



Advanced Planning Strategies

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February 2005

Dear Reader,

President Bush has prioritized Social Security reform as a critical item on his agenda. Unfortunately, we don't have all the details at the time this letter is going to the printer, but it is clearly an undertaking that will have a significant impact on many Americans. Legislators from both parties have already questioned the underlying principles of the proposed reform and have suggested other solutions. We expect a lengthy debate, and it will be important to watch for specifics of the proposals as the process unfolds.

The basic principles outlined in the President's plan are summarized as follows:

- Benefits will not be changed for those in or near retirement.
- Payroll taxes will not be increased.
- Voluntary accounts will be permitted to give younger workers the opportunity to invest a portion of payroll taxes to provide for future benefits.
- Workers who do not opt to invest in personal accounts will continue to benefit from the traditional program.
- Personal accounts that give participants the opportunity to achieve greater returns than under the current system will contain limitations on the choice of investments to permissible low-risk, low-cost options.

There are many more questions than answers at this point and the solutions will inevitably be complex. However, there are some important issues that need to be addressed. First, the Social Security program has proven to be one of the most popular programs the federal government ever created. Any fundamental change will be a tough sell to the participating public. Second, the program has always provided a "defined benefit" that was created to provide a specified income payment for retired and disabled workers. The proposal will, in part, create a defined-contribution account retirement plan that shifts the investment risk to workers to the extent the private accounts are used. Third, the Social Security system includes other components, such as disability benefits and Medicare. Although the retirement component is generally thought to create a deficit problem by 2042, the combination of the retirement and Medicare components creates a much more immediate budgetary problem. We promise to watch carefully and report the developments as they occur.

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 continue the business successfully 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 the estate holds. 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 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:

- It guarantees a market 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 agreement enhances the chances of successful continuation for the business.

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 to fund 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 the agreement specifies 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.

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 advisor(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. Price provisions should be formed with adequate negotiation and be re-examined periodically. If the IRS is successful in challenging the adequacy of the purchase price, 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 *True v. Commissioner*, 94 AFTR 2d 2004-7039, where the purchase price was determined not to establish the estate tax value of the stock, resulting in \$18.2 million in tax deficiencies and \$3.1 million in penalties for substantial undervaluation of the business interest for estate tax purposes.)

FUNDING CONSIDERATIONS

Prefunding buy-sell agreements offers 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

GROUP UNIVERSAL LIFE INSURANCE PLAN HELD NOT TAXABLE UNDER IRC SEC. 79

In a recent technical advice memorandum (Ltr. 200502040), the IRS examined the taxation of a corporation's group term life and group universal life plans. The participating employees were covered under a group term life plan that offered a death benefit of two times the employee's salary. Participating employees were also eligible to apply for supplemental life insurance under a group universal life insurance program. The IRS held that the employees would not be taxed under Sec. 79 as a result of participation in supplemental coverage through the group universal life insurance plan.

The plan design was rather complex and required a contribution from employees for the group term life coverage, with the balance of the cost paid by the corporation. The employees participating in the group universal life insurance plan paid premiums with after-tax dollars. In addition, a participating employee could contribute through payroll deduction to a group universal life fund. The employee could use the funds to pay the next policy premium, purchase paid-up insurance, or take withdrawals or loans. The coverage under the group universal life plan was available under similar terms to insureds who did not purchase any other coverage from the insurer. The IRS held that under the design of this plan, the group universal life insurance plan and fund could be treated separately from the group term life insurance plan. Thus, the universal life plan is not taxable under Sec. 79. In addition, because the employee paid for the cost of coverage under the group universal life insurance plan, it is not taxable to the employee as a transfer of property under Sec. 83.

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.

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for the future*



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