Business Succession Planning – Traps and Opportunities

Mark J. Marroni

Mark J. Marroni, J.D., LL.M., is the managing director for the Boston Partners office of John Hancock Financial Services. Prior to his work in the field, Marroni was a director of John Hancock's Estate & Business Planning Group and was formerly engaged in private practice as a trusts and estates attorney. Currently, he serves as president of the John Hancock Managing Directors Association. He received his J.D. magna cum laude from the New England School of Law, and he earned an LL.M. in taxation from New York University School of Law.

Boston Partners
138 River Road, Suite 310
Andover, MA 01810
Phone: 978.689.6930
E-mail: mjmarroni@sfnonline.com

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Overview:

Business succession plans are simple concepts which often lead to significant planning problems. We will review several planning concepts, uncover common traps for the unwary, and design planning opportunities for the prepared.

The Background Basics

Let's review the typical business organizations which we often run into in doing this type of planning work. These include C-Corporations, S-Corporations, Partnerships, Limited Liability Companies (LLC's), Limited Liability Partnerships (LLP's), Professional Corporations (PC's), and Sole Proprietorships. A discussion of the organizational structure, the pros and cons of forms of ownership, and why one would choose a particular organization are outside of the scope of this presentation. What I want us to focus on is the basic taxation issues facing these owners and where the tax burden lies.

In general, you either have taxation at the entity level or you have a pass-through type organization. The former will have two levels of tax, one at the entity level and one at the shareholder level. The latter will have no tax at the entity level but will instead pass-through all of the tax burden to the shareholders or owners. It is important to know where and how your clients are taxed so you can properly structure a business succession plan or Buy/Sell.

The table below will give you a simple overview of each entity and how it is taxed:

Entity	Tax Rates
C-Corp	15% - 35%
S-Corp	None (pass-through)
Partnership	None (pass-through)
LLC/LLP	None (pass-through)
P.C.	35%
Sole Prop	15% - 35% (Owner is the business – i.e. no entity)

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Next, I want to briefly discuss how you can get cash out of a Corporation. There are only two ways. (Some of you may list a third using a section 83 transfer. However, that really applies to transfers of "property" out of a Corporation and is beyond the scope of this discussion.) One way is to pay it to the owners. In general, payments of compensation are deductible to the Corporation and are income, and hence taxable, to the shareholder/owner. The second way is to dividend it out. Dividends are a distribution of earning and profits of the Corporation. While the Corporation does not receive a deduction of these distributions even though it has paid a corporate level income tax on its earnings and profits, the shareholder who receives these dividends must nonetheless include them as income incurring additional tax. This is the basis for the so-called "double-tax" on corporate earnings.

That is all we are going to talk about concerning business organizations, cash flows, and corporate taxation. We will, however, refer to these principles as we discuss planning concepts.

One final background tax concept we need to talk about is "Transfer for Value." Transfer for Value is a tax concept concerning the transfer of life insurance policies. As we all know, life insurance, as a financial product, enjoys outstanding tax characteristics including a deferral of tax on the inside build-up of cash value and an income tax free death benefit. These tax preferences are deeply rooted in public policy which favors and promotes the ownership of life insurance by individuals and families. These attributes are outlined in the tax code in §101.

The "Transfer for Value" rule, applies to situations where a life insurance policy is sold or exchanged or is otherwise transferred to another owner in a business transaction. Public policy generally frowns upon such transfers and as such the code, under §101, removes the tax preference and subjects the death benefit to income tax to the extent it is in excess of the purchase price of the policy. A contemporary example of this is in the viatical life insurance business. Here transfers for value happen all the time.

We look for Transfer for Value problems in the Buy/Sell Planning work that we do. Knowledge of the doctrine will be used to discredit current planning, to disturb, and to create new planning opportunities. It can definitely be a trap for the unwary, but it can also present fantastic opportunities for the prepared.

There are several exceptions to the harsh application of the transfer for value rule including:

1) A transfer to the insured,
2) A transfer to a partner of the insured,
3) A transfer to a partnership in which the insured is a partner,
4) A transfer to a Corporation in which the insured is an officer or shareholder,
5) A transfer in which the transferee's basis is determined by reference to the transferor's.

The last one is a fancy way to say that the transfer is a gift. In other words, the "value" received by the transferor is love and affection. Wouldn't it be easier to say gifts are exception to the rule? Don't you just love lawyers?

Finally, every well-constructed Buy/Sell Plan must have a method to value the business defined in the plan. Business valuations are an art and definitely not a science. For large businesses or potentially contentious situations, a formal valuation should be done by a professional business valuation firm. These are often also done by CPAs and attorneys. They are expensive and time consuming. For most businesses, the owners themselves can adopt a method to value the business. As long as the method makes generally good business sense, the IRS will most likely accept it. The assumption is that business partners will decide on a value at "arms length." In other words, each will bargain for the most value for themselves. This would not be true in a closely-held family business where you could have "love and affection" issues affecting valuation. The IRS is concerned about below market valuations in these situations in that the family may strive to undervalue assets for transfer tax considerations.

Many producers new in the business or starting to work in the business market often are very concerned about the

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valuation aspect of the planning process. I suggest they let the lawyer/CPA work that out with the client business owner. In fact, the easiest way to start defining a value is to simply ask the owner how much he or she would sell the business for today. They will always have a figure in mind. Often the only issue is that they usually overvalue their businesses in their own minds and we then, perhaps, sell them more insurance than they may have required. If the owner dies prematurely, the only downside is the family will be in an even better financial situation.

While on the topic of values and insurance, let me also comment briefly on how much life insurance is needed to fund a Buy/Sell Plan. This will, of course, be determined by the value of the business. However, I strongly encourage you to help your clients "buy some of their tomorrows today" and over fund the plan. Their businesses are growing and they will need additional funding later but they have their health now. In a worse case scenario, in the event of a "premature" death, the extra funds may go to the family or can be positioned to solve multiple needs such as key-man funding.

Buy/Sell Concepts – Cross Purchase Plans

Cross Purchase Plans are probably the simplest and most widely used of all Buy/Sell Plans. At the heart of all Buy/Sell Plans is a Buy/Sell Agreement. This is a formalized document which outlines the provisions of the plan. In its most basic form, the Cross Purchase Buy/Sell is an agreement between two or more business partners. The lawyers may say not all of the business owners are true partners. Many, and possibly most, of the clients we will see in our practices are shareholders and hence the term co-shareholder should technically be used. However, I strongly urge you not to use legalistic terms like that when dealing with your business owner clients. They would never call themselves or refer to each other as co-shareholders. They will most likely refer to themselves as partners or business partners even if they technically are not. I suggest that we do the same.

The first step to put a Cross Purchase Buy/Sell in place is for the partners to agree to a succession plan. The legal Buy/Sell or Agreement will state that Owner A will purchase Owner B's interest in the business when he dies and vice versa. A most important element of the Agreement is that there is compulsion on both sides of the Agreement. Both A and B must sell and both must purchase each other's interest from their respective estates per the terms of the Agreement.

Let's now walk through what happens from a financial and tax perspective. We have a business called "A&B Painting." Let's call it a C-Corporation. We'll assume that it is worth $600,000 and that each of the "partners" has a 50/50 ownership interest in the business. Let's also assume that each of them invested $25,000 in the business to start it up.

First, a Buy/Sell Agreement will be drafted and entered into by A and B. The Agreement, as we previously reviewed, basically states that if A dies first, B will purchase his share from A's estate for the value that they have agreed upon per the valuation terms of the Agreement. It works the same if B should die first. Each party is bound to act; i.e., to both buy and sell. This compulsion is binding on their estates as well. In addition, notice that the Agreement is solely between the owners, the Corporation is not a party to the Agreement.

What happens if one day B falls off a ladder while reaching to paint the peak of a house? The ladder is in a back of a pickup truck parked three stories below on the driveway. B falls to his untimely death. Per the Agreement, A must buy B's ownership interest from B's estate. Since they were 50/50 owners, B's interest in our example is worth $300,000. A must buy B's shares for $300,000 in cash. Notice that there is no provision for A to pay over time or on terms. The Agreement states that the full amount will be paid to B's estate. How does A come up with the funds? You guessed it ~ Life Insurance. We would have A own a policy worth at least $300,000 on B's life and B would own a policy worth $300,000 of A's life. They would each be the owners and beneficiaries of each other's policy. In this way when B dies, A would receive $300,000 of death benefit proceeds. Is he taxed on the $300,000? No, it is a death benefit and is thus received tax free.

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Let's walk through the financial and tax consequences of the transaction. Let's look at B and his estate first. Before he fell and died, B had a Fair Market Value (FMV) in his 50% share of the business worth $300,000. His basis was $25,000. Therefore, if he had sold his interest prior to this death, his gain would have been $275,000. Would that have been taxable? Sure, it is fully taxable as income to him, either ordinary or capital depending on how long he held it. How about after his death? What is the FMV to B's estate? It is the same $300,000 defined in the valuation section of the Agreement. Assuming that the value was agreed upon in an arms-length Agreement, the IRS will almost always honor it for estate purposes. What is the basis to the estate on the 50% ownership interest? $25,000 or something else? The estate will enjoy a step-up in basis of this property upon B's death. The property's basis will be stepped up to FMV at the time of death which is $300,000. Therefore, the gain to the estate will be zero! A is treated as purchasing the property for $300,000 and B's estate has a basis of $300,000 so the gain in the sale is zero.

Let's look at A's side of the transaction. Before B's death, he had a 50% ownership interest worth $300,000, and a basis of $25,000, and a potential taxable gain of $275,000. How about after the Buy/Sell transaction? The FMV now is $600,000 representing 100% ownership of the business. His 50% interest plus B's former 50% interest. What is the basis? It was $25,000 on his previous 50% interest and it is $300,000 on his new 50% interest from B. Total basis is now $325,000. His gain if he sells the business after B's death is $275,000. That looks wrong! It's the same gain before and after but he owed half the business before B's death and all of the business afterwards. That is the inherent beauty of the Cross-Purchase type of Buy/Sell. The entire step-up in value to B's estate is essentially transferred to A. A is now the 100% owner of the business but he is in the same tax liability situation as he was before. Furthermore, B's estate got its full value of $300,000 income tax free.

What else happens at this time? If A and B had "purchased some tomorrows today" and had funded the $300,000 obligation with, for example, $500,000 of death benefit, we would have some excess cash to consider. In this scenario, A still has $200,000 in tax-free death benefit left after buying B's share. He could then contribute this to A & B Painting in the form of a capital contribution. This will raise his basis in the company by the additional $200,000. The business will then have key man replacement funds to hire a replacement for B. Not a bad way to use the excess death benefit. Have you ever met a widow or a new business owner with too much cash?

But there is still another loose end. B's estate still owns a life insurance policy on A's life. I usually suggest to my clients that they include an option in the Buy/Sell Agreement for the surviving partner to buy this policy from the decedent's estate. This is another use for the excess death benefit. In this manner, B's estate gets additional dollars and A gains control of his own policy.

Hey, wait a minute. Isn't that a transfer for value? Didn't A buy a policy for value and didn't B's estate transfer it to him? Yes, it is indeed a transfer for value. However, remember the list of exemptions. This transfer was to the insured himself and is therefore not subject to the harsh results of the transfer for value rule.

Let's review the planning opportunities of the Cross Purchase Buy/Sell Plan. First, as we have seen, it is very simple to explain, simple to put in place, and simple to understand and administer for your clients. Second, it effectively captures the step-up in basis from the first to dies estate and transfers it to the survivor. This is a real advantage when the survivor ultimately sells the business. Remember, he will probably sell it during his lifetime and will therefore not enjoy a step-up in basis like B's estate did. Third, in closely held family businesses, the Cross Purchase helps avoid family and estate attribution rules. Fourth, it offers an outstanding opportunity to introduce life insurance as the funding mechanism of choice both for the Buy/Sell obligation, as well as potential key man funds and cash for the survivor to buy his own policy from the partner's estate. The Agreement has allowed the surviving partner to retain control of the business. He is not in the awkward situation of having the spouse or

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children of the deceased owner suddenly become a partner in the business. And finally, these Agreements provide a ready and able cash buyer for the decedent's business interest thus providing his family with much needed and appreciated funds.

Let's now talk about potential problems or traps for the unwary in the Cross Purchase Buy/Sell. First, there is often a problem of too many policies. If there are two partners A and B, you need two policies. However, if there are three partners you need six policies ~ Both B and C need one each on A. A and C each need one on B, and A and B each need one on C. Six policies. The formula is n (n-1) when n-equals the number of owners. As you can see, with more than three owners, the number of life insurance policies needed to fund the Agreement gets to be administratively unwieldy. Often times, we will suggest a redemption or entity plan instead to avoid this problem.

One other potential idea to avoid the multiple policy issue is to use a Trusteed Cross Purchase Plan. In this scenario, a third party owns a policy on each partner "in trust" for the others. In the previous example of a Cross Purchase Buy/Sell with three partners, A, B, and C, let's look at what happens on the first death. We'll assume that C dies. The trustee will use the death proceeds from C's policy to buy out C's estate and will then transfer C's former business interest to A and B. On the surface, this seems to work great and be the solution to the issue of too many policies. It also makes a third party Trustee responsible for owning the policies and paying the premiums. It even removes potential creditor claims issues of a partner which may impede his or her ability to effectively act as the buyer in the Buy/Sell transaction. The problem is that the IRS has never issued a formal opinion on the tax consequences of this type of Cross Purchase Plan. Many tax commentators contend that a transfer of value exists when A and B's beneficial interest in the policies on their own lives, held by the Trustee, change from 1/3 interest in each before C's death to ½ interest in each after C's death. It is an unsettled area of the law and for that reason, we most often do not recommend Trusteed Buy/Sell Plans. However, a quick side note: Not to get too far off track, but many planners have A, B, and C from a partnership on the side. For example, to own equipment or real estate. In that manner, they then argue that an exception to the transfer for value rule exists because any change in ownership interest in A and B's policies, even if deemed to be a "transfer," are an exception from the rule since the transfers are to a "partner of the insured." Pretty neat!

Now, back to traps or problems. In the Cross Purchase Plan, we also have no "Corporate" control of funding for the life insurance policies. Each partner must rely on the other to properly and adequately fund the life insurance contracts and to pay the premiums. If B dies and the policy A is supposed to have on B has lapsed due to non-payment of premium, B's estate is out of luck. Sure they have legal recourse, but it can be costly and time consuming. This is not often a problem, but when it is, corporate funding with an entity type plan may be the answer.

Another funding problem with Cross Purchase Plans occurs when the two partners have dramatically different premium costs for their policies. Health, smoking status, age, avocations, etc. may all affect the cost of the policy that the other partner must bear. When there are wide discrepancies in the cost of coverage, an entity level ownership of the policies and an entity level plan may again be the answer. In the alternative, the business could give additional compensation to the partner with the increased costs. The solution will depend on the particular clients and their relationship. Sometimes the younger, healthier, skinnier, non-smoking partner will simply acknowledge that the other guy will probably pass away first and he will end up with the business.

The final trap for the unwary can really be looked at as an opportunity for the prepared. Often times, when you meet a business owner client who already has a plan in place, you will find one of three things: 1) the plan is unfunded; 2) the plan is under-funded, or 3) the plan is funded but ownership and beneficiary designations are wrong. The first two are pretty easy. They both create opportunities to help your client and to place additional life insurance to ensure proper funding of the plan. The last one is more problematic.

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Misfunded plans and incorrect beneficiary designations are so common that it is scary. Let's take a look at the three most common situations. First, the Cross Purchase Buy/Sell is in place but A owns a policy on A and is the beneficiary and B owns a policy on B and B is the beneficiary. On B's hypothetical death, the estate would own B's shares of the business and would receive the death proceeds for B's insurance. Not bad for the estate, but A is out in the cold. This type of situation must be reworked. A must purchase a new policy on B and B on A. The current policies can either be kept individually or can be transferred to the company as a capital contribution to be used as key man policies. There is no transfer for value since the policies are being transferred to the company which will satisfy an exception to the rule. If there are underwriting problems, the only way to fix this is to transfer as above and re-write the plan as an entity plan.

The second scenario you will find usually has a Cross Purchase Buy/Sell Plan in place but the company owns the insurance and is the beneficiary. Again, the survivor must own the insurance and be the beneficiary on the decedent's policy, not the company. To fix this situation, many planners try to assign A's policy to B and B's to A. First, there is a tax consequence to this transfer ~ remember our discussion on moving cash or assets out of a Corporation. Second, it is a transfer for value with no exceptions. Ouch. That hurts. The situation, typically, is to apply new insurance on A and B properly owned. The existing insurance owned by the business can be used for key man insurance or can be transferred to the insured's upon sale or dissolution before death.

The third scenario is also very common. In this one, A owns A's policy and names B as the beneficiary and B owns B's policy and names A as the beneficiary. The service has ruled that this again constitutes a transfer for value. Ouch again! The service has rationalized that the only reason that each owner names the other as the beneficiary of the policy on their own life is for the corresponding naming of themselves as a beneficiary on the policy held by their partner. This constitutes value and the payment of the death benefit to the other partners constitutes a transfer. Thus another transfer for value problem. There is no way to fix this other than with new policies. Existing policies can be kept or transferred to the company to use as key man. In addition, as in the first example, underwriting concerns may also necessitate assignment to the company and a new entity-based Buy/Sell Plan put in place.

As you can see, the "simple" cross purchase plan is often not so simple. Traps for the unwary abound. However, for the prepared professional, there are many opportunities to bring great value to your clients and place life insurance to create outstanding tax advantages.

Buy/Sell Concepts – Unilateral Plans:

Unilateral Buy/Sell Plans are very similar to cross purchase plans. The main difference is that there is only one potential buyer and one potential seller. The way they work is the owner will enter into an Agreement with the buyer. The Agreement will state that upon the owner's, death, the buyer, is obligated to buy and the owner's estate is obligated to sell his business interest. In this scenario, the buyer will purchase a life insurance policy on the owner. Cash flows and tax consequences will be the same as in the previous discussion of the Cross Purchase Plan. The descendant's estate will receive a step-up in basis and will therefore have no gain on the side of the business interest to the buyer. The buyer will have tax free receipt of the death proceeds and will enjoy the full step-up in basis in the newly acquired property. Seems like a good deal and both parties are happy and get what they want.

Why do people enter into these types of Agreements and how should you position them in your planning and sales presentation with your individual business owner client? First, I suggest that you discuss the potential traps for the unwary with your client. Explain that as a sole owner, when he dies his family and estate may face considerable problems including estate liquidity issues, insufficient funds due to "fire sales", and loss of going concern value. A Unilateral or One-Way Buy/Sell is a great way to address all of these. First, it creates a ready, willing, and able market for the business at a pre-determined value. What a great way for an owner to bring in a

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younger manager. Give him or her a Unilateral Buy/Sell so he or she knows that they will own the business when the older owner passes. This not only creates a market for the owner but places huge "Golden Handcuffs" on the manager! In fact, the owner can even bonus the manager the cost of the premium on the policy he will use to buy-out the estate further tightening the "Golden Handcuffs" while also essentially self-funding his own buyout. I love Unilateral Buy/Sells!

Buy Sell Concepts –
Stock Redemption or Entity Plans:

A Stock Redemption Plan is very similar to a Cross Purchase Plan. At the heart of the plan is an Agreement. The major difference is that the Agreement is between the company and each owner, not between the owners themselves. Let's walk through the mechanics and tax consequences.

Let's again assume that we have a business, A & B Painting. Like before, it is a C-Corporation with a FMV of $600,000. A and B are equal 50/50 owners and each has a basis in their stock ownership of $25,000. They each have an Agreement in place with the company that essentially outlines that the company will buy (redeem) their stock from their estate and the estates will sell it to the company. Both parties are contractually bound to act.

Assuming again that B dies first, what happens? First, A & B Painting will submit a death claim and it will receive a check for death proceeds in the amount of $300,000. Is this taxable to the company? No. Just like before, this constitutes tax-free death proceeds. But how does the cash get to B's estate? As we initially discussed, the only way to get cash out of the Corporation is to pay it out as compensation or a dividend. Here it is clearly not compensation so that leaves dividend treatment. The company dividends the $300,000 out to B's estate for the stock worth $300,000. The company now owns the stock as treasury stock and the estate has the cash which it received as a dividend. Is the estate taxed on the dividend it received? No. There is relief from dividend treatment under the code if the dividend is paid in complete consideration of the owner's entire interest in the company. If this happens the transaction is re-characterized as a sale or exchange and the estate is treated as having sold the stock for $300,000. Since the basis to the estate is stepped-up at B's death to the FMV of $300,000, we see that there is no gain on the sale and the estate has no income tax liability. Thus, from an income tax and financial prospective, B is in the same position as he was under the Cross Purchase. What about A's position?

As noted, A was not a party to this transaction. Before B's death, A owned 50% of the company worth $300,000 with a basis of $25,000. However, after B's death, A owns all of the company worth $600,000. What is his basis? Is it still $25,000? If he were to sell, he would have gain of $475,000! All of B's step-up in basis has been lost.

With this negative tax result, especially when compared to the Cross Purchase, why does anyone enter into such entity based plans? There are several planning reasons why they may be attractive. First, it moves the insurance and funding to the company thus avoiding some of the financial fairness issues we previously discussed. It also positions the plan to use the company checkbook to pay premiums. All business owners, especially small business love to use the company checkbook for anything they can. This is the same reason you find so many mis-owned and mis-funded Cross Purchase Plans. Second, when the dividend payment is made in the redemption, it is deemed to distribute retained earnings and profits on a pro-rata basis. This can be very important from a tax planning prospective. It is always an important point to discuss with you client's CPA. And third, it involves less insurance policies when dealing with multiple owners than does a Cross Purchase Plan making it easier to administer.

How about traps for the unwary in relation to these plans? There are several to consider. We already discussed the lost step-up in basis. Essentially, the survivor winds up paying his partner's income tax. Second, any time you own life insurance on the company books, your client is potentially subject to AMT or alternative minimum tax problems. Another negative and trap for the unwary is that the life insurance, while held by the individual owners

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in a Cross Purchase Plan, usually is afforded creditor protection under state law. When the insurance is held by the business, it becomes a business asset and thus subject to the claims of business creditors. Finally, the redemption obligation per the Buy/Sell Agreement may constitute a liability under FAS 5 and/or FAS 150. Again, talk to your client's CPA about this potential situation.

What do you do if you find a client who has an Entity based Stock Redemption Buy/Sell Plan and you believe that they would be better served by using a Cross Purchase? The Agreement can be terminated and a new Cross Purchase Agreement can be put in place. It is always a temptation to then suggest (or your client will) that the life insurance policies owned by the company be transferred to A and B to fund the new Cross Purchase Plan. A would get B's policy and B would get A's. Does this work? No, you guessed it ~ it is a Transfer for Value. We usually suggest that new policies be put in place. The existing policies can then be left in the company as key man insurance.

Advisors, CPAs, and lawyers, often suggest that Redemption Buy/Sell Plans can be avoided by using a Section 303 Redemption. What is this all about? Section 303 of the Internal Revenue Code basically states that a shareholder's estate may transfer stock to the Corporation in an amount no greater that the estate tax liability plus administration costs and avoid divided treatment by having the transaction treated as a sale or exchange. This is definitely true. The problem is that there is no funding mechanism in place in the company to affect the Section 303 Redemption. In addition, the company doesn't have to perform the redemption, there is no compulsion. Finally, the redemption is limited to the estate tax plus administration cost value. What happens if the deceased partner's ownership interest was worth much more than that? Where will the estate find a ready, willing, and able market for a limited interest in a closely held business? For these reasons, I therefore believe that Section 303 Redemption sounds good in theory but have too many negative issues and problems to be effective.

As you can see, Stock Redemption or Entity Buy/Sell Plans have their uses and their limitations. The prepared practitioner will always find himself or herself in position to use them effectively or to plan against them.

Last thoughts on Traps for the Unwary:

Finally, I want to just touch on a collection of potential Buy/Sell triggering events other than death which the prudent planner should consider and discuss with his or her client. These include: 1) Disability ~ Many Buy/Sell Agreements have provisions for a buyout on disability. These are funded using appropriately placed DI policies; 2) Divorce ~ We have very infrequently seen a buy/out trigger in the case of "business disruption" in pre-divorce situations; 3) "Bad Boy Clauses" ~ This would entail a forced Buy/Sell stemming from termination of employment; and 4) Bankruptcy ~ of a partner has been used to trigger a Buy/Sell as well. In addition, it is often a wise idea to either limit or have a strict right of first refusal on lifetime transfers in closely held businesses.

Conclusion:

Overall, it is my hope that our time today has helped you form a firm understanding of the cash flows and tax ramifications of Business Succession Plans. Furthermore, it was my intention to really try to help identify hidden Traps for the Unwary as well as Opportunities for the Prepared that are inherent in this type of work. There are so many ways to really help your business owner clients in this area of planning. I hope you will include this type of work in your practice and it is my sincere hope that you enjoy it as much as I do.