volume 26, number 4

assets
a business, tax, and financial newsletter

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Business mergers, takeovers, and buyouts are still occurring at a phenomenal rate in the U.S. Savvy business owners are reaping top dollar as payment for their sweat equity in their companies. If you were to place your business on the market, would you readily know its worth? Surprisingly, very few business owners do.

What's It Worth to You?

Malcolm Forbes once said, "People overvalue what they are not and undervalue what they are." The same can be said of determining the value of a business. Setting the price (and getting a good one) is often the most important aspect of the transaction.

Some business owners base their companies' worth on their years of "sweat equity." However, that doesn't have anything to do with market value. To learn the true value of your business, you need a more scientific approach, starting with a valuation method. The most common methods are the following:

1. *Comparables*—Value is determined by the ratio of sales price/earnings of recently sold companies (similar in nature to your own) multiplied by either your earnings or your revenues.
2. *Discounted cash flow*—Value is determined by your company's projected cash flows discounted back to the present at a rate that incorporates risk.

Other factors come into play as well, such as company size, industry, customer base, growth potential, competitive positioning, product mix, technological capabilities, and management talent. It's also important to realize that a company's value is different to different buyers. Some buyers identify synergies and are willing to pay a premium; others try to prey upon naïve sellers who don't know the values of their own companies.

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So, how do you become more knowledgeable about your company's worth? Retain the services of a professional valuator—someone who understands the buyers in your market, is objective, and has years of appraisal experience.

Taxes Play a Big Part

In all the excitement of buying or selling a business, it may be hard to concentrate on taxes, but they affect the real price of the business. And, being unprepared can cause a serious blow to your economic expectations.

Do you know the *real* price of your business? Components that make up the real price include the following:

- The type and quality of the consideration.
- The timing of the payments.
- The tax effect of the transaction.

These components overlap, with the type and quality of the consideration and the timing of payments having a huge impact on the overall tax effect of the transaction. To determine the real price of your business, you will need to compare the tax effect of various reporting alternatives and a range of prices. Intangible assets, such as goodwill and intellectual property rights, both inside the business and outside the business (if any) will need to be identified. You should also consider other interrelated agreements, such as employment, consulting, or noncompete. Don't start negotiating until you know what you really have and what your possible options are.

Taxable or Not?

The majority of businesses are sold in taxable transactions. Nontaxable transactions include mergers and situations where the seller takes as consideration buyer stock or qualifying property in an exchange.

Although the general tax-planning rule is to avoid or postpone tax, there are some advantages of a taxable sale:

- When the seller gets cash, concerns about the quality of buyer stock or the limitations inherent in selling buyer stock are nonexistent.
- The buyer doesn't have to contend with the seller as a shareholder, and the buyer can get a stepped-up basis in the assets.
- The parties also don't have to worry about the technical requirements of a tax-free or tax-deferred transaction.

A taxable sale can be structured as either an asset sale or a stock sale. In general, the seller wants a stock sale and the buyer wants an asset sale. See the chart for a comparison of these two alternatives.

Timing of Payments

Sales are often structured as installment sales (where the payments are extended over a number of years) because the buyer doesn't have enough cash on hand. Installment sales are also useful since many small businesses are sold with an "earn-out" provision, where the buyer pays a contingent amount over a number of years, based on the business' performance. Use of the installment method for tax purposes is advantageous for the buyer as it helps match the recognition of gain to when cash is actually received.

If you sold a business in an installment sale but were unable to treat it as such for income tax

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Asset vs. Stock Sale

Asset Sale	*Stock Sale*
Seller: • Potential double taxation resulting in less net, after-tax proceeds. • Potential ordinary income, recapture, or higher tax rates on some assets. • Business can generally sell without minority shareholder consent.	*Seller:* • One level of taxation. • Capital gain treatment. • Minority shareholders may not want to sell.
Buyer: • Can avoid (not acquire) unwanted assets and liabilities. • Assets have basis equal to fair market value paid.	*Buyer:* • Takes over all assets and liabilities of corporation at purchase. • Assumes exposure to potential liabilities. • May have minority shareholder issues. • Assets have carryover basis (tax basis doesn't change).

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purposes, you need to amend your prior tax return to use the installment method. However, many business owners that sold businesses during the repeal period probably weren't able to structure their sales as installment sales. As a result, they may have had to sell their businesses at much lower prices. While they may be able to go back and restructure their sale agreements, most will probably never recover their losses.

If you're considering the big move, call your tax professional. He or she can help you determine the true value of your business and work with your attorney in reviewing the sale documents for accounting and tax issues.

The "A's" and "B's" of Asset Preservation

Asset preservation goes hand in hand with wealth accumulation. The federal estate tax has an uncertain future, which makes planning your estate and staying abreast of legislative changes essential. While the federal estate tax is currently scheduled for repeal, this reprieve is temporary and will be in effect for one year only—2010—unless Congress enacts further legislation.

Every estate may exclude a certain amount of property from estate tax, and in 2006 that amount is $2 million. The amount that may be excluded will rise over the next several years until repeal in 2010, according to the following schedule:

Scheduled Estate Tax Exemption Increases

Year	Exemption Amount
2006–2008	$2,000,000
2009	$3,500,000
2010	Estate tax repealed
2011	$1,000,000

Thanks to the unlimited marital deduction, assets that are passed to a spouse at death do not incur any estate taxes. However, for high net worth married individuals, "over-qualifying" for the marital deduction may create a large estate tax bill at the death of the surviving spouse. If the unlimited marital deduction is used at the death of the first spouse, that spouse's estate tax exemption ($2 million for 2006) is lost, and all remaining assets in the estate of the surviving spouse will be subject to estate tax at the second death (only $2 million would be offset by the survivor's exemption).

Setting Up A/B Trusts

One common estate planning technique available to help *both* spouses utilize their estate tax exemptions is the combined use of marital and bypass trusts—the A/B trust arrangement. Here is how the A/B trust arrangement might work for a married couple with a combined estate valued at $4 million. This example assumes both spouses die in a year when the estate tax exemption amount is $2 million.

Let's suppose the husband owns assets worth $3 million, his wife owns $1 million, and the husband dies first. When the husband dies, $2 million of his $3 million estate is funded into the "B" (bypass) trust. These assets *are* subject to estate tax, but there are no taxes due because the assets are offset by his estate tax exemption of $2 million. Furthermore, the amount in the "B" trust could be available to the wife for income and support, and upon the wife's death, it would be distributed to children according to the husband's wishes.

The remaining $1 million funds the "A" (marital) trust, which is a trust for the sole benefit of the wife. These assets, while included in the husband's estate, would be exempt from federal estate taxes due to the unlimited marital deduction.

When the wife passes away, assets remaining in the marital trust, and also those owned outright by the wife, would be included in her taxable estate. For illustrative purposes—if we assume no appreciation, consumption, or gifting of assets at the wife's death—there would be $1 million in her name and $1 million in the marital trust, for a total of $2 million. These assets can then pass to the children free of estate tax because her estate tax exemption of $2 million offsets the value of her estate. Upon death, these assets will be distributed according to her wishes.

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Tax-Saving Potential

In this simple example, using the "A/B" combination allows the couple's $4 million (assets in the bypass trust, plus assets in the wife's estate) to pass to the children free of *federal* estate taxes. (Although, there may be *state* estate tax consequences.) Any appreciation in the bypass trust ("B") will also pass to the children estate tax free. However, any appreciation in the wife's estate could be taxed. Remember, only $2 million of her estate will be offset by her exemption—any excess in the estate over that amount would be taxed. The estate could also be *reduced* if assets are consumed or gifted away.

An important distinction between the trusts is the issue of post-mortem control of the final disposition of trust assets. While the decedent (out of whose estate the bypass trust was created) will determine who receives the property in the bypass ("B") trust, the surviving spouse has post-mortem control over the property in the marital ("A") trust.

An A/B trust arrangement is but one of a variety of strategies available to help protect and preserve assets. As with any strategy, it is important to let the individual's objectives and financial situation direct the design of the plan.

Retirement Saving in 2006

The tax landscape is constantly changing, making it a challenge to keep up with the amount you can put into a retirement account. Certain dollar amounts are scheduled to change annually, while others are indexed for inflation. Let's take a look at what you can contribute in 2006.

For 2006, you can put up to $4,000 in an Individual Retirement Account (IRA) or a combination of IRAs, and earnings grow tax deferred. Contributions to a traditional IRA may be deductible, depending on your income and participation in an employer-sponsored retirement plan. Through 2006, those who are age 50 or older are allowed to make "catch-up" contributions of $1,000. Qualified withdrawals from a traditional IRA will be subject to income tax, while qualified withdrawals from a Roth IRA are tax free.

Simplified Employee Pension plans (SEPs), 401(k), 403(b), and 457 plans allow participating employees to make pre-tax salary deferrals of up to $15,000 in 2006. Earnings for all plans grow tax deferred. These plans also permit catch-up contributions. Those age 50 and older may make additional contributions of $5,000 in 2006.

Savings Incentive Match Plans for Employees (SIMPLEs) allow employees to make pre-tax contributions of up to $10,000 in 2006; earnings grow tax deferred. Catch-up contributions for participants age 50 and older are limited to $2,500 in 2006.

With fewer companies offering traditional pensions, taxpayers are increasingly responsible for saving for retirement. An early start puts time on your side.

The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

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