
Business Organizations

There are four basic types of business organizations:

1. Sole Proprietorships

When an individual engages in business as the sole owner, the business does not exist apart from the owner. Business debts are the proprietor's personal debts and personal assets are subject to claims of business creditors. There is no formal paperwork involved in creating the proprietorship, but businesses using a trade name must register with state and/or local authorities. Income and expenses will appear on the proprietor's tax return. At death, the executor may liquidate the business, sell it, or continue it under the terms of the deceased's will.

2. Partnerships

Partnerships are formed by oral or written agreement between two or more individuals. Each partner has unlimited liability for the business debts. The partnership files an information tax return, but the income is taxed to the individual partners. At transfer of a partnership interest, or at death, the partnership is dissolved unless there is agreement to the contrary.

3. Corporations

Corporations are formed under the Articles of Incorporation filed with the State. The state issues a Charter. The corporation is a legal entity, separate and distinct from those who comprise it. A shareholder's liability is limited to the assets of the corporation. The corporation files its own income tax return. "Reasonable" salaries are deductible by the corporation and are taxable to the employee, including employees who are shareholders. Corporate shares of stock may be transferred to others during life or after death. If a properly drawn buy-sell agreement is in place, it will control the disposition of shares in the event of death, disability or sale. The corporation does not dissolve at the death of a shareholder, and thus may be said to have "perpetual life" under the terms of the Charter.

One type of corporation is the Subchapter S Corporation. This is one which has elected to have its income taxed to the individual shareholders rather than to the corporation. In this respect it is very similar to a partnership in that it avoids the double taxation which may occur if a regular C Corporation pays dividends to its stockholders.

Several conditions must exist for a Subchapter S status to be effective: it must be a domestic corporation; it must not have more than 75 shareholders who must be individuals, estates or certain trusts (but not partnerships or other corporations); it may have only one class of stock. Stockholders must consent to the election of Subchapter S status. An attorney and accountant should be consulted to determine the feasibility of electing Subchapter S status.

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4. Limited Liability Companies

Limited liability companies (LLCs) are formed by filing appropriate articles of operation and following state law. The principals of LLCs are known as "members." In many cases, the members create an "operating agreement" which states the rules they will follow in operating the business. LLCs provide owners the same limited liability offered by C corporations but eliminate the complex issues associated with S corporations. They may also provide the tax advantages of partnerships when classified as such under "check-the-box" entity classification regulations. Not all states have enacted laws allowing LLCs and there are many variations in the relevant laws among states that have. As a result, LLCs probably work best for small businesses that operate in very few states.

Valuation of A Business Interest

A decedent's interest in a closely held business must be valued for Federal Estate Tax purposes. The value is the "fair market value," which is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Treas. Reg. 20.2031-1(b).

For the purpose of retirement, disability, and death, business owners should have an agreed upon formula to be used to determine the value of the interests of the business.

Several factors are considered when determining fair market value, including:

- General nature of the business.
- History of operations.
- Company's book value/net worth (assets - liabilities), including goodwill and other intangible assets.
- Prospective earning capacity.
- Dividend paying ability (not the company's history of dividends) - if applicable.
- Economic outlook for businesses in general; this industry and this business in particular.
- Degree of control of the business presented by the interest to be valued. A controlling interest may result in a "control premium" and a minority interest may result in a "minority discount."
- Value of interest in same or similar line of business that is publicly traded, including consideration of size of prior sale of this business' interests.

Because a taxpayer's valuation may differ greatly from the value determined by the Internal Revenue Service, the taxpayer is advised to attempt to "peg" the value of the business for tax purposes by entering into a valid, binding buy/sell agreement during life.

Business interests will be valued without regard to any agreement unless the agreement is a bona fide business arrangement, is not a device to transfer the property to members of the decedent's family for less than full or adequate consideration in money or money's worth, and has terms comparable to those entered into by persons in an arms' length transaction.

The estate must be obligated to sell at death; the price must be fixed by the terms of the agreement, or the agreement must contain a formula or method for determining the price; the agreement must prohibit the owner from disposing of his interest during life without first offering it to the other party or parties at no more than the contract price; and the price must be fair and adequate when the agreement is made.

Buy-Sell Agreements

A Buy-Sell Agreement can provide for the orderly disposition of a closely held business interest if an owner dies, becomes disabled, or sells. Buy-Sell Agreements have many advantages. They can:

- Help transfer ownership of a business to the other owners or partners.
- Provide the heirs with a buyer for the deceased's interest. This is especially important to the heirs where the deceased owned a minority interest.
- Provide cash to buy out the deceased or disabled owner's interest by funding the agreement with life insurance and disability income insurance.
- Be useful in establishing the value of a business for Federal Estate Taxes.

Problems Could Occur Without A Properly Written Buy-Sell Agreement

An owner in a closely held business will be well advised to plan for the orderly disposition of his or her interest at death or disability. Without proper planning, many problems can face the executor or heirs of the deceased owner. Some of these are:

- If the decedent held a minority interest, what would the heirs do with the interest? Would the business or majority owners buy the deceased's interest, and if so, at what price? Since small companies usually don't pay dividends, the financial future and income of the deceased's family may be jeopardized.
- If the decedent was an equal owner, the heirs will have a vote equal to the surviving owners. Heirs may want dividends paid to provide income, but the other owners may want to plow back profits to help the business grow. A conflict of interest could result and lead to costly litigation.
- If the decedent held a majority interest, would the surviving owners be able to afford a buy-out? If any buy-out payments are notes, will the minority owners be able to run the business successfully and pay off the notes?
- If the decedent were the sole owner, who would buy the business from the estate? Possibilities could include a key employee now active in the business, or a competitor. What price would be paid, and where would the money come from?

These potential problems can be taken care of during life by executing a binding, arms length Buy-Sell Agreement. Advantages include:

- The deceased's heirs will receive a "pre-negotiated" price for the deceased's interest and will not have to worry about the future success of the business.
- The buyer(s) of the deceased's interest can have complete control of the business; all future decisions can be made without interference from the deceased's family.
- The value of the deceased's interest and the purchase terms are agreed upon by all parties in advance of an owner's death.

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- If the agreement is funded by life insurance, a federal income tax-free death benefit is available to purchase the deceased's interest.
 - The agreement can also provide for a buy-out at an owner's disability. Funds can be made available through disability income insurance coverage.

There are two basic types of Buy-Sell Agreements. There are advantages and disadvantages to each.

- **Entity Purchase Plan:** The corporation agrees to buy (redeem) the interest of a deceased owner.

Advantages: Entity Purchase plans are easily understood. Only one life insurance policy on the life of each owner is needed to fund the agreement. Premiums are paid by the company. Proceeds are generally received income tax-free.

Disadvantages: There is no step-up in basis for a surviving owners' interest in a C Corporation and generally only a partial step-up in S Corporations and Partnerships. Problems with the Accumulated Earnings Tax and the corporate Alternative Minimum Tax are possible. It is also possible that in a family owned business the purchase by a C Corporation of the decedent's stock will be considered a dividend which would be taxable.

- **Cross Purchase Plan:** Owners personally agree to buy the stock of a deceased owner.

Advantages: There are no problems with corporate Accumulated Earnings Tax or corporate Alternative Minimum Tax. The cash values and proceeds are not available to corporate creditors. Owners get a new cost basis for the interest purchased, which could save taxes at a later sale.

Disadvantages: If the plan is insured, it could require several insurance policies. For example, if there were 3 owners, 6 policies may need to be purchased. (The problem of multiple policies may be alleviated by using a "trusteed" type of cross purchase plan).

There are many variations on the two basic types of Buy-Sell Agreements. An attorney should always be consulted to draft the actual Buy-Sell document.