PRESERVE YOUR BUSINESS FOR FUTURE GENERATIONS

Business succession planning using the buy-sell agreement

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Your business represents a lifetime of hard work, personal invested capital, and a significant time commitment from you and your business partners. Having a documented succession plan using the buy-sell agreement can help ensure your business and family are cared for well beyond your lifetime.

A buy-sell agreement can help you protect your family and promote business continuity by specifying how ownership will be transferred and facilitating the continuation of the business in case of sudden death, disability or retirement of one of the owners. It can be funded using proceeds from insurance policies purchased on the lives of the business owners, ensuring that your equity in the business is safely and efficiently passed on to your beneficiaries.

FOUR BENEFITS OF A BUY-SELL AGREEMENT

A GUARANTEED BUYER

The selling owner's family is provided a guaranteed buyer and will receive a fair market value for their equity in the business. Conversely, the remaining owners are protected against the sale of significant interest in the business to an outside investor.

LIQUIDITY

The death, disability or retirement of a business owner often results in his or her family needing cash to replace lost income or settle estate tax liability, which is typically due nine months after the date of death. Having an agreement in place protects the family from having to initiate and execute the sale of their portion of the business and potentially receiving less than the fair market value.

A FAIR SELLING PRICE

Since the agreement is made while all the owners are active and engaged, a fair and equitable valuation of the business is easier to determine and will assist with a smoother settlement of the deceased owner's estate.

Once an owner dies or is otherwise unable to participate in the valuation negotiations, agreeing on a fair selling price can be a difficult and even contentious process. Establishing a buy-sell agreement can help minimize the time required for the process and possibly reduce the risk of costly disputes.

PRESERVED GOODWILL

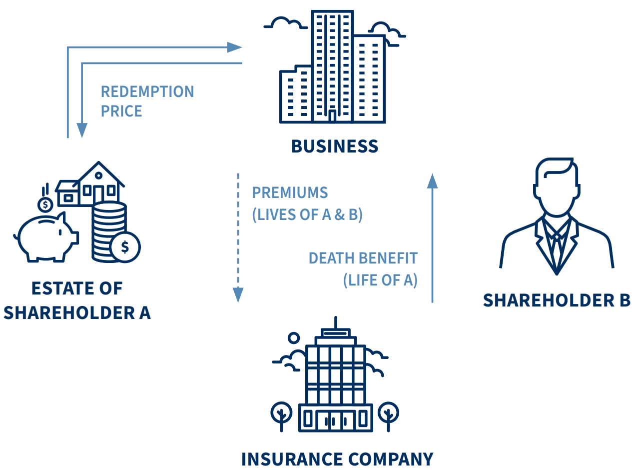
A buy-sell agreement protects the surviving owners, as well as the interests of the deceased partner's family, as it dictates and makes known the terms of transfer of ownership. Having a plan in place can help reduce strain on relationships, especially when an owner dies and his or her family becomes involved in the business.

TYPES OF BUY-SELL AGREEMENTS

There are a number of ways to execute a buy-sell agreement, but most fall under one of three types. Naturally, the most appropriate type depends on the kind of business involved and the specific goals and needs of the owners.

ENTITY PURCHASE

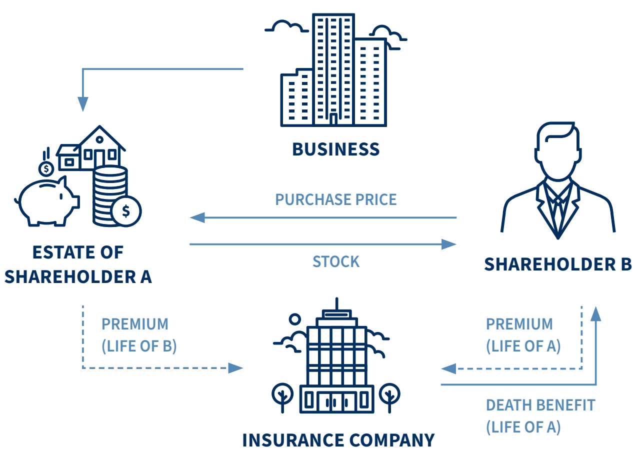
Also known as stock redemption, this is an agreement between the owners and the business (or entity) whereby the business has the right and/or obligation to buy back the owner's interest. When insurance is used to fund an entity purchase, the business owners are the insured and the business is the owner, beneficiary and premium payor of the policy.



Under an entity purchase agreement, the business receives the death benefit of the insurance policy on the deceased partner, Shareholder A. The business then uses the benefit to purchase the shares owned by the estate of Shareholder A. The business will continue to own a policy on the life of Shareholder B.

CROSS PURCHASE

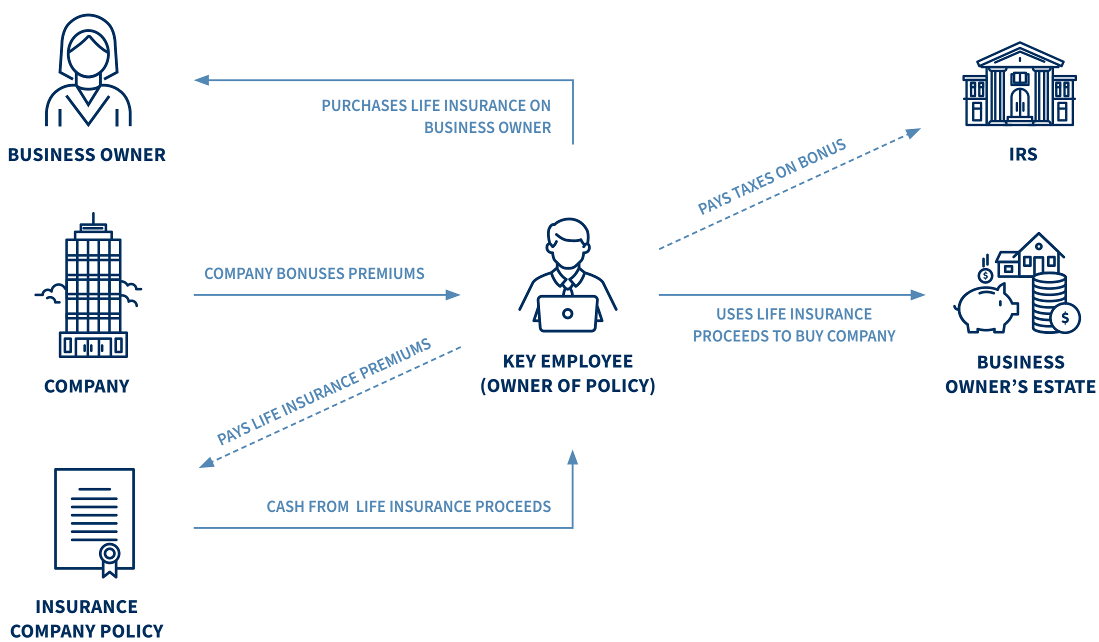
In this agreement, the owners (or their estates) are obligated to sell their interests to each other. The business (or entity) is not a party to the arrangement. When insurance is used to fund a cross purchase, each business owner is the owner, beneficiary and premium payor of the life insurance on the other owners.



In a cross-purchase agreement, Shareholder B uses the death benefit of the life insurance policy to buy out Shareholder A's stock in the business. Shareholder A's estate will continue to own a policy on the life of Shareholder B, which can be sold to the business or to Shareholder B.

UNILATERAL OR ONE-WAY AGREEMENT

In this scenario, a willing buyer (usually a family member working in the business or a key employee) will purchase and own a life insurance policy on the life of the business owner and will be the beneficiary of the policy. The funds will then be used to purchase the owner's share (part or all) from the owner's estate.



Under a one-way agreement, the appointed buyer purchases a life insurance policy on the life of the owner, often funded through bonuses or other compensation (on which the buyer may be required to pay income taxes). The buyer then uses the death benefit to purchase the owner's share of the business from the owner's estate.

VALUING THE BUSINESS

An important part of a buy-sell agreement is settling on the valuation methodology. The method that's most prudent for you and your beneficiaries depends on the type of business you own.

BOOK VALUE

With this method, value is determined on the date of death or the close of the preceding fiscal year. While simple, book valuation is seldom accurate as it reflects depreciated historic values and ignores earnings potential.

CAPITALIZATION OF EARNINGS

In some cases, value is determined by multiplying earnings by a capitalization factor determined by analyzing the price-earnings ratio of comparable businesses in the same industry. However, relying solely on the earnings of a closely held business may result in inaccurate valuation.

FORMULA

Value can also be determined by combining valuation methods, such as book value and capitalization of earnings, to arrive at a more accurate figure.

APPRAISAL

Partners can agree to an independent appraisal at the time of sale. While this can be done equitably among the surviving owners and the selling shareholder, and it can provide an accurate valuation at a given point in time, it can be expensive and delay the settlement process.

FUNDING THE BUY-SELL AGREEMENT

The most common and convenient way to fund a buy-sell agreement is by purchasing life insurance on the lives of the owners. However, there are other methods.

BORROWING FUNDS

Taking out a loan may seem like a convenient solution, but the business and remaining owners may have difficulty obtaining one. Furthermore, the ability to get additional loans for expansion or working capital may be significantly diminished, and extra collateral may be needed for the loan.

SINKING FUNDS

Another way is to create a sinking fund by setting aside a portion of the business' earnings. However, this arrangement requires time to raise the necessary funds and if one of the owners dies soon after the arrangement is made, the business may not have had enough time to accumulate sufficient earnings. An option is for the business to purchase permanent life insurance and use the cash value as a sinking fund to provide a downpayment.

INSTALLMENT PURCHASE

This should be a part of all buy-sell agreements. If the business does not have sufficient cash or life insurance to fund a buy-sell agreement, the parties can agree to use an installment sale to facilitate transfer of owner equity. However, installment payments can put a financial strain on the business and potentially jeopardize the family of the deceased owner from receiving fair market value for their equity interests.

LIFE INSURANCE

In addition to being the most cost-effective solution, the primary advantage of purchasing insurance on the lives of the owners is that it ensures that cash will be made available upon the death of an owner. And if a permanent life insurance policy is purchased, the cash value of the policy may be sufficient to fund a buyout at retirement. If the entity purchase method is chosen, care must be taken in drafting and following the formalities of the agreement to prevent cash value and death benefits from increasing the value of the business.

THE BUY-SELL LIFE INSURANCE CONSIDERATION

- Draft a buy-sell agreement, which will be retained by the business owner(s).
- Quantify the value of the business and determine the face amount of life insurance coverage needed on each owner (proposed insured) and select the type of policy. Complete life insurance application(s) with the owner(s) of the business as the proposed insured(s).
- Where the business is the premium payor, execute a board resolution authorizing payment of the stipulated premium.
- Prior to policy issue, execute employer-owned life insurance notice and consent documentation as required under Internal Revenue Code § 101(j). This documentation should be retained by the business to prove compliance. Annually report with the business tax return the data requested for employer-owned life insurance.
- Periodically review the by-sell agreement and reassess the adequacy of the life insurance coverage.

We can help you protect your family, partners and business

Every viable business should have a written succession plan that accounts for each owner to ensure the smooth transition of ownership and ongoing continuity of the business. Your Raymond James financial advisor has the experience to help you and your partners protect what you've built and preserve it for future generations.

Talk to your advisor today about business succession planning.

LIFE WELL PLANNED.

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