BUSINESS INSURANCE

Business owners have so much on their minds; the last thing they want to worry about is insurance. They have employees depending on them, family members, and sometimes entire industries. They have long-term financial goals, plans to send their kids to college. But what if the business owner is no longer there to support them or their life plans take a detour? The right insurance as part of business succession planning can help fill the financial gaps. Below are two worthy business insurance options that can ensure the business survives:

BUY-SELL PLANNING

Having a buy-sell agreement in place at the death of a business owner is critical to the continuation of the business. That's a commonly accepted principle. But did you know it's also important to have a buysell agreement in place when other major life events change the relationship of one of the owners to the business? Think disability. Think retirement. Think conflict between owners. Think one owner's desire to pursue another business opportunity. A buy-sell agreement acts as a road map, allowing business owners to mitigate conflict and speed the transition.

What is a Buy-Sell Agreement?

A legally binding contract that can be used with all types of businesses, both large and small. It stipulates that, upon the death, retirement, disability, or other withdrawal of a principal, the other partner(s) or shareholder(s) or the business itself must buy -- and the insured (or estate of the deceased) must sell -- at an agreed upon value, maintaining the value to the insured's estate and guaranteeing a purchaser

There are two ways life insurance can be used to fund a buy-sell agreement:

1. **Cross purchase -** One owner owns a policy on the other and is the beneficiary. Upon death, the living owner gets the proceeds and buys the shares from the deceased's estate.
2. **Stock redemption -** The company owns all the policies on all the owners, pays the premiums, and receives the death proceeds. Upon death, the company purchases the share and retires them.

A real-life case study

Have you heard of Anna C. Ewing? Anna was in the carpet manufacturing business. When she died, her estate valued her business at $2,400.00 per share. Uncle Sam valued each share at $6,530.00. Bet you can guess what happened next: The case went to court. The court decided the estate's value was too low and the IRS's value was too high, so it set its own value, somewhere in the middle but more favorable to the IRS's at $4,750.00 per share, basically double the estate's value. Federal estate taxes are due within nine months of death. To add insult to injury, the case lasted seven years, six months, and 24 days. What's the moral of this story? If Anna had a life insurance-funded buy-sell agreement, it would have fixed the value of the business and provided an orderly transition to all parties because the legal and financial aspects would have been addressed.

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KEY PERSON COVERAGE

Many business owners already place a premium on key employees or principals – the individuals who are critical to the long-term objectives of the business: a partner, the operations manager, the client relationship manager, the creative financier. And many business owners have in place incentives to satisfy and retain those key employees.

But how long would it take most business owners to replace a key person? How much business would be lost during that transition? While nothing can replace a long-time valued partner or employee, in the event of an unexpected death, the business can use income tax-free life insurance proceeds to sustain the business until a replacement can be found, hired, relocated, and trained.

Cash values of key person policies grow tax-deferred and can be used by the business as a balance sheet asset.

Key Person Coverage for Partnerships

One partner carries a life insurance policy naming the business as beneficiary. If that partner dies, and sound financial planning decisions were made, the business can use the proceeds of the policy to buy out the share of the decedent's partnership interest from the estate.

Key Person Coverage for Employees

The company typically owns the policy, pays the premiums, and is listed as beneficiary. The death benefit is paid to the company when the key employee dies.

How to Value a Key Person

Four commonly used valuation methods:

1. **Multiple of Salary**
   The value of the key person is based on a multiple of earnings. The business can determine just base salary or a multiple that incorporates bonuses or commissions.

2. **Loss of Value to the Business**
   Assign a percentage of the business's value to the contributions of a key employee. (ie, if the key person left the business, the belief is that the business would decline in value by the percentage or amount assigned)

3. **Cost to Replace Profits from Sales**
   Estimate what profits might be generated, over time (typically 1 to 10 years), by a replacement. The difference (lost profits) are present-valued.

4. **Cost to Replace Contribution to the Business**
   Looks at sales generated by the key person after compensation and matches that to estimates that a replacement would generate (from 1 to 10 years). The difference (lost sales) is present-valued to determine the value of the key employee, along with the costs of searching for a replacement, hiring, relocation, and training. This method often results in a higher valuation than Cost to Replace Profits from Sales since a large portion of the valuation is tied to replacing gross sales, not entirely net profits.

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