the Estate PLANNER

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Creative financing

Designing and funding a buy-sell agreement for your business

If you own a business, it's probably your most valuable asset. So it's important to take steps to preserve that value for your family after your death or in case you become disabled or leave the business for some other reason. One of the most powerful tools available to help you achieve that goal is a buy-sell agreement.

A buy-sell agreement creates a market for your interest in the business, providing liquidity to pay estate taxes and other expenses, and smoothing the transition from one generation to the next. Because the agreement provides for the company or the other owners to buy you out, it's critical to make arrangements to fund the purchase.

Buy-sell benefits

A buy-sell agreement is a contract among the owners of a business that provides for the company or the remaining owners to buy back a deceased, disabled or departing owner's interest under specified circumstances for a specified price. Typical "trigger events" include:

- Death,
- Disability,
- Divorce,
- Retirement or termination of employment,
- Bankruptcy, and
- Loss of a professional license.

By establishing buyout terms, a buy-sell agreement creates a market for otherwise unmarketable shares, providing a source of liquid funds the owner's heirs can use to pay estate taxes and other expenses without being forced to sell the business.

A buy-sell agreement also can help keep ownership of the business within a family or another select group by preventing: 1) departing owners from selling their interests to outsiders, and 2) an

owner's spouse from acquiring an interest in a divorce proceeding.

Other potential benefits of a buy-sell agreement include minimizing disputes among owners over price and other buyout terms, and establishing the value of the business for gift and estate tax purposes (if certain requirements are met).

Types of agreements

There are two basic types of buy-sell agreements: redemption and cross-purchase. Under a redemption agreement, the company buys back a departing owner's interest, and under a cross-purchase agreement, the remaining owners purchase the interest. Each has advantages and disadvantages:

Redemption agreements. An important distinction of a redemption agreement is that the *company* is responsible for funding the buyout, not the other owners. Redemption agreements have some big drawbacks, especially if the company is a C corporation. For one thing, if a redemption agreement is funded by insurance on the owners' lives, insurance proceeds received by the company may trigger corporate alternative minimum tax (AMT). The company can avoid AMT by funding the agreement with corporate savings rather than life insurance, but this approach can create accumulated earnings tax (AET) issues.

Another disadvantage of a redemption agreement is that the company's purchase of an owner's

interest enhances the value of the remaining owners' shares — because each owner now owns a greater percentage of the company — without a corresponding step-up in tax basis. A lower tax basis potentially increases the tax hit for owners who later sell their interests.

Cross-purchase agreements. These agreements can provide several advantages but can be unwieldy and expensive — especially for larger companies — because each owner must maintain insurance policies on the lives of all of the other owners. On the plus side, however, in addition to avoiding AMT and AET problems, cross-purchase arrangements provide the remaining owners with additional tax basis in any acquired interests, reducing their capital gains — and, therefore, their taxes — if they sell their shares.

Considerations for pass-through entities

The disadvantages of redemption agreements are generally less of a concern for pass-through entities — such as S corporations, partnerships and limited liability companies — because they're not subject to AMT or AET.

Also, there is less of a basis issue on pass-through entities. Like a C corporation, a pass-through entity's buyout of a deceased or retiring owner doesn't produce a basis increase for the surviving owners. But if the buy-sell agreement is funded by life insurance, the basis of all owners is increased by the pass-through entity's receipt of the insurance proceeds.

For example, Tom, Dick and Harriet each own one-third of the stock of TDH Advisors, an S corporation valued at $3.6 million. Under a cross-purchase agreement, if one of the shareholders dies, the other two are obligated to buy back the shares for $1.2 million. To fund the agreement, Tom, Dick and Harriet each buy $600,000 life insurance policies on the lives of the other two shareholders. When Tom dies, Dick and Harriet each collect $600,000 in life insurance proceeds tax-free and use those funds to buy half of Tom's shares. Dick's and Harriet's interests in TDH Advisors increase in value by $600,000 each, but they also enjoy a basis increase of $600,000.

Suppose, instead, that TDH Advisors and its shareholders have a redemption agreement that requires the company to buy back Tom's shares for $1.2 million, funded by a $1.2 million life insurance policy. Even though the company, rather than the shareholders, buys Tom's shares, Dick and Harriet each become 50% owners, so the value of their shares increases by $600,000 each. The basis of each shareholder (including Tom) is increased pro rata by the $1.2 million in life insurance

FTD delivers cost savings

For many businesses, first-to-die (FTD) life insurance offers a lower-cost alternative to traditional insurance for funding a buy-sell agreement. In a typical buy-sell arrangement, individual life insurance policies are purchased for each owner. Alternatively, an FTD insures two or more lives simultaneously and pays a death benefit on the death of the first insured to die.

The primary advantage of FTD insurance is lower premiums: An FTD policy covering two people typically costs 25% to 30% less than two individual policies. But even though FTD insurance is an effective alternative for a redemption agreement, it can present some tricky tax and planning issues for cross-purchase agreements.

Joint ownership of an FTD policy used to fund a cross-purchase agreement may cause the insurance proceeds to be included in the deceased owner's taxable estate and may also have negative income tax consequences. Many experts believe this result can be avoided if the buy-sell agreement requires the proceeds to be used to purchase the deceased owner's interest or if the FTD policy is owned by a properly designed trust. The problem is that there's little guidance on this issue and it's difficult to predict how the IRS or the courts will treat such an arrangement.

proceeds collected by the S corporation. Thus, Dick's and Harriet's bases both increase by $400,000. Tom's basis also increases by $400,000, but that increase is wasted because Tom's estate receives a stepped-up basis equal to the fair market value of his shares.

Setting the price

Your buy-sell agreement's terms for valuing the company's shares and setting the purchase price are critical. Generally, the most effective method is to conduct regular, independent appraisals of the business, but a well-designed valuation formula can be an effective low-cost alternative. If you use the formula approach, however, there's a risk the IRS will find that the business is undervalued, creating unexpected estate tax liabilities, interest and penalties.

Funding options

There are three basic methods of funding a buy-sell agreement:

1. Savings plan. The company or its owners simply save enough money to cover their obligations under the agreement. The problem with this approach is that funds may not be available if an owner dies or leaves the business sooner than expected or if savings are needed for unforeseen expenses. It also can cause AET problems for a C corporation.

2. Bank loans. When an owner dies or leaves the business, the company or the remaining owners borrow the money needed to fund the buyout. But this approach can fall short if the company or its owners run into financial difficulty and have trouble obtaining a loan.

3. Life insurance. In most cases, life insurance is the most cost-effective method of funding a death buyout under a buy-sell agreement. It ensures that the funds will be available when needed. In addition, the insurance proceeds are generally tax-free (but watch out for AMT issues raised by C corporation redemption agreements).

Complex planning issues

Developing a buy-sell agreement that's right for your business requires consideration of a number of complex tax and business planning issues. Thus, it's wise to consult legal, tax and financial advisors to design an agreement and funding mechanism that meets your needs. ▮

Asset protection planning alive and well

BAPCPA revises bankruptcy rules for better and worse

Estate planning and asset protection planning go hand in hand. After all, strategies for minimizing transfer taxes are meaningless if you have no assets to transfer. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) — which applies to bankruptcy filings on or after Oct. 17, 2005 — contains a number of provisions that affect asset protection.

Spelling out BAPCPA

Contrary to what some pundits would have you believe, BAPCPA doesn't spell the end of asset protection planning as you know it — but it does change some of the rules. And even though some of these changes make it harder to protect your assets, others — most notably, new protections for IRAs and other retirement benefits — make it easier.

It's also important to recognize that BAPCPA is a *bankruptcy* law. Most people don't file for bankruptcy, and involuntary bankruptcies for individuals are rare. So in most cases, the act has no effect on traditional asset protection planning. But if bankruptcy is inevitable, it's worthwhile to learn the new rules.

Homesteads less steadfast

State homestead exemptions, which shield your principal residence against creditors' claims, are less effective under BAPCPA. For example, with prior bankruptcy law you were required to live in a state for only 180 days to use its homestead exemption. BAPCPA increases the residency requirement to 730 days (two years).

BAPCPA also makes it harder to take advantage of the more generous exemptions available in some states. Most states place a dollar limit on their homestead exemptions, but in some states the limits are quite high and a few states offer an unlimited exemption. Under the new law, you're generally required to live in a state for 1,215 days (three years plus 120 days) before you can exempt more than $125,000 in homestead equity.

Limitation periods less limiting

BAPCPA expands the bankruptcy court's power to set aside some fraudulent transfers — that is, transfers by a debtor with the intent to defraud creditors and certain transfers for less than "reasonably equivalent value." Under prior law, the court could recover property transferred fraudulently within one year prior to the bankruptcy filing. The new law extends this "look-back" period to two years.

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The act also creates a special 10-year look-back period for some transactions, including transfers to self-settled asset protection trusts and conversions of nonexempt assets into homestead equity.

These provisions don't make nonfraudulent asset protection planning any less effective, but they do expose debtors to potential litigation over transactions that previously would have been considered ancient history.

Should you change your plans?

Despite the changes brought by BAPCPA, most traditional asset protection planning strategies remain effective. Nevertheless, it's a good idea to review your plan and make any necessary revisions. If you're thinking about relocating to a more homestead-friendly state, for example, consider making your move sooner rather than later to satisfy BAPCPA's waiting periods. In general, taking action early is preferable, because the sooner BAPCPA's 10-year limitation periods expire, the better.

In addition, BAPCPA extends the asset protection benefits — up to a $1 million limit — enjoyed by "qualified" retirement plans, such as 401(k)s, and traditional and Roth IRAs. ■

The future of estate planning

As laws change, focus shifts to income tax, state taxes

The future of the estate tax may be uncertain, but one thing is clear: Rumors of the death of estate planning are greatly exaggerated. Permanent repeal of the federal estate tax seems unlikely, but many experts expect legislators to push for even higher estate tax exemptions, reducing the number of Americans subject to the tax.

Whether Congress kills the estate tax or increases the exemption, the need for estate planning will live on. But its focus will shift from federal estate taxes to other issues, such as federal income taxes and state death taxes.

Income tax planning

For many years, when estate tax rates were high and exemptions relatively low, estate planning revolved around avoiding the federal estate tax. But that's beginning to change. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) lowered estate tax rates and boosted the estate tax exemption from $1 million to $1.5 million for 2004 and 2005, to $2 million in 2006, and to $3.5 million in 2009.

As the estate tax becomes less of a factor, income tax issues take on added importance, turning traditional estate planning techniques on their head. Traditionally, taxpayers strive to minimize the value of their taxable estates to reduce or eliminate estate taxes. But taxpayers who are well within the estate tax exemption may benefit by increasing the value of their estates. Why? Because assets transferred at death receive a stepped-up basis in the hands of their heirs, minimizing the effects of income taxes. Here's an example:

Jean owns a 35% interest in a business worth $4.7 million. Her daughter and sole heir, Julie, owns the other 65%. Jean's remaining assets consist of $115,000 in cash and marketable securities. Assuming a 25% minority interest valuation discount, Jean's interest in the business is worth

$1,233,750. If Jean dies in 2006, when the federal estate tax exemption is $2 million, there's no estate tax liability. Julie inherits Jean's interest in the business with a stepped-up basis equal to its fair market value, or $1,233,750.

Suppose, instead, that Jean purchases a 20% minority interest in the business from Julie in exchange for a $705,000 promissory note, increasing her stake to a 55% controlling interest worth $2,585,000. When this amount is combined with Jean's remaining assets and the $705,000 liability is subtracted, her estate is valued at $1,995,000, still within the federal estate tax exemption.

But under this scenario, Julie's basis is stepped up to $2,585,000. If Julie were to sell the business for $4.7 million, the increased basis would save her more than $270,000 in capital gains taxes, assuming a 20% capital gains tax. Bear in mind that this strategy might cause an increase in state death taxes if Jean lived in a state that has decoupled its estate tax from the federal estate tax.

State estate tax planning

In addition to lowering rates and increasing exemptions, EGTRRA also eliminated the state estate tax credit and replaced it with a federal

estate tax deduction for state taxes paid. Before EGTRRA, estates received a dollar-for-dollar credit for estate or inheritance taxes they paid to a state.

Rather than create separate tax systems, most states simply imposed death taxes in an amount equal to the federal credit. These were called "pick-up" taxes because the state would pick up the amount allocated as a credit under federal law. Of the states without a pick-up tax, most had death taxes that were coupled in some way with the federal estate tax and exemption scheme.

But by increasing the estate tax exemption and repealing the state death tax credit, EGTRRA reduced or eliminated the tax revenues collected by a state with the pick-up tax. To make up for these lost revenues, many states have decoupled from the federal tax and established their own estate or inheritance taxes.

This phenomenon affects estate planning in two ways: First, depending on your state's laws, you may be subject to state death taxes even if you're exempt from the federal estate tax. And second, the lack of uniformity among state death taxes complicates your estate plan, especially if you own property in more than one state or relocate to another state.

Weighing potential tax consequences

Income tax and state death tax issues aren't new, but until recently these taxes were generally eclipsed by the federal estate tax. If the estate tax is repealed, estate planning will shift its focus to minimizing income taxes and state death taxes. Or, if Congress retains the estate tax but increases the exemption, estate planning will get more complicated as taxpayers attempt to strike a balance between estate tax and income tax concerns.

To evaluate estate planning strategies, weigh the potential estate, income and state tax consequences, and choose the option that provides the greatest benefits to you and your family. ∎

Estate planning red flag

You have a charitable remainder trust

A charitable remainder trust (CRT) allows you to support your favorite charities while providing an income stream for yourself and generating a variety of tax benefits for you and your family. But new IRS rules may endanger those benefits unless you file additional paperwork.

The rules address laws in most noncommunity-property states that prevent you from disinheriting your spouse. These rules give your surviving spouse a "right of election" to receive a portion of your estate regardless of the terms of your estate plan.

The IRS was concerned that a surviving spouse could use the right of election to appropriate CRT assets that were intended for charity and were used to generate charitable deductions. To prevent this result, the new rules disqualify CRTs created on or after June 28, 2005, if they're subject to a surviving spouse's right of election (regardless of whether the right is actually exercised).

To preserve your CRT's benefits, have your spouse sign an irrevocable waiver of his or her right of election against the CRT assets. Even if you live in a state where a waiver isn't needed, it may be advantageous to get one anyway to protect your CRT in the event you relocate to a state where it is required.

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