

# focus

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# Preparing for any business scenario

A buy-sell agreement can steady a company through uncertain times

**D**uring an unsettled economic environment, business risks that are out of your control are abundant. What if a key supplier goes out of business? Will cash-strapped consumers continue to find value in your product? Smart business owners work to control the risks they can — such as if an owner leaves the company. To guard against the negative consequences that might arise from such a predicament, you need to be proactive and establish a buy-sell agreement.



## Buy-sell agreement in action

In a nutshell, a buy-sell agreement is a contract among a business's owners that sets guidelines for the transfer of their ownership interests. The agreement gives the remaining owners (or the business itself) the right — or, in some cases, the responsibility — to buy an exiting owner's interest if a "triggering" event occurs. A triggering event may include an owner's divorce, disability, retirement, desire to leave the company, death, or loss of a professional license or certification.

So, the agreement creates a market for a withdrawing owner's interest. Additionally, by outlining when and to whom interests can be sold, it can help avoid conflicts among remaining owners or with the withdrawing owner's family.

A buy-sell agreement also addresses how the price of the interest will be determined, including defining the valuation method and standard of value to be used. (See "Fair market value vs. investment value" on page 3.)

## Life insurance as a funding means

When a triggering event occurs, a substantial amount of money likely will be needed to buy the departing owner's interests. Properly funding a buy-sell agreement helps to ensure that money will be available to cover the purchase.

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A popular funding means is life insurance. Even though life insurance might be thought of primarily as a means to provide liquidity on the death of one of the owners, it's not limited to such situations.

Using life insurance to fund the buy-sell is beneficial because it can ensure that the departing owner or his or her beneficiaries will receive the agreed-upon price for the business interests in a timely manner. It also can ease the strain on your company's cash flow or reduce the chance that you'll have to sell off assets to pay the bill resulting from a buyout.

One option is a cross-purchase agreement, where each owner takes out a life insurance policy on each of the other owners. For example, let's say you buy an insurance policy on your business partner. When he or she dies, triggering the buy-sell agreement, you'll collect the death benefit and use it to buy his or her partnership interest from the estate.

Owning the policy (assuming it's large enough) guarantees you'll have the money needed to fulfill your obligations under the agreement. Other benefits are that the insurance proceeds won't be taxable (as long as you plan properly), and that your tax basis in your newly acquired interests will be equal to the purchase price.

But a cross-purchase agreement can be cumbersome if there are more than a few owners because of the number of policies required. It also can be unfair if there's a significant disparity in owners' ages or health, causing the policy premiums to vary substantially.

One alternative is establishing a trust or a *separate* partnership to buy a policy on each owner. When one of you dies, the trust or partnership collects the death benefits on behalf of each owner. You then use your portion from the trust or partnership to pay your share under the buy-sell agreement.

Another alternative is a redemption agreement. It requires a withdrawing owner to give the business entity first right of refusal if he or she wants to sell the interest to a nonowner. The life insurance is purchased by the business, rather than the owners, so only one policy on each owner's life is required. The policy proceeds will be tax free to the business.

A disadvantage of a redemption agreement is that the remaining owners won't receive a step-up in basis when the company purchases

## Fair market value vs. investment value

Business valuation plays a major part in a buy-sell agreement because the agreement establishes how the value of the business will be determined. Not only does an effective agreement define the valuation method to be used — it also defines the standard of value.

Agreements typically call for fair market value — the price at which the property would change hands between a willing buyer and a willing seller with neither party being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

Fair market value also assumes an arm's length deal. This differs from investment value, which identifies a particular buyer or seller and the attributes that that buyer or seller brings to a transaction.



the deceased owner's interest. This can result in higher capital gains taxes when they sell their interests.

### Be ready for the unexpected

As you and your partners continue to navigate the tumultuous waters of today's business world, it's best to take whatever steps possible to protect your business. One way to do so is to create and update a buy-sell agreement. ♦

# Now is the time

Take advantage of today's low interest rates to transfer more wealth tax free

To help jumpstart a struggling economy, the federal government began lowering key interest rates last year, and they remain at their lowest level in several years. This is good news if you're looking to transfer wealth out of your estate. By choosing the right lifetime giving strategies, you can take advantage of these low rates to transfer more wealth tax free.

## Outperforming the "hurdle rate"

Many estate planning strategies allow you to transfer substantial amounts of wealth to your children or other beneficiaries free of gift and estate taxes. Their tax-saving potential is based on a simple principle: The value of certain assets for gift tax purposes is based on the assumption that they'll earn a specified rate of return — the applicable federal rate (AFR) — for the month the transfer is made. Any returns above the assumed rate (often referred to as the "hurdle rate") are transferred to your beneficiaries free of transfer taxes.

Lifetime giving strategies are particularly effective when interest rates are low because the probability of outperforming the hurdle rate — and, therefore, transferring wealth tax free — is high.

## Family loans

This simple, yet effective, technique involves making a low-interest or interest-free loan to your child or another family member. The IRS treats the forgone interest as a taxable gift. You can avoid gift tax, however, by charging interest equal to or greater than the AFR in effect when you make the loan. Each month, the IRS publishes AFRs for short-term loans (less than three years), mid-term loans (three to nine years) and long-term loans (more than nine years).

For example, Kim lends \$1 million to her son, James, during a month when the long-term AFR is 4.25%. By charging interest at 4.25%, Kim avoids gift tax. The loan calls for only interest to be paid for 10 years, with a balloon payment at the end of the tenth year.

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James invests the money in growth stocks and mutual funds that earn a 6% return. Assuming that he uses the earnings to make the interest



payments and reinvests what's left, he will end up with more than \$230,000 gift-tax-free after paying back the loan. And if James successfully invests the proceeds and earns, say, an 8% return, he will have amassed more than \$540,000. This analysis ignores the income tax consequences of the investments, which of course would have an impact on the results.

### GRATs and CLATs

A grantor retained annuity trust (GRAT) and a charitable lead annuity trust (CLAT) work in essentially the same way: You contribute assets to an irrevocable trust, which makes annuity payments to a designated beneficiary during the trust term. At the end of the term, any remaining assets are transferred to your children or other beneficiaries free of gift and estate taxes.

The main difference between the two techniques is that a GRAT pays the annuity to you, as grantor, while a CLAT pays the annuity to a charity. In either case, when you fund the trust you make a taxable gift to the remainder beneficiaries equal to the value of the assets contributed to the trust less the present value of the annuity payments. Present value is computed using an assumed rate of return known as the Section 7520 rate.

If you set the annuity payments high enough, their present value will be equal to the value of the trust assets, resulting in no gift tax consequences. From the previous example, let's suppose Kim contributes \$1 million to a 10-year GRAT or CLAT for the benefit of James. If the applicable Sec. 7520 rate is 4%, an annuity payment of \$123,291 will "zero out" the trust.

In other words, assuming the trust assets grow at a rate of 4%, the annuity payments will completely deplete the trust assets during its 10-year term, leaving nothing for James and, therefore, no taxable gift. But if you assume that Kim funds the trust with assets expected to grow at a 6% rate, earnings in excess of the hurdle rate result in a tax-free gift to James of nearly \$166,000.

### Take action soon

Transferring wealth in a low interest rate environment has its advantages, but low rates won't last forever. They eventually will trend up as the economy rebounds. Now is the time to meet with your estate planning advisor to determine which strategy is right for your circumstances. ♦

## Don't let family matters interfere with business matters

**G**etting along with family members can be a challenge during Thanksgiving dinner, let alone while having to work with them daily in the family business. And even though knowing family members are watching the shop can be reassuring, the requirements of running a business can strain even the strongest family ties. The stresses

can become further exacerbated when sibling rivalry exists or when you work with your spouse.

### Keeping a lid on sibling rivalry

Kevin and Ivy had worked for their father, Steve, in the family business for about 10 years when he died unexpectedly. Unfortunately, Steve

hadn't created a succession plan. So Steve's wife, Jennifer, was left in the difficult position of choosing which of her children would take over. This task was especially challenging because of the sibling rivalry that had developed between the two.

Ultimately, Jennifer sold the company because she felt her children's rivalry would prevent them from being capable of running it together successfully, and she didn't want to choose one child over the other.

If you have children who are in constant competition, take action before the rivalry causes irreparable harm to your business — and your family.

One step to consider when they start working for your company is having them work together on the same project or in the same department. Doing so can help them view each other as peers rather than as competitors. But don't give one child more authority, responsibility or recognition than the other. Unequal treatment could trigger rivalry, and the goal is to get them to work as a team.

### **Working with your spouse**

It's common for a spouse to work in a family business — whether he or she was there from

its inception or joined after marrying into the family. But it can be difficult to maintain both a harmonious marriage and a successful business partnership.

This is not to say a couple can't have both; they can. This is especially true if each spouse has unique skills and experience, because it can be easier to divide responsibilities in a way that will help both maintain marital harmony and ensure the business' success.

### ***When a spouse works in the family business, it can be difficult to maintain both a harmonious marriage and a successful business partnership.***

For example, Lynn and Mark own a furniture store. Lynn has a degree in interior design and is responsible for selecting inventory, merchandising and sales. Mark was the COO of another retail business before the couple

launched the store, and he manages the store's finances, operations and marketing. In this situation, the couple's skills and experience are complementary and allow them to run their business as effectively as possible. Plus, they each get to do what they truly enjoy.

What if you and your spouse don't have skills and experience that



naturally complement each other? The division of responsibilities can easily become murky. Conflicts can arise if you both want to handle the same responsibilities, or if there are responsibilities that neither of you wants to handle.

In this case, it will be advantageous for you to sit down and formally divide up responsibilities. You'll both need to be open to compromise, because you each may need to give up some responsibilities to the other spouse for the good of the company — and the good of your marriage. And you each also may need to take on some critical duties that will require training or that you may not enjoy.

To keep things happy on the home front, set some boundaries. It's difficult for most people to avoid bringing their work problems home with them, and it can be even harder when you're married to your business partner. So make a commitment to each other to *not* discuss the business when you're at home.

### Taking the right steps today

The line between "the family" and "the business" can easily become blurred in the process of running a family business. Taking proactive steps to snuff out a sibling rivalry or maintain a happy marriage when working with a spouse is key to the success of a family business. ♦

## First-time homebuyer tax credit set to expire Dec. 1

If you're ready to purchase your first home, consider doing so before Dec. 1. Why? Because that's when, as of this writing, a refundable "first-time" homebuyer tax credit equal to 10% of the purchase price of a principal residence is set to expire. The credit is capped at \$8,000.

The American Recovery and Reinvestment Act of 2009 extended the credit (which had been set to expire after 2008) and, for homebuyers whose qualifying purchase occurs *after* Dec. 31, 2008, eliminated the repayment requirement — except in situations where a home is sold within three years of purchase. (If you made a purchase *before* 2009 that qualified for the credit, you're still required to repay the credit — generally over a 15-year period but with no interest. In this case the break is more accurately defined as an interest-free loan from the government rather than a genuine tax credit.)

You can qualify for the credit if you've had no ownership interest in a principal residence in the United States during the prior three-year period. But the credit begins to phase out for joint filers with adjusted gross incomes (AGIs) exceeding \$150,000 (\$75,000 for single filers). It's completely eliminated for joint filers with AGIs exceeding \$170,000 (\$95,000 for single filers).

If you don't qualify for the credit because your AGI is too high, consider seeing if your adult children might. If they're in the market for a first home and you've been thinking about making a gift to help them fund a down payment, now may be a great time to do it.

