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# Basic Types of Business Organizations

	<b>Sole Proprietor</b>	<b>Partnership</b>	<b>C Corporation</b>	<b>S Corporation</b>	<b>Limited Liability Company</b>
<b>Creation</b>	No written document is necessary.	Created by oral or written agreement.	Articles of incorporation filed with state.	Articles of incorporation filed with state.	Operating agreement/articles of organization filed with state.
<b>Life span</b>	Expires when owner dies.	Agreement can set time. Otherwise, dissolved at death of any partner.	Continues on after shareholder's death.	Continues on after shareholder's death.	May dissolve on a member's death, retirement, bankruptcy, resignation or expulsion.
<b>Management responsibility</b>	Rests with sole proprietor.	Rests with Partners.	Rests with board of directors who are elected by shareholders.	Rests with board of directors who are elected by shareholders..	Rests with managers.
<b>Liability</b>	Sole proprietor is personally liable for all debts.	Each partner is personally liable for all business debts or liabilities.	Liability is limited to the assets of the corporation, not shareholder's assets.	Liability is limited to the assets of the corporation, not shareholder's assets.	Liability is limited to the assets of the company, not member's assets.
<b>Income taxes</b>	All income and expenses are reported on tax return of sole proprietor.	Partnership prepares information return, but income is taxable to partners. <sup>1</sup>	Corporation pays tax on net income. Reasonable salaries are deductible to corporation and taxable to employees.	Corporation files information return, but income is taxed to shareholders. <sup>1</sup>	Company files information return, but income is taxed to the owners (members). <sup>1</sup>
<b>Sale or transfer during lifetime</b>	Sole proprietor may sell or give away any asset.	A transfer will dissolve the partnership, unless remaining partner(s) agree(s) to new partner.	Stock is transferrable. Remaining shareholders may have a first right of refusal prior to a sale to an outsider.	Restricted to 100 shareholders who are resident U.S. citizens, estates and certain types of trusts.	Members owning substantially all of the company may transfer interests without consent.
<b>Sale or transfer at death</b>	Is usually dissolved. Estate may sell or operate it.	Automatically dissolved, unless agreement to the contrary.	Stock can be transferred to heirs. Stock can also be sold or retained, unless a buy-sell agreement exists.	Estate is eligible shareholder only during estate administration. Otherwise, same as above.	Deceased's estate is an eligible shareholder. Otherwise, same as above.

<sup>1</sup> State law will vary: some states tax partnership, S corporations and LLC income.

# Advantages and Disadvantages of Corporations

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A corporation is an artificial person created through state charter. As a legal person, the corporation can enter contracts, own property, and hire employees. A corporation is a separate taxpayer from its owners, the shareholders.



## Advantages of Incorporation

- **Limited liability:** The shareholders are not generally liable for the debts and liabilities of the corporation beyond their contributions to capital. However, lenders will usually require personal guarantees by the shareholders on loans to the corporation.
- **Continuity:** The corporation continues in existence, even if its shareholders die.
- **Ease of transfer:** Shares of stock can be transferred to children or other buyers to raise capital or for estate distribution purposes.
- **Centralized management:** The shareholders elect the Board of Directors, who manages the affairs of the corporation, including appointment of officers.
- **Tax and fringe benefits**
  - Tax-qualified retirement plans
  - Medical and disability plans
  - Group life insurance
  - Split-dollar insurance plans
  - Salary continuation plans

## Disadvantages of Incorporation

- Cost to establish a corporation
- Need to observe corporate formalities
- Double taxation of income if dividends are paid. Possible tax on excess corporate accumulated earnings.

# S Corporations

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Corporations that elect to be taxed as small business corporations under IRC Sec. 1362 are taxed similarly to a partnership. The corporation (as long as it qualifies for S corporation status) generally pays no tax.<sup>1</sup> All profits and losses flow through the corporation to the shareholders and they are taxed on the profits whether or not they are taken out of the corporation.



The S corporation is often used to spread corporate income among family members who own the company stock (after employees receive adequate salaries).

Business losses, often incurred in the early years of a business, can be passed through to the shareholders and can be used to offset other ordinary income. Deductible losses are limited to shareholder's basis in stock including loans to the corporation.

## Requirements to Elect S Corporation Treatment

- Election must be made on or before the 15th day of the 3rd month of a corporation's tax year to be effective for that year.
- The number of shareholders cannot exceed 100, with all members of a family (and their estates) automatically being treated as one shareholder. The members of a family include a common ancestor, lineal descendent of the common ancestor, and the spouses, or former spouses, of such lineal descendants or common ancestor, spanning no more than six generations. See IRC Sec. 1361(c)(1).
- Each shareholder must be an individual, a decedent's estate, a bankrupt's estate or certain trusts specified in IRC Sec. 1361(c)(2), including a qualified subchapter S trust provided for by IRC Sec. 1361(d)(1).<sup>2</sup> Eligible shareholders also include an electing small business trust,<sup>3</sup> charities, and qualified pension, profit sharing and stock bonus plans,<sup>4</sup> and certain IRAs holding bank corporation stock.<sup>5</sup>
- There must not be more than one class of stock, although there can be voting and nonvoting shares.
- All stockholders must consent to the election.

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<sup>1</sup> Some states impose a tax on income.

<sup>2</sup> A shareholder's agreement can be used to prevent stockholders from transferring S corporation stock to a nonqualifying trust.

<sup>3</sup> Each beneficiary of the trust is counted in determining whether the shareholder limit has been exceeded. An interest in these trusts must be acquired by gift or bequest (not purchased).

<sup>4</sup> See IRC Secs. 1361(b)(1)(B) and 1361(c)(6).

<sup>5</sup> IRC Sec. 1361(c)(2)(A)(vi).

# S Corporations

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## Termination of the S Election<sup>1</sup>

- S corporation status is automatically terminated if any event occurs that would prohibit the corporation from making the election in the first place. The election terminates as of the date of the disqualifying event.
- The S election can be revoked with the consent of more than 50% of the outstanding stock held by shareholders.
- If a corporation, for three consecutive years, has both accumulated earnings and profits, as well as passive investment income exceeding 25% of its gross receipts, its election will be revoked beginning with the following tax year.

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<sup>1</sup> If the election is terminated or revoked, the corporation cannot re-elect S status without IRS consent until the 5<sup>th</sup> year after the year the termination or revocation is effective.

# Limited Liability Companies

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The limited liability company (LLC) is, for federal income tax purposes, a pass-through entity like a partnership or S corporation, but it includes the limited liability of a corporation.

	Partnership		Corporation		LLC
	General	Limited	C Type	S Type	
<b>Personal liability for business</b>	Yes fully liable	Only limited	Only limited	Only limited	Only limited
<b>Participate in management</b>	Yes	No <sup>1</sup>	Yes	Yes	Yes
<b>Any type or number of shareholders</b>	Yes	Yes	Yes	No <sup>2</sup>	Yes
<b>Avoids double taxation</b>	Yes	Yes	No <sup>3</sup>	Yes	Yes

LLCs are created by statute and vary from state to state. The operating agreement sets forth the relationship of its members (owners) and governs how the LLC will be operated, allocation of earnings, capital contributions and distributions. The formalities found in the corporate business organization, like directors meetings, written minutes, etc., may not be required.

## Federal Income Taxation of LLCs

Federal income tax law<sup>4</sup> provides some flexibility as to how an LLC and its members are taxed:

- **Single member LLC:** An LLC with a single member by default is “Disregarded as an entity separate from its owner...”. For LLCs with a single individual member, this means that income and expenses are generally reported on the individual’s personal return on Schedule C, E, or F. An LLC with a single individual member may elect to report income and expenses as a corporation. For LLCs with a single corporate member, income and expenses are typically reported on the corporation’s return.
- **Multiple member LLC:** An LLC with two or more members (individual or corporate) by default reports income and expenses as a partnership. Such an LLC may elect to report income and expenses as a corporation.

State income tax law can vary and does not necessarily follow federal law.

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<sup>1</sup> Limited partners cannot participate in management.

<sup>2</sup> The S corporation is currently limited to 100 shareholders and there can be only one class of stock.

<sup>3</sup> C corporation’s net income is subject to the corporate federal income tax up to 35%.

<sup>4</sup> See IRC Reg. 301.7701-3.

# Retirement and the Business Professional

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## Don't Put All Your Eggs in One Basket

Many entrepreneurs who start or purchase a business do so for a number of reasons, both emotional and financial. Social status, the freedom to be your own boss, and the potential for a high income are a few of the reasons commonly cited.

For some, business ownership is also seen as a primary way to pay for retirement. If everything goes as planned, the business owner works hard and, over time, the business grows and becomes more valuable. When the owner reaches a certain age the business is sold, with the proceeds from the sale funding the retirement years.

## The Realities of Business Ownership

Using the business as the sole means of achieving financial independence amounts to placing a bet that the owner will be able to sell at the right time, the right price and under the right terms. There are several reasons why this may not happen:

- **Business failure:** Despite good intentions and hard work, businesses do fail. In 2008, for example, there were an estimated 627,200 new, small (less than 500 employees) businesses started in the United States; in the same year, an estimated 595,600 small businesses closed their doors, and 43,546 filed for bankruptcy.<sup>1</sup>
- **Timing of the sale:** Selling a business is a complex, often time-consuming procedure. The actual process of finding a buyer, negotiating the deal, arranging financing and finally closing the sale may extend over months or even years.
- **Proceeds:** Depending on market conditions, the amount realized may not be enough to pay for retirement. Income taxes will inevitably consume some of the proceeds. The owner may have to accept installment payments, rather than a lump sum.
- **"I am the business":** The value of a business may depend largely on the skills and/or customer relationships of a particular owner.

## Diversification to Reduce Risk

A business owner who seeks to reduce risk will view his or her business as being simply one asset among many. In addition to the business, a diversified portfolio could include the following:

- **Qualified retirement plans:** Business income is used to fund employer-sponsored qualified plans with a current deduction for contributions and tax-deferred growth.
- **Nonqualified plans:** Nonqualified deferred compensation plans are often used to reward selected employees and serve to supplement qualified retirement plans.
- **General investment portfolio:** A business owner can develop a general investment portfolio, outside of the framework of the business.

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<sup>1</sup> Source: U.S. Small Business Administration, Office of Advocacy: "Frequently Asked Questions," January 26, 2010.

# Split-Dollar Arrangement

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The term “split-dollar arrangement” refers to a method of paying for life insurance. In a typical contract, an employer and employee agree to split the cost (premiums) and benefits (cash-value and death benefits) of a permanent life insurance policy.

The agreement between the employee and employer can take many forms. The elements commonly found in split-dollar agreements are outlined below.



## Policy Ownership

There are two basic forms of policy ownership<sup>1</sup> for split-dollar plans.

- **Endorsement method:** The employer owns the policy but a written endorsement is added to the policy which splits the benefits between the employer and the employee.
- **Collateral assignment:** The employee owns the policy and assigns certain interests in the policy to the employer as collateral for payments made by the employer.

## Splitting the Cost (premiums)

Dividing the cost of a policy can be done in any manner desired. Listed below are several typical payment arrangements:

- **Classic method**
  - Employer pays an amount equal to the annual cash-value buildup.
  - Employee pays the balance.
- **Employer-pay-all method**
  - Employer pays the entire premium.
  - Employee is taxed on the value of the economic benefit received.

## Making the Payment

- **Employer pay all:** The employer pays the entire premium; the employee pays tax on the value of the economic benefits received.
- **Executive bonus plan:** The employer pays a bonus to the employee. From the bonus, the employee pays the economic benefit portion of the premium. The bonus payment is a deductible expense to the employer and taxable income to the employee. Some agreements provide an extra bonus amount to cover the additional tax due.

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<sup>1</sup> This report highlights split-dollar arrangements in the employer and employee context. Split-dollar arrangements are also possible between other parties, for example between a corporation and a shareholder, an employer and an independent contractor, a partnership and a partner, or a private individual and a trust.

# Split-Dollar Arrangement

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## Splitting the Benefits

The employer and employee can decide to split the policy benefits in any way they wish.

- **Classic method**
  - **Employer's share:** At death, the employer receives the greater of the cash value or the total premiums paid.
  - **Employee's share:** The employee's beneficiary receives the balance of the proceeds, e.g., the face amount less the amount repaid to the employer.
- **Employer-pay-all method**
  - **Employer's share:** At death, the employer recovers the agreed-upon amount.
  - **Employee's share:** The employee's beneficiary receives the balance of the proceeds, e.g., the face amount less the sum paid to the employer.

## A Few Uses of Split-Dollar

- **Fringe benefit:** Since the employer can pick and choose those employees who will benefit, split-dollar can be used to attract and retain key executives.
- **Estate planning:** When the estate is large enough to incur a federal estate tax (a taxable estate in excess of \$5,000,000 in 2011), an estate owner may consider removing life insurance from the estate. One way of reducing death taxes is the irrevocable life insurance trust.
- **Business continuation:** In a family-owned business there is a risk of adverse tax treatment when the corporation redeems the deceased owner's stock. See IRC Secs. 302 and 318. The proceeds of corporate owned life insurance might also create a corporate AMT problem. Under a corporate stock redemption the surviving stockholders would own stock worth more, but with an unchanged cost basis. Using a cross-purchase buy-sell agreement funded with life insurance can eliminate these problems. Differences between the owners in age and/or percentage of ownership may cause the life insurance premiums to be expensive for some stockholders. A split-dollar arrangement may assist each stockholder in purchasing enough insurance on the other stockholder(s).
- **Group term replacement:** Nondiscrimination rules can limit the amount of group term insurance available to key executives. With a split-dollar plan, executives can have increased protection now and substantial benefits at retirement.

# Split-Dollar Arrangement

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## Federal Taxation of Split-Dollar Arrangements

Split-dollar arrangements are subject to a complex web of federal income tax law<sup>1</sup> and regulation, including:

- **Treasury Decision 9092:** Under the final federal regulations contained in Treasury Decision 9092, issued on September 11, 2003, many of the economic benefits of a split-dollar arrangement will be treated as currently taxable. Such taxable benefits may include: (1) the value of current life insurance protection; (2) accrued cash value; (3) imputed loan interest; or (4) premium contributions from the non-owner of the policy. Depending on the relationship between the parties to a split-dollar arrangement, the economic benefits may be treated for tax purposes as compensation, dividends, a capital contribution, a gift, or "a transfer having a different tax character." Under certain circumstances, death benefits paid to a beneficiary (other than a policy owner) will be taxable income.
- **IRC Sec. 409A – nonqualified deferred compensation:** IRC Sec. 409A concerns the federal income tax treatment of nonqualified deferred compensation agreements. Income deferred under an arrangement which does not meet the requirements of IRC Sec. 409A is generally subject to income taxation in the current year, including substantial penalties and interest. In some instances, a split-dollar arrangement may be deemed to come under the provisions of IRC Sec. 409A. See Treasury Decision 9321 and Notice 2007-34 for further details.
- **Employer-owned life insurance contracts:** Under federal law, amounts received under a life insurance contract paid by reason of the death of the insured are generally excluded from income. Under the provisions of the Pension Protection Act of 2006, however, death proceeds paid to an employer from a life policy owned by the employer on the life of an employee are generally includable in income, unless certain requirements are met. This law was effective for contracts issued after August 17, 2006, except for policies acquired in an IRC Sec. 1035 exchange. Until the full scope of this new legislation is clarified by the IRS, caution is advised. See IRC Sec. 101(j).

## Seek Professional Guidance

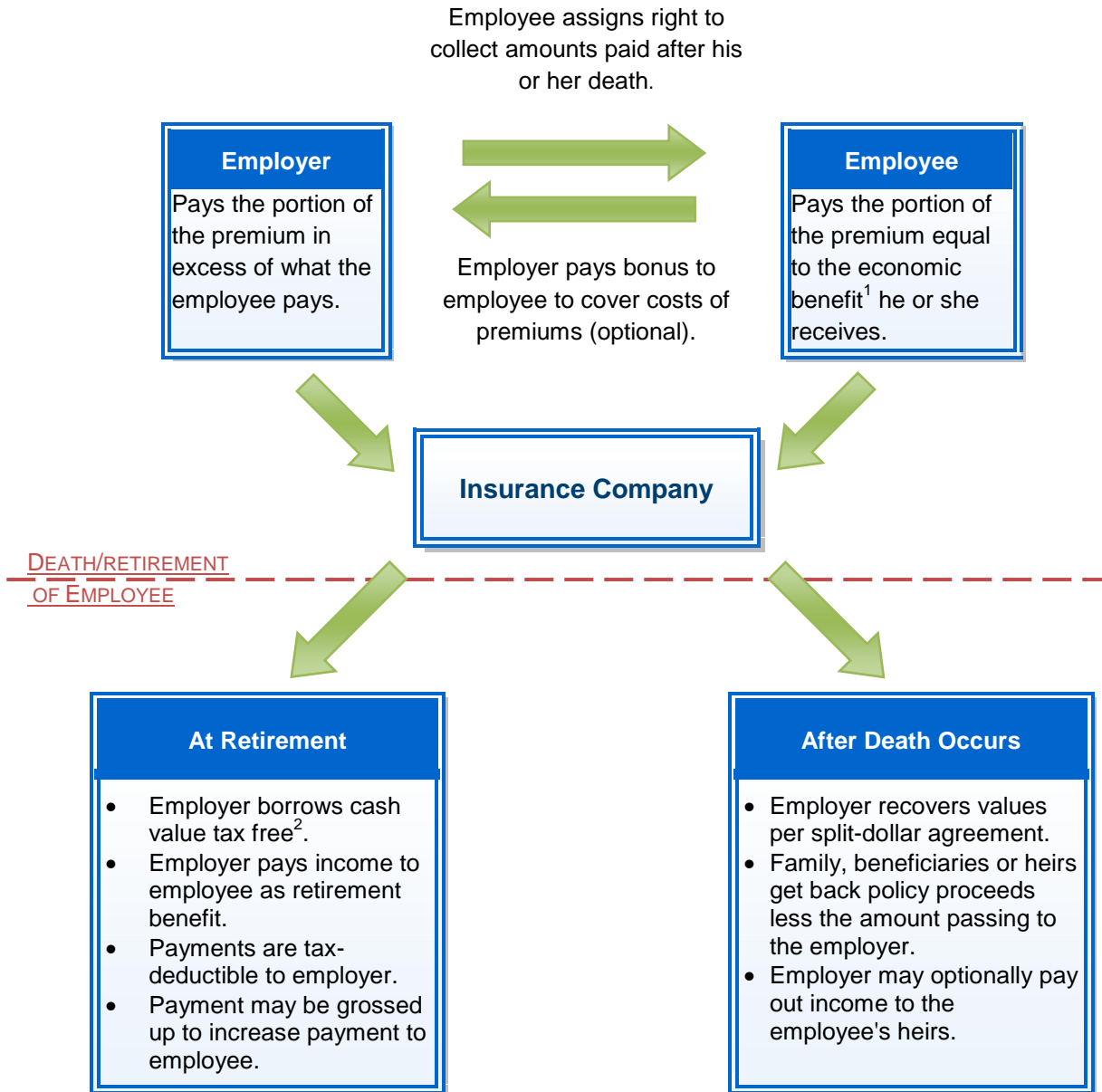
Split-dollar arrangements involve complex legal, tax and insurance questions. The guidance of a Certified Public Accountant (CPA), IRS Enrolled Agent (EA), or other financial professionals is strongly recommended.

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<sup>1</sup> The discussion here concerns federal income tax law; state or local law may vary.

# Split-Dollar Arrangement

## Deferred Compensation - Collateral Assignment Method

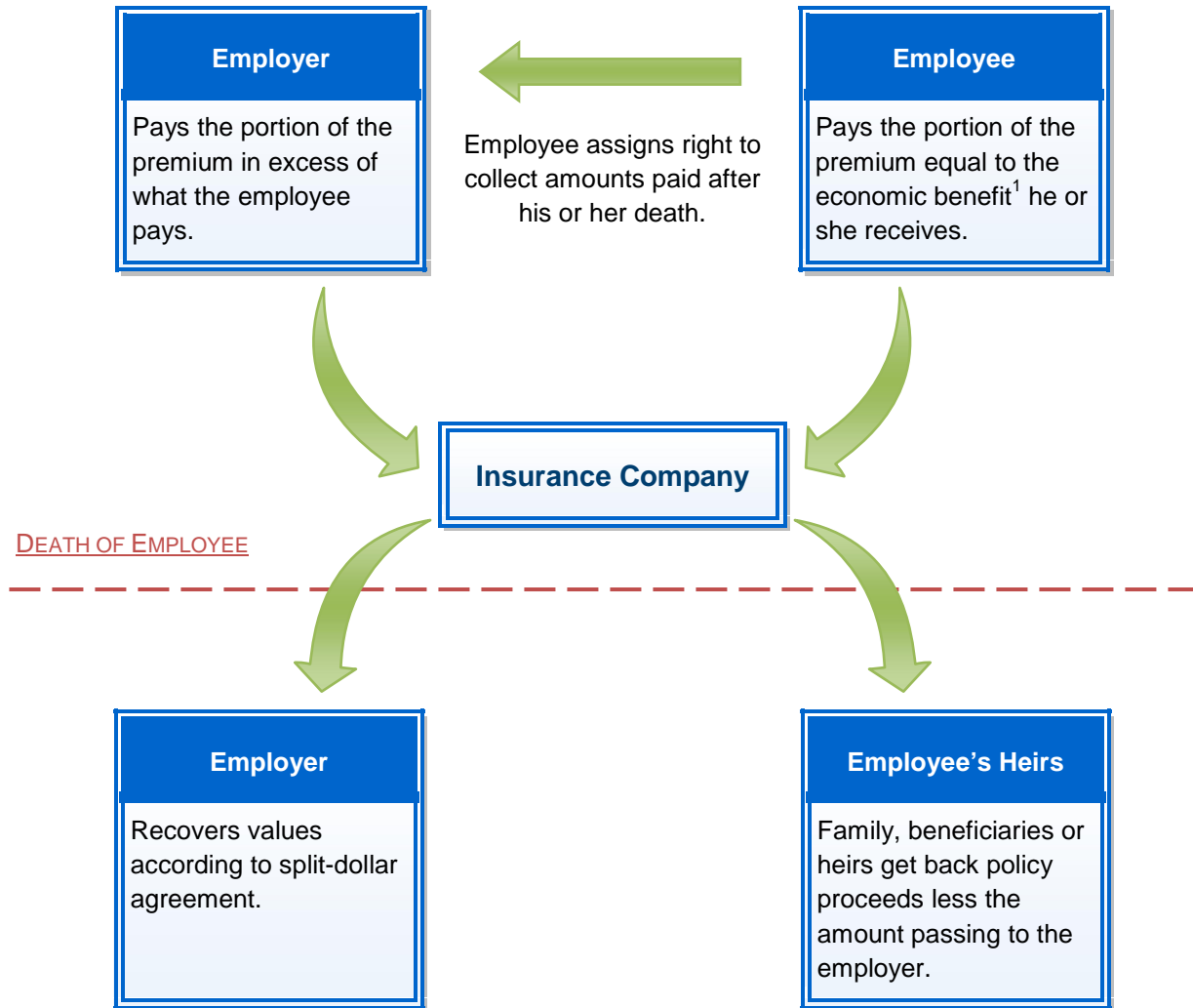


**Note:** This diagram illustrates a very basic variety of split-dollar plan which can be modified to meet the needs of both employer and employee. A separate agreement is required to address the deferred compensation aspect of this arrangement.

<sup>1</sup> Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

<sup>2</sup> Interest charges may apply. Loans reduce death benefits. Borrowed amounts may be taxable and subject to a 10% penalty if the policy is a MEC. For details see policy information and insurance ledger.

# Split-Dollar Arrangement Collateral Assignment Method



**Note:** This diagram illustrates a very basic variety of split-dollar arrangement which can be modified to meet the needs of both employer and employee.

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# Split-Dollar Arrangement

## Funding an Irrevocable Life Insurance Trust

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Since the federal estate tax is imposed on all the assets inside an estate, many people prefer to reduce this tax by arranging to have some of their assets outside of their estate. One method of achieving this is the irrevocable life insurance trust (ILIT), a type of trust designed primarily to own life insurance policies. At death, the policy proceeds are used to provide additional dollars for estate liquidity needs. Such a trust takes maximum advantage of the gift tax laws and at the same time ensures that the proceeds of any policies inside the trust are received free of federal income and estate taxes.<sup>1</sup>

A split-dollar life insurance arrangement can help a key employee achieve this important estate-planning goal.

### During Life

In general, the following steps would be taken.

- The employee establishes an irrevocable life insurance trust.
- The trustee of the trust obtains life insurance on the life of the employee, naming the trust as beneficiary of the policy.
- The employer and the trust enter into a split-dollar agreement, providing for a sharing of the premiums and death benefits of the policy owned by the trust. Typically the trust will pay that portion of the premium equal to the economic benefit<sup>2</sup> received. The employer pays the remaining balance. As a part of the agreement, the trust assigns the policy to the employer as security for the repayment of premiums advanced.
- The employee gifts funds to the trust, to allow the trust to pay its portion of the premium. The employer may, if desired, bonus sufficient funds to the employee to cover these gifts.

### At Death

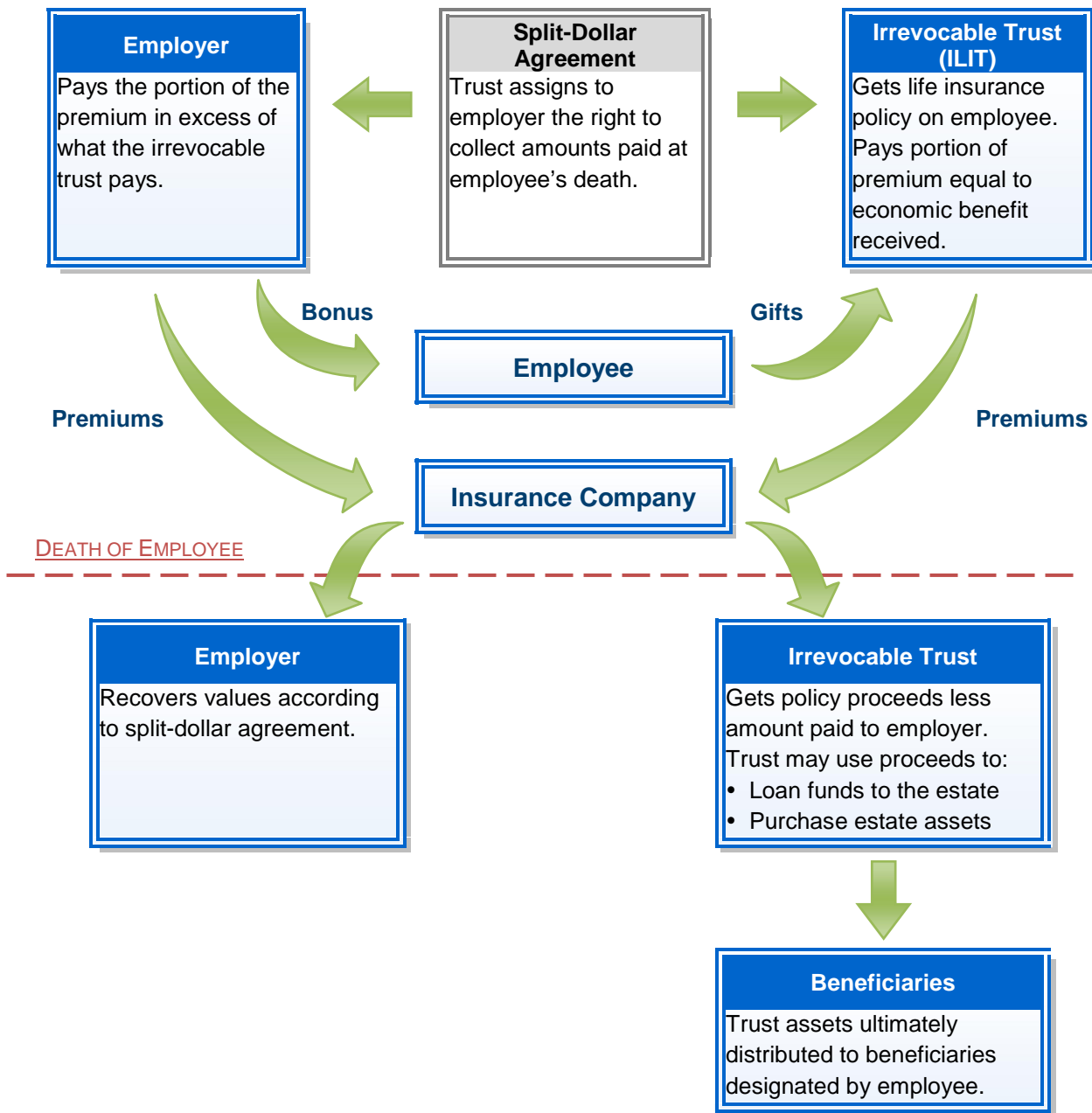
- The insurance company typically returns to the employer the amounts specified in the split-dollar agreement.
- The balance of the policy proceeds is paid directly to the trustee of the irrevocable life insurance trust. The trust (if trust provisions so provide) may then lend the funds to the employee's estate, or may use them to purchase assets from the estate. The executor would then have the cash necessary to pay the estate settlement costs without increasing the taxable estate.
- Ultimately, assets in the trust are distributed to the employee's beneficiaries.

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<sup>1</sup> State or local law may vary.

<sup>2</sup> Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

# Split-Dollar Arrangement Funding an Irrevocable Life Insurance Trust



**Note:** Under Treasury Decision 9092, (September 11, 2003) many economic benefits of a split-dollar arrangement are currently taxable; death benefits paid to a beneficiary other than the policy owner may also be taxable. Under Treasury Decision 9321 and IRS Notice 2007-34, (April 10, 2007), some split-dollar arrangements may come under the requirements of IRC Sec. 409A concerning nonqualified deferred compensation. Those considering a split-dollar arrangement should first consult with their legal and/or tax advisors. State or local law may vary.

# Meet the Business Planning Team

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Business planning, especially for the succession of the business, is a very complex discipline and will generally require the efforts of more than one professional.

A business planning team might consist of two or more of the following persons:

## **The CEO of the Team**

You are the Chief Executive Officer of this team. You will make all of the final decisions after carefully reviewing the recommendations of the various members of your team.

## **Estate and Business Planning Attorney**

Most attorneys can draft a will or establish a small corporation. However, it may be wise to choose one who specializes in estate planning and business continuation. Your choice could mean the difference between successfully achieving your goals and failure of the business plan.

## **Life Underwriter**

Life insurance is very often a key element in the smooth transfer of a business to either heirs or surviving business associates. An insurance professional will be able to assist you in determining the best type of policy and the amount required to meet your goals.

## **Certified Public Accountant (CPA)**

Almost all successful businesses require the services of a qualified accountant. The CPA designation is an indication that a person has passed rigorous examinations and has been in practice for a number of years. Some CPAs have pursued additional studies in the complex areas of business valuation methods.

## **Business Appraisal Expert**

In the event of a disagreement with the IRS as to the value of the business interest, it would be prudent to possess a detailed appraisal by a trained and qualified expert. There are experts who specialize exclusively in this field.

## **Financial Professional**

Sometimes the life insurance professional, accountant or other member of the business planning team may have special training in financial planning. Other times a person who specializes in financial planning may be a part of your team. This broader knowledge may help to coordinate the efforts of the team.

# Importance of a Business Continuation Plan

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## Competing Interests of Heirs and Surviving Owners

These interests are many and may include the following:

What Heirs of Deceased Owner Want	What Surviving Owners Want
Top dollar for their interests	Minimum cost for the interest
Prompt settlement of the estate	Prompt transfer of the business interest
Set value of business for estate tax purposes	Full control of the business - no interference from decedent's family
Relief for family of worries regarding the business and its creditors	Continuing line of credit
	Retention of customers and employees

## Potential Problems Without a Written Agreement

Frequent results include:

- Heated conflicts among the remaining owners and the decedent's family;
- Unhappiness on all sides, and sometimes litigation;
- Delays in settling the estate and continuing business growth;
- Loss of customers; and
- Possible liquidation of the business which may bring less than full value.

## The Solution: A Written Agreement (and Cash)

Taking the time now to see that the business will pass in an orderly manner at time of death will benefit all parties and their heirs. A written agreement can provide:

- An orderly transfer of the business;
- A mutually agreeable sales price;
- Mutually agreeable terms of sale;
- A value that is binding on the IRS for federal estate tax purposes; and
- Stability for customers, staff, creditors and investors.

An agreement which is favorable to all parties can be more easily drafted prior to a crisis.

# Commonly Asked Business Continuation Questions

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The following are commonly asked business continuation questions. Each question is followed by an answer that highlights the issues involved and the importance of taking action.

**Question:** What's the problem?

**Answer:** Think about the essence of a closely-held business. If it's like most firms, it has these characteristics.

- The majority stockholders operate the business.
- The majority stockholders receive most of their income from salary or bonuses.
- Stockholders have limited creditor liabilities.
- If a stockholder were to die or become permanently disabled, the legal structure of the business would survive.
- If a stockholder were to die or become permanently disabled, the personnel structure would be significantly changed.

The problem is, when a business owner dies, the business often dies too: not because anything wrong has been done but because nothing has been done, and that's wrong!

At death (or disability), no asset tends to deteriorate as quickly or as totally as a business. Often, the precipitous drop in value is staggering!

Think about it. If a friend owned a car or a home or almost any other tangible asset, one month after that friend died, the value of that car or home would be relatively the same. But if the friend owned a restaurant that didn't reopen for a month or was a doctor whose practice was closed for a month or owned a manufacturing plant which produced no goods for a month, what would the business be worth at the end of that month?

**Question:** Why can't leaving the business to the proper parties in a will solve the problem?

**Answer:** Leaving the business to successors at death through will provisions does not answer the key problems. A disgruntled heir or a dissatisfied spouse may attack a will. Often, part of the business ends up in the hands of inactive heirs who can add little to the business but who want income equal to working stockholders. The result is an increased probability of business failure and inevitable family discord. Most importantly, a will cannot address the central problems created when a business owner dies or becomes permanently disabled.

# Commonly Asked Business Continuation Questions

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Look at these four points, seen from the perspective of a surviving stockholder and the decedent's survivors.

Surviving Stockholder	Decedent's Survivors
Continue reasonable salaries	Pay dividends and hire family
Build and expand the business	Pay dividends and hire family
Maintain a long-term outlook	Pay dividends and hire family
Build a strong cash reserve	Pay dividends and hire family

A surviving stockholder doing his or her own job, and probably that of the deceased co-stockholder as well, would want at least the same salary as before, if not a greater salary, in recognition of the increased responsibilities. And the surviving stockholder may want profits plowed back into the business rather than being paid out as dividends.

On the other hand, the heirs of a deceased stockholder would want the corporation to pay dividends and/or hire one or more family members at the highest possible salary. Typically, lots of income will be needed to maintain the current living standard and to pay the unexpectedly high debts, taxes, and expenses that accompany death.

This is why the death or long-term disability of a stockholder almost always creates conflicting interests and dissension.

**Question:** What happens after a stockholder's death or disability?

**Answer:** When a working stockholder dies or becomes permanently disabled, there is inevitably a reorganization of the business.

The remaining stockholders generally must:

- Buy out the heirs;
- Sell out to the heirs;
- Accept the purchasers of their stock as business associates; or
- Take the heirs into the business and share profits and decisions.

Is it possible to take one of these courses of action now? Given a choice, which course of action is realistically the most appealing?

# Commonly Asked Business Continuation Questions

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**Question:** Can one be more specific about the problems and objectives of the heirs?

**Answer:** This can be answered by thinking about the following questions.

- If the heirs are invited to take an active part in the operation and management of the business, will they have the training, experience, and willingness to carry their load and earn their salaries?
- Will all the surviving stockholders be comfortable with the new arrangement?
- If the heirs decide to trust the surviving stockholder to run the business and take care of them and remain inactive, will the dividends the firm pays be sufficient for their needs and meet their expectations?
- Will the heirs panic if business income must be re-invested back in the business rather than paid out as dividends?
- How will the heirs react if the surviving stockholder decides to sell stock to an outside party? Where will that leave them?
- If the heirs decide to sell their stock to an outside party, will they obtain a price they feel is fair and adequate, or will the price they need for the stock be more than a knowledgeable buyer is willing to pay?
- Do the heirs know the true value of the stock?
- Can the heirs find a buyer at a reasonable price, or at any price, if they hold only a minority interest?
- Will the surviving stockholder lose his or her job if the heirs own, and then sell, their majority interest?

**Question:** What are the objectives of the surviving stockholder when another stockholder dies or becomes permanently disabled?

**Answer:** Typically, a surviving stockholder will want to retain control. Retaining control and preventing outsiders from interfering in the management of the business and its affairs will be crucial objectives. If the business has elected S Corporation treatment (pass through of taxation), the surviving stockholder will want to be sure that election is not lost (which could easily happen if the stock falls into the wrong hands). Further, it will also be desirable to have the cash to guarantee a fair payment to buy out the deceased co-stockholder's heirs.

# Commonly Asked Business Continuation Questions

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**Question:** What are the odds that death or disability could actually occur between two co-stockholders?

**Answer:** If either event does occur, the probability against it happening doesn't really matter, does it? But it is helpful to at least know what the actuaries know.

**Probability of Death Prior to Age 65<sup>1</sup>**

Probability of Death Prior to Age 65	Ages of Business Owners
33.7%	25/25
32.9%	30/30
31.8%	35/35
30.5%	40/40
28.7%	45/45
25.9%	50/50
21.3%	55/55
40.2%	25/30
39.3%	30/35
38.2%	35/40
36.8%	40/45
34.8%	45/50
31.5%	50/55

**Note:** Statistics courtesy of NumberCruncher Software, version 2007.04. June, 2008. (610.527.5216).

**Question:** What's the solution to all of these problems?

**Answer:** A legal agreement called a buy-sell is often the best solution. The document, prepared by an attorney, is a legal instrument which requires the corporation (in the case of a stock redemption agreement) or the remaining stockholders (in the case of a cross-purchase agreement) to buy the stock of a deceased, retiring, or permanently disabled stockholder. It would require the estate of the stockholder to sell under a formula devised while both parties are alive and well.

There is even a type of buy-sell that combines the flexibility of both the stock redemption and the cross purchase. This is called the wait-and-see buy-sell. With it one can wait and see the best course of action, tax-wise, and then take it, even many years after the agreement is drafted.

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<sup>1</sup> The probability that one of two business owners in average physical condition will die prior to age 65 is illustrated.

# Commonly Asked Business Continuation Questions

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**Question:** How is this agreement funded? Is there a perfect buy-sell funding mechanism?

**Answer:** There's no free lunch or perfect buy-sell funding vehicle. The ideal is a method that will facilitate a trouble-free transfer of the business interest and provide funds for that purchase in a manner that:

- Is relatively inexpensive;
- Is easy to administer; and
- Will not adversely affect the business or the surviving stockholder's working capital or credit position.

Since two of the most common causes of ownership termination are death and long-term disability, the financial mechanism chosen must provide ample amounts of cash, at the time needed most, whenever that occurs!

**Question:** What are the various funding alternatives?

**Answer:** There are four ways to fund a buy-sell. They are using cash on hand, borrowing, making installment payments, and through life and/or disability insurance.

Here are some thoughts and questions that should be discussed with the business planning team.

- **Cash**
  - How much cash will be required and will it be available when needed?
  - When will that cash be needed?
  - Will after-tax dollars need to be kept on hand to finance the purchase?
  - Will a higher alternative rate of return have to be sacrificed in order to keep adequate cash on hand?
- **Borrowing**
  - Will the firm or the surviving stockholders be able to borrow money after the death or long-term disability of a stockholder/employee?
  - What rate of interest will be required and would it be deductible?
  - How serious will the cash drain impact be on corporate or personal reserves?

# Commonly Asked Business Continuation Questions

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- **Installment payments**

- Can the decedent's family afford to leave substantial sums of money at the risk of the business?
- Where will the deceased stockholder's family obtain cash to pay taxes, debts, and other immediate estate settlement costs?
- What rate of interest will the decedent's family want to charge on the unpaid balance? Will that interest be deductible?
- What will the total cost be?
- Can the business carry the extra debt and still find future growth?

- **Insurance**

- Will the buyers be guaranteed that the event which creates the need, death or disability, will create sufficient cash to satisfy that need?
- Will this method reduce or eliminate the strain on future working capital in return for relatively small, predictable annual transfer of cash to cash values?
- Can policy cash values be used, before an insured's death, for a corporate emergency or opportunity?

A question commonly arises at this point, "Where does the IRS come in?"

The answer is that the IRS (and the state inheritance tax people) typically value a business as a going concern. They take the highest sustainable value and add that to the value of all other assets. The total may be subject to federal estate tax rates as high as 35%.<sup>1</sup> Without the cash to pay the tax on the estate, the tax may absorb most of the estate, including the business.

The son of a business owner was recently quoted as saying:

*"You can't inherit a family business anymore. If it's got any value at all, you've got to sell it just to pay inheritance taxes."*

It should be obvious that setting up a buy-sell agreement can be crucial to the survival of a business, as well as essential to guarantee the economic security that the business represents to family and loved ones. Such an undertaking involves a considerable amount of time, thought, and background experience in many areas, as well as teamwork and cooperation among all the members of your advisory team.

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<sup>1</sup> 2011 value.

# Buy-Sell Agreement

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In order to guarantee a buyer for the interest in a business (particularly a minority interest which may be of very little value to one's heirs), consideration should be given to a lifetime agreement among the business owners as to how to dispose of the business.

## Entity Plan

Under an entity plan the corporation (or partnership) buys the interest of the deceased business owner. This type of arrangement is often used when there are several owners.



## Cross-Purchase Plan

Under this plan each surviving owner agrees to buy the interest of any deceased owner.



An attorney should be consulted in deciding which plan is better.

## Advantages of Buy-Sell Agreements

- Guarantees a buyer for an asset that probably will not pay dividends to one's heirs.
- Can establish a value for federal estate tax purposes that is binding on the IRS. See IRC Sec. 2703.
- Spells out the terms of payment and is easily funded with life insurance and disability insurance, if desirable.<sup>1</sup>
- Provides a smooth transition of complete control and ownership to those who are going to keep the business going.

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<sup>1</sup> Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Buy-Sell Agreement - Partnership

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At death, the disposition of a partner's interest depends upon several key factors.

- Does the partner want his/her interest sold or retained by the heirs?
- Will death costs force the sale of the business?
- Can the remaining partners afford to buy the deceased partner's interest?
- Can the partners operate without each other?

In the absence of a continuation agreement, a partnership is dissolved at the death of a partner. The surviving partner(s) becomes the liquidation trustee, who is responsible by law for dissolving and terminating the business.

## Common Problems During Dissolution

During the dissolution process, the liquidating trustee partner can expect problems.

- Creditors may become worried and may want to be paid immediately.
- Operating the business may be difficult without the deceased partner's skills.
- Debtors may not pay.
- The remaining partner may be forced to sell assets.
- Good will may be lost.
- Deceased partner's family may not understand why the income has stopped.

## A Better Solution Is a Binding Buy-Sell Agreement

- **Entity plan:** Under this arrangement, the partnership purchases the deceased or withdrawing partner's interest.



- **Cross-purchase plan:** Under this arrangement, the surviving partners purchase the deceased or withdrawing partner's interest.



**Note:** An attorney should be consulted in deciding which plan is better and in preparing the agreement.

# Buy-Sell Agreement - Partnership

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## A Buy-Sell Agreement Benefits All Parties<sup>1</sup>

### Benefits to Deceased's Family

- Freed of business worries.
- Not forced to sell assets.
- Family gets a fair price for business interest.
- Probate estate is settled more quickly.

### Benefits to Buyer of Business

- The owner has full control of the business and its future earning potential.
- May alleviate concerns of creditors or suppliers.

### Additional Lifetime Benefits

- The agreement can cover a buy out at retirement, disability or disagreement.
- It produces a sense of security that heirs are protected and that the business will continue.

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<sup>1</sup> Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Buy-Sell Agreement - Sole Ownership

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## The Death of a Sole Owner

When the sole owner of a business dies, his or her executor has several choices, some of which have potential problems.

- **The executor can continue the business.**
  - The executor may be unfamiliar with the business.
  - There can be some loss in good will.
  - The executor may be liable for any business losses.
  - Creditors will typically want to be paid immediately.
  - Subsequent sale may bring less than the value determined for federal estate tax purposes.
- **The executor can close down the business.**
  - Loyal employees are out of work.
  - Family income ceases.
  - Accounts receivable may be very difficult to collect.
- **The business can be transferred by will to the heirs.**
  - Heirs may not have the desire or ability to run business.
  - There can be some loss of good will.
  - The business may have to be sold to pay the taxes and expenses.
  - Creditors will typically want to be paid immediately.
  - Accounts receivable may be very difficult to collect.
- **The executor can liquidate the business.**
  - Buyers may pay only a fraction of the going-concern value.
  - Good will is totally lost.
  - Creditors will want to be paid immediately.
  - Accounts receivable may be very difficult to collect.
  - Family income is eliminated.

# Buy-Sell Agreement - Sole Ownership

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## A Better Solution

There is a better solution - a binding buy-sell agreement which benefits all parties.

- **Benefits to the deceased's family.**
  - Freed from business worries.
  - Not forced to sell assets.
  - Family gets a fair price.
  - Probate estate is more quickly settled.
- **Benefits to the buyer of business** (usually a key employee).
  - He or she still has a job and his or her income continues.
  - He or she owns the business and controls its future success.

## Lifetime Benefits

In addition to the benefits explained above, there are also various benefits which occur during the lifetime of the owner.

- Knowing the business will continue gives employees a more stable feeling.
- Knowing that he or she may some day own the business, the prospective buyer works harder.
- Key employee can be put in charge when owner retires.

# Buy-Sell Agreement - Corporation

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When a stockholder dies, the disposition of his stock depends upon several key factors.

- Is the decedent a majority or minority stockholder?
- Is retention or sale of stock desired?
- Will death costs force the sale?
- Is there a market for the stock?

Ownership Situation	Additional Considerations
<b>Decedent was minority owner</b>	A minority interest in a corporation has little value to an owner who is not an employee. Close corporations rarely pay dividends. Without an agreement the estate is in a poor bargaining position. Minority stockholders can cause problems.
<b>Decedent was equal owner</b>	Decedent's spouse or children may have a vote equal to the shareholder who is running the business.
<b>Decedent was majority owner</b>	Can a minority stockholder afford the buyout? Are the payments tied to the success of the business? Can a minority stockholder keep the business successful?
<b>Decedent was sole owner</b>	Who will buy the stock? Child? Key employee? Competitor? How will he or she pay for it if the business fails?

## A Buy-Sell Agreement Brings Certainty<sup>1</sup>

The best way to bring certainty to these unanswered questions is a binding buy-sell agreement which benefits all parties.

- **Benefits to the deceased's family**
  - They receive a fair price for the stock.
  - They are free from business worries.
- **Benefits to the buyer of business**
  - He or she has control of business and its future earning potential.
- **Price and terms**
  - These are established prior to the crisis.
- **Additional lifetime benefits**
  - Prospective owners work harder if the business may someday be theirs.
  - The agreement can cover a buyout at retirement, disability or disagreement.

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<sup>1</sup> Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Types of Corporate Continuation Plans

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If the owners want to keep the business in the family, but money is needed to pay estate taxes or other estate settlement costs, a partial stock redemption under IRC Sec. 303 should be considered. If the business interest is to be passed to others, several choices are available.<sup>1</sup>



## Continuation Plans in Brief

- **First offer of stock to existing stockholder(s):** The stockholders agree not to sell their stock to an outsider during life or at death without first offering it to the other stockholders or the corporation at an agreed price. This plan gives no certainty to a deceased owner's heirs and will not peg the value for federal estate tax purposes.
- **Option to buy:** An agreement giving the corporation (and/or surviving stockholders) an option to purchase a deceased stockholder's shares. Since the estate is required to sell if the option is exercised, the value for federal estate tax purposes may be pegged. The heirs have no certainty since the corporation is not required to purchase the stock.
- **Cross-purchase buy-sell agreement:** A written agreement among the stockholders to purchase each other's shares at the death of an owner. The price is either stated in the agreement, set by a formula, or provides for the use of independent appraisers
- **Stock redemption plan:** Stockholders enter into an agreement with the corporation to have their estates sell their shares back to the corporation at death. The company usually carries key employee insurance policies to finance the payments for the stock.
- **Wait-and-see plan:** A written agreement among the stockholders and the corporation, generally giving the corporation an option to buy the stock. If it elects not to purchase, the surviving stockholders may buy it and, if they don't, the corporation may be required to buy the shares.

## Considerations in Choosing a Plan

- What is the value of the corporation and who can afford to buy it?
- How many owners are there and how old are they? What percentage of ownership does each person have?
- What is the net worth of each owner? Are the owners related?
- Are they all insurable?
- What are the individual tax brackets and the corporate tax bracket?
- Does the non-active spouse have any rights, e.g., community property interest?

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<sup>1</sup> Many types of corporate continuation plans are funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Buy-Sell Agreement - Cross-Purchase vs. Corporate Stock Redemption

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	<b>Cross-Purchase Buy-Sell</b>	<b>Corporate Stock Redemption</b>
<b>Parties to the plan</b>	A cross-purchase plan is between the shareholders themselves.	A stock redemption plan is between the corporation and the stockholders.
<b>Income tax treatment at a later sale of stock by the surviving shareholders</b>	Purchasing stockholders get a new basis in acquired stock, which is used to measure taxable gain at a later sale of the stock.	The surviving stockholders own a larger percentage of the outstanding shares, but their basis in the stock does not change, causing a higher capital gain at a later sale of the stock.
<b>State laws restricting stock redemptions</b>	Only applies to redemptions by the corporation.	State laws may require that redemptions of stock can be made only from surplus.
<b>Family attribution rules IRC Sec. 318</b>	Only applies to redemptions by the corporation.	These rules may cause what appears to be a total redemption of a decedent's stock, to be treated as a taxable dividend.
<b>Are life insurance policies available to corporate creditors?</b>	Not usually. It is possible if the creditor is, for some reason, able to pierce the corporate veil.	The cash values and the proceeds would generally be available to the creditors of the corporation.
<b>Who pays the premiums on insured plans?</b>	The shareholders. If corporation pays, it must be treated as additional compensation. <sup>1</sup>	Corporation is the policy owner, beneficiary, and the premium payer. <sup>1</sup>
<b>Are there problems when transferring the policies which the decedent owned on other shareholders?</b>	A purchase of these policies by a surviving shareholder will create a transfer for value which may cause the proceeds to be partially subject to income taxation.	Policies are owned by the corporation. No need to make a transfer when one shareholder dies.
<b>What if the corporation needs the proceeds?</b>	Available only if the surviving shareholders are willing to lend the proceeds to the corporation.	Corporation has the right to collect the proceeds at date of death.
<b>Which is easier to understand?</b>	At death, there may be multiple buyers of the decedent's shares. In an insured plan this also means multiple policies on each shareholder.	Generally thought to be easier to understand. At time of death, only one buyer (the corporation) and one seller (the deceased shareholder's estate).

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<sup>1</sup> Both cross-purchase and stock-redemption agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Buy-Sell Agreement - Cross-Purchase vs. Corporate Stock Redemption

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	Cross-Purchase Buy-Sell	Corporate Stock Redemption
<b>What's wrong with multiple insurance policies?</b>	The plan may require many policies. The formula is: (number of shareholders) times (number of shareholders - 1). For example, if there were 5 shareholders, you would need 20 life insurance policies, i.e., 5 X (5-1)	Need only one policy for each shareholder.
<b>Other considerations</b>	<ul style="list-style-type: none"> <li>• If a Stockholder is having trouble paying the premium, he or she may allow the policy to lapse.</li> <li>• Insurance may cost more if the corporation is in a lower tax bracket than the individuals</li> </ul>	<ul style="list-style-type: none"> <li>• It permits the pooling of premium obligations.<sup>1</sup></li> <li>• No question arises as to unreasonable compensation. This often occurs when salaries are increased to pay the premiums for life insurance used to fund a cross-purchase agreement.</li> <li>• Life insurance proceeds are included in adjusted current earnings for purposes of the alternative minimum tax.</li> <li>• The voting power could be altered in an undesirable way.<sup>2</sup></li> </ul>

<sup>1</sup> When one stockholder is older and/or the majority owner and the other is younger and/or a minority owner, the insurance premiums may be vastly different.

<sup>2</sup> Example: Father owns 30%, son owns 30% and unrelated key man owns 40%. A combined vote of father and son controls the business. If father's stock is redeemed at his death, the unrelated key man would own a majority of the outstanding stock and control the business.

# Buy-Sell Agreement - Cross-Purchase vs. Corporate Stock Redemption

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## Wait-and-See Buy-Sell Agreement

If it seems difficult to make the decision as to which plan to use, one may consider what is called a wait-and-see buy-sell agreement.

**A.** Stockholders and corporation agree to the following.

- The surviving shareholders have the option<sup>1</sup> to purchase the shares of the deceased shareholder, and
- The corporation has the obligation to redeem the shares to the extent they are not purchased by the shareholders.

**B.** Funding should be as in a cross-purchase plan.

**C.** When a shareholder dies, the survivors elect one of two options.

- Option one
  - Collect insurance proceeds.
  - Buy the shares individually.
- Option two
  - Collect insurance proceeds.
  - Lend proceeds to the corporation.
  - Cause the corporation to redeem the shares.
  - Corporation issues interest-bearing notes to repay loans.

**D.** An alternative arrangement

- The corporation has the first option to purchase the stock at the price or formula set in the agreement.
- If the corporation fails to exercise its option, the surviving shareholders have a second option to purchase the stock.
- If the survivors fail to purchase the stock, or only purchase a portion of it, then the corporation is required to purchase the remainder.

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<sup>1</sup> The wait-and-see plan is generally most desirable, however, if a shareholder is obligated to purchase stock and doesn't, a later purchase by the corporation would likely be a dividend.

# Buy-Sell Agreement - S Corporation

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## Cross-Purchase

A cross-purchase buy-sell agreement would be basically the same in an S corporation as with a regular C corporation.



## Stock Redemption

Because of the tax treatment of the S corporation, the stock redemption plan has a few different considerations:

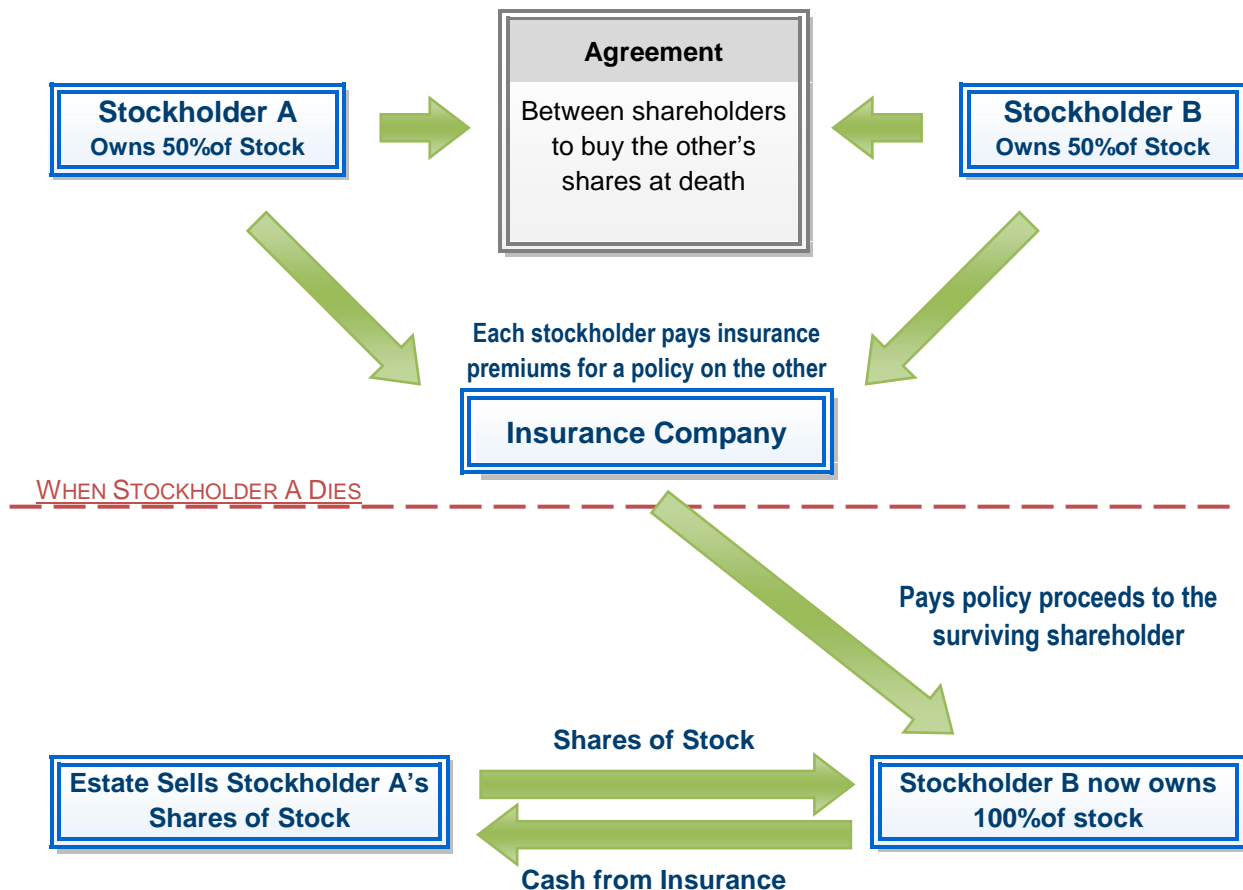
- Since most income passes through to the shareholders, there is little opportunity to manipulate the corporate and individual tax brackets.
- Accumulation of funds by the S corporation would be taxed at the shareholders' top marginal tax brackets. Life insurance would lessen this problem because the premiums are so much less than the amount needed for the buyout. Applicable state insurance laws must be reviewed to make sure shareholders have an "insurable interest" in the other shareholders.
- If stock passes to too many persons in addition to the existing shareholders, currently limited to 100 persons, the S corporation election may be lost.
- A beneficiary who inherits S corporation stock (so that he or she then owns more than 50% of the shares) could possibly revoke the election, contrary to the wishes of the other shareholders.
- Life insurance proceeds may be income tax exempt to both the S corporation and individual shareholders;<sup>1</sup> the basis of stock held by each shareholder is increased by his or her share of the proceeds. See IRC Secs. 1366(a)(1)(A) and 1367(a)(1)(A). Income from a stock redemption may be treated as a mix of taxable dividend and capital gain, or it may be treated solely as a capital gain transaction. See IRC Sec. 1368.

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<sup>1</sup> Buy-sell agreements are frequently funded with life insurance. Under the provisions of IRC Sec. 101(j), added by the Pension Protection Act of 2006, death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. State or local law may vary. Professional legal and tax guidance is strongly recommended.

# Cross-Purchase Buy-Sell Agreement

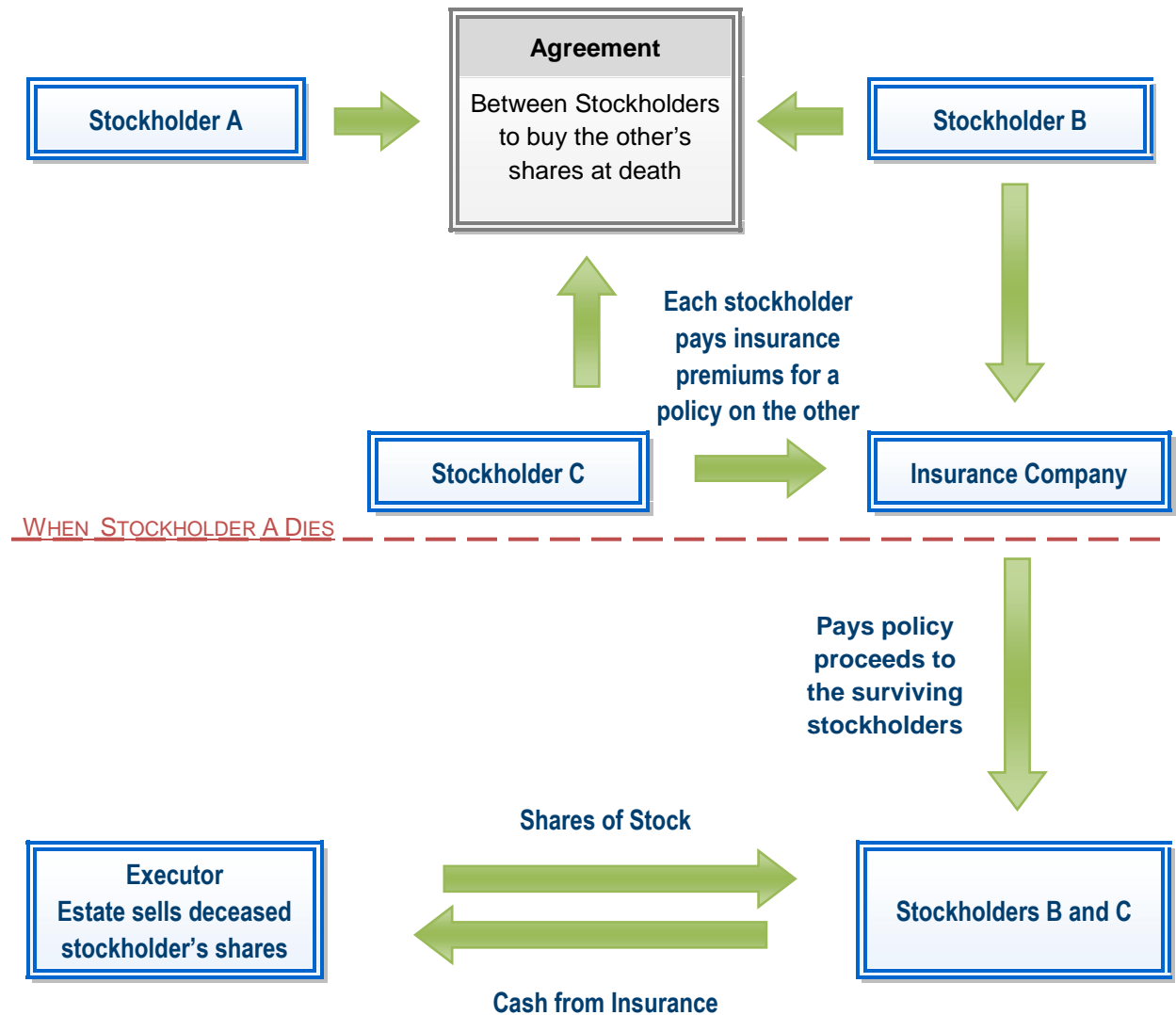
A cross-purchase buy-sell agreement involves shareholders entering into an agreement with each other, rather than with the corporation, to insure an orderly disposition of their stock in the event of an untimely death or disability.



Advantages	Disadvantages
The transferred shares receive a new income tax basis equal to the price paid. This will mean a tax savings, if the stock is later sold at a higher price.	Plan is more difficult to administer if more than two or three shareholders.
No problem with state laws restricting redemptions.	Requires more policies, e.g., 12 policies for 4 shareholders, 20 policies for 5 shareholders, etc.
No problem with IRC Sec. 318 attribution rules.	Some policies may lapse if owner doesn't make the payments.
Life policies may be insulated from the corporation's creditors.	Life insurance proceeds may be taxable if the provisions of IRC Sec. 101(j) apply.

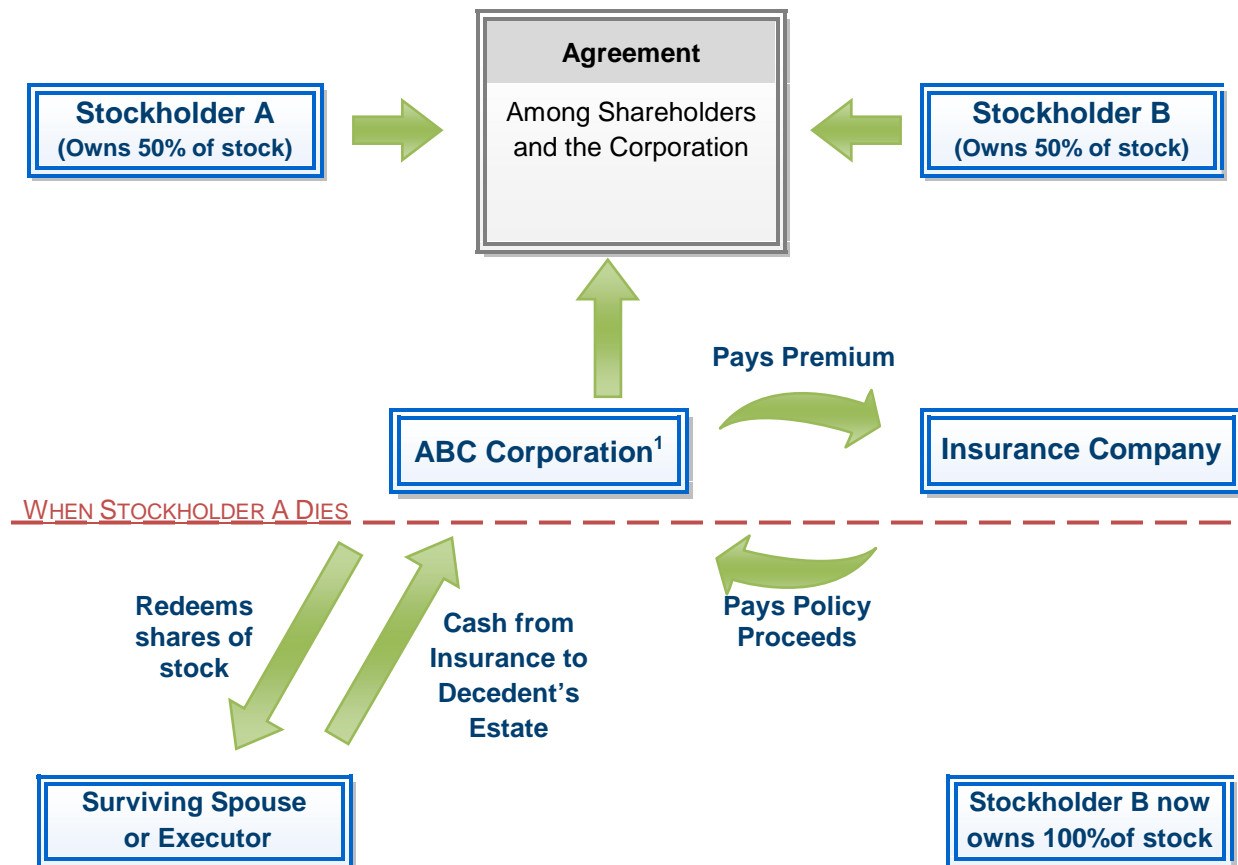
# Cross-Purchase Buy-Sell Agreement with Three or More Owners

A stock redemption plan involves shareholders entering into an agreement with the corporation to ensure an orderly disposition of their stock in the event of an untimely death or disability.



# Stock Redemption Plan

A stock redemption plan involves shareholders entering into an agreement with the corporation to ensure an orderly disposition of their stock in the event of an untimely death or disability.



Advantages	Disadvantages
Usually easier to understand than the cross purchase plan.	Possible accumulated earnings tax on earnings retained to fund the buyout.
Fewer policies in insured plans.	Possibility that family attribution rules will make the buyout a dividend.
No questions as to unreasonable compensation.	Voting power may be altered unfavorably.
	Strict state redemption laws must be followed.
	Value of survivor's shares increase, but not basis.
	Possible increase in corporate AMT

<sup>1</sup> Unless certain requirements are met, life insurance proceeds may be includable in income. See IRC Sec. 101(j).

# Reasons to Value a Business

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The following are a few of the most common reasons to value a business.

- Establish a purchase price in a buy-sell agreement.
- Determine the size of the gross estate for death tax purposes.
- Determine if the estate qualifies for tax relief provisions.
  - IRC Sec. 303 stock redemption
  - Installment payments of death taxes (IRC Sec. 6166)
  - IRC Sec. 2032A current use valuation of business-owned real estate
  - IRC Sec. 2057 qualified family-owned business interest (QFOBI) deduction<sup>1</sup>
- Plan for an equitable disposition of the estate among children where some are active in the business and some are not.
- Determine the value of lifetime gifts of the business.

Other reasons include private annuities, installment sales, recapitalizations, mergers, divorce settlements, charitable contributions, etc.

## Fair Market Value

Treasury regulations set forth the following definition for fair market value.

“...the net amount which a willing purchaser...would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” See Reg. Sec. 20.2031-3.

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<sup>1</sup> Under the provisions of The Economic Growth and Tax Relief Reconciliation Act of 2001 and the 2010 Tax Relief Act. The QFOBI deduction is not available to the estates of decedents dying in 2010-2012.

# Business Valuation Factors

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The value of a business interest is generally based on two things:

1. What the company owns, which is reflected on the balance sheet, and
2. What the company earns, which is reflected in the income statement.

The IRS is guided by the factors set forth in Revenue Ruling 59-60<sup>1</sup> in valuing a business for tax purposes.

## The Nature and History of the Business

Consideration is given to the following.

- Size and consistency of the growth rate
- Stability of the business or lack thereof
- Products, services and company assets
- Record of sales
- Management - especially recent changes
- Diversity of operations

## Economic Outlook

The general economic outlook and condition of the particular industry in which the business operates will affect how a business is valued. Common questions to be considered include the following.

- Is it a growth industry?
- How competitive is this company in the industry?
- What would be the economic effect of the loss of a key employee?

## The Book Value of the Stock

- Based on assets minus liabilities - to show liquidity position.
- Believed to be unreliable in valuing most businesses.

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<sup>1</sup> See Revenue Ruling 59-60, 1959-1 CB 237. Also see Rev. Rules. 65-192, 1965-2 CB 259; 65-193, 1965-2 C. B. 370 and 77-287, 1977-2 CB 319

# Business Valuation Factors

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## The Earning Capacity of the Company

This is perhaps the most significant factor.

- Earning capacity is average earnings over a five-year period multiplied by a capitalization rate.
- There is no standard table of capitalization rates.
- Capitalization rates are usually based on price-earnings ratios of similar, publicly traded companies.

## The Dividend Paying Capacity

This is considered to be a primary factor.

- This does not mean dividends actually paid, but the capacity to pay.
- The IRS recognizes the need to retain a reasonable portion of the profits for expansion needs.

## Goodwill and Other Intangible Values

- Goodwill is based on earning capacity.
- It represents an excess of net earnings over and above a fair return on the net tangible assets of the business.
- Other intangibles include the following.
  - Ownership of a trade or brand name
  - Prestige and renown of the business
  - Prolonged successful operation in a particular locality

## Prior Sales and Size of Block

- Prior sales may be meaningful if they were arms-length transactions.
- Small isolated sales or distress sales are not significant.
- Valuation of a controlling interest may carry a premium value.
- Valuation of a minority interest should include a discount.

# Business Valuation Factors

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## Similar Companies

How the business performs in comparison to its competitors is another consideration in valuing the business. For example, the valuation may consider the market price of stocks in similar, publicly traded corporations as a way of assessing performance.

- Companies must be sufficiently comparable.
- The comparative appraisal method examines price-earnings, price-book value and price-dividend ratios of each corporation.

## Weight to Be Given to Each Factor

Some factors will carry more weight in the valuation than others. There is no exact mathematical formula that can be applied.

A study by Standard Research Consultants<sup>1</sup> showed that in 74 tax cases the most frequently used factors were:

- Sale price in 33 cases;
- Book value in 24 cases; and
- Earning power in 17 cases.

Earnings will typically have more importance in companies selling products and services, whereas net worth will be more important in real estate holding companies.

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<sup>1</sup> Study by Standard Research Consultants, as quoted in the CLU Journal, Vol. 34, No. 2, April 1980, pp. 61-70.

# Valuation Methods Explained

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Since no single method can be applied in determining the value of every business, a number of approaches have developed over the years. The American Society of Appraisers has grouped these approaches into three classifications.

1. Income based
2. Market based
3. Asset based

## Valuation Techniques

- **Income approach:** This approach attempts to measure the stream of benefits coming into the business. The two most commonly used methods are capitalized returns and discounted future returns.
  - **Capitalized returns method:** This method examines the company's history of earnings or cash flow (either gross or net), generally over the previous five or more years. The average annual return is determined and then divided by a capitalization rate selected for the particular kind of business being valued.
  - **Discounted future returns method:** This method looks at projected future earnings of the company and then applies a discount to them to determine the current or present value of the projected income stream.
- **Market approach:** This approach is similar to that used in valuing residential real estate, wherein a house is compared to similar houses which have recently sold (after adjustments for any differences). With the market approach, a search is made for similar companies with publicly traded stock and then the selling price of its shares is adjusted to account for any differences between the two companies. Comparisons will commonly look at one or more of the following factors.
  - Price/earnings ratio
  - Ratio of price to dividends
  - Gross cash flow
  - Book value
  - Revenues
  - Net asset value

A major problem with these methods is that it is often difficult to find similar publicly traded companies. Another problem is that comparing a closely held or privately held company with that of a publicly traded firm where the above information is readily available is often a case of comparing apples with oranges. Publicly held firms are accountable to their stockholders, where closely held or privately held firms are accountable to their owners and, as a result, are often managed entirely differently.

# Valuation Methods Explained

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- **Asset based approach:** This approach is more concerned with the underlying net value of the company's tangible assets. If the business is to be continued after the owner's death, the fair market value of the assets is commonly used. If, however, the business were to be liquidated, a lower value would be used to compensate for the loss which generally occurs with the forced sale of assets.
  - **Book value:** Book value is company assets minus liabilities as shown on the balance sheet.
  - **Book value or adjusted book value:** These methods are most frequently used with companies which own many tangible assets, like a real estate holding company or with a company that has very low or negative earnings.
  - **Excess earnings method:** This method is also called Treasury method because it was developed by the Treasury Department in the 1930's. It is based on Rev. Rul. 68-609, 1968-2 CB 327 and considers both the adjusted book value and a capitalization of earnings in excess of a fair return on the company's assets.

## Weighting the Methods

When several valuation methods are used, some are generally more accurate in determining the true value of the business. For example, in high asset/low income companies, more weight would probably be given to the adjusted book value than to the capitalization of earnings. Because of the influence that weighting methods have in the outcome of the business valuation, a CPA, attorney, valuation specialist or other business advisor should be consulted to arrive at the appropriate weightings.

## Ownership Premium or Discount

Adjustments to the estimated value of the business are made to reflect unique circumstances which may affect its marketability. These may include location, degree of specialty required to run the business, presumed availability of buyers and other factors which could affect the sale price if offered on the open market. For example, a closely held business is often discounted in value to reflect the control that other owners may exercise over a single owner's ability to sell his or her interest.

There are no specific rules or guidelines associated with these adjustments. Frequently they serve as a reality check to help influence the outcome of the valuations or better approximate the expectations of the valuation specialist, CPA, attorney, owners or other business advisors. As a result, the discount or premium applied to the business will usually be arrived at as a consensus of opinion among the business advisors. Particular care should be applied in selecting a rate of adjustment and, whenever possible, the rate should be provided by a valuation specialist experienced in the specific market for which the business is being valued.

# Advantages and Disadvantages of Valuation Methods

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There are many different methods for valuing a business, with some better suited to a specific type of business than others. A key task of the valuation specialist is to select the most appropriate method for valuing a particular business. The method chosen should provide a reasonable estimate of value, be suitable for the intended purpose and be able to face legal challenges by the IRS or other opposing parties.

As a part of the process, a valuation specialist will often employ several different methods and average the results to arrive at a “ballpark” estimate. Because each method has strengths and weaknesses, business owners and their advisors should be familiar with the most commonly used valuation techniques.

## Net Asset Value

The value is based on a sale at fair market value (FMV) of the firm’s assets on a going-concern basis.

- **Strengths**

- Data required to perform the valuation are usually easily available.
- Allows for adjustments (up and down) in estimating FMV.
- Suitable for firms with heavy tangible investments (e.g. equipment, land).
- Helpful when the firm’s future is in question or where the firm has a brief or volatile earnings record.

- **Weaknesses**

- Can understate the value of intangible assets such as copyrights or goodwill.
- Does not take into account future changes (up or down) in sales or income.
- Balance sheet may not accurately reflect all assets.

## Discounted Future Earnings

The value of the firm is equivalent to the capital required to produce income equal to a projected future income stream from continuing operations of the firm. The rate of return used is adjusted to take into account the level of risk assumed by a buyer in purchasing the business as a going concern.

- **Strengths**

- The value of the firm is based on projected future results, rather than assets.
- Can be used with either net earnings or net cash flow.
- Useful when future results are expected to be different (up or down) from recent history.

# Advantages and Disadvantages of Valuation Methods

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- **Weaknesses**

- May understate the value of balance sheet assets.
- Discounts the valuation based on the level of risk. A business perceived as riskier typically receives a lower valuation than a more stable business.
- Projections are not guarantees; unforeseen future events can cause income or earnings projections to be completely invalid.

## Excess Earnings (Treasury Method)

The value of the firm is determined by adding the estimated market value of its tangible assets to the capitalized value of projected income resulting from goodwill.

- **Strengths**

- Takes into account both tangible and intangible assets.
- Includes projected future values of income resulting from goodwill.
- Is based on IRS Rev. Rul. 68-609, 1968 CB 327.

- **Weaknesses**

- Relies on estimate of period for which goodwill is expected to last, which is often difficult to assess. Projections based on this value can be unreliable.
- May understate future revenues or value of intangible assets.
- Though based on IRS rulings, the IRS cautions that the method can be relied on “only if there is no better basis therefore available.”

## Capitalization of Earnings

Value is equivalent to the capital (invested at a reasonable rate of return) required to generate an income equal to an average of the firm’s recent, historical results.

- **Strengths**

- A simplified approach that arrives at an easily determined value.
- Does not rely on projections, but on an average of results from the recent past.
- Most useful for businesses with stable, predictable cash flows and earnings.

- **Weaknesses**

- May understate value for firms using aggressive strategies to reduce taxable income.
- May overlook value of tangible or intangible assets.
- Reliance on past earnings may ignore potential future growth.

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