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Entrepreneurs Need Succession Planning

Introduction

What is the biggest threat to your business? When asked this question, many business owners respond that the biggest threats to their business are health insurance costs, pensions, taxes, the economy, demand for their product and competition. These factors in the near term are certainly very legitimate concerns; however, there is one threat that is more certain to happen and more detrimental than any of the factors listed.

The absolute biggest threat to any closely held business is the loss (through death or retirement) of the owner of the business when no succession plan is in place.

The threat is very real. Nationally only approximately 35% of businesses passes one from generation to the next successfully. The percentage is much less for the third generation and the percentage is near zero for the fourth generation.

Often times, substantial family wealth is lost. A lifetime of work of the original owner is lost because no succession plan is in place at the time of his or her death. Family members who worked for the company find themselves without jobs, without income, and without the opportunity to file for unemployment. People who depended on the firm for money

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A CASE STUDY: Key- Man Insurance

In a Letter Ruling, an S Corporation requesting guidance was instructed that Key-man Insurance was recognizable in the year of the key-man's death. In the immediate case, the shareholder's purchased a key-man insurance policy for their key-man. Thereafter, the key-man

died in one year and the proceeds were received in the next year. The S Corporation requested guidance on when the proceeds should have been included in the company's capital accounts. The IRS determined that since the taxpayer was an

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are forced to take lower paying jobs to feed themselves. The unfortunate part is that had the business created a succession plan, the business might exist today. Businesses that have a succession plan face much greater odds of surviving.

What is a Succession Plan?

A succession plan is a process where the business owner and a professional build a plan of action and take appropriate measures to ensure a business passes smoothly from one generation to the next. In the process, the professional will meet with the owner, the family, and others to determine what the owner wants and what can be done to achieve that goal. Many documents will be drafted, very likely insurance will be purchased, and other actions will be taken to achieve the result desired. The owner is typically involved as little or as much as he or she desires.

How Does a Succession Plan Help?

Businesses face many challenges if the owner of the business dies or retires suddenly. There are two very important problems facing businesses upon the removal of an owner. The two problems are so detrimental, that businesses often do not survive if the owner dies suddenly.

The first major problem is estate taxes. If a business is contained in an estate valued to be worth \$2,000,000 or above, that estate must pay taxes per the applicable estate tax rate. This often presents a huge problem for the business in the fact that most businesses or people cannot pay what the IRS demands it to pay. The company is often forced to liquidate on unfavorable terms. Building a succession plan in this instance would allow the owners



and their professionals to project the value of the estate and its cash needs to pay the estate taxes due. When the owner dies, the procedures from the plan come into play. Second, when an owner dies or retires from a business, certain “holes” are created. The owner may have been the only person who did billing or had their signature on checking. If the owner departs suddenly, these “holes” can become insurmountable obstacles. In fact, these obstacles are so challenging, that they commonly destroy the business. If a succession plan is in place, these “holes” may be taken care of in advance or at least the original owner would have the opportunity to give guidance in advance of the departing event.

Conclusion

Most businesses (67% in fact) do not have a complete business succession plan in place. Given the importance of a succession plan, business owners would be well advised to have a complete succession plan from the filing of the articles of incorporation to the retirement of the owner. If the owner dies suddenly, the family can often find itself in a very unenviable position and be forced to liquidate. The Center routinely builds succession plans and would be happy to develop one for you. Contact The Center for Financial, Legal and Tax Planning, Inc. if you have any questions.

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that since the taxpayer was an accrual taxpayer and all events had been realized to give rise to the amount, it was proper to include the proceeds in the year of the key-man's death.

Editor's Comment:

Had this S Corporation been on a cash method, the guidance from the IRS would have netted a different result. First, in this case, the taxpayer was an accrual method taxpayer. This means when all events are realized giving way to revenue, the amount realized must be booked. According to the contract, the life insurance was to be paid in the event of the key-man's death. There were no contingencies. Therefore, the insurance company had no choice but pay upon receiving the death certificate and statement. Since these acts were ministerial in nature, they could not be counted as a contingency and the proceeds had to be booked in the year of death.

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Role & Importance of Seller Financing

Almost without exception, all business sellers would prefer to get 100% of their selling price in cash at closing – and for some very good reasons. Most sellers have heard horror stories about other sellers who sold their business for little or no cash down, and carried a seller's note for almost the entire purchase price, and lived to regret it.

Nonetheless, I generally coach my selling clients that they should be prepared to take back a least a small seller's note – perhaps for only 10% of the selling price – if the need arises.

Often when the seller insists on getting 100% cash at closing, the buyer, his banker and other advisors, begin to suspect that perhaps the seller knows something is about to go wrong with the business, and is eager to get as far away as possible. One study focused on the impact zero seller financing has on selling price, and concluded that businesses which sold with zero seller financing, sold for as much as 40% and 60% less than comparable businesses.

Studies have shown that 70% of all business sales include some element of seller financing. This is particularly true of smaller businesses. One study concluded that in over half of all businesses sold, the seller financed over 50% of the selling price. Some businesses which are particularly difficult to "bank," such as construction contractors, may be almost unsalable without significant seller financing.

Another benefit of taking even a small seller's note and treating the transaction as an installment sale for tax purposes is that it may reduce the seller's total tax burden.

If you know of a business owner who's thinking of selling and who might benefit from a free consultation, have them contact me, or any of the M&A professionals at The Bradway Group.

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Frequently Asked Questions

Q: Are active partners in a partnership considered to be employees or self employed?

A: Partners are considered to be self employed. The disadvantage to this is that all income earned by the partnership is subject to self employment tax. Owners of formal entities such as S corporations only pay Medicare and social security taxes on compensation. Their distributive share is not subject to employment taxes.

Q: I just purchased a computer. Can I deduct all of it immediately or must I depreciate the computer over a number of years?

A: The entire cost of the computer can be written off in the first year. Section 179 allows business taxpayer to deduct up to \$108,000 in 2006 provided the business did not invest over \$430,000 in said year. Otherwise, the business can deduct the cost of the computer over a 5 year period provided the computer is used for business 50% or more.

Q: For business travel, is the deductibility of meals limited?

A: Meal deductibility is limited to 50%. In order for the meals to be deductible, the traveler must be away long enough to justify the need for sleep or rest to properly perform the job function. When the meal is purchased, the traveler must be able to substantiate the expense with a receipt. If not, the traveler can use a standard meal allowance in its place.

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