

SPECIAL REPORT

Planning for Your Business

CASE STUDY 1: INADEQUATE BUY-SELL AGREEMENT LEADS TO LITIGATION

Three physicians have gone into practice together. Their corporation was formed 15 years ago at which time articles of incorporation were filed, a buy/sell agreement was signed, stock certificates were issued, and all basic corporate formalities were followed. The buy/sell agreement provided a cross purchase arrangement where, in the event of the death of one of the parties, the remaining physicians agreed to purchase the interest in the practice from the deceased's estate. The agreement provided that the purchase price would be \$40 per share and would be reviewed every three years. Since the initial incorporation the physicians did not review the buy/sell agreement, failed to have annual meetings, and never revisited the \$40 a share price. No provision was made for retirement or disability. Recently, one of the three physicians was diagnosed with cancer and spent much of the year in and out of hospital treatments. The cancer treatment left the afflicted physician incapacitated and unable to practice medicine. He stopped receiving his salary from the corporation and his wife, acting as his agent under a general durable power of attorney, decided that he should exit the practice. She approached the other physicians to attempt to withdraw from the corporation. The cross purchase only applied in case of the death of one of the physicians. The remaining

physicians agreed to buy the physician out at \$40 a share. At the time of the physician's incapacity the corporation's net worth was about \$200 a share. The incapacitated physician had mounting medical expenses and limited investments outside of the corporation.

Since the agreement failed to adequately provide for the terms of the buyout, litigation was required to resolve the dispute.

CASE STUDY 2: LACK OF PLANNING LEADS TO FAMILY DISCORD AND LITIGATION

Father is married and has two children, a son and a daughter. For his entire adult life the father has run a small tool store which he inherited from his father. When his son finished his education, his son began working in the business. Over the years the son had grown into a very competent manager, had expanded the business to a second location, and insisted that a corporation be formed to operate the business. Although the father was very proud of the job that his son had done he refused to relinquish control of the business. The father has not executed a will, power of attorney, or advance medical directive nor has he made any plan which provides for his exit from the business. The father has no other assets except for the home he and his wife lived in. The father has had mild cognitive impairment for years however in the last six

months he has become completely incapacitated and has been moved to a locked Alzheimer's unit in a local nursing home. The mother is still competent but is elderly and tired of caring for her husband so she has moved into an assisted living facility. The business may have to be sold to pay for the father's care. The son wants to be certain that the business provides for his mother but that he inherits the business since he has spent his adult life working for and improving the business. His sister had completed her education was now living in New York. She is now claiming that she wants half of the business since that was the only asset for her to inherit. Shareholders seldom held annual meetings, stock certificates were never issued, and minutes were not kept up to date.

Father's failure to properly plan has resulted in discord amongst the family members and the son is considering opening his own business. His sister is considering litigation.

CHOICE OF BUSINESS ENTITY

The first step in starting any business is considering a proper choice of business entity. Each has advantages and disadvantages. As with each option there are advantages and disadvantages. The type of entity will vary in each circumstance and an attorney should assist in choosing the business type. Choices include the following:

- Sole Proprietorship.
 - Advantages. Simplicity and control.
 - Disadvantage. Liability.
- Corporation.
 - Advantages. Limited liability, potential tax benefits, control can be retained or transferred.
 - Disadvantage. Filings required and possible double taxation with an ordinary corporation
- Limited Liability Company.
 - Advantages. Limited liability, potential tax benefits, control can be retained or transferred.

- Disadvantage. Filings required.
- Partnership.
 - Advantages. Limited liability, potential tax benefits, control can be retained or transferred.
 - Disadvantage. Filings required.
- Limited Liability Partnership.
 - Advantages. Limited liability, potential tax benefits, control can be retained or transferred.
 - Disadvantage. Filings required.

TAX ISSUES

Among other things to be considered when choosing a business entity, the following tax issues must be considered:

- Estate tax
- Gift tax
- Income tax

CONTROL

Management and control is often important to business owners both now and in the future. The choice of business entity should be designed to ensure that control is maintained for as long as desired, and that control can be transferred according to the owner's wishes.

TOOLS

Certain documentation is required for most business entities.

- Entity Selection. After a choice of entity has been decided upon appropriate documentation must be filed with the State office having jurisdiction, except in the case of a sole proprietorship. But even then, a fictitious name certificate should be considered.
- Internal Documentation. Internal documentation is required, including an operating agreement, partnership agreement, or by-laws depending on the entity form. The internal document may provide not only for the day to day management of the

company, but should also include the succession plan and provisions such as a buy-sell agreement.

- Buy-Sell Agreement. This is an agreement among the business owners as to how the business will be valued and what will happen in the event of the death, retirement or disability of one of the business owners. Important sections include:
 - Issuance and endorsement of shares or membership certificates or partnership units
 - Restrictions on transfers
 - Determination of valuation
 - Mandatory purchase on death of shareholder
 - Optional purchase upon termination of employment for reasons other than death
 - Stock pledge
 - Personal guarantees of corporate obligations
 - Modification and termination of agreement
 - S Corporation status
 - Miscellaneous provisions
 - Provisions relating to life insurance
- Employment Agreement. An employment agreement provides for compensation and duties of a business owner employed by the business entity. Important provisions include:
 - Compensation
 - Duties
 - Vacation
 - Termination
 - Employer's authority
 - Records
 - Expenses
 - Reimbursement of disallowed compensation and expenses
 - Military service and disability
 - Term
- Medical Reimbursement. If the business entity adopts a medical reimbursement plan, an agreement to that effect should be prepared.
- Written Succession Plan. Each business plan should include a succession plan which provides for how the owner will leave the

business either at retirement or upon his disability.

THE TEAM

Each business owner should have a team of professional advisors to assist in the business plan and maintenance. The team should consist of the following:

- Attorney
- CPA
- Financial advisor
- Family business consultant, if the business is large and the emotional issues are complex

THE IMPORTANCE OF BUSINESS SUCCESSION PLANNING

- Business owners should take steps to ensure that there is a plan for the business in the event of their retirement, death, or disability.
- Succession Planning should be considered at the time the business is formed and provisions should be included in the original business entity documents. However, as in case study #1 the plan should be annually reviewed and updated to avoid any mishaps such as a failure to plan for a disability or a poor valuation formula where either shareholders or their loved ones are forced to take less than their interest is worth or become involved in a court battle to overcome a low valuation.
- Business owners designing or updating an estate plan should review their succession planning. For business owners nearing retirement this is a particularly critical issue.

THE NEXUS BETWEEN BUSINESS SUCCESSION PLANNING AND ESTATE AND FINANCIAL PLANNING

Business succession planning defines certain events triggering sale of a business interest. These generally include death, retirement or permanent disability and the plan and related documents provide a mechanism for the purchase of the business interest of an owner who dies, retires or becomes

permanently disabled. The business interest can be purchased by the business entity or by other business owners. If there are no other members of the business entity, a business succession plan would include efforts to find a buyer.

Business succession planning and estate planning should be done in conjunction with each other. In actuality, your business succession plan is a part of the overall estate and financial plan and consideration should be given to the effect of the business plan on the estate plan. Both the business plan and estate and financial plan must be reviewed regularly to be sure they are kept up to date.

As in case study #2 if the son takes over the business during his lifetime, how will the wife be taken care of? Or, if the father dies and leaves all his assets to his wife, how will the son's place in the business be preserved? How will the father provide for his daughter?

Failing to do business succession planning and estate planning together may result in an unsatisfactory disposition of your assets or result in expensive litigation and fractured family relationships.

WHAT ISSUES NEED TO BE CONSIDERED BEFORE PLANNING?

The first thing required for business planning is a vision of the future of the business. Will it grow? Will it stay the same size? Will one or more children take over the business? Will the business be sold to a third party or will the business end on the death, disability or retirement of the business owner? How does the income from the business fit into the business owner's personal financial plan? Is it a significant source of retirement income for the business owner or his spouse?

IF THE BUSINESS IS THE MAIN SOURCE OF INCOME FOR THE BUSINESS OWNER AND/OR HIS SPOUSE, HOW CAN SOMEONE ELSE TAKE OVER?

There are a number of options with respect to planning for succession.

- Deferral Continuation Plan. One option is a

deferral continuation plan where the business agrees to pay some of the owner's salary in a later year than when it is initially earned. Another option is a salary continuation plan where the business agrees to continue your salary for a period of time after your retirement, disability or death. By doing this over a number of years a reasonable salary may be received in retirement. The agreement is an enforceable contract.

- Retirement Plan. Another option is a qualified pension, profit sharing plan, SIMPLE, SEP IRA, or KEOGH. This may provide reasonable retirement compensation at a favorable tax basis and the company may take a tax deduction for the contributions it made when the plan was made. Since the plan is not a taxpayer, income on contributions is earned tax-free but is taxed upon distribution.
- Structured Payout. If you plan on selling your business, you may consider a structured payout over a period of years.
- Separate Business Entities. Many business owners form separate business entities, one which holds the business and one which holds the real estate. The entity with the real estate then leases it to the business. You may wish to retire from the business but keep the entity with the real estate so that the rent income will help fund the business owner's retirement.

EMPLOYEE BENEFITS

As soon as possible the business should consider basic benefits for its employees. These would include, but not be limited to, the following:

- Life Insurance (especially life insurance to fund the Buy-Sell Agreement)
- Disability Insurance
- Medical Insurance
- Retirement Account

FAMILY-OWNED BUSINESS

Where there is a family-owned business there are special circumstances to be considered. Family

business owners rank the issues that confronted them in the following descending order of importance:

- Organizational structure of the business
- Capable and supportive key management
- Motivation of successors and management
- Accommodation of family members
- Estate planning
- Retirement planning for current management
- Retaining competent professional advisors
- Operating with a board of outside directors

SELECTING THE SUCCESSOR OWNER/MANAGER

If the business owner has a specific individual in mind to take over the helm of the business, be it a child, relative, or extraordinary employee, begin planning and grooming that person for succession now. Consider transferring day to day control of the business to the desired successor during the business owner's lifetime and taking an advisory position so that the chosen individual can get used to running the business but the founder's knowledge and experience is available for the new person during rough times.

The person to own the business is not necessarily the best person to manage the business. The business owner must consider these two roles and decide who should be owner and who should be manager.

During your lifetime you could sell interests in the business to your chosen successor and you could enter into a contract by which he buys the balance of the business at your death.

SITUATIONS WHERE ONE CHILD OR CHILDREN PARTICIPATE IN THE BUSINESS AND OTHER DO NOT

As in case study #2 this issue is a big one in both business succession planning and estate planning. Often one child has worked for years in the family business expecting to take over at some point but there are relatively few other assets to provide for the other children. One way to plan for this is to purchase a life insurance policy effective at the death of the second parent. Using life insurance will reward the child who has worked in the business for their "sweat equity" and will still provide equal amounts for other children.

PLANNING FOR THE RETIREMENT, DISABILITY OR DEATH OF A BUSINESS WITH MULTIPLE OWNERS

- Buy-Sell Agreement. As in case study #1 the best way to plan for a business owner's retirement, disability or death when there are multiple owners is likely to be a "Buy Sell Agreement." There are three common types of buy sell agreements, a redemption agreement, a cross purchase agreement, and a hybrid of the two.
 - Redemption Agreement. The redemption agreement is a contract between all the owners and the business where the owner agrees to sell his interest in the company back to the company at an agreed upon price (usually based on a formula rather than an exact figure). If the owner wishes to sell to a third party, the redemption agreement generally requires that he first offer the interest to the company and if the company refuses to buy, then the interest can be sold to a third party.
 - Cross-purchase Agreement. The cross-purchase agreement is generally a contract among the owners in which the exiting owner (or estate) offers to sell his interest to the remaining owners at a specified price (again based typically on a pre-determined formula)
 - Hybrid Agreement. The hybrid agreement is usually between the entity as well as the owners and provides for either the entity or the remaining owners to purchase the exiting owner's interest. In many cases agreement requires that the owner (or his estate) offer the interest first to the company and if the company refuses the purchase, then the other owners may purchase the interest.
- Life Insurance. Appropriate life insurance is a possible way to fund the agreement. Another way is to provide for owner financing with deferred payments secured by a lien on the purchaser's assets.
- Installment Sale. Life insurance may not be a satisfactory way of purchasing the business

interest from a disabled or retiring business owner. In those cases, an installment sale may be required. Under an installment sale the remaining business owners pay a lump sum shortly after the disability retirement of one owner, and periodic payments thereafter.

Each of the different agreements has varying tax consequences which should be carefully considered.

HOUSEKEEPING

In addition to succession planning make certain to follow all business formalities such as filing annual reports with the State Corporation Commission, paying annual dues, filing a tax return, and having annual meetings. Failing to do so may be considered evidence that there is not a formal business. That can call into question issues such as valuation of the business, any favorable tax positions, and may leave business assets open to individual creditors.

Following the corporate formalities and having an annual meeting will ensure that the original plan put into place is reviewed and updated as required. As in case study #1 failing to update can leave the business

owner and his family in a precarious position.

Important steps that must be taken are:

- Annual meeting of shareholders, members or partners
- Minutes of annual meeting of shareholders, members or partners
- Board of Directors' or Managers' meeting
- Minutes of Board of Directors' or Managers' meeting
- Adjustment of valuation agreement, if the buy-sell agreement so provides

ANNUAL MEETING

After the business owner's estate plan and business succession plan are in place the business owner should meet yearly with his attorney, accountant, and any other professional advisors to review and update his plan as necessary.

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