

The TAX STRATEGIST

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ESTATE PLANNING RED FLAG

You've recently divorced and haven't reviewed your estate plan

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IS YOUR BUY-SELL AGREEMENT DOING ITS JOB?

If you own an interest in a family or closely held business, a buy-sell agreement should be a fundamental part of your estate plan. The agreement provides for the disposition of each owner's interest after a "triggering event," such as death, disability, divorce, termination of employment or withdrawal from the business.

A properly drafted buy-sell agreement can help address a variety of issues business owners and their families may face when a triggering event occurs. But if yours doesn't include the appropriate provisions, it may not do its job.

ARE YOU REAPING THESE BENEFITS?

A buy-sell agreement gives the company or the remaining owners the right or the obligation to buy a departing owner's interest. Properly structured, it can provide these benefits:

- ◆ Restricting ownership or control to family members, management or some other select group,
- ◆ Creating liquidity for a departing owner's family to pay estate taxes (if applicable) and other expenses,
- ◆ Creating a market for otherwise unmarketable interests, and
- ◆ Avoiding disputes over ownership and control of the company when an owner leaves the business.

In addition, in some cases, a buy-sell agreement can establish an ownership interest's value for gift and estate tax purposes. (See "Is the price right?" on page 3.) Note that even though, as of this writing, an estate tax repeal is in effect for 2010, the estate tax is scheduled to return in 2011. Plus



the repeal may be repealed. Check with your estate planning advisor for the latest information.

HOW IS IT STRUCTURED AND FUNDED?

A buy-sell agreement can fall into one of three general categories: *Redemption* agreement, *cross-purchase* agreement or *hybrid* agreement. A redemption agreement permits or requires the company to repurchase an owner's interest. A cross-purchase agreement permits or requires the remaining owners to purchase the interest, usually on a pro-rata basis.

A hybrid agreement involves some combination of redemption and cross-purchase features. For example, it might require a selling owner or his or her representatives to first offer the interest to the company. If the company declines, the remaining owners are required to purchase the interest.

Typically, buy-sell agreements are funded using life insurance. On the death of an owner, the insurance provides a ready source of funds to purchase his or her shares. A properly structured funding arrangement will also provide for the liquidity needed on the retirement or disability of the owner.

HAVE YOU CONSIDERED THESE ISSUES?

The right type of buy-sell agreement for your business and the specific provisions that should be included depend on several tax and practical business factors. Here are some of the issues to consider:

Taxes. From a tax perspective, cross-purchase agreements have an advantage, particularly if your business is organized as a C corporation. If a redemption agreement is funded by life insurance, the company's receipt of insurance proceeds might trigger corporate alternative minimum tax (AMT). Also, a redemption agreement boosts the value of the remaining owners' shares without increasing their basis, which may result in higher taxes if they sell their interests. A cross-purchase, on the other hand, *does* increase basis, because the owner is purchasing additional shares.

Another tax concern for C corporations is constructive dividends. If a buy-sell agreement requires the remaining owners to purchase a departing owner's shares, but they have the corporation redeem the shares instead, the purchase may be treated as a taxable dividend. You can avoid this result by making the corporation a party to the agreement and permitting, but not requiring, the remaining shareholders to buy back the stock.

Taxes generally are less of an issue for pass-through entities — such as S corporations or limited liability companies (LLCs) — and for such entities the tax implications of redemption and cross-purchase agreements are usually roughly the same. Nevertheless, don't overlook potential issues that may give rise to additional liability.

For example, if your S corporation used to be a C corporation and has accumulated earnings and profits, there could be some unexpected tax consequences. So, it's important to review the specifics of your situation to ensure there are no lurking issues.

Control. One advantage of a redemption agreement is that it ensures the remaining owners maintain their relative interests in the business. But that isn't always a desirable result.

Is the price right?

Generally, for a buy-sell agreement to establish the value of a business interest for estate tax purposes it must:

- ◆ Be a bona fide business arrangement,
- ◆ Not be a device for transferring the business to family members at a discounted value,
- ◆ Have terms comparable to similar, arm's-length agreements,
- ◆ Fix the purchase price that's reasonable when the agreement is executed, and outline a pricing formula to consider valuation changes in the intervening period.
- ◆ Require an owner's estate or beneficiaries to sell the shares at the specified price, and
- ◆ Restrict owners' disposition of their interests during life and at death.

If at least 50% of a company's value is owned by nonfamily members subject to the same terms as family members, a buy-sell agreement is presumed to meet these requirements.

Typically, buy-sell agreements are funded using life insurance.

Suppose, for example, that you own 35% of a family business, your daughter owns 25% and two nonfamily employees own 20% each. When you die, the company redeems your interest and your family will lose control of the business. To avoid this result, consider drafting an agreement that gives your daughter the option to purchase sufficient shares to acquire a controlling interest.

Valuation. A buy-sell agreement's valuation provision is critical. It sets the price — or establishes a method for calculating the price — paid for a

departing owner's interest. The most effective approach is to conduct regular appraisals to ensure that the price is fair and accurately reflects the value of the interest at the time it's transferred. Some companies use valuation formulas tied to book value or earnings, but these formulas often lead to skewed results if the valuation is done at a time when the business is doing particularly well or, conversely, is going through a particularly difficult stretch.

REVIEW YOUR PLAN

Your estate planning advisor and attorney can work with you to design a buy-sell agreement that helps preserve the value of your business for your family. After you have an agreement in place, it's a good idea to review it periodically to be sure that it continues to meet your expectations. ❀

BALANCING RISK AND REWARD

A SELF-CANCELING INSTALLMENT NOTE CAN BENEFIT YOUR ESTATE PLAN UNDER CERTAIN CIRCUMSTANCES

It can be difficult to determine how to pass assets — especially those with large built-in capital gains — on to your loved ones at the lowest possible tax cost. If you're in poor health and don't expect to reach your actuarial life expectancy, this decision can be even more difficult. One option to consider is a self-canceling installment note (SCIN).

ESTATE PLANNING WITH A SCIN

To use a SCIN in estate planning, you sell your business or other assets to your children or other family members (or to a trust for their benefit) in exchange for an interest-bearing installment note. As long as the purchase price and interest rate are reasonable, there's no taxable gift involved. So you can take advantage of a SCIN without having to use up any of your annual gift tax exclusions or lifetime gift tax exemption.

Generally, you can avoid gift taxes on an installment sale by pricing the assets at fair market value and charging interest at the applicable federal rate. As discussed below, however, a SCIN must include a premium.

The "self-canceling" feature means that if you die during the note's term — which must be no longer than your actuarial life expectancy at the time of the transaction — the buyer (that is, your children or other family members) is relieved of any future payment obligations.

A SCIN offers a variety of valuable tax benefits. For example, if you die before the note matures, the outstanding principal is excluded from your estate. This allows you to transfer a significant amount of wealth to your children or other family members tax free. And any appreciation in the assets' value

after the sale is also excluded from your estate.

(Note that this article is written with the assumption that the federal estate tax will be in effect for the year of death. As of this writing, an estate tax repeal for 2010 only is in effect, but the repeal may have been repealed by the time you're reading this. Check with your estate planning advisor for the latest information.)

You also can defer capital gains on the sale by spreading the gain over the note term. If you die before the note matures, however, the remaining capital gain will be taxed to your estate even though no more payments will be received. Finally, your children or other family members can also benefit because they may be able to deduct the interest they pay on the note.

PAYING A PRICE

Like most things in life, you can't get something for nothing. To compensate you for the risk that the note will be canceled and the full purchase price won't be paid, the buyers must pay a premium — in the form of either a higher purchase price or a higher interest rate. There's no magic number for this premium; the appropriate premium is a function of the age of the payee and the stated duration of the note. If the premium is too low, the IRS may treat the transaction as a partial gift and assess gift taxes.

Both types of premium can work, but they may involve different tax considerations. If you add a premium to the purchase price, for example, a greater portion of each installment will be taxed to you at the more favorable capital gains rate, and



the buyers' basis will be larger. On the other hand, an interest-rate premium can increase the buyers' income tax deductions.

The premium catch also comes with risk. In fact, SCINs present the opposite of mortality risk: The tax benefits are lost if you live *longer* than expected. If you survive the note's term, the buyers will have paid a premium for the assets, and your estate may end up *larger* rather than smaller than before.

WEIGHING THE RISKS

There are many factors to consider in determining if a SCIN is right for your estate plan — perhaps the biggest being the risk involved. But if your actuarial life expectancy greatly exceeds your probable life expectancy, a SCIN may work in your favor. Consult with your estate planning advisor to determine whether a SCIN can benefit your family. ❖

MISSION CONTROL

FAMILY MISSION STATEMENT PROMOTES A HARMONIOUS ESTATE PLAN

Typically, much of the estate planning process focuses on money. But the most successful estate plans are founded on relationships.

Building and preserving family wealth isn't an end in itself. Rather, it's a tool for promoting shared family values — such as philanthropy, education, financial security, quality of life — or encouraging family members to lead responsible, productive, healthy lives. Drafting a family mission statement can be an effective way to define and communicate these values.

NO MAGIC FORMULA

There's no magic formula for creating a family mission statement. Indeed, every family has different values and beliefs. In many ways, the process is just as important as the end result. To avoid conflict and



hurt feelings, it's critical for you and your family to be on the same page, and communication is the key.

Perhaps you wish to leave your children with more than just money. For example, you may want to pass on a family tradition of charitable giving or community service. Or, like Warren Buffett, you may want to give your kids “enough that they feel they can do anything, but not so much that they feel they can do nothing.” Whatever your objective, simply giving away a significant portion of your estate to charities or community groups may not be enough to get the message across.

To be sure that your children (or grandchildren) don't feel as if they've been “disinherited,” discuss your plans with them and get their insights into the best strategies for achieving your objectives and promoting shared values. Developing a family mission statement can be a great way to open the lines of communication. For the process to be successful, it's important to include all affected generations.

WHAT THE STATEMENT SHOULD COVER

Because each family is different, there's no cookie-cutter formula for drafting a family mission statement. The most important thing is for the statement to clearly articulate your family's shared values, whatever they may be.

Ideally, the mission statement will also create mechanisms for intrafamily communication and for putting the statement's ideas into action. For example, the statement might call for regular family meetings and create a governance structure for managing the family's wealth and making decisions about charitable giving and other endeavors.

Few families agree on everything. But facilitating communication and decision making in this way minimizes conflicts that can arise when family members don't know what's going on or feel that they have no say. To make family meetings more efficient and effective, consider inviting outside advisors to lead or participate in the meetings.

A PRINCIPLED APPROACH

Many people today are moving away from a rules-based approach to estate planning and embracing a principles-based approach. Rather than conditioning a child's inheritance on a rigid list of "acceptable" behaviors, for example, a

A mission statement can create mechanisms for intrafamily communication and for putting the statement's ideas into action.

principles-based approach allows greater flexibility for trustees and others to make decisions based on the values you wish to promote.

A family mission statement can be an invaluable tool for defining and communicating these principles and values. ❁

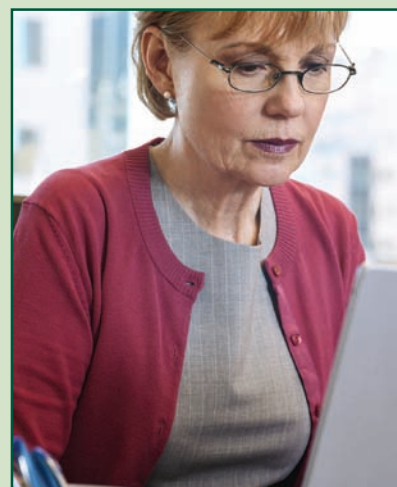
ESTATE PLANNING RED FLAG

You've recently divorced and haven't reviewed your estate plan

If you've recently divorced and haven't yet revisited your estate plan, you may be in for some surprises. It's important to review your estate plan to be sure that it doesn't confer any unintended benefits or rights on your former spouse. Here are some questions to consider:

- ◆ Does your former spouse have access to any jointly owned assets, such as bank accounts, investments or real estate?
- ◆ Is your former spouse still the designated beneficiary of any life insurance policies, IRAs or other retirement plans?
- ◆ Did you give your former spouse any powers of attorney or designate him or her as your agent for health care decisions?
- ◆ Did you name your former spouse as a beneficiary of any trusts? Are they irrevocable? If so, do they provide for your spouse's interest to terminate automatically in the event of divorce? If not, do the trust documents and applicable state law allow you to change beneficiaries or modify the disposition of the trust assets?
- ◆ Does your divorce settlement or judgment address any of these issues?

After a divorce — or any other major life change, such as marriage, birth of a child or death of a family member — meet with your estate planning advisor as soon as possible to review your plan. Failure to modify your plan to reflect these changes can lead to unexpected and, in many cases, undesirable results.



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MISSION STATEMENT

M&J is committed to continuing its tradition of delivering excellent, personalized legal services by working together to provide effective solutions for its clients.

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