Buy sell agreements

How prepared are you to exit your business at retirement?

The right planning can help ensure a successful transition

Effective buy-sell agreements are critical

As a business owner, you might be thinking about using the sale of your business to fund a large amount of your retirement income. But developing a plan for retirement income and an exit strategy is one of the biggest financial challenges facing many business owners today. It's important to get a fair business purchase price at retirement - and putting mandatory terms in place for the sale.

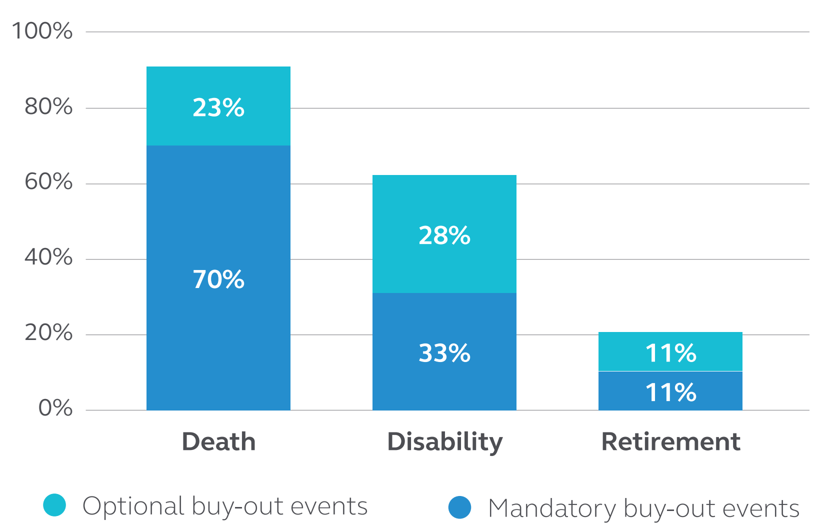
For non-family businesses with more than one owner, being able to successfully sell their business interest at retirement can be dependent on the quality of the buy-sell agreement. A sale at retirement works best when the buy-sell agreement:

- Includes a purchase obligation for the remaining business owners.
- Identifies a method for easily determining a price.
- Uses firm and clear purchase terms.

Risks of a negotiated sale

For many business owners, retirement means a negotiated sale - rather than a pre-planned sale under terms included in the existing buy-sell agreement. And the impact of a negotiated sale increases when there's a motivated seller who's ready to retire. Buy-sell agreement review data from Principal® indicates only 11 percent of agreements include retirement as a mandatory purchase and sale event.

Percentages of business owner agreements that cover the **top three transition events** and those that include them as **mandatory triggers**



What are the impacts of a negotiated sale at retirement?

- Motivated sellers might not receive the full fair-market value of their interest.
- Remaining owners may get a financial advantage by dragging out the negotiation process.
- Motivated sellers may end up taking a smaller down-payment, receive payments for a longer term, or accept a lower interest rate on installment payments.

Effects of no sale or a deferred sale

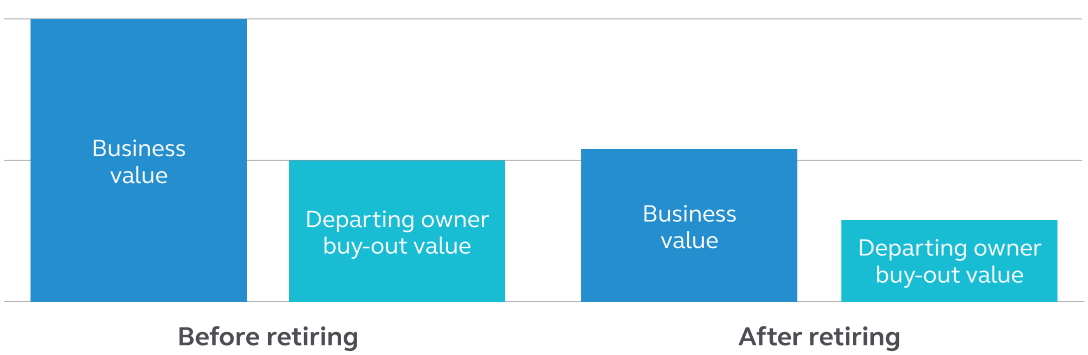
What if a negotiated sale can't be reached? The planned source of retirement income may be lost or deferred. Since the retiring owner remains an owner of the business, they're entitled to their pro rata share of the company profits - taxed as ordinary income. And this assumes a majority of the remaining owners don't allocate expected profit into compensation. Payments for the purchase of a business interest are generally taxed under a more favorable taxation system:

- Tax-free return of cost basis.
- Capital gains subject to a 15 or 20 percent capital gains tax rate.
- Ordinary income for the interest portion of the payment.

If the purchase and sale are deferred, this puts another risk on the owner who wants to retire. And the value of the business is changing over time. What does it mean to the retiring owner if the value of the business increases during the deferral period? Will the remaining business owners feel obligated to share the growth? And what happens if the value of the business declines?

All of these things could cause a business owner to keep working. And since he or she wants to exit the business, will the owner looking to retire be welcomed to continue running the business?

A retiring owner may be penalized if the value of the business drops after retirement, leaving a future buy-out based on a lower company value at that time.



Remaining business owners can also be impacted

Remaining business owners should also pay attention to the lack of a firm purchase requirement for a retiring owner. An owner — even one who isn't working full time — still has the rights of an owner to access company financial information.

A retired owner who is forced to retain an interest in the business is still entitled to his or her pro rata share of company profits. This is true even if they don't show up for work. This reality might be viewed negatively by the remaining owners who continue to operate and address risks facing the business.

The right planning can help ensure a successful transition

Many of the issues we've talked about can be avoided with an effective buy-sell agreement. It needs to require a purchase and sale when an owner reaches retirement. This retirement trigger should be mandatory, and not optional as it's usually seen in agreements today. And the agreement should define a fair and firm purchase price with clear purchase terms. Not following the purchase and sale terms of the agreement could lead to a breach-of-contract lawsuit.

Get started

Request a complimentary informal business valuation – Valuing the business is key to an owner's exit. A key risk facing business owners is a potential mismatch between the actual value of their business and the value of the company determined under the buy-sell agreement. A complimentary informal business valuation prepared by Principal might be helpful in identifying if a valuation mismatch exists.

Request a complimentary buy-sell review – A second business transfer planning risk often exists due to an incomplete or poorly drafted buy-sell agreement (e.g. one that doesn't include retirement as a mandatory purchase and sale event.) A detailed buy-sell agreement review from Principal can be helpful in identifying these risks and suggesting solutions for business owners to share with their legal and tax advisors.

Explore the benefits of a cash-value life insurance policy and/or a disability buy-out policy – Planning for funding of lifetime purchase and sale events is just as important as funding for a sale at death. Cash-value life insurance policies (owned by the business) are helpful in establishing a sinking fund for a down payment upon a purchase occurring at retirement, while also providing funding for purchase following an unexpected death. Disability insurance can provide needed liquidity or protect cash flow from being used for funding a purchase and sale upon a disability.

What's next?

With proper planning you can leverage your business for retirement income. Having an effective buy-sell agreement in place should be a top priority. Rely on the tools and resources available from your financial professional and Principal to help guide you through this planning process.

Learn more | Contact your financial professional or go to **principal.com.**

Source: Review of 1,485 buy-sell reviews by Principal Financial Group®, January 1, 2011 - January 31, 2017.

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