Business

ONE-WAY BUY-SELL AGREEMENT

Presented for

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Line 2 Contact Information

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ONE-WAY BUY-SELL AGREEMENT

A Dilemma…

The sole owner of a business—whether it's an unincorporated proprietorship or a one-person corporation—faces a unique set of problems:

- There are no co-owners to buy the business interest when the owner dies or otherwise leaves the business.
- Without co-owners as logical buyers, the owner stands to lose all the value and customer goodwill built up over years of hard work and smart decisions.
- The owner and surviving family members lose an important source of income.
- Faithful, long-term employees are suddenly thrown out of work.
- Vendors, banks and other creditors may want to be paid off, or may be unwilling to extend additional credit.
- Receivables may become more difficult to collect.
- If the business is transferred to heirs according to the owner's will, the heirs may be ill-prepared to take over the business if they haven't been active in it.
- An executor authorized to continue the business may lack the expertise to run it 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 if the assets have to be sold to pay death taxes and other costs.

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

A Potential Solution…

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

The Process…

- The sole 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 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's liabilities.
- The owner's executor uses cash from the purchase to pay off business liabilities and probably other estate costs and taxes.
- The balance is distributed under the terms of the owner's will to estate beneficiaries, or perhaps to a trust for their benefit.

The Funding...

- The buyer typically purchases a life insurance policy on the owner's life sufficient to meet his or her obligations under the buy-sell agreement.
- The buyer is owner and beneficiary of the policy.
- The agreement may require the buyer to maintain the policy—such as by paying premiums—and to notify the owner before exercising any policy rights that might affect the policy's value.
- The agreement may prevent the owner from disposing of key business assets, or assigning them as collateral, without the buyer's consent.
- If the buyer is also obligated to purchase the business if the owner becomes disabled, the buyer often will want to insure this obligation as well.

Other Considerations...

- If the buyer has a "right of first refusal" on any 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 buyout required under the agreement at the owner's death can't be defeated by the owner's lifetime disposition of the business, provided the buyer exercises his or her option to buy.

- The buyer can make the purchase in installments complying with the Internal Revenue Code's installment sale rules. This could be useful in the event of a lifetime purchase when only the life insurance policy's cash value—not the full death proceeds—is available to the buyer.
- The buyer could then use the net income from ongoing business operations to help complete the purchase.
- For the owner, a qualifying installment sale can spread any taxable gain on the sale over the installment payment period instead of being taxable in 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 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.

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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.

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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.

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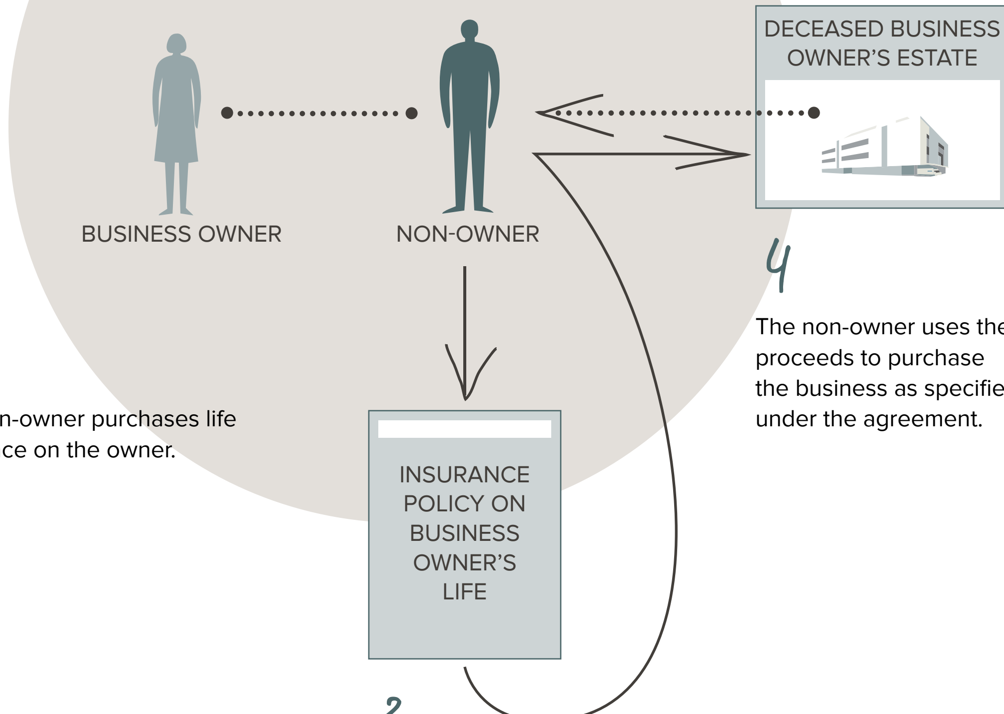
1

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 (or 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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