Beyond the Handshake: Why a Buy-Sell Agreement Is the Prenup Every Business Partnership Needs

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Many business partnerships are built on trust and a handshake, but often owners neglect to consider what happens when that trust is tested by death, divorce, disability, or a falling-out. A sophisticated buy-sell arrangement can help business owners preserve business continuity and ensure liquidity throughout the unexpected storms of life, acting as a "prenuptial agreement" designed to protect both the business and its legacy.

At its core, a buy-sell agreement transforms ownership in a closely held business from an open-ended personal relationship into a defined economic investment with enforceable exit rights.

Despite its importance, many owners rely on generic templates or personal estate plans that offer only an illusion of protection.

This article will discuss the common pitfalls of 'off-the-shelf' succession planning and provide best practices for avoiding common tax, valuation, and funding issues.

Buy-Sell Agreements, Generally

A properly drafted buy-sell agreement is a legally binding contract between business owners—or between owners and the business itself—that governs the transfer of ownership interests upon the occurrence of specific "triggering events." Rather than leaving ownership transitions to uncertainty, a carefully drafted buy-sell agreement establishes a structured mechanism for how and when ownership interests may be transferred.

The primary purpose of a buy-sell agreement is to preserve business continuity and stability by preventing unwanted third parties from gaining control of the company. At the same time, it establishes a defined framework for the buyout of an ownership interest, ensuring liquidity for the departing owner or the owner's estate while providing the remaining owners and the business with certainty, continuity, and control over the ownership transition.

Estate Planning/Formation Documents are Not Enough

Many business owners, and even some practitioners, mistakenly assume that estate planning documents (e.g., a will or revocable living trust) and/or basic entity formation documents (e.g., an operating agreement) are sufficient for business succession planning.

While estate planning documents may determine who inherits the business interest upon a business owner's death or disability, they cannot force a buyout, set a price, or prevent a surviving spouse or child from becoming an unwanted co-owner. Further, estate planning documents generally do not cover other adverse events, such as bankruptcy or divorce.

Similarly, a company's formation documents often contain generic "right of first refusal" (ROFR) provisions, but do not contain comprehensive buy-sell provisions.

For example, an LLC's operating agreement may grant the company an *option* to buy back membership interests but often does not provide the departing owner or the owner's family the *right* to be bought out, which is what the owners may have agreed upon verbally. Compounding this issue, formation documents often fail to define a valuation methodology (e.g., EBITDA multiple vs. appraisal), leading to disputes during a triggering event.

What Can Go Wrong?

Without a standalone buy-sell agreement, an estate may find itself "asset rich and cash poor," holding a minority interest in a private company with no market for resale and no guaranteed income stream. The result is often deadlock, litigation, or years of dysfunction - great news for litigators, but not for the business owners.

Consider the case of "Jamboree Enterprises," a fictional Irvine-based firm. Founded by two best friends, Art and Bob, the company grew from a garage startup to a $20 million enterprise. When they incorporated, they signed a "simple" template operating agreement downloaded from a legal document site. They figured their individual revocable trusts handled the rest.

When Art unexpectedly passed away, the "simple" plan collapsed. Art's widow, now the fiduciary of his estate, expected a buyout to fund her retirement. However, the template agreement only granted Bob a "right of first refusal," not an obligation to purchase the interest from Art's estate. Bob, now running the company alone, decided to reinvest all profits into R&D instead of issuing dividends.

The widow was left holding a 50% interest in a company that neither had the cash nor the intention to buy out her interest, while Bob was stuck with a grieving partner lacking business experience but holding equal voting power. As a result, neither party could force a buyout or take major action without the other's consent, creating a governance and economic deadlock. This stalemate illustrates how the absence of a properly structured buy-sell agreement can create not only succession problems, but also deadlock, valuation disputes, funding mismatches, and operational instability.

Similar challenges often arise when partners seek to exit voluntarily, disagree over price, lack liquidity to fund a buyout, or face involuntary transfers through divorce or creditor claims. These risks can largely be avoided through a well-drafted, properly funded mandatory buy-sell agreement.

Buy-Sell Agreement Best Practices

At its core, a buy-sell agreement performs four critical functions.

First, the agreement identifies the buyer and seller by establishing who has the right or obligation to purchase a departing owner's interest, whether it be the remaining partners (a cross-purchase agreement) or the business entity itself (an entity-purchase or redemption agreement).

Second, the agreement defines the triggering events that require or permit an ownership transfer, thereby functioning as a contractual exit mechanism. These triggering events typically include death, disability, retirement, termination of employment, bankruptcy or insolvency, divorce, deadlock, or a voluntary desire to exit the business. By clearly specifying when an owner must sell, or when the company or remaining owners must buy, the buy-sell agreement eliminates ambiguity around if and when an exit occurs, rather than leaving it to negotiation or litigation at the worst possible time.

Third, the agreement establishes a valuation methodology by outlining a clear, predetermined methodology for valuing the business interest—such as a fixed price, a formula based on earnings (EBITDA), or a professional appraisal—to prevent costly disputes during an emotional transition.

Finally, the agreement addresses funding by specifying how the buyout will be financed, often utilizing life insurance policies to provide immediate liquidity, which ensures the departing owner's estate receives fair value without draining the company's operating capital.

By defining these terms in advance, a buy-sell agreement mitigates the risk of litigation and provides a guaranteed market for an otherwise illiquid asset. It protects surviving owners from having to partner with inexperienced heirs or ex-spouses, and it protects the heirs of a deceased owner by ensuring they receive a fair cash settlement for their share of the business.

Tax Considerations

In addition to these best practices, there are tax traps for the unwary that must be considered when structuring the buy-sell agreement and any life insurance policies that fund the agreement.

<u>The "Transfer-for-Value" Rule</u>

While life insurance proceeds are generally non-taxable for income tax purposes, there is an exception for policies that are transferred for valuable consideration prior to the insured's death under IRC Section 101(a)(2). In such cases, the beneficiary(ies) will owe taxes at the decedent's death on the difference between (i) the life insurance proceeds received and (ii) the consideration paid for the policy plus any subsequent premiums or other amounts paid by the transferee.

Even if ownership of the policy is never transferred, the IRS will consider a transfer for value to have occurred if two or more parties enter into an agreement to change beneficiaries on their personally held policies.

That said, the transfer-for-value rule will not apply if the transfer falls within certain statutory exceptions, including transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. These exceptions are narrowly construed and should be carefully evaluated before relying on them.

Taxation of Company-Paid Life Insurance Premiums

Another important tax consideration involves the treatment of company-paid life insurance premiums. Those premium payments may be taxable to the business owners, depending on who own the policy.

When the company owns the life insurance policy used to fund the buy-sell agreement and pays premiums, those premium payments are generally not treated as taxable income to the business owners, although the company is not entitled to deduct the premiums.

On the other hand, if the business owners hold life insurance policies on each other’s lives and the company pays the premiums, such payments are generally treated as taxable distributions or compensation to the business owner who owns the policy.

Practitioners should ensure that clients understand the tax implications of company-paid life insurance premiums when structuring a buy-sell agreement.

Estate Tax Implications: The Corporate Ownership Dilemma

Life insurance policies can also create unintended estate tax consequences when one or more business owners have a taxable estate.

For example, in *Connelly v. United States*, a 2024 U.S. Supreme Court case, the Court held that insurance proceeds received by a company to fund its obligation to redeem a deceased owner’s interest in the company under a buy-sell agreement must be included in the company’s value for estate tax purposes. This ruling overturned prior case law that had treated those insurance proceeds as having no effect on the company’s value because they were to be used to buy back the deceased owner’s interest. This can result in an inflated estate tax value (i.e., more estate taxes) for the estate’s interest in the company.

Further, under IRC Section 2703, the IRS may ignore an agreed value under a buy-sell agreement and instead value a business interest according to its fair market value for estate tax purposes (subject to an exception where the parties can show that the buy-sell agreement (1) is a bona fide business arrangement; (2) is not a device to transfer property to family members for less than full consideration; and (3) has terms comparable to arm’s-length transactions).

Either of these issues can result in an estate tax liability that severely cuts into the proceeds received in the buy-sell purchase. In extreme cases, these issues could create a "liquidity crunch" where the estate tax owed on the inflated business value exceeds the actual cash received from the redemption.

To avoid a *Connelly* outcome, cross-purchase buy-sell agreements are preferrable to redemption agreements when one or more parties expect to have a taxable estate. Because the proceeds flow directly to the surviving business owner(s) to buy the deceased's shares, the insurance never hits the company's balance sheet and does not inflate its value for estate tax purposes.

Additionally, holding policies in irrevocable life insurance trusts can protect the proceeds from the purchaser's taxable estate as well as loss to third parties like a divorcing spouse, predators, and creditors.

Beyond the structural design of the buy-sell agreement, practitioners should also pay close attention to valuation procedures and compliance with the buy-sell agreement's terms. In *Connelly*, the parties' failure to follow their own valuation process (ignoring required appraisals) was a fatal blow to their defense. Strict compliance with the buy-sell agreement's terms is essential—especially annual certificates of value or mandatory appraisals—lest the IRS disregard the buy-sell agreement entirely.

Finally, practitioners should ensure that buy-sell agreements with agreed-value provisions qualify for the exception in IRC Section 2703.

Beyond the Handshake

If you do not know when you can exit your business or what happens if your partner must, then you do not have a buy-sell agreement—you have a handshake. And if you are relying on a handshake to protect an asset that may be worth hundreds of thousands or millions of dollars, it is worth asking what that handshake is really worth.

Proper business succession planning requires a sophisticated buy-sell agreement that lays out (1) who the parties are; (2) what the triggering events are; (3) the purchase price; and (4) the source of funds. Additionally, proper business succession planning requires a thorough analysis of income and estate tax considerations to avoid tax traps for the unwary.

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He advises clients on a wide range of matters, including entity formation, mergers and acquisitions (M&A), business transactions, securities transactions, real estate transactions, and various commercial transactions, including purchase agreements, shareholders' agreements, lease agreements, and employment agreements.

Steven also offers strategic advice on corporate governance and assists clients with the legal challenges that arise in their day-to-day operations.

Steven has also represented nonprofit entities on matters related to formation and maintaining a tax-exempt status.

Steven graduated in the top 15% of his class at Loyola Law School. There, he also participated in the Internal Revenue Service (IRS) Small Case Tax Clinic, where he performed legal research, drafted memoranda, and made court appearances on behalf of the IRS. Steven is fluent in Korean.

Steven Hilton is a tax attorney who specializes in tax planning for business owners and real estate investors, covering areas such as mergers and acquisitions, like-kind exchanges of real estate, general business tax planning, ultra-high-net-worth tax and estate planning, as well as other federal and state tax matters.

While enrolled in Brigham Young University's highly-ranked accounting program, Steven worked as a tax intern for Ernst & Young LLP in Washington, D.C., which sparked his interest in the legal side of the tax world.

This experience ultimately led him to earn joint Master of Accounting and Juris Doctor degrees. Steven enjoys helping clients find creative solutions to problems through his work as a tax attorney.

Outside of work, Steven loves spending time outdoors with his wife and five kids and serving in the community. An avid sports fan and Orange County native, he always finds time to cheer for the Angels, as well as his beloved BYU Cougars. Steven is also passionate about all things India, where he served as a missionary for two years.