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Adviser's guide to family business succession planning

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The Adviser's Guide to

FAMILY BUSINESS SUCCESSION PLANNING

Edward Mendlowitz, CPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



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Edward Mendlowitz, CPA
WithumSmith+Brown

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AICPA®

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Statistics on the ownership profile of businesses in the United States should serve as a wakeup call for the pressing need for succession planning. Owners of companies valued between \$5 million and \$150 million say that chances are better than two out of three they will leave the business within 10 years, according to a 2005 survey by PricewaterhouseCoopers. Yet only 22 percent of these owners have done succession planning.

The failure to plan adequately for the transfer of power (who will run the company) as well as the transfer of assets (who will own the company) can undermine the viability of the company and seriously erode the wealth of the owners' families. Owners spend their lives building up their businesses, the value of which is the number one asset for many. But without adequate planning for a change in both management and ownership, the value of the very asset they've built up can be seriously diminished. For instance, the family may face a huge estate tax bill that can force a sale of some or all of the business or borrowing at less-than-favorable terms just to pay this bill.

The difficulties and opportunities of the succession process are amplified when it comes to family-owned businesses, which account for 90 percent of the approximately 21 million companies in the United States today, according to the U.S. Small Business Administration. In fact, one-third of Fortune 500 companies are family owned or family controlled. Yet the success rate of transferring the business to succeeding generations is dismal—less than 30 percent succeed into the second generation and only 15 percent into the third generation. One of the prime reasons why family businesses fail to be sustained generation after generation is lack of proper succession planning.

It is therefore imperative that owners focus on the need for succession planning as soon as possible. This will enable owners to work out both the personal and financial issues that this planning entails. Working with a knowledgeable adviser, business owners can start the decision-making process. They can identify potential succession candidates and set a realistic value for the business. They can determine whether to sell their interest or give it to family members. They can incorporate their succession planning into their overall estate planning. And they can address how best to structure the transfer from a legal and tax perspective.

The sooner owners start the process, the greater the chances for success. Why? Making decisions and taking steps *before* the onset of

illness, age, or other debilitating conditions ensure that the owners retain control over the planning process. Time also affords the widest range of options. For example, early planning can incorporate the purchase of life insurance, something that may not be obtainable or affordable later on. And starting early can allow for a gradual rather than a drastic shift in management and ownership, which may be prized by owners and help to ensure the continued value of the business.

Of all the business owners' advisers, accountants are in the best position to quarterback succession planning by encouraging clients to start the process and advising them at each step of the way. The accountant can help to coordinate the efforts of other professionals, including attorneys, bankers, business brokers, insurance agents, and others involved in the succession planning process.

To be an effective adviser, accountants must gain expertise in each aspect of succession planning. This book is an essential tool in the learning process. It clearly and concisely walks the reader through the planning steps, showing how best to assess alternative dispositions. The book also provides practical suggestions, case studies, and practice aids, all of which help accountants to better serve their clients' needs.

Succession planning is a comprehensive approach to transferring a business. Often it is not a one-time activity, but rather an ongoing process to ensure that the plan continues to meet the owners' objectives while taking into account changing factors, such as new market conditions, changes in family makeup and tax law revisions. The ongoing nature of the process requires that accounting professionals continue to remain involved and proactive in succession planning.

Barbara Weltman*

June 2006

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Succession Planning

Succession planning is an important process that affects the owner, his or her family, the employees, customers, suppliers, professionals frequently consulted with, and the landlord. It can even affect a neighborhood or small town. Succession planning requires a carefully thought-out plan, or chaos could result.

Succession planning should be done, even if there are no immediate plans to retire. Life insurance is purchased even though there are no immediate plans to die, and prenuptial agreements are signed even though there are no immediate plans to get divorced. So too, should succession plans be formulated as a precaution against unforeseen, unintended, and perhaps inevitable future events.

There is a responsibility of the owner to consider the needs of all those involved. Many times the owner is an inner-directed person even though he or she is outgoing when with people. The owner simply may not be aware of the people that would be affected by what is done or, really, what is not done properly. The owner's advisers must relate the plan in the terms of the owner's own self-interests. It is in his, or her, best interest that a succession plan be conceived, planned, and implemented. Following are some of the reasons for this:

1. Employees know when owners are getting older, or lacking the drive they once had. This creates a doubt in employees' minds about the future of the business, or certainly the future of their secure positions. This will most definitely affect their performance. It may also cause the best employees to seek employment, or opportunities, elsewhere.
2. Major customers get that same sense. It causes them to consider alternate sources of supply affecting the sales or future orders and possibly long-term commitments.
3. Suppliers no longer feel as secure in the relationship. Your clients' orders are no longer as important as they once were, perhaps affecting in a slight way the quality or delivery time.

4. Professionals such as lawyers, accountants, and marketing and advertising people do not any longer consider the relationship a long-term one and look for replacement business, thus affecting the time they once had for that business.
5. Bankers start "thinking" about their loans, especially if they think the owner will not survive the term.
6. Landlords, considering they might lose a tenant at the expiration of the lease term, may look to sell the property that they once thought they would pass on to younger generations of their own family.
7. A general lethargic attitude creeps into the business, taking away the "snap" it once had. The fun the owner once had is no longer there. The business becomes a chore, thus confirming everyone else's thoughts.

The above reasons can, and will, all contribute to a reduced value of the company. The owner, seeking to maximize the value of the business and his or her income from it creates a self-defeating situation where the value is diminished, and the income or cash flow declines on a regular basis. When the owner finally reaches a point where he or she decides to sell, he or she will realize much less.

Lifetime Planning

At some point a business owner will part with his or her business. It could be voluntarily or involuntarily, but it will happen.

Many people do not like to think about retiring—and many do. The ones who plan, plan fully—even to the day that the retirement starts. They think, dream, fantasize, and work out every alternative. These are usually people employed by large organizations. The larger the organization, the more time consumed in this activity. On the other hand, entrepreneurs usually plan the least—and make the least effort toward that inevitable day.

The character traits leading someone into business are the same personality that drives them to continue. These are people who feel they will live forever. And they are not easy subjects when it comes to succession or estate planning. These are the people dealt with in the following pages.

Some of the many reasons that cause entrepreneurs to divest themselves of their business are:

1. Retirement
2. Illness or disability
3. Death
4. Continuity of the business
5. Desire to change lifestyle
6. Boredom
7. Not fun anymore
8. Owner burnout
9. Business losses
10. Lack of need to “prove” something
11. Not being “hungry”
12. Reaching their “capacity”

13. Complacency
14. Refusal, or inability, to adapt to changing business environment
15. Family pressures
16. Changing economic, political, or business conditions
17. Acts of terrorism
18. Loss of product viability
19. Having a one-product or one-market business
20. Loss of franchise, distributorship, major supplier, lease, major customer or supplier, key employee, or patent
21. Loss of respect in industry
22. Changing tax laws
23. Need for greater, or more steady or certain, personal cash flow
24. An offer they cannot refuse

Some of these can be planned for, and some cannot, such as more stringent environmental controls laws. Failure to plan forces a decision to do nothing, and that has its consequences.

Decision Making

It is hard for someone who built a business to make the decision to slow down, pass the baton to the younger people in the business, or to sell. One reason is simple human nature—it requires the realization that it might be time to retire—because that is what is actually occurring.

Waking up one morning and realizing it is that time (that is, to retire or start to really plan for retirement) can be a heavy load to absorb. In many cases, that creates the greatest barrier to making the decision.

Advisers

It is important for the business owner to understand that there are choices. Doing nothing is a major choice and carries with it the natural consequences of that path.

One method of illustrating the “do nothing” alternative is to project the businesses current operations and trends. Following is an illustration of a “do nothing” scenario.

When you look at the projections keep in mind that this is a good business. It is increasing its sales annually, and is profitable.

BT Manufacturing Company
Income statement summary — 2001 to 2011

Assumptions used:

	% increase per year
Sales	3%
Cost of sales	4%
Operating expenses	6%
# units sold	0%

(in Thousands except price per unit)

Current

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
	Actual	Actual	Actual	Actual	Actual	Projected	Projected	Projected	Projected	Projected	Projected
Sales	\$4,000	\$4,120	\$4,244	\$4,371	\$4,502	\$4,637	\$4,776	\$4,919	\$5,067	\$5,219	\$5,376
Cost of sales	2,400	2,496	2,596	2,700	2,808	2,920	3,037	3,158	3,285	3,416	3,553
Gross profit	1,600	1,624	1,648	1,671	1,694	1,717	1,739	1,761	1,783	1,803	1,823
Operating expenses	1,000	1,060	1,124	1,191	1,262	1,338	1,419	1,504	1,594	1,689	1,791
Officer's salary, pension, perks	300	300	300	300	300	300	300	300	300	300	300
Net income before taxes	\$300	\$264	\$224	\$180	\$132	\$79	\$21	(\$42)	(\$111)	(\$186)	(\$268)
# units sold	200	200	200	200	200	200	200	200	200	200	200
Average price per unit	\$20.00	\$20.60	\$21.22	\$21.85	\$22.51	\$23.19	\$23.88	\$24.60	\$25.34	\$26.10	\$26.88

This business has “settled” into a niche and the owner has become somewhat complacent, not wanting to “upset the applecart” with any kind of changes. At 200,000 units per year, the business is not losing unit sales, but if it is in an industry that is growing, then the company is losing market share, and the costs of sales and operating expenses are increasing at a faster rate than the sales. Projecting the operations forward five years shows a loss on the horizon. Left to its own equilibrium or inertia this business will run itself out. The final result will be loss of income, assets, and value, and a succession possibility.

Now, what about businesses whose sales have dropped or who had a really bad year mixed in somewhere in that 10-year period?

Reversing the trend of complacency might be possible because the following elements that made the entrepreneur successful may no longer be there.

1. Youthful enthusiasm and energy
2. Their initial hunger
3. The desire to prove they can do it
4. Risk tolerance
5. Ego gratification
6. Friendship with customers, suppliers, and key employees (Many of the people who were there at the beginning have either retired, died, had strokes, turned the business over to their successors, sold, liquidated or went bankrupt.)
7. Inability to conceive of failure

Getting Started

To start working on a plan the following are some of the things that are usually needed by the advisers who will put the plan together.

1. An actual statement of what is to be accomplished that is prepared, or agreed to, by the owner.
2. A financial plan of the alternatives.
3. An understanding of the roles of the people involved and a listing of the key employees of the company.
4. The retention of a “quarterback,” which is usually the company’s accountant, but could also be the attorney, a close friend who may have gone through the process, or a consultant engaged specifically for the purpose. It could be an employee, but this generally is not the best choice because of his or her lack of experience in this area, and it is counter to what the employee might want, which is a secure job.
5. The company’s last three years’ financial statements and tax returns. Five would be better, but a minimum of three years is needed.

6. The owner's last three years' individual income tax returns.
7. The owner's personal financial statement.
8. The owner's will, and any trust agreements.
9. Copies of *all* of the owner's and spouse's gift tax returns.
10. A projection or business plan of the company, and a copy of the company's break-even analysis, if available.
11. Copies of all life insurance policies of the owner and spouse.
12. Copies of any shareholders' or buy-sell agreements. If there are multiple owners, state which ones will be remaining with the company, and which ones are employed full-time by the company.
13. Any employment contracts, or memoranda of compensation arrangements with employees, and copies of qualified employee pension, profit sharing, 401k, or employee stock option (ESOP) plans.
14. Union contracts.
15. Leases.
16. Details of any business real property owned by the business, business owner, or spouse.
17. Appraisals, if any, of the business or any of the business' property.
18. Estimate of the future cash flow needs or requirements of the owner and spouse.
19. History of the firm.
20. Description of the company's operations, and product lines, and major customers and key suppliers; a percentage breakdown, if applicable, of sales by product lines—foreign and domestic, government or organizational, and commercial or industrial.
21. Any contracts, franchise, distributorship, or representation agreements the company has.
22. History of company ownership, if there have ever been any changes.
23. Listing of affiliated organizations, and all their information, if owned by the owner or spouse, or immediate family.
24. A statement indicating the importance of research, design, fashion, or new products to the company.
25. The geographic area served by the company, and the importance of the company's present location to the success of the business.
26. A description of the competition, including competitors' approximate size; sales; number of employees and customers; the ownership and whether there have been any changes in the last five years; or noticeable business, marketing, or operational changes within the last five years.
27. Fixed asset schedules of the company including assets written down to \$1.00 or \$0.00.
28. Schedule of intangible assets, including patents, trademarks, copyrights, secret processes, and distributorships and franchises both actual and in fact.

29. Listing of any pending or proposed or anticipated litigation, both for and against the company.
30. A listing of any contingent obligations or liabilities of the company.
31. Explanations of any unusual transactions over the last five years.
32. An overall assessment of the company's strengths, weaknesses, potential in the marketplace and market position.
33. Background, including education, of the owner's children—and which ones want to remain with the company, as well as which ones the owner *wants* to remain.
34. Any unique features about the family.
35. Any thoughts ever given to public ownership, or ownership by passive investors.
36. Any environmental issues, audits, assessments, fines, penalties, cleanup, or any other type of problem or concern at present or during the last five years.
37. Copies of any bank loan agreements and covenants.
38. Any hobbies and nonbusiness interests of the owner.
39. Web site printouts.
40. Any Internet strategies in place or being discussed.
41. Web site addresses of competitors.

Identifying Succession Candidates

Following are some typical scenarios of situations where owners will have to make succession planning decisions. Obviously the chapter does not cover every alternative, but there are enough examples most entrepreneurs can identify with.

1. Owner is age 65, and two children are working in the business, ages 42 and 38.
2. Owner is age 65, and two children are working in the business, ages 30 and 26.
3. Owner is age 70 and two children are working in the business. The owner is a sales-oriented person and the business is sales driven. The children work in the technical and financial or bookkeeping parts of the business.
4. Same as item 3, except the children work in the sales and technical, or sales and financial ends of the business.
5. The father is age 75 and his son is responsible for 65 percent of the sales of the company, and his two daughters are totally uninvolved in the business.
6. The owner is age 70 and her ex-son-in-law runs the business.
7. The owner is age 65, has no children in the business, and has two key employees, both with the business for over 20 years and both in their late 40s.
8. The owner is age 50 and has five children who work in the business; the owner wants to “get out.”
9. The business has created substantial net worth, and has substantial cash flow, but has chemically polluted the real estate it owns.
10. The owner has a “cash business” and wants to reduce his time spent at the business.

11. The owner has a distributorship of a nationally branded product that is based upon her remaining active in the business.
12. A small professional firm's senior partner wants to retire.
13. A husband and wife in their mid-50s run a business and want to take it easier.
14. A family-run restaurant, established over 50 years ago, no longer has young family members working in the business.
15. A law firm, or medical practice, wants to "keep" younger professionals.
16. The main salesperson of a sales-driven company wants a substantial ownership position in the company.

These situations may all seem to be different, but they are not. The personalities of the owners are basically the same. They are usually all self-driven, well-rounded, originally risk-oriented people who manage by gut feelings, with extremely high intelligence and motivation, with a hand-picked group of people they completely trusted. They are independent people who treat their business as the main constant in their lives, and who fail to visualize themselves without a place to go to in the morning. It is also, on occasion, a refuge and an excuse for traveling without their spouses. They are also "king of the hill" when they walk through the front doors of their business. And they take pride at every nook and cranny at their office or factory. They are loath to part with what they see as a major part of their life.

Who Should Do the Succeeding

The choices of who the successor will be are sometimes very limited because of the *perceived* lack of qualifications of the successor. When people are held to a tight rein and are second guessed every time they make a mistake, there is a more limited chance of success than if they were permitted to work things out for themselves and had to deal fully with the consequences of their mistakes.

We have seen the most improbable successors succeeding when they are placed in a position where they have no choice. We once had a client that was a fuel oil dealer. Our client would be so concerned for the welfare of his customers that he would get up many times at 2:00 or 3:00 A.M. to rush out to supply fuel to a house that was out of heat in the middle of the winter. He did okay making a living, but was not quite ever able to get a little ahead financially. Unfortunately he died suddenly, at a relatively young age—45—leaving a 22-year old son who worked for him and a wife, who was his bookkeeper, receptionist, and scheduler. Her first reaction was to sell the business, which was operated out of their house. We told her to wait a little while until the initial panic left her and she could see things objectively. Also, the husband's only asset was the business—the house, trucks, and cars being fully mortgaged—and her ability to earn a living was very limited, since the only work she ever did was for her husband.

She was, you might say, not given any choice but to make a go of the business. She immediately hired an additional person to work for her delivering the fuel oil. Becoming aware of her payroll costs and incurring overtime premium pay for late night deliveries, she developed a much better system of scheduling the work, and watching the degree days much closer. And occasionally when a late night delivery was needed, she charged extra for it, as she did for every extra service that her husband always did for nothing, such as minor repairs, and extra servicing of the boilers. At the end of her first full year running the business she showed a far greater profit than her husband ever did, with fewer crises than he ever had. After three years, when it was determined her son did not want to buy the business from her, she sold

it for about four times what she would have gotten had she sold it just after her husband's death.

Another time a client with an art gallery decided to get a divorce. He was much older than his wife, who was a homemaker with two young children, and did not want to have to pay her alimony. He decided to give her the art gallery and he would open a new one elsewhere. He felt the profits from the gallery would permit her to earn a living and would relieve him of any ongoing obligations. Otherwise, he would have had to pay alimony until it was determined his wife was self-supporting. She was backed into a situation that she did not want to be in but felt she had no choice, so she agreed. She sought help and suggestions from everyone she knew, including her banker, accountant, attorney, landlord, fellow gallery owners, the artists, and some large wholesalers. She immediately liquidated slow-moving inventory; negotiated better terms with the artists her gallery represented; got the landlord to extend the lease, which had only two remaining years; picked up some new artists; made up a mailing list of past customers; aggressively promoted shows; and in four years more than doubled the sales and tripled the profits.

Still another illustration is a father who owned a printing business had a heart attack. His college-student son, who worked for his father summers and on school vacations, had to take a leave of absence to keep the business together until his father recovered. The son, not being familiar with the bookkeeping and paper work, outsourced it to their CPA firm, and he concentrated on the printing and customer relations. It turns out that the paper work took more than half the father's time, and the father's time with customers was next to nonexistent. In the four months the father was out, business increased 30 percent, and much of it was high-end jobs that needed the printer to speak to the customer. After the son graduated college, he went to work at the family business full-time, and the business is now three times larger than when the father was running it himself. P.S.—the bookkeeping is still outsourced to the CPA firm.

The point is that people generally rise to the occasion. And it is actually harder when they *do not have to!*

Another important point is there must be a boss. A business cannot be run by a committee, or even two equal people. Someone must have the ultimate responsibility. When two siblings are in the family business, the parent must choose one of them over the other. This does not mean the parent loves one over the other, but one must be chosen to drive the train. A committee, or board, can be selected to set overall broad-range policies, and to evaluate the performance of those operating the business on a day to day basis, but should not be constituted to run the business on a day-to-day basis. There are exceptions (and we know of one great exception) but the exceptions are rare and infrequent.

The hardest choice is probably when there are two siblings working in a business with more or less similar responsibilities, and the parent favors the younger. The younger one is most likely used to the eldest getting special or

extra responsibility—but the oldest is not used to the youngest getting it, unless there is a special relationship between them.

A decision must be made that is best for the continuity of the business and the earnings of all the family members, and other employees, that are flowing from the business. The preservation of the business, not the egos of the people involved, has to be the primary reason for the decision, although the way the decision is handled should take into account the sensitivities of each individual.

A parent/business manager looks at things with a much more critical eye than others. Following are some of the things he or she is usually able to see in a much more directed way than the others in the company. The parent/business manager:

1. Is able to measure actions, temperament, the application of each person's intelligence, and how they deal with situations in the normal course of business and during crises.
2. Can evaluate objectively how the children will interact with other employees and customers and suppliers. He or she can also detect who is, and who is not, a leader by the way the children's peers treat them, either with respect or jokes.
3. Can see more clearly the micro/macro thinking abilities of the next generation, and which is more critical to the business' future success.
4. Can see which sibling is more tolerant of the other.
5. Can see which sibling can handle people, or money, better.
6. Knows the training each has received. It is impossible for both to have received the same training and instruction from the father. This also includes time when they both were very young.
7. Sees who is better with responsibility and the approach of each in dealing with his or her own personal responsibilities.
8. Knows which child's personal life is in better line with his or her parent's expectations, or approval.
9. Knows the skills, training, and education of the children, and maybe the way they did their homework.
10. Sees the relationship with other siblings not involved in the business.
11. Senses whether the children need to have a "boss" over them.
12. Knows whether they are leaders or managers.
13. Sees how they interact with others that are being considered for the mantle of leadership.
14. Knows their decision-making ability.
15. Knows what kind of security the children need.

We have clients who have children in the business, and who crave to have their children carry on the business. Some of the methods used are as follows:

1. The parent had five children working in the business. He gathered them together and told them he wanted to phase himself out of the business and that they could have it if they wanted it. He gave them a month to decide among themselves how they wanted to do it. They met and told their father they did not want the responsibility of being a boss, and if he did not want it anymore, he should sell it. Short and sweet. And it saved a lot of anxiety and time.
2. Two children worked in the business with their father. The younger child was trained in the technical aspects of the business and really wanted the business. The older did the bookkeeping, wanted no responsibility, and liked being able to leave early to play basketball and racquet ball a couple of times a week. The younger one got the business, with the promise to the father that the sibling would always remain with the company.
3. A younger son learned the business while working for his father since he graduated high school. When the father decided he wanted to retire, he offered the business to his two children. The older one, college educated and in a different field, joined with the younger one to take over the business from the father, as equal partners.
4. A father, who was primarily involved with sales, wanted to retire and had a daughter handling the office, finances, work scheduling, and purchasing for the company. The father offered the key salesman an equal partnership interest with the daughter.
5. A father has two young children working in the business. He instituted a 10-year program to have them learn the business, literally from the ground up. Within seven years the children were completely co-running the business, and the father was almost fully retired. Sales tripled during this period.
6. A father wanted his son to carry on the business he got from his father. The son did not work in the business and never expressed any interest in it. The father took a last stab by structuring a no-cash-down leveraged buyout for the son. When it was turned down, he liquidated it many years later, after it was run into the ground because there was no other designated successor, and inertia forced him to stay in the business.
7. The business has chemically polluted the ground it stands on. The business throws off a very substantial net income and cash flow, but cannot be sold. A successor was hired with a profit sharing arrangement following a three-year training and breaking-in period.
8. A business has a "nontransferable" national distributorship. About three years before he wanted to retire, the owner arranged for a new source of supply from a competing manufacturer to make the product with the client's own brand name on it. Over the next three years he weaned his customers away from the national brand to his own. The business was then able to be sold to the sales personnel at very favorable terms.

Valuing the Business

Before any plan can be presented, the parties have to get a sense of the business' value. The classic definition of value—the business is worth what a willing buyer will pay a willing seller, with both being under no compunction to have to complete the transaction—does not apply since it is a privately structured transaction with the terms, more or less, being dictated.

Planning a succession transfer is usually not an arm's-length transaction. It is done between two parties, one of whom is not in a strong position to negotiate or dictate terms. Taxes also play a strong role, and many times the payment is made from the business's cash flow, not independent investment sources.

Entrepreneurs who want to pass the baton need to come up with a value that would be suitable to them, their family, and the people paying the price. In many instances the value of the stock passing hands is based upon what the buyer can pay, and no other reason. From a practical standpoint, the business has to be paid for, but it will most likely be from someone who does not have the money to pay for it. Accordingly, structuring the transaction has to be done not only with extreme care, but also with a great amount of finesse.

Time is an important element in structuring the transaction. A lot more can be done if 5 to 10 years were available than if only one or two years, or less, are the timeline—say, if a death or disability is causing the transfer. An orderly transfer can accomplish much more for everyone involved. It can also tend to minimize the tax bite, no matter how the transfer is structured.

If a business owner wants to receive the most that he or she could get for the business, he or she would probably have to find and sell it to a ready and willing buyer, and not family members or loyal and capable employees working in the business. Accordingly, no true discussion of value has any meaning, except with respect to justifying the value to “interested” third parties, such as the IRS.

What then needs to be done is a calculation of what cash the business could afford to part with over a reasonable period, say 5 to 10 years:

determining a fair market value that would be acceptable to the IRS and possibly the banker. The tax consequences of the payments also play a part.

For a true valuation, keep in mind that the business is usually never worth what the founder thinks it is worth. However, depending upon the buyer, it could also be worth much more than the owner imagines.

The value of a closely held business is transitory. Following are some of the things that can happen suddenly, and greatly reduce the value of a client's business:

1. A major customer can go out of business.
2. A key employee can quit.
3. A manufacturer who is being represented by your client could cancel its distributorship.
4. The owner can die or become incapacitated.
5. Laws regarding the environment can be enacted that adversely affect the ability to transfer the business.
6. The bank can call in its loan because of factors affecting the bank and through no fault of the business.
7. Oddball and unanticipated tax assessments, such as for sales taxes or payroll taxes on independent contractors, can crop up unexpectedly.
8. A discovered fraud by a key employee subjects the company to possible criminal defense costs.
9. There are changes in the tax laws.
10. There is sudden loss of market share, such as from negative publicity resulting from illegal tampering with the company's product.
11. Internet competition can suck up market share.
12. The Internet service provider (ISP) can be down or go out of business.

Methods of Valuing a Business

There are many ways of valuing a business. One of the jobs of the CPA and other advisers would be to identify the best way of valuing the business so the successor does not overpay for it. However, usually it will be a lower price, but every circumstance is different.

Usually the sale price is based on negotiations. However, the seller usually sets a higher starting price and asks for all cash. Keep in mind that everything is negotiable. You will, though, need ammunition to counteroffer. This will come when you uncover circumstances that are not exactly as the seller reported them. It does not mean the seller is lying; it just means that you see something differently than he or she does.

An example could be a business with increased sales, but where higher prices cause the increases and where there are decrease units being sold. Losing market share is a major factor and could contradict the solid picture

the seller is painting. Another issue of strength is the seller pointing to his or her long-term loyal employee base with almost no appreciable turnover. You might see aging overpaid personnel, with no fresh ideas, who are waiting for the right time to retire.

A good accountant and business appraisal might be able to identify many areas of value, or nonvalue that are not so evident. The value of this might not be as much to help you pay a lower price, as to convince you not to buy the business.

The price determined by using any of these methods is for the business in “good working order.” The buyer will usually determine what he or she wants to pay for the business based upon an expected investment and rate of return. For instance, if the seller’s calculations determine that they should get \$2,000,000, and your investigation uncovers the need for an initial \$300,000 that must be spent for software, to buy out certain contracts, to move, or to purchase additional equipment, then the purchase price should be \$2,000,000 less the required \$300,000 investment. Of course if the price goes down too much, the seller always has the option of not selling.

Some of the methods used to valuing a business are as follows.

Fair Market Value Appraisal

We do not recommend this because the elements for a fair market value (FMV) appraisal are not present, nor do we feel it would present you with a reasonable value for your company. A FMV appraisal takes into account past history of the company—as much as five years back. Businesses are generally sold based upon the current and prospective situation. A backward approach, which FMV is, does not help a seller.

Also, the purpose of FMV is to value a business where there is no actual buyer or seller. It is a hypothetical value. Once there is a serious seller or buyer where one of them has a reason for completing the transaction, we do not believe a “fair market” valuation should be used.

Capitalization of Earnings

This is a method we would work out. It would be a good starting point for valuing the business.

The first issue here becomes what earnings to use. Do we use the earnings reported on the financial statements, or recast earnings after adding back expenses that would not have occurred had the business been owned by someone else?

Also we have to choose a cap rate. A usual cap rate range is between 4 and 7 times EBITDA. Obviously, the wide range gives widely disparate values.

Another part of the valuation is the earnings period that is used. A buyer might want to use the average of the past five years’ earnings, especially where the trend is up. The seller would prefer to use only the previous or current year’s earnings. In some instances projected earnings might even be more appropriate.

Excess Earnings

The excess earnings method quantifies goodwill as equal to the intangible value of the business and adds this to the tangible asset value.

Projected Earnings

This includes a multiple of projected earnings. This is a harder one to "sell" but there are times when it is appropriate.

Cost to Duplicate Business

This looks at the cost to duplicate business, including any going concern value, dies and molds, distribution outlets, customer lists, and supplier relationships.

Intangible Value

This is the value of leases, trademarks, patents, copyrights, and contracts.

Industry Standard

Some industries have price standards that are generally followed, such as a percent or multiple of revenues or cash flow, or so much cents or dollars a unit or per square foot.

Strategic Value

Occasionally a buyer has a greater interest in the business than the seller. Perhaps the buyer is a foreign company wanting to penetrate the U.S. market. In that situation, they would be willing to pay a price based upon what they foresee their costs of entering the market are and not based upon the value of that individual company.

Other reasons to buy the business that can create exceptional value for the buyer is the value assigned to a larger market share by the acquirer, the synergy flowing from the combination or association with other products, enhanced value created when a more sophisticated company becomes the owner, and importance of the product in a much bigger product.

Going Concern Value

The assemblage of the business as it exists (including personnel, contracts, office facilities, dies and molds, distribution outlets, customer lists, and supplier relationships) might cost far more to duplicate than the indicated value from its earnings. This too makes it an attractive acquisition for the right buyer. This is similar to strategic value.

Book Value or Net Asset Value

Sometimes the actual value of the individual assets is greater than the business as a whole, and an orderly piecemeal sale of the assets yields the

greatest price. Include in this estimate the value of leases, trademarks, patents, copyrights, mailing lists, databases, Web sites, and contracts.

Benchmark or Guideline Company Method

This yields a price based upon the multiple of earnings a similar company that is publicly held sells for. However, this price should be adjusted for taxes, the instant marketability of the minority shares, a professional management team, and other attributes that that particular public company has that the private company it is compared to lacks.

Ego Value

Some businesses have high ego value, such as professional ball teams, including minor league baseball teams; Broadway shows; restaurants; or nightclubs. Other types of businesses, such as those with political value or power (including newspapers, radio and television stations), may also command a higher value.

Human Capital

It is possible that the talent in the business presents a greater value than the business. In that eventuality, the price will be based on what use and benefits the buyer believes could be gotten from the work force.

For a true valuation, keep in mind that the business is usually never worth what the founder thinks it is worth. However, depending upon the buyer, it could also be worth much more than he or she imagines.

The reason the business is being bought will also determine the price you are willing to pay. A straight investment purchaser will pay a lot less than someone that is looking to “buy a job.” A strategic buyer might throw out all the books and offer what it is worth for them to get into that business.

What Would Be Acquired?

Two things are generally bought—either the corporate stock or the individual assets.

Corporate Stock

A sale of the corporate stock would be the easiest way of effecting the transaction and would present the lowest tax cost to the seller, but usually the highest cost to the buyer.

Buyers should not buy the stock unless it absolutely cannot be avoided. Anyone acquiring the stock will also become the “owner” of any unknown or contingent liabilities. Also the buyer would not be able to deduct (either directly or through an amortization process) the price paid for the business and could become liable for the tax on locked in corporate profits, such as on the

eventual sale of appreciated assets including goodwill and other intangible assets. Furthermore, by buying the stock, the buyer could end up paying for and becoming the owner of nonoperating or nonessential assets that the buyer either does not need or has no desire of owning. This also will increase the price the buyer will have to pay for the business.

If a stock sale is done, it is usually accompanied by a separate covenant not to compete, on an individual basis, with the business's owners or major stockholders.

If the corporation has contracts that are nontransferable, it could make an asset sale more difficult, or preclude it all together. However, please note that there are ways to deal with this, which would require separate discussions and analyses (not covered here).

Asset Sale

Generally, in a sale of a closely held business, the operating assets are what are sold, not the corporate stock.

What most likely occurs is that the company sells its contracts, inventory, copyrights, mailing lists, goodwill, covenants not to compete, and other intangible and tangible operating assets. The operating assets may or may not include cash, accounts receivable, and accounts payable. Whatever value is agreed upon, the company will receive that amount.

Discounting a Business's Value

If only part of the business is being sold, there might be a discount to an attributed value for a minority interest. The reasoning is that the person with the minority interest has less say, and less, or no, control, of the affairs of the business and whether they can share in the success of the business by declaring dividends, or selling or liquidating the company. Accordingly, there is the belief that a minority interest is not worth its proportionate share of the whole. These discounts could range up to 40 percent, depending on the type of business, number of stockholders, and a myriad of other factors that could limit the control of the minority stockholder.

Another discount that might be appropriate is for the lack of marketability of the stock or partnership interest. Lack of marketability adjustments reflect the reality that stock in a closely held business is not portable and easy to sell. These discounts could be around 25 percent, depending on circumstances. This discount could be in addition to the minority interest discount.

Another discount that could be considered is for the costs attributable to selling the business or stock such as a broker's commission.

If the owner is selling or transferring the business in some manner to a successor, there has to be a way the business is valued so it will not be subjected to too strong of an attack by the IRS.

Definitions

Following are some definitions of terms that will be commonly referred to during any negotiation or purchase or sale of a business.

- *EBIT*. Earnings before interest and taxes.
- *EBITDA*. Earnings before interest, taxes, depreciation, and amortization. A problem with this is that it does not take into account cash payments for fixed asset acquisitions. Many businesses where depreciation is a factor have continuous equipment acquisitions offsetting the depreciation add back giving you EBIT.
- *Capitalization or cap rate*. The interest rate or yield that a potential investor expects to make. For example, if a 20 percent return is expected, that will be the cap rate. This translates into a number multiple that is applied to the EBIT or EBITDA to determine the price they would be willing to pay. The cap rate is divided into 100 to get the multiple. Then, 100 divided by 20 equals 5. Therefore, a buyer expecting a 20 percent cap rate will pay you 5 times the EBITDA. Someone expecting a 25 percent return will only pay 4 times the EBITDA; and someone expecting a 16.67 percent return will pay 6 times EBITDA. The cap rate also reflects the unmarketable nature of the business. Further, the cap rate is measured against alternative investments and strategic situations.
- *Price/Earnings or P/E multiple*. The multiple referred to in the previous paragraph. This does not equate to the P/E multiple of a public company. One such reason is that a public company's earnings are counted after taxes, interest, and depreciation. More reasons exist but are beyond the scope of this chapter.
- *Earnout*. This is a contingent portion of the purchase price. When a business is experiencing rapid growth and the price is based on future increased profitability, an earnout might be in order. This is where additional amounts are paid if certain targets are met. These targets are

usually profit based but can also be based on sales, new client growth, or key employee retention. Earnouts usually cover the first three years after the sale, but can be longer or shorter based upon circumstances.

- *Applicable Federal Rate or AFR interest rate.* The minimum interest rate that must be charged on deferred payments in order for the IRS to not recharacterize the designation of a portion of the payments as interest. New rates are published monthly.

The Selling Process

The plan may be to transfer the business to a successor, but in the process it might become obvious that this will not work and that the only way the owner could realize anything for the business is for it to be sold. Even with a sale to a successor, and when the price is dictated either by the seller or by the cash flow circumstances, attorneys, accountants, bankers, and others might be involved. For those reasons it is important for both the owner and successor to be conversant with the usual selling process.

Many players are involved when a business is sold: appraisers, investment bankers, business brokers, attorneys, CPAs, business consultants, and maybe a trusted adviser.

Appraiser

The appraiser could give your client an independent look at their business. I believe they are best to be used when the client is not contemplating selling but would like an idea of how someone outside the business would value it. They are also necessary when stock is to be transferred to family members via gift. I have found that owners best appreciate the value when given to them by an “official” appraiser in a 60-page book. However, these values are usually clouded by the client’s needs. If it is for estate planning purposes, the value is usually lower than what is reasonable, and if it is for ego purposes, it is usually at the high end of reason. They are best to be used when the business has unique assets, where the industry has formulas or standards for valuing the business, or where the purpose is estate planning and you need a somewhat “objective” determination of the discounts for minority interests and for lack of the stock's marketability. Their fees are usually fixed in advance and are related to the amount and type of work they have to do, not the value of the business.

Investment Banker

The investment bankers or business brokers will help identify and locate the buyer. Their role will include the presentation of the company in the best and most favorable position and to assist and move along the negotiation process. They are usually given a nominal retainer, and receive a fee if the deal is concluded, and nothing more if it is not. Each fee has to be negotiated, but an industry standard is the Lehman Formula, as follows:

Sales Price	Percent of Sales Price
Sales price up to \$1,000,000	5%
Portion from:	
\$1 million to \$2 million	4%
\$2 million to \$3 million	3%
\$3 million to \$4 million	2%
Over \$4 million	1%

Many investment bankers are using a formula known as the Twice Lehman Formula, which is as follows:

Sales Price	Percent of Sales Price
Sales price up to \$2,000,000	5%
Portion from:	
\$2 million to \$4 million	4%
\$4 million to \$6 million	3%
\$6 million to \$8 million	2%
Over \$8 million	1%

Under the above formulas, a \$10,000,000 selling price will give a fee of \$200,000 under the Lehman Formula and \$300,000 under the Twice Lehman Formula. Keep in mind that all fees and the amount and type of work are

negotiable. I've had clients in situations where the only thing the investment banker did was introduce them to the buyer and that was well worth the fee.

Business Consultant

A business consultant does the same things as an investment banker but does not introduce you to the buyer. They are usually paid a fee, which can contain a bonus clause based upon their contribution to the deal getting done and the final price. They could write the “book” and help restructure the company to make it more attractive for a buyer.

Attorney

The lawyer is necessary to prepare and/or review the contracts and negotiate the best legal posture for the client with the most protection. The lawyer also reviews the tax structure of the deal (along with the CPA) and covers any environmental and product liability issues. The lawyer usually receives a fee, the basis of which is negotiated in advance. It is a combination of time charges, value added, and dollar value of the entire transaction.

CPA

The CPA probably has the least understood role but is usually the most important adviser. The traditional role of the CPA is to present the historic financials, do any recasting or restating of the numbers, and work out the cash flow of the payments and the tax aspects of the deal. However, the CPA, along with, or instead of, a trusted personal adviser, is charged with the responsibility of making sure the deal stays on track with the stated goals of the client. In many instances the CPA assumes the role of “negotiating” with the client's own investment bankers and attorneys to keep them on the course that is what the client wants, or needs to be on.

The accountant is most likely the closest financial adviser to the business owner. This is inherent in a relationship that has grown and matured over repeated visits and meetings that have occurred over a number of years under varying business climates and conditions. The astute CPA usually learns how the client thinks, what is important to them, and what values they have, and the CPA should know what the client actually wants out of the deal. It is impossible to know how someone will feel when they sell the business they started, nurtured, and grew, but the accountant should be in a better, more knowledgeable position than anyone else. And this will help the client with the deal—not just closing the deal, but why they are doing it in the first place.

The CPA starts by helping the client articulate their thoughts and projects them into an effective plan or course of action. The CPA then should monitor

the negotiations and contracts to see that they are on target with the projections. The CPA also has to be there to help the client immediately adapt to changing situations and conditions. The CPA also has to consider the estate tax and the income tax aspects of the sale, as well as the method for insuring the succession of the entity. Additionally, the CPA helps construct the earnout provisions, parameters, and safeguards for monitoring the company if necessary.

Whether you are a buyer or seller, it is very important to have realistic financial projections with assumptions that are reasonable and that recognize the true situation. The CPA's role is to review the projections or to prepare or assist in their preparation, as the case may be, and help arrange the financing if needed.

Fees for the CPA are usually on a fixed fee, or time basis, with a bonus to be negotiated afterwards with the client. Some accountants are now "value billing" these assignments. Because of CPAs' codes of ethics, they cannot set a contingent fee for attest clients.

Checklist of the Accountant's Role

The accountant's role in helping the client decide on a succession plan is crucial. As advisers, accountants are probably the closest to the client. Also, accountants usually can explain things logically and if they use numbers and illustrations correctly, they can make their points dispassionately.

Following are some of the important things accountants can do:

- Help the client define and articulate their thoughts.
- Translate the thoughts into courses of action.
- Quantify the client's choices.
- Develop choices into an action plan.
- Project the cash flow from each decision.
- Structure the transaction to achieve maximum tax savings opportunities.
- Illustrate clearly where each path takes the client.
- Plan the retirement income of the client and their spouse and other family members.
- Offer choices to minimize the displacement of long-time, loyal employees.
- Plan the estate of the business owner.
- Become the quarterback of the transaction and coordinate the efforts of the other professionals, including the attorney, insurance person, appraiser, investment banker, outplacement specialist, realtor, and whoever circumstances dictate should be involved.
- Preparing clear presentations for the spouse and others who are affected by the transaction.

The Book

Not a person, but a necessary player. In order to sell a business, a “book” is needed. This is usually a selling memorandum or company presentation book, which is similar to a business plan. It should contain all the information a buyer, and the buyer's lawyers, CPAs, and other team members would want to see. At a minimum it should have a summary of the company's history, its market and customer information, community and environment issues, product and production information, and the past five years' financial statements or tax returns.

Many deals start out where the owner does not want to pay to have a “book” prepared, and where the prospective buyer says it is not necessary. However, regardless of original intentions, some sort of book will be needed because there will be anonymous financial and other people who will need to have the information before they could advise their client on the best course for them. The book then gets put together, in a haphazard and rushed manner, and in a way that does not present the company in the best light. The client usually has taken pains to present their product in the most appealing way. Why not for the entire company, which is a much more important transaction? If the client was selling a car, they would take it to the car wash first. Why not do the cosmetics for the entire business? The advance efforts pay great dividends.

Tax Aspects of Buying or Selling a Business

You can save a lot of money when you buy a business by structuring the transaction in tax favorable ways. Following are some tax aspects to be aware of.

Buy Assets Instead of Stock

Buy the individual assets of the business rather than its corporate stock. Buying the assets lets you allocate the purchase price among them. This maximizes the benefits of the tax deductions you take. (Any amount you pay beyond the price of the assets is considered goodwill, which can be amortized over time.) By contrast, the price you pay for a business's shares, including any amount over the value of the assets, is not deductible.

Sellers of businesses typically prefer selling the corporate stock, particularly if they are structured as a C corporation. This is because the gain is taxed as a capital gain and there is no additional tax on the profits from any separate assets. In a C corporation, the gains on the sale are taxed to the corporation and then to the shareholders when the funds are distributed. In a C and S corporation, the sale of equipment assets generates a combination of ordinary income (including the recapture of previously taken tax breaks)—with a top tax individual rate of 35 percent—and capital gains. For C corporations, the asset sale is taxed at the corporate level and again when the sales proceeds are distributed to shareholders.

Allocate Payments for Services

Carefully label payments for continuing assistance and advice from the sellers. Former business owners who will be paid to continue working for the

company following the sale should have those payments characterized as “covenants not to compete” in the sales contract. When such payments are characterized as compensation—for example, consulting fees—the payments are subject to Social Security and Medicare taxes as well as state unemployment and disability insurance. However, payments for covenants not to compete are exempt from those taxes.

Consider Taxes When Allocating the Purchase Price

Factor in tax costs to the seller of the business when you calculate the purchase price. Buyers want to structure acquisitions so they gain as many tax write-offs as quickly as possible. Figure in the tax breaks when you make your offer.

- Goodwill, covenants not to compete, trade names and trademarks, copyrights, and contract acquisitions are amortized over 15 years for tax purposes.
- Equipment and software can be depreciated and amortized according to IRS guidelines (generally, over three to seven years).

Use Contingent Prices

Earnouts are an additional payment based upon future profitability or reaching preestablished targets. It is a contingent payment that can add to the cost of the business. When you provide for an earnout to the seller, the additional payments are added to the price and qualify as a capital gain for the seller and not as “compensation” income and additional intangible assets that were purchased. Earnouts allow you to pay a lower up-front price and to incur lower interest costs.

Earnouts make sense when the price of a rapidly growing business is based on future increases in profitability. They call for additional payments, typically over three years after the sale of the business, when certain targets are met. Targets are usually based on profits, but they can also be based on sales, new client growth, or key employee retention, for example. Interest does not have to be imputed in the earnout price.

Structure as Installment Sale

Structuring the purchase of the business as an installment sale will reduce the up-front cash payment. The benefit to the seller is that tax is not generally due until each installment payment is received. Interest costs paid will be deductible.

A strategy is to reduce the purchase price for selling the business on an installment sale and raise the component of the payments that is considered interest. Interest will be deductible as paid while the tax benefits associated with the part of the purchase price allocated to hard assets (equipment) and soft assets (goodwill) will accrue slowly over time. The benefit to seller is that a lower allocation to depreciable assets will reduce the immediate tax on depreciation recapture on an installment sale.

Example. Equipment that cost \$400,000 has a book value of \$100,000. When the equipment is sold for \$300,000, the \$200,000 gain is attributable entirely to depreciation recapture. A special tax rule says that the gain attributed to depreciation recapture is fully taxable in the year of sale. This is true even though there is an installment payout.

Use the Applicable Federal Interest Rate

Use the applicable federal rate as your interest rate. The applicable federal rate is the minimum interest rate that must be charged on deferred payments. If you use a lower rate, the IRS can recharacterize a portion of the payments as interest payments. New rates are published monthly in Internal Revenue Bulletins.

This usually results in lower payments than bank-based rates.

Use Payment Terms

Use payment terms as a negotiating strategy. Payment terms are an essential part of a business' value but are usually negotiated separately from the value. Buyers therefore should be aware of this and not fall into a trap of thinking that they have made a deal until all the terms of the purchase have been agreed upon. When deferred prices are negotiated without a stated interest rate, the IRS will impute interest, changing the characterization of the purchase price. On the other hand, excessively high interest will result in a lower purchase price.

Select the Payroll Wage Base

After the acquisition, elect to use the previous owner's Social Security and unemployment wage base amounts (for employees that stay on) instead of starting over. This will reduce the employment taxes because the new owner will not have to start over for the year. This is done using IRS Revenue Procedure 96-60.

Allocate Assets

When a deal is structured, allocate assets based on relative current value. Buyers of businesses typically structure their acquisitions to create as many current tax write-offs as possible. Maximize the deductions by allocating assets based on their relative current values. The asset allocation is also critical to determine the taxes owed by the buyer and seller.

For example, when a buyer acquires the stock in a corporation, none of the purchase price can be deducted for tax purposes. For accounting or financial statement purposes, however, it might have to be deducted over a very short period. Buyers and sellers each must file IRS Form 8594, "Asset Acquisition Statement Under Section 1060," when the transfer of the business includes an allocation of goodwill or going concern value.

Set Up a Personal Holding Corporation

Sellers of advanced ages can consider keeping the corporate entity intact in the form of a personal holding company when they must sell corporate assets rather than stock. Setting up a personal holding company for the proceeds of the sale of the company lets sellers avoid immediate double taxation. The tax is deferred until the time when the personal holding company is liquidated.

Even better, when a seller still owns a personal holding company at death, no capital gains tax is owed on the liquidation of the corporation.

Preplan

Sellers can preplan a couple to a few years before actually selling the business by electing S corporation status before selling the business to eliminate double taxation of the proceeds. Income from S corporations flows through and is taxed on the individual shareholders' tax returns.

Caution. Businesses that convert from C corporations to S corporations must value the business' assets on the date of the conversion. When assets are sold within 10 years, profits are realized to the extent of any built-in gains as of that date. Taxes are figured as if the company was still a C corporation: The company pays its own capital gains tax on the built-in gains and distributes the after-tax balance to corporate shareholders in the form of a dividend.

Keep the Accounts Receivable

Where sellers sell the separate assets, and they were on the cash basis and the sale takes place near the end of a year, they should keep the accounts receivable to reduce taxes in the year of sale.

When a buyer acquires the accounts receivable of a cash-basis business, the entire amount of the accounts receivable is taxed as income to the seller in the year the business is sold, even if the sale is structured as an installment sale. When the seller keeps the accounts receivable rather than transferring them to the buyer, taxes are due only as the money in the accounts is collected.

Sell Stock to an ESOP

Sellers can consider deferring their tax by selling company stock to an employee stock ownership plan (ESOP). When business owners sell at least 30 percent of their company's stock to an ESOP, the proceeds are not currently taxable as long as they are invested in common stock of U.S. corporations. The tax is deferred until the replacement shares are sold. Structure the sale so the third-party buyer acquires its shares from the ESOP.

On the following pages is a copy of Form 8594 and its instructions. These are for illustration only. The form for the current tax year is available from IRS.gov, at <http://www.irs.gov/pub/irs-pdf/f8594.pdf> (form) and <http://www.irs.gov/pub/irs-pdf/i8594.pdf> (instructions).

Form **8594**
 (Rev. February 2006)
 Department of the Treasury
 Internal Revenue Service

**Asset Acquisition Statement
 Under Section 1060**

OMB No. 1545-1021

Attachment
 Sequence No. **61**

▶ **Attach to your income tax return.** ▶ **See separate instructions.**

Name as shown on return	Identifying number as shown on return
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Check the box that identifies you:
 Purchaser Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
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Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale	3 Total sales price (consideration)
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Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	\$	\$
Class II	\$	\$
Class III	\$	\$
Class IV	\$	\$
Class V	\$	\$
Class VI and VII	\$	\$
Total	\$	\$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? Yes No
 If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? Yes No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? Yes No
 If "Yes," attach a schedule that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

Part III Supplemental Statement—Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	\$	\$	\$
Class II	\$	\$	\$
Class III	\$	\$	\$
Class IV	\$	\$	\$
Class V	\$	\$	\$
Class VI and VII	\$	\$	\$
Total	\$		\$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Horizontal lines for providing reasons for increase or decrease.

Instructions for Form 8594

(Rev. February 2006)



Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement Under Section 1060

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Both the seller and purchaser of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Form 8594 must also be filed if the purchaser or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the purchaser's cost of the assets or the amount realized by the seller.

Who Must File

Generally, both the purchaser and seller must file Form 8594 and attach it to their income tax returns (Forms 1040, 1041, 1065, 1120, 1120S, etc.) when there is a transfer of a group of assets that make up a trade or business (defined below) and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both.

If the purchaser or seller is a controlled foreign corporation (CFC), each U.S. shareholder should attach Form 8594 to its Form 5471.

Exceptions. You are not required to file Form 8594 if any of the following apply.

- A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which section 1031 applies. If section 1031 does not apply to all the assets transferred, however, Form 8594 is required for the part of the group of assets to which section 1031 does not apply. For information about such a transaction, see Regulations sections 1.1031(j)-1(b) and 1.1060-1(b)(8).
- A partnership interest is transferred. See Regulations section

1.755-1(d) for special reporting requirements. However, the purchase of a partnership interest that is treated for federal income tax purposes as a purchase of partnership assets, which constitute a trade or business, is subject to section 1060. In this case, the purchaser must file Form 8594. See Rev. Rul. 99-6, which is on page 6 of Internal Revenue Bulletin 1999-6 at <http://www.irs.gov/pub/irs-irbs/irb99-06.pdf>, and Regulations section 1.1060-1(b)(4).

When To File

Generally, attach Form 8594 to your income tax return for the year in which the sale date occurred.

If the amount allocated to any asset is increased or decreased after the year in which the sale occurs, the seller and/or purchaser (whoever is affected) must complete Parts I and III of Form 8594 and attach the form to the income tax return for the year in which the increase or decrease is taken into account.

Penalties

If you do not file a correct Form 8594 by the due date of your return and you cannot show reasonable cause, you may be subject to penalties. See sections 6721 through 6724.

Definitions

Trade or business. A group of assets makes up a trade or business if goodwill or going concern value could under any circumstances attach to such assets. A group of assets can also qualify as a trade or business if it qualifies as an active trade or business under section 355 (relating to distributions of stock in controlled corporations).

Factors to consider in determining whether goodwill or going concern value could attach include:

- The presence of any section 197 or other intangible assets (but the transfer of such an asset in the absence of other assets will not be a trade or business);
- Any excess of the total paid for the assets over the aggregate book value

of the assets (other than goodwill or going concern value) as shown in the purchaser's financial accounting books and records; or

- A license, a lease agreement, a covenant not to compete, a management contract, an employment contract, or other similar agreements between purchaser and seller (or managers, directors, owners, or employees of the seller).

Consideration. The purchaser's consideration is the cost of the assets. The purchaser's consideration is the amount realized.

Fair market value. Fair market value is the gross fair market value unadjusted by mortgages, liens, pledges, or other liabilities. However, for determining the seller's gain or loss, generally, the fair market value of any property is not less than any nonrecourse debt to which the property is subject.

Classes of assets. The following definitions are the classifications for deemed or actual asset acquisitions.

Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.

Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and Regulations section 1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

Class III assets are assets that the taxpayer marks-to-market at least annually for federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include:

- Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;
- Contingent debt instruments subject to Regulations sections 1.1275-4 and 1.483-4, or section 988, unless the instrument is subject to the noncontingent bond method of Regulations section 1.1275-4(b) or is described in Regulations section 1.988-2(b)(2)(i)(B)(2); and
- Debt instruments convertible into the stock of the issuer or other property.

Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

Note. Furniture and fixtures, buildings, land, vehicles, and equipment, which constitute all or part of a trade or business (defined earlier) are generally Class V assets.

Class VI assets are all section 197 intangibles (as defined in section 197) except goodwill and going concern value. Section 197 intangibles include:

- Workforce in place;
- Business books and records, operating systems, or any other information base, process, design, pattern, know-how, formula, or similar item;
- Any customer-based intangible;
- Any supplier-based intangible;
- Any license, permit, or other right granted by a government unit;
- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business; and
- Any franchise (including a sports franchise acquired after October 22, 2004), trademark, or trade name.

However, the term “section 197 intangible” does not include any of the following:

- An interest in a corporation, partnership, trust, or estate;
- Interests under certain financial contracts;
- Interests in land;
- Certain computer software;
- Certain separately acquired interests in films, sound recordings,

video tapes, books, or other similar property;

- Interests under leases of tangible property;
- Certain separately acquired rights to receive tangible property or services;
- Certain separately acquired interests in patents or copyrights;
- Interests under indebtedness;
- Professional sports franchises acquired before October 23, 2004; and
- Certain transactions costs.

See section 197(e) for more information.

Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

Allocation of consideration. An allocation of the purchase price must be made to determine the purchaser’s basis in each acquired asset and the seller’s gain or loss on the transfer of each asset. Use the residual method for the allocation of the sales price among the amortizable section 197 intangibles and other assets transferred. See Regulations section 1.1060-1(c). The amount allocated to an asset, other than a Class VII asset, cannot exceed its fair market value on the purchase date. The amount you can allocate to an asset also is subject to any applicable limits under the Internal Revenue Code or general principles of tax law.

Consideration should be allocated as follows.

1. Reduce the consideration by the amount of Class I assets transferred.
2. Allocate the remaining consideration to Class II assets, then to Class III, IV, V, and VI assets in that order. Within each class, allocate the remaining consideration to the class assets in proportion to their fair market values on the purchase date.
3. Allocate consideration to Class VII assets.

If an asset in one of the classifications described above can be included in more than one class, choose the lower numbered class (e.g., if an asset could be included in Class III or IV, choose Class III).

Reallocation after an increase or decrease in consideration. If an increase or decrease in consideration that must be taken into account to redetermine the seller’s amount realized on the sale, or the

purchaser’s cost basis in the assets, occurs after the purchase date, the seller and/or purchaser must allocate the increase or decrease among the assets. If the increase or decrease occurs in the same tax year as the purchase date, consider the increase or decrease to have occurred on the purchase date. If the increase or decrease occurs after the tax year of the purchase date, consider it in the tax year in which it occurs.

For an increase or decrease related to a patent, copyright, etc., see *Specific Allocation*, later.

Allocation of increase. Allocate an increase in consideration as described under *Allocation of consideration*. If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before the increase occurs, any amount allocated to that asset by the purchaser must be properly taken into account under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid after the asset has been disposed of, depreciated, amortized, or depleted.

Allocation of decrease. Allocate a decrease in consideration as follows.

1. Reduce the amount previously allocated to Class VII assets.
2. Reduce the amount previously allocated to Class VI assets, then to Class V, IV, III, and II assets in that order. Within each class, allocate the decrease among the class assets in proportion to their fair market values on the purchase date.

You cannot decrease the amount allocated to an asset below zero. If an asset has a basis of zero at the time the decrease is taken into account because it has been disposed of, depreciated, amortized, or depleted by the purchaser under section 1060, the decrease in consideration allocable to such asset must be properly taken into account under the principles of tax law applicable when the cost of an asset (previously reflected in basis) is reduced after the asset has been disposed of, depreciated, amortized, or depleted. An asset is considered to have been disposed of to the extent the decrease allocated to it would reduce its basis below zero.

Patents, copyrights, and similar property. You must make a specific allocation (defined below) if an increase or decrease in consideration is the result of a contingency that

directly relates to income produced by a particular intangible asset, such as a patent, a secret process, or a copyright, and the increase or decrease is related only to such asset and not to other assets. If the specific allocation rule does not apply, make an allocation of any increase or decrease as you would for any other assets as described under *Allocation of increase* and *Allocation of decrease*.

Specific allocation. Limited to the fair market value of the asset, any increase or decrease in consideration is allocated first specifically to the patent, copyright, or similar property to which the increase or decrease relates, and then to the other assets in the order described under *Allocation of increase* and *Allocation of decrease*. For purposes of applying the fair market value limit to the patent, copyright, or similar property, the fair market value of such asset is redetermined when the increase or decrease is taken into account by considering only the reasons for the increase or decrease. The fair market values of the other assets are not redetermined.

Specific Instructions

For an original statement, complete Parts I and II. For a Supplemental Statement, complete Parts I and III.

Enter your name and taxpayer identification number (TIN) at the top of the form. Then check the box for purchaser or seller.

Part I—General Information

Line 1. Enter the name, address, and TIN of the other party to the transaction (purchaser or seller). You are required to enter the TIN of the other party. If the other party is an individual or sole proprietor, enter the social security number. If the other party is a corporation, partnership, or other entity, enter the employer identification number.

Line 2. Enter the date on which the sale of the assets occurred.

Line 3. Enter the total consideration transferred for the assets.

Part II—Original Statement of Assets Transferred

Line 4. For a particular class of assets, enter the total fair market value of all the assets in the class and the total allocation of the sales

price. For Classes VI and VII, enter the total fair market value of Class VI and Class VII combined, and the total portion of the sales price allocated to Class VI and Class VII combined.

Line 6. This line must be completed by the purchaser and the seller. To determine the maximum consideration to be paid, assume that any contingencies specified in the agreement are met and that the consideration paid is the highest amount possible. If you cannot determine the maximum consideration, state how the consideration will be computed and the payment period.

Part III—Supplemental Statement

Complete Part III and file a new Form 8594 for each year that an increase or decrease in consideration occurs. See *Reallocation after an increase or decrease in consideration*, on page 2, and *When To File*, on page 1. Give the reason(s) for the increase or decrease in allocation. Also, enter the tax year(s) and form number with which the original and any supplemental statements were filed. For example, enter "2004 Form 1040."

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping	11 hr.
Learning about the law or the form	2 hr., 34 min.
Preparing and sending the form to the IRS	2 hr., 52 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS at the address listed in the instructions for the tax return with which this form is filed.

Allocating the Purchase Price

A major factor in the buyer structuring the acquisition is the buyer wants to get as many tax write-offs as quickly as possible and the seller wants to pay as little tax as possible. When a deal is structured, an allocation of the assets should be made based on relative current values. Also, based upon the allocation, taxes might be higher for one side and lower for the other.

If a buyer acquires the stock in the corporation, none of the purchase price can be deducted for tax purposes. However, for accounting or generally accepted accounting principles (GAAP) purposes, it might have to be deducted over a very short period.

Both sides of the transaction must file Form 8594, "Asset Acquisition Statement Under Section 1060," if there is an allocation of goodwill or going concern value.

Following is a listing of some of the assets the sales price could be allocated to and how the purchaser and seller are treated for tax purposes. Also note that the accounting treatment under GAAP could be completely different; that is not covered here.

Category	How Seller Is Taxed	How Purchaser Treats for Tax Purposes
Accounts receivable	No effect if on accrual basis. Fully taxable if sold by a cash basis taxpayer. Cash basis taxpayers report the amount allocated to accounts receivable in full in the year of sale, regardless of full payment not being received because the installment sale method was used.	No tax effect. Basis will be amount paid.

(continued)

Category	How Seller Is Taxed	How Purchaser Treats for Tax Purposes
Bad debts	If not deducted, bad debts transferred will be deducted at point of sale.	Basis will be amount given credit for. Income will be recognized to extent of any recoveries.
Inventory	Ordinary income or loss if valuation is higher or lower than book value.	Basis will be amount paid.
Supplies	Ordinary income.	Expensed as consumed.
Equipment	Ordinary income, to extent of depreciation previously taken. Any excess is long-term capital gain. Amounts received below book value create ordinary losses. Recaptured income is reportable in full in the year of sale regardless of full payment not being received because the installment sale method was used.	Amount paid is depreciable over MACRS life.
Realty lease	Capital gain.	Amortizable over MACRS life for underlying real estate regardless of remaining period of lease.
Leasehold improvements	Gain over basis is capital gain.	Amortizable over MACRS life for underlying real estate regardless of remaining period of lease.
Land	Capital gain	Costs attributable to land acquisitions are capitalized and not depreciable.
Real estate	Gain over basis to the extent of depreciation greater than straight-line depreciation is ordinary income. Gain to the extent of straight-line depreciation is taxed at a capital gains rate of 25%. Remaining gain is taxed at 20% capital gains rate. There are different rules for residential property.	Depreciable over MACRS life of real estate.

Category	How Seller Is Taxed	How Purchaser Treats for Tax Purposes
Liquor licenses	C corporations have no special capital gains rate and pay tax on the entire gain at their regular rates.	Amortizable over 15 years.
Covenants-not-to-compete or restrictive covenants in connection with the transfer of a business' ownership.	Ordinary income.	Amortizable over 15 years regardless of period of covenant.
Goodwill, going concern value, workforce in place, information base, patent, copyright, formula, design or similar item, customer-based intangible, supplier-based intangible, licenses, permits, or rights granted by a governmental unit, or franchise, trademark, or trade name.	Capital gain.	Amortizable over 15 years regardless of type of intangible or underlying reason for intangible.
Consulting agreement	Ordinary income and subject to FICA and Medicare taxes.	If services are to be rendered then deductible as services are performed. If no services are to be performed then amortizable over 15 years.
Customer list or patient list or database or mailing list.	Capital gain.	Amortizable over 15 years. If a specific allocation can be made to each item on list, those amounts can be deducted as the items drop off list. However, there would be no deduction until the customer is lost.

Estate Taxation

A basic understanding of estate taxes is essential in being able to develop a succession plan, partly because if nothing is done, the business might have to be sold after the owner's death and these issues have to be dealt with, and partly because properly structuring the transaction can reduce the eventual estate taxes. Note that even if the decedent's estate might not be subject to federal estate taxes, it could be subject to state estate or inheritance taxes.

Following are explanations of general estate taxation considerations and principles as they might relate to someone involved in planning for the succession of their business.

Estate Tax Rate Structure

Estates have their own specific tax returns and rate structure. This is separate and apart from income taxes. Note that the recipient of an inheritance does not pay federal estate tax. The estate pays estate taxes on the assets left by the decedent.

The estate tax covers items passing through lifetime gifts as well as death. The federal estate tax had a top tax rate that will be dropping to 45 percent by 2007. Estates also have a basic exemption that is referred to as the "equivalent exemption." There is no estate tax on transfers up to that amount. Note that the gift tax, which is \$1,000,000, will not change.

The equivalent exemption amount will be increased to \$3,500,000 by 2009, is eliminated for 2010, and reverts to \$1,000,000 in 2011. Following is a table of the various rates and amounts through 2011.

Year of Death	Top Estate Tax Rate	Equivalent Exemption	Credit Amount	Generation-Skipping Transfer Exemption	Gift Tax Exemption
2001	55%*	\$ 675,000	\$220,550	\$1,060,000	\$ 675,000
2002	50%	1,000,000	345,800	1,100,000	1,000,000
2003	49%	1,000,000	345,800	1,120,000	1,000,000
2004	48%	1,500,000	555,800	1,500,000	1,000,000
2005	47%	1,500,000	555,800	1,500,000	1,000,000
2006	46%	2,000,000	780,800	2,000,000	1,000,000
2007	45%	2,000,000	780,800	2,000,000	1,000,000
2008	45%	2,000,000	780,800	2,000,000	1,000,000
2009	45%	3,500,000	1,455,800	3,500,000	1,000,000
2010	Tax suspended	n/a	n/a	n/a	1,000,000
2011	55%*	1,000,000	345,800	1,000,000+ as indexed	1,000,000

* The highest rate is 60% in some cases.

Note that Congress enacted a tax bill in 2001 that terminates at the beginning of 2011 (called the sunset provision). Accordingly, the 2001 tax law reverts to what it would be in 2011 as if the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) never were. We do not cover the 2011 change in here.

Correct and Incorrect Way to Calculate Estate Tax

The estate tax is calculated before the unified credit is subtracted from the tax. The equivalent exemption is the amount of the gross estate, using the lowest brackets, that corresponds to the unified credit.

Following is an illustration of the correct and incorrect way to calculate the estate tax using 2006 estate tax rates and exemptions.

2006	Incorrect	Correct
Taxable estate	\$4,000,000	\$4,000,000
Less "equivalent exemption"	-2,000,000	
Taxable estate after deducting equivalent exemption	2,000,000	4,000,000
Federal estate tax	780,800	1,700,800
Less unified credit		-780,800
Estate tax	780,800	920,000

Lifetime transfers or gifts are cumulative, so spreading out gifts over a number of years will not let you take advantage of lower rates each year (except to the extent you can apply multiple annual exclusions that would not have otherwise been used). The current year's taxable gifts are added to the cumulative lifetime taxable gifts to arrive at the current year's gift tax. When someone dies, his or her net estate assets are added to the total lifetime gifts to arrive at the gross estate tax. From this is subtracted the gift tax he or she paid during his or her lifetime to determine the estate tax.

Gift Tax Annual Exclusion

There are some exceptions to transfers that are subject to the gift tax. Annual gifts of up to \$12,000 (for 2006 with this amount being indexed for future inflation) may be made gift-tax-free.

The lifetime equivalent exemption and annual gift exclusion amounts can be doubled if a spouse consents to the transfers. The consent is obtained by checking a box and having the spouse sign the gift tax return Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return."

Additionally transfers (of any amounts) to a spouse or charity are exempt from the estate or gift tax, as are direct payments of school tuition and medical expenses.

Planning for Both Spouses' Estates

In considering an estate plan, a method has to be adopted so that both spouses' estates will be subject to a minimum of tax. The planning cannot just deal with one spouse. Because estates are eligible for an unlimited marital deduction, any amounts left to a spouse will not be taxed until that spouse dies. If the major portion of an estate is left to, or gifted to, the surviving spouse, the issue becomes one of minimizing the tax on the estate, not that of the first to die.

Generally, the "equivalent exemption" is the minimum amount of estate assets that should be left to children or other beneficiaries and not

to the spouse. The reason is this represents an amount that will completely escape estate taxation, either in the estate of the first to die or his or her spouse. However, by using a trust creatively, the decedent can provide for the income on this amount to go to the surviving spouse until the time of ultimate distribution of the principal to the children or other beneficiaries.

Following is an illustration showing the benefits of using the full equivalent exemption for a married couple. It assumes the following:

- Both spouses die in 2006.
- The family's net estate taxable assets are \$4,000,000.
- There are no other deductions.
- There is no state tax.
- No reportable or taxable gifts have ever been made.
- The husband has the family assets and that he will predecease his wife.

Assumes Everything Is Left to Wife	Husband Dies First	Wife Dies Second
Total assets	\$4,000,000	\$0
Everything left to wife	-4,000,000	+4,000,000
Estate taxable assets	0	4,000,000
Federal estate tax before unified credit	0	1,700,800
Unified credit		-780,800
Net estate tax		920,000

Assumes Everything Is Left to Wife Except Equivalent Exemption Amount	Husband Dies First	Wife Dies Second
Total assets	\$4,000,000	\$0
Everything left to wife except equivalent exemption amount	-2,000,000	+2,000,000
Estate taxable assets	2,000,000	2,000,000
Federal estate tax before unified credit	780,800	780,800
Unified credit	-780,800	-780,800
Net estate tax	0	0

Note that the savings is \$920,000!

Credit Shelter Provisions

Many wills contain credit shelter formula provisions, leaving the amount up to the exemption credit to beneficiaries other than their spouse. Further, many of the wills drawn up before the current act may have unintended results. For instance, the will may have been executed when the maximum exemption was \$1 million. Now it will be increased to \$3.5 million. Do they still intend to leave the full credit shelter amount to heirs other than their spouse? Every will should be reviewed with the higher and increasing exemption limits in mind.

This also affects generation-skipping transfers that have similar formula clauses.

Bequests to Spouse

Many people leave most of their assets to their spouses, preferring to have the taxation of their estate delayed until after their spouse dies. However, they also wish to assure the designation of the ultimate beneficiaries of their assets.

A common technique is to set up, through the will, a qualified terminable interest property (QTIP) trust. This gives the surviving spouse the full income of the assets during his or her lifetime, while limiting his or her ability to designate the beneficiaries or to restrict the choices to the decedent's children or other delineated heirs.

Trusts that are established pursuant to a will are referred to as testamentary trusts. Trusts set up during the lifetime of the grantor are called "inter vivos" or "living" trusts.

In case of simultaneous deaths, the spouse with the larger share of the assets should be deemed to predecease the spouse but to have survived all other beneficiaries. This can be a vehicle to equalize both estates, thereby resulting in the lowest possible tax, and still assure that the richer decedent's beneficiary designation will be followed. The will would have to state that any designations of beneficiaries of the remaining assets must be made by specific reference to the receipt of them from the estate of the richer spouse.

The lowest estate tax results when the estates of the spouses are equalized.

Payment of Estate Taxes

Estate taxes are due nine months after the date of death and must be paid in cash, in full.

To the extent the estate is not liquid, assets would have to be sold to raise the funds for the estate tax. To the extent any part of the estate taxes will have to be paid with money in an IRA, pension, or other tax-deferred account, income taxes will have to be paid in addition to, and because of, the estate taxes.

There is one exception to the nine-month payment date: where there is closely held stock or businesses whose value exceeds 35 percent of the adjusted gross estate. In those cases, the executor may elect to defer the payment of the estate tax attributable to the business for up to 14 years. Interest must be paid throughout the deferral period. Interest on the tax on the first \$1,000,000 of the business' value is at a bargain rate.

This deferral benefit might remove some pressure on the liquid assets of the estate, or on trying to raise cash, but it is a lien or "mortgage" on the assets left by the decedent! The better approach is to try to reduce the estate tax by advance planning.

Extensions to file the estate tax return, which is Form 706, can be granted for six additional months.

State Estate Taxes

Many states have an estate tax that is in addition to the federal estate tax. Since 2005, estates could deduct any state estate taxes. A planning tip for state taxes is to not have any direct real estate ownership in a state other than your state of primary residence upon death. This can be accomplished by converting such ownership into an intangible asset such as a limited liability company or S corporation. Living trusts will not accomplish this.

Some Observations

Because of the higher equivalent exemptions, the estate tax (and gift tax and generation-skipping tax) is now actually a flat tax with very little differences in the rates between one bracket and the next.

Even though the estate tax goes away for 2010, an income tax will then apply on the sale of inherited assets, since there will no longer be a step-up in basis (see Chapter 12).

Gift Giving

A method of reducing an eventual estate is the making of gifts. The amount of gifts that can be made annually to those other than a spouse and escape tax is \$12,000 per recipient for a donor and \$24,000 if the donor's spouse consents.

Gifts exceeding these amounts accumulate during lifetime and are not taxed until they exceed \$1,000,000. At that point, the federal estate tax starts at 41 percent. Keep in mind that gifts, once made, are irrevocable.

Not counted as taxable gifts are direct tuition or medical payments on someone else's behalf. These can be unlimited amounts as long as they are paid directly to the school or health care provider.

Gifts exceeding the annual exclusions are subject to the gift tax, which rates come from the same schedule as the estate taxes. However, they are applied differently. Estate taxes are paid out of the gross estate that includes the funds needed to pay the state taxes. The gift taxes are paid from funds separate and apart from the gift and will serve to reduce the total assets that will eventually be subject to estate taxes.

An example is as follows. The major benefit to the donor is that the donor is alive when the gift taxes are paid rather than dead when their heirs pay the estate taxes. It also assumes that the donor is in the 45 percent unified tax bracket, that there is no state tax, and that the full unified credit had been previously utilized.

	Transfer From Estate	Transfer by Gift
Amount to be disposed of by either bequest or gift	\$2,000,000	\$2,000,000
Less estate tax (Assumed 46% of total amount)	-920,000	n/a
Less gift tax (Assumed 46% of actual amount of gift)	n/a	-630,137
Amount passing to beneficiaries	1,000,000	1,369,863

Note that the beneficiaries receive \$369,863 more from the gift than the bequest.

The gift tax is paid on the amount of the gift, while the estate tax is paid on the amount of the total assets, which include the funds that will be used to pay the estate tax.

Note that the calculation of the gift is determined by dividing the gross amount by one plus the tax rate.

The following illustration assumes that the donor is in the 46 percent unified tax bracket, that there is no state tax and no state tax credit, and that the full unified credit had been previously utilized.

	Transfer From Estate	Transfer by Gift
Total asset value (prediscount)	\$2,000,000	\$2,000,000
Combined discounts (20% for lack of control and 20% for lack of marketability for a total of 40%) (Note: Pre-discounted gift is \$1,515,152)		556,242
Less estate tax (46% of total amount)	-920,000	n/a
Less gift tax (46% of actual amount of gift) (Gift is \$1,515,152 - \$545,455, or \$969,697)	n/a	-454,883
Amount passing to beneficiaries (Gross undiscounted assets)	1,000,000	1,545,117

Note that the beneficiaries receive \$545,117 more from the gift than the bequest.

The gift tax is paid on the discounted amount of the gift, while the estate tax is paid on the undiscounted amount of the total assets, including the amounts that will be used to pay the estate taxes. The gift is made tax-exclusive, while the estate transfer is made tax-inclusive.

The amount of any gift tax that is paid will be removed from the decedent's taxable estate. However, to stop people from making "death bed" gifts with paying the gift tax rather than have the asset included in the estate and be subject to the much higher estate tax, there is a special rule that requires any gift tax that was paid within three years of the death to be added back to the taxable estate and be subject to the higher tax.

Stepped-up Basis

Until 2010, inherited assets will have their basis "stepped up" to the value at the time of death, or a date six months later, at the executor's discretion. This means that no capital gains are taxed.

The recipient will use as their cost basis of the inherited assets the date of death (or six months later) value. Accordingly, any increments in value through that time are not subject to capital gains taxes. However, the full value of the assets is still subject to estate tax.

The step up in basis does not apply for assets received as a gift. Donees retain the donor's basis of appreciated assets. This means that the donee will pay the capital gains tax when the asset is disposed of. However, the gift tax is based on the fair market value at the time of the gift, which presumably and hopefully would be lower than the value would be if the asset was retained and left as an inheritance, resulting in an even much greater savings. Additionally, the gift tax will also be removed from the estate as well, which would not occur with the estate tax if that were to be paid.

If appreciated property is transferred, the tax basis of the donee will be increased by the gift tax attributable to the appreciation component of the property. Consequently, some benefit will be available to the donee because of the payment of gift tax.

Property that has depreciated in value should not ordinarily be transferred by gift. If the donee subsequently sells the property, for purposes of determining loss, his or her basis will only be the fair market value of the property at the time of the gift, not the donor's higher tax basis.

EGTRRA set up new basis rules when the estate tax is repealed (in 2010). The aggregate basis of assets is permitted an increase of \$1.3 million. Also permitted will be an additional \$3 million basis step up for assets left to spouses. Accordingly, a spouse, at that time, will get a \$4.3 million step up.

Gift Planning Observation

A factor to consider where gifts are key elements of the plan is that once a gift is made, all of the future income and appreciation from that property will

never be included in the estate of the donor. In many instances this could be a much more important factor than the asset itself. An example is a piece of undeveloped land adjacent to a proposed major real estate complex. The current value could be a fraction of what it could be a short period later. Another example is stock in a company planning to go public.

Estate Tax Apportionment

The will should state whether the estate tax should be apportioned among each bequest or paid from the residuary estate. This is particularly important if there are assets passing outside of the estate, such as life insurance proceeds and IRA or pension distributions. An apportionment clause determines which of the beneficiaries will bear the payment of the estate taxes.

One way of apportioning taxes is to have the taxes paid only from the assets passing through the will. Amounts passing outside the will, such as through a living trust, IRA, or pension plan, will not bear any of the estate taxes. Accordingly, this could substantially reduce bequests made in the will.

The other way is to apportion the taxes to all heirs, including those receiving assets outside the will, such as through estate taxable life insurance, living trusts, and IRA or pension plans.

If estate taxes are apportioned to IRA and pension plan beneficiaries, and the funds are withdrawn to pay such taxes, this would accelerate the payment of income taxes on those amounts, further reducing the amounts left to those beneficiaries. Likewise, beneficiaries of nonmonetary assets such as a car or a painting would have to reach into their own funds to pay their share of the estate taxes.

A testator might want to leave fixed sums to specific people. To do this, he or she should consider whether these amounts should or should not bear any of the estate tax burden. Keep in mind that if taxes are not apportioned, the heirs of the residue will have their bequests reduced by the taxes.

Following is an example showing the effects with and without apportionment. The amount of estate tax paid by the beneficiary, where there is apportionment of the estate taxes, is in the same ratio as its value to the gross taxable estate. Note that this is different than the calculation for the estate tax income tax deduction for a beneficiary's income received in respect of a decedent (IRD) distribution; that is arrived at by calculating the federal estate tax with and without the IRD.

Also note the results for a married person with a marital deduction will be different. The illustration assumes 2006 rates and unified credit. This is not an exact calculation of estate taxes, since the sole purpose of the illustration is to show the effect of apportionment versus the residuary estate paying the estate tax.

	Residuary Estate Pays Entire Estate Tax		Beneficiary Pays Estate Tax Allocated to Assets Passing Outside of Estate (Such as From an IRA, Pension, or Living Trust)	
	Residuary Estate Beneficiary	Asset Passing Outside of Estate Beneficiary	Residuary Estate Beneficiary	Asset Passing Outside of Estate Beneficiary
Assets passing outside of estate		\$2,000,000		\$2,000,000
Other assets net of liabilities	\$2,000,000		\$2,000,000	
Estate tax	920,000		460,000	460,000
Net to beneficiary	1,080,000	2,000,000	1,540,000	1,540,000

Apportionment Observation

Unless the testator is completely clear on the eventual distribution of his or her assets, and there is no possibility of plans being thwarted, apportionment should be provided for.

Generation-Skipping Transfers

There is a special tax on generation-skipping transfers (GST). These are gifts or bequests that are made to beneficiaries in a second, or more, generation away from the donor or decedent. This covers transfers from a grandparent to a grandchild. The tax is a flat tax at the highest estate tax rate for that year on all such transfers and is payable upon the death of the transferor, in addition to the estate tax. There is a \$2.0 million (starting in 2006 through 2008) GST exemption, and the \$12,000 annual exclusion and medical and educational amounts are also exempt from the GST tax.

Following is an example of \$1,000,000 bequest and gift to a grandchild, assuming the estate and GST tax rate is 46 percent. We assumed there are no available GST exemptions. In the illustration, the estate tax is part of the bequest (tax inclusive), while the gift tax and GST tax are tax exclusive, meaning that the transfer is net of the tax. In the case of bequests, the GST tax is calculated on the amount passing to the grandchild after reducing it by the estate tax and the GST tax. For a gift, the gift tax is not part of the equation and the GST tax is reduced from the gift amount being transferred to the grandchild.

	Bequest	Gift
Amount to be disposed of by either bequest or gift	\$1,000,000	\$1,000,000
Less estate tax	-460,000	n/a
Less gift tax		-315,068
Less GST tax	-170,137	-215,800
Net to grandchild	369,863	469,131

Per this example, for every dollar left to a grandchild, only 33.33 cents will go to the grandchild. For gifts, 44.44 cents of every dollar ends up with the grandchild.

Allocation of GST Exemption

EGTRRA made a major change in how the GST exemption is allocated. Previously it had to be specifically elected and applied. This could have had disastrous effects in situations where it was inadvertently omitted, such as where there was a life insurance trust for multiple grandchildren and the premium was less than the total annual exclusions. In that situation, a gift tax return did not have to be filed to claim the gifts, but the transfer did not qualify for exemption from the GST tax, necessitating or requiring a gift tax return to claim the GST exemption. If such exemption were not claimed, the entire life insurance proceeds would be considered a GST and taxed accordingly.

EGTRRA creates a presumption that the GST exemption is automatically made and if it is not wanted, there must be an election out of it. This presents a different set of issues, but most likely of *less* serious, but still *very* serious, consequences.

Under EGTRRA, every gift must be reviewed with the GST exemption in mind. For instance, many gifts to trusts where there are children as primary beneficiaries and grandchildren as secondary beneficiaries have the possibility but unlikelihood that the grandchildren will inherit some of the assets. In most situations the GST exemption might not be claimed. However, under the present law it will be automatically applied. To stop this, there must be an election not to apply it.

In situations where there are life insurance policies and the GST exemption has been made or applied automatically, and if the policy is subsequently terminated, all the claimed exemptions will have been wasted.

What must be done is for every nondirect gift to be carefully reviewed and examined to determine if the possibility exists for a generation-skipping person to receive a distribution upon the donor's death. If so, an overt definite decision must be made on a timely filed gift tax return whether to keep the automatic GST exemption or to elect out of it.

Structuring the Transfer

Transferring stock to the next generation involves many variables, none the least is a method to do it.

Succession planning is not the same as retirement planning or planning for the sale of the business. These usually involve consideration of realistic market conditions and valuations, and the need for and actual receipt of cash, either initially or over a fixed term. A true succession plan involves the sale or transfer of the business to the next generation of owners, be it relatives or long-term employees. The seller's needs have to be balanced against the business's ability to make the payments. The payments are not just the direct payments to the leaving owner. They could be to a bank or other lender who provided the funds to the business so the retiring owner could get a lump sum payment, or to a venture capital group that is a co-owner with the designated successors.

There are many ways a business can be transferred in connection with a succession plan. Each of them carries a cost, tax, or risk consequences and practical considerations. Some obvious choices are not so simply done when you see the taxes that result. Some of the ways are explained as follows.

Sale of Stock

The stock is paid for out of the savings of the employee. If there are no savings, the employee has to borrow the money. However, loan repayments have to be made with after-tax funds from earnings taken out of the business, substantially raising the cost of acquiring the stock.

Gift of Stock

Some stock can be given as a gift. However, gift tax is payable or chargeable against the unified tax credit, thereby reducing the lifetime

equivalent exemption amount to the extent the gift exceeds \$11,000 per year per donee, or \$22,000 if there is a consenting spouse.

Annual tax-free gifts of \$22,000 per year per person can be accomplished this way. This can be a slow way to transfer a substantial business. Also, the tax basis to the donee is the same as the donor's, which could be quite lower than the current value.

If gifts are made of noncontrolling interests, the pro rata value can be reduced by valuation adjustments or discounts.

Gifts could be of voting or nonvoting stock. This method results not only in no cash to the donor, but can result in a cash cost if gift taxes are paid, or a reduction of lifetime exemptions.

Stock Given as Additional Compensation

All such stock is taxable to the recipient, and deductible for a corresponding amount by the paying corporation. The amount of tax paid by the employee can make receiving the stock quite costly.

If the corporation has made an S election, it might not be currently deductible to the extent the stock compensation creates a loss that there is no basis for, or to the extent the annual cash flow is withdrawn and there is no positive AAA balance to apply the distribution to.

C corporations can take a noncash deduction for the stock issuance. If no current tax is payable, the loss can be carried back or forward, or both. This method results in no cash receipt by the majority owner.

Stock and Cash Given as Additional Compensation

The cash will be used to cover the taxes on the compensation. This neutralizes the cost to the employee. The cash covers the tax and the stock ends up being owned at no cost, but with a full basis. The corporation gets a deduction for the full value of the stock and cash, which should save the corporation, or its stockholders if an S corporation and basis exists, taxes sufficient to cover the cash outlay.

An example of how this works is shown here. It assumes both the employee and corporation, or its stockholders, are in a 40 percent effective tax bracket.

Value of stock given	\$100,000
Amount of cash paid	<u>66,667</u>
Total compensation	\$166,667
Tax cost to employee (40%)	\$ 66,667
Tax savings to corporation (40%)	\$ 66,667

This method results in no cash receipt *and* no tax savings by the majority owner.

Stock Options: Nonqualified Options

If the option price is not less than 15 percent below the value of the business when the option is issued, it will not be taxed when issued. Nonqualified options are taxed when exercised to the extent the value when exercised exceeds the option price.

A method to reduce the value of the company when the option is eventually exercised would be for the grantor to split his or her shares into two parts (for example, gifting part of the business to the spouse), with neither part having more than 50 percent. This would reduce the value subject to tax since two noncontrolling interests would be acquired.

Make sure the transferor does not inherit it back. This gives the employee/successor all the upside growth with no current cost, no current tax, and the seller current value but at discounted future dollars.

Incentive Stock Options

Incentive stock options (ISO) are options granted that meet the statutory requirements and do not allow the acquisition of stock for a price below the value when granted.

ISOs are not taxed when issued or exercised but when the stock is disposed of. However, the difference in value over the option price at the time of exercise is a preference item subject to the alternative minimum tax (AMT). This gives the employee/successor all the upside growth with no current cost, no current tax, and the seller current value but at discounted future dollars.

A strategy here would be to immediately (that is, within 30 days) exercise the ISOs and make a Section 83(b) election within 30 days of having the ISO granted. There should be no taxable income, there will be no AMT income, and a holding period will start for long-term capital gain treatment. The downside to this is the payment for the exercised shares. This puts the successor in the same position as if he or she were granted restricted stock and immediately made the Section 83 (b) election.

Restricted Stock Issuance

Restricted stock is given to the successor. The stock is not vested, or irrevocably owned by the successor, until certain restrictions are removed or lapse. An example of the type of restriction that is attached to the stock is the

employee must work for the company for a minimum period after receiving the stock, such as three years. At the end of the three-year period, the restriction is removed and the stock becomes fully owned by the successor.

Nothing is taxed until the stock restrictions are removed. This can cause a very high tax at that time if the stock's value has appreciated substantially. This is particularly applicable if the company develops new technology or products that take off.

At the moment the restrictions lapse, there will be a tax event. There is no control over that. A way to protect against the tax occurring when the restrictions lapse at a higher amount is to make an election under Section 83(b) within 30 days of the stock issuance and pay tax at the values when the stock was issued.

This is not that different from the stock option method, except that there is a current tax cost to the employee if the 83(b) election is made and a possible cost to the employee if the stock has to be paid for upon issuance.

The employer is entitled to a deduction during the same period the employee reports the income, and equal to any amounts the employee has to pick up as income. This includes income recognized with respect to the Section 83(b) election.

Stock Options or Restricted Stock Issued in Tandem With Cash

This is similar to stock and cash given as additional compensation, discussed in a previous section, and applies whenever stock is issued in a taxable transaction. Here the tax payments are delayed until the options are exercised, or restrictions lapse.

Golden Parachutes

Cash and/or stock compensation arrangements are set up and are activated when defined outside events occur, such as the sale of the company. This is nothing more than a bonus mechanism that gives the employee a share of the upside benefits. Any payments under this plan are taxed as compensation income.

Phantom Stock

This has the same affect as if stock or options were issued, except actual stock does not change hands.

Units corresponding to shares of stock are assigned to certain employees. They get any benefits that would be attributable to those shares as if they were actual shares. The major difference from a tax standpoint is that the

gains are fully taxed as compensation and no capital gain treatment is available. Also, taxes are never paid unless cash changes hands. Other names for this are stock appreciation rights or stock performance rights.

This is a bonus mechanism that tries to duplicate stock ownership by the employee without any initial cash or tax outlay, or financial risk to the employee.

Shareholders', Members', or Partners' Agreements

These agreements are ways of tying up stock and involve no cash. One method would be to give the anointed successor a small minority interest and through a buy-sell or cross-purchase agreement provide for a stock redemption when the major stockholder decides to leave, or dies.

An alternative is to purchase a large quantity of life insurance on the majority shareholder. When he or she dies, the insurance is used to acquire the stock from the estate.

A buy-sell agreement is where the business owns the insurance and acquires the stock from the decedent's estate. Note that C corporations would possibly have the insurance proceeds subject to the AMT. In the buy-sell format, the remaining stockholders do not get a stepped up basis.

A cross-purchase agreement is where the individual shareholders, partners, or members own the insurance on each other either individually or through a partnership or trust. The premiums are paid with personal after-tax funds. The life insurance proceeds are completely tax free and the buyers get a stepped-up basis. It can get cumbersome as the number of shareholders rise, but the step up could be well worth it.

The life insurance costs are paid out of earnings and profits and are not deductible, or paid with after-tax cash.

Clauses in Compensation Agreements

Clauses in a compensation agreement can provide for additional compensation based on a percentage of profits as they are earned. This does not give stock ownership but it pays out the cash profits as they are earned with respect to the percentage designated. The payments are paid as compensation.

An alternative would be criteria that do not only include profits. For instance, it could be based, in part, on sales increases, new accounts opened, increases or decreases in payroll, number of units produced, or decreases in inventory.

Setting Up a New Business

One possible way to transfer a business where the payments to the present owner are not a major consideration would be to set up a new entity owned by the designated successor to carry on the present business.

In this method the assets and customers cannot just be transferred outright. Perhaps the new entity would only accept new customers. The present business, whose resources would be used, would be paid for the labor, equipment, and other assets used.

To the extent working capital is needed, it could be loaned to the new entity by the old business. At some point, the personnel would be transferred to the new company, as would the equipment and other assets, including any intangibles.

The new entity cannot blatantly take over the existing business. A clear business purpose must be established and there must be strong business (and not only succession planning) reasons why it was done. The IRS also has rules vitiating a liquidation or reincorporation; the plan must not run afoul of those rules.

Clauses in a Will

The will says who gets what. Of course the will can be changed anytime during a person's life, so the successors should take care to remain on the good side of their benefactor. Also, wills give no contractual rights to the successor.

This can also be done through a living trust where the majority owner puts his or her stock in the trust. The owner is the initial trustee. An alternate is designated who will carry out the instructions in the trust, which would spell out who gets what and what the payment price and terms will be. The trust provisions will effect the transaction immediately after the death and not be delayed by the probate process to which the will is subjected. Note that the living trust, like the will, can be changed during the lifetime of the grantor.

The purpose of either of these two methods is to provide comfort to the designated successor that plans have been made to establish a "manageable" price and terms and at the same time enable all the ramifications to be dealt with during the life of the business owner.

Note that the living trust will have no income or estate tax benefits during the lifetime of the grantor. There are no tax filing requirements, the grantor's Social Security number is used, and all transactions are reported on the grantor's individual tax return. Upon death, the trust becomes irrevocable, an employee identification number must be obtained, and tax returns have to be filed.

Living Trust Combined With an Option

We occasionally use a stock option in connection with a living trust. The option gives the successor the right to acquire the stock at a higher price than the will or living trust provides, and it would only be activated in the event the grantor changes their will or living trust.

The option price is a form of protection for the successor, and is usually substantially below the market value. A further clause should be put in the will or living trust calling for an apportionment of estate taxes with respect to any excess value that is subject to estate tax. The apportionment clause will cause the successor exercising the option to have to pay the extra estate taxes attributed to the unpaid value of the business being purchased.

Stock Redemption

This is a method where the designated successors acquire a small number of shares (at a minority shareholder discounted price), followed by a complete redemption by the majority shareholder. The redemption price paid must be fair market value and will be taxed as a capital gain (since 2003, meeting the requirements of Code Section 302 to have the gain taxed as a capital gain to the seller or redeemer is not necessary because dividends are taxed the same as capital gains).

If there is not enough cash, or if a tax deferral is wanted, the sale can be set up as an installment sale, thereby stretching out the time to pay the tax on the gain. Keep in mind the age and estate tax picture of the seller. If he or she is older, the successors might want to look at the loss of the step up in basis before they do this transaction.

This method would be best used where there is a cash rich company. If there is insufficient cash, and if the funds have to be borrowed, then the repayment would be with after-tax dollars, possibly causing a tax and cash flow burden on the successors.

Installment Sale

Installment sales of business stock or other business interests will result in capital gain tax to be paid by the seller.

With lower capital gains rates, having the predeath transaction taxed might not be so terrible, or costly, if the business throws off substantial income or rapidly increases in value. Also, the capital gains tax payments will reduce the gross estate, saving estate taxes, with the successor getting a step up to the price paid. Also, interest rates can be set at the lowest allowable AFR, presenting an opportunity to reduce the estate tax value of the installment note if it is still held upon death. A suggestion could be a

long-term note using the three-year AFR and having it reset every three years at the then-current rate.

If the sale takes place after death, there will be a step up in basis, and the seller's estate will avoid capital gain tax.

Following is a brief illustration of the effect of the imposition of the capital gains tax. A 20 percent capital gain tax rate has been used, which includes state taxes. This, as well as everything else suggested herein, should be thoroughly researched before a transaction is entered into.

	Sale of Stock	Retained at Death	50% Increase in Value of Stock Retained at Death
Selling price or value at death	1,000,000	1,000,000	1,500,000
Basis	10,000		
Long term capital gain	990,000		
Tax (20% including state tax)	198,000		
Balance remaining	792,000	1,000,000	1,500,000
Estate tax (assumes 50%) or gift tax	396,000	500,000	750,000
Balance to heirs	396,000	500,000	750,000
"Loss" to heirs	104,000		
Assume a 50% increase in value of stock after sale	500,000		
Less 20% eventual capital gains tax to heirs	125,000		
Total to heirs after 50% increase in value and after all taxes	771,000		750,000
Total value "working" for owner of stock (during period while eventual capital gains taxes are not paid)	996,000		750,000

There are special rules for installment sales between related parties. If the related party sells the stock within two years while there are still unpaid notes, there will be an acceleration of the tax on the installment gain to the extent the related party receives proceeds on the sale.

Unpaid installment notes are taxable as IRD by the decedent's estate to the extent the obligation exceeded the decedent's basis, and notes are also included in the gross estate at the present value of the remaining payments. This means that the capital gains will be taxed on the sale at death, even though the funds were not realized. There is no step up for this

capital gain asset. Note that there will be an income tax deduction for the estate tax attributable to the IRD taxed to the estate.

Self-Canceling Installment Note

The unpaid portion of a self-canceling installment note (SCIN) is not includible in the gross estate, but the gain attributable to the canceled installment notes is accelerated and is includible as income by the decedent's estate. This means that the untaxed capital gain will be taxed at death.

For a SCIN to work, a higher interest payment amount is usual to offset the value of the self-cancellation feature, and the term must not exceed the life expectancy of the seller.

Installment Sale to a “Defective” Grantor Trust

In this method, an intentionally defective irrevocable trust, also known as a grantor trust, is established. Shares of the company are sold to the trust. As long as the shares are noncontrolling interests, the valuation of the shares is adjusted to reflect their lessened value.

The stock is sold for installment notes payable at a minimum of the AFR interest rate. Payments must be made at least annually. It is also advisable to have some additional assets (an additional 10 percent to 20 percent of the installment note principal) in the trust so the IRS cannot contend the note's payment is tied solely to the success of the business.

For estate tax purposes, the trust is considered irrevocable and is excluded from the grantor's estate.

For income tax purposes, the person who sets up the trust—the grantor—is considered the owner of the company stock held in trust. Therefore, the transaction is not recognized for income tax purposes. There is no capital gains tax and no income tax on the interest paid on the installment note. The trust pays no tax. The trust's income is taxed with the grantor's other income on his or her individual tax return. In effect, the sale is considered to be a sale by a person to himself or herself.

Using a trust takes the stock out of the grantor's taxable estate and simultaneously provides cash flow, asset ownership, or appreciation benefits to the beneficiaries of the trust. The grantor pays tax on the trust income, creating a “tax-free gift” from the grantor to the trust beneficiaries. This method also freezes the value of the business in the event the grantor dies before the notes are paid off. The amount includible in the grantor's estate will be the unpaid balance of the notes. A downside is that the basis to the beneficiaries will be the grantor's basis, not a stepped-up basis.

Charity Remainder Trust

Instead of a redemption (see the section titled “Living Trust Combined With an Option”) the majority stockholder might want to consider gifting the stock to a charity remainder trust (CRT) that will redeem the stock. Here the capital gain will be avoided, and the annual cash flow to the original owner from the trust will be much higher since there is no diminution in the assets able to be invested because of the capital gains taxes.

Also, there will be a charitable deduction equivalent to the present value of the remainder interest reverting to the charity. This charitable deduction is age related: the younger you are, the lower the deduction. The deduction might be limited based on the donor's adjusted gross income but can be carried forward for five additional years. The annual deduction cannot exceed 30 percent of adjusted gross income.

There are a number of variations of CRTs. These include charity remainder annuity trusts (CRAT) and charity remainder unitrusts (CRUT). CRATs provide a fixed annual distribution determined at the inception of the CRAT. CRUTs provide a changing distribution based upon the value of the investments within the trust. Taxes are payable on the distributions from the CRT based upon the nature of the trust's income.

The grantor can be the trustee.

Note that capital gain will *not* be avoided if the trust has a legal obligation to redeem the stock.

When the beneficiaries eventually die, the remaining trust principal is transferred to one or more named charities. Note that this charity can be a private family foundation, thereby prolonging family control over the distribution of assets to charities.

GRATs and GRUTs

Stock can be transferred via a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT). These are used where the transferor and/or spouse want to retain an income interest in the assets transferred.

With a GRAT, the grantor receives at least annually a specific dollar amount that is determined when the trust is established. Under a GRUT, the annual income is refigured annually based on the current value of the trust's assets.

Gift tax is payable on the present value of the asset interest remaining in the trust at the end of its term. The longer the term and the higher the income reserved for the donee, the lower the gift value.

A period less than the donor's life expectancy should be used, since if the grantor dies before the trust term ends, the trust corpus will be included in his or her estate (unless the beneficiary of the trust assets is

the grantor's spouse). However, the value used might be less than the actual value of the stock at that time, since a life interest was stripped away from the stock that was given to the trust. Because of the inclusion in the estate, it might be advisable to form multiple GRATs with varying terms, so if the donor dies, not all of the GRAT stock would be includible in his or her estate. For example, stock could be put into three GRATs with lengths four years apart, instead of one GRAT with a 12-year life.

With a closely held business, a GRAT might be better than a GRUT since there is no requirement to revalue the asset each year. Also, the initial calculations for a GRAT can produce lower remainder values.

There are no limitations on the duration of the GRATs or GRUTs, or on the amount of income that can be reserved. Also, the grantor may be the trustee. Accordingly, a grantor/parent can transfer stock with a child as beneficiary, remove it from the grantor's estate, and still control the business.

In valuing the stock transferred to the GRAT or GRUT, a "lack of marketability" discount can be applied to the value determined for the stock. The basis of the stock to the beneficiary is the same as the donor's basis. There is no step up.

S Corporation stock can be owned by a GRAT or GRUT since they are considered "grantor trusts" under the grantor trust rules.

The grantor can be the trustee. However, it might be more advisable to have someone other than the grantor to be appointed the trustee, with the grantor reserving the right to remove the trustee and appoint a successor at any time.

Employee Stock Ownership Plans

Employee stock ownership plans (ESOPs) are one way a business can be passed to the next generation of business owners without the transferor being subjected to capital gains tax on the sale.

An ESOP is an employee benefit plan designed to invest primarily in employer stock or other securities. ESOPs belong to the same family of qualified employee benefit plans as profit sharing plans and are subject to those rules and antidiscrimination requirements.

The ESOP can purchase part of the company's shares, with the participants sharing in the ownership of the stock held by the plan. If the acquisition is structured properly, the desired successors could control the company with shares they own outside the plan, along with the shares attributed to them from the ESOP.

The big advantage of selling to an ESOP is that the capital gain on the proceeds can be deferred to the extent the proceeds are invested in stock or other public marketable securities, provided at least 30 percent of the seller's stock is sold to the ESOP.

One way the ESOP transaction can be structured is for a newly created ESOP to purchase 49 percent of the owner's stock, with the balance being sold or gifted to his or her children. This way the family still will have absolute control.

The ESOP could borrow the money to pay for the stock. This is called a leveraged ESOP transaction. The company's annual tax deductible payments to the ESOP will correspond to what the ESOP needs in cash flow to make the annual interest and loan payments. Also, any dividends paid by the company on stock owned by the ESOP are fully tax deductible. Note that by doing it this way, the company is able to deduct the loan principal payments since the bank is being repaid from the ESOP, not the company.

Sale-Leaseback

In this method, a stock redemption is paid for with equipment or real estate of the business. If the property has a fair market value greater than the book value, taxable income to the corporation will result. The redeeming shareholder will get the asset at the fair market value, and will also be taxed as a dividend or capital gain.

The property could be leased back to the company and the income would be partially offset by the depreciation deductions. Even though the transaction is taxed twice (the gain by the corporation, and the redemption by the stockholder), no cash has to be paid for the stock. If the redemption takes place in a year, the company has an operating loss and the tax on the gain will be reduced. Also, this is a method of providing a future cash flow to the seller with tax deductible corporate dollars.

Preferred Stock Recapitalization

The owner could transfer some common stock to his or her child and have the balance exchanged for newly issued preferred stock with a face value equivalent to the fair market value of the balance of his or her stock.

As long as the preferred stock is entitled to a cumulative market rate dividend, and is valued at fair market value, and the value assigned to the common stock is at least 10 percent of the total value of the corporation, no gift or income tax would result with regard to the recapitalization. Note that provisions of IRC sections 2701 and 2702 must be adhered to.

This is sometimes referred to as a stock freeze, since the value of the company remains unable to grow (except with regard to market rate fluctuations).

S Election

A C corporation can make an S election and thereafter the current year's profits can be distributed to the shareholders. This would enable the current owners to "freeze" the value of the company with respect to growth attributed to earnings.

If a small number of shares were transferred to eventual successors, and an agreement were made to sell them additional shares, the shares could be paid for with the after-tax cash flow distributions from the S corporation with respect to the current year's income.

The S election has pitfalls if the company is sold within 10 years, but this treatment would be no different than if the S election were never made. The IRS requires a "fair market value" appraisal when the S election is made, so the built-in gain at the time the S election is made could be measured and fixed. If the company is sold within 10 years of making the election, any gains up to the built-in gain amount would be taxed as if the company were still a C corporation. An advantage to this is that the FMV appraisal may not represent the actual value of the company if it were to be sold based on strategic value, current or projected earnings, or for some special processes or formulas. Also, the growth could be exponential rather making the built in gain less significant.

S shares can be placed in a defective grantor trust or an electing small business trust, creating other scenarios.

A-B Stock Recapitalization

A corporation can recapitalize by issuing A shares representing voting interests and B shares representing nonvoting interests. Each existing shareholder ends up with the same ownership percentage of both A shares and B shares. This can also apply to S corporations, which can have two classes of stock only when the sole difference between the two classes is that one carries voting rights.

An example is where the corporation recapitalizes up to 10 percent of the corporation with A shares—which allow voting rights—and 90 percent or more of the company with B shares—which have no voting rights. The B noncontrol shares are then transferred to the successors at discounted values.

Private Annuity

A private annuity is a property transfer in exchange for an obligation to receive periodic payments of a fixed amount for the rest of the transferor's life. The total gain realized is the excess of the annuity's present value over the transferor's basis. If the property is a capital asset, the gain is capital

gain. Any excess fair market value (over the present value of the annuity) is taxed as a gift.

If the annuity is secured, the entire capital gain is immediately taxed. If it is unsecured, the gain is deferred and is taxed ratably as payments are received, over the life expectancy of the annuitant. The annual payments are partially considered as capital gain, ordinary income, and return of basis. If the annuitant outlives his or her life expectancy at the time the annuity was issued, the entire payments thereafter are treated as ordinary income. There is no tax deduction available to the payor, even though part of the annuity is actually an interest payment. All payments are with posttax dollars.

At the point the annuity is issued the assets will be out of the transferor's estate. If the transferor lives much longer than the initial life expectancy, this transaction could end up costing substantially more than if it were never done. An appropriate place to use it is where children, jointly, have to support a parent who is not involved in the business, say a mother who inherited the stock from her husband, and where the stock is paying little or no dividends, and where the support will most likely have to continue for the rest of her life.

Stock Split Up

Section 355 provides that where there are distinct businesses within a corporation, each line of business can be placed in a separate corporation and the stock distributed tax free to the shareholders.

There is a requirement that at least 80 percent of the transferred corporation be transferred to the shareholders of the transferor corporation and that the assets transferred must be that of an active business owned and operated by the transferor corporation for at least five years before the split up.

This could be done where a child or sibling does not want to be part of the business with the others who are presently involved; or where part of the business is being sold to outsiders, the child does not want to be included in the package, the child can clearly define the part of the business he or she is running, and the child can carve it out of the company.

Examples are divisions in two states, a machine tool and manufacturing division, or an electroplating and parts assembly operation.

Family Limited Partnership

A family limited partnership (FLP) can be a vehicle to transfer ownership in a business into, while the transferor can still maintain control, and reduce estate taxes at the same time.

An FLP would be created with the corporate stock, or business interests, transferred into the partnership in exchange for the partnership interests. The business owner would retain the general partnership interests and children would be given, over time, limited partnership units. The general partner will have complete control over the partnership. An FLP also removes any future appreciation of the shares transferred from the estate of the original owner.

The transfer of the limited partnership units can be as a gift to the intended successors, as a conventional sale, or as a sale to a grantor trust with the partnership interests valued at a discount from the value of the assets the FLP owns. The discount recognizes that the limited partnership shares have no control or say in the management of the partnership, and are not marketable, and possibly represent a minority interest in the business.

It also keeps the shares out of the grasp of creditors, or estranged spouses, of the limited partners and can control the disposition of the units if a limited partner dies.

Leveraged Buyouts

This could be accomplished where arrangements are made by the original owner for a bank to lend money to the company on a leveraged basis so that he or she could be bought out with cash. The loan will be repaid by the company that would now be under the new ownership.

Any additional notes received by the selling stockholder would then be subordinated to the leveraged buyout debt.

This method will enable the owner to strip out all existing cash and borrowing power of the company and enable the owner to still get more from a sale of the business if it continues to be successful through payments of the subordinated note.

Also, instead of additional notes payable to the owner, there could be a long-term consulting agreement so the company could at least pay this portion with tax deductible money. A variation of this, and perhaps a better tax transaction, is the leveraged ESOP, discussed previously.

Conclusion

Structuring a business transfer involves maximum skill of the adviser. It has to take into account the source of the funds, income, estate and gift taxes, the reasons, personalities, and the ultimate wishes of the client and the people who will be carrying on the business. Many of the methods discussed here are usually used in combination with each other. Additionally, many can be done pre- or postdeath; it just needs the proper contractual agreements. The accountant, as the adviser usually closest to

the situation, will need to be able to formulate a plan that could accomplish the multiple objectives.

A word of caution is that many of these methods are highly technical, and provisions of the Internal Revenue Code and regulations must be strictly adhered to. Additionally, in some cases it might be desirable to secure an IRS ruling.

Family Limited Partnerships

Sometimes the owner desires to transfer a business to a successor, but he or she wants to retain control or make it available to get valuation discounts for either gift or estate tax purposes. In those cases a limited partnership method can be used. The transaction is described as a “family” limited partnership even though it might not be with family members, or even if a limited liability company or limited liability partnership entity form will be used.

Introduction

You may put selected assets into a family limited partnership (FLP). The FLP will consist of a small amount of general partner units and a larger amount of limited partner units.

The general partner will have control over the partnership. The limited partners will have absolute control or say in the management of the FLP. When you gift the limited partnership interest to your children and grandchildren, the value of the gifts will be entitled to discount because of lack of control over the FLP.

There are no tax consequences when assets are transferred to an FLP in exchange for general and limited partnership units. This is because the person transferring the assets into the partnership has complete control immediately after the transfer. Economically nothing has changed. Changes take place once a share is transferred to someone else.

General Partner

This general partner can be an individual or another entity.

Recent tax cases have suggested that the person transferring the assets into the FLP should not have any control over the FLP after the transfer. So,

we caution our clients that they should not consider forming an FLP if they intend to maintain control over it.

Limited Partners

Any individual or entity can be a limited partner. Usually the limited partners are the children or grandchildren of the general partner. Occasionally it is a life partner. As stated above, limited partners have no say or control over the activities of the FLP.

Business Reasons for Using FLPs

Following are some of the business reasons for using FLPs:

1. Make a profit, increase wealth, and provide a means for the family to become knowledgeable of, manage, and preserve family assets.
2. Maintain control of the family assets.
3. Consolidate fractional interest of family assets.
4. Consolidate the management of the family assets.
5. Establish a method by which annual gifts can be made without fractionalizing family assets.
6. Avoid the greater sales potential of the property of the partners.
7. Continue the ownership of family assets and restrict the right of nonfamily to acquire the interest in family assets.
8. Provide protection to family assets from claims of future creditors against family members.
9. Prevent the transfer of a family member's interest in the partnership as a result of a failed marriage.
10. Provide flexibility in business planning.
11. Facilitate the administration and reduce the costs associated with the disability or probate of the estate of family members.
12. Promote the family's knowledge of and communication about family assets.
13. Establish an investment policy for the partnership, which encourages investments primarily for the growth of the value of the family assets.
14. Avoid multistate probate, if real estate is held in more than one jurisdiction.
15. To facilitate a succession plan for the properties

Note that a limited partner of an FLP does not own the assets of the partnership outright. The assets become the underlying assets of the partnership. Different kinds of assets may also be contributed to the FLP. This will allow greater control of the family assets and greater flexibility in

business planning and management. Generally, the more assets in an FLP, more the discount amount.

Form Over Substance

When a family limited partnership is created, its actual operation must be in conformity with sound business practices, as would be conducted if the partnership were set up and had nonfamily ownership, direction, and control. The FLP should not be run like the general partner's personal checkbook.

Of late, it seems the IRS has thrown in the towel attacking the validity of FLPs and is now winning more cases. Seems contradictory, but it really is not. The IRS is now saying, "O.K. You have an FLP for legitimate reasons, so let's see if the operations are consistent with those reasons, and...oops...they are not!" The IRS is winning because the "i's" are not being dotted and the "t's" are not being crossed.

Some of the things that should be done on a regular basis to maintain the validity of FLPs are as follow:

1. Regular meetings (at least once a year).
2. Regular communications and financial updates (for example, quarterly summaries or the information currently provided to your existing partners in each partnership).
3. Management fees paid to the general partner.
4. Cash distributions to cover the taxes to be paid by the limited partners.
5. Separate partnership bank accounts.
6. Proper business practices in operating the partnership.
7. The partnership agreement followed where appropriate matters require it.
8. Periodic review of state law to make sure there are no conflicts with the partnership agreement.
9. No commingling of general partner's personal transactions with those of the partnership.
10. Proper notification to limited partners of anything that requires such notice by the partnership agreement.
11. No transactions from the partnership that would discharge any type of personal obligation by the partners.
12. Maintenance of regular books of account, including minutes of partnership meetings.

The more the partnership is treated like a business, the greater the likelihood that the IRS will recognize the non-tax motives for organizing the partnership.

Observation. Make sure the FLP is fully implemented with all the necessary details followed to the letter.

Problems in the Family

Wanting to save estate taxes is a very good reason for a parent to give his or her stock to the children. However, life brings unexpected paths that people have to travel. Following are a number of contingencies that should be considered when stock is given to the children.

Marriage of Child

When children marry, they usually leave their assets to their spouse or children. In either case, there could be stockholders who could cause a problem for the parent or other siblings running the business. A way to reduce this possibility is to have signed shareholders' agreements restricting the distribution of the stock to anyone other than the company or existing stockholders. A properly considered agreement would even provide for the method and timing of the payment if there is no insurance, or to the extent the payment is to come from the company.

With no buy-sell agreement, valuing the company and the individual's stock can become an adversarial ordeal. The interests of the executor, or wife's attorney, or children's trustee (if the child died intestate) can all converge on the people trying to keep the business going. Another situation arises when there is a simultaneous death of the child and spouse and the child's assets are left to the spouse's designated beneficiaries. Now you really have strangers owning the stock!

If there is a divorce, the spouse can lay claim to a portion of the stock, or the stock's value as part of the settlement negotiations. Here the spouse wants to get appraisals with as high a value as possible. Also the company books could most likely be open to the scrutiny of outsiders and perhaps subject to cross-examination in a court room. Even a buy-sell agreement will not protect the company from the valuation process. Therefore it is prudent to have prospective spouses sign a prenuptial agreement setting a fixed amount that

the spouse will get if there is a divorce. (Note: it is easier to write it here than have a client's child carry this out!)

Child Dropping Out

When stock is given to an infant, the parent has no way of knowing how the child will turn out. For example, will the child complete college? As the value of the company grows, the child can become more independent of the parents. Perhaps a better way is for the stock to be placed in a trust rather than given as a custodianship. This way there is control over the stock, including the trustee having the right to resell the stock to the company, or restricting the transference of the stock out of the trust. You may not be able to keep the value out of the child's net worth statement, but you certainly can keep the cash out of his or her direct grasp!

Buy-Sell Agreement Provisions

Provisions can be put into the buy-sell agreement and employment contracts that force a sale if any shareholder stops working in the company, and the value can be set at relatively low amounts, such as book value. Also, payment terms can be drawn out so the person leaving does not get a "windfall" associated with the leaving.

The business can be valued at different amounts for different purposes. For instance death and disability can be funded with insurance and the price paid for the stock can be the greater of the formula value, or insurance proceeds. Someone leaving the industry could command a higher value than if they are leaving to start a competing business. All of these can be provided for in the agreement.

Multiple Siblings

When some children work in the business and some do not, problems can be created unwittingly by the parents. Let's assume that a son works in the business and two daughters do not. If the estate is worth \$3,000,000, with \$2,000,000 of it made up of the business' value, how is the estate to be set up? Also, for the sake of the illustration, assume the other \$1,000,000 is made up of cash or its equivalent.

For starters, the estate tax, assuming a combined \$2,000,000 exemption, would be around \$400,000. That leaves \$600,000 in cash and the \$2,000,000 business. If the parents leave the assets equally to the three children, each child would get about \$200,000 cash and one-third of a \$2,000,000 business. How will this work out?

The two sisters do not want the business and would rather have cash. The brother, who will run the business, and who is probably earning his living from it, now has two sisters and maybe two brothers-in-law looking over his shoulder and making him account for many normal-in-the-course-of-business decisions. It could get messy and certainly strain the brother-sister relationship. Even if the sisters are sympathetic and loving toward their brother, they might get hassles from their husbands—also a messy situation.

The reality is that now the brother has to account for his actions and probably make some cash distributions to his shareholders. Each shareholder has an asset worth about \$666,667. Shouldn't they expect a decent return from it? And if they do not, they would not be out of order in suggesting that either the business be sold or their brother buy them out. The brother could have been given voting control, but he still has to contend with unhappy stockholders.

Buying out the sisters could be very impractical because neither the brother nor company could have the cash or wherewithal to make the payments. And even if he did, it would most likely affect the cash flow or credit situation of the company.

In this situation, which is quite common, there is no happy solution, unless the sisters and brother have a very unique relationship. And keep in mind that in this example, the estate was made up of \$1,000,000 cash. Suppose, instead of the cash, it was a \$600,000 house, as well as art, jewelry, a boat, a couple of fancy cars, and other nonliquid assets. Now they would not even be able to pay the estate taxes, would get no cash at all, and owe the IRS about \$400,000 with interest payments due annually, at best. What we can do is make sure our clients in similar situations know what can happen because of their lack of proper planning and foresight, and their self-centered attitude toward their affairs.

The next chapter addresses planning techniques that can avoid these untenable situations.

Ownership Transfer Where There Are Family Issues

Following are some suggestions of what a client can do in the situation discussed in the previous chapter: A son works in the family business and two daughters do not. The estate is worth \$3,000,000, with \$2,000,000 made up of the business' value. Also assume the other \$1,000,000 is made up of cash or its equivalent.

The youngest and most easily insured spouse buys life insurance, in a trust, possibly paying some gift tax or using part of the equivalent exemption. They can also buy a second-to-die policy, with the daughters as beneficiaries. The cost of the life insurance can be justified in a number of ways (accountants can be very good at rationalizing spending). First, the premium payments should not be looked at as a "cost" out of income, but rather as a trade of one asset for another: cash for life insurance. Second, if the client considers it a diminution of assets, what is he actually losing? Only the income the payment would have thrown off. Therefore, a \$50,000 annual life insurance premium would only "cost" \$3,000, assuming the client is earning 6 percent on his or her money. Third, if the client wants to consider it a reduction of his annual income and wants to make sure he has the cash flow to cover it, his income must be quite high and the assets substantial enough to last at least a lifetime or two. Fourth, life insurance payments can be seen simply as a prepayment of estate taxes, except they are being paid at about 10 cents on the dollar. And, finally, any payments for life insurance and any resulting gift tax will reduce the accumulation of income that would be also subject to a later estate tax. Work out the numbers. It makes sense.

Okay, the client will absolutely not buy life insurance. Now what to do? The client can let the son have all the voting stock. He can also give the son, via the company, as additional compensation, enough stock so when the son inherits the balance, he will own a little bit over 50 percent and

have control. The father can also set binding terms that will set the buyout of the stock from the estate, that is, the daughters. It could be made a long-term payout with interest only and a balloon, say after 10 years. This will freeze the value of the stock, will allow the son to plan in relative comfort on how to get the principal payments to his sisters, and give his sisters a decent amount of cash flow. There will be pressure, but it is manageable.

The father could make plans now to sell the business, so the taxes and every other problem could be solved. But why is this preferable to life insurance?

Illustrative Succession Plans

Following are some illustrations of succession plans that have worked for clients.

1. A father had two sons working in his business. There were two distinct business segments: a sales and a service business. The sons did not want to have any involvement in the service end of the business, which included service contracts and service on a call-by-call basis.

The father arranged to split up the corporation into two separate entities, with the sons retaining the sales business and the father the service business. He then brought in someone to run it, with the possibility of his acquiring up to 50 percent ownership. It worked out, and now the father is basically uninvolved in either business and collects his "dividends" regularly from both companies.

2. An ex-father-in-law wanted his ex-son-in-law to be able to "buy" the business from his estate, since neither of his children nor their spouses had any interest, and he wanted to maintain continuity for the business, both for his employees' and customers' sake. His ego also wanted the business to continue with someone he groomed.

He put his stock in a living trust, the terms of which spelled out in detail that the stock must be offered to the ex-son-in-law and the specific terms of sale. This included little value for goodwill, low rent for 24 months in the family-owned real estate, and delayed principal payouts with low interest. The protection for the family was that they were to have a lien on the assets, and could accelerate the debt if any interest payments were missed.

3. A sole practitioner, internal-medicine physician wants to retire in about five years. Her choices are to wait until that time and try to sell her practice or bring in someone now, to groom for the succession.

The physician was told by a number of knowledgeable sources that because of the nature of her practice, she could only expect to get about 40 percent of her practice's gross, paid with 20 percent down, and the balance monthly over four years. Assuming the practice grosses

\$400,000 and she nets \$240,000, she will only get about \$160,000 for her practice. The alternative—bringing someone in—would cost about \$80,000 per year, with annual increments of \$20,000 for four years. However, under this method she sees that her practice would have some growth and she could retain some of the business she refers to other physicians, especially if she takes in someone with a different subspecialty. The physician estimates that new business would bring her practice up about 20 percent, which would cover in full the additional physician. She looks at it as a no-lose situation, plus her retirement package is based on her receiving 20 percent of her previous net income for a 10-year period, or approximately two times her net income of \$240,000. This is substantially more than she would net if she waits and sells the practice. Also, under this new arrangement, she could take more, and extended vacations, and become more of an “elder” statesman. The tradeoff is that now she will be involved in a larger business with someone else to answer to, which she resisted all her working life.

4. A father, age 75, has a son in his business who accounts for 65 percent of the company’s sales. There are also two daughters, who have nothing to do with the business.

The son is given as additional compensation enough stock so when his father passes away and he and his two sisters inherit the stock, he will have just over 51 percent of the company. The father also specified in a buy-sell agreement with the son that the son will have the right to purchase all his sisters’ stock from the estate at a predetermined price, allowing for minority discounts, with a deferred payout and “reasonable” interest paid regularly. It will be the son’s choice to acquire all the stock after the father dies.

5. A father and mother have a daughter in the business they would like to continue, but they do not feel the daughter could do it by herself after they both retire.

They made an offer to two key employees for them, and the daughter, to acquire the business from them, in a leveraged buyout sort of transaction.

Grooming

Once successors are identified, they have to be groomed for the job. Following are suggestions of what the grooming process should consist of.

1. Successors have to be told they are being considered as a, or the, successor.
2. Successors must be told what is expected of them in the way of their learning what they have to know. They will have to attend extra

meetings during the day and study what they learned at night and possibly on weekends.

3. The owner must transfer his or her specialized accumulated knowledge. The successors must grab every opportunity possible. Their eye has to be on everything, and all questions must be asked, and answers sought. The primary responsibility for this will be theirs, not the owner's. They must make the opportunities.
4. Books about business ownership, management, and leadership have to be read and studied on successors' own time. They should also take courses and seminars on those subjects.
5. They should become active in professional, trade, or industry groups as well as in local organizations such as the chamber of commerce or a service club.
6. They have to be able to interact, if they are not already, with all the company's employees. This means that if a sizable group's primary language is not English, the successors should learn the other language.
7. Company financial information should be shared with successors. They should sit in with meetings with the company's accountants and lawyers. Arrangements should be made for the CPA and attorney to meet privately with the designated successor for them to teach him or her what they must know about the company and the business in general.
8. The financial arrangement on how the shares will be given or sold or transferred to successors should be spelled out. Their compensation package should also be outlined.
9. A team should be formed around the designated successor. If successors are to lead effectively, they have to have backup.
10. A timetable should be set up to serve as a guide to what is happening.
11. A memorandum of what is going to happen should be prepared. However, the owner should contractually bind himself or herself without an out, for any reason, of his or her choosing.
12. A technique we employ to help our clients find out what plan the successor has is to have successors draw up a series of organization charts as follows:
 - a. How they envision the company at the present time.
 - b. How they think others see the company's chain of responsibility.
 - c. What they would like it to be.

This is then discussed and analyzed and becomes a road map for the future growth of the company. Regardless of the technique, the intended successors should present a plan and be made to articulate their thoughts of what they expect.

14. The entire family should be told what is happening, how it would affect them, and what their role will be, if any.

15. A committee should be formed consisting of the company's accountant, attorney, some family members, consultants, marketing or advertising agency representative, and whoever else might be of help in the process. Noncontributors can be eliminated from future meetings.
16. Immediately a contingency plan should be drawn up if there is a sudden death of the primary owner. Note: if a reluctant founder agrees to a contingency plan and follows through in setting it up, it might then be possible to start formulating a true succession plan.
17. Key customers, major suppliers, and certain other employees should be made aware of the plan, what is expected to be accomplished, how the success of it will be to everyone's benefit, and what participation might be needed from them.
18. At some point the founder will have to relinquish his or her role as CEO or president, and become a chairman of the board. His or her method of control should be with budget and financial accountability and periodic meetings, not with day-to-day involvement.
19. The new person must have adequate authority and responsibility from the first day. We call it the ability to make a mistake. If he or she is not permitted that luxury, and the associated costs, then the program probably will not work.
20. A plan of stock retirement of the founder also has to be established.

Keep in mind that a properly planned program would take a minimum of three years, and possibly up to 10 years, depending on who the designated successors are, their ages, and their relationship to the owner.

Also consider that succession plans may not be for everyone, and if one cannot be put together, plans should be made for the owner to either sell the business, or die leaving behind a possible mess and a smaller inheritance for his heirs.

Structuring a Deal

Following are illustrative terms and methods of structuring a deal by successors desiring to acquire the business, and where they will have to have the owner either financing the sale, or a passive investor providing the funding.

Terms

Payment terms are an essential part of the business' value and are usually negotiated separately from the value. No price is valid until the terms have been agreed upon.

Sellers usually want an all-cash deal. Buyers usually want a spread-out term. Interest is usually charged on all deferred payouts for assets, and not charged for payments to individuals for consulting contracts or covenants-not-to-compete. The interest rate could be as low as the AFR or greater than prime.

Putting Together an Offer

Following is an edited reprint of a memo we prepared for a client discussing how they should structure their offer to buy a restaurant they manage from the owner who wants to retire.

Following are some thoughts I have regarding how you should structure the offer to purchase Big Time Family Restaurant. After you review this memo we should meet to discuss it further.

Introductory Comments

1. The owner wants \$3,100,000 for the land, building, and restaurant (which includes the transfer of the liquor license).

2. Please note that we are not discussing here how much you should offer, or what we feel the right price should be. We can do this, but only after we make a thorough review of Big Time's books, records, and sales register system.
3. You will need to do a due diligence review of the business, entity, transfer laws, insurance policies and coverage, law suit, fines, penalty, and violation notices and actions, human resource issues, title clearances, property appraisals, customers profile, and the accounting, recordkeeping, and compliance matters. You should also make sure the liquor license is transferable, and that you and the other investors will qualify. At the proper time we could give you an extensive due diligence checklist that could be used as a guide to the process.
4. Once you decide on the price you want to pay and the terms (which this memo will suggest) you will need to have a letter of intent prepared by your attorney. Again, we could suggest things that could be put in the letter of intent that could protect you should you wish to renegotiate the price and terms offered.
5. Taxes also play a role in structuring the deal. How you deduct the payments, and the buyer is taxed on their receipt of the payments, becomes integral to the transaction. If you make nondeductible payments, you would only be able to use after-tax funds, substantially increasing your cost. If the payments are not collected in a tax-favored manner, the benefits of the sale would be drastically reduced. An initially satisfactory deal can become the subject of bitter litigation if the taxes are not properly considered.
6. The offer has the following elements: the price, terms, transition assistance, conditions, and obligations by the seller. Each has to be considered separately and jointly. They are each essential to a successful acquisition.
7. The terms are somewhat dependent on the needs of the seller. For instance, if the seller will be using the proceeds to acquire another business, the need for an all-cash deal will be much greater than if the seller will be retiring and intends to live on the income from the principal. In the latter, the terms could be constructed to greatly provide more cash flow to the seller, while enabling the buyer to commit to much less of a down payment.
8. You told us the original asking price of \$3,000,000 was increased by \$100,000 to cover the broker's commission. It would seem that there is room here for some negotiation. For purposes of this memo and for illustration purposes, we will use \$3,000,000 as the price.
9. Since you told us the seller was planning on retiring, an offer with less up-front cash and a greater interest-bearing payout would give the seller a higher annual income. For one, there would be no

tax to the seller on the installment notes allowing a greater principal to be used to earn interest. Second, any interest you add to the deferred payout would be higher than what he would be able to earn given today's low-interest-rate climate. Third, a higher cash flow should provide the seller with such a greater degree of security that would offset the risk he would take by being paid out instead of being paid in full. An example of the range of annual (pretax) income to the seller is as follows:

	No Note	No Upfront Cash
Gross sales price	3,000,000	3,000,000
Up-front payment	3,000,000	0
Less taxes (25%)	750,000	0
Net proceeds	2,250,000	0
Installment note	0	3,000,000
Interest rate received:		
From a bank	3.00%	
From the buyer		5.00%
Annual income to seller	67,500	150,000

10. One strategic comment about the above. The seller might be concentrating on the amount he would receive for the business, and not the cash flow he could expect. The relatively low net he or she could expect might dissuade him or her from selling. Also, it is not your job to do his financial planning, but you can take it into account in your offer.

Offer and Terms

11. We suggest an offer of \$750,000 cash and a note of \$2,250,000.
12. The note would bear interest at 5 percent and would be self-liquidating over 10 years. The monthly payments would be \$23,865; that would have to be factored into the cash flow analysis of the business. The seller would be given a second position security interest in the real estate subordinate only to the SBA that would lend \$500,000.
13. Using this model, your upfront cash would be \$250,000, with an additional \$250,000 being invested for working capital, transaction costs, fixing-up expenses, marketing, initial beautification, and contingency reserves.
14. An alternative is an all-cash offer, at a 15 percent to 20 percent lower purchase price, with the funding in excess of \$500,000 coming from the SBA. An alternative to the SBA might be a financial institution such as GECC or Merrill Lynch, but they might require a higher down payment.

15. Another alternative that is a little more exotic would be to separate the restaurant from the real estate and offer \$750,000 for the restaurant and get an option for the real estate. This would actually permit a greater eventual total sales price and make it a lot easier for you to pay for the business, and at the same time provide you with some protection against an exorbitant overpayment. Also, from the seller's tax standpoint, there would be no capital gains tax on the option price until the actual purchase and if the option is exercised after the seller's death, there would be a step up in basis for the estate, thereby fully avoiding estate tax on the sale (this estate tax advice is subject to the vagaries of Congress). The option could be for 5, 10 or 15 years at varying prices: For five years at today's value of \$2,250,000; for an additional five years at an inflation-adjusted price, say \$2,500,000; and a final five years for a \$2,750,000 price. A 5 percent option price would be paid up-front and rent would be paid annually equal to the 5 percent of the option price. This would offset any "interest" that would have been earned by the seller had there been payment in full. The base rent payment would be in addition to the tenant paying all real estate taxes, insurance and other costs of operating and maintaining the property, and could also be adjusted at five-year intervals to be the greater of 5 percent or the average five-year CD rate offered by five major banks on a given date one month before the five-year option trigger date. The base rent payments would be \$112,500 for the first five years, \$125,000 for the next five years, and \$137,500 for the final five years. In effect the lease would be a "triple net" lease.

Tax Structure

16. You should offer to buy individual assets and not the corporation or entity.
17. There is a significant legal issue with purchasing the stock. This should be discussed with your attorney.
18. There is also a significant tax issue for the buyer. Any price paid for the stock would not be deductible. There would be no opportunity to use taxes as an ally to pay for the business and property, or to repay any borrowings. Therefore all payments with the exception of interest would be not deductible.
19. If you purchase the individual assets, the price would be allocated among the assets acquired. Each asset class has its own tax attributes. At the end of this memo is a sample schedule of how the purchase price could be allocated.

Entity Structure

20. Your legal and tax structure also has to be set up before the purchase. We could assist you in this. A first-hand impression tells us one solution would be to set up two limited liability companies (LLCs), one to own the real estate and one to operate the restaurant.

21. It would seem that no matter how you structure the acquisition, there would be initial tax losses. An LLC would allow the smooth pass through of these losses.
22. An LLC also permits tiered profit and loss allocations, and easy periodic rearrangements of the allocations. An S corporation does not allow either of these. An S corporation also will not allow basis for entity borrowings for operating losses while an LLC does.

Seller's Obligations

23. The seller's obligations might involve him remaining for a period of as little of three months to an indefinite period with a continuing presence or responsibility.
24. How long the seller stays, and what he does, will depend on how well you learn the business part of the business and its peculiarities. This is something that only you could know after you've done your due diligence.

Other Issues

25. Before making an offer, we should prepare detailed operating projections and cash flow forecasts to determine how the purchase price and other costs can be absorbed into the business.

The above represents some thoughts I have regarding the purchase. After you have had the chance to review this memo, call me to discuss it further. Please note that once you have decided on the terms, you will need an attorney to prepare a formal agreement.

Offer to Successor's Investor

The offer to buy is only one of the offers you need. You also have to structure the deal with someone who will be a passive investor with you. Following is what we put together for the client who wants to buy the restaurant mentioned in the previous section.

Following are some thoughts I have regarding your arrangement with Partner in connection with the purchase of Big Time Family Restaurant. After you review this memo we should meet to discuss it further.

Introductory Comments

1. An entity or entities will have to be established. See the comments on this in our memo regarding structuring the purchase of Big Time. Regardless of how the entities are structured, your arrangement will be basically what is suggested here, or what is eventually agreed upon by the two of you, and or other investors. Portions of this arrangement might also suggest the type of entity, so this is a decision that will be made after you decide on the structure of your agreement with Partner.

2. We could set up the purchase in two portions: a real estate interest and an operating business. For purposes of this memo, we are assuming that you will both participate pro rata financially in each activity.
3. One reason to keep the real estate and operations in separate entities is a legal one, which should be further discussed with your attorney. One reason would be to protect you against losing the real estate in case there is a lawsuit with an award for a very high-uninsured amount.

Structure of Your Arrangement

4. We understand that Partner will be investing \$500,000 and you will not invest any cash.
5. Partner will be inactive, and you will be the operating member.
6. Both of you would own a 50 percent interest in the business.
7. You would be receiving a salary of \$150,000 per year. There will be no provision to increase your salary. Any increases would come out of your share of the profits. However, nothing would stop you from negotiating a higher salary should conditions warrant. You will also receive medical insurance plus other typical employee benefits generally available to the other employees of the business.
8. Partner would receive 8 percent interest on his money before any profits are split. This will be a cumulative return prior to any profits being split. Note that it is possible that there will be no profits to be split, and also no interest payments to Partner.
9. All remaining profits, if any, would be split 50-50.
10. The tax reporting will be consistent with this arrangement.
11. If there is not enough cash flow for you to receive your \$150,000 salary, the unpaid portion would be deferred the salary to future years. This will become a preferred cumulative amount and will be paid prior to the cumulative interest payments. Alternatively, you and Partner could agree to waive this on a year-to-year basis; or this cumulative provision with respect to your salary just would not be put into the agreement—if you don't get it, you don't get it.
12. None of Partner's principal will be repaid as long as there is any outstanding bank or purchase money debt. Once there is no debt, arrangements should be made to repay his original principal with 8 percent interest and a 10-year self-liquidating schedule.

Operating Arrangement

13. You will be the managing partner, or operating member. You will make all decisions with regard to running the business.
14. A restriction should be placed on you regarding your ability to make any financial decisions relating to any type of borrowing, or the purchase of any single item costing over \$50,000, or the hiring of anyone with a

salary in excess of \$80,000 per year. These will have to be made jointly. Since you both have 50 percent, a negative vote will prevail.

15. Monthly financial statements and information internally prepared minimally should be presented to Partner by the 15th of the month for the previous month. This would include sales by and cost of sales by category, monthly payroll, and month-end bank balance information, and such other information necessary for the seller to maintain reasonable knowledge on the operations.

Sale of an Owner's Interest

16. You should have agreements restricting the sale of your interests. However, determining a value of price at this point would be difficult and perhaps not feasible. Also, since you will be the managing partner, the sale of your interest might put Partner in a disadvantageous position.
17. Accordingly, should you want to sell, Partner should have the choice of replacing you, taking over as the managing partner until he decides what he wants to do, or buying you out.
18. Your buyout price, for the first two years, should be \$10,000. After that time you should give Partner a 30-day "right of first refusal" to buy your interest after you've found a buyer. Keep in mind that this right of first refusal will restrict your actions effectively forcing you to deal with Partner and negotiate what to do, but the primary right will be his since he is the one putting in the money, and he is placing his reliance on you to operate the business.
19. Partner would be permitted to sell his interest back to you or the entity any time after the second year through the end of the fifth year for his original \$500,000 investment, plus any accrued but unpaid interest. This will be payable with a self-liquidating 10-year note with interest at 5 percent (not the 8 percent he is getting as a partner).
20. If Partner wants to sell, and you do not want to buy his share, he may find a buyer for his share, but if the price is less than he offered it to you for, he must first then offer it to you at that price, and you will have 30 days to accept the offer and terms. If his offer is at least what he offered it to you for originally, he does not have to reoffer it to you.
21. Neither of you will be permitted to do anything to force the other to sell, other than as mentioned in this memo.

The above represents some thoughts I have regarding your arrangement with Partner. After you have reviewed the memo, call me to discuss it further. Please note that once you have decided on the terms, you should have an attorney prepare a formal agreement.

Due Diligence

Due diligence is a process of assessing the unknown and possibly hidden information about the target company. Even though successors work in the business and are familiar with it, they are mainly familiar with the parts they work on and in what their role is. Understanding everything about a business in a closely held situation is usually restricted to the owner—and not to “hired” help no matter how involved, knowledgeable, and trusted they are.

During the period from the execution of the letter of intent to the closing, the buyer checks out the company, its finances, its contracts, leases, law suits, customer and supplier relationships, employment situation including fringe benefits and union relations, its product line, manufacturing abilities and capacity, patents, copyrights and intellectual property, and other intangible assets and anything else that might affect the value of the company and its cash flow.

The buyer might engage accountants, attorneys, appraisers, personnel specialists, pension and fringe benefits consultants, technology and computer consultants, environmental engineers, investment bankers, risk specialists, industry specialists or consultants, antitrust and governmental law attorneys, and marketing consultants.

The due diligence process should also include assessing the value of the brand and culture and how well they will fit into the purchasing company’s culture, if applicable.

Those skilled at due diligence should be able to properly react to negative and problematic information disclosed during the process keeping the deal alive, although the price will be adjusted accordingly.

If we are representing a seller with a detrimental issue, we consider recommending that it is disclosed almost immediately when the buyer expresses his or her initial interest. This neutralizes later assertions and is substantially off the table as a value reducer when it is verified during due diligence.

Sometimes we advise our clients who are buyers to not accept certain information relying solely on the representations made to them. In those cases we suggest that part of the purchase price be held in escrow covering the purchaser from loss from misrepresentation. Knowing this, we advise our clients who are sellers to make sure that correct and accurate information is submitted.

Accountants should look for the value drivers of a target company to use the financial statements to develop useful deal issues and opportunities. Knowledge of the application of generally accepted accounting principles is very useful to uncover deficiencies in the asset values presented to the buyer.

Checklist of Items to Be Available for Successors' Due Diligence

Before you start talking to sellers, the following information should be available. It does not have to be put together in a bound book, nor does it have to be released at one time. It can be given in stages.

Usually the buyer, and sometimes the seller, sign confidentiality agreements where they state they will not disclose or use anything they learn or receive during the process.

- Financial statements for the last five years.
- Organization chart. The background or credentials of key staff should be included.
- A listing of the 10 largest customers. At the initial stage the names are usually left off the list.
- A list of any large suppliers, if applicable.
- A percentage breakdown, if applicable, of sales by product lines, foreign and domestic, or government or organizational and commercial or industrial.
- Equipment and software listing, including age and condition.
- Schedule of intangible assets, including patents, trademarks, copyrights, secret processes, and distributorships and franchises actual and in fact.
- Listing of any pending or proposed or anticipated litigation, both for and against the company.
- A listing of any contingent obligations or liabilities of the company.
- Any environmental issues, audits, assessments, fines, penalties, cleanup, or any other type of problem or concern at present or during the last five years.
- Explanations of any unusual transactions over the last five years.
- Any employment contracts, or memoranda of compensation arrangements with employees, and copies of qualified employee pension, profit sharing, 401k, or ESOP plans.
- Union contracts.

- Leases.
- Details of any business real property owned by the business, business owner, or spouse.
- Any contracts, franchise, distributorship, or representation agreements.
- History of the business.
- History of company ownership, if there have ever been any changes.
- Listing of affiliated organizations, and all their information, if owned by the owner, spouse, or immediate family.
- A statement indicating the importance of research, design, fashion, or new products to the company.
- The geographic area served by the company, and the importance of the company's present location to the success of the business.
- A description of the competition, including their approximate size, sales, number of employees and customers, the ownership and whether there have been any recent (in the last five years) changes in ownership, business, marketing, or operations.
- A printout of the company's Web site and major competitors' sites.
- Any Internet strategies in place or being discussed.
- A sampling of contracts and promotional and advertising literature.
- A "narrative" of what the business does, how they make their money, how sales are made, a timetable of how the business flows, what the seller's day-to-day involvement is, and how the seller spends his or her time.
- Ask the seller how he or she envisions the business' growth, both with new owners and new money, and under the present ownership with no changes.
- The seller should be able to identify the business's current problems and alternative solutions for them, as well as an overall assessment of the company's strengths, weaknesses, potential in the marketplace, and market position.

Contract Preparation

The contract can be prepared either by the buyer's or seller's attorney. We believe that whoever prepares the contract is given a tactical advantage in the negotiations that will accompany the contract construction and the period before it is executed.

Our clients use good attorneys who generally work quickly and do not hold up the process. However, the deal depends on both sides' attorneys working diligently and coordinating their efforts, and that does not always work out the way it should. Sometimes it cannot work because of legitimate issues arising after the letter of intent is signed. Realistically, the quickest one might expect a contract to be prepared and signed is six weeks, with two to three months being the norm.

Also, the due diligence will take place simultaneously with the contract preparation and things might be disclosed that would require changes or inclusion of special terms in the contract. Every change requires negotiation, and that takes time.

Continuing Involvement of Seller

Sometimes sellers want to be involved and sometimes they want to walk away and never see the business again after the sale. Every alternative is an issue and subject to negotiation. It is important for the buyer to be clear about what the seller will do and wants to do.

Sometimes, the buyer agrees to long-term employment contracts only to cancel them almost immediately after the closing. This has a cost and the buyer is willing to bear it, even though the seller would have preferred to remain working in the business.

Timing

Once the business is identified and there has been a surface review, negotiations will start. Negotiations would take about a month and end when a letter of intent is signed. Preparing and negotiating the contract could take two to three months, during which time the buyer does due diligence. The closing could take place simultaneously with the signing of the contract a month to six weeks later. One advantage of the closing taking place when the contract is signed is that a negotiating stage or period is eliminated.

Costs

The costs of the sale can vary widely. If you used an investment banker or business broker, you could pay anywhere from 4 percent to 10 percent of the purchase price. Legal, accounting, and appraisal fees could run around another 5 percent. These fees are usually based on time expended, with up-front retainers. All of this adds to your purchase price.

State Bulk Sales Reporting

This form accounts for, or exempts, sales tax on equipment and other tangible property where there is a sale of an entire business. Each state has its own rules. You should check with the Division of Taxation of the state the business is located in. In some cases the form must be submitted days or weeks before the transaction is completed.

Shareholder/Partnership Agreement Issues to Consider

Unless the successor completely buys out the owner, some form of partnership will be formed. Following is a listing of major items that should be considered in shareholder or partnership agreements. An attorney would properly prepare the agreements that will be executed.

1. Parties to agreement
 - a. Should parties be all shareholders, partners, members, or owners?
 - b. Should there be prohibitions or restrictions on transfers to family members or trusts for their benefits, or transfers through a will? Suppose one owner wants to make transfers for estate tax purposes.
2. Form of agreement
 - a. Buy-Sell. This is where the entity will repurchase the interest.
 - b. Cross-purchase. This is where the agreement is between each partner or owner and not with the entity.
 - c. The agreement should state whether the purchase is mandatory or optional (usually the offer to sell is mandatory).
3. Value of business
 - a. How will business be valued?
 - b. Will there be a formula or periodic revaluation?
 - c. Should a default purchase price formula be set?
 - d. Will valuation discounts be considered in determining the buyout price?
 - e. Will book value, or will parts of book value, be treated separately?
 - f. If a valuation is required, should the agreement state how it should be done and by whom?

4. Compensation. This can be covered in the shareholders' agreement, or in a separate compensation or employment agreement. Either way, it is an issue that has to be covered.
 - a. How will salaries be paid?
 - b. How will bonuses be paid?
 - c. How will SEP, 401k, pension plan, or similar type of payments be figured in as compensation?
 - d. What will compensation be in case of disability? Our suggestion is for full salary for three months; half salary for three more months; then nothing.
 - e. What happens upon termination of employment? Is a sale triggered or can the shares be retained?
5. Profits and losses
 - a. How will profits and losses be divided?
6. Decisions
 - a. How will decisions be made? Our suggestion is equally or based on ownership percents.
 - b. How are deadlocks handled?
 - c. What decisions are unanimous? Our suggestion is unanimous decisions are to admit a new partner, moving the office, borrowing, or involving individual items in amounts over \$xx,xxx.
7. Voluntary buyout
 - a. Can it happen for any reason except death, disability, retirement, or any other reason that is specifically covered?
 - b. What will be the price determination and terms or payout?
 - c. What happens if remaining people do not want to do buyout?
 - (1) Is there a dissolution?
 - (2) Will the person originally requesting buyout get the opportunity to buy out those refusing for the same price or a discounted amount and more extended terms?
8. Buyout upon death
 - a. What is price determination and terms of payout?
 - b. Is life insurance wanted and how quickly will payment be made after receipt of the proceeds from the insurance company?
9. Disability buyout
 - a. What are price determination and terms or payout?
 - b. What is the determination of definition of disability?
 - c. What is the determination of period of disability that will trigger buyout? Our suggestion is that 18 months after start of disability, the disabled partner must sell his or her partnership interest under the same terms as a voluntary buyout, if the partner was disabled and unable to perform his or her full duties for at least 15 of those months.

- d. Is disability buy-sell insurance wanted, and how quickly will the payment be made after receipt of the proceeds from the insurance company? Also, what will happen to insurance proceeds if they are received before the buyout is triggered under the agreement, and disabled?
10. Buyout on losing license
 - a. What are price determination and terms or payout?
 - b. Will employment be determined?
11. Buyout on personal bankruptcy
 - a. What are price determination and terms or payout?
 - b. Will employment be continued?
12. Retirement buyout
 - a. What are price determination and terms of payout?
 - b. What is the age after which retirement can or must start?
 - c. What is the minimum notice required?
13. Funding
 - a. Will funding be done on a regular basis, or after the event occurs?
 - b. Will funding be on a tax-advantaged basis?
14. Restrictive covenants
 - a. What restrictions will be placed on the person being bought out from working in the profession or industry, and for how long, and within what geographic area?
15. Taxability of payments
 - a. How will the payments be deducted and how will they be taxed to the person being bought out?
16. Ownership of nonoperating, investment, or intellectual property
 - a. How will nonoperating assets (such as artwork in offices) be treated?
 - b. How will investment assets be treated?
 - c. Who will own copyrights and patents? Will royalties be payable to person leaving?
17. Vacation and personal and sick days
 - a. How much vacation and personal and sick time will each owner be permitted?
 - b. How much will be the most consecutive time that can be taken?
 - c. Will untaken time be cumulative from one year to the next or lost?
18. Other business ventures
 - a. Will other ventures be permitted and, if so, under what conditions?
19. Timing of signing of agreement
 - a. Should it be executed before shares are issued?

Illustrative Succession/Estate Planning Transaction

Limited Partnership and a Sale to a Grantor Trust

This is an illustration of a possible estate-planning transaction. Presented is a summary of certain scenarios that might be applicable to use where assets are intended to be transferred or passed to nonspouse recipients or beneficiaries. This summary is presented to introduce a multiple-step transaction and is not to be considered a complete discussion. Also, tax laws are continually changing and there should be thorough research before any action is taken or recommendations made.

1. Assets transferred to a limited partnership
 - a. There will be 1 general partnership unit and 99 limited partnership units.
 - b. The transferor will own the 1 general partnership unit and the 99 limited partnership units.
 - c. The limited partnership agreement will provide that the limited partners will have no rights, votes, control, or ability to sell or otherwise transfer their shares under any and all circumstances.
 - d. The limited partnership will be organized in a state that does not, by law, confer rights (such as to demand a liquidation) to the limited partners.
 - e. There are no tax consequences to this part of the transaction.
2. Valuation of limited partnership units
 - a. The limited partnership units will be valued using fair market method in accordance with IRS Revenue Ruling 59-60.

- b. The limited partnership units will be individually valued when they are transferred by the original transferor to other people; accordingly, they will be valued taking into account minority lack of control and lack of marketability discounts.
 - c. The basis of the assets will remain at the basis to the transferor.
3. Intentionally defective grantor trust to be established
 - a. The trust will provide for the beneficiaries to be the person or persons who will ultimately be the recipients of the transferor's assets upon his or her death.
 - b. The trust will be funded with an amount of cash equivalent to 10 percent of the fair market value of the limited partnership units the trust will "purchase."
 - c. The funding will be a taxable gift to the trust.
 - d. If a trust beneficiary is a generation-skipping person, then the GST exemption should be properly claimed on a timely filed gift tax return.
 - e. The trust will not be defective by its terms, but the trustee will do a transaction that will make the trust "defective," such as lend money to the grantor.
 - f. If the trustee wants to end the defect, is the trustee has to repay the loan. The trust will then not be considered defective for the following year.
 - g. Provisions that could be included in the trust instrument that render a trust defective are those that allow the grantor to borrow from the trust, giving the trustee power to pay life insurance premiums on life of grantor or his or her spouse, or to add a beneficiary, or to substitute trust assets.
 - h. Income the trust earns does not have to be distributed to the beneficiaries. Also, the trustee can have discretionary power to "sprinkle" the income to the beneficiaries.
 4. Limited partnership units to be sold to the trust
 - a. The sale would be for the fair market value of the limited partnership units being sold.
 - b. The sale would be an installment sale with interest at the applicable federal rate (AFR) payable with self-amortizing annual payments.
 - c. The note will be paid with cash flow of the trust (from the cash contributed to the trust and the trust principal).
 5. Grantor's taxes
 - a. The installment sale would be considered a sale by the grantor to himself or herself, so it would not be subject to capital gains taxation.
 - b. The interest would likewise not be taxed; the interest would be deemed paid by the grantor to himself or herself.
 - c. The grantor would be taxed on the earnings of the trust under the grantor trust rules as long as the trust is defective.

- d. The payment of the taxes on the trust’s earnings is not considered a taxable gift.
 - e. If the trustee wants the trust to start paying its own taxes, the trustee would end the defect (such as by repaying the loan).
6. Death of grantor
- a. Upon the grantor’s death, the unpaid installment note will be included in his or her estate and will also be taxed as income in respect of a decedent.
 - b. If the installment note has been paid in full, there will be no reporting on the estate tax return.
 - c. The assets owned by the trust will not be included in the estate.
 - d. If a generation-skipping person were a beneficiary of the trust, there would be no additional generation-skipping transfers since no transfer was made to that person other than the original funding to the trust when the proper exemptions should have been claimed (see above comments).
7. Result
- a. The beneficiaries end up with the assets with no gift or estate tax except for the gift tax on the initial 10 percent funding.
 - b. The grantor has depleted his or her estate to the extent of:
 - The taxes paid on the income of the trust
 - The excess of the income the grantor would have received had he or she retained the assets trust over the installment note principal and interest payments received from the trust
 - The full undiscounted value of limited partnership units sold to the trust
 - The increment in value of the trust’s assets
 - c. The beneficiaries own the assets at the same basis as the grantor (this is a downside to the transaction).
8. Following is an example of the “numbers” of the transaction

	Discount	\$
Value of assets transferred to limited partnership		\$10,000,000
Discount for minority interest	20%	2,000,000
Net		8,000,000
Discount for lack of marketability	20%	1,600,000
Net value and amount of installment note		6,400,000
Cash flow from assets (using an 6 multiple)		1,666,667
Installment note at 7% over 5 years		1,560,000
Income taxes at 45% on cash flow from assets		702,000
Net cash flow to grantor		858,000
Net cash flow to trust		106,667

9. Following is another number example:

	<u>Discount</u>	<u>\$</u>
Value of real estate partnership limited partnership interests transferred to limited partnership		\$10,000,000
Discount (combined 20% and 20%)	36%	3,600,000
Net value of assets transferred to limited partnership		6,400,000
Discount for minority interest	20%	1,280,000
Net		5,120,000
Discount for lack of marketability	20%	1,024,000
Net value and amount of installment note		4,096,000
Cash flow from assets (using an 6 multiple)		1,666,667
Installment note at 7% over 3 years		1,560,000
Income taxes at 45% on cash flow from assets		702,000
Net cash flow to grantor		858,000
Net cash flow to trust		106,667

10. Some additional comments

- a. This transaction should be compared to a grantor retained annuity trust (GRAT).
- b. No annual trust tax returns have to be filed unless a federal identification number is obtained. The identification number that should be used is the grantor's Social Security number.

Sample Succession Plan: Living Trust and Option

Memorandum: Transfers of Property to a Son and Daughter

To Ralph
Date January 31, 2006
From EM
RE Land to Kiner and Cardi

This memo represents some thoughts I have re: you and Wilma transferring land to Kiner and Cardi. Please call me to discuss after you've had the chance to review it.

Facts

Wilma owns 28 acres with the house and barn, shop, and office buildings. It is anticipated that the land with the shop and office buildings will be carved out and separated from the 28 acres.

Famcompany owns 38 acres with no buildings.

Famcompany owns an additional 40 acres that will not be preserved as farmland.

Famcompany also owns 17 acres that it would like to sell and 29 acres that it has a contract to sell.

Famcompany is owned 99.5 percent by Wilma and .5 percent by Kiner.

The cost basis of the land is approximately \$250,000.

The process has been set in motion to have the State of Idaho preserve the 28 and 38 acres as farm land that would restrict future use to farming. You indicated the state will pay you \$500,000 for this to be done, and that Kiner and Cardi would be the owners and could use the property as their business and residential property so long as they do not further develop the land, except in connection with farming. You indicated that Kiner could build a house on the property he will end up with from Famcompany, and Cardi could remodel or build an addition on the land she inherits.

A suggested method to provide an option to Kiner for him to acquire Famcompany is attached.

Goals

You (*you* and *your* as used in this memo refers to you, Wilma, and Famcompany either collectively or separately as the case may be) would like Cardi to eventually end up with a 28-acre plot, exclusive of the shop and office buildings, and Kiner with the piece with the shop and office buildings

Kiner would end up with 100 percent of Famcompany as described in the memo dated October 21, 2004.

You would like these transfers to occur in such a way that there can be no issues of ownership after you and Wilma pass away.

You would like the transfer to take place with as little cost and taxes as possible. However, you told me your primary goal is the eventual ownership transfer and not the tax cost.

Initial Comment

To the extent Kiner exercises the option to acquire Famcompany, he would wind up owning 100 percent of Famcompany. Following this memo is a memo dated October 21, 2004 (with some minor updating) detailing a method of how Kiner will get the eventual 100 percent ownership of Famcompany. Accordingly, this memo will not discuss any of the land owned by Famcompany that will be transferred to Kiner. It will discuss the piece with the shop and office buildings that Wilma owns that will be transferred to Kiner.

Issues

The land Wilma owns with the shop and office buildings should be separated from the 28 acres into a separate lot, and that would be left to Kiner. It could also be transferred to Famcompany and be part of the Famcompany option.

Arrangements can be made either now, or after you and Wilma die, to have the property suitably transferred to Kiner and Cardi. If you transfer the shop and building to Famcompany, you will not have to do anything now for Kiner, as the option would cover him completely.

Any lifetime sales by you will be subject to income taxes either when payment is received or when you and/or Wilma die. There will be a step up in basis equivalent to the purchase price. Also, interest would have to be added to such payments.

Any lifetime gifts by you will result in Kiner and Cardi assuming your basis and possible capital gains taxes when they dispose of the assets.

Transfers at death will result in no income tax and a step up in basis to Kiner and Cardi that would wipe out the capital gains tax should they sell the property.

Transfers can also be made using an installment sale to grantor trust with rent being paid by the businesses to the trust, and you receiving the note payments. However, this would cost the business cash that it is not presently paying.

At a later time, if you wish, we could consider methods to reduce potential estate tax. This has not been done at this time.

Suggested Method (for discussion purposes)

You will not transfer anything during lifetime.

You will establish a revocable trust (referred to as a living trust). This is a trust set up by a grantor (you) where you and/or Wilma are the trustee(s). Your attorney will decide whether you need three separate living trusts (two for the land owned by Wilma and one for the Famcompany option described in the attached memo), or one.

Living trusts are always revocable during the lifetime of the grantor and are not recognized for income or estate tax purposes. This is a mechanism that will save no tax—neither income, estate, nor inheritance taxes.

Living trusts do not need to file tax returns or use taxpayer identification numbers. They use the grantor's Social Security number and the transactions are reported on the grantor's individual income tax return.

Living trusts are sometimes considered as substitute wills and become irrevocable upon the death of the grantor/trustee. At that time, the alternate trustee immediately becomes the trustee and assumes complete control of the trust.

You or Wilma will be the respective trustees of the trusts you each establish. You can each be the alternates for each other's trusts. Kiner and Cardi could be joint second alternates, or you can select an independent trustee.

The terms of the trust would be that Kiner and Cardi would receive the property after your deaths.

The property could be then transferred outright to them or remain in the trust for asset protection purposes. (This can be explained by your attorney, and does not necessarily have to be decided when the trust is established.)

This is not dissimilar to the living trust suggested for the Famcompany partnership interests after you both pass away.

The living trust will enable the property to pass outside of the probate process.

The property must be titled in the name of the living trust, or the living trust will have no effect. This should be done as soon as possible after the living trusts are executed.

To the extent there will be estate taxes, they would have to be paid either out of your estate's assets, or by each beneficiary. That should be explained to you by your attorney. Your wills or living trusts should state who would pay the estate taxes. I suggest that each person inheriting property be responsible for his or her apportioned share of the estate taxes.

Any transfers from Famcompany should be in accordance with the previous option you gave to Kiner to acquire Famcompany upon your deaths.

Other Comments

The transfer through the living trusts will cause the property to be valued for estate tax purposes at the time of death. The living trust does not provide an opportunity to "freeze" the value at the current amounts.

Caveat

Nothing should be done without the advice of an attorney, since we are discussing legal transactions that you want to make sure are "air tight."

No legal advice by us should be inferred or implied by anything in this memo or by our discussions.

Memorandum: Transfer of the Business to the Son

To Ralph
Date October 21, 2004 (and partially updated January 31, 2006)
From EM
RE Famcompany to Kiner

This memo represents some thoughts I have re: he and Wilma transferring the Famcompany operating business and land to Kiner. Please call me to discuss after you've had the chance to review it.

Facts

Wilma owns 99.5 percent, Kiner .5 percent, and Ralph 0 percent.

Partners' capital accounts totaled \$350,000 as of December 31, 2004.

The primary assets consist of:

1. Equipment with a December 31, 2004, book value of \$900,000 with an offset of equipment loans.
2. Land with a book value of \$250,000.

Note that to the extent Wilma has negative basis and transfers any part of her interest to Ralph, she might have to recognize income. The actual amounts will be determined when we complete the tax returns. However, we do not anticipate that there is a loss this year that would create a negative basis.

Goals

Your stated goal is to turn over the operating business and land (that is, the entire Famcompany) to Kiner in such a way that there can be no issues of ownership after Ralph and Wilma pass away.

Issues

Any lifetime sales by Wilma to Kiner will be subject to income taxes either when payment is received or when Wilma dies. There will be a step up in basis equivalent to the purchase price.

Any lifetime gifts by Wilma will result in Kiner assuming Wilma's basis and possible capital gains taxes when he disposes of the assets.

Any lifetime transfers will result in ownership by Kiner and the lack of complete control by you. Some things could be put in place for you to have effective control, but there would still be the tax ramifications. Our discussions eliminated this as a current choice.

Transfers at death will result in no income tax and a step up in basis to Kiner that could possibly permit him to get greater depreciation deductions on the equipment.

Suggested Method (for discussion purposes)

Do not transfer anything during lifetime to Kiner.

Wilma will transfer half of her ownership in Famcompany to Ralph. Therefore, each of you will then own 49.75 percent. This will result in no income or gift tax. Ralph will assume Wilma's basis.

Ralph and Wilma each will transfer their partnership interest in Famcompany to a living trust with a provision that the partnership interest will be given to Kiner upon each of their deaths.

For purposes of the living trust the value will be considered to be \$1.00.

To the extent the value is, or deemed to be greater than that, and if it is taxed on the estate tax return as such, the value for this transaction will still be fixed at \$1.

Any estate taxes attributed to the increase in value (that is, whatever the actual value is at that time) will be borne by Kiner. This will require that your wills, or living trusts, or however the attorney determines it should be, should state that the estate taxes should be so paid or apportioned.

To further the irrevocability of the transaction, and to provide protection to Kiner should Ralph or Wilma change their minds, Ralph and Wilma should give Kiner an option for him to purchase the property from them, their trusts or their estates for \$500,000 cash exercisable either upon their deaths, or after a fixed time period such as 20 years. The only time this would have any meaning is if Ralph or Wilma change their minds about transferring Famcompany to Kiner.

The option should permit Ralph and Wilma to add to or take the land out of Famcompany as they please, but to not transfer any equipment or operating assets for less than valid consideration and that any proceeds from the preservation payment will go to you and Wilma.

Caveat

Nothing should be done without the advice of an attorney since we are discussing legal transactions that obligate Ralph and Wilma and possibly restrict their future actions.

No legal advice by us should be inferred or implied by anything in this memo or by our discussions.

All numbers and amounts have been taken from information Ralph related at meetings and has not been reviewed or in any other way verified or ascertained by us.

To Do List Based Upon Previous Memoranda

Based upon attached memos

Prepared January 31, 2006

- It would be presumed that all of the documents would be executed simultaneously.
- Wilma will carve out of her property, a lot that contains the office and shop building.
- Wilma will transfer that lot to Famcompany.
- After the living trust is established, Wilma will transfer the title in her land from her name to the name of the living trust.
- Wilma will transfer half of her Famcompany interest to Ralph. The transfer will be for 49.75 percent of Famcompany.
- Wilma and Ralph will execute the living trust for Cardi.
- Wilma and Ralph will execute the living trusts with the option for Kiner.
- Ralph's and Wilma's wills will add a tax apportionment clause.

Sample Succession Plan: Stock Performance Rights Are Given to the Successor

Memorandum

To Laura, Dick, Brian, and Jack
From Edward Mendow
RE Jack's arrangement
Date November 10, 2006

Notice: To ensure compliance with U.S. Treasury rules, unless expressly stated otherwise, any U.S. tax advice contained in this communication (including attachments) is not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

Our Role: Please note that our role is to recommend what the corporation should do, and not to advise any stockholder individually about the advisability of the transaction. Our role is to present a methodology of obtaining the objective of promoting Jack to the position of general manager, replacing Brian. Any individual guidance or advice should be provided to each of you by your own attorneys and such other advisers or consultants as you deem necessary.

Alternatives

1. Based upon our preliminary exploratory discussion, two major methods have been considered.
 - a. Actual stock issuance. This is a fine way to address the intangible benefit of being a stockholder. However, it will involve substantial costs by Jack to purchase the stock at the company's present value, which will (assuming a deferred payment schedule, with AFR interest, with no use of his present funds or bank borrowings) greatly diminish his current cash flow for

the period of payment. Also, all payments for the stock would be with after tax funds greatly increasing his cost.

b. A stock performance rights plan. This is the plan we recommend. A particular advantage to this plan is that it would provide Jack with the same annual income he would get if he were a shareholder, and the plan enables Jack to benefit from the growth in value of Jarchem without any cost of entry or risk of loss (if the value decreases) or tying up any of his capital. This is a plan that will provide Jack with maximum cash flow. The only tradeoff for Jack is that any eventual stock sales will be taxed as ordinary income and not as a capital gain.

Following are the details of how the stock performance rights plan will work.

Stock Performance Rights

2. Under this plan Jack would be assigned stock performance rights (SPR) shares that would correspond to actual shares of stock.
3. Jack will also receive a base salary. Jack will be given an initial five-year contract that will be continued indefinitely if there is no notification of termination. After the fifth year, the company must give Jack one year notice of termination. If Jack is terminated for cause, he will not be entitled to any notice or pay after the date of termination.
4. The SPR shares will be designated a base value. Any increments above that value would inure to Jack's benefit. This will require a valuation of Jarchem as of the date the SPRs are issued.
5. There would be two ways the SPRs could increase in value: by retained earnings and by an increase in the actual value of the company.
6. As long as the company remains an S corporation for income tax purposes, there is no likelihood the retained earnings would increase the company's value, as the retained earnings would be attributed to the stockholders and would be "owned" by them and not be available to increase the company's value. It is the company's present policy to distribute all of the earnings as the cash flow warrants. The present situation of the company and its shareholders further make it improbable that the company would voluntarily terminate its S status.
7. The other way for an increase in value is if the company is sold for an amount greater than the present value; or if a valuation, formula, or methodology is decided upon and the value increases from the initial date through Jack's termination date.
8. Presumably any value attributed to the SPRs upon Jack's termination would not accrue prior to a minimum "retirement" date (not earlier than age 62). Otherwise, the reasons for making Jack the general manager would be thwarted. Note that the earlier the retirement date, the earlier Jack might leave, especially if he would realize substantial payment for the increment. This has to be further worked out. See next paragraph. The payments for the SPR increment would be paid over five years starting after he retires (or dies or becomes disabled), or after the payments described in the next paragraph cease.
9. A further benefit to provide Jack with financial security from Jarchem and to provide incentive for Jack to remain until his minimum retirement age and later (assuming the company will be growing), would be to have the SPR portion of his agreement continue for five years beyond his retirement, or death or disability if earlier than his minimum retirement age; that is, Jack would

continue receiving his percent of the actual income for those years. This provision will cease upon any sale of the company.

10. Following is an illustration of the above retirement payments described in the above two paragraphs. The income amounts assume that the \$4,000,000 per year income will remain at that amount for each of the five years after Jack's retirement. The valuation payout will be determined when he retires and will remain that amount regardless of future profits. Neither alternative will include interest. The value of the retirement payout in the illustration does not present value the stream of payments; it shows the gross payments to Jack, or his family.

Calculations of Jack's retirement pmts	Assumption	Total Amount	Per Year	When Paid
Assume net income when Jack retires	4,000,000			
Jack's percentage	10.00%			
Amount attributed to Jack	400,000			
Payout over 5 years (not present valued)		2,000,000	400,000	<i>First five years after retirement</i>
Assume present value	6,000,000			
Assume value when Jack retires	20,000,000			
Net change	14,000,000			
Jack's percentage	10.00%			
Amount attributed to Jack		1,400,000	280,000	<i>Second five years after retirement</i>
Total payout to Jack		3,400,000		

These amounts have been chosen for illustrative purposes and do not represent an opinion or expectation.

11. In the event of Jack's death or disability, regardless of his age, he would become fully entitled to the increments in the SPR's value. Note that disability has to be defined.

12. If Jack should die after his retirement date or after any date where it has been determined that he is entitled to a payout under this agreement, such payment will be continued and paid to his designated beneficiaries for the full remaining term.

13. To the extent the company purchases life insurance to cover any payments, said life insurance proceeds will be paid to liquidate in full, or as much of the obligation to Jack as possible, within 30 days of receipt of the life insurance benefits. Any remaining unpaid amounts will be then paid in accordance with the terms of this agreement.

14. If there were to be a sale of the company, there would be no minimum waiting period and Jack would immediately share in the proceeds, as if he were a shareholder for the proportion of the company represented by the SPRs.

15. Jack would receive a "bonus" each year based on the company's profitability as applied to his percentage "ownership" represented by the SPR shares. This bonus will vest at the end of each year but will only be paid when proportionate distributions are made to the shareholders. This is no different from the payment he would receive if he were a stockholder. The difference is that Jack would only be taxed when he actually receives payment, rather than when the amounts vest as of the last day of the fiscal year, as the stockholders are taxed.

16. Note that recent tax law changes might have changed the time of deductibility of the payments to Jack by the company. This will not affect the distributions or payments to Jack, but it might cause adjustments to be made in the calculation of the company's income to take into account differences in timing of the deductions for the payments to Jack. An alternative to this would be to use the GAAP taxable income, but we prefer the tax basis income for the agreement with Jack. If Jack's taxability timing would be affected, it might be possible to avoid his being taxed prior to Jack actually receiving the money by having him "vest" after the end of the year, say on January 1 or April 1 of the next year. This is something that we will be researching more fully.

17. The SPR "bonus" payments described in paragraph 15 would start Jack's shareholder distributions in 2007. Even though Jack would receive the SPR shares in 2006, and there would be shareholder distributions in 2006, Jack's participation in distributions would start in 2007.

18. For 2006's earnings Jack would be entitled to an SPR payment of 5 percent of the entire year's taxable income, and 5 percent of the entire year's ProductLineTwo division profits (and 7.5 percent to the extent Jack would be entitled to 15 percent of the ProductLineTwo division profits). The ProductLineTwo division profits would be paid consistent with the previous pattern that has been established. The SPR income payments would be paid to Jack as distributions are made to the shareholders. We will not make separate six-month calculations of the income and ProductLineTwo division's profits for this agreement. Note that there will be separate calculations made for the valuation determination.

19. Please be advised that it is unlikely that the company would be able to fully distribute the income that has been taxed to the shareholders through 2005. These amounts would either become "locked in" or converted to notes (with AFR interest payments). In either event, distributions will not be made on those amounts to the extent it would reduce any SPR payments to Jack, except in the event of the shareholder's death, or either a sale or liquidation, or upon the ability of Jarchem borrowing so distributions could be made with respect to those amounts.

20. The amount of net income attributed to the SPRs would be the company's taxable net income before any deductions or reduction for SPR amounts under the agreement with Jack. This is the same as would be done if he were an actual shareholder. Note that there might be adjustments to adjust the taxable income to the extent Jack's payments are not deductible in the year accrued, but only in the year paid.

21. To the extent the company does not have profits, Jack would not receive his expected or intended bonus. Note that this is not the case with his present arrangement, but it becomes his “risk” of being an SPR owner.
22. If Jack is terminated for cause, he would be entitled to any increment in value of the SPRs as of the previous valuation date and any earned SPR payments for the year of his termination up until the date of termination. He will not lose what has already been earned.
23. To the extent Jarchem reacquires a deceased stockholder’s (or any stockholder’s) shares, Jack’s SPR percentage share of Jarchem would increase without the offsetting payment to the deceased stockholder’s estate. To recognize that this would happen, Jack’s SPR percent *or* number of SPR shares would have to remain a constant. This would have to be worked out in the agreement. Alternatively, the remaining stockholders would then personally acquire the stock rather than the corporation.
24. Note that all payments to Jack with respect to the SPRs would be taxed to him as compensation and no part would be taxed as capital gains. Any amounts taxed to Jack would give Jarchem a corresponding deduction. There might be a difference in the timing of the deduction to Jarchem and the recognition of income to Jack. Also, FICA and Medicare withholding and reporting requirements might also be different. Whatever it is, the intention of this agreement is that Jack would not be taxed before he receives any payment. The company will do the best it can do to see that this occurs, but cannot guarantee it.

Nonfinancial Issues

25. Jack will immediately be given the title of vice president and, when Brian fully retires, Jack will be vice president/general manager.
26. When Jack becomes the general manager, he will only report to the board of directors.
27. Jack should be made a member of the board of directors when he becomes general manager.
28. The financial arrangement will start, in full, July 1, 2007. The percentages will be prorated for the first year and applied to the entire year’s taxable income and ProductLineTwo division income.
29. It will be presumed life and possibly disability and disability buy-sell insurance will be purchased to insure as much of these payments as possible if Jack dies or becomes disabled. Any payments received by the company will be paid when received, and not on a deferred payout basis as it will be upon retirement.
30. A valuation will be needed to establish the base value of the company for the purposes of this agreement. Another one will be necessary when Jack retires or otherwise is entitled to a payout. For all future valuations, I suggest using either December 31 or the immediate preceding December 31 as the valuation date, if the termination is not on or as of December 31. I also suggest that the valuation be for the entire company and then applied to his percentage ownership without minority or marketability discounts or adjustments for the shares represented by Jack’s SPR shares. The initial valuation will be as of June 30, 2006.
31. Although it has never been discussed, it is possible that at some point the corporation might be dissolved. In that eventuality, there will be no value greater than the net realizable value of the company’s assets most likely eliminating any value to the SPR shares.

32. Disability will have to be defined, as will other issues. This will be best done by the attorney drawing up the agreement.

Jack's Present Compensation

33. Jack is currently receiving a base salary of \$120,000 and a 10 percent bonus on the ProductLineTwo division profits that will be approximately \$180,000 this year, bringing his total compensation (without fringes) to \$300,000. Note that Jack's arrangement provides for a 15 percent bonus on ProductLineTwo profits in excess of \$2,000,000.

34. Any new arrangement must take into account what he is making now, and might make, without his elevation to general manager. Otherwise there would be no incentive for him to put his efforts into running the entire company instead of just the ProductLineTwo chemical division.

35. No matter what plan is adopted, the focus has to be to make Jack richer than he would be had he not been made general manager, while having the company make more money and grow in value.

36. A secondary issue, which has not heretofore been discussed, is to put the company in a position to be sold. That issue will not be covered in this memo. If you wish to discuss this, let me know and we could schedule a separate meeting for that.

37. We did not calculate the value of the pension plan, life insurance, fringes, and extra benefits that Jack presently receives, and what the total cost to the company is. This would not change under any new arrangement and will be in addition to the payments discussed in the memo.

Illustrations of the Various Methods

38. Following are comparisons of the various methods using the current year's estimated profits.

Note that under the SPR plan bonuses will be paid as S corporation distributions are made and this would not necessarily be paid in the year earned, or shortly thereafter, but as the stockholders decide on the distribution.

39. The breakdown between the ProductLineOne and ProductLineTwo division profits is based on present methods of allocating overhead and fixed costs. This is not necessarily the best way to do it, or the way it would be or should be done in the future. Actually, if Jack's compensation is based on the total company profits, the allocation will not matter. Note that the present method was determined years ago when the ProductLineOne division was stronger and the ProductLineTwo division was considered marginal. This method has been maintained for compensating Jack but is not necessarily the best or the most currently appropriate way to make the allocations.

40. Under the illustrations, Jack's base would increase by 10 percent of this year's ProductLineOne division loss. Then, assuming the ProductLineOne loss remains the same, his compensation would be substantially unaltered and would be about the same as his existing arrangement (with the exception of the loss by him of the extra 5 percent for ProductLineTwo profits over \$2,000,000). However, to the extent the ProductLineOne losses decline, Jack's bonus would increase by 10 percent of that amount, plus the declining losses would increase the value of the company, further providing him with extra long-term benefits.

	Present compensation	Stock performance rights
Profits from ProductLineOne division	1,800,000	1,800,000
Profits from ProductLineTwo division	-500,000	-500,000
Total profits	1,300,000	1,300,000
Base compensation	120,000	170,000
Percent of ProductLineOne profits	10%	
Percent of total profits		10%
Bonus	180,000	130,000
Total compensation	300,000	300,000
Less payment for stock purchased		
Net received	300,000	300,000

41. Following is the same chart but with higher estimated profits

	Present compensation	Stock performance rights
Profits from ProductLineOne division	2,000,000	2,000,000
Profits from ProductLineTwo division	-500,000	-500,000
Total profits	1,500,000	1,500,000
Base compensation	120,000	170,000
Percent of ProductLineOne profits	10%	
Percent of total profits		10%
Bonus	200,000	150,000
Total compensation	320,000	320,000
Less payment for stock purchased		
Net received	320,000	320,000

Conclusion

42. Once a plan is agreed to, in principal, it would have to be given to your attorney for his or her input and comments and for him or her to draw up the actual agreement.

43. Each of you, and Jack, would then have to seek the advice of your individual advisers and attorneys.

Sample Succession Plan: Redemption of a Brother's Stock Followed by the Issuance of Stock to a Son

Note: This chapter highlights two different methods of valuing the same shares.

Memorandum: Redemption of a Brother's Stock

To John Adams
From Edward Mendow
RE Arrangement With Samuel
Date December 1, 2005
Copy Samuel Adams

Notice: To ensure compliance with U.S. Treasury rules, unless expressly stated otherwise, any U.S. tax advice contained in this communication (including attachments) is not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

Caveat: This memo has been prepared for a discussion of a method of Samuel selling his shares and providing Quincy with shares (not necessarily the same shares or number of shares). A separate memo addresses shares to be issued to Quincy. This memo presents no opinions of any choices but is intended to present a method of accomplishing your goals. It is expected that there will be a future meeting where this plan will be discussed and alternatives explored.

Our Role: Please note that our role is to recommend what the corporation should do, and not to advise any stockholder individually about the advisability of the transaction. Our role is to present a plan and possible alternatives, their pros and cons, and a methodology for getting the objectives accomplished. Any individual guidance or advice should be provided to each of you by your own attorneys and such other advisers or consultants as you deem necessary.

Initial Comment

1. This is intended to be an agreement between two siblings to provide a reasonably equitable method of redeeming the shares over a period of time without any cash outlay by the remaining shareholder. It is not a typical purchase and sale transaction under a fair market value premise or conditions, nor is it intended to be.

Facts

2. Presently John owns 128 shares (64 percent) and Samuel 72 shares (36 percent) of the outstanding shares of Adams Construction Co., Inc. (the company).
3. John, Samuel, and Quincy are employed by the company.
4. The company owns life insurance on John and Samuel.
5. There is an existing shareholders' agreement between John and Samuel determining the redemption value upon death.

Objectives

6. The eventual objective is for Quincy to own 100 percent of the shares.

Issues to Consider

7. Bonding is critical for the company.
8. Samuel would sell his shares, but wants some employment security.
9. John would want to transfer as a gift some shares and sell the balance to Quincy.
10. Quincy does not have sufficient personal funds to acquire the shares.
11. The company has a large amount of cash that can be used to redeem the shares.
12. If any gifts were to be given to Quincy, it should be considered by December 31, 2006, to take advantage of the annual gift tax exclusion. Once lost, it can never be recovered.
13. If the company were to commit to acquire any shares, the liability or commitment would be reflected on the financial statement reducing the company's net worth.
14. Any commitment to acquire shares might have to include an interest payment thereby increasing any payment.

Discussion

15. The repurchase of the shares should be structured so that:
 - a. The company is not obligated to purchase, that is, redeem, the shares.
 - b. The company has an irrevocable right to redeem the shares if it so desires.

- c. The remaining shareholder, rather than the company, could reacquire the shares, if that is determined to be to the remaining shareholder's advantage.
 - d. The price is objectively determined and reflects the value of the shares then.
 - e. The value for the redemption would be determined without any valuation discounts. It would be pro rata for the subject shares.
 - f. The value would be determined on a per-share basis, based on the original number of shares Samuel had at the start of this agreement.
 - g. The value would not be diminished by any dividends or shareholder distributions paid to John or anyone else in any amounts other than the payments to Samuel under this agreement, and also not reduced by the company's expense or if any compensation shares are issued to Quincy or anyone else, or further without any increase or decrease of payments received for any shares sold to anyone other than Samuel under this agreement. This means that any capital account or shareholders' equity transactions other than to Samuel and current profits or loss under this agreement will be disregarded with respect to the calculation of the payments to Samuel.
 - h. Such other terms as the parties agree.
16. The transaction should be structured so Samuel could acquire the life insurance policy on him. To the extent there are insurance proceeds while the company owns the policy, the funds would be paid in full to acquire any remaining shares, irrespective that there were previously redeemed shares and payment for those shares.
17. The company would have to be valued at the start of this agreement, and at annual intervals thereafter. An alternative is an agreement among the shareholders that the value of the company for the purposes of this agreement be both:
- a. The average of the stockholders' equity as determined on the year-end federal tax return prepared consistent with the present method of determining taxable income.
 - b. The audited financial statement prepared consistent with generally accepted accounting principles in the United States for the same year end date.
18. Note that if the IRS or other authority challenges or alters the valuation used under your agreement, it might cause additional taxes. We suggest that this not cause any change in your agreement or the values used, and to the extent there are taxes, each party would be solely responsible for the taxes assessed against them. To the extent taxes are assessed against the company, the company's stockholders' equity would be so adjusted. However, if any adjustments are made after Samuel's final payment, Samuel would not be liable to reimburse the company for any amounts. This consequence can somewhat be mitigated if you obtained fair market valuations and used those amounts for the shares in question.
19. The payments for the shares would be taxable to Samuel (to the extent the proceeds exceed his basis) and not deductible by the company. If Samuel owned the shares upon his death, there would be no capital gains tax.
20. The life insurance, for this agreement, would be valued at its then cash value and will be used to make the final payment for the shares.
21. Note that the life insurance might be valued for income tax purposes at a different (possibly higher) amount causing tax consequences to the company. This should be treated in your agreement as a shared cost between the company and Samuel with each of the two apportioning the tax cost on a 64:36 ratio (the ownership starting point of this agreement) in determining the value of the policy being transferred to

John. To the extent John wishes the policy transferred to someone or entity other than directly to him, there might be additional taxes. Those taxes will be borne entirely by John and will be adjusted in the valuation used to apply to the redemption price for the final shares acquired by the company.

22. The valuation date should be the immediately preceding December 31 in every instance (except upon death where the life insurance proceeds are the deciding factor).

23. Samuel indicated that he wants, or would like, permanent job security. We suggest that he be guaranteed his job for five years after the final shares are redeemed by the company. The guarantee would not include any bonuses and the salary amount would be consistent with his present compensation, including all fringes and benefits he is presently receiving, except for qualified profit sharing plan contributions. If Samuel becomes disabled or otherwise unable to perform his duties (other than death), then after three months his salary will be reduced by half and his fringes will be eliminated except for health insurance, and he will be paid for the remainder of the five-year guarantee period. If he dies, this provision would terminate.

24. This agreement would remain in effect and be continued even if John dies before there is a full redemption of Samuel's shares.

Method

25. Samuel would grant an option to the company to acquire his shares exercisable over three years as follows:

Exercise Date	Number of Shares	Payment Price
April 1, 2006	24	24/200ths of December 31, 2005, calculated value
April 1, 2007	24	24/200ths of December 31, 2006, calculated value
April 1, 2008	24	24/200ths of December 31, 2007, calculated value

26. Following is a sample illustration of how the buyout would work:

Sequence of Events	Annual earnings	Redemption payment on April 1 of year	End of year value (for illustration purposes)	Original # of shares	End of year value per share based on original # of shares outstanding	# shares Archie is redeeming each April 1
12/31/2005 value			1,200,000	200	6,000	
04/01/2006 payment		144,000				24
12/31/2006 earnings	300,000					
12/31/2006 value			1,356,000	200	6,780	
04/01/2007 payment		162,720				24
12/31/2007 earnings	400,000					
12/31/2007 value			1,593,280	200	7,966	
04/01/2008 payment		<u>191,194</u>				<u>24</u>
Total payment		<u><u>497,914</u></u>				<u><u>72</u></u>

27. The option would give the company the right, but not the obligation, to acquire the shares. Samuel would have the obligation to sell if the option is exercised, but not a right to demand a sale.

28. An alternative to the above method would be to fix the price at the December 31, 2005, value and increase the second and third payments by an "interest" factor, say 5 percent to 10 percent.

Additional Comment

29. It is understood that John would want to start transferring or providing shares to Quincy and this agreement would permit it. It is also understood that this agreement would provide that nothing done with Quincy would have any effect on this agreement with Samuel.

Memorandum: Transfer of Stock to a Son

To John Adams
From Edward Mendow
RE Arrangement With Quincy
Date December 1, 2005

Notice: To ensure compliance with U.S. Treasury rules, unless expressly stated otherwise, any U.S. tax advice contained in this communication (including attachments) is not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

Caveat: This memo has been prepared for a discussion of a method of Samuel selling his shares and providing Quincy with shares (not necessarily the same shares or number of shares). A separate memo addresses the acquisition of shares from Samuel. This memo presents no opinions of any choices but is intended to present a method of accomplishing your goals. It is expected that there will be a future meeting where this plan will be discussed and alternatives explored.

Our Role: Please note that our role is to recommend what the corporation should do, and not to advise any stockholder individually about the advisability of the transaction. Our role is to present a plan and possible alternatives, their pros and cons, and a methodology for getting the objectives accomplished. Any individual guidance or advice should be provided to each of you by your own attorneys and such other advisers or consultants as you deem necessary.

Initial Comment

1. This memo is intended to present a method of Quincy obtaining ownership in Adams Construction Co., Inc. (the company).

Facts

2. Reference is made to the memo prepared for the redemption of shares from Samuel and the facts thereon.

Objectives

3. The eventual objective is for Quincy to own 100 percent of the shares.

Issues to consider

4. There are many ways Quincy can acquire shares. Three such ways are:
 - a. Quincy can be given shares from John.
 - b. Quincy can be given shares as compensation from the company.
 - c. Quincy can purchase shares from either John or the company.
5. Because of the cash in the company, and the cash that will be remaining after the redemption of Samuel's shares, consideration has to be given to John redeeming his shares.
6. As shares are redeemed, the remaining shareholders' percentage ownerships are increased.
7. As long as John has control, there is no need for any employment agreement. However, at the point his ownership drops to just over 50 percent, an agreement will be needed. That should be dealt with at that time.

8. Nothing in any agreement with Quincy should affect in any way the agreement with Samuel.
9. To the extent Quincy receives shares as a gift, his tax cost basis will be John's tax basis.
10. Any shares provided to Quincy would have to be subject to a shareholders' agreement that should be executed prior to his receiving any shares.
11. Irrespective of any compulsion to provide Quincy with shares by the end of the year, we do not believe anything should be done before an agreement with Samuel and a shareholders' agreement with Quincy.

Discussion

12. We assumed you start giving shares to Quincy by December 31, 2005, valued up to the \$22,000 gift tax exclusion for 2005.
13. This can be repeated in 2006; and possibly annually afterwards.
14. Additional shares can be provided by a combination of sale, compensation, and redemption. The details of this have to be worked out, and we will, after you decide on how you want to approach it.
15. Following is a schedule showing how this might work.

Sequence of Events	Estimated Company Value	# Shares Outstanding	# shares owned by John	# shares owned by Samuel	# shares owned by Quincy	% owned by Quincy
12/31/05 beginning amounts	1,200,000	200	128.00	72	0.0	0.00%
12/31/05 gift to Quincy		200	-5.4		5.4	2.70%
04/01/06 redemption		176		-24		
12/31/06 gift to Quincy		176	-4.6		4.6	
12/31/06 balances	1,356,000	176	118.0	48.0	10.0	5.7%
04/01/07 redemption		152		-24		
12/31/07 gift to Quincy		152	-3.4		3.4	
12/31/07 balances	1,593,280	152	114.6	24.0	13.4	8.8%
04/01/08 redemption		128		-24		
12/31/08 gift to Quincy		128	-2.7		2.7	
12/31/08 balances	1,700,000	128	111.9	0.0	16.1	12.6%

16. The above plan shows a method how Quincy could end up with 7.5 percent of the company by December 31, 2008, without any cost.
17. The valuation of the shares gifted to Quincy would be subject to a fair market valuation, which would include discounts for lack of control and marketability. This would require a formal valuation. The illustration assumes a 33.33 percent combined discount. Note that these discounts are not being considered or used in the agreement with Samuel.
18. We have assumed in the illustration that the shares gifted to Quincy are valued at just under the \$22,000 (\$24,000 for 2006 and later) annual gift tax exclusions. If you want to give a greater amount, we could discuss this with you.

19. To the extent a gift is made with a valuation discount, there can be no guarantee that the IRS would not revalue this gift upon the death of either John or Dottie, or upon the death of the later of them, unless a gift tax return is filed stating that a valuation discount was taken and setting forth the full basis of the discount. The filing of the gift tax return would result in the payment of no tax, but would give the IRS only three years in which to challenge the valuation and discount. Afterwards, they would lose the right to any challenge or revaluation. This is something that we will discuss with you should you plan on making a gift prior to December 31, 2005. We would need to know if any prior gift tax returns have ever been filed and, at a minimum, get a copy of the last one that was filed.

20. After the redemption and payments are completed with Samuel, a similar arrangement could be made with Quincy, where his percentage ownership would automatically be increased as John's shares are redeemed.

21. At the point when you are ready to redeem, sell, or otherwise transfer your shares to Quincy, the method of valuing the shares would have to be discussed.

22. One method, and perhaps the only acceptable one by the IRS, would be to use a fair market value valuation, which would provide for discounts and valuation adjustments.

23. Note that there are many ways to transfer shares to Quincy, and receive the excess cash sitting in the company. This is something that would need some time and considered thought, and which we think should be done after an agreement is made with Samuel.

Method

24. Please note that the method of transferring shares to Quincy are actually more complicated than the transaction with Samuel. When you decide what you want to do with Quincy, we will be available to meet with you and discuss it further.

Sample Succession Plan: Physician Acquires Ownership in the Practice in Which She Works

Memorandum

To George Herrmann
From Edward Mendow
Date December 7, 2005
RE Buy-in arrangement with Lou Anderson based upon meeting

This memo represents a summary of our meeting with Lou and O'Malley. After you review it with Lou, you need to have an attorney prepare the agreement. You should also meet with an attorney to advise you and review the agreement. If you have any questions, please do not hesitate to call.

Introductory Comments

1. Presently you are employed by Lou, who owns the practice.
2. This agreement is intended to present a method where you will acquire 50 percent of the practice over a period of years.
3. The payments to Lou will be out of your share of future profits until you are equal to him in all financial respects.
4. At some point—when Lou decides to retire—you will acquire the balance of the practice.

Assumptions

5. At present, we assume there is a \$50,000 differential in your respective base compensation.
6. The amount of present fringe benefits will not be changed and will continue as is. Any changes will be adjusted through the compensation.
7. The equalization will take place over four years, so you will be equal starting year five.

8. The equalization will be in two parts: increases in compensation that will be retained by Amelia, and increases due to profits that will be primarily paid to Lou.
9. The value as determined by Lou is \$600,000. Accordingly, Amelia will have to pay \$300,000 for the share she is acquiring.
10. The growth of the practice will be \$50,000 for 2006 and an additional \$25,000 thereafter. The growth should come from fee increases due to inflation and additional patients.

Discussion

11. There are two parts to consider: equalization of compensation and division of the profits.
12. The compensation equalization will take place so that Amelia's compensation will be equal to Lou's starting in year five. This would be accomplished without Lou taking any decreases in compensation, so that the 2005 year will be the base to which all increases will be added. In order to achieve this, Amelia will be allocated 70 percent of the first \$25,000 of new profits annually, or profits in excess of combined compensation. Each year the previous year's combined compensation would be the new base to which that year's additional \$25,000 will be allocated. This will continue each year until Amelia's compensation is the same as Lou's. This should be accomplished over four years, assuming the \$50,000 beginning differential.
13. The profit allocation will be based on a division that will have Amelia equal with Lou starting in year four. The ratio of additional profits will be 75 percent for Lou and 25 percent for Amelia in 2006, 66.66:33.33 in 2007, 60:40 in 2008 and 50:50 in 2009.
14. Following is an illustration of how the compensation equalization would work.
15. Amelia will start making payments to Lou in 2007 of her 75 percent net, after-tax retained profits, for the prior year.
16. No interest will be added or included in these payments. However, for income tax purposes the payments will have interest imputed based upon IRS requirements and rates and using a schedule of expected payments (similar to the schedule in the illustration but amended each year based upon actual amounts). The interest payment will be ordinary income to Lou and the remainder will be capital gains. Likewise the interest would be deductible by Amelia (subject to possible limitations) and the principal will not be deductible, but will be considered the acquisition of a capital asset.
17. The schedule of payments will call for Amelia deducting her approximate marginal income tax rate including federal, New York State, and Medicare taxes from her share of the profits. Amelia will then make a payment of 75 percent of the net after tax amount to Lou toward the \$300,000 purchase price.
18. Following is an illustration of how the practice payments would flow.
19. Note that our discussion suggested fixed payments over seven years for half the payment starting in year three by Amelia, with a sliding scale upward over the years with a balloon in the eighth year. If you wanted to do that, a scale can be developed similar to the scale below. However, I think the percentage of earnings would create less pressure on Amelia, while at the same time provide for faster payments should the practice do better than estimated in the illustrations.

Assumed Growth in Profits	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
		50,000	75,000	100,000	125,000	150,000	175,000	200,000	225,000	250,000	275,000	300,000
Additional profits over excess compensation	25,000	50,000	75,000	100,000	125,000	150,000	175,000	200,000	225,000	250,000	275,000	
George's percentage	25.00%	33.33%	40.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%
Amount allocated of George	6,250	16,667	30,000	50,000	62,500	75,500	87,500	100,000	112,500	125,000	137,500	
George's income tax — 40% rate	2,500	6,667	12,000	20,000	25,000	30,000	35,000	40,000	45,000	50,000	55,000	
Net retained	3,750	10,000	18,000	30,000	37,500	45,000	52,500	60,000	67,500	75,000	82,500	
Payment to Lou — 75% of net retained	2,813	7,500	13,500	22,500	28,125	33,750	39,750	45,000	50,625	56,250	62,500	563
Cumulative payments to Lou	2,813	10,312	23,812	46,312	74,437	108,187	147,562	192,562	243,187	299,437	300,000	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Schedule with \$150,000 payments over seven years with a balloon in year eight												
Annual percentage of \$150,000 total payments				5.00%	8.00%	10.00%	15.00%	15.00%	20.00%	27.00%		
Annual payments				7,500	12,000	15,000	22,500	22,500	30,000	40,500		
Cumulative payments				7,500	19,500	34,500	57,000	79,500	109,500	150,000		
Final payment											150,000	
Accrued interest at AFR (5% used for calculation)		7,500	7,875	8,269	8,682	9,116	9,572	10,051	10,553	11,081		
Cumulative interest		7,500	15,375	23,644	32,326	41,442	51,014	61,065	71,618	82,699		
Total payment											232,699	

20. Note that the illustration only provides for a \$300,000 profit growth through 2016. This is a less than a 100 percent growth in the profitability of the practice over 10 years. When you consider the effects of added business, added services and increased rates just to keep up somewhat with inflation, this appears to be fairly conservative.

21. Any part of the base or other compensation, fringe and any other benefits, and perks or days off that are not taken in any year will not be accumulated or carried forward and will be lost.

Additional Issues

22. In the event of one of you becoming disabled, the practice will pay three months' full compensation and three months' half compensation and then nothing.

23. Life insurance should be purchased to the extent possible to provide cash for the buyout in case of death. The ownership should be structured so the remaining partner receives the insurance and uses it to acquire the balance of the practice from the estate of the deceased.

24. Either of you can pull the trigger for retirement. There will be restrictive covenants prohibiting the solicitation in any form of patients of the practice during the two years preceding someone leaving for the two years following their leaving, and that no office can be opened within 10 miles of any office of the practice by the person leaving during the first two years after leaving.

25. At the point of retirement or withdrawal, a purchase price will be negotiated or decided upon; this agreement will not determine any price or formula method.

26. An alternative would be to decide now on a price and method of payment.

27. One suggestion would be to value the practice at a straight percentage or multiple of the previous year's or average of the previous three years' gross and have equal payments over seven to 10 years, with no interest, for the 50 percent interest being acquired. Keep in mind that the person making the payment will be using after-tax dollars; the person receiving the payments will get capital gains taxation on all but the imputed interest portion of the proceeds; that the salary of the retiring person will disappear and will be replaced by a younger podiatrist; that the younger person would probably have to be hired and start work earlier than the date of retirement; and that the younger person might be the person acquiring some or all of the retiring partner's portion of the practice.

28. Following is an illustration of a possible buyout scenario:

Evaluating buyout	
Assumed gross receipts/billings	1,200,000
Multiple of gross	100.00%
Practice value	1,200,000
Portion being acquired	50.00%
Purchase price	600,000
Annual payments over:	
Seven years	85,714
Eight years	75,000
Nine years	66,667
Ten years	60,000

29. There are purely legal issues that are not covered in this memo but that will be raised by your attorneys, including the legal structure of the entity.

30. The effective date of the agreement should be July 1, 2005, and any agreement signed after that date would make allowance for retroactive adjustments.

Caveat

31. Please note that this memo represents my recollection of the meeting, with added comments, and is not intended to be the actual agreement between the two of you. The illustrations represent my points in amounts that I consider reasonable and that can clearly illustrate the issues, but are not intended to be the actual amounts that you should use, or that I am recommending.

Tax Notice

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Marketing Your Succession Planning Services

Accountants usually are the best people to advise clients. However, many times the clients are not completely aware of what the accountants can do or that an activity requires a separate, and quite extensive, engagement. Following is an outline of the issues in marketing succession planning services.

Mission

- To better serve your clients.
- To generate more revenues.
- To reach new clients.
- To graduate from commodity/compliance services to premium services.

Technical Training Needed

- None, to start.
- If you end up doing a lot of this work, you had better take some courses, read appropriate books and magazine and newspaper articles, and acquire the broad-based awareness needed for this type of work.
- You *have* to be really good to be great!

Value of Image or Brand

- The difference between a bottle of Coke and an unbranded cola.
- The reason you'll order a Big Mac in a foreign country but will not touch a hamburger in any other restaurant.
- The rate you charge for yourself over a midlevel staff person.

Value of Marketing

- See previous section and *really* think about it.
- Marketing is what makes the product or service a premium service.
- Client perception creates value.
- Value to the client also helps.
- Unique value to the client helps more.
- Life alteration creates the best value.

Do You Market Products or Services?

- Commodities are bought by price and maybe delivery and terms.
- Commodities can be developed into a profitable volume business.
- Do you have the capacity and ability to handle the volume needed to really make good money? H&R Block does.
- H&R Block made tax preparation into a commodity product.
- So did Turbo Tax.
- And so did QuickBooks® for writeups and financial statements.
- And so did ADP and Paychex.

Do You Have the Talent?

- Of course you do. Ask yourself why the client uses you and what value you add to them and the benefit your client gets for the fees paid to you.

Why...

- ...aren't you making more for your special efforts?
- ...doesn't the client recognize the value you provide them?
- ...don't you get paid better for what you do for the client?

Bad Marketing

- Or no marketing.
- No recognition by you that you are a valuable *partner* to your client.
- No conscious effort by you.

Ways to Market Your Services

- Elevate your staff.
- Promote your partners.
- Establish an image for yourself.
- Raise the level.
- Make it an event when you see the client.
- Excite your clients.

Elevate Your Staff

- How you refer to them.
- How they dress.
- The work they do.
- How they present their work.
- Work papers and work paper security.
- How you use what they do.
- Telephone calls they make/receive, and follow-up actions.

Promote Your Partners

- You can't be an expert on everything.
- Refer often to your partners' expertise.
- Make yourselves "experts" in different areas.
- Brag about the seminars your partners attend.
- Bring your partners in to consult with client.
- When a partner consults for more than a lunch, it should become a separate engagement.

Raise the Stakes

- Deal with big picture items.
- Treat the client's nickel and dime items with respect and see that the situation is followed up by the *right* person in your organization (as long as it's not you).
- Be a resource for what's happening.
- Push the client to reach for the stars...
- ...and let them know you *will* help them.

Event Management

- Always be prepared and let the client see how much you prepared.
- Stay focused.
- Do not let the client drag you offline.
- Limit the client's time with you, even though they would spend all day with you if they could.
- Set the agenda *before* you start.
- State what you accomplished just before leaving.

Excite Your Clients

- Get the client to vent.
- Get the client to articulate their dreams.
- Make the client understand that you can help them make their dreams reality.
- Set the focus and agenda.
- Do not get sidetracked from your mission.
- Be clear what has to be done and who'll do it.
- Follow up to see that client is following through.
- Be the "make it happen!" person.
- WOW your clients.

What to Market

- Buy-sell agreements.
- What-ifs, such as the client dying suddenly.
- Family security.
- Heading off family fights.
- Avoiding the evils of money.
- Rewarding and retaining loyal employees.
- Keeping key employees that the client does not want to have to replace.
- Increasing asset value of business.

Buy-Sell Agreements

- Any client with at least two owners must have a buy-sell agreement.
- A buy-sell agreement is a will for a business.

- Get started by asking them what they *think* will happen if one of them dies, becomes temporarily or permanently disabled, wants to leave the business, gets divorced, and so on.
- Tell them what to expect, especially how their heirs will react to advice from their lawyers and accountants to “protect” their interests.

What If the Client Dies Suddenly?

- For one-owner businesses, the client should have a “will” for the business.
- The business ownership should be put into a living trust. Explain the probate process.
- How will every person involved in the business—employees, customers, vendors and consultants, family members working in business, and spouse and dependents—be affected?
- How and when will value be captured or realized?

Family Security

- How your client’s family will be affected by the loss of the business.
- The dependency of the family on the business.
- The different interests of family members in the business. (Would fighting erupt?)
- Wealth outside the business.

Heading Off Family Fights

- Recurring theme where business has family members working in business.
- Also an issue if no family members work in business.
- And a major issue where some work and some do not work in business.
- How much to leave to family.
- How to provide for spouse and kids.
- How to reduce fighting to a minimum and possibly eliminate it altogether.

Rewarding and Retaining Loyal Employees

- Does the client feel any responsibility to loyal, long-term employees?
- Should there be any responsibility?
- How can the client provide for employees?
- What happens to employees if the business is liquidated?

- What happens to an employee who spent his or her entire career with a client who retires, dies, or is disabled?
- What should happen?

Keeping Key Employees That the Client Does Not Want to Lose

- Do any employees have the client in a tight spot?
- Determine an “inconvenience” factor.
- List things the client can do to keep them.
- Are those employees adding value to the business or are they dependents?
- Can the client view them objectively?

Increasing the Value of the Business

- Does the client realize that the business has a value?
- Show the client what the value is.
- Show the client how the value can change.
- Show the client how the value is illusory.
- Value is a big picture discussion.

Getting Paid

- Fee embarrassment.
- Confrontation avoidance.
- Keeping the client.
- Separate fee for that engagement.
- Added fee for regular work.
- Fee increase readily accepted.
- Extra efforts to recommend you.

What You Should Do *Now*

- Target two or three clients *now*.
- Prepare a meeting agenda for them by the time you get home.
- Set up at least one appointment as soon as you get back to your office.
- Show the client why they need you to do more for them.

Sample Succession and Estate Planning Letters

Sample Succession Planning Engagement Letter: Business

Following is an example of a letter addressed to a client, age 60, initiating a succession planning engagement.

Mr. Richard Client
Very Big Mfg. Corp.
456 Main Street
East City, NJ 00000

Re: Start of a Succession/Estate Plan

Dear Mr. Client:

This letter is to initiate discussions between us regarding an estate plan for you. The discussion will center on trying to formulate a direction for the company in the future and what your role in it will be. The estate plan can perhaps more appropriately be called a life plan. Eventually, you will end up with a new will and perhaps shareholders' agreements and trusts. Nothing in this letter at this time should be taken as definitive; rather, its purpose is to get you started thinking about your future as well as that of your business and your family. At the appropriate time, specific recommendations will be made and a plan will be set up.

To start, we must establish certain assumptions or parameters within which we will be working. The way we see it, you have a number of choices:

1. You will live forever and continue doing whatever you are doing now forever.
2. You will die tomorrow.
3. You will work 10 more years and then retire.

None of these alternatives is certain. Even if you pick a plan, things can happen that could thwart it. What must be done is to establish some semblance of a plan to serve as a road map to take you where you want to go. If you change your mind during the way, or see forks in the road, they can be dealt with at that time.

We should look to see if there are any methods that we can eliminate. Two come to mind as candidates for elimination. I think it is clear that you will not live forever, and you might not want to continue doing what you are doing for as long as you live. If this is not the case, let's recognize it and go forward on that basis.

Another situation that can be eliminated is you dying tomorrow. There is no guarantee that you will not, but on the other hand, it can be provided for quite easily. Life insurance is a great equalizer. What we do is determine how much money your family should have so they are not dependent on the value received from the business. Then, you can insure against it; in effect that alternative is completely eliminated.

With respect to any plans you may or may not make, if the living and sustenance for your family will come from the life insurance completely, it is not necessary to dwell on what happens to the company. Since this appears to be quite an easy thing to do and because of your age, it is still possible for you to buy term insurance at relatively low prices. I would suggest without further ado you make arrangements to purchase more insurance. For purposes of discussion, we can assume \$2,000,000 of life insurance. The total premium for the first year will amount to approximately \$12,000, and everybody is provided for.

There are some mechanical things that must be done before you can buy the insurance, such as setting up an irrevocable life insurance trust. Instructions on what this is and how it can be done are appended to this letter. I can feel safe in recommending that you go ahead with this immediately. At the same time we can discuss the pros and cons of it. If you decide that it is not necessary, we can stop at any point before you actually write out the check for the life insurance. However, if you decide that it is important and necessary to have, you will have it in the works and will not have lost any more time.

Now that we have eliminated our first two alternatives, we have the third one, which seems to involve quite a few issues to consider. For instance, will you work for 10 years and then sell or liquidate the business? Do you want to turn it over to the children within a reasonable time (10 years can be defined as that reasonable interval)? Do you want to bring someone else in to help run it? We would have plenty of time to formulate a plan and set in the works any implementation of that plan.

Along the lines of trying to narrow our choices, let's consider the sale and liquidation at the end of 10 years. Why does it have to be 10 years? Why not sooner or longer? Is 10 years considered to be an adequate amount of time for you to evaluate whether your children can continue to run the business? If so, is it enough time to get them up to snuff or decide to sell if they couldn't handle it? If you think it is the proper time to start bringing your children into the "fold," maybe you should immediately start treating your children as if they were going to take over and run this company. It also gives adequate time for you to determine if they could run the company and, if it is necessary, to bring someone else in to help them.

If your plan is that the children will take over the company, you should decide which one will have the controlling interest over the other. Also, we would have to work out how they would acquire ownership in the company and a compensation pattern. At this point it might be a little premature, but there has to be an ultimate goal that you have to work toward so things can flow smoothly without crisis or emotions dictating how things are to be done.

Sample Succession Planning Engagement Letter: Doctor

Following is another sample letter to a client regarding succession planning.

Dr. John and Mrs. Jane Doe
99 Accounting Drive
Yourtown, NJ 12345

Dear John and Jane,

This letter sets forth a proposal of the terms and objectives of our being engaged by you to provide financial, tax, planning, conceptualization, and general consulting services.

Scope and Nature of Services

The scope and nature of the services to be provided are not clearly defined but will include all consulting services, discussions, and exploratory work on any of the items we discussed at our meeting, and that were included in the meeting agenda, and any other issues you wish to raise. Services will not include any detailed written memos, letters, or analyses that are intended for third parties.

Some of the items we will cover are as follows:

1. What your financial arrangements are with your children, what they should be, and how they should be administered. The types of documentation, ground rules and oversight that should be established. Whether your children have wills, and what should be in them regarding you and your businesses should also be established. Any other such issues that might arise will be discussed.
2. A clear articulation of your broad goals and objectives, understanding that these will continuously change based on your many activities.
3. We will discuss your individual financial statements, your significant assets, an overview of each company you are involved in, and cash flow from each activity. We will also review all agreements you have with each person running the businesses.
4. We will review your buy-sell and shareholders' agreements for all your business interests, and discuss what should be in such agreements, should there not be any.
5. We will review your life insurance policies, their ownership, and payment arrangements for them.
6. We will prepare or review your detailed income tax projection for the current year, and discuss it with you. We will particularly review the status of any tax losses and credit carry forwards, and help you in planning for their utilization.
7. We will review yours and your wife's wills, trusts, and estate plan. We will suggest things that should be considered or followed through. We will also review all designation of beneficiary forms for your retirement accounts and coordinate them with your estate plan.
8. We will discuss the advisability, benefit, and cost, if any, of rolling over your IRA into a Roth IRA.
9. We will meet with you, your wife, your attorney, or other advisers and your staff as necessary to accomplish what is necessary for us to effectively and appropriately advise you.
10. Included will be responses to all enquiries by you or your staff, whether in person or by telephone or e-mail, and we will include the preparation of any necessary memos and calculations to explain the

answers or issues internally, as long as extensive research (defined as questions or issues that will take more than two hours to research) does not have to be performed. If we come across such issues we will tell you in advance of performing the service what our fee will be for the completion of that issue. Our services described in this letter will not include anything of any sort that will be given to anyone other than your immediate staff. Attendance at meetings of up to two hours per issue with your other advisers is included.

We will use our full efforts and resources to obtain an overall familiarity and thorough understanding of your complete financial affairs.

Continuing Services

This engagement is *not* for continuing services and will terminate at the conclusion of the stated period. If you wish us to continue, we will discuss the nature and scope of the services to be provided and the fee arrangement.

Fees

The services will take place over the next three months. Our fee will be fixed at \$XX, payable \$XX upon acceptance and \$XX at the beginning of each of the next two months. We will bill you for out-of-town-travel disbursements, if any. We do not bill for telephone, delivery, or copying charges, unless they are extraordinary in nature. We will inform you in advance of any such charges.

Guarantee. If you are not satisfied in any manner with our service, you do not have to pay the final \$XX payment and our relationship will be terminated.

We will also be entitled to an additional fee of \$25,000 for any of our staff people that you hire or engage to perform services for you.

Limitation on Scope of Services

These services are not designed, and should not be relied upon, as a substitute for your own business judgment; nor are they meant to mitigate the necessity of an ongoing review. These are not investment advisory services. These services are designed to supplement your own planning and analysis and aid you in fulfilling your financial, business, and estate planning objectives. In addition, these services are not designed to discover fraud, irregularities, or misrepresentations made in materials provided to us.

The services described in this letter do not include other services that may also be provided by us, upon your request, including but not limited to:

1. Tax (income, trust, and gift returns) preparation, compliance, and planning.
2. Accounting and auditing services.
3. Appraisals and business valuations.
4. Any other services not specifically outlined herein.

We will bill separately for any such additional services requested by you, and provided by us, based on a predetermined agreed-upon fee.

Right to Terminate

Either party may terminate the relationship at any time, for any reason, within 10 days of written notice to the other party. It is understood that any unpaid services that are outstanding at the date of termination are to be paid in full within 10 days from the date of termination.

Conclusion

If this letter correctly sets forth your understanding of the terms and objectives of the engagement, please so indicate by signing in the space provided below and returning a copy to us.

Cordially,

The above letter sets forth my understanding of the terms and objectives of this engagement.

Signed _____

Date _____

Sample Estate Planning Engagement Letter

Following is another sample letter to a client regarding estate planning.

Dr. John and Mrs. Jane Doe
99 Accounting Drive
Yourtown, NJ 12345

Dear John and Jane,

This letter sets forth a proposal of the terms and objectives of our being engaged to provide estate planning services to you. The scope and nature of the services to be provided are as follows:

Review and Evaluation

We will determine the amount of your projected estate assets, what the estate tax on both of your estates will be, and what your current cash flow income and expenses are expected to be. We will also make the same projections for a period sometime in the future. A major concern will be your comfort and the “security” of your future cash flow needs. We will also discuss the probable estate asset distribution to each of you, as well as to your intended heirs. We will determine if there are sufficient assets in the appropriate hands to accomplish what you say you would like to accomplish. We will also point out basic estate tax reduction techniques and make suggestions on how to take advantage of them. We will also indicate ways to use any “excess” cash flow to save further estate taxes. We will also review distribution plans for IRA and pension funds under your control and discretion. We will also make suggestions on how to leave funds, and which funds to leave, to charitable organizations, if you are interested in this. We will further review your ownership in your real estate interests to determine if there are possibilities to save taxes through lifetime planning with respect to these assets.

We will consider your company ownership and your wishes about the succession of your ownership in it to your heirs. We will make suggestions about techniques that could accomplish your objectives. (Please note that our services in performing a business valuation and review and structuring a buy-sell agreement would not be included in this engagement.)

This stage will supply you with “real” information that we believe would be usable by you and family members if you wish to involve them in the process, your attorney, and any other adviser you choose to consult with. It will not leave you with definite plans or courses for you to follow. That will be developed in next phase. The review and evaluation phase is primarily an exploratory information-gathering and idea-producing process.

Review and evaluation will generally consist of two meetings.

Estate Planning Recommendations

We will suggest specific estate tax savings alternatives and plans and discuss their application to you and your wishes. This stage will develop ideas with which you may be comfortable and determine which estate tax reduction ideas with which you may want to proceed. We will then work those out with numbers regarding the estate tax savings and cash flow implications. When you are fully comfortable with the plans developed in this phase, we will proceed to the next phase.

Estate planning recommendations can consist of from one to four meetings, depending upon the complexity of your estate and what you might want to do. In many instances one meeting is sufficient because of the ideas developed in review and evaluation.

Written Estate Plan

We will put everything discussed and decided upon by you in a written report expressing the ways and means of achieving what you decided you would like to do. We will prepare a road map for your attorney (and other advisers, if any) to follow in their discussions, analysis, recommendations, and document drafting. This written report will be reviewed thoroughly with you to make sure it completely expresses your views and wishes. Only when you are completely satisfied will we give you final copies to distribute.

This phase will consist of one meeting to discuss and review a draft of the written report to be followed by the final copy being sent to you. The time frame between this meeting and the conclusion of estate planning recommendations will be about three weeks.

Review of Documents and Attorney Recommendations

We will review any recommendations made by your attorney or others you consulted. We will also review the legal documents drafted to see that they meet with the objectives you said you wanted to achieve. We will, of course, be available to discuss any thoughts or questions you may have. This stage may or may not require a meeting.

Implementation

We will assist you in implementing the plan in any way you want. Accordingly, we will be available for a period of up to 90 days after the completion of the review of documents and attorney recommendations phase, by telephone or in person, to answer questions, to assist you or your other advisers to take necessary actions, and to make recommendations regarding these matters.

Fees

Our fee for these services will be fixed at \$XX. A \$XX retainer will be required when we begin, \$XX will be due upon completion of estate planning recommendations, and the balance of \$XX will be payable upon conclusion of review of documents and attorney recommendations.

Post-Completion Follow-ups

We recommend that you have annual checkups or a revisiting and review of your situation to see if there should be any changes in your plan as measured by your then present situation. We should review how any changes in the tax laws would affect you. We should look to see if there have been any changes in your family's situation, thinking, needs, or desires, or how any changes in the economy might interface with your previous planning. There would be additional fees for this service at a predetermined, agreed-upon fixed price.

Limitation on Scope of Services

These services are not designed, and should not be relied upon, as a substitute for your own business judgment; nor are they meant to mitigate the necessity of an ongoing review. These are not investment advisory services. These services are designed to supplement your own planning and analysis and aid you in fulfilling your estate planning objectives. In addition, these services are not designed to discover fraud, irregularities, or misrepresentations made in materials provided to us.

The services described in this letter do not include other services that may also be provided by us, upon your request, including but not limited to:

1. Tax compliance services, including income tax and gift tax return preparation.
2. Accounting and auditing services.

3. Appraisals and business valuations.
4. Review and analysis of proposals to purchase life insurance.
5. Any other services not specifically outlined herein.

We will bill separately for any such additional services provided, based on time expended, at our standard hourly rates or at your option on a predetermined, agreed-upon fixed price.

Additional Professionals Needed

Please note that after we have completed our work, you will need to obtain the services of an attorney to review our findings, discuss the legal ramifications of the estate plan, and to draft all legal documents such as your and your wife's wills, possible trusts, and any other agreements and contracts. Depending on the plan, you may need to engage the services of appraisers to value real estate, the business, and your ownership in other entities.

Conclusion

If this letter correctly sets forth your understanding of the terms and objectives of the engagement, please so indicate by signing in the space provided below and returning a copy to us.

Cordially,

The above letter sets forth my understanding of the terms and objectives of the engagement to provide estate planning services.

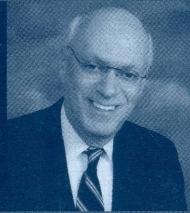
Signed _____

Date _____

The Adviser's Guide to

FAMILY BUSINESS SUCCESSION PLANNING

BY EDWARD MENDLOWITZ, CPA



Edward Mendlowitz, CPA, PFS, ABV, is a shareholder in WithumSmith+Brown and a member of the AICPA, New Jersey Society of CPAs, and New York State Society of CPAs (NYSSCPA). Mendlowitz has written 12 books and edited four others, and has written hundreds of articles for business and professional journals and newsletters. He appears regularly on television news programs and has been quoted in almost every major newspaper and periodical in the United States. He is the winner of the Lawler Award for the best article published during 2001 in the *Journal of Accountancy*.

FOREWORD BY BARBARA WELTMAN

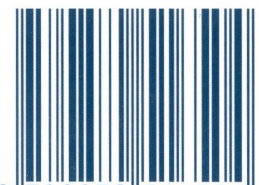


Barbara Weltman, J.D., is a noted author, respected attorney, publisher, and media commentator. Weltman provides entrepreneurs with expert advice, tax guidance and products on a wide range of small business issues and trends. Weltman has appeared in many prestigious national media outlets, including CNBC, CNN, WNBC-TV, Bloomberg TV and the Wall Street Journal. She is the founder and publisher of the highly-regarded newsletter, *Barbara Weltman's Big Ideas for Small Business*(R). She has written numerous books, including J.K. Lasser's *1001 Deductions and Tax Breaks 2006*, and J.K. Lasser's *Small Business Taxes 2006*.

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