Premier Insurance Contracts, Inc
contact@prinsuco.com

Business Continuation Planning

Even the happiest, healthiest, most successful business owners may face the unexpected. That's why one of the key tools in any business owner's toolbox is a business continuation plan.

Why You Need a Business Continuation Plan

You've worked hard to build a successful business, but have you worked as hard to ensure it continues beyond your retirement, possible disability, or death? Unfortunately, we cannot know what the future has in store, so it's wise to prepare for a range of possibilities.

Many businesses are continued by a spouse, child, or other family member. This may be an easy decision if you have an heir with the aptitude and desire to take the reins; however, if your intended successor suffers from a lack of knowledge, experience, or motivation, your business could face a risky future. In this case, it might make sense to consider selling your business to co-owners, outsiders, or even your own employees.

If you think selling may be the right decision for your company, bear in mind that it could take five to ten years to find a qualified buyer. On the other hand, if passing along the business to a family member is your likely course of action, consider that the transition from one generation to another, if not planned carefully, can be one of the biggest threats to a family-owned business.

These are just some of the reasons why creating a business continuation plan now makes sense.

Creating a business continuation plan

With proper planning, you can help ensure that your business and the people whose incomes and lives depend on it will succeed when you're no longer at the helm.

A business continuation plan typically has three steps:

- Business valuation — determining how much your business is worth
- Succession planning — deciding who will take over once you step aside
- Developing a buy-sell agreement — creating a contract that secures your interest in the business in the future transition to new ownership

In this workbook, we'll take a closer look at each of these steps.

PREMIER
INSURANCE CONTRACTS, INC.

Business Valuation

Business valuation is a critical component to business continuation planning. Your business may be your largest asset, and if you plan to sell or pass along your closely held business at some point in the future, you will need to determine its worth for both selling price and tax purposes.

Perhaps a key reason to be concerned about valuation is the Internal Revenue Service (IRS), which is always on the lookout for sales of assets that are made at below or even above fair market value. If you sell assets below market value, the IRS could deem the sale a partial gift, and charge you gift tax on the difference between the sale amount and the amount the IRS determines to be a fair selling price. On the other hand, a sale above market value may also be deemed a gift — from the buyer to you — and gift taxes will apply accordingly.

Because transactions are valued by the IRS on the date of transfer, a business valuation should be determined (or updated) as near to the transaction date as possible.

How to determine value

The valuation of large, publicly traded companies is usually set by the buyers and sellers in the market through active trading. This price is generally accepted as the fair market value. With a closely held business, however, there isn't an active market, so valuation becomes much more challenging. This is one reason why you should consider engaging the assistance of a qualified accountant or professional business appraiser. If you plan to sell your business, be aware that lenders often require a professional appraisal before they will extend credit to interested buyers.

According to IRS guidelines, there are three generally accepted valuation approaches. A professional may employ one or more of the following techniques, depending on the purpose of the valuation, the nature of your business, and other relevant factors.

1. With the **asset-based (or cost) approach,** the balance sheet becomes a key resource. You determine the fair market value of fixed assets and equipment, as well as the wholesale value of current inventory, minus any liabilities. Three types of analyses may be used:

- **Book value:** The book value fairly represents the value of the business's underlying assets, less its liabilities.
- **Adjusted book value:** This method takes into account many of the same considerations as the book value, but it adjusts for the assets that have risen or fallen in value.
- **Liquidation value:** This method does not consider the business as an ongoing concern but rather assumes the business would cease operations, sell its assets, and pay off all its creditors.

2. The **income approach** assumes that your business's ability to earn income is the best indicator of its value. There are two primary methods

PREMIER
INSURANCE CONTRACTS, INC.

of determining the value of a business using this approach:

- **Capitalization of earnings:** This formula determines the company's value based on its continuing ability to earn profits, rather than on the worth of the company's assets.
- **Discounted future earnings:** This approach attempts to estimate the future earnings of the company and then discounts them back to the present to determine the value of the company.

3. The **market approach** attempts to determine the value of a business by comparing it to similar enterprises that have sold recently. Adjustments can be made to account for differences in size, risk, market position, and other factors.

The nature of the business itself may indicate the preferred method of valuation. For example, while the asset-based approach is often used to determine the base value for a business considering liquidation, it may also be the most appropriate method for a holding company with a significant amount of real estate.

Another factor to consider is that any valuation is just a subjective estimate, based on a number of variables that can change over time. Disputes over perceived value can occur between seller and buyer, and even between business owners and the IRS. Also, inaccurate valuations for tax purposes can be subject to penalties.

Despite the importance of family business succession plans, just 58% of family businesses have succession plans, and most are informal.

Source: 2019 US Family Business Survey, PwC

Succession Planning

Determining what will happen to your business in the event of your retirement, death, or disability is called succession planning. When developing a succession plan, you will face many decisions. Should you sell your business or give it away? Should you structure your plan to take effect during your lifetime or after your death? Should you transfer your ownership interest to family members, co-owners/partners, employees, or an outside party? Having a documented succession plan in place can not only clarify the future for you and your family, but also for your business and legal advisors, investors, and even your valued customers.

When you develop a business succession plan, you have two basic choices: You can sell your business or you can give it away. Once you choose whether to sell or gift, you can create a plan that takes effect either during your lifetime or upon your death.

Selling your business

You can sell your business outright, choosing the right time to sell — now, at your retirement, at your death, or anytime in between. The sale proceeds can be used to maintain your lifestyle or to pay estate taxes and other final expenses. As long as the price is at least equal to the full fair market value of the business, the sale will not be subject to gift taxes. (If the sale price is deemed to be too low, it could be considered a gift to

PREMIER
INSURANCE CONTRACTS, INC.

the buyer. Alternatively, if the sale price is deemed to be too high, it could be considered a gift to the seller.) But if the sale occurs before your death, it may result in capital gain tax.

You can also choose to sell your business interest via a buy-sell agreement, which is a legally binding agreement that establishes when, to whom, and at what price you can sell your interest in a business. A typical buy-sell agreement gives the business itself or any co-owners the opportunity to purchase your interest in the business at a predetermined price. This can help avoid future adverse consequences — such as disruption of operations, entity dissolution, or business liquidation — that might result due to your sudden incapacity or death. A buy-sell agreement can also minimize the possibility that the business will fall into the hands of outsiders. More details on buy-sell agreements can be found later in this workbook.

Gifting your business

If you're like many business owners, you'd prefer to have your children inherit the result of all your years of hard work and success. Of course, you can bequeath your business in your will, but transferring your business during your lifetime has many additional personal and tax benefits. By gifting the business over time, you can hand over the reins gradually as your offspring become better able to control and manage the business on their own, and you can minimize gift and estate taxes.

Gifting your business interests can help minimize gift and estate taxes because:

- It transfers the value of any future appreciation in the business out of your estate to your heirs. This can be especially valuable if business growth is expected.
- Gifts of $15,000 (2019) per recipient are tax free under the annual gift tax exclusion.
- Aggregate gifts of up to $11,400,000 (in 2019) are tax free under your lifetime exemption.
- Partial interest gifts (such as with grantor retained annuity trusts, grantor retained unitrusts, or family limited partnerships) may be valued at a discount for lack of marketability or restrictions on transferability.

Another option: liquidation

While technically not a "succession" plan, per se, liquidation is also an option. In many circumstances, liquidation may be an appropriate choice; however, often liquidation can be the result of a forced sale or lack of planning on the part of the business owner. Before determining whether liquidation is the right option for your business, be sure to examine all possible consequences, including income and estate taxes and the loss

PREMIER INSURANCE CONTRACTS, INC.

of future income for your family. A better route might be a sale or transfer of ownership.

Developing a Buy-Sell Agreement

Another type of agreement — the unilateral or one-way buy-sell — may be used when only one owner is selling an interest. It is often used when a sole owner is arranging to sell the entire business to a family member or key employee.

Buy-sell agreements are important planning tools that can accomplish many objectives for a business with two or more owners. They are primarily used to ensure the smooth continuation of a business after a potentially disruptive event, such as the owner's retirement, disability, or death.

A buy-sell agreement is a legally binding agreement that establishes when, to whom, and at what price you can sell your interest in a business. A well-crafted buy-sell agreement creates a market for your business interest, establishes its price, and provides cash to complete the business purchase.

The ability to fix the purchase price as the taxable value of your business makes a buy-sell agreement especially useful in estate planning. Agreeing to a purchase price can minimize the possibility of unfair treatment to your heirs. And if your death is the triggering event, IRS acceptance of this price as the taxable value can help minimize estate taxes.

Additionally, because funding for a buy-sell agreement is typically arranged when the agreement is executed, you're able to ensure that funds will be available when needed, providing your estate with liquidity that may be needed for expenses and taxes.

Nuts and bolts

A buy-sell can be a separate agreement or can be created by including buy-sell provisions in a business's operating agreement.

It must clearly identify the potential buyers, any restrictions and limitations, and the conditions under which a sale will occur. Sale triggering events typically include death, long-term disability, retirement, divorce, personal insolvency or bankruptcy, criminal conviction, loss of professional license, and resignation or termination of employment.

A buy-sell should set forth the purchase price or a formula for determining the purchase price. Without establishing this price in advance, lengthy disputes and lawsuits can arise at the time the ownership interest must be bought back.

When the buy-sell involves family members, it must also be proven that the transaction is comparable to arms-length sales between unrelated people, and was entered into for a bona fide business purpose.

Financing a buy-sell agreement

A key step in creating a buy-sell agreement is establishing the source of funds for the buyout. Without a funding plan in place, the buyer(s) may be forced to sell assets, borrow money, or even file for bankruptcy. There are many different ways to fund a buy-sell agreement, including a sinking fund, cash, borrowed funds, installment sale, self-canceling installment note, private annuity, life insurance, disability insurance, and many others. Depending on the situation, one or more of the possible methods may be used.

Factors that typically influence the funding method include:

- Business structure, size, and tax bracket
- Number of owners, their ages, tax brackets, and ownership percentages
- Levels of cash or credit available to the business or the owners
- Type of buy-sell agreement

Buy-sell agreement structures

Buy-sell agreements can be structured to meet the needs of both the business and the owners, taking into consideration tax consequences and individual goals. Following are three types of buy-sell agreements, along with brief descriptions of each:

- An **entity purchase (or redemption) buy-sell** obligates the business to buy the interests of the departing owner(s).
- With a **cross-purchase buy-sell,** each owner agrees to buy a share of the departing owner's interest. The business is not a party to the transaction.
- A **wait-and-see buy-sell** is used when the parties are unsure whether the business or the owners will buy the business interest. Typically the business is given the first option, and if it does not exercise it, the remaining owners are given the opportunity. If the remaining owners do not wish to buy, the business must purchase the interest.

PREMIER
INSURANCE CONTRACTS, INC.

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

Premier Insurance Contracts, Inc
contact@prinsuco.com

Prepared by Broadridge Investor Communication Solutions, Inc. Copyright 2019