BUSINESS STRATEGIES

The Benefits of Establishing a Buy-Sell Arrangement

BUSINESS CONTINUATION

Business owners need to plan for the continuation of wealth and control of the business.

For many business owners, the focus is on today—running the business, managing day-to-day operations and expenses, and growing revenues. Most business owners can't imagine the day when they will be unable to participate in their business. However, that day arrives sooner or later, and business owners need to plan for the continuation of wealth and control of the business. Without proper planning, death, disability, or retirement can create chaos for all parties involved.

One solution.

A buy-sell arrangement can help ensure that the business will continue and can eliminate many of the difficulties and uncertainties for the remaining owner(s) and their heirs. However, without adequate funding to ensure that the buy-sell can be implemented as documented, the arrangement may fall by the wayside. A solution to consider is life insurance.

Life insurance can not only help provide the needed funds at death, regardless of when death occurs, but it also can be the most cost-effective method for the purchase of the business, as small premium dollars can generate lump sum, income tax-free death benefits under IRC §101(a).[1] Plus, where cash value life insurance is purchased, the policy serves double duty, since the cash value accumulates on an income tax-deferred basis and can be accessed through withdrawals and/or loans to fund the down payment for lifetime buyouts.[2]

BENEFITS TO THE BUSINESS ENTITY

- **Enables the execution of a smooth transition in the control and ownership of the entity, allowing the business to remain in good standing with clients, creditors, and employees.** At an owner's death, incapacity, or retirement, a business is often thrown into turmoil because the person who was the driving force in the business is no longer there. A carefully structured buy-sell arrangement permits the owner to begin the process of transferring ownership and control before the triggering event—allowing for a smoother transition.
- **Prevents unwanted parties from acquiring an ownership interest.** A properly drafted agreement will help prevent meddling family members from becoming involved in the daily decision-making of the business or third-party competitors from acquiring the business.
- **Provides an independent mechanism for determining a price or pricing formula for the business interest, decreasing the potential for disputes.** It is simpler for all parties involved to negotiate payment terms before the fact, when presumably no party is operating from a position of weakness and emotions are not at a high. Not only does a buy-sell agreement set pricing parameters prior to the event, but flexible drafting can also give "first rights of purchase" to family members, ensuring that they are given priority over third-party buyers.
- **Helps avoid transfers that could have a negative impact on the business entity's formation or tax status.** For example, tax rules exist that dictate what types of individuals or entities can have an ownership interest in a business structured as an S corporation. Shares transferred to a prohibited shareholder terminate the S corporation tax status, causing the business to be taxed as a regular C corporation. A buy-sell agreement can prevent this from happening by requiring that stock be transferred only to eligible S corporation shareholders.

PRUDENTIAL ADVANCED MARKETS TEAM — EXPERIENCED GUIDANCE FOR COMPLEX CHALLENGES

[1] For employer-owned life insurance policies issued after August 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally income tax-free under IRC §101(a).

[2] Based on sufficient death benefit and/or cash value availability. Loans and withdrawals may reduce policy cash values and death benefits, may affect policy guarantees, and may have tax consequences.

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BENEFITS TO THE DECEASED OWNER'S ESTATE/HEIRS

- **Creates a market for the deceased owner's interest.** Closely held business owners often have a difficult time locating a willing buyer for their interest. Without a buy-sell arrangement in place, this could possibly force an estate to sell the interest for less than it is worth. An enforceable buy-sell agreement ensures that a buyer is available and that the "price is right."
- **Establishes the value of the interest for federal estate tax purposes.** An "arm's-length" negotiated value documented properly in the buy-sell agreement helps to establish business value at an owner's death, reducing the possibility of IRS challenge.
- **Provides for increased efficiency in the administration of the owner's estate.** Since the terms of the sale have been completed during the life of the owner, a buy-sell arrangement can help prevent delays in the administration of the estate and alleviate disputes between the deceased owner's heirs and the surviving business owners.
- **Relieves the heirs of the estate from the affairs of the business.** Heirs who are not participating in the business generally will not want to be exposed to the ongoing risks of operating a business. A funded buy-sell arrangement can help to ensure that disinterested heirs are bought out and protected from any business risks.
- **Ensures that the estate receives cash for estate liquidity, survivors' income, or other family needs.** Often the bulk of an owner's estate is tied up in non-liquid business assets. Without a buy-sell arrangement in place, the personal representative may have to sell assets under less than favorable conditions in order to pay estate taxes or provide a living allowance for the surviving spouse and minor children.
- **Avoids negotiating price and terms when the estate may be in a weak bargaining position.** The lack of a valid buy-sell agreement at an owner's death alters the negotiation playing field. When an estate is facing administrative and tax costs and has few liquid assets, a "fire sale" may be the result.

BENEFITS TO THE SURVIVING OWNERS

- **Helps to prevent disputes between heirs of the deceased owners.** Disputes commonly occur from the clash between passive owners' short-term goals, which favor return on investment and frequent distributions, and the long-term goals of active owners, who are typically more interested in retaining funds to grow the business. Both parties' objectives can be met if a funded buy-sell arrangement is in place and inactive heirs are bought out.
- **Helps avoid a moral dilemma that could arise from negotiating with the spouse and children of a deceased owner.** While the personal feelings of the surviving owners might lean towards "generosity," the fact remains that the remaining owners have a fiduciary duty to the business and an obligation to their creditors. One solution is a prearranged, funded buy-sell arrangement to help ensure that all parties to the transaction receive the needed funds to continue.

Guarantees are based on the claims-paying ability of the issuing insurance company.

Life insurance is issued by The Prudential Insurance Company of America, Newark, NJ, and its affiliates. Like most insurance policies, our policies contain exclusions, limitations, reductions of benefits, and terms for keeping them in force. A financial professional will be glad to provide you with costs and complete details.