Business by Design

Sample Buy-Sell Case Study

The Independent Financial Group

James Lorenzen, CFP®, AIF®
Founding Principal

Arranging Your Business Sale In Advance

…and why it's important

Most small businesses are run by owners who've never owned a business before. Very few are running their second, third, or dare I say, their fourth venture. It therefore follows that these business owners have never successfully sold or exited a business… or even planned for it – but, they all hope to do it.

Finding an all-cash buyer is unlikely to happen, unless the business is well-beyond the small business stage, highly successful, well-established, and has caught the attention of a deep-pockets corporation looking for either a vertical integration target, a chance to increase market share, or finds the acquisition both financially attractive and compatible with its long-term plans.

There may be buyers who can buy on the installment plan, using operating cash flow to fund the sale; however, that could put the seller's future income at risk should the business experience reverses or even fail. Even if the buyer is highly qualified and a good manager, s/he could subsequently sell to someone who isn't, putting the original owner's retirement at risk.

Case Study Example

Jay West started his own local advertising agency ten years ago and began contacting car dealers, restaurants, and other local businesses to sell his services. Even though he had a strong graphics background, business growth was falling far short of his goals. It was about five years ago he met Judy at Chamber of Commerce luncheon. She was a successful marketing executive looking for a chance to build something more than simply making higher commissions. After a few meetings, he invited Judy to join his advertising agency as a full partner and the business subsequently began its dramatic growth.

iStock Images

There was an issue, however, that needed to be addressed: If something were to happen to Jay, Judy didn't want to be partners with Jay's wife, Anne. Anne was a nice person and they all got along fine; but,, Judy wanted to make sure the business remained in capable (her) hands, and Anne wanted to make sure her future would be protected. … makes sense.

Jay and Judy contacted their attorney about establishing a buy-sell agreement. Obviously, a major issue is business valuation. The agency's pre-tax earnings for the last five years looked like this:

Last year	$600,000
2 years ago	$475,000
3 years ago	$400,000
4 years ago	$325,000
5 years ago	$250,000

Jay is 45, married to Anne and has four children. He's in good health but does have elevated blood pressure. Judy is 35, single and healthy.

A simple calculation reveals the agency's average pretax net earnings for the past five years is $410,000. Using that figure and a suggested multiplier of 6, the agency's value, for purposes of the buy-sell agreement is determined to be $2,460,000 ($410,000 x 6).[i] Since both Jay and Judy are equal partners, the value of each business interest is half the total, i.e., $1,230,000.

Obviously, neither partner has the savings required to buy-out the other; but, the business is successful and well able to afford a risk-transfer funding vehicle: life insurance on each partner for $1,230,000.

The expected annual premiums for the two partners turn out to be $4,950 for the policy covering Judy's life and $11,800 for the policy covering Jay's life.

There are two ways this could be accomplished:

1. **Cross purchase agreement**: each could purchase a policy on the other partner's life. However, in this case the premiums are so unequal, this wouldn't seem to be the best choice.

2. **Entity plan agreement**: the agency pays the premiums, owns both policies, and is the beneficiary of both policy's death benefits.

Under #2, the premium burden is shared equally. Since the form of their business is a partnership, the purchase of the deceased owner's business interest at death will increase the surviving partner's cost basis in the business, which could be important should there be a subsequent sale. The death benefit flows tax-free to the business, however the buy-out funds flowing to Jay's wife, Anne, are taxable just as any buy-out proceeds would be.[ii]

With a buy-sell agreement and a funding mechanism in-place, Jay's wife is protected and Judy's business interest is protected. And, using our hypothetical figures, it's all accomplished at an annual cost ($16,750) that is just 2.8% of last year's pre-tax earnings – a percentage that is likely to decline each year.

There are three components to this strategy:

1. **A buy-sell agreement** – A good financial advisor can act as your navigator/guide in getting your 'ducks lined up' and even help choose the right strategy. Be sure to work with competent counsel for agreement creation. Your advisor can attend and provide helpful input.

2. **An informal business valuation** utilizing well-accepted, industry-specific practices – best advice: work with a professional who can provide industry-specific services beyond 'boiler-plate' or 'rule of thumb' valuations (see footnotes).

3. **A funding mechanism** – a specially-designed life insurance policy, rather than a generic 'off-the-shelf' product, can provide enhanced, tailored benefits. Best advice: utilize the services of an independent advisor who is both a Certified Financial Planner professional and an independent insurance agent (not a captive of any particular company). While all insurance companies offer business solutions, some are stronger in this space than others and provide greater design services. A good advisor will be able to help guide you to a carrier that doesn't pay for its "high" ratings.

I hope you have found this helpful. If you have questions, feel free to contact me.

The Independent Financial Group
A Registered Investment Advisor

Jim Lorenzen, CFP®, AIF®

805.265.5416 ♦ info@indfin.com
Outside California 800.257.6659
2655 First Street, Suite 250; Simi Valley, California 93065

By Appointment Only

Jim Lorenzen *is a CERTIFIED FINANCIAL PLANNER® professional and an ACCREDITED INVESTMENT FIDUCIARY® serving private clients' wealth management needs since 1991. Jim is Founding Principal of* ***The Independent Financial Group****, a Registered Investment Advisor providing retirement and wealth management solutions. He is also licensed for insurance as an independent agent under California license 0C00742. The Independent Financial Group* does not provide legal or tax advice and nothing contained herein should be construed as securities or investment advice, nor an opinion regarding the appropriateness of any investment to the individual reader. The case studies are hypothetical examples only and do not represent an actual case history. The general information provided should not be acted upon without obtaining specific legal, tax, and investment advice from an appropriately licensed professional. All images used in this communication are in public domain unless otherwise noted.

i806b

[i] Informal business valuations are often used for buy-sell purposes in order to avoid the expense of formal appraisals. However, since both parties desire a valuation that is realistic,, they often turn to their local accountant. While many are competent in this area, it's also true that many, if not most, are primarily focused on tax preparation. To learn more and see a sample report, you can visit http://www.indfin.com/business-valuation-methods-which-one-is-right-for-you/.
[ii] Consult your tax advisor