

## Business Continuity: Using a Low Valuation for Lifetime Transfer Events

Today we are going to talk about valuation in business continuity arrangements. Business continuity arrangements must cover both lifetime and death events. Your challenge (and that of your advisors) is to establish a valuation that is consistent for both events.

As a general Exit Planning principle, we assign the lowest defensible value on a company except when we anticipate a sale to an outside third party for cash.

Unless you (the owner) anticipate selling to an outside party for cash, you will receive much of payment for your ownership interest in the form of deferred compensation, rental income, etc. The value of your stock (for tax reasons) will be minimized.

Expect to see your advisors employ this same concept when they design the transfer at death provisions in your buy-sell agreement. Why? First, the IRS does not look kindly on two different valuations of the same business interest: one high (because life insurance is funding the buy-out), and one low (designed to avoid the double tax consequences of a lifetime purchase of stock). Therefore, we create consistency by using the lowest defensible value for both life and death transfers.

### How does this apply to a "real" situation?

Curly and Moe were two equal owners of a business—one that could possibly be sold to an outside third party for \$5 million. Because one of Curly's objectives was to leave the business and transfer his ownership interest to Moe (and/or a group of key employees including Larry and Shemp), the more tax-efficient design would be to sell the Curly's interest at the lowest defensible value and have him receive a significant part of the cash through the direct receipt of future income.

To achieve that goal, we typically use non-qualified deferred compensation plans, royalty and licensing fees, and increased rental fees (with respect to real property or equipment rented or leased to the company).



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These tactics serve both to reduce the value of the business (because they create financial obligations on the part of the business) and to provide a justifiable reason to pay money directly to Curly after he leaves the business.

Should Curly die before his lifetime exit begins, (or is complete), Moe would probably want to receive \$2.5 million dollars for Curly's ownership interest rather than the lower value used to reduce income tax consequences on that lifetime sale.

The difference between the lifetime value Curly is entitled to and the total amount of money he wants for his family (if he dies) can be made up if Curly acquires life insurance on his life for the difference between what Moe must pay him and what Curly wants for his family. That insurance must be owned outside of Curly's estate (perhaps in a revocable life insurance trust or perhaps a partnership).

This technique (insuring a buy/sell agreement using a lower value and having the owners replace the "lost value" by acquiring life insurance outside of the buy/sell agreement and outside of the estate) can also be used when one co owner is not insurable or one co owner does not wish to acquire life insurance. It is critical to obtain the services of a certified valuation appraiser to ensure that the valuation used is both appropriate and defensible (if the IRS should question it).

Typically, the owner of the additional insurance is an Irrevocable Trust or partnership. Asset protection and estate tax avoidance are natural by-products (and additional benefits) of this design. This technique also allows the other co owners to acquire the needed life insurance on their own lives so that should they die before a complete lifetime exit, their families will receive the full value of their ownership interest.

When planning for the transfer of your ownership achieving valuation consistency is both necessary and attainable. The techniques described in this article can help you save income taxes (if there is a lifetime transfer) as well as estate taxes (if you exit the business unexpectedly).

As always, in this and all exit planning situations, you should use capable and experienced advisors to help you leave your business in style.

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