A Registered Investment Advisor
Indfin.com/business

The One-Way Buy-Sell

Maybe the best kept secret in business succession.

Jim Lorenzen, CFP®, AIF®

According to the U.S. Census Bureau's "Statistics of U.S. Businesses"[i], more than five million firms employ fewer than 20 employees. This is the vast majority of businesses, when you consider that, in the same report, the total number of firms with 500 or fewer employees was just below 5,750,000.

Typically, small business owners are the active managers of their businesses, are heavily invested in their businesses, and generally rely on a small number of important accounts and suppliers. Also, in most, if not all, cases no secondary market exists for easy valuation and quick disposition of ownership interests – owners can't simply sell their ownership on an exchange; they have to seek out a private buyer.

Finding the right buyer can be problematic. Sellers hoping to find an all-cash buyer for their business are virtually always disappointed simply because buyers of small businesses generally either don't have cash available or what they do have is earmarked for reserves. The new buyer may not have the same industry or supplier contacts, banking relationships, or even the right background – all issues that can make accepting installment payments over time problematic, as well.

I know the feeling well. Years ago I was in the publishing business putting out weekly shopping guides and monthly coupon mailers. The business model was a combination of service, manufacturing, and distribution. We had a small staff but did amazingly well – well enough that I later ended-up teaching my systems to managers and employees at major publications across the U.S., Canada, and the U.K. The systems even translated to other major corporations outside publishing who also became clients.

I was young and successful at what I did; but, like many young business owners, I didn't know anything about – or give much thought to - businesses succession.

Getting Your Buyer In-Place Early

Many small business owners have their buyer right under their noses! Often, the ultimate business sale is made to a family member or a key employee. The next question is when?

The issues are fairly obvious:

- Does the family member or key employee have the money to buy the business? If not, how will the purchase be funded?
- If the sale is to take place at the owner's retirement, how can the owner secure his/her retirement income even if business reversals should occur?
- If the owner suffers a premature death, is the owner's survivor able to operate the business? If not, what happens to the survivor's retirement plans? What happens to the employees?

True Case History (names changed)

Roger built six small businesses in different locations around his state - all in the same industry. Each business unit was set-up as a separate corporation, each with a separate partner contributing capital, as well as active participation. He was able to attract partners for these corporations due to his strong industry track record. In essence, he was 50% owner of six corporations with six separate partners, each with 50% ownership of their operation.

Roger was doing fine, even if he was using leverage to expand. His wife, Joan, occasionally did payroll but was, for the most part, not really involved in the business.

Then it happened. Roger was diagnosed with cancer and passed away within three months. Joan was now 50% owner of six businesses she knew little about. Just as bad: The six partners had to deal with a 50% partner who knew nothing about the business; and none had the money to buy her out.

They had nothing in-place that could have addressed this issue.

All six operations soon became insolvent and filed for bankruptcy.

Roger did have a life insurance policy for $1 million. Their 'financial advisor', really an investment sales representative, told Joan he could invest it for her. He never told her that the $1 million death benefit could provide, at most, about $40,000 a year with a reasonable hope of not running out of money. Nor did he tell her that her home and lifestyle, currently consuming $100,000 annually would soon deplete this nest-egg. They had no other savings or investments because "the businesses would take care of her". He put Joan in high-commission investments, including $250,000 in a high-commission, illiquid limited partnership.

The businesses failed and Joan began going through her money, without knowing the danger lurking ahead.

A pre-funded solution can save a lot of headaches. And, done correctly, it can help solve other problems along the way.

One of the easiest solutions that can assist with providing the funding when it's needed, regardless of when, is called the **One-Way Buy-Sell**. It can be structured to maximize tax efficiency or to maintain long-term control – It can even be tailored to address estate planning concerns.

There are two types:

- Bonus structure – features a current tax deduction
- Endorsement split-dollar – provides long-term control to the owner

Both types actually help encourage participation for both the owner and buyer because of the financial incentives each receives.

Who's your buyer?

- Bonus structure – typically used in family situations where a next generation buyer is intended to assume control of the business.
- Endorsement split-dollar – usually the structure used when the sale involves a key employee outside the family.

Each structure has different characteristics:

Bonus structure – This is the most straightforward of the two strategies. A one-way buy-sell agreement is created with the help of legal counsel and a properly-designed life insurance policy serves as the funding vehicle. Life insurance is used simply because it's the only financial tool (I know of) that will immediately fund a sale due to a premature death.

While a qualified financial advisor can bring experienced strategic resources to the table that can help regarding agreement provisions, the agreement should be drafted by an attorney, regardless of the availability of sample documents or other help.

Typical provisions

- create an obligation on the part of the deceased owner's heirs to sell the business interest for an amount that is either specified in the agreement or determinable under its terms.
- create an obligation on the part of the buyer to purchase the business interest under the same terms.
- Restrict the sale of the business interest during the owner's lifetime to ensure the integrity of the agreement
- Require that appropriate amounts of insurance are maintained to facilitate the transaction.

How it works:

The owner bonuses the premium payments to the family member employee(s) as compensation. As compensation, the bonuses are tax-deductible to the business. The premium payments purchase life insurance coverage on the owner. Note: The business can "gross up" the extra compensation to account for all taxes, making the transaction income tax neutral to the recipient(s), and still be fully-tax deductible to the business.

iStock Images

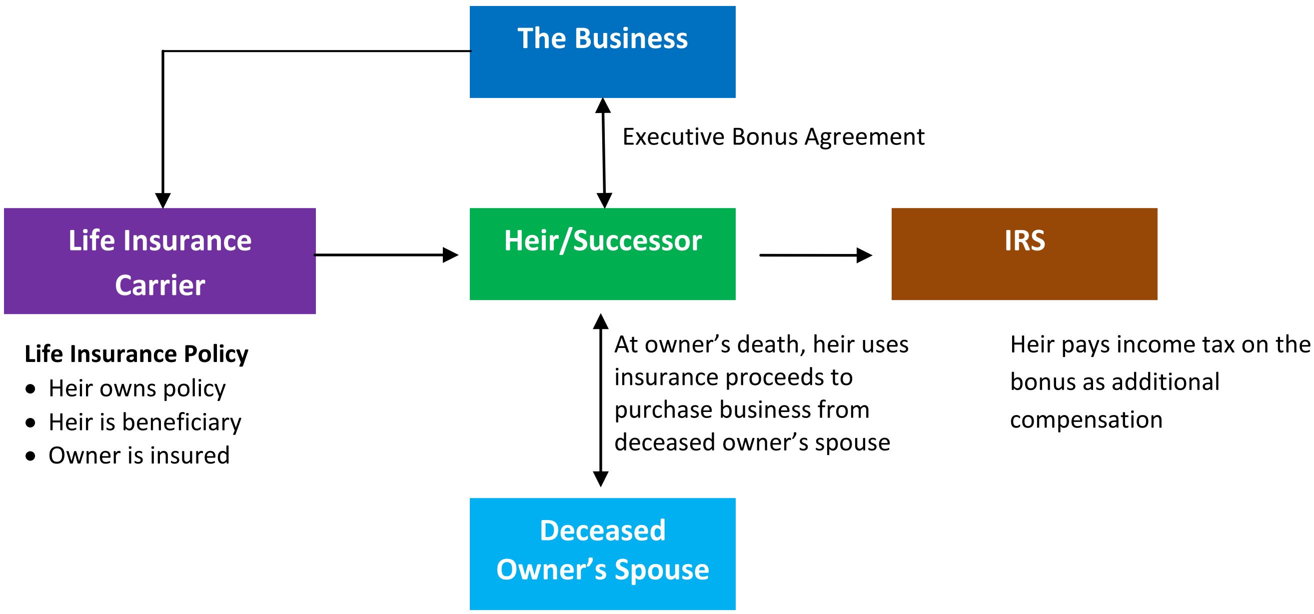
It's worth noting that the equity in the life insurance contract can be used as a 'sinking fund' that can be used on a down payment on a sale that takes place during the owner's lifetime. How much equity is available will depend on funding levels and policy design. The death benefit generally flows income tax-free.

This approach provides tax-deductible funding of tax-free dollars to buy-out the deceased owner's spouse and establishes a new owner's tax-basis in the business. It also creates liquidity outside the deceased owner's taxable estate that can be used to pay estate taxes while using leveraged dollars from the business to create funds for the purchase by the owner's heirs.

Endorsement Split-Dollar – Typically used when the sale involves a key employee from outside the family and more control is more important than the tax deduction to the business owner.

Under this arrangement, the owner can personally own the life insurance policy and endorse a portion of the death benefit to the key employee. The key employee will have to recognize the economic benefit for tax purposes, measured by either the I.R.S. table of annual term rates available or the issuing carrier's alternative rates (if available) times the share of the death benefit due to the key employee. It's like renting.

Example: One Way Buy-Sell Bonus

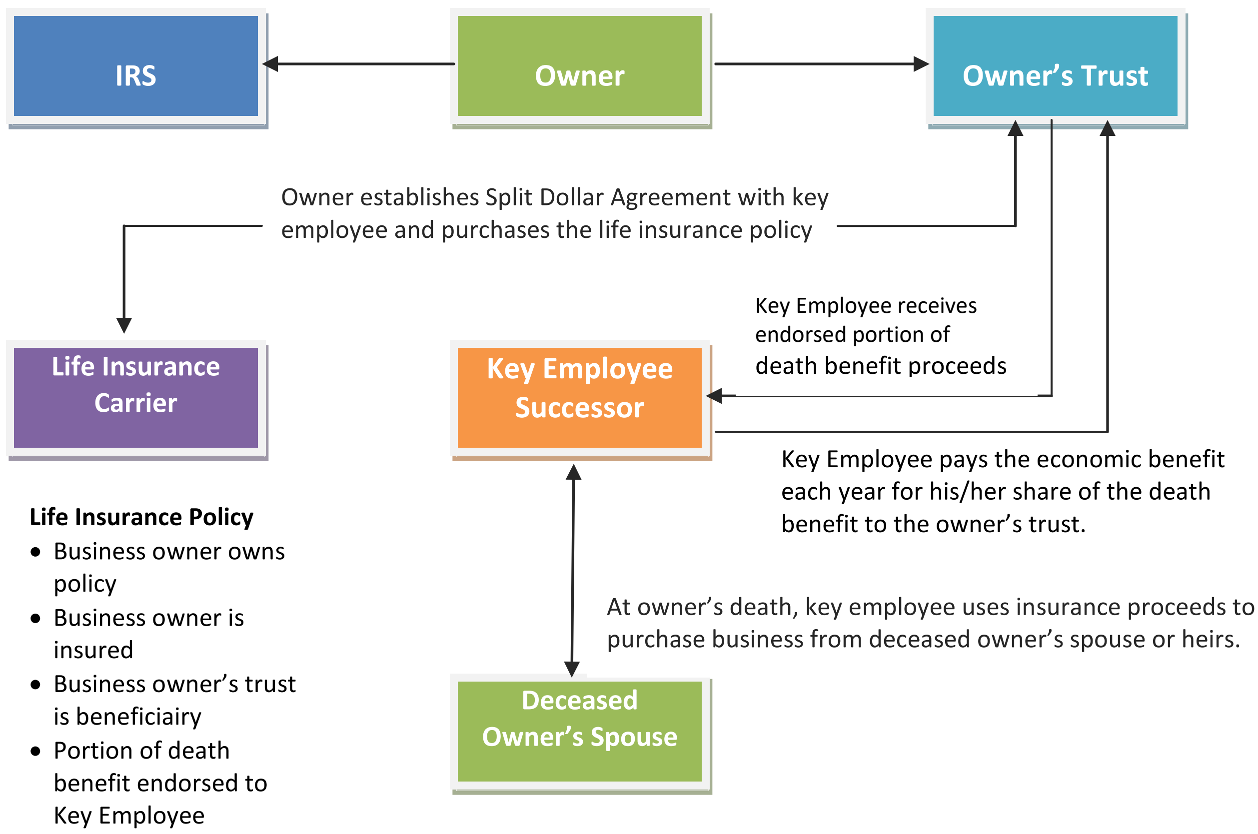


- **A "One-Way Buy-Sell" agreement is executed** between the business (owner) and heir/successor in which the owner is obligated to sell and the purchaser is obligated to purchase the business subject to the terms and conditions of the agreement, using funding provided by the life insurance whether the transfer is triggered by death, disability (rider), or retirement (policy's cash value).
    - The owner agrees s/he will not sell, assign, convey, encumber, or otherwise dispose of the business or any asset of the business except as allowed by the agreement.
    - If the owner decides to dispose of the business during his or her lifetime, the heir employee has first right of refusal.
- **The heir/successor purchases the policy** on the owner naming the heir as beneficiary. The heir has an "insurable interest" due to the buy-sell agreement.
- **The owner bonuses the heir/employee** so the employee can pay the premiums on the policy (see 'gross-up' above). The business can deduct the bonus and the employee pays income tax on compensation.
- **At the owner's death, the policy proceeds flow to the heir income-tax free.** The heir is obligated to buy-out the deceased owner's interest in the business. The heir/employee now owns the business and the deceased owner's heirs have sold their interest in the business.

What happens if the heir/employee leaves the business, or becomes disabled or dies before the owner? What if the owner decides to terminate the heir/employee?

The heir/employee, as owner of the policy could sell the policy for its fair market value to either the owner (the insured) or to the business.[ii] S/he could also gift the policy to the owner; but this could require an appraisal by a third-party and will likely require a gift tax return to report the value of the policy for the tax year the gift occurred. Either selling or gifting will require the policy to be included in the owner's estate unless the owner establishes an irrevocable life insurance trust (ILIT). The sale then could be made to the trustee of the ILIT based on its fair market value. Either way, if the heir/employee were unable to fulfill the terms of the agreement, preserving the policy through the sale to either the owner or the ILIT assures that the owner's heirs will be taken care of regardless of the disposition of the business.

Example: The Endorsement Split-Dollar Arrangement



Due to the grantor trust rules, trust income is taxable to the business owner; but, because the trust is irrevocable, the policy is outside the owner's estate.

Succession planning for a closely held business presents unique challenges not seen in businesses with multiple owners. **One-Way Buy Sell strategies provide owners with the flexibility to retain control of the business and its income right through the end of life, even while turning over day-to-day operations over to the key employee or family member.** It can be a highly tax-efficient way of funding succession planning while maintaining control. In addition, the key employee or family member becomes even more tied to the business.

Looking back on the true case history related on page 2, if Roger had arranged for a pre-funded buy-sell, whether with a family member (in this case there was none) or a key employee (each partner for each business unit), his successful business' cash flow could have easily provided the funds necessary to fund a buy-out. Joan would very likely have had sufficient funds to preserve her lifestyle and the surviving partners wouldn't have had to deal with Joan as 50% owner of a business she knew nothing about yet wanted to protect. Those businesses just might have avoided going into receivership.

An ounce of protection is worth…. you know the rest.

Jim Lorenzen, CFP®, AIF®
Founding Principal
THE INDEPENDENT FINANCIAL GROUP
A Registered Investment Advisor
California Insurance License #0C00742
2655 First Street, Suite 250
Simi Valley, California 93065
805-235-5416 • 800-257-6659
www.indfin.com/business

[i] Based on 2009 data and released Nov. 20, 2011, www.census.gov/econ/susb.

[ii] Either transfer qualifies as an exception to the Transfer for Value rules under IRS Sec. 101(a)(2)(B), preserving the income tax-exempt status of the policy's death benefit. Be sure to consult with legal counsel and your tax advisor.