



Advanced Planning Strategies

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June 2008

There has been some activity in Congress concerning tax legislation since our last letter. We previously mentioned a package of extenders for expiring tax provisions introduced in the Senate (S. 2886). Senator Baucus indicated the legislation would be marked up this month. The House of Representatives passed its version of the extenders bill (The Renewable Energy and Job Creation Bill of 2008--H.R. 6049) with significant energy incentive tax provisions. The bill includes (1) a new credit for facilities generating electricity from waves and tides, (2) an extension of the credit for wind energy facilities through 2009, and (3) an extension of the credit for biomass, geothermal, hydropower, landfill gasses, and trash combustion facilities through 2011. The costliest extender in the legislation is a one-year extension of the research and development tax credit. The bill will have a revenue-raising offset that would change the taxation of deferred compensation paid by managers of offshore hedge funds. The bill did not contain the expected AMT relief provision.

The Senate quickly voted to override President Bush's veto of the farm subsidy bill—the Food, Conservation, and Energy Act of 2008 (HR 2419). The bill would alter (1) agricultural tax-exempt bonds, (2) the rules for self-employment taxes to facilitate farmers and ranchers to qualify for Social Security, (3) depreciation for race horses, and (4) tax-free exchanges of water rights. The biggest revenue raiser in the bill is a provision to cut the ethanol tax credit to 45 cents.

The IRS had issued over \$45 billion in rebate payments under the Stimulus Bill at the time this letter was written. The IRS reported an increase of 12 percent in returns filed electronically over the same period last year, with an over 19 percent increase in self-prepared e-filed returns. The visits to the Service's website (www.irs.gov) increased over 21 percent compared to a comparable period last year—over 160 million visits to the site as of April 18. The availability of stimulus checks probably accounted for some of this increase.

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.) Another interesting case is *Estate of Blount v. Commissioner*, 428 F3d 1338, where the court increased the estate tax value of the decedent's stock above the buy-sell mandated price after concluding the agreement was not comparable to similar agreements entered into at arm's length. The circuit court, however, refused to further enhance the value of the stock held by the estate by the amount of life insurance proceeds received by the corporation to purchase the decedent's stock.

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' 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

IRS Rules That Power To Substitute Assets Of Equal Value Does Not Result In Adverse Estate-Tax Consequences

The tax rules for transfers to a trust are different for income, gift, and estate-tax purposes. A trust could potentially be designed to be a defective (A/K/A grantor) trust for income-tax purposes yet be treated as a completed gift for gift and estate-tax purposes. This could be useful for many purposes. For example, a grantor trust is an eligible shareholder of S corporation stock. In addition, sales from a grantor to a defective trust are ignored for the purposes of gain recognition.

The IRS examined a fact pattern in which the grantor retained the power to substitute assets of equal value in exchange for property held by the trustee. The grantor is prohibited from serving as trustee and must exercise the substitution power in a nonfiduciary capacity. This power creates a defective trust for income tax purposes under IRC Sec. 675(4). The IRS ruled that the power held by the grantor will not cause inclusion of the trust property in his or her gross estate under IRC Secs. 2036 or 2038 (Rev. Rul. 2008-22, IRB 2008-16). The IRS reasoned that the grantor could not serve as trustee and the fiduciary obligation to determine the value of the substituted property and investment of the trust falls on an independent trustee and gives the grantor no powers to make the trust "defective" for estate tax purposes.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future***



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