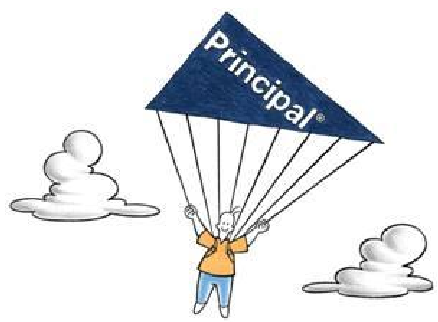
FOR INDIVIDUALS

Business Continuation

# Proposal

Presented to
Consolidated Industries, Inc.

Presented by
Your Financial Representative




| | |
|---|---|
| Not FDIC/NCUA Insured | Not Guaranteed By the Bank |
| Not a Deposit | May Go Down in Value |
| Not Insured By Any Federal Government Agency | |

# Important Notes

These pages depict certain business planning options. All of these options are based on the information you shared with us for this purpose and the assumptions stated throughout the report. Of course, any variance in the information or assumptions could change the results.

Inclusion of one or more of these options does not constitute a recommendation of that option over any other option(s). This report simply shows the effect of particular options on your business and potentially your estate, based on certain assumptions detailed in the report.

All assets assume specific growth rates, which are provided by the client. These individual rates are used to project the possible growth of the business. These projections are made to estimate future business insurance needs.

Although the informal business valuation from The Principal® can provide a valuable starting point in helping you determine the value of your business, the valuation will not be a substitute for a formal valuation nor does it establish a value for tax purposes. A formal valuation should be constructed with the guidance of your legal and/or tax advisors.

The term *Proposed Plan*, when used within this report, does not imply a recommendation that a specific business planning option should be implemented. Rather it represents a summary of potential considered strategies, which each individual should discuss with his or her tax advisor, attorney, and/or other professional advisor before taking any action.

Because your business planning goals may change in the future, periodic monitoring should be an essential component of your program.

Not valid without an attached illustration for each policy shown. Comparisons are not valid for variable products. Please refer to basic policy illustrations for guaranteed values and other important information.

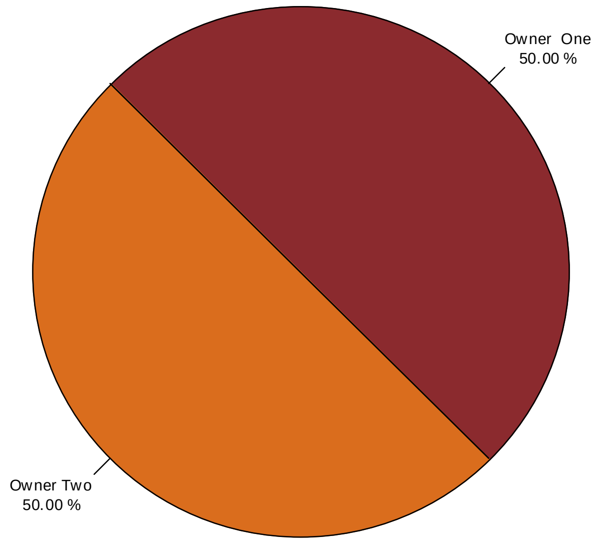
**While this communication may be used to promote or market a transaction or an idea that is discussed in the publication, it is intended to provide general information about the subject matter covered and is provided with the understanding that The Principal is not rendering legal, accounting, or tax advice. It is not a marketed opinion and may not be used to avoid penalties under the Internal Revenue Code. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.**

Insurance products from the Principal Financial Group® are issued by Principal National Life Insurance Company (except in New York), Principal Life Insurance Company. Securities offered through Princor Financial Services Corporation, 800-247-1737, member SIPC, Des Moines, IA 50392.

# Total Values Today

*Current Values*

Business Type: S Corporation
Nature: Manufacturing



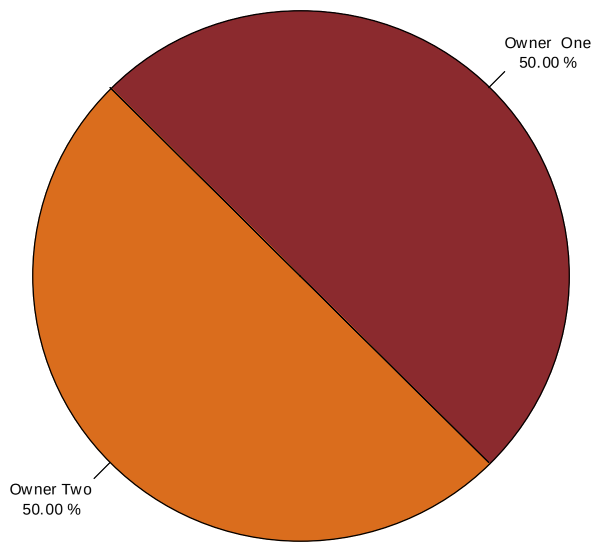

Current Value
$6,530,435

| | Owner | Owner Tax Bracket | Ownership |
|---|---|---|---|
| | Owner One | 28.00% | 50.00% |
| | Owner Two | 28.00% | 50.00% |

# Business Values

## *Future Values*

| | Owner | Today | 10 Years |
|---|---|---|---|
| | Owner One | $3,265,218 | $8,469,134 |
| | Owner Two | $3,265,218 | $8,469,134 |



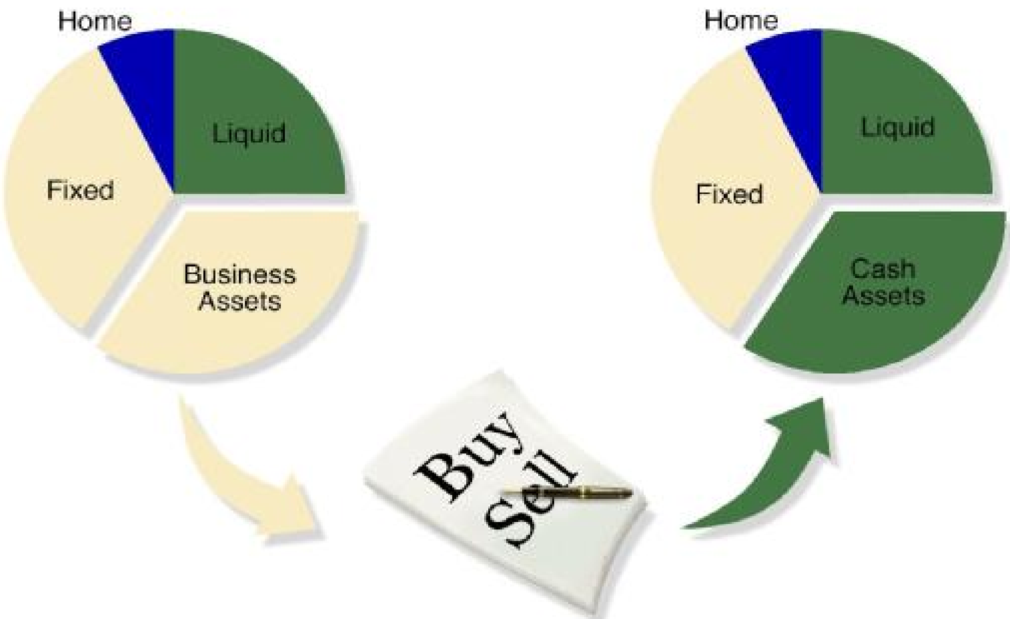

Estimated
Value in Year 10
$16,938,267

Growth at
10.00%

Current Value
$6,530,435

# Buy-Sells Can Provide Needed Cash

## *Convert Business Interest to Cash*




**A buy-sell agreement requires the executor to sell and the buyer to buy the decedent's business interests in accordance with a written agreement.**

A buy-sell agreement converts the decedent's business interests to liquid cash assets. Although this arrangement does not actually change the value of the estate, it changes the composition of the estate; it changes a business interest to a liquid asset. It may be a factor to be considered in determining the value of the business interest for estate tax purposes.

A buy-sell agreement can assure the continuation of the business by providing a buyer, and it can provide the estate with needed liquidity to pay estate taxes and expenses. These two benefits may be very beneficial to your estate settlement.

The buyer, typically a business partner or the business itself, usually purchases life insurance on your life. At your death the buyer receives the life insurance proceeds which are used to buy the business.

# How Property Passes at Death

*Transfer of Assets*

## Deed


• Property owned jointly with survivorship rights passed to the surviving joint owner

## Contract

• A life insurance policy is an example of a contract that pays death benefits to a named beneficiary

## Will

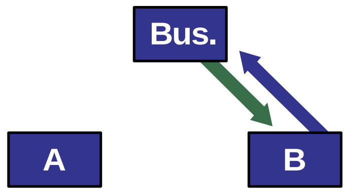

• All remaining property is distributed according to the terms of the will

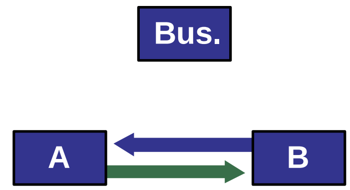
## Law

• If you have no will, the remaining property is distributed according to state intestacy law

# Basis

## *Business Sold Following the Buy-Sell*




| | Entity Purchase: Business | Entity Purchase: Owner A | Entity Purchase: Owner B or B's Estate | Cross Purchase: Business | Cross Purchase: Owner A | Cross Purchase: Owner B or B's Estate |
|---|---|---|---|---|---|---|
| **Prior to Owner B's Death** | | | | | | |
| Ownership | | 50% | 50% | | 50% | 50% |
| Value | | $500,000 | $500,000 | | $500,000 | $500,000 |
| Cost Basis | | $100,000 | $100,000 | | $100,000 | $100,000 |
| **Buy-Sell at Owner B's Death** | | | | | | |
| Cash | Pays $500,000 | Pays $0 | Receives $500,000 | Pays $0 | Pays $500,000 | Receives $500,000 |
| Business Interest | Receives Business | — | Transfers Business | — | Receives Business | Transfers Business |
| **Buy-Sell at Owner B's Death** | | | | | | |
| Ownership | | Outstanding Stock 100% | 0% | | Outstanding Stock 100% | 0% |
| Value | | $1,000,000 | | | $1,000,000 | |
| Cost Basis | | $100,000 | | | $600,000 | |
| **Sale after Owner B's Death** | | | | | | |
| Owner A's Capital Gains | | $900,000 | | | $400,000 | |

The choice of business continuation needs to consider whether or not the surviving owner is likely to sell the business. Although the ownership and values will be the same after an entity purchase as in a cross purchase, the surviving owner's cost basis is very different.

# Considerations

*Recommendations for Owner One*

### If you died or became disabled last night—

- Would a willing buyer be available today?
- How would the value of the business be determined?
- Would you or your family get a fair price?
- Where would the money come from to pay for the business?
- Would the buyer have the cash?

### Your Preference

You indicated that your preference would be to sell or transfer the business to a co-owner.

### A Formal Buy-Sell Arrangement

Guarantees a buyer.
Establishes a fair price or valuation method in advance.
Arranges the terms of the purchase-obligates buyer and seller.
Drafted properly, may set the value of the business for federal estate tax purposes.
Assures a smooth transition for you, your family and the buyers.
Provides reassurance for creditors and employees of continuation of the business.

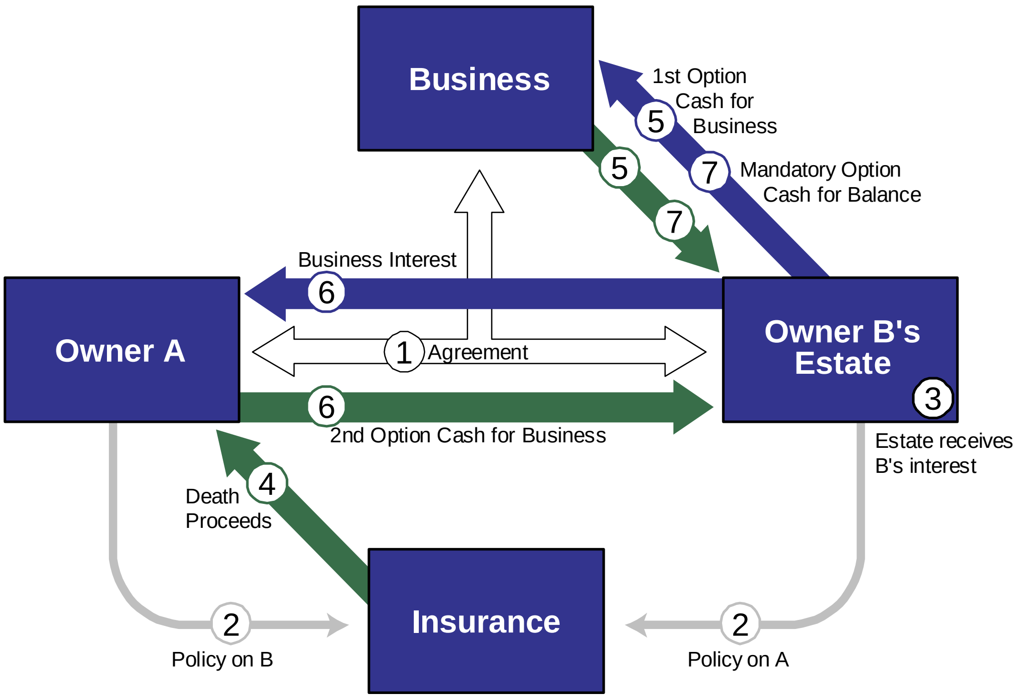
### Funding Alternatives

| | |
|---|---|
| **Cash** | Will sufficient funds be available to pay the full price at the time needed? |
| **Borrowing** | Credit availability and cost of borrowing in the future are unknown. Any borrowed funds must be repaid with interest from earnings. |
| **Saving** | Since timing is not predictable, you cannot be assured that sufficient funds will be available when needed. |
| **Installment Sale** | Requires repayment from earnings and forces you or your heirs to rely upon the future success of the business in order to receive your payments. |

**The potential solution is to establish a wait 'n see buy-sell arrangement with insurance purchased similar to a cross purchase plan.**

# Wait 'n See Buy-Sell

*Funded like a Cross Purchase*




1 Both owners and the corporation enter into an agreement for the purchase of a deceased/departing owner's interest that obligates the departing owner or decedent's estate to sell.

2 Life insurance is purchased on the life of each shareholder using a cross purchase approach. (Each owner is the premium payer and beneficiary of a policy on each owner's life)

3 At the death of Owner B, the estate receives B's interest.

4 The surviving owner receives the tax-free life insurance proceeds.

5 The corporation is given the option to purchase the stock within a certain period stated in the buy-sell agreement. The corporation can purchase all or any portion of the decedent's stock.

6 If the corporation chooses not to fully exercise its option, Owner A is given an option to purchase all or some of the remaining shares within a stated period of time.

7 To the extent stock still remains, the corporation is obligated to complete the purchase, assuring 100% of the decedent's interest will be acquired.

# Assumptions

## Additional Notes and Details

| | |
|---|---|
| Business Type: | S Corporation |
| Nature of Business: | Manufacturing |
| Business Value Today: | $6,530,435 |
| Business Growth Rate: | 10.00% |

An S Corporation is permitted to have up to 100 shareholders (provided they all met special permissible shareholder's definitions). Spouses (and their estates) are treated as one shareholder. In planning for the continuations of a business interest in an S corporation, care should be taken to preserve the corporation's S status. Without proper planning, a transfer of stock could inadvertently terminate the S election.

S corporations may not issue more than one class of stock. However, an S corporation may issue voting and nonvoting stock of the same class. Thus, buy-sell agreements should not create differences in the rights of shareholders that could be construed as creating more than one class of stock.

A stock redemption agreement may offer advantages not available to C corporation shareholders upon the death of a shareholder; therefore, many S corporations choose a stock redemption plan instead of a cross purchase or trusteed cross purchase. These advantages and related details should be discussed with your attorney or legal advisor.

Recommended amounts of life insurance are based on the solution being considered and the assumption that the successive owners would desire that their relative ownership to one another should remain the same. This may or may not reflect the owner's actual objectives.

The numbers produced by this analysis in no way guarantee the right to purchase life insurance in the amounts illustrated. Premiums may vary based on many factors, including the age, sex, and health of the insured. If life insurance is illustrated, this presentation is not valid unless accompanied by a complete illustration of proposed policy values.

We offer you this presentation to help you understand how life insurance can be used to provide funds for business continuation arrangements. This material contains references to concepts that have legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Consult your own attorney and/or accountant for advice regarding your particular situation.

# The Problem of Business Valuation

## *How to Determine the Value of Your Business*

An exact method for determining the value of a business does not exist. The more *experts* you ask, the more opinions you will receive. And more than likely, the opinions will vary widely.

There are many instances when the value of business assets is needed, such as for buy-sell agreements, business loans, and for estate planning purposes. At your death, the value of your estate is subject to estate taxes. Your business assets are part of your estate. Therefore, the higher the value of your business in your estate, the more estate taxes you will pay. The lower the value of your business, the less estate tax you will pay. The IRS will attempt to value your business at the highest reasonable level, while your heirs will try to minimize the value of your business.

There are many methods by which a business may be valued. Five of the most commonly used methods are described below:

- **Book Value:** The value at which the business is carried on a balance sheet, with all assets adjusted for fair market value (fair market value may not be the same as the depreciated value for income tax purposes).
- **Straight Capitalization Method:** The amount of capital that would have to be invested at a specified rate to yield the current average net annual earnings of the business.
- **Capitalization of Earnings Method:** Assumes that part of earnings are attributed to the assets of the business (book value). Remaining earnings are capitalized at a rate consistent with the relative risk of the business. The result is then added to book value.
- **Years' Purchase Method:** A conservative rate (the pure money rate for an investment with generally accepted lower risk) is used to determine the earnings attributed to assets. The balance is assumed to be provided by goodwill. The earnings provided by goodwill are then multiplied by the number of years for which goodwill is expected to be valuable to a purchaser. The result is then added to the book value to obtain the valuation.
- **Discounted Future Earnings Method:** Projected future business earnings are forecasted, and then discounted using an appropriate rate which reflects the return from the next best investment opportunity with a comparable level of risk. The sum of the discounted future earnings is the current valuation.

The average of these five methods is not an acceptable method of valuation. It is shown in this presentation for comparison purposes only. Each business should have a professional appraiser determine the method that will best represent all of its factors.

# Transfer for Value

## *Hidden Dangers with Buy-Sell Life Insurance*

One advantage of life insurance is that the death proceeds are usually received income tax free! Certain transfers can jeopardize this tax advantage. After a policy is transferred, only the amount paid (consideration and premiums) will be granted this tax-free treatment, unless the transfer is one of these specific exceptions:

• **Self**
  Transfer to the insured

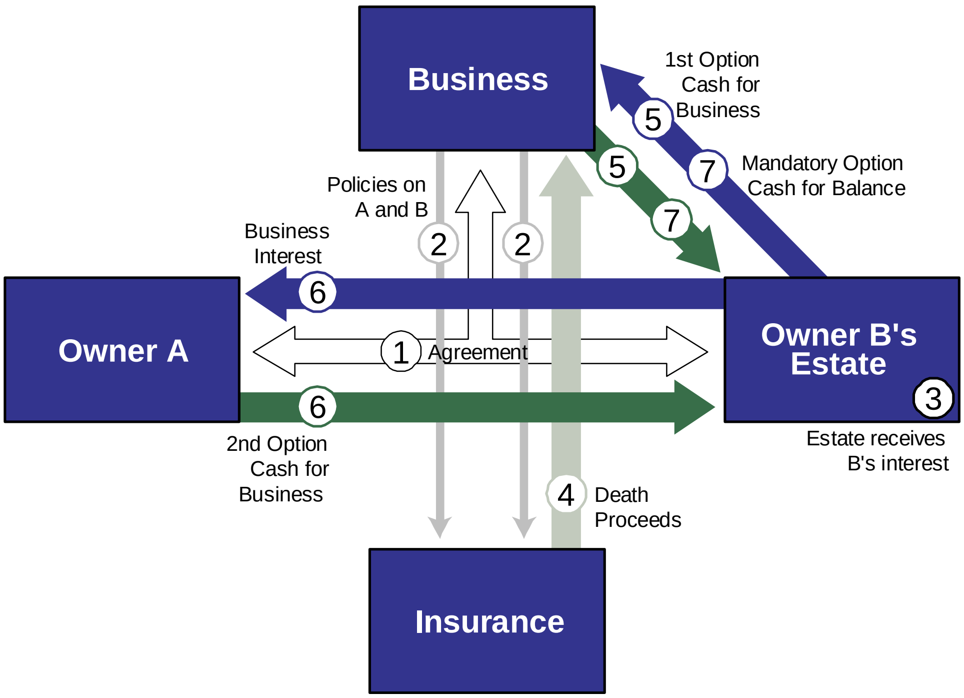
• **Certain Business Associates**
  Transfer to a partner of the insured
  Transfer to a partnership in which the insured is a partner
  Transfer to a corporation in which the insured is a stockholder or officer

• **Same Tax Basis**
  Transfers where any gain or loss is figured, whole or in part, by the cost basis of the transferor
  (Examples: transfers between spouses, gifts of a policy, and from one corporation to another in a tax-free reorganization)

Often the policies used in business continuation agreements are transferred among the remaining owners after the death of one of the owners. Unless the transfer is one of these specific exceptions, the death proceeds will not have the full tax-free advantage. Particular attention needs to be observed whenever stockholders are transferring policies. A transfer to the corporation is permitted, but transfers among the stockholders are not!

# Wait 'n See Buy-Sell

*Funded like an Entity Purchase*

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