



CONTINUING EDUCATION



Business Succession Planning Using Buy-Sell Agreements and Business Valuation



Transamerica Life Insurance Company

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Business Succession Options

Three choices:

- Liquidate business
- Continue business
- Sell business



Types of Business Entities

- Sole proprietorships
- Partnerships and limited liability companies (LLCs)
- C and S corporations



Sole Proprietorships

- Unincorporated business enterprise owned by one person
- Owner is personally liable for all financial obligations
- Sole proprietor retains control of business during lifetime



Partnerships and LLCs

- Partnership is voluntary association of two or more people entering into business for profit
 - Partnership may be limited or general
 - Profits, losses, liabilities, and assets are shared based on type of partnership
- LLC shares several of partnership's characteristics; for example, ability to pass through income at member's personal tax rate
- LLC also shares some traits of corporations
 - Members not exposed to unlimited liability
 - Must establish control measures similar to articles of incorporation



C and S Corporations

- Two types of corporations: C and S
- Advantages include limited liability and transferability
- S corporation income taxation is similar to partnership's
- C corporation profits may be subject to double taxation if paid as dividends
 - Taxable to corporation when received/earned
 - Taxable to recipient when received as dividends



Financing Buy-Sell Agreement

- Personal assets
- Borrowed funds
- Cash flow
- Business assets
- Installment sale
- Life insurance



Personal Assets

- May not have adequate cash to complete purchase
- May have to liquidate income-earning assets



Borrowed Funds

- Lender may reduce or cancel credit line if key person is lost
- Interest on loan for purchase may further deplete remaining assets
- Leveraged employee stock ownership plan (ESOP) is alternative if employee ownership is desired



Cash Flow

- Fund cash reserve over time for buyout purposes
- If event causing buyout occurs before reserve is fully funded, must borrow or liquidate to complete purchase



Business Assets

- Substantial liquidation may be required to fund buy-sell agreement
- Selling off large portion could jeopardize business's survival



Installment Payments to Heirs by Buyer

- If buyer dies before all payments made, seller may not receive any more payments
- Use of life insurance guarantees entire amount owed is paid to seller



Life Insurance

- Provides liquidity when needed most: at termination of owner's interest in business
- Policy cash values provide funds for buyout



General Provisions of Buy-Sell Agreements

Each owner agrees:

- To provide first right of refusal to other owners
- To purchase other owners' interests in event of retirement, death, or disability
- That all purchases be based on agreed-upon price



Types of Buy-Sell Agreements

- Cross-purchase
- Stock redemption
- Wait-and-see

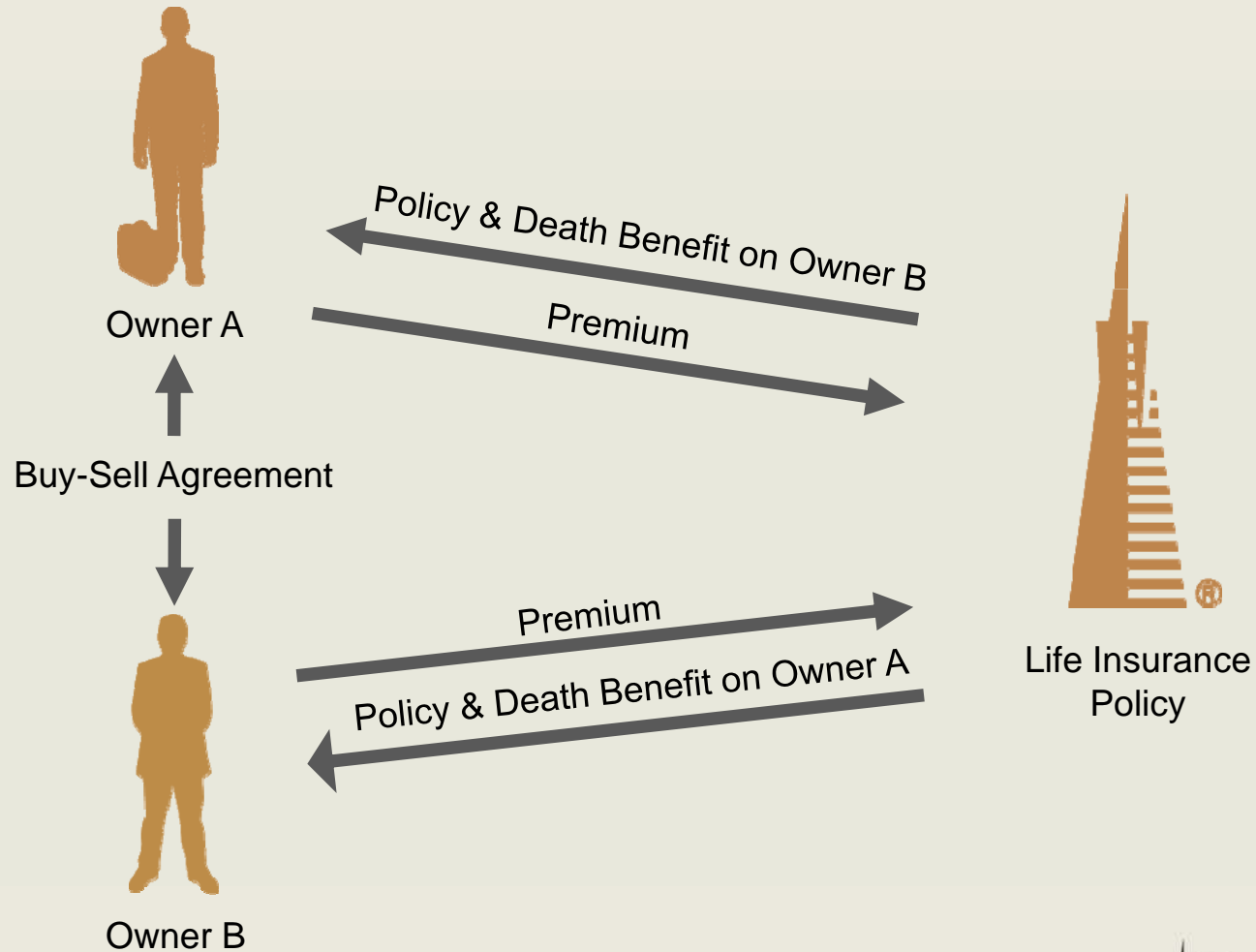


Cross-Purchase Buy-Sell Agreement

- Business owners agree to purchase ownership interests of other owners
- Often funded with life insurance
- Cross-purchase benefits
- Cross-purchase drawbacks



Cross-Purchase Agreement



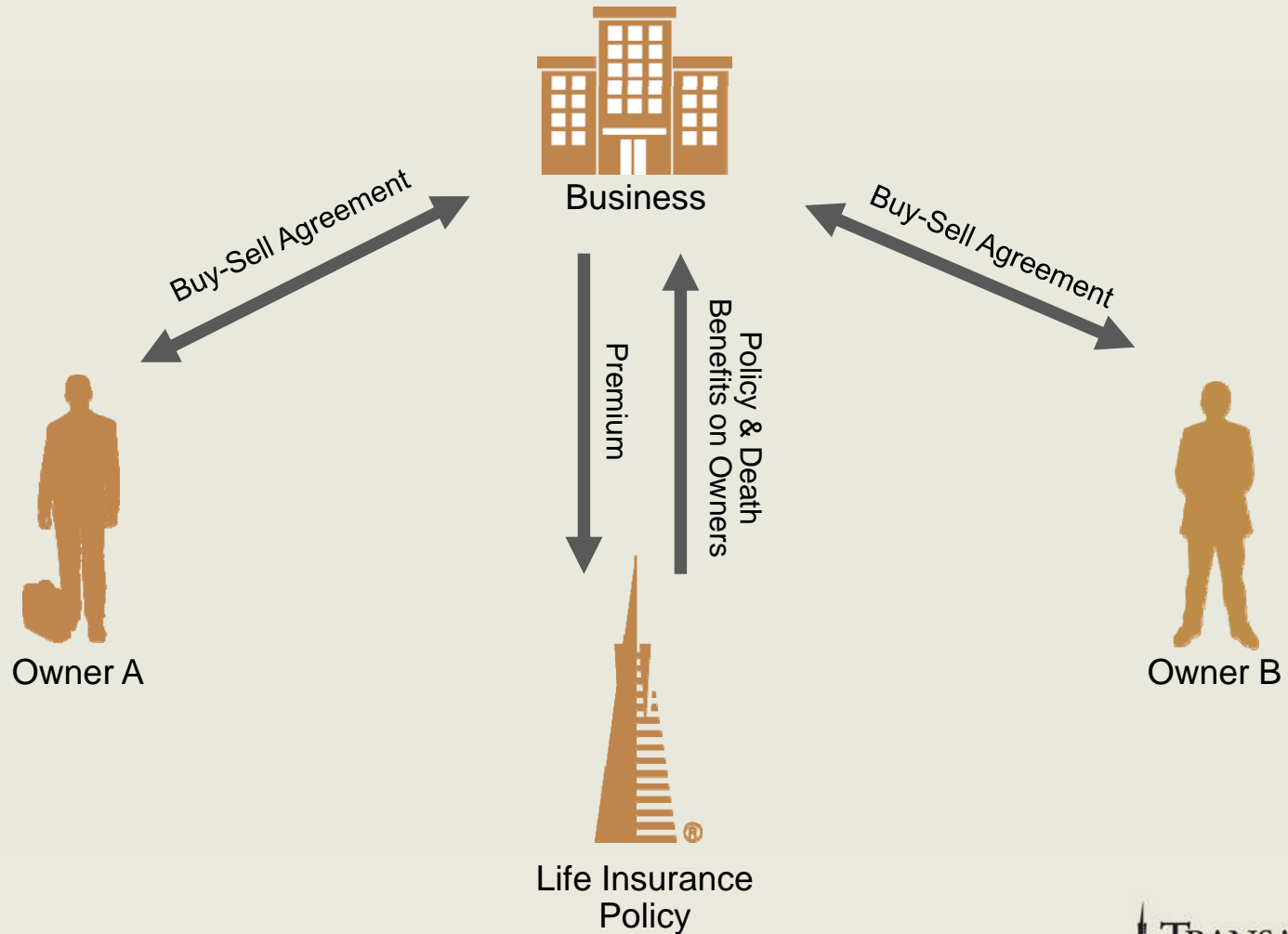


Stock-Redemption Buy-Sell Agreement

- Business entity agrees to purchase ownership interests
- Entity purchases one insurance policy per owner
- Stock redemption benefits
- Stock redemption disadvantages



Stock-Redemption





Example: Understanding How Step-Up in Cost Basis Is Calculated for Cross-Purchase Agreement

- Two C corporation owners, each with 50% ownership interest
- Total initial investment for both together is \$100,000 so each owner has \$50,000 basis
- Owners each purchase \$250,000 life insurance policy on other owner
- Surviving owner's ending basis now \$300,000



Example: Understanding How Step-Up in Cost Basis Is Calculated for Stock-Redemption Agreement

- Two C corporation owners, each with a 50% ownership interest
- Total initial investment for both together is \$100,000—each owner has \$50,000 basis
- Corporation purchases \$250,000 life insurance policy on each owner
- Surviving owner's ending basis remains \$50,000



Avoiding Dividend Treatment

- *General rule:* When C corporation redeems its stock, redemption payment will probably be deemed taxable dividend
- Three exceptions to rule:
 - Facts and circumstances prove that redemption not essentially equivalent to dividend
 - Complete redemption of all of shareholder's interest in corporation
 - "Substantially disproportionate" redemption



IRC Section 303 Redemptions

- What is § 303 redemption?
- How does § 303 redemption work?

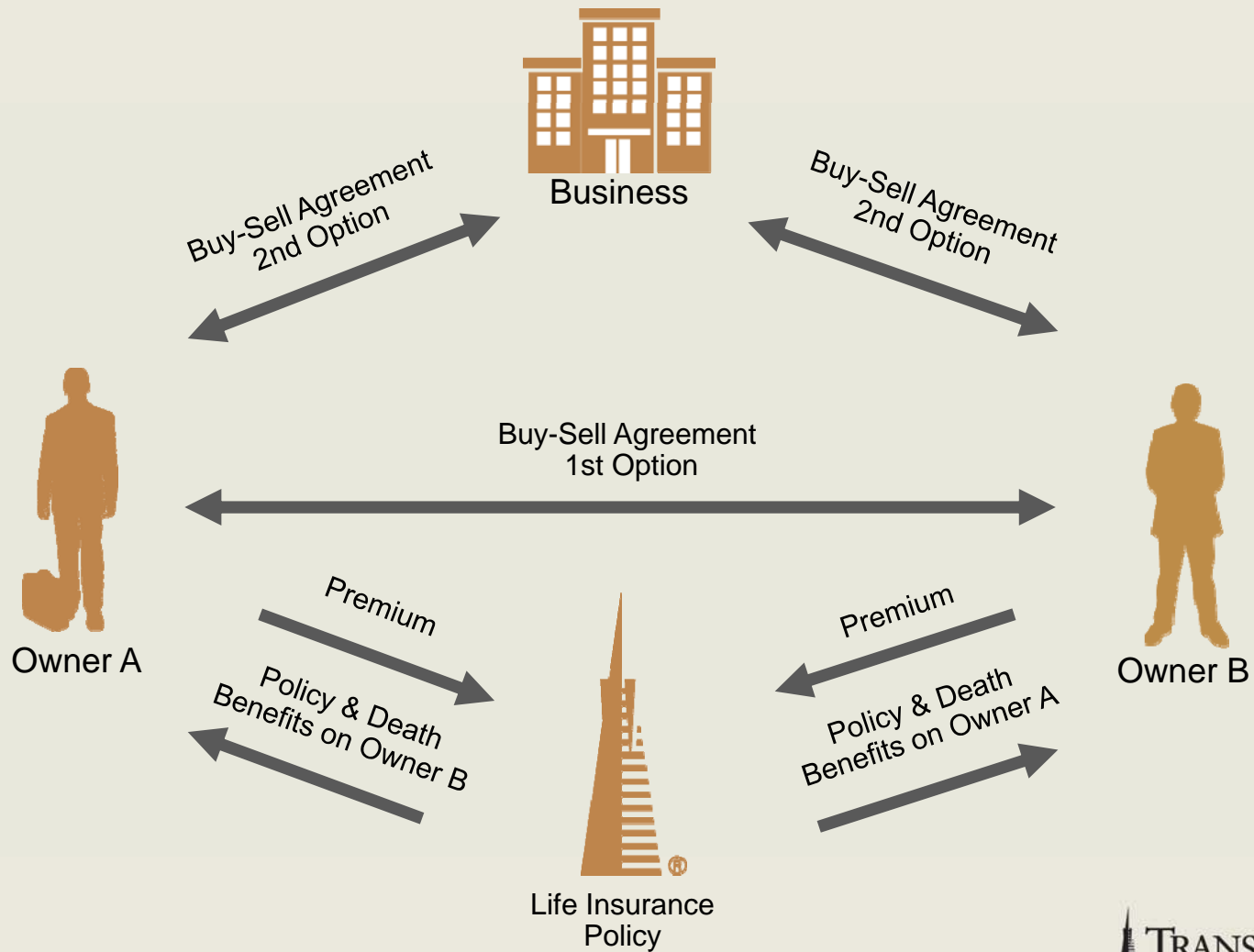


Wait-and-See Buy-Sell Agreement

- Accommodates changes in tax laws or business needs
- Actual purchaser of decedent's interest not determined until death of owner



Wait-and-See Approach





Reasons for Performing Business Valuations

- Bank financing
- Business and personal financial planning
- Employee ownership
- Buy-sell and key person funding
- Estate planning



Importance of Business Valuations

- Business entity often owner's most valuable asset
- Preparation for unexpected events
- Integral to success of buy-sell agreement



Business Valuation Methods

- Market approach
- Income approach
- Asset approach



IRS Guidelines on Business Valuations for Closely Held Businesses

Per Rev. Rul. 59-60, some of the most integral factors in IRS evaluations are:

- Nature and history of business
- General economic outlook and condition of industry
- Book value of business
- Earning capacity of business
- Business's ability to pay dividends
- Evaluation of goodwill and other intangibles



Calculating Business's Fair Market Value (FMV)

- Add value for control premium
- Decrease value for minority interest
- Compile and examine prior sales of company stock, if done in arm's-length transactions
- Compare market price of stocks in similar, publicly traded companies
- Examine price/earnings, price/book value, and price/dividend ratios



IRS Requirements for Binding Business Valuation

- Fixed price or price determinable by formula
- Fair and adequate price at time of agreement
- Estate bound to sell at predetermined price at death; purchaser obligated to buy, or have option to buy, decedent's interest
- Agreement must be arm's-length transaction



Using a Professional Valuation Firm

Third-party confirmation of business's worth provides credible source



IRC Section 101(j)

- Code Provision created by Pension Protection Act of 2006
- Establishes rules for EOLI
- Requirements for notice to and consent from the insured employee must be met prior to the issuance of the life insurance policy
- Unless requirements under Section 101(j) are met, death benefits from EOLI will be included in the gross income of the employer



Insurance Professional Plays Important Role

- Consults on business succession plan
- Ensures buy-sell agreement is written by qualified attorney
- Helps obtain valuation of business in timely manner
- Makes sure life insurance is purchased and properly structured



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