

“How to Fund the Plan to Exit Your Business”

By

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I meet many business owners who have a plan to exit their business but very few have considered the plan's funding mechanism. In many cases, they have spent the necessary time devising a plan, paid for an attorney to draw it up, even established the purchase price and intended to fund it when the need arises but are not certain where the financing will originate. The owners fully intend to figure this out, but while busy running a demanding business, the issue is low down on their list of priorities. Unfortunately, the unexpected can happen and making decisions during a time of crisis, such as an owner's death, is not a prudent strategy.

Claire's husband, Robert, died of a heart attack at age 42. Robert and his business partner, Bill, had drafted a succession plan five years previously and established a sinking fund for its implementation. A sinking fund is a means of repaying funds borrowed through a bond issue. The issuer makes periodic payments to a trustee who retires part of the issue by purchasing the bonds in the open market. During two lean years no payments were made and when Robert's untimely death occurred insufficient funds had accumulated. Bill did not have the funds to purchase Robert's interest in the business, from Claire. Claire had assumed she would receive a cash sum from the business if anything was ever to happen to Robert. Instead she was left with insufficient means to support her family.

Choosing a reliable source to fund a succession plan ensures that the funds are available for the remaining partners or shareholders when required. It provides security for their heirs, who stand to inherit the business owner's shares and ensures that all interested parties are treated fairly.

There are different funding methods, usually a life insurance policy is recommended as it has several major advantages. It ensures that the total financing is available from the outset instead of trying to amass the funds overtime as Robert and Bill attempted. Generally, not only can the proceeds be tax free if structured correctly, but the cash value of a universal life policy may be used for a buyout due to retirement or disability. A term life policy, with the advantage of lower costs than policies with a cash value, is another funding alternative. If the policy owner were to die in the first few years of coverage, a term policy would be less cost than a cash value policy.

The buy-sell agreement should specify a purchase price tied to the fair market value of the business. A predetermined formula to assess the future value of the business should be devised and included in the agreement. Obviously, as the business prospers the value of the business will increase and additional life insurance may be required. Guaranteed insurability options can be utilized on insurance policies to allow the insured to purchase additional coverage as necessary.

What happens if the business owner is uninsurable due to age or poor health? Hopefully, the uninsurable partner may hold a current policy that has appreciated in value and may be purchased by either the corporation or other shareholders. There are different tax consequences

to be considered. If the corporation buys the policy the proceeds are not taxable but the shareholders will be taxed when the policy proceeds are received.

When a corporation is a party to the agreement and purchases the policy or policies with after-tax dollars the corporation can deduct interest payments as an ordinary business expense, but the premiums are not tax deductible. In a Cross Purchase Agreement, the other shareholders or partners purchase the interest of the departing partner. This can become unwieldy if there are more than 3 owners as each owner must own a policy on the others, and the owners pay the premiums individually. For example if there were 5 owners, it would require 20 policies. Also, premium payments may be inequitable if there is a large disparity in the health or ages of the company ownership is unequal.

If an owner dies, his estate will own the policies on the surviving partners, therefore a method should be established which permits the remaining partners to purchase the insurance held by the estate. In addition to life insurance, the purchase of disability buy-out insurance may fund the agreement if the disability of a partner becomes the triggering event.

It is clear that the choice of funding must be integrated with the overall plan and business objectives of the owners. A thorough examination of the transaction should be completed by a qualified professional prior to the program's implementation.

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