The Business Library — Resource Report #27

Your Family's Role In Business Continuity

- ***The Process:*** **4 Steps**
- **Assure Business Continuity**
- **Protect Value of Company**
- **Plan for Estate Tax-Saving Options**
- **Provide for Orderly Distribution of Assets**
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- **Living Will and Living Trust**
- **Know Trust Options**
- **Select Right Executor/Executrix**
- **Prepare Family Information Roadmap**
- **Nine Ways to Value a Business**

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Your Family's Role in Business Continuity

Familiarizing your spouse, heirs, or successors with important aspects of your business is good protection for your family in case something should happen to you. It's also good protection for the company.

Reason: An informed spouse will be better equipped to keep the business running if you should become disabled or die. Even if the business is eventually sold, its value — and selling price — will be significantly enhanced by the fact that it is still operating and even more enhanced if it continues to be profitable.

Learning about the business doesn't commit a spouse to becoming active in its operations. All you're trying to do is provide general information in four areas: the business and its operations, its financials, business continuity, and estate tax-saving options.

More backup: You also may wish to include adult children in the education process. If you have no spouse or children, you still need a backup. Get the executor/executrix of your estate or a business associate involved in the business. The point is you need to equip those people who will inherit the business with the skills needed to run it in your absence and to oversee an orderly transfer or sale of its assets.

Spin-off benefit. At the same time as you are educating your spouse, children, or personal heirs, you will be *educating yourself* on the big areas to cover if you want to provide for your family, organize your personal and business finances, plan for estate taxes, and protect the value of your business after your departure or death.

Selling the idea. We know that some spouses of business owners want little or nothing to do with the business; they rely on you and your business acumen and judgements. It's your career, not theirs. So you might have to really work hard at getting your spouse to agree to learn about the company.

One approach: Stress that it's merely a good precautionary measure, like writing a will. It in no way commits your spouse to work in the business on a day-to-day basis. If your spouse remains adamant in his or her refusal, and it does happen, you might want to select an adult child to assume the role.

Here is how to proceed.

The Process — 4 Steps

***Step #1:* Exposure to the business.** The best way to start is by having your spouse attend important meetings, including board meetings and sessions at which new products are assessed and launched, marketing plans drawn up, and budgets written. The more your spouse learns about the business, the more he or she will feel a part of the company and better able to play a role if you should die or become disabled before retiring or selling the business.

***Step #2:* Education in the financials.** The best tools are your company's financial records, business contracts, and tax returns. Your advisers can help you review with your spouse your company's financial statements, bank loans, buy-sell and succession agreements, employment contracts, wage-continuation plan, retirement benefits, deferred compensation plan, life insurance policies, and company investments, including all affiliated businesses.

At the same time, make sure that, first, your spouse knows where all these important business papers are stored and second, has personal access to them independent of you.

***Step #3:* Business continuity.** There should be ongoing discussions between you and your spouse on business succession and interim management. You and your advisers also may want to involve your spouse in drawing up a list of five or more potential buyers of the company, hiring a consultant to prepare a valuation report, and establishing some plan for interim management and continuation of the business in the event of your absence. Specific questions to answer and discuss with your spouse:

- What is my percent ownership in the company and what do I think it's worth? This will help you determine the potential selling price of the business and projected federal and state estate taxes.
- Who do I recommend to manage the company until final decisions are made on its sale or transfer through my will?

- Which investment banking firms (include one local firm) could help sell the business?

- Which advisers, including the executor/executrix of my estate, should be relied on most because they have the best *total picture* of the company and my personal finances?

Step #4: **Estate planning.** Get answers to these big-dollar questions with your spouse: Are our wills and trust agreements up to date? Who are the owners and beneficiaries of our personal and business life insurance policies? Do they need to be changed? How much retirement money do we have and are the beneficiary designations correct? (*Important:* You don't want your estate to be beneficiary of your retirement money since the money could be subject to *both* income and estate taxation.) Is legal title of our property correct? (*Example:* Tenants in common versus joint tenants with right of survivorship, discussed later.)

On my death, is there sufficient cash and liquidity, including life insurance proceeds, to support my spouse and children and pay for funeral expenses and estate taxes? Have I established a wage-continuation or deferred compensation plan to continue my salary after disability, death, or retirement? Is there a buy-sell agreement in effect to purchase my ownership position in the business? Is it funded by life insurance so my family is more assured of receiving the cash for my ownership in the business?

Now to estate planning options for business owners and their families.

Options to Lower Value of Estate and Save Taxes

Your estate will include the value of your business so make a note for both you and your spouse to discuss the following Internal Revenue Code sections with your accountant and lawyer. Both sections provide tax-saving options when the value of the business **represents more than 35%** of the total value of your estate.

- *Section 303* — this allows your estate to sell back to the company sufficient shares of your stock ownership to pay estate taxes, legal and administrative expenses, and funeral expenses. *Note:* Any profit on the stock redeemed by the corporation is taxed at the capital gain rate of 15% rather than as a dividend or salary distribution from the company, which

would be taxed as personal income at rates up to 35%.

- *Section 6166* — this allows your estate to pay estate taxes due on the business portion of your estate over 14 years at 2% interest. For the first four years, only the 2% interest is payable on the tax due on the first $1,250,000 (2007) of your taxable estate. The interest rate on the amount in excess of $1,250,000 is 45% of the regular IRS statutory interest rate, currently around 8%.

What to do to meet 35% ownership test: If your business doesn't currently represent more than 35% of the total value of your estate, but it's close, talk to your advisers about transferring the ownership of select assets to family members in order to meet the test. There are ways to accomplish this:

(a) Gift the ownership of nonbusiness assets to your spouse or other family members either directly or through an irrevocable trust. In 2007, you can give $12,000 to any individual without paying gift taxes. The amount is $24,000 if your spouse joins in the gift. You also can use $1 million of your $2 million lifetime exemption to make more gifts.

(b) Transfer the ownership of life insurance policies directly to family members or to a trust for the benefit of your spouse and children. Plan ahead; the transfer must be completed at least three years prior to your death. If not, the life insurance proceeds will be included in the value of your estate.

(c) Provide for a credit shelter trust in your will. This will shelter $2 million of assets from estate taxation by using your lifetime exemption of $2 million.

All of the strategies above lower the value of your estate; (a) and (b) increase the percentage of your estate represented by your business so you meet the 35% ownership test.

Now to other subjects to get your estate in order and protect your heirs.

Distribution Mistakes

You want your will to distribute your assets as well as specific gifts the way you intend to have them distributed to your spouse, children, grandchildren, and others. That might not happen if you don't take the time to understand the complex legal terms used in will documents and, in particular, the use of the words: *Issue, Per Stirpes,* and *Per Capita.* The use of any one of these terms will have very different effects on how your estates' assets are distributed and the percentage allocation received by each family member or group, e.g., your children.

To help you discuss these terms with your lawyer, here are some definitions.

Issue — The term "issue" refers to the *direct* descendants of a deceased taxpayer: children, grandchildren, great grandchildren, etc. It does not include the spouse, but, depending on state law, it usually includes adopted children.

Per Stirpes — Distribution of an estate's property so that the *surviving* descendants receive what their immediate ancestor (e.g., a deceased mother or father) would have received if she or he had been alive at the time of the estate owner's death.

Per Capita — Distribution of the estate's property so that *all* surviving descendants (children, grandchildren, etc.) receive *equal shares* of the property, regardless of generation. Thus, a grandchild or even a great grandchild would receive the same amount as one of the children.

Discuss these terms with your lawyer; you want your estate's assets distributed the way you intend. And that intent may be *very different* today than when you originally signed your will. A new will or revision of your old will may be in order.

Plan for Inability to Make Decisions

A formal will is not sufficient protection. It should be supplemented by other documents that provide protection in case of disability, incompetence, or any short-term inability to make your own decisions on both personal and business matters.

Discuss with your advisers which of the following documents you should complete, sign, and put in a safe place for easy access by your family.

- *Living Will:* A set of instructions relied on by health-care providers in determining the level of extraordinary life support they will provide in the event of terminal illness or injury.

- *Health Care Proxy:* Appointment of an agent to make health-care decisions for you in the event you become unconscious, are found incompetent, or are otherwise unable to make the decisions yourself.

- *Durable Power of Attorney:* Appointment of an individual to manage the assets in your name in the event of your disability or incompetency. But be careful; a *power of attorney* can empower that individual to write checks against your account, sell and buy assets, and make other business and legal decisions on your behalf. Consider appointing two people, neither of whom can act alone.

- *Living Trust:* A formal legal document which spells out your wishes regarding your assets, estate, and medical decisions. It's a "living" trust since it can be changed or revoked *at any time* while you're alive. Individuals use a living trust to minimize or avoid the costs and delays associated with the probate process and to appoint a legal guardian for minor children.

- *Guardianship:* If you and your spouse die simultaneously or within a short time of each other or your spouse has already passed away and you didn't provide for a guardian for your minor children, the court will appoint one to raise them and administer the income and assets received by them from your estate. Also, the children may be wards of the court pending a decision. To prevent this from happening, indicate your intentions in your will or living trust.

- *Interim Management Agreement:* A document that takes effect on the death or disability of a business owner and names an individual or firm to manage the company until the estate is settled or the disability ends.

Discuss these documents with your spouse and lawyer. All of them provide important protection and can be changed or revoked at any time.

Check state laws: For your information, some states have enacted laws, called *Default Surrogate Decision Making Statutes*, which specify the priority of individuals who can make decisions for you if you become incompetent. In that case, state law would determine who has control over decisions for you and could take precedence over the documents described above. Consult with your lawyer regarding the statutes in your state.

Tax Alerts and Cautions

- *Arm's-length:* When transacting with your children or other family members, treat them as outsiders, i.e., on an arm's-length basis. If that's impossible for you, at least get supporting documentation. For example, if you own a business and are hiring your children, pay them *comparable* salaries to other employees on your company's payroll who perform similar jobs. Or, if your company rents properties from your children (or even from you), the rental amount should be fair and reasonable, i.e., based on *comparable* rentals per square foot in the area the property is located. *(Important:* Getting comparable data from independent sources in advance is a key to documenting an arm's-length transaction if it is later questioned by the IRS.)

- *Retaining rights:* Be careful of *incidents of ownership* where you retain certain rights (e.g., voting rights) over properties given to family members. Retaining incidents of ownership may lead the IRS to decide you have constructive ownership, making the income from those properties *currently* taxable income to you and including the assets in the value of your taxable estate.

- *Gift limits*: If you *exceed* the annual gift limitation of $12,000 per recipient for 2007 — even by only one penny — the gift must be reported on a gift tax return even if you are not liable for federal gift taxes. So it's better to plan far enough ahead so that you stay within the annual limitation of $12,000 per recipient or $24,000 if your spouse joins in the gift. If you do exceed the annual limit, you can use your lifetime gift exemption of $2 million in 2007. However, you will still have to file a gift tax return. *Note:* The total *lifetime* gifts is $1 million per taxpayer.

  Be cautious also of *irrevocable gifts* which you can't take back. In most states, money put into custodial accounts cannot be reclaimed by the donor.

- *Future interests*: Do not make a gift of a *future interest* of property without expert advice. For example, if you "gift" your child *income-producing property* and retain the right to the income (e.g., giving title to an apartment building but keeping the rental income), that would be a gift of a *future interest* and a tax and valuation problem can arise.

- *Your advisers:* Don't use inexperienced advisers when preparing complex estate, trust, and security sale and transfer documents. The accountant who prepares your tax return or the lawyer who handles your business matters may not be the right choice for those tasks. You want an expert who specializes in estate and succession planning, and is knowledgeable and up-to-date on tax changes, IRS Revenue Rulings, and any proposed legislation which could affect your financial, tax, and estate plan going forward.

Joint Ownership: **Definitions and Cautions**

If you own assets with another person, say your children, spouse, or business partner, check the *joint ownership* wording with your lawyer. Typical terms are: tenancy in common, joint tenancy with right of survivorship, and tenancy by the entirety (usually between spouses). Each of them has different effects on the death of an owner. In some cases, the *total* value of the asset may be included in your personal estate and, in other cases, your share of the asset may automatically go to the other joint owner.

- *Tenancy in Common:* Each individual owns an interest in the property, usually 50%. On the death of the first owner, the interest does *not* pass automatically to the surviving owner. It is distributed in accordance with the terms of the decedent's will or, if there is no will, by the laws of intestacy in the decedent's state of residence.

- *Joint Tenancy with Right of Survivorship:* On death, the decedent's 50% interest in the property passes *automatically* to the surviving joint owner, irrespective of what the other owner's will indicates.

- *Tenancy by the Entirety:* A special form of joint tenants created under the laws of many states where right of survivorship is *automatic*. It is almost always

limited to spouses.

Since state laws control the meaning of property ownership terms, checking out the *joint ownership* wording is particularly important if: (a) you have moved to a new state since purchasing the asset in joint name *and* (b) the joint asset is located in a state other than the state in which you're currently a resident. The greater the value of the asset owned in joint name, the more critical it is that you check the joint ownership wording and applicable state laws.

How to Select the Right Executor/Executrix

A person with a simple estate can afford to name an executor for personal reasons, e.g., a spouse or a friend. But, in today's complex financial environment, it's rare to have a simple estate and so the choice of an executor with good judgment and business acumen who understands the details of your estate is critical.

The complexities of the job increase when a business ownership represents a sizable portion of the estate. In that case, your executor/executrix may have to contend with disputes among your heirs or even minority stockholders. There is always the chance that someone will challenge the will or trust agreement, including any succession or management agreements, you signed during your lifetime. That's why you should appoint an executor/executrix who is financially astute and capable of understanding the details of your estate and your assets.

Here are some guidelines to consider.

1. If your executor doesn't have investment or real estate management expertise, you may wish to specify or recommend certain individuals or firms with whom he or she should consult on decisions in those areas.

2. Don't automatically name your spouse as sole executor. That may be appropriate if your estate will be simple. But if your estate will include such items as a business, or investment income that must be re-invested periodically, you may want to name co-executors — a spouse *and* a financial institution or a trusted friend and a financial institution. If a business is part of the estate, selecting your accountant, lawyer, or a company executive as executor or co-executor is often a

good idea because he or she is already familiar with your business, knows your intentions, and can better assist in directing the operations of the business. Your executor and advisers also should be aware of the tax options discussed on page 5, which are available to deceased business owners.

3. Your executor should not have a conflict of interest. *Example:* You don't want a business associate who owns part of the business to be the executor. His or her personal goals regarding the business may be very different from your goals or your family's.

4. Consult with your lawyer as to whether you can make your recommendations *binding* on your executor; state law can vary on this issue. Also discuss the *blank-check* or *disclaimer* option whereby your spouse has the right to change the *amount* and *form* in which the assets are received.

5. Discuss the job with your executor before naming him or her to determine willingness to serve, and be certain he or she understands the commitment being made. Also provide for an alternate executor just in case your primary executor is unable to perform or becomes sick or disabled before the estate is settled.

6. Costs should be considered. If an individual outside your family acts as an executor, he or she may want to be compensated for the services. You can negotiate the fee or follow statutory precedents. If a financial institution is selected, fees will vary depending on the size of your estate and state law.

The burden of an executor is great. Estates can take months or a year to settle, much longer if disputes arise or if there is a problem valuing the ownership in a business. In addition, the liability of an executor is significant since the responsibilities are fiduciary. So select an individual or firm who is up to the task.

Signals to Write a New Will

To reinforce the importance of updating your will, here is a summary of the major events that will require a call to your lawyer.

- *You move to a new state:* The will drawn in the state you left may not be

completely valid in the state in which you currently reside. Be sure your will conforms to the laws in your *new* state of residence. *Important:* A move from a community-property state to a common-law state — or vice versa — can definitely signal a will revision.

- *You purchase property in another state:* Complications can arise if you have property in two different states because two sets of laws and taxation may apply. Furthermore, there are additional legal and probate costs for properties located in states other than the state in which your will is being probated, i.e., the state in which you are domiciled at the time of your death. Be sure your lawyer is advised of new property purchases.

- *Your family changes:* Birth, death, marriage, divorce, adoption, separation — any of these may affect certain provisions of your will and life insurance needs, e.g., your children are no longer dependent on you or a beneficiary you designated has died.

- *Your asset structure is complicated:* If you own homes in more than one state, make sure it's clear which home is your principal residence, e.g., the same as on your tax returns. Also, any changes in your asset structure, such as inheriting property from a relative or the sale of a business, may require an amendment to or a revision of your will.

- *Tax law changes:* New tax legislation can affect your estate planning, life insurance needs, and the value of a business. For example, the unlimited marital deduction and the lifetime exemption of $2 million per taxpayer reduce your potential estate tax bill and possibly the need for select life insurance policies. However, be sure your advisers consider the repeal of the 2001 Tax Act in 2011, at which time the current lifetime exemption of $2 million **goes back** to $1 million and the tax rate to 55%, from today's rate of 45%.

* * *

Remember, the administration and settlement of an estate which includes a business is not an easy task. Your spouse's personal knowledge of financial and business affairs will go a long way in reducing the burden of that task, saving

estate taxes, and assuring a more orderly transfer of your estate/assets and an easier transition period for the business.

Also keep reminding yourself that a totally uninvolved, uninformed spouse can be a danger to the company and family — to the company because it can quickly disintegrate if you as a majority or 100% owner become disabled or die and — to your family because the company's assets, cash flow, and market value are likely to be a principal source of income for your spouse and dependents.

We have included the subjects below to help you further plan for your estate and value your business. ☐

References —

Exhibit 1: How to Prepare a Family Roadmap, next page

Exhibit 2: Nine Ways to Value a Business, page 17

Exhibit 3: Know Trust Options and Cautions, page 22

Exhibit 4: *Gift Today vs. Bequest through Your Will:* Estate Planning and Capital Gains, page 25

Exhibit 5: *What to Know:* Estate Planning and Repeal of Estate Taxes in 2010, page 28

Exhibit 1

How to Prepare a Family Roadmap For Distribution of Your Assets

Preparing a will and estate plan are just the first steps in facilitating the orderly distribution of your estate and assets. Another important step is to prepare a "summary" of your personal finances that lists in a *single* accessible record everything your heirs would need to administer and finalize your estate.

Remember also that your heirs will need to document the cost basis of assets and investments and place a current value on them. Good recordkeeping will help them do that. Here's what to include in your *Family Information Memo.*

☐ *Your assets:* Home and other real properties, IRA, Keogh, 401(k), and other retirement accounts, boats, and luxury items (jewelry, furs, art, antiques).

☐ *Investments:* Type of investment (real estate, savings, bonds, stocks) and the purchase price and date of securities and other major assets.

☐ *Life insurance:* Name of insurer, policy number, face amount of insurance, type of insurance (e.g., whole life, term, universal), dividend accumulations, borrowings, beneficiaries, and location of the policies.

☐ *Financial records:* Deeds, personal financial statement, past tax returns, credit card numbers, Social Security number, marriage and death certificates, etc.

☐ *Legal papers:* Your Will, Living Trust, Health Care Proxy, Power of Attorney, Trust Agreements, Beneficiary Designation Forms, all Titles to Ownership, and Loan and Mortgage Agreements.

☐ *Business-related documents:* Business ownership papers, buy-sell agreement, employment contract, deferred compensation agreement, pension plans, and business insurance on your life (group, split-dollar, key-executive).

☐ *Tax-related papers:* Tax returns and backup with W-2s and 1099s, investment statements, cancelled checks, bank statements, purchase documenta-

tion for stocks, bonds, collectibles, etc., charitable receipts and appraisal reports. For special tax deductions, e.g., for a second/vacation home or business expenses, include all cancelled checks, receipts, and other required documentation, such as depreciation writeoffs on investment properties.

☐ *Gifts:* Legal documents, correspondence, and all tax returns which refer to gifts made to family members and others. *Reason:* The IRS will look at all gifts in the context of your lifetime exemption when reviewing your estate tax return.

☐ *Advisers:* Names, addresses, and telephone numbers of your lawyer, insurance agent, broker, accountant, and banker.

☐ *Instructions on death:* Include funeral arrangements, burial plot, persons to be notified, location of safe deposit box and its key.

☐ *Joint ownership:* When preparing the information above, make a notation of which assets are jointly owned with your spouse. This notation is needed to place a value on your own estate since only 50% of jointly held property may be included in the value of your estate.

The steps in good recordkeeping: (a) Determine the information that has to be collected, both personal and business, (b) compile the data, (c) set up files for each area of finances (e.g., home, investments, Social Security benefits, estate papers), and (d) prepare your *Family Information Memo,* which lists all individual files, the documents and papers included in each file, and where the files are located (i.e., at home, in your safe deposit box, or with your lawyer).

Remember, the goal of good recordkeeping is to assure that your family receives everything to which they're entitled and to protect your deductions from IRS attack, both today and after your death. Without proper documentation, the IRS can disallow a deduction and challenge the cost basis of any assets which can't be confirmed by a cancelled check or other means. ☐

Nine Ways to Value a Business

- ☐ Valuation Methods
- ☐ How to Weight the Values
- ☐ How to Use Discounts to Lower the Value

Here are the basic valuation methods by which businesses are valued. You will want to use as many valuation methods as possible; the more you use, the more accurate your average and final, weighted value.

➜ *Reported net book value:* This value is prepared by your accountant; it's simply the company's reported assets less all liabilities. To determine *tangible net book value,* simply subtract intangible assets, e.g., goodwill and capitalized financing costs, from reported net book value.

➜ *Adjusted net book value:* This method increases the company's net book value to the extent that certain assets (principally real estate, equipment, and inventory) exceed the cost basis of the assets as shown on the company's balance sheet. This approach usually increases the value of the assets and thus the company's net book value.

➜ *Replacement value:* This method writes up all assets to their replacement value and then subtracts the liabilities. It can substantially increase a company's value and is principally used when selling a business to company executives or to another company which wants to get into your line of business.

➜ *Price-earning's (p / e) multiple:* Here, you simply apply a multiple, say 12, to the company's net income after taxes. If the net income is $200,000, the value of the company is $2.4 million. The faster the growth rate, the higher the p/e multiple. This is how most publicly held companies are valued.

➜ *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT and apply a multiple to it, usually 4 to 8, principally depending on the company's growth rate, its profit margin on each dollar of sales, and other factors. *Note:* Some appraisers and analysts add depreciation and amortization expenses to the formula for what is referred to as EBIT-DA.

➜ *Liquidation value:* This value assumes liquidation of a company's assets and payment of all liabilities. It is used to determine the *absolute* minimum value of a business. *Example*: To determine the liquidation value of a business, you might apply a 25% liquidation value to inventory, 70% to accounts receivable, etc. You then subtract all liabilities to determine the final liquidation value. *Note:* For this valuation method, you may wish to consult with a recognized Asset-Based Lender in your area.

➜ *Dividend value:* This method assumes the company pays out a certain percentage of its net income, say 50%. You average the last three years' net income, say, $200,000. Then divide the $100,000 dividend payout (50% times $200,000) by a desired annual return, e.g., 8%, which results in a value of $1,250,000 ($100,000 dividend payout divided by 0.08).

➜ *Projected value of earnings:* This method applies a present value rate of about 15% to a company's projected net income. Basically, it is *today's* value of projected net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow* value. This valuation method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is also appropriate for young companies with high growth rates.

➜ *Multiple of Sales Value:* This valuation method, principally used to value service businesses, applies a multiple of 0.75 to 1.50 to last year's sales, this year's projected sales, or an average of the last three years. *Example:* Your company's sales last year were $850,000. Based on the higher multiple of 1.50, the value of the business is $1,275,000. (*Note:* For the factors which affect the multiplier, see *Earnings Before Interest and Taxes*, above.)

Adjustments, Weighted Value, and Discounts

Valuation adjustments: When determining a company's earnings or net income, most valuation experts adjust the earnings for the following: (a) excessive owner compensation and fringe benefits, (b) extraordinary writeoffs of bad debts, unusable inventory, etc., and (c) the recapture of non-recurring expenses incurred in one year which benefit the company over future years, e.g., establishing another sales office and research and development costs.

Many times, an average of the last few years' earnings are used or they are weighted, e.g., a 50% weight to the company's current earnings, 30% to last year's earnings, and 20% to the prior year's. You can do the same, particularly if the company's earnings are increasing every year. That will help maximize the value of the business.

Weighted value: The final step is to list the results from each valuation method and apply a "weight" (percentage allocation) to each value. An example is shown below, using three of the nine valuation methods explained on the prior pages. To get a conservative reading of the company's value, we applied a greater weight to the adjusted net book value method, which is also less volatile than the other two methods because it doesn't involve earnings, which are more uncertain.

Weighted Value of the Business

Valuation Method	Value	Percent Weight	Weighted Value
Adjusted Net Book Value	$1,000,000	40	$ 400,000
Price-Earning's Multiple	$1,200,000	30	360,000
Projected Earnings	$1,500,000	30	450,000
Weighted Value		100	$1,210,000
Average Value without Weights			$1,233,333

As computed, the weighted value of this business is $1,210,000. However, *before* accepting that $1,210,000 weighted value, it should be compared to the *average* value of $1,233,333 (total values of $3,700,000 divided by three) and the

median value ($1.25 million). Here are the comparisons. The final weighted value of $1,210,000 represents:

- 98% of the *average* value of $1,233,333.
- 97% of the *median* value of $1,250,000.

As a general rule, when the weighted value is within 80% to 120% of the average and median values, you have a reasonable, defensible value.

Advisory: The IRS' Revenue Ruling 59-60 states that "*all available financial data*" and "*other relevant factors affecting the fair market value of the stock*" also must be considered. With that wording, the IRS can question *any* aspect of a business it deems relevant in setting its own value on the business.

How to Use Discounts to Lower Value

A discount of 20% to 40% can be applied to the value of a closely held ownership position to lower its value for gift and estate tax purposes and minority ownership positions. The discount applies to corporate stock, limited liability companies, partnership interests, sole proprietorships, and other business ownership positions.

Reasons for discount: An ownership position in a closely held business:

- is illiquid — there is no public market to sell the securities;
- generally carries no dividend and thus no current yield;
- can be restricted from sale (e.g., federal and state laws, a buy-sell or succession agreement, or a company's bylaws or charter);
- has greater risks when compared to stock ownership in larger, better-capitalized businesses with good management depth and financial substance; and
- may represent a minority position and consequently lack of control by that minority owner.

In addition, the loss of a business' only or principal executive — the driving force behind the company — also will support a discount, the assumption being

that the business is heavily reliant on the owner and that future sales and profits would be negatively affected by his or her absence.

Discount example: Let's assume a minority stockholder dies or wants to sell his or her 20% ownership position and the total value of the business is $1 million. Using a 30% discount, here's the value of that 20% ownership position:

Value of Business	$1,000,000
Value of 20% Ownership Position	$ 200,000
Application of 30% Discount	-60,000
Net Value of 20% Ownership Position	$ 140,000

Thus, this ownership position is worth $140,000, not $200,000. That same discount of 20% to 40% is generally applicable to other minority ownership positions, including stock gifted to family members and shares owned by an estate. *Caution:* Be sure you can document the discount and that it's reasonable. The IRS can question any discount which reduces the value of your estate, a gift, or other ownership transfers below fair market value.

* * *

When valuing a business for family transfers and potential gift and estate taxes, remember that you will no longer be around to defend the value. So document that value in writing, including all the reasoning and calculations. ☐

Exhibit 3

Know Trust Options and Cautions

Shifting assets and taxable income from yourself to your children or other family members through a trust can save taxes, provide more income for your family, and lower the value of your taxable estate. But be careful. Trusts — because of the federal and state laws and the administrative costs involved — can be complicated to set up.

Here are some trust options to consider.

- **Trusts and Custodial Accounts** — If you are setting up a trust or custodial accounts for your children, do not tie up so many assets that you are left with insufficient cash or liquidity to support yourself in your retirement years. You may be better off with a revocable trust (you can change the terms and conditions), especially if you're young or your future financial needs and income are at all uncertain.

Strategy: You can always set up separate trusts to cover different purposes (care of aging parents, children's college education, etc.) or to shelter different assets, e.g., placing higher-income-producing assets in the names of your children, particularly those age 18 and over, so the income is *not* taxed at your higher, marginal tax bracket.

Before setting up trusts, get advice from two professionals, principally your lawyer and accountant. Depending on the terms of the trust agreement, income may be taxable to the beneficiaries or the trust The tax rates on trusts are high at low income levels. For 2007, the top tax rate of 35% applies to trust income of $10,450 or more and the 33% tax rate to income between $7,651 and $10,450.

- **Insurance Trust** — You can provide for your family and substantially lower the value of your estate by *not* personally owning life insurance policies which would be included in your estate and taxed at rates up to 45%. An insurance trust can own the policies and be the beneficiary for your spouse and children. The trust can provide annual income to your spouse with cash benefits

(the principal) payable to your children upon his or her death. You also can structure the trust to permit your spouse to withdraw from the principal for medical emergencies and the children's educations.

Here's a simple example: If there is a $400,000 life insurance policy in the trust and it earns 6% after taxes, your spouse receives $24,000 annual income and has the ability to withdraw each year about $20,000 (5% times $400,000) for medical emergencies and support. That's a total of $44,000 annual income. Furthermore, your family saves up to $180,000 in potential federal estate taxes (45% estate tax rate times $400,000).

Don't rush into an insurance trust: Before setting up an insurance trust, project your spouse's cash needs after your death. Calculate the after-tax liquid (cash) value of your own estate and add to that amount your spouse's liquid assets. If the total is not enough to support your spouse at least through his or her life expectancy, forget about the insurance trust. You don't want to make the avoidance of taxes a high priority when your assets are needed to meet the future cash and lifestyle needs of your spouse. An insurance trust is an option only when you have assets in *excess* of what your spouse can reasonably be expected to need or spend in his or her lifetime.

- **Living Trust** — A living trust, which you set up and use during your lifetime, can be an attractive estate planning vehicle. The principal benefit is that you can control, change, or revoke a living trust at any time. It is popular because the assets in it do not pass through probate, thereby avoiding probate costs and also speeding up distribution to your children and other heirs. However, for tax purposes, living trusts are part of your taxable estate and there are legal and administrative costs involved.

Be aware: You must legally transfer title to the trust because the trust must actually own the assets if it is to be effective. Consult with your advisers before undertaking such a move. Also keep in mind that any income generated from a living trust is still taxable income to you.

Trust Cautions

1. *Study all the tax consequences of alternative trust arrangements carefully.* There's not just the current tax on income earned by the trust to be considered. There's also the gift tax involved in transferring assets to a trust for

the benefit of someone else and the potential federal estate tax if the trust is in your name or controlled by you at your death. And don't overlook applicable state laws. They can vary significantly in their tax treatment of trusts.

Alert: If you moved to another state since the trust was drawn, have the trust documents reviewed by a lawyer in the state where you currently reside.

2. *Determine how much control you want to retain over the trust and its assets.* Don't give up control or ownership rights casually. For example, if your children are the beneficiaries of the trust, they may choose to spend trust assets frivolously on something other than a college education unless you have retained some control over how the trust money will be used.

Be careful of establishing an *irrevocable trust* (terms are not subject to change); it may have tax advantages for you now but cause you serious financial problems later.

3. *Use experts to prepare documents:* Don't use inexperienced advisers when preparing complex estate, trust, and security sale and transfer documents. You want an expert who specializes in these areas and is knowledgeable and up-to-date on tax changes, IRS Revenue Rulings, and any proposed legislation which could affect your financial, tax, and estate plan going forward. □

Exhibit 4

Gift Today vs. Bequest through Your Will: Estate Planning and Capital Gains

Question. I recently received 500 shares of stock from my father. The market value on the date of the gift was $42 per share (a total value of $21,000). He originally bought the shares years ago at $12; the price is now $55. If I sell the stock, what cost basis do I use — $12 or $42 and how do I compute my capital gain?

Answer. Since the 500 shares were gifted to you while your father was alive, you assume his cost basis of $12 per share and his purchase date. Thus, if you sell the stock today at $55, it's a long-term capital gain taxed at a maximum rate of 15%. Your profit is $43 ($55 less $12 cost basis) times 500 shares, which equals $21,500. The capital gain tax is 15% of that profit, or $3,225.

Give shares through your will. If you have received the 500 shares *through your father's will*, your cost basis would be $42 — the fair market value of the stock at the time of his death. Your capital gain would be reduced to only $13 per share ($55 less $42) for a total gain of $6,500 and 15% taxes of $975. That's **$2,250 less tax** when compared to the $3,225 tax under the gifting method your father used.

There's a lesson here for business owners: Note the difference in the cost basis in the examples above — $12 per share if gifted while the doner is alive or $42 per share if given through a will. By "gifting" the same stock to the daughter now, for example, her capital gain tax would be $3,225 — or **3.3 times** the $975 tax if the shares were given to her through a will.

Now apply that 3.3 additional tax burden to the total value of your business, say $1 million-plus, and to the value of any ownership gifts you intend to make to family members. Since your stock's cost basis in the business is probably very low, *bequeathing* the shares through your will has *very significant* tax savings for your heirs. This same tax savings apply to your home and other assets you wish to give

family members. Another advantage to using your will to bequest the shares/assets is that you maintain control over them during your lifetime. The downside is the inclusion of those assets in your estate which is subject to federal estate taxation at rates up to 45% in 2007. In contrast, the maximum long-term capital gain rate is 15%. That's 30 more percentage points in potential taxes.

Back to the father's gift: Since the $21,000 value of stock exceeded the $12,000 annual gift limit for 2007, he has to file a gift tax return. The return is required even if he uses part of his $2 million lifetime exemption to shield the *excess* gift amount of $9,000 from gift taxes ($21,000 less $12,000 exemption). He would be better off spreading his gift over several years to stay within the annual limit. If his wife is still living, she can join in or consent to the gift for a total exempted gift amount of $24,000 a year.

Of course, gifts — even financial gifts of considerable value — are not made for tax reasons alone. There are many other factors that will influence your decision on when and how to distribute assets, including your heirs' need for funds at a particular stage of life (e.g., starting college, acquiring a business, buying a home), as well as your and your spouse's desire to retire or sell the business.

You also must consider the new estate laws enacted in 2001. For example, starting in 2010, the *stepped-up basis rule,* whereby an heir could receive assets at their current fair market value, is eliminated. Instead, the decedent's cost basis will be used to establish the cost basis for the heir, which means more taxation when the assets are eventually sold. *Exceptions:* $1.3 million for assets left to beneficiaries and $3 million for a surviving spouse.

What About Capital Losses?

Here, the tax scenario changes. Let's assume the stock falls to $8 and you sell it. Even though your cost basis is $12 per share, you *cannot* claim a capital loss of $2,000 ($4 times 500 shares). The IRS has a special formula for calculating cost basis on the sale of stock if the cost basis is above the stock's fair market value or the selling price. For the rules, see IRS Publication #551, *Basis of Assets*. To download the publication, visit the IRS website at www.irs.gov.

* * *

You have to analyze all the possibilities when planning gifts, beneficiary designations in life insurance policies, trusts, and estates. As usual, expert advice is always needed. Don't rush into deciding one component (e.g., gifts) *without* reviewing your entire personal and business profile and the effect of that decision on your overall estate plan. ☐

Exhibit 5

What to Know: Estate Planning and Repeal of Estate Taxes in 2010

Don't make the mistake of assuming that the repeal of estate taxes means you don't have to do any estate planning. *That's not the case for several reasons.*

First, all of the changes below *apply only* through 2010; the law itself **automatically expires** in 2011. Second, the phase-out of the taxes continues to take place over the next four years so estate plans must be carefully designed. Third, the new law passed in 2001 contained several negative provisions that in part offset the lower/eliminated taxes and carry their own new tax burdens.

- *Lifetime Exemption:* The lifetime estate tax exemption per taxpayer is $2 million in 2007, and then increases to $3.5 million in 2009. In 2010, the estate tax is **fully repealed** so no federal estate taxes will be payable in that year. However, in 2011, the estate tax laws are then **reinstated** effective January 1, 2011 at which time the lifetime exemption **goes back** to $1 million and the tax rate to 55%.

- *Estate Tax Rates:* In 2007, the top federal estate tax drops to 45% from 55% (before the new legislation) and stays at 45% through 2009.

- *Gift Taxes:* Starting in 2010, the top gift tax rate will be the taxpayer's top individual income tax rate. *Note:* The lifetime gift tax exemption **remains** constant at $1 million even though the lifetime estate tax exemption increases to $3.5 million in 2009.

- *State Death Tax Credit:* Under prior law, the state death tax could be used as a credit against a taxpayer's federal estate tax bill. Starting in 2004, the tax credit was eliminated and replaced with a tax deduction, which means more federal estate taxes through 2010.

Note on state laws: Most states currently have an estate tax that's similar

to the federal estate tax. While some states may decide to repeal or amend their estate tax laws, many won't. That means you will have to continue to take state taxes into account in drafting your will or planning for estate taxes.

- *Stepped-Up Basis:* Starting in 2010, the *stepped-up basis rule,* whereby an heir could receive assets at their current fair market value, is eliminated. Instead, the decedent's cost basis will be the established fair market value for the heir, which means more taxation when the assets are eventually sold. *Exceptions:* $1.3 million for assets left to beneficiaries and $3 million for surviving spouses.

What to do: The thing to keep in mind is that, under the old tax law, you could design an estate plan that provided maximum protection for your heirs no matter when you died. But, with the *annual* adjustments in estate tax rates and exemptions over the next four years, you might have to build annual adjustments into your estate plan also. Then, in 2011, when the 2001 tax law expires, you will have to do yet another estate plan to comply with and reflect whatever new law replaces it. □

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