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# The Buy-Sell Agreement More Important Than Ever

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“Not having a plan, is a plan....  
and not a very good one”



# Buy-Sell Agreement

- A Buy-Sell Agreement is your Firm's and its owners plan that clearly defines when and how ownership in your Firm will change hands.



# Buy-Sell Considerations

- Written Contract
- Negotiate when not under pressure
- Provides for changing conditions
- Clearly defined price and terms
- More important than ever due to changing conditions



# Five Places not to Negotiate your Buy-Sell Agreement?

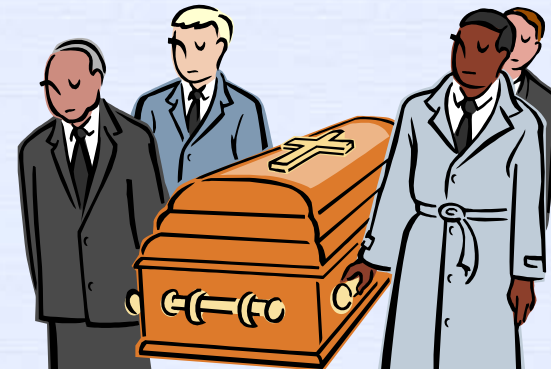


The Courthouse



# Five Places not to Negotiate your Buy-Sell Agreement?

## The Funeral Home



# Five Places not to Negotiate your Buy-Sell Agreement?



## A Retirement Party



# Five Places not to Negotiate your Buy-Sell Agreement?

When the Owners are  
Fighting





# Five Places not to Negotiate your Buy-Sell Agreement?

When an Owner is  
being Fired





**WARNING!**

**WE ARE NOT  
ATTORNEYS**



# Business Owner's Goals

- Binding Contract
- Define Trigger Events
- Predictable Value
- Clear Pay-Out Terms
- Quick and Inexpensive Transition
- Income Tax Issues Understood
- Firm Survival



# What is a Buy-Sell Agreement?

Binding contract between

- The Firm
- Owners
- Other Co-Owners





# What is a Buy-Sell Agreement?

- Effective at a Certain Date
- “Trigger” Events
  - Puts the agreement “into play”
  - No changes allowed
- Defines the Price & Terms



# Binding Contract

- Legally Binding on all Parties
- Clear Language and Terms
- Computations are understood and not subject to interpretation





# Who is the Purchaser?

- The Firm
- Existing Owners
- New Eligible Owners
  - Define outside buyer's eligibility



# Triggering Events

- Retirement
- Death
- Disability
- Bankruptcy
- Voluntary Resignation
- Breach in Contract or Termination



# Determining the Price

- Disagreements
- Too High or Too Low
  - Each Party betting against the other
- Owner's Objectives
  - Fairness
  - Easily Understood
  - Avoid Dispute



# Valuations

- The Value of an A/E Firm is the present value of owners future earnings in excess of a reasonable salary for their services
- The Firm has a Fair Market Value only to the extent of excess earnings
- Valuations may vary
- One size does not fit all



# Valuation Approaches

- Fixed Price Agreement
- Formula Agreement
- Independent Valuation



# Fixed-price Agreement

- Owners agree upon price
- Advantages
  - Simple
  - Inexpensive
  - Funding can target price
- Disadvantages
  - Likely high or low
  - Stale almost immediately
  - Must be updated annually



# Formula Price

- Defined formula that computes the price
- Uses financial metrics
  - Multiple of Earnings
  - Book Value
  - Percentage of Revenue
  - Various Others



# Formula Agreement

- Problems
  - Unrealistic Value of Business
  - Adjustments
  - Contingencies
  - Clear definition of terms
- Solutions
  - Update
  - Define formula and metrics
  - Consultant or Appraiser



# Process or Valuation Agreement

- Names Independent Appraiser or Firm
- Defines a process for selecting an Independent Appraiser
  - Credentials of Appraiser
    - CVA, ASA, CBA, ABV
  - Independence is Crucial



# Valuation Agreement

- Advantages
  - Informed professional opinion of value
  - Current Value as of trigger date
  - Consider adjustments and contingencies
- Disadvantages
  - Current Value may not match the funding plan
  - Time consuming and expensive
  - Multiple Appraisers



# Instructions for Valuation Professional

- Standard of Value
  - Fair Value
  - Fair Market Value
  - Other
- What to Value
  - Selling owners shares or units
- The Valuation Date
  - Trigger Event Date
  - Last full Accounting year end
  - Last quarterly Accounting year end



# Instructions for Valuation Professional

- Consider 3 Main Valuation Approaches
  - Income
  - Asset
  - Market
- A/E Firms
  - Usually valued under Income Approach



# Summary of Valuation Elements

- Each Firm is unique
- Generally the Firm is worth the present value of future earnings of the Owners in excess of Reasonable Salaries
- The Buy-Sell Agreement should incorporate an agreed value or method of determining the value
- Clearly define the terms and Standard of Value



# Funding the Buy-Sell Agreement

- Redemption by the Company
  - Time frame
- Purchase by Existing Owners
- Purchase by New Eligible Owners



# Funding Sources

- Cash
- Notes Payable
  - Firm
  - Existing Owners
  - New Eligible Owner
- Firm Owned Life Insurance
- Disability Insurance
- External Loans
- ESOP



# Life Insurance

- Treatment of Insurance Proceeds
- Funding Vehicle vs. Corporate Asset
  - Changes Value of the Company
- Adequate for buy-out price?
- Clearly state intentions for Life Insurance



# Shareholder Notes

- Terms of the Note
  - Down payment
  - Interest Rate
  - Payments over period of time
  - Guarantee by Company or Owners
- Impairment of Capital



## Example of Buyout

FMV of Equity	\$250,000
Buyout Period	10 years
<u>Interest rate Fed AFR</u>	<u>3.8%</u>
Monthly Payments	\$2,506

\*Typical buyout range is 7 to 15 years



# Provisions for Agreement

- Divorce
  - Barton v Barton (GA, 2007)
    - Buy-Sell did not determine value of business
- Spousal Consent
  - Acknowledgment of Agreement



# Provisions for Agreement

- Claw-back provision
  - Company is sold after buyout
  - Redemption price adjusted
    - Up and/or down
- Change in control
  - Redeemed partner has right to call note
  - Deferred compensation agreement **MUST** consider tax impact



# Other Provisions for Buy-Sell Agreements

- Management decisions
- Non-Compete Agreements
- Tag-along and Drag-along Clauses
- Jurisdiction and Law
- Require permission to sell
- Prohibit sale to Ineligible Owners



# TOP TEN WORST BUY-SELL AGREEMENTS





# Tax Issues

- C Corporations
- S Corporations
- Partnerships/LLC/LLP
- ESOPs
- Deferred Compensation



# C Corporations

- The Corporation pays its own tax
- Owner/Employees receive Salary, Bonuses and Dividends
- The Redemption of Stock provides no tax deduction to the Corporation
- The selling Shareholder receives capital gains income (loss)
- The purchase by other Co-Owners provides no tax deduction until resold



# Large C Corporations

- Greater than \$5,000,000 revenue
- 95% of stock must be owned by active or retired employees
- A former employee who is not retired is not an eligible stockholder
- 95% of activity (by time) is devoted to the Engineering Profession directly or indirect support
  - Administrative personnel count
- Failing either test results in immediate loss of the favorable cash method of income tax reporting



# S Corporations

- Owner/Employees receive salaries
- Shareholders pay tax on corporate income
- Large C Corporation rules do not apply unless S Corp Election terminated
- Eligible Shareholders
  - US Citizens
  - Resident Aliens
  - ESOPs
  - Certain Trusts
  - Estates During Administration



## S Corporations (cont)

- An Ineligible Shareholder will terminate the S Corp election
- The redemption of stock is not deductible
- The selling Shareholder receives capital gains (loss) treatment
- Purchase by Co-Owners provides no immediate tax benefit



# Partnerships/LLC's/LLP's

- Members or Partners pay tax on profits
- Members or Partners receive draws not salaries
- Large C Corporation rules do not apply unless there is a C Corporation Partner/Member
- Redemptions can be tricky
- Some or all may be ordinary income
- Conversions to Limited Partner/Member interest can minimize receiving taxable income before cash is received



# ESOPs

- Any type of retirement plan
- Holds C Corp or S Corp stock
- Favorable tax treatment
- Liquidity source for owners
- All employees are owners
- Much of the employees retirement is tied to the Firms stock



# Deferred Compensation

- Converts Owners equity into tax deductible payments upon retirement or separation
- Employee/Owner receives ordinary income when received
- Requires a Deferred Compensation Plan
- Value of equity reduced by Deferred Compensation Liability
- Common approaches:
  - Accrued Untaxed Income
  - Percentage of compensation
  - Multiple of earnings



# Summary



# Q&A