

BUSINESS SUCCESSION: TRANSITION PLANNING

TRANSITION PLANNING

All closely held businesses face the possibility of an owner dying, retiring, or becoming disabled. A business owner's death or disability can create major problems, potentially jeopardizing a lifetime of hard work and investment and leaving the other owners and the deceased's family in the difficult position of sorting things out. A properly structured and funded buy-sell agreement permits an orderly transfer of the business.

There are several occurrences that can cause disruption of a business:

- Death of an Owner
- Disability of an Owner
- Bankruptcy or Divorce of an Owner
- Retirement of an Owner
- Withdrawal of an Owner prior to retirement
- A key non-owner whose death or resignation would greatly impact the success of the business

For Family-Owned Businesses, there are additional considerations:

- Failure or liquidation of the business in event of sudden incapacity of the business owner, partner, or key employee
- Unqualified and/or inexperienced heirs running the business
- Loss of income stream to remaining family members who are not active in the business
- The potential for unwanted litigation expenses due to disagreements between active and inactive family members

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

PEXB
PINNACLE
EXECUTIVE BENEFITS

BUSINESS SUCCESSION: TRANSITION PLANNING

Continued

IF THERE IS NOT A FORMAL BUY-SELL AGREEMENT

Is this business owner one of the vast majority without a plan to exit their business? These issues may help the business owners reach their financial goals:

1. If a business owner feels the business will be their retirement plan, can they:
 - Sell the business to a third party at fair market value?
 - Sell it on their timetable?
 - Get a “lump sum” cash payment?
2. If the value of the business has not been locked in by a formal agreement, things are left to chance:
 - Are the owners prepared in the event that the post-death sale proceeds received by the family may be substantially less than the value of the business they used for estate planning purposes?
 - If an owner has an estate tax problem, would they want the fair market value to be negotiated with the IRS for estate tax purposes on the date of death?
3. Is there funding in place to financially complete the transfer of the business?
 - What if the transfer is to another owner?
 - What if the transfer is to a child while the spouse and/or other children are also heirs?
 - What if the transfer is to a key employee?
4. Is the investment in the business protected from the death or premature departure of a key non-owner employee?
 - If the key employee(s) are not “locked in,” will they choose to remain employed with the business after a business transfer event occurs?
 - Are funds available to the business to overcome the unexpected death of a key employee?
5. If a spouse is not committed to the terms of the buy-sell agreement in writing, will issues arise?
Conversely, are spousal rights protected?
 - If the spouse has not agreed in writing, would a divorce court be determining the valuation?
6. Is it okay for an executor to make the decision as to what should be done with the business?
7. A “seller in liquidation” or a “motivated seller” is unlikely to receive the fair market value of the business.

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

PEXB
PINNACLE
EXECUTIVE BENEFITS

BUSINESS SUCCESSION: TRANSITION PLANNING

IF THERE IS A FORMAL BUY-SELL AGREEMENT

A buy-sell agreement usually lists a variety of events which trigger the obligations to buy and sell the interest of a departing owner. Effective buy-sell agreements establish the price, payment, terms, and procedures for transferring a departing owner's interest.

1. Are purchases of business interests in the agreement mandatory or optional?
2. Does the agreement cover ALL the important transition events?
 - Death
 - Divorce
 - Disability
 - Termination
 - Retirement
 - Bankruptcy
 - Criminal Conviction
 - Other
3. Does the purchase price spelled out in the agreement reflect the current value of the business?
4. Have the owners' spouses signed the agreement?
5. Will the implementation of the agreement result in an unanticipated change in voting control?
6. Does the agreement prevent an owner's child/children from inheriting the owner's interest?
7. Have any of the owners signed personal guarantees promising to pay back current loan balances and/or bank lines of credit?
8. Are there any non-owner employees who may leave if they don't become owners or who may not accept the results of the current buy-sell agreement? Have any steps been taken to retain their talents and experience?
9. If a key employee does leave, has he/she signed an enforceable non-compete clause?
10. Has money been set aside to fund the agreement? Has the funding vehicle been regularly reviewed to be sure it is doing the job anticipated?
11. Are 101(j) insured consent forms on file for life insurance policies owned by the business to keep the life insurance death benefits from being taxed for income tax purposes?

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

PEXB
PINNACLE
EXECUTIVE BENEFITS

BUSINESS SUCCESSION: TRANSITION PLANNING

Continued

HOW WILL THE AGREEMENT BE FUNDED?

There are four ways to fund the agreement:

Cash

Will sufficient cash be available? Earnings of the business may already be depressed. The cost of this method is the full purchase price.

Borrow

Lenders may be unwilling to loan money due to the death of a key owner. If a loan can be obtained, interest and principal payments may strain cash flow. The cost of this method is the full purchase price PLUS interest.

Installment Sale

Repayment of the note will be a strain on cash flow. If surviving owners can't keep the business afloat after the loss of a key owner, how will the remaining installment payments be made? The cost of this method is the full purchase price PLUS interest.

Life Insurance

- Life insurance is cost effective and provides high immediate death benefits and relatively low annual costs.
- Immediate funds are available in the event of death
- Cash values may be available for a down payment on a living buy out occurring due to retirement or withdrawal from the business
- The cost of this method is premiums paid until death.

THE TYPICAL AGREEMENT TYPES ARE

There are four ways to fund the agreement:

Cross Purchase: Co-owners purchase the departing owner's business interest.

Entity Purchase: The business purchases the departing owner's business interest.

Wait-and-See: The purchase of the departing owner's business interest by either the remaining owner(s) or the business. The decision as to who will buy is made at death but there is an obligation to buy.

The type of business entity, whether there are other entities owned by the same people, who has majority interest after the first death, and how many policies will be initially required may determine the type of plan used. In certain situations a combination of plans can be used.

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

PEXB
PINNACLE
EXECUTIVE BENEFITS

BUSINESS SUCCESSION: TRANSITION PLANNING

Continued

PLAN COMPARISONS

Insurance Arrangements

	Premium Payer	Owner	Beneficiary
Cross Purchase	Each owner pays premium on the policies he/she owns	Each owner owns a policy on the life of each other owner	Each owners is the beneficiary of the policies he/she owns
Entity Purchase	The business pays premium	The business is owner	The business is beneficiary
Wait-and-See	Remaining owner(s) or business pay premiums	Remaining owner(s) or business are owner (Most often the remaining owners must own policies)	Whoever owns the policies

Income Tax Aspects

	Purchasing Owner	Seller Upon Death	Seller Upon Lifetime
Cross Purchase	<ul style="list-style-type: none"> • Premiums not deductible • Death benefit received tax-free • Purchaser's basis in business is increased by amount paid to the deceased's family 	Purchase price received generally doesn't cause taxable event	Seller recognizes gain to extent proceeds exceed the seller's basis in the business
Entity Purchase	<ul style="list-style-type: none"> • Premiums not deductible • Death benefit received tax-free¹ • If C corporation, there is no basis increase to surviving owners • If S corporation or other pass-through entity: with planning, surviving owners may be able to obtain some basis increase 	Purchase price received generally doesn't cause taxable event	Seller recognizes gain to extent proceeds exceed the seller's basis in the business
Wait-and-See	Depends on the identity of the purchasing owner (either surviving owners or business entity) at time of death	Purchase price received generally doesn't cause Income tax event (Subject to 101(j) forms if business is purchaser)	Seller recognizes gain to extent proceeds exceed the seller's basis in the business

1) To avoid taxation, 101(j) insured consent forms must be completed prior to policy issue and kept on file.

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

BUSINESS SUCCESSION: TRANSITION PLANNING

Continued

GOING A STEP FURTHER: USING A GENERAL PARTNERSHIP FOR BUY-SELL PURPOSES

When there are more than 2 owners of a business entity, the use of a general partnership to buy the insurance to fund a buy-sell agreement for a business may be an efficient way to fund a buy-sell agreement for a corporation.

- The partners in the general partnership will be the owners of the corporation
- The purpose of the general partnership will be to provide for business continuation and to accumulate additional money to enhance the partners' retirement income

Advantages

- The general partnership only needs to purchase one life insurance policy per owner. It can also fund the buy-sell for multiple business entities
- The funding of the premium payments to the general partnership is treated as capital contributions by the partners to the partnership. The partners can get these premium payments as a bonus, if reasonable additional compensation, from the corporation. In addition, there is flexibility in allocating the premium expense among partners in different ways
- The partnership agreement can provide that any life insurance death benefit received by the partnership will be specially allocated to just surviving partners.¹
- Transfers of life insurance policy interests will generally not trigger the transfer-for-value rules since partnerships in which the insured is a partner and partners of the insured are exceptions for the rule

Concerns

- The IRS refuses to issue an advanced ruling on the establishment of a general partnership for the sole purpose of funding a buy-sell agreement. If the client's advisors are concerned about this, consideration may be given to adding other assets to the partnership. In addition, existing partnerships may be used when all corporate owners are partners of the partnership
- There may be a concern that a general partnership arrangement is not suitable because the individual partners will be subject to potential general partnership liability. In that case, an LLC taxed as a partnership may be an alternative solution
- This additional layer as a business entity has additional costs for creation as well as ongoing accounting and tax filings

1 IRC Section 704(a)
2 Rev. Proc. 96-12

While this communication may be used to promote concepts discussed in the publication, it is intended to provide general information and is provided with the understanding that Pinnacle Executive Benefits is not rendering legal, accounting, or tax advice. It may not be used to avoid penalties under the Internal Revenue Code. On all matters pertaining to legal, tax or accounting obligations and requirements, the appropriate counsel or other advisors should be consulted.

FOR ADVISOR USE ONLY

PEXB
PINNACLE
EXECUTIVE BENEFITS