Buying and Selling the Business when an Owner Dies

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Like many business owners, Rick and Warren thought it would be a simple process to continue the business when one of them died.

Nothing could be further from the truth.

Rick and Warren had a printing company and were equal partners. Warren died suddenly. Warren's shares passed to his widow, Sarah, who became Rick's new partner. She expected a regular paycheque to continue, even though she knew nothing about the printing business and could not contribute to the daily operations of the company.

Rick went to several banks to get a loan so he could buy Sarah out. The banks refused to lend him the money to purchase the shares of a business that had just lost a co-owner. With only one qualified person running things and not enough cash flow to hire a replacement for Warren, the printing business quickly failed.

This situation could have been avoided if Rick and Warren had properly funded what is known as a buy-sell agreement. In most cases, the easiest way to fund a buy-sell agreement in the event of death is with the use of life insurance.

The three most common methods are:

Criss-Cross - This method involves Rick buying a life insurance policy on Warren and Warren buying a life insurance policy on Rick. As the owner and beneficiary of the policy on Warren's life, Rick would soon receive the proceeds from the life insurance company and have enough cash to buy the shares from Sarah. Provisions can be made for Rick to take over the policy Warren had on his life. Warren's estate would be responsible for any income taxes triggered by the sale of his shares.

Promissory Note - This method has the company buying policies on both Rick and Warren. The company would be the owner, beneficiary and premium payor of each policy. When Warren died, the company would receive the proceeds from the policy on his life. In the mean time, Rick would buy the shares from Sarah (or Warren's estate) and pay for them with a promissory note. Once the proceeds are received from the life insurance company, and because they would be received tax-free, the company could declare a capital dividend. This allows the company to pay Rick proceeds tax-free which he would then use to pay off the promissory note. Warren's estate would be responsible for any income taxes triggered by the sale of his shares.

Corporate Redemption - This method involves the company buying life insurance on both Rick and Warren. The company would be the owner, beneficiary and premium payor of each policy. When Warren died, the company would receive the proceeds from the policy on his life. The company would then declare a capital dividend and the proceeds would be used to purchase (or redeem) the shares directly from Warren's estate. Rick's shares would reflect the increase to full company value but retain Warren's cost base, meaning income taxes would be postponed until Rick's shares are sold.

A properly funded buy-sell agreement provides the surviving partner enough cash to buy the shares from the deceased's estate and gives the surviving spouse fair value for the shares. And Rick would have enough cash-flow to continue the business.

**Fictional characters for illustrative purposes only.*

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