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Effective Use of Buy & Sell Agreements: Alternatives to the Traditional Buy & Sell Agreement

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EFFECTIVE USE OF BUY & SELL AGREEMENTS
ALTERNATIVES TO THE TRADITIONAL
BUY & SELL AGREEMENT

By

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I. Hypothetical Fact Pattern in The Family Business

A Business Succession Study is one of the most important planning opportunities available to the family business. Often too little consideration is given to the important questions of who will be running the business in five or ten years or even next week should something suddenly happen to the President, such as an untimely death or disability.

Let's take a look at a hypothetical situation.

The President of the family business thought he had completed his estate planning because he had recently executed a Will and Trust Agreement. The Trust provided that in the event of his death his assets would be held by the Trustee for the benefit of his wife for the remainder of her lifetime, and then be distributed to his children. The President's interest in the family business was the largest asset in his estate. As is usually the case, he thought that he had a plan. However, when he was killed in an accident, it turned out that everyone, except the president had a plan.

The commercial banker had a plan. The bank collected the credit life insurance proceeds made payable to it when the company took out a large loan.

The sales manager had a plan. He thought he was the most important person in the company and that it simply could not exist without his brilliant sales effort. He was certain that he should be named President so he encouraged the widow to make him President or he threatened to leave and take his sales efforts to a new company.

The operations manager had a plan. If he became the President, he would fire the sales manager whom he didn't trust and didn't like. The operations manager felt that only he knew about the operation of the company inside and out. He told the widow that her late husband thought he should be the president.

The vendors had a plan. They knew that the smooth continuity of the business was essential to maintain the distribution flow and service for the products that the family business had sold for years under the leadership of the now deceased President. Their plan was to find another company who could maintain the line since they assumed there was no succession or continuity plan.

The competitors had a plan. Within a month, they would approach the widow about their willingness to "help her out" by buying the company at a distressed price.
The widow had a plan. She would stay home, perhaps get the youngest child through high school and simply continue to draw the salary that her husband had received. If a salary could not be paid to her, she would declare a dividend to maintain her level of income and accustomed standard of living. Her plan included trying to maintain the business until the children could come into the business.

Had the Business Succession Study been completed, it might have been possible for the President, long before his death, to have helped his wife learn enough about the business, its employees, and its other relationships to have a chance of maintaining the business in the event of his untimely death or incapacity.

One of the sons had a plan. He would follow his ambition to be a rock star and the family would have plenty of money to buy him out. The daughter had a plan. She and her husband would move back to the middle west and run the company for her mother.

The Internal Revenue Service had a plan. It was to value the business on the basis of what it earned as a going concern before the President died.

Remember how this all began with the President thinking he had a plan? His plan was to leave his assets in trust. The Trustee had a plan. It wanted to sell the family business since the Trustee no desire to manage it and did not want the liability of running a business.

By undertaking a Business Succession Study, through competent counsel, the President could have left a blueprint to be followed by everyone involved. He could have said in the Business Succession Report who he considered to be the most reliable and talented members of the management team. He could have discussed business continuity with his employees and vendors and given them assurance through a Buy & Sell Agreement or by other means that the business would be maintained. The Buy & Sell Agreement would have set the value of the company for estate tax purposes. He could have discussed an organization chart with the key managers that would have been in place in the event of his early demise. He could have worked with his accountant to develop financial statements to help his wife understand the business, and given her the opportunity to realize that sound management and advice was available to help run the company. He could have given the key employees assurances that they would have a future in the business by rewarding them with bonus arrangements, stock options, deferred compensation programs and qualified retirement plans, including an ESOP. The Study might have revealed a need for life insurance to pay the estate taxes or to fund the Buy & Sell Agreement. By
completing and periodically updating the business continuity plan with counsel, the President could have given the Trustee (a) the comfort to allow the business to continue to operate as a family business; or (b) ideas about finding potential purchasers for the company and how the company should be valued in ways that might have been unique to the company or its industry.

For all of the years that the President had spent building his dream company, a relatively small amount of time and money could have been spent in developing a Succession Plan -- this study might have been worth more than any decision that had ever made for the company. The family business and its owner might have had a Plan.

II. The Need For A Business Succession Analysis Which Should Be Undertaken Periodically In Planning For The Passage Of Control Of The Family Business

A. To assist the family

B. To assist the corporation

C. To assist the trustee

III. Why the Owner Might Consider Selling the Company

A. The retiree or the decedent's estate and family may need cash:

1. To pay estate taxes
   a. Consider installment payment of estate taxes under Section 6166 or 6161*
   b. But it is still with after-tax dollars and limitation on deduction of interest
   c. Statutory limitations - 35% of adjusted gross estate includes interest in a closely held business

2. To provide for living expenses for surviving family

3. To equalize distribution to family members who are not in the business

4. The remaining owners do not want anyone owning an interest in the business who is not an active employee where conflicts can arise regarding:

* - All section references are to the Internal Revenue Code unless otherwise indicated
a. Salaries
b. Dividends
c. Expansion plans

B. Family or owner disputes even when they are all active in the business

1. The owners may have differing points of view about:
   a. Future direction of the company
      (1) Whether to expand into other businesses
      (2) Whether to admit other owners
      (3) Whether to permit nepotism
      (4) Etc., etc.
   b. Compensation levels, expense allowances, types of fringe benefits

C. Desire to transfer control to younger generation

1. Younger generation may have less incentive to cause the business to grow if ultimately he has to buy out siblings or parent's estate.

D. Desire to diversify to more liquid investments, or what is perceived as a better investment opportunity, however:

1. Business may not be able to afford to pay fair market value for seller's interest
2. New investments have drawbacks:
   a. Less control -- example -- public companies
   b. Less knowledge about the new investment
   c. Lower return -- few investments as good as closely held business
   d. More leverage -- equals greater risks, e.g. real estate
   e. Less liquidity e.g. real estate
E. Owner may have been approached by outsiders or management wanting to buy the business through a leveraged buy out

IV. Reasons to Find Alternatives to the Traditional Redemption Type Buy & Sell

A. With lower personal tax rates now applicable, receiving personal compensation is not as bad

B. Higher corporate tax rates now exist, so it is important for the corporation to obtain a deduction

C. Repeal of capital gains deduction in TRA '86 had eliminated the primary advantage of the traditional agreement to the seller. As of September 29, the House had approved a 19.6% preferred rate window for capital gains.

D. Recognition that buy outs are often funded from future earnings, i.e. gross income which should be offset by deductible payouts

V. Problems With Traditional Buy & Sell Arrangements

A. These problems may be present whether selling a corporate or partnership interest

B. Usually funded and paid with non-deductible, after tax income

C. Closely held business is growing so rapidly, it outpaces ability of the company or remaining shareholders to pay for it. Therefore, a redemption may not be possible and one of the alternatives may be essential.

D. Although often funded with insurance, the company may not be able to afford life or disability buy out insurance.

   1. Also selling shareholder may not be insurable at reasonable rates

   2. Redemption may result from retirement or withdrawal, not death or disability, so no proceeds available to fund a non-deductible buy out.

E. Selling owner or surviving family may end up with an unsecured promise of the company to pay for the interest purchased on an installment basis.

   1. Get personal guarantee of remaining owners
2. Retain a security interest
   a. The stock or partnership interest sold
   b. All outstanding ownership interest
   c. Other collateral
   d. Loan agreement should restrict
      (1) dividends
      (2) sale or pledge of assets
      (3) all but limited salary adjustments
      (4) transfer of control
   e. Loan agreement should require
      (1) personal guarantee of remaining shareholders
      (2) Right of seller during pay back period to review financials of the company and to accelerate loan if condition worsens

F. No stepped-up basis for remaining shareholders

1. One solution is to use cross purchase agreement
   a. Fund it with life/disability buy out insurance bought by other shareholders
      (1) Cumbersome if multiple shareholders
      (2) Use an escrow or trust agreement
         (a) Reduces number of policies
         (b) Assures proceeds will be used to buy out the interest
      (3) Insurance bought with after-tax, but lower bracket, income
   b. Avoids alternative minimum tax on 75% of proceeds in excess of book value of policy

2. Partners can get a stepped up basis by filing a Section 754 election
G. State law may preclude corporate redemption if inadequate capital or retained earnings

1. Agreement should provide remaining shareholders must purchase the stock proportionately if capital is inadequate under state law.

H. May have wanted to retain investment in business for other family members

VI. Warnings

A. Any deductible alternatives will be carefully scrutinized by IRS to see if payments are simply disguised payouts for corporate stock or disguised dividends.

B. Legal ethics and need for engagement letter

1. Dual representation issue - model code of professional responsibility - E.C.5-16

   a. Representing the business and multiple shareholders

   b. Invite each to have separate counsel

      (1) Try to represent business and the remaining owner

      (2) Develop the ideas and draft the agreements for each party to show their respective counsel

2. Each owner is different and has individual considerations

   a. Age, health and stage in life

   b. Ability to pay for the buyout with outside funds or to reduce salary to fund the buy out internally

   c. May have different objectives e.g. diversification vs. retaining for family member

3. Get each party to sign engagement letter acknowledging conflict was revealed and discussed (See Appendix A)
VII. Alternatives Which May Be Used In Lieu of the Typical Redemption Approach

A. There can be a combination of the alternatives and perhaps still a need for some redemption element

1. Spin-offs, split-offs and split-ups Section 355

a. Where the shareholders of single business have a disagreement regarding corporate policy such as how certain aspects of the business should be run, it is frequently possible for the co-owners to split up their existing corporation tax-free under the provisions of Section 355 so that each of the shareholders ends up with a separate corporation.

b. To qualify for tax-free treatment, the division ordinarily involves a type D reorganization Section 368(a)(1)(D).

c. These transactions frequently involve the transfer by a corporation of one of its businesses to a new subsidiary which is controlled by the corporation. The subsidiary is then distributed to a shareholder in exchange for all of the shareholder's stock of the parent corporation.

d. To be tax-free, the following requirements must be met:

(1) The distributing corporation must distribute solely stock or securities to a shareholder in exchange for his securities in the distributing corporation.

(a) The stock or securities distributed must be a corporation which was "controlled" by the distributing corporation immediately before the distribution.

(b) The transaction must not be used principally as a device for distributing the earnings and profits
of either the distributing corporation or the controlled corporation.

(c) Immediately after the distribution, each of the corporations must be engaged in the active conduct of a trade or business.

(d) The distribution can be tax-free even though it is not made pro-rata to all of the shareholders of the distributing corporation. Section 355(a)(2)(A)

2. Sale - leaseback of corporate assets

a. Although not tax-free, a corporation can distribute a portion of its assets to a shareholder in redemption of his shares. Those assets can then be leased by that shareholder back to the corporation or to others. The lease payments made by the corporation would, of course, be deductible under Section 162.

b. There can be some subjectivity in the value of the assets distributed, and some negotiation in the amount of rental payments made by the corporation to the new owner of the property which is leased back to the corporation.

c. The use of a sale and lease-back is a common method to permit a shareholder to withdraw from the corporation and to have separate, more liquid and diversified assets that he can either continue to lease to the corporation, lease to others or sell in order to diversify his investment further.

d. The redemption with appreciated assets is generally taxable to the corporation. Section 311

e. This technique is particularly useful when an owner is retiring and needs to continue to receive income, or where one child is not active in the business
3. **Allocate accounts receivable to selling shareholder as wage continuation.** Stock has a smaller book value.

   a. This technique is frequently used in a professional corporation redemption to more accurately reflect the fact that the accounts receivable really belonged to or were associated with the selling shareholder, and would have been the source of his compensation had he remained an employee.

   b. Example: In a law firm, the shareholder might have been compensated under a formula approach when he was paid for business produced. Without this technique of allocating A/R as wage continuation, the corporation would have had to collect the receivables as ordinary income and then have paid money to the shareholder on a non-deductible basis for his stock which might have included a value for the accounts receivable. The method of providing wage continuation to the shareholder more accurately reflects a continuation of the earnings of the firm by the professional having to pick up the ordinary income resulting from his efforts while an employee. It is not uncommon for a professional corporation to provide that the value of a professional's stock does not include any value for goodwill or for the outstanding accounts receivable. If this allocation is on an arms-length basis and is not treated as a disguised payment for the value of the professional's stock, it should hold up as a valid bifurcated recognition of the separate interest of a professional in the business.

   c. In cases in which a shareholder receives, under a Wage Continuation Agreement, an amount for his shares in excess of their book value, the IRS has been unsuccessful in arguing that such payments are non-deductible compensation when the excess is attributable to good will. However, the result has been different when the excess is attributable to accounts receivables.
In Muskogee, Radiology Group, Inc. v. Commissioner, 37 T.C. Memo, 1978-490 (1978), a physician in a radiology group received $131,016 for his shares in a professional corporation. Of this amount, $31,016 was received as book value of the stock and the remaining $100,000 was payable under a deferred compensation arrangement. The court held that the $100,000 was deductible as compensation. The tax court rejected the IRS's contention that this excess over book value represented an intangible asset, in this case goodwill, because the doctor performed essentially personal services. Therefore, any goodwill depended on the patient/doctor relationship which could not be transferred with a mere sale of stock.

In Ted N. Steffen v. Commissioner, 69 T.C. 1049 (1978), a doctor sold his stock in a professional corporation for $43,975. This amount was broken down as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Equipment</td>
<td>$ 3,200</td>
</tr>
<tr>
<td>Cash Value of Life Insurance Policy</td>
<td>$  775</td>
</tr>
<tr>
<td>Book Value of Common Stock</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Salary</td>
<td>$39,000</td>
</tr>
</tbody>
</table>

The corporation was a cash basis taxpayer and the book value of the stock did not include outstanding accounts receivable. The court held that the $39,000 was not deductible as salary expense. The court stated that to the
extent that such amount was attributable to the corporation's accounts receivable, it did not constitute compensation for the doctor, but rather represented a distribution to the redeeming shareholder of appreciation in the value of corporate assets.

4. Deferred compensation agreements

a. Frequently the deferred compensation paid to a terminated or retiring or deceased shareholder is coincident with the purchase of his interest in a corporation. Obviously the amount that he receives for his stock will be of less consequence to the selling shareholder if, at the same time, he is receiving deferred compensation for services rendered while he was in the employ of the corporation or in recognition of past services. With proper advanced planning, a corporation can have an agreement prefunded to pay a former employee for services previously rendered by him.

b. Rev. Rul. 60-31 (1960-1 C.B. 174) is the beginning point for any consideration deferred compensation.

c. There has been a great amount of activity in the entire non-qualified deferred compensation area since the Internal Revenue Service held in a series of Private Letter Rulings that employer deposits into an irrevocable trust known as "Rabbi Trust" would not be taxable to the employee as long as the trust assets were subject to the claims of the employer's creditors. IRS Private Letter Ruling 81-13107; 83-29070; 84-18105; 85-09023 and 86-34031.

d. Secular Trust, i.e. funded deferred compensation agreements, have also received a great deal of interest recently.
5. Severance pay

If a corporation truly has an employment contract with one of its employees, it should be able to deduct the payment to that employee to sever his employment relationship as long as the amount is reasonable. However, in S. Blechman and Sons, Inc. v. Commissioner (229 2d 925) the Second Circuit held in 1956 that a corporation could not pay its treasurer $96,000 in retirement of its stock and bonds held by him, which had an aggregate book value of $96,000, and deduct the excess of $24,000 as the cost of cancelling the treasurer's employment contract in the absence of an agreement allocating the payment. The court held that the entire $120,000 was solely for the redemption of the stock and the bonds.

6. Consulting agreements

a. Where a former employee will truly render consulting services to a corporation, it should be possible to deduct the consulting payments under Section 162. On the other hand, pursuant to the complete redemption provision rules of Section 302, the redeemed shareholder cannot have any relationship to the corporation other than that of a creditor.

b. As long as there is relatively little tax rate difference between capital gains and dividend income, it may not seem to matter whether the transaction is treated as a complete redemption. But there is still an advantage in capital gain treatment because (a) tax free recovery of basis (b) capital gains can be used to offset capital losses; and (c) the capital gain deduction may be re-enacted in the future. It is possible to have a consulting relationship without simultaneously having a redemption of a shareholder's stock, and therefore the issue remains can a corporation deduct consulting payments made to a terminated employee. The tax court answered that affirmatively and A. Yelencsics (74 T.C. 1513) Acq. 1981-2 C.B.2 In that situation, the payment made by the corporation was pursuant to a consulting
agreement that was contained in the stock purchase agreement and it was permitted as a business expense deduction.

7. Covenants not to compete and confidentiality agreements

a. Covenants not to compete are deductible by a corporation if it can show that the amount paid is reasonable, and if there was truly a threat of competition from a shareholder. If the shareholder is too old to compete, or if the amount paid for the covenant is unreasonable, then it will not be allowed. The general rule is that where the seller of a business promises not to compete with the purchaser for a given period of time, a purchaser may amortize the amount paid for the covenant over its stated life. Tax Management Portfolios, Amortization of Intangibles 209-3rd, A-19 (1987) citing Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (CA-9 1962). Most cases require the covenant to have independent significance apart from assuring the transfer of goodwill. Additionally the covenant should have been separately bargained for by the parties so that separate or severable consideration can be shown. Id.

(1) Separate allocation

Courts apply four tests in determining whether any amount may be separately allocated to a covenant not to compete:

(a) Is the compensation paid for the covenant separable from the price paid for goodwill?

(b) Is either party to the contract attempting to repudiate an amount knowingly fixed as allocable to the covenant under the circumstances giving rise to the likelihood that the tax effect of the allocation would be considered;
(c) Is there proof that the parties actually intended that some portion of the purchase price be allocated to the covenant not to compete when they signed the agreement; and

(d) Was the covenant economically real?

(2) Allocation of price in contract

In order to substantiate the amortization deduction, an allocation of a portion of the price of a contract is sufficient to support the amortization deduction. See Ullman v. Commissioner, 264 F.2d 305 (CA-2 1959), aff'd 29 T.C. 129 (1957) (strong proof must exist to overcome the declaration or an assigned value to the covenants in the contract); Dauksche v. Busey, 125 F. Supp. 130 (D. Ohio 1954) (Allocation of part of the price to the covenant was held realistic because (a) the partner could have competed had he not signed the agreement, and (b) the price assigned to the covenant was not disproportionate to the amount of business done.

The parties' intent is significant when determining if the allocation will be effective. In Ackerman v. Commissioner, T.C. Memo 1968-254, an allocation of $30,000 to the covenant not to compete was upheld because it was freely and knowingly made. However, in Lemery v. Commissioner, 52 T.C. 367 (1969), the court disallowed the parties' allocation of $200,000 in a covenant not to compete and held that the covenant was not subject to
amortization. The court apparently did not believe that the taxpayer demanded the covenant, and there was little risk of competition.

Where there is no allocation in a contract, the Tax Court has held it to be strong evidence that no allocation was intended Schmitz v. Commissioner, 51 T.C. 306 (1968), aff'd 457 F.2d 1022 (9th Cir. 1972), or has determined for itself the amount to be attributed to the covenant (Herndon v. Commissioner, T.C. Memo. 1962-184).

Where stockholders and their spouses agreed not to compete with their corporation in exchange for 10 annual payments of $10,000, the covenant was held as merely a device to obtain deductions for the corporation for annual distributions in the nature of dividends. The corporation was denied amortization of deductions for payments under covenants. G. A. Nye, 50 T.C. 203, Dec. 28,942. Accord Mackey's Inc., 34 T.C.M. 1214, Dec. 33,413(M), T.C. Memo 1976-280.

Ten annual payments to an individual for refraining from competition in a restricted territory for ten years were held deductible. Eitington-Schild Co., 21 BTA 1163, Dec. 6629. Payments made by a taxpayer in consideration for a partnership's agreement not to compete during the period payments were made are deductible as amounts representing exhaustion of a contract used in the taxpayer's business. Carboloy Co., Inc. 2 T.C.M 413, Dec. 13,351 (m). See also News Leader Co., 18

The payments for the covenant not to compete is amortizable over the entire term of the covenant. Warsaw Photographic Associates, Inc., 84 T.C. 21, Dec. 41,822.

(3) Amortization of covenant not to compete

A taxpayer claiming a deduction for amortization of the cost of the seller's covenant not to compete has the problem of the duration of the intangible. Under the tax code, depreciation of intangibles is allowable only where the use of the intangible is of limited duration. Depreciation of goodwill is expressly disallowed. An agreement to refrain from competing generally has a specified life, but if it is a necessary adjunct of goodwill, its life is indeterminate despite the fact that the contract recites that it runs for a definite period of time. The buyer has the burden of showing that the covenant not to compete is not the purchase of goodwill.

If the covenant not to compete is really goodwill, the cost cannot be depreciated. CCH Standard Federal Tax Reporter Reg. Section 1.167(a)–3 Paragraph 1717.

Twenty percent (20%) amortization of the contract price of a business was allowed where that amount was stated to be for a contract not to compete requiring the former chief stockholder to hold his services available to the

Where an agreement not to compete was not bargained for separately and no value was assigned to it in the contract, it could not be amortized over the period of the covenant. General Insurance Agency, Inc., 401 F.2d 324 (4th Cir. 1968); Robins v. Weill, Inc., 382 F. Supp. 1207 (_______); J.L. Danehy, T.C. Memo 1974-2281.

b. Confidentiality agreements, on the other hand, which provide that the shareholder who is receiving payments to keep certain information confidential as part of his buy out, are generally not amortizable because they are in the nature of goodwill and generally are not thought to have a limited period or useful life. Perhaps it would be possible to structure an agreement that said that the employee could not reveal confidential information for a certain limited time if it could be shown that the confidential information would only have a market value for a limited period, such as until a public announcement was made about a new product.

(1) Trade Secrets. Secret formula and processes are not subject to depreciation because their useful lives cannot be determined with reasonable accuracy. Kaltenbach v. United States, 1 U.S.T.C. ¶353 (Ct. Cl. 1929); Yates Industries, Inc. v. Commissioner 58 T.C. 961 (1972). But see Liquid Paper Corp. v. United States, 83 U.S.T.C. 9305 (Cl. Ct. 1983) (manufacturer of typewriter correction fluid was entitled to depreciate his secret formula where its estimated useful life was reasonably ascertainable due to technological advancements occurring within the taxpayer's industry). Evidence indicated
that the secrets had a useful life far in excess of the four-year termination date of a noncompete agreement obtained from the seller of secrets.

(2) Customer lists. Generally courts have held that amortization of customer lists is not permitted because it is inseparable from the purchased goodwill, or considered mass assets, or both. 209-3rd BNA Tax Management Portfolios, Amortization of Intangibles A-40 citing Klein v. Commissioner 372 F.2d 261 (2d Cir. 1966); Metropolitan Laundry Co. v. United States, 100 F. Supp. 803 (N.D. Cal. 1951.)

The mass asset rule is frequently cited in customer list cases to deny amortization. See, e.g., Boe v. Comm'r, 372 F.2d 261 (2d Cir. 1966) (Tax Court concluded that the taxpayer purchased a single intangible capital asset when one partner purchased a medical practice).

The court in Fullerton Co. v. United States, 381 F.Supp. 1353 (D. Ore. 1974) explained, "The question whether the purchaser of a customer list is acquiring a single mass asset or a group of individual assets is frequently a factual question and will depend on the method used to evaluate the acquisition in light of the nature of the business being acquired." (In Fullerton, an insurance company was not entitled to depreciate the value allegedly assigned to customers of the company since the taxpayer failed to establish ascertainable useful life.)
A list of all customers regularly using goods or services was held to be a single capital asset and amortizable. Metropolitan Laundry Co. v. U.S., 100 F. Supp. 803 (N.D. Cal. 1951).

Remember that the test to determine whether an intangible asset may be amortized is whether it has a limited useful life which is fixed in time or can be measured with reasonable accuracy. Regs. Section 1.167(a)3. One who acquires a customer list knows that these customers have needs for goods and services, but the purchaser will be able to retain customers if he provides satisfactory services. Customer lists are usually considered to retain their value because new customers are referred by old customers, and some of the old customers continue to use the services indefinitely. While some customers discontinue because they move out of the community, new customers are acquired among those who are new in town. Thus a list is considered a mass asset, the individual components of which may expire or be replaced, causing fluctuations in the value of the whole, but which has no measurable loss of value. Id.

The cost of lists of laundry customers was found to be 75% depreciable over a five-year life. The remaining 25% related to institutional customers which could be expected to be retained on an indefinite basis. Manhattan Co. of Virginia, Inc. 50 T.C. 78, Dec. 28, 918. Accord E. Panichi, 834 F.2d 300 (2d Cir.).
In a Kansas City case, a customer card file acquired in the liquidation of a subsidiary had a value separate from goodwill and was amortizable over a five-year period. However, only two-thirds of the amount claimed as attributable to such file was allowed because one-third of the customers would repurchase from the company regardless of the use of the customer card file. 


8. Defined benefit pension plans and other qualified retirement plans

Qualified retirement plans provide an excellent way for corporations and unincorporated businesses to reduce the amount that an owner would otherwise need from the sale of his interest upon his retirement. A Defined Benefit Pension Plan is particularly meaningful because it can provide up to $98,064 (with cost of living adjustments) of annual retirement income to an employee. This benefit can be funded over a relatively short period because the annual contribution to the plan can be allocated in an actuarial manner which results in the largest portion of the allocation going to the employee closest to retirement. Contributions to all retirement plans are (a) deductible to the business, (b) not taxable to the participant until they are paid out, (c) compound within the retirement trust on a tax-free basis until distributed, and (d) are generally distributable as ordinary income throughout the participant's and his spouse's retirement years, or received in a lump sum and taxed on the basis of either a 5 year average at current rates, or a 10 year average at pre-TEFRA rates if the participant was age 50 on January 1, 1986.

a. A floor offset pension, which provides that the benefit will be offset by benefits from a defined contribution benefit, may make it possible to only fund a defined benefit for the employee nearing retirement.
9. Employee stock ownership plans

a. ESOPs may offer the most favorable technique of acquiring a deceased or retiring shareholder's stock on a favorable tax basis. They represent a win-win situation for both the corporation and the shareholder or his family. ESOPs are a form of qualified retirement plan which have as their primary objective the acquisition of corporate stock which will be held for the purpose of providing a retirement benefit for the employees of the corporation.

b. Like other qualified retirement plans, contributions to the ESOP are deductible by the corporation, and not taxed to the participant until he receives a retirement benefit. The funds grow within the retirement trust tax-free until they are ultimately paid out. What makes ESOPs particularly useful for our purposes is the fact that the ESOP is designed to invest in employer securities, and therefore, it is a perfect market for the stock of a shareholder who is retiring, who has become disabled, who has died, or who simply wants to diversify his investments.

c. It is especially attractive that the purchase of a shareholder's stock can be accomplished on a tax deductible basis by the corporation either making deductible contributions, in advance, to accumulate a fund to purchase the stock, or by the ESOP borrowing money to purchase the stock of the selling shareholder or his estate. The exemption to the prohibited transaction rules allowing the ESOP to borrow is Section 4975(d)(3). These borrowed funds will be paid back by the corporation making tax deductible contributions to the ESOP which are adequate to service the debt on the loan. Furthermore, 50% of the interest paid on the loan to a third party financial institution will be excluded from the income of the lender, and therefore, the loans will be available at

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a lower than standard rate, approximately 25% to 30% below market interest rates. (Section 133)

(1) Rostenkowski has proposed elimination of the 50% interest exclusion

d. Another tremendous advantage of selling stock to the ESOP is that the gain on the sale of the stock can be deferred if it is invested within a 15 month window in the securities of another domestic corporation. This will permit the selling shareholder who desires to diversify his investments to turn around and reinvest the proceeds from the sale of his stock in other corporations without paying a tax on the proceeds. Section 1042

e. If a deceased shareholder's family sells stock of the corporation to its ESOP, 50% of the proceeds of the sale will be excluded from estate tax and can result in estate tax savings of up to $750,000. (Section 2057)
f. The following illustration shows step by step how these transactions work:

STEP NO. 1 - The ESOP borrows money from a bank to acquire the decedent's stock.

STEP NO. 2 - The bank receives a note from the ESOP.

STEP NO. 3 - The corporation guarantees the Note.

STEP NOS. 4 & 5 - The corporation acquires the stock of the decedent and uses that stock as collateral for the bank loan.

STEP NO. 6 - The corporation makes annual contributions to the ESOP and deducts them.

STEP NO. 7 - The ESOP uses the corporate contributions to pay back the principal and interest on the loan that it received to acquire the stock.

STEP NO. 8 - Not illustrated. A retiring shareholder can reinvest the sale proceeds tax deferred in securities of a domestic operating company within 15 months. Section 1042
10. Recapitalizations

a. Tax free recapitalizations have been permitted under Section 368(a)(1)(E) for many years. A recapitalization is simply an exchange of the securities of the corporation for a different form of securities. For example, the exchanging of common voting stock for non-voting preferred stock or for debentures has been permitted for some time. If a shareholder was retiring and was willing to give the future growth of the company to the other shareholders and to receive a guaranteed income in preference to the other shareholders, he might have exchanged his common stock for preferred. Such a recapitalization would have been an ideal technique for encouraging a younger generation who would continue to be active in the business to stay involved and to reap all of the benefits of future growth without having to immediately purchase the interest of the older generation who is ready to retire but needs a stream of income from the preferred dividends. This would also permit a distribution of dividends to only those shareholders who needed the income, while freeing the corporation of the obligation to distribute dividends to a younger generation who was more interested in reinvesting available funds in the corporation.

b. Section 2036(c). It was only when tax planners became very aggressive and created voting preferred stock which was retained by a parent, and which was frozen in value, and distributed the common stock, often with no voting rights, to a younger generation in an effort to freeze estate tax values, that Congress and the Treasury became concerned. The major problem was in the valuations where the older generation contended that the preferred stock had substantially all of the present value of the corporation, and that the common stock with all of the rights to the future growth could be given to a younger generation free of gift tax. The
response was Section 2036(c) which provides, in general, that a decedent's estate will include the value of the common stock where the decedent retained a disproportionate part of the income of the corporation while distributing a disproportionate part of the appreciation potential to a younger generation.

(1) As of the date of this outline, the Senate Finance Committee adopted the Boren--Daschle Amendment to repeal Section 2036(c) and to substitute some valuation rules.

c. Notwithstanding Section 2036(c), recapitalizations provide an excellent opportunity to divide the ownership of the business into different categories to satisfy the respective needs of the owners. Other forms of recapitalization include the formation of a partnership where the operating control can be in the hands of either a managing partner or a general partner, while the passive partner could have a limited partnership interest but with preferential distribution rights.

11. Charitable gifts of corporate stock interest

a. An older shareholder desiring to reduce his interest in a corporation may have at least two objectives satisfied by the transfer of a portion of his corporation stock to a charity: (1) to satisfy the desire to make charitable contributions in the most tax effective way; and (2) to increase the residual percentage of ownership in the younger generation; By transferring stock to a charity, the donor obtains an income tax deduction while at the same time eliminating the gain that he would realize if he first sold the stock and then transferred the remaining cash to the charity. The gain is subject to the alternate minimum tax Section 57(a)(6).

b. As is frequently the case, the charity that is the owner of a minority interest in the business will seek out a buyer for the stock. It will often sell the stock
to the corporation, and it will sometimes also sell stock to the younger generation who desires to increase its interest in the corporation. If the younger generation buys the stock from the charity, the purchase may be funded by the payment of a cash bonus to the younger generation employee.

c. If the corporation is obligated to redeem the stock, but the charity is not obligated to sell the stock to the corporation, the transaction will not likely be treated as a step transaction by the IRS and taxed as a redemption of the donor's stock by the corporation. D.D. Palmer (62 T.C.685); Rev. Rul. 78-197 (1978-1 C.B.83)

d. It is important in these transactions that care is given to establish a proper valuation of the gift to the charity.

e. The charitable gift is less likely to be challenged if the charity can shortly thereafter sell the stock for that established value. It might be a good time for the older generation to simultaneously gift stock to the younger generation since a challenge by the Internal Revenue Service of the gift valuation to the child would only result in a larger charitable contribution of the donor.

12. Stock bonuses and stock options

a. The overall topic of buy/sell agreements presupposes that the shareholder desires to sell his stock in the company and receive cash. In fact, he may have as his primary objective simply the transfer of control to other members of the family. It is important for shareholders to not enter into a binding buy/sell agreement when there is still the possibility that their children may some day want to enter or take control of the business.

b. Do not overlook the possibility of simply gifting stock to members of the family or bonusing stock to employee family members. One of the problems of gifting
stock is that the value may be growing so rapidly that the gifts cannot be made within the annual exclusion because the company is growing faster per year than the total permitted annual exclusion. This may necessitate a combination of techniques, including gifting to the maximum extent of the annual exclusion, or even the unified gift tax allowance.

(1) Too often parents retain the unified credit while the value of the business continues to grow

(2) The unified credit is not indexed

(3) The unified credit could be repealed

c. Bonuses. There are numerous alternative forms of stock bonuses and stock options for family members. Awarding the family member employees the opportunity to acquire more stock through their employment:

(1) Restricted or non-restricted stock bonuses may be awarded periodically. The stock bonus is taxable to the employee when the risk of forfeitures lapse. Section 83. Unless the employee elects to be taxed in the year of transfer. Section 83(b)

(2) Various forms of stock options including Incentive Stock Options (Section 422A) and non-statutory stock options may also be awarded to employees. Incentive stock options assure the younger generation active in the business that they will have the right to purchase the stock at the present value at a future time. The granting of incentive stock option is tax free to the employee if the option price is at 110% of the current fair market value at the time the option is granted
and the option is exercised within 5 years. Section 422A(c)(6). The bargain element, however, on the date the stock is issued is a tax preference item. If properly adopted, the employee could have up to 5 years to exercise the option which may mean that the employee can wait to see if he is still interested in the business before he actually exercises the option. Without stock options, an employee may have a disincentive to increase the value of the business because he would have to buy the stock from his family at a later time at a higher value reflecting the result of his successes in running the business.

13. Voting Trusts

a. Voting trusts are another way to assure younger generations that they will have the right to control the future management of the corporation without (1) actually redeeming the stock while the older generation is alive; or (2) having the consequences, i.e. gift taxes, low basis carryover, etc. of gifting stock.

b. A voting trust, for example, might assure one sibling who is in the business that the transfer of stock to this other siblings will not affect the ultimate control of the business.

c. This may permit other siblings to retain corporate stock

14. S Corporations

a. Particularly with the advent of lower personal tax rates, S corporations have grown significantly in importance and popularity in the last few years.

b. The obvious benefit of an S corporation is that members of the family who are not active in the business can still receive distributions of income. For example,
the older generation who wants to retire but retain an income interest could do so with the use of S corporations. Also, an S corporation can permit income to be distributed to a sibling who is not active in the business.

c. With the use of two classes of common stock, voting and non-voting, the child active in the business can be assured of control while sharing the income with members of the family who are not involved in the business and who will hold only non-voting common stock.

d. By being able to distribute income to a retired shareholder, it may eliminate or postpone the necessity of having to buy that shareholder's interest, at least until the death of the shareholder when there would be a stepped-up basis.

15. Sale of the business to outsiders

a. Sometimes it is not possible for a corporation to redeem the stock of a shareholder, particularly if it had to be done with after-tax dollars. When a conflict arises between shareholders and neither shareholder can, nor is willing to purchase the interest of the other shareholder, it may be necessary for the entire company to be sold.

b. Perhaps one of the shareholders who wanted to remain active in the business could enter into an employment relationship with the new owners.

c. The new shareholders will often arrange for the acquisition on a leverage buyout basis which usually will involve (1) a reduction of the payroll of the corporation by the elimination of the high salaries previously paid to the shareholder employees, and perhaps other employees; (2) tax deductible covenants not to compete and consulting agreements; (3) the use of an employee stock ownership plan; (4) the sale of corporate assets, even a subsidiary, to obtain cash; (5) perhaps a sale and leaseback of some corporate assets; (6) the deduction of interest on junk bonds; and (7) other techniques.
16. Going public

a. An alternative to a shareholder selling out his entire interest in a corporation will be to have a public offering by the corporation of some of its stock which in turn will ultimately create a market for the major shareholder's interest. This may make it possible for the shareholder to have the opportunity to diversify his holdings during retirement, or to assure his family of the ability to sell their stock at his death to obtain income. It may also make it possible for a shareholder to transfer a portion of the business to a family member who is not active in the business with assurance that the inactive family member would have a market for their minority interest in the corporation.

b. This may be an initial public offering or the shareholder may piggy-back on the offering by the sale of his own stock.

c. Going public helps establish the value of the balance of the stock for estate tax purposes.

17. Guaranteed income payments to partners

a. One of the advantages of partnerships is the flexibility of writing a partnership agreement that can provide for special distributions to certain partners. Included in these provisions is Section 736(a) that permits a partnership to make guaranteed payments with respect to a retiring or deceased partner which are deductible in computing the net income of a partnership.

b. The payments for a retiring or deceased partner's interest may also be deemed to be in exchange for the withdrawing or deceased partner's share and treated as a sale of a capital asset eligible for long term capital gain. Section 736(b)

c. Special allocation payments may be paid to a partner who is not active in the management of the partnership. This may permit a partner to retain his partnership interest, and even pass it on
18. The use of life insurance to assist in the purchase of a shareholder's interest in a business

a. Group term life insurance. Section 79 permits a corporation to provide life insurance to employees on a very favorable basis. It provides that the employee will not be taxed on the cost of the first $50,000 of group term insurance provided to him, and will be taxed on a favorable basis for other group term insurance which is provided by the corporation on his life. As a practical matter, a large recovery of insurance proceeds on the death of a shareholder will reduce the amount that his family will need to receive for his interest in the corporation.

b. Individual term or ordinary policies. Any insurance purchased by a corporation and payable to the insured or his family will permit the corporation to deduct, if reasonable compensation, the cost of the premiums. Although the premiums will be taxable to the employee, and included in his W-2 income, the proceeds of the life insurance will be tax-free and, like group term insurance, will have the practical impact of reducing the amount that the decedent's family will need to obtain for the business interest following the death of the shareholder or partner. Such life insurance will also make it possible for the decedent to divide his estate by giving the inactive siblings cash and the active siblings stock or ownership interest which would eliminate the necessity of redeeming a portion of the decedent's interest in order to provide the liquidity for an equalization of the estate.
c. Split dollar insurance.

(1) Split dollar insurance has grown in popularity and is now a major technique by which corporations assist an owner/employee in purchasing life insurance. While the full premium of ordinary life insurance is taxable to an employee, under a split dollar plan, only the PS-58, i.e. current value of the annual coverage, is included in the income of an employee. Rev. Ruling 64-328 (1964-2 CB 11)

(2) Rather than the corporation paying the entire premium and having an employee taxable on the PS-58 element, the corporation may want to bonus the PS-58 cost, and perhaps even the tax on such bonus, to the employee which will be deductible by the corporation, and the employee can pay his own PS-58 costs.

(3) Frequently, to remove the policy from the insured's estate, the employee's ownership interest in the split dollar insurance policy is owned by an irrevocable trust and the employee makes an annual contribution to an irrevocable "Crummey" trust. Crummey v. Commissioner 397 Fed 2d 82 CA-9 1968

(4) Beware that under Section 2042, an employee's estate will include the value of split dollar life insurance if the employee is the sole shareholder and if he retains the incidents of ownership in the policy through his control of the corporation. Rev. Rul. 82-145 1982-2 CB 213
d. Reverse split dollar

(1) This is the latest twist of split dollar insurance. Under this concept, the corporation is the beneficiary of a life insurance element of a split dollar policy and the corporation reports the PS-58 costs on the current value of the life insurance.

(2) This technique is used to let the corporation recover for the loss of a key man.

(3) The corporation can also use the proceeds to redeem his interest in the corporation.

e. Disability buyout insurance

(1) Similar to life insurance, disability buyout insurance will pay proceeds after the insured has been disabled for a period of time, such as one year. This would provide the proceeds needed to fund the redemption of a shareholder's stock who is forced to retire because of a disability.

(2) Warning - read policy carefully to be certain the policy will be payable by the insurance company to meet the corporation's obligations.

f. Any technique that can assist in either providing the corporation with the cash to buy out a retiring or deceased shareholder, or which will give the disabled or deceased shareholder's estate cash will dramatically ease the burden of purchasing an interest in a business in what would otherwise have been a non-deductible redemption.
19. Installment payments with deductible interest

a. Any time there is a purchase of a shareholder's interest in the corporation, it may be structured on an installment basis with the deferred payments bearing interest. The opportunity to balance a fair price for the shares or partnership percentage purchased and a reasonable rate of interest will give the opportunity for some latitude in obtaining the best balance.

b. The installment note may also provide that a "bargained for" element of the Note is that any unpaid installments remaining at the death of the holder of the note are forgiven. John A. Moss 74 TC 1239, Acq. 1981-1 CB 2 This may be very useful where the selling shareholder needed cash during his lifetime, but upon his death he had no heirs to whom he wanted to leave the balance of the note, and where he was more interested in preserving the company for the employees, which may include a family member.

20. Issue debentures. Similar to the installment note is the issuance by a corporation of its debentures. Debentures are simply collateralized, mortgage backed promissory notes. The interest paid on these notes is deductible by the corporation and can serve as a means of financing a stock redemption.

21. Private annuities

a. One technique for a shareholder to be able to get the maximum amount of income for his interest in the corporation, while minimizing his estate tax would be to sell his ownership interest pursuant to a private annuity. Each payment that he receives will be part interest, part tax free recovery of basis and part capital gain.

b. The major advantage of the private annuity is that it is payable to the seller as long as the seller lives, and immediately disappears on the seller's death, free of estate tax.
22. Plan for the continuity and succession of the business by the family

VIII. SUMMARY

A. All of the foregoing techniques are alternatives to the straight non-deductible redemption of a shareholder's or partner's interest in a business. They may be used individually, in combination, or to buy a portion of the withdrawing shareholder's or partner's interest.

B. In some cases, they are simply payments to the owner so that he will not have to sell his interest in the business and will be free to give it to members of the family who are active in the business.

C. As indicated above, "disguised" methods of paying for the stock or partnership interest will be scrutinized by the Internal Revenue Service when:

1. They appear to be treated as compensation for services that have not been rendered

2. They appear to be a bargain sale, i.e. a gift to remaining shareholders, particularly family members

3. Or when the substance of a transaction otherwise does not meet the form in which the taxpayers try to structure it

D. Good planning and a fair effort to value the interest being purchased or the services being rendered should permit a good balance of the tax positions of the various parties involved.
Dear Shareholder of Quicksilver, Inc.:

You have asked us to perform certain services for you relating to your proposed Buy & Sell Agreement. We are pleased to do so; however, it is in your best interest, and our own ethical obligation to each of you requires, that you fully understand the considerations involved in "dual representation" of your corporation and its respective shareholders.

The different shareholders can have differing, and sometimes conflicting, interests and objectives regarding their corporate planning. For example, they may have different views on how to value the corporate stock upon the death or retirement of a stockholder. There may be a conflict in whether the selling shareholder should be subject to a covenant not to compete. There may be a conflict in how an installment payout is secured. These are just a few general examples. Each situation is unique.

If you each had a separate lawyer, you would each have an "advocate" for your position and would receive totally independent advice. Information given to your own lawyer is confidential and cannot be obtained by your fellow shareholders without your consent.

That may not be the case here where we are advising the entire family, but the opportunity for conflict does exist. We cannot be advocates for one of you against the other. Information that any of you gives us relating to your thoughts and special needs cannot be kept from the other shareholders. If you ask us to continue to serve you jointly and the corporation, our effort will be to assist in developing a coordinated overall buy out plan and to encourage the resolution of differing interests in an equitable manner and in the best interests of your mutual business affairs. We will attempt to represent your corporation without a bias in favor of any of you.
After considering these factors, each of you must decide whether you wish us to continue to represent you jointly in connection with your corporation and related matters. If you do, please review the statement that follows, sign it as indicated, and return this letter to us. An extra copy is enclosed for your records. If at any time any of you wishes to have the advice of separate counsel, you are completely free to do so. We hope that the information provided will assist you in using our services effectively. Again, we appreciate the opportunity to be of service. We look forward to a long and successful professional relationship with each of you and your corporation.

Very truly yours,

THE SILDON LAW GROUP, P.C.

By

Myron E. Sildon

We have each reviewed the foregoing letter. Each of us realizes that there are areas where our interests and objectives may differ and areas of potential or actual conflict of interest between us in connection with our estate planning and related matters. We understand that each of us may retain separate, independent counsel in connection with these matters at any time. After careful consideration, each of us requests that you represent us and our corporation jointly in connection with our corporation succession planning and related matters. Each of us also understands and agrees that communications and information which you receive from any of us relating to these matters may be shared with the others.

I.M. QUICK

U.R. QUICK

QUICKSILVER, INC.

By

P.A. QUICK