

## Special Edition

# Successor Planning Part 8

I discussed the shrinking of the estate and various liquidity issues including the use of life insurance. This week, I want to address the issue of how to ease you out of the business.

Over the last 7 or 8 weeks, I've been discussing successor planning as it relates to:

- Selling to family members, or;
- Creating an employee succession plan.

I stated that depending upon how your business is organized; you can sell to your partners, a buy/sell agreement to your employees using ESOP or to your competitors. When you're making this important decision, you need to look more closely at other options for transferring the ownership of the business such as buy/sell agreements.

Buy/sell agreements are primarily intended to create a winning market for closely held business ownership. This agreement can be between the business and its owner or among the various owners. Frequently, the agreement will be backed by life insurance policies on all the principles, so ready supplied cash will be there when needed.

In a partnership, a buy/sell agreement is like a prenuptial agreement between the partners. For corporations, it's an attempt to set future value on a rational basis that may hold up on IRS scrutiny.

Buy/sell agreements can provide liquidity when the purchaser has funded the purchase price with life insurance on the descendants life. A further advantage of a buy/sell agreement is that it's an organized plan for the disposition of the business interest. An additional benefit; it can also establish the value for the purposes of estate tax. This can avoid expensive disagreements with the IRS over the evaluation of the ownership interest. First and foremost, the agreement insures your ownership interest can be sold at a price you decide is fair.

In addition, a properly drafted buy/sell agreement will set the estate tax value of the business ownership interest. In other words, the price your estate sells the interest for, will also be used as a value for calculating your estate tax obligation.

However, be cautious! You cannot set an artificially low value and attempt to save estate taxes by passing your business to relatives at a discount. Provisions in the Reconciliation Act of 1990 spell out the rules against "low balling". You should review this with your tax expert.

Specifically, there are 5 tests that must be met for a buy/sell agreement price to be agreed to by the IRS for the purposes of the legitimate estate tax evaluation. They are;

1. The buy/sell agreement must establish a realistic price. The method of determining the price must be outlined in the agreement. The intent is to make sure that the price isn't really an attempt to reduce the value and minimize estate taxes. It's crucial that you use an independent appraiser to verify your evaluation method as a reasonable move. Someone such as Ahern.

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2. The price set by the buy/sell agreement must indicate that the agreement is a bonified business arrangement and not a disguised request to family members. The tax law and regulations are silent on how to meet this rule; however, you should be alright if you can demonstrate the purpose of the buy/sell. Such as; to maintain continuity of ownership and management.
3. The buy/sell agreement must obligate the descendents estate to sell the ownership interest at a price in excess of the price stated.
4. The buy/sell agreement must prohibit the lifetime transfer of the ownership interest at a price in excess to the price stated, and;
5. Its terms must be comparable to similar arrangements negotiated at arm's length transactions. Buy/sell agreements meet this rule if the agreement could have been negotiated between two unrelated parties. Hiring an expert to review the terms and conditions is advisable. It's important to understand the burden of proof is always on the tax payer to prove that the agreement is consistent with market practices.

**Executing and drafting a buy/sell agreement requires careful planning.** Finding an attorney confident in section 2703 of the Internal Revenue Code, which is where estate tax rules cover buy/sell agreement, is critical. Ahern has a list of confident attorneys if you're interested.

**Next week, I will discuss private annuities and how they can be used as a business succession tool.**

**QUOTE OF THE WEEK: “The end may justify the meanings as long as there is something that justifies the end.”**