

Buy Sell Funding – Sinking or Sailing

Once the owners of a business agree that they need to have a proper buy-sell agreement in place, the next step is to fund the plan.

Most owners choose to fund the plan in one of four ways:

- A Sinking Fund
- Borrow Money
- Installment plans
- Life and Disability Insurance

As you will see below, these options are not all created equal.

Sinking Fund

To accumulate money for a buy-out, the owners can create a savings plan, called a sinking fund. Cash from earnings is set aside and earmarked for the fund.

Let's assume we are dealing with an owner whose interest in a business is worth \$500,000 today and will grow modestly in value over time (see column 2 below). Column 3 shows the annual contributions that must be made after taxes by the business to accumulate the buy-out price for this owner, assuming 8%* interest after-tax can be earned on the funds. Column 4 is the cumulative total of the annual sinking fund contributions over time. Column 5 shows the amount the business must earn to make the contribution to the sinking fund if owners are in a 32% tax bracket. Column 6 is the cumulative total of before tax earnings

| 1 | 2 | 3 | 4 | 5 | 6 |
|------------------|----------------|------------------------|------------------------|--------------------------------|-----------------------------------|
| TRIGGER EVENT | Business Value | Annual A/T Contrib. | Cumulative Contrib. | Annual Earnings Required | Pre-tax Cumulative Earnings |
| TODAY | \$500,000 | \$500,000 | \$500,000 | \$735,294 | \$735,294 |
| 5 YEARS | 525,505 | 82,941 | 414,705 | 121,972 | 609,860 |
| V10 YEARS | 552,311 | 35,302 | 353,020 | 51,914 | 519,147 |
| 15 YEARS | 580,484 | 19,796 | 296,940 | 29,111 | 436,676 |
| 20 YEARS | 610,095 | 12,345 | 246,900 | 18,154 | 363,088 |
| 25 YEARS | 641,216 | 8,122 | 203,050 | 11,944 | 298,602 |

*8% interest rate is used for illustrative purposes only; investment returns are not guaranteed and subject to market conditions.

Upon review of the above chart, it is easy to see that this is only a viable plan if begun early enough to accumulate the purchase price and assuming the company can afford to make the contributions year over year (and not dip into the fund for other business purposes). Further, if there is an unplanned exit that triggers the buy-out before the plan can materialize, then the sinking fund will be inadequate to cover the buy-out.

Borrowing to Fund the Buy-Out

As an alternative to a sinking fund, or if the sinking fund is underfunded, a business can borrow the money (assuming they can qualify for the loan after a partner leaves) from a bank or other lender.

The chart below shows the cost of borrowing to fund the buy-out price. Let's continue to assume that the owner's interest in the company is worth \$500,000 today and will grow modestly as shown in Column 2.

Column 3 is the repayment schedule when the buy-out price is borrowed and repaid over a 10-year installment period at 7% interest.

| 1 | 2 | 3 | | |
|---------------|------------------|---------------------|----------|-----------|
| TRIGGER EVENT | Price of Buy-Out | Repayment Schedule* | | |
| | | Monthly | Yearly | Total |
| TODAY | \$500,000 | \$5,805 | \$71,188 | \$711,887 |
| 5 YEARS | 525,505 | 6,101 | 74,820 | 748,820 |
| 10 YEARS | 552,311 | 6,413 | 78,636 | 786,366 |
| 15 YEARS | 580,484 | 6,739 | 82,647 | 826,478 |
| 20 YEARS | 610,095 | 7,084 | 86,363 | 868,638 |
| 25 YEARS | 641,216 | 7,445 | 91,294 | 912,947 |

*deduction for interest paid on the loan not shown

Concerns with borrowing the money center around, if the business could qualify, would they be able to afford to make the payments and what is the interest rate associated with the loan.

An **installment sale** by the departing owner falls under the topic of borrowing. The difference being that rather than borrowing from a lender the seller is self-financing the buy-out price to the buyer. While it sounds simple, the seller is still assuming the risk associated with the business. The payments will be contingent on the business's ability to make the scheduled payment plus interest. It is because of this risk that the installment method typically not recommended and is usually the choice of last resort if planning was inadequate.

Insuring the Buy-Out Price

It is well established that life insurance and disability buy-out insurance are efficient ways for a business to accumulate buy-out funds. By insuring the owners, the business (or other owners depending on the plan design) will have funds available to put towards a purchase price if an owner experiences an unplanned exit such as a premature death or disability. On the other hand, the accumulated cash value can be accessed to help fund a planned exit such as retirement.

The chart on the next page shows the cost of insuring a buy-out triggered by the death of a 45-year old male in good health. The value of his share is \$500,000 today and will grow modestly as shown in Column 2. The annual premium for the policy is approximately \$10,985.* The increasing cash value is shown in Column 4. Column 5 is the tax-free death benefit that the business or surviving owners will receive upon a premature death.

| 1 | 2 | 3 | 4 | 5 |
|---------------|------------------|---------------------|-------------------|-----------------------|
| TRIGGER EVENT | Price of Buy-Out | Total Premiums Paid | Total Cash Value* | Death Benefits Total* |
| TODAY | \$500,000 | \$10,985 | \$1,071 | \$503,488 |
| 5 YEARS | 525,505 | 54,925 | 34,743 | 530,373 |
| 10 YEARS | 552,311 | 109,850 | 100,872 | 573,699 |
| 15 YEARS | 580,484 | 164,775 | 180,919 | 624,483 |
| 20 YEARS | 610,095 | 219,700 | 284,353 | 705,970 |
| 25 YEARS | 641,246 | 274,625 | 421,426 | 820,825 |

*This example is hypothetical and for illustrative purposes only. It does not project the actual performance of any life insurance product. Premiums will vary depending upon the insurance carrier, age, medical history, health, and other underwriting factors.

For the annual premium of \$10,985, the business and other owners will have immediate funds to help purchase a departing owner's interest whether exit is planned or unplanned. No time is needed to accumulate a sinking fund to protect against an unplannable event, and there is no uncertainty about being able to obtain a loan from a lender. The retiring owner can sail off into retirement with a majority of his interest purchased using the cash value from the life insurance contract.

