How Can I Preserve My Smaller Business?

Where Small Businesses Are Vulnerable

In a small to medium-sized business, the death of a partner or key officer/shareholder reduces the value of its business assets (as well as legally terminates a partnership). In order to preserve the partnership assets, the survivors must liquidate the partnership with care. The partnership's reformation must deal with different needs. Typically, the surviving partners wish to continue the business without the deceased partner's heirs. The deceased partner's family is most concerned with income replacement.

The death of a stockholder in a small, closely held corporation also creates a substantial risk of business failure. At best, the corporation may face a serious loss of business, reduction in asset values and the loss of jobs.

All of the above consequences may be avoided with a carefully planned buy-sell agreement.

Buy-Sell Agreement
A popular method of keeping a business in operation after the death of a partner or a major officer/shareholder is the use of the Buy-Sell Agreement (also known as a Business Continuation Agreement).

A typical buy-sell agreement between the partners allows the surviving partner to purchase the interest of the deceased in order to keep the business operating and keep it out of the deceased's estate and probate. A buy-sell agreement stipulates that if one partner dies, the other partner will have the right to purchase the deceased partner's share of the business at a predetermined price or according to a specified formula.

In a small business where money is often tight, finance is the critical piece of the buy-sell scenario. The purchase of a life insurance policy is an ideal way to fund the agreement.

For purposes of illustration, let's assume that we have two partners who formulate a buy-sell agreement. In the formulation of the policy, they agree that each will take out a $100,000 policy on the other. Their small corporation purchases the life insurance. Upon the death of one, the other will have the money to pay to buy out half of the business.

Cross-Purchase Plans

If the two partners were to personally purchase the life insurance on the other, the arrangement would be referred to as a Cross-Purchase Plan. Let's assume for a minute that we have multiple partners. If we have six partners and try to do a cross-purchase plan, then each partner would own 5 policies on the other partners for 30 total policies. While this may be a life insurance salesperson's dream, it certainly isn't a practical arrangement. In this situation, we would be more likely to use the entity agreement. In an entity agreement, the partnership owns Life insurance on each partner, and the partnership agrees to purchase the share of the business that belonged to the now deceased partner. This requires 6 policies rather than 30.

The Advantages

While the Life insurance premiums are not tax deductible, the proceeds are not subject to federal income tax. Further, a funded buy-sell agreement offers other advantages, including:

* A fair market value for the business is established
* Funding ensures that the surviving family is financially compensated
* The agreement legally binds the partners
* Each partner's interest in the business is determined
* The partnership gains greater security
* The employees' jobs at the business become more secure
* The money is available to implement the agreement

It's extremely important to involve both an attorney and an accountant when arranging a buy-sell agreement since the written terms vary with the structure of the business.