The buy-sell agreement could also give the company or remaining shareholder an option to purchase the stock of a departing shareholder if the company or remaining shareholder chooses to do so.

In addition to establishing how each transfer event will obligate the company, remaining shareholders or departing shareholders, the obligation decision interacts with valuation and payment issues. For example, if a shareholder is fired, the company may want the option, but not the obligation, to purchase his or her stock possibly at a value that is less than the fired shareholder might have received had he or she worked until retirement.

These are a lot of decisions to make, and each has varying consequences that may benefit or adversely affect you. To help you through this decision-making process, it may be helpful to review the following decision outline.

1. For each transfer event to be covered in the agreement (death, disability, sale to an outside party, termination of employment, planned or voluntary retirement, and shareholder dispute), you should decide:
    1. Does the departing shareholder have a right or obligation to sell?

    2. Does the remaining shareholder and/or company have a right or obligation to purchase? (see below)
2. How will the ownership interest in question be valued?
3. What are the terms and conditions of any acquisition?

Who Should Buy?

Another consideration in the buy-sell agreement is who should buy the selling shareholder's stock – the company or the other owners? This can be resolved by asking:

- Which entity has the most cash available to pay for the stock? The company or the individual owners?
- At what level do the most favorable tax consequences occur?

Generally, when the buyout of a departing shareholder's stock is not funded by some form of insurance, the corporation is more likely to have cash available to fund an installment buyout. However, it's important to talk to your tax professional to determine which buyer—the company or the remaining owners—makes the most tax sense.

Of course, when the remaining shareholder sells his or her stock during his or her lifetime, taxes generally will be paid on the amount of gain. The gain is the same whether the remaining shareholders purchase the departing shareholder's stock (this is called a cross-purchase buyout) or whether the corporation buys the selling owner's stock (this is called a stock redemption). Still, at least with a regular (or "C") corporation, there is a substantial tax advantage in using a cross-purchase arrangement. The advantage lies with the remaining shareholders when it comes time to sell their stock as the "basis" in their ownership interest is increased by the purchase price they paid to acquire the departing owner's interest. Money subsequently received by them when they in turn sell is not taxed to the extent of basis. Since you should always be planning for the eventual sale of your business, you cannot afford to ignore this crucial difference between a cross-purchase and a redemption when acquiring a departing owner's interest.

In designing the most appropriate business continuity agreement for you and your company, you can use the decision outline as a guide when talking to your other owners and to your company's outside professionals.

If you have any questions about business continuity agreements and their role in helping you exit your business in style, please contact us to discuss your particular situation.

appreciate your interest.

Any examples provided are hypothetical and for illustrative purposes only. Examples include fictitious names and do not represent any particular person or entity.