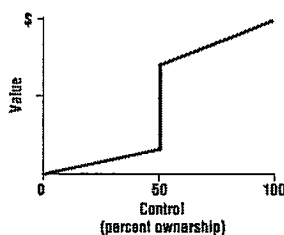


POINTERS

Value And Control.

It is essential for any successful business continuation or disposition plan to consider the factors of value and control. Complete control of a business with no value is worthless; and value in a business you do not control is tenuous. With most successful operating businesses, value and control are typically fixed and determined. In the small closely-held business it is generally accepted that the same individual, or group of individuals, both control the business and own the value. But what happens to control and value upon the death of the business owner? This is the essential question you must address in developing an effective business succession plan. By charting the interrelationship of these two factors you can better appreciate how control dictates value. Greater control means greater value – less control means less value. But the relationship is not linear! Having a controlling interest (i.e., more than 50 percent) in a closely-held corporation produces a “control premium,” as can be seen from the sharp increase in value in the chart. The flip side of the control premium is the discount allowed for a minority interest (page 411).



control means less value. But the relationship is not linear! Having a controlling interest (i.e., more than 50 percent) in a closely-held corporation produces a “control premium,” as can be seen from the sharp increase in value in the chart. The flip side of the control premium is the discount allowed for a minority interest (page 411).

Continued – Sold – Liquidated.

There is no better place to begin a discussion of business succession planning than by asking the questions set forth on page 119. But before you begin the discussion, visit the chart on page 117. Where would you place your client on this chart? Just as importantly, where would your client place himself on this chart? This insight should enable you to more effectively work with your client in developing *and implementing* a business disposition plan.

Know The Entity.

Before proceeding, it is essential to identify the type, or format, of the business: C corporation, S corporation, partnership, limited liability company, or sole proprietorship. The form of organization is an important consideration in selecting an agreement to be used if it is intended that the business will be sold (e.g., a stock redemption agreement does not work very well with a sole proprietorship). In this regard, you may wish to consult the materials on pages 176-178, 193-194, 445, 465-467, 471, 483, and 510-512. Knowing the type of business is also important when considering employee benefits (pages 286-294).

Pointers

Retain Control . . . Shift Value.

If your client's business is to be *continued* by a family member, there are many techniques that can be used to reduce estate taxes – while at the same time maintaining control (e.g., family limited partnerships or recapitalizations, see pages 162-169). Implementation of a specific arrangement will often depend not only upon your client's willingness to proceed, but also upon the ability of your client's professional advisors to work as a team.

Compare The Charts.

The cross purchase agreement involves an agreement between the owners to buy and sell their respective interests. You might think of it as a horizontal obligation running from business owner to business owner. On the other hand, the entity purchase agreement, also referred to as a stock redemption agreement if used with a corporation, involves an agreement by the owners to sell their respective interests to the business. You might think of it as a vertical obligation running between the business owners and the business. However, because of changing individual and business circumstances, choosing between a cross purchase agreement and an entity purchase agreement can be difficult. To keep their options open, your clients may prefer to use the highly flexible “wait and see” buy/sell agreement. With this arrangement, the decision as to who will make the purchase is delayed until after the death of an owner. All of these agreements provide for the complete sale of a business interest, and can be used with either a corporation or a partnership, but not with a sole proprietorship. To gain a better understanding of these plans, compare the charts on pages 127, 131 and 139.

← Cross Purchase →



Business Valuation Is Art . . . Not Science.

With the business owner the subject of business valuation is a wonderful “ice breaker.” However, do not promise more than you can deliver. Business valuation is art, it is not science. The chart on page 123 provides a good place to begin, but a capitalization of earnings approach is not relevant in valuing many businesses (e.g., a medical practice or professional corporation). If appropriate, do not hesitate to advise your client to retain an accredited expert to perform a comprehensive business valuation.

Risk Management.

You should discuss “risk management” with the business owner. As stated by Judge Staley, “The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself from the loss of its most vital assets – managerial skill and experience” (see quotable quotes, page 340). The statistics on pages 179 and 180 will help you quantify this risk for your business-owner clients.

Company Owned Life Insurance (COLI)

Employer-owned life insurance contracts must meet certain notice and consent requirements in order for the death proceeds to be excluded from taxable income. Application of a “related persons” provision, together with complicated attribution rules, will likely cast a very wide net (see discussion, pages 367-369). The general rule is that death proceeds from these contracts are taxed as ordinary income. Exceptions to this general rule are based upon the insured’s status, or how death proceeds are paid or used. However, to qualify for any exception, it is essential to first meet strict notice and consent requirements. For each tax year the contract(s) is owned a reporting requirement mandates that all employers owning one or more employer-owned life insurance contracts must file Form 8529 (Report of Employer-Owned Life Insurance Contracts). *It is strongly recommended that notice be given, and consent be obtained, at the time an application is taken for virtually any life insurance contract that might conceivably fall within the scope of this law.*

Understand The Attribution Rules.

These rules have been aptly described as “infamous and insidious.” While at first they may appear esoteric and difficult, they are important to understand. In family held corporations, if stock owned by one family member is to be sold to the corporation it is extremely important to consider the effect of the attribution rules (pages 170-175). Violation of these rules means that the sale will be treated and taxed as a stock dividend.

Reality Checks . . . They Are Important!

Often your business owner client will want to retain the business for the benefit of a son or daughter. Good planning will usually help this happen, but not if the child is a 2-year-old. Then there is the sole proprietor, who is convinced that his key man will take over the business and run it for the benefit of his survivors. This sounds just fine, until you discover that the “keyman” is a stock clerk hired just a year ago – but he is a “bright” young man. And then there is the physician, who is practicing as a sole proprietor, and who is convinced that his practice is easily worth five or six times annual billings, plus the book value of all the equipment he purchased a few years back. These clients will be well served if you help them perform a “reality check-up.”