

For the Closely Held Business Owner—  
**Business Succession: A Case Study**



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Truth can be stranger than fiction

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## **On the Cover**

### ***GUIDANCE AND DIRECTION***

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# Truth Can Be Stranger Than Fiction

## Introduction

- The goal of every entrepreneur is to create, develop and nurture his or her business.
- Another goal is to earn income while increasing the value of that business.
- An additional goal for the owners of a family business is to preserve the business for future generations.

Keeping a business in the family may become a Herculean task, often requiring more effort than it took to build the business in the first place. Families with the best of intentions, even those who have put plans in place, may be faced with difficult situations. Taxes, legal fees and family discord often lead to the loss of the business and the loss of a legacy.

The following story, based in part on an actual case, demonstrates what may happen to a family business if dangers are ignored, issues are not carefully examined, and opportunities are missed, resulting in the failure of a plan that was implemented.

We hope you can make use of the points made in the story to help you successfully maintain the operation of your business throughout your lifetime and the lifetimes of those who will take over for you in the future.

## The Family and the Business: The Background

Harry started his business in a small storefront in 1975. The business was structured as an S corporation<sup>1</sup>. At first, he and his wife, Elizabeth, were the only employees. Over time, the business grew to become a leading supplier of certain machine parts throughout a major city. Harry and Elizabeth had three sons, Stan, Arnold and Patrick. In 1986, Stan (the eldest) started working in the store and became very important to the continued success of the business. Eventually, Harry considered Stan as an equal partner in making business decisions. To reward Stan, Harry gave him a 35% interest in the business. Over the next few years, Stan's two children (Harry's grandchildren) started working in the business. When Harry wanted to give Stan another 15% interest in the business, other family members convinced him that the grandchildren should receive that 15% interest. So, the business was then owned 50% by Harry, 35% by Stan and 7½% by Stuart and Ellen (Harry's grandchildren), each. The business continued to be successful.

## Creating a Business Continuity Plan: The Family Entered into a Formal Buy-Sell Agreement

The family recognized that it was important to enter into some sort of arrangement that would help facilitate the transfer of the business, particularly if Harry or Stan should die. The following written agreement was entered into:

1. Upon Harry's death, the corporation would purchase his shares.
2. Upon Stan's death, however, no purchase would take place: since his children were already involved in the business, it was assumed that Stan's heirs would receive his shares through his will.
3. The contract set forth a value for the business at \$1.6 million. Provisions were made for an annual revaluation and for arbitration if no revaluation occurred for two years prior to a death.
4. 15% of the buyout price was to be paid on Harry's death with the balance paid over 7 years at 10% interest.

<sup>1</sup>Although this story revolves around a business operated as a S corporation, the lessons learned also apply to businesses operated as regular C corporations, limited liability companies, and partnerships.

## **A Formal Agreement in a Family Business**

Formal buy-sell agreements are not just for strangers. The shareholders in a family business should, and often do, enter into them.

A formal agreement can help accomplish a number of goals for both the family and the business. The agreement can establish the future ownership of the company so that there will be no question as to who will be running the business. The agreement can provide the deceased shareholder's estate with needed liquidity to pay estate taxes and final expenses, allowing the surviving spouse and family to benefit from the value of the business interest. The agreement can also give family members and perhaps trusted key employees options to become owners of the business.

It is imperative, however, to give careful consideration to even unlikely future events when entering into any agreement. Even one that has the appearance of being well thought out may encounter disasters caused by misdirected sentiment and overlooked possibilities and tax traps.

## **Two Deaths and a Family Disrupted**

Harry's wife, Elizabeth, passed away in 2004. Soon after her death, Harry decided to review his estate situation. The family became concerned that the increased value of the business would cause estate tax problems for Harry. At about this time, Harry's grandson, Stuart, who already owned 7½% of the business, purchased 10% more of the business from his grandfather.

Grandpa Harry accepted a note as payment of the purchase price. At this point, the business was owned 40% by Harry, 35% by Stan, 17½% by Stuart and 7½% by Ellen. Stan, while not a true majority shareholder, exercised control over the business—which was fine with Harry. Unfortunately, soon after these transactions were completed, an unexpected tragedy occurred—Stan, although to all appearances in good health, suffered a massive heart attack and literally died at his desk. Harry, faced with the loss of his son and business partner, was now faced with another unexpected twist of fortune. Since the buy-sell agreement did not apply to Stan's 35%, and since Stan had not updated his will to leave those shares to his children, his wife Irene, as the sole heir of the estate, became the owner of 35% of the business.

That meant, moreover, that in conjunction with her children, Irene now effectively controlled 60% of the business. Suddenly, Harry was a true minority owner. He was not invited to meetings with the corporate attorneys and accountants, and business decisions were made without consulting him. While he received a salary from the business, his participation had become insubstantial. It appeared to Harry that, overnight, he had become an outsider in his own business.

### **The Result Could Have Been Anticipated**

In reality, it was Harry who created this result and there was nothing “overnight” about it.

Contracts should not be taken lightly. While it was unlikely that Harry would survive his son, the family’s buy-sell agreement should have provided for that possibility. Even if the family viewed this outcome as a remote contingency, all contractual terms should have been reviewed for the unexpected, and the shareholders should have openly discussed what the possible results of the plan would be for each.

### **At Harry’s Death**

The next act in this family’s drama was Harry’s death a year later. In his will, Harry forgave the note that his grandson, Stuart, had not yet repaid. He left his interest in the business and all of his other assets, in equal shares to his two sons, Patrick and Arnold, who were also named executors. But those shares, you’ll recall, were subject to the buy-sell agreement: the estate was required to offer them to the corporation, and the corporation was obligated to redeem them.

### **Remember the Valuation?**

The buy-sell agreement provided an initial valuation of \$1.6 million for the company as a whole. However, there had been no revaluation for more than two years before Harry’s death. Therefore, the appropriate purchase price for the shares was unknown.

Irene, who controlled the corporation, contended that the value of the business was \$4 million. Patrick and Arnold argued that the business value was much higher. Negotiations over the proper value of Harry’s shares began.

## **Parties Now at Cross Purposes**

At this point, the corporation (controlled by Irene and her children) and the executors were on opposite sides of this valuation issue.

It was in the corporation's best interest to argue for a lower valuation, and it was in Patrick's and Arnold's personal best interests to argue for a higher valuation.

As executors, however, a lower valuation would benefit Harry's estate for estate tax purposes.

## **Arbitration and Litigation over the Valuation**

The parties first submitted the valuation of the business to an arbitration panel, as required by the buy-sell agreement. Patrick and Arnold requested access to the corporation's books and records so that their attorneys and accountants could present an appraisal.

The majority shareholders were not cooperative, and only after costly and prolonged legal proceedings was a court order obtained requiring that the books of the corporation be made available to Patrick and Arnold. Their accountants then placed the corporation's value at \$12 to \$14 million.

The majority shareholders grudgingly upped their valuation to \$5.6 million, so the parties were still far apart.

A three-day arbitration hearing was held. Highly compensated expert witnesses were called, and voluminous documents were reviewed. The arbitration panel decided the value of the corporation to be \$12.5 million. That was good news for Patrick and Arnold, but bad news for the majority shareholders. It meant the corporation would have to pay \$5 million (40% of \$12,500,000) for the estate's 40% interest.

Upset at what they perceived to be an overvaluation of the business, the majority shareholders commenced a legal action to vacate the arbitration panel's decision. This action was later withdrawn, but only after the expenditure of substantial legal fees by both sides.

What were the consequences of all this activity? Legal bills were mounting—court actions, arbitration hearings, and attorney fees. Accounting bills were also growing—reviews of the books, testifying at hearings, etc. The cost of arbitration, paid for by all parties, was high. Relationships among family members became unmanageable as Harry’s surviving sons fought their sister-in-law, niece and nephew. Cousins no longer communicated outside of the courthouse. The business continued to operate, but the family fell apart.

## Valuation Issues

Placing a value on the shares of a closely held business is one of the most difficult tasks to accomplish. So many factors may be brought into the analysis that it is unusual for any two people, including professionals, to agree on one price.

However, the current owners of a business often have a good sense of its value. More importantly, there are preferred times for the owners to set the business value or to agree on a formula for setting the value, i.e., when all are roughly in the same position relative to one another; when, if possible, no one party is in a substantially stronger negotiating position; and when business is successful, everyone is getting along and can reasonably agree upon an issue.

Revaluation of a business may become something of a moving target because revaluations should be done on a regular basis and are subject to economic times, but they, nevertheless, should be made. If they are not, the value of the business stated in the buy-sell agreement may become outdated and inaccurate.

Once valuations have been set, the parties who are required to buy can prepare to finance the purchase price so that they will have the funds to fulfill their obligation ensuring that the surviving family of the deceased will get paid promptly. One of the key reasons to enter into a buy sell agreement is to “create certainty.” Failure to maintain an updated and accurate valuation destroys certainty and is a disservice to all of the parties to the agreement.

In our story, there was another consequence of all of the litigation that we had not yet mentioned. Time was passing, causing other legal and tax issues to develop . . .

## The Estate Is Taxed on Corporate Profits

Like many family businesses, this company was an S corporation for federal income tax purposes. S corporations, like partnerships and LLCs, are “pass-through” entities, paying no income taxes themselves, but passing the tax consequences of their profits (or losses) on to their owners, in proportion to each person’s ownership interest. During all this time, Harry’s estate still owned 40% of the stock. At the end of the year, since the company had \$800,000 of income, it reported, to the IRS and to the estate, that \$320,000 was income to the estate (this is done via a Form K-1, issued by the business). Unfortunately, for Arnold and Patrick, no checks were actually issued to distribute the corporate income to the estate because Irene and her children voted against making any distributions. (In pass-through entities, the owners are taxed on income whether or not there is an actual distribution of income.) Other estate assets, therefore, had to be sold to get the cash to pay the income taxes on the K-1 income. Arnold and Patrick even ended up using some of their personal funds to pay the estate’s tax liabilities.

Was this result fair—a personal tax on corporate income but no distribution of cash from the corporation? Patrick and Arnold, as executors, tried to force a distribution through a lawsuit, but they lost the case after paying even more legal fees.

When planning a buy sell arrangement or doing any kind of business succession planning, consideration must be given to the tax impact on the owners as a result of the form of business organization they have chosen or will choose. While profits for S corporations, partnerships, and LLCs end up on each owner’s personal tax return, *pro rata*, there is no guarantee that they will receive any cash from the business unless they have a pre-existing agreement requiring the company to make such distributions unless the owners *unanimously* agree to waive them in a particular year. Remember, the “pass-through” does not represent cash received by the shareholders or partners; it only represents the necessity for each owner to include on her or his personal Form 1040 income tax return, his or her *pro rata* share of the firm’s profits or losses.

## Completing the Buy-Out: Two More Issues Emerge:

1. Where Does the Business Get the Money; and
2. Does the Estate Have to Pay Income Taxes on It?

Once the arbitration and court proceedings were completed, the corporation was faced with a significant drain on its cash flow. It had to come up with 15% of the purchase price (\$750,000) immediately, and it had to pay off the remaining \$4.25 million of the purchase price over the next 7 years at 10% interest. To meet this payment schedule, the corporation would have to earn \$8,231,420. Paying off this debt would impact corporate earnings and severely reduce what the owners could earn from the business. It would also impact the owners' ability to acquire loans or lines of credit, a vital factor for most businesses.

An essential part of a buy-sell plan is anticipating the cost of the buyout and finding the most economical method of funding that cost. Some of the methods generally used to pay a buyout price: surplus, savings, installment payments, and borrowing, have certain costs, risks and benefits. The key is to find the method that (1) is most cost-efficient, (2) will provide funds when needed, and (3) is predictable as to cost and availability. That method is typically the use of life insurance (as well as disability insurance for a buy-out based upon disability). Life insurance, unfortunately, had not been used here.

The estate was also able to dodge another potential problem typical of corporate redemptions of stock because the corporation was an S corporation, not a C corporation (sometimes known as a "regular" corporation). Normally, when stock is transferred back to the corporation which issued it, certain complex rules must be met in order for the transaction to be treated as a "sale" and not as a dividend, under the Internal Revenue Code. These "constructive ownership" or "attribution" rules are especially troublesome with family-owned corporations. In this case, the attorney assured the executors that since the company had always been an S corporation, those rules were irrelevant. Had the company been a C corporation or had been a regular corporation that elected Subchapter S treatment (making it an S corporation), with leftover retained earnings after operating as a C corporation, and if those attribution rules were not followed, the IRS would have found that the estate was in receipt of \$5 million in dividends.

What difference does this make? If the redemption was treated as a “sale,” under the tax laws, the estate would be able to deduct its basis in its shares from the amount received and to treat the result as capital gains. Moreover, since the estate’s basis in stock was the fair market value of the stock at the date of death, and since a properly drafted buy-sell agreement could “set” (or “fix”) that value as the price set in the agreement, the amount received by the estate would be equal to the estate’s basis and as a result, there would be no capital gains, and hence no capital gains taxes, on the transaction.

On the other hand, when the tax law views the payment as a dividend, the entire amount received must be included in gross income as a dividend.

In effect, the income tax result for this transaction was no taxes. But, for a C corporation or an S corporation that used to be a C corporation, there could have been a tax on \$5 million!

As you can see, family-owned corporations often need to avoid stock redemption plans as they may lead to taxable dividends rather than a tax-free sale. The strategy is to use a “cross purchase” buy-sell plan, where the co-shareholders personally agree, not the corporation, to purchase each other’s shares. That will completely avoid the possibility of dividend treatment.

## **All Those Problems—What Good Was the Agreement?**

Poorly drafted and poorly thought out agreements can be just as disastrous as no agreement at all. The situation that we’ve been reviewing demonstrates this statement. Guardian’s financial representatives and our Living Balance Sheet® system can help you ensure that a disaster such as the one described doesn’t happen to your business and your family.

There are numerous factors that must be taken into consideration when putting together a buy-sell plan for a family business. Some of those factors deal with the personal relationships among family members; others with estate and income tax issues; and still others with finances. Your Guardian financial representative can work with your attorney and accountant to assist you in developing the right plan for your situation.

In this case, it was more than likely that no one expected Stan to die before his father. Yet the agreement contained a provision, triggered by Stan’s death, which set much of the trouble in motion. The disaster that followed could have been mitigated or even avoided by better planning.

## Were Better Results Possible?

1. Harry, unintentionally, gave up his controlling interest in the corporation while still living. While many patriarchs or matriarchs of family businesses ultimately give up operating control, doing so should be reviewed carefully. The key is to make sure that everyone recognizes that when control is released, there is no going back. There are a number of planning techniques which allow for the orderly transfer of business interests to the next generation while significant control is maintained by the current generation.
2. A “non-family” family member (a daughter-in-law) effectively became the controlling stockholder. The buy-sell agreement could have provided that Harry would have an option to purchase Stan’s stock if Stan died first. The agreement could have provided that at Stan’s death the shares would be non-voting as long as Harry was alive. The result would have been that even though Harry would no longer own a majority interest in the corporation, he could still have controlled all business decisions. Creative uses of trusts could have also given the same results.
3. The payment of the buyout price was not treated as a dividend only because this had always been an S corporation, a nuance of which the principals were unaware. If that had not been the case, instead of a stock redemption, the shareholders should have entered into a cross purchase buy-sell plan. Dividend treatment would then be completely avoided, regardless of S or C status for the corporation.
4. The parties entered into protracted litigation over the valuation of Harry’s shares. Why were the parties arguing so heatedly over the valuation? On the corporation’s side, a high value meant a severe drain on its cash flow and possible severe financial problems in the future. The majority shareholders of the corporation had nothing to gain by setting a high value.

The executors, however, were also the beneficiaries. Their intent was to obtain the highest possible value for the shares—the higher the value, the more they as beneficiaries would receive. Obviously, the parties were at cross purposes. The valuation contained in the buy-sell agreement should have been updated annually to accurately reflect the growth or decline in the value of the business. The shareholders' continual procrastination regarding this duty ultimately resulted in a costly arbitration proceeding and the payment of substantial legal and appraisal fees.

5. The buyout was costly and disruptive for the corporation. The funds needed to complete it drained the corporation of significant operating funds. Proper planning would have provided for a more certain funding of the buy-sell arrangement. Most often, permanent life insurance is used in these situations. It can provide an income tax free death benefit, has an ascertainable cost and is the most economical funding plan. (Disability insurance and cash values from a permanent life insurance policy can be used for buyouts on account of disability or some other life event.)
6. This was an S corporation. "Pass through" entities are often recommended for family businesses. Unanticipated income tax consequences, however, can occur, unless all the owners protect their right to get cash distributions each year, in at least an amount sufficient to pay the taxes on their shares of the corporate profits.

# Conclusion

Harry's desire to pass his business to his family suffered serious setbacks as a result of inadequate planning. Only a fraction of the value of Harry's business passed to his remaining children. The continued viability of the business was seriously threatened as a result of the drain on cash flow necessary to pay off the installment note held by the estate.

Every business owner (including those who are not involved in a family business) should take the time to develop an effective and sensible buy-sell plan. Together, with your Guardian financial representative and your other professional advisors, you can develop a properly conceived plan that will help you to achieve your goals. This will allow you to minimize taxes and expenses, assure that the business continues to function, and allow the family members to continue as owners, and maintain a harmonious family relationship.

As you develop your business continuation plan, in addition to a buy-sell agreement triggered at death, other triggering factors should also be considered, including: permanent disability of an owner, bankruptcy, loss of a professional license, felony convictions, and of course, simple retirement. These triggering events should also be anticipated and funded for. Similar to using life insurance for a buy-out on account of the death of an owner, disability insurance can be used to fund a disability buy-out. Permanent life insurance that builds up cash values can be used not only for a buy-out upon death, but the cash values can be used to help fund a buy-out for one of the other lifetime reasons mentioned.

**Don't delay. Consult with your Guardian financial representative today to review your business succession plan.**

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