Unilateral ‘One-Way’ Buy-Sell Agreements for Family Businesses

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Financial professionals often encounter successful family-owned C corporations, S corporations or limited liability corporations where the founder of the business owns 100 percent of the shares.

Typically, there are one or two members of the family’s younger generation whom the sole shareholder would like to see take over the business at some future time in order to keep the business as an ongoing enterprise when the sole shareholder dies.

In addition, the owner wants to make sure that a surviving spouse has enough income to keep “the lifestyle to which he or she has become accustomed.”

Are there planning concepts that could be put in place now that would essentially guarantee the results described above? And could business dollars be used to finance such a plan? The answer is yes! A unilateral “one-way” buy-sell agreement coupled with well-designed estate-planning documents can provide the solution to guarantee business continuation for the adult children while providing income security for the surviving spouse.

A “one-way” buy-sell agreement works in tandem to guarantee both business continuity and spousal income security. A unilateral agreement between the sole shareholder and the younger family members (who are usually adult children working in the business) is drafted by your client’s law firm. These adult children will buy the shares from the founder’s estate for a specified price when the founder dies.

These younger family members are the ones whom the founder wishes to take over the business. They will become equal owners and equal beneficiaries of a life insurance policy on the life of the sole shareholder.

The policy will have a face amount equal to the buyout price specified in the buy-sell agreement. The business can advance the premium in the form of Section 162 bonuses to the younger family members. If desired, a “trusteed” unilateral agreement also may be used. In this case, a third-party trustee may be designated as the fiduciary-administrator of the agreement both in life and after death.

The sole shareholder also executes the usual basic estate-planning documents (i.e., pour-over will and revocable trust). The trust can provide the surviving spouse with unlimited access to all the income and principal after the business owner's death.

Here's a simple fact pattern: Assume A (age 60) owns an S corp with a value of $3 million as part of a total gross estate of $5 million. A is married to B, who will need significant income to support an accustomed lifestyle. C (age 34) and D (age 32) are A and B's children and have worked in the business for many years.

Case design and life insurance solution

A executes a unilateral buy-sell agreement with C and D in which C and D agree to buy A's shares of the S corp for $3 million from A's estate at death. C and D are listed as equal owners and equal beneficiaries of a $3 million life insurance policy on A's life from a competitive carrier. The S corp advances tax-deductible Section 162 bonuses to C and D to pay the premium. C and D must report the bonuses as taxable earned income, which is also subject to FICA taxes. A also executes the usual pour-over will and revocable trust for the surviving spouse and family to provide portfolio asset management after A's death.

At A's death, C and D receive $3 million of income-tax-free proceeds, which they use to buy equal shares of the S corp from A's estate. A's estate now has $3 million in cash to distribute to the revocable trust via A's pour-over will. This trust automatically becomes irrevocable at A's death. The surviving spouse has unlimited access to the income and principal of the trust for life to satisfy lifestyle needs.

Are there any other ways to fund a unilateral buy-sell plan?

Often, business owner clients believe the annual premium for a permanent life insurance policy is more expensive than what they thought would be needed to fund the plan adequately. However, the real question is, what will it cost if certain alternative funding methods are chosen instead? Here is a summary of the most common alternative buy-sell funding methods and the disadvantages of each when compared to the advantages of life insurance funding:

» Personal funds of the buyers (i.e., the adult children): Most business owners and key employees who may take over the business do not keep large sums of personal liquid assets easily accessible. They may have their personal funds available as potential paid-in capital or loans to the business in an emergency, or they may simply wish to keep funds altogether separate from the business for their personal retirement needs.

» Sinking fund in the business: Such a fund will be inadequate if the majority shareholder parent dies prematurely or the timing of the future buyout is uncertain. And so-called business-owned "sinking funds" have a way of being depleted over time due to economic downturns and other emergency business needs. Plus, the annual interest, dividends or capital gains on the fund are subject to income taxes. These tax and timing hurdles make it difficult to accumulate an adequate "sinking fund."

» Funds borrowed from a financial institution: The loss of the majority shareholder may impair the creditworthiness of the business and place a financial strain on the surviving family members who will become shareholders. Interest costs, in addition to loan principal payments, may be excessive. These future loan payments will have to come from the future operating revenue of the business and may seriously hinder the firm's economic viability in tight economic times.

» Installment payments made by the buyers to the deceased's estate: The new shareholders (i.e., adult children) may find the principal and interest payments on the installment note to their deceased parent's estate to be too burdensome. Most if not all of these installment payments would be paid to the spouse of the deceased majority shareholder and may create an extended operating cash flow burden on the business.

Life insurance owned by the buyers (i.e. , adult children) to pre-fund the purchase of the shares from the majority owner's estate offers the following advantages: An actuarially leveraged and contractually guaranteed death benefit is available no matter when the majority shareholder dies; the death benefit is income-tax-free as a death benefit of life insurance under IRC Section 101; cash values of a permanent cash accumulation type of policy can be withdrawn tax-free as a down payment for a lifetime buyout due to the majority shareholder's retirement or disability; and the financial cost of the annual premium out to life expectancy is the lowest lump-sum present value cost to fund the buy-sell plan.

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