BUSINESS LAW REPORT

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BUSINESS SUCCESSION PLANNING

What happens to the corporation, limited liability company, or partnership if one of the owners dies or becomes disabled? What happens to the owner's share of the business entity when the owner retires? The answer depends on what type of business succession plan is in place.

PROBLEM

If there is no business succession plan in place when one owner dies or becomes disabled, the heirs (or the disabled owner) might be left with little or nothing from the owner's years of hard work. Or, the business might need to be sold, or go into debt, to buy-out the interest of the heirs of the deceased owner's share, or pay-off the disabled owner's interest in the business. And, without a business succession plan, the business might have to be sold to buy-out an owner who decides to retire.

SOLUTION

A business succession plan that is tailored to meet the needs of the business and its owners should be in place. An appropriate succession plan will avoid serious damage to the ongoing business enterprise. And, the plan will protect the interests of the disabled or retiring owner, or his heirs. Typically, such a business succession plan involves either a cross-purchase agreement between the owners, or a redemption agreement between the business and the owners. The written agreement will specify the circumstances that trigger the activation of the plan, a mechanism to establish value (for the buy-out price), and how the owners' interests in the business will be paid.

CROSS-PURCHASE PLAN

In a cross-purchase ("buy-sell") plan, the business owners agree to purchase the ownership interests of each other in the event of death, disability, or retirement. Usually, a cross-purchase agreement is funded with life insurance to make funding the buy-out easier. Each business owner acquires and pays for life insurance policies on the lives of the other owners. Upon the death of an owner, the life insurance company pays the policy proceeds to the other owner(s) who purchased the insurance. The life insurance proceeds are then used to purchase the deceased owner's interest from his heirs. Thus, the business continues, the heirs of the deceased owner receive a benefit, and the remaining business owners increase their stake in the business.

In the event of an owner's disability or retirement, the remaining owners usually agree to pay the retiring/disabled owner over time based on a valuation formula for the business.

An advantage of a cross-purchase plan is that the acquiring owners receive a step-up in income tax basis in the interest they purchase (with the insurance proceeds or as purchased over time from the retiring/disabled owner).

REDEMPTION PLAN

In a redemption plan, the business entity agrees to purchase (i.e., redeem) the ownership interest of each owner in the event of death, disability, or retirement. If the redemption plan is funded by life insurance, the business acquires and pays for life insurance on the lives of each owner. Upon the death of an owner, the life insurance company pays the policy proceeds to the business. The business then uses the life insurance proceeds to purchase the deceased owner's interest from his heirs. The remaining business owners do not acquire the deceased owner's share but their proportionate interests in the business increase.

In the event of an owner's disability or retirement, the business entity redeems their interest by paying the retired/disabled owner over time based on the established valuation formula.

An advantage of the redemption plan is that the business acquires the life insurance and purchases the interest of the departing owner. And, the life insurance value and proceeds (on pay-out) can be protected from creditors by a life insurance trust.

There are other advantages and disadvantages with these two succession plans. Other options are also available to meet specific succession goals. If you have any questions regarding succession planning for your business, call Jay D. Fullman A Professional Corporation at 1-562-694-6005.