Guardian

The Wait and "C" Buy-Sell Agreement

A Financial Win for "C" Corporation Shareholders

As a successful business owner, you likely make many decisions based on facts. However, traditional buy-sell agreements require you to make decisions, now, that will impact your business many years later. A "wait and see" buy-sell agreement allows you to make decisions about your business in real-time, based on the facts as they exist at the time of a sale. When funded with insurance, a "wait and see" buy-sell agreement facilitates an orderly sale of a departing owner's stock, protects your business' bottom line, and can save income taxes.

What is a "Wait and See" Buy-Sell Agreement?

A "wait and see" buy-sell agreement is a legal document drafted by an attorney that controls the sale of a business interest upon various triggering events (e.g., disability, death, etc.). In a cross-purchase buy-sell agreement, the remaining owners have the obligation to buy a departing owner's interest. In a stock redemption (entity purchase agreement), the business has the obligation to buy a departing owner's interest.

With a "wait and see" buy-sell agreement, you don't know who is responsible for purchasing a departing owner's interest – until the owner actually departs the business. You have to wait and see.

How does a "wait and see" buy-sell agreement work? "Wait and see" buy-sell agreements often provide the business with the first option to purchase a departing owner's interest. If the business doesn't exercise its option, the remaining owners have the option to purchase. The business is then obligated to purchase any portion of the departing owner's interest that the remaining owners did not elect to purchase.

Why is it Advantageous to "Wait and See?"

The "wait and see" buy-sell agreement adds an important element of flexibility to the traditional buy-sell agreement, allowing you to consider the following facts before making a decision:

- The financial condition of the business and its owners;
- Tax consequences;
- The larger economic climate;
- The owners' personal and family situations; and
- Other important realities.

Circumstances can be evaluated at the time of a triggering event so that the owners can make the most appropriate and financially friendly choices.

Funding a C Corporation "Wait and See" Buy-Sell Agreement with DBO Insurance and Life Insurance

When the "wait and see" buy-sell agreement is funded with disability buy-out insurance (DBO) and life insurance it will provide significant financial and intangible benefits to the departing shareholder and her/his family, to the business, and to the remaining shareholder(s).

Let's first examine how the insurance will be structured and then explore the multiple benefits that flow from this arrangement. Each shareholder will own, and be the beneficiary of, a DBO policy and a life insurance policy insuring her/his co-shareholder(s). If your corporation has four or more shareholders, you may want to consider utilizing a partnership or LLC to hold the insurance. For more information on this topic, ask your Guardian Financial Representative for our informational memos *"Using a Partnership or LLC to Complete a Corporate Business Continuation Plan"* and *"Using a Limited Liability Company to Fund Business Continuation Agreements."*

Upon the occurrence of a triggering event (e.g., disability or death), the insurance proceeds are paid to the remaining shareholders, who now have a choice to make. They can either:

- Purchase the disabled or deceased shareholder's interest directly, or
- Contribute the proceeds to the corporation (i.e., a capital contribution) and the corporation will redeem the departing shareholder's interest.*

The presence of the DBO or life insurance proceeds at this critical time, and their receipt by the remaining shareholders, are important from both a pragmatic and financial perspective.

Financial Benefits from Funding the Agreement with Insurance

The insurance proceeds will appear at the exact time they are needed – upon the disability or death of a co-shareholder. Being able to promptly satisfy the financial obligations under the buy-sell agreement will prevent a prolonged drain on the corporation's cash flow and will provide the departing shareholder and her/his family with funds at a critical time (e.g., medical bills, final expenses, etc.).

The insurance proceeds should be received by the remaining shareholders income tax free. Whether they use the insurance proceeds to purchase the departing shareholder's interest directly or contribute the proceeds to the corporation, the remaining shareholders will increase their basis in their stock! Why is more basis a good thing? More basis means less capital gains tax upon a future sale of stock.

Further, income tax free DBO and life insurance proceeds paid directly to the corporation increase the corporation's earnings and profits (E & P). Increasing a corporation's E & P increases the chances that future distributions will be treated as taxable dividends, which are generally subject to a 15% or 20% qualified dividend tax rate. Owning the insurance outside of the corporation will not increase the corporation's E & P, which may help avoid future distributions from being treated as non-deductible, taxable dividends.

What Are You Waiting For?

A "wait and see" buy-sell agreement may be suitable for your business because important decisions about the future of your business can be made when all of the relevant facts are in view. When used with "C" corporations and funded with DBO and life insurance, the arrangement makes eminent business and financial sense.

Do not let unnecessary dividends and capital gains taxes sneak up on you. Make sure that your corporation is fortified against such expenditures – today. It will surely pay off, tomorrow. Just wait and see.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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