

BUSINESS LAW NOTES

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Business Succession Planning: PART TWO

BUY-SELL AGREEMENTS

By F. Stephen Glass

Advance planning for the orderly succession to your business interest is important. "Business succession planning" determines how a person's interest in a business will be transferred upon certain agreed-upon triggering events which might include:

- The death or disability of an owner
- The divorce of an owner
- The retirement of an owner
- The involuntary transfers (judgments against an owner, bankruptcy, etc.)
- Business disputes among owners
- Certain business valuation issues.

A *Buy-Sell Agreement* or "Shareholders' Agreement" will also permit an owner to preserve the family's control over the business. Because a company is a legal entity separate from its individual owners, it is usually advisable for owners of closely held companies to enter into a buy-sell agreement to regulate the relationships with each other and with the company. LLC and Partnership Operating Agreements should contain similar provisions. Buy-sell agreements may also create a mechanism for liquidating the shares or interests of children who are not active in the family business. Mechanisms that are often used include either stating the price for which the business interest may be purchased upon a triggering event and establishing a formula for determining the price of that interest.

It is important that a buy-sell be adopted by the company early in its formative stage when feelings and attitudes are in harmony. If a buy-sell is not in place when a dispute arises among the owners, it may be impossible for the various factions to carry on the business of the company.

Generally, types of buy-sell agreements fall within these categories:

Cross-purchase agreements. In a cross-purchase agreement, the other owners of a company are obligated to buy the departing (either by retirement, disability, death etc.) owner's interest. The company itself as an entity is not a party to the buy-sell agreement. Cross-purchase agreements enjoy certain tax advantages, in that proceeds from the sale of stock are treated as capital gains rather than as dividends. The purchasing owners receive an increase in their basis equal to the purchase price as result of the purchase. In addition, if the cross-purchase agreement is funded with life or disability insurance, the insurance proceeds to the individual owners are tax-free.

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IT IS NOT TRASH!

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Business Succession Planning: PART TWO

BUY-SELL AGREEMENTS

F. Stephen Glass

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In the case of a cross-purchase agreement, policies are owned by the individual owners or partners on the lives of each other. If there are more than three owners, however, policy ownership can become complicated and it may be wiser to use the entity purchase. As an alternative to this, you may establish a trust outside of the entity to hold the contracts and avoid multiple policies. Also, when insuring a cross-purchase agreement, a split-dollar funding technique may be utilized in which the individuals own the policies and the company pays the premium, thus avoiding personal-income taxation on the full premium.

Cross purchase method alternatives include the "trusteed buy-sell", which is an arrangement where a trust purchases and owns one policy on each owner's life. The owners have an equitable interest in the trust in proportion to their interest in the company and pay a proportional share of the premium payments through contributions to the trust. At the death of a owner, the trust purchases the decedent's interest. The surviving owners receive a distribution of the decedent's business interest from the trust in proportion to their equitable interest in the trust.

Advantages: Stepped-up basis, no capital gains treatment and income tax-free insurance proceeds; one policy per owner.

Disadvantages: Unless the business is taxed as a partnership, the purchase by the trust of the decedent's contributed premiums is subject to income tax.

Redemption or entity repurchase agreements

specify that the company, by way of agreements made between the company and the individual owners, is obligated to purchase the stock of the departing owner. The major advantage to this type of agreement is simplicity — each owner deals with one entity, the company, rather than several other owners. The company generally purchases life insurance on each of the owners in order to fund the redemption of a deceased owner's stock and the company is the owner and beneficiary of the life insurance on the owners. When the redemption occurs, the remaining owners' basis in the company is increased proportionately, since the interest is split fewer ways.

"Wait-and-see" agreements allow the owners to defer the decision between the entity purchase and the cross-purchase until such time as they can determine the most tax-wise strategy. With a "wait-and-see" agreement, the decision as to whether the entity or the individuals will purchase the interest of a departing owner is deferred until a buy-out situation actually occurs. Waiting allows the decision to be based on the circumstances present at the time the buy-out occurs. The "wait-and-see" agreement gives the entity the first option to purchase the departing or deceased owner's stock. This agreement benefits the seller by guaranteeing a buyer -- providing there is sufficient liquidity -- and helping to avoid dividends and by possibly fixing the value for estate tax purposes. The agreement can benefit the buyer by eliminating potential friction at the time of sale, avoiding the possibility of hostile buyers, avoiding doing business with heirs and, if funded with life insurance, by providing the buyer with the cash to meet the purchase price.

Cross Purchase Agreement or Redemption? The tax basis of the purchaser of shares is higher with a cross purchase agreement than with a stock redemption agreement. With a stock redemption, the seller must sell all stock, or make a "substantially disproportionate" sale, to avoid dividend treatment on the stock purchase price. The purchaser uses *pre-tax dollars* to purchase under a stock redemption arrangement and uses *after-tax dollars* with a cross-purchase agreement. In an S-Company, the income tax cost is the same to the purchaser, whether under a cross-purchase or a redemption. A cross-purchase offers a step up in basis for the surviving owners.

[Next issue: *Anatomy of typical buy-sell agreements.*]

BUSINESS LAW NOTES

BUSINESS TAX LAW

By F. Stephen Glass

“Responsible Persons” — § 6672 of the Internal Revenue Code mandates an employer to withhold federal income taxes and social security taxes from employees’ wages. The employees are given a credit against their tax liability for taxes withheld whether the employer remits the funds to the government or not. The IRS cannot collect this tax from the employee even if the employer does not pay the tax to the government. To protect the government when the employer does not pay this tax, § 6672 of the IRC subjects all “responsible persons” — **PERSONALLY** — for the withholding and payment of the taxes to a penalty equal to the amount of the taxes due where the employer failed to pay such taxes to the government. Section 6672 imposes the penalty on anyone who is required to collect, administer and pay over the tax and who willfully fails to do so.



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- Firm Publications (back issues of BLN)
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COLLECTING ON YOUR ACCOUNTS

by: Sam Johnson

The following are useful practices that may improve the probability that you will collect on the accounts due your business:

- **COMMUNICATION** – Throughout the relationship with debtor, you should communicate on a regular basis with a friendly phone call to see if everything is going smooth, and address any problems that arise before they get out of hand.
- **WRITTEN CONTRACT** – A written contract describing the assignment and provision for timely payment of services and expenses is important.
- **ADVANCED PAYMENT** – In some cases you may be wise to require an advanced payment.
- **SECURITY** – It may be appropriate to require a promissory note and deed of trust on real estate or other form of security from a customer or client that is likely to encounter financial problems. You will need the services of your attorney to draft the documents and file them in an appropriate office. If this is done properly, you will likely be protected, even in bankruptcy.
- **BUSINESS ORGANIZATION** – Clearly understand the identity of your client/customer. Is the business a corporation or sole proprietorship or something in between? If the client is a new corporation with limited assets, then it is appropriate to have a personal guaranty signed by the owners and their spouses. If the owners refuse to sign, this is an indication of future collection problems.
- **RECORD KEEPING** – There is no substitute for thorough record keeping. Develop a system that collects and retains all essential records, statements and correspondence regarding your accounts.
- **TIMELY BILLING** – Billing on a regular, usually monthly, basis. The longer the interval between delivery of service or product and the billing, the more likely there will be difficulty in collecting the bill.
- **LEGAL ACTION** — Before filing legal action, investigate collectability, consult with your attorney and make a prudent decision.

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CONSIDERATIONS FOR FORMING YOUR NEW BUSINESS

F. Stephen Glass

The following are some steps necessary to plan, form and launch a new business are similar for every type of venture, although some steps differ based on the specific type of business and its complexity or the product or service.

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| Retain an attorney and CPA | Open banking accounts |
| Develop the business plan | Obtain required licenses and permits |
| Choose the type of legal entity | Draft standard contracts |
| Choose and protect the company name | Establish company policies |
| Capitalize (secure funding for) the business | Establish a financial management procedure |
| Establish a buy-sell agreement | Establish a document management procedure |
| File the official formation documents | Establish "branding" for documents & forms |
| Obtain tax identification numbers | Analyze marketing/communication materials |
| Obtain insurance coverage | Implement a trade secret protection plan |
| | Implement a data backup and security plan |

Jean Winborne Boyles

Frequently a client asks "What is this? I have a demand letter for several thousand dollars from a bankrupt company." I question the client if he knew the company was bankrupt and if he had received bankruptcy notices. The usual answer is "Yes, but they were bankrupt, I didn't expect to get anything and I threw it in the trash." It is not trash!

When one gets a notice from the Bankruptcy Court, it is prudent to have an internal policy which funnels the notice to an individual who knows what to do. You should do these basics:

1. Set up a file;
2. Determine if this debtor has paid you anything within 90 days of the date of filing of the bankruptcy; and
3. Save the Proof of Claim form and information about what monies the bankrupt debtor owes you and determine how to file the Proof of Claim.

If the debtor has made payments to you within 90 days of the date of filing (the "preference period"), he may make a demand for repayment of these funds. Such demand will usually happen a year or so after the bankruptcy has been filed and after the bar date for filing a Proof of Claim has passed. If you have, in fact, received payments within the 90 day period, contact an attorney to discuss your situation. Fill out a Proof of Claim to the best of your ability. I recommend that you let your attorney do this. Do not try to claim a secured debt if it is unsecured. Attach the supporting documentation and make a notation that you reserve the right to amend your claim. Send it to the address noted on the form. Remember, this bankruptcy notice is not trash. It does not mean you have lost money, it may mean you owe money! Pay attention and do not trash the notice.