



Advanced Planning Strategies

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Dear Reader,

Filing the 2001 tax returns is now a painful memory, unless less you filed an extension and deferred the anguish until August. The IRS, which has taken a more active role in assisting taxpayers, hopes to receive 80 percent of tax returns electronically by 2007. Currently under consideration is providing free filing of simple returns through the IRS's website. As part of the Internal Revenue Service Restructuring and Reform Act of 1998, the IRS has offered tax preparation assistance at 400 walk-in sites. Return preparation assistance was provided to 1 million taxpayers in 2001. Of course, the more complex returns will generally require professional private-sector preparation. The walk-in assistance was recently limited to Forms 1040 (with schedules A, B (interest only), and R), 1040EZ, and 1040A.

The IRS recently announced relief from the normal substantiation requirements for taxpayers who contributed to charities in 2001 after September 10 (IRS Notice 2002-25, IRB 2002-15 (4/15/2002)). This relief responds to the extraordinary charitable relief efforts for the September 11th victims. Normally, a taxpayer who contributes \$250 at one time to a charity must substantiate the contribution on the income tax return with a contemporaneous receipt from the charity; a cancelled check is not sufficient. For 2001 contributions after September 10, the taxpayer has until October 15, 2002, to receive substantiation. If the taxpayer's efforts to receive the receipt fail, the IRS will accept a good faith attempt, such as a letter or e-mail, as substantiation from the charity.

The tax legislation debate is beginning to heat up again. President Bush reiterated his call for increased tax benefits for charitable giving. Additional tax cuts are being proposed. Particularly important in these discussions is the proposal to remove the "sunset" provisions included in last year's tax cuts. Under the sunset provisions, the tax changes from the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 would be repealed in 2011, returning the tax law to pre-EGTRRA rules. This proposal is estimated to cost an additional \$373 billion by 2012. The debate will ultimately focus on the affordability of any further tax relief. Treasury Secretary O'Neill recently redirected some federal retirement funds after failing to get Congress to increase the statutory federal debt ceiling of \$5.95 trillion. Clearly, no legislators want to be held responsible for shutting down the government or invading the Social Security trust fund. The potential for gridlock appears high at this point.

Knowledge is not power. Only knowledge in use is power.

BUY-SELL AGREEMENTS FOR CLOSELY HELD BUSINESSES

Owners of closely held businesses often form buy-sell agreements to plan for the risks that threaten the continuation of the business. The death of an owner of the closely held business is disruptive to the business and often leads to business failure. If there is more than one owner of a closely held business, the death of one owner often places the surviving owner(s) in a tenuous position. The survivors must attempt to successfully continue the business and somehow satisfy the needs of the decedent's heirs. The problems each party faces will depend on the facts and circumstances of each case. The executor of the decedent's estate may have the ability to force liquidation of the business. Or the executor may be forced to negotiate with the surviving owner(s) in an attempt to receive a fair price for the business interest held by the estate. The rights of the executor/heirs and the surviving owners depend on the type of entity, the size of the ownership interest held by the estate vis-à-vis the surviving owner(s), and the provisions of state law where the business is organized. Regardless of the individual differences for each business, the failure to form an effective continuation plan for the business will create an uncertain future for all the parties.

BENEFITS OF A BUY-SELL AGREEMENT

A properly designed buy-sell agreement offers both business and personal estate planning benefits. The benefits of such an agreement include the following:

- A market is guaranteed for the decedent's business interest because the estate will be able to sell it to the surviving owner(s) under the terms of the agreement.
- The deceased owner's estate is more liquid because the business interest will be sold for cash or other consideration.
- The purchase price in the agreement helps to establish the estate tax value of the business interest.
- The survivors can continue the business without interference from outsiders.
- The chances of successful continuation for the business are enhanced.

KEY COMPONENTS OF A BUY-SELL AGREEMENT

A buy-sell agreement is a binding purchase and sale contract, and many of the terms are obvious. Some key components are emphasized below:

- The commitment of the parties should be clearly worded. The most effective buy-sell agreement is mandatory. The estate should be bound to sell, and the purchasers (either the surviving owners or the business itself) should be compelled to buy.
- The business interest should be clearly described. In some instances this is straightforward. For example, in the case of a corporation, the decedent's stock will be purchased (or redeemed) from the estate. In the case of a proprietorship, the assets should be carefully described.
- The purchase price provision should be unambiguous. Either a stated price or a clear method for determining the price should be included. As the material below indicates, a formula method should probably be used in a buy-sell for a family business.
- The method of funding the purchase should be addressed. Ordinarily, life insurance is the recommended method for funding a buy-sell effective at an owner's death. The insurance ownership terms, beneficiary designations, and premium payment obligations should be

provided. If installment notes will be included in the purchase price, the terms of the notes should be spelled out.

- Lifetime transfer restrictions should be carefully designed. The agreement should not permit one of the owners from selling to outsiders while all owners are alive without first offering the business interest to the remaining owners at the contract price. In fact, IRS regulations indicate that the agreement will be ineffective at establishing the estate tax value of the business interest unless such lifetime restrictions are incorporated.
- Provisions for disability and retirement should also be considered. Although most buy-sell agreements focus on the sale of the business interest at death, there is a greater probability that an owner will leave due to disability or retirement. It is important to consider buy-sell strategies for these triggering events.

FAMILY BUY-SELL AGREEMENTS

Buy-sell agreements are often used to transfer a family business to the next generation. However, the IRS will carefully scrutinize the purchase price provision to prevent the transfer to the next generation at a bargain price without gift or estate taxes. To avoid valuation abuses in a "cozy" family buy-sell agreement, the purchase price specified by the agreement will establish the estate or gift tax value of the business interest only if

- the contract is a bona fide business agreement
- the contract is not a method to sell the business to family successors for less than full consideration
- the contract price is comparable to similar agreements formed by unrelated parties

A buy-sell agreement is subject to these rules if more than 50 percent of the business is owned by family members. If the buy-sell agreement is formed with family successors who receive minority (50 percent or less) interests in the business, it is permissible to discount the purchase price to successors for lack of control (i.e., the minority discount). In addition, it is appropriate to discount for lack of marketability in a closely held business.

Recent cases have demonstrated the difficulty in sustaining the purchase price as the estate tax value of the stock in family or friendly buy-sell agreements. It is clear that the parties must be bound by the agreement. For example, the controlling business owner should not have the right to amend the agreement unilaterally. The business purpose for the agreement will be examined. It must be more than an estate plan for the owners. The preservation of control by successor family management or the use of the agreement to retain key participants in the business will suffice.

In addition, the price provision should be adopted with appropriate methodology and be expected to result in fair market value (with due consideration for minority or marketability discounts). It is generally not sufficient to rely on book value or informal opinions of the client's attorney, CPA, or other adviser(s) (unless they are qualified to appraise businesses and diligently examine the business before providing the opinion). The IRS will also compare the purchase price to other evidence such as actual sales or gift tax valuations of the business to determine if the buy-sell price is too low. If the IRS is successful, the downside risk is that the estate will be forced to include the business interest at a higher value while bound by the agreement to receive the lower value from the purchasers—a potentially devastating liquidity problem. (See *Lauder v. Commissioner*, TC Memo 1992-736, *Bommer Revocable Trust v. Commissioner*, TC Memo 1997-380, *Gloeckner v. Commissioner*, TC Memo 1996-148, and *True v. Commissioner*, TC Memo 2001-167.)

FUNDING CONSIDERATIONS

Prefunding buy-sell agreements provides the greatest chance for successful continuation of the business and ensures liquidity for the deceased owner's estate. Without prefunding, where will the survivors find the necessary funds to complete the buy-out? Where will the executor get the cash to pay the estate and inheritance taxes on a timely basis? Borrowing is a risky proposition because the business's future will be burdened by debt repayment. Well-planned buy-sell agreements are fully funded by a combination of life and disability insurance. The insurance arrangements should be carefully designed. The products and contract terms should match the needs of the owners and the requirements of the buy-sell agreement.

RECENT CASES AND RULINGS

TAX COURT DENIES ANNUAL GIFT TAX EXCLUSION FOR TRANSFERS OF BUSINESS INTERESTS TO FAMILY MEMBERS

The taxpayers gave membership interests in a family limited liability company (LLC) to children and grandchildren in 1995 and 1996. The taxpayers sheltered the gifts of the business interests from gift taxes by applying the \$10,000 gift tax exclusion to each transfer. The property held by the LLC was timberland purchased as a growth investment that was not expected to produce income for several years. The operating agreement designated the primary donor as the LLC's sole manager. All distributions were to be made in the manager's sole discretion and could be made only from the LLC's excess cash above anticipated expenses and operating reserve. In addition, members were not permitted to withdraw capital from the LLC and could not transfer their interests in any meaningful manner without the manager's consent. As anticipated, the LLC suffered losses and made no distributions for several years.

The tax court held that the annual exclusion did not apply to the gifts of LLC interests in this case (*Hackl v. Commissioner*, 118 T.C. 14). The taxpayers argued that the outright transfer of a property interest provides the donees with the requisite present interest required for the annual exclusion. The court reasoned that the analysis must extend beyond the form of the conveyance to determine if the gift provides future or present interest. Examining the rights received by the donees, the court determined that the donees did not receive any current substantial economic benefit or enjoyment of the property. First, inability to withdraw capital or transfer the LLC interests prevented present enjoyment. Second, the lack of a predictable income distribution stream also negated the annual exclusion based on an income interest. In reaching this conclusion, the court, in a troubling fashion, compared the rights of the donees of a business interest to beneficiaries of a trust to determine whether a present interest was received.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients
for the future***



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