You’ve worked hard to build your business—putting in countless hours during the week, sacrificing weekends and postponing vacations. There’s a lot of satisfaction to owning your own business, watching it grow and benefiting from your efforts. But have you thought about what would happen to your business when you finally decide to retire—or if you should become disabled or die? As much as we don’t want to think about them, the reality is that these things happen every day.

You Can Only Rely on Yourself

When business owners do not make any contingency plans to transfer the business in the event of retirement, disability, death or other circumstance resulting in a separation from the business, negative consequences can arise for the owner, his or her loved ones, the remaining owners, employees and the business itself. When a sole owner fails to create a succession plan, those negative consequences can be magnified to disastrous levels. Sole owners are in a far more precarious position because, should something happen, often there is no one else to immediately run the operation and the business may quickly fail or need to be liquidated.

As a sole owner, it’s likely you may have only relied upon yourself to grow your business. If so, who do you know that can take over your company in an emergency:

- a key employee,
- a colleague,
- a competitor,
- a family member, or
- no one?

If you’re a certified professional, such as an engineer or accountant, then the pool of potential candidates is even smaller because your successor would also need the correct credentials and certification to take over the business. Thus, even if you wanted to create a business succession plan, you may have to go through the process of locating a third-party buyer.

This is where a buy-sell agreement becomes a useful alternative. Having a buy-sell agreement in place can help business owners mitigate conflict and speed up the transition by creating a road map for the future. A buy-sell agreement is a legally binding contract that can be used with all types of businesses. Life insurance would be purchased to fund the agreement at the owner’s death or retirement.

What’s the worst that could happen?

Without a succession plan in place, a business with one owner could suffer the following events at that owner’s death or disability:

- Downturn in revenue, resulting in inability to make payroll or other liabilities
- Loss of clients due to a lack of trust or image of instability
- Reduction or complete loss of income stream for your spouse and family
- Poor operational decisions from uninformed or unqualified employees or family members
- Conflicts and disagreements amongst family members and employees
- Employees defecting to competitors
- Liquidation for certain businesses such as sole proprietorships or professional companies
Planning Ahead: The One-Way Cross-Purchase Buy-Sell Arrangement is an Option

A potential strategy you may consider as a sole owner is the one-way cross-purchase buy-sell arrangement. Using this strategy, you would identify a buyer of your business, and negotiate a sale. You and the buyer would enter into an agreement where you agree to sell the business and the buyer agrees to be the purchaser. You would both agree to a value of the business, decide which assets and liabilities are being sold, and determine how the buyer will pay for the property. Funding can be arranged when the buyer agrees to purchase, own and pay the premiums on a life insurance policy on your life as the owner. By using the death benefit, or policy withdrawals or loans, the buyer is able to purchase your business from you or your estate. Depending upon who the buyer is, for instance a key employee or family member, you may decide to help fund the payment of the policy premiums through an executive bonus plan or split-dollar arrangement. Use of an escrow agent to administer the policy ensures that the sale agreement will be enforced at the necessary time.

What are the Advantages?

- Retirement, disability and death are facts of life. However sole business owners who take the time to develop a blueprint for what should happen to their business if—or when—something happens, will gain more than just peace of mind.
- A buyer is identified ahead of time, preventing a loss of the business or the below-value liquidation of assets. This is especially important for licensed professionals.
- Value of the business for estate planning purposes has been set and agreed upon.
- The sale proceeds replace the value of the business as well as the lost income stream for surviving family members.
- Life insurance provides a guaranteed means of liquidity to enable the buyer to make the purchase at the needed time.

1 Loans and withdrawals will affect the cash value of the policy and could affect the death benefit. Amounts received on withdrawals and surrenders may be subject to federal income taxes and/or company-imposed surrender penalties.
Meet Daisy: Daisy is a 60-year-old owner of The Floral Emporium, a florist shop. She would like to retire in five to ten years and wants to have a business succession plan in place for her retirement, or other contingencies such as disability or death. Her 32-year-old manager, Lily, is her person of choice to take over the florist shop, but Lily doesn’t have enough savings to buy the business from Daisy.

Here’s how the One-Way Cross-Purchase Buy-Sell Arrangement Works

Step 1: Daisy and Lily negotiate a one-way, cross-purchase, buy-sell agreement, in which Lily agrees to buy the florist shop, Daisy agrees to sell it to her, and they both agree on a sale price.

Step 2: Daisy sets up an executive bonus plan, where the company makes bonus payments to Lily. Lily uses the after-tax amount to make non-deductible premium payments on a life insurance policy she purchased on Daisy’s life.

Step 3: At Daisy’s death, Lily uses the policy proceeds to purchase the florist shop from Daisy’s estate. Lily is now the owner of The Floral Emporium, and Daisy’s loved ones have the sale proceeds, providing them liquidity to pay any estate taxes or fees.²

²Considerations—The bonus is deductible to business as compensation. Lily must recognize the bonus as income. If set up correctly, the policy proceeds are federal income-tax-free to Lily. Lily’s basis in the business is equal to the sale price. The value of the florist shop would receive a step-up in basis for the estate at Daisy’s death; however, this does not include a step-up in value for any income in respect of a decedent, such as accounts receivable.
Conclusion
The one-way cross-purchase buy-sell arrangement is just one option available to a sole owner in creating a business succession plan. There are other strategies that also may work to achieve your goals. The key is to take planning steps now to ensure the continued legacy of the business you worked so hard to build.

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