

## 22. Planning for the Owner of a Closely-Held Business

If you own a business, or part of one, nobody has to tell you what a struggle it was to get it started and how much work it takes to keep it going. This article explains what it takes to keep from losing what you've built when events beyond your control occur.

### Here are some real-life examples:

*Example 1.* Al, Bob, and Charlie Black, brothers, have been involved as equal shareholders in a car repair business for the past 15 years in downtown Bellevue. Charlie Black is killed in an automobile accident during the time a final divorce decree is pending with his wife. Charlie's widow is appointed as executrix of his estate and is his sole beneficiary. (Charlie never got around to revising his Will, even though the divorce had been pending for a year.) She is now making demands Al and Bob feel are unreasonable for the corporation to repurchase Charlie's stock at a price Al and Bob believe to be inflated. How can Bob and Al protect themselves?

*Example 2.* Fred Smith and George Williams are partners in the A-I House Painting partnership. Both have been active in this successful business for years. Fred becomes incapacitated by a serious illness. It is unlikely he will ever be able to return to active participation in the business. The existing partnership agreement says that Fred is to receive one-half of the net profits of the business. The agreement does not require him to be able to work to get it. How can George protect himself against the claims of Fred for one-half of the net profits even though Fred is no longer working?

### Planning in Advance Is the Key

These problems and others can be handled through proper planning. All too frequently business owners do not recognize the importance of planning for the various contingencies that can arise among or between partners or shareholders in closely held businesses. The death, retirement disability, or divorce of a business associate may all have significant impacts on the continuing, smooth, and profitable operation of a business. Agreements worked out in advance can avoid what may otherwise turn into a costly and heated dispute regarding the operation and control of business or the price at which the business interest should be bought or sold.

### What to Plan For

The key concerns facing you, the owner of a closely-held business, are the following:

- What happens to my business interest upon my death, disability, or retirement?
- Will there be a market for my business interest if it must be or should be sold to raise cash to pay estate or other taxes or for other family purposes? What will the price be? Where will the money come from?
- How will the income that I was receiving through wages or other forms of

compensation be continued to my heirs if I should die, or to me if I should become disabled or retire?

- How can key employees be induced to stay in the business and run it profitably if I should die or be unable to continue in the business myself?
- How can I assure continuing adequate working capital for the business if one or more business owners attempt to withdraw and take with them their portion of the capital?
- How can I provide adequate cash for payment of any death taxes which might be payable upon death, especially when a significant part of my estate is in the value of my business interest?

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### **How Planning Is Done**

These and other concerns are often best dealt with at the time the business is formed. Basic agreements can be made to control the disposition of a business interest and define how the disposition will be handled in the event of an owner's death, retirement, disability, or divorce. As the business grows (and hopefully prospers), the agreements should be periodically reviewed and refined, as necessary, to meet the changing circumstances of the business and its owners.

### **Drafting a Buy-Sell Agreement**

The first concern addresses the question most often raised: "What happens to my business interest upon my death?" The first part of the answer is that the business interest is an asset of the business owner's estate. For a corporation, the interest consists of the shares of stock owned. For a partnership, it is the individual's partnership interest (rather than partnership assets). For a sole proprietorship, the interest consists of the assets used in the business.

Ownership of the business interest will pass either under the individual's Will or revocable trust or under Washington's laws of intestacy, which specify how property is distributed when a person dies without a Will. (See related chapter on Wills.) These methods of transferring ownership can be modified by a binding contractual arrangement between or among the business owners, commonly called a "buy-sell agreement" but sometimes also known as a "shareholders agreement" or "business continuation agreement."

The potential pitfalls of not properly planning for the disposition of a business interest are illustrated by the situation of Al, Bob, and Charlie Black. They should have considered (ideally, at the time the business was formed) whether or not an interest in their business should be permitted to pass by Will or intestacy at all. In the example, Charlie's

wife (as his beneficiary) has created an unnecessary complication in the operation of the car repair business. A properly drafted buy-sell agreement could have solved the problem.

### **Setting the Price**

In the event of the death of a shareholder (Charlie), the agreement could have provided a price—either set by preagreement or by formula— under which either the corporation or the other shareholders would be obligated to buy Charlie's stock and under which Charlie's wife would be obligated to sell. This would have avoided any dispute with Charlie's wife over the appropriate price for the stock and ensured that Al and Bob need not deal with Charlie's wife—or her new husband—as a shareholder in the future.

Buy-sell agreements force all parties to be fair, for no party knows who will die first and whose beneficiaries will be bought out at the agreed price. However, the price set in the agreement may or may not be binding on the IRS for estate tax purposes, depending on a number of factors, including whether the family controls the business. Careful attention should be given to the requirements which will cause the agreement to be binding on the IRS as well as the parties.

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### **The Buy-Out Terms**

Another provision of a buy-sell agreement concerns buy-out terms. These can provide either for an all-cash sale or for payments made over time, with appropriate terms and interest rate. The corporation (or partnership) itself or the other business owners can be obligated to purchase the interest—whatever amount is appropriate based upon the facts and circumstances. Often, life insurance is purchased to fund part or all of the purchase obligation. The beneficiary of the insurance is the company or the owners— whoever is obligated to purchase the interest. In other cases, the cash reserves and future earnings of the business fund the purchase. A combination of funding sources can also be used.

A variation sometimes used is to offer the remaining owners an option to purchase, rather than to force a sale. The option allows the other business owners to decide whether the recipient of the transferred business interest will continue as a business owner. This

approach is more common where the business interest is left to a person who is already involved in the business or who wishes to become involved.

For example, if Charlie Black's son were already involved in the business with his father and uncles, a specific disposition of the business interest under Charlie's Will to his son might be acceptable to all concerned. However, careful consideration needs to be given to whether a business interest should pass to a beneficiary under a Will, both from the point of view of the recipient of the business interest and from the point of view of the other business owners.

Regardless of the details, a thoughtfully planned buy-sell agreement will ensure a smooth transition at the death of a business owner. It assures the remaining business owners that there will be no interference from outside parties that might hinder the continuing operation of the business and jeopardize their investment. It ensures that the beneficiaries of the deceased business owner will receive fair value for the business interest if they are not to continue actively in the business themselves.

### **Planning for an Owner's Disability**

What will happen to your business interest if you become disabled? The disability of a business owner is especially critical in a service-oriented business such as A-I House Painting in Example 2. Without the continuing cooperation and work of both Fred Smith and George Williams, A-I House Painting probably cannot continue as it has operated in the past. Further, it is doubtful that George can or would be willing to work the business himself and share the profits with Fred for very long.

Again, a buy-sell agreement can solve many potential problems and can achieve a balance between the needs of those continuing the business and the needs of the disabled business owner and his or her family.

For Fred and George, the buy-out could have been triggered by a disability that rendered either owner incapable of continuing his past activities for a stated period of time. As with the death contingency, the agreement would provide the buy-out terms, including either a preagreed price or a formula (based on earnings, for example) under which a price can be determined at the time.

The cash to fund the purchase could come from the earnings of the business, disability insurance proceeds, the assets of the continuing business owner, or a combination of these sources.

Finally, special attention should be given in the agreement to the definition of a "disability" and the amount of time to be allowed to pass before the other business owner (or owners) will have the right to purchase the interest of the disabled owner. Interim payments from the owner can be handled through disability insurance until the buy-out occurs. This will prevent a drain on the business or a hardship to the disabled owner.

### **Being Prepared for the Effects of a Partners Divorce**

Although divorce is an unpleasant event to contemplate, the protection of business owners from one another's divorce is important. Most business owners would not want a former spouse to be awarded some portion of the business as the result of a divorce. The business owner involved in the dissolution proceeding and the other business owners may well want the contractual right to purchase back any business interest awarded to a former spouse in the proceeding.

To be sure that the buy-sell agreement is binding upon the owners' spouses, each business owner's spouse should approve the agreement, although perhaps not be a direct party to it. Give careful attention to whether the business owner's spouse has a full understanding of the contract and is entering into the agreement with full knowledge of its consequences. Separate legal counsel may be warranted to ensure such understanding.

### **Business Interests and Estate Taxes**

In connection with planning for the disposition and transfer of business interests, the owner and his advisors should review federal estate tax consequences. ( See related article on estate taxes.) Special relief provisions exist under federal estate tax law that benefit a deceased owner of a closely held business.

Under certain circumstances, real estate used in the business may be valued *for estate tax purposes* (as opposed to income tax purposes) at its current use rather than its potential highest and best use. The difference in value may be significant and could generate substantial estate tax savings.

Certain family-owned businesses may qualify to transfer up to \$1.3 million free from estate tax. However, the technical requirements for qualifying are complex and require careful planning. The 2001 Tax Act repeals the \$1.3 million Qualified Family Business Exclusion, effective in 2004.

Special extended tax payment provisions may be available. These allow for a deferred payment (up to 14 years) of some or all of the federal estate taxes attributable to the value of the deceased owner's business. The estate makes annual interest payments for the first four years and thereafter pays the balance in up to 10 annual payments of principal and interest. A special 2% interest rate applies to a portion of the deferred taxes under this extended payment

provision. These extended estate tax payment provisions were expanded in the 2001 Tax Act to include, at modified levels, certain real estate and investment businesses.