Business Planning

# One-Way Buy-Sell Agreement

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# Summary

## A UNIQUE PROBLEM

The sole owner of a business faces a unique dilemma—there are no co-owners to buy out the owner's interest when he or she dies, retires, becomes disabled, or decides to leave the business. Unless the owner can solve this problem, he or she stands to lose all the value built up in the business over many years of hard work and smart decisions.

There are other problems, too. The owner or surviving family members lose a source of income. Faithful, long-term employees are suddenly thrown out of work. Vendors, banks and other creditors may want to be paid off. Receivables may be difficult to collect.

Too many sole-owner businesses do not outlast their founder, no matter how viable their market franchise, because of a lack of competent successor ownership.

## A VIABLE SOLUTION

Fortunately, there may be an answer. If the owner can identify a possible buyer—ideally from among the employees—a special version of the buy-sell agreement used in partnerships and multi-shareholder corporations can be adapted for the sole-owner situation. This is sometimes called a one-way buy-sell agreement because only one party—the non-owner—is obligated to purchase in the event of the owner's death.

## HOW IT WORKS

With a one-way buy-sell agreement, the sole owner commits to sell, and the purchaser commits to buy, the business interest upon the occurrence of a specified event or events, such as the owner's death. The purchase price is either a fixed value, which is recalculated from time to time, or a fixed method for determining the value.

The agreement usually provides that the buyer will not assume the business liabilities. The sole owner's executor will receive cash from the purchase and may use it to pay off the liabilities, as well as other estate costs and taxes. The balance is distributed under the terms of the owner's will to the estate beneficiaries, or perhaps to a trust for their benefit.

## HOW IT'S FUNDED

The buyer purchases a life insurance policy on the owner's life in an amount sufficient to meet the purchaser's obligations under the buy-sell agreement. The agreement may require the buyer to maintain the policy, such as by paying the premiums when due.

As the policy's owner and beneficiary, the buyer is obligated to notify the owner before exercising any policy rights that might affect the policy's value. Similarly, the owner may be precluded from disposing of key business assets, or assigning them as collateral, without the buyer's consent.

The buyer often has a "right of first refusal" on any lifetime disposition of the business by the owner. This means that the owner must first offer the business to the buyer before selling it to a third party during the owner's life, including at retirement. Only after the buyer declines the option can the owner pursue a sale to a third party.

In other words, the death buyout required under the agreement can't be defeated by the owner's lifetime disposition of the business, provided the purchaser exercises the option to buy. While this clearly restricts the owner's freedom, it assures the buyer that he or she will not pay the insurance premiums in vain.

## AN INSTALLMENT SALE

The buyer can make the purchase in installments, providing it's structured to comply with the Internal Revenue Code's installment sale rules. This could be particularly useful in the case

of a lifetime purchase, when only the policy's cash value—not the full death proceeds—is available to the buyer.

With an installment sale, the buyer could then use the net income from ongoing business operations to help carry out the purchase. And for the owner, it can spread any taxable gain from the sale over the installment payment period instead of being bunched into one tax year.

Clearly, a one-way buy-sell agreement is an effective way to resolve a myriad of problems that can otherwise affect a one-owner business. The key is to find a willing buyer to complete the agreement—ideally, someone already employed by and familiar with the business.