An educational guide for business owners

Guardian®

Your business guides your future

Business continuation planning

You've worked long and hard to make your business what it is today.

You've made financial sacrifices by using most of the revenue and profits to continue to grow and build your business, instead of using the money for yourself and your family.

Your family has had to remain strong and supportive, and may have even made some sacrifices, while you concentrated your efforts on the business.

It hasn't been easy, but you're finally seeing the fruits of your labor. Your dreams for your business and your family are coming true. You can start seeing the day when you and your family are finally rewarded for all of your hard work.

But have you taken all of the necessary steps to protect what you have already built so that your business can continue to grow and your dream will actually be realized?

How would you answer the following questions?

Do the questions or your answers raise any concerns?

You and your family:

- Are most, or all, of your family's cash flow requirements dependent upon your business?
- How much of your family's financial health and net worth is tied to the success of your business?
- What would happen to your business if you should become disabled or die?
- Who would take over the day-to-day operations if you're disabled or no longer here?
- Do your spouse or children have the ability to take an active role in the management of the business? Do they even want to be involved in the business?
- What would happen to your business if you simply want to do something else or retire?
- What is your business worth if you wanted to sell it? What if you had to sell it?

Your partners, shareholders and co-owners:

- What would happen to the business if a co-owner should become disabled or die?
- Would you be concerned with continuing to pay a salary to a disabled co-owner employee who is no longer contributing to the success and profits of the business?
- Would you be concerned with his or her continuing to have a voice as co-owner in the way the business is run?
- Could you work effectively with the spouse or family of a deceased or disabled co-owner? Would you even want to?
- Do you have the means to buy out a deceased or disabled co-owner's business interest?
- Do your co-owners have the means to buy out your share of the business?
- What happens if you or one of your co-owners wants to leave the business or retire?

These are just a few of the questions that you need to ask yourself. Not having a fully considered and satisfactory answer for even one question can lead to unintended and unfortunate consequences. Fortunately, you're in a position to do something about it now, and to protect your business and your family today, and for the future. The action required is for you to create, implement, and fund a business continuation plan.

Business continuation plan

If you're a **sole proprietor**, you probably are the business.

If you're a **partner** in a **partnership**, it's the teamwork between the partners that has created the synergy to be a successful business.

If you're a **shareholder** in a closely held corporation, the growth and success of the business depends upon the shareholders, even if, at some point, a non-owner employee manages the daily operations.

If you're a member of an **LLC**, your business can be operated similarly to a partnership or corporation, but in either event, the continued success and growth of the business rests on the shoulders of the owners.

The common theme in each situation is — what happens to the business if you, or one of your co-owners, dies or becomes disabled? What happens to your family's financial well-being? What happens if you're in the best stage of your life, but you want to simply transition out of the business to do something else, pursue a lifelong passion, or simply retire?

To obtain this freedom and financial confidence requires you to sit with your Guardian Financial Professional, along with your other advisors (such as your accountant, attorney, liability insurance agent, etc.), to discuss a business continuation strategy, and to implement that strategy with a properly funded Buy-Sell Agreement (also commonly known as a business continuation agreement or keep-sell agreement).

The benefits of a funded Buy-Sell Agreement

When all is said and done, the departing owner or his/her family will walk away with a fair price for the business interest and most importantly, preserve and convert business wealth into family wealth. For the remaining owners, the business will continue to grow and flourish without the burden of paying a non-productive disabled or retired owner, or having to deal with family members of a deceased owner.

Buy-Sell Agreement

A Buy-Sell Agreement is a written legal contract that specifies what happens to your business interest in the event you die, become disabled, or otherwise leave the business. The same is true for your co-owners. This agreement, when funded, will:

1. Establish a ready market to purchase a business interest.
2. Establish a value for the purchase price of the business interest.
3. Identify the future buyer(s) — typically your co-owners or key employees.
4. Identify the events that would trigger the Buy-Sell Agreement.
5. Create a legal obligation for the departing owner to sell his or her business interest, and a legal obligation for the buyer to purchase the interest.
6. Provide a source of funds necessary to make the Buy-Sell Arrangement effective.

The other benefits of a funded Buy-Sell Agreement:

- Removes uncertainty and provides protection.
- Provides liquidity to a deceased owner's family for estate purposes.
- Helps to set the value of the business interest for tax purposes.
- Provides reassurance to creditors, employees, and clients that the business continues to operate and thrive without a particular owner.
- Removes potential unwanted or unqualified family members from the operation of the business.
- Protects the owners and their family members from a forced liquidation of the business.

Structuring the Buy-Sell Agreement:

There are several ways to structure a Buy-Sell Agreement. The appropriate method depends upon several factors, including:

- The number of owners
- The number of buyers
- Whether the buyers are family members, co-owners, or outsiders
- The legal structure of the business entity (i.e., corporation, LLC, partnership, etc.)
- Tax consequences

By meeting with your Guardian Financial Professional and your other tax and legal advisors, as well as with your co-owners, and discussing the needs and objectives of all of the owners and the business, the best structure for the Buy-Sell Arrangement can be determined.

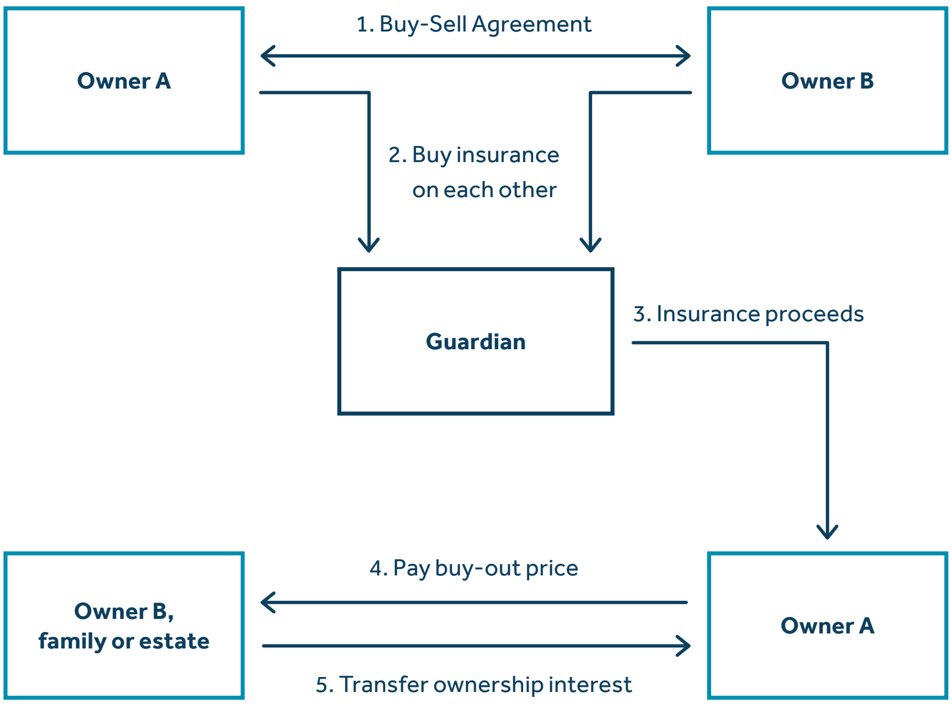
Generally, there are three basic approaches to structuring a Buy-Sell Agreement.

They are commonly referred to as:

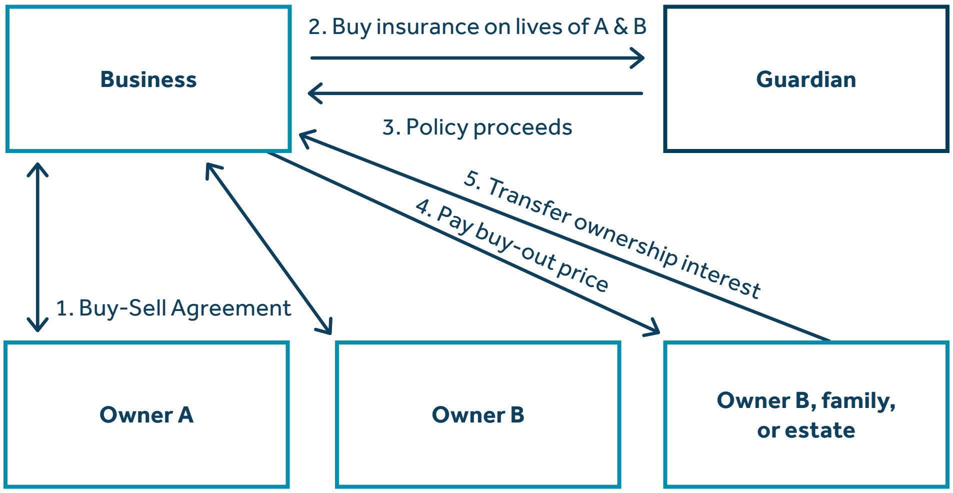
1. Cross Purchase;
2. Entity Purchase; and
3. Wait-and-See.

The **Cross Purchase** anticipates that a co-owner will be the buyer of a departing owner's business interest. The agreement is solely between the co-owners of the business. The business itself is not a party to this agreement. The advantage to this method is that the purchasing owner will receive an increase in the tax basis of his/her ownership interest equal to the fair market price paid for that interest. This basis increase will help to reduce capital gains taxes in the future, if the purchasing owner later decides to sell the business.

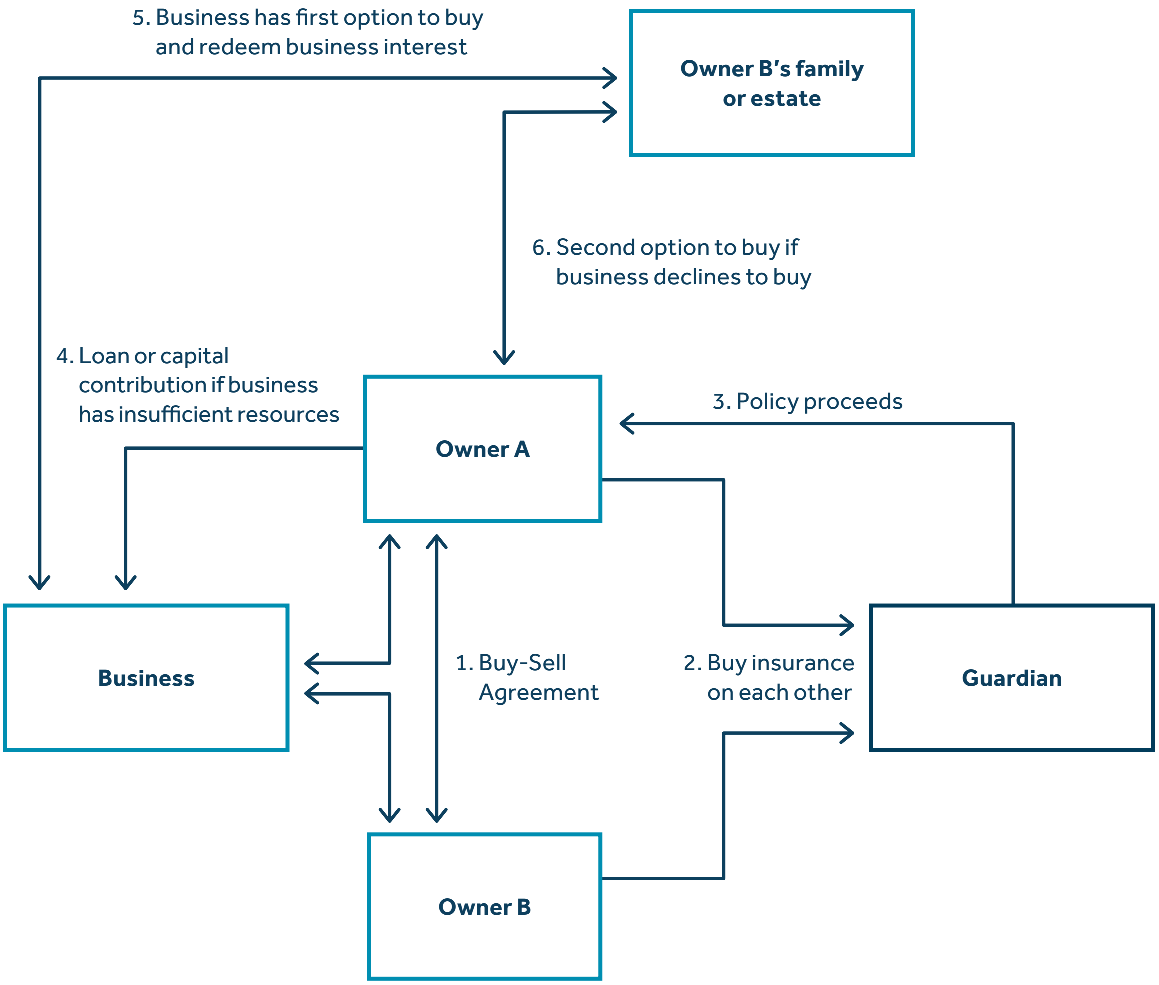
Where the business is a sole proprietorship or single member LLC, the sale will, of necessity, be made to a third party.[1] The general Cross Purchase buy-sell structure is used in this instance and is commonly referred to as a unilateral Buy-Sell Agreement.



In an **Entity Purchase,** the Buy-Sell Agreement is between the business and the individual owners. The business will be the buyer of a deceased/departing owner's business interest. Where the business is in the form of a corporation, the Entity Purchase Buy-Sell Agreement is known as a stock redemption agreement. The advantage to this method is that the business controls the administration and maintenance of the arrangement. However, unlike the Cross Purchase Arrangement, although the remaining owners receive an increase in their respective ownership interests, there may not be a basis increase using this method. In addition, when the business is a family-owned corporation, additional care is required in the structuring of the Buy-Sell Arrangement because the redemption of an owner's stock may be treated as a dividend rather than a capital transaction.



The **Wait-and-See approach** is a hybrid approach when, at the time of the structuring of the arrangement, it is difficult to determine if one method is better than the other. The Wait-and-See approach defers the choice until a triggering event occurs. Generally, the Wait-and-See approach provides the business with the first option to purchase the deceased/departing owner's interest. If the option is not exercised within a stated period of time, the remaining owners are given the option to purchase the business interest. If, however, the remaining owners do not purchase some or all of the business interest, the business is obligated to complete the purchase of the remaining interest. The main advantage to this approach is the flexibility it allows.



Valuing the business

A key component of any Buy-Sell Agreement is the method used to determine the value of the business and hence, the value of the business interest being sold. While there are many ways to value a business, each has its advantages and disadvantages, and rarely is one method, on its own, the right method.[2] Some of the more common valuation methods include:

- **Fixed price** — co-owners periodically fix the sales price based upon agreement. Using this method, the value must be constantly updated. In addition, the IRS may ignore the sale price and attribute a higher value to the business interest.
- **Book value** — equates to the owner's equity, determined by the value of assets minus liabilities. While simple, this method ignores the earnings potential of the business.
- **Straight capitalization method** — this method determines value by multiplying earnings by a certain capitalization factor. In closely held businesses, however, earnings may not reflect the true value of the company, since the owners of comparable companies may take different salaries and benefits, impacting earnings.
- **Comparative sales method** — this method seeks to compare previous sales of similar businesses. That is difficult to do because most sales of closely held businesses are private, and in a particular geographic region, there may not be enough recent sales of similar companies to make a realistic comparison.
- **Formula** — this method seeks to utilize a combination of several different methodologies.

Perhaps the best method is to have an independent appraisal made of the business by a qualified appraisal firm that has experience in valuations and the type of business you have to come up with a fair market value.

Funding the Buy-Sell Agreement

A Buy-Sell Agreement, on its own, is not effective unless the agreement is also properly funded. Indeed, an unfunded Buy-Sell Agreement may cause severe financial hardship due to legal obligations that cannot be practicably fulfilled.

Permanent life[3] and disability buy-out insurance[4] policies are ways to fund Buy-Sell Agreements. Business cash flow, cash reserves, or borrowing may also be used, but they are typically insufficient and expensive solutions. They are more suited for supplementary funding.

In many situations, it is unrealistic to expect a business to have sufficient cash flow to pay the purchase price of the Buy-Sell Agreement, and still have enough to support new salaries, recruiting, and training expenses... and that assumes there is no reduction in business revenues and profits after an owner dies or departs from the business.

Cash reserves are typically accumulated to fund growth activities, not to pay off debt that has no positive impact on future revenue and profit.

Borrowing may be even tougher to come by with the death, disability, or departure of an owner. Interest expense may also be excessive and drain the cash flow of the business.

An installment sale approach may be used, but that, too, can lead to insufficient and expensive funding because business cash flow is typically the source of the funds used. Installment sales carry additional risk due to the time required to pay off the debt. Time increases the risk of default on payments, insolvency of the business in the future, and the possibility that the deceased or departing owner or his/her family will need to take back the business, which is contrary to the purposes of the Buy-Sell Agreement in the first place.

Insurance, on the other hand, can provide the funds needed at the appropriate time — at death or upon disability. In addition, by using permanent life insurance, the business is also building a balance sheet asset (i.e., the policy cash values[5]) that can be used to fund a Buy-Sell Agreement on account of the voluntary departure of an owner, supplemented by some of the other funding methods discussed on page 10.[6]

Buy-Sell Agreement funding in action: a case study

Take a look at how much less money may be required to fund a Buy-Sell Agreement when permanent life insurance is used, versus other methods, such as setting aside the premium dollars in a sinking fund (where a business owner deposits money over the course of several years to help fund the agreement), borrowing the full amount of the purchase price, or purchasing the business from a departing owner or his or her estate through an installment sale. We'll illustrate this through a case study that shows the potential cost savings of the life insurance funding method.[7]

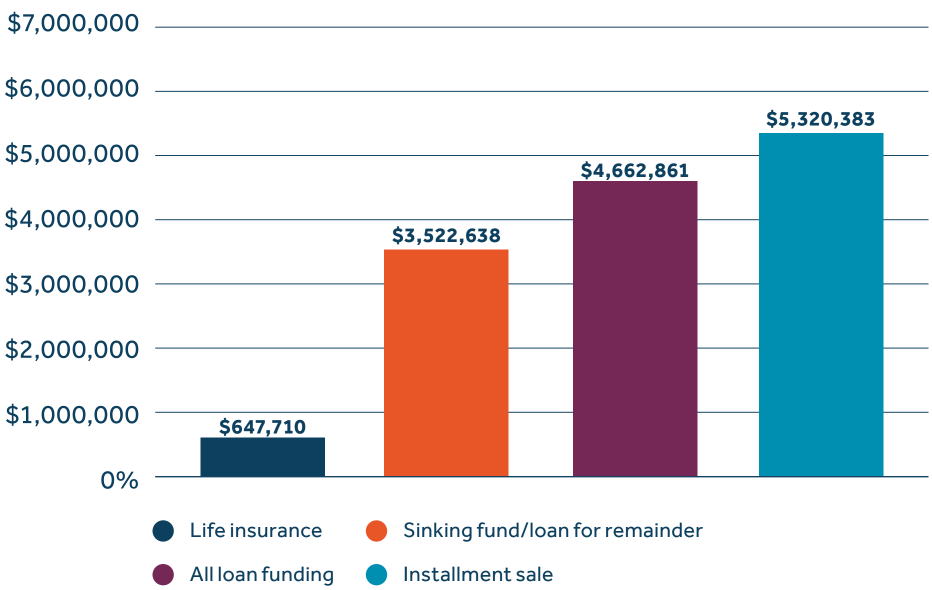
Roger Thornhill is a 48-year-old advertising executive. He founded the Thornhill advertising agency and over the years, brought in a younger associate, George Kaplan, as a partner. Roger and George now each own 50% of the business and are concerned about the continued success of that business should something happen to either of them. Their Guardian Financial Professional suggests a Cross Purchase Buy-Sell Arrangement funded with life insurance. The business is currently worth about $7M, so each of them will buy a $3.5M policy on the other partner. Roger and George like the approach, but the premium for the policy on Roger is about $80K. When George hears this, he asks about different approaches that might reduce the cost. So their Guardian Financial Professional provides an analysis for them to help them compare some common alternatives.

Keep in mind that the alternatives for funding are:

- Permanent life insurance
- Using a sinking fund in tandem with loan funding
- All (100%) loan funding
- Installment note funding

Each funding method is represented in the chart below. Note the smaller net cost of life insurance when compared to all other funding methods — on a net cost basis. In the final analysis, permanent life insurance can potentially fund the Buy-Sell Agreement at a lower cost than any of the other three methods.

Comparison of alternatives



This is a hypothetical whole life illustration and is not representative of an actual whole life insurance policy. This hypothetical illustration is intended to show, in general terms, how a typical participating whole life insurance policy might work. If purchase of a Guardian whole life insurance policy is being considered, a full illustration with guaranteed values and other important information must be provided.

Life insurance funding: This equals the cumulative premiums after subtracting out any additional death benefit left after paying for the buy-sell. The annual premium is $80,000 for 15 years.

Sinking fund/loan funding: Annual deposits equal to the insurance premiums with 5.0% interest, plus a $1.7M loan with a stated interest rate of 6.0%.

All loan funding: The cost to borrow the full amount using a 10-year loan with a stated interest rate of 6.0%.

Installment note funding: Payment of the purchase price ($3.5M) over 10 years, secured by a promissory note with a stated interest rate of 9.0%.

Now may be the best time to create a strategy to protect the future of your business and your family.

You can feel more confident knowing that you have done everything you can to help ensure that you and your family reap the benefits of all of your hard work to build the business to where it is today. If you have partners or co-owners, now is the time to plan together while the business is operating smoothly. Contact a Guardian Financial Professional to learn more.

Guardian has been helping people protect their futures and secure their lives for 160 years. Every day, we serve approximately 29 million people through a range of insurance and financial products. As one of the largest mutual insurance companies, we know what matters most: putting the needs of our customers first. Because everyone deserves a Guardian. Learn more about Guardian at guardianlife.com.

[1] In most states, a business operated as a sole proprietorship or as a single member LLC will be dissolved upon the death of the owner, unless the business is sold. A single shareholder corporation may continue to exist after the death of the sole shareholder with heirs replacing the owner as the shareholders.

[2] Revenue Ruling 59-60 provides guidance with respect to some of the various factors that must be considered when valuing a company. They are: (1) The nature and history of the business; (2) The economic outlook of the industry in which the business is engaged; (3) The book value of the business and its financial condition; (4) The business's earning capacity; (5) If a corporation, its dividend-paying capacity; (6) The existence or absence of goodwill and other intangible values; (7) Prior sales of stock and the size of the block of stock to be valued; and (8) The market price of stock in comparable companies.

[3] All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

[4] Individual disability income products underwritten and issued by Berkshire Life Insurance Company of America, Pittsfield, MA, a wholly owned stock subsidiary of The Guardian Life Insurance Company of America (Guardian), New York, or provided by Guardian. Product provisions and availability may vary by state.

[5] Some whole life policies do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial representative and refer to your individual whole life policy illustration for more information.

[6] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under age 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

[7] Disability provisions, including disability buy-out insurance should also be considered to fund the Buy-Sell Arrangement in the event that it is triggered by the disability of one of the participating owners.

Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

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