The Installment Sale Buy-Sell:  
A Risky Proposition For Business Owners

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Many business owners expect to sell their ownership interest during their lifetimes. In fact, some see selling their business interest as a practical way to fund their retirements. Although sellers prefer to be paid in a lump sum, many buyers won’t have enough cash to pay the full purchase immediately. Consequently, many buy-sell agreements are structured with the buyer making an initial down payment and then paying the balance to the seller over a specified number of years. The buyer also pays interest on the remaining balance at the rate specified in the agreement. In many installment sales the buyer is counting on business profits to provide the cash needed to pay both the principal and the interest.

For most buyers, an installment sale is similar to quite similar to getting a bank loan to pay the purchase price. In an installment sale, however, the buyer is borrowing from the seller rather than from a bank. In both cases, the buyer is taking on a new liability and promises to pay what is owed over a period of years plus interest. The financial impact on the buyer is the same regardless of whether the payments are made to a bank or to the seller.

From the seller’s standpoint, however, there is a big difference. In an installment sale, there are a several ramifications and risks to the selling owner (or if the owner has died, the seller’s heirs) that are not present in a lump sum sale.

Inflation Will Reduce the Spendable Value of the Payments.

Many sellers aren’t aware that inflation works against them in an installment sale. Even if the installment payments are made on time and everything goes as planned, the seller suffers financially in an installment sale. That’s because when the seller receives the purchase price in increments over several years, inflation will reduce its purchasing power. The lost purchasing power can be significant. The true impact depends on several factors, including: the year-to-year inflation rate, the amount of principal paid each year, and the number of years over which payments are made. For example, suppose Joe Smith is paid $500,000 plus interest for the purchase of
his interest in ABC, Inc. The money will be paid in 10 equal installments of $50,000 plus interest. If the inflation rate is 3% each year during this ten year period, The total purchasing power of the $500,000 paid to Joe is only $426,510, a loss of $73,490 which is about 15% of the $500,000. See Appendix A for a year-to-year summary.

The interest due on the outstanding balance isn’t designed to make up for the impact of inflation. Rather, interest is a charge to the buyer for the use of the seller’s money. It is designed to replace what the seller could potentially have earned on the unpaid balance if the purchase price had been paid in a lump sum. Just as inflation reduces the purchasing power of the principal paid in future years, it will also reduce the purchasing power of the interest paid on the unpaid principal payments.

**New Risks To The Seller.**

In addition to the impact of inflation of the spendable value of the payments, the seller may assume a number of other risks by participating in an installment buy-sell arrangement. Some of these additional risks include:

1. **The Seller May Still Be Liable For Business Debts.** Just because a business owner sells his ownership interest doesn’t necessarily end his/her responsibility for business debts. If the seller has signed some type of personal guarantee (as is often the case with business loans from banks), the seller may still be personally liable if the business defaults on the loan. Savvy sellers usually try to negotiate a release of their personal guarantees when they sell their business interests. Also, some buyers will specifically structure the buy-sell agreement so current business debts will remain the seller’s responsibility. In these cases the sale is designed as an “asset sale.” The buyer doesn’t purchase the seller’s stock or ownership interest. Instead, the buyer only purchases selected business’ assets and thereby leaves the liabilities as the seller’s responsibility.

2. **The Impact of Taxes and Rising Tax Rates.** The seller must consider the impact of taxes on the installment payments. For income tax purposes each payment is generally divided into three parts: (1) return of basis, (2) capital gains on growth in excess of basis and (3) interest on the unpaid principal balance. The return of basis portion of the payment is usually income tax-free. However, principal growth over basis is generally taxed at capital gains rates and interest is usually taxed at ordinary income rates. Thus, the seller needs to consider that the installment payments may generate several different federal and state taxes. During the term of the installment payments, the seller has the risk that the federal and state governments could increase some or all of the applicable tax rates.

3. **The Business May Not Be Able To Produce Enough Money For the Buyer To Make the Payments.** When the buyer will be using business profits to make the payments to the seller, it is possible there won’t be enough money. Because the installment payments are usually a significant new expense, the business will likely have to increase the revenues it generates if there are going to be enough after-tax profits to make the payments. Increasing business revenues and profits can be difficult after an owner has left the business. The buyer must have both the skills and the discipline to operate the business profitably over the number of years that installment payments are to be made.

4. **Future Events Could Reduce the Buyer’s Ability To Make the Payments.** Even if everything looks good at the time the installment sale is made, future events could take place during the payout period which may reduce the buyer’s ability to make the promised payments. For example:

   a. The buyer may die unexpectedly
   b. The buyer may become sick or disabled
   c. Key employees could leave the business
   d. The economy and business environment could falter (e.g. recession)
   e. New developments, technologies or competitors may reduce business revenues or cash flow
      (e.g. the impact of digital cameras on Polaroid and Eastman Kodak)
   f. The business could incur unexpected liabilities (e.g. injury to a customer or employee)
   g. Natural disasters may damage the business’ earning capacity or adversely impact important customers and thereby reduce the revenues they can afford to spend

Business owners who sell their ownership interests in installments need to be cognizant of these risks. If the buyer is unable or unwilling to make the promised payments, the selling owner may have to go to court to protect his/her rights. If the buyer defaults, the seller may have to find another buyer or take back the business and operate it personally. Neither alternative is usually attractive. Wise sellers do the best they can make sure the buyer is reliable and has the ability to run the business profitably. They also negotiate buy-sell terms that are realistic and achievable by the new owner.

**Suggestions For Sellers.**

At first glance, installments sales can appear to be relatively easy ways for sellers to exit their businesses. A closer examination, however, shows there sellers assume some serious new risks when they agree to an installment sale. Many things
could go wrong during the installment payment period. But there are some strategies sellers can potentially use to protect themselves, including:

1. **Try to avoid an installment sale**—the seller can insist that the buyer get a bank loan or use other sources of funds to make a lump sum purchase. If the buyer borrows money to finance the purchase, the seller should avoid giving a personal guarantee.

2. **Negotiate a Larger Down Payment and/or a Shorter Payment Period**—The potential impact of inflation on the seller’s purchasing power can be significant when the principal is paid over time (Review Appendix A). Even if the installment sale is completed as planned, the Seller will still suffer a loss of purchasing power from inflation. If an installment sale is the only way to fund the purchase, the seller should try to reduce his/her risk by getting more upfront and reducing the size and/or the term of the installment payments.

3. **Get a Personal Guarantee From the Buyer**—just as banks demand personal repayment guarantees of the owners when they make business loans, sellers can also ask for the buyer’s personal guarantee. If the buyer defaults, a personal guarantee may permit the seller to access the buyer’s non-business assets to get paid.

4. **Insist on an “Indemnification” Clause**—Seller should negotiate with lenders and other creditors to eliminate personal liability after he/she sells his interest. In the event lenders or creditors are unwilling to do so, the buy-sell agreement can include a provision in which the business and/or the remaining owners agree to pay back to (indemnify) the seller for any funds he/she is forced to pay to lenders or creditors under their personal guarantees.

5. **Focus on Funding the Agreement**—Business owners often pay more attention to the terms of their buy-sell agreements than they do to funding it. Once the agreement is finalized, the promises in it become legally binding. Adequate funding is key to making sure the buyer has the means to keep those promises. A thoughtful, regularly monitored funding strategy is the key to carrying out the agreement. Without the funds to back it up, a buy-sell agreement can be a bunch of empty promises.

**Life Insurance Funding.**
Life insurance may help both the seller and the buyer in an installment purchase buy-sell. In many buy-sell agreements, the seller’s death is a “triggering event” which requires the buyers to purchase the seller’s interest. Because the seller’s death is such a common triggering event, buyers often purchase life insurance policies on
the seller to cover this risk. In fact, it is not unusual for the agreement to REQUIRE potential buyers to purchase life insurance.

Buyers often purchase term life insurance. One reason they do so is to keep the cost for the life insurance coverage to a minimum. Unfortunately, this strategy may not serve them well in the long term. If the event that triggers the buy-sell is something other than the seller’s death (e.g. the seller’s retirement or disability), a term life insurance policy won’t provide any funds to make the payments. That’s because most term life insurance policies only pay benefits when the insured dies. For a lifetime buy-out the buyer will have to use other financial resources to make the installment payments. If, on the other hand, the buyer had purchased cash value life insurance on the seller instead of term insurance, policy cash values could possibly be distributed to help the buyer make the installment payments.* Thus, cash value life insurance has the potential to provide a buyer with buy-out funds regardless of whether the purchase takes place during a seller’s lifetime or at the seller’s death.

When the purchase takes place during the seller’s lifetime, a buyer may be tempted to stop paying premiums on the seller’s policy and allow it to lapse. This may be “penny-wise and pound foolish.” A buyer may still benefit from a policy on the seller, even after the agreement is triggered and payments begin. Some reasons a buyer may wish to keep the policy on the seller in force include:

1. The seller may die during the installment payment period; if this happens, the buyer’s obligation to make the promised payments doesn’t end—the remaining payments must still be made. The life insurance death benefit payable at the seller’s death can provide the cash needed to make those payments.

2. The buyer may wish to recover all or part of the costs which were incurred to purchase the seller’s interest; life insurance death benefits may help the buyer recover those costs when the seller dies.

Life insurance may also benefit the seller. In an installment buy-out the seller has the risk that the buyer may die before making all the promised payments. When this happens, the responsibility to make the remaining payments usually falls to the buyer’s estate. The seller now has a new risk—that the buyer’s estate will not be able to make the remaining payments. The buyer is no longer around to operate the business in a way that generates the needed revenues. The seller may address this risk by having a provision in the buy-sell agreement that requires a buyer to purchase sufficient life insurance coverage on him/herself to pay off the remaining payments if he/she dies before the installment payments have been completed. That death benefit could be assigned to the seller as security for the payments. After the last payment is made, the assignment could be released.

In the alternative, the agreement could give the seller the right to purchase coverage on the buyer to the extent of the amount likely to be due. If the seller already owns a policy insuring the buyer, the agreement could give the seller the right to continue that policy until the final installment is paid.

Conclusion
A workable buy-sell agreement has two primary components: (1) a binding written agreement that contains the terms of the purchase, and (2) adequate funding to allow the buyer(s) to make the required payments. Buy-sell agreements must be backed up by money or else the promises they make are illusory. Installment agreements designed to purchase an owner’s interest create serious risks for the seller. This is especially true if the buyer is relying on the business to produce the after-tax cash needed to make the payments. It can be dangerous to expect a business to increase its revenues after an important owner has left. Even if everything goes as planned, inflation may cause the seller to experience a significant loss of purchasing power. Identifying the potential risks and planning for them will help both buyers and seller accomplish their respective objectives. Thoughtful use of cash value life insurance in the buy-sell funding can help reduce the risks to both the buyer and the seller.

*2 Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Withdrawals will reduce the policy’s cash value and the policy’s death benefit. Policy loans will reduce the policy’s cash value and may reduce the death benefit. This assumes the policy qualifies as life insurance and does not lapse.

Appendix A (See Chart on corresponding page) —Impact of Inflation on Purchasing Power of Installment Payments
Joe Smith agrees to sell his interest in ABC, Inc. for $600,000. Fred Brown agrees to pay $100,000 as a down payment and make ten annual $50,000 payments on December 31st of each year. In addition, he will also pay interest annually on the remaining principal balance. The table below computes the pre-tax purchasing power of each $50,000 principal payment at 2%, 3% and 4% annual inflation. It does not consider the taxation of the principal payment or the amount and taxation of the interest payment. It assumes that Mr. Brown makes the payment on time each year.
<table>
<thead>
<tr>
<th>End of Year</th>
<th>Principal Payment</th>
<th>Adjusted Value 2% Inflation</th>
<th>Adjusted Value 3% Inflation</th>
<th>Adjusted Value 4% Inflation</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>49,020</td>
<td>48,544</td>
<td>48,077</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>48,058</td>
<td>47,130</td>
<td>46,228</td>
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<tr>
<td>3</td>
<td>50,000</td>
<td>47,116</td>
<td>45,757</td>
<td>44,450</td>
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<tr>
<td>4</td>
<td>50,000</td>
<td>46,192</td>
<td>44,424</td>
<td>42,740</td>
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<tr>
<td>5</td>
<td>50,000</td>
<td>45,287</td>
<td>43,130</td>
<td>41,096</td>
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<tr>
<td>6</td>
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<td>44,399</td>
<td>41,874</td>
<td>39,516</td>
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<tr>
<td>7</td>
<td>50,000</td>
<td>43,528</td>
<td>40,655</td>
<td>37,996</td>
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<tr>
<td>8</td>
<td>50,000</td>
<td>42,675</td>
<td>39,470</td>
<td>36,535</td>
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<tr>
<td>9</td>
<td>50,000</td>
<td>41,838</td>
<td>38,321</td>
<td>35,129</td>
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<tr>
<td>10</td>
<td>50,000</td>
<td>41,017</td>
<td>37,205</td>
<td>33,778</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>$500,000</strong></td>
<td><strong>$449,130</strong></td>
<td><strong>$426,510</strong></td>
<td><strong>$405,545</strong></td>
</tr>
</tbody>
</table>

Percent Lost

Vs. Lump Sum: 10.2% 14.7% 18.9%

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