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Importance of a Business Continuation Plan

Competing Interests of Heirs and Surviving Owners

These interests are many and may include the following:

What Heirs of Deceased Owner Want	What Surviving Owners Want
Top dollar for their interests	Minimum cost for the interest
Prompt settlement of the estate	Prompt transfer of the business interest
Set value of business for estate tax purposes	Full control of the business - no interference from decedent's family
Relief for family from worries regarding the business and its creditors	Continuing relationship with creditors
	Retention of customers and employees

Potential Problems Without a Written Agreement

Frequent results include:

- Heated conflicts among the remaining owners and the decedent's family.
- Unhappiness on all sides, and sometimes litigation.
- Delays in settling the estate and continuing business growth.
- Loss of customers and loss of business value.
- Possible liquidation of the business which may bring less than full value.

The Solution: A Written Agreement (and Cash)

Taking the time now to see that the business will pass in an orderly manner at time of death will benefit all parties and their heirs. A written agreement can provide:

- An orderly transfer of the operation, management, and ownership of the business.
- A mutually agreeable sales price and preservation of business value.
- Mutually agreeable terms of sale.
- A value that is binding on the IRS for federal estate tax purposes.
- Stability for customers, employees, creditors and investors.

An agreement which is favorable to all parties can be more easily drafted prior to a crisis.

Business Succession - Selling Your Business

The owner of a closely-held business faces a series of unique problems when planning to sell his or her interest in the business. Typically, an owner who would like to retire from a business can anticipate some difficulty in finding a buyer who is both willing and able to pay market value for the business, and who will be able to profitably operate the business once the retiring owner is gone. Careful planning can allow an owner to successfully make this transition, achieve a profitable sale of the business, manage the risks associated with operating the business during the transition, and reduce any potential income tax liability.

Necessary pre-sale planning includes ensuring that the business books and records are in order, all tax filings are current, any significant collections or legal issues are resolved, employee benefits are current and paid, and outstanding business debt is at a minimum. These key preparatory steps can add significant value for a potential buyer.

A Buyer for the Business

- **Employees:** Current employees, either key employees or other employees who have indicated an interest in managing the business, can be highly motivated buyers for the business.
- **Family members:** Children or other family members may be interested in purchasing the business.
- **Competitors:** Other business owners in the same field may wish to expand their operations.
- **Suppliers:** Suppliers or vendors may have an interest in the business.
- **Business broker:** An experienced business broker, one familiar with the specific industry or profession, can be helpful in finding a qualified buyer.

A "Phased-In" Transaction

If appropriate, ownership can be transferred over a period of time, allowing the new owner time to adjust to the responsibilities of management and providing for an orderly continuation of the business as the retiring owner has less and less involvement with daily business operations. The sale agreement can:

- Provide for shared ownership and control during the transition to the new ownership.
- Create an orderly transition between owners.
- Minimize potential conflicts that could disrupt successful business operations.
- Create incentives for the parties to successfully operate the business for the benefit of both.

Funding the Sale

In some instances the buyer will have the resources to pay the full purchase price, in cash. Borrowing the money, the sale of other assets, or private investors are all possible sources of funds.

Very often, however, the retiring owner will need to finance all or part of the sale and receive payments for the balance over a period of time. While this approach does entail a degree of risk, the sale can be structured as an installment sale, allowing for the deferral of reporting of both income and capital gain until the year payments are actually received.[1] An installment sale also replaces an income source that might otherwise be lost once the business is sold.

Death or Disability of the New Owner

If a retiring owner chooses to finance the sale of the business, continued payments are often dependent on the successful operation of the business by the new owner. In the event of the death or disability of the new owner, the business may fail and payments to the retired owner stop. The retiring owner can protect against these risks by requiring, as a part of the sale agreement, that life and disability insurance be purchased on the new owner, with benefits payable to the retiring owner.

Income Tax Considerations

There may be a significant income tax liability when the business is sold. Under an installment sale, the interest portion of each payment is treated as ordinary income. A sale of a business also usually involves capital gains or losses, although the tax treatment is dependent, in part, upon the form of the business entity sold:

[1] The discussion here concerns federal income tax law. State or local law may differ.

- **Sole proprietorship:** A sole proprietorship is not considered a separate entity apart from the assets of the business. The sales price is allocated among each of the individual business assets, with a resulting gain or loss reported for each asset.

- **Partnership:** An owner who sells a partnership interest generally realizes a capital gain or loss on the difference between the amount realized less the adjusted basis of the partnership interest. The sale of certain assets such as inventory may be treated as ordinary income rather than capital gain.

- **Limited liability company (LLC):** The federal government does not recognize an LLC as an entity classification for income tax purposes. An LLC must file as a sole proprietorship, a partnership, or a corporation.

- **Corporation:** An owner of a corporation can either sell his or her corporate stock or the assets of the corporation:

  - *Sale of corporate stock*: From the retiring owner's perspective, a sale of corporate stock is highly preferable, since the resulting capital gain or loss is realized only by the retiring owner, with, generally, no tax impact to the corporation. A portion of certain qualified Small Business Stock sales may be excluded from tax.

  - *Sale of corporate assets*: From a buyer's perspective, however, a sale of corporate assets is usually preferable since the buyer receives a basis in the assets equal to the purchase price. If the seller is a "C" corporation, an asset sale can result in a double tax liability; any gain is taxable to the corporation, with additional tax payable by the shareholder when the corporation is dissolved and funds distributed. If the seller is an "S" corporation, tax liability is generally paid by the shareholder, but a corporate tax may also be due if the asset sale results in any built-in gains.

Seek Professional Guidance

The successful sale of a business interest requires careful planning, sometimes well in advance of an actual transaction. The guidance of experienced tax, legal, insurance, and other financial professionals is strongly recommended.

Buy-Sell Agreement

In order to guarantee a buyer for the interest in a business (particularly a minority interest which may be of very little value to one's heirs), consideration should be given to a lifetime agreement among the business owners as to how to dispose of the business.

Entity Plan

Under an entity plan the organization buys the interest of the deceased business owner. This type of arrangement is often used when there are several owners.

Cross-Purchase Plan

Under this plan each surviving owner agrees to buy the interest of any deceased owner.

An attorney should be consulted in deciding which plan is better.

Advantages of Buy-Sell Agreements

- Guarantees a buyer for an asset that probably will not pay dividends to one's heirs.
- Can establish a value for federal estate tax purposes that is binding on the IRS. See IRC Sec. 2703.
- Spells out the terms of payment and is easily funded with life insurance and disability insurance.
- Provides a smooth transition of complete ownership, management, and control to those who are going to keep the business going.

Funding a Buy-Sell Agreement

Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. If these regulatory requirements are met, the proceeds can be received income-tax free. State or local law may vary. Professional legal and tax guidance is strongly recommended.

Reasons to Value a Business

The following are a few of the most common reasons to value a business:

- Establish a purchase price in a buy-sell agreement.
- Determine the size of the gross estate for death tax purposes.
- Determine if the estate qualifies for tax relief provisions, such as:
  - IRC Sec. 303 stock redemption.
  - Installment payments of death taxes (IRC Sec. 6166).
  - IRC Sec. 2032A current use valuation of business-owned real estate.
- Plan for an equitable disposition of the estate among children where some are active in the business and some are not.
- Determine the value of lifetime gifts of the business.
- To develop an exit strategy when planning retirement.

Other reasons include private annuities,[1] installment sales, obtaining financing, recapitalizations, mergers, divorce settlements, charitable contributions, etc.

Fair Market Value

Treasury regulations set forth the following definition for fair market value.

"...the net amount which a willing purchaser...would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." See Reg. Sec. 20.2031-3.

[1] On 10/17/06, the IRS issued proposed regulations (NPRM REG-141901-5) on the exchange of appreciated property for an annuity contract. These proposed regulations treat the transaction as if the transferor had sold the property for cash and then used the proceeds to purchase an annuity contract. These proposed regulations were generally effective for transactions occurring after 10/18/06, with a six-month delay until 04/18/07 for certain types of transactions.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.