THE ESTATE PLANNER

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BUSINESS OWNERS: NOW'S THE TIME TO REVISIT BUY-SELL AGREEMENTS

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Business owners: Now's the time to revisit buy-sell agreements

If you own an interest in a closely held business, a buy-sell agreement should be a critical component of your estate and succession plans. These agreements provide for the orderly disposition of each owner's interest after a "triggering event," such as death, disability, divorce or withdrawal from the business. This is accomplished by permitting or requiring the company or the remaining owners to purchase the departing owner's interest. Often, life insurance is used to fund the buyout.

Buy-sell agreements provide several important benefits, including keeping ownership and control within a family or other close-knit group, creating a market for otherwise unmarketable interests, and providing liquidity to pay estate taxes and other expenses. In some cases, a buy-sell agreement can even establish the value of an ownership interest for estate tax purposes.

However, because circumstances change, it's important to review your buy-sell agreement periodically to ensure that it continues to meet your needs.

Focus on the valuation provision

It's particularly critical to revisit the agreement's valuation provision — the mechanism for setting the purchase price for an owner's interest — to be sure that it reflects the current value of the business. There are a couple of reasons why now is an appropriate time to review your agreement.

First, the COVID-19 pandemic may have affected the value of your business, so it's a good idea to ensure that your buy-sell agreement will produce a fair price. Second, legislation has been proposed that would reduce the lifetime gift and estate tax exemption, so a carefully drafted buy-sell agreement may soon be even more important than before.

As you review your agreement, pay close attention to the valuation provision. Generally, a

Choosing the right type of buy-sell agreement

The type of buy-sell agreement you use can have significant tax and estate planning implications. Generally, these agreements are structured either as "redemption" agreements, which permit or require the company to purchase a departing owner's interest, or "cross-purchase" agreements, which permit or require the remaining owners to make the purchase.

A disadvantage of cross-purchase agreements is that they can be cumbersome, especially if there are many owners. For example, if life insurance is used to fund the purchase of a departing owner's shares, then each owner will have to purchase an insurance policy on the lives of each of the other owners.

But cross-purchase agreements also have significant advantages. For one thing, when the remaining owners purchase a departing owner's interest, they receive a stepped-up basis, reducing their taxable capital gains should they sell those interests in the future. Redemption agreements may trigger a variety of unwelcome tax consequences.

A cross-purchase agreement may also provide an estate planning advantage. Suppose, for example, that you own 35% of a business, your son owns 25% and two non-family members own 20% each. If the company redeems your shares, your family loses control over the business. But a cross-purchase agreement could be designed that gives your son the right to purchase enough of your interest to maintain control.

valuation provision follows one of these approaches when a triggering event occurs:

1. Formulas, such as book value or a multiple of earnings or revenues as of a specified date,
2. Negotiated price, or
3. Independent appraisal by one or more business valuation experts.

Independent appraisals almost always produce the most accurate valuations. Formulas tend to become less reliable over time as circumstances change and may lead to over- or underpayments if earnings have fluctuated substantially since the valuation date.

A negotiated price can be a good approach in theory, but expecting owners to reach an agreement under stressful, potentially adversarial conditions is asking a lot. One potential solution is to use a negotiated price but provide for an independent appraisal in the event the parties fail to agree on a price within a specified period.

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Establishing estate tax value

Business valuation is both an art and a science. Because the process is, to a certain extent,

subjective, there can be some uncertainty over the value of a business for estate tax purposes. If the IRS later determines that your business was undervalued on the estate tax return, your heirs may face unexpected — and unpleasant — tax liabilities. A carefully designed buy-sell agreement can, in some cases, establish the value of the business for estate tax purposes — even if it's below fair market value in the eyes of the IRS — helping to avoid these surprises.

Generally, to establish business value, a buy-sell agreement must:

- Be a bona fide business arrangement,
- Not be a "testamentary device" designed to transfer the business to family members or other heirs at a discounted value,
- Have terms that are comparable to similar, arm's-length agreements,
- Set a price that's fixed by or determinable from the agreement and is reasonable at the time the agreement is executed, and
- Be binding during the owner's life as well as at death, and binding on the owner's estate or heirs after death.

Under IRS regulations, a buy-sell agreement is deemed to meet all of these requirements if at least 50% of the business's value is owned by non-family members.

A valuable exercise

For the owner of a closely held business, a buy-sell agreement is an indispensable tool for protecting the business when owners die or exit the business and for providing liquidity for your heirs. To ensure that a buy-sell agreement continues to meet these needs, it's important to review it periodically and, if appropriate, to update it in light of changing circumstances. ▮

Provide your heirs the option of creating an inheritor's trust

Even though it may not be top of mind when you're developing or revising your estate plan, it's important to consider how bequeathing assets to your family might affect them. Why? Because when your heirs receive their inheritance, it becomes part of their own taxable estates. Giving a loved one permission to create an inheritor's trust can help avoid this outcome.

How the trust works

In a nutshell, an inheritor's trust allows your loved one to receive the inheritance in trust, rather than as an outright gift or bequest, thus keeping the assets out of his or her own taxable estate. Having assets pass directly to a trust benefiting an heir not only protects the assets from being included in the heir's taxable estate, but also shields them from other creditor claims, such as those arising from a lawsuit or a divorce.

Because the trust, rather than your family member, legally owns the inheritance, and because the trust isn't funded by the heir, the inheritance is protected. For example, if your son is having marital problems and is concerned that his inheritance could one day become community property, establishing an inheritor's trust can provide asset protection.

The reason is because everything you gift or bequeath to the trust (including growth and income

from the trust) is owned by the trust, and therefore can't be treated as community property. An inheritor's trust can't replace a prenuptial or postnuptial agreement, but it can provide a significant level of asset protection in the event of divorce.

With an inheritor's trust, your heirs can also realize wealth building opportunities. If you fund an inheritor's trust before you die, your loved one can use a portion of the money to, for example, start a new business. A prefunded inheritor's trust can also own the general partnership interest in a limited partnership or the voting interest in a limited liability company or corporation. If you decide to fund the trust now, your initial gift to the trust can be as little or as much as you like.

Maximize creditor protection

To ensure full asset protection, your heir must set up an inheritor's trust before he or she receives the inheritance. The trust is drafted so that your heir is the investment trustee, giving him or her power over the trust's investments.

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Your heir then selects an unrelated person — someone whom he or she knows well and trusts — as the distribution trustee. The distribution trustee will have complete discretion over the distribution of principal and income, which ensures that the trust provides creditor protection.

Your loved one should design the trust with the flexibility to remove and change the distribution trustee at any time and make other modifications when necessary, such as when tax laws change. Bear in mind that the unfettered power to remove and replace trustees may jeopardize the creditor protection aspect of the trust. That could result in the inclusion of the trust property in the heir's taxable estate.

Because it's your heir, and not you, who sets up the trust, he or she will incur the bulk of the fees, which will vary depending on the trust. In addition, he or she may have to pay annual trustee fees. Your cost, however, should be minimal — only the legal fees to amend your will or living trust to redirect your bequest to the inheritor's trust.

Your heir should consult an estate planning professional to draft the trust in accordance with federal and state law. This will help avoid potential IRS audits and court challenges — and maximize the asset protection benefits of the trust.

Talk to your heirs first

As you draft or revise your estate plan and consider who to pass your assets to, it's a good idea to talk to family members first. Determine if they would accept the bequests and then inform them of their option of creating an inheritor's trust. Turn to your estate planning advisor for help in explaining how the trust works. ▮

Should you consider a psychiatric advance directive?

Many people include health care powers of attorney or advance directives in their estate plans to have some influence over critical medical decisions in the event they're incapacitated and unable to make those decisions themselves. A psychiatric advance directive (PAD) is less well known, but worth considering if your family has a history of mental illness. Or, you may simply want to memorialize your wishes in the event a psychiatric episode renders you unable to make decisions about your treatment.

Health care directives

To cover all the health care bases, it's a good idea to have two documents: an advance health care directive (sometimes referred to as a "living will") and a health care power of attorney (HCPA). Some states allow you to combine the two in a single document.

An advance directive expresses your preferences for the use of life-sustaining medical procedures — such as artificial feeding and breathing, surgery, invasive diagnostic tests, and pain medication — specifying the situations in which these procedures should be used or withheld. For example, you might instruct health care providers to withhold treatment in the event of a coma or permanent brain damage with little or no chance of recovery or include a "do not resuscitate" order.

A document prepared in advance can't account for every scenario or contingency, however, so it's wise to pair an advance directive with an HCPA. This allows you to authorize your spouse or other trusted representative to make medical decisions or consent to medical treatment on your behalf when you're unable to do so. An HCPA can include specific instructions to your representative, as well as general guidelines or principles to follow in dealing with complex medical decisions or unanticipated circumstances.

Why a PAD?

Many states allow generic HCPAs and advance directives to address mental as well as physical health issues. But some states limit or prohibit mental health treatment decisions by general health care representatives. Around half of the states have PAD statutes, which authorize special advance directives to outline one's wishes with respect to mental health care and appoint a representative to make decisions regarding that care.

PADs may address a variety of mental health care issues, including:

- Preferred hospitals or other providers,
- Treatment therapies and medications that may be administered,
- Treatment therapies and medications that *may not* be administered, such as electroconvulsive therapy or experimental drugs,

- A statement of general values, principles or preferences to follow in making mental health care decisions, and
- Appointment of a representative authorized to make decisions and carry out your wishes with respect to mental health care in the event you're incapacitated.

Although requirements vary from state to state, to be effective, a PAD must be signed by you and your chosen representative, and in some states by two witnesses. Be sure to discuss the terms of the PAD with your family, close friends, physician and any mental health care providers. And to be sure that the PAD is available when needed, give copies to all of the above persons, keep the original in a safe place and let your family know where to find it.

Get the facts

If you're concerned about the possibility of mental illness and wish to have some say over your treatment in the event you're incapacitated, learn about the relevant laws in your state. Consider a PAD if it's available or look into options for using generic advance directives and HCPAs to address mental health care. ▮

ESTATE PLANNING RED FLAG

You're donating appreciated assets to charity

If you're charitably inclined, you probably know that donations of long-term appreciated assets, such as stock, have an advantage over cash donations. But in some cases, selling appreciated assets and donating the proceeds may be a better strategy. That's because adjusted gross income (AGI) limitations on charitable deductions are higher for cash donations. Plus, if the assets don't qualify for long-term capital gain treatment, the deduction rules are different.

All things being equal, donating long-term appreciated assets directly to charity is preferable. Not only do you enjoy a charitable deduction equal to the assets' fair market value on the date of the gift (assuming you itemize), you also avoid capital gains tax on their appreciation in value. If you were to sell the assets and donate the proceeds to charity, the resulting capital gains tax could reduce the tax benefits of your gift.

But all things aren't equal. Donations of appreciated assets to public charities are generally limited to 30% of AGI, while cash donations are deductible up to 60% of AGI (100% for those donated through the end of 2021). In either case, excess deductions may be carried forward for up to five years.

So, if you're contemplating a donation of appreciated assets that's greater than 30% of your AGI, it's a good idea to crunch the numbers first. Then determine whether selling the assets, paying the capital gains tax and donating cash up to 60% of AGI will produce greater tax benefits in the year of the gift and over the following five tax years. The answer will depend on several factors, including the size of your gift, your AGI in the year of the gift, your projected AGI in the following five years and your ability to itemize deductions in each of those years.

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