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Guide to Planning for the Closely Held Business Owner

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NOTICE TO READERS

The *Guide to Planning for the Closely Held Business Owner* was prepared by the Personal Financial Planning Closely Held Business Owner Task Force of the PFP Practice Subcommittee. It is designed as educational and reference material for members of the Institute and others who provide *personal financial planning* services. The nonauthoritative practice aids in this guide do not present positions but attempt to offer some alternatives that practitioners can choose from and then modify, if necessary, to meet their needs. They are intended as time-saving illustrations and tools. They are not intended to establish standards or preferred practices. Authoritative technical literature should be consulted in carrying out all engagements, including personal financial planning engagements.

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Guide to Planning for the Closely Held Business Owner

American Institute of Certified Public Accountants

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PREFACE

The Personal Financial Planning Division has prepared this guide of nonauthoritative practice aids to assist certified public accountants in the efficient and competent delivery of personal financial planning services to their clients. This practice aid is intended for practitioners who are developing comprehensive personal financial plans as well as those performing segmented planning and consultation engagements.

The AICPA has established a membership section for its members and non-CPAs employed by CPA firms that are interested in personal financial planning services. The Personal Financial Planning Division's membership section provides a broad range of practice support services. Information on the Personal Financial Planning Division's membership section can be obtained by writing to the AICPA at the address below or by calling the Personal Financial Planning Division at 1-800-TO-AICPA.

The Personal Financial Planning Division encourages users of this practice aid to provide comments and suggestions that will ensure that future publications and updates will be valuable to our users. Please address your comments and suggestions to:

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PLANNING FOR THE CLOSELY HELD BUSINESS OWNER

I. INTRODUCTION

.01 This guide provides general guidance to the CPA planning for a closely held business owner (CHBO). The CPA should become familiar with the technical modules of the *AICPA Personal Financial Planning Manual* (the Manual) and recognize that planning for a CHBO is a specialized area within financial planning.

.02 Certainly, the fact that a separate taxable entity may be involved can add potential opportunities in the income tax planning area. The focus of any plan could be the personal goals and objectives of the client. The closely held business owner (CHB), because of its relative size in the client's asset portfolio and the client's control over the operations of the business, provides many opportunities for meeting those goals and objectives.

The CPA's Role in Planning for the CHBO

.03 Personal financial planning for a CHBO requires that special consideration be given to the business. This type of planning engagement is much more extensive than one for an owner/nonemployee or a nonowner/employee because the CPA's analysis must consider the business entity, its operation, management, and business plan. Although the CPA is not necessarily an expert in business planning or management advisory/consulting services, the ability to recognize and deal with those aspects of the business that have a direct bearing on the personal financial decisions of the client is important.

.04 When planning for the owner/employee of a closely held business, the CPA may find that the CHB requires the expertise of a specialist other than a CPA.

.05 CPAs should be the first to recognize their limitations in areas of specialized expertise, and should strongly urge clients to seek the needed expertise with their help. Such expertise could include performance of a business valuation, a risk management analysis, an accounting control evaluation, or other management consulting services. It is important that any specialists brought into the engagement be thoroughly familiarized with the team approach to the engagement. The CPA should take full charge of the engagement and should assure that budgets and timetables are met. In addition, communications with the client should include the CPA, unless that is considered unnecessary.

Determining the Nature and Form of the CHB

.06 A CHB can range in size from a sole proprietorship to a huge corporate conglomerate. The size or operating form of the business is not relevant to the CPA's determination of whether or not the client is a CHBO. The only determining factor is the client's degree of control over the business.

.07 The CHB's form — sole proprietorship, partnership, or corporation (for tax purposes, a C corporation or an S corporation) — dictates the income- and estate-tax treatment and affects transfers of ownership, control, continuity, and legal liability. The CPA should consider reviewing the advantages and disadvantages of each business form with the CHBO to determine the one that is most suitable.

.08 **Sole proprietorship.** Briefly, a sole proprietorship cannot be separated from the owner: they are one and the same for all purposes, including tax. The sole proprietor is fully liable for the debts of the sole proprietorship. The assets of the sole proprietorship are included in the estate of the sole proprietor.

.09 **Partnership.** A partnership is a business carried on by at least two people who, by agreement, determine how profits are to be divided. Partners, unless they are limited partners in a limited partnership (not discussed here because it is not a common business form for a CHB), are fully and severally liable for the debts of the partnership. For tax purposes, a partnership is not a taxpaying entity, although it must file an annual information return, keep certain accounts — including special capital accounts — and make certain elections.

.10 A partnership interest is includable in the estate of the deceased partner. Further, unless special provisions have been included in the partnership agreement, the death of a partner will terminate the partnership.

.11 **Corporation.** A corporation is an entity that exists separate and apart from its shareholders, who are only liable for the debts of the corporation to the extent of their investment in the corporation. For federal tax purposes, unless it elects S corporation status, a corporation is a taxpaying entity generally referred to as a C corporation. A corporation electing S corporation status for federal tax purposes is not, in most situations, a taxpaying entity; the shareholders are taxed currently on its income in a manner somewhat similar to partnership taxation. State tax laws differ in their treatment of corporations electing S corporation status for federal tax purposes.

.12 For non-tax purposes, there is no distinction between a C corporation and an S corporation. The evidence of ownership of a corporate interest — shares of stock — is includable in the estate of the owner, and can be transferred freely (unless there is a shareholders' agreement limiting transferability). The death of a shareholder does not terminate the existence of a corporation.

.13 This brief review of the attributes of the various forms of doing business is introductory. The CPA should consider becoming familiar with the attributes of each form and its inherent advantages and disadvantages. In most instances, the non-tax attributes will control the choice of a business form. The following are some of the important planning factors that should be kept in mind.

- *Consider using multiple forms.* A CHB can be divided up into parts. For example, the operating business may be incorporated while the real estate the business uses is incorporated separately or ownership is retained in the names of individual shareholders.
- *Consider the stage of the business' growth cycle.* Because a business in its start-up phase usually shows a loss, either a partnership or an S corporation is commonly chosen to allow the CHBO to benefit tax-wise from the anticipated losses. When the business becomes profitable, the desire to expand ownership interests or attract new capital could lead to the choice of a C corporation.
- *Consider the tax treatment of employee benefits.* Medical insurance costs are generally fully deductible by C corporations, while more stringent rules apply to S corporations, partnerships, and proprietorships.
- *Consider the applicable special tax rules.* Generally a partnership can, by agreement, provide for special allocations of tax or economic benefits; this is not generally possible with a corporation. A C corporation pays tax at both the corporate level and at the shareholder level when earnings and profits are distributed (generally in the form of dividends).
- *Consider the ease of transferring interests.* Partnerships generally terminate if a partnership interest is transferred; this is not true for corporations. In the case of an S corporation, however, transfer of stock to an ineligible shareholder — certain trusts, foreign corporations, or members of consolidated corporate groups — will terminate the S corporation election.

II. PRELIMINARY CONSIDERATIONS

Understanding the CHBO's Business

.01 Additional Information. To understand the CHBO's business, the CPA should consider using checklists (see exhibits 1-3) to assist in gathering information. Planning for the CHBO requires enough additional information that a revised data organizer, or a supplement to the standard organizer, may be useful. The *Data Organizer for a CHB* in exhibit 2 provides a sample of additional information that the CPA should consider requesting. Note that the supplement should be used in conjunction with the *Information-Gathering Checklist* (see exhibit 1 for this checklist of documents) and the motivation questions discussed below at paragraph II.03. The organizer, including the supplement, could be designed so that the client, or an assistant, could complete it.

.02 Uncovering Financial, Business and Personal Motivations. A critical part of the initial information-gathering process is obtaining a profile of the client's motives. To achieve this, it may be important for the CPA to go beyond the formal, quantitative data-gathering process typically associated with providing public accounting services to a company.

.03 The CPA's success in providing recommendations to a CHBO may hinge on the CPA's understanding of the client's underlying motives for owning the CHB. Consider the following questions as a starting point in understanding the CHBO client:

- How was the CHB originally acquired?
  - If it is a start-up CHB, what were the major factors considered before the final decision to proceed was made?
  - If it is a family CHB, what was the primary reason that ownership passed to the current owners?
- What is particularly gratifying to the client about owning this CHB?
- What is the biggest drawback to the client in owning this CHB?
- What five changes related to the CHB would make life better for the client? Have the client make a list including even impossible changes. (Provide one or two examples to get the client started: more time off, better employees, more dedicated executives, more owners, fewer owners, end to family interference, greater profitability, less government regulation, sale of the business.) The list is potentially long and it is important that the CPA let the client complete it without interruption.
- If a buyer for the CHB were found tomorrow, would the client be willing to negotiate a sale?
- In the absence of the CHB, what would the client be doing to generate income?
- If the CHB were sold tomorrow for a fair price, what would be the client's immediate plans?
- Does the client desire his or her children to run the CHB at some future time? Is this a likely outcome?

.04 It is important for the CPA to understand that how a client answers these questions is just as important as the answers themselves. Read between the lines. Like every other person the CPA deals with, the client will often respond to important questions with what is believed to be the expected answer, rather than the honest one. Question an answer that seems insincere or inconsistent with earlier statements. With tact, diplomacy, and sincerity the CPA may be able to build an open and lasting relationship with the client. Once the client understands that candid answers are necessary and that the CPA is willing to dig for them, a great deal can be accomplished. Helping the client to answer the questions honestly could prove invaluable to the client and to the planning process.

Determining the CHB's Life-Cycle Stage

.05 Generally, industries and businesses pass through three stages before reaching the final stage: decline. The time it takes to reach or to pass through each stage varies by industry and by business. It is important that the life-cycle stage of the CHB (and industry in which it participates) be identified so that the CPA can help the client establish realistic goals for the future. The four life-cycle stages are start-up, growth, maturity, and decline.

.06 The CPA who does not know how to identify the life-cycle stage of an industry or business can review materials that address this in detail. The following is a brief description of the traits associated with each cycle.

A. **Start-up:** This stage is characterized by innovation, high risk, few barriers to entry, lack of a definite market leader, and low profit margins.

B. **Growth:** Leaders and specialty market niches emerge in the industry, consumer demand is established and increases, the company experiences increasing sales, profit margins increase, and a market is established that can be exploited further.

C. **Maturity:** Market leaders are established, market demand is fully exploited, intensive advertising may be needed to increase or maintain market position, and there is little product innovation. Nonmarket leaders cater to specialty market niches and profit margins stabilize.

D. **Decline:** The market begins to shrink, there is no product innovation, businesses cut costs to maintain profits, merger activity or business failures increasingly reduce competition, and profit margins are thin.

.07 Action Tips. Understanding the ramifications of the present life-cycle stage of a business and industry can assist the CPA in establishing realistic goals for the client, in applying rates of growth to the CHB portion of the client's asset portfolio, in determining the ongoing value of the CHB (particularly at the time of the client's death), and in predicting future income growth, stability, or decline.

.08 Many brokerage firms do extensive business life-cycle analysis. The CPA should consider using contacts in this area for assistance. Note that an industry can revert to an earlier life-cycle stage through innovation in products or services.

Valuing the Business

.09 Valuing a client's CHB may be an important part of designing the overall financial plan. Because business valuation is a specialized area of practice, it may need to be performed by an expert. Please refer to the AICPA Management Advisory Services (MAS) Small Business Consulting Practice Aid 8, *Valuation of a Closely Held Business*, or other sources for more information on performing a business valuation study.

.10 Obtaining an accurate business valuation may be necessary to providing a useful and reasonably accurate personal financial plan for the CHBO. If the CHBO thinks that he or she already has a reasonably accurate estimate of the value of the CHB and does not wish to incur the cost of a business valuation study, the CPA should consider recommendations on that basis. Unless the CPA is an experienced business valuator or has an opinion of the value of the business that differs greatly from that of the client, the CPA should consider making a reasonable effort to convince the client to have an independent appraiser conduct a business valuation study.

.11 Action Tips. Keep in mind that a business valuation study can be based on criteria relevant to the goals and objectives of the client. The importance of having a professional valuation study may vary depending on the client's goals.

.12 Valuations (and their degree of accuracy) can vary according to the methods used or the needs of the client. For example, values for estate planning based on liquidation criteria may differ from going-concern values used in a retirement planning analysis.

.13 One factor that should be considered when valuing a business is the client's particular business skills and abilities, which may not be readily replaceable. (A by-product of discussions relating to business valuation could be concerns about succession planning.)

.14 In addition, a CHB's current and ongoing value could be affected by the life-cycle stage of the business or industry. The risk associated with the CHB (for example, its ability to maintain or increase profitability) is a critical valuation factor and may be a function of the life-cycle stage.

.15 Business Valuations. Financial planning issues that can be influenced by a business valuation include:

- Projection of net worth available for retirement funding.
- Estate planning and post-mortem planning.
- Establishment and maintenance of an employee stock ownership plan (ESOP).
- Gift-giving programs.
- Buy-sell agreements.
- Life and disability insurance planning.
- Divorce settlements.
- Investment planning.
- Planning for protection from creditors.

.16 When addressing the problem of valuation, the AICPA MAS Small Business Consulting Practice Aid 8, *Valuation of a Closely Held Business*, which is one of many available primers, can provide the starting point for developing an understanding of valuation concepts and approaches. The CPA should consider determining whether the CHB in question was valued in the past for any purpose and how the valuation was done. Also, the CHBO may know how similar businesses have been valued for various purposes.

.17 Except in the rare situation of a comparable asset's having been valued, the process of determining value is difficult. In the case of a CHB, this is often compounded because there may be assets owned by one entity that are used in several businesses, or the assets used in one business may be owned by several entities. Given these complexities, it is not uncommon for disputes to arise over the value of a CHB. Even the concept of *accuracy* is difficult to define in the valuation process. If the objective is to predict accurately how the IRS or the courts might react to a given valuation, precision may be extremely important. If the objective is to predict a selling price, someone in the business of buying and selling a given type of business could provide a reasonable valuation.

.18 The CHBO may be ambivalent as to the exact value. Thus, it is important that the CPA determine the purpose of the valuation before deciding how the value should be determined. For example, it might be prudent to rely on the CHBO's estimate of current value and growth when planning the estate of a forty-year-old owner. Conversely, if an ESOP is being created, the CHBO should carefully consider complying with IRS valuation requirements, which would normally require a professional appraisal. Finally, the CHBO should carefully consider the side effects of any valuation. If a divorce is imminent, it may be prudent for the CHBO to forgo any step that would require a formal valuation. Generally, the CPA should carefully consider potential conflicts of interest when there are joint owners of a CHB, including spouses with joint interests or alleged joint interests.

.19 Typically, the CPA has obtained the CHBO's estimate of value in the early stages of the planning engagement. As factors are identified that indicate the need for a different approach to valuation, the process must be reexamined; for example, consideration should be given to the probable drop in value if there is a possibility that the CHBO may die suddenly. Note also that there is some art in deciding what is to be valued; for example, the CHB itself, the equity ownership of the total business, or the separate lines of business. The CPA should compare the cost of obtaining a valuation against the likely impact of the valuation on the planning decisions. For example, when a CHBO is deciding to give a small percentage interest in a CHB, the actual value may have little current impact on planning if the highest possible value is under $600,000 ($1,200,000 for a married couple) and the unified credit is available. In the case of a pending divorce settlement, the CHBO may be well advised to incur the costs of determining the probable value a divorce court might place on the CHB. If it is likely that formal valuations will be needed on a regular basis, as may be the case with an ESOP, the process should include establishing a mechanism for repeated valuations at minimum cost and disruption to the CHB.

.20 Action Tips. In many planning situations, the purpose of going through a valuation may not be to determine the value, but rather to determine what management steps to take in the future to affect the value at a later date. If this is the objective, the methodology could be more important than the valuation result. Therefore, if a professional appraiser is retained, the objective of the engagement should be made clear to all parties.

.21 The Standards of Value. Depending on the purpose of the valuation, different standards of value can be applied. The following discussion describes some of the more important standards encountered by CPAs. These include:

- Fair-market value for tax purposes.
- Statutory fair-market values for special purposes other than tax purposes.
- Investment value.
- Liquidation value.

.22 For most tax purposes, the fair-market value of an asset is the price that a willing buyer would pay a willing seller, both dealing at arm's length and neither being under a compulsion to buy or sell. The determination of the value under this concept is directly affected by how the IRS approaches the problem and how the courts deal with disputes. The IRS position is stated in *Revenue Ruling 59-60*, 1959-1 Cumulative Bulletin 237, and subsequent rulings. With the advent of specific statutory language governing the allocation of purchase price to assets and the quality of appraisals, much of the planning leeway that once existed is gone. Any attempts to unrealistically skew an appraisal or allocations on the sale of a business could lead to the imposition of penalties.

.23 Value is also defined under statutes other than the tax laws. Some of these definitions are different from the tax definition. Others may appear to be the same, but in practice the courts accept different approaches. When faced with an unfamiliar definition of value, the CPA should consider working with both an appraiser and an attorney familiar with the applicable statutory rules.

.24 Investment value may be appropriate for a contemplated sale of a CHB. In contrast to fair-market value, which assumes no specific buyer, investment value can be defined as the value of a CHB to a particular investor or class of investors. For example, the investment value of a distributor of a product to the manufacturer of the product could exceed estimated fair-market value as defined for tax purposes.

.25 Liquidation value may be appropriate if the client does not contemplate a sale of the CHB at retirement, but instead is intent on liquidating all the CHB's assets at that time. In this instance, liquidation value may be less than the fair-market value of the CHB as a going concern. Liquidation values may, however, exceed the going-concern value of the equity interest in a business, especially when a business owns assets that have value independent of their use in the business, for example, rights to natural resources, or favorable leases.

.26 **Methods of Valuation.** When selecting the most appropriate appraisal method, the appraiser should consider the type of business and the purpose of the valuation, among other factors. Often several methods are used. Thus, the appraiser should carefully determine the most appropriate course to adopt for the engagement.

.27 **Action Tips.** One or more techniques, including the following, can be used to value a business:

- Discounting future earnings or cash flow
- Capitalizing current, normalized or historical earnings, cash flow, or dividend paying capacity
- Applying a multiple of gross revenue or physical volume
- Applying an excess earnings approach
- Determining adjusted net asset value
- Applying the ratio of price to book value or adjusted net asset value
- Comparing with comparable companies
- Applying contract terms that specify a method

.28 Marketability and minority discounts can also play an important role in determining final valuation figures. When applying these methods the CPA should consider the life-cycle stage of the CHB. Also, the death of the CHBO could affect a valuation performed for estate planning purposes.

.29 While these methods may appear to involve a high degree of precision, there are many uncertainties; valuation is not an exact science. The application of each method requires the experience and talent of a qualified appraiser. For example, in discounting earnings or cash flow, the selection of the appropriate discount factor is a major determinant of value. Even in comparisons with similar companies, the selection of what is comparable may be as much art as science.

.30 To-Do List. Before valuing a CHB, the CPA should consider taking the following actions:

- Complete the information-gathering checklists (see exhibits 1-3) as appropriate.
- Adjust the financial statement.
- Determine the life-cycle of the client's CHB and the industry.
- Determine the need for a formal valuation of the CHB in light of the stated primary goals of the client.
- Select an appropriate valuation technique.

III. CASH-FLOW PLANNING

.01 Separation of CHB and CHBO's Cash Flow. Financial planning strategies often require funding to accomplish a goal. The most significant (if not the only) source of income for funding the financial goal of a CHBO may be the CHB itself. Therefore, cash-flow planning for a CHBO is a good starting point in the planning process.

.02 Many CHBOs, combining their personal financial lives with the life of the CHB, view themselves and their CHB as one entity. The CPA should consider stressing to the client the importance of separating the two (in both the financial and psychological sense). For example, it is much easier to establish the value of a CHB for the purpose of obtaining financing or disposing of an interest if the financial records of the CHB are separate from those of the CHBO. Financial privacy and, in some cases, risk minimization are additional reasons for this separation.

.03 Action Tips. When engaged in cash-flow planning for the CHBO, it is important that the CPA understand the CHBO's business objectives and the CHB's life-cycle stage, and cash flows. These factors may affect, and should be incorporated into, the cash-flow plans of the CHBO. During this process, consideration should be given to the following:

- *Fluctuations in the CHB's cash flow.* Should the cash requirements of the CHB be funded from reserves of the CHBO, CHB's credit lines, or individual credit lines?

When a CHB has seasonal fluctuations, should the CHBO structure cash withdrawals accordingly? What are the merits and disadvantages of maintaining excess cash balances in the CHB rather than distributing them to the CHBO for investment?

- *Business Expenditures*. Should expenditures be paid for by the CHB rather than the CHBO? The CPA should consider this issue in light of its impact on income taxes, estate planning, and business valuations.

.04 The CPA often becomes involved in the process of cash-flow planning for the CHB as well as for the CHBO. (Please refer to the AICPA *Personal Financial Planning Library*, Cash-Flow Module for more information on cash flow planning.) When this occurs, it is necessary to address the business' cash flow, use of credit and control of accounts receivable, accounts payable and inventory.

Business Considerations

.05 Cash Budgeting and Planning. To maximize a business' cash flow, it is important to understand and monitor its cash inflows and outflows. The CPA might consider preparing a monthly cash-flow budget at the beginning of every year. In addition, if long-term cash-flow planning is appropriate and included in the engagement, annual cash budgets with projections for the next five to ten years may be needed. The budgeting process should also include a review of prior-year financial statements, with a focus on the cost versus the benefit of each line item. That is, it should address the question of what benefit each item provides for the CHBO. Variable-cost items should be evaluated carefully.

.06 The CPA should consider developing a plan for investing excess cash balances to maximize investment income without reducing the availability of needed liquid reserves. When there are recognized fluctuations in liquidity because of the seasonal nature of the business, thought could be given to developing methods to spread out cash flow more evenly throughout the year. For example, merchandise could be offered for sale at a discount during off-seasons.

.07 A system should be in place to monitor the cash-flow budget on a monthly basis. For example, a budget-to-actual statement could be prepared on a spreadsheet, or the client's general ledger system could provide budget-to-actual statements. Regardless of the method used for preparing the information, the CPA should consider stressing to the client the importance of reviewing the information generated on a regular basis. Variances between the budget and the actual financial information should be identified and analyzed. These variances could indicate problem areas that should be improved. The CPA can assist clients to create a system to help monitor the cash-flow budget and, when appropriate, can meet with them to review the results.

.08 Use of Credit. It is important that a business have resources available that enable it to function normally during off-seasons and when markets are depressed, and to expand when desired. The CPA can assist the CHBO by identifying and evaluating the CHB's cash-credit requirements. The short- and long-term needs of the CHB should be considered, including the following:

- Desired level of business indebtedness
- Cost of credit versus use of cash reserves
- Debt versus equity financing for large or long-term expenditures
- Seasonal cash-flow fluctuations
- Funding large or irregular expenditures (for example, pension plan contributions)
- Use of credit in comparison with industry practice
- Need to provide personal guarantees of business debt

.09 Once the credit requirements of the CHB have been determined, credit availability and lender relationships should be assessed. If the CHB is not currently strong enough to obtain its desired level of credit, a plan, which could include establishment of a relationship with a new lender, should be developed to achieve that level.

.10 Control of Accounts Receivable, Accounts Payable, and Inventory. The success of a business may depend on its ability to collect revenue. However, payment of expenses prior to the collection of related income, and losses from the lack of proper inventory controls can significantly reduce profitability.

.11 Although it may be outside of the engagement to assist clients in accounts receivable, accounts payable, and inventory control procedures, it is important to stress the importance of these areas. The CPA should consider assessing the client's comfort level in these areas by posing questions such as whether billings are generated and collections are received on a timely basis. The goal should be to identify, rather than to solve, problems. When appropriate, a systems specialist may be brought in to work with the client to achieve the desired objectives.

.12 To-Do List. The CPA should review the following to-do list before completing a cash-flow analysis for a CHB.

- Consider separating the cash flows of the CHBO and the CHB.
- Consider the cash-flow patterns of the CHB and their relationship to those of the CHBO.
- Consider preparing a cash-flow budget or plan for the CHB and developing a monitoring system.
- Consider the use and availability of credit for the CHB.
- Consider the adequacy of the internal cash and related control systems, for example, controls of accounts receivable, accounts payable, inventories, and petty cash. Consider bringing in a systems specialist when problems may exist and specialized expertise is needed.

IV. INCOME TAX PLANNING

.01 This section presents a brief overview of major income tax considerations. The CPA's knowledge of income taxes and tax planning strategies is assumed to be at a level that makes detailed discussion in this practice aid unnecessary. Please refer to the AICPA *Personal Financial Planning Library*, Income Tax Module, for more information on income tax planning.

Income Tax Planning Strategies

.02 Accurate and complete record keeping is crucial to the ultimate success of many of the tax strategies the CPA advises a client to implement. The CPA should review the CHBO's books and records to determine the diligence with which he or she has separated personal activities from those of the CHB. If this is a problem for the CHBO, the CPA should discuss with the client the importance of separating personal from business activities for tax purposes.

.03 Tax planning strategies generally fall into three categories: tax deferral, tax reduction, and income shifting. The existence of a business merely expands the opportunities available to the client in each of these areas. Accelerating depreciation expense is a deferral strategy; carefully identifying all available business-related expenses, such as travel and entertainment, is a reduction strategy; employing relatives or using multiple entities can be a shifting strategy. The structure of the business entity may have significant implications for planning.

Data Gathering and Analysis

.04 The CPA may not always be the preparer of the client's business tax return. In this case, more information might need to be gathered from the tax preparer's files. In addition, the CPA may not be a business tax expert, but typically will need a working knowledge of key tax issues. The CPA will usually need to work closely with the tax return preparer to devise and implement strategies.

.05 The data-gathering forms (see exhibits 1-3) provide the minimum amount of information needed to begin planning for the CHBO client. The *Tax Planning Checklist for the CHBO* (exhibit 4) may assist a CPA when accumulating information about existing and potential tax planning opportunities for a business.

Special Considerations

.06 When planning for a CHBO, there are a number of special concerns the CPA can address, a few of which deserve special mention. However, the following list is not intended to be all-inclusive.

- *Shareholder loans*. Shareholder loans can be effective—

- — To meet the cash needs of a business without creating additional paid-in capital.
- — To generate tax-deductible interest expense as opposed to dividends.
- — To create at-risk basis in an S corporation or partnership.

- *Ownership of assets*. The ownership of assets, that is, by the CHB or the CHBO, may dictate a change for business or tax reasons.
- *Passive loss rules*. The passive loss rules may present opportunities to maximize the tax benefits of passive activities that generate income.
- *Tax-free fringes*. Certain fringe benefits are received on a tax-free or tax-deferred basis. In addition, tax-free fringes should be considered to be part of a compensation package to attract and retain key non-owner employees.
- *Personal holding companies*. Avoiding personal holding company (PHC) status for a client's C corporation is an important part of tax planning. If PHC potential exists, the CPA should review with the client the impact of the PHC tax and the alternatives available to avoid it.
- *S corporation elections*. Because inadvertent disqualification can be very costly to a CHBO, the CPA should educate clients about events that can cause a loss of S corporation status.
- *Accumulated earnings tax*. The CPA can assist the CHBO operating through a C corporation to avoid the accumulated earnings tax by monitoring accumulated earnings so they do not become excess accumulations or by adopting a formal corporate plan that sets forth reasonable business purposes for the accumulations.
- *Personal service corporations*. Personal service corporations (PSCs) are subject to special rules. If the CPA determines that a CHBO is subject to the PSC rules, the impact on the CHBO and the CHB should be identified for the client.
- *Built-in-gains (BIG) tax*: The CHBO should be advised of the impact of the BIG tax on sale of assets of a corporation following a change from C to S corporation status. Any planning for a CHBO who is considering switching the CHB to S corporation status or selling off significant assets of an S corporation should include a review of the potential impact of the BIG tax.
- *Unreasonable compensation*. The danger of the IRS reclassifying the compensation of a shareholder/employee as a dividend should be addressed. Because the test for reasonableness of compensation is based on the surrounding facts and circumstances, attention should be given to the applicable rulings and cases to avoid a possible confrontation with the IRS.
- *Related entities*. The CPA should attempt to identify all entities related to the client to avoid the traps presented by the many attribution rules. Some of the potential danger areas are stock redemptions, pension plan contributions, and exchanges between related entities.

.07 To-Do List. The CPA should consider taking the following measures for a CHBO:

- Completing the *CHBO Information Gathering Checklist* (see exhibit 1)

- Becoming familiar with the above section on Special Considerations and identifying relevant potential planning opportunities for the client
- Completing the *Tax Planning Checklist for the CHBO* (see exhibit 4) and following through as needed.

V. RISK MANAGEMENT

.01 The CHBO's risk management/insurance concerns usually include all those that the CPA normally addresses in any planning engagement. These are addressed in the Risk Management and Insurance module of the *PFP Manual*. However, the CHBO's ownership and control over the business creates additional risks, as well as greater planning opportunities.

Primary Considerations

.02 As the decision maker, the CHBO has increased exposure to risks, including personal liability for the following:

- Retirement plan failures
- Employee injuries
- Product failures
- Employee actions
- Social irresponsibility (for example, polluting accidents)
- Nonpayment of debts, when the corporate veil can be pierced (for example, failure to pay over trust-fund taxes)

.03 When management has not exercised prudence and reasonable care, its negligence can create a personal liability once thought to be *contained* within the legal entity of the corporation.

.04 The CPA should educate clients as to the risks and the means to mitigate the impact of any claims. Solutions to consider include:

- Engaging a qualified business risk manager to identify existing and potential risks and to suggest ways to minimize them.
- Obtaining liability insurance for the CHBO that provides broad coverage against potential business-related claims.
- Positioning the personal assets of the CHBO so that a claim not covered by insurance would not consume the CHBO's assets. This may be accomplished, for example, by carefully separating the ownership of and responsibility for the CHB of one spouse from the assets owned (preferably in trust) by the other spouse.

.05 The CHBO has the prerogative to decide what personal liability insurance coverages are needed. The CPA can help the CHBO review the costs and benefits of the coverages available (for example, group versus individual). The need to provide employee coverages for competitive reasons should be considered.

.06 Another risk commonly incurred by the CHBO stems from personal guarantees on company liabilities. One way to protect against a complete loss of personal assets is to transfer assets to a spouse or another individual before incurring the liability.

Life Insurance

.07 CHBO status opens up several avenues of life insurance planning. The most commonly used coverages are group term, split-dollar life insurance, and reverse split-dollar life insurance. Because the CHBO's pocketbook is dependent on the CHB's cash flow, the ability to spend dollars on life insurance cannot be left out of either personal or business planning. When investigating life insurance for a CHBO, the CPA should review potential benefits in the context of estate planning, income tax planning, investment planning, and cash-flow management. Also, remember that if the CHBO is likely to have difficulty obtaining life insurance — especially for health reasons — the only choice available may be group insurance. For a more detailed explanation of life insurance planning, see the risk management and insurance module of the *PFP Manual.*

Risk Management Strategies

.08 Proper insurance protection and risk management do not happen by chance, but are achieved through organization and planning. Unless the client takes the following measures, a lifetime of work can be lost in a few minutes.

- *Decide which one of the risk management techniques works best and most economically for the CHBO.* Commercial insurance is only one of the means available for handling the risks facing most CHBOs. Evaluate other methods (for example, loss prevention, self-insurance, risk transfer) to see if they offer improved protection at a lower net cost. Many businesses use a combination of two or more of these techniques.
- *Deal with the largest potential loss exposure first; as the client's budget permits, deal with the more frequent, less severe exposures.* Use insurance premium dollars where protection is most needed. Some businesses insure automobile property damage but then neglect to purchase adequate personal injury insurance. Automobile property damage losses seldom bankrupt an organization, but personal injury losses do have that potential.
- *Make proper use of deductibles.* For many lines of insurance, *full coverage* is usually not economical, because of the high cost of covering *first-dollar* losses. Place the deductible levels at amounts that can be comfortably absorbed by the business and that provide a reasonable premium offset.
- *Buy the largest possible unit of insurance.* Insurers typically price their policies with a provision for volume discounts. This is particularly true of life insurance and many types of property insurance. Usually, the more property is insured on a

single policy, the cheaper it is for the insurer to administer the policy and the lower the premium rate.

- *Insure the correct exposure.* Make sure that the insurance coverage purchased extends to all areas of the business operation. For example, if a business is insuring against the risk of loss from employee dishonesty, the policy should extend beyond employees who handle cash to employees who handle merchandise or inventory. Depending on the type of business, a loss in either area could be very large.
- *Analyze the insurance policy terms and conditions.* On occasion, businesses attempt to save money by purchasing cheaper policies. They then discover that a specific exposure or hazard that was intended to be insured was not. Some insurers can offer cheaper insurance contracts because they reduce services, narrowly focus coverage, or maintain a frugal claims policy. The CPA should carefully investigate what the client will be sacrificing to save money before changing insurers or policies.
- *Review insurance periodically.* Automatic annual renewal of business insurance policies greatly increases the possibility that the CHBO may either fail to increase protection when needed or deprive the CHB of a rate reduction when a risk factor — previously charged for — no longer exists.
- *Take full advantage of loss prevention services offered by the insurer or agent.* Many insurers offer a full range of loss prevention and loss control services, the cost of which is included as part of the insurance premium. CHBOs should determine what services are available and how to take full advantage of them.
- *Check the marketplace occasionally to confirm that the client's insurance is reasonably priced.* While it is not practical to switch insurers each time a lower price is quoted, the CHBO and CPA should consider monitoring the average costs for the amount and type of coverage needed.
- *Consider company quality.* Recent insurance company failures demonstrate the need to consider the ability of the company to pay future claims or benefits.

Sources of Information

.09 Some CHBOs require more in-depth assistance in evaluating the above items. A list for sources of information and assistance follows.

Assistance Needed	**Sources**
Explanation of policy terminology	Agent of record on the insurance policy, insurance consultant
Comparison of costs of different types of policies	Local agent, broker, insurance consultant

Assistance Needed	Sources
Survey of exposures to loss	Insurer's loss prevention specialist, local agent, broker, insurance consultant
Help in loss-control programs	Insurer's loss prevention specialist, agent of record on the insurance policy
Assistance after a loss to determine amount recoverable	CPA, public adjuster, agent of record on the insurance policy, insurance consultant
Help in collection of losses for which an insurer denies liability	Agent of record on the insurance policy, commissioner of insurance, attorney, insurance consultant
Facts about insurers' finances	Commissioner of insurance, bank officers, agent of record on the insurance policy, insurance consultant

.10 **To-Do List.** The CPA should consider the following as part of risk management/insurance planning.

- Determine who can best provide the risk analysis and review for the CHB (an independent risk management professional may be best).
- Communicate weaknesses of present coverages and planning opportunities to the CHBO.
- Integrate planning strategies with the CHBO's personal risk management plan.

VI. INVESTMENT PLANNING

.01 The steps in the investment planning process (see the investment planning module in the *PFP Manual*) are the same for a CHBO as for any other individual. However, such factors as the ability to diversify, cash-flow constraints, and risk tolerance attributes are key to investment planning for a CHBO.

Classifying the Business

.02 The CPA should consider determining the asset category of the business. A CHB can appropriately fall into one of the following three categories:

A. *Business asset.* The CHBO critically assesses the going concern versus liquidation value of the business, but the ability or willingness to sell the business is limited by a variety of factors. They include severely restricted marketability of the CHB and the CHB's providing a job for the client. In the latter case, the CHBO values the *asset* based on the livelihood it provides.

B. *Investment asset.* The CHBO views the CHB as a readily saleable asset. A reasonable degree of marketability exists, and the CHBO is more concerned about the asset's investment value than the livelihood it provides.

C. *Personal asset.* The CHBO would not consider the sale of the business for anything other than an exaggerated, unrealistic market price. The business goals focus on retiring from the business, passing ownership onto family members, or a similar resolution.

Diversification

.03 A substantial portion of the net worth of most CHBOs is invested in an illiquid, nonmarketable investment, namely the business. Because of this, diversification into other illiquid, nonmarketable investments (such as real estate, oil and gas partnerships, and other direct investments) should be avoided. Cash equivalents, fixed income, and marketable equity investments may be areas to focus on to improve liquidity and marketability. After a CHB has matured and the cash flow to the owner has achieved a degree of consistency, additional illiquid or nonmarketable investments may be appropriate.

.04 Assets held by the CHB should be considered as if owned directly by the CHBO for purposes of assessing the adequacy of diversification. If the business holds assets, such as financial securities, raw land, or commercial real estate, consider their effect on diversification for the CHBO's entire portfolio. Whereas the investments will supply needed diversification, they remain subject to the vagaries of the CHB and the potential claims of its creditors. Thus, the CHB's assets are subject to a different level of risk than are those held directly by the CHBO.

Action Tip

.05 The CPA should consider introducing the concept of diversification to the CHBO, even if it is not possible. Do not attempt to convince a CHBO to sell part of the CHB for purposes of diversification.

Cash Flow

.06 A CHBO frequently encounters cash-flow problems because personal income is directly related to the cash flow of the business. Thus, a CHBO could require a cash reserve or emergency fund to draw upon that is larger than that required by someone who does not rely on a CHB for cash flow.

Risk Tolerance Attributes

.07 The CHB is often so much a part of the CHBO's life that personal assets, activities, hobbies, and lifestyle are inseparable from the business. Many CHBOs are decisive leaders with dominant personalities who may impress the CPA as highly aggressive risk takers. The opposite may in fact be the case. Thus, the CPA and the CHBO need to have a clear meeting of the minds as to acceptable risk levels. Consideration should be given to documenting the client's perceived risk level.

.08 As part of the investigation of the CHBO's risk tolerance, the CPA may discover that the CHBO likes to control all investments. While this is fine for directly held investments such as the CHB or real estate owned outright, it will not work for most readily marketable investment vehicles. In the case of such investments, the CHBO can control which investment is made (stock versus bonds or Corporation A stock versus Corporation B stock) but not the management of the underlying entity.

.09 To-Do List. The CPA should perform the following tasks as part of investment planning for a CHBO.

- Determine the asset category in which the CHB belongs.
- Analyze the CHBO's portfolio, giving consideration to the risk incurred by holding the CHB interest.
- Complete the investment planning process as for any other client (see the investment planning module of the *PFP Manual*) and make recommendations accordingly.

VII. RETIREMENT AND SUCCESSION PLANNING

Employee Benefits

.01 Retirement Plan Design Considerations. Successful retirement plan design starts with an understanding of the CHBO's lifestyle, ability, and desire to use the resources (for example, the money) of the CHB to fund the plan. The CHBO should already have largely satisfied personal needs and be able to make the long-term commitment generally associated with qualified plans.

.02 An understanding of the cash flow of the CHB is important. The CHB should generate disposable income to support a qualified plan. If the CHB is capital intensive or in a period of growth, there might not be sufficient cash flow to meet the funding requirements. This is why many CHBOs think that a retirement plan is a tax-advantaged accumulation vehicle for excess funds.

.03 To-Do List. The CPA may use the following questions to pre-screen a CHB for a qualified plan.

- Is the CHBO taking sufficient salary to satisfy personal needs?
- Does the CHBO have any existing or potential cash-flow needs that could require withdrawing funds from the CHB?
- Does the CHBO have the ability and desire to make a commitment to a reasonably long-term program?
- Does the CHB generate excess cash?
- Are there any plans for major changes in the CHB that would require the use of cash reserves or excess cash?
- Is the CHBO willing to bear the cost of covering other employees?

Key Factors in Plan Selection

.04 The demographics or census data of the CHB play a key role in plan selection. The *key* group should be identified. For example, the key group may include older or younger employees, or those with consistently higher income or more past service. A meticulous review of the CHBO's census data should enable the CPA to determine those attributes that separate the key group from the rest of the employees. In addition, plans for the future should be analyzed in light of possible changes in demographics.

Plan Types

.05 Defined Contribution Plans, Defined Benefit Plans and Simplified Employee Pension Plans should be reviewed before making a final decision on designing a retirement plan.

.06 Defined Contribution Plans. There are several types of defined contribution plans, including money purchase, profit sharing, target benefit, and 401 (k) plans. The common characteristic of these plans is that they define the contribution rate or allocation method that an employer applies to current employee compensation to determine funding levels. The employee's account balance at retirement determines the amount of benefits received. Younger employees are generally favored by defined contribution plans because the period in which their accounts can accumulate funds is longer.

.07 Money purchase plans require an annual contribution or funding regardless of the profitability of the business. Money purchase plans are generally appropriate when the company has stable earnings and the employees are young.

.08 A profit-sharing plan allows discretionary annual contributions. This feature tends to make profit-sharing plans more suitable when the CHBO and key employees are relatively young and when profits are available but tend to fluctuate from year to year.

.09 A target benefit plan is a hybrid of defined benefit and defined contribution plans. It is treated by the tax law as a defined contribution plan but it has many of the attributes of a defined benefit plan. A target benefit is calculated for each employee based on age and years of service. As a result, the older worker who has accumulated years of service tends to benefit more than the younger worker with little accumulated service. On retirement, the employee receives the amount accumulated in his or her account.

.10 A 401(k) plan permits the employee to participate in retirement funding by electing to reduce salary (subject to certain limits) and contribute the amount deducted to a plan that qualifies under IRC section 401(k). A 401(k) plan cannot stand alone. It has to be part of a defined contribution plan.

.11 **Defined Benefit Plans.** Defined benefit plans promise to pay an employee a pension at retirement that is either a percentage of compensation or some other benefit that is defined in advance. This is in contrast to a defined contribution plan, which establishes the formula for the contributions in the plan document. The contributions that are required to be made each year are determined actuarially to provide sufficient funds for the benefits promised. Administratively, defined benefit plans are considered to be more burdensome and more costly to maintain because of the need to engage an actuary to calculate the annual funding requirement and the annual required contribution. Older employees with accumulated years of service tend to benefit more from a defined benefit plan than do younger employees.

.12 **Simplified Employee Pensions (SEP).** A SEP offers the advantage of simplicity. The plan agreement is generally short and there are no annual reporting requirements. The money contributed to the plan is placed in an IRA in the name of the plan member (i.e., the employee). For a CHBO who desires simplicity and no reporting requirements, a SEP may be appropriate. An elective deferral provision can be added to the SEPs of qualifying small businesses with fewer than twenty-six eligible employees.

.13 **Summary.** The CPA should become familiar with the benefits these plans can provide their CHBO clients. There are many other plan variations and designs available in addition to those that have been discussed. The key ingredients, in assisting CHBOs to select a plan are understanding their objectives, the census data of the employee group, and the CHB's ability to financially support a plan. The CPA may wish to undertake a cost-benefit analysis comparing the after-tax cost with the benefits of the various alternatives.

Succession Planning

.14 **The Importance of Succession Planning.** CPAs who provide financial planning services for family-owned CHBs typically find that the CHB is the major portion of the net worth of the family. In addition, the CHB often represents the primary source of income for one or more family members, and possibly for the family as a whole. Consequently, the financial security of the CHBOs upon retirement, and the perpetuation of family wealth for the next generation, can be dependent on the successful transfer of the family-owned CHB.

.15 Despite the importance of succession planning, studies indicate that among families that survive the first decade of business, less than 35 percent survive into the second generation of the family, and less than 15 percent survive into the third generation. CPAs are in the unique position of being able to offer the broad perspective that ties succession planning into the overall financial planning picture.

Key Considerations and Constraints in Succession Planning

.16 Retirement Security. The CHBO's retirement security is one of the key considerations in succession planning. If the CHBO has been able to accumulate a considerable retirement fund apart from the value of the CHB, for example in pension accounts or personal investments, receiving a monetary value for the business may not be the prime consideration. In this situation, the CHBO has the additional flexibility of being able to transfer the CHB to the next generation through gifts and bequests. In addition, planning includes steps to preserve the value of the CHB in the event of the unexpected death or disability of the CHBO.

.17 If the CHBO's retirement security is dependent on the value of the CHB, attention will generally center on how to draw down the value of the CHB. If the value can only be received in installments, the management capabilities of the next generation become additional factors in the CHBO's retirement security. If the management capabilities of the next generation are questionable, the CHBO may decide that retirement security should have priority over providing employment for the next generation. In this case, it may be in the best interest of the CHBO to sell the CHB rather than attempt to pass it on to the next generation.

.18 Past experience with the CHBO and other family members can help the CPA to place the CHB in perspective within the CHBO's financial plan, and within the context of intergenerational financial planning for the family. In particular, the CPA may have a good idea of whether the full value of the CHB is likely to be received.

.19 Emotional Issues. Despite the important financial role of the CHB, many CPAs find that emotional issues take precedence over financial issues. Many decisions in a family business are made for emotional reasons rather than for good business or financial reasons. The CPA should be aware that a business problem may in fact be evidence of problems within the family. In these instances, it may be prudent for the CPA to suggest professional counseling for the family as an aid to the succession process.

.20 Many CHBOs recognize that succession planning necessarily involves some difficult decisions that can have important effects on family members. For example, how will family members react to decisions about who receives an ownership interest and who does not? How will family members react to the sale of the CHB? Moreover, many CHBOs realize that succession planning can have a substantial impact on their own lives. In many cases, the CHB is the CHBO's favorite child, or the business is the CHBO's alter ego and a source of prestige and status within the community. As much as a CHBO may have complained about the demands of the CHB, in actuality it probably has been a source of enjoyment and self-esteem.

.21 **Personality Traits.** The personality traits of the CHBO and the characteristics of a family-owned CHB may present barriers to succession planning.

.22 **Desire for Control.** In general, entrepreneurs are competitive individuals who like to control and dominate their business environment. These traits, which are essential for business success, often present barriers to succession planning. Although the CHBO can come to grips with transferring control, stepping away from operational control can prove difficult. The CHBO may harbor the belief that no one else could possibly operate the CHB as well as he or she has, and that anything less is unacceptable.

.23 **Inability to Communicate.** Many CHBOs find it difficult to communicate their feelings and desires about the CHB or are reluctant to do so. On the rare occasion that such a CHBO makes any reference to succession, it is probably in such vague terms as, "Someday all this may be yours." The intended heir is left to wonder how and when.

.24 **Management Practices.** The failure to adequately address succession planning may be a result of management practices. Frequently, CHBs do not have organizational charts or even written business plans. If a business plan does exist, its details often reside only in the CHBO's head. As difficult as it is to establish a formal business plan, it may be even more difficult for the CHBO to begin the succession planning process without it. The CHBO may be so wrapped up in the day-to-day operations that he or she has little time or energy to step back and gain the perspective necessary for long-range planning. In these instances, the management and delegation practices of the CHBO can present a barrier to planning. Without a CPA's encouragement, succession may never be addressed. In addition, without the pressure and time frame that a plan entails, the business skills of the intended heirs may not develop.

.25 As a result of these potential barriers to succession planning, many CHBOs fail to confront the issue and instead do nothing. Once they are gone, the business and their heirs will be left to fend for themselves. In taking this course, the CHBO may have avoided making some difficult decisions, but the family's financial well-being may suffer as a consequence.

Begin With an Emergency Succession Plan

.26 Some CPAs have obtained positive results by encouraging the CHBO to establish an emergency plan. This may be a less threatening first step for the CHBO who is reluctant to begin the succession planning process.

.27 Involve All Family Members. Throughout the succession planning engagement, the CPA should remember that a plan involves more than a rational financial decision. More often it is an emotional decision that has financial planning consequences. The viewpoints of all affected family members should be solicited. Succession planning can offer the CPA the first opportunity to talk privately with the sons and daughters of the CHBO. The insights that are gained about family relationships can often assist in early identification of potential problems.

.28 Succession planning typically involves many family members, some of whom can have opposing interests. Consequently, the CPA should give careful consideration to his or her role and to whether his or her allegiance should lie with the CHB, the CHBO and spouse, or with the family as a whole. Balancing the financial and emotional needs of family members makes succession planning a difficult and challenging endeavor.

When to Start Succession Planning

.29 Some CHBOs have a clear conception at the formation of the CHB of when and how they want to exit. Most do not. Ideally, in either case, succession planning should be ongoing throughout the lifetime of the CHBO. Every client who owns a CHB should be periodically encouraged to reexamine how the long-term plan for the CHB fits into the CHBO's overall personal plan.

.30 Present a Balanced View of the CHB. The ongoing actions and attitudes of the CHBO can affect later succession plans. For example, if the discussion at the family dinner table every night for the past twenty years has centered around the demands of the CHB and how the stress might send the owner to an early grave, it should not come as a surprise if sons and daughters are not anxious to jump into the business. It may be human nature to complain about negatives without mentioning the positive. However, when the CHBO desires to pass the CHB on to the next generation, the CPA should encourage the client to make a consistent effort to present a balanced and realistic view of the advantages and disadvantages of owning the CHB.

.31 Assemble a Competent Management Team. Throughout the CHBO's business career, he or she should make an effort to assemble a competent management team that can effectively manage the CHB in the CHBO's absence. A good benchmark of progress is how long and how often the CHBO is able to stay away from the CHB for personal reasons, such as extended vacations. Often the size of the CHB prohibits the assembly of a management team. Just as frequently, the CHBO's inability to relinquish decision-making control undermines efforts to form an effective team. In any event, succession planning necessarily involves an evaluation of whether a capable management team is in place.

.32 Begin Formal Planning at Least Five Years Before Retirement. Formal succession planning should begin at least five years before the CHBO's intended retirement date. When the retirement date is established well in advance, successors can gradually assume operational control. This enables the CHBO to observe how the successors run the CHB before he or she relinquishes control. This may be particularly important in the case of an installment sale to the new family management team, where the CHBO depends on receipt of the installment payments to supplement retirement income.

.33 If the CHB is to be sold outside the family, the planning process should also begin at least five years before the intended retirement date. Finding a buyer and consummating the transaction can take time. Given adequate lead time, the CHBO will be in a better position to obtain a satisfactory price for the CHB. Early planning can also allow the CHBO to implement decisions that might enhance the value of the CHB. Furthermore, the buyer may want the CHBO to continue performing his or her duties for a period of time after the sale in order to provide for continuity in the management of the CHB.

Who Will Be the Successor(s)?

.34 The alternatives for transferring a CHB include:

- Sale, gift, or bequest to family members
- Sale to key employees
- Sale to an ESOP
- Sale to outsiders
- Public offering
- Retention of a professional manager
- Outright gift or gift in trust to a charity

.35 This section will examine the first alternative, with limited references to the second and third alternatives. However, the CPA and CHBO should carefully consider the merits of all of them.

.36 A transfer to family members is usually the alternative that is favored by the CHBO. In a family with only one child, the candidate to succeed the CHBO is clear. Nevertheless, questions remain that need to be addressed. They include the following:

- Is retention of the CHB in the best interest of the family as a whole?
- Is the successor capable of managing the CHB?
- When should the transfer occur?
- What consideration, if any, should be paid for the CHB?

.37 Two or More Potential Successors. When there is more than one potential successor to the CHBO, the decisions become more complicated. The initial inclination of many CHBOs is to treat all successors equally by transferring an equal ownership interest to each. However, the successors may not be equal in ability or in the role that they will assume within the CHB. Indeed, some may not have a direct involvement with the CHB at all.

.38 The CPA should alert the CHBO to the perils involved in granting ownership to sons or daughters who are not involved in the operations of the CHB.

.39 Conflicting Objectives. Conflicts can develop as a result of the differing objectives of the parties. Heirs involved in CHB operations may be concerned with the long-term growth of the company, while nonoperating owners may seek to maximize the current payout of income. Nonoperating owners can second-guess the management or compensation policies of those involved in operations. For these reasons, nonoperating ownership may not be advisable.

.40 If nonoperating ownership is desired, shifting operations to an S corporation or partnership should be considered. This would enable distributions to be made to nonoperating owners without the double-tax consequences of dividends paid by a C corporation.

Equal Treatment Versus Fair Treatment of Successors

.41 Although equal CHB ownership treatment may not be practical, the successors can still be treated fairly through gifts or bequests designed to equalize the total property received. The real question in equalization is how to value the CHB in relation to gifts or bequests of other property. Certainly a CHB is not a liquid asset. Therefore, the interests in the CHB that are transferred can justify a discount in value for the purpose of equalizing the distribution of other assets. In addition, if the recipients of interests in the CHB have played a major role in developing its value, that also may be taken into consideration.

.42 Equalizing Transfers. If the nonbusiness assets that are available for gifts or bequests are not sufficient to equalize the property transferred, it is possible to use the future earnings of the CHB to equalize the transfers. Briefly, interests in the CHB can be given to the nonoperating owners with an agreement in place to have those interests redeemed by the CHB. The mechanics may be complex depending on the relationship of the parties, the form in which the CHB operates, the CHB's profitability, and the degree of security desired.

.43 Alternatively, some CHBOs prefer to segregate operating assets, such as real estate and equipment, in a separate CHB. The nonoperating successors are then granted ownership of this CHB. The lease payments that the new CHB receives for the use of the assets are then available for distribution to the nonoperating successors to help equalize the assets transferred to each operating successor.

.44 Resolving Conflicts. When more than one successor is to receive an ownership interest, the question of who ultimately is to assume voting and operational control should be addressed. Methods of resolving conflicts, such as tie-breaking votes, buy-sell agreements, or arbitration agreements, should be in place.

.45 Professional Management and Trusts. If the CHBO's successors are too young to manage the CHB, ownership can be placed in trust with professional managers until the children have demonstrated the ability and responsibility required to manage the CHB.

.46 Transfer to Employees. If the CHBO's successors are not capable or interested in assuming ownership, the CHBO can look to key employees capable of operating the CHB. The ability of the employees to finance the purchase might be enhanced by the establishment of an ESOP. In a sale to an ESOP, the CHBO may be able to obtain the added benefit of deferring the tax on the gain. For additional information, see the estate planning module in the *PFP Manual*.

Grooming Family Successors

.47 The training of potential successors is perhaps the most important factor in the long-term survival of a CHB.

.48 Obtain Prior Work Experience. Before they enter the family business, it is often desirable for the CHBO's children to have experience working for another company. Exposure to different business practices and superiors can prove invaluable to potential successors. Employment by a company within the same industry provides the most practical and useful experience. However, competitive considerations may eliminate this possibility.

.49 In response to the need for relevant outside employment experience, some industries have developed formalized successor training programs. In these programs, sons or daughters of CHBOs are employed by a company within the industry, but outside the geographic area of competition.

.50 Establish a Training Program. When a successor to the CHBO is ready to enter the CHB, it is important to have in place a formal program designed to provide the knowledge and skills that ultimately will be needed to run the CHB. The CHBO should make sure that the successor gains experience in areas that are essential to the profitability of the CHB. Although the tendency is to create an office position for the successor, the founder CHBO most likely did not acquire the skills used to build and run the CHB by working in the office. Instead, the experience was probably gained by working in the line operations of the CHB. Similarly, the successor may be best served by beginning his or her career there.

.51 The CPA should encourage the CHBO to determine what knowledge and skills are crucial to managing the CHB and ways in which these skills can best be developed. For example, the CHBO of a construction company might determine that cost estimation and field operations are the most important factors in the success of the CHB. Consequently, although the successor should become familiar with all areas of the CHB's operations, the emphasis should be on developing the knowledge necessary to understand, manage, and control cost estimation and field operations.

.52 Often the necessary knowledge can be obtained by working side by side with key employees responsible for each of the operations. When this is done, the CHBO should consider the attitude that each key employee brings to the training process. The CHBO should communicate the plan for succession to the key employees, and the CHBO should consider their reactions and feelings. It is necessary for the CHBO to encourage the key employees involved in the training process to be objective and candid in their appraisals of the progress being made and the CHBO should conduct regular progress reviews.

.53 The CHBO may wish to consider incentive compensation techniques for key employees as part of the succession plan. Possible techniques include creating phantom stock or stock appreciation rights.

.54 The CHBO should forewarn the successor about the importance of gaining the respect and support of employees. A poor initial impression can result in a long climb to the top, and can culminate in the departure or lack of support of key employees.

.55 After becoming familiar with the functional operations of the company, the successor can begin training to assume the duties of the CHBO who should be encouraged to reflect upon his or her successes, failures and lessons learned. The CHBO should communicate reflections about successes, failures and lessons learned to the successor to help prevent the repetition of mistakes. This, of course, presupposes that the successor is willing to learn from a parent or other older family member.

Surviving the Transition

.56 One difficulty that may be encountered in the transition process is the reluctance or inability of the retiring CHBO to let go of operating control. Separating from the CHB is often difficult because the retiring CHBO had devoted all of his or her time to running the business, leaving no time to develop interests or hobbies outside the CHB. Thus, it is not unusual to find the retiring CHBO looking over the shoulder of the successor, second-guessing decisions and conveying his or her opinions to key employees. This can disrupt what would otherwise be a smooth transfer of power.

.57 One solution is a gradual and steady decrease in the time that the retiring CHBO spends at the CHB. This can give the retiring CHBO the opportunity to develop other interests. Once the process takes hold, the retiring CHBO can still keep a finger in things through the chairman of the board of directors.

Relation of Succession Planning to Estate Planning

.58 Succession planning and estate planning are necessarily interrelated. As a result, the CPA should be aware of the estate-planning consequences of succession planning suggestions. Particular consideration should be given to the effect that the tax laws governing estate freeze techniques and deferred payment of estate taxes (IRC section 6166) will have on the succession plan.

Buy-Sell Agreements

.59 Buy-sell agreements may be used to overcome a cash crunch that can arise because interests in CHBs are rarely marketable — they are generally considered to be an illiquid asset — although they can make up a large portion of a client's net worth (see section VI.03). Briefly, a buy-sell agreement is a contract — drawn by legal counsel — that establishes a procedure for redeeming or buying out an ownership interest in a CHB upon the occurrence of a specific event. In addition to specifying the triggering event (or events), a buy-sell agreement establishes the mechanics for setting the price to be paid and other conditions of the buy out, such as the period of time over which the buy out will take place. The potential benefits of a buy-sell agreement are:

- Preservation of control among existing owners.
- Avoidance of a disruption in managing the CHB.
- Establishment of a market for an otherwise illiquid asset.
- Establishment of a predetermined method for determining a fair price and terms for the buy out.
- Use of agreement price as a factor in determining estate-tax value.

.60 Questions to address when structuring the buy-sell agreement include:

- Who should be the buyer?
- What events should trigger the buy-sell agreement?
- How should the buy-out price be established?
- How should the payment terms of the buy out be structured?

.61 Who is to Be the Buyer? There are two basic forms of buy-sell agreements: entity-purchase agreements and cross-purchase agreements. An entity-purchase agreement is an agreement between the CHB and each owner. The CHB is obligated to buy the departing owner's interest. A cross-purchase agreement is an agreement among the owners obligating the ones who will remain to buy the departing owner's interest. Factors to consider in selecting the form of buy-sell agreement include:

- The number of owners.
- If funded by insurance, the burden of the policy premiums.
- Income tax, including:
    - — Tax treatment of proceeds received at redemption.
    - — Tax basis of the remaining owners' newly organized interest.
    - — Alternative minimum tax.
    - — Accumulated earnings tax.

.62 Number of Owners. A buy-sell agreement is only as good as the ability of the parties to satisfy its terms. Because death is often a triggering event, buy-sell agreements may be backed by life insurance. The life insurance provides an immediate source of funds that can be used to purchase the deceased owner's interest (see exhibit 5). If the triggering event is something other than death, the policy surrender value can be used to partially fund the buy out. However, the use of life insurance in direct-purchase agreements may make little or no economic sense when one owner has a majority interest or is significantly older than the other owners. Disability buy-out insurance may be advisable to fund agreements in which disability is a triggering event.

.63 Because the CHB is the designated buyer in an entity-purchase agreement, it is the CHB that insures the lives of its CHBOs and is named the beneficiary under the policies. In an entity-purchase agreement, the CHB purchases one policy for each CHBO. Life insurance represents only one way of creating a workable entity-purchase agreement and may in fact create an inequitable situation for a majority CHBO and his or her heirs.

.64 If the CHBOs determine that life insurance should be purchased to provide liquidity for estate-tax purposes, an irrevocable life insurance trust may be the best vehicle for buying the insurance. However, it is important to look beyond the easy solutions generally promoted by the insurance industry and consider other funding alternatives.

.65 In a cross-purchase agreement, each CHBO insures each of the other CHBOs. For example, in a CHB with four CHBOs, CHBO A insures CHBOs B, C, and D. CHBO B and the other CHBOs do likewise. Thus, for four owners, a cross-purchase agreement requires twelve insurance policies, while an entity-purchase agreement requires only four. As the number of owners increases above two, the number of policies for a cross-purchase agreement increases exponentially and becomes more cumbersome. In addition, the total premium amount will often be larger. Insurance premiums are frequently graded by the size of the policy; because each policy in a cross-purchase agreement may be comparatively small it may bear a higher cost for each $1,000 of coverage.

.66 The number of policies in a cross-purchase agreement may be reduced by establishing a business insurance trust. This arrangement is similar to an entity-purchase agreement, except that the trust purchases, owns, and is named the beneficiary of a life insurance policy insuring each CHBO. On the death of a CHBO, the trust would receive the death benefit and use the proceeds to purchase the interest of the deceased CHBO pursuant to the cross-purchase agreement.

.67 In a cross-purchase arrangement, life insurance policies that are no longer needed after the departure of a CHBO can present a problem. In an agreement between three CHBOs, if CHBO C dies, the heirs of CHBO C inherit the policies insuring CHBOs A and B that they do not need. One option is for the heirs to surrender the policies to the insurance company for their cash value. However, the policies are often worth more than simply their cash value. For example, CHBOs A and B now need to increase their insurance coverage of each other. Ideally, CHBO A would purchase the policy on CHBO B's life from owner CHBO C's heirs. Likewise, CHBO B would purchase the policy on CHBO A's life from his or her heirs. This would be particularly attractive if one of the CHBOs had become now uninsurable.

.68 Entity- and cross-purchase agreements are subject to the transfer for value rule, an important exception to the normal tax-free treatment of life insurance proceeds provided by IRC section 101. This exception provides that if a policy is transferred or assigned for valuable consideration, the tax-free death benefit is limited to the amount the new owner paid for the policy plus any subsequent premiums paid. The transfer for value rule generally does not apply to partnerships, to a sale of the policy to the insured, or to a sale of the policy to the CHB. The sale of the policy to the CHB is often an attractive option that is used to supplement a key-person insurance program, or alternatively, to fund a combined cross-purchase/entity-purchase agreement.

.69 Burden of the Policy Premiums. In an entity-purchase agreement, the CHB pays the policy premiums. This can be a disadvantage for a majority CHBO, who has an implied entitlement to the majority of the profits, distributed either in the form of compensation or dividends. If profits are used to pay insurance premiums, the majority CHBO is, in a sense, funding the buy out. If other factors strongly favor an entity purchase, this seeming inequity can be alleviated when setting the buy out price by including the cumulative premiums paid.

.70 In a cross-purchase agreement, the minority CHBOs bear the heaviest premium burden. The policy that the minority CHBO purchases to insure the majority CHBO will generally be larger than the policy insuring a minority CHBO, because the majority interest is worth more. This may not be inequitable, because the minority owners do have the most to gain from a triggering event. Further, because the majority owner is frequently older, which raises the rates, there is a greater likelihood of near-term economic benefit from the premium payments. The minority CHBOs, however, are least likely to have funds available to pay high premiums. As a result, it is occasionally necessary for the majority CHBO to lend to the minority CHBOs the funds necessary to pay the premiums. Typically, buy-sell agreements are adjusted to satisfy any outstanding loans on the triggering event.

.71 Tax Treatment of Proceeds Received at Redemption. In a cross-purchase agreement, the income realized from a buy out is characterized as a capital gain. In an entity-purchase agreement, the funds received from the redemption must meet strict tests to be classified as a capital gain. If the tests are not met, the proceeds may be taxed as a dividend and no income tax basis offset is allowed against them.

.72 In an entity-purchase agreement, the CHB redeems the departing owner's interest. If sufficient insurance coverage is in place, the value of the company may not decline following the redemption. As a result, the value of the interests of the remaining CHBOs increases. However, despite this increase in value, the tax basis of the ownership interests remains the same. In a cross-purchase agreement, the remaining CHBOs purchase the departing CHBO's interest, with the purchase price becoming their tax basis for the newly acquired interests. Thus, although entity-purchase and cross-purchase agreements result in the same ownership percentages, a cross-purchase agreement will provide a higher tax basis.

.73 Entity-Purchase Drawbacks. Under the alternative 1992 minimum tax (AMT) rules, the life insurance proceeds that a C corporation receives may be a tax preference for AMT purposes. Thus, the AMT can affect an entity-purchase agreement, whereas it will not be imposed upon a cross-purchase agreement. In addition, creditors of the corporation have a legal claim against the insurance proceeds received from an entity-purchase agreement. If an attempt is made to restructure an entity-purchase agreement to a cross-purchase agreement, it should be designed to avoid the transfer for value rule.

.74 An entity-purchase agreement can compound an accumulated earnings problem for a C corporation that has retained excess earnings. Although life insurance cash surrender values are considered accumulated earnings, the courts have generally held that the cash value of key-person protection is a reasonable accumulation. However, the cash value of policies held for an entity-purchase agreement has generally been held to be an unreasonable accumulation for purposes of the accumulated earnings tax. Therefore, if there is a potential problem with accumulated earnings, a cross-purchase agreement would be preferable.

.75 What Events Should Trigger the Buy-Sell Agreement? Some of the triggering events that are commonly incorporated into a buy-sell agreement include:

- Death, retirement, disability, or expulsion of a CHBO.
- Bankruptcy of a CHBO.
- Revocation of a CHBO's occupational license.
- An attempt by a CHBO to:
  - Sell or transfer ownership to an outsider.
  - Dissolve the CHB.

.76 The overall business objectives of the CHBOs should be kept in mind when selecting the triggering events to be included in the buy-sell agreement.

.77 How Is the Buy-Sell Price to Be Established? When determining the buy-sell price parameters, consideration should be given to the method of valuation, the date of the valuation, and the property to be included in the valuation.

.78 Some of the valuation methods that can be specified in the agreement include book value, a multiple of earnings, a combination of the two methods, or an independent appraisal. Options for determining the valuation date include the actual date of the triggering event or the month or year ending before the triggering event. When determining the property to be included in the valuation, attention should be given to the value of the life insurance policies. Is the cash surrender value or the death benefit of the policies to be included in the valuation?

.79 Note that values agreed to by certain related parties may no longer be acceptable standards of value for estate-planning purposes. Since 1990, the IRS has had the leeway to use the valuation techniques it deems most appropriate (see IRC section 2703).

.80 How Should the Payment Terms of the Buy Out Be Structured? A particularly important consideration for triggering events that do not produce an insurance death benefit, such as disability or voluntary departure by a CHBO, is whether to provide for an installment payout to ease a possible burden on cash flow. If an installment note is needed, the term of the note and the interest to be charged should be specified.

.81 Periodic Review of the Agreement. In conjunction with a client's ongoing financial planning, any buy-sell agreements should periodically be reviewed and updated. Particular attention should be given to the continued appropriateness of the method for determining the buy-sell price. In addition, if insurance proceeds are to be the source of funds for the buy-sell agreement, the adequacy of insurance coverage should be reviewed.

.82 To-Do List. The following are some of the steps the CPA should take as part of retirement and succession planning for a client:

- Review the tax implications of life insurance in exhibit 5.
- Review existing qualified plan arrangements and determine whether the most appropriate programs are in place. Communicate your recommendations to the client.
- Address key succession planning issues with the client, including:
  - The business goals of the owner.
  - Whether the business can survive without the owner.
  - Whether the owner can survive without the business.
- Develop strategies to achieve succession goals.
- Assign implementation responsibility and establish deadlines.

VIII. ESTATE PLANNING

Introduction

.01 The CHBO has unique estate-planning concerns because his or her primary asset is usually the business interest. Generally, an interest in a CHB is illiquid and, therefore, can cause an estate-tax burden. To provide liquidity and to minimize or defer estate-taxes, a CPA should consider applying special estate-planning strategies when planning for a CHBO.

.02 The following are some examples of strategies that can provide liquidity or minimize or defer the estate-tax burden of the CHBO. Although strategies can be implemented independently, in most cases a combination of several strategies will be used (e.g., life insurance employed to fund a buy-sell agreement). When alternative planning strategies exist, the CPA should review and select those that can best achieve the client's desired results. While this discussion focuses primarily on estate-planning issues, it is important that the business succession plan (see section VII.14) be included in the estate plan.

Please refer to the AICPA *Personal Financial Planning Manual* Estate Planning Module for more information on estate planning.

Provide for Liquidity

.03 Buy-Sell Agreement. A buy-sell agreement is an important tool in providing liquidity and ensuring the continuity of a CHBO. While these agreements can benefit any type of business, they are particularly important to professional service organizations (for example, medical or law practices), which typically lack value on the open market. Buy-sell agreements provide for the purchase or sale of a business interest on the occurrence of a predetermined event (for example, the death or disability of an owner) for a pre-determined price or a price based on a pre-determined formula. The advantages of a buy-sell agreement include:

- Providing comfort to the CHBO through the knowledge that heirs will receive funds from the disposition, that an acceptable disposition price has been determined, and that a forced sale will be avoided. The pricing formula should be reviewed periodically and when circumstances change (for example, business profits dramatically increase), appropriate adjustments should be made.
- Ensuring the continuity of the CHB on the death or disability of the CHBO.
- Establishing the value of the CHB for estate-tax purposes, provided the buy-sell agreement meets IRS guidelines.

.04 The CPA should be familiar with the use of buy-sell agreements in planning for the CHBO, and should assist the client in incorporating the strategy in an overall estate plan. (See section VII.59—82 on buy-sell agreements.)

.05 Life Insurance. Life insurance can provide the liquidity necessary to fund a buy-sell agreement, supplement the value of a CHB when the death of a CHBO might cause a reduction in value, and provide funds to an otherwise illiquid estate. In addition, if the CHB is to be retained by other family members at no cost to them, life insurance can provide the necessary liquidity.

.06 There are many ways in which life insurance can be used in estate planning for the CHBO; however, the CPA should take care when structuring the plan, because the structure may dictate the tax impact. The chart in exhibit 5 illustrates the tax implications of various forms of insurance used in estate planning for the CHBO.

.07 Sale-Leaseback. A sale-leaseback arrangement may be appropriate when a CHBO wants to cash out of a business, but remain involved in its control and/or operation. Although the transaction can generate taxable income, this potential cost should be measured against any potential estate-tax savings. When real estate and a separate operating business are involved, each asset should be evaluated separately. The CPA should consider recommending an installment basis to defer the potential income tax liability. However, consideration should also be given to the risk of potential estate-tax liability on the note balance should the CHBO die before the note matures.

.08 Stock Redemptions. When the value of stock in a CHB operating as a corporation represents a large portion of the CHBO's estate (more than 35 percent of the value of the adjusted gross estate) and control of the corporation is to be maintained within the deceased shareholder's family, favorable tax treatment is available on redemption of the stock. The goal is to avoid dividend treatment for the proceeds of a stock redemption to prevent the entire distribution from being taxed as ordinary income.

.09 Under IRC section 303, to the extent that redemption proceeds are used directly for the payment of estate taxes (including state estate and inheritance taxes) and administration expenses, the transaction is treated as a sale or exchange so that only the excess of the redemption price over basis in the stock is taxable. Any excess may be covered under the rules of IRC section 302, which generally provide that only the gain (excess of redemption amount over basis in stock) is taxed when the disposing shareholder's interest is effectively reduced by the redemption. The favorable tax treatment under IRC sections 302 and 303 can provide additional funds for surviving heirs while also maintaining control of the CHB within a family.

.10 There are several methods of allowing new or existing stock to be issued for the purpose of retaining control of the CHB within a family while providing for the desired liquidity on redemption of the deceased CHBO's stock. Many of these methods will not reduce the applicability of IRC sections 302 and 303. The CPA should be familiar with these methods and consider their application when planning for the CHBO. If necessary, a specialist should be used to implement these methods.

.11 Regardless of the tax treatment, the corporation redeeming the stock must have sufficient funds to distribute. Life insurance may be used for this purpose; however, the policy value can increase the value of the stock for estate-tax purposes. Accumulated assets of the corporation can be used as well, but caution should be taken to avoid any accumulated earnings tax potential. Alternatively, a note can be used to fund a redemption. Also, when corporate tax rates are higher, it may be more appropriate to elect S corporation status and have the funding occur outside the corporation.

Easing the Estate Tax Burden

.12 Although an interest in a CHB may receive a stepped-up basis when it passes to the heirs of a deceased CHBO, its tax cost in doing so may be significant. The following discussion describes various methods available to ease the estate-tax burden.

.13 Estate Freeze. Before 1988, the estate freeze was a flexible and frequently used vehicle for transferring the appreciating component of a business to future owners while retaining control over business operations and cash flow. The vehicles used to accomplish this were commonly a corporate recapitalization or family partnership. Congress initially eliminated most forms of estate freezes in 1987 by enacting IRC section 2036 (c), which was later repealed retroactively in 1990 and replaced by a less restrictive provision, IRC section 2701. While estate freezes are more restricted and difficult to design under the new rules, they can still be an effective estate-tax reduction strategy.

.14 **Lifetime Gifts.** Gifts of business interests to family members during the CHBO's lifetime can reduce the potential estate- or gift-tax liability. The recipient's loss of the step-up in basis at death should always be measured against the benefit of a lifetime gift. For example, a CHBO can give shares of stock (within the annual exclusion) to family members tax-free. If the amount given in any year exceeds the annual exclusion and the given property is expected to appreciate significantly, use of the unified credit to remove the asset from an estate may be warranted. The CHBO should also be careful not to lose control of the CHB because of gifts.

.15 When a CHBO is married, asset ownership should be structured between the spouses so that the unified credit can be used fully by each spouse upon the death of the other. In some cases, it may be necessary to give an ownership interest to a spouse to achieve this. This should be done with caution, however, and only after considering the state's divorce laws.

.16 In some states transfers of assets to a revocable trust may be an effective way to avoid probate and publicity costs and to provide flexible asset management at death. Although this technique will not remove the assets transferred from the individual's taxable estate, the non-tax benefits may justify its use.

.17 **Valuation.** The value of the CHB is the basis on which estate and gift taxes are computed. There is an inherent conflict between reducing the value for tax purposes and increasing the value for economic purposes. (The various methods available for computing value are described at section II.10 above.) Because there will always be differences of opinion about the comparative merit of the methods used to value business interests, an effort should be made to achieve what might best be called a supportable arm's-length valuation. The valuation must be supportable because it will have to withstand potential challenges (for example, third parties and the IRS); it must be arm's length because that is the ideal for all valuations. In addition, the advent of severe penalties for tax returns based on valuations that are not reasonably supportable has made it less attractive to both the CPA and the client to play the high-low valuation game.

.18 **Employee Stock Ownership Plans.** An ESOP can enable a CHBO to use funds within a CHB operating as a C corporation to redeem an interest with favorable income tax results. The corporation can accumulate these funds on a before-tax basis, rather than on an after-tax basis as with life insurance. In addition, the ESOP is a fringe benefit to the employees, can be a useful tool in management control fights, can reduce accumulated earnings tax problems, and can create a market for closely held stock. The cost of creating and maintaining an ESOP should always be measured against benefits.

.19 Since 1989, an estate can no longer benefit from a partial deduction for the proceeds of a sale of stock to an ESOP.

.20 Generation-Skipping Transfer of Tax. The generation-skipping transfer (GST) tax levies an excise tax on transfers — both direct and indirect — that skip a generation of estate tax. Thus, a direct transfer from a grandparent to a grandchild can be subject to the GST tax. The 55 percent tax is imposed upon the death of the transferor in addition to the estate tax. There is a $1 million exemption permitted that can still provide planning opportunities for a CHBO. In addition, the $10,000 annual gift exclusion, for direct and limited indirect transfers and for transfers made for the purpose of directly funding medical and education costs, are exempt from the GST tax.

.21 Installment Payment of Estate Taxes. The federal estate tax is generally payable within nine months of death. Because an interest in a CHB is generally illiquid, provision is usually made — through buy-sell agreements, life insurance or other planning tools — as part of the ongoing planning process to ensure that sufficient funds are available to pay the estate tax. In some cases, however, it may be more attractive to pay the tax on the installment basis. IRC section 6166 provides an election to pay the federal estate tax (and GST tax) attributable to an interest in a CHB over a fourteen-year period. To qualify for this treatment, the value of the business interest includable in the estate must be at least 35 percent of the adjusted gross estate. The business must be of a nonpassive nature to qualify. CHB interests can be aggregated for this purpose, provided the decedent owned at least a 20 percent interest in each included business. If the interest is a partnership interest, the partnership must have fifteen or fewer partners, or 20 percent of the total capital interest in the partnership must be includable in the decedent's gross estate. During the first four years, only payments of interest are needed. Over the remaining ten years, the principal and interest must be repaid in full. Up to certain limits, interest can be paid at the rate of 4 percent per annum, with the balance charged at the applicable federal rate. An additional benefit is that the interest under this alternative is deductible by the estate as an administrative expense, whereas the interest on borrowing may not be.

.22 Special Valuation of Business Real Estate. There is an estate-tax election available for real property used in a CHB, including a farm, whereby value can be based on the real property's value to the business rather than its fair market value (highest and best use). The reduction cannot reduce the decedent's gross estate by more than $750,000. This election can be used by the CHBO's estate to reduce estate taxes and increase liquidity. The benefit from the election can be significant when the family desires to retain the business and no funds are available to pay estate taxes. If the real property is rapidly appreciating in value, a lifetime gift may be more beneficial than the special valuation. The fact that the real property will receive a lower stepped-up basis because of the special election should also be considered. Also, the election requires that a special lien be placed on the property that can inhibit future financing and sales transactions.

.23 To-Do List. In reviewing or developing an estate plan for a CHBO, the following should be considered:

- The ability to generate estate liquidity through—
  - Buy-sell agreements
  - Life insurance
  - Sale-leaseback of the business
  - Stock redemptions
- The ability to minimize or defer estate taxes through—
  - Lifetime giving of CHB interests
  - A transfer of the appreciating component of the business to family members using an estate freeze or family partnership
  - The generation-skipping transfer tax exemption of $1 million
  - The installment payment of estate taxes
  - The election to value real property used by a CHB based on its value to the business rather than its fair market value

IX. CASE STUDY: PLANNING FOR THE CHBO

Purpose

.01 The purpose of the following case study is to illustrate the planning issues that face CPAs dealing with CHBOs.

Facts

.02 John, age forty-five, is a 70 percent shareholder of Raleigh, Inc., who spends seventy hours per week, including weekends, working in the business. (The 30 percent co-owner, Tom, is a nonactive shareholder who contributed capital and lent money to the corporation.) John's wife Betty, a forty-four year old German national, is also actively involved in the business but owns none of the stock. They have three children: Bob, age seventeen; Steve, age thirteen; and Lisa, age two. John is active in the community, serving on various boards and community groups. He spent fifteen years as a manager at RNK. He draws a salary of $90,000 and Betty takes a $25,000 salary. Because of fluctuations in the company's cash flow, they usually are forced to take no salary from August through November, but they catch up in December.

.03 Raleigh, Inc., is taxed as a C corporation and timely elected a September 30 fiscal year-end. Its annual taxable income averages $100,000. There are currently ten full-time employees, only three of whom John expects to stay with the company for more than two years. The company currently does not have a retirement plan or other definable fringe benefits. While no business valuation has been conducted, John estimates its value at $1,000,000. His original capital contribution was $15,000.

.04 Other assets owned by John and Betty are their $100,000 house, which has a $30,000 mortgage at 7 percent, and their $60,000 vacation home, which has a mortgage of $10,000 at 11 percent. In addition, there are jewelry, furs, and collectibles worth $20,000, household furnishings worth $20,000, RNK stock worth $45,000, and $5,000 in cash. John often conducts business out of the house at night and on weekends. He has no personal umbrella liability policy.

.05 Raleigh, Inc., has approximately $100,000 in cash at year-end. It provides autos to John, Betty, and their top saleswoman Phil, who has recently been discussing the need for additional compensation and benefits. To reduce workers' compensation premiums, John has opted out of workers' compensation coverage for himself and has no other disability insurance. He has personally guaranteed the corporation's loans from a bank. No formalized cash-flow planning has been performed for the corporation. The corporation leases approximately $300,000 of equipment to its customers and annually acquires approximately $100,000 of new equipment to rent.

.06 Both Bob and Steve work in the business during the summer because John wants to involve his sons in the business. However, to minimize costs, John has not paid them for their services. Both John and Betty have a strong commitment to assist their children in paying for their college educations. Since most excess funds in the past have gone back into the business, there are no funds specifically earmarked for college. John has a $75,000 term life insurance policy; Betty has no coverage. Wills were executed at the time of their marriage.

.07 When John left RNK, he received a retirement plan distribution of about $30,000 that he rolled over into his IRA. Betty plays an active role in the business and manages the Hillsboro office with Phil. Phil has also expressed an interest in purchasing a portion of Raleigh, Inc., in the future. During 1993, John is planning to construct a new $75,000 warehouse.

.08 Both John and Betty have expressed a strong desire to manage their personal finances and their corporation's finances more actively.

Additional Data Gathering

.09 Many business owners are impatient during the data-gathering stage of financial planning. They want quick answers and solutions. However, to be effective a CPA should resist any pressure to minimize the data-gathering phase. Ultimately, the client will appreciate the well thought out recommendations that result from thorough data gathering.

.10 When planning for a CHBO in real life, the CPA will generate a large number of questions as preliminary facts are uncovered.

.11 The following is a sampling of some of the additional questions that will arise (each of which may lead to other, related questions).

- What is Tom's age, business sophistication, health, and general financial situation? What is John's understanding of what happens to Tom's stock when Tom dies?
- Why has Betty not become a U.S. citizen?
- Would she be willing to do so if financial considerations made it a wise step?
- Is Betty capable of operating the business on her own?
- Would she want to?
- Will John receive retirement income from RNK?
- Have ways of dealing with Raleigh, Inc.'s, cash-flow problem been addressed and rejected already?
- How does John's salary compare to that of others in the industry?
- Why was C corporation taxation selected?
- Why was a September 30 taxable year-end selected?
- Has any previous consideration been given to installing qualified retirement plans?
- What does John know about qualified retirement plans?
- Does Raleigh compete for qualified workers within a competitive marketplace?
- What are the ages of the employees?
- Is the $1,000,000 business value estimate based on going-concern criteria (perhaps more relevant for retirement planning) or liquidation criteria (perhaps more relevant for estate planning)?
- How critical are John's personal services to the value of the company?
- Would John and Betty consider using their assets to liquidate the mortgages if financially prudent?
- Are there any extended-coverage insurance riders on the personal property?
- Would John consider shifting assets to Betty for financial reasons?
- Would the bank consider excluding certain personal assets from John's guarantees of Raleigh, Inc.'s, loans?
- Who is the beneficiary of the life insurance policy?
- How was the $75,000 life insurance amount determined?
- How is the planned $75,000 warehouse to be financed?
- How likely is it that Bob, Steve and Lisa will attend college?
- When does John want to retire?

Planning Opportunities

.12 Based on the facts of this case, the following concerns and potential planning opportunities might be addressed.

- An acceptable buy-sell agreement should be in place, as well as a complete plan for succession in the event of John's death, disability, or retirement.
- As a non-U.S. citizen, Betty does not qualify for unlimited marital giving or the unlimited marital exclusion for estate and gift-tax purposes. John and Betty's estate planning is significantly complicated by Betty's citizenship status.
- Minimize Betty's income and increase John's to reduce FICA tax costs.
- Look closely at the short- and long-term effects of electing Subchapter S tax status.
- Review the benefits of retirement plans in the context of John's circumstances.

- Consider a payoff of the 11 percent mortgage if the liquidity is not needed.
- Consider whether the autos are being properly treated for tax purposes.
- John should consider disability coverage, and he should have a medical insurance policy that does not exclude worker's compensation-related injuries.
- John should acquire directors' and officers' insurance.
- Consider shifting personal asset ownership to Betty, if she is not to become an owner of Raleigh, Inc., as a way to limit potential losses on John's bank loan guarantees. (For obvious reasons, the bank may be reluctant to release any existing assets from John's guarantee of existing loans. It may, however, be a negotiable item, especially for future loans.)
- Recognize that cash-flow planning at the corporate and individual level is a must.
- Begin paying Bob and Steve for work performed as a way to reduce taxes while saving for college. This will be particularly effective if Betty's salary, which is already subject to FICA tax, is reduced.
- The wills are extremely outdated; revising them is a priority short-term goal.
- Consider compensation techniques that will motivate Phil and provide her with an opportunity to acquire an equity interest in the company. A buy-sell agreement might provide a way for Phil to acquire an interest in the future at John's death or disability.

Common CHBO Planning Considerations

.13 The following table lists the traits common to CHBOs and CHBs, and correlates them to the case of John and Raleigh, Inc.

General Traits

CHBs	*John and Raleigh, Inc.*
• Client is founder or co-founder of own business	• Started Raleigh in 1980
• CHBOs entire life is centered around the CHB; weekdays, evenings, weekends, and social activities often focus on the business	• Works seventy hours a week, including weekends
• CHBO's success with the CHB follows initial training period with another employer	• Left RNK after fifteen years
• CHBOs entire effort has been devoted to making the CHB do well, while personal financial management has been neglected	• Desires more active management of personal, as well as corporate, finances
• CHBO is decisive, likes to lead, and has strong personality	
• CHBO is looking for solutions, not questions, and is frustrated during the data-gathering phase of the planning engagement; wants to get to the bottom line as soon as possible	
• Other family members (if not the entire family) are involved in the CHB	• Spouse and two eldest children work in the business
• CHBO has concerns about the ongoing continuity of the business were something to happen to him or her	
• CHBO's salary fluctuates during the year, depending on the CHB's cash needs	• No salary during August through November; income catches up in December
• CHBO lacks diversification of investment; the CHB's value dominates the portfolio	• 85% of net worth is corporate stock

Cash-Flow Planning

CHBs

- There is usually excess cash within the CHB, but monthly cash flows fluctuate and the short term is often unpredictable
- CHBO views the CHB, even though it is a corporation, as an extension of his or her own personal assets; the CHB's assets are often used to supplement the CHBO's personal finances
- Lack of coordination between personal and CHB tax planning
- Personal need for predictable, systematic cash withdrawals from the CHB
- Objective to use CHB cash flow for pre-tax fringe benefits, such as
    - Medical insurance benefits
    - Health and accident insurance
    - Medical reimbursement
    - Group term life insurance
    - Legal service plans
    - Educational assistance
    - Travel and entertainment
    - Auto
    - Retirement plans

John and Raleigh, Inc.

- No salary taken from August through November
- CHB provides autos
- Large December salaries (no August-November salaries)
- Non-use FYE benefits
- No benefits currently
- Retirement plan and medical plan are needed

Risk Management and Insurance

CHBs	*John and Raleigh, Inc.*
• Potential exposure areas:	
Death - Business needs - Family needs - Estate-tax funding	• John only has $75,000 life insurance, no coverage for Betty • Potential estate tax liability
Disability - Own occupation definition - Social security - Overhead insurance	• No disability coverage • Opted out of workers' compensation
Illness	• No medical insurance or medical reimbursement plan
Property/Casualty	
Liability - General liability - Umbrella liability - Business pursuits endorsements - Homeowners Floater endorsement for scheduled items - Annual inventory - Auto insurance Integrated business-personal use	• Secure umbrella, both personal and corporate • Jewelry and furs need rider • No current inventory • Replacement insurance on home and contents
• Key-person insurance - Permanent insurance - Nondeductible premiums - Benefit tax-free to the corporation, assuming it had insurable interest and employee did not have incidents of ownership - Cash surrender value is corporate asset	• None currently on John • None currently on Phil
• Directors' and officers' insurance - Covers wrongful acts - Reimburses corporation and/or individual - With endorsement, can apply to fiduciary liability arising from trustee on retirement plan	• Applicable if retirement plan established for fiduciary liability

Estate Planning

CHBs	*John and Raleigh, Inc.*
• Business valuation	• Only John's opinion as to corporate valuation
• Succession planning — Family Partnership — Private annuity — Segment sale — Installment sale — Reorganization — Sale to outsiders	
• Buy-sell agreement — Types — Section 303 redemption — ESOP	• Buy-sell with Phil (future) • Buy-sell with Tom
• Credit-shelter trust	• Potential liability with Raleigh, Inc., 100 percent in John's name
• Deferring estate taxes	• Deferral of tax for fourteen years because corporation exceeds 35 percent of adjusted gross estate
• Lifetime gifts	• $10,000/$20,000 annual exclusion
• Marital deduction	• Betty non-U.S. citizen
• Power of attorney	
• Lack of liquidity	
• Lack of diversification	• More than 85 percent of portfolio is Raleigh, Inc., stock, real estate, and RNK stock • 85 percent of total net worth is Raleigh, Inc., stock
• Coordination of CHB retirement fund investments with personal investment portfolio	
• Real estate — Leaseback to company	• New warehouse being constructed • Children considered to be owners

Education Planning

CHBs	*John and Raleigh, Inc.*
• Children on payroll — Reasonable compensation issue — Social Security Unincorporated businesses do not have to cover children 18 and under; spouse coverage required	• Children not currently paid • Social Security needed
• Equipment leasing	
• Fair Labor Standards Act — State law requirements	
• Ownership of assets — Kiddie tax	• Consider having children own some of the equipment purchased annually

Retirement Planning

CHBs	*John and Raleigh, Inc.*
• Qualified plan — Employee nonworking spouse — Plan development-administration selecting actuary	• Consider having children own some of the equipment purchased annually
• Nonqualified plan deferred compensation	
• Liquidation of business assets on retirement	• Consider retirement plan set up
• Lack of diversified investment portfolio	• Increase John's salary to allow maximum plan funding
• Excise tax on excess accumulations	

EXHIBIT 1

INFORMATION-GATHERING CHECKLIST

CLIENT NAME: ____________________ **DATE:** ____________________

Name of Business ____________________ **Address** ____________________

Form of Business ____________________ **Percentage Owned** ____________________

a. *Obtain a copy of the client's business plan.* ___________

[The business plan, if available, should provide information about goals of the client's CHB as well as anticipated growth and future cash flow. If the client does not have a written business plan, the CPA should assist the client in identifying business objectives.]

b. *Obtain a copy of the articles of incorporation and by-laws (or other relevant CHB documents, such as partnership agreements).* ___________

[Although much of this is in the form of standard wording required by the state, there might be pertinent information regarding stock restrictions, ownership restrictions, or partnership allocations that the CPA should be aware of.]

c. *Review copies of minutes as appropriate.* ___________

[Past minutes can be revealing about corporate activities, including stock ownership restrictions, loan approvals, etc. If minutes are absent, this is a danger signal that corporate housekeeping may be lax.]

d. *Obtain copies of business income statements, balance sheets, tax returns, and internal management information for past years, as appropriate.* ___________

[It is critical that the CPA understand the cash flow of the business. If cash flow is cyclical, increasing, decreasing, or temporarily high or low, the CPA should consider that fact before making recommendations.]

e. *Obtain or create a list of all advisors used by the company (e.g., attorney, banker, accountant/auditor, management consultants, risk management advisers).* ___________

[This list is helpful for coordinating with the client's advisers.]

f. *Review the employee handbook, if available.* __________

[The employee handbook can provide information about benefits, systems and procedures, and policies regarding training, hiring, and firing.]

g. *Inquire into and obtain copies of loan covenants, personal guarantees, and restrictions relating to loans.* __________

[Prepare a concise, easy-to-follow summary of the above documents for review with the client.]

h. *Familiarize yourself with the client's industry.* __________

[Subscribe to trade publications, attend trade shows (with or without the client) and watch for relevant articles in news publications. Consider purchasing publications that provide financial ratio data on businesses.]

i. *Inquire into recent or pending Internal Revenue Service examinations or exposure, outstanding litigation, government audits, etc.* __________

[It is critical that the CPA understand the CHB's tax exposure, or other contingent liabilities that could affect the CHB's fiscal integrity or the client's investment.]

j. *Obtain copies of buy-sell agreements, sub S election, management contracts, relevant trust documents, compensation agreements, key person life and disability contracts.* __________

[These documents provide information about the current status of items affecting the CHB and the client that must be known before further action can be taken.]

Note: If the CPA is unable to obtain information requested, this may highlight other problems that might need to be addressed.

EXHIBIT 2

DATA ORGANIZER FOR A CHB

CLIENT NAME: ______________________ **DATE:** ________________

Name of Business ____________________ **Address** ______________________

Form of Business ____________________ **Percentage Owned** ______________

OTHER OWNERS

Name	Age	Percent Owner - ship	Family Relationship	Health	Active Role With Firm
______	___	___	______	___	________
______	___	___	______	___	________
______	___	___	______	___	________
______	___	___	______	___	________

KEY EMPLOYEES

Name	Age	Percent Owner - ship	Family Relationship	Health	Active Role With Firm
______	___	___	______	___	________
______	___	___	______	___	________

Explain any special cash-flow considerations of the business:

____

____

____

Describe briefly any equity-based compensation techniques being used and the current level of satisfaction regarding same:

____

____

____

Indicate your satisfaction or dissatisfaction with other employee benefits being provided:

____

____

____

Value of ownership interest (best guess if necessary) ______________________

Method used to value business: ______________________

____

Number of nonunion employees	________
Union employees	________
Anticipated gross income: Current year	________
Anticipated before-tax net income: Current year	________

EXHIBIT 3

CHB INFORMATION FORM

CLIENT NAME: ______________________ **DATE:** ____________________

Name of Business ______________________ **Address** ______________________

Form of Business ______________________ **Percentage Owned** ____________________

Objective: To gather more information about the client's business than could readily be ascertained by analyzing historical financial information. Using this form helps the CPA obtain information about average balances of balance sheet items at estimated fair market value rather than cost, so the CPA can learn the approximate net worth of the business. In addition, the CPA should obtain more information for each line item when appropriate (for example, when asking for the average accounts receivable balance, the CPA might lead the client into a discussion of collections and the average turnover of accounts receivable).

CLIENT: ____

Year Started: ______________ Last Full Year __________

Assets

Average Cash Balance	________	Average Balance Short-term Liabilities	________
Average A/R Balance	________	Average Balance Long-term Liabilities	________
Average Inventory Balance	________	Total Liabilities	________
Property and Equipment (estimated fair-market value)	________	Net Equity	________
Total Assets	________	Estimated Business Value	________

List unique circumstances and commitments with regard to the business, including personal guarantees: ____

____

____

Gross Revenue	________
Cost of Sales	________
Net Profit	________
Operating Expenses	________
Debt Service	________
Salaries/Distribution to Owners	________
Income Tax	________
Net Cash Available to Fund Objectives	________

EXHIBIT 4

TAX PLANNING CHECKLIST FOR THE CHBO

CLIENT NAME: ____________________ **DATE:** ______________

Name of Business ________________ **Address** ________________

Form of Business ________________ **Percentage Owned** ____________

	YES	NO	N/A/COMMENTS
I. Data Gathering			
A. Have you obtained CHB's prior-years tax returns?	___	___	__________
B. Has the CHB prepared current and/or future-year projections of taxable income?	___	___	__________
• Have you reviewed these?	___	___	__________
C. Have you determined who is responsible for CHB's tax compliance work?	___	___	__________
• Have you determined who is responsible for the CHB's tax planning?	___	___	__________
• Have you discussed *your* role with all interested parties?	___	___	__________
D. Have you investigated and determined the existence of controlled or related entities?	___	___	__________
E. Have you determined the effect of restrictions on ownership imposed by tax authorities?	___	___	__________

	YES	NO	N/A/COMMENTS
F. Have you determined why the particular form of business entity was selected?	___	___	___
• Have you reviewed the alternatives?	___	___	___
G. Are there loans between the client and the CHB that may have tax planning implications?	___	___	___
H. Have the existence of employee benefit plans and their impact on the client been documented?	___	___	___

II. Asset Transfers

To the CHB:

A. Have the cash requirements of the CHB been analyzed to determine whether future transfers to the CHB may be needed?	___	___	___
B. Has the future financing of the CHB been considered to determine whether it should take the form of debt or equity?	___	___	___
C. Has consideration been given to the available future sources of financing for the CHB, the client, or other sources?	___	___	___
D. Does the current form or tax status of the CHB preclude different classes of stock or hybrid debt securities?	___	___	___

	YES	NO	N/A/COMMENTS
From the CHB:			
A. Compensation			
• Does the potential for unreasonable compensation exist?	___	___	___
• If yes, has consideration been given to—			
— An employment contract providing for reasonable compensation based on production?	___	___	___
— Deferred compensation to establish a track record of higher compensation not tied to earnings?	___	___	___
— Changing the tax status?	___	___	___
• Are opportunities to shift income to related parties being considered?	___	___	___
• Is the CHB using every legitimate opportunity to enhance the client's standard of living without creating taxable income?	___	___	___
eg. - Business trips	___	___	___
- Automobile for business purposes	___	___	___
- Employee benefits, such as medical and life insurance	___	___	___

	YES	NO	N/A/COMMENTS
B. Employee Benefits			
• Are there employee benefits that would be beneficial for the CHB to provide (on a cost-benefit basis), while simultaneously providing a tax-free benefit to the client?	___	___	______________
• Is the client's benefits package competitive in the market for employee talent?	___	___	______________
D. Have the tax consequences of distributing property from the CHB been considered?	___	___	______________
III. Transfers of Interests			
A. Have ownership transfers to related parties been considered?	___	___	______________

EXHIBIT 5

TAX IMPLICATIONS OF LIFE INSURANCE IN PLANNING FOR A CORPORATE CHB

	Policy Owner	Beneficiary	Premiums Deductible for Income Taxes	Use of Proceeds Reason for Policy	Proceeds Taxable	Premiums Paid by	Proceeds Includable in Owner's Estate
1.	CHBO	Spouse	No	1,2	No	CHBO	Yes
2.	CHBO	Employee/ Co-owner	No, Unless Treated as Additional Compensation	3	No	CHBO	Yes
3.	Irrev. Trust	Irrev. Trust	No	1,2	No	Trust	No
4.	Employee/ Co-owner	Employee/ Co-owner	No	3	No	Employee/ Co-owner	No, but may impact value of business included in estate
5.	Corporation	Corporation	No	3	No	Corporation	No, but value of stock in decedent's estate may be affected by proceeds
6.	Corporation	Employee/ Co-owner	No	3	No	Corporation	No, but value of stock in decedent's estate may be affected by proceeds

(continued)

EXHIBIT 5

TAX IMPLICATIONS OF LIFE INSURANCE IN PLANNING FOR A CORPORATE CHB (Continued)

	Policy Owner	Beneficiary	Premiums Deductible for Income Taxes	Use of Proceeds Reason for Policy	Proceeds Taxable	Premiums Paid by	Proceeds Includable in Owners Estate
7.	Corporation	Spouse	No	1,2	Right of dividend treatment at time premium payments made or upon receipt of proceeds or additional compensation	Corporation	Yes, proceeds either includable due to controlling stockholder (50% of CHBO owned by descendent) or if not directly includable (benefit CHBO) may be considered in valuing CHBO stock included in decedent's estate
8.	Spouse	Spouse	No	1,2	No	Corporation by loan	No

NOTE: This chart provides general information. When planning for a particular client, carefully addresss that client's specific circumstances.

CAUTION: Insurance proceeds may be taxable under the corporate alternative minimum tax

Key:
1. Fund living expenses
2. Fund estate taxes
3. Fund buy-sell agreement/Acquire owners interest

Spouse=of CHBO
Employee=of CHB

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