Alternatives to Buy-Sell Agreements and Business Succession Planning

Myron E. Sildon

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ALTERNATIVES TO BUY-SELL AGREEMENTS
AND
BUSINESS SUCESSION PLANNING

PRESENTED TO THE
WILLIAM & MARY FEDERAL TAX CONFERENCE
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BY

MYRON E. SILDON, ESQ.
THE SILDON LAW GROUP, P.C.
800 WEST 47TH STREET, SUITE 500
KANSAS CITY, MISSOURI  64112
816/531-8877
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The Need For a Business Continuity Plan,
A Blueprint for Success

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I. The Business Succession Plan

A. A Blueprint For Success 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.

B. It outlines how the family can create liquidity to get money out of the family business, often without having to sell it.

C. See Hypothetical Fact Pattern in Appendix A.

D. Types of information in a Business Succession Analysis and Report.

1. Key management
2. Key competitors
3. Prospective purchasers
4. Valuation issues
5. Compensation issues

II. The Blueprint for Success Should Be Updated Periodically to Plan for the Passage of Control of the Family Business:

A. To assist the family
B. To assist the corporation
C. To assist the trustee
D. To assist the bank

III. Why the Owner Might Consider Selling the Company Publically or to Outsiders, Key Employees, or Certain Members of the Family:

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 – to use Section 6166 the decedent’s interest in the closely held business must constitute at least 35% of adjusted gross estate.

2. To provide for living expenses for surviving family.

3. To use cash 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:
   a. Salaries
   b. Dividends
   c. Expansion plans

B. There can be 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.

*(All section references are to the Internal Revenue Code unless otherwise indicated).*
C. Desire to transfer control to younger generation.

1. 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.

2. Younger generation family employee 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 to 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 draw backs:
   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.

F. Entering into Buy-Sell with key employees may be only way to adequately compensate them for staying in the business.

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 as when there were higher personal rates versus more favorable capital gains rates.
B. Higher corporate tax rates now exist, so it is important for the corporation to obtain deductions through compensation and other deductible techniques.

C. Repeal of capital gains deduction in TRA '86 had eliminated the primary advantage of the traditional agreement to the seller. In the last session of Congress, the House had approved a 19.6% preferred rate window for capital gains. Both Democrats and Republicans proposed capital investment incentives during Presidential campaigns.

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 insurance proceeds will be available to fund a non-deductible buy out.

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

1. Get personal guarantee of remaining owners, and their spouses.

2. Retain a security interest.

   a. Not just the stock or partnership interest sold.
b. Other collateral, e.g. company or personal real estate, or other liquid securities.

c. Loan agreement should restrict.
   (1) dividends
   (2) sale or pledge of assets
   (3) all but limited salary adjustments
   (4) transfer of control
   (5) going into new ventures

d. Loan agreement should require 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 that remaining shareholders must increase equity of company or purchase the stock proportionately if capital is inadequate under state law.
H. Sale to outsiders may be sale of assets resulting in double tax.

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

VI. Ethical Considerations in Estate and Business Planning.

A. Possible Conflicts of Interest Among Family Business Owners.

1. Attorneys and other professional advisors are often asked to represent all of the shareholders or partners of a family owned or controlled business, as well as the business itself.

2. The opportunity for a conflict of interest in such representation is obvious and must be addressed.

   a. Each shareholder may need separate counsel.

   b. The corporate counsel may try to represent business and the remaining owner.

   c. A single counsel may develop the ideas and draft the agreements for each party to submit to their respective counsel.

3. Each owner is different and has individual considerations.

   a. Age, health and stage in life.

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

   c. May have different objectives e.g., diversification vs. retaining the business for his own family member.

4. In 1983 the American Bar Association adopted the Model Code of Professional Responsibility Rule 1.7 which provides that a lawyer shall not represent a client if the representation of that client will be directly adverse or materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

   a. The lawyer reasonably believes the representation will not adversely affect the
relationship with the other client, and

b. The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and the risks involved.

5. The Model Rules do not automatically preclude representation of clients with conflicting interest, but require a lawyer to determine whether the conflict would materially interfere with the lawyer's "independent professional judgment" and if the lawyer believes he can undertake the representation, all clients must consent after consultation.

a. Each client must be advised of the benefit and right to separate counsel.

b. Have client either sign a conflict of interest engagement letter, see Appendix B.

c. Include a provision in Buy-Sell or other agreements acknowledging the conflict - See Appendix C.

6. In the family business and estate planning context the opportunity for conflicts arises where:

a. Different family members are not all active in the business.

   (1) How do you give inactive shareholders adequate protection and some control of activities without unduly restraining active employee shareholders?

   (2) How are decisions regarding salary and fringes to be made?

b. In advising about Buy-Sell Agreements:

   (1) What if one shareholder wants to pass stock to a spouse or child who may come into the business, when another shareholder does not want to have to deal with them?
(2) How do you advise about a formula for valuing the business when you realize one shareholder is older and more likely to be bought out and the other is the more likely survivor/purchaser?

(3) How do you advise the likely selling shareholder to impose loan restrictions on business during payout, without limiting the likely purchasing corporation or shareholders?

(4) How do you advise the business on tax deductible ways to buy out a shareholder, when it will result in taxable income to the seller and no stepped-up basis at death?

(5) How do you advise the parents how to leave their family business to their children when you represent one of the children who is not in the business?

(a) Should you advise the parents to sell the company to provide for their own retirement security?

(b) What about your own conflict where you would lose a corporate client if the parents sold the business?

(6) If a family business is thinking about selling, and you believe you could afford it, and could retain the managers to run it, can you buy it?

(7) If the attorney recognizes that there is a conflict, but feels it is not material, and would not prevent him from giving sound advice in a non-prejudicial manner, he still must:

(a) Disclose the conflict.

(b) Explain the possible consequences of the dual representation, and

(c) Obtain the written consent to the representation.
(8) Impermissible Conflicts.

(a) Even with full disclosure and consent of the parties, a lawyer cannot represent clients with conflicting interests if a party would be seriously affected.

(b) Code of Professional Conduct Rule 1.8 sets out per se conflicts:

- Where there is active litigation between the clients.
- Spouses in a pre-nuptial agreement.
- Spouses in characterizing community and separate property.
- Where knowledge of one client’s health or other personal need to sell can be used to the disadvantage of that client without his consent.

(c) When compensation for representing a client is paid by someone else unless:

- The client consents.
- There is no interference with the lawyer’s independence of professional judgment or the client lawyer relationship, and
- Information relating to the representation of the client is protected under Rule 1.6.

B. Tax Representation.

1. Where the parties to a business succession or business buy-out will have conflicting tax consequences, the attorney must fully disclose the conflict.

2. A lawyer can advise a client how to structure a transaction to minimize taxes, but cannot advise a client to take tax positions which are illegal, or
which cannot be supported by the law, regulations or other established authority.

3. IRS Circular 230 imposes a number of duties and restrictions on practice before the IRS by attorneys, accountants, and other enrolled agents.

a. A person authorized to practice before the IRS:

   (1) May not interfere with an effort by the IRS to obtain information unless the person believes in good faith and on reasonable grounds that the information is privileged or that the effort is of doubtful legality.

   (2) Retained by a client who has not complied with the revenue laws or has made an error in or omission from a return or document the client is required to execute must advise the client promptly of the omission or error, but is not required to insist on compliance by clients. This is consistent with:

      (a) AICPA position that the CPA should consider the implications of the client's refusal to comply on the CPA's future relationship with the client.

      (3) May not represent conflicting interests, except by express consent of all directly interested parties after full disclosure has been made.

      (4) Plus other prohibitions.

4. Warning - The suggestions for some of the alternatives to the traditional Buy-Sell Agreement set out below could be scrutinized by the IRS to examine whether they are disguised dividends and non-deductible, so great care must be shown to properly document them, but they are legal if properly used.

VII. Alternatives Which May Be Used in Lieu of the Typical Buy-Sell 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 a 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 end 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 have a business purpose.

   (c) 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.

   (d) Immediately after the distribution, each of the corporations must be engaged in the active conduct of a trade or business.
(e) 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. Pay Wage Continuation to Selling Shareholder, and Exclude Accounts Receivable and Goodwill in Valuing His Stock.

a. This technique is frequently used in a service or 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. Caution: In cases in which a shareholder receives, under a Wage Continuation Agreement, an amount for his shares in excess of book value, the IRS has often challenged the arraignment arguing that such payments are non-deductible compensation.

(1) The IRS was unsuccessful 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
The IRS has been more successful where a deductible payment is blatantly for accounts receivable or goodwill.

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, 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 of 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 a "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 because individuals are in lower tax brackets than highly profitable corporations.

(1) Particularly under attack are Secular Trusts founded with life insurance. See recent private letter rulings 9206009 and 9207010 which suggest that the annual increase in cash value may be taxed to a highly compensated employee as a vested accrued benefit under Sec. 402(b)2.

(2) Investing in annuities may be preferable, because clearly the increase in value is not taxed.

e. Why would deferred compensation be funded with life insurance:

(1) Self completing if early death.

(2) Convenient investment vehicle.

(3) Can be paid out as an annuity.

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 F2d 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 canceling 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 it 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. Velencsics (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. Additionally the covenant should have been separately bargained for by the parties so that separate or severable consideration can be shown.

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

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

(2) 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;

(3) 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

(4) Was the covenant economically real?

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 generally subject to depreciation because their useful lives cannot be determined with reasonable accuracy.

(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.

However, a list of all customers regularly using goods or services was held to be a separate capital asset and amortizable in 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.

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. Metro Auto Auction of Kansas City, Inc., T.C. Memo 1984-440.

(3) Generally courts have been split on whether customer-based intangibles, such as customer lists, insurance expirations, newspaper subscription lists, and core deposits can be authorized. Section 167(a) allows amortization of intangibles, but not goodwill. Whether one can amortize a particular intangible depends on which definition of goodwill the court chooses to apply. The courts have generally applied a two part test to interpret Reg. Section 1.167(a)-3 which is that the intangible have (1) an ascertainable value separate and distinct from goodwill and (2) a reasonably
ascertainable useful life. See Houston Chronicle Publishing Co. v US 481 F2d 1250 (5th Cir 1974) Cert Denied 414 US 1129 (1974); Donrey Inc. v US 809 F2d 534 (8th Cir 1987). Whatever certainty is possible to amortize intangibles is where customer based lists are purchased separately from other company assets in the sale of a business. See Panichi v. US 834 F2d 300 (2nd Cir 1487) where amortization of a trash collection list was allowed. Because this is forcing sellers to sell intangibles apart from the going concern, there are three bills before congress to clarify rights to amortize intangibles by simplifying the definition of goodwill: HR 3035, HR 1456, and HR 563. See Note in ABA Tax Lawyer Vol. 45, No. 4, Page 1031 "The Amortization of Customer Based Intangibles: 'The Separate and Distinct from Goodwill' Requirement".

8. Defined Benefit and Target Benefit Pension Plans, and Age Weighted Profit Sharing and Other Qualified Retirement Plans.

(a) 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 $108,963 (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
(b) Target benefit and age weighted profit sharing plans are individual account defined contribution plans that compare projected retirement benefits to show that the benefit of younger and lower paid employees will be comparable to the benefit of older employees who will be retiring soon even though a larger allocation of the contribution goes to the older employee.


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 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.

d. Another tremendous advantage of selling stock to the ESOP is that the gain on the sale of the stock, if the stock had been held for three years prior to the sale, 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 reinvest the proceeds from the sale of his stock in other corporations without paying a tax on the proceeds. Section 1042. The ESOP must own 30% of the corporation after the "redemption". Neither the redeemed shareholder nor his family can receive future ESOP allocations for 10 years.

e. Another very significant benefit of using an ESOP is that a financial institution which loans money to an ESOP to acquire stock of a selling shareholder can exclude 50% of its interest income pursuant to Section 133 if the ESOP owns at least 50% of the stock of the corporation.
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 Seller 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.
g. ESOPs can be used to obtain a charitable deduction for the shareholder and a deduction for the corporation.

h. ESOPs can be used to provide liquidity to an estate with deductible life insurance.
10. Recapitalizations.

a. Tax free recapitalization have been and still are 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 voting rights and future growth of the company to the other shareholders and to retain 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 to stay involved in the business and 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 have permitted 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 more interested in reinvesting available funds in the corporation.

b. Section 2036(c). 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. 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. Congress responded with Section 2036(c) which provided that a decedent's estate would 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.

c. Repeal of 2036(c) and Enactment of Chapter 14. The approach of 2036(c) was overly broad, unclear and unduly burdensome, and in 1990 Congress repealed it retroactively substituting for it a new Chapter 14.
and Sections 2701 to 2704. The new rules adopt a gift tax approach for traditional corporation, partnership and trust freezes to replace the estate tax approach of 2036(c). The focus is on establishing an accurate value for the common stock transferred. In arriving at such value, certain discretionary rights retained by the preferred stock interest will be valued at zero, thereby increasing the residual value of the common stock transferred.

d. Working within the carefully drawn parameters of the new valuation rules, recapitalizations still provide an excellent opportunity to divide the ownership of the business into different categories to satisfy the respective needs of the owners. Recapitalizations 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.


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. By establishing a Charitable Remainder Trust the donor may retain or increase his income, plus receive a charitable deduction. Often the donor will use the cash flow and tax savings to purchase wealth replacement insurance through an Irrevocable Trust.

c. 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.

d. 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).

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

f. 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. 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. HR4848

(4) Even taxable gifts are more favorable than estate tax.
b. 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 forfeiture lapses. 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 an incentive stock option is tax free to the employee if the option price is at least 100% 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.


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 the other siblings will not affect the ultimate control of the business.

c. This may permit other siblings to retain corporate stock.


a. Particularly with the advent of lower personal tax rates, S Corporations and Limited Liability Companies ("LLC’s") have grown significantly in importance and popularity in the last few years.

b. The obvious benefit of an S Corp. or LLC 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. Also, both an S Corp. and LLC can permit income to be distributed to a sibling who is not active in the business.

c. With an S Corp., the use of two types 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 or member, the S Corp. or LLC may eliminate or postpone the necessity of having to buy that shareholder’s or member’s interest, at least until death 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 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 buy out 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.


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 and LLC Members.

a. One of the advantages of partnerships and LLC’s is the flexibility of writing a Partnership or Membership Agreement that can provide for special distributions to certain partners or members. 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 or member who is not active in the management of the business. This may permit retention of an ownership interest to pass on to members of the family, thereby reducing the necessity of the business purchasing the interest on a non-deductible basis.

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 lower of the term premium or PS-58 cost, 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 controlling shareholder and if he retains the incidents of ownership in the policy through his control of the corporation. 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. New product developed by some companies - first to die - because no need to have insurance on the last survivor.

f. 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.

g. 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.
   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.

   a. If the children are not subject to Non-Completion and Confidentiality Agreements, there is nothing to prevent them from starting a new business with their know how and contacts.
   b. This provides liquidity to parent who receives the accounts receivable and other cash from the wind down business.
   c. In affect there has been a transfer of the good will and know how to the child or children in the business without gift or estate taxes.

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.
Hypothetically, the President of a closely-held business comes into your office or ours and says that he has already done his estate planning, but wants to have it reviewed. He has a Will, and perhaps even a Trust Agreement, that says "leave all of my assets to the Big Bank Trust Company for the benefit of my wife and family". There are no specific provisions in the Trust regarding the business. In fact, he has never met anyone from the trust company which he has named as trustee only because his neighbor works for the Bank that has the trust department.

The BUSINESS OWNER thought he had his estate plan in place, but in fact, the family business, which was overwhelmingly the largest asset on his financial statement, was not mentioned in the plan. If this business owner had been killed in an accident, hit with a serious illness or died unexpectedly, he is the only one who would not have had a plan:

The TRUST DEPARTMENT would have a plan to immediately sell the company which it received since it did not want to be responsible for running a family business, about which it knew very little and had no particular expertise, and had been given no authority nor instructions. The trust company would prefer to convert the business to a portfolio of cash that could be invested in the trust company's common investment funds. The company did not have key man insurance to assure the trust company that there would be adequate cash to hire a top manager.

The trust department would immediately notify the COMMERCIAL DEPARTMENT of the death of the owner, and the commercial department would immediately review the promissory notes to determine whether they could be called in the event of the death of the owner, and whether his wife had personally guaranteed the notes. The commercial department would be happier had the loan been secured by life insurance, then its plan would be to collect the insurance proceeds and pay off the loan, leaving the company without a renewed line of credit at its most vulnerable time.

The SALES MANAGER had a plan. He would think that his brilliant sales effort was the entire reason for the company's success, and he would advise the widow that he should become the President of the company. He would threaten that if not made President, he would have plenty of opportunities to sell for a competitor, and the owner's planning never included a covenant not to compete or a forfeitable deferred compensation plan.

The OPERATIONS MANAGER would have a plan, and he would tell the widow that her husband had relied most heavily on him to run
the company, and had assured him if something happened to the
President, he, the Operations Manager, was supposed to become the
President (and, by the way, his plan would be to fire the Sales
Manager). There was not a split dollar nor reverse split dollar
policy to build loyalty with this key manager.

The WIDOW's plan was either to run the company that she knew
nothing about, or to stay at home and live on dividends equal to
what her husband had been drawing as a salary. An irrevocable life
insurance trust funded with life insurance had not been presented
to the President to provide for the widow independent of the
earnings of the business.

One of the SONs who had worked at the company during the
summer, decided that the only appropriate plan for him was to drop
out of college and run the company, rather than have HIS SISTER who
is married to a Wall Street lawyer follow through on her plan (threat)
of bringing her husband back to run the company while the
sister pursued her career in retailing at a local gift shop.

The PRIMARY MANUFACTURER whose products the company
distributed had a plan to find a new dealer and exercise its rights
under the Distributorship Agreement to terminate the dealership,
and to buy back the inventory at cost, and to offset this book
value of inventory against the financing that it had provided the
distributor. There was not a cross purchase agreement funded
through insurance, or otherwise, for the key employees to acquire
control of the company and preserve its goodwill i.e., going
concern value. A business succession plan had not been approved by
the manufacturer.

The INTERNAL REVENUE SERVICE, of course, had a plan to value
the business on the basis of what it earned as a going concern
before the President died. Interestingly, the IRS plan was quite
different than the COMPETITOR's plan to buy the company at a
distressed sale price from the widow and her family.

Perhaps the company did have an old key man insurance policy
on the owner which was payable to the company. No one had
mentioned that the insurance proceeds would be subject to the
alternate minimum tax, which could have been avoided by an S
corporation election. Similarly, no one had mentioned to the owner
that the insurance would be included in his estate because he had
retained the right to change the beneficiary and other "incidents
of ownership" in the policies. Of course, the insurance would also
be included as a portion of the net worth of the company thus being
doubly taxed for estate tax purposes.
By good fortune the BUSINESS OWNER had found his way to a sophisticated life agent, accountant, trust officer, and an attorney who worked together and knew the importance of preparing a blueprint for the continuity of his business.

The advantages of undertaking a periodic review of the business and writing a business continuity plan are the following:

1. A plan will force the owner to consider who is available to run the business in the event of his early demise or incapacity. This process may open opportunities for a transition from entrepreneurship to a professionally managed firm.

2. The process of analyzing the succession plan may cause the owner to realize the need for his own estate planning, for a buy and sell agreement, and for alternative ways to provide for his own retirement through Qualified Retirement Plans or an ESOP.

3. The BLUEPRINT for SUCCESS may cause the owner to think about ways in which the business could someday be sold to key employees, to outside investors, to an employee stock ownership plan, or in a public offering.

4. When the blueprint is finished, copies of it can be furnished to the spouse and other family members, the trustees under the estate plan, other key advisors, and to the primary suppliers, which can be asked to give their consent in advance to the owner's succession scheme.

5. Undertaking the review of the succession plan may cause the owner to have the company valued for gift or estate tax purposes, charitable contributions, the buy and sell agreement, and for obtaining working capital or other loans from the bank.

6. The process of continuity planning should cause the owner to analyze whether the company's real estate needs are adequately handled for the next few years, and whether (a) it should be contemplating a modernization of its facilities or a move to new facilities, and (b) whether it should continue to lease or purchase its facilities, etc.

7. The process of considering the blueprint for continuity of the business should assist the dealer in determining whether there will be a way to pass the business on in an "equitable" manner to various members of his family, including providing adequate income for his widow, and future opportunities for his children. The process of writing the blueprint may cause the dealer to realize that one or more of his children may be
interested in remaining with the company, while other children have no interest in the operations of the business.

The actual blueprint should be a written set of instructions for the company’s advisors. It would set forth the answers to such questions as the following:

1. Who the owner feels are the key employees and the responsibilities he would assign to them to run the company if there was an unexpected change in management due to his death or disability.

2. An explanation of the succession plan which had been approved by the company’s primary supplier or manufacturer evidencing its consent to the transfer of management outlined in the plan.

3. How the company would be valued if it were to be sold and who the natural purchasers would be.

4. The relationship with the banker and the assurances that had been given that the banker would work with the family during the transition of ownership.

5. The arrangements that have been made to pay estate taxes, including the possibility of paying the taxes in installments as permitted by the Internal Revenue Code.

6. Methods of valuing the business depending on whether the valuation was for estate tax purposes or for purposes of selling the business to company executives or to outsiders.

7. Instructions and the authority for the trustee, the family and the probate court to retain or sell the business, as appropriate.

The blueprint could set out whether there are covenants not to compete in place to preclude key employees from threatening to leave, whether the key employees have been given assurances with regard to their options to purchase stock, and whether they are entitled to contingent bonus arrangements.

The blueprint could also describe the types of retirement plans that the company has, and the benefits that the family should be expecting, as well as other benefits that are to accrue to the family of the deceased owner.
The succession plan should list the key advisors to the company including its lawyer, accountant, and insurance agent. The plan should confirm that the will and trust contains specific authority for the bank to rely on certain key members of the family and executives to continue to run the company, and the blueprint could confirm whether the bank had agreed to retain the family business as the key income producing asset of the estate.

Among the other considerations in the succession plan, it could describe the tax status of the corporation including whether the corporation was an S corporation and what would be necessary to either preserve that election in order to assure the income of the corporation would flow through to a qualified subchapter S trust, or whether the S corporation election should be terminated.

For all of the years that the President had spent building up the corporation, he would have been better off spending a few dollars each year considering his blueprint for the continuity of the business, and updating the plan from time to time.

The professional team could have developed many liquidity alternatives for the benefit of the owner through:

a. key man protection.

b. a funded cross purchase agreement.

c. a funded deferred compensation plan to retain key employees.

d. a retirement plan to complete the funding of a tax sheltered rollover to fund the widow’s needs.

e. An irrevocable life insurance trust for the widow and her children free of estate tax in the owner’s estate.

f. A separate trust to own a second-to-die policy to pay the estate tax at the widow’s death with greatly discounted dollars and free of estate tax.

All of the foregoing can provide ways to take care of the business and family needs with greatly discounted dollars, but they take knowledgeable professionals who understand the technicalities and need for proper titling, corporate action, and well drawn documents prepared in a prompt, efficient, and professional manner.

Appendix A
APPENDIX B

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
APPENDIX C

Waiver of Conflict of Interest

The parties to this Agreement acknowledge that this Agreement has been prepared by The Sildon Law Group, P.C. (the "Law Firm") on behalf of the parties hereto. There is an inherent potential for conflicts of interest among the parties to this Agreement because this agreement establishes the rights and obligations of each of the parties to this Agreement. Due to such potential conflicts of interest, the Law Firm has advised and hereby advises each of the parties that it would be in their best interest to obtain the services of their own independent legal counsel to review this document. Notwithstanding the fact that the Law Firm has prepared this Agreement and has provided legal advice to one or more of the parties in preparation of this Agreement and in related matters, the parties hereby waive as evidenced by the execution of the Agreement any potential conflicts of interest that may arise as a result of the above actions by the Law Firm, whether or not one or more of the parties to this Agreement may have consulted with separate legal counsel concerning this Agreement.