
# Buy/Sell Agreements

**Tax and Business Update**

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## What Are They?

A *buy/sell agreement* is a contract that restricts the ability of corporate shareholders, partners or limited liability company (LLC) members to freely transfer their ownership interests. A buy/sell agreement not only places restrictions on the transferability of interests, but often also places requirements on the owners to transfer their interest (for example, upon death, disability, etc.) It provides that an owner's interest in the business will be sold (or at least offered for sale) at a specified price to the other owners and/or to the entity upon the occurrence of specified events. This prevents unwanted individuals from joining the owner group and ensures a ready market for closely held interests.

| Who Needs One? | |
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| **Liquidity of Ownership Interests Is Desired** | • Owners want to ensure a ready market for their ownership interests (in the event of death, disability, retirement, etc.).<br>• Can be particularly important for heirs or retiring owners with noncontrolling interests. |
| **Owners Want to Eliminate Uncertainty About Ownership Transfers** | • Co-owners are comfortable with an owner's plans to transfer ownership to a child in the event of death or disability.<br>• A buy/sell agreement between the parent and child (with an option on the part of the remaining owners to buy the interest if the child doesn't) removes the uncertainty that exists if a will or other document is being relied upon to effectuate the transfer.<br>• Wills can be changed at the last minute or challenged by heirs or potential heirs. A binding buy/sell agreement can nail down the rights and obligations of the various parties. |
| **Future Ownership Conflicts Can Be Foreseen** | • It is anticipated that the remaining owner(s) would have difficulties coexisting with the family of a deceased or withdrawing co-owner who would inherit an interest.<br>• A former spouse could obtain an ownership interest in a divorce settlement.<br>• A buy/sell agreement can ensure that the remaining owners control the interest. |
| **Ownership By Outsiders Is Undesirable** | • This factor can arise in any business when the owners are a tight knit group.<br>• In the event of an owner's insolvency, a creditor may become a member of the ownership group.<br>• A buy/sell agreement ensures that ownership interests cannot fall outside the existing group without the group's approval. |
| **Owners' Heirs Not Interested** | The heirs feel the business is too risky or they simply have no desire to participate. |
| **Valuation for Estate Tax Purposes Is Desired** | • Owners are interested in establishing their ownership interests' value for federal and state estate tax purposes.<br>• A buy/sell agreement can be used if certain requirements are met. |
| **Ownership By Nonparticipants Is Undesirable** | Ownership by a spouse or other beneficiary of the key person is not acceptable. |
| **Owners Want to Assure Affordability and Certainty of Ownership Transfers** | • Owners want to set out terms that assure affordability for purchases of ownership interests. For example, a redemption agreement that is not funded by insurance can use an installment payout to preserve cash flow.<br>• Owners want to tie the receipt of life insurance proceeds to the obligation to pay those proceeds to the heirs of the decedent when life insurance is to be used to fund a buyout.<br>• Owners want to obligate the surviving owners to use the insurance proceeds for the buyout when there is a cross-purchase agreement involving several owners. |

## How Are They Funded?

A buy/sell agreement is of little benefit without a funding mechanism to provide the cash needed to fund the purchase upon the occurrence of a triggering event. Life insurance is the most common method of funding buy/sell agreements because it assures that a large lump sum will be available upon the death of the insured while requiring only modest annual premiums. Some prospective purchasers may choose to accumulate earnings over time to fund a buyout obligation (a sinking fund). Disability buyout insurance is commonly used to fund the purchase of a disabled owner's business interest. An installment sale can enable funding in the absence of adequate cash reserves or insurance.

| Types of Buy/Sell Agreements | |
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| **Type** | **Description** |
| **Redemption Agreement** | • The owner of a business entity and the entity itself (whether a corporation, partnership or LLC) enter into a contract. The owner agrees to sell his ownership interest to the entity according to the specified price, terms and circumstances.<br>• Typically amounts to giving entity the right of first refusal when an owner wishes to sell the interest to a party outside the current ownership group. If entity chooses not to exercise its right, the owner is typically free to sell to the third party. May obligate entity to purchase if no outside buyer.<br>• If there is no third-party buyer, entity must buy owner's interest upon certain circumstances (for example, death, disability or retirement). Agreement can require deceased owner's estate to offer the interest to entity at specified price and terms.<br>• Sometimes referred to as entity plans. For partnerships, often called a liquidation agreement. |
| **Cross-Purchase Agreement** | • A contract between the owners of a corporation, partnership or LLC (sometimes referred to as a "criss-cross" agreement) under which the owners agree to offer their ownership interests for sale to each other at the specified price and terms.<br>• Upon an owner's death, the estate normally must offer ownership interest for sale to other owners at a specified price and terms. If there is no third-party buyer, other owners are generally obligated to buy interest in the event of certain circumstances (for example, death, disability or retirement). A cross-purchase agreement is essentially a right of first refusal combined with a purchase obligation (or option).<br>• Work best when business only has two or three owners. As number of owners increases, the mechanics of a cross-purchase become complex. |
| **Hybrid Agreement** | • The business owners contract both with the entity and the other owners. Upon certain events, the owners agree to offer their ownership interests for sale to the entity and/or other owners at a price and terms specified in the contract. The same is true for the estate of a deceased owner.<br>• Sometimes provide that ownership interest will be offered first to entity and then to other owners if entity doesn't buy interest. In other agreements, owners may have option to purchase interest with entity required to buy if other owners decline.<br>• May provide that part of ownership interest first be offered to entity and remainder to other owners.<br>• A right of first refusal if there is a third-party buyer or a purchase obligation (or option) if not.<br>**Practice Tip:** Hybrid agreements generally aren't used in a C corporation setting when insurance is necessary for the buyout, because of the uncertainty as to who might actually be the buyer (the entity or the remaining owners). Thus, hybrid agreements typically tend to be used when the buyout will be seller financed. |
| **Third-Party Agreement** | Involves a contract between the owners and one or more parties outside the current owner group. |




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