

Keeping Your Business Alive

By

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You've may have heard the grim statistics. Family firms comprise 80% to 90% of all business enterprises. More than 30% of these family-owned businesses survive into the second generation. Twelve percent will still be viable into the third generation, with 3% of all family businesses operating at the fourth-generation level and beyond.

You also know the dangers of not planning ahead for the transfer of your business at your death or when you retire.

- The IRS may value your business at much more than you think it's worth, making your estate potentially liable for estate tax.
- Your estate may have little or no cash to pay the estate tax, forcing your family to sell the business.
- If you own a partnership interest, your partners will have to hire someone to replace you, possibly at a higher salary since you were building equity.
- The partnership may experience a financial lag while the new person is learning the ropes.
- The family member you want to take over your business may not be ready to do so.
- Your fellow shareholders may be uncomfortable with the idea of a family member replacing you.
- Your family may wish to sell your share of the business to your co-owners, but the co-owners may not have enough money to buy it outright.

You're not worried, though. You've prepared for these possibilities with a business buy-sell agreement. But are you really prepared?

Do You Have the Right Agreement?

A buy-sell agreement outlines how business ownership will change hands and how the transfer will be paid for in case of a co-owner's death, disability, or retirement.

Generally, the agreement provides for the purchase of the departing business owner's interest by the surviving co-owners or the company itself.

A buy-sell agreement may be a cross-purchase arrangement or a stock-redemption arrangement. With a cross-purchase agreement, the owners agree among themselves to buy a deceased owner's interest. A stock-redemption agreement is an agreement between a corporation and its shareholders under which the corporation redeems stock in the event of a shareholder's death. Life insurance can be used to fund both.

Cross-purchase agreements have several advantages. For example, the surviving owners receive a “stepped up” income-tax basis in the stock bought from the deceased’s estate, which can reduce capital gains taxes if they later sell the stock. Additionally, the insurance proceeds from a policy used to fund a cross-purchase agreement aren’t subject to the corporate alternative minimum tax. Nor are they subject to the claims of corporate creditors.

On the minus side, cross-purchase agreements can be hard to administer, particularly when the business has numerous owners. For instance, since the owners carry insurance policies on each of their fellow owners, absent other planning, 30 separate insurance policies would be needed for a business with six owners.

Stock redemption agreements can be a better choice when a corporation has multiple owners, some of the owners are considerably older or younger than the others, the size of the ownership interests vary significantly, or the corporation is in a lower tax bracket than the owners. Despite the clear advantages, stock redemption plans have a couple of drawbacks. First, the life insurance proceeds received by the corporation may be subject to the corporate AMT. (Certain small corporations aren’t subject to AMT.) Second, the surviving shareholders do not get the benefit of an increase in the income-tax basis of their shares when the corporation redeems the stock.

Have You Avoided These Common Mistakes?

When you create a buy-sell agreement, you have to give careful consideration to how the contract fits your and other owners’ particular needs now and in the future.

One common mistake business owners make is not adequately funding their buy-sell agreements. For example, if two partners each own half of a business and agree to buy the other out in the event of death or incapacity, how will the remaining owner finance the purchase of the other half of the business? Most agreements use insurance as the funding vehicle. But business owners can get tripped up if the business increases in value and their insurance arrangements don’t keep pace with the increase.

Another mistake is not considering the possibility of an owner becoming disabled or divorcing. In the event of divorce, for example, an ex-spouse could end up as an unwanted partner. Other easy-to-overlook events that could adversely affect your business include the departure of a minority owner and the personal bankruptcy of one owner. When you structure your agreement, you should consider all the events that could cause an ownership change.

Perhaps the biggest mistake business owners make with their buy-sell agreements, though, is not keeping their business valuation up to date. Unless you have your business revalued regularly, the buyout amount in your agreement may quickly become outdated, leaving the business vulnerable to serious disputes should a buyout become necessary.

These are just some of the factors to consider when developing a business succession plan to keep your business alive for future generations. A professional financial advisor can help you identify the various issues and considerations that specifically affect your business and determine what type of buy-sell agreement and other planning strategies make the most sense for you.

For more information on how ESG and its national platform of M&A firms and Investment Bankers can help sell your business, please call us at 201-556-4618 or 1-866-807-0325, or email us at DPrisciotta@equitystrategiesgroup.com.

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