**8808. How is a buy-sell agreement funded?**

A buy-sell agreement can be funded through the use of the prospective buyer’s own funds, accumulated earnings, debt instruments or insurance (either life or disability).

While self-funding on the part of the buyer is possible, many selling business owners may prefer the certainty that is provided through other funding methods. Self-funding presents the possibility that the buyer may be unable to obtain the funds upon the selling owner’s death or withdrawal. This approach also requires the business to continue to be profitable in order to fund the buy out.

As a result, many buy-sell agreements are funded through insurance. The type of insurance that is required will depend upon the triggering events specified in the buy-sell agreement itself (see Q 8810). If a right to purchase under the agreement is triggered by the seller’s death, the buyer or business may fund the agreement by purchasing life insurance that insures the life of the selling business owner (see Q 8809). Death, however, is not the only type of event that may trigger a buy-sell agreement. If the triggering event is the selling owner’s disability or retirement from the business, funding may be provided more effectively through a disability insurance policy or a permanent life insurance policy that provides the potential for tax-free loans during the life of the insured.

**Planning Point:** There are certain issues which arise when dealing with disability as a triggering event. First, disability buy out insurance is often expensive to purchase. Second, it can sometimes become contentious to determine when an owner is “disabled”. In some cases, the departing owner may want to be disabled in order to trigger the purchase. In other cases, the remaining owners may want to exercise their right to purchase the interest at a time when the senior owner still feels they are contributing.

It is also common to treat an “involuntary transfer” as a triggering event. Essentially, this will become applicable if a creditor of an owner attempts to seize an interest in the business in pursuit of the collection of a debt. This can occur if an actual debt is owed to a third party or if one of the owners is subject to a divorce proceeding and the interest in the business is being transferred to a spouse who is not an owner. In the event that an involuntary transfer is a triggering event, insurance will not likely be available to fund the purchase.

If the parties have entered into a cross-purchase agreement, insurance funding is accomplished by the business owners purchasing insurance on the lives of each participating co-owner.

The entity itself may also set aside accumulated earnings to fund a buy-sell agreement. In a closely held corporation, however, it might be difficult to set aside adequate funds when the operation of the business could benefit from the use of these funds. Further, in case of a C corporation, accumulated earnings above $250,000 can be subject to the accumulated earnings penalty tax (see Q 8783).[[1]](#footnote-1) While accumulation of earnings and profits to meet the reasonable needs of the corporation is permissible, the parties must carefully evaluate the strategy to avoid the penalty tax, which may prove time consuming.[[2]](#footnote-2)

If insurance funding or accumulation of earnings has not been accomplished in advance, and the buying owners have insufficient cash on hand to fund the buy-sell agreement upon occurrence of a triggering event, a debt instrument can be used. The buying owners may be able to negotiate a series of payments to the selling owner or the estate. In choosing this option, the owners must consider whether the sale will be taxed under the installment sale rules[[3]](#footnote-3) and the possible taxation (or deductibility) of the interest payments (see Q 8819 for a discussion of the installment sale rules).[[4]](#footnote-4)

**Planning Point**: As a general proposition, it is good to have the note be for as short a term as possible without causing hardship to the business in funding the purchase. Also, if the estate is subject to an election under Sec. 6166; it may be advisable to structure the sale as a series of transactions in order to avoid accelerating the deferral of the estate tax because of a disposition of the estate’s interest in the business. 4

**Planning Point:** It is also important to consider the terms of the promissory notes. Examples include how long the term will extend, if there will be security for the note (i.e. a pledge of the stock being purchased) and if the note is due upon the sale of the business by the remaining owners. It is often good practice to attach a sample of a proposed note to be used for the payout.

1. . IRC Sec. 533(c)(1), *United States v. Donruss Co*., 393 US 297 (1969). [↑](#footnote-ref-1)
2. . IRC Sec. 537(a)(2). [↑](#footnote-ref-2)
3. . See IRC Sec. 453, *American Taxpayer Relief Act of 2012*, Pub. L. No. 112-240 (which increased the maximum tax rate for long-term capital gains from 15 to 20 percent). [↑](#footnote-ref-3)
4. . IRC Sec. 163(a).

   4. IRC Sec. 6166(g) [↑](#footnote-ref-4)