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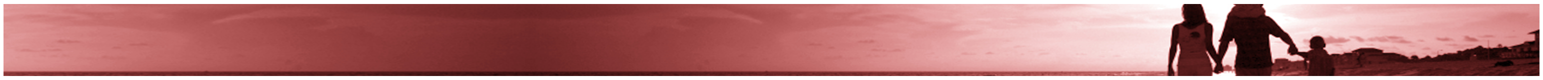
One-Way Buy-Sell Agreement

August 03, 2017



One-Way Buy-Sell Agreement

What is it?

Legal contract--a form of buy-sell agreement

A one-way buy-sell agreement is a form of buy-sell agreement and is a legal contract between an owner of a closely held business and a future buyer. The buyer under your one-way buy-sell agreement might be an employee, a competitor, or any other third party.

Establishes buyer for your business interest

Under the terms of a one-way buy-sell agreement, the buyer is legally obligated to buy your interest in the business from you (or your estate), and you (or your estate) are legally obligated to sell your interest to the 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. If your buyer is a corporation, you can insulate yourself from the risk of the buyer dying, although there may be other potential risks with a corporate buyer (e.g., bankruptcy, reorganization).

Defines events triggering sale of business interest

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, your advisors, and the other parties to the agreement will determine the triggers appropriate for your business situation. Possible triggering events include those shown in the following table:

Typical Triggering Events	**Other Possible Triggers**
• Death • Long-term disability • Retirement • Divorce	• Personal insolvency or bankruptcy • Conviction of a crime • Loss of professional license • Withdrawal prior to retirement • Termination of employment

When can it be used?

You own a business

You are an owner of a closely held business. The business can be organized as a sole proprietorship, partnership, C corporation, S corporation, limited liability company (LLC), or professional corporation (PC). The one-way buy-sell agreement is well suited for a sole proprietor.

Strengths

Includes all the strengths of a buy-sell agreement

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

- Can provide a guaranteed buyer for the business interest
- Can provide liquidity for payment of estate taxes and settlement expenses (but only if agreement is funded)
- Can avoid potential conflicts of interest
- Can establish taxable value of the business, if structured properly
- Can maintain stability of business operations

- Can improve creditworthiness of the business
- Can maintain tax status of your S corporation, partnership, or professional corporation (if relevant)

Especially appropriate for the unincorporated sole proprietor

The one-way buy-sell generally allows for the sale of your business at a higher price than might be received from a forced sale of individual assets. Under the law, your unincorporated sole proprietorship terminates at your death, at which time your business and personal assets would be collected and distributed to your heirs. The liquidation of business assets could result in a much lower value for distribution to your heirs than if your business were to be sold as a going concern. As a sole proprietor, you can enter into a one-way buy-sell agreement with any willing buyer, thus ensuring a potentially higher sale price for your business than if the business was to be sold as individual assets.

Tradeoffs

Restrictions can affect personal estate planning (you may not be allowed to give away your share of the business)

Gifting strategies are important estate planning tools for owners of closely held businesses. Lifetime gifts of your interest in the business to your children may be part of your estate planning strategy to pass your business interest to your heirs and reduce the total value of the estate. Restrictions in the agreement could prevent you (and your co-owners) from passing all or part of your interest in the business as a gift. The parties to the buy-sell, therefore, must consider whether to restrict transfers by gift.

Tip: *If your buy-sell agreement allows gift transfers, the group of permissible donees should generally be defined. The donee group should probably be subject to the terms of the buy-sell agreement.*

Restrictions could limit your access to outside credit

Restrictions within the one-way buy-sell agreement could prohibit you from pledging your own interest in the business as collateral for outside credit, or could require the consent of the other owners. Without the ability to pledge your business interest, a lender might turn you down for a loan.

Tip: *If the one-way buy-sell agreement is set up to include a right of first refusal, the owners would be allowed to pledge their individual business interests as loan collateral. If a foreclosure occurs, the stock acquired by the creditor would have to be offered for sale to the other parties under the agreement before it could be sold to a third party. Under the right of first refusal, the buyer under the agreement would have the right to buy (or refuse to buy) the shares held by the creditor. The lender must be notified the shares are subject to a right of first refusal, and the loan amount probably could not exceed the shares' fixed purchase price. This restriction should be indicated on the stock certificate (many states have laws requiring this).*

How to do it

There are certain steps required in every buy-sell agreement. There are also some levels of detail that are not required but could save you trouble if they are included.

Things to Do Now

Decide what you want to happen to your business

You should consider all of your financial, tax, and estate planning goals. If you have co-owners who will be part of the agreement, you will need to talk with them about it.

Consider terms of agreement

You should consider possible components to the agreement, some of which are shown in the following table:

Components--One-Way Buy-Sell Agreement	Description
The parties	Who is selling? 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 Specific liabilities included in transfer
Price (or method of determining)	Could be agreed-upon dollar value or a valuation method based on formula, appraisal, adjustment, or percentage of book value Purchase price should be allocated to each asset
Sale terms	Lump-sum cash, installment payments, combination, or other
Time period for transaction	For example, how soon after death should sale occur? Should there be a waiting period before sale for disability? How long should installment payments continue?
Funding method	Could be cash, borrowings, life insurance proceeds, or other method
Modification provisions	Could be used to provide for valuation update or changes to or termination of agreement

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

Pay special attention to these agreement clauses

You may want to pay special attention to the following parts 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, it is very important that the one-way buy-sell agreement for a proprietorship specify which of the assets will be sold as business assets. Likewise, specifying which liabilities will be transferred with the business and which will remain with the estate can allow for advance planning by you and your buyer. The choice and valuation of assets and liabilities under the one-way buy-sell agreement has tax implications to you and the buyer.

Price: You don't 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 purchase price should be allocated to each asset under the sale.

Caution: *It is important that the valuation method used in the agreement represent the fair market value (FMV). The agreement is a legal contract, and the price (or method of determining price) specified will lock in the sale price. Unless the agreement is drafted carefully, the sale price could be different from the taxable value. The IRS is not obligated to accept the sale price as the FMV for taxation. If the IRS determines that the sale price is less than FMV, your estate will be taxed on the difference between the sale price and the FMV (assuming there is an estate tax). This means it is possible that the estate could be required to pay tax on value it did not (and never will) receive.*

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 of time may be suitable for retirement.

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

Meet with your attorney

Setting up a buy-sell agreement can be very complex, because it involves legal and tax issues, so you should consult an attorney. Each party under the agreement should have his or her own attorney. Your attorney can help ensure that conditions in the agreement will be reasonable and enforceable under state law.

Fund the agreement

Set up the cash fund, buy the life insurance policies, make arrangements for whatever method has been chosen to fund the buy-sell agreement. Without the funding to back it up, the agreement won't be effective.

Things to Do Later

Periodically review the agreement

You and your buy-sell participants should review the agreement on a regular basis, perhaps yearly. You want to be sure that the agreement still meets your objectives. The valuation provisions may specify an annual valuation of the business, which should be conducted. You should review the pricing method if there is a significant change in the business. It is hard to say exactly what type of change is considered significant and will require a price change, especially when the courts use language like "unusual intervening events or circumstances," but there is a chance your price might not set FMV after the change.

Caution: *Failure to update an agreement when called for within the agreement could lead to problems.*

Tax considerations

Income Tax

Normally no capital gain to seller's estate

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 shouldn't be any capital gain or loss realized by your estate upon the sale of your interest in the business.

Example(s): *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. This value is accepted as 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.*

Capital Gain with and without Step-Up

	No Step-Up	Estate Receives Step-Up
FMV/Sale Price	$150,000	$150,000
Basis	$50,000	$150,000
Capital Gain	$100,000	$0

Even though this seems clear-cut, it still would be wise to consult a tax advisor.

Caution: *If an estate of a person who died in 2010 elected out of the federal estate tax, estate property may have received a carryover or modified carryover basis and not a step-up in basis.*

Notes and accounts receivable do not receive step-up in basis

Notes and accounts receivable are treated differently than other assets received by your estate and do not receive a step-up in basis. Amounts received by your estate for notes and accounts receivable are deemed income in respect of a decedent, and any gain on the accounts is taxable as ordinary income to your estate.

Certain assets provide depreciation allowance

The allocation of the purchase price to specific assets is important to the buyer because certain assets will provide a depreciation allowance when the buyer uses them in the continuing trade or business, while other assets will not. The following table shows general classes of assets that will and will not provide the depreciation allowance:

Depreciable Assets Depreciation Allowance	No Depreciation Allowance
• Buildings • Machinery • Furniture • Fixtures • Goodwill	• Land • Receivables • Inventory or property held for sale in ordinary course of business

It is to the buyer's advantage to have as much of the purchase price as possible allocated to the depreciable assets to achieve a larger basis for depreciation, although the amount that can be allocated to each asset is limited to the fair market value (FMV). In negotiating the allocation of the purchase price among business assets, you should consult with your tax advisor.

Gift and Estate Tax

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 assets of the business interest that is 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. This means it is possible that the estate could be required to pay tax on value it did not (and never will) receive.*

Questions & Answers

What can happen if the buyer under your one-way agreement dies, and then you die shortly after, before another buyer has been arranged?

If the buyer under your one-way buy-sell agreement dies, and then you die shortly thereafter, your family or estate could hold the buyer's estate to the terms of the buy-sell contract because it is a legal contract.

What would be considered an unreasonable (and therefore unenforceable) restriction?

A restriction that may be viewed as extremely prohibitive (thus unreasonable) is one that permanently and absolutely bans lifetime transfers of shares of a business's stock, along with a mandatory resale of the shares to the corporation at death for the original purchase price. A restriction like this could be viewed as a forfeiture; unreasonable, and therefore unenforceable. If the only condition for a profitable transfer of stock is a pure right of first refusal that requires the offer of the stock at the same price to the other parties, it does not restrict the transfer of stock, only the persons who may buy the stock. In this case, the restriction is not extremely prohibitive and would almost always be enforceable.

In general, if the terms of the restrictions were reasonable when the agreement was executed, such as rights of first refusal and rights to buy interests in the business based on a formula set price, then the restrictions would be enforceable. Whenever a buy-sell agreement is ambiguous, the courts will not uphold the enforceability of the restrictions. However, a carefully drafted, clearly outlined buy-sell agreement containing reasonable terms of restriction should be able to avoid any issues with state law.

What happens if the existing agreement calls for periodic updating and it isn't done?

If the agreement requires an update, the failure to do the updating could have serious consequences. For example, if the agreement calls for a revaluation of the business at specified intervals, and the revaluation is not calculated, the value set under the agreement may be lower than the taxable value set by the IRS. If you die, your estate would be bound under the agreement to sell your shares at the agreement price. The taxable value assigned by the IRS could be higher, subjecting your estate to taxation on value it didn't receive.

In addition to the potential tax consequence, the failure to update the agreement when called for in the terms could affect the ability of the agreement to stand up in a court case.

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