

Savvy Succession Planning for Business Owners

By

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For any “wannabe” entrepreneur, perhaps one of the most worrying questions to answer before becoming self-employed is, “How can I provide security for my family?” Giving up the comfort of a regular salary is not for the fainthearted and even after surviving the first five years of business, most owners will admit that it is an issue that still causes them some sleepless nights.

As all business managers know, the only way to deal with ‘what-if’ worries is to look the problem squarely in the eye and find solutions to mitigate the risk. Part of the solution is a well-crafted buy-sell agreement, which is a legally binding contract detailing the terms of ownership transfer between the owners of the company. It ensures, not only the continuity of the business, but that all parties are treated fairly. It answers the questions... What will happen if one of the owners dies or becomes disabled? Who will purchase the company? Where will the money come from to pay for it? How much is the company worth? Will the deceased owner’s family be taken care of?

A buy-sell agreement solves a lot of problems before they arise, not only about owners’ interests, but regarding the concerns of employees, suppliers and clients’ and creditors’ perceptions of the business.

Consider Jim Taylor, a well-respected graphic designer and his two partners: Carl and Joanne. Their business has been built on Jim’s reputation as an exceptional designer. He has never been able to see himself as retired but recent health problems have forced the issue. Jim is expecting to draw money out of the business to fund his retirement but has yet to draw-up a salary continuation agreement. From a second marriage, he has younger children to support and is concerned about their future welfare. In the event of his death, his ownership share would pass to his wife, who would become part owner of the business. Jim’s partners are concerned that in order to meet the needs of her young family, Jim’s wife may be able to force the sale of the business. The uncertainty has made Joanne restless. Secretly, she has been considering an ownership position offer from a competing company. Carl is convinced the company needs to secure the loyalty of a highly talented key employee by allowing him to buy ownership in the company. All of these issues can be addressed by a buy-sell agreement.

There are three basic types of agreements: Entity Purchase (a redemption plan), Cross-Purchase and the “Wait-and-See” agreement. The Entity purchase allows the business to purchase the interests of individual owners. In a Cross-Purchase agreement, the owners agree to individually buy the interests of the seller using a pre-determined formula. The “Wait-and-See” contract allows owners to defer the decision of a Cross-Purchase or Entity Agreement until they can determine which would be most beneficial.

A good buy-sell agreement contains key elements, which ensure the smooth transition of the ownership of the business. It should address the type of buy-out, the triggering events (death,

divorce, disability, retirement, desire to sell or employment termination) and most importantly, the method of funding the sale. Plus a pre-determined formula to assess the future market value of the business in the event of ownership transfer. A thorough analysis of the tax effects of such a transaction should be undertaken by a tax expert and included in the wording of the buy-sell agreement. Tax consequences to the individual owners and the company should be carefully assessed.

There are many 'do-it-yourself' documents on the market today but like a pre-nuptial agreement you will need the advice of a good attorney and financial professionals! You want the agreement to withstand IRS scrutiny, any possible litigation attempts or the interference of outside parties. In two following articles, we will address how to fund the agreement and determining the market value of a business.

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