One-Way Buy-Sell Agreement

A Dilemma…

The sole owner of a business—a sole proprietorship, for example, or a single person corporation—faces a unique set of problems:

- There are no co-owners to buy the business interest when the owner dies or leaves the business.
- Without co-owners as logical buyers, the owner stands to lose the value and customer goodwill that have been built up through years of hard work and good decisions.
- The owner and surviving family members lose an important source of income.
- Faithful, long-term employees may suddenly find themselves without a job.
- Vendors, banks and other creditors may want to be paid in full or refuse to extend additional credit.
- Receivables may become difficult to collect.
- If the business is transferred by will to heirs, heirs may not be prepared to manage the business when they haven't been actively involved in the daily operations.
- Even an executor, authorized to continue the business, can lack the expertise to run the business successfully.
- If the executor liquidates the business, the estate may receive only a portion of its value as a going concern. Still, this may be the only option when business assets have to be sold to pay taxes and other expenses.

The moral of the story: Too many sole-owner businesses, no matter how successful, do not outlast their founders because they do not have succession plans in place.

A Potential Solution…

- When 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 buy in the event of the owner's death.

The Process…

- The owner commits to sell—and the purchaser commits to buy—the business interest when one or more specified events occur, such as the owner's death.
- The agreement defines the purchase price by specifying either a fixed amount (which should be recalculated from time to time) or a formula for establishing the price.
- The agreement usually provides that the buyer will not assume the business liabilities.
- The executor will use cash from the purchase to pay off the business liabilities, as well as other estate expenses and taxes, then distribute the balance under the terms of the owner's will to estate beneficiaries (or perhaps to a trust for the benefit of the heirs).

The Funding…

- The buyer typically purchases a life insurance policy on the owner's life sufficient to meet the purchase obligations under the buy-sell agreement.
- The buyer is owner and beneficiary of the policy.
- The agreement may require that the buyer maintain the policy (by paying premiums) and notify the owner before exercising any policy rights that might affect the policy value.
- The agreement may prevent the owner from disposing of key business assets or assigning them as collateral without the buyer's consent.

Other Considerations…

- If the buyer has a "right of first refusal" on the lifetime disposition of the business, 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. While this restricts the owner's freedom, it ensures that the buyer will not pay the insurance premiums in vain.
- The buyer can make the purchase in installments complying with the Internal Revenue Code installment sale rules. This could be useful in the event of a lifetime purchase when only the policy's cash value—not the full death benefit—is available to the buyer.
- The buyer can use the net income from ongoing business operations to complete the purchase.
- For the owner, a qualifying installment sale spreads the taxable gain on the sale over the entire payment period instead of lumping it into one tax year.

The Bottom Line…

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

SUMMARY

A Unique Problem

The sole owner of a business faces a unique dilemma—there are no co-owners to buy the business when the owner dies, retires or decides to leave the business. Without a competent successor who agrees to purchase the business when the time comes, the owner stands to lose all the value that has been built up through years of hard work and wise decisions.

There are other problems, too. The owner or surviving family members lose a source of income. Faithful, long-term employees suddenly find themselves without a job. Vendors, banks and other creditors may become wary, refusing to extend additional credit or wanting to be paid off. Receivables may be difficult to collect.

Too many sole-owner businesses, no matter how successful, do not outlast their founders because they do not have succession plans in place.

A Practical Solution

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

How It Works

Under 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 (such as the owner's death or retirement). The purchase price is based on either a fixed method for determining the value or on a fixed value that is recalculated from time to time.

The agreement usually provides that the buyer will not assume the business liabilities. The sole owner's executor may use cash from the purchase 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.

Funding

The buyer purchases a life insurance policy on the owner's life in an amount equal to the purchase obligation under the agreement. The agreement may require the buyer to maintain the policy 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 value. Similarly, the agreement may prevent the owner 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 third-party sale. While this clearly restricts the owner’s freedom, it also ensures that the buyer will not pay insurance premiums in vain.

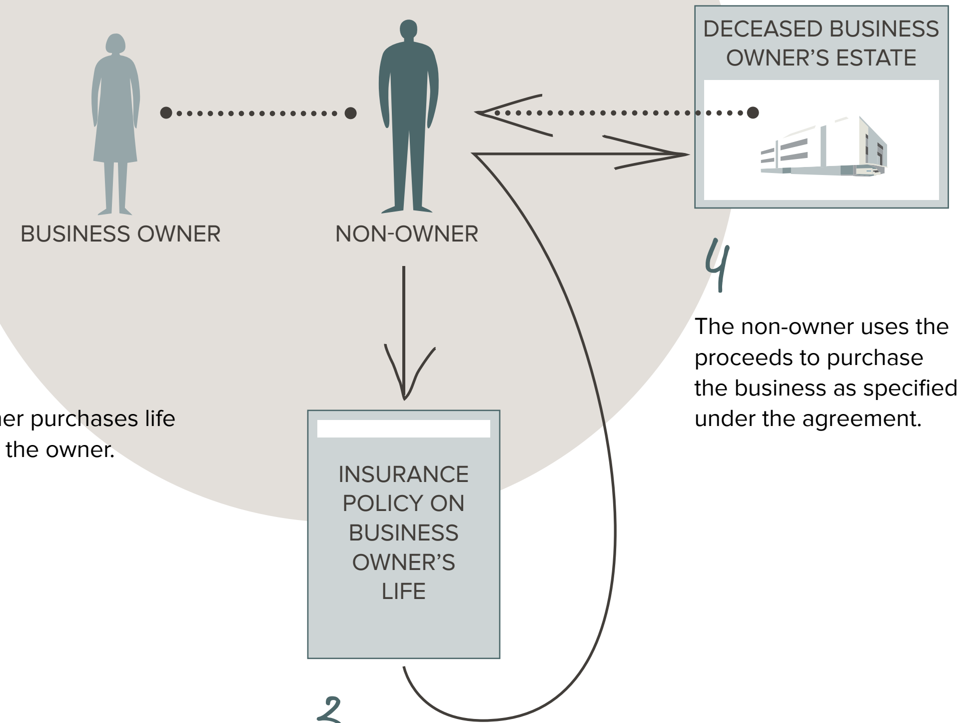
An Installment Sale

The buyer can make the purchase in installments, providing the installment sale is 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 benefit—is available to the buyer.

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 or familiar with the business.

1

The owner of a business enters into a buy-sell agreement with a non-owner under which the owner agrees to sell, and the non-owner agrees to buy, the business upon the owner's death (and possibly other triggering events) at a price specified in the agreement.



2

The non-owner purchases life insurance on the owner.

3

When the owner dies, the non-owner receives the death proceeds.

4

The non-owner uses the proceeds to purchase the business as specified under the agreement.

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