

# Commonly Asked Business Continuation Questions

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The following are commonly asked business continuation questions. Each question is followed by an answer that highlights the issues involved and the importance of taking action.

**Question:** What's the problem?

**Answer:** Think about the essence of a closely held business. If it's like most firms, it has these characteristics.

- The majority stockholders operate the business.
- The majority stockholders receive most of their income from salary or bonuses.
- Stockholders have limited creditor liabilities.
- If a stockholder were to die or become permanently disabled, the legal structure of the business would survive.
- If a stockholder were to die or become permanently disabled, the personnel structure would be significantly changed.

The problem is, when a business owner dies, the business often dies too: not because anything wrong has been done but because nothing has been done, and that's wrong!

At death (or disability), no asset tends to deteriorate as quickly or as totally as a business. Often, the precipitous drop in value is staggering!

Think about it. If a friend owned a car or a home or almost any other tangible asset, one month after that friend died, the value of that car or home would be relatively the same. But if the friend owned a restaurant that didn't reopen for a month or was a doctor whose practice was closed for a month or owned a manufacturing plant which produced no goods for a month, what would the business be worth at the end of that month?

**Question:** Why can't leaving the business to the proper parties in a will solve the problem?

**Answer:** Leaving the business to successors at death through will provisions does not answer the key problems. A disgruntled heir or a dissatisfied spouse may attack a will. Often, part of the business ends up in the hands of inactive heirs who can add little to the business but who want income equal to working stockholders. The result is an increased probability of business failure and inevitable family discord. Most importantly, a will cannot address the central problems created when a business owner dies or becomes permanently disabled.

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Look at these four points, seen from the perspective of a surviving stockholder and the decedent's survivors.

Surviving Stockholder	Decedent's Survivors
Continue reasonable salaries	Pay dividends and hire family
Build and expand the business	Pay dividends and hire family
Maintain a long-term outlook	Pay dividends and hire family
Build a strong cash reserve	Pay dividends and hire family

A surviving stockholder doing his or her own job, and probably that of the deceased co-stockholder as well, would want at least the same salary as before, if not a greater salary, in recognition of the increased responsibilities. And the surviving stockholder may want profits plowed back into the business rather than being paid out as dividends.

On the other hand, the heirs of a deceased stockholder would want the corporation to pay dividends and/or hire one or more family members at the highest possible salary. Typically, lots of income will be needed to maintain the current living standard and to pay the unexpectedly high debts, taxes, and expenses that accompany death.

This is why the death or long-term disability of a stockholder almost always creates conflicting interests and dissension.

**Question:** What happens after a stockholder's death or disability?

**Answer:** When a working stockholder dies or becomes permanently disabled, there is inevitably a reorganization of the business.

The remaining stockholders generally must:

- Buy out the heirs;
- Sell out to the heirs;
- Accept the purchasers of their stock as business associates; or
- Take the heirs into the business and share profits and decisions.

Is it possible to take one of these courses of action now? Given a choice, which course of action is realistically the most appealing?

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**Question:** Can one be more specific about the problems and objectives of the heirs?

**Answer:** This can be answered by thinking about the following questions.

- If the heirs are invited to take an active part in the operation and management of the business, will they have the training, experience, and willingness to carry their load and earn their salaries?
- Will all the surviving stockholders be comfortable with the new arrangement?
- If the heirs decide to trust the surviving stockholder to run the business and take care of them and remain inactive, will the dividends the firm pays be sufficient for their needs and meet their expectations?
- Will the heirs panic if business income must be re-invested back in the business rather than paid out as dividends?
- How will the heirs react if the surviving stockholder decides to sell stock to an outside party? Where will that leave them?
- If the heirs decide to sell their stock to an outside party, will they obtain a price they feel is fair and adequate, or will the price they need for the stock be more than a knowledgeable buyer is willing to pay?
- Do the heirs know the true value of the stock?
- Can the heirs find a buyer at a reasonable price, or at any price, if they hold only a minority interest?
- Will the surviving stockholder lose his or her job if the heirs own, and then sell, their majority interest?

**Question:** What are the objectives of the surviving stockholder when another stockholder dies or becomes permanently disabled?

**Answer:** Typically, a surviving stockholder will want to retain control. Retaining control and preventing outsiders from interfering in the management of the business and its affairs will be crucial objectives. If the business has elected S Corporation treatment (pass through of taxation), the surviving stockholder will want to be sure that election is not lost (which could easily happen if the stock falls into the wrong hands). Further, it will also be desirable to have the cash to guarantee a fair payment to buy out the deceased co-stockholder's heirs.

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**Question:** What are the odds that death or disability could actually occur between two co-stockholders?

**Answer:** If either event does occur, the probability against it happening doesn't really matter, does it? But it is helpful to at least know what the actuaries know.

**Probability of Death Prior to Age 65<sup>1</sup>**

Probability of Death Prior to Age 65	Ages of Business Owners
33.7%	25/25
32.9%	30/30
31.8%	35/35
30.5%	40/40
28.7%	45/45
25.9%	50/50
21.3%	55/55
40.2%	25/30
39.3%	30/35
38.2%	35/40
36.8%	40/45
34.8%	45/50
31.5%	50/55

**Note:** Statistics courtesy of NumberCruncher Software, version 2007.04. June, 2008. (610.527.5216).

**Question:** What's the solution to all of these problems?

**Answer:** A legal agreement called a buy-sell is often the best solution. The document, prepared by an attorney, is a legal instrument which requires the corporation (in the case of a stock redemption agreement) or the remaining stockholders (in the case of a cross-purchase agreement) to buy the stock of a deceased, retiring, or permanently disabled stockholder. It would require the estate of the stockholder to sell under a formula devised while both parties are alive and well.

There is even a type of buy-sell that combines the flexibility of both the stock redemption and the cross purchase. This is called the wait-and-see buy-sell. With it one can wait and see the best course of action, tax-wise, and then take it, even many years after the agreement is drafted.

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<sup>1</sup> The probability that one of two business owners in average physical condition will die prior to age 65 is illustrated.

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**Question:** How is this agreement funded? Is there a perfect buy-sell funding mechanism?

**Answer:** There's no free lunch or perfect buy-sell funding vehicle. The ideal is a method that will facilitate a trouble-free transfer of the business interest and provide funds for that purchase in a manner that:

- Is relatively inexpensive;
- Is easy to administer; and
- Will not adversely affect the business or the surviving stockholder's working capital or credit position.

Since two of the most common causes of ownership termination are death and long-term disability, the financial mechanism chosen must provide ample amounts of cash, at the time needed most, whenever that occurs!

**Question:** What are the various funding alternatives?

**Answer:** There are four ways to fund a buy-sell. They are using cash on hand, borrowing, making installment payments, and through life and/or disability insurance.

Here are some thoughts and questions that should be discussed with the business planning team.

- **Cash**
  - How much cash will be required and will it be available when needed?
  - When will that cash be needed?
  - Will after-tax dollars need to be kept on hand to finance the purchase?
  - Will a higher alternative rate of return have to be sacrificed in order to keep adequate cash on hand?
- **Borrowing**
  - Will the firm or the surviving stockholders be able to borrow money after the death or long-term disability of a stockholder/employee?
  - What rate of interest will be required and would it be deductible?
  - How serious will the cash drain impact be on corporate or personal reserves?

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- **Installment payments**

- Can the decedent's family afford to leave substantial sums of money at the risk of the business?
- Where will the deceased stockholder's family obtain cash to pay taxes, debts, and other immediate estate settlement costs?
- What rate of interest will the decedent's family want to charge on the unpaid balance? Will that interest be deductible?
- What will the total cost be?
- Can the business carry the extra debt and still find future growth?

- **Insurance**

- Will the buyers be guaranteed that the event which creates the need, death or disability, will create sufficient cash to satisfy that need?
- Will this method reduce or eliminate the strain on future working capital in return for relatively small, predictable annual transfer of cash to cash values?
- Can policy cash values be used, before an insured's death, for a corporate emergency or opportunity?

A question commonly arises at this point, "Where does the IRS come in?"

The answer is that the IRS (and the state inheritance tax people) typically value a business as a going concern. They take the highest sustainable value and add that to the value of all other assets. The total may be subject to federal estate tax<sup>1</sup> rates as high as 45%<sup>2</sup>. Without the cash to pay the tax on the estate, the tax may absorb most of the estate, including the business.

The son of a business owner was recently quoted as saying:

*"You can't inherit a family business anymore. If it's got any value at all, you've got to sell it just to pay inheritance taxes."*

It should be obvious that setting up a buy-sell agreement can be crucial to the survival of a business, as well as essential to guarantee the economic security that the business represents to family and loved ones. Such an undertaking involves a considerable amount of time, thought, and background experience in many areas, as well as teamwork and cooperation among all the members of your advisory team.

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<sup>1</sup> Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.

<sup>2</sup> The top bracket will be 45% in 2008 and 2009, with zero taxes in 2010. If Congress does not act at that time to repeal the federal estate tax for the years following, in the year 2011 the top bracket of 55% will automatically return.