

# Succession Planning: If You Can't Take It With You, Where Should Your Business Go?

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# 1. Introduction

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- Liquidation
- Sale to Third Party
- Sale to Partners
- Transfer to Next Generation

## 2. Liquidation

# 3. Sale to Third Party

- Is It Time to Sell?
  - Factors Favoring Retention
    - Profitability
    - Growth
    - Family Security
    - Personnel
    - Tax Considerations

# Sale

- Is It Time to Sell?
  - Factors Favoring Sale
    - Diversification
    - Family Security
    - Family Conflict
    - Conflicts Among Owners
    - Lack of Financing
    - Industry Trends

# Preparing the Business for Sale

- Plan Ahead
- Assemble an Expert Team
- Improve Earnings
- Improve Assets
- Clean Up Potential Liabilities
- Recast Financial Statements

# Finding a Buyer

- Family Members
- Key Employees
- ESOP
- Third Party Buyers
  - Financial Buyers
  - Strategic Buyers

# Valuation Methodologies

- Earnings
- Debt Paying Ability
- Underlying Assets
- Special Assets



# Structuring the Purchase Price/Financing

- Structuring the Price
  - Cash/Down Payment
  - Seller Financing
  - Earn Outs
  - Escrows; Offset Rights
  - Stock
  - Other Compensatory Agreements

# Due Diligence Issues

- Due Diligence Checklist
  - Good Standing
  - Financial Statements
  - Records Check
  - Employee Issues
  - Contractual Arrangements
  - Environmental Matters
  - Legal Matters

# Negotiating & Preparing the Purchase Agreement

- General
- Letter of Intent
- The Definitive Agreement
- Seller's Representations and Warranties
- Other Agreements

# Income Tax Considerations

- Stock Sales
- Asset Sales
- Purchase Price Allocation

# Sale to Partners (Buy-Sell Agreements)

- Introduction
- Business Issues in Structuring Buy-Sell Agreements

# Sale to Partners (Buy-Sell Agreements)

- Why Are Buy-Sell Agreements so Important in Business Planning?
  - The Buy-Sell Agreement will balance the competing objectives of the business entity itself and the objectives of the individual owners.
  - In the absence of a Buy-Sell Agreement, North Carolina state law may defeat the parties' objectives and goals

# Buy-Sell Agreements

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## Structuring the Buy-Sell Agreement

### Events Triggering the Buy-Sell Obligation

- In General
- “Mandatory” versus “Optional” Buyout Provisions

# Buy-Sell Agreements

## – Death

- Advantages to the Deceased Owner's Estate
  - Provides a Ready Market
  - Providing Liquidity
  - Guaranteeing a Fair Price
- Advantages to the Continuing Business Owner
  - Autonomy
  - Eliminates Friction
  - Life insurance provides funding method



# Buy–Sell Agreements

- Disability

- Advantages to the Disabled Owner

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- Disability Funding

- Ensuring a Ready Market and a Fair Price

- Advantages to the Continuing Business Owners

- Mandatory vs. Optional Buyouts at Disability

- Usually Optional

- Typical Structure

- Partial or Temporary Disability

- Total or Long Term Disability

# Buy–Sell Agreements

- **Default**

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- Usually Optional
- Bankruptcy or Insolvency of an Owner
- Attempted Transfers of Business Interests to Third Parties
- Transfers to Spouses at Divorce
- Fraud, embezzlement, etc.

# Buy-Sell Agreements

## –Events of “Divorce”

- Retirement or Voluntary Termination of Employment
- Involuntary Termination of Employment
- Deadlock

# Buy–Sell Agreements

## Establishing the Purchase Price

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- In General
- Alternative Valuation Methods
  - Fixed Price Specified In the Agreement
  - Book Value Method
  - Appraised or Fair Market Value
  - Fair Market Valuation
  - Capitalization of Earnings Method

# Buy-Sell Agreements

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- **Payment Terms**
  - **Funding Methods**

# Buy-Sell Agreements

- **Identifying the Purchaser Under a Buy-Sell Agreement**
- **In General**
  - **Entity Redemption Arrangement**
  - **Cross-Purchase Arrangement**
  - **Hybrid Arrangement**

# Buy-Sell Agreements

- **Entity Redemption Arrangement**
- **Advantages**
  - Use of Business Funds
  - Simplification of Insurance Plan
  - Payment of Life Insurance Premiums on Entity Owned Policies

# Buy-Sell Agreements

- **Entity Redemption Arrangement**
- **Disadvantages**

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  - **Corporate-Owned Investment Assets and Life Insurance Policies are Subject to Claims of Creditors**
  - **Inequality of Premium Payments**
  - **Shift in Ownership Percentages**
  - **Increase in Entity Value**
  - **Application of State Law**
  - **Income Tax Issues**
  - **Debt Issues**



# Buy-Sell Agreements

- **Cross-Purchase Arrangement**

- **Advantages**

- Tax Basis Increases
- Capital Gain Recognition to the Selling Shareholder

- **Disadvantages**

- Issuance of Multiple Policies
- Individual Responsibility for Funding Buy-Outs

# Buy-Sell Agreements

- ~~Use of Hybrid Arrangement~~

# Buy-Sell Agreements

## Other Buy-Sell Provisions

- Introduction

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- Compensation and Dividend Payment Policies
- Minority Participation in Management
- Put Options for Minority Owners
- Arbitration Provisions
- “Tag-along” Provisions
- Capital Calls and Contribution Obligations

# Selected Tax Issues Applicable to S Corporations

## Preserving S Corporation Status

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- S Corporation Status Provisions
- Effect of Shareholder Agreements on the Application of the “One Class of Stock” Rules for S Corporations

## Income Tax Allocations for S Corporation Buy-Outs

## Mandatory S Distributions to Cover S Corporation Tax Liabilities

# Structuring Corporate Buy-Outs Using Stock Redemptions vs. Cross Purchase Buy-Outs

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## In General

### Income Tax Basis Considerations for Continuing Shareholders

- C Corporations
- S Corporations
- Partnerships and LLCs

# Structuring Corporate Buy-Outs Using Stock Redemptions vs. Cross Purchase Buy-Outs

- Dividend v. Capital Gains Treatment to the Redeemed Shareholder
  - S Corporations with no C Corporation E & P
  - C Corporations and S Corporations with E & P
  - Family Attribution Problem

# Estate and Gift Tax Consequences of Buy-Sell Agreements

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“Fixing” Estate and Gift Tax Values

Disregarding Certain Restrictions

Potential Impact on Marital Deduction

# 5. Transfer to Next Generation

## Introduction

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### Overview of Estate Tax System

- Unified Credit (exemption equivalent is currently \$11,200,000)
- Tax Rate is 40%
- Unlimited Marital Deduction
- Spousal Portability
- Unlimited Charitable Deduction



# Transfer to Next Generation

## Introduction

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### Estate Planning Strategies and Issues for the Business Owner

- Credit Shelter Estate Planning
- Lifetime Interspousal Transfers to Take Advantage of Minority Interest Discounts and to Maximize Credit Shelter Estate Tax Plan

# Transfer to Next Generation

- Gifts – Life Insurance
  - Irrevocable Life Insurance Trust
  - Key Man Coverage
- Gifts
  - \$15,000 Annual Gift
  - Taxable Gifts of Shares – Without Generation Skipping
  - Taxable Gifts of Shares – With Generation Skipping

# Transfer to Next Generation

- Grantor Retained Annuity Trust and Grantor Retained Unitrust (GRAT and GRUT)
  - Description
  - Advantages
  - Disadvantages
  - Comparisons Between GRAT and GRUT

# Transfer to Next Generation

## ◦ Sales – Standard Installment Sale

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### ◦ Advantages

- Reduced Gift Taxes
- Removal of Property from Estate
- Generation-Skipping Benefits
- Tax Brackets
- Retention of Income Stream and Security
- Interest Deduction

### ◦ Disadvantages

- Income Tax Liability
- Does Not Necessarily Reduce Estate

# Transfer to Next Generation

- Self-Cancelling Installment Note (“SCIN”)
- Sale to Intentionally Defective Grantor Trust

# Transfer to Next Generation

- Private Annuity
- Diversion of Future Opportunities

# Transfer to Next Generation

## – S Corporations and Trusts

- Introduction
- Grantor Trusts
- QSST Trusts
- The Electing Small Business Trust

# Transfer to Next Generation

- Section 6166 Election to Defer Estate Tax on Closely-Held Business Interests



# Transfer to Next Generation

## Non-tax Family Business Issues

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- Sale v. gift
- Lifetime or at death
- Include all children or only active participants
- Equalization with other assets
- Equity v. control
- Use of life insurance to address shortfall

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