
Meet the Business Planning Team

Business planning, especially for the succession of the business, is a very complex discipline and will generally require the efforts of more than one professional.

A business planning team might consist of two or more of the following persons:

The CEO of the Team

You are the Chief Executive Officer of this team. You will make all of the final decisions after carefully reviewing the recommendations of the various members of your team.

Estate and Business Planning Attorney

Most attorneys can draft a will or establish a small corporation. However, it may be wise to choose one who emphasizes estate planning and business continuation. Your choice could mean the difference between achieving your goals and failure of the business plan.

Life Insurance Professional

Life insurance is very often a key element in the smooth transfer of a business to either heirs or surviving business associates. An insurance professional will be able to assist you in determining the best type of policy and the amount of insurance required to meet your goals.

Certified Public Accountant (CPA)

Almost all successful businesses require the services of a qualified accountant. The CPA designation is an indication that a person has passed rigorous examinations and has been in practice for a number of years. Some CPAs have pursued additional studies in the complex areas of business valuation methods.

Business Appraisal Expert

In the event of a disagreement with the IRS as to the value of the business interest, it would be prudent to possess a detailed appraisal by a trained and qualified expert. There are experts who specialize exclusively in this field.

Financial Professional

Sometimes the life insurance professional, accountant or other member of the business planning team may have special training in financial planning. Other times a person who specializes in financial planning may be a part of your team. This broader knowledge may help to coordinate the efforts of the team.

Types of Corporate Continuation Plans

If the owners want to keep the business in the family, but money is needed to pay estate taxes or other estate costs, a partial stock redemption under IRC Sec. 303 should be considered. If the business interest is to be passed to others, several choices are available.



Continuation Plans in Brief

- **First offer of stock to existing stockholder(s):** The stockholders agree not to sell their stock to an outsider during life or at death without first offering it to the other stockholders or the corporation at an agreed price. This plan gives no certainty to a deceased owner's heirs and will not peg the value for federal estate tax purposes.
- **Option to buy:** An agreement giving the corporation (and/or surviving stockholders) an option to purchase a deceased stockholder's shares. Since the estate is required to sell if the option is exercised, the value for federal estate tax purposes may be pegged. The heirs have no certainty since the corporation is not required to purchase the stock.
- **Cross-purchase buy-sell agreement:** A written agreement among the stockholders to purchase each other's shares at the death of an owner. The price is either stated in the agreement, set by a formula, or provides for the use of independent appraisers
- **Stock redemption plan:** Stockholders enter into an agreement with the corporation to have their estates sell their shares back to the corporation at death. The company usually carries key employee insurance policies to finance the payments for the stock.
- **Wait-and-see plan:** A written agreement among the stockholders and the corporation, generally giving the corporation an option to buy the stock. If it elects not to purchase, the surviving stockholders may buy it and, if they don't, the corporation may be required to buy the shares.

Types of Corporate Continuation Plans

Considerations in Choosing a Plan

- What is the value of the corporation and who can afford to buy it?
- How many owners are there and how old are they? What percentage of ownership does each person have?
- What is the net worth of each owner? Are the owners related?
- Are they all insurable?
- What are the individual tax brackets and the corporate tax bracket?
- Does the non-active spouse have any rights, e.g., community property interest?

Funding

Many types of corporate continuation plans are funded with life insurance. Under IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income. If certain regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Importance of a Business Continuation Plan

Competing Interests of Heirs and Surviving Owners

These interests are many and may include the following:

What Heirs of Deceased Owner Want	What Surviving Owners Want
Top dollar for their interests	Minimum cost for the interest
Prompt settlement of the estate	Prompt transfer of the business interest
Set value of business for estate tax purposes	Full control of the business - no interference from decedent's family
Relief for family from worries regarding the business and its creditors	Continuing relationship with creditors
	Retention of customers and employees

Potential Problems Without a Written Agreement

Frequent results include:

- Heated conflicts among the remaining owners and the decedent's family.
- Unhappiness on all sides, and sometimes litigation.
- Delays in settling the estate and continuing business growth.
- Loss of customers and loss of business value.
- Possible liquidation of the business which may bring less than full value.

The Solution: A Written Agreement (and Cash)

Taking the time now to see that the business will pass in an orderly manner at time of death will benefit all parties and their heirs. A written agreement can provide:

- An orderly transfer of the operation, management, and ownership of the business.
- A mutually agreeable sales price and preservation of business value.
- Mutually agreeable terms of sale.
- A value that is binding on the IRS for federal estate tax purposes.
- Stability for customers, employees, creditors and investors.

An agreement which is favorable to all parties can be more easily drafted prior to a crisis.

Commonly Asked Business Continuation Questions

The following are commonly asked business continuation questions. Each question is followed by an answer that highlights the issues and the importance of taking action.

Question: What's the problem?

Answer: Think about the essence of a closely-held business. If it's like most firms, it has these characteristics.

- The majority stockholders actively work and manage the business and are critical to its operation.
- The majority stockholders receive most of their income from salary or bonuses.
- Stockholders have limited creditor liabilities.
- If a stockholder were to die or become permanently disabled, the legal structure of the business would survive.
- If a stockholder were to die or become permanently disabled, the personnel structure would be significantly changed.

The problem is, when a business owner dies, the business often dies too: not because anything wrong has been done but because nothing has been done, and that's wrong!

At death (or disability), no asset tends to deteriorate as quickly or as totally as a business. Often, the precipitous drop in value is staggering!

Think about it. If a friend owned a car or a home or almost any other tangible asset, one month after that friend died, the value of that car or home would be relatively the same. But if the friend owned a restaurant that didn't reopen for a month or was a doctor whose practice was closed for a month or owned a manufacturing plant which produced no goods for a month, what would the business be worth at the end of that month?

Question: Why can't leaving the business to the proper parties in a will or trust solve the problem?

Answer: Leaving the business to successors at death through will or trust provisions does not address the key problems. A disgruntled heir or a dissatisfied spouse may attack a will or trust. Often, part of the business ends up in the hands of inactive heirs who can add little to

Commonly Asked Business Continuation Questions

the business but who want income equal to working stockholders. The result is an increased probability of business failure and inevitable family discord. Most importantly, a will or trust cannot address the central problems created when a business owner dies or becomes permanently disabled.

Look at these four points, seen from the perspective of a surviving stockholder and the decedent's survivors.

Surviving Stockholder	Decedent's Survivors
Continue reasonable salaries	Pay dividends and hire family
Build and expand the business	Pay dividends and hire family
Maintain a long-term outlook	Pay dividends and hire family
Build a strong cash reserve	Pay dividends and hire family

A surviving stockholder doing his or her own job, and probably that of the deceased co-stockholder as well, would want at least the same salary as before, if not a greater salary, in recognition of the increased responsibilities. And the surviving stockholder may want profits plowed back into the business rather than being paid out as dividends.

On the other hand, the heirs of a deceased stockholder would want the corporation to pay dividends and/or hire one or more family members at the highest possible salary. Typically, lots of income will be needed to maintain the current living standard and to pay the unexpectedly high debts, taxes, and expenses that accompany death.

This is why the death or long-term disability of a stockholder almost always creates conflicting interests and dissension.

Question: What happens after a stockholder's death or disability?

Answer: When a working stockholder dies or becomes permanently disabled, there is inevitably a reorganization of the business.

The remaining stockholders generally must:

- Buy out the heirs;
- Sell out to the heirs;

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- Accept the purchasers of their stock as business associates; or
- Take the heirs into the business and share profits and decisions.

Is it possible to take one of these courses of action now? Given a choice, which course of action is realistically the most appealing?

Question: Can one be more specific about the problems and objectives of the heirs?

Answer: This can be answered by thinking about the following questions.

- If the heirs are invited to take an active part in the operation and management of the business, will they have the training, experience, ability, and willingness to carry their load and earn their salaries?
- Will all the surviving stockholders be comfortable with the new arrangement?
- If the heirs decide to trust the surviving stockholder to run the business and take care of them and remain inactive, will the dividends the firm pays be sufficient for their needs and meet their expectations?
- Will the heirs panic if business income must be re-invested back in the business rather than paid out to them as dividends?
- How will the heirs react if the surviving stockholder decides to sell stock to an outside party? Where will that leave them?
- If the heirs decide to sell their stock to an outside party, will they obtain a price they feel is fair and adequate, or will the price they need for the stock be more than a knowledgeable buyer is willing to pay?
- Do the heirs know the true value of the stock?
- Can the heirs find a buyer at a reasonable price, or at any price, if they hold only a minority interest?
- Will the surviving stockholder lose his or her job if the heirs own, and then sell, their majority interest?

Question: What are the objectives of the surviving stockholder when another stockholder dies or becomes permanently disabled?

Answer: Typically, a surviving stockholder will want to retain control. Retaining control and preventing outsiders from interfering in the management of the business and its affairs will be crucial objectives. If the business has elected S Corporation treatment (pass

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through of taxation), the surviving stockholder will want to be sure that election is not lost (which could easily happen if the stock falls into the wrong hands). Further, it will also be desirable to have the cash to guarantee a fair payment to buy out the deceased co-stockholder's heirs.

Question: What are the odds that death or disability could actually occur between two co-stockholders?

Answer: If either event does occur, the probability against it happening doesn't really matter, does it? But it is helpful to at least know what the actuaries know.

Probability of Death Prior to Age 65¹

Probability of Death Prior to Age 65	Ages of Business Owners
33.7%	25/25
32.9%	30/30
31.8%	35/35
30.5%	40/40
28.7%	45/45
25.9%	50/50
21.3%	55/55
40.2%	25/30
39.3%	30/35
38.2%	35/40
36.8%	40/45
34.8%	45/50
31.5%	50/55

Note: Statistics courtesy of NumberCruncher Software, version 2007.04. June, 2008.
(610.527.5216).

Question: What's the solution to all of these problems?

Answer: A legal agreement called a buy-sell agreement is often the best solution. The document, prepared by an attorney, is a legal instrument which requires the corporation (in

¹ The probability that one of two business owners in average physical condition will die prior to age 65 is illustrated.

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the case of a stock redemption agreement) or the remaining stockholders (in the case of a cross-purchase agreement) to buy the stock of a deceased, retiring, or permanently disabled stockholder. It would require the estate of the stockholder to sell under a formula devised while all parties are alive and well.

There is even a type of buy-sell agreement that combines the flexibility of both the stock redemption and the cross purchase. This is called a wait-and-see buy-sell agreement. With it one can wait and see the best course of action, tax-wise, and then take it, even many years after the agreement is drafted.

Question: How is this agreement funded? Is there a perfect buy-sell funding mechanism?

Answer: There's no free lunch or perfect buy-sell funding vehicle. The ideal is a method that will facilitate a trouble-free transfer of the business interest and provide funds for that purchase in a manner that:

- Is relatively inexpensive;
- Is easy to administer; and
- Will not adversely affect the business or the surviving stockholder's working capital or credit position.

Since two of the most common causes of ownership termination are death and long-term disability, the financial mechanism chosen must provide ample amounts of cash, at the time needed most, whenever that occurs!

Question: What are the various funding alternatives?

Answer: There are four ways to fund a buy-sell agreement. They are using cash on hand, borrowing, making installment payments, and through life and/or disability insurance.

Here are some thoughts and questions that should be discussed with the business planning team.

- **Cash.**
 - How much cash will be required and will it be available when needed?
 - When will that cash be needed?
 - What will happen if the cash is unavailable due to an unforeseen situation?
 - Will after-tax dollars need to be kept on hand to finance the purchase?
 - Will a higher alternative rate of return have to be sacrificed in order to keep adequate cash on hand?

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- **Borrowing.**
 - Will the firm or the surviving stockholders be able to borrow money after the death or long-term disability of a stockholder/employee?
 - What rate of interest will be required and would it be deductible?
 - How serious will the cash drain impact be on corporate or personal reserves?
 - How will the borrowed funds be repaid?
- **Installment payments.**
 - Can the decedent's family afford to leave substantial sums of money at the risk of the business?
 - Where will the deceased stockholder's family obtain cash to pay taxes, debts, and other immediate estate settlement costs?
 - What rate of interest will the decedent's family want to charge on the unpaid balance? Will that interest be deductible?
 - What will the total cost be?
 - Can the business carry the extra debt and still fund company operations and future growth?
- **Insurance.**
 - Will the buyers be guaranteed that the death or disability will create sufficient cash to satisfy that need?
 - Will this method reduce or eliminate the strain on future working capital in return for relatively small, predictable annual transfer of cash to cash values?
 - Can policy cash values be used, before an insured's death, for a corporate emergency or opportunity?

It should be obvious that setting up a buy-sell agreement can be crucial to the survival of a business, as well as essential to guarantee the economic security that the business represents to family and loved ones. Such an undertaking involves a considerable amount of time, thought, and background experience in many areas, as well as teamwork and cooperation among all the members of your advisory team.