One-Way Buy-Sell Agreements

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A one-way buy-sell agreement is between an owner of a closely held business and a future buyer. Under your one-way buy-sell agreement, the buyer might be an employee, a family member, or another third party.

Under the terms of a one-way buy-sell agreement, the buyer has a legal obligation to buy your interest in the business from you or your estate. And you, or your estate, must sell your interest to the buyer upon the occurrence of a future triggering event.

A one-way buy-sell agreement protects both the business owner a future buyer.

If the buyer under the agreement dies first, you have no obligation to buy anything from the buyer's estate, thus the "one-way" nature of the transaction. Often, to protect against the possibility of the buyer dying before purchasing your interest, the business may obtain life insurance on the buyer.

The buyer named in the agreement (and there could be more than one buyer) agrees to buy your interest in the business, and you (or your estate) agree to sell it at the occurrence of some triggering event. You and the other parties to the agreement will determine the triggers appropriate for your business situation. Possible triggering events include:

- Death
- Long-term disability
- Retirement
- Personal insolvency or bankruptcy
- Divorce
- Conviction of a crime
- Loss of professional license
- Withdrawal before retirement
- Termination of employment

Consider all your financial, tax, and estate planning goals when establishing a buy-sell agreement.

Benefits

A one-way buy-sell agreement, like other buy-sell agreements, can do the following things:

- provide a guaranteed buyer for the business interest
- provide liquidity for the seller on retirement or liquidity for estate on death
- provide liquidity for payment of estate taxes and settlement expenses (but only if the agreement is funded)
- avoid potential conflicts of interest
- establish the taxable value of the business, if structured properly
- maintain the stability of business operations
- create an incentive for a key employee or another buyer to stay in business and drive success

Potential Drawbacks

There are a few drawbacks to consider. For example, restrictions within the one-way buy-sell agreement could prohibit you from pledging your interest in the business as collateral for outside credit or requiring the other owners' consent. Without the ability to pledge your business interest, it may be difficult to obtain loans. Furthermore, you may be locked in and cannot change your mind if a family member or other party wants to buy the business.

Other Considerations

Decide what you want to happen to your business. Consider all of your financial, tax, and estate planning goals. If you have co-owners who will be part of the agreement, you need to discuss it.

You should consider the terms of the agreement, including the following:

- *The parties:* Who is selling and who is buying?
- *Triggering events:* Could include death, disability, retirement, divorce, bankruptcy, or other events
- *Obligations:* Is purchase mandatory or optional?
- *Restrictions:* Could include first-offer provisions or rights of refusal, ability (or lack of) to pledge shares for collateral, ability (or lack of) to use shares in gifting strategy, or other restrictions
- *Specific assets and liabilities to be transferred (for proprietorship):* Specific assets to be sold as business assets or liabilities included in the transfer

Factors such as your business's size, structure, and tax bracket will influence your choices in setting up your one-way buy-sell agreement.

- *Price (or method of determining):* Could be agreed-upon dollar value or a valuation method based on a formula, appraisal, adjustment, or percentage of book value (should allocate the purchase price to each asset)
- *Sale terms:* Lump-sum cash, installment payments, combination, or other
- *Timing for the transaction:* For example, how soon after death should the sale occur? Should there be a waiting period before the sale for disability? How long should installment payments continue?
- *Funding method:* Could be cash, borrowings, life insurance proceeds, or other methods
- *Modification provisions:* Could be used to provide for valuation update or changes to or termination of the agreement

Factors such as your business's size, structure, and tax bracket will influence your choices in setting up your one-way buy-sell agreement. Here is where your tax advisor, financial planner, and attorney can be helpful.

You may want to pay close attention to the following special provisions of the agreement:

Specific assets and liabilities: Unlike partnerships or corporations, the assets of a proprietorship are not legally separate from the owner's personal assets. For this reason, the one-way buy-sell agreement for a proprietorship must specify which of the assets will be sold as business assets. Likewise, establishing which liabilities will be transferred with the business and which will remain with the estate can allow for planning by you and your buyer. The choice and valuation of assets and liabilities under the one-way buy-sell agreement have tax implications for you and the buyer.

Cash: If, like many owner or family led businesses, you keep more cash in your business than is otherwise necessary for business operations, you should make provisions to distribute any cash exceeding stated operating cash or, conversely, to retain a certain level of operating cash by the company as part of the sale.

Price: You do not necessarily have to name a dollar value. There are several ways to set the value of the business. For instance, there may be a valuation method commonly used in your industry that you could easily use in the agreement. In the case of a proprietorship, the transfer is treated as a series of individual asset sales for tax purposes, so the

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purchase price should be allocated to each asset under the sale.

Sale Terms: The specific triggering events in your agreement may influence the terms of the sale. For instance, a lump-sum payment is appropriate in the event of a death, where an installment payment plan over some specified period may be suitable for retirement.

Restrictions: State property laws favor the right of business owners to transfer an interest in a business to whomever they want, whenever they want, at whatever terms they want. Restrictions in a buy-sell agreement that are extreme are generally viewed as unreasonable and therefore unenforceable.

Funding: One of the keys to a buy-sell agreement functioning as designed is the proper funding of the purchase price. Without a funding mechanism, the risk that the seller or the seller's estate does not realize the full agreed value increases. To work properly, a buy-sell agreement should be funded with life and other appropriate insurance for some or all of the anticipated purchase price.

Fund the Agreement

Set up the cash fund, buy the life insurance policies, and arrange the method chosen to fund the buy-sell agreement. Without funding to back it up, the agreement won't be effective.

Periodic Review

You and the other parties should regularly review the agreement, perhaps yearly. You want to be sure that the agreement still meets your objectives. The valuation provisions may specify conducting an annual valuation of the business. You should review the pricing method if there is a significant change in the business. It is difficult to predict what type of change is considered significant and will require a price change, but there is a chance your price might not set fair market value after the change.

Capital Gains

When you die, your estate receives a new basis equal to the fair market value (FMV) typically determined at the date of death (called a step-up in basis).

When the sale price under the one-way buy-sell agreement is accepted as the FMV, there should not be any capital gain or loss realized by your estate upon the sale of your interest in the business.

It is prudent to consult your tax advisor about possible tax considerations.

Example: Assume that your basis for the assets used in your business is $50,000 at the time of your death. Your estate sells your business assets to the buyer under your one-way buy-sell agreement and receives $150,000, representing the sale price for your assets under the agreement. That value becomes the FMV for taxation. The basis of your interest is stepped up from your original $50,000 to the new value of $150,000 at your death, and your estate does not need to recognize any capital gain.

It is prudent to consult your tax advisor. Tax considerations can be much more complex if you sell a sole proprietorship or an interest in a partnership (or LLC taxed as a partnership).

Amount Seller's Estate Receives from Sale Sets Estate Tax Value

When your estate sells your business assets under the one-way buy-sell agreement, the amount received from the sale usually sets the value for the business interest assets included in your gross taxable estate.

Caution: If the price received is determined to be less than the fair market value (FMV), the estate will be taxed on the FMV determined by the IRS. That means the estate could be required to pay tax on a value it did not (and never will) receive.

BAKER LAW

801 West South Boundary | Suite C
Perrysburg, OH 43551
567.806.5200
chad.baker@bakerlawltd.com