The equity in small business owners’ companies is a valuable asset. But in a privately held company, how can equity be converted to cash when the owner exits the business? Creating an exit plan – commonly called a “succession plan” – is an integral part of strategic business planning. This article will help business owners understand: 1) why a succession plan is important; 2) how to begin the process; and 3) how to put the plan into action.

**The Tax Impact at an Owner’s Exit**
Succession planning, which involves passing ownership to an heir or selling the company, aims to achieve an optimal outcome for the business, which includes converting business equity into cash whenever necessary. This goal is important for two reasons:

1. At retirement, business owners usually want to enjoy themselves or pursue other opportunities. After giving up control, they don’t want to worry about the health of their business.

2. An owner’s heirs may lack the knowledge or interest to manage the business – and may prefer, at the owner’s death, to liquidate it.

The value of a business passed to heirs is included in the owner’s estate at death and could be subject to federal estate taxes. These taxes must be paid in cash, and the filing deadline for federal estate taxes is nine months after the date of death, unless an extension is requested. Federal and state governments require cash to settle taxes – regardless of the status of the business in the wake of the owner’s death. In the worst cases, valuable businesses have been sold at “fire sale” prices simply to meet estate tax obligations.

Heirs may also need cash for other reasons, such as business debts and obligations, probate and attorneys’ fees, the cost of business appraisals, audits, and the costs of closing down the business. Consequently, almost every business needs cash to work through the transition in ownership. Providing this cash is one of the most important steps in the succession planning process.

**Key Questions**
One starting point for business succession planning is to ask and answer three questions:

1. **What is the business worth now on a “fair market value” basis?** Fair market value is the amount that a willing buyer would pay a willing seller in an arm’s-length negotiated transaction. (A business appraisal conducted by a qualified professional can help to answer this question.)

2. **What will the business be worth when the owner exits?** Any future growth in revenues or profits should increase business value – as should the grooming of one or more successors.

3. **How will heirs obtain a fair value for the business when the owner exits?** One solution, called a buy-sell agreement, pre-determines the terms of a sale (including transaction price) and may also pre-determine the funding mechanism necessary to complete the sale and help pay expenses and taxes.

**Terms of a Buy-Sell Agreement**
A buy-sell agreement may be formed between co-owners or partners, who each agree to buy out the other’s interest upon a “triggering” event. Alternatively, it may involve the current owner and a designated successor owner, perhaps a family member or top manager.

Most buy-sell participants lack the personal resources to buy a partner or owner’s business interest outright. Since most business owners prefer to receive cash at the closing, strategic planning requires that the source of the cash be identified well in advance. Often, the primary source is permanent life insurance. The death benefit is a cost effective way to fund a death buyout and the cash value component can be utilized for lifetime buyout events.

**Valuing the Business**
After a successor is identified, the next step is to determine the buy-out value. Although small business owners have some flexibility in setting the price of a buy-out transaction, the IRS and courts require a valuation that represents fair market reality. Some valuation methods include:
Comparable recent transactions – Business value is based on the terms of sales or mergers involving companies of comparable size in the same industry or market area.

Multiple of revenue or book value – Business value may be pegged to a multiple of gross revenues in the year or two just before the owner exits. For example, some service-oriented businesses may sell for about one to two times annual gross revenues. Or, the value may be pegged to an audited balance sheet as a multiple of “book value.”

Discounted cash flow – The value is based on total cash flow that the business is projected to generate for a period of years (typically three to five) after the owner’s exit, discounted by a cost of capital.

Drafting the Legal Agreement
The next step is to formalize the buy-sell agreement in writing with the help of an attorney experienced in succession planning – and ideally, one who also has a background in estate tax planning and business valuation. An important section of the agreement defines the “trigger events” that will require ownership to change hands. Common trigger events include an owner’s death, disability, retirement, divorce, or separation from employment. When a buyout is triggered by an event other than death, the legal agreement also may include provisions that prevent the departing owner from competing against the company or disclosing its trade secrets.

Funding the Buy-Sell Agreement
As noted earlier, permanent life insurance is often used to fund buy-sell agreements. This is because coverage can continue, and premiums remain constant, at any age. Funding these agreements with permanent life insurance also has other benefits:

Quick and convenient cash for heirs – Life insurance solves the problem of turning an illiquid asset (the business) into cash.

Tax advantages – Life insurance pays a death benefit that is generally free of federal income taxes. In buy-sell agreements, the benefit is usually paid to the party who has the obligation to buy the shares: the surviving shareholders or outside buyer – so the death benefit does not create estate tax consequences for the estate of the deceased.

Affordable, level premiums – Permanent life insurance can be purchased at affordable level premiums, especially when the insured person is fairly young and in good health.

Cash value – The cash value of a permanent policy can provide buyout funds if an owner exits at a lifetime triggering event, such as a divorce or normal retirement. Most agreements include provisions for terminating the buy-sell agreement by mutual consent or if specified events occur. In such instances, the policy’s owner can recoup part of the premium cost from the cash value.

Planning for a Long-Term Disability
One trigger event that can be funded with insurance is an owner’s long-term disability. In this case, disability income insurance can be purchased to fund an obligation written into the buy-sell agreement. Subject to the terms of the policy, disability buy-out insurance pays to the business beneficiary or other owner a stated amount of money or periodic income (after a waiting period) that can be used to fund part or all of the buyout.

Successful business owners rarely stop working long enough to ask why they are working so hard. But ultimately, most are striving to achieve a certain level of security for themselves and their loved ones. With the right succession planning, small business owners can help to ensure both the long-term success of their business – and greater financial security for themselves and their family for many years to come.

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