

# Business Continuation



*For*

**BC Corp**

March 15, 2012

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# Important Notes

These pages depict certain business planning options. All of these options are based on the information you shared with us for this purpose and the assumptions stated throughout the report. Of course, any variance in the information or assumptions could change the results.

Inclusion of one or more of these options does not constitute a recommendation of that option over any other option(s). This report simply shows the effect of particular options on your business and potentially your estate, based on certain assumptions detailed in the report.

All assets assume specific growth rates, which are provided by the client. These individual rates are used to project the possible growth of the business. These projections are made to estimate future business insurance needs.

The report generated by this software represents an estimate of the value of the business for the purpose of estimating the amount of life insurance necessary for covering estate taxes or funding a buy and sell agreement. The values computed are, at best, only rough estimates and this report is not intended to be a substitute for a thorough professional appraisal.

The term *Proposed Plan*, when used within this report, does not imply a recommendation that a specific business planning option should be implemented. Rather it represents a summary of potential considered strategies, which each individual should discuss with his or her tax advisor, attorney, and/or other professional advisor before taking any action. Nothing contained in this report is intended to be used on any tax form or to support any tax deduction.

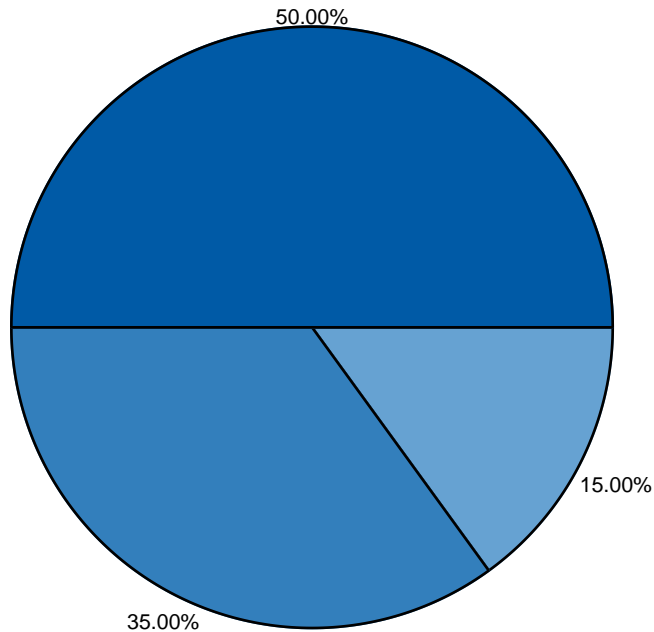
**IMPORTANT:** The projections or other information generated by this investment analysis tool (Business Continuation) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.

**IRS CIRCULAR 230 NOTICE:** To ensure compliance with requirements imposed by the IRS, this notice is to inform you that any U.S. federal tax advice contained in this presentation is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this presentation.

# Total Values Today

## Current Values

Business Type: S Corporation  
Business Nature: Wholesale Trade



Current Value  
\$5,000,000

Owner/Key Person	Owner Tax Bracket	Ownership
Bob Clay	35.00%	50.00%
Bonnie Clark	35.00%	35.00%
Brian Carnes	35.00%	15.00%

Business values based on values provided by the client. Each business should have a professional appraiser determine which method will best represent its value.

# The Problem of Business Valuation

## How to Determine the Value of Your Business

An exact method for determining the value of a business does not exist. The more *experts* you ask, the more opinions you will receive. And more than likely, the opinions will vary widely.

There are many instances when the value of business assets is needed, such as for buy-sell agreements, business loans, and for estate planning purposes. At your death, the value of your estate is subject to estate taxes. Your business assets are part of your estate. Therefore, the higher the value of your business in your estate, the more estate taxes you will pay. The lower the value of your business, the less estate tax you will pay. The IRS will attempt to value your business at the highest reasonable level, while your heirs will try to minimize the value of your business.

There are many methods by which a business may be valued. Five of the most commonly used methods are described below:

- **Book Value:** The value at which the business is carried on a balance sheet, with all assets adjusted for fair market value (fair market value may not be the same as the depreciated value for income tax purposes.)
- **Straight Capitalization Method:** The amount of capital that would have to be invested at a specified rate to yield the current average net annual earnings of the business.
- **Capitalization of Earnings Method:** Assumes that part of earnings are attributed to the assets of the business (book value). Remaining earnings are capitalized at a rate consistent with the relative risk of the business. The result is then added to book value.
- **Years' Purchase Method:** A conservative rate (the pure money rate for an investment with generally accepted lower risk) is used to determine the earnings attributed to assets. The balance is assumed to be provided by goodwill. The earnings provided by goodwill are then multiplied by the number of years for which goodwill is expected to be valuable to a purchaser. The result is then added to the book value to obtain the valuation.
- **Discounted Future Earnings Method:** Projected future business earnings are forecasted, and then discounted using an appropriate rate which reflects the return from the next best investment opportunity with a comparable level of risk. The sum of the discounted future earnings is the current valuation.

The average of these five methods is not an acceptable method of valuation. It is shown in this presentation for comparison purposes only. Each business should have a professional appraiser determine the method that will best represent all of its factors.

# Business Valuation

## Comparison of Methods

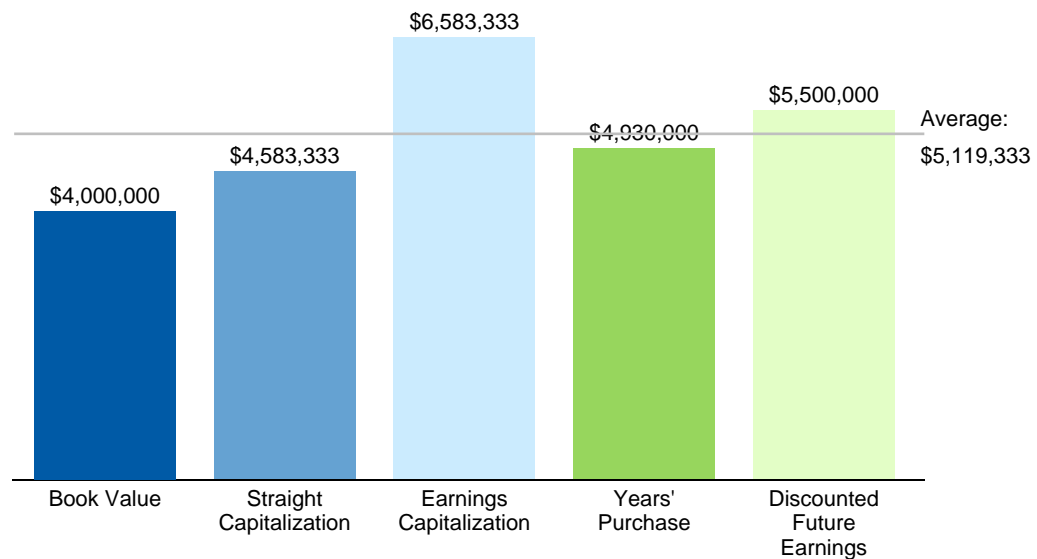
	Value
<b>Book Value:</b>	\$4,000,000
<b>Straight Capitalization Method:</b>	
Adjusted Average Annual Earnings <sup>1</sup>	\$550,000
Capitalization Rate	<u>12.000%</u>
Total Value	\$4,583,333
<b>Capitalization of Earnings Method:</b>	
Adjusted Average Annual Earnings <sup>1</sup>	\$550,000
Estimated Earnings on Assets <sup>2</sup>	<u>- 240,000</u>
Excess Earnings	\$310,000
Excess Earnings Capitalized at 12.000%	\$2,583,333
plus Book Value	<u>+ 4,000,000</u>
Total Value	\$6,583,333
<b>Years' Purchase Method:</b>	
Adjusted Average Annual Earnings <sup>1</sup>	\$550,000
Estimated Earnings on Assets <sup>2</sup>	<u>- 240,000</u>
Earnings Attributed to Goodwill	\$310,000
Multiply by 3 Years Goodwill	\$930,000
plus Book Value	<u>+ 4,000,000</u>
Total Value	\$4,930,000
<b>Discounted Future Earnings Method:</b>	
Adjusted Average Annual Earnings <sup>1</sup>	\$550,000
Annual Growth Rate	5.000%
Years to Forecast Future Earnings	10
Rate to Discount Future Earnings	5.000%
Resulting Future Value	\$5,500,000

<sup>1</sup> Adjusted Average Annual Earnings is the sum of an Average Annual Earnings of \$450,000 and an Excess Owner Salary of \$100,000.

<sup>2</sup> Estimated Earnings on Assets is calculated from the book value and a Rate of Return value of 6.000%.

# Business Valuation

## Valuation Graph



<b>Book Value</b>	<b>\$4,000,000</b>
<b>Straight Capitalization</b>	<b>\$4,583,333</b>
<b>Earnings Capitalization</b>	<b>\$6,583,333</b>
<b>Years' Purchase</b>	<b>\$4,930,000</b>
<b>Discounted Future Earnings</b>	<b>\$5,500,000</b>

Each business should have a professional appraiser determine which method will best represent its value. The average of the five valuation methods is not an acceptable method of valuation. It is shown in this presentation for comparison purposes only.

# Valuation Guidelines

## Revenue Ruling 59-60

A buy-sell agreement may be used to establish or *peg* the value of a business interest for federal estate tax purposes. So long as the agreement meets the standards set by IRC Section 2703 and subsequent related case law, it should be accepted by the IRS.<sup>1</sup> This assumes, of course, that the value specified in the agreement is deemed to be a reasonable valuation as of the time of the agreement. A perfectly legitimate buy-sell agreement will still be challenged if the value it specifies is not a reasonable estimation of the value of the business interest in question. So the question still exists as to how to determine this value.

Estate and gift tax regulations show that the standard to be used here is fair market value, which is loosely defined as "the amount at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts." While this may be an adequate definition for the purpose of valuing many assets, it is usually far too vague a standard to be useful when valuing business interests.

Revenue Ruling 59-60 supplements this vague standard by specifying several important factors that must be considered when valuing a business interest for tax purposes. It establishes that although several valuation methods exist, no single method is adequate for determining an acceptable value for a business interest. Instead, all relevant facts and circumstances regarding the business must be considered. The ruling lists the following factors which must be accounted for:

- The nature and history of the business
- The outlook of the economy in general and of the specific industry
- The financial condition of the business and the book value of its stock
- The earning capacity of the company
- The dividend-paying capacity of the company
- The nature and value of any intangible assets of the business, such as goodwill
- The relative size of the block of stock to be valued and prior sales of the stock
- The market price of actively traded stocks of corporations in the same or a similar business

The relative weights of each of these factors are largely dependent on the circumstances of the business and of the specific interest in question. The ruling therefore provides specific guidelines to apply, while retaining the flexibility needed for individual circumstances.

<sup>1</sup> Under Section 2703, a buy-sell agreement will be disregarded unless: (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to members of the decedent's family for less than full value; and (3) the terms of the agreement are comparable to similar arm's length arrangements.

# Buy-Sell Agreements

## IRC Section 2703

One method to solve the problem of business valuation is to establish a buy-sell agreement. A buy-sell agreement is a contract between a buyer and a seller which stipulates that the buyer must purchase the property in question from the seller upon the occurrence of a specified event. The event is usually death, disability or retirement of the owner of the property. A price for the property in question is specified in the agreement. Therefore, a buy-sell agreement can solve the problem of establishing a reasonable value for a business interest.

To make it likely that the value established in a buy-sell agreement will be accepted by the IRS<sup>1</sup>, the following criteria must be met:

- The agreement must be a bona fide business arrangement, negotiated at arm's length.
- It must not be merely a device to transfer the business interest to family members for less than full and adequate consideration.
- The terms of the agreement must be comparable to those found in similar arrangements entered into at arm's length.
- There must be an option to buy and a binding obligation to sell.
- The price must be fixed in the agreement, or the agreement must specify a formula or method for determining the price.
- The agreement must prohibit the owner of the business interest from selling or otherwise disposing of the property during lifetime without first offering it to the other party at a price which does not exceed the price determined in the agreement.

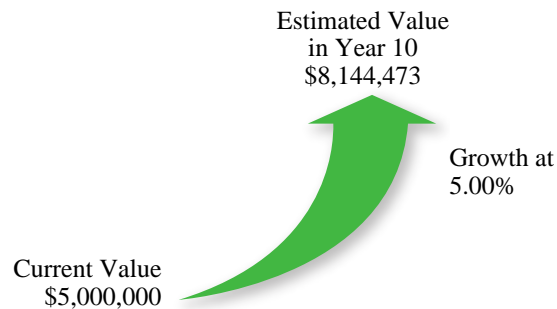
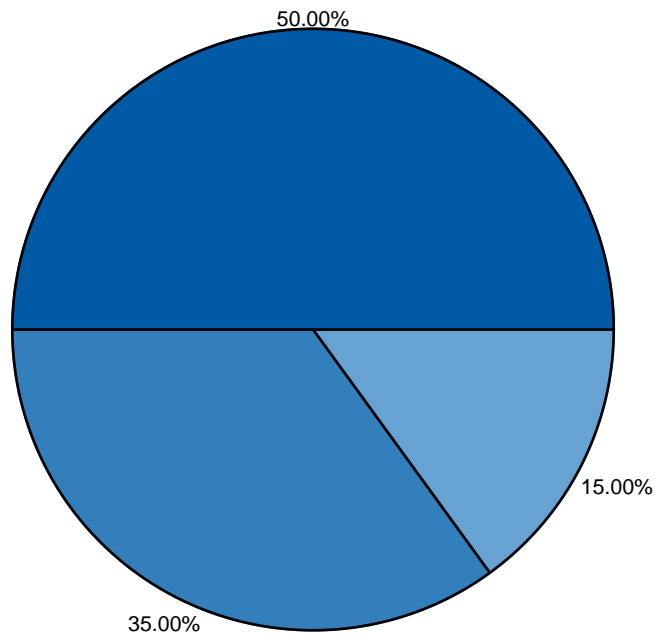
NOTE: The Conference Committee Report for the Revenue Reconciliation Act of 1990 recognizes that there is more than one method of valuing a business (even in the same industry) and it does not require that the method producing the highest value be used.

<sup>1</sup> These guidelines are derived from IRC Section 2703 and prior case law. Technically, while it is a question of fact, a buy-sell agreement could bind the IRS or the courts if all of the above requirements are met, and if the value set in the agreement follows the guidelines discussed in Revenue Ruling 59-60, as outlined on the Valuation Guidelines page. If the business is held by primarily family members, it is subject to the special valuation rules of Chapter 14 (IRC Sections 2701-2704)."

# Business Values

## Future Values

Owner	Today	10 Years	Owner	Today	10 Years
Bob Clay	\$2,500,000	\$4,072,237	Bonnie Clark	1,750,000	2,850,566
Brian Carnes	\$750,000	\$1,221,671			



Business values based on values provided by the client. Each business should have a professional appraiser determine which method will best represent its value.

# Business Valuation Assumptions

BC Corp

## Financial:

Book Value	\$4,000,000
Average Annual Earnings	\$450,000
Excess Owner Salary	\$100,000

## Calculation:

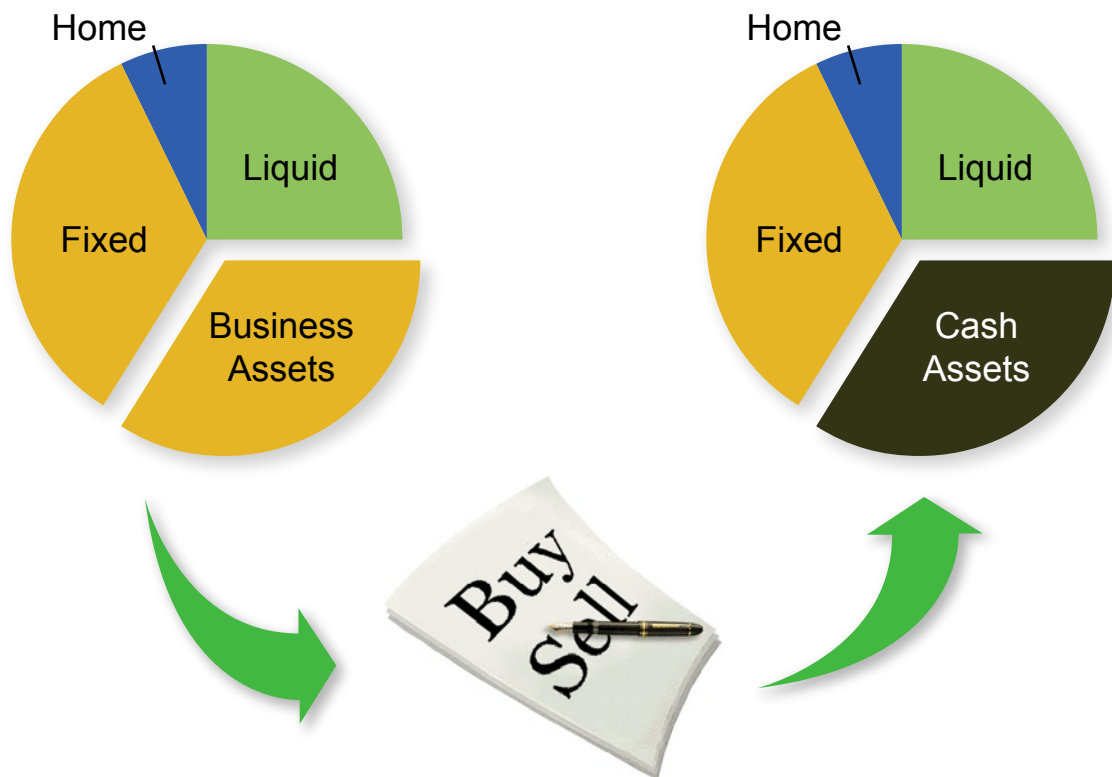
Capitalization Rate	12.000%
Fair Rate of Return	6.000%
Goodwill Multiplier	3 years
Annual Growth Rate	5.000%
Forecast Future Earnings	10 years
Rate to Discount Future Earnings	5.000%

## Discounts for Restrictions:

Lack of Marketability Rate	0.000%
Lack of Control Rate	0.000%

# Buy-Sell Can Provide Needed Cash

Convert Business Interest to Cash



**A Buy-Sell Agreement requires the executor to sell and the buyer to buy the decedent's business interests in accordance with a written agreement.**

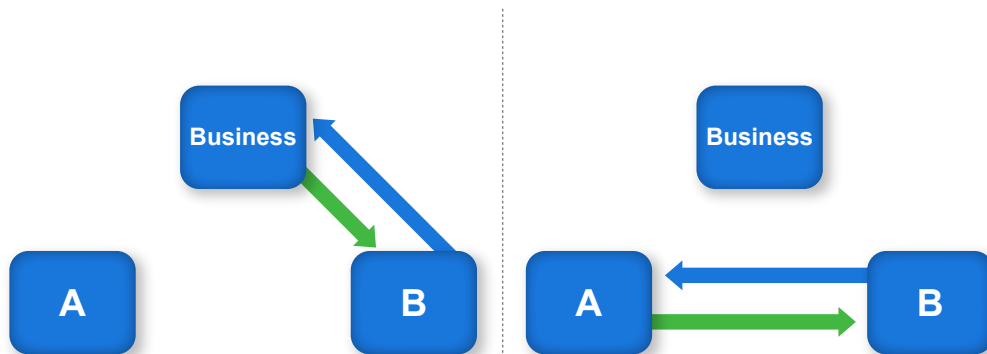
A buy-sell agreement converts the decedent's business interests to liquid cash assets. Although this arrangement does not actually change the value of the estate, it changes the composition of the estate—it changes a business interest to a liquid asset. It may be a factor to be considered in determining the value of the business interest for estate tax purposes.

A buy-sell agreement can assure the continuation of the business by providing a buyer for the decedent's business interest, and it can provide the estate with needed liquidity to pay estate taxes and expenses. These two benefits may be very beneficial to your estate settlement.

The buyer, typically a business partner or the business itself, usually purchases life insurance on your life. At your death the buyer receives the life insurance proceeds which are used to buy the business.

# Basis

## Business Sold Following the Buy-Sell



### Entity Purchase

### Cross Purchase

	Business	Owner A	Owner B or B's Estate	Business	Owner A	Owner B or B's Estate
<b>Prior to Owner B's Death</b>						
Ownership		50%	50%		50%	50%
Value		\$500,000	\$500,000		\$500,000	\$500,000
Cost Basis		\$100,000	\$100,000		\$100,000	\$100,000
<b>Buy-Sell at Owner B's Death</b>						
Cash	Pays \$500,000	Pays \$0	Receives \$500,000	Pays \$0	Pays \$500,000	Receives \$500,000
Business Interest	Receives Business	---	Transfers Business	---	Receives Business	Transfers Business
<b>Buy-Sell at Owner B's Death</b>						
Ownership		Outstanding Stock 100%	0%		Outstanding Stock 100%	0%
Value		\$1,000,000			\$1,000,000	
Cost Basis		\$100,000			\$600,000	
<b>Sale after Owner B's Death</b>						
Owner A's Capital Gains		\$900,000			\$400,000	

The choice of business continuation plan needs to consider whether or not the surviving owner is likely to sell the business. Although the ownership and values will be the same after an entity purchase as in a cross purchase, the surviving owner's cost basis is very different.

# Considerations

## Recommendations for Bob Clay

### If you died or became disabled last night—

- Would a willing buyer for your business interest be available today?
- How would the value of the business be determined?
- Would you or your family get a fair price?
- Where would the money come from to pay for your interest in the business?
- Would the buyer have the cash?

### Your Preference

You indicated that your preference would be to sell or transfer the business to a co-owner.

### A Formal Buy-Sell Arrangement

- Guarantees a buyer
- Establishes a fair price or valuation method in advance
- Arranges the terms of the purchase-obligees buyer and seller
- Drafted properly, may set the value of the business for federal estate tax purposes
- Assures a smooth transition for you, your family and the buyers
- Provides reassurance for creditors and employees of continuation of the business

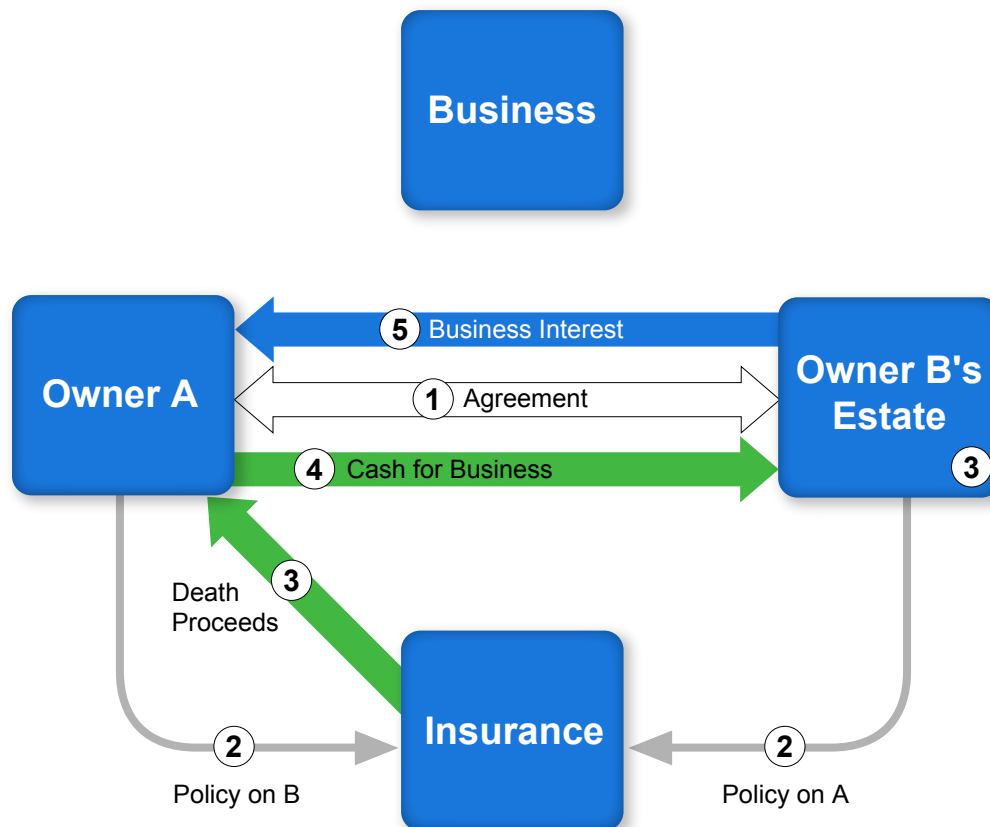
### Funding Alternatives

<b>Cash</b>	Will sufficient funds be available to pay the full price at the time needed?
<b>Borrowing</b>	Credit availability and cost of borrowing in the future are unknown. Any borrowed funds must be repaid with interest from earnings.
<b>Saving</b>	Since timing is not predictable, you cannot be assured that sufficient funds will be available when needed.
<b>Installment Sale</b>	Requires repayment from earnings and forces you or your heirs to rely upon the future success of the business in order to receive your payments.

**The potential solution is to establish a cross purchase agreement with co-owners.**

# Cross Purchase

## How It Works



1. All owners enter into an agreement obligating the survivors to purchase a decedent's interest and obliging the decedent's estate to sell.
2. Each owner purchases and is the premium payer and beneficiary of a life insurance policy on the life of each other.
3. At the death of one of the owners, the surviving owner(s) receive income tax-free death proceeds from the policy.
4. The surviving owner pays the proceeds of the policy to the estate of the decedent according to the provisions of the buy-sell agreement.
5. The estate of the deceased owner transfers the business interest to the surviving owner.

# Recommended Policies

Policies Required for Cross Purchase Solution

Recommendations based on future business value of \$8,144,473

## Owner Considered: Bob Clay

Future Share Value: \$4,072,237

Policy Owner / Beneficiary	Insured	Needed Amount <sup>1</sup>	Face Amount
Bonnie Clark	Bob Clay	\$2,850,566	\$2,800,000
Brian Carnes	Bob Clay	1,221,671	1,200,000

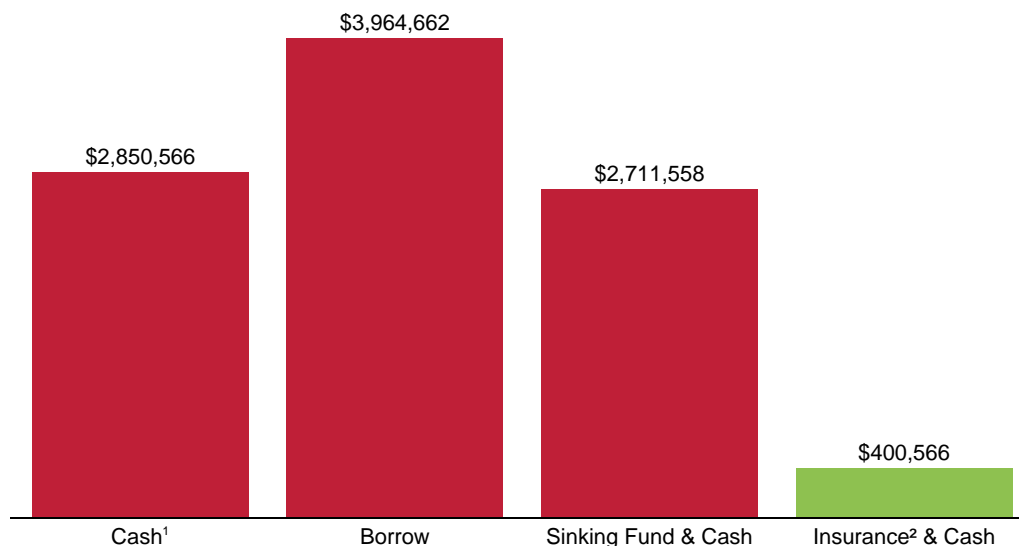
<sup>1</sup> Recommended death benefit amounts are based on the surviving owners maintaining the same ownership relative to the other surviving owners. There are a number of reasons why a different amount may be more appropriate. All factors must be considered when deciding on the proper amount.

# Comparison of Funding Alternatives

Buying Bob Clay's Interest at Death

Owner/Beneficiary: Bonnie Clark  
Insured: Bob Clay

*Comparison at End of 10 Years*



As your business grows, the value of the business changes each year. This comparison assumes values in 10 years. Deposits to a sinking fund as well as insurance premiums reflect just the payments during these 10 years; time value of money is not reflected. Some numbers show the amount at death, the sum of the payments beginning at death, and sum of premiums beginning now. See the following page for net present values.

<b>Cash<sup>1</sup></b>	\$2,850,566
<b>Borrow</b>	At 9.00% interest, 7 annual payments of \$566,380 for total payments of \$3,964,662
<b>Sinking Fund &amp; Cash</b>	Sinking fund of \$489,007 (annual deposits equal to life insurance premiums with interest at 6.00%) plus the balance necessary of \$2,361,559 in cash.
<b>Insurance<sup>2</sup> &amp; Cash</b>	Total premiums for 10 years plus immediate cash need at death of \$50,566 for a total of \$400,566

<sup>1</sup> Value represents the amount needed for Bonnie Clark to buy out Bob Clay's interest at death, based on the values in year 10.

<sup>2</sup> This cost only reflects premiums during these 10 years. See the complete life insurance illustration attached for all policy values.

# Comparison of Funding Alternatives

## Buying Bob Clay's Interest at Death

Owner/Beneficiary: Bonnie Clark

Insured: Bob Clay

*Net Present Value Calculated at 5.00% over 10 Years*

	<b>Total Cost</b>	<b>Net Present Value</b>	<b>Cost of One Dollar</b>
<b>Cash<sup>1</sup></b>	\$2,850,566	\$1,750,000	\$1.00
<b>Borrow</b>	3,964,662	2,011,971	1.15
<b>Sinking Fund &amp; Cash</b>	2,711,558	1,733,566	0.99
<b>Insurance<sup>2</sup> &amp; Cash</b>	400,566	314,817	0.18

As your business grows, the value of the business changes each year. This comparison assumes values in 10 years. Deposits to a sinking fund as well as insurance premiums reflect just the payments during these 10 years; time value of money is not reflected. Some numbers show the amount at death, the sum of the payments beginning at death, and sum of premiums beginning now. Net Present Value shows the relative value in today's dollars.

**Cash<sup>1</sup>**                      \$2,850,566

**Borrow**                      At 9.00% interest, 7 annual payments of \$566,380 for total payments of \$3,964,662

**Sinking Fund & Cash**    Sinking fund of \$489,007 (annual deposits equal to life insurance premiums with interest at 6.00%) plus the balance necessary of \$2,361,559 in cash.

**Insurance<sup>2</sup> & Cash**        Total premiums for 10 years plus immediate cash need at death of \$50,566 for a total of \$400,566

<sup>1</sup> Value represents the amount needed for Bonnie Clark to buy out Bob Clay's interest at death, based on the values in year 10.

<sup>2</sup> This cost only reflects premiums during these 10 years. See the complete life insurance illustration attached for all policy values.

# Comparison of Funding Alternatives

## Buying Bob Clay's Interest at Death

Owner/Beneficiary: Bonnie Clark

Insured: Bob Clay

Below are the year by year details of Bonnie Clark's various funding alternatives. The "Premium Outlay" shows the year by year cost of the Life Insurance funding alternative. The "Cumulative Premiums Plus Int." gives the ongoing balance of the Sinking Fund funding alternative. The "Borrow-Total Payments" shows the year by year amount needed for the Borrow funding alternative. The last two columns illustrate the annual net present value "Cost of One Dollar" amount for the Life Insurance and Borrow funding alternatives.

Year	Value of Business <sup>1</sup>	Life Insurance Death Benefit	Annual Premium Outlay	Cumulative Premiums Plus Int. at 6.00%	Borrow- Total Payments <sup>2</sup>	Insured Plan-Cost Per Dollar <sup>3</sup>	Borrow-Cost Per Dollar
1	\$1,837,500	\$2,800,000	\$35,000	\$37,100	\$2,555,657	-\$0.50	\$1.15
2	1,929,375	2,800,000	35,000	76,426	2,683,440	-0.41	1.15
3	2,025,844	2,800,000	35,000	118,112	2,817,612	-0.32	1.15
4	2,127,136	2,800,000	35,000	162,298	2,958,492	-0.24	1.15
5	2,233,493	2,800,000	35,000	209,136	3,106,417	-0.16	1.15
6	2,345,167	2,800,000	35,000	258,784	3,261,738	-0.09	1.15
7	2,462,426	2,800,000	35,000	311,411	3,424,825	-0.02	1.15
8	2,585,547	2,800,000	35,000	367,196	3,596,066	0.05	1.15
9	2,714,824	2,800,000	35,000	426,328	3,775,869	0.12	1.15
10	2,850,566	2,800,000	35,000	489,007	3,964,662	0.18	1.15

<sup>1</sup> Recommend amount of Bob Clay's business interest assumed to increase at the rate of 5.00% annually (end of year value).

<sup>2</sup> Assumes a loan to purchase Bob Clay's business interest with annual payments for 7 years at 9.00% interest.

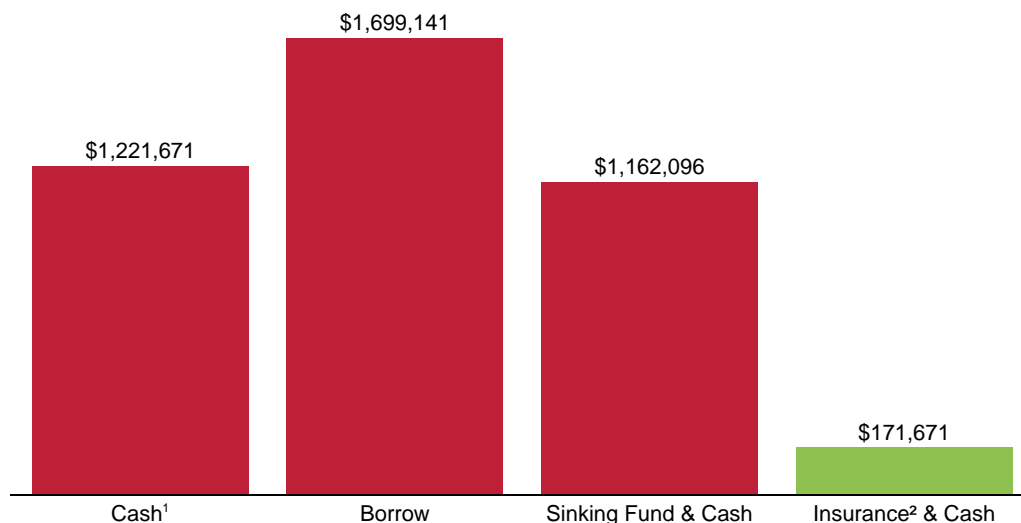
<sup>3</sup> Based on cumulative premiums at the time of death and the business value less life insurance death proceeds. The life insurance death proceeds in excess of the value of the business provides a gain which is represented by a negative cost per dollar.

# Comparison of Funding Alternatives

Buying Bob Clay's Interest at Death

Owner/Beneficiary: Brian Carnes  
Insured: Bob Clay

*Comparison at End of 10 Years*



As your business grows, the value of the business changes each year. This comparison assumes values in 10 years. Deposits to a sinking fund as well as insurance premiums reflect just the payments during these 10 years; time value of money is not reflected. Some numbers show the amount at death, the sum of the payments beginning at death, and sum of premiums beginning now. See the following page for net present values.

<b>Cash<sup>1</sup></b>	\$1,221,671
<b>Borrow</b>	At 9.00% interest, 7 annual payments of \$242,734 for total payments of \$1,699,141
<b>Sinking Fund &amp; Cash</b>	Sinking fund of \$209,575 (annual deposits equal to life insurance premiums with interest at 6.00%) plus the balance necessary of \$1,012,096 in cash.
<b>Insurance<sup>2</sup> &amp; Cash</b>	Total premiums for 10 years plus immediate cash need at death of \$21,671 for a total of \$171,671

<sup>1</sup> Value represents the amount needed for Brian Carnes to buy out Bob Clay's interest at death, based on the values in year 10.

<sup>2</sup> This cost only reflects premiums during these 10 years. See the complete life insurance illustration attached for all policy values.

# Comparison of Funding Alternatives

## Buying Bob Clay's Interest at Death

Owner/Beneficiary: Brian Carnes

Insured: Bob Clay

*Net Present Value Calculated at 5.00% over 10 Years*

	<b>Total Cost</b>	<b>Net Present Value</b>	<b>Cost of One Dollar</b>
<b>Cash<sup>1</sup></b>	\$1,221,671	\$750,000	\$1.00
<b>Borrow</b>	1,699,141	862,273	1.15
<b>Sinking Fund &amp; Cash</b>	1,162,096	742,957	0.99
<b>Insurance<sup>2</sup> &amp; Cash</b>	171,671	134,921	0.18

As your business grows, the value of the business changes each year. This comparison assumes values in 10 years. Deposits to a sinking fund as well as insurance premiums reflect just the payments during these 10 years; time value of money is not reflected. Some numbers show the amount at death, the sum of the payments beginning at death, and sum of premiums beginning now. Net Present Value shows the relative value in today's dollars.

**Cash<sup>1</sup>** \$1,221,671

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**Insurance<sup>2</sup> & Cash** Total premiums for 10 years plus immediate cash need at death of \$21,671 for a total of \$171,671

<sup>1</sup> Value represents the amount needed for Brian Carnes to buy out Bob Clay's interest at death, based on the values in year 10.

<sup>2</sup> This cost only reflects premiums during these 10 years. See the complete life insurance illustration attached for all policy values.

# Comparison of Funding Alternatives

## Buying Bob Clay's Interest at Death

Owner/Beneficiary: Brian Carnes

Insured: Bob Clay

Below are the year by year details of Brian Carnes's various funding alternatives. The "Premium Outlay" shows the year by year cost of the Life Insurance funding alternative. The "Cumulative Premiums Plus Int." gives the ongoing balance of the Sinking Fund funding alternative. The "Borrow-Total Payments" shows the year by year amount needed for the Borrow funding alternative. The last two columns illustrate the annual net present value "Cost of One Dollar" amount for the Life Insurance and Borrow funding alternatives.

Year	Value of Business <sup>1</sup>	Life Insurance Death Benefit	Annual Premium Outlay	Cumulative Premiums Plus Int. at 6.00%	Borrow- Total Payments <sup>2</sup>	Insured Plan-Cost Per Dollar <sup>3</sup>	Borrow-Cost Per Dollar
1	\$787,500	\$1,200,000	\$15,000	\$15,900	\$1,095,281	-\$0.50	\$1.15
2	826,875	1,200,000	15,000	32,754	1,150,046	-0.41	1.15
3	868,219	1,200,000	15,000	50,619	1,207,548	-0.32	1.15
4	911,630	1,200,000	15,000	69,556	1,267,925	-0.24	1.15
5	957,211	1,200,000	15,000	89,630	1,331,321	-0.16	1.15
6	1,005,072	1,200,000	15,000	110,908	1,397,888	-0.09	1.15
7	1,055,325	1,200,000	15,000	133,462	1,467,782	-0.02	1.15
8	1,108,092	1,200,000	15,000	157,370	1,541,171	0.05	1.15
9	1,163,496	1,200,000	15,000	182,712	1,618,230	0.12	1.15
10	1,221,671	1,200,000	15,000	209,575	1,699,141	0.18	1.15

<sup>1</sup> Recommend amount of Bob Clay's business interest assumed to increase at the rate of 5.00% annually (end of year value).

<sup>2</sup> Assumes a loan to purchase Bob Clay's business interest with annual payments for 7 years at 9.00% interest.

<sup>3</sup> Based on cumulative premiums at the time of death and the business value less life insurance death proceeds. The life insurance death proceeds in excess of the value of the business provides a gain which is represented by a negative cost per dollar.

# Action Plan

## Checklist

- \_\_\_\_\_ Seek professional legal advice regarding your needs for disposition of the business.
- \_\_\_\_\_ Meet with a qualified, professional appraiser to determine business value.
- \_\_\_\_\_ Determine appropriate business solution.
- \_\_\_\_\_ Have an attorney:
  - \_\_\_\_\_ Draft proper agreement and necessary resolutions to implement a cross purchase agreement with co-owners.
- \_\_\_\_\_ Apply for life insurance and complete medical requirements.
- \_\_\_\_\_ Execute all agreements and put plan into effect.
- \_\_\_\_\_ Schedule annual review of business continuation plan.

# Assumptions

## Additional Notes and Details

Business Type:	S Corporation
Nature of Business:	Wholesale Trade
Business Value Today:	\$5,000,000
Business Growth Rate:	5.000%

Recommended amounts of life insurance are based on the solution being considered and the assumption that the successive owners would desire that their relative ownership to one another should remain the same. This may or may not reflect the owner's actual objective.

The numbers produced by this analysis in no way guarantee the right to purchase life insurance in the amounts illustrated. Premiums may vary based on many factors, including the age, sex, and health of the insured. If life insurance is illustrated, this presentation is not valid unless accompanied by a complete illustration of proposed policy values.

We offer you this presentation to help you understand how life insurance can be used to provide funds for business continuation arrangements. This material contains references to concepts that have legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Consult your own attorney and/or accountant for advice regarding your particular situation.

# Valuation Guidelines

## Revenue Ruling 59-60

A buy-sell agreement may be used to establish or *peg* the value of a business interest for federal estate tax purposes. So long as the agreement meets the standards set by IRC Section 2703 and subsequent related case law, it should be accepted by the IRS.<sup>1</sup> This assumes, of course, that the value specified in the agreement is deemed to be a reasonable valuation as of the time of the agreement. A perfectly legitimate buy-sell agreement will still be challenged if the value it specifies is not a reasonable estimation of the value of the business interest in question. So the question still exists as to how to determine this value.

Estate and gift tax regulations show that the standard to be used here is fair market value, which is loosely defined as "the amount at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts." While this may be an adequate definition for the purpose of valuing many assets, it is usually far too vague a standard to be useful when valuing business interests.

Revenue Ruling 59-60 supplements this vague standard by specifying several important factors that must be considered when valuing a business interest for tax purposes. It establishes that although several valuation methods exist, no single method is adequate for determining an acceptable value for a business interest. Instead, all relevant facts and circumstances regarding the business must be considered. The ruling lists the following factors which must be accounted for:

- The nature and history of the business
- The outlook of the economy in general and of the specific industry
- The financial condition of the business and the book value of its stock
- The earning capacity of the company
- The dividend-paying capacity of the company
- The nature and value of any intangible assets of the business, such as goodwill
- The relative size of the block of stock to be valued and prior sales of the stock
- The market price of actively traded stocks of corporations in the same or a similar business

The relative weights of each of these factors are largely dependent on the circumstances of the business and of the specific interest in question. The ruling therefore provides specific guidelines to apply, while retaining the flexibility needed for individual circumstances.

<sup>1</sup> Under Section 2703, a buy-sell agreement will be disregarded unless: (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to members of the decedent's family for less than full value; and (3) the terms of the agreement are comparable to similar arm's length arrangements.

# "Fixing" the Business Value

How can you know the value that will be used?

One method to solve the problem of business valuation is to establish a buy-sell agreement. A buy-sell agreement is a contract between a buyer and a seller which stipulates that the buyer must purchase the property in question from the seller upon the occurrence of a specified event. The event is usually death, disability or retirement of the owner of the property. A price for the property in question is specified in the agreement. Therefore, a buy-sell agreement can solve the problem of establishing a reasonable value for a business interest.

To ensure that the value established in a buy-sell agreement will be accepted by the IRS<sup>1</sup>, the following criteria must be met:

- The agreement must be a bona fide business arrangement, negotiated at arm's length.
- It must not be merely a device to transfer the business interest to family members for less than full and adequate consideration.
- The terms of the agreement must be comparable to those found in similar arrangements entered into at arm's length.
- There must be an option to buy and a binding obligation to sell.
- The price must be fixed in the agreement, or the agreement must specify a formula or method for determining the price.
- The agreement must prohibit the owner of the business interest from selling or otherwise disposing of the property during lifetime without first offering it to the other party at a price which does not exceed the price determined in the agreement.

NOTE: The Conference Committee Report for the Revenue Reconciliation Act of 1990 recognizes that there is more than one method of valuing a business (even in the same industry) and it does not require that the method producing the highest value be used.

<sup>1</sup> These guidelines are derived from IRC Section 2703 and prior case law. Technically, while it is a question of fact, a buy-sell agreement could bind the IRS or the courts if all of the above requirements are met, and if the value set in the agreement follows the guidelines discussed in Revenue Ruling 59-60, as outlined on the Valuation Guidelines page. If the business is held by primarily family members, it is subject to the special valuation rules of Chapter 14 (IRC Sections 2701-2704)."

# Double Duty Dollars

## Business Continuation & Retirement Needs

### Uses of Business-Owner<sup>1</sup> Life Insurance

- Protection for the business during working years
- Death proceeds available for Business Continuation
- Cash to supplement retirement benefits
- Values taken from the policy may not be taxable to the business, but may be deductible when paid to the retired executive



### Business Continuation

- Business owned life insurance on owner or key person can provide funds for stock redemption or entity purchase agreement
- Death proceeds could provide tax free dollars for replacing the owner or key person

### After Owner's or Key Person's Retirement

- Business could use cash values to provide retirement benefits
- Favorable taxation may be available on policy withdrawals up to basis and on policy loans
- With a deferred compensation arrangement, benefits paid to retirees are usually deductible to the business

<sup>1</sup> Corporate owned life insurance may be subject to alternative minimum taxes.

# Stock Redemption Plans

## Using IRS Section 303 Stock Redemption Plans

The Sec. 303 Stock Redemption option could be beneficial for stockholders who want their stock in the corporation to remain in the family, but who have not provided enough liquidity in their estate to cover final expenses and administrative costs.

Under the provisions of Sec. 303, the surviving family can sell a portion of the decedent's stock to the corporation, thereby providing cash to pay the decedent's final expenses and estate taxes. This transaction is treated as an exchange, and the gain is treated as a capital gain rather than ordinary income, to the extent that the sales proceeds do not exceed the taxes and expenses.

### Pitfalls of Section 303

- The amount redeemable under Sec. 303 is limited to the cost of the funeral, administrative expenses, and estate taxes (both federal and state).
- The party whose stock is being redeemed must bear the tax and administrative costs.
- To qualify, corporate stock must comprise more than 35% of the adjusted gross estate, or the decedent must have owned 20% or more of at least two corporations.
- It is difficult to plan its use: Other estate assets may appreciate to the point that the 35% rule is not met, the stock value may decline, etc.
- Existing stockholders do not receive a stepped-up basis in stock purchases under Sec. 303 (as they would in a cross purchase).

# Transfer for Value

## Hidden Dangers with Buy-Sell Life Insurance

One advantage of life insurance is that the death proceeds are usually received income tax free! Certain transfers can jeopardize this tax advantage. After a policy is transferred for valuable consideration; only the amount paid (consideration and premiums) will be granted this tax-free treatment, unless the transfer is one of these specific exceptions:

1. **Self**

Transfer to the insured

2. **Certain Business Associates**

Transfer to a partner of the insured

Transfer to a partnership in which the insured is a partner

Transfer to a corporation in which the insured is a stockholder or officer

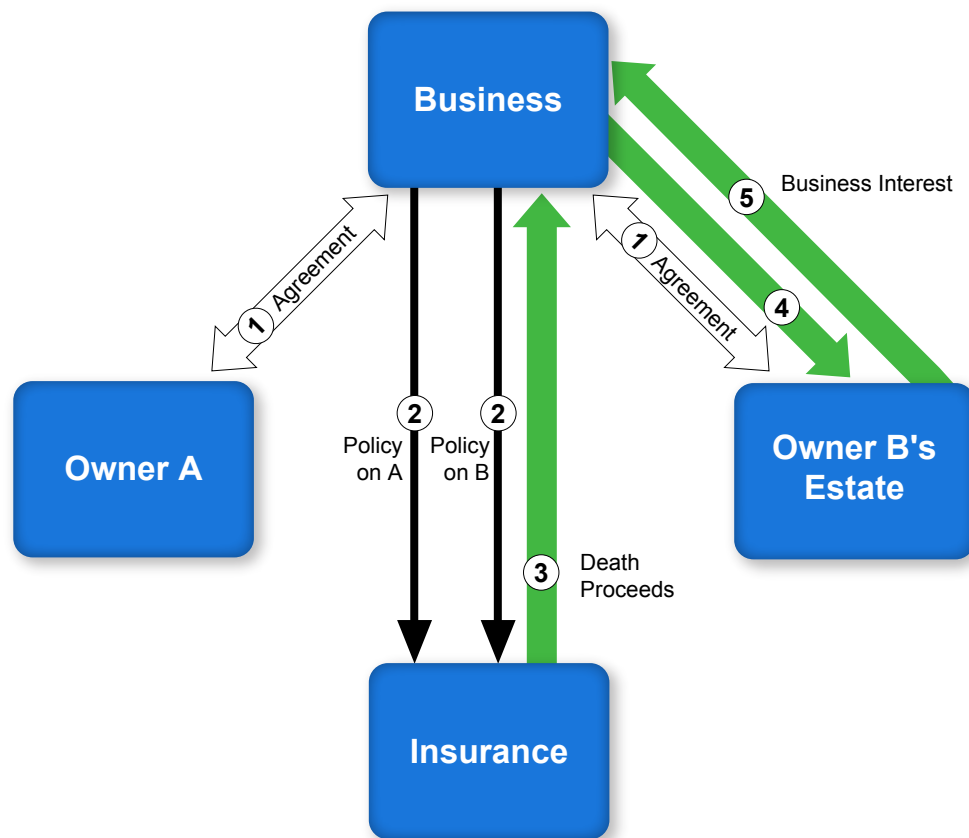
3. **Same Tax Basis**

Transfers where any gain or loss is figured, whole or in part, by the cost basis of the transferor (Examples: transfers between spouses, gifts of a policy, and from one corporation to another in a tax-free reorganization)

Often the policies used in business continuation agreements are transferred among the remaining owners after the death of one of the owners. Unless the transfer is one of these specific exceptions, the death proceeds will not have the full tax-free advantage. Particular attention needs to be observed whenever stockholders are transferring policies.

# Entity Purchase

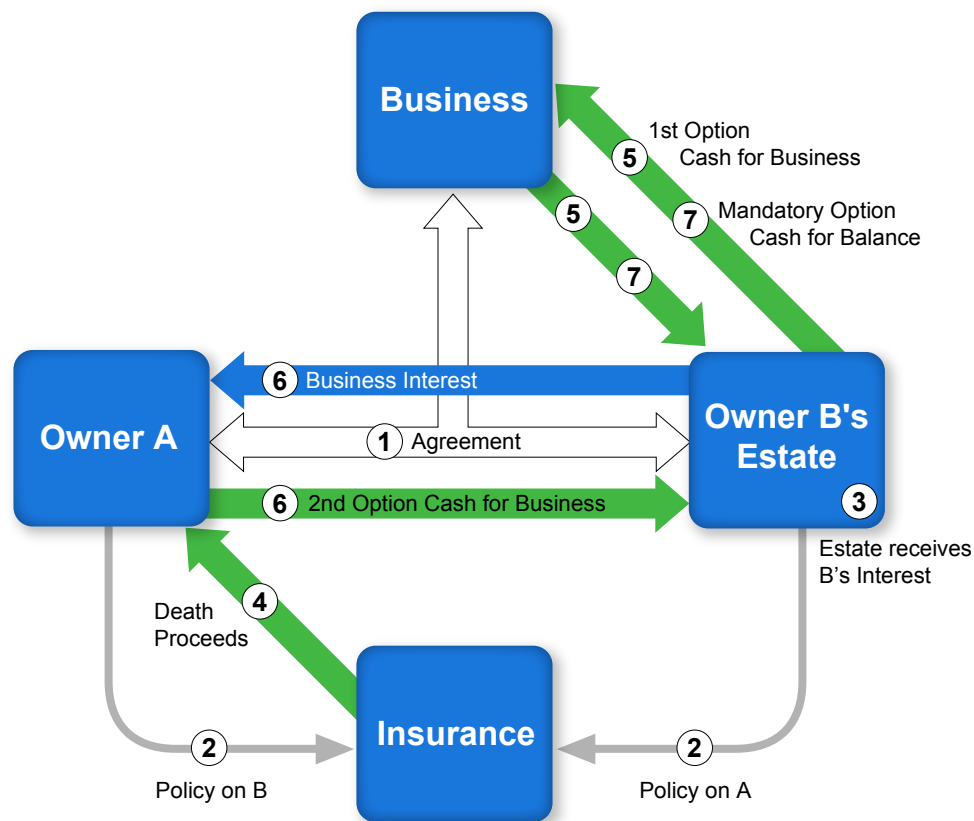
## How It Works



1. Business enters into an entity purchase agreement with each owner obligating the business to purchase a disabled or deceased owner's business interest in the business. Each owner or owner's estate agrees to sell the business interest to the business.
2. The business purchases insurance protection on the life of each owner. The business is the policy owner, the premium payer and beneficiary of each policy.
3. At the triggering event, the business collects proceeds from the policy.
4. The business pays an amount, determined according to the terms of the entity purchase agreement, to the owner or owner's estate.
5. The owner or the owner's estate transfers the business interest to the business.

# Wait 'n See Buy-Sell

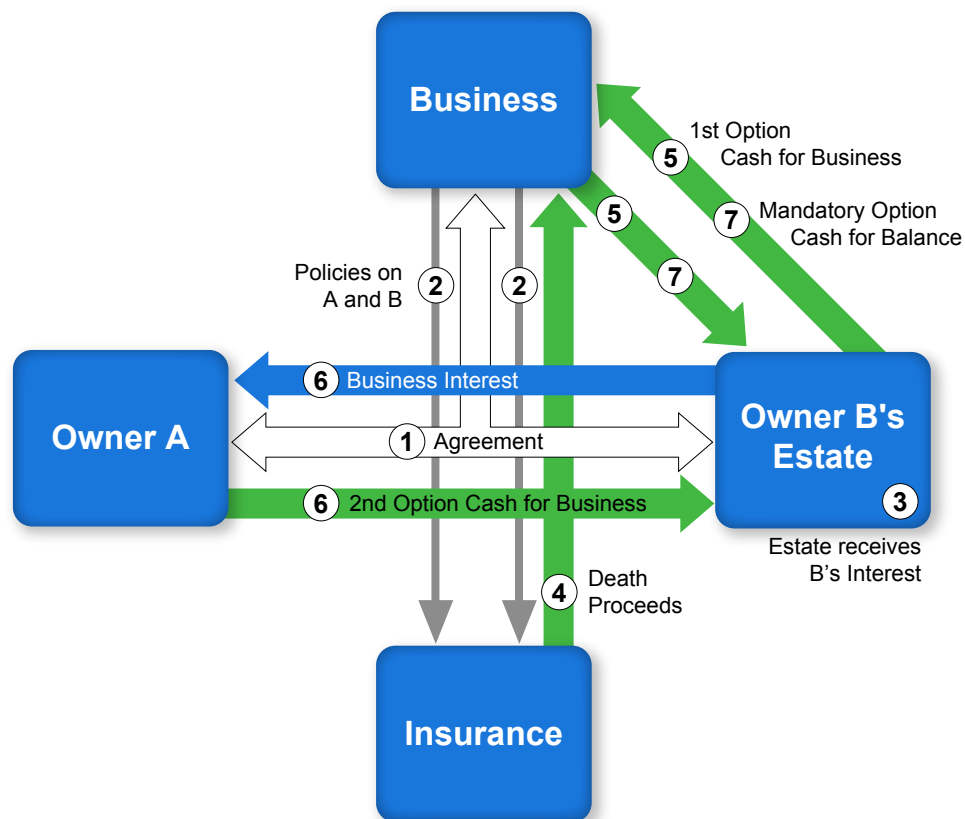
Funded like a Cross Purchase



1. Both owners and the corporation enter into an agreement for the purchase of a deceased/departing owner's interest that obligates the departing owner or decedent's estate to sell.
2. Life insurance purchased on the life of each shareholder using a cross purchase approach. (Each owner is the premium payer and beneficiary of a policy on each owner's life.)
3. At the death of Owner B, the estate receives B's interest in the business.
4. The surviving owner receives the tax-free life insurance proceeds.
5. The corporation is given the option to purchase the stock within a certain period stated in the buy-sell agreement. The corporation can purchase all or any portion of the decedent's stock. Owner A could lend some of the insurance proceeds to the corporation to buy Owner B's stock.
6. If the corporation chooses not to fully exercise its option, Owner A is given an option to purchase all or some of the remaining shares within a stated period of time. Owner A uses the insurance proceeds to buy Owner B's interest.
7. To the extent stock still remains, the corporation is obligated to complete the purchase, assuring 100% of the decedent's interest will be acquired.

# Wait 'n See Buy-Sell

Funded like a Entity Purchase



1. Both owners and the corporation enter into an agreement for the purchase of a deceased/departing owner's interest that obligates the departing owner or decedent's estate to sell.
2. Life insurance is purchased on the life of each shareholder using an entity purchase approach, where the corporation is the owner, premium payer, and beneficiary.
3. At the death of Owner B, the estate receives B's interest in the business.
4. The business receives the tax-free life insurance proceeds.<sup>1</sup>
5. The corporation is given the option to purchase the stock within a certain period stated in the buy-sell agreement. The corporation can purchase all or any portion of the decedent's stock, using the insurance proceeds to pay the purchase price.
6. If the corporation chooses not to fully exercise its option, Owner A is given an option to purchase all or some of the remaining shares within a stated period of time. Owner A could borrow some of the insurance proceeds from the corporation to buy Owner B's stock.
7. To the extent stock still remains, the corporation is obligated to complete the purchase, assuring 100% of the decedent's interest will be acquired.

<sup>1</sup> Death benefit on life insurance is a preference item for C corporation alternative minimum tax purposes. Thus, death benefit received by a C corporation could cause payment of alternative minimum tax.