

# *the* Estate PLANNER

November/December 2006

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## **Insuring a comfortable retirement**

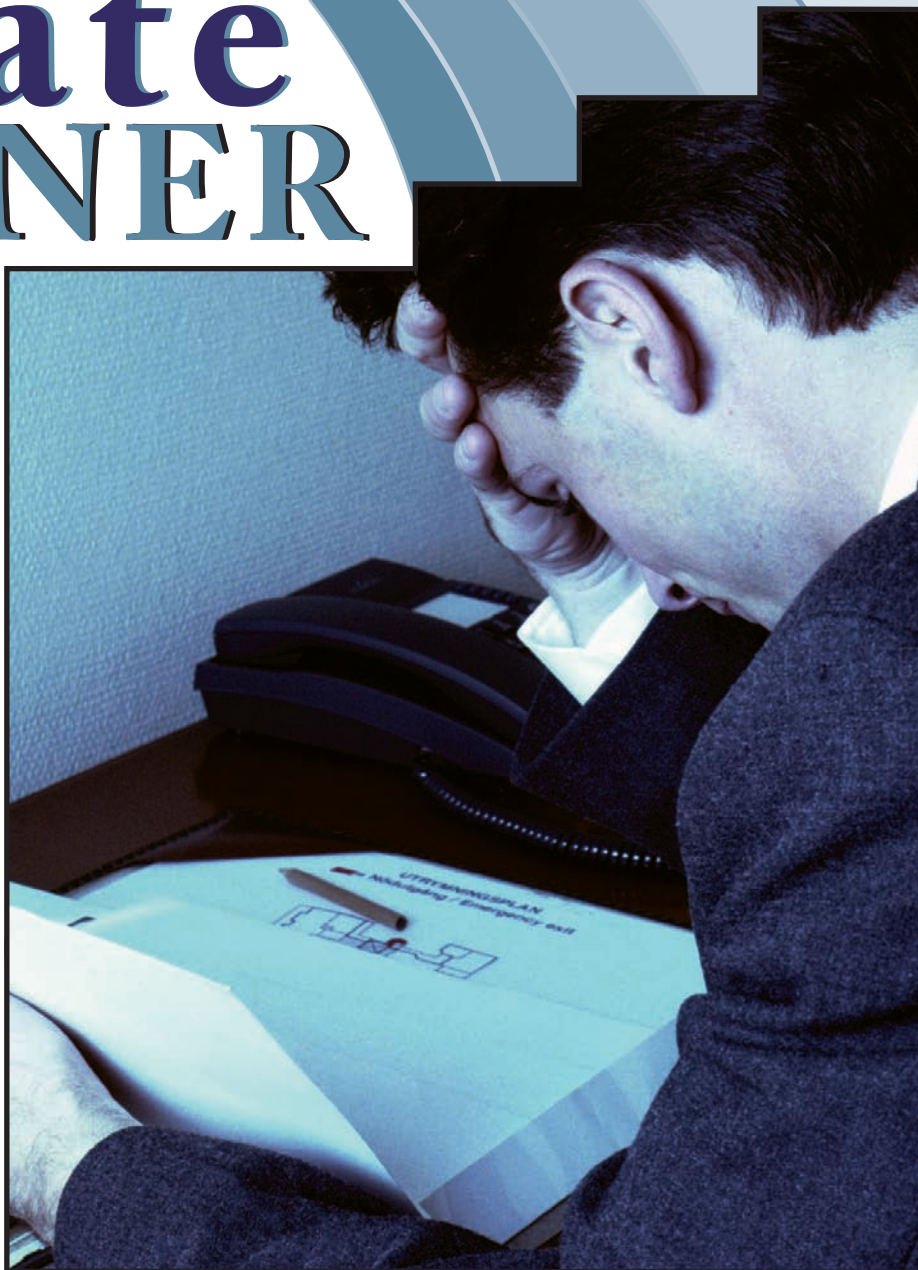
412(i) plan offers guaranteed benefits

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# Surprise, surprise!

Don't let a buy-sell agreement result in an unexpected outcome

If you own an interest in a closely held or family business, chances are you signed a buy-sell agreement. A buy-sell, among other things, sets the price for repurchasing shares from an owner who dies or leaves the business.

If your business has a buy-sell agreement, do you understand its potential impact on your estate plan? A buy-sell may be legally binding on the parties involved, but if the IRS determines the stock is undervalued for estate tax purposes, your family may be hit with an unexpected — and sizable — estate tax liability.

## Wayne and Diane's story

Wayne and his wife, Diane, have a typical two-trust estate plan. When one spouse dies, his or her assets are transferred to a credit shelter (or “bypass”) trust and a marital trust. The credit shelter trust, which is held for the benefit of the couple's children, Amy and Nick, is funded with enough assets to use up the deceased's exemption amount (currently \$2 million). The remainder goes into a marital trust for the surviving spouse's benefit.



The two-trust strategy is designed to eliminate estate taxes when the first spouse dies and to make the most of each spouse's exemption. Assets in the credit shelter trust are shielded from tax by the deceased's exemption and, because the surviving spouse has limited control over the trust, they bypass his or her estate. Assets placed in the marital trust are protected from tax by the unlimited marital deduction. Eventually, they'll be included in the surviving spouse's estate, where they may be sheltered from tax, in whole or in part, by his or her exemption.

**It remains difficult for a family business to use a buy-sell agreement to establish a sub-FMV transfer tax value.**

Wayne also owns 50% of a successful construction firm, and his son, Nick, owns the other 50%. In 1996, they signed a buy-sell agreement providing that when one of them dies the survivor has the option to buy the other's interest for \$5 million. They also agreed to reevaluate the purchase price annually, but never did, despite the company's steady growth.

Wayne dies in 2006. At the time of his death, in addition to his interest in the construction firm, Wayne owns \$3,050,000 in stocks, bonds and other marketable securities. Because of the buy-sell agreement, the estate's executor sells Wayne's interest in the firm to Nick for \$5 million. The executor uses \$2 million to fund the credit shelter trust, pays \$50,000 in administration expenses and transfers the remaining \$6 million to the marital trust.

On Wayne's estate tax return, his interest in the construction firm is valued at \$5 million — the price set by the buy-sell agreement. After applying Wayne's \$2 million exemption amount,

## A taxpayer finally wins one

In *Estate of Amlie v. Commissioner* (T.C. Memo. 2006-76), the U.S. Tax Court found that a buy-sell agreement among family members met all of Section 2703's requirements, even though the price it set was well below the stock's apparent fair market value.

Pearl Amlie owned a 13.6% common stock interest in a closely held bank. In the late 1980s, she agreed to have a court-appointed conservator manage her financial affairs. The conservator then began a decade-long quest to secure a guaranteed price for Amlie's stock.

In 1994, the bank and the conservator entered into a buy-sell agreement under which the bank agreed to pay Amlie \$118 per share in exchange for the stock and certain other rights. In accepting this price, the conservator engaged a valuation specialist who reviewed merger and acquisition multiples in the banking industry and concluded that the price was fair. The conservator submitted the agreement for court approval, but for various reasons the court rejected it.

In 1995, after lengthy negotiations, the family entered into a buy-sell agreement providing that the stock would be sold to Amlie's son, Rod, for \$118 per share. After Amlie died in 1998, Rod sold the stock back to the bank for \$217 per share under a separate agreement.

In upholding the \$118-per-share price for estate tax purposes, the Tax Court placed a great deal of emphasis on the fact that the conservator had engaged a valuation professional to determine whether it was a fair price. The court also noted that the 1995 agreement "was virtually identical to the terms of the 1994 agreement, which had been reached in arm's-length negotiations between the conservator" and the bank.

With regard to Rod's apparent windfall, the court found the agreement was a bona fide business arrangement.

deducting the administration expenses and applying the marital deduction to the \$6 million transferred to the marital trust, Diane expects an estate tax liability of zero.

Unfortunately, the IRS has other plans: It disregards the buy-sell agreement for estate tax purposes and estimates the fair market value (FMV) of Wayne's interest at \$10 million. The result: The IRS assesses \$2,555,556 in estate taxes, the credit shelter trust is depleted and the amount that passes to the marital trust is reduced to \$5,444,444.

### IRC Section 2703 and buy-sell agreements

Ordinarily, the price fixed by a buy-sell agreement establishes the value of a business interest for estate tax purposes. But when a family business is involved, special rules come into play. Internal Revenue Code Section 2703 is designed to prevent family businesses from using buy-sell agreements and other restrictions to depress the value of business interests for gift and estate tax purposes.

Sec. 2703 allows the IRS to disregard the value established by a buy-sell agreement unless the family can show that the agreement:

- Is a bona fide business arrangement,
- Isn't a testamentary device to transfer property to family members for less than full and adequate consideration, and
- Has terms comparable to similar arrangements entered into by persons in an arm's-length transaction.

In addition, under pre-Sec. 2703 case law, the agreement should:

- Set a fixed purchase price or determine the price according to a formula or methodology that was reasonable when the agreement was made,
- Require an owner's estate or beneficiaries to sell the interest at the specified price, either automatically or at the other parties' option, and
- Restrict owners' disposition of their interests both during life and at death.

Keep in mind that Sec. 2703 applies only to family businesses. If at least 50% of a business's value is owned by nonfamily members subject to the same rights and restrictions, a buy-sell agreement is presumed to meet the code's requirements. The rationale for this "safe harbor" is that nonfamily members have no incentive to undervalue their shares, so there's little chance for abuse.

### A losing record

Family businesses have a dismal record in court when attempting to set a transfer tax value that's below FMV. Establishing that a buy-sell agreement is a bona fide business arrangement usually isn't a problem: There are many legitimate purposes for such an agreement, including keeping the business in the family and creating liquidity for surviving family members. And with careful planning, you can avoid a finding that the agreement is a testamentary device.

What usually trips families up is the third prong of the Sec. 2703 test: It's difficult to find similar

arm's-length transactions with comparable terms. That's because most participants in arm's-length negotiations won't settle for much less than FMV.

Until recently, no buy-sell agreement had ever passed this critical test in court. (See "A taxpayer finally wins one" on page 3.) And even though the taxpayer prevailed in that case, the facts were somewhat unusual. It remains difficult for a family business to use a buy-sell agreement to establish a sub-FMV transfer tax value.

### Give your buy-sell agreement a fair shake

To avoid what happened to Wayne and Diane, make certain to base your buy-sell price on FMV. And the best way to do that is by periodic independent appraisals by a qualified valuation professional. Another option may be to adopt a formula valuation approach that uses a combination of relevant factors such as gross sales, net earnings, etc., to arrive at an FMV figure. ■

## Insuring a comfortable retirement

### 412(i) plan offers guaranteed benefits

Estate planning and retirement planning go hand in hand. After all, if you don't accumulate a sufficient retirement nest egg, there may be little left for your heirs. If you're self-employed or own a small business, you may be able to set aside more for retirement with an insurance-funded 412(i) plan.

### Defined benefit advantages

The popular 401(k) plan is a defined *contribution* plan. You make tax-deductible contributions to your account each year, but your retirement benefit is uncertain — it depends on the vagaries of the stock market and the economy.

### 412(i) plan requirements

A 412(i) plan is a defined *benefit* plan. It's designed to provide a specific benefit at your retirement. You make tax-deductible contributions



that are actuarially calculated to fund the target benefit. A 412(i) plan may not offer the upside potential of a defined contribution plan, but

because the benefits are guaranteed by an insurance company, there's far less risk. Plus, the limits on tax-deductible contributions to a 412(i) plan generally are much larger than other plans, allowing you to maximize your retirement savings.

A 412(i) plan is a qualified retirement plan subject to the same participation, vesting and benefit provisions as other qualified plans. It also must meet the following requirements:

- The plan must be funded exclusively with individual or group insurance contracts, including annuities, life insurance or a combination of the two.
- The plan must provide for level premium payments on the insurance policy from the time a participant enters the plan until retirement.
- Benefits must be guaranteed by an insurance company.
- The policy must not lapse.
- No rights under the contracts may be subject to a security interest.
- No policy loans may be outstanding during the plan year.

Because the insurance company guarantees the benefits, 412(i) plans are exempt from minimum funding requirements (and stiff penalties for non-compliance) and need not obtain an annual actuarial certification. This makes 412(i) plans less costly to administer than other defined benefit plans.

## Definite benefits

In addition to lower administration costs, 412(i) plans offer a variety of attractive benefits:

**Higher contributions.** Defined benefit plans usually allow higher tax-deductible contributions than do defined contribution plans. The maximum contribution to a defined contribution plan this year is the lesser of \$44,000 or 100% of compensation. But with a defined benefit plan, you can contribute up to \$175,000 or, if less, 100% of your average compensation for the highest three consecutive years. Higher contribution limits make defined benefit plans particularly attractive to older

business owners who need to “catch up” on their retirement savings.

A 412(i) plan may allow you to contribute even more than a typical defined benefit plan will. That's because the actuarial assumptions used to calculate contributions may be based on the insurance company's guaranteed return rates, which often are lower than the assumed rates of return published in IRS tables. The lower the assumed rate of return, the greater the contribution you need to make to achieve the targeted benefit.

## A 412(i) plan is a defined benefit plan designed to provide a specific benefit at your retirement.

**Decreasing contributions.** 412(i) contributions often decrease over time because any investment returns that exceed the guaranteed rate are used to reduce future contributions.

**Asset protection.** Like other qualified plans, a 412(i) plan allows you to take considerable amounts of money out of your business on a tax-advantaged basis and shield those sums from business and personal creditors.

**Estate planning benefits.** A 412(i) plan allows you to set aside more for retirement, increasing the amount available to your heirs. In addition, it allows you to reduce the amount of assets tied up in your business, providing greater estate planning flexibility.

## Potential disadvantages

Although a 412(i) plan can be a powerful retirement and estate planning tool, it's not for everyone. For example, the high level of required contributions makes it appropriate only for an established, profitable business. Unlike those to a defined contribution plan, contributions to a defined benefit plan can't be adjusted or skipped in an off year. Further, you aren't permitted to take loans from the policy.

Also, as with other qualified plans, you'll need to make contributions for all eligible employees. For that reason, a 412(i) plan usually is most appropriate for an older business owner who's self-employed or has only a few employees who are all relatively young.

A 412(i) plan generally is considered a conservative retirement vehicle. Even though it offers the peace of mind of a guaranteed return, there's also less upside growth potential and limited investment flexibility. These limitations should be weighed against the advantages of higher contributions.

## Accelerate your savings

Under the right circumstances, a 412(i) plan can be the ideal tool for building and protecting your retirement nest egg. And if you've fallen behind on your retirement planning, it may provide an opportunity to accelerate your savings.

But be sure to consult a professional to help you set up and manage the plan. In 2004, the IRS tightened regulations in an effort to shut down certain insurance-funded benefit plans it felt were being used to claim excessive tax benefits. ■

# Estate planning red flag

## Your trust is unclear about how to remove a trustee

Selecting the right trustee to manage your assets and carry out your wishes is a critical part of estate planning. But it's also important to spell out the circumstances under which a trustee may be removed and the procedure for doing so.

Even if your trust doesn't address this issue, your beneficiaries can petition a court to remove a trustee for misconduct in carrying out the terms of the trust, mismanagement of trust assets or certain other reasons, such as being legally incapacitated. But going to court can be expensive and time-consuming, and most courts are reluctant to remove a trustee specifically designated in the trust instrument.

To save time and expense for your heirs, consider including a trust provision giving the beneficiaries the right to remove a trustee under circumstances you specify. In drafting such a provision, use clear, unambiguous language.

In one case, a couple created a joint revocable trust, naming themselves as trustees. The trust provided that one of the trustees could act alone if the other died or became "legally incapacitated." The wife signed a document purporting to revoke the trust on the ground that her husband had become incapacitated. She also sought a court ruling on the matter, but both she and her husband died before the court reached its decision. The court, however, found that the trust had not been revoked, interpreting the term "legally incapacitated" to require a court determination.

The couple could have avoided this quagmire by including a detailed definition of "legally incapacitated" and, for example, providing for removal of a trustee by obtaining a physician's certificate stating that the trustee was incapacitated as defined by the trust. But be sure to check your state's requirements to ensure your definition isn't in conflict with your state's definition.

# The well-appointed estate plan

## Powers of appointment can build flexibility into your plan

One of the challenges of estate planning is that it requires you to provide for the disposition of property years or even decades from now, when family and financial circumstances or tax laws may have changed dramatically. General and limited powers of appointment allow you to build flexibility into your estate plan. This is particularly valuable now, because there is uncertainty over the future of the estate tax.

### Two types of powers

A power of appointment authorizes another person (the holder) to designate who will receive your property. A *general* power of appointment allows the holder to direct the property to anyone, including him- or herself. When a person receives a general power of appointment over property, that property is included in his or her taxable estate.

A *limited* power of appointment is any power that's not considered a general power of appointment. Typically, limited powers authorize the holder to direct the timing or relative size of distributions to a designated beneficiary or among a limited class of beneficiaries. For example, you might give your daughter a limited power to distribute property among her children, either outright or in trust, in equal or unequal shares. This gives her the discretion to determine how the property will be distributed and in what amounts, and even allows her to leave out one or more children if she so desires.

Generally, a limited power of appointment can't be exercised for the benefit of the holder unless it's limited to an "ascertainable standard" relating to the holder's health, education, support or maintenance. In addition, a limited power of appointment generally has no tax consequences for the holder.

### Harnessing the powers

A power of appointment postpones the determination of how property is distributed until the holder has all of the relevant facts he or she needs to

make an informed decision. It allows the holder to distribute property in a manner that minimizes taxes or that best meets the beneficiaries' needs.

A general power of appointment also may be used to eliminate generation-skipping transfer (GST) taxes. The GST tax is a flat tax (46% in 2006) on gifts and certain trust distributions to a "skip person," such as a grandchild. An exemption allows you to give up to \$2 million (scheduled to increase to \$3.5 million in 2009) to skip persons without GST tax, but once you exceed that amount the tax consequences are harsh.



By giving general powers of appointment to your children, they can transfer property to your grandchildren without triggering GST taxes. Although the general power of appointment causes the property to be included in your children's taxable estates, in many cases the overall tax bite would be significantly higher if the property were to pass directly to your grandchildren.

### Handle with care

A power of appointment is a valuable tool that can give your estate plan the flexibility to adapt to changing circumstances. To be effective, however, it must be drafted using precise language, so be sure to consult a professional to ensure that your powers achieve the desired results. ■

